

No. 15-____

IN THE
Supreme Court of the United States

SALEM FINANCIAL, INC.,
As Successor-in-Interest to Branch Investments LLC,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

**On Petition For A Writ Of Certiorari
To The United States Court Of Appeals
For The Federal Circuit**

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

To avoid double taxation by a foreign country and by the United States, Section 901 of the tax code provides U.S. corporations with a foreign tax credit for taxes paid to another country. This case involves the denial of a foreign tax credit for hundreds of millions of dollars in taxes paid by a U.S. corporation to the United Kingdom in connection with a multi-billion dollar cross-border financing transaction. Even though it is undisputed that Petitioner complied with all statutory and regulatory requirements for a foreign tax credit, the Federal Circuit, expressly disagreeing with the Fifth and Eighth Circuits, disallowed that credit because of its view that the multi-billion dollar transaction lacked “economic substance.” The questions presented are:

1. Whether, as the Federal Circuit and the Second Circuit have held in conflict with the Fifth and Eighth Circuits, it is proper to evaluate the economic substance of a cross-border transaction based on neither its pre-tax nor post-tax viability, but instead based on a hybrid approach that considers the foreign taxes that must be paid without considering the U.S. tax credits that are presumptively available.

2. Whether, and to what extent, the “economic substance” doctrine can be used as a means for disregarding longstanding and well-developed foreign tax credit rules with which the taxpayer has fully complied, as opposed to a means to address questions that arise in the application of specific statutory and regulatory provisions.

CORPORATE DISCLOSURE STATEMENT

Petitioner Salem Financial, Inc. is a wholly-owned subsidiary of Branch Banking and Trust Company. Branch Banking and Trust Company is a wholly-owned subsidiary of BB&T Corporation, a publicly traded company listed on the New York Stock Exchange.

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PETITION FOR A WRIT OF CERTIORARI

Petitioner Salem Financial, Inc. respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Federal Circuit in this case.

OPINIONS BELOW

The opinion of the Court of Appeals (Pet. App. 1a-51a) is reported at 786 F.3d 932. The opinions of the Court of Federal Claims (Pet. App. 52a-60a and 61a-177a) are reported at 119 Fed. Cl. 84 and 112 Fed. Cl. 543.

STATEMENT OF JURISDICTION

The Federal Circuit issued its decision on May 14, 2015. On July 14, 2015, Chief Justice Roberts extended the time for filing a petition to and including September 11, 2015. *See* No. 15A45. On August 17, 2015, Chief Justice Roberts further extended the time for filing a petition to and until October 11, 2015. *See id.* This Court has jurisdiction under 28 U.S.C. §1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

Selected portions of Section 901 of the Internal Revenue Code, 26 U.S.C. §901, are attached at Pet. App. 178a-179a. Selected portions of Treasury Regulation 1.901, 26 C.F.R. §1.901, are attached at Pet. App. 180a-190a.

STATEMENT OF THE CASE

Petitioner (“BB&T”) paid approximately \$500 million in U.K. taxes on income from a trust and claimed a foreign tax credit under U.S. law to ensure it would not be double taxed on that same income. No one doubts that BB&T actually paid the British taxing authorities. And no one doubts that BB&T complied with all requirements of the applicable foreign tax credit rules. Those rules are “a byzantine structure of staggering complexity,”¹ that are specifically designed to address the precise circumstances in which foreign tax credits are available and to prevent double taxation of foreign income. Nevertheless, despite BB&T’s payment of approximately \$500 million in U.K. taxes and its compliance with all applicable statutory and regulatory provisions, the Federal Circuit disallowed a tax credit for the foreign taxes paid on the basis that, in the court’s view years later, the multi-billion dollar cross-border transaction that gave rise to the U.K. tax liability lacked “economic substance.” The Federal Circuit then upheld tax penalties for good measure. The result of that decision is a crushing burden of double taxation—BB&T must pay U.S. taxes on the full amount of its income from the trust without any credit or deduction for the hundreds of millions of dollars already paid to the U.K. for that same income.

¹ Boris Bittker & James Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶15.21[1][a] (7th ed. Supp. 2014).

The Federal Circuit reached this result by employing a counterintuitive mode of analysis that the Fifth and Eighth Circuit have expressly rejected. In particular, in concluding that BB&T's cross-border transaction lacked economic substance, the Federal Circuit evaluated the profitability of the transaction by including the foreign taxes paid as expenses but excluding the foreign tax credits entirely. In other words, rather than view the profitability of the transaction either pre- or post-tax, the Federal Circuit counts taxes paid but not the credits earned by paying those same taxes. That methodology skews the analysis and stacks the deck against cross-border transactions. It directly affects the viability of a wide range of international transactions by U.S. companies implicating hundreds of billions of dollars each year.

The Federal Circuit's holding opens up an explicit conflict with the Fifth and Eighth Circuits, *see Compaq Computer Corp. v. Comm'r*, 277 F.3d 778 (5th Cir. 2001); *IES Indus. Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001), which has deepened with the Second Circuit's recent decision siding with the Federal Circuit. *Bank of N.Y. Mellon Corp. v. Comm'r of Internal Revenue*, --- F.3d ---, 2015 WL 5234396, at *19 (2d Cir. Sept. 9, 2015) (“[I]t is appropriate, in calculating pre-tax profit [for foreign tax credits], for a court both to include the foreign taxes paid and to exclude the foreign tax credits claimed.”). The Second Circuit aptly summarized the current state of the law: “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).” *Id.* Only this Court can resolve this deep and acknowledged split on an issue that

dictates the viability of scores of cross-border transactions.

Even beyond the circuit split, the Federal Circuit's application of the economic substance doctrine creates vast uncertainty about the availability of foreign tax credits and other tax benefits. The Federal Circuit employs the economic substance doctrine not to inform the application of the extensive regulatory framework governing foreign tax credits, but as an amorphous threshold inquiry that threatens to render the entire foreign tax credit regulatory framework (and other tax provisions) irrelevant. Here, BB&T undeniably paid hundreds of millions of dollars in U.K. taxes that satisfied all the relevant regulations. Yet years later—after substantial amounts of money changed hands and substantial taxes were paid—BB&T has been denied a tax credit, denied a deduction, and penalized for those same transactions. In light of the Federal Circuit's nationwide jurisdiction over tax refund appeals, this misguided approach now affects every taxpayer seeking a refund for denied credits and other tax benefits. Taxpayers deserve greater certainty than the Federal Circuit's rule provides. Only this Court's review will provide that certainty and resolve the split among the Circuits.

A. Statutory and Regulatory Background

Foreign tax credits play a prominent role in the modern global economy. In recent years, U.S. corporations have claimed more than \$100 billion annually in foreign tax credits. The substantial amount of credits claimed is a result of the fact that many critical transactions straddle jurisdictions and require U.S. companies to pay taxes abroad. *See* IRS,

Statistics of Income – 2010, 2011, 2012, Corporation Income Tax Returns, <http://www.irs.gov/uac/SOI-Tax-Stats-Corporation-Complete-Report>.

The claiming of these credits is, and long has been, the subject of extensive and detailed government regulation. In recognition of the stifling economic effect of taxing the same income twice, the United States adopted its first foreign tax credit in 1918. That credit attempted to alleviate the “very severe burden” on U.S. companies that resulted from double taxation, H.R. Rep. No. 65-767, at 11 (1918), and, in so doing, “facilitate the[] foreign enterprises” of U.S. taxpayers, *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 9 (1932). *See id.* at 7 (the “primary design” of the 1918 foreign tax credit “was to mitigate the evil of double taxation”).

In the century that has passed since the adoption of that first foreign tax credit, Congress and Treasury have endeavored to revise and refine the statutory and regulatory framework such that it provides clear rules for taxpayers and prevents abuse. Bittker & Eustice, *supra*, ¶15.21; D. Kevin Dolan, *The Foreign Tax Credit Diaries - Litigation Run Amok*, 71 Tax Notes Int’l (TA) 831 (Aug. 26, 2013). The result of those efforts is a highly reticulated regime that, while complicated, is meant to provide the certainty necessary to encourage economically desirable cross-border investment. The backbone of that framework is a series of definitions intended to make clear which payments of foreign taxes count—and which do not—for foreign tax credit purposes.

Thus, the relevant statutory provisions and regulations clearly define what constitutes a creditable foreign “tax” as opposed to a non-creditable

penalty or fee, *see* 26 U.S.C. §901(b)(1); 26 C.F.R. §1.901-2(a)(1)-(3), and establish what constitutes a creditable compulsory tax and a non-creditable voluntary tax, *see* 26 C.F.R. §1.901-2(e)(5)(i). The rules also define what amount of foreign taxes is considered paid and not otherwise refunded, directly or indirectly, to the taxpayer or a counterparty by the levying foreign authority. *See* 26 U.S.C. §§901(b)(1), 901(i); 26 C.F.R. §§1.901-2(e)(2)-(3), 1.905-2(a)(2).

These comprehensive definitions are complemented by an equally comprehensive set of guidelines with the identical aim of creating certainty and preventing abuse. Among other things, the foreign tax credit rules establish when credits may be claimed for foreign taxes imposed on payments or other items not recognized as income for U.S. tax purposes, including transactions that are treated as circular flows of cash or as non-economic payments under U.S. tax principles but are respected under foreign tax principles. *See generally* 26 U.S.C. §904(d)(2)(H); 26 C.F.R. §1.904-6(a)(1)(iv); H.R. Rep. No. 108-755 at 381-85 (2004); Rev. Rul. 83-142, 1983-2 C.B. 68; I.R.S. Tech. Adv. Mem. 78-40-001 (Sept. 15, 1977); I.R.S. Gen. Couns. Mem. 38,467 (Aug. 11, 1980) (“After losing a number of court cases, the [government] long ago conceded that the amount of creditable foreign tax is the amount paid to the foreign government (assuming the tax examined in its entirety is a qualified income tax) regardless of whether the foreign government taxes some items that under United States law would not be

income.”).² The foreign tax credit rules also draw clear lines regarding who is treated as having paid a foreign tax when there are multiple parties to which the tax liability could be attributed, *see* 26 C.F.R. §1.901-2(f)(3), or when one party pays or reimburses the foreign tax imposed on another party, *see* 26 C.F.R. §1.901-2(f)(2).

If a U.S. corporation’s foreign tax payments fall within the relevant definitions and comply with applicable rules and regulations, the corporation is entitled to a tax credit in “the amount of any income ... taxes paid or accrued during the taxable year to any foreign country.” 26 U.S.C. §901(b)(1); *see also id.* §27(a) (“The amount of taxes imposed by foreign countries . . . shall be allowed as a credit against the tax imposed by this chapter to the extent provided in section 901.”).

B. The STARS Transaction

In 2002, BB&T was growing rapidly throughout the southern United States. JA280, 294. To fulfill the substantial funding need associated with that growth, BB&T entered into the transaction at the heart of the instant dispute. That transaction, known as a Structured Trust Advantaged Repackaged Securities transaction, or STARS, is undeniably complex. JA280; JA196; JA21346; JA16323. But that

² Notably, the government initially promulgated and then rescinded a requirement in the foreign tax credit rules for taxpayers to demonstrate a non-tax business purpose to enter a foreign jurisdiction. JA49627-29. Citations to “JA” refer to the joint appendix filed in the Federal Circuit.

complexity only reflects the sophistication of the parties involved and the nature of cross-border transactions that must account for the statutory and regulatory requirements of multiple jurisdictions.

The STARS transaction had three critical components: (1) a \$1.5 billion loan from Barclays to BB&T; (2) a Trust, which was a U.K. resident, and a Trust subsidiary used to facilitate the transaction and generate U.K. tax benefits for Barclays; and (3) a series of payments made by Barclays to BB&T (the “Bx payments”). The loan was effectuated through a \$1.5 billion contribution by Barclays to the Trust. Pursuant to the STARS agreements, BB&T was permitted to draw that cash from the Trust and obligated to return the entire \$1.5 billion—with interest accrued at a rate of LIBOR + 25 basis points—within five years to Barclays via a purchase of Barclays’ interest in the Trust. Pet. App. 114a.³

BB&T contributed \$6.1 billion in assets to the Trust and Trust subsidiary in the form of income-generating auto and home loans and other assets. *Id.* at 110a-111a. Approximately \$1.5 billion of those assets represented collateral for BB&T’s obligation to repurchase Barclays’ interest in the Trust and return Barclay’s \$1.5 billion cash. *Id.* The remaining \$4.6 billion generated income for the Trust and Trust subsidiary and was available to satisfy any claims that Barclays might have against BB&T (and ahead of any other creditors of BB&T). The Trust

³ LIBOR—the London Interbank Offered Rate—is a published interest rate index commonly used to set interest rates on interbank loans.

submitted annual U.K. income tax returns reflecting the income earned on these assets and paid all U.K. taxes. *Id.* at 118a.

With these assets in place, the Trust subsidiary made monthly distributions of cash to the Trust based on income generated from the BB&T loan assets and received monthly re-investments of that cash (net of U.K. taxes owed and minor distributions made on other interests in the Trust). *Id.* at 114a-116a. Barclays, in turn, received monthly distributions of cash from the Trust and then re-contributed the cash to the Trust. *Id.* These distributions and re-contributions allowed Barclays to claim certain U.K. tax benefits; those benefits were one of the primary drivers of Barclays' willingness to engage in the STARS transaction.⁴ *See id.* at 127a-129a. BB&T was not directly involved in and did not receive any direct benefit from these distributions,

⁴ Barclays' U.K. tax treatment can be understood with a straightforward example in which the Trust receives \$100 of income from the assets that BB&T contributed. *Id.* at 127a-128a. Under the U.K. corporate rate of 30%, Barclays was subject to \$30 of U.K. corporation tax on the distributions it received from the Trust. *Id.* at 127a. This tax liability was offset by three tax attributes: (i) a \$22 credit for the \$22 in taxes already paid by the Trust (based on a 22% tax rate for a trust), thus preventing taxation of the same income twice by the United Kingdom; (ii) a \$23.40 trading loss deduction realized under U.K. law on the re-contribution of cash to the Trust; and (iii) a \$3.30 deduction for the Bx payments. *Id.* at 127a-128a. The net result was a tax benefit that Barclays used to reduce its U.K. tax on income wholly unrelated to the Trust or the STARS transaction, thereby increasing its aggregate after-tax income. *See, e.g.*, JA44458; Pet. App. 5a-6a.

which related only to Barclays' U.K. tax treatment, not to BB&T's U.S. tax position. In fact, BB&T affirmatively disregarded these distributions and recontributions for U.S. federal income tax purposes.

The last component of the STARS transaction, the "Bx payments," constituted payments from Barclays to BB&T and totaled approximately \$240 million over the nearly five-year life of the Trust. Pet. App. 124a-126a. Those payments were intended to provide compensation (and taxable income) to BB&T for entering into the STARS transaction. *Id.* at 124a-125a. These monthly payments reduced the net cost of the STARS funding well below BB&T's normal cost of funds. JA11723-24. The parties determined the amount of the Bx payments before entering into the transaction; although the amount of the payments was based on Barclays' anticipated UK tax benefits, the payments were negotiated and pre-set according to a fixed schedule at the outset of the transaction and were not dependent upon Barclays' actual realization of these U.K. benefits. JA724, 47347, 50016; Pet. App. 6a.

Both Barclays and BB&T realized tangible benefits and incurred real costs as a result of the STARS transaction. Barclays' \$1.5 billion contribution to the Trust was unavailable to Barclays during the life of the Trust—a hard cost for Barclays. In exchange for that cash contribution, Barclays stood to gain the interest BB&T would pay on top of repaying the \$1.5 billion and the U.K. tax benefits associated with the operation of the Trust. On the other side of the ledger, BB&T had access to the \$1.5 billion in cash provided by Barclays and received the Bx payments from the Trust in exchange for making the loan interest payments and tying up \$6.1 billion

in auto loans, home loans, and other income-generating assets in the Trust. More than this, BB&T received additional benefits from the STARS transaction because it permitted the bank to diversify its funding base, JA25634; JA25636; JA110, and reduce its liquidity risk, JA295.

C. BB&T's U.S. Tax Treatment

The Trust earned income of approximately \$2.3 billion over its approximately five-year life and BB&T paid \$500 million in taxes—the applicable 22-percent U.K. rate—to the U.K. government based on that income. BB&T's projected U.S. tax liability for that \$2.3 billion in income was \$805 million based on the U.S. 35-percent corporate tax rate. When BB&T filed its U.S. corporate income tax returns for the years corresponding to the life of the Trust (2002-2007), BB&T claimed a foreign tax credit for the \$500 million paid to the U.K., which reduced its STARS-related U.S. tax liability to roughly \$305 million.

BB&T's reasons for claiming the credit based on the \$500 million paid to the U.K. government were straightforward. BB&T satisfied all applicable statutory and regulatory requirements for such a credit. What is more, in the absence of a credit, BB&T faced double taxation at a rate of 57-percent and a combined tax liability of \$1.3 billion on \$2.3 billion of income—\$500 million in U.K. taxes and

\$805 million in U.S. taxes.⁵ Despite this straightforward justification, the IRS denied BB&T's foreign tax credit claims and imposed accuracy-related penalties on the bank.

D. Proceedings Below

BB&T paid the IRS what it claimed it was due and then filed suit in the Court of Federal Claims seeking a refund based on its full compliance with the foreign tax credit rules discussed *supra*.⁶ The Court of Federal Claims denied BB&T's request in its entirety. The court did not conclude that BB&T ran afoul of any of the applicable foreign tax credit statutory provisions or regulations. Instead, ignoring the tangible benefits realized and costs incurred by BB&T and Barclays in connection with the STARS transaction, the court held that key components of the transaction lacked "economic substance" and that, as a result, BB&T was not entitled to the foreign tax credit claimed. In the Court of Claims' view, the components of the STARS transaction—including the \$1.5 billion loan and the Trust and Trust subsidiary payments—"lack[ed] both objective economic reality and a bona fide non-tax business purpose," which meant that the \$500 million in taxes actually paid to the U.K. could not serve as the basis

⁵ BB&T also claimed deductions for interest paid on the Loan Transaction and for transaction costs associated with STARS. Those deductions are not at issue in this Petition.

⁶ The Court of Federal Claims had jurisdiction under 28 U.S.C. §1491.

for a foreign tax credit in the U.S. Pet. App. 9a. Despite the fact that BB&T had complied with all relevant statutory and regulatory provisions and received advice from three separate firms about the proper tax treatment of the STARS transaction before claiming a credit, the court held that BB&T was liable for penalties under 26 U.S.C. §6662 on the basis of negligence and tax understatement.

BB&T appealed and while the Federal Circuit reversed the Court of Claims on the “economic substance” of the \$1.5 billion loan, it agreed that the Trust component of the STARS transaction lacked “economic substance.” Pet. App. 32a-33a. The Federal Circuit began its analysis by stating that BB&T’s compliance with all applicable statutory and regulatory requirements did not control and declined even to consider the import of any of those requirements. *Id.* at 11a-15a. The court instead explained that, in its view, the economic substance doctrine is “a prerequisite to the application of any Code provision allowing deductions.” *Id.* at 13a (internal quotation marks omitted).

Having cast aside the comprehensive regulatory framework painstakingly developed by Congress and Treasury over the course of a century, the Federal Circuit proceeded to apply a two-prong “economic substance” test under which the court first considered whether the STARS Trust transaction had “economic reality” as an objective matter, and, second, if not, “whether the STARS Trust transaction nonetheless had a bona fide business purpose.” *Id.* at 33a.

Applying the first prong of its “economic substance” test, the Federal Circuit concluded that

BB&T incurred a foreign tax expense (approximately \$500 million of U.K. taxes) that exceeded BB&T income from the Trust (the \$240 million of Bx payments) and that “[t]he Trust transaction therefore is profitless before taking into account BB&T’s expected foreign tax credits.” *Id.* at 28a. This meant that the STARS Trust transaction lacked “economic reality” because (i) foreign tax payments should be included in the economic substance profitability analysis and (ii) BB&T had incurred U.K. taxes in excess of the income from the Bx payments. In so holding, the Federal Circuit recognized that it was parting ways with the Fifth and Eighth Circuits, which had both already held that foreign tax payments *should not* be included when considering a transaction’s profitability for purposes of the “economic substance” analysis. *Id.* at 24a-27a; see *Compaq*, 277 F.3d at 784-785; *IES*, 253 F.3d at 354. Had the Federal Circuit not incorporated BB&T’s foreign tax payments into its profitability analysis, or taken account of both the tax payments and BB&T’s available foreign tax credits, the STARS Trust transaction would have been indisputably profitable.

The Federal Circuit then went on to consider whether despite its view that the STARS Trust transaction lacked economic reality, it “nonetheless had a bona fide business purpose.” Pet. App. 33a. While the court had already determined (Pet. App. 15a-23a) that the Bx payment component of the transaction represented real, non-tax, economic income to BB&T pursuant to this Court’s reasoning in *Old Colony Trust Co. v. Commissioner*, 27 U.S. 716 (1929), the court concluded that the \$240 million in Bx payments from Barclays could not represent “profit from any business activity” supporting a non-

tax business purpose and was instead “the means by which Barclays and BB&T shared the tax benefits of the Trust transaction.” Pet. App. 35a-36a. The court summarized its analysis by declaring that “[t]o hold that a transaction has a bona fide business purpose whenever it has a prospect of producing economic benefit for the taxpayer would eliminate the ‘business purpose’ test altogether, since the taxpayer normally will not engage in a transaction absent the prospect that it will result in some monetary gain.” *Id.* at 36a.

Furthermore, despite recognizing that BB&T had paid in cash U.K. taxes and had received no rebate or refund of those taxes and thus no U.S. tax benefits, the Federal Circuit concluded that the STARS Trust transaction had no bona fide business purpose because it represented a “prepackaged strategy” in which BB&T would “self-inflict” U.S. assets to U.K. tax and generate U.S. *and* U.K. tax benefits. *Id.* at 33a, 35a.⁷

Finally, even though it recognized that it had split with the decision of two other Circuit courts that were issued years before the STARS transaction, the Federal Circuit upheld the Court of Claims’ decision

⁷ As structured by BB&T and Barclays, the STARS transaction was a single, integrated financing transaction. The government argued that the transaction should be bifurcated into a loan transaction and a trust transaction. BB&T disagrees with that characterization, but has accepted a bifurcated treatment for purposes of the appeal of this case to focus the discussion on the critical issues raised in this Petition. Pet. App. 11a.

to impose accuracy-related penalties. The court rejected BB&T's argument that it had reasonable cause for claiming foreign tax credits related to STARS and did so in good faith. The Federal Circuit justified the imposition of penalties by stating that it did "not regard the application of the economic substance doctrine to this case to present any ambiguity." *Id.* at 51a.

As already noted, after the decision in this case, the Second Circuit held that a similar STARS transaction lacked economic substance. *Bank of N.Y. Mellon*, 2015 WL 5234396, at *19. The Second Circuit explicitly agreed with the Federal Circuit's decision here and expressly disagreed with the Fifth and Eighth Circuits, and held that foreign tax expenses (but not foreign tax credits) should be included in the profitability analysis. *Id.*

REASONS FOR GRANTING THE WRIT

I. This Court's Review Is Necessary To Unify The Courts Of Appeals' Approach To The "Economic Substance" Test.

A. There Is a Square and Well-Developed Circuit Conflict on How to Account for Foreign Taxes Paid in Determining a Transaction's Profitability.

As the Second Circuit recently affirmed, there is a clear division of authority in the nation's federal appellate courts regarding the application of the economic substance doctrine to cross-border transactions. The Second Circuit in *Bank of N.Y. Mellon* and the Federal Circuit in this case have both held that in evaluating the profitability of a cross-border transaction, courts must *include* expected foreign tax expense and must *exclude* U.S. tax credits

that would flow from those foreign taxes. Rather than evaluate the transaction from a purely pre-tax or post-tax standpoint, the Second and Federal Circuits take a hybrid approach in which foreign taxes count, but U.S. credits do not. The Fifth and Eighth Circuits have reached the opposite conclusion, holding that neither foreign taxes nor resulting U.S. credits should be taken into account when assessing a transaction's profitability. *See Compaq*, 277 F.3d 778; *IES*, 253 F.3d 350; *see also Bank of N.Y. Mellon*, 2015 WL 5234396, at *19 (“[W]e agree with the Federal Circuit in *Salem* and disagree with decisions of the Fifth and Eighth Circuits (*Compaq* and *IES*, respectively)—“it is appropriate, in calculating pre-tax profit [for foreign tax credits], for a court both to include the foreign taxes paid and to exclude the foreign tax credits claimed.”).

The division in authority is amply demonstrated by a brief review of *Compaq* and *IES* and the Federal Circuit's hostile treatment of those decisions. *Compaq* and *IES* involved nearly identical fact patterns, in which U.S. corporations bought and sold shares in a publicly traded foreign company that issued dividends subject to foreign income tax. *Compaq*, 277 F.3d at 779-80; *IES*, 253 F.3d at 352. The Tax Court in *Compaq* had concluded that there was no prospect for gain or profit using what the Fifth Circuit called “a curious method of calculation”: the Tax Court included the foreign tax payments, but not the foreign tax credit, in the analysis of profitability. 277 F.3d at 782. As the Fifth Circuit explained, the Tax Court “assessed neither the transaction's pre-tax profitability nor its post-tax profitability,” but rather “assessed profitability by looking at the transaction after [the foreign] tax had

been imposed but before considering U.S. income tax consequences.” *Id.* Thus, “the court treated the [foreign] tax as a cost of the transaction, but did not treat the corresponding U.S. tax credit as a benefit of the transaction.” *Id.*

On appeal, the Fifth Circuit in *Compaq*, expressly agreeing with the Eighth Circuit in *IES*, held that the gross dividend, not the dividend net of foreign taxes, should have been used to compute the taxpayer’s pre-tax profit. The Fifth Circuit explained that Compaq’s transaction resulted in a pre-tax profit and thus “[t]he transaction had economic substance.” *Id.* at 786; *see also IES*, 253 F.3d at 354 (“Because the entire amount of the . . . dividends was income to IES, the . . . transactions resulted in a profit, an economic benefit to IES.”). The Fifth Circuit also strongly rebuked the Tax Court’s “half pre-tax, half after-tax” approach, recognizing that the IRS’s approach of counting taxes “only when they subtract from cash flow is to stack the deck against finding the transaction profitable,” and that it was necessary to “un-stack the deck.” 277 F.3d at 782, 785.

The Federal Circuit did exactly what the Fifth Circuit and the Eighth Circuit proscribed in *Compaq* and *IES*—it counted foreign tax payments “only when they subtract[ed] from cash flow” and thereby “stack[ed] the deck against finding the transaction profitable.” *Id.* at 785. In the course of doing so, the Federal Circuit sharply criticized the transactions in *Compaq* and *IES* and the Fifth and Eighth Circuit’s reasoning. The Federal Circuit commented that the transactions in *Compaq* and *IES* “did not meaningfully alter the taxpayers’ economic position (apart from their tax consequences); they involved essentially no risk (other than the risk that the

transactions would be disallowed for tax purposes); and they offered no opportunity for economic gain (except for the tax benefits).” Pet. App. 26a. Based on that view, and directly contradicting the Fifth and Eighth Circuits, the Federal Circuit concluded that “[t]he *Compaq* and *IES* transactions produced no real economic profit.” *Id.* The Federal Circuit emphasized that any apparent profit in those cases was a result of including in income the amount of the dividend “without taking into account the foreign taxes paid on the dividend.” *Id.*⁸

The Federal Circuit split from the Fifth and Eighth Circuits on this critical issue in another way. Both *Compaq* and *IES* heavily relied on this Court’s opinion in *Old Colony Trust*, and the principles announced therein. As the Fifth and Eighth Circuits recognized, *Old Colony Trust, supra*, establishes that “[t]he discharge by a third person of [a taxpayer’s] obligation” is “equivalent to receipt by the person

⁸ While the Federal Circuit referenced commentary arguing that the transactions in *Compaq* and *IES* lacked economic substance (Pet. App. 27a n.6), it failed to acknowledge (as the Fifth Circuit had in *Compaq*, 277 F.3d at 783 n.3) commentary supporting the analysis in those decisions. See, e.g., Marc D. Teitelbaum, *Compaq Computer and IES Industries: The Empire Strikes Back*, 86 Tax Notes 829, 836 (Feb. 7, 2000); Dolan, *supra*, at 842; Richard Lipton, *BNY & AIG – Using Economic Substance to Attack Transactions the Courts Do Not Like*, 119 J. Tax. 40, 46 (2013); James M. Peaslee, *Creditable Foreign Income Taxes and the Economic Substance Profit Test*, 114 Tax Notes 443 (Jan. 29, 2007); 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).

taxed.” *Compaq*, 277 F.3d at 783; see *IES*, 253 F.3d at 354; see also *Diedrich v. Comm’r*, 457 U.S. 191, 197 (1982) (“[T]he donor realizes an immediate economic benefit by the donee’s assumption of the donor’s legal obligation to pay the gift tax”). The Fifth and Eighth Circuits held that this “venerable principle” applies to foreign taxes: when a taxpayer earns income subject to a foreign tax, “the economic benefit to [the taxpayer] [is] the amount of ... *gross* [income], before the foreign taxes are paid.” *IES*, 253 F.3d at 354; *Compaq*, 277 F.3d at 784 (“Pre-tax income is pre-tax income regardless of the timing or origin of the tax.”). In disagreeing with the Fifth and Eighth Circuits, the Federal Circuit failed to address this fundamental point.

In short, the Federal Circuit made clear that, under its approach, the transactions in *Compaq* and *IES* “produced no real profit” and thus it would have decided those cases differently. Pet. App. 26a-27a. If this case had arisen in the Fifth or Eighth Circuit, the foreign tax expense incurred by BB&T would be excluded; the Trust transaction would have generated substantial pre-tax profit in the form of the Bx payments; the goal of seeking this profit would have represented a valid non-tax business purpose; and BB&T would not be required to pay approximately \$500 million in double taxation. The Second Circuit has subsequently deepened the split and underscored that it is open, acknowledged and consequential. See *Bank of N.Y. Mellon*, *supra*. This Court should grant certiorari and resolve it.

B. This Case Presents a Clean Vehicle for Resolving the Critical Issue of How to Account for Foreign Taxes When Applying the “Economic Substance” Doctrine.

Lest there be any doubt, the issue presented for review is important and recurring. The decisions of the Federal Circuit and the Second Circuit have cast a fog of uncertainty over a wide variety of cross-border transactions—and have done so at a time when the global economy makes that issue especially salient. In each of the past three years for which public figures are available, U.S. corporations claimed over \$100 billion of foreign tax credits. See IRS, *Statistics of Income – 2010, 2011, 2012, Corporation Income Tax Returns*. In sharp conflict with the goals of the foreign tax credits rules, U.S. corporations now do not know whether they will be liable for taxes in more than one country on the same income. Businesses and financial institutions contemplating major international transactions need to know which rule governs—the rule in the Federal and Second Circuits, which, in determining profitability of a transaction, includes foreign tax expense as a cost, or the rule in the Fifth and Eighth Circuits, which excludes foreign tax expense and thus “unstack[s] the deck” against taxpayers. It is this very form of uncertainty that this Court has long sought to avoid in the application of the tax laws.

Founders Gen. Corp. v. Hoey, 300 U.S. 268, 275 (1937).⁹

Moreover, this case presents a clean and compelling vehicle for this Court's consideration of the issue. In light of the parties' agreement on bifurcation (Pet. App. 11a), there is no question whether income from the Bx payments and earnings from investing the Loan proceeds together could exceed the foreign tax expense and create pre-tax profit regardless of whether the foreign tax expense is taken into account or not. Instead, a fundamental, outcome-determinative issue in this case is whether the U.K. tax expense should or should not be used to offset the Bx payments and find the transaction unprofitable. The inclusion or exclusion of foreign tax expense in this case determines whether BB&T has pre-tax profit or loss, whether BB&T's transaction thus represents "genuine business activity," and thus whether BB&T's transaction has economic substance. If the Trust transaction was

⁹ The Federal Circuit and Second Circuit profitability test tilts the scale even further against taxpayers by refusing to consider the income that gave rise to the foreign tax expense if the income is not new or incremental. In other words, a U.S. person can decide to move \$1000 out of a U.S. bank account yielding 6% to a foreign bank account yielding 8% but subject to a 30% creditable foreign income tax. Under the Federal Circuit and Second Circuit's test, one counts only the \$20 of "incremental income" and reduces that income by \$24 of foreign tax expense, resulting in a \$4 loss for a transaction that makes complete economic sense and is exactly what the foreign tax credit is intended to facilitate.

profitable (as it is without the inclusion of the foreign tax expenditures), the Trust transaction meaningfully changed BB&T's position and BB&T had substantial purpose apart from tax effects for contributing assets to the Trust. Inclusion or exclusion of foreign taxes thus determines the economic substance inquiry. The issue over which the circuits have split is starkly presented for this Court.

Finally, there is no reason to allow this issue to “percolate.” There already exists a direct, acknowledged split involving four Circuits. Indeed, one of those courts—the Federal Circuit—has national jurisdiction over taxpayers seeking refunds of taxes erroneously collected. Moreover, the Tax Court, which has national jurisdiction, has spoken to this issue definitively in the *Compaq* case, 113 T.C. 214 (1999), and then again in the *Bank of N.Y. Mellon* case, 140 T.C. 15 (2013). Under its procedures, the Tax Court's *Compaq* decision, although reversed by the Fifth Circuit, applies to all Tax Court cases except for those that will go to the Fifth Circuit (and to the Eighth Circuit because of the *IES* decision). See *Golsen v. Comm'r*, 54 T.C. 742, 757 (1970) (Court of Appeals opinion reversing Tax Court applies only to Tax Court cases that will be appealed to that Court of Appeals), *aff'd*, 445 F.2d 985 (10th Cir. 1971); see also *Bank of N.Y. Mellon*, 140 T.C. at 35 n.9 (confirming that the Tax Court will follow its reversed *Compaq* decision in cases that are

not within the Fifth or Eighth Circuits: “we are not bound by Fifth and Eighth Circuit precedent here”).¹⁰

The issue presented in this case has thus been extensively discussed and considered by the Second, Fifth, Eighth, and Federal Circuits (along with the Tax Court), and there is no reason to wait for more courts to weigh in on the issue. The issue has direct bearing on several cases already filed; affects even more cases working their way through the administrative process before the Internal Revenue Service; and has a significant impact on a broad swathe of corporate and financial transactions. The Court should accordingly decide this issue now in the interest of judicial and administrative economy, as well as economic predictability, and allow BB&T, which has more than \$600 million in taxes and penalties at stake, the chance to have its case heard on this fundamental issue that has divided the Courts of Appeals.

¹⁰ Two STARS cases are pending in district court. See *Santander Holdings USA, Inc. v. United States*, 977 F. Supp. 2d 46, 53 (D. Mass. 2013) (STARS transaction had economic substance; other issues pending); *Wells Fargo & Co. v. United States*, No. 09-cv-2764 (D. Minn. Filed Oct. 5, 2009). Neither of those cases has reached final judgment in the district court, and they provide no basis for deferring consideration of this important issue.

II. The Federal Circuit's Decision Conflicts With This Court's Formulation Of The "Economic Substance" Doctrine.

This case also raises important issues about the scope of the economic substance doctrine and the appropriate role of the judiciary in deciding to rely on its own evaluation of business activities to decide tax consequences, rather than adhere to the otherwise applicable statutory and regulatory provisions.

The Federal Circuit articulated and applied an "economic substance" framework in which the judiciary applies the economic substance doctrine as an independent "prerequisite" unmoored to the applicable statutory and regulatory provisions, rather than as a tool for ensuring that specific, identified provisions are honored in substance as well as form. *See, e.g.*, Pet. App. 13. Thus, in this case, the Federal Circuit never considered or addressed any of the extensive foreign tax credit provisions, including the anti-abuse provisions, and never explained precisely how it needed to use the economic substance doctrine to give effect to a duly enacted or promulgated provision.

This free-floating "threshold" inquiry conflicts with the carefully limited economic substance doctrine explicated by this Court beginning in *Gregory v. Helvering*, 293 U.S. 465 (1935). In that case, the question was whether a corporate "reorganization" had occurred within the meaning of the Revenue Act of 1928. This Court held that the putative reorganization was not a reorganization in substance because it had "no business or corporate purpose"—it was a "mere device" to "disguise" the "real character" of the transaction—and thus the

transaction was “outside the plain intent of the statute.” *Id.* at 469-70. This Court explained that “the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.” *Id.* at 469.

In *Knetsch v. United States*, 364 U.S. 361 (1960), the question was whether certain payments made by the taxpayer arose from “indebtedness” within the meaning of § 23(b) of the Internal Revenue Code. Applying *Gregory*, this Court held that there “was nothing of substance” to the “sham” transaction and so there was no “indebtedness” within the terms of the statute. *Id.* at 366.

Similarly, in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), this Court considered the “objective economic realities” of a sale-and-leaseback transaction to decide if the taxpayer was entitled to claim deductions that accrue only to the owner of property that “held” or “used” the property. *Id.* at 570, 573, 581.

In each of these cases, the Court examined the economic substance of a transaction to decide whether a particular statutory term applied. *See also Boulware v. United States*, 552 U.S. 421, 429 (2008) (“tax classifications like ‘dividend’ and ‘return of capital’ turn on ‘the objective economic realities of a transaction’”) (quoting *Frank Lyon Co.*, 435 U.S. at 573); *Comm’r v. Clark*, 489 U.S. 726, 737 (1989) (looking to “the language and history of the statute, as well as a commonsense understanding of the economic substance of the transaction at issue” in deciding whether a stock-for-stock exchange had “the effect of the distribution of a dividend,” 26 U.S.C. §356(a)(2)); *United States v. Consumer Life Ins. Co.*,

430 U.S. 725, 740-41 (1977) (rejecting the Government’s argument that the transaction lacked economic substance and should be disregarded because of a lack of risk-shifting where “[t]he word ‘risk’ does not occur” in the statute); *cf.* *Cottage Savings Ass’n v. Comm’r*, 499 U.S. 554, 562 (1991) (rejecting the Government’s view that the term “material difference” in 26 U.S.C. §1001(a) should be construed to mean “differ[ing] in economic substance” where the statute “embodie[d] a much less demanding and less complex test”).

Here, the foreign tax credit statute provides: “In the case of ... a domestic corporation, the amount of any income ... taxes paid or accrued during the taxable year to any foreign country” “shall be allowed” as a “credit.” 26 U.S.C. §901(b)(1). There is no question that, as a consequence of the STARS transaction, Petitioner incurred a foreign income tax liability of approximately \$500 million. Nor is there any question that Petitioner actually paid that sum in income taxes to the United Kingdom and those taxes were not refunded or rebated to Petitioner by any means. The satisfaction of the relevant statutory terms is not in doubt in form or substance. The Federal Circuit did not use economic substance as a tool to construe a disputed statutory term—such as “reorganization” or “indebtedness”—but as a judge-made means of denying favorable tax treatment to a taxpayer that has qualified for such treatment under the applicable statutes and regulations.

The First and D.C. Circuits have each followed the precedent of the Court, looking to the applicable statutes and regulations to inform and limit their application of the economic substance doctrine. *See, e.g., Horn v. Comm’r*, 968 F.2d 1229, 1234 (D.C. Cir.

1992) (judge-made doctrines are tools “for divining and effectuating congressional intent, not for supplanting it”); *Deweese v. Comm’r*, 870 F.2d 21, 29 (1st Cir. 1989) (citing *Gregory* quote above)).¹¹

In contrast to this Court, and to the D.C. and First Circuits, the Federal Circuit refused to limit itself to the policies and purposes reflected in the finely reticulated foreign tax credit rules that the Government agrees that BB&T satisfied. Rather than considering any specific statutory or regulatory provisions, the Federal Circuit merely referred broadly to “the kinds of transactions on which Congress intended to confer the benefit of the federal tax credit provision.” Pet. App. 14a. The Federal Circuit’s misconception about this Court’s economic substance doctrine—and about the appropriate judicial role under that doctrine in declining to enforce otherwise applicable statutory and regulatory provisions—played a crucial role in the Federal Circuit’s erroneous analysis.

¹¹ Notably, rather than citing or addressing these decisions from the First and D.C. Circuits (upon which Petitioner had relied), the Federal Circuit cited only the Third and Eleventh Circuits, which also had articulated a “prerequisite” or “threshold” approach. See Pet. App. 13a (citing *In re CM Holdings, Inc.*, 301 F.3d 96, 102 (3d Cir. 2002) and *Kirchman v. Comm’r*, 862 F.2d 1486, 1491 (11th Cir. 1989)). Compare *Nassau Lens Co. v. Comm’r*, 308 F.2d 39, 45-46 (2d Cir. 1962) (“[T]he judicial gloss imposed upon the Code must be derived from the congressional purpose underlying the provisions involved in each case.”).

Perhaps not surprisingly, the Federal Circuit's use of the economic substance doctrine for a far-reaching judicial inquiry into permissible business practices led to several severe distortions of the comprehensive foreign-tax-credit legal architecture, as well as, at the most basic level, a deeply inappropriate judicial role.

First, Congress's purpose in enacting the foreign tax credit rules was to prevent double taxation and treat foreign taxes as equivalent to U.S. taxes. Congress expressly stated that the rules "treat the taxes imposed by the foreign country *as if they were imposed by the United States*." H.R. Rep. No. 83-1337 (1954) (emphasis added); *see also id.* at 4103 ("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."). In contrast, the Federal Circuit justified its denial of BB&T's foreign tax credits by treating foreign taxes and U.S. taxes disparately, including U.K. taxes but not U.S. taxes in its profit calculations. In so doing, the Federal Circuit now requires taxpayers to evaluate foreign transactions after deducting foreign tax while evaluating domestic transactions as if they were tax free. Such a rule upsets the neutrality and uniformity that Congress sought to achieve with the foreign tax credit and creates a bias against cross-border transactions in sharp conflict with the statutory purpose.

Second, the Federal Circuit's references to BB&T "voluntarily" subjecting or "self-inflict[ing]" income to foreign tax, Pet. App. 32a-33a, contradicts Treasury's own express decision reflected in the compulsory tax regulations (26 C.F.R. §1.901-2(e)(5)(i)) not to second-

guess a taxpayer's reason for incurring foreign tax. The Government has promulgated rules interpreting 26 U.S.C. §901 acknowledging that taxpayers may structure their investments and otherwise arrange their affairs giving rise to foreign tax in any form and manner that they so wish. *See, e.g.*, 26 C.F.R. §1.901-2(e)(5)(i). Once taxpayers choose to transact in a foreign country, they need only take reasonable actions to minimize their foreign tax bill. The taxpayer's initial choice to transact in a manner that triggers foreign income tax liability and the form of the transaction are within the taxpayer's permissible discretion under the Government's own regulations.

Third, the Federal Circuit expressly took into account *Barclays'* U.K. tax benefits and motives to determine the propriety of *BB&T's* U.S. tax credit. This stretches the economic substance doctrine beyond its bounds, as the focus of this doctrine has solely been on "the taxpayer" whose tax position is at issue, not its counterparties (and certainly not the benefits of a foreign counterparty under foreign tax law). *See Frank Lyon*, 435 U.S. at 576-77. Relying on *Barclays'* U.K. tax benefits and motivations is glaringly inconsistent with the foreign tax credit rules, which contain express guidance regarding when a foreign counterparty's tax benefits under foreign law is "in substance" connected to, and thus can be used to deny, a taxpayer's foreign tax credit. *See* 26 U.S.C. §901(i); 26 C.F.R. §1.901-2(e)(3); *see also Amoco Corp. v. Comm'r*, 138 F.3d 1139, 1145 (7th Cir. 1998) ("[I]t is easy to envision circumstances in which a third party pays foreign tax on behalf of a U.S. taxpayer and then receives a refund of that same payment. . . . [I]t seems to us that this is precisely what the indirect subsidy rule of §1.901-

2(e)(3) was designed to cover.”) The Government agreed that BB&T satisfied those rules, and thus no further inquiry into Barclays’ tax benefits is warranted.

Fourth, the Federal Circuit’s requirement that a foreign tax be paid incident to a transaction that is recognized for U.S. tax purposes, Pet. App. 34a-35a, 41a-42a, conflicts with long-standing interpretations of section 901, reflected in rulings and regulations and later codified, that taxpayers may credit foreign taxes that are substantively paid but incurred incident to transactions substantively disregarded for U.S. tax purposes. *See supra* p. 6. These transactions often arise in the context of taxpayers structuring transactions to generate foreign tax benefits with no U.S. tax effects (other than the claiming of foreign tax credits to offset foreign taxes incurred). *See, e.g.*, Rev. Rul. 83-142, 1983-2 C.B. 68; I.R.S. Tech. Adv. Mem. 78-40-001. As the Government has repeatedly recognized, this policy is compelled by “the statutory language of section 901” and reflects a policy decision to avoid the “monumental tracing problems” that would result from attempting to “adjust the amount of foreign tax to the amount that would have been imposed by using United States standard of income.” I.R.S. Gen. Couns. Mem. 38,467. The critical requirement is that a foreign income tax be paid in full and not refunded, and the Federal Circuit agreed that requirement was wholly satisfied in this case. Such full payment highlights why economic substance has been satisfied in this case: BB&T obtained “no [tax] advantage,” paying “the same amount of tax, regardless of which country it was paid to.” *Santander Holdings USA*, 977 F. Supp. 2d at 53.

Most fundamentally, the Federal Circuit’s interpretation of the “economic substance” doctrine—as a free-floating judicial inquiry that is a “prerequisite” unhinged from specific statutory and regulatory provisions—raises fundamental concerns about the appropriate judicial role. The Court has not given guidance on the economic substance doctrine in almost 40 years (since *Frank Lyon*), and, as in this case, some lower courts have transformed what began as a tool of statutory interpretation into an unbounded roving commission for judicial assessment of business practices when evaluating taxpayer transactions that indisputably comply with the Internal Revenue Code and settled interpretations. This case demonstrates how far courts have stretched the economic substance doctrine beyond its original purpose: the Federal Circuit (which the Second Circuit followed) takes into account taxes in what is supposed to be a *pre-tax* analysis. Courts must instead carefully tailor application of this doctrine to the relevant, duly enacted and promulgated statutory and regulatory provisions.

Particular care should be afforded to applying this doctrine to the foreign tax credit rules, which implicate sensitive issues of foreign affairs, such as the tax regimes of foreign sovereigns and how our Government, our residents, and our tax system interact with them. The precise and detailed foreign tax credit rules reflect a delicate balance of cross-border policy concerns, and the judicial application of economic substance to prevent the ordinary operation of the foreign-tax-credit statute and rules must proceed with extra care and caution. *See, e.g., Benz v. Compania Naviera Hidalgo, S.A.*, 353 U.S. 138,

147 (1957) (“For us to run interference in . . . a delicate field of international relations there must be present the affirmative intention of the Congress clearly expressed.”).¹²

Quite simply, it is an event with profound separation-of-powers and rule-of-law implications when a court, at the request of the Executive Branch and in the name of “economic substance,” overrides specific statutory and regulatory provisions and pre-empts their application. As this Court has long articulated, deploying the powerful “economic substance” weapon is appropriate only when it is necessary to effectuate specific, identified provisions, rather than as a charter for a sweeping, plenary

¹² The importance of resolving this circuit split and correcting the Federal Circuit’s flawed analysis is highlighted by Congress’s decision, after the tax years in question, to codify the economic substance doctrine in 26 U.S.C. §7701(o). Pet. App. 16a n.4. The codification provides that the “economic substance doctrine” in the statute refers to the “common law doctrine,” 26 U.S.C. §7701(o)(5)(A). As a result, this Court’s elucidation of the economic substance issues presented by this case will illuminate the economic substance doctrine for purposes of the statute. Moreover, the statute provides that the Secretary shall “issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit” only “in appropriate cases,” *id.* §7701(o)(2)(B), not, as the Federal and Second Circuits would have it, in all cases. Notably, the Secretary has failed to issue regulations setting forth *any* “appropriate cases” for the inclusion of such expenses, but instead has merely declared that the “the enactment of [section 7701(o)(2)(B)] does not restrict the ability of the courts to consider the appropriate treatment of foreign taxes in economic substance cases.” Notice 2010-62, 2010-40 I.R.B. 411.

judicial inquiry into what the court views as appropriate business practices. The Federal Circuit's approach here sharply conflicts with an appropriately cabined interpretation of the economic substance doctrine.

CONCLUSION

The Federal Circuit's treatment of foreign tax expense in evaluating the economic substance of transactions giving rise to foreign tax credits conflicts with decisions of the Fifth and Eighth Circuits, contravenes the purposes and history of the foreign tax credit rules and the economic substance doctrine, and defies common sense. The Court should provide guidance on this critical issue to resolve an important Circuit split; to provide legal certainty and clarity for economic actors contemplating major cross-border transactions; and to address the proper judicial role in applying a judicial doctrine that overrides otherwise applicable statutory and regulatory provisions. For the foregoing reasons, the petition for certiorari should be granted.

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Respectfully submitted,

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APPENDIX

1a

APPENDIX A

786 F.3d 932

UNITED STATES COURT OF APPEALS
FEDERAL CIRCUIT

No. 2014-5027

SALEM FINANCIAL, INC., as Successor-in-Interest to
Branch Investments LLC,
Plaintiff-Appellant,

v.

UNITED STATES,
Defendant-Appellee.

May 14, 2015

Attorneys and Law Firms

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Opinion

Before O'MALLEY, BRYSON, and HUGHES, Circuit Judges.

BRYSON, Circuit Judge.

Salem Financial, Inc., a subsidiary of Branch Banking & Trust Corporation ("BB & T"), challenges a final judgment of the Court of Federal Claims denying BB & T's claim for a refund of taxes, interest, and penalties. We affirm in part, reverse in part, and remand for further proceedings.

I

A

BB & T is a financial holding company chartered under the laws of North Carolina. In 2002, BB & T entered into a transaction with Barclays Bank PLC ("Barclays"), which is headquartered in the United Kingdom. The transaction, known as the Structured Trust Advantaged Repackaged Securities transaction ("STARS"), was in effect for nearly five years, from August 1, 2002, through April 5, 2007.

At issue in this case is the U.S. tax treatment of several aspects of BB & T's involvement in the STARS transaction. When the IRS reviewed BB & T's tax treatment of STARS, it disapproved various tax benefits that BB & T had claimed based on the transaction. In particular, the IRS disallowed foreign tax credits in the amount of \$498,161,951.00; it disallowed interest deductions in the amount of \$74,551,947.40; it imposed taxes on certain payments from Barclays to BB & T in the amount of \$84,033,228.20; it disallowed certain transaction cost deductions in the amount of \$2,630,125.05; and it imposed penalties in the amount of \$112,766,901.80.

STARS was principally developed by Barclays and KPMG LLP, an international accounting firm. The original version of the STARS transaction was marketed to non-bank businesses as a means of enhancing investment yield for large, cash-rich corporations located in the United States by taking advantage of differences between the tax systems in the United States and in the United Kingdom. The central component of this early version of STARS was a trust having a U.K. trustee and paying U.K. taxes. The U.S. participant would then realize an economic benefit by claiming foreign tax credits for the U.K. taxes paid by the trust.

In its original form, STARS failed to attract the non-bank entities Barclays had targeted. Those entities responded that the yield enhancement was not high enough to justify the level of complexity and potential risk in the transaction. With that feedback, Barclays combined the original STARS structure with a loan component in order to attract banks. Barclays and KPMG then promoted the new version of STARS as a “low cost financing” program. The economic benefit to the U.S. participant arising from the foreign tax credits remained the same, however, for both the early version and the later version of STARS.

In November 2001, Barclays representatives contacted the head of BB & T's Tax Department regarding the prospect of entering into a STARS transaction. The parties “discussed in some detail [BB & T's] appetite to do a [foreign tax credit] trade.” Shortly thereafter, BB & T met with KPMG and Barclays. At the time of that meeting, KPMG had participated in the implementation of STARS transactions between Barclays and two other U.S. banks, and BB & T was aware of that fact. It was proposed that BB & T would form a U.K. trust with its U.S.-based income-generating assets,

and Barclays would provide a large loan to BB & T. KPMG and Barclays represented that BB & T would obtain foreign tax credits against its U.S. tax obligations for the U.K. taxes paid by the trust and also share in the tax benefits that Barclays would obtain from the U.K. based on its participation in the transaction.

The tax risks of STARS were apparent to BB & T from the outset. Those risks included that BB & T might be denied the full amount of the foreign tax credits on its U.S. taxes and that Barclays might be unable to obtain the expected tax benefits from the U.K. After a lengthy negotiation regarding the allocation of the tax risks, BB & T and Barclays reached an agreement and closed the transaction on August 1, 2002.

On KPMG's recommendation, BB & T engaged Sidley, Austin, Brown & Wood LLP ("Sidley") as its tax advisor on the STARS transaction. Sidley issued its tax opinion on STARS in April 2003. In addition, BB & T tasked accounting firm PricewaterhouseCoopers ("PwC"), its outside auditor, with evaluating the tax reserve level of STARS.

B

STARS is a complex transaction consisting of many components. The trial court conducted a thorough analysis of the various structures and steps that made up STARS. We summarize below the most salient aspects of the transaction.

STARS consisted of a trust component ("the Trust") and a loan component ("the Loan"). Although many intermediary entities were created to implement STARS, the real parties in interest at all times were BB & T and Barclays. BB & T created the Trust, to which it contributed approximately \$5.755 billion of U.S.-based income-generating assets. The Loan consisted of a

payment by Barclays of \$1.5 billion in cash to the Trust in return for subscription to three classes of equity interests in the Trust. The Trust, however, remained at all times under BB & T's control, and Barclays was contractually obligated to sell its interests in the Trust back to BB & T for \$1.5 billion when the transaction terminated, so the effect of that portion of the transaction was a \$1.5 billion Loan from Barclays to BB & T. The interest rate on the Loan was set at a floating rate of approximately one-month LIBOR plus 25 basis points.¹

BB & T appointed a U.K. trustee for the Trust. The trustee's U.K. residence subjected the Trust's income to U.K. taxation. Pursuant to the STARS agreements, BB & T would receive monthly distributions of the income generated from the assets held by the Trust. After setting aside an amount to pay the U.K. taxes and the management fee, the Trust would remit the remaining funds to BB & T. Before doing so, however, the Trust would temporarily place the distributions into the "Barclays Blocked Account" at BB & T, which would then immediately return those funds to the Trust. That circular movement of the Trust distributions generated a substantial tax benefit for Barclays by allowing it to claim a "trading loss deduction" under U.K. law.

BB & T had the Trust use its funds to pay the U.K. tax on the Trust's income. Barclays would then obtain U.K. tax deductions and credits for almost all of the U.K. taxes paid by the Trust based on Barclays' nominal equity interest in the Trust and the circulation of funds through the Barclays Blocked Account.

¹ LIBOR, short for "Intercontinental Exchange London Interbank Offered Rate," is a benchmark rate that some of the world's leading banks charge each other for short-term loans.

As part of the STARS transaction, Barclays would make a monthly payment to BB & T, known as the “Bx payment.” The Bx payment was set to be equal to 51 percent of the U.K. taxes paid by the Trust, which had been paid by BB & T and which resulted in the tax benefits obtained by Barclays. Each month, BB & T’s interest obligation under the Loan and Barclays’ Bx payment obligation to BB & T were netted against each other. From September 2002 until mid-2005, Barclays, the lender, made net monthly payments to BB & T, the borrower, because the amount of Barclays’ Bx payment obligation exceeded the amount of BB & T’s interest obligation.

The following example illustrates the cash flows in and out of the Trust based on \$100 of Trust income (ignoring fees). The Trust income was subject to U.K. taxation at a 22 percent rate. Therefore, \$22 for every \$100 of Trust income was set aside for payment of the U.K. taxes, leaving the Trust with \$78 after the U.K. tax payment. Because of its nominal equity interest in the Trust, Barclays was also taxed on the Trust income under U.K. law at a corporate tax rate of 30 percent, or \$30 for every \$100 of Trust income. Barclays, however, was able to claim a \$22 U.K. tax credit for the \$22 of tax paid by the Trust as an “imputation credit” that partially offset the higher corporate tax imposed on the Trust’s distributions. As a result, Barclays effectively paid \$8 in U.K. tax.

The Trust distributed the after-tax amount of \$78 of Trust income to the Barclays Blocked Account, from which that sum was immediately re-contributed to the Trust. Under U.K. law, Barclays was able to treat the re-contributed \$78 as a “trading loss,” thereby claiming a trading loss deduction. At the 30 percent tax rate, that deduction was worth \$23.40. Barclays’ \$8

U.K. tax liability was then completely offset by the \$23.40 tax deduction, leaving Barclays with a net tax benefit of \$15.40.

In the example, the Bx payment that Barclays paid to BB & T, which was predetermined to be equal to 51 percent of the Trust's U.K. tax payments, would be approximately \$11. Barclays would then deduct the \$11 Bx payment from its U.K. corporate taxes, which at the 30 percent tax rate yielded another tax benefit worth \$3.30. The net benefit to Barclays, for every \$100 in Trust income, was thus \$7.70, based on U.K. tax credits and deductions (the net tax benefit of \$15.40 minus the Bx payment of \$11, plus the tax benefit of \$3.30 attributable to the deduction for the Bx payment).

For its part, BB & T, having paid the \$22 U.K. tax on the Trust income, would claim a foreign tax credit of \$22 for the entire amount of the Trust's U.K. taxes. However, having received the \$11 Bx payment from Barclays, BB & T would have a net gain of \$11.

The U.K. government effectively collected \$3.30 in tax for every \$100 of Trust income, because the Trust paid \$22 in U.K. taxes while the U.K. government gave back \$18.70 in tax benefits to Barclays (\$15.40 attributable to the trading loss deduction plus \$3.30 attributable to the Bx payment deduction). Based on the structure of the transaction and the amount of the income-generating assets in the Trust, BB & T anticipated receiving approximately \$44 million per year from the STARS Trust transaction in addition to the revenue generated by the assets themselves.

The capacity of the STARS Trust transaction to generate profits for Barclays and BB & T depended both on Barclays' obtaining the expected tax benefits from the U.K. and on BB & T's obtaining the expected foreign

tax credits from the U.S. Because of the risks associated with obtaining those tax benefits, the parties incorporated features into the Trust agreement that were designed to minimize those risks. The agreement included a “make-whole” provision under which BB & T was obligated to reimburse Barclays if the credits generated by the Trust failed to match the parties’ expectations. The parties also agreed to an indemnity provision, which would be triggered if the Trust paid no tax, either because it was not treated as a collective investment scheme under U.K. law or because it was not deemed a U.K. resident. BB & T’s indemnity payment to Barclays would be approximately one-half of the U.K. tax that the Trust would have paid. Finally, both parties were entitled to terminate the STARS transaction for any reason, subject to 30 days’ notice.

On March 30, 2007, the IRS published proposed regulations entitled “Regulations on Transactions Designed to Artificially Generate Foreign Tax Credits,” 72 Fed.Reg. 15081 (proposed Mar. 30, 2007). The comments accompanying the proposed regulations noted that “certain U.S. taxpayers are engaging in highly structured transactions with foreign counterparties in order to generate foreign tax credits,” *id.* at 15081, and explained that the regulations were intended to prohibit the use of “highly engineered transactions where the U.S. taxpayer benefits by intentionally subjecting itself to foreign tax,” *id.* at 15084. Under the regulations, “an amount paid to a foreign country in connection with such an arrangement is not an amount of tax paid,” and as a consequence, “a taxpayer would not be eligible to claim a foreign tax credit for such a payment.” *Id.* The notice of the proposed regulation stated that the IRS would analyze STARS transactions entered into before the effective date of the final regulation under anti-abuse doctrines, including the economic substance

doctrine. 72 Fed.Reg. 15084 (Mar. 7, 2007). Six days after the issuance of the proposed regulations, BB & T terminated the STARS transaction pursuant to its at-will termination right.

C

BB & T filed corporate income tax returns for the tax years when it was participating in the STARS transaction. In its returns, BB & T claimed foreign tax credits for the Trust's U.K. tax payments and interest deductions for interest it had paid on the Loan. The IRS denied both claims and imposed accuracy-related penalties on BB & T.

BB & T filed suit in the Court of Federal Claims, seeking a tax refund for the items listed above. Following a lengthy trial, the court denied BB & T's refund request in its entirety. *Salem Fin., Inc. v. United States*, 112 Fed.Cl. 543 (2013). Applying the "economic substance" doctrine, the court concluded that the STARS Trust was an economic sham lacking both objective economic reality and a bona fide non-tax business purpose. The court therefore held that the tax consequences of the STARS transactions had to be disregarded.

The court ruled that the Trust component, "where BB & T revenue momentarily is cycled through a U.K. trustee to create U.K. taxes and foreign tax credits, and then is returned to BB & T, quite clearly is an abusive tax avoidance scheme." 112 Fed.Cl. at 549. The court explained that the Trust "creates a series of instantaneous circular cash flows starting and ending with BB & T where no economic activity has occurred abroad to justify the assessment of a U.K. tax. While inarguably sophisticated and creative, the trust purely and simply is a sham transaction accomplishing nothing more than a redirection of cash flows that should have

gone to the U.S. Treasury, but instead are shared among BB & T, Barclays, and the U.K. Treasury.” *Id.*

The court also denied BB & T’s claim for interest deductions on the Loan component of the STARS transaction, based on a finding that the STARS Loan, too, was an economic sham. The court reasoned that the Loan was not structured to make a profit, but instead was devised merely to provide BB & T with a purported business purpose for engaging in the STARS transaction. 112 Fed.Cl. at 587.

The court also examined the Trust and the Loan as part of a single integrated transaction under the economic substance doctrine. It concluded that, viewed as an integrated transaction, the components of the STARS transaction still lacked economic substance. 112 Fed.Cl. at 588-89.

Finally, the court upheld the accuracy-related penalties assessed by the IRS. The court found that it was unreasonable for BB & T to rely on tax opinions from KPMG and Sidley, as well as the additional advice from PwC. The court thus concluded that the tax opinions were ineffective to create a reasonable justification for BB & T’s understatements of its tax liability and that the imposition of penalties was proper. 112 Fed.Cl. at 589-94. This appeal ensued.²

² Besides the Court of Federal Claims in this case, the Tax Court in *Bank of N.Y. Mellon Corp. v. Comm’r*, 140 T.C. 15, 42 (2013), has held that another STARS Trust transaction lacks substance, and a preliminary ruling in a district court case involving another STARS transaction has rejected the taxpayer’s motion for summary judgment on the business purpose issue. *Wells Fargo & Co. v. United States*, Civil No. 09-cv-2764, 2014 WL 4070782, at *26-31 (D.Minn. July 22, 2014) (report of special master). One district court has ruled that the STARS transaction in the case before it did not violate the economic substance doctrine.

II

The characterization of a transaction for tax purposes is a question of law that is subject to de novo review, while the underlying facts are reviewable for clear error. *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 n. 16, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1978). For purposes of this appeal, BB & T “accepts the trial court’s holding that the Trust Transaction and the Loan may be bifurcated.” Appellant’s Br. 18. That is, both sides treat the tax consequences of the Trust and Loan transactions separately, rather than considering them as a single integrated transaction. We accordingly take the same approach and start with the Trust.

A

The characterization of the Bx payment is important to the resolution of this case. The government argues that the Bx payment is in substance a rebate of the U.K. taxes that BB & T paid on behalf of the Trust. BB & T contends that under the Internal Revenue Code and the Treasury Regulations, the Bx payment must be treated as income to BB & T and not as a tax rebate.

Section 901(i) of the Code provides that payments made to a foreign country that result in a subsidy or rebate to the taxpayer from that country are not creditable taxes. *See* 26 U.S.C. § 901(i)(1)-(2). Under section 901(i),

Any income, war profits, or excess profits tax shall not be treated as a tax for purposes of this title to the extent—(1) the amount of such tax is used (directly or indirectly) by the country imposing such tax to provide a subsidy

Santander Holdings USA, Inc. v. United States, 977 F.Supp.2d 46 (D.Mass.2013).

by any means to the taxpayer, a related person (within the meaning of section 482), or any party to the transaction or to a related transaction, and (2) such subsidy is determined (directly or indirectly) by reference to the amount of such tax, or the base used to compute the amount of such tax.

Id. The pertinent Treasury Regulation provides:

(i) General rule. An amount of foreign income tax is not an amount of income tax paid or accrued by a taxpayer to a foreign country to the extent that—

(A) The amount is used, directly or indirectly, by the foreign country imposing the tax to provide a subsidy by any means (including, but not limited to, a rebate, a refund, a credit, a deduction, a payment, a discharge of an obligation, or any other method) to the taxpayer, to a related person (within the meaning of section 482), to any party to the transaction, or to any party to a related transaction; and

(B) The subsidy is determined, directly or indirectly, by reference to the amount of the tax or by reference to the base used to compute the amount of the tax.

(ii) Subsidy. The term “subsidy” includes any benefit conferred, directly or indirectly, by a foreign country to one of the parties enumerated in paragraph (e)(3)(i)(A) of this section. Substance and not form shall govern in determining whether a subsidy exists. The fact that the U.S. taxpayer may derive no demonstrable benefit from the subsidy is irrelevant in determining whether a subsidy exists.

26 C.F.R. § 1.901-2(e)(3). The government concedes that BB & T received no tax rebate under the literal terms of section 901(i) and the regulation.

Seizing upon the government's concession, BB & T contends that the inquiry regarding the proper characterization of the Bx payment should stop with the literal terms of the Code and regulations. Because the Treasury regulation provides that "substance and not form" determines whether a particular payment is a tax rebate, 26 C.F.R. § 1.901-2(e)(3), BB & T argues that the government's concession that BB & T literally complied with section 901(i) means that BB & T in substance received no tax rebate and thus that BB & T received no tax rebate for purposes of the economic substance doctrine.

We disagree that the existence of the "substance-over-form" provision in the Treasury regulation precludes analysis under the economic substance doctrine. In *Coltec v. United States*, 454 F.3d 1340 (Fed.Cir.2006), we concurred with the Third Circuit and the Eleventh Circuit that "economic substance is a prerequisite to the application of any Code provision allowing deductions." *Id.* at 1356 (citing *In re CM Holdings, Inc.*, 301 F.3d 96, 102 (3d Cir.2002), and *Kirchman v. Comm'r*, 862 F.2d 1486, 1491 (11th Cir.1989)). We analyzed the transaction at issue in *Coltec* under both the statutory "anti-abuse" provision, which required an inquiry into the substance of the transaction, and "the general economic substance doctrine." *See id.* at 1350-52. The economic substance doctrine thus applies even to a transaction that is governed by a statute or regulation that itself contains a "substance-over-form" provision.

While courts may perform a concurrent substance analysis under both the specific provisions of the Internal Revenue Code and the economic substance doctrine, *see Glass v. Comm'r*, 87 T.C. 1087 (1986); *DeMartino v. Comm'r*, 862 F.2d 400 (2d Cir.1988), the analysis under the two is not always the same. For

example, BB & T offers several reasons why the Bx payment should not be deemed a tax rebate under section 901(i). Those reasons include that neither the Bx payment nor Barclays' trading loss deduction was tied to any payment of taxes, and that Barclays' credit for the U.K. taxes paid by the Trust was an "imputation credit" and thus was not an indirect tax rebate.

Those arguments are highly technical in nature and do not address the broader inquiry under the economic substance doctrine: whether the Trust transactions lack economic reality, whether they lack a bona fide business purpose, and whether they are not the kinds of transactions on which Congress intended to confer the benefit of the foreign tax credit provision. *See Stobie Creek Invs. LLC v. United States*, 608 F.3d 1366, 1375 (Fed.Cir.2010) (to distinguish between a real transaction and a sham transaction under the economic substance doctrine, the court examines the economic reality and business purpose of the transaction); *Coltec*, 454 F.3d at 1353 ("The economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code.").

BB & T's argument that the inquiry begins and ends with the Code and regulations, if accepted, would largely eviscerate the common-law economic substance doctrine. Challenges to assertedly abusive tax shelters have frequently involved transactions devised to comply with the letter of governing statutes and regulations. As the D.C. Circuit observed, "[a] tax system of rather high rates gives a multitude of clever individuals in the private sector powerful incentives to game the system. Even the smartest drafters of legislation and regulation cannot be expected to anticipate every device." *ASA Investering P'ship v. Comm'r*, 201 F.3d 505, 512 (D.C.Cir.2000). Under the traditional economic substance

doctrine, the issue in such cases is whether the transactions are contrivances that are inconsistent with the purposes served by the Code provisions and should therefore be disregarded. *See, e.g., Gregory v. Helvering*, 293 U.S. 465, 469–70, 55 S.Ct. 266, 79 L.Ed. 596 (1935). Accordingly, the government’s concession that BB & T complied with the literal terms of section 901(i)—although relevant to our consideration of the objective nature of the transaction—does not bar the government from arguing that the STARS transaction is an economic sham.³

B

We now turn to the government’s arguments under the economic substance doctrine. “The economic substance doctrine seeks to distinguish between structuring a real transaction in a particular way to obtain a tax benefit, which is legitimate, and creating a transaction to generate a tax benefit, which is illegitimate.” *Stobie Creek*, 608 F.3d at 1375. “Under this doctrine, we disregard the tax consequences of transactions that

³ BB & T also argues that our precedent precludes any further inquiry, beyond section 901(i), into whether there was an “in substance” rebate of U.K. taxes in the STARS transaction. BB & T relies on a group of cases known as the Mexican Railroad Car Cases, which were decided before the enactment of section 901(i). In those cases, our predecessor court held that, for purposes of determining the amount of creditable foreign taxes, it was irrelevant that the foreign government later gave a tax rebate to the taxpayer’s foreign counterparty. *See Chicago, Burlington & Quincy R.R. Co. v. United States*, 455 F.2d 993, 1022–23 (Ct.Cl.1972), *rev’d on other grounds*, 412 U.S. 401, 93 S.Ct. 2169, 37 L.Ed.2d 30 (1973); *see also Bankers Trust N.Y. Corp. v. United States*, 225 F.3d 1368 (Fed.Cir.2000). The *Mexican Railroad Car Cases* and *Bankers Trust* are inapposite here, because neither addresses the applicability of the economic substance doctrine.

comply with the literal terms of the tax code, but nonetheless lack economic reality.” *Id.* We have also held that transactions must be disregarded if they are “shaped solely by tax-avoidance features,” i.e., if they have no bona fide business purpose. *Id.*; *see also Coltec*, 454 F.3d at 1355.

Ultimately, we have treated the economic substance doctrine as a means to “prevent taxpayers from subverting the legislative purpose of the tax code” by engaging in fictitious transactions with no economic purpose other than the possibility of reaping a tax benefit. *Coltec*, 454 F.3d at 1353; *see Klamath Strategic Inv. Fund ex rel. St. Croix Ventures v. United States*, 568 F.3d 537, 543 (5th Cir.2009) (“The economic substance doctrine allows courts to enforce the legislative purpose of the [Tax] Code by preventing taxpayers from reaping tax benefits from transactions lacking in economic reality.”).⁴ In assessing a transaction’s economic substance, “all courts have looked to the objective reality of the transaction.” *Coltec*, 454 F.3d at 1356.

⁴ In 2010, Congress codified the economic substance doctrine in 26 U.S.C. § 7701(o). That statute provided that a transaction shall be treated as having economic substance only if “the transaction changes in a meaningful way (apart from Federal income tax effects) the tax-payer’s economic position” and “the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.” *Id.* § 7701(o)(1). The statute was made applicable only to transactions initiated after 2010, and it is therefore inapplicable to this case; however, our decisions applying the economic substance doctrine are consistent with the definition Congress adopted in the 2010 legislation, and since Congress in that legislation expressed its intention to codify the existing judge-made rules, our application of those pre-statutory rules is consistent with Congress’s endorsement of that approach in 2010.

We start by examining the “economic reality” of the STARS Trust transaction. This inquiry is conducted based on objective evidence, rather than on the taxpayer’s subjective motivation. *Stobie Creek*, 608 F.3d at 1375; *Coltec*, 454 F.3d at 1356. The “economic reality” inquiry asks whether a particular transaction or set of transactions meaningfully altered the taxpayer’s economic position, apart from their tax consequences. That inquiry often focuses on whether the taxpayer had a “reasonable possibility of making a profit from the transaction.” *Stobie Creek*, 608 F.3d at 1376-77.

BB & T asserts that it realized income from the Trust transaction in the form of the monthly Bx payments. The IRS initially took the same position and treated the Bx payments as part of BB & T’s gross income. The government has since abandoned that position. It now argues that the Bx payments should be excluded from BB & T’s gross income because they are “in substance” rebates of the U.K. tax that was paid by BB & T from the assets BB & T contributed to the Trust.

The government treats the Bx payments as tax rebates based on the theory that the payments derived from Barclays’ U.K. tax credits, which in turn derived from the Trust’s U.K. tax payment. BB & T contends that the Bx payments should not be characterized as a tax rebate, because they were independent of Barclays’ actual receipt of any U.K. tax benefits; Barclays was obligated to make the Bx payments regardless of whether it received the expected U.K. tax credits. BB & T further argues that the Bx payments should be treated as income pursuant to the Supreme Court’s decision in *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 49 S.Ct. 499, 73 L.Ed. 918 (1929).

We are not persuaded by BB & T's first argument, because the Bx payments were not truly independent of Barclays' U.K. tax benefits. It is true that the amount of the payments was fixed in the transaction documents and was not conditioned on Barclays' actual receipt of any tax benefits. However, the transaction documents provided that an indemnity provision would be triggered if Barclays were unable to claim the expected U.K. tax credits, either because the Trust paid no tax or because the U.K. authority refused to recognize the Trust as a U.K. resident for tax purposes. BB & T would then be obligated to indemnify Barclays for approximately one half of the U.K. tax that the Trust paid, which was roughly equal to the Bx payments. The effect of the indemnity provision was that if Barclays were unable to recover its expected U.K. tax benefits, BB & T would have to return an amount approximately equal to the Bx payments to Barclays. Therefore, the Bx payments were not independent of Barclays' expected U.K. tax benefits at all. BB & T's ability to benefit economically from the Bx payments depended on Barclays' receipt of its expected tax benefits, which in turn depended on the Trust's U.K. tax payments.

BB & T's second argument—that the Bx payments should be treated as income under *Old Colony* and its progeny—has more force. In *Old Colony*, a taxpayer's employer agreed to pay all income taxes imposed on salary payments to the taxpayer. *Old Colony*, 279 U.S. at 721, 49 S.Ct. 499. The Supreme Court held that the income tax payments made by the employer constituted additional income to the taxpayer (and therefore were not tax effects), even though those payments were made directly to the government. That was because, like the taxpayer's salary, the income taxes were paid “upon a valuable consideration, namely, the services

rendered by the employee and as part of the compensation therefor.” *Id.* at 729, 49 S.Ct. 499. “The discharge by a third person of an obligation to [the taxpayer] is equivalent to receipt by the person taxed.” *Id.*; see also *Diedrich v. Comm’r*, 457 U.S. 191, 197-98, 102 S.Ct. 2414, 72 L.Ed.2d 777 (1982) (“[T]he donor realizes an immediate economic benefit by the donee’s assumption of the donor’s legal obligation to pay the gift tax. . . . [T]he economic benefit to the donors in the discharge of the gift tax liability is indistinguishable from the benefit arising from discharge of a preexisting obligation.”).

Other courts have followed *Old Colony* in assessing a taxpayer’s foreign income and tax liability. For example, in *Compaq Computer Corp. & Subsidiaries v. Commissioner*, 277 F.3d 778 (5th Cir.2001), the Fifth Circuit held that the payment of Compaq’s Netherlands tax obligation by Compaq’s Netherlands counterparty was income to Compaq. The Eighth Circuit followed the same approach in *IES Industries, Inc. v. United States*, 253 F.3d 350 (8th Cir.2001).

The government does not appear to dispute that, if Barclays had paid half of the Trust’s U.K. tax on BB & T’s behalf, that direct tax payment would have constituted income to BB & T under *Old Colony*. The government argues, however, that the *Old Colony* principle is inapplicable in this case because Barclays did not pay BB & T’s U.K. tax directly; rather, it reimbursed BB & T for half of its U.K. tax expense through the Bx payment.

That is a distinction without a difference. The Supreme Court held in *Old Colony* that a third party’s assumption of a taxpayer’s tax liability constituted income to the taxpayer because the tax payments had been made in consideration of services rendered by the taxpayer, and the taxpayer had realized an economic benefit from the payments. *Old Colony*, 279 U.S. at 729, 49

S.Ct. 499. That principle is not limited to a situation in which a third party paid the taxpayer's taxes directly to the government. Rather, that rationale applies equally if the third party instead reimbursed all or part of the taxpayer's tax expenses in exchange for services rendered.

In *Reading & Bates Corp. v. United States*, 40 Fed.Cl. 737 (1998), the Court of Federal Claims held that a taxpayer realized income when its Egyptian counterparty contractually assumed the taxpayer's Egyptian tax liability pursuant to a tax indemnification provision in their contract. The court recognized that if the contract had provided for the counterparty to reimburse the taxpayer's Egyptian tax expenses, instead of assuming the taxpayer's Egyptian tax liability, the change would not have affected the characterization of the reimbursements as income to the taxpayer; it would have affected only the date the taxpayer would be deemed to have received the income. *Id.* at 750 n. 8.

Like the taxpayer in *Old Colony*, BB & T realized an immediate economic benefit by receiving the Bx payments from Barclays, which payments effectively repaid half of BB & T's U.K. tax expenses. The payments were made in consideration of BB & T's services rendered under the STARS transaction, including BB & T's acts of creating the STARS Trust and subjecting its U.S.-based assets to U.K. taxation. Under the principle of *Old Colony*, the reimbursements that BB & T received from Barclays must therefore be treated as income to BB & T, not tax effects.

The government nonetheless contends that the specific circumstances of this case justify treating the Bx payments as tax rebates. It argues first that the Bx payments are tax rebates because they were designed

as such. The government points out that, in assessing the U.S. tax risk of the STARS transaction, BB & T itself referred to the Bx payments as a “Rebate from Barclays.” KPMG represented to BB & T that the STARS transaction would provide a “rate reduction of 50% of [the Trust’s] UK tax.” Barclays likewise stated that the “benefit under STARS arises from the ability of both parties [i.e., Barclays and BB & T] to obtain credits for the taxes paid in the trust.”

We do not view this evidence as dispositive for purposes of characterizing the Bx payments. We emphasized in *Coltec* that the economic reality of a transaction must be viewed objectively rather than subjectively. *See Coltec*, 454 F.3d at 1356. The contracting parties’ own subjective view of the transaction may be pertinent to the existence of a tax avoidance purpose; however, “all courts have looked to the objective reality of the transaction in assessing its economic substance.” *Id.* Furthermore, the government’s evidence at best establishes that the Bx payments were designed as a way for Barclays to reimburse BB & T for 50 percent of its U.K. tax expenses. It does not explain why, contrary to the *Old Colony* principle, Barclays’ reimbursement of BB & T’s tax expense must be deemed to be a tax effect rather than income.

The government next argues that the Bx payment must be treated as a tax rebate because the payment, which was calculated by reference to the Trust’s U.K. taxes, was the product of “tax collusion” between BB & T and Barclays; that is, the two entities used the U.K. government as a “conduit” to cycle BB & T’s tax payments to Barclays through Barclays’ U.K. tax credit, after which Barclays returned 51 percent of the taxes to BB & T and kept the rest as its fee. The government paints a simple picture: that money merely

changed hands from BB & T to the U.K. government, then to Barclays, and finally back to BB & T. The reality, however, is not that simple.

Barclays was willing to make the payment to BB & T because BB & T's participation in the STARS transaction enabled Barclays to realize substantial tax benefits under U.K. law. For every \$100 of Trust income, Barclays (1) paid \$30 in corporate income tax; (2) claimed a \$22 tax credit for taxes already paid by the Trust; (3) claimed a trading loss deduction worth \$23.40 for the cash it re-contributed to the Trust; and (4) claimed a deduction for the Bx payments that was worth \$3.30. Those payments, credits, and deductions gave Barclays a net total of \$18.70 in U.K. tax benefits, out of which Barclays paid \$11.00 to BB & T in the form of the Bx payment.

It is not at all clear that the Bx payments were the result of "cycling" BB & T's U.K. tax payments through the U.K. government and Barclays. The Bx payments were paid out of Barclays' net U.K. tax benefits, which consisted of items clearly linked to BB & T's U.K. taxes (such as the \$22 tax credit), as well as items unrelated to BB & T's U.K. tax payments (such as the trading loss deduction worth \$23.40). Thus, the Bx payments could just as well be said to have been derived from the portion of Barclays' tax benefits that was independent of BB & T's U.K. tax payments, such as the trading loss deduction, as from BB & T's U.K. tax payments. The government's own expert agreed that the real benefit of STARS was the trading loss deduction. It is thus impossible to identify the exact source of the Bx payments, much less to link the Bx payments directly to BB & T's payments of U.K. taxes.

That the Bx payments were calculated by reference to BB & T's U.K. taxes is insufficient to convince us otherwise. Contracting parties are free to structure their transactions based on any payment formula, including calculating a payment by reference to a party's tax liability. *See, e.g., Reading*, 40 Fed.Cl. at 738-39 (pursuant to a drilling contract, a foreign counterparty to the U.S. taxpayer agreed to assume the taxpayer's entire foreign tax liability); *Doyon Ltd. v. United States*, 37 Fed.Cl. 10, 13 (1996), *rev'd on other grounds*, 214 F.3d 1309 (Fed.Cir.2000) (taxpayer contracted to sell its net operating losses and investment tax credits to unrelated corporations that sought to shelter some of their income from tax liability). Such a tax-based payment formula does not convert income into a tax effect.

We are aware of no authority, and the government has provided none, in which courts have treated private payments as tax effects rather than income simply because the amount of the payments was calculated based on a tax-based formula. The government's position in this regard cannot be squared with prior judicial decisions that have held that even when an unrelated party has paid 100 percent of a taxpayer's taxes, that payment must still be considered income to the taxpayer. *See Old Colony*, 279 U.S. at 729, 49 S.Ct. 499; *Compaq*, 277 F.3d at 784; *IES*, 253 F.3d at 354; *Reading*, 40 Fed.Cl. at 750.

We therefore conclude that the Bx payments should not be characterized as tax effects. Pursuant to *Old Colony* and its progeny, the Bx payments are income to BB & T.

The government next argues that even if the Bx payments are treated as income to BB & T, BB & T realized no profit from the Trust transaction absent the foreign tax credit because the Bx payments must be offset against the Trust's U.K. taxes that were paid by BB & T. The government argues that, for every \$100 of income from the Trust assets, even if BB & T were credited with \$11 income in the form of the Bx payment, that \$11 would have to be offset against BB & T's \$22 U.K. tax expense, which would yield a loss of \$11. According to the government, the Trust transaction produced a net loss and therefore lacked economic substance.⁵

BB & T contends that the government is wrong in seeking to have the Trust's U.K. taxes treated as an item of expense. BB & T relies on *Compaq* and *IES*, two cases with almost identical fact patterns, in which the Fifth and Eighth Circuits rejected a similar argument. See *Compaq*, 277 F.3d at 785; *IES*, 253 F.3d at 354. In *Compaq*, the taxpayer (Compaq) engaged in a foreign transaction involving the purchase and immediate resale of certain publicly traded securities that represented shares of a foreign corporation held in trust by a U.S. bank. The settlement dates for the purchase and sale were arranged so that the securities were purchased *cum* dividend and sold *ex* dividend. The purchase and sale transaction thus generated a gross dividend for Compaq, which was subject to a foreign withholding tax. In addition, because the post-

⁵ BB & T contends that we should not address this argument because it is raised for the first time on appeal. The record shows, however, that the trial court treated BB & T's U.K. taxes as its "out-of-pocket" cost in assessing the profit from the STARS transaction. Because the trial court addressed this issue, the government's argument is properly before us.

dividend sale price of the securities was lower than the purchase price (by the amount of the dividend, net of the foreign withholding tax), Compaq claimed a capital loss on its U.S. taxes for the transaction. It also claimed a foreign tax credit for the foreign taxes paid on the gross dividend. As a result, the purchase and sale transaction produced a net gain for Compaq after all taxes were taken into consideration. *See Compaq*, 277 F.3d at 782.

The Tax Court found that the transaction lacked economic substance because it was in essence a circular transaction entailing no risk and no prospect for gain other than as a result of the various domestic and foreign tax consequences. *Compaq Computer Corp. v. Comm’r*, 113 T.C. 214 (1999). In short, it was a classic case of cross-border tax arbitrage, and not the kind of transaction that, in the Tax Court’s view, Congress intended to benefit through the foreign tax credit statute. *Id.* at 225 (“The foreign tax credit serves to prevent double taxation and to facilitate international business transactions. No bona fide business is implicated here, and we are not persuaded that Congress intended to encourage or permit a transaction such as the [Compaq securities] transaction, which is merely a manipulation of the foreign tax credit to achieve U.S. tax savings.”).

The Fifth Circuit reversed. The court held that the gross dividend, rather than the dividend net of the foreign tax, should have been used to compute Compaq’s pre-tax profit. *See Compaq*, 277 F.3d at 784. In addition, the court faulted the Tax Court for failing to include Compaq’s foreign tax credits in assessing the after-tax profit of the entire transaction. *See id.* at 785. The Fifth Circuit reasoned that “[i]f the effects of tax law, domestic or foreign, are to be accounted for when they subtract from a transaction’s net cash flow, tax

law effects should be counted when they add to cash flow.” *Id.* “To be consistent, the analysis should either count all tax law effects [both foreign tax credits and foreign tax expenses] or not count any of them.” *Id.*; see also *IES*, 253 F.3d at 354 (taking the latter approach and treating the gross dividend, not the net dividend, as the economic benefit to the taxpayer).

The transactions at issue in *Compaq* and *IES* involved an almost simultaneous purchase and sale of the securities in question; the purchase price was greater than the sale price by the amount of the dividend received by the taxpayer after foreign taxes on the dividend. The transactions therefore did not meaningfully alter the taxpayers’ economic position (apart from their tax consequences); they involved essentially no risk (other than the risk that the transactions would be disallowed for tax purposes); and they offered no opportunity for economic gain (except for the tax benefits). Because of the fees paid in connection with the transactions, the consequence of the transactions, but for the foreign tax credits, would have been a certain loss. Thus, the transactions relied for their profitability entirely on the availability of a U.S. foreign tax credit for the taxes paid to the foreign government.

The *Compaq* and *IES* transactions produced no real economic profit. The taxpayer incurred a loss from the sale of the securities in the amount of the dividend, net of the foreign tax. Any apparent profit from the transactions was the result of offsetting that loss by the amount of the dividend, without taking into account the foreign taxes paid on the dividend. And the fact that the transactions produced a net gain to the taxpayer after taking both the foreign taxes and the foreign tax credit into account says nothing about the economic reality of the transactions, because all tax

shelter transactions produce a gain for the taxpayer after the tax effects are taken into account—that is why taxpayers are willing to enter into them and to pay substantial fees to the promoters.⁶ 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.

Our 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. For

⁶ Academic commentators, sometimes referring to the transactions at issue in those cases as a form of “foreign tax arbitrage,” have argued that the transactions should have been disregarded as lacking in economic substance. See Bryan Camp, *Form Over Substance in Fifth Circuit Tax Cases*, 34 Tex. Tech. L.Rev. 733, 752-53 (2003); Mitchell Kane, *Compaq and IES: Putting the Tax Back in After-Tax Income*, 94 Tax Notes 1215, 1217 (Mar. 4, 2002); Michael S. Knoll, *Compaq Redux: Implicit Taxes and the Question of Pre-Tax Profit*, 26 Va. Tax Rev. 821, 840 (2007); Michael J. McIntyre, *A Vote in the Compaq Debate*, 94 Tax Notes 1716 (Mar. 25, 2002); Daniel N. Shaviro and David A. Weisbach, *The Fifth Circuit Gets It Wrong in Compaq v. Commissioner*, 94 Tax Notes 511 (Jan. 28, 2002); George K. Yin, *The Problem of Corporate Tax Shelters: Uncertain Dimensions, Unwise Approaches*, 55 Tax L.Rev. 405, 407-13 (2002). Professors Klein and Stark argue that the Compaq transaction was not really tax arbitrage, but instead was a form of economic arbitrage. Nonetheless, they agree that the absence of risk in the *Compaq* transaction “may well be an adequate reason for ignoring the transaction entirely.” William A. Klein & Kirk J. Stark, *Compaq v. Commissioner—Where is the Tax Arbitrage?*, 94 Tax Notes 1335, 1338 (Mar. 11, 2002).

example, in *Rothschild v. United States*, 407 F.2d 404 (Ct.Cl.1969), our predecessor court examined the economic reality of a transaction by asking whether there was “a possibility [or] an opportunity of profit to the taxpayer separate and apart from the tax [benefits].” *Id.* at 412; *see also IES*, 253 F.3d at 354 (under the objective economic substance test, the court “will first consider whether there was a reasonable possibility of profit . . . apart from tax benefits”); *Rice’s Toyota World, Inc. v. Comm’r*, 752 F.2d 89, 94 (4th Cir.1985) (“The second prong of the sham inquiry, the economic substance inquiry, requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits.”). In this case, BB & T incurred a large foreign tax expense (\$22 for every \$100 of Trust income) only to obtain a smaller income (the \$11 Bx payment for every \$100 of Trust income). The Trust transaction therefore is profitless before taking into account BB & T’s expected foreign tax credits.

With that said, however, we disagree with the government’s contention that a transaction’s lack of potential for profit before taking U.S. tax benefits into account conclusively establishes that the transaction lacks economic reality. The government argues that a transaction lacks economic reality if it fails to realize a post-foreign-tax profit, i.e., if the pre-tax profit is less than the foreign tax expense. Without foreign tax credits, such a transaction would result in an economic loss. This is in essence the “economic profit” test contemplated in I.R.S Notice 985, which was never issued as a regulation and was later withdrawn. *See* I.R.S. Notice 98-5, 1998-1 C.B. 334, 1997 WL 786882 (1997); I.R.S. Notice 2004-19, 2004-1 C.B. 606, 2004 WL 292126 (2004). The rationale for the “economic profit” test was to disallow credits if the “reasonably expected

economic profit were determined to be insubstantial compared to the value of the foreign tax credits expected to be obtained” as a result of the transaction. 2004 WL 292126, at *1.

What is critical is to identify transactions lacking economic reality, i.e., those that do not alter the taxpayer’s economic position in any meaningful way apart from their tax consequences, typically entailing no risk and no significant possibility of profit other than as a result of tax considerations. This 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.” *Frank Lyon*, at 583-84, 98 S.Ct. 1291. 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. *See, e.g., Knetsch v. United States*, 364 U.S. 361, 365-66, 81 S.Ct. 132, 5 L.Ed.2d 128 (1960) (the taxpayer’s transaction with the insurance company “was a fiction,” because for a claimed interest deduction of \$233,297.68, the taxpayer’s annual borrowing only kept a net cash value “at the relative pittance of \$1,000”).

While looking to the potential for economic profit is useful, the Supreme Court has cautioned that 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, 98 S.Ct. 1291. The government’s economic profit test, if applied rigidly, would implicate a wide range of transactions that, in the government’s view, have not earned a minimum profit to justify a

finding of economic reality. Yet commentators have identified transactions that would fail the profit test but nonetheless should be honored as legitimate business transactions meriting the allowance of foreign tax credits. See Daniel N. Shaviro & David A. Weisbach, *The Fifth Circuit Gets it Wrong in Compaq v. Commissioner*, 94 Tax Notes 511, 515 (2002) (“To be sure, there are many cases where a foreign transaction without a pre-tax profit (net of foreign taxes) is not a sham meriting disallowance.”) (giving an example in which a U.S. company borrows at 8 percent to make a genuine investment, over a significant period, in a foreign bond or business opportunity that is expected to earn 10 percent before foreign tax and 7 percent after foreign tax); James M. Peaslee, *Creditable Foreign Taxes and the Economic Substance Profit Test*, 114 Tax Notes 443, 450 (Jan. 29, 2007) (“On those facts, the taxpayer would have a powerful argument that allowing the [foreign tax] credits is consistent with Congressional intent despite the lack of a post-foreign tax profit.”); David P. Hariton, *The Compaq Case, Notice 98-5, and Tax Shelters: The Theory Is All Wrong*, 94 Tax Notes 501, 502 (Jan. 28, 2002) (under the government’s profit test, “any taxpayer who borrowed money and invested the proceeds in foreign stock would have lost its right to credit any foreign withholding taxes it paid, since its interest deductions would invariably have exceeded its net dividend income”).

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. See *Sacks v. Comm’r*, 69 F.3d 982, 990–92 (9th Cir.1995) (upholding the taxpayer’s claim for regular investment credit

and a business energy investment credit, where the taxpayer entered into a sale/leaseback transaction for solar water heaters, and the IRS deemed the transaction as a sham because it was unprofitable before tax benefits were accounted for). Indeed, Congress often provides tax benefits to encourage socially beneficial activity that would not be pursued absent tax advantages.

Therefore, although inquiring into post-foreign-tax profit can be a useful tool for examining the economic reality of a foreign transaction, we disagree with the government that a transaction that fails the profit test must necessarily be deemed a sham. Nonetheless, if a taxpayer has incurred a large foreign tax expense that would render the transaction unprofitable absent the foreign tax credit, that situation demands careful review of the transaction. In particular, it requires an inquiry into whether the transaction meaningfully alters the taxpayer's economic position (other than with regard to the tax consequences) and whether the transaction has a bona fide business purpose. The fact that the transaction lacks a post-foreign-tax profit does not by itself end the economic substance inquiry.

In this case, the trial court's finding that the Trust transaction lacked economic reality was supported by more than just the absence of a prospect for profit. The trial court found that the Trust transaction consisted of "three principal circular cash flows," which, apart from their intended tax consequences, had no real economic effect. 112 Fed.Cl. at 585. Through those circular cash flows, BB & T (1) created an entity that it used to make monthly distributions to the Trust, which the Trust immediately returned to that entity, resulting in subjecting the income to U.K. taxes; (2) caused the Trust to deposit a predetermined amount of funds into a blocked account and then to withdraw those funds

immediately, enabling Barclays to claim a U.K. tax loss even though the transaction had no net economic effect; and (3) “cycled tax through the U.K. taxing authority, then to Barclays, and then back to [BB & T].” *Id.* None of those transactions, the court found, had any economic substance.

As explained above, we do not accept the trial court’s characterization of the Bx payment as simply a rebate of the Trust’s U.K. tax payments; we agree with the trial court, however, that the Trust transaction was a contrived transaction performing no economic or business function other than to generate tax benefits. The trial court correctly concluded that the income “from BB & T’s preexisting assets cycled through the STARS Trust was not [economic] profit from STARS,” but was akin to the “transfers of income-producing assets to controlled entities that do not imbue an arrangement with substance,” because “the transfer has no incremental effect on the taxpayer’s activities.” 112 Fed.Cl. at 586 (citing cases). As the trial court found, the Trust transaction reflected no meaningful economic activity by BB & T: the incremental profit potential of the Trust (beyond the income already generated by the underlying assets) depended entirely on Barclays’ and BB & T’s anticipated tax benefits; it exposed BB & T to no economic risk (other than the risk that the IRS would challenge the tax treatment of the transaction); and it had no realistic prospect of producing a profit (apart from the effect of the foreign tax credits).

Rather than being a genuine business transaction involving economic risk, the STARS Trust transaction was simply a money machine. By voluntarily subjecting the Trust income to U.K. taxes, BB & T obtained a post-foreign-tax-credit “profit” of \$11 for every \$100 of Trust income, free of economic risk. If BB & T had

increased by ten-fold the value of the assets it placed in the Trust, it would have increased by ten-fold its “profit” from the transaction, quite apart from the legitimate income generated by the assets. In addition, Barclays’ gain from the transaction would have increased by the same multiple, as would the U.K.’s receipt of taxes, all at the expense of the U.S. Treasury. The artificiality of the transaction is shown by its unlimited capacity to generate gains, without any additional exposure or commitment of resources. The trial court therefore correctly characterized the transaction as lacking economic reality, and it properly found that allowing foreign tax credits for such an arrangement would be inconsistent with the purposes of the foreign tax credit statute.

D

We next turn to the second element of the “economic substance” test—whether the STARS Trust transaction nonetheless had a bona fide business purpose. The trial court found that the STARS Trust had no non-tax business purpose, and that, instead, its sole function was “to self-inflict US-sourced BB & T income in order to reap U.S. and UK tax benefits.” That finding is amply supported by the evidence.

“Asking whether a transaction has a bona fide business purpose is another way to differentiate between real transactions, structured in a particular way to obtain a tax benefit (legitimate), and transactions created to generate a tax benefit (illegitimate).” *Stobie Creek*, 608 F.3d at 1379 (citing *Coltec*, 454 F.3d at 1357); see also *Shriver v. Comm’r*, 899 F.2d 724, 726 (8th Cir.1990) (“The business purpose inquiry examines whether the taxpayer was induced to commit capital for reasons only relating to tax considerations or whether a non-tax motive, or legitimate profit motive,

was involved.”); *Winn-Dixie Stores, Inc. v. Comm’r*, 254 F.3d 1313, 1316 (11th Cir.2001) (“The [sham-transaction] doctrine has few bright lines, but it is clear that transactions whose sole function is to produce tax deductions are substantive shams.”) (internal quotations omitted).

When BB & T first learned of the STARS transaction, it expressed to Barclays *952 its “appetite to do an FTC [foreign tax credit] trade.” During the two parties’ subsequent discussions, Barclays represented to BB & T that “[t]he benefit under STARS arises from the ability of both parties to obtain credits for the taxes paid in the Trust.” KPMG likewise promoted STARS to BB & T as generating a benefit “based on the U.K. tax credit,” in which the greater the amount of Barclays’ tax credits, the greater the benefit to BB & T would be.

When the STARS transaction was presented to BB & T’s board of directors in February 2002, BB & T’s chief financial officer described the expected benefit of the transaction as “one half of UK tax credit received by investor [Barclays] for UK income taxes paid by Trust.” A BB & T witness confirmed at trial that STARS “sounded like a good deal” at the time because it allowed BB & T to claim a foreign tax credit equal to the entire amount of the Trust’s U.K. taxes while BB & T was also receiving “a payment from Barclays that they had used the tax credit as a basis for calculating.”

BB & T and Barclays finalized the STARS transaction in July and August 2002. What emerged from the parties’ agreement was a Trust consisting entirely of BB & T’s U.S.-based assets, which BB & T voluntarily subjected to U.K. taxation. Beyond that, BB & T conducted little activity in the U.K. The monthly Bx payment it received, sometimes characterized by the parties as a “[loan] interest adjustment,” bore no relationship to the amount of the STARS Loan; instead,

the payment was calculated based on the Trust's U.K. tax payments. Aside from income generated by the Trust's assets, all incremental cash flows into the transaction were the U.K. tax benefits that Barclays claimed under STARS.⁷

The evidence thus supports the trial court's finding that the STARS Trust was a "prepackaged strategy" created to generate U.S. and U.K. tax benefits for BB & T and Barclays. *See Stobie Creek*, 608 F.3d at 1379. Barclays agreed to bear half of BB & T's U.K. tax expense under the transaction in exchange for an opportunity to claim substantial U.K. tax benefits for itself (through the trading loss deduction). BB & T, on the other hand, benefited by claiming a foreign tax credit equal to the entire amount of the Trust's U.K. taxes while "getting back one-half of the U.K. tax" from Barclays. Absent those tax advantages, the STARS transaction would never have occurred.

BB & T contends that the Trust transaction was motivated by valid, non-tax-related business purposes. Significantly, although BB & T argued in the Court of Federal Claims that the purpose of the STARS transaction, including the Trust, was to obtain financing, BB & T does not make that argument in this court. Instead, BB & T argues, first, that it sought to earn a profit, in the form of the Bx payment, and that earning a profit is "a quintessential business purpose, universally accepted by the courts." Appellant's Br. 55. The Bx payment, however, does not represent profit from any business activity; it is simply the means by which Barclays and BB & T shared the tax benefits of the

⁷ Both parties agree that the analysis of the transaction should focus on the transaction's incremental income beyond the income already generated by the Trust assets.

Trust transaction. It therefore is not an indication that the Trust transaction had a business purpose. To hold that a transaction has a bona fide business purpose whenever it has a prospect of producing economic benefit for the taxpayer would eliminate the “business purpose” test altogether, since the taxpayer normally will not engage in a transaction absent the prospect that it will result in some monetary gain.

BB & T next argues that the Trust had a legitimate business purpose because it was established to enable Barclays to claim certain U.K. tax benefits. BB & T relies on *Northern Indiana Public Service Co. v. Commissioner*, 115 F.3d 506, 512 (7th Cir.1997), for the proposition that accommodating a counterparty’s tax position is a legitimate business purpose.

BB & T misconstrues *Northern Indiana*. In that case, it was undisputed that the taxpayer had structured the transaction at issue to access the Eurobond market, where it could borrow at a lower interest rate, and to allow foreign lenders to avoid paying a 30 percent U.S. withholding tax. *See Northern Indiana*, 115 F.3d at 511. The Seventh Circuit found that the desire to avoid the 30 percent withholding tax was not the taxpayer’s sole purpose in structuring the transaction, and that the taxpayer’s foreign counterparty had “engaged in business activity of borrowing and lending money at a profit,” which had resulted in “actual, non-tax related” changes in the taxpayer’s economic position. *Id.* at 509, 512. The court held that such a transaction should not be disregarded as an economic sham simply because tax avoidance was one of the motives for creating or structuring the transaction. *See id.* at 511, 514. *Northern Indiana* thus does not stand for the proposition that accommodating a counterparty’s tax

position is always a legitimate business purpose, as BB & T asserts.

The Seventh Circuit in *Northern Indiana* recognized that a transaction that is “unrelated to any economic activity” and is created solely to obtain tax benefits should be disregarded as a sham. 115 F.3d at 511. The creation and operation of the STARS Trust is just such a transaction. The incremental profit potential of the Trust depended entirely on Barclays’ and BB & T’s anticipated tax benefits. The risk of the transaction rested on “interpretations of tax laws and regulations of the United States, the United Kingdom and the State of North Carolina”; the risk was unrelated to market conditions, “the time value of money,” or the “attendant risks” associated with the transaction. *See Bank of N.Y. Mellon Corp. v. Comm’r*, 140 T.C. 15, 42 (2013) (discussing another STARS transaction). Thus, while the transaction before the court in *Northern Indiana* was a “real transaction [that was] structured in a particular way to obtain a tax benefit,” the STARS Trust was created solely to generate tax benefits; it therefore lacked a bona fide business purpose.⁸ *Stobie Creek*, 608 F.3d at 1379; *see also Northern Indiana*, 115 F.3d at 512 (recognizing that Knetsch and similar

⁸ BB & T further argues that saving state taxes with the STARS Trust is a legitimate business purpose. BB & T avoided North Carolina state tax by shifting the Trust’s income-producing assets from North Carolina to Delaware. In *Coltec*, we held that “the transaction to be analyzed [under the economic substance doctrine] is the one that gave rise to the alleged tax benefit.” *Coltec*, 454 F.3d at 1356. At issue in this case is BB & T’s claimed foreign tax credit, which did not arise from BB & T’s domestic relocation of assets. Therefore, BB & T’s asserted business purpose regarding its state tax savings fails because it “focuses on the wrong transaction.” *Id.* at 1358.

cases “allow the Commissioner to disregard transactions that are designed to manipulate the Tax Code so as to create artificial tax deductions”).

We recognize that most of the “business purpose” cases have dealt with transactions created solely to generate U.S. tax benefits. The STARS Trust is unusual in that it was structured to generate both U.S. and U.K. tax benefits, which were then allocated between the two participating entities. That fact, however, does not change our conclusion regarding the absence of any business purpose underlying the Trust transaction.

Allowing credits for taxes paid to other sovereigns “is a privilege and a matter of Congressional grace.” *Federated Mut. Implement & Hardware Ins. Co. v. Comm’r*, 266 F.2d 66, 70 (8th Cir.1959); *see also Chrysler Corp. v. Comm’r*, 436 F.3d 644, 654 (6th Cir.2006). Thus, the ultimate question is “whether what was done, apart from the tax motive, was the thing which the statute intended.” *Gregory v. Helvering*, 293 U.S. 465, 469, 55 S.Ct. 266, 79 L.Ed. 596 (1935); *Coltec*, 454 F.3d at 1355-56. The enactment of the foreign tax credit statute “indicates appreciation of the practical exigencies which lead to the foreign incorporation of subsidiaries for the extension by domestic corporations of their business abroad.” *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 9, 52 S.Ct. 275, 76 L.Ed. 587 (1932).

The foreign tax credit system aims to achieve “capital export neutrality,” thereby removing a possible disincentive to engage in foreign trades because of the burden of double taxation. *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.”); Richard E. Andersen, *Foreign Tax Credits* 1-2, 5 (1996); *Hart v. United States*, 585 F.2d 1025, 1029

(Ct.Cl.1978) (“The purpose of allowing the credit was to avoid the inequity of double taxation of foreign source income.”). In other words, the foreign tax credit was intended to remove the effect of foreign taxation from an investor’s decisionmaking process and to facilitate purely economic decisions regarding business opportunities overseas. *See* Elisabeth A. Owens, *The Foreign Tax Credit* 3 (1961) (“[T]he result of the operation of the [foreign tax] credit is that United States corporations . . . with the same amount of income bear an equal total tax burden on income whether or not they are subjected to foreign income taxation.”); Andersen, *supra*, at 1-2. An elaborate scheme set up solely to take advantage of a foreign tax system and involving no “economically-based business transactions” is not the type of transaction Congress intended to promote with the foreign tax credit system. *See Northern Indiana*, 115 F.3d at 512.

Although BB & T received income in the form of the Bx payment, the transaction that generated that income involved no genuine business activities, and the transaction that produced the Bx payment would not have been engaged in but for the system of taxes imposed by the U.S. and U.K. governments. *See Northern Indiana*, 115 F.3d at 512. Congress could not have intended to allow a taxpayer to claim a foreign tax credit, at the expense of U.S. tax revenue, for a transaction involving no commerce or bona fide business abroad and having no purpose other than to obtain foreign and domestic tax benefits. *See Goldstein v. Comm’r*, 364 F.2d 734, 742 (2d Cir.1966) (“[T]o allow a deduction for interest paid on funds borrowed for no purposive reason, other than the securing of a deduction from income, would frustrate [the legislative] purpose . . . [and] would encourage transactions that have no economic utility but for the system of taxes imposed by Congress.”)

(citing *Knetsch v. United States*, 364 U.S. 361, 367, 81 S.Ct. 132, 5 L.Ed.2d 128 (1960)).

We therefore sustain the trial court's finding that the STARS Trust lacked a bona fide business purpose. The tax consequences of the STARS Trust accordingly must be disregarded.⁹ See *Stobie Creek*, 608 F.3d at 1375.

E

BB & T further alleges that the trial court committed legal error by questioning the U.K. government's imposition of taxes on the Trust. Specifically, BB & T argues that the "act of state" doctrine bars the trial court from reconsidering the U.K.'s imposition and collection of income taxes from the Trust, and that such reconsideration conflicts with the express allocation of tax jurisdiction in the U.S.-U.K. Tax Treaty, 2224 U.N.T.S. 247 (July 24, 2001).¹⁰ We do not read the trial court's determination of the economic substance of STARS to depend in any way on a repudiation of the U.K.'s authority to impose taxes on the Trust. Nor do we base our decision on such a determination. We therefore do not find BB & T's argument as to the Treaty or the act of state doctrine to be persuasive.

⁹ BB & T also argues that if the Bx payment were to be treated as an "in-substance" tax rebate, BB & T should be allowed to claim forty-nine percent of the foreign tax credits because the Bx payment rebated only \$51 of every \$100 of U.K. taxes paid on the Trust. Because we disagree that the Bx payment should be deemed as a tax rebate, we need not address that argument.

¹⁰ The act of state doctrine "requires that, in the process of deciding, the acts of foreign sovereigns taken within their own jurisdictions shall be deemed valid." *Voda v. Cordis Corp.*, 476 F.3d 887, 904 (Fed.Cir.2007).

Aside from the foreign tax credits arising from the STARS Trust, BB & T also seeks to recover deductions for the interest it paid on the \$1.5 billion STARS Loan. The trial court disallowed the interest deductions, holding that the Loan, like the Trust, lacked economic substance. The court based its decision primarily on two grounds. First, it emphasized that, putting aside the Bx payment, the cost of borrowing for the STARS Loan was “significantly higher than rates on comparable sources of available funds.” 112 Fed.Cl. at 587. The court thus concluded that the STARS Loan was not the sort of financing transaction a large commercial bank such as BB & T would normally engage in. Second, the court found that the Loan had no non-tax business purpose, but “simply was a method by which to camouflage Barclays’ rebate of a portion of BB & T’s UK payments, through [the Bx] payment.” We reach a different conclusion regarding the economic substance of the STARS Loan transaction.

Section 163(a) of the Internal Revenue Code, 26 U.S.C. § 163(a), permits the deduction of “all interest paid or accrued within the taxable year on indebtedness.” The statute speaks in broad terms. *See Coors v. United States*, 572 F.2d 826, 831 (Ct.Cl.1978); *Goldstein*, 364 F.2d at 741. It “does not contain any general requirement that interest payments, to be deductible, be ordinary, necessary, reasonable or for a business purpose.” *Coors*, 572 F.2d at 831. Nevertheless, “[i]f a transaction underscoring interest payment is considered to be a sham . . . said payments are not allowed as interest deductions.” *Id.* at 832.

Our predecessor court noted that cases dealing with interest deductions generated by loan transactions that are challenged as having no prospect for economic

gain lack uniformity. *See Rothschild*, 407 F.2d at 408. However, the court explained that the “common denominator to be found in those cases denying the interest deduction is the conclusion that the loan transaction could not appreciably affect the tax payer’s beneficial interest except to reduce the taxpayer’s federal income tax.” Coors, 572 F.2d at 837; *see also Lee v. Comm’r*, 155 F.3d 584, 586 (2d Cir.1998) (“Interest payments are not deductible if they arise from transactions that can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences.”) (internal quotation and citation omitted); *see also Knetsch*, 364 U.S. at 366, 81 S.Ct. 132 (disallowing tax deductions when “it is patent that there was nothing of substance to be realized by [the taxpayer] from this transaction beyond a tax deduction”).

The government contends that the STARS Loan lacked economic reality because, absent the Bx payment, BB & T had effectively borrowed the Loan funds at an interest rate that was more than 30 basis points higher than the rates on comparable sources of funding available to BB & T. The government thus asserts that the STARS Loan provided no economic benefit to BB & T (other than tax benefits) because the proceeds of a loan from another source would have yielded the same return at a lower cost.

The government relies on *Kerman v. Commissioner*, 713 F.3d 849 (6th Cir.2013), for the proposition that a loan transaction is “economically unreasonable” if alternative, lower-interest funding sources were available to the taxpayer. We do not interpret *Kerman* as standing for that broad proposition or as being otherwise helpful to the government’s argument in this case.

While the Sixth Circuit scrutinized the “absurdly high interest rate” of the loan transaction in *Kerman* (7000 basis points above market rate), it did not find the transaction to be a sham based solely on the interest rate. Rather, the court examined the cost and returns of the loan transaction and found that, but for the claimed tax benefits, the transaction would have resulted in a sure loss. *See* 713 F.3d at 865 (“[R]egardless of what investment *Kerman* planned to use the loan proceeds for (if any), financing with [the loan] transaction did not provide him with a reasonable possibility of profit.”). The *Kerman* court thus did not hold that a higher-than-market-rate interest or the availability of alternative, lower-interest funding alone established that the underlying loan transaction was a sham; rather, it engaged in the same inquiry that the *Rothschild* court did, asking whether there was something of substance to be realized by the taxpayer from the loan transaction, other than tax deductions.

We also do not find the Second Circuit’s decisions in *Lee v. Commissioner* and *Goldstein v. Commissioner* to be helpful to the government. In both of those cases, the Second Circuit found that interest on the debts in question was not deductible because in each case the underlying transaction giving rise to the debt was “devoid of economic substance,” and had “no prospect of realizing anything of substance other than tax benefits.” *Lee*, 155 F.3d at 586, 587; *see also Goldstein*, 364 F.2d at 740 (deduction for interest paid not available for transactions “that can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences”).

In this case, the trial court found that there was no economic substance to the STARS Loan, because it was only a means to “camouflage” Barclays’ rebate of a portion of BB & T’s U.K. tax payments. Incorporating a loan component into STARS to give the entire transaction the appearance of “low cost financing” no doubt was one intended purpose of the Loan. However, unlike the sort of “contrived, ingenious, and complex” loan arrangement contemplated in *Coors*, “whose only ultimate and/or realistic purpose was to secure intended tax deduction benefits,” *Coors*, 572 F.2d at 839, the structure of the STARS Loan appears straightforward. Moreover, unlike the transactions in *Lee* and *Goldstein*, there is no evidence that BB & T designed the Loan solely to claim the interest deductions. Despite the Loan’s higher-than-market interest rate, it has not been shown that the transaction would result in an economic loss “regardless of what investment [BB & T] planned to use the loan proceeds for.” *See Kerman*, 713 F.3d at 865.

While it may be true that the Loan operated partly to camouflage the Bx payment, it also resulted in a substantive change in BB & T’s economic position. As a result of the Loan transaction, BB & T obtained unrestricted access to \$1.5 billion in loan proceeds. An impact of that sort cannot be said to have resulted in no change in the economic benefits enjoyed by the taxpayer. *See Coltec*, 454 F.3d at 1355 (“[T]ransactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration.”); *Kerman*, 713 F.3d at 865 (noting that the taxpayer did not have unfettered access to all the loan proceeds under the sham transaction).

Obtaining financing of that magnitude, in and of itself, would “appreciably affect” the beneficial interest of a commercial bank such as BB & T. *See ACM P’ship*, 157 F.3d at 261-62 (allowing deduction of economic losses that were “separate and distinct from the \$87 million tax loss that did not correspond to any actual economic loss”); *Lee*, 155 F.3d at 586 (reciting the “undoubted proposition that interest on loans incurred to support an economically substantive investment is not disqualified as a deduction merely because the borrower is also motivated by favorable tax consequences”); *Rice’s Toyota World*, 752 F.2d at 95-96 (“[I]t does not follow that the sham nature of the underlying transaction supports the Tax Court’s conclusion that the recourse note debt was not genuine. . . . [A] sham transaction may contain elements whose form reflects economic substance and whose normal tax consequences may not therefore be disregarded.”); *Coors*, 572 F.2d at 835 (“Since plaintiffs received insurance coverage of this magnitude during the years in issue, it is hard to accept defendant’s repeated assertion that plaintiffs during those years received nothing of substance from the various policy advances or loans except a purported interest deduction.”).

The evidence shows that after the failure of the original STARS transaction, which lacked a loan component, Barclays added a financing vehicle (the Loan) to the transaction in order to attract banks. Thus, entirely apart from the anticipated tax consequences, the STARS Loan had real economic utility to BB & T.

In the *Bank of New York Mellon Corp.* case, which involved a similar STARS trust and loan transaction, the Tax Court in its initial opinion did not separately address the question whether the interest on the loan component of the transaction was deductible. *Bank of*

N.Y. Mellon Corp., 140 T.C. at 15. On reconsideration, however, the court held that the interest on the loan was deductible. *Bank of N.Y. Mellon Corp. v. Comm’r*, 106 T.C.M. (CCH) 367 (2013). The court based its ruling in that case on the same factors that are present here: (1) the loan was not necessary for the STARS structure to produce the disallowed foreign tax credits; (2) the loan proceeds were not used to finance, secure, or carry out the STARS structure; and (3) the loan served a purpose beyond the creation of tax benefits. Even though the interest rate on the loan was above the market rate, the court held that interest is deductible under section 163(a) if it accrues “on a real loan that is used for economically substantive activity . . . even if the borrower is also motivated by favorable tax consequences.” *Id.* at 370. Even though the loan was overpriced, the court held that the interest was deductible because “the loan proceeds were available for use in petitioner’s banking business.” *Id.*

We agree with the Tax Court’s analysis of the loan component of the STARS transaction. It was therefore error for the trial court to conclude that the STARS Loan had no economic substance and functioned only to camouflage the Bx payment. As in the *Bank of New York Mellon Corp.* case, the STARS Loan in this case functioned to provide financing to BB & T, which is a legitimate business purpose. Accordingly, we hold that the Loan portion of the transaction satisfies the economic substance test and that BB & T is entitled to claim interest deductions for the interest it paid on the Loan.

IV

The final issue on appeal is whether the trial court properly upheld the accuracy-related penalties imposed on BB & T. Section 6662(a) of the Internal Revenue Code provides that “[m]andatory, accuracy-related penalties

apply to certain underpayments of tax that meet the statutory requirements.” 26 U.S.C. § 6662(a); *Stobie Creek*, 608 F.3d at 1381. Section 6664(c) of the Code recognizes “a narrow defense” to section 6662 penalties, provided that the taxpayer can prove that it (1) had reasonable cause for the underpayment and (2) acted in good faith. 26 U.S.C. § 6664(c); *Stobie Creek*, 608 F.3d at 1381. Whether a taxpayer had reasonable cause is a question of fact reviewed for clear error. 608 F.3d at 1381. The most important factor in determining reasonable cause is “the extent of the taxpayer’s effort to assess the taxpayer’s proper tax liability,” judged in light of the taxpayer’s “experience, knowledge, and education.” *Id.*

BB & T asserts that it had reasonable cause for the underpayments because it reasonably relied on the favorable tax opinion from Sidley and received additional supportive advice from PwC.¹¹ For reliance on such advice to be reasonable for purposes of section 6664(c), the taxpayer must show (1) that the advice relied on was based on “all pertinent facts and circumstances and the law as it relates to those facts and circumstances”; (2) that the advice was not based on any “unreasonable factual or legal assumptions” and did not “unreasonably rely on the representations, statements, findings or agreements of the taxpayer or any other persons”; and (3) that the taxpayer’s reliance on the advice was “objectively reasonable.” *Stobie Creek*, 608 F.3d at 1381. Reliance is not reasonable if the advisor has “an inherent conflict of interest” about which the taxpayer knew or should have known; nor is it reasonable if the taxpayer knew or should have

¹¹ On appeal, BB & T no longer argues that it reasonably relied on the advice it received from KPMG, the principal marketer of STARS.

known that the transaction was “too good to be true.” *Id.* at 1381-82.

The trial court found that BB & T’s reliance on Sidley’s tax opinion was unreasonable because Sidley had an inherent conflict of interest of which BB & T knew or should have known. That finding is not clearly erroneous. The evidence shows that BB & T had selected Sidley on the recommendation of KPMG, the principal marketer of STARS. Sidley was the tax advisor in a prior STARS transaction, also marketed by KPMG. A BB & T witness testified at trial that both KPMG and Sidley, BB & T’s two principal advisors, were involved in “put[ting] [the STARS transaction] together.” In a 2001 internal memorandum regarding Sidley’s compensation package, Mr. Raymond J. Ruble—BB & T’s initial tax advisor at Sidley—stated that “I intend to continue to exploit ties with KPMG . . . in connection with the development of structured tax products.” In light of that evidence, the trial court did not clearly err in finding that Sidley and KPMG had a significant interest in convincing BB & T to engage in the STARS transaction and that their interest in marketing the STARS transaction rendered their advice suspect.

The evidence also supports the conclusion that BB & T knew or should have known of Sidley’s conflict of interest. Sidley was recommended to BB & T by KPMG, the principal marketer of STARS. At the time of the recommendation, BB & T knew that Sidley had prepared a favorable tax opinion for a prior STARS transaction. Despite that knowledge, BB & T’s witness stated that BB & T was expecting an independent opinion from Sidley because the facts and circumstances surrounding the STARS transaction offered to BB & T were different from the previous version of STARS.

Yet even before BB & T formally engaged Sidley, Mr. Ruble sent BB & T a redacted copy of a tax opinion prepared for another client, which endorsed the STARS transaction. That circumstance alone should have raised a red flag that Sidley was not a truly “independent” advisor, because it was willing to endorse a transaction before it even started exploring the specific circumstances of the transaction for the client. The trial court reasonably concluded from that evidence that Sidley had an inherent conflict of interest about which BB & T knew or should have known. The trial court therefore did not clearly err in finding that BB & T’s reliance on Sidley’s opinion was unreasonable.

BB & T also relies on PwC’s participation in the transaction to support the reasonableness of its belief in the validity of its tax position. The trial court, however, found that PwC’s participation did not give BB & T a reasonable basis for believing that its tax position was sound, because PwC provided no tax opinion to BB & T. That finding is not clearly erroneous. BB & T reported only Barclays, KPMG, and Sidley as its tax advisors on the STARS transaction. It instructed PwC, its auditing firm, to focus solely on the STARS tax reserve issue and not to explore whether STARS complied with the Internal Revenue Code. PwC also explicitly informed BB & T that it “in no way [was] providing an Opinion” regarding STARS. Thus, PwC’s advice to BB & T was not a tax opinion that a reasonable taxpayer would have relied on in assessing the validity of the transaction for tax purposes.

Moreover, PwC ultimately arrived at a “less than should” level of comfort that the IRS would accept the STARS transaction. Despite the qualified nature of PwC’s advice, BB & T went ahead with the transaction. BB & T cannot now claim that PwC’s “less than

should” advice provided a reasonable basis for engaging in the STARS transaction. Therefore, the trial court did not clearly err in concluding that PwC’s involvement in the STARS transaction did not provide a reasonable cause for BB & T’s understatements.

BB & T’s reliance on its advisors’ opinions was unreasonable for the additional reason that it should have known that the STARS transaction was “too good to be true.” *Stobie Creek*, 608 F.3d at 1383. BB & T’s executives who had reviewed the STARS transaction were highly educated and well-versed in banking and financing transactions. The evidence shows that during the early stages of the discussions between BB & T and Barclays, BB & T’s executives were extremely skeptical of the tax benefits of the STARS transaction in light of the potential downside tax risks. The trial court found that, based on its executives’ education and experience, BB & T knew or should have known that claiming nearly \$500 million in foreign tax credits by subjecting income to economically meaningless activities was “too good to be true.” That finding is not clearly erroneous.

Finally, BB & T cites the district court opinion in *TIFD III-E Inc. v. United States*, 8 F.Supp.3d 142 (D.Conn.2014), for the proposition that when an area of law is uncertain, a taxpayer cannot be penalized for taking a position that could have been a reasonable interpretation of the law. In *TIFD*, the taxpayer had initially won the case before the district court. The Second Circuit reversed but, as the district characterized the circuit court’s opinion, “openly acknowledged that the case was not a slamdunk for the government, because the relevant statute and regulations are ambiguous and subject to multiple interpretations.” *TIFD*, 8 F.Supp.3d at 150. On remand for an assessment of

penalties, the district court found that the taxpayer had a “reasonable basis” for the tax position that the court itself had initially upheld.

The court in *TIFD* held that the taxpayer’s position was reasonable because the Second Circuit had explicitly acknowledged that the relevant statute and regulations bearing on the tax issue in that case were ambiguous. We do not regard the application of the economic substance doctrine to this case to present any ambiguity. Accordingly, we are not persuaded that BB & T’s position regarding the appropriate tax treatment of the STARS transaction was reasonable. In any event, the district court in *TIFD* was not construing the “reasonable cause” and “good faith” exception of section 6664(c), but instead the “reasonable basis” provision of section 6662(d)(2)(B)(ii) which, as the court explained, is more easily satisfied. *See* 8 F.Supp.3d at 151.

We conclude that the trial court did not err in imposing accuracy-related penalties on BB & T. The amount of the penalties, however, requires reassessment, as we have found that BB & T is entitled to claim interest deductions for the interest it paid on the STARS Loan. In light of our decision regarding the interest deductions, there may be other necessary adjustments in the judgment as well, which we leave to the trial court on remand.

Each party shall bear its own costs for this appeal.

AFFIRMED IN PART, REVERSED IN PART, AND REMANDED.

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APPENDIX B

119 Fed.Cl. 84

UNITED STATES COURT OF FEDERAL CLAIMS

No. 10-192T

SALEM FINANCIAL, INC.,

Plaintiff,

v.

UNITED STATES,

Defendant.

Filed: January 7, 2014

Attorneys and Law Firms

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Dennis M. Donohue, with whom were John L. Schoenecker, Raagnee Beri, Kari M. Larson, and William E. Farrior, Trial Attorneys, and Alan S. Kline, Special Attorney, Tax Division, U.S. Department of Justice, Washington, D.C., for Defendant.

Tax Refund Suit; STARS Structured Transaction
Between BB & T Bank and Barclays Bank; Rule 59(e)
Motion to Alter or Amend the Court's Judgment

OPINION AND ORDER ON PLAINTIFF'S
MOTION TO ALTER OR AMEND JUDGMENT

WHEELER, Judge.

On September 20, 2013, the Court issued its post-trial Opinion and Order denying Plaintiff's claim for a tax refund, holding that BB & T Bank¹ was not entitled to foreign tax credits, interest expense deductions, or transaction cost deductions claimed in connection with its participation in a financial transaction known as STARS ("Structured Trust Advantaged Repackaged Securities"). On November 5, 2013, BB & T filed a motion under RCFC 59(e) to alter or amend the Court's judgment with respect to the Court's decision that BB & T is not entitled to claim \$74,551,947.40 in deductions for interest expenses on the STARS loan. This motion has been fully briefed and is ready for decision. A detailed factual history of this case can be found in the Court's previous opinion. *See Salem Fin., Inc. v. United States*, 112 Fed.Cl. 543 (2013). The Court will provide a brief overview of the factual findings relevant to BB & T's motion to alter or amend the judgment.

Background

The BB & T STARS transaction was in effect for nearly five years, from August 1, 2002 through April

¹ The named Plaintiff, Salem Financial, Inc., is a subsidiary of BB & T Corporation and a bank chartered under the laws of North Carolina.

5, 2007. Barclays Bank and KPMG developed STARS to generate tax benefits to be shared among the transaction's participants. The transaction consisted generally of a trust ("Trust") and a loan ("Loan").

In the BB & T STARS transaction, BB & T established the Trust which contained approximately \$6 billion in revenue-producing assets. *Id.* at 549. The administrator of the Trust was based in the United Kingdom, so the monthly revenue from the Trust assets was taxable in the U.K. rather than in the U.S. Barclays received the proceeds from the Trust and contributed the amount back to the Trust in a circular flow of funds. The subsequent transfer of revenues out of the U.K. generated U.K. tax credits, which were split between BB & T and Barclays. In an effort to give the transaction the appearance of having a legitimate business purpose, the STARS transaction included a \$1.5 billion Loan from Barclays to a BB & T subsidiary. On a monthly basis, Barclays made a payment to BB & T representing BB & T's share of the tax credits. This was known as the "Bx payment" and had the effect of reducing the interest cost of BB & T's loan. *Id.*

In the opinion denying BB & T's claim for a tax refund, the Court analyzed the STARS transaction according to the economic substance doctrine, which prevents the recognition of tax benefits from abusive tax shelters. *Id.* at 583. Under the economic substance doctrine, a taxpayer bears the burden of demonstrating that a given transaction carries both (1) the objective possibility of realizing a pre-tax profit (objective economic substance), and (2) a non-tax business purpose (subjective economic substance). *Wells Fargo & Co. v. United States*, 91 Fed.Cl. 35 (2010), *aff'd*, 641 F.3d 1319 (Fed.Cir.2011).

The pre-tax profit prong of the economic substance test requires an objective analysis of whether a prudent investor had a reasonable possibility of making a profit from the transaction apart from tax considerations. *Stobie Creek Investments LLC v. United States*, 608 F.3d 1366, 1376-77 (Fed.Cir.2010). Applying this standard, the Court found that no prudent investor would view the Loan transaction as having a reasonable possibility of making a pre-tax profit. *Salem*, 112 Fed.Cl. at 587. The Bx payment cannot be considered pre-tax profit on the Loan because it was generated by the circular cash flows designed for tax purposes and thus is purely a tax effect of the transaction. Excluding the Bx payment, the cost of borrowing on the STARS Loan was LIBOR + 25 basis points. This rate was significantly higher than rates on comparable sources of funds available to BB & T. The Court found that no reasonable commercial banks would engage in such a transaction when it had less expensive and less complex funding sources available. *Id.*

The non-tax business purpose prong of the economic substance test focuses on whether the taxpayer's sole subjective motivation is tax avoidance. The Court found that the Loan lacked any non-tax business purpose and served only to camouflage the true nature of the tax avoidance scheme. *Id.* Furthermore, the Court found that the Loan and Trust were artificially linked to enable BB & T to deduct U.S. tax benefits generated by the Trust structure from the cost of the Loan, thereby making the Loan appear to be low-cost funding. Whether viewed separately or together as one integrated STARS transaction, the Court found that the entire transaction must be disregarded for lack of economic substance. *Id.* at 585-89.

Analysis

A. Standard of Review

Under RCFC 59, the Court may reconsider and alter or amend its judgment if the movant can show (1) that there has been an intervening change in controlling law, (2) that previously unavailable evidence is now available, or (3) that the motion is necessary to prevent manifest injustice. *See Dairyland Power Co-op v. United States*, 106 Fed.Cl. 102 (2012); *Henderson Cnty. Drainage Distr. v. United States*, 55 Fed.Cl. 334, 337 (2003).

Granting reconsideration or amendment under Rule 59 “requires ‘a showing of extraordinary circumstances.’” *Shapiro v. Sec’y. of Health and Human Servs.*, 105 Fed.Cl. 353, 361 (2012) (collecting cases). A motion for reconsideration is not intended to give an “unhappy litigant an additional chance to sway” the court. *Matthews v. United States*, 73 Fed.Cl. 524, 526 (2006). Nor may a party prevail on a motion for reconsideration by raising an issue for the first time on reconsideration when the issue was available to be litigated at the time the complaint was filed. *Id.*

B. BB & T Fails to Meet the Standard Required for Reconsideration.

BB & T’s motion for reconsideration fails to meet the standard required for an RCFC 59(e) motion to alter or amend the Court’s judgment. Rather than pointing to a manifest error in law or fact, BB & T argues that the Court should reconsider its decision in light of a recent decision by the United States Tax Court involving a different STARS transaction. In *Bank of New York Mellon Corp. v. Commissioner*, the Tax Court granted a motion for reconsideration and issued a supplemental opinion allowing the Bank of New

York to deduct interest on its STARS loan. T.C. Memo. 2013-225 (Sep. 23, 2013) (“*Bank of New York*”). The Tax Court reasoned that, as a corollary of its determination that the STARS loan was independent from the STARS trust, it was required to evaluate the loan separately. Upon such evaluation, the Tax Court determined that Bank of New York was entitled to interest deductions because the loan was a bona fide loan available for use in its banking business notwithstanding the fact that the loan may have been relatively expensive. *Id.* at *2. The Tax Court concluded that interest on a loan used for economically substantive activity is deductible even if the remainder of the transaction was found to lack economic substance.

The Tax Court’s decision is not controlling authority in this Court. *See Otis Elevator Co. v. United States*, 618 F.2d 712, 719 (Ct.Cl.1980) (finding that Tax Court decisions are not controlling law in the Court of Federal Claims). At best, this decision provides persuasive authority. However, what little persuasive value the decision might have is undermined by the fact that the Court has already considered and rejected the arguments advanced in BB & T’s motion. A motion for reconsideration is not an opportunity for the losing party to retread old arguments from earlier briefs as BB & T attempts to do here. In its RCFC 59(e) motion, BB & T argues that it paid interest on a bona fide loan, the proceeds of which were available for it to use in its banking business. Similarly, in its post-trial briefing, BB & T argued that the Court should find that the Loan had a non-tax purpose and non-tax effects such that the Court should allow BB & T to deduct interest payments made on the Loan. *See BB & T Post-Trial Br.*, Dkt. No. 210 at 242-46. The Court rejected the argument in BB & T’s post-trial brief and

found that the STARS Loan lacked economic substance because it was devised solely to provide BB & T with a pretext for engaging in a sham transaction. *Salem*, 112 Fed.Cl. at 587. The Tax Court's decision in *Bank of New York* provides no basis for the Court to revisit arguments that have been litigated, considered by the Court, and rejected.

BB & T raises one new matter that differs from its post-trial brief when it argues that the Loan was commercially viable on its own because it did not assist as a technical matter in the claim for foreign tax credits. As described below, the Court rejects the argument that the Loan was commercially viable on its own. However, even if this was not the case, the Court would not consider this argument. A motion for reconsideration may not be used to raise an issue that was available to be litigated at the time the complaint was filed, and this argument was available to BB & T when it filed its post-trial brief. Thus, BB & T has failed to meet the standard for reconsideration and its motion is denied.

C. The Tax Court's Supplemental Opinion is Not Persuasive due to Differences in its Factual Findings.

Even if BB & T had met the standard required for reconsideration, the Tax Court's supplemental opinion carries little weight because the Tax Court's findings of fact differ from the Court's findings. In its motion for reconsideration, BB & T suggests that the Tax Court's findings in *Bank of New York* and this case are identical. However, the findings of fact in the two cases differ in key respects that lead the Tax Court and this Court to reach different conclusions regarding whether interest expenses on the STARS loan are deductible.

In its supplemental decision, the Tax Court relied upon two findings of fact from its original opinion: (i) the STARS loan was independent from the trust and (ii) the Bank of New York was free to use the loan proceeds in its banking business. *Bank of New York*, T.C. Memo. 2013-225, at. These findings are incongruent with the Court’s findings in the present case.

First, the Tax Court concluded that the STARS loan was independent from the trust because the loan was “separate and distinct” from the remainder of the STARS transaction and was not used to “finance, secure or carry out the STARS structure.” *Id.* Here, the Court found (and BB & T previously argued) that the Loan was necessary to the remainder of the STARS transaction. Technically, the Loan and Trust were two discrete components, but the Court found that the Loan component was essential to “carry out” the STARS structure and was necessary to successfully market the STARS transaction to U.S. companies such as BB & T. Indeed, the Court found that BB & T only entered into the Loan because of the need to hide that the Trust structure was a sham. *Salem*, 112 Fed.Cl. at 587. Unlike the Tax Court’s findings in *Bank of New York*, the Court found that the Loan was necessary to the remainder of the STARS transaction and therefore the Loan was not separate and distinct from the remainder of the transaction.²

² As the Court has pointed out, the terms of the BB & T Loan lacked economic reality in the business world. Without the tax benefits of the sham Trust, no astute business person would have ever considered a Loan where the *lender* makes significant payments to the *borrower* for 35 months after the Loan took effect. These terms were made possible solely because of the sham Trust. *See Salem*, 112 Fed.Cl. at 580.

Second, the Tax Court found that proceeds from the STARS loan were available for use in the Bank of New York's banking business. This finding led the Tax Court to conclude that the loan had economic substance because there was a non-tax business purpose to the loan. Here, the Court excluded BB & T's alleged profits from the loan proceeds because such profits are irrelevant for purposes of the economic substance analysis. *Id.* at 588. Furthermore, BB & T was required to establish that it objectively anticipated a profit from the transaction apart from the tax benefits, but BB & T produced no evidence that it anticipated profit from the loan proceeds when deciding whether to engage in STARS. *Id.* Thus, the Court found that BB & T did not enter into the Loan because of a reasonable possibility of making a profit. Rather, BB & T entered into the Loan to disguise Barclay's rebate of a portion of BB & T's U.K. tax payments through payment of the Bx. Under the Court's factual findings, the Loan fails the economic substance test and BB & T is not entitled to deduct interest payments.

Conclusion

For the reasons set forth above, Plaintiff's motion to alter or amend the judgment is DENIED.

IT IS SO ORDERED.

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APPENDIX C

112 Fed.Cl. 543

UNITED STATES COURT OF FEDERAL CLAIMS

No. 10-192T

SALEM FINANCIAL, INC.,

Plaintiff,

v.

UNITED STATES,

Defendant.

Filed: September 20, 2013

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Tax Refund Suit; STARS Structured Transaction
Between BB & T Bank and Barclays Bank;
Availability of Foreign Tax Credits From
Payment of United Kingdom Taxes; Deductions for
Interest and Transaction Costs; Economic Substance
Doctrine Applied to Trust and Loan Components of
Transaction; Assessment of Penalties

OPINION AND ORDER

WHEELER, Judge.

In this tax refund case, the Court must determine the proper tax treatment for an unusually complex financial transaction known as STARS (“Structured Trust Advantaged Repackaged Securities”). Plaintiff, Salem Financial, Inc. (“Salem”), is a subsidiary of BB & T Corporation, a bank chartered under the laws of North Carolina. Although many entities were involved in the STARS transaction, the real parties in interest were BB & T Bank and Barclays Bank PLC, which is headquartered in the United Kingdom (“U.K.”). The other entities were created or became involved to serve some special purpose for the transaction.

The BB & T STARS transaction was in effect for nearly five years, from August 1, 2002 through April 5, 2007. The purpose of the STARS transaction was to generate large-scale foreign tax credits for a U.S. taxpayer, which could be used to enhance revenue and reduce taxes in the United States. The amount at issue in this case, including the potential assessment of taxpayer penalties, is \$772,144,153.45. This amount is comprised of the following: disallowed foreign tax credits (\$498,161,951); disallowed interest deductions (\$74,551,947.40); the tax paid on “Bx” payments from

Barclays to BB & T (\$84,033,228.20); disallowed transaction cost deductions (\$2,630,125.05); and penalties (\$112,766,901.80).

The complexities of the STARS transaction, including the concept of a Bx payment, will become apparent below. Stripped to its essence, however, STARS called for the U.S. taxpayer, in this case BB & T, to establish a trust containing approximately \$6 billion in revenue-producing bank assets. The monthly revenue from the trust was then cycled through a U.K. trustee, an act that served as a basis for U.K. taxation. Although the revenue was immediately returned to BB & T's trust, the assessment of U.K. taxes generated U.K. tax credits that were shared 50/50 between Barclays and BB & T. A \$1.5 billion loan from Barclays to BB & T also was part of the structured transaction, although the loan was not necessary to the objective of generating foreign tax credits. The Barclays monthly Bx payment to BB & T represented BB & T's share of the tax credits, and had the effect of reducing the interest cost of BB & T's loan. The main question presented is whether the STARS transaction had any purpose other than to generate tax savings, and if not, whether penalties should be assessed against BB & T.¹

The parties provided a STARS tax tutorial presentation to the Court on February 13, 2013 before the trial began. The Court held 21 days of trial in Washington, D.C. from March 4 through April 2, 2013. During the trial, the Court heard the testimony of 26 witnesses, of

¹ The acronym "STARS" is not particularly descriptive of the transaction at issue. There is no indication of a loan in the acronym and there are no "repackaged securities" in the transaction. The evidence suggests that the concept of STARS began as something different, and only grew to include a loan when marketed to banks in the United States.

which thirteen were experts. The Court admitted deposition excerpts for eleven additional witnesses, principally from those persons who reside outside the United States or where the parties agreed that a deposition could substitute for relatively brief testimony. The Court received in evidence approximately 1,250 exhibits during the trial. The parties submitted post-trial findings of fact and memoranda of law on June 7, 2013, and post-trial reply briefs on July 3, 2013. The Court heard closing arguments on July 30, 2013.

There are different ways of looking at the BB & T STARS transaction, and the Court has wrestled with the question of how best to analyze its various components. The STARS trust component, where BB & T revenue momentarily is cycled through a U.K. trustee to create U.K. taxes and foreign tax credits, and then is returned to BB & T, quite clearly is an abusive tax avoidance scheme. The trust creates a series of instantaneous circular cash flows starting and ending with BB & T where no economic activity has occurred abroad to justify the assessment of a U.K. tax. While inarguably sophisticated and creative, the trust purely and simply is a sham transaction accomplishing nothing more than a redirection of cash flows that should have gone to the U.S. Treasury, but instead are shared among BB & T, Barclays, and the U.K. Treasury. The Court finds that the trust component of STARS lacks economic substance.

However, the Court must consider whether the existence of Barclays' \$1.5 billion loan to BB & T at favorable interest rates somehow provides the necessary economic substance to salvage the STARS transaction. In analyzing this question, the Court notes that the loan interest rate actually is higher

than normal for BB & T until the Barclays' rebate of U.K. taxes through the Bx payment comes into play. The Barclays' Bx payment each month from the sham trust transaction creates the unusually attractive interest rates. Without the Bx payments, the Court is persuaded that BB & T would not have entered into the STARS transaction. The loan transaction thus is substantially influenced by the payments from the sham trust. The loan lacks economic reality where the interest rate is so low that for nearly the first three years of the transaction, Barclays, the lender, makes Bx payments to BB & T, the borrower, exceeding by millions the interest payments due from BB & T to Barclays. An arrangement where a *lender* makes payments to a *borrower* for the first three years of a loan surely would raise the eyebrows of even an experienced financier.

Regardless of whether the Court views the trust and the loan separately or together as one integrated STARS transaction, the Court concludes that the entire arrangement must be disregarded for lack of economic substance. Among the most telling evidence at trial was the revelation that the amount of the loan was unrelated to the amount of the Bx payments. That is, in the relevant formulas created for the STARS transaction, a change in the loan amount does not have any effect on the Bx payment amount. Thus, rather than being intricately linked together with the trust, the loan serves only to add a hoped-for business purpose to the tax avoidance scheme. The Court cannot find economic substance in a loan transaction that is so heavily driven by Bx payments from the sham trust.

For reasons that will be explained, the Court also finds that BB & T is liable for tax penalties for its

participation in the STARS transaction. The conduct of those persons from BB & T, Barclays, KPMG, and the Sidley Austin law firm who were involved in this and other transactions was nothing short of reprehensible. Perhaps the business environment at the time was “everyone else is doing it, why don’t we?” Perhaps some of those who participated simply were following direction from others. Nevertheless, the professionals involved should have known better than to follow the STARS path, rife with its conflicts of interest, questionable pro forma legal and accounting opinions, and a taxpayer with a seemingly insatiable appetite for tax avoidance. One of Defendant’s experts, Dr. Michael Cragg, aptly stated that “enormous ingenuity was focused on reducing U.S. tax revenues.” Cragg, Tr. 4687. After wading through the intricacies of the STARS transaction, the Court shares Dr. Cragg’s view that “[t]he human effort, the amount of creativity and overall effort that was put into this transaction . . . is a waste of human potential.” *Id.*

I. Findings of Fact²

A. Entities Involved in the BB & T STARS Transaction

There are five business entities that each played an important role in this STARS transaction: (1) BB & T, which established controlled subsidiaries to achieve certain transaction-related objectives; (2) Barclays PLC, which developed the concept of STARS and

² In this opinion, the Court will cite to the evidentiary record as follows: February 8, 2013 Joint Stipulations—Stip. ¶ __; Trial Testimony—Witness name, Tr. page; Joint Exhibits—JX __ at page; Plaintiff’s Exhibits—PX __ at page; Defendant’s Exhibits __ USX __ at page; Deposition Transcripts—Witness name, Dep. Tr. page; Demonstrative Exhibits—Demo. Ex. __.

served as a counterparty in the STARS structure; (3) KPMG LLP, an international accounting firm that assisted Barclays in marketing STARS in the United States, and provided tax opinions to BB & T and other U.S. banks who chose to participate; (4) Sidley Austin Brown & Wood LLP, a law firm which supplied tax opinions and legal services in connection with STARS; and (5) PricewaterhouseCoopers LLP (“PwC”), an international accounting firm that served as BB & T’s outside auditing firm beginning in 2002 and examined the STARS transaction at BB & T’s request. The Court will briefly describe the role of each of these entities below.

1. *BB & T*

Branch Banking & Trust Corporation (“BB & T”) is a financial holding company headquartered in Winston-Salem, North Carolina and incorporated in the State of North Carolina. Stip. ¶ 1. BB & T conducted business primarily through its banking subsidiaries, which during 2002 through 2007 included offices in North Carolina, South Carolina, Virginia, Maryland, Georgia, West Virginia, Tennessee, Kentucky, Alabama, Florida, and Washington, D.C. JX 209 at 358414. The largest subsidiary of BB & T is Branch Banking and Trust Company (“BB & T Bank”), a state bank chartered under North Carolina law. Stip. ¶ 3; JX 209 at 358414. BB & T is the oldest bank headquartered in North Carolina, having been chartered in 1872. BB & T Corporation has two other banking subsidiaries: (1) Branch Banking and Trust Company of South Carolina (“BB & T-SC”), headquartered in Greenville, South Carolina; and (2) Branch Banking and Trust Company of Virginia (“BB & T-VA”), headquartered in Richmond, Virginia. JX 209 at 358414.

As of December 31, 2002, BB & T Bank operated 335 branches, and was the second largest bank in North Carolina measured by deposit market share. *Id.* at 358415. BB & T-SC operated 94 branches and was the third largest bank in South Carolina measured by deposit market share. *Id.* BB & T-VA operated 241 branches, and was the fourth largest bank in Virginia measured by deposit market share. *Id.* BB & T Bank's principal subsidiaries include: BB & T Leasing Corp., based in Charlotte, North Carolina, which provides lease financing to commercial businesses; BB & T Investment Services, Inc., also located in Charlotte, which offers non-deposit investment services including annuities, mutual funds and discount brokerage services; BB & T Insurance Services, Inc., headquartered in Raleigh, North Carolina, a retail insurance broker offering property and casualty, life and other insurance products through 71 agencies in eight states; and Stanley, Hunt, DuPree & Rhine, Inc., headquartered in Greensboro, North Carolina and Greenville, South Carolina, which offers group medical plans, insurance and investment consulting, and actuarial services. *Id.*

From 1987 to 2002, BB & T acquired 56 community banks and thrifts, 60 insurance agencies, and 21 non-bank financial services providers. *Id.* at 358418. During 1995, BB & T merged with Southern National Corporation, and retained the BB & T corporate name for the merged entity. The transaction was described as a "merger of equals" because each entity had assets of approximately \$10 billion immediately prior to the merger. Through this combination, the assets of the merged entity doubled. Johnson, Tr. 59; Goodrich, Tr. 383-84.

As a financial holding company, BB & T is subject to regulation under the Bank Holding Company Act of 1956, as amended, and the examination and reporting requirements of the Board of Governors of the Federal Reserve Board. JX 209 at 358427. As state-chartered commercial banks, BB & T Bank, BB & T-SC and BB & T-VA are subject to regulation, supervision, and examination by state bank regulatory authorities in their respective home states. Stip. ¶¶ 3, 33. These authorities are the North Carolina Commissioner of Banks, the South Carolina Commissioner of Banking, and the Virginia State Corporation Commission's Bureau of Financial Institutions, respectively. Each of the state chartered banks also is subject to regulation, supervision, and examination by the Federal Deposit Insurance Corporation. JX 209 at 358427.

The following present or former BB & T officers and employees testified at trial: (1) John Allison, former Chief Executive Officer of BB & T Corporation; (2) John Watson, former Tax Director of BB & T Bank; (3) Donna Goodrich, former Deposits and Corporate Funding Manager of BB & T and current senior executive vice president and member of the executive management team; (4) Hal Johnson, former Corporate Finance Manager of BB & T; (5) Ronald Monger, former overseer of the BB & T Bank Tax Department and Manager of Shareholder Reporting; (6) Howard Hudson, in-house counsel at BB & T; (7) Ida Marie Hyder, Balance Sheet Risk Manager for BB & T; and (8) Katherine Coffield, accounting employee responsible for day-to-day operations relating to the STARS transaction.

2. Barclays

Barclays Capital is the investment banking division of Barclays Bank PLC. Abrahams Dep., 534-35. The Structured Capital Markets Group of Barclays Capital developed the STARS-type of structured transaction. The Structured Capital Markets Group (“SCM”) generally was responsible for executing complex structured transactions. *Id.* at 16, 535. SCM’s objectives were to identify and create value enhancements through accounting, legal, regulatory and tax opportunities, which in some cases involved exploiting differences between tax systems in different countries. Sultan, Dep. 10, 533.

Barclays Capital’s structured finance transactions required approval from the SCM Approvals Committee, and were subject to review by two separate credit committees based upon the dollar amount involved. Sultan, Dep. 135-36, 147-48; Abrahams, Dep. 19-20; PX 297 at 204218R. Barclays Capital operated the Barclays Capital Credit Committee (“BCCC”) and Barclays Group (consisting of Barclays entities and business units worldwide) operated its own Group Credit Committee (“GCC”), which had ultimate credit authority for Barclays transactions. Abrahams, Dep. 579. When a transaction exceeded a fixed size, it had to be submitted to the BCCC following approval by the SCM Approvals Committee. Sultan, Dep. 147-48. For still larger transactions, BCCC and GCC approvals were required. Sultan, Dep. 150-51, 158-59; Abrahams, Dep. 21. For complex or structured transactions, any submission to the GCC had to include an explanation of the transaction structure. Abrahams, Dep. 92. The BB & T STARS transaction required GCC approval and an extensive review. *Id.* 601-02.

Each year, Barclays Group engaged in a budgeting process under which the Group's total regulatory capital was allocated among its various business divisions, including Barclays Capital. *Id.* 32. Barclays Capital in turn allocated regulatory capital among its various business units, including SCM. *Id.* Each business division was assigned a revenue target and charged with the duty of managing its transactions and consumption of regulatory capital to produce an acceptable overall return. *Id.* 556. Barclays recently disbanded SCM amid reports that it was a "tax avoidance unit." Peacock, Tr. 2270-71. Former U.K. Chancellor of the Exchequer Nigel Lawson called SCM's business "industrial scale" tax avoidance. Monger, Tr. 1220-23.

The following Barclays personnel provided deposition testimony that the Court admitted into evidence:³ (1) Iain Abrahams, an employee of the Barclays SCM division responsible for managing risk of the structured transactions; (2) Sohail Sultan, a Barclays SCM division employee involved in the initial conceptualization of STARS and its development into a viable structure that could be promoted to North American banks as a tax-advantaged financial product; (3) Alkis Ioannidis, a Barclays SCM division employee who worked with Mr. Sultan on structured investments and finance; and (4) David Williams, a Barclays Group Tax Department employee, responsible for overseeing the compliance of Barclays Group with U.K. tax laws.

³ These witnesses were unavailable to testify at trial because they reside outside of the United States

3. KPMG

KPMG is an international accounting firm, providing accounting and tax services to its clients around the world. Beginning in 1999, KPMG partnered with Barclays to promote the STARS structure in the United States, and to explain the mechanics of STARS and its tax benefits to U.S. banks who might be interested in participating. Sultan Dep. 691-92; USX 69, 335. Washington National Tax (“WNT”) is an office of KPMG tax professionals in the United States who are organized based upon practice specialty such as corporate tax, partnership tax, and international tax, among others. Wilkerson, Tr. 1636. In 2002, the international tax group in WNT consisted of 30-35 tax professionals. *Id.* 1640-41. KPMG introduced the STARS transaction to BB & T at a January 17, 2002 meeting, using a slide show presentation to outline the various steps. Monger, Tr. 970; Watson, Tr. 3425; USX 343. Except for some limited audit work that KPMG performed on a BB & T mutual fund, BB & T was not a client of KPMG during 2002-2007. Monger, Tr. 1150.

Robert Wilkerson was the only KPMG witness who testified at trial. Mr. Wilkerson was a principal in the international tax group of the WNT office. David Brockway, the partner in charge of the WNT office, was heavily involved in the development of the STARS concept, and in drafting STARS tax opinions and promotion materials. At the time of trial, Mr. Brockway worked for Plaintiff’s law firm, Bingham McCutchen LLP, Wilkerson, Tr. 1865, but he did not testify.

4. Sidley Austin Brown & Wood

Sidley & Austin LLP was an international law firm that merged with Brown & Wood in 2001 to become Sidley Austin Brown & Wood LLP. Chapman Tr. 2976, 3177. At all relevant times before the merger, these two firms each maintained a tax department. *Id.* 2982. Raymond J. Ruble was a partner in Brown & Wood's tax department, and then with Sidley Austin after the merger. USX 85. By 2000, Mr. Ruble had built a significant tax practice based upon developing and promoting tax shelters, which he called "structured tax products." *Id.* He coordinated much of his work with KPMG, Ernst & Young, Arthur Andersen, and BDO Seidman. *Id.* Mr. Ruble also developed a relationship with Mr. Sultan of Barclays, with whom he worked to create and promote the STARS transaction. Sultan, Dep. 38, 532. At the suggestion of Barclays and KPMG, BB & T hired Sidley Austin, and specifically Mr. Ruble, to provide a tax opinion for the BB & T STARS transaction. Hudson, Tr. 1518-19, 1545-47; Chapman, Tr. 3062-63; JX 264; USX 436, 617. Mr. Ruble signed the May 7, 2002 engagement letter where BB & T retained Sidley Austin as legal counsel. JX 264. BB & T had not previously used Sidley Austin as its counsel. Hudson, Tr. 1549. BB & T received two Sidley Austin opinions for STARS. The first was a U.S. tax opinion authored by Mr. Ruble. *Id.* at 1518-19. The second was a U.K. tax opinion. Monger, Tr. 1301-02, 1347-48; JX 287.

Craig Chapman was the only Sidley Austin witness at trial, although the Court accepted the deposition of Graeme Harrower into evidence as an unavailable witness who resides in the U.K. Mr. Chapman is a partner in Sidley Austin's New York office and is co-head of the global securities practice. Chapman, Tr.

2974-76. He advised BB & T on the STARS transaction alongside Mr. Ruble, as well as advising Bank of New York and Sovereign Bank on their respective STARS transactions. *Id.* at 2974. Mr. Chapman, however, is not a tax lawyer. *Id.* at 3048.

Mr. Chapman's work on BB & T's STARS transaction began when Barclays contacted Sidley Austin to ask if the law firm would represent BB & T on the transaction. Chapman, Tr. 3008. Shortly thereafter, Mr. Ruble and Mr. Chapman traveled to Winston-Salem, North Carolina to meet with BB & T's Ronnie Monger, John Watson, and Howard Hudson to discuss STARS. Chapman, Tr. 3008-10. BB & T then retained Sidley Austin as its counsel for STARS. *Id.* at 3010. Mr. Chapman testified that he was the relationship partner with BB & T, but Mr. Ruble signed the engagement letter with BB & T. *Id.*; JX 264 at 902.

Sidley Austin issued Mr. Ruble's tax opinion letter on STARS to BB & T on April 4, 2003. Stip. ¶ 74; PX 174. In October 2003, Sidley Austin expelled Mr. Ruble from the law firm due to serious irregularities in his tax shelter practice. Harrower, Dep. 253-54. BB & T became aware that Mr. Ruble had been terminated from Sidley Austin. Hudson, Tr. 1598; Watson, Tr. 3553-54. In November 2003, in hearings before the U.S. Senate's Permanent Subcommittee on Governmental Affairs, and with respect to the Subcommittee's investigation of "U.S. Tax Shelter Industry: the Role of Accountants, Lawyers, and Financial Professionals," Mr. Ruble refused to respond to questions, citing his Fifth Amendment right not to answer. USX 1526 at 100-01; Wilkerson, Tr. 1849-50.

In August 2005, the United States indicted Mr. Ruble and charged him with tax evasion for “designing, implementing, and marketing fraudulent tax shelters.” *United States v. Pfaff*, 619 F.3d 172, 173 (2d Cir.2010). On December 17, 2008, a jury found Mr. Ruble guilty on ten counts of attempting to evade or defeat U.S. tax laws, and he was sentenced to 78 months of incarceration and two years of supervised release. He currently is incarcerated in the United States penitentiary in Lewisburg, Pennsylvania. Defendant deposed Mr. Ruble in this case, but in response to every question after providing his name, Mr. Ruble asserted his Fifth Amendment right not to answer. Mr. Ruble did not testify at trial. The STARS transactions were not among the tax shelters at issue in Mr. Ruble’s criminal proceedings.

Prior to the start of trial, Plaintiff filed a motion in limine to preclude Defendant from seeking adverse inferences against Plaintiff due to Mr. Ruble’s assertion of the Fifth Amendment in response to all questions. Later, after trial, Plaintiff filed a motion to reopen the trial record to obtain Mr. Ruble’s substantive testimony in response to written questions previously posed to him in his deposition. On June 13, 2013, the Court issued an order regarding the testimony of Raymond J. Ruble, denying Plaintiff’s motion to reopen the trial record, but granting Plaintiff’s motion to preclude the application of an adverse inference from Mr. Ruble’s assertion of his Fifth Amendment rights. The Court reasoned that Mr. Ruble most likely had asserted the Fifth Amendment for personal reasons, not because of a desire to protect Plaintiff or influence the outcome of this case. *See* Order, June 13, 2013, D kt. No. 213.

5. PwC

In March 2002, after terminating Arthur Andersen & Company as its audit firm, BB & T selected the PwC accounting firm to be its new outside auditor. Monger, Tr. 774-75, 1151-53; USX 470. One of PwC's first tasks was to evaluate the STARS transaction, with a specific focus on the STARS tax reserve level. Monger, Tr. 776-77, 1161, 1190. BB & T did not seek a separate legal opinion from PwC regarding the STARS transaction. Monger, Tr. 945-47; JX 259 at 277. Ultimately, PwC arrived at a "less than should" level of comfort that the Internal Revenue Service ("IRS") would accept the STARS transaction, but BB & T nonetheless decided to move ahead with the transaction. Boss, Tr. 2098, 2100-02, 2117-18; USX 951 A at 7183-84; JX 256 at 2802; USX 553, 601, 611.

PwC expressed concerns that the STARS transaction did not comply with technical provisions of the Internal Revenue Code. Monger, Tr. 782-85; PX 42; JX 259 at 278-85; USX 529. After PwC had articulated these concerns, Mr. Monger told PwC on April 19, 2002 to focus strictly on the STARS tax reserve issue. Monger, Tr. 1257-58; JX 259 at 277. If the reserve level was too high, STARS would not be profitable to BB & T even on an after-tax basis, and BB & T would not go forward with the transaction. Monger, Tr. 776-77, 1239-43, 1246.

PwC representatives Rich Boss and Chip Harter testified at trial. Mr. Boss was an international tax manager in PwC's Charlotte office, and took the lead in coordinating PwC's national tax group and the audit team. Mr. Harter was an international tax specialist in PwC's Washington, D.C. office, and provided technical assistance on certain STARS issues.

B. BB & T's Participation in Other Tax Shelters

Aside from the STARS transaction, BB & T has had a number of experiences with other transactions designed to reduce U.S. tax liabilities, some of which ultimately were disallowed for tax purposes. These transactions include lease-in-lease-out (“LILO”) and sale-in-lease-out (“SILO”) tax shelters, employed during 1997 through 2001, a structured transaction known as OTHELLO, which KPMG marketed to BB & T in 2002, and Project Knight in 2007, another Barclays structured transaction similar to STARS.

1. SILO/LILO

In 1997 through 2001, BB & T entered into many LILO transactions that were later disallowed for tax purposes. PX 68 at 382688. In these transactions, BB & T acquired leasehold interests in two convention centers and various equipment, and entered into operating leases with foreign municipal corporations and entities. *Id.* BB & T entered into similar SILO transactions that also were disallowed. Monger, Tr. 1269-70; PX 68 at 382688. A key objective of SILOs and LILOs was for the taxpayer to take advantage of depreciation deductions on assets owned by public entities, without assuming any of the ownership risks of these assets. *See, e.g., Wells Fargo & Co. v. United States*, 91 Fed.Cl. 35 (2010) (denying tax deductions for public transit industry equipment where tax shelter transactions lacked economic substance), *aff'd*, 641 F.3d 1319 (Fed. Cir.2011). These SILO and LILO tax shelters involved circular cash flows aimed at reducing taxes, just as the STARS transaction does.

In a February 2002 presentation to BB & T's Board of Directors, the Tax Management team described the benefits of these tax shelters as including deferred

income taxes of \$635 million through December 31, 2001, and an additional \$12.1 million in 2001 earnings. PX 29 at 361386; Monger, Tr. 1046-47. BB & T entered into approximately 37 SILO or LILO transactions between June 1997 and July 2001. Watson, Tr. 3515-16; PX 68 at 382688-89. The cumulative tax loss on the SILO/LILO transactions for 1997 through 2001 was \$1.4 billion. The projected losses for 2002, 2003, and 2004 were \$343 million, \$122 million, and \$65 million respectively. PX 68 at 382687; Watson, Tr. 3516.

As of February 2002, the IRS had completed its audit of BB & T's 1996 through 1998 taxable years, and had determined that the SILO/LILO deductions claimed for those years would be disallowed. Monger, Tr. 1047-48; PX 92 at 350335. BB & T was aware that the IRS would be disallowing hundreds of millions of anticipated tax benefits from the ongoing SILO and LILO transactions. Watson, Tr. 2886-87; Monger, Tr. 1049-50; PX 29 at 361392.

BB & T filed a tax refund action in the U.S. District Court for the Middle District of North Carolina challenging the IRS's disallowance of the tax benefits claimed on one of its LILO transactions. On January 4, 2007, the district court granted summary judgment in favor of the United States. *BB & T Corp. v. United States*, 2007 WL 37798, 2007 U.S. Dist. LEXIS 321 (M.D.N.C., Jan. 4, 2007). On appeal, the U.S. Court of Appeals for the Fourth Circuit affirmed the district court's grant of summary judgment. *BB & T Corp. v. United States*, 523 F.3d 461 (4th Cir.2008). BB & T's management quickly understood the adverse impact that these court decisions would have on BB & T's continued participation in LILO and SILO transactions. Watson, Tr. 3588-89. BB & T settled its other

LILO and SILO disputes after receiving the Fourth Circuit's decision. Watson, Tr. 3517-18.

2. OTHELLO

In January 2001, before the beginning of the STARS transaction, BB & T began implementing another tax shelter promoted by KPMG called OTHELLO, which reduced BB & T's effective tax rate. Watson, Tr. 3510, 3530; Monger, Tr. 966; USX 941. BB & T paid KPMG \$4.5 million in fees for carrying out the OTHELLO transaction. Monger, Tr. 1178; USX 483 at 3. These fees, however, were linked to the favorable tax consequences that BB & T anticipated from OTHELLO. A portion of KPMG's fees was deferred until the tax year when OTHELLO closed, or until the IRS examined the transaction. Monger, Tr. 1181-83; USX 485. Deferring these fees ensured that KPMG would not be fully compensated until OTHELLO's tax risk had been determined. *Id.* BB & T considered a similar risk-sharing arrangement with KPMG on the STARS transaction, deferring a portion of KPMG's fees until a later period. Monger, Tr. 1177-79; USX 485. The OTHELLO and STARS transactions had similar characteristics. Wilkerson, Tr. 1845-46; Monger, Tr. 1307; USX 950 at 3; USX 634. The November 2003 Senate Hearings on tax shelters characterized OTHELLO as "a potentially abusive tax shelter." USX 1526 at 193, 228.

3. Project Knight

Near the termination of STARS, BB & T entered into another tax shelter with Barclays known as Project Knight. Johnson, Tr. 253-54; PX 260 at 259802. In January 2007, BB & T anticipated that Project Knight would involve receiving a \$4 billion

loan from Barclays for three years at a floating interest rate of LIBOR⁴ minus 40 basis points. USX 1944 at 2. BB & T believed that Project Knight would produce a \$12 million tax benefit each year. *Id.*

Project Knight had many features “very similar” to STARS. Johnson, Tr. 255-56. Like STARS, Project Knight involved setting up an entity structured as a joint investment between BB & T and Barclays. *Id.* While the joint investment in STARS was a trust, in Project Knight it was a partnership. *Id.* Just as in STARS, Project Knight involved placing assets in the structure to generate income—the same auto loan assets used in STARS. Johnson, Tr. 255, 352. Project Knight involved a forward sale agreement for undoing ownership interests at the end of the transaction. Johnson, Tr. 255. Project Knight incorporated a swap instrument designed to turn a fixed-rate interest rate obligation into a floating interest obligation. *Id.* Project Knight involved a purported sub-LIBOR loan from Barclays to BB & T, which has been characterized as a sharing of Barclays’ U.K. tax benefits. Johnson, Tr. 258; USX 1944 at 2. BB & T and Barclays could unilaterally terminate Project Knight early for any reason. Johnson, Tr. 324.

The termination provisions in Project Knight were important to the parties. BB & T contemplated that the IRS might challenge Project Knight, and it planned to terminate the transaction if this occurred. USX 1944 at 3. BB & T also expected that Barclays would terminate Project Knight early if it did not receive its planned tax benefits, and BB & T would do

⁴ “LIBOR” refers to the London Inter-Bank Offer Rate, and is comparable to the “prime rate” in the United States. A “basis point” is 1/100 of a percentage point.

the same if its tax benefits were not forthcoming. Johnson, Tr. 286-88; USX 1944 at 3.

BB & T and Barclays terminated Project Knight in 2008. Watson, Tr. 2876. Barclays had come under mounting media attention regarding its role in U.S. banks' participation in foreign tax shelters. On March 29, 2009, the U.K. newspaper *The Guardian* reported "U.S. banks pull out with 11 billion Barclays tax avoidance partnerships: Bank of America and BB & T repay loans early, Project Knight meant to generate 100 million next year." Johnson, Tr. 332-36. *The Guardian* also referred to Barclays' Structured Capital Markets unit as "a tax avoidance factory" and reported that in 2009, whistleblowers uncovered SCM's "dark arts practice" that "created multibillion pound deals, which routed vast amounts of money in elaborate circles through offshore networks with the prime purpose of magic-ing profits out of tax credits." Peacock, Tr. 2270-71; Monger, Tr. 1220-23. As noted above, Barclays disbanded its SCM unit in the wake of negative publicity.

C. Design and Development of STARS

BB & T's STARS transaction does not stand in isolation. Barclays and KPMG principally developed the concept of STARS over a long-term period to achieve tax benefits. Barclays and KPMG marketed STARS to bank and non-bank businesses in the United States, and ultimately executed STARS transactions with six U.S. banks, including BB & T. The evolution of the STARS structure, and the near identical method of implementation with the six U.S. banks, sheds light on the purpose of STARS and its dependence on a series of tax-motivated steps.

1. Developers

Sohail Sultan of Barclays' SCM division led the development of STARS. Sultan, Dep. 73. Mr. Sultan also marketed other SCM products to U.S. financial institutions and remained engaged in the execution of STARS deals as a transaction team leader. *Id.* Originally, STARS was a strategy to enhance the investment yield of large, cash-rich corporations in the United States, Canada, and Europe. *Id.* at 25. Mr. Sultan marketed the early iteration of STARS to Microsoft, AIG, Intel, and Prudential. *Id.* 187-88. In general, these entities responded that the yield enhancement was not attractive enough to justify the level of complexity and potential risks. *Id.* With this feedback, Barclays decided to retain the structural components from the early iterations of STARS and combine them with a financing vehicle that might be attractive to banks. *Id.* at 60-62.

The London law firm of Freshfields, Bruckhaus, Deringer LLP assisted Mr. Sultan with the development of the STARS structure. Mark Watterson of Freshfields analyzed the U.K. tax treatment of STARS and provided advice to Barclays on the tax effects of including the unit trust and the U.K. trustee, both of which were central components of STARS. Watterson, Dep. 18, 29-33. Mr. Watterson conveyed his views of U.K. tax treatment to KPMG's Mr. Brockway for use in determining how STARS might be characterized from a U.S. tax perspective. *Id.* at 123-24.

During the period when Barclays developed STARS, Barclays had an agreement with the U.K. taxing authority, Her Majesty's Revenue & Customs ("HMRC"), under which all newly-closed SCM transactions would be submitted for review at the end of the year to determine whether they would be

challenged under U.K. tax law. Williams, Dep. 114-17. This process allowed Barclays' Tax Group to explain the complex structures and draw HMRC's attention to potential nuances that might not otherwise be apparent. *Id.* at 121-22.

In 2001 and 2002, John Mawson served as the U.K. Principal Inspector of Taxes responsible for reviewing the tax affairs of the Barclays Group. *Id.* at 116-17. Starting in August 2001, Messrs. Williams and Mawson engaged in discussions regarding the first STARS deal, the First Union Bank transaction referred to as Monument Street Funding. *Id.* at 113-14; USX 358. In a letter dated April 16, 2002, Mr. Williams stated “[i]n respect of both First Union and Bank of New York transactions this leads to additional U.K. corporate tax payable by the Barclays Group as a result of the transaction of £5.7m in 2001 and approximately 30.2m in 2002 (please see schedule at Point 4 below.)” USX 557 at 2-4; Zailer Tr. 2696-97. Mr. Watterson of Freshfields observed “if the U.K. Revenue could see that these transactions [STARS] were tax additive to the Revenue or to the Exchequer then they'd probably be less minded to seek to challenge the result that Barclays was looking to achieve.” Watterson, Dep. 107-08. In reality, however, Barclays did not pay any U.K. corporate tax on either of these STARS transactions. Zailer, Tr. 2697. The amounts listed in Mr. Williams' April 16, 2002 letter actually were paid by First Union and the Bank of New York, through the trustees of their Delaware trusts. *Id.* at 2698, 2702. This letter makes it appear that Barclays is paying a U.K. corporate tax, but in fact Barclays was receiving tax benefits while paying no U.K. tax at all. Zailer, Tr. 2700-05; Demo. Ex. 12-13; USX 557.

Through collaboration with Barclays, KPMG specialized in developing transactions that took advantage of differences between tax systems, including STARS. Wilkerson, Tr. 1779-80. The initial STARS development focus was on achieving tax objectives, including U.K. tax objectives. *Id.* at 1757. For the U.S. participants, the primary objective was to claim foreign tax credits, while characterizing the transaction as a financing. *Id.* 1757, 1774. Without the foreign tax credits, the STARS transaction would not be profitable to the U.S. taxpayer. *Id.* at 1760-61. In order to characterize STARS as involving a loan, KPMG wanted to avoid “negative interest” and to assure that the U.S. participant receiving the loan would make at least some positive interest payments. *Id.* at 1759. However, in the BB & T STARS deal, the first 35 months of the transaction involved payments from Barclays (as lender) to BB & T (as borrower), and no payments going the other way. Wilkerson, Tr. 1759; Kawaller, Tr. 4901-02; Demo. Ex. 18; USX 1994 at 22.

Mr. Brockway of KPMG performed extensive development work on STARS to enable Barclays and KPMG to market the transaction. USX 192 at 3. In the first half of 2000, nearly all of KPMG’s time devoted to STARS consisted of Mr. Brockway’s services. *Id.* Mr. Wilkerson joined Mr. Brockway in analyzing technical tax issues relating to the First Union transaction, including the important question of whether First Union would be allowed to claim foreign tax credits under Internal Revenue Code (“IRC”) § 901. Wilkerson, Tr. 1679-80. Mr. Wilkerson also analyzed the possible use of deconsolidation to assure that First Union could fully utilize the foreign tax credits, an issue that also arose in the BB & T STARS transaction. *Id.* at 1760.

In developing STARS, KPMG treated Barclays as its client. Wilkerson, Tr. 1755-56; Sultan Dep. 655; USX 957 at 1-3. Under a revised fee arrangement, KPMG's accrued time was folded into the value based fee, and thus made contingent on the closing of a STARS transaction. USX 192 at 3. KPMG understood that Barclays would pay a larger fee on STARS transactions where KPMG had identified the client or played an important role in Barclays "landing the engagement." USX 108 at 2. KPMG initially expected a \$1 million fee from Barclays if the first STARS transaction (First Union) successfully closed. Wilkerson, Tr. 1763; USX 108 at 1. Instead, Barclays paid KPMG \$4 million for the First Union STARS deal, and more fees were promised if other STARS transactions could be closed. Wilkerson, Tr. 1763-65; USX 108 at 2.

In light of the fee structure, KPMG encouraged its professionals to promote STARS and provided incentives for them to do so. Wilkerson, Tr. 1776; USX 342. Mr. Wilkerson personally met with prospects, including SunTrust Bank, Regions Bank, and Key Bank to present STARS and explain its U.S. tax benefits. Wilkerson, Tr. 1769-71. Mr. Wilkerson conveyed his view that the transaction would achieve its intended U.S. tax objectives by generating foreign tax credits in the United States while allowing the structure to be characterized as a financing. *Id.* 1773-74. KPMG hoped that it could realize more fees through the execution of additional STARS transactions. *Id.* at 1772. The relationship between Barclays and KPMG was so close that Mr. Brockway even asked for input from Mr. Sultan on setting compensation levels for KPMG professionals working on STARS. Wilkerson, Tr. 1792; USX 957 at 3. Mr. Sultan suggested compensation of approximately \$1 million

for each of the KPMG persons with whom Barclays worked. USX 957 at 2.

2. Early Iterations of STARS

STARS was not always characterized as “low cost financing.” Sultan, Dep. 188; PX 312 at 224352R. In 1999, STARS conceptually began as an investment-based transaction or an “asset play” involving a U.K. unit trust that would “generate an enhanced return for a U.S. investor by way of a Stock Lending Arrangement (SLA).” *Sultan, Dep. 188; USX 69 at 1.* The transaction would “enhance[] the yield on an existing portfolio of assets held by a U.S. counterparty, generated by allowing Barclays to claim the taxes paid on the income accrued on the portfolio of underlying assets through a U.K. unauthorised trust.” PX 312 at 224352R. The enhanced yield would be accomplished through a stock loan from the U.S. participant to Barclays with the U.S. participant receiving lending fees that represented a split of the tax benefits. *Id.*

This “asset play” investment version of STARS did not have a loan component going from Barclays to the U.S. participant. Abrahams, Dep. 263-64; USX 89. However, a STARS transaction did not need a loan component to accomplish its tax objectives. Abrahams, Dep. 742. From Barclays’ standpoint, a STARS deal only needed a U.S. counterparty to help Barclays create a purported trading loss that formed part of the transaction’s U.K. benefit for Barclays. *Id.* at 742-44, 859-62. Without a counterparty to create the appearance of some financial activity, Barclays may not have been able to deduct the purported loss for U.K. tax purposes. *Id.*

Barclays marketed the investment version of STARS to well-known corporations, AIG, Microsoft,

Intel, and Prudential. Sultan, Dep. 188. Barclays targeted these entities because they were viewed as having excess assets that could be used to move revenue through the transaction structure. *Id.* This version of STARS had no loan component. Mr. Sultan found, for example, that Microsoft was not plausibly interested in a \$1.5 billion loan. *Id.* at 188-89. By lending to a corporation such as Microsoft, Barclays would need to maintain 100 percent of its regulatory capital requirements associated with such a loan, as opposed to a fractional amount for bank lending. *Id.* at 189-91. Ultimately, none of the targeted U.S. companies chose to participate. *Id.* at 194; James, Tr. 3832. STARS therefore had to evolve by adding a loan component to the transaction, which Barclays was able to sell to six banks.

Barclays would have preferred to execute STARS without a loan to the U.S. participant, because the loan feature required Barclays to commit capital to the transaction. *Id.* at 209-10. By adding a cash loan, Barclays was required to retain more regulatory capital. *Id.* at 209-211. However, the economic benefit to the U.S. participant arising from its foreign tax credits remained the same for both the investment version and the later loan version of STARS. Sultan, Dep. 349-50; USX 102.

3. Prior STARS Transactions With First Union and Bank of New York

Barclays entered into six STARS transactions with U.S. financial institutions between 2001 and 2005: First Union National Bank in June 2001, Bank of New York in November 2001, BB & T in August 2002, Wells Fargo in November 2002, Sovereign Bank in November 2003, and Washington Mutual in June

2005. PX 297 at 204207R; JX 2; USX 1502; USX 2095; USX 2210 at 41, n.97; USX 2212 at 121. Two of these transactions, First Union and Bank of New York, closed before the BB & T STARS transaction. Barclays itself has described First Union as “very similar” to BB & T STARS. PX 297 at 204207R.

The First Union STARS transaction involved financing in the amount of \$2.5 billion and a commitment of approximately \$7 billion in First Union assets to the STARS trust structure. Ioannidis, Dep. 150; Sultan, Dep. 193; USX 358 at 2; USX 1389. The First Union STARS transaction currently is in litigation. As successor in interest to First Union through its merger with Wachovia in 2001 and through its acquisition of the merged entity, Wells Fargo filed suit on August 13, 2012 challenging the IRS tax treatment of the First Union STARS transaction. The litigation is ongoing. *Monument St. Funding Trust, Centurion Funding, Inc., Tax Matters Partner v. Comm’r*, Dkt. No. 20216-12 (U.S. Tax Court, 2012).

Bank of New York (“BNY”) was the second U.S. financial institution to implement a STARS transaction with Barclays, on November 9, 2001. Chapman, Tr. 3008. At that time, BNY was engaged in the banking business and had worldwide banking operations. *Bank of New York Mellon Corp. v. Comm’r*, 140 T.C. 15, 17 (2013). KPMG introduced STARS to BNY during discussions with the bank’s tax director. *Id.* Thereafter, KPMG and Barclays presented STARS to BNY through various meetings, discussions, promotional materials and correspondence. *Id.* Barclays described BNY STARS as “substantially similar” and “very similar” to BB & T STARS. PX 297 at 20407R, 204214R. The transaction involved a \$1.5

billion financing and a commitment of more than \$7.8 billion in BNY assets to the STARS trust structure. *Bank of New York*, 140 T.C. at 20-21.

The IRS challenged BNY STARS, and the matter was tried in the U.S. Tax Court in April 2012. The Tax Court issued an opinion on February 11, 2013, finding in favor of the Government. The Tax Court concluded:

In sum, the STARS transaction (bifurcated or integrated) lacks economic substance and Congress did not otherwise intend to provide foreign tax credits for transactions such as STARS. Accordingly, the STARS transaction is invalid for Federal tax purposes and the foreign tax credits and expense deductions claimed in connection with it are disallowed.

Id. at 48. The Tax Court emphasized:

The STARS transaction was structured to meet the relevant requirements in the Code and the regulations for claiming the disputed foreign tax credits. The STARS transaction in essence, however, was an elaborate series of pre-arranged steps designed as a subterfuge for generating, monetizing and transferring the value of foreign tax credits among the STARS participants.

Id. at 31. In addition, the Tax Court found that “the activities or transactions that the STARS structure was used to engage in did not provide a reasonable opportunity for economic profit. The STARS structure’s main activity was to circulate income to itself and Barclays. . . . These circular cash flows or offsetting payments had no non-tax economic effect.” *Id.* at 35-36.

D. Marketing of STARS to BB & T

1. Initial Contact with KPMG

In November 2001, Mr. Monger received a telephone call from Maurice Beshlian of Barclays, in which Mr. Beshlian asked Mr. Monger to put him in contact with BB & T's corporate tax director regarding "tax implications" of the STARS transaction. Monger, Tr. 958-63. Thereafter, on November 20, 2001, Messrs. Beshlian and Sultan of Barclays participated in a telephone call with Mr. Watson, the head of BB & T's Tax Department, in which they "discussed in some detail [BB & T's] appetite to do a [foreign tax credit] trade." USX 308. In the follow-up correspondence, they agreed to meet in January 2002 to discuss the STARS transaction and the tax issues involved. *Id.*; Monger, Tr. 625, 632.

On January 17, 2002, Mr. Monger and Mr. Watson met with three tax specialists from KPMG—David Brawley, Charles Butler, and David Schenck—who made a presentation to BB & T regarding the STARS transaction. Watson, Tr. 3423-35; Monger, Tr. 966; JX 241. At the time of this meeting, both Mr. Watson and Mr. Monger were aware that KPMG was intricately involved in the development of the STARS transaction and that KPMG had participated in implementing two prior STARS transactions with U.S. banks. Monger, Tr. 632; Watson, Tr. 3441. Around this time, BB & T Chief Financial Officer Scott Reed tasked Mr. Monger with coordinating BB & T's efforts on the STARS transaction. Monger, Tr. 1045.

In its presentation to BB & T, KPMG proposed a trust asset base of \$3.5 billion and a proposed loan of \$1 billion. USX 343; JX 241; Monger, Tr. 969-71; Watson, Tr. 3423-24. KPMG explained that BB & T's

benefit from STARS would be “based on the U.K. tax credit” and that the greater the amount of Barclays’ tax credits, the greater the benefit to BB & T. Monger, Tr. 973-75; Watson, Tr. 3430. KPMG also stated that BB & T’s interest charge on the loan would be reduced by half of the U.K. tax paid by the STARS trust. Watson, Tr. 3427-28. Mr. Monger understood that, as a result of the STARS transaction, Barclays would not receive any fee from BB & T, but rather would receive “a split of tax credits.” USX 343; JX 241; Monger, Tr. 992-93. KPMG further explained that BB & T would never lose control of the assets it committed to STARS, nor would it lose control of the income from those assets. Monger, Tr. 978-79. During the meeting, KPMG explained that the Class C Unit distribution amounts would be paid into an account held by BB & T in Barclays’ name, and that all money paid into that account would simultaneously be returned to the trust. Although the account was held in Barclays’ name, Barclays would have no control over that account, and only BB & T employees would make transfers in and out of the account. Monger, Tr. 988-89. KPMG also noted that BB & T might have an “overall foreign loss” across the consolidated BB & T group, which would limit or prevent BB & T’s ability to claim foreign tax credits for the U.K. taxes paid by the trust. JX 241; USX 343; Monger, Tr. 993-94. In the event of such a loss, KPMG suggested that BB & T may be able to avoid limitations on claiming foreign tax credits by deconsolidating a special purpose entity BB & T employed to implement STARS. Monger, Tr. 993-94.

After this initial meeting, on January 28, 2002 Mr. Butler of KPMG sent an email to Mr. Watson and Mr. Monger. USX 366; Watson, Tr. 3432. In encouraging BB & T to implement the transaction, Mr. Butler

referred to STARS as one of few “tax related opportunities to achieve significant above the line savings.” USX 366. Mr. Butler also addressed the issue of a potential overall foreign loss, stating that “we also need to confirm whether, as a result of LILo investments, BB & T has an overall foreign loss for purposes of calculating the foreign tax credit.” USX 366. On February 20, 2002, Mr. Butler sent a follow-up email, in which he stated: “A deconsolidation would allow the full foreign tax credit [from STARS] to be utilized for book and tax purposes, notwithstanding the existence (to be confirmed) of foreign losses from the LILo transactions.” USX 402; Watson, Tr. 3449-51. The proposed deconsolidation would be accomplished by issuing preferred stock in the entity to be deconsolidated; that preferred stock would need to transfer 20 percent or more of the voting interest in the entity to the preferred stockholder. Watson, Tr. 3451-52; USX 402. BB & T eventually concluded that it “would be better off going ahead and doing the deconsolidation.” Monger, Tr. 999-1000.

2. Communications with Barclays

Also in January 2002, Mr. Monger met with Messrs. Jenkins, Sultan, and Beshlian of Barclays regarding STARS. *Id.* at 1003-04. The Barclays representatives described the STARS transaction as applicable to BB & T, which contemplated a \$1.5 billion loan to BB & T and a benefit of \$44 million in the first year alone, based on the 50/50 split of the trust’s U.K. tax liability of \$88 million. USX 340; Monger, Tr. 1010-11. Barclays characterized this benefit as a 293-basis-point reduction in BB & T’s interest rate on the loan, which it calculated by dividing the \$44 million benefit to BB & T by the \$1.5 billion loan amount to BB & T. USX 340; Monger, Tr. 1010-11.

On February 4, 2002, Mr. Ioannidis of Barclays sent Mr. Monger a clarifying email regarding the STARS projection for BB & T. JX 242; Monger, Tr. 1012-13. Mr. Ioannidis explained Barclays' belief that STARS could be structured in a way that BB & T could avoid paying North Carolina state taxes on the trust income. JX 242. Mr. Ioannidis also clarified that "[a]ll the income received by Barclays on the [Class C Units] will be mandatorily reinvested into additional consideration for these units. Thus, the asset pool will increase each year, effectively generating additional income. . . . Over the 5 years, this accretion is expected to result in \$22 million of additional benefits for BB & T." *Id.* Further, Mr. Ioannidis explained that BB & T's monthly benefits from STARS would be subject to an adjustment as a result of "timing delays in [Barclays] obtaining tax credits," but noted that "BB & T will obtain the full benefit of timing delays in paying income taxes in the Trust." *Id.*

On February 14, 2002, Mr. Ioannidis sent Mr. Monger a memorandum entitled "Project STARS Q & A." JX 243. In this memorandum, Mr. Ioannidis revisited the possibility of BB & T avoiding state taxation. *Id.* He explained, "[i]f InvestCo is formed in the appropriate State and if structured correctly," then BB & T could avoid paying state income taxes on income generated by the assets committed to STARS. *Id.* Mr. Ioannidis also discussed the possibility of withholding taxes, explaining that "[f]ollowing the recent changes to the U.K./ U.S. double transaction treaty," any interest payments in the transaction deemed "contingent" could be subjected to a 20 percent withholding tax. *Id.* He further explained that to avoid any risk of withholding, the parties needed to agree on fixed pre-determined amounts for the monthly

payments from Barclays to BB & T under the Zero Coupon Swap. *Id.*

These monthly benefits that BB & T received from the STARS transaction were referred to as the Bx. JX 35; Monger, Tr. 1017-19. As described in the Formulae Letter, “the b_x is equal to 51 percent of the tax credits received by Barclays on the Class C Unit.” JX 35. Mr. Monger understood the Bx to be a sharing agreement between Barclays and BB & T, in which Barclays would reduce BB & T’s interest rate expenses based on the tax credit Barclays received. Monger, Tr. 1110-11. Contemporaneously, Mr. Monger referred to the Bx payment as a “[r]ebate from Barclays.” USX 437; USX 465.

To protect itself and ensure that the taxes BB & T paid to the STARS trust were sufficient to match the necessary predetermined Bx payments, Barclays required an indemnity provision. JX 23; Monger, Tr. 1203-04. The “Expected Class C Unit Distributions” were also predetermined, as they were calculated to coordinate with the predetermined Bx payments. JX 23; Monger, Tr. 1204-05. The combination of these predetermined amounts and distributions, along with the indemnity provision, led Mr. Ioannidis to conclude that “[t]here will not be any withholding tax in the STARS transaction.” JX 243.

In mid-February, Mr. Sultan sent a memorandum to BB & T entitled “STARS Benefit Analysis,” which Mr. Monger received and reviewed. JX 244. Mr. Sultan explained that “the benefits [from STARS] are driven from the asset side and asset yield only.” *Id.* In this memorandum, Mr. Sultan also discussed the calculation of benefits that STARS would generate, noting that “[t]he benefit under STARS arises from the ability of both parties to obtain credits for the taxes

paid in the Trust. Thus, the benefits to both BB & T and Barclays are easy to calculate and are equal to 50% of these taxes for each party.” JX 244; Monger, Tr. 1032-34. In describing a sample accounting of the potential benefits to BB & T, Mr. Sultan stated that “[t]o calculate BB & T’s real benefit from STARS, we have to deduct the [Trust] Asset Income (which would be received by BB & T anyway).” JX 244.

Mr. Monger understood Mr. Sultan’s statements to mean that the benefits of the transaction were driven by the size of the trust asset pool and the yield on those assets. Monger, Tr. 1031-32. Nonetheless, Mr. Monger conducted several of his own calculations regarding BB & T’s potential economic benefits from STARS. *Id.* at 1037-39; USX 437. In his calculations, Mr. Monger assumed that the use of \$1.5 billion of loan proceeds from STARS and the use of \$1.5 billion of loan proceeds from an alternate borrowing would yield the same amount, and thus would cancel out. Monger, Tr. 1038-39. He did not include the potential yield on use of the loan proceeds as an element of profit in his analysis. *Id.*

During this information exchange between BB & T and Barclays, BB & T began to hear that another U.S. bank had declined to enter into a STARS transaction. On or about February 18, 2002, personnel in BB & T’s funding department informed Mr. Watson that SunTrust had rejected entering into a STARS transaction because of potential tax risk. Watson, Tr. 2857, 3443-46; USX 396. Mike Blevins of BB & T also communicated to Mr. Monger information received from SunTrust employees, that “[t]hey didn’t pursue the transaction because of their concern over long-term tax implications, and the status of their foreign tax credit.” USX 388; Monger, Tr. 678, 681-82. Mr.

Monger relayed this information to Mr. Watson and Mr. Reed. Monger, Tr. 682-83; USX 388. Mr. Watson then investigated this information by calling Deborah Jameson, the tax director of SunTrust. Watson, Tr. 2856-58. Mr. Watson testified that in their correspondence, Ms. Jameson told him that she had “liked” the transaction, but did not have the time to conduct proper due diligence on it. *Id.* at 2858.

3. Discussions Regarding STARS Tax Risks

On February 26, 2002, Mr. Reed gave a presentation to BB & T Corporation’s Board of Directors, in which he informed the Board of the potential STARS transaction. JX 245; PX 29. Mr. Reed described the expected benefit to BB & T from STARS as “one-half of UK tax credit received by investor [Barclays] for UK income taxes paid by Trust.”⁵ PX 29; Monger, Tr. 1045-46, 1051-52; Watson, Tr. 3452-55. Two days later, on February 28, 2002, Mr. Ioannidis sent Mr. Monger an email showing Barclays’ analysis and allocation of BB & T tax risks as a result of STARS. USX 453; Monger, Tr. 1145-48. Under Barclays’ allocation of tax risk, “the U.S. tax repo risk falls with BB & T and the risk of Barclays getting the tax credits falls with Barclays.” USX 453. However, the risk that the STARS trust would be found either not a tax-resident or a collective investment scheme in the U.K. would be shared between Barclays and BB & T. *Id.*

From the outset, in BB & T’s and KPMG’s discussions regarding STARS, KPMG informed BB & T that the transaction involved tax risks. Watson, Tr. 3461. During the course of multiple meetings and

⁵ Both Messrs. Monger and Watson assisted in preparing the slides presented by Mr. Reed, although they did not attend the meeting.

correspondence among BB & T, Barclays, and KPMG, the potential downside risks and tax ramifications of STARS were discussed. *See, e.g.*, USX 431; JX 247. One of these downside risks was the possible situation in which BB & T was not allowed to take the full foreign tax credit, but was nevertheless allowed to take a deduction on its U.S. tax returns for the U.K. tax it paid. JX 247; Monger, Tr. 1097-98. Mr. Monger relied upon KPMG's representations that deducting the U.K. taxes paid in STARS would be possible, and did not obtain any independent analysis. Monger, Tr. 1100. At the time of KPMG's representations in March 2002, Mr. Monger knew that KPMG had not been paid for any of its work on BB & T STARS, and that KPMG would not be paid for its work if BB & T decided not to close the transaction. *Id.* at 1100-01.

Mr. Monger did, however, prepare his own calculation of BB & T's potential downside U.S. tax risk. USX 437; Monger, Tr. 1105-06; Watson, Tr. 3465. On March 8, 2002, he circulated his "Illustration of Downside Risk" to Messrs. Watson and Butler, in which he referred to the potential \$44 million benefit to BB & T as a "Rebate from Barclays." USX 437; Monger, Tr. 1108-10; Watson, Tr. 3465-66. This "rebate" was precisely half of the \$88 million listed as U.K. taxes payable in STARS and the \$88 million in projected foreign tax credits. USX 437. This illustration also showed the interest expense for borrowing the \$1.5 billion (at 5.25 percent) as \$78,750,000, an expense not reduced by the \$44 million rebate that BB & T expected to receive from Barclays. *Id.* In making these calculations, Mr. Monger assumed that the yield to BB & T on the \$1.5 billion loan proceeds would be identical to the cost of borrowing that amount: 5.25 percent. JX 247; Monger, Tr. 1113-14. In order to isolate the profit attributable

to the STARS transaction, Mr. Monger made a typical banking assumption that BB & T would realize no profit on the \$1.5 billion loan proceeds. Monger, Tr. 1114-15. At the time when Mr. Monger prepared these calculations, he knew of the possibility that the monthly rebates from Barclays could offset BB & T's monthly interest payments. *Id.* at 1111-12. This scenario would result in Barclays making net monthly payments to BB & T, which would be characterized as "negative interest" on BB & T's tax returns and financial statements. *Id.* In correspondence that followed the circulation of Mr. Monger's calculations, Messrs. Monger and Butler agreed that the amount of BB & T's tax risk or "downside" was equal to the amount of BB & T's potential benefit from STARS. *Id.* at 1122.

On March 20, 2002, Mr. Butler sent a formal letter to Mr. Reed, addressing the tax risks BB & T faced from STARS. Monger, Tr. 1126-27; Watson, Tr. 3466; JX 250. Messrs. Monger and Watson had previously reviewed this letter, and knew that the tax risks to BB & T included the inability to claim foreign tax credits, a finding that the transaction lacked economic substance, and the potential for an IRS assessment of penalties. Monger, Tr. 1102-04, 1126-37; Watson, Tr. 3466-68; JX 248.

On March 21, 2002, Mr. Butler sent an email to Mr. Sultan in which he recapped a meeting he had with Messrs. Reed, Monger, and Watson, and Sherry Kellet of BB & T. Monger, Tr. 1151-52; USX 470. The meeting participants had discussed KPMG's risk assessment, which was satisfactory to BB & T. USX 470; Monger, Tr. 1155. The participants also negotiated KPMG's fees. USX 470; Monger, Tr. 3469-73. KPMG initially requested \$8 million in fees on the STARS transaction,

but BB & T sought to reduce its exposure in the event of an early termination of the transaction. USX 470; Watson, Tr. 3469-70; Monger, Tr. 1156-57. KPMG offered to provide future services supporting the foreign tax credit calculations, and thereby defer \$2 million of the requested fees. USX 470. Ultimately, BB & T negotiated an agreement in which KPMG would provide approximately 350 hours of professional service if the STARS transaction was examined or challenged by the IRS on audit. Watson, Tr. 3471-73, 3622-25; JX 254.

That same day, BB & T announced that it had fired the Arthur Andersen accounting firm as its outside auditor and had engaged PwC in that capacity. Monger, Tr. 1152-53; USX 470. In March and April 2002, BB & T provided PwC with materials to review the proposed STARS transaction. USX 465; Monger, 1248-51.

KPMG and BB & T continued to negotiate KPMG's fees, and on March 27, 2002, Mr. Monger proposed a fee deferral similar to the fee arrangement in the OTHELLO transaction, where payment was deferred until the deal had either closed or been examined by the IRS. USX 485. On April 2, 2002, Mr. Butler sent an email to KPMG's Vice Chairman, reporting a verbal agreement on KPMG's fee for the transaction. USX 2238. Mr. Butler explained that "[t]he transaction will still be contingent upon PwC signing off on the tax and accounting treatment." *Id.* Mr. Monger also believed that BB & T's participation in STARS would only occur if PwC signed off on the transaction. Monger, Tr. 1190-93.

On April 5, 2002, BB & T and KPMG entered into an engagement letter agreement for tax advisory services related to STARS. Monger, Tr. 1193; JX 254. The agreement provided that BB & T would pay KPMG \$6.5 million in fees for its work on BB & T STARS, and of that amount, \$500,000 would be deferred for each of the five projected years of STARS. Monger, Tr. 1196; JX 254. These fees were to cover “implementation assistance, 350 hours of examination assistance and U.S. opinion.” JX 254.

BB & T’s Executive Management committee planned to meet on April 8, 2002, and Mr. Monger requested that Barclays and KPMG send representatives to this meeting. PX 36; Monger, Tr. 1148-49. Together with Mr. Monger, Mr. Ioannidis prepared a presentation on BB & T’s exposure to tax risks related to the STARS transaction and KPMG’s assessment of those risks. PX 36; Monger, Tr. 1148, 1217, 1224-27; JX 255. A few days before the committee meeting, Mr. Butler circulated a draft opinion memorandum on the U.S. tax consequences of STARS to Messrs. Monger, Watson, and Cox. Watson, Tr. 3473; PX 46. Mr. Watson provided PwC with a copy of the KPMG memorandum, as well as a copy of a redacted STARS legal opinion from Sidley Austin. Watson, Tr. 3501-02. BB & T did not ask PwC to issue its own opinion on the STARS transaction, *id.* at 3502-03, even though BB & T’s participation in STARS was contingent upon PwC being “comfortable with the transaction at a high level,” *id.* at 3495-500, USX 529, Monger, Tr. 1238-47.

On April 17, 2002, Messrs. Monger and Ioannidis exchanged emails regarding STARS. USX 559; Monger, Tr. 1227-38. Mr. Monger inquired whether Barclays would be willing to increase the size of the

borrowing in STARS or “the size of the trust and therefore the size of the tax credits.” USX 559. Mr. Ioannidis replied that Barclays likely would be interested in increasing the size of the trust “and hence the benefit for both parties,” but noted that an increase in the loan size might be more difficult. *Id.* During the next few weeks, Messrs. Monger and Watson conferred with representatives from KPMG and PwC regarding opinion levels and downside risk potential to BB & T from STARS. Watson, Tr. 3504-05; Monger, Tr. 1251-55. In particular, the transaction participants discussed whether BB & T would be able to deduct the U.K. tax payments on its U.S. returns in the event that STARS was determined to lack economic substance. USX 564. Mr. Watson asked KPMG to research that issue, as the loss of a deduction would add significantly to BB & T’s potential downside risk. Watson, Tr. 3506-08. Mr. Butler concluded that deductions would only be disallowed “if a court believed you engaged in such a sham that they would not even allow economic losses. . . . I am assuming we [KPMG] believe such a chance is so remote as to not need to be considered.” USX 564.

On April 30, 2002, Mr. Ruble of Sidley Austin sent Mr. Monger a redacted favorable tax opinion regarding STARS, which Mr. Watson also reviewed. USX 599; Monger, Tr. 1265-66; Watson, Tr. 3508-09. KPMG had recommended Mr. Ruble and his law firm to BB & T because of his work on previous STARS transactions. Watson, Tr. 3511-12. At the time of Mr. Ruble’s April 30 email forwarding the tax analysis opinion, BB & T and Sidley Austin had not reached a fee agreement for work on STARS. Monger, Tr. 1267.

On May 7, 2002, BB & T formally engaged Sidley Austin for the STARS transaction. Monger, Tr. 1295; JX 264. The engagement letter provided that BB & T would pay Sidley Austin a flat fee for its “Tax Representation,” with the amount dependent on the need for deconsolidation. Monger, Tr. 1295-97; JX 264. Tax Representation included federal income tax advice and the provision of a tax opinion on STARS. JX 264. All “other legal advice and documentation” with respect to STARS was defined as “Corporate Representation,” which would be billed at Sidley Austin’s usual hourly rates on a monthly basis. *Id.*; Monger, Tr. 1296-97. The engagement letter also contained a waiver by BB & T of any legal conflict with Sidley Austin’s past and potential future representation of Barclays Bank and its affiliates. JX 264.

4. Negotiation of STARS

In early May 2002, representatives from BB & T and KPMG discussed whether BB & T would have an overall foreign loss from its LILO transactions, and if so, how BB & T’s STARS transaction could be structured to preserve BB & T’s ability to claim foreign tax credits. Monger, Tr. 1267-68; Watson, Tr. 3513-14; PX 68. BB & T provided KPMG with detailed information on the LILO and SILO transactions BB & T had engaged in between June 1997 and July 2001. Watson, 3515-16; PX 68. From this information, KPMG calculated that, through December 31, 2001, BB & T had a cumulative tax loss on the transactions of \$1.4 billion. Watson, Tr. 3516; PX 68. KPMG stated that BB & T would have a current overall foreign loss in subsequent years. PX 68. Therefore, KPMG concluded that “it will be necessary to structure the STARS transaction through a deconsolidated entity

that will generate passive basket income in order to utilize the credits” generated by STARS. *Id.* Based on its projected overall foreign loss, BB & T decided to deconsolidate InvestCo as part of STARS. Watson, Tr. 3516-17, 3521.⁶

The Participation Agreement for BB & T’s STARS transaction provided that BB & T would indemnify Barclays for losses if the BB & T STARS trust was not found to be a U.K. resident or a collective investment scheme under U.K. law. Monger, Tr. 1302-03; JX 17. At this time, BB & T had no U.K. or other foreign presence, and Mr. Monger expressed concern regarding the foreign tax treatment of the STARS trust. PX 67. Given that KPMG was “on both sides” of the U.K. residency risk because of its representation of Barclays, PX 67, Sidley Austin provided a U.K. legal opinion on the issue. Monger, Tr. 1301-02; JX 287.

On May 20, 2002, Nicholas Vasudeva of Barclays circulated an email and memorandum to BB & T and Barclays representatives containing an analysis of the comparative benefits of STARS to BB & T and Barclays. Monger, Tr. 1309-10; Watson, Tr. 3563-67; JX 267. In one of these documents, Mr. Vasudeva stated that “BB & T’s proposed split of the benefits is 50 percent of the UK tax credit available to Barclays as holder of the C and D Units.” JX 267. Mr. Vasudeva also separately set forth the U.K. tax loss Barclays expected to receive, stemming from the receipt and mandatory return of the monthly Class C Unit

⁶ Mr. Watson testified that BB & T would not have needed to deconsolidate InvestCo, because after the IRS challenged the LILO and SILO transactions, the settlement with the IRS precluded BB & T from claiming tax losses arising from them. Watson, Tr. 3517-18.

distributions. *Id.* Based on Mr. Vasudeva's memorandum, Mr. Monger generated his own calculation of the various benefits Barclays would claim from STARS, in addition to the tax credits on taxes paid by the STARS trust. Monger, Tr. 1316. Based on his own calculations, Mr. Monger asked that BB & T receive a higher percentage of U.K. tax rebates from Barclays, from 50 percent to 51 percent, which was agreed to by the parties. Monger, Tr. 1316.

On May 29 and 30, 2002, participants from BB & T, KPMG, Sidley Austin, and Barclays held a meeting in New York City regarding STARS. *Id.* at 1317-18; PX 77. After the meeting, KPMG circulated follow-up documents, including a calculation that BB & T could be exposed to a \$2 million alternative minimum tax as a result of its participation in STARS. Monger, Tr. 1318-19; PX 77. KPMG suggested that BB & T consider this additional cost "in finalizing negotiations with Barclays on the benefit split and breakage fee." PX 77.

On June 5, 2002, the associate general counsel of BB & T sent a letter to the North Carolina Commissioner of Banks, seeking a non-objection letter for BB & T's participation in STARS. Monger, Tr. 1322-23; USX 661. In this letter, BB & T represented that it expected the transaction to "add approximately \$25 million of after-tax benefits per annum to BB & T, or, approximately \$125 million of benefits" over the entire projected term of STARS. USX 661. BB & T also stated that its ability to receive the after-tax benefits described was "predicated on interpretations of both United States and United Kingdom tax laws and regulations." *Id.*; Monger, Tr. 1323.

On June 17, 2002, Mr. Ioannidis sent an email to the STARS team members at BB & T, KPMG, Sidley Austin, and Barclays Capital, which included a draft formula letter, formula and cash flow examples, and a spreadsheet model for the numbers in the formula letter. Monger, Tr. 1209-17; USX 690. The draft formula letter discussed the “makewhole payment,” explaining:

In summary, this payment compensates Barclays if the distributions out of the Trust (and hence tax credits) are less than agreed at the start. Barclays needs to be compensated, because it has already paid BB & T a spread based on the agreed distributions. As discussed, the reason why the spread has to be pre-determined is in order to avoid potential withholding tax on interest payments under the Zero Coupon Swap under the new U.S./U.K. Double Taxation Treaty.

USX 690 at 13. The draft formula letter clarified that the make-whole amount would be equal to the lost tax credits to Barclays due to the lower trust income. *Id.* Mr. Monger understood that this payment would be due at the termination of STARS unless BB & T made up any shortfalls in Class C Unit distributions. Monger, Tr. 1213-15. BB & T had an economic incentive not to allow such shortfalls, as BB & T could not claim foreign tax credits for payments made to Barclays. *Id.* at 1215-16.

On June 27, 2002, the Board of Directors of BB & T met to discuss the STARS transaction originally presented to the Board in February 2002, and to learn additional details regarding the proposed transaction. USX 728 at 1-3, 7-9. After Mr. Reed gave the

presentation, the directors adopted a resolution approving BB & T's participation in STARS. *Id.* at 5-9. The Board of Directors for the BB & T holding company also approved the transaction on or about the same day. Monger, Tr. 1326-27. BB & T's STARS transaction closed on August 1, 2002. Johnson, Tr. 496; Monger, Tr. 1195-96; JX 1.

5. Post-Closing Communications

On August 27, 2002, Mr. Watson informed Mr. Reed of the possibility that BB & T would be subject to an alternative minimum tax due to its participation in the STARS transaction, and suggested a reassessment of tax-favored investments in order to avoid such a tax. Watson, Tr. 3526-31; USX 941.

On October 1, 2002, Mr. Reed sent to KPMG BB & T's representations to be used by KPMG in issuing its tax opinion on STARS. Monger, Tr. 1351-54; Watson, Tr. 3539-42; JX 281. KPMG had previously written the representations letter, and transmitted it to BB & T for review and signature. Monger, Tr. 1352-55. That same day, Mr. Butler circulated within KPMG a final draft of KPMG's tax opinion on BB & T STARS. Watson, Tr. 3552-53; USX 1005.

On October 11, 2002, KPMG sent Mr. Monger an analysis on "Deductions for Foreign Taxes Paid" if BB & T was not entitled to claim foreign tax credits. Watson, Tr. 3531-36; JX 284. KPMG stated that BB & T "should be entitled to a deduction under section 162, 164 or 165 [of the Internal Revenue Code] in the event they are not entitled to a section 901 or section 903 foreign tax credit." JX 284.

On February 24, 2003, Mr. Monger sought Mr. Ioannidis' opinion on the disclosures BB & T planned to include regarding STARS in its annual Form 10K report to the Securities & Exchange Commission. Monger, Tr. 1356-58; USX 1163. Mr. Ioannidis responded that referring to a trust in the income tax note was "tricky," and that Barclays "may have a small preference for simply stating that these foreign taxes were incurred in the context of a financing deal with a foreign lender." USX 1163. In March 2003, BB & T filed its annual Form 10K for the period ending December 31, 2002. Monger, Tr. 1358-63; JX 209. The filing did not refer to a trust, but instead stated, consistent with Mr. Ioannidis' advice, that "[t]he foreign income tax expense included in the 2002 provision for income taxes is related to income generated on assets controlled by a foreign subsidiary of Branch Bank." JX 209.

On April 7, 2003, Sidley Austin issued its U.K. tax opinion on BB & T STARS, addressing the issues of U.K. tax residency and the characterization of STARS as a collective investment scheme under U.K. law. Monger, Tr. 1347-52; Watson, Tr. 3536-39; JX 287.

On September 19, 2004, InvestCo filed its U.S. Corporation Income Tax Return for the year ending December 31, 2003. Watson, Tr. 3596-99; JX 234.

E. Implementation and Structure of BB & T STARS⁷

In marketing the STARS transaction, Barclays and BB & T used generic names to identify the various entities that would be used in setting up the STARS structure. The generic names were designed to be suggestive of the role that each entity would play in the structure. Thus, in the section below, following the promoter's naming convention, the Court will identify names such as InvestCo, Manager, NewCo, and DelCo. All of the necessary structure and entities were created within a span of one week. Monger Tr. 583.

The references to "Class A, B, C, D, and E Units" are simply nomenclature to describe ownership rights of the various entities and the transfers that would occur in the STARS transaction. Despite the many components and entities making up the STARS transaction, the real parties in interest at all times were BB & T Bank and Barclays Bank. The transaction also consists generally of a trust ("Trust") and a loan ("Loan").

1. Creation and Funding of the STARS Structure

Branch Investments LLC ("InvestCo") was a wholly owned subsidiary of BB & T. Stip. ¶ 4. InvestCo was a preexisting investment holding company formerly known as Skylight Investment Corporation, and was

⁷ The Court regrets the complexity of describing the STARS transaction. Government counsel rightly observed during his opening statement that STARS exhibits a "Byzantine complexity," and "in the annals of tax shelter history, there probably has never been a more complex transaction than the STARS transaction at issue in this litigation." Donohue, Tr. 37.

organized under the laws of the state of Delaware. Stip. ¶¶ 4, 16. On July 26, 2002, InvestCo formed Branch Management LLC, known as “Manager,” a wholly owned Delaware corporation for U.S. federal income tax purposes. Stip. ¶¶ 5, 11. InvestCo acquired all of the issued and outstanding shares of Manager in exchange for \$100,000 in cash. Stip. ¶ 11. BB & T retained control of Manager. Cragg, Tr. 4461-62; USX 661 at 5.

On July 26, 2002, InvestCo also formed Branch Holdings LLC (“NewCo”). Stip. ¶ 12; JX 283 at 3897. InvestCo organized NewCo as a wholly owned Delaware limited liability company. JX 283 at 3897. NewCo did not issue any membership interests until September 12, 2002. Stip. ¶ 12; JX 283 at 3897. BB & T retained control of NewCo. Cragg, Tr. 4460; USX 661 at 5.

Prior to executing STARS, BB & T held all of the common stock of Matewan Real Estate Holdings, Inc. JX 283 at 3896. On July 29, 2002, Matewan REIT executed an exchange of its common stock with BB & T. Stip. ¶ 13. On July 29, 2002, BB & T transferred 2,000 shares of its Class A Matewan REIT Stock in exchange for 2,000 shares of Class B REIT Stock. Stip. ¶ 14; JX 283 at 3896.

On July 29, 2002, InvestCo converted to a limited liability company and changed its name from Skylight Investment Corporation to Branch Investments LLC. Stip. ¶ 16; JX 283 at 3896. InvestCo held \$414 million in investment securities as of July 30, 2002. Stip. ¶ 17. BB & T controlled InvestCo. Cragg, Tr. 4460; USX 661 at 5.

On July 29 and 30, 2002, BB & T contributed approximately \$5.755 billion in assets to InvestCo in exchange for additional common shares of InvestCo valued at \$5.755 billion. Stip. ¶ 18. The assets contributed to InvestCo consisted of the Matewan Class B REIT Stock, automobile loans, constant credit loans, first deed loans, and other assets. Stip. ¶¶ 15, 18. At the conclusion of this step, InvestCo held approximately \$6.169 billion in assets, consisting of \$5.755 billion contributed from BB & T, and \$414 million in investment securities already held by InvestCo. Stip. ¶¶ 17, 19.

On July 30, 2002, InvestCo formed Branch Finance LLC, known as “DelCo.” InvestCo contributed \$6.080 billion in assets and \$10,000 in cash to DelCo. Stip. ¶ 20. In return, DelCo issued two classes of shares to InvestCo: (a) \$65 million in Class I voting shares with rights to receive approximately 1 percent of any DelCo distributions; and (b) \$6.015 billion in Class II non-voting shares with rights to receive approximately 99 percent of any DelCo distributions. *Id.* Thereafter, InvestCo owned all of the issued outstanding shares in DelCo. Stip. ¶ 21. DelCo owned \$6.080 billion in income-producing assets and \$10,000 in cash transferred from BB & T via InvestCo. Stip. ¶ 22. BB & T controlled the DelCo distributions through its ownership of the Class I shares. Cragg, Tr. 4460; USX 661 at 5. Of the approximately \$6 billion owned by DelCo, \$1.5 billion served as collateral for the Loan, and the remaining \$4.5 billion generated income for the required revenue stream. Johnson, Tr. 175-76.

Branch Funding Trust, known as “Trust,” was established on July 30, 2002. Stip. ¶ 23; JX 283 at 3895. The Trust was 100 percent owned by InvestCo. Stip. ¶ 23. The Trust Agreement that created the

Trust also delegated management and administration of the Trust to Manager, which was controlled by BB & T. Stip. ¶ 23; Cragg, Tr. 4461-62; USX 661 at 5.

On July 30, 2002, InvestCo contributed its DelCo Class II non-voting stock and \$89 million in assets to the Trust. Stip. ¶ 24. In return, the Trust issued to InvestCo (a) the Class A Units with an aggregate stated value of \$4.604 billion, and (b) the Class B Unit with a stated value of \$1.5 billion. *Id.*; JX 283 at 3897-98.

On August 1, 2002, Barclays provided \$1.5 billion in cash to the Trust in return for a Class C Unit with a stated value of \$1,474,999,000, a Class D Unit with a stated value of \$25 million, and a Class E Unit with a stated value of \$1,000. Stip. ¶ 26. Despite the Barclays Unit purchase, BB & T retained control over the Trust. Cragg, Tr. 4461-62; USX 661 at 5. Also on August 1, 2002, using the cash received from Barclays, the Trust immediately redeemed InvestCo's Class B Unit for \$1.5 billion in cash. Stip. ¶ 32. This step completed the transfer of \$1.5 billion in financing from Barclays to the BB & T Group through the Trust. *Id.*

On the closing date of August 1, 2002, InvestCo transferred 50 percent of the Trust's Class A Units to NewCo in return for a 100 percent membership interest in NewCo. *Id.* ¶34. Contribution of 50 percent of the Class A Units in the Trust to NewCo created a second member in the Trust, allowing it to elect to be classified as a partnership for U.S. tax purposes. JX 283 at 3943.

On August 1, 2002, InvestCo issued preferred shares to Asteras (to be addressed below) in return for \$65 million in cash. Stip. ¶ 30. Of the amount invested by Asteras, \$64.75 million was loaned to Asteras by a

wholly owned subsidiary of Barclays. *Id.* The remaining \$250,000 came from an entity known as GSS Holdings. Cragg, Tr. 4554-55. Also on August 1, 2002, InvestCo loaned the proceeds from the Class B redemption (\$1.5 billion) and the preferred stock issuance (\$65 million) to two state-chartered BB & T banking subsidiaries, Branch Banking and Trust Company of Virginia and Branch Banking and Trust Company of South Carolina. Stip. ¶ 33.

The Trust and DelCo each filed a form 8832 with the IRS, electing to be classified as partnerships for U.S. tax purposes. *Id.* ¶35. On August 2, 2002, Branch Administrators Limited, also known as the U.K. Trustee (“Trustee”), was formed as a U.K. incorporated company established under the laws of England and Wales. *Id.* ¶36. In exchange for interests in the Trustee, InvestCo and DelCo funded the Trustee with \$990,000 and \$10,000 in cash, respectively. *Id.*

On August 8, 2002, the U.K. Trustee replaced the U.S. Trustee as the trustee of the Trust pursuant to the Trustee Accession Agreement. *Id.* ¶37. The U.K. residence of the Trustee made the income of the Trust subject to U.K. tax. Cragg, Tr. 4462; Demo. Ex. 15; USX 607 at 5. BB & T nevertheless retained control of the Trustee. USX 661 at 5. The Trustee’s responsibilities were limited to administrative activities. Cragg, Tr. 4462-63; Demo. Ex. 13; JX 243 at 2394.

2. Changing Barclays’ Trust Unit Purchase Into a Collateralized Loan

Barclays and InvestCo executed two forward sale agreements (addressed below), including one related to the Class C and E Units, and the other related to the Class D Unit. Stip. ¶ 28. The combined effect of the forward sale agreements was that InvestCo agreed to

purchase the Class C, D, and E Units from Barclays at the termination of the transaction for a price equal to the total original subscription amount of \$1.5 billion, plus an amount calculated by reference to a fixed interest rate, known as the “accretion.” *Id.* The forward sale agreements had a stated maturity date of August 15, 2007 (a term of approximately five years), but could be terminated by either party with 30 days’ notice. Stip. ¶¶ 57-59. InvestCo’s obligations to Barclays were collateralized by \$2.14 billion in assets (\$391 million in investment securities and \$1.75 billion in auto loans). Stip. ¶¶ 53-56. In addition, BB & T guaranteed InvestCo’s obligations to Barclays in the STARS transaction. Stip. ¶ 27.

Barclays and InvestCo also simultaneously executed a Zero Coupon Swap Agreement (addressed below), which effectively converted InvestCo’s fixed-interest-rate obligation payable at termination pursuant to the Class C Unit and Class E Unit forward sale agreement into a floating rate interest obligation payable monthly. Stip. ¶ 29. This floating interest obligation was calculated as the product of (a) a notional principal amount of \$1.475 billion and (b) a floating rate tied to the one-month LIBOR rate. *Id.* Also as part of the Zero Coupon Swap Agreement, the floating interest obligation was offset against a separate predetermined amount characterized in the closing documents as the “Floating Rate Spread Amount” or the “Bx.” *Id.* The fixed leg of the Swap Agreement required Barclays to pay a fixed amount at termination, which was exactly equal to the accretion. Cragg, Tr. 4573-74; JX 20 at 431.

The accretion payment from BB & T to Barclays calculated by reference to the fixed interest rate contained in the Class C Unit and Class E Unit

forward sale agreement was designed to be exactly offset by an identical payment from Barclays to BB & T in the Zero Coupon Swap Agreement. Cragg, Tr. 4571-74; Demo. Exs. 153-56. The net effect of Barclays' purchase of Trust units, the forward sale agreements, and the Zero Coupon Swap Agreement was to provide BB & T with \$1.5 billion in funding from Barclays at a floating rate of approximately one-month LIBOR plus 25 basis points, and the payment of a monthly "Bx" amount from Barclays to BB & T. Cragg, Tr. 4577-78; Demo. Ex. 159.

3. Cash Flows Associated With the STARS Structure

The Trust received 99 percent of the monthly distributions as the holder of DelCo's Class II ordinary stock, and InvestCo received one percent of the monthly distributions as the holder of DelCo's Class I ordinary stock. Stip. ¶ 38. InvestCo determined the magnitude of these distributions through its ownership of the DelCo Class I ordinary stock. InvestCo could cause DelCo to make distributions in excess of its income, by distributing capital. Stip. ¶ 20; Cragg, Tr. 4486; Demo. Ex. 48. Each month, the Trust paid the Manager a fee to compensate the Manager for managing the assets of the Trust. Stip. ¶ 50.

After payment of the Manager's fee, the remaining Trust income was subject to U.K. tax liability. Stip. ¶ 39; Coffield, Tr. 4420-21. These U.K. taxes were payable semi-annually at a rate of 22 percent. Stip. ¶¶ 39, 63. To pay these taxes in the United Kingdom, the Trust set aside a portion of the cash received (the "Tax Amount") each month in a tax set-aside account held at Barclays. Stip. ¶ 39. Since the Trust was required to pay tax in British pounds sterling while the cash

received by the Trust was in U.S. dollars, the Trust exchanged the Tax Amount for an amount of British pounds sterling at the prevailing exchange rate. *Id.*

After deducting the Manager fee and setting aside funds to pay the U.K. taxes, the Trust distributed its remaining cash to its unit holders pursuant to the Trust Agreement in the following order: (1) Class A Units—one percent of the Trust's income (proceeds split evenly between InvestCo and NewCo, as each of those entities held 50 percent of the Class A Units); (2) Class D Unit—LIBOR-based distribution to Barclays based on the \$25 million D Unit stated value; (3) Class C Unit—all remaining distributable income. No distributions were made on the Class B Unit (which had been redeemed) and the Class E Unit (which had no distribution rights). Stip. ¶¶ 32, 40. The Class C Unit distribution was placed into the “Barclays Blocked Account,” held in the name of Barclays at BB & T and described in the Bank Agreement. JX 18. The precise amount of the C Unit distributions was specified in the Class C Unit and Class E Unit forward sale agreement. JX 23 at 478-80. The C Unit distributions were approximately 99 percent of the Trust's remaining income after payment of the U.K. tax. Cragg, Tr. 4495; Demo. Ex. 66.

At the time they entered into the STARS transaction, the parties agreed to a schedule of expected monthly Class C Unit distributions set forth in the Class C Unit and Class E Unit forward sale agreement. Stip. ¶ 41; JX 23 at 478-80. The Class C Unit distributions were required to be paid each month into the Barclays Blocked Account at BB & T. Stip. ¶ 41. The amount of the monthly distribution ranged between approximately \$25 million and \$35 million. Cragg, Demo. Ex. 33. Barclays had no

authority to withdraw funds from this account. *Id.* At the closing date, Barclays irrevocably directed that all funds paid into the Barclays Blocked Account be returned to the Trust on the same day (or as soon as practicable thereafter). *Id.* In every month the STARS transaction was in effect, the Class C Unit distribution was made in exactly the target amount, and these distributions were always returned to the Trust on the same day. Cragg, Tr. 4474-75; Demo. Ex. 36; Stip. ¶ 41. While the distributions differed somewhat from month to month, this variation is explained by the differing number of days across time periods. Cragg, Tr. 4473-74; Demo. Ex. 34.

Each month the Trust would distribute income to the Class D Unit holder (Barclays) equal to (one-month U.S. dollar LIBOR + 25 basis points) x 0.875 x \$25,000,000 (the stated amount of the Class D Unit). Stip. ¶ 42.

Barclays was obligated, pursuant to the Class C Unit, Class D Unit and Class E Unit Subscription Agreement, to return all Class C Unit cash distributions received from the Trust back to the Trust via the Barclays Blocked Account. Stip. ¶ 43. These returns of funds were represented by the parties to be further investment in the Class E Unit. *Id.* However, further investments in the Class E Unit did not increase the Class E Unit distributions because the Class E Units were not entitled to Trust distributions, Stip. ¶ 40, and did not affect the price at which the Class E Unit would be repurchased by BB & T under the forward sale agreement. Cragg, Tr. 4497-99; JX 23 at 476. The Trust then took the returned Class C Unit distributions and purchased additional DelCo Class II shares. Cragg, Tr. 4500; USX 918 at 30-31. The Trust's increased investment in DelCo Class II shares did not

increase its rights to DelCo distributions. Cragg, Tr. 4501; JX 7 at 111.

Under the forward sale agreements, InvestCo agreed at the termination of the STARS transaction to purchase, and Barclays agreed to sell, the C, D, and E Units at a predetermined price consisting of \$1.5 billion plus a fixed amount. Stip. ¶ 44. The fixed amount was calculated by multiplying \$1.5 billion by 4.43 percent (the five-year swap rate of 4.18 percent plus a spread of 25 basis points) less the Bx amount. *Id.* The parties simultaneously executed the Zero Coupon Swap Agreement that effectively converted BB & T's fixed-rate obligation payable at termination under the Class C Unit and Class E Unit forward sale agreement into a floating rate interest obligation payable monthly. *Id.* ¶45. Under the floating leg of the Zero Coupon Swap Agreement, Barclays received from InvestCo a variable payment calculated by multiplying \$1.475 billion (the Class C stated value) by (one-month U.S. Dollar LIBOR + 25 basis points) minus the Bx (referred to in the Swap Confirmation as the "Floating Rate Spread Amount"). *Id.*

The parties agreed to a schedule of specific Bx payments at the inception of the transaction. Stip. ¶ 47. Over the expected 60-month period of the STARS transaction, the monthly Bx payment ranged from a low of \$3,633,996 (month 7) to a high of \$5,650,566 (month 1). *Id.*

Each month, InvestCo's floating interest obligation and Barclays' Bx obligation were netted against each other. Stip. ¶ 46. In instances where InvestCo's floating interest obligation exceeded Barclays' Bx obligation, InvestCo would make a payment to Barclays. *Id.* In instances where InvestCo's floating interest obligation was less than Barclays' Bx

obligation, Barclays would make a payment to InvestCo. *Id.* From September 2002 until mid-2005 (nearly three years), Barclays made monthly payments to InvestCo under this agreement. Coffield, Tr. 4433-34; Stip. App. A. In 2003, the Barclays payments to InvestCo exceeded \$25 million, and in 2004, they were more than \$26 million. Stip. App. A. Banks, in making a loan, do not normally pay interest to the borrower. Monger, Tr. 1113.

Over the life of the transaction, InvestCo agreed to pay to Asteras quarterly dividend payments at a rate of one-month dollar LIBOR + 35 basis points multiplied by the \$65 million stated value of its preferred stock. Stip. ¶ 49. Asteras was obligated to make payments to Barclays' subsidiary, Barclays Oversight Management, Inc. ("BOMI") at a rate of one-month dollar LIBOR + 24 basis points multiplied by \$64,750,000, the amount Asteras had borrowed from BOMI to acquire the preferred shares. *Id.* The detailed spreadsheet used by the parties to analyze the STARS cash flows disregarded Asteras, and treated Barclays as the recipient of the preferred dividend. Cragg, Tr. 4555-56; Demo. Ex. 134.

The amount of Trust income placed into the U.K. tax set-aside account was used to pay U.K. taxes as they became due. Stip. ¶ 48. The Trust's payment of U.K. taxes generated the foreign tax credits claimed by BB & T. JX 241 at 187488. The Trustee, acting through the Manager in its management and administration capacity, made U.K. tax payments from the U.K. tax set-aside account to the U.K. taxing authority. Stip. ¶ 48. Pursuant to U.K. law, the Trust's taxable years ended on April 5 each calendar year, triggering the following events: (a) payment by January 31 of 50 percent of the estimated tax due for the year; (b)

payment by July 31 of the remaining 50 percent of the estimated tax due for the year; and (c) payment by the following January 31 of the balance due, if any, as evidenced in the concurrently filed tax return. *Id.*

4. Loan

Barclays and BB & T created the \$1.5 billion STARS Loan component with subscription agreements and two types of derivative contracts known as a forward sale agreement and a zero coupon swap, discussed above. JX 14; JX 19; JX 20; JX 23; JX 24; JX 36; JX 38. Barclays transferred \$1.5 billion in cash to BB & T by means of the subscription agreements at the beginning of the STARS transaction. JX 14; JX 38. On the August 1, 2002 closing date, Barclays subscribed for, or purchased, the STARS Trust's C, D, and E Units for \$1.5 billion. Cragg, Tr. 4466; Demo. Ex. 21; JX 2 at 9-10; JX 38. By using this method, Barclays briefly placed the \$1.5 billion in the Trust. JX 38 at 855-56. With this \$1.5 billion, the parties put a value of \$1,474,999,000 on the C Unit, a value of \$25 million on the D Unit, and a value of \$1,000 on the E Unit. JX 2 at 9-10.

A forward sale agreement is an agreement to sell an asset at a future date for a price that is agreed to on the date of the agreement. Kawaller, Tr. 4874. Barclays and BB & T entered into two forward sale agreements: (a) a Class C Unit and a Class E Unit Forward Sale Agreement, and (b) a Class D Unit Forward Sale Agreement. Kawaller, Tr. 4873-74; JX 23 at 468-83; JX 24 at 484-94. Under these agreements, Barclays committed to sell, and BB & T (through InvestCo) committed to buy the C, D, and E Units at the end of the STARS transaction. Kawaller, Tr. 4884-85; JX 23 at 470; JX 24 at 486.

Although Barclays originally subscribed for these units from the Trust entity directly, Barclays agreed to forward sell the C and E Units at termination for \$1.475 billion and agreed to forward sell the D Unit at termination for \$25 million. Kawaller, Tr. 4884-85; JX 2 at 9-10; JX 23 at 470; JX 24 at 486, 491. InvestCo agreed to forward buy the C, D, and E Units for these amounts. *Id.* The Class C and E Unit Forward Sale Agreement did not discuss or recognize the mandatory return of the Class C Unit distributions each month, characterized as “reinvestments” in the Class E Unit, and did not allow for an increase in the sale price on the Class E Unit commensurate with these additional payments. JX 2 at 11; JX 23 at 470; USX 918 at 36, 40. This arrangement assured that at the end of the transaction Barclays would receive only the \$1.5 billion that it originally put into the transaction. *Id.* The forward sale prices for the C, D, and E Units were due to Barclays at termination, when Barclays was to transfer these units to InvestCo. JX 23 at 470; JX 24 at 486.

The Class C and E Unit Forward Sale Agreement formula calculated the accretion of interest on \$1.475 billion at a fixed rate of 4.43 percent (composed of a swap rate of 4.18 percent plus a credit spread of 25 basis points), adjusted for the cumulative future value of Barclays’ monthly Bx payments to BB & T. James, Tr. 3798; JX 23 at 476; JX 36 at 721. However, the parties never intended for this fixed interest rate to be paid. Cragg, Tr. 4573-74; Demo. Exs. 155, 156. Instead, the parties simultaneously entered into a Zero Coupon Swap, which Dr. Cragg concluded “has the effect of eliminating the accretion payment,” by “exactly offsetting it.” *Id.* As a result, the fixed rate accretion under the Class C and E Unit Forward Sale

Agreement had no economic effect. Cragg, Tr. 4573-75; Demo. Exs. 155-157; JX 36 at 725.

Because InvestCo paid the D Unit interest currently over the life of the STARS transaction, the forward sale price for that Unit was simply \$25 million, the same as the initial acquisition price. JX 24 at 491. The forward sale payments for the C, D, and E Units were due at termination, when Barclays was to transfer the units to InvestCo. JX 23 at 470, 472, 486-87. Although the Forward Sale Agreement for the C and E Units could have applied a variable rate of interest or scheduled the interest payments to be paid monthly, it did not. The parties simply did not need a swap to convert the forward sale's fixed interest rate to a variable interest rate. Kawaller, Tr. 4882. Rather, the parties used a simultaneously executed interest rate swap to set the actual interest rate to be paid each month at LIBOR + 25 basis points on \$1.475 billion. Kawaller, Tr. 4884-85; Demo. Ex. 8. However, Barclays needed the fixed-payment accruing interest of the forward sale to make it appear that Barclays would suffer a predictable U.K. tax loss by its purported equity investments in the Trust's E Unit, which by design, did not return anything of value to Barclays. Monger, Tr. 649-50; Watson, Tr. 3546. Over the course of the transaction, Barclays would thus realize a U.K. tax loss because of how it priced the forward sale, namely that it had to increase the value of its investment in the Class E Unit of the Trust but had to sell back the Class E Units at a fixed price. Sultan, Dep. 52. Under U.K. tax law, Barclays was able to deduct this anticipated future loss. Monger, Tr. 649-50; Zailer, Tr. 2665-66; Demo. Ex. 2; USX 2215 at 20.

Under a typical interest rate swap, two parties agree to exchange payments, each calculated with reference to the same principal amount. Kawaller, Tr. 4876-77; Demo. Ex. 5. One party to the interest rate swap agrees to pay a variable rate on the principal amount, and the other party agrees to pay a fixed rate. *Id.* These two payment obligations are offset against each other, and the net difference is paid by one party or the other. Kawaller, Tr. 4878; JX 281 at 3903.

BB & T and Barclays entered into an interest rate swap agreement simultaneously with the forward sale agreements, known as the Zero Coupon Swap. JX 20; JX 23; JX 24. By this swap agreement, the parties replaced the lump sum accretion amount due at termination on the C and E Units into a series of monthly payments computed at a variable interest rate based upon LIBOR. Cragg, Tr. 4567; Demo. Ex. 147; JX 281 at 3903.

The fixed leg of the Zero Coupon Swap required Barclays to pay BB & T the net of (a) the accrued interest for the term of the STARS transaction, using a fixed rate of 4.43 percent on \$1.475 billion, and (b) the cumulative future value of Barclays' monthly Bx payments to BB & T. Lys, Tr. 4217; JX 20 at 430; JX 36. This amount precisely equaled the accretion amount that InvestCo was obligated to pay Barclays under the Forward Sale Agreement in connection with the C and E Units. JX 23 at 476. As a result, Barclays' fixed rate accretion amount obligation under the Zero Coupon Swap cancelled out InvestCo's fixed rate accretion amount obligation under the C and E Unit Forward Sale Agreement, effectively negating the fixed interest rate component of the Forward Sale Agreement. Cragg, Tr. 4573-74; Demo. Ex. 155; JX 36 at 725.

Because the fixed rate accretion in the Forward Sale Agreement and the Zero Coupon Swap were designed to cancel each other out, the choice of 4.18 percent plus 25 basis points as the rate to be included in both of these agreements had “no commercial importance” and was entirely arbitrary. Finard, Tr. 5048-49; USX 1479; USX 771. The parties could have specified any number at all in place of the 4.18 percent, and the economics of STARS would not have changed. Finard, Tr. 5048-49.

In addition, under the Zero Coupon Swap, InvestCo agreed to make monthly payments to Barclays on the same principal sum of \$1.475 billion at the variable rate of LIBOR + 25 basis points. Cragg, Tr. 4575; JX 20 at 432. The cumulative effect was to replace InvestCo’s fixed interest obligation under the Forward Sale Agreement with a variable interest obligation payable monthly. Cragg, Tr. 4573-74; Demo. Ex. 155; JX 283 at 3903. Thus, the net effect of combining the Forward Sale Agreement with the Zero Coupon Swap was that InvestCo paid Barclays interest at LIBOR + 25 basis points on \$1.475 billion. Cragg, Tr. 4573-74; Demo. Ex. 155.

Evaluating the net economic effect of the Loan therefore requires piecing together three agreements: (1) the Class C, D, and E Unit Subscription Agreement, under which Barclays paid the Trust \$1.475 billion for the C and E Units; (2) the Class C and E Unit Forward Sale Agreements under which InvestCo committed to purchase those units at termination for \$1.475 billion plus an interest component of 4.43 percent each year; and (3) the Zero Coupon Swap, under which Barclays agreed to pay identically computed interest at 4.43 percent each year, and InvestCo agreed to pay monthly interest at

LIBOR + 25 basis points. Kawaller, Tr. 4884-85; Demo. Ex. 8; James, Tr. 3798; JX 2 at 8-11; JX 20; JX 23 at 476; JX 36 at 721; JX 38.

With the offsetting fixed-rate interest payments under the Zero Coupon Swap and the Forward Sale Agreement netting out to zero, and the remaining monthly interest payments by InvestCo to Barclays at LIBOR plus 25 basis points, the net effect of this structure's three agreements was that BB & T received \$1.475 billion from Barclays at an interest rate of LIBOR + 25 basis points. Kawaller, Tr. 4893-94; JX 20; Finard, Tr. 5047-48; Demo. Ex. 27.

5. Bx Payments From Barclays to BB & T

The Bx payment was the monthly payment that Barclays made to BB & T as part of the STARS transaction and constituted one of the key components of the transaction. The monthly Bx payments were listed in a schedule in the Amended and Restated Formulae Letter. JX 36 at 721-22; Cragg, Tr. 4513-14; Demo. Ex. 96. The Formulae Letter set forth the agreed interpretation of how the formulas would operate in the Forward Sale, Zero Coupon Swap and Trust Agreements. JX 36 at 718-19. The Formulae Letter contained the mathematical equation used to calculate the monthly Bx payments. JX 36 at 724; Cragg, Tr. 4514; Demo. Ex. 97.

The June 2002 draft Formulae Letter stated: "BB & T's portion of the benefits under the transaction for each month (Bx in the Forward Sale and Zero Coupon Swap formulas) will be calculated before the Closing Date by the formula below," which references the specific Bx formula used in the BB & T STARS transaction. Cragg, Tr. 4516; JX 690 at 1398. As noted, it was important for the parties to fix the monthly Bx

payments before closing to avoid potential withholding tax on the interest payments under the Zero Coupon Swap and the U.S./U.K. Double Taxation Treaty. Cragg, Tr. 4516-17; Demo. Ex. 101; USX 690 at 13.

The Bx payment formula was directly related to the amount of U.K. taxes paid by the Trust. From an economic perspective, the amount of the Bx monthly payment constituted a rebate of the U.K. taxes paid by the Trust. Cragg, Tr. 4517; Demo. Ex. 103. Barclays described the monthly Bx payments as a percentage of the U.K. taxes. In a February 16, 2002 memorandum to BB & T, Barclays' Mr. Sultan highlighted that the benefits from STARS were equal to 50 percent of the U.K. taxes. Mr. Sultan stated: "The benefit under STARS arises from the ability of both parties to obtain credits for the taxes paid in the trust. Thus, the benefits to both BB & T and Barclays are easy to calculate and are equal to 50 percent of these taxes for each party." JX 244 at 16419; Cragg, Tr. 4519-20; Demo. Ex. 105. KPMG also described the monthly Bx payments as a percentage of the U.K. taxes. In a January 2002 KPMG presentation to BB & T, KPMG emphasized that "BB & T obtains [a] rate reduction of 50 percent of UK tax, or \$27 million." Cragg, Tr. 4520; Demo. Ex. 106; JX 239 at 11266.

The Formulae Letter defined the monthly Bx payments as a percentage of the U.K. taxes. This letter stated: "In words, Bx is equal to 51 percent of the tax credits received by Barclays on the Class C Unit. . . ." The Class C Unit constituted virtually all of the Trust's income. Cragg, Tr. 4520-21; Demo. Ex. 107; JX 36 at 724. Barclays referred to the monthly Bx payments as both a percent of the U.K. taxes and as a percent of Barclays' U.K. tax credit generated from the STARS transaction. Barclays used these terms

interchangeably. Cragg, Tr. 4526; Demo. Ex. 109; JX 244 at 16419-20. KPMG also used the terms interchangeably. JX 239 at 11254.

The “floating rate spread amounts” in the Zero Coupon Swap were precisely the same values identified as the Bx in the Formulae Letter. The parties to the transaction used Bx and “floating rate spread amount” to describe the same cash flows. Cragg, Tr. 4584-86; Demo. Exs. 165, 166; JX 36 at 726.

Significantly, the Bx payments have no relationship to the amount of the Loan in the parties’ modeling of the STARS transaction. Cragg, Tr. 4589-90, 4592-93; Finard, Tr. 5098-99; Demo. Ex. 65, 66; Ioannidis, Dep. 184. Barclays created a spreadsheet for the STARS model, and shared it with BB & T and other STARS’ counterparties. Finard, Tr. 5086-87. The STARS model for the BB & T transaction had built-in parameters to allow the parties to explore the impact of different relationships using four specific variables, which included the amount of the Loan. Finard, Tr. 5088-99; Demo. Ex. 57-66. The model also included a variable for the Bx payments. *Id.* The model permitted the parties to make projections of cash flows and to perform other calculations. *Id.* Application of the model demonstrated that when the amount of the STARS Loan was increased or lowered, there were no changes to the amounts of the monthly Bx payments, confirming that there was no relationship between the monthly Bx payments and the size of the STARS Loan. Cragg, Tr. 4590-93; Finard, Tr. 5088-99; Demo. Exs. 57-66. The amount of the Bx payment was determined solely by the amount of income that flowed through the Trust, which had no relation to the amount of the Loan. Cragg, Tr. 4593-94; Demo. Ex. 170; USX 1545 at 14. The Bx amount was calculated from a formula,

which did not contain any mathematical term or symbol representing the STARS Loan. Cragg, Tr. 4595-96; Demo. Ex. 171; JX 36 at 724. The Loan had no connection with the Bx. Cragg, Tr. 4595-96.

6. U.K. Tax and Accounting Treatment

The U.K. tax treatment of the STARS transaction is highly complex, but results in substantial benefit to Barclays, BB & T, and the U.K. taxing authority, HMRC, all at the expense of the United States Treasury. At trial, the parties employed an example based upon the existence of \$100 of Trust income.

Under section 469 ICTA⁸ 1988, the Trustee paid income tax to HMRC at 22 percent, or \$22 of the \$100 Trust income, leaving the Trustee with \$78 after the payment of U.K. income tax. Zailer, Tr. 2663-72. Under the same section, Barclays was treated as receiving a Trust distribution of \$78, but the amount was grossed up for the U.K. income tax of \$22 so that Barclays received a distribution of \$100 and a tax credit of \$22. *Id.* Because Barclays paid corporate tax at 30 percent, Barclays had to pay only \$8 in tax, which is the difference between its corporate tax liability of \$30, less the tax credit of \$22. *Id.*

The Trustee distributed the after-tax amount of \$78 to Barclays, and Barclays recontributed the \$78 back to the Trust. *Id.* Barclays then claimed a \$78 tax deduction, which at a 30 percent tax rate, yielded a \$23.40 tax benefit. *Id.* Barclays' tax liability of \$8 could be eliminated using the \$23.40 tax benefit from the deduction, leaving Barclays with a total tax benefit of \$15.40 (\$23.40 minus \$8). *Id.* Under Barclays'

⁸ "ICTA" refers to the U.K.'s Income and Corporation Taxes Act of 1988.

agreement with BB & T, Barclays had to rebate to BB & T a portion of the \$22 tax credit. *Id.* In marketing STARS to BB & T, the Barclays and KPMG promoters showed the rebate payment as 50 percent, or \$11, although the parties ultimately agreed to a 51 percent rebate. PX 17 at 11223; USX 343 at 17; JX 36 at 724. Barclays deducted the \$11 rebate payment, which, at a 30 percent corporate tax rate, yielded \$3.30. The total tax benefit to Barclays was \$18.70 (\$3.30 plus \$15.40). In economic terms, the benefit to Barclays was the U.K. tax benefit of \$18.70, less the \$11 rebate to BB & T, or a total of \$7.70. Peacock, Tr. 2205-06. The percentage split between Barclays and BB & T is contained in the Formulae Letter, where the Bx payment is described as 51 percent of the \$22 tax credit. JX 36.

The Trustee paid HMRC \$22 in taxes, but because Barclays obtained an \$18.70 U.K. tax benefit, the total tax collected by HMRC was \$3.30 (\$22 less \$18.70). Zailer, Tr. 2700-02. Barclays itself did not pay U.K. tax as part of the STARS structure. *Id.*

The U.K. tax treatment above makes the following assumptions: (1) that the STARS Trust is an unauthorized unit trust whose Trustee is a U.K. resident for tax purposes; (2) that it is correct as a matter of U.K. law to treat Barclays as the holder of the Class C Unit; (3) that it is correct as a matter of U.K. law to treat Barclays as the recipient of the Class C Unit distributions; and (4) that Barclays was entitled to claim a tax deduction for the re-contribution of \$78 to the Trust. Peacock, Tr. 2187-96.

Barclays assumed some risk that the HMRC would challenge the above assumptions, and if challenged, there was a risk that the challenge would be successful. Zailer, Tr. 2691-94; Demo. Ex. 9, 10. A

successful challenge would invalidate the intended STARS tax treatment, and Barclays' expected U.K. tax benefits under STARS. Zailer, Tr. 2691-92; Demo. Ex. 9.

7. Transaction Features Designed to Minimize Barclays' Economic Risks

The Class C and Class E Unit Forward Sale Agreement contained a make-whole feature under which BB & T was obligated to reimburse Barclays if the credits generated by the Trust failed to match the parties' expectations. Peacock, Tr. 2212; JX 23 at 472, 480; JX 36 at 840. This provision provided safety to Barclays if there was less than full payment of U.K. taxes by the Trust: ". . . this payment compensates Barclays if the Class C Unit distributions out of the trust (and hence the tax credits) are less than the agreed level." Cragg, Tr. 4530-31; JX 36 at 841. The make-whole payment would only be made to Barclays on the Class C and Class E Forward Sale Date, and therefore the makewhole payment also compensated Barclays for the time value of money. JX 236.

If BB & T became obligated to reimburse Barclays under the make-whole provision, it would be making a direct payment to Barclays rather than a tax payment to the United Kingdom. Cragg, Tr. 4533-34; JX 36 at 840-41. In this circumstance, BB & T would be unable to claim foreign tax credits for the payment. Cragg, Tr. 4534-35. BB & T had an economic incentive to ensure full and timely payment of U.K. tax on the Trust income. *Id.*

The Amended and Restated Participation Agreement contained an indemnity provision that would be triggered if the Trust paid no tax because it was not a collective investment scheme, or if the Trustee was not a U.K. resident. Cragg, Tr. 4543-44; JX 17 at 297. BB

& T's indemnity payment to Barclays would be approximately one-half of the U.K. tax that the Trust would have paid. Cragg, Tr. 4545; JX 17 at 298-99.

The parties also negotiated at-will termination rights. Johnson, Tr. 282-83; JX 23 at 472-73. Under the Forward Sale Agreement, Barclays could terminate STARS for any reason with 30 days' notice. JX 23 at 473. If Barclays did not receive its anticipated tax benefits, it could have terminated the transaction. USX 2219 at 14. BB & T also could terminate STARS for any reason with 30 days' notice. JX 23 at 472-73. BB & T was well aware of this 30-day termination right. Monger, Tr. 1063; Watson, Tr. 2867-68. BB & T wanted sufficient time to replace the STARS Loan if it became necessary. Monger, Tr. 730.

8. Trust Income

Every month during the STARS transaction, BB & T targeted a pre-determined amount of money that it would briefly and nominally transfer to Barclays. JX 23 at 478-80; USX 1972. These transfers were to occur on the fifteenth day of each month. Over the expected 60-month duration, the predetermined monthly transfers averaged \$31,332,400. *Id.* As noted, the amounts varied from month to month because of variations in the number of days per month and compounding asset income in the transaction. Cragg, Tr. 4473-74. BB & T transferred these amounts, known as the Class C Unit distributions, to the Barclays Blocked Account. Monger, Tr. 653-54; Coffield, Tr. 4414; USX 1972, rows 253, 257; USX 1994 at 2. A BB & T employee would make these Class C Unit distributions, and at the same time, would make another equal and opposite transfer from the Barclays' Blocked Account back to the original account. Coffield,

Tr. 4427; USX 1972, rows 250, 253, 256-57. This latter transfer was known as the E Unit reinvestment. Wild, Tr. 2625; USX 1972, rows 296-97.

The C Unit distribution amounts came from loan income held by BB & T's DelCo entity, known as Branch Finance LLC. Coffield, Tr. 4398-99, 4412-13. A BB & T employee reviewed the pre-determined Class C Unit distribution amounts monthly and calculated how much money to transfer from DelCo to make the distribution. Coffield, Tr. 4414; USX 1988. These distributions involved a simple chronological pattern:

- A payment from DelCo to the Trust;
- A payment from the Trust to the blocked account;
- A payment from the blocked account back to the Trust; and
- A payment from the Trust back to DelCo.

Monger, Tr. 1007-08. Logistically, all of these transfers took place during the same overnight process every month. Coffield, Tr. 4430.

The purpose of exactly matching transfers to and from the blocked account was to create a trading loss for Barclays on its U.K. taxes. Peacock, Tr. 2196; Wild, Tr. 2539-41. The transfers made it appear that Barclays received STARS Trust income by the initial transfer to the blocked account, but then Barclays immediately and mandatorily "reinvested" the distributed amount into the Class E Unit. Barclays then lost the "reinvested" contributions because it had to sell the E Unit back to BB & T for an amount equal to its initial capital contribution. Peacock, Tr. 2196; Sultan, Dep. 106-07. Barclays had no economic interest in the Class C Unit distributions and never

intended to receive any benefits from these distributions aside from tax benefits. Sultan, Dep. 122, 263; Abrahams, Dep. 48. Nevertheless, Barclays took the position that U.K. tax law would respect the Class C Unit ownership because of the law's alleged recognition of form over substance. Sultan, Dep. 122-23.

DelCo held the assets used in STARS, rather than the Trust, for U.K. tax reasons. Wilkerson, Tr. 1808-09. If the Trust had held the STARS assets, it might have exposed the assets to U.K. capital gains taxes and foreign currency gains taxes, neither of which would have produced a benefit for Barclays within the STARS structure. Wilkerson, Tr. 1808-09; Lys, Tr. 4060. Further, BB & T would have been required to reimburse Barclays for any U.K. tax that Barclays incurred on capital gains arising in the Trust. USX 2215 at 54-56. BB & T also recognized that it might not be able to claim foreign tax credits for any payment of a capital gains tax paid by the Trust. *Id.*

In order to ensure that DelCo maintained a large enough pool of assets to make the monthly payment of the dividend on the Branch Finance Class II Shares, BB & T employees monitored the Loan assets in DelCo on a daily basis. Coffield, Tr. 4397-98, 4401. For example, if DelCo auto loans were paid off or otherwise retired, new assets had to be transferred to DelCo to maintain the necessary income levels. Coffield, Tr. 4398-400; Finard, Tr. 5119. This exercise involved determining what assets DelCo could purchase from the main BB & T North Carolina entity, and then internally selling those Loan assets from BB & T North Carolina to DelCo as necessary. Coffield, Tr. 4399-400.

9. STARS Submission to the North Carolina Commissioner of Banks

In the spring of 2002, BB & T informed the North Carolina Commissioner of Banks (“NCCOB”) of the STARS transaction. Hudson, Tr. 1565; JX 258; JX 268. The NCCOB is the public regulator of North Carolina state-chartered banks. The NCCOB is responsible for ensuring that North Carolina is served by banks that are able to meet the credit needs and other financial services of those within the state. Smith, Tr. 2950. A fundamental element of this responsibility is reviewing the “safety and soundness” of regulated banks, which consists of assessing a bank’s capital, asset quality, management, earnings, liquidity, and sensitivity to interest-rate risk. Smith, Tr. 2906-07. The NCCOB does not assist North Carolina chartered banks in complying with federal tax law. Smith, Tr. 2950. The NCCOB staff is not trained in federal tax law. Smith, Tr. 2920-22, 2952-53.

BB & T sought from the NCCOB a non-objection letter regarding STARS in order to secure the NCCOB’s determination that the STARS entities would be considered operating subsidiaries under North Carolina law. Smith, Tr. 2928-29. BB & T’s purpose essentially was to obtain the NCCOB’s permission to form the STARS entities. Hudson, Tr. 1565-66. If BB & T had not taken this step, and if the NCCOB later had determined that, under North Carolina law, the STARS entities were subsidiaries engaged in nonbanking activities, the consequences to BB & T would have been “significant.” Smith, Tr. 2967-68; Hudson, Tr. 1476.

BB & T’s in-house counsel, Howard Hudson, sent the NCCOB a letter dated April 11, 2002 that discussed STARS as “making available to BB & T over

the next five years cost effective funding of \$1.5 billion at approximately 300 basis points below BB & T's normal funding cost on an underlying asset pool of \$7.2 billion." JX 258 at 1. This letter described STARS "as somewhat complex in nature," and BB & T offered to make Mr. Watson and Mr. Monger available to explain STARS to the NCCOB staff. *Id.* BB & T intended to give the NCCOB a preliminary tutorial on STARS before formally seeking non-objection. Hudson, Tr. 1476. In approaching the NCCOB, BB & T did not mention a sharing of U.K. tax benefits with Barclays, or that the low financing was made possible by claiming foreign tax credits in the United States. Smith, Tr. 2954-58; JX 258.

On April 23, 2002, the NCCOB's Daniel Garner requested a conference call with BB & T, and asked that BB & T assume "they are talking to a college student taking an accounting class, and then walk[ing] [NCCOB] through it at that level." JX 263. Shortly thereafter, BB & T executives met with Daniel Garner and others at NCCOB to provide them with an overall briefing about STARS. Hudson, Tr. 1560. During the briefing, BB & T did not describe the C Unit distribution and the corresponding E Unit recontribution as a circular cash flow. Smith, Tr. 2962-63. Before STARS, Mr. Smith had not heard of a financing transaction with an interest rate of 300 basis points below LIBOR, and he never fully understood how Barclays was able to offer below-LIBOR financing to BB & T via the STARS transaction. Smith, Tr. 2959, 2961.

By letter dated June 5, 2002, BB & T formally sought non-objection from the NCCOB regarding the STARS entities. JX 268. In that letter, BB & T described STARS as "a synthetic financing transaction

under which BB & T will borrow approximately \$1.5 billion from Barclays. . . . The primary benefit of the Financing Transaction is that the interest rate payable by BB & T will be at an effective rate of 290 basis points below BB & T's normal cost of funds. . . ." *Id.* According to this letter, such a benefit was "predicated on interpretations of both United States and United Kingdom tax laws and regulations." *Id.*

On June 6, 2002, the NCCOB informally indicated to BB & T its non-objection to the STARS entities. USX 667. By letter dated June 14, 2002, the NCCOB formally provided to BB & T such non-objection. JX 270. The NCCOB issued the formal nonobjection letter with the understanding that BB & T would "obtain opinion letters as outlined in the application . . . and attempt to insure that the activities of . . . the agents, employees, and affiliates . . . that may be taken on behalf of the Bank shall comply with all applicable federal, state, and local laws and regulations." *Id.* at 13509. The nonobjection letter also stated it was not an endorsement of STARS, but rather, was merely a statement by NCCOB that the STARS entities did not appear to pose a threat to BB & T's "safety and soundness." *Id.*

The NCCOB never independently analyzed the tax treatment of BB & T's STARS transaction, and never sought a third-party analysis for this purpose. Smith, Tr. 2959-60. The NCCOB relied on BB & T's assurance in its formal request for non-objection that BB & T would receive written tax opinions from both Sidley Austin and KPMG regarding STARS' tax effects. Smith, Tr. 2960; JX 268. During his tenure as NCCOB Commissioner, Mr. Smith personally wanted BB & T to become the largest state-chartered bank in the United States. Smith, Tr. 2948-50.

F. Possible Second STARS Transaction

Starting in June 2003, various newspaper stories were published regarding KPMG, Sidley Austin and Mr. Ruble, and their role in allegedly improper tax shelters. *See* USX 1296; USX 1453; USX 1475.⁹ On or about October 2003, Mr. Monger knew that Sidley Austin had terminated Mr. Ruble, and discussed that fact with Messrs. Hudson and Reed. Monger, Tr. 1372-74. At some time in 2003 or 2004, Mr. Watson and other executives at BB & T learned that KPMG, Mr. Ruble, and Sidley Austin were all under scrutiny for tax shelter activity. Watson, Tr. 3553-55. Although KPMG and Sidley Austin were receiving negative publicity regarding abusive tax shelters, Barclays pitched a second STARS transaction to BB & T. Watson, 3559-60.

By April 15, 2004, there was a pending IRS audit of BB & T's listed transactions from 1998-2002, which included STARS. USX 1601. In an internal Barclays email sent that day, Mr. Ioannidis stated that Mr. Monger "does not want to be expanding a trade which is currently under IRS review." *Id.*; Monger, Tr. 1363-68; Watson, Tr. 3561-63. Despite this pending audit, in mid-May 2004, BB & T was considering extending its STARS transaction. USX 1623. The following month, Barclays presented a proposal to BB & T

⁹ These articles, published in *The Wall Street Journal* and *The Chicago Tribune*, were titled "KPMG's Emails Pointed to Concerns Over Tax Shelters," "U.S. Government Sues Sidley Austin On Tax Shelters," and "Sidley Austin expels partner; Played key role in tax shelters." Mr. Monger testified that he dismissed these articles as "probably inflammatory, probably highly erroneous, [and] obviously slanted," and observed that "[a]nybody that depends on the newspaper, I think, is being rather short-sighted." Monger, Tr. 1387.

regarding “Additional STARS Financing.” USX 1623; Watson, Tr. 3558-60.

By August 2004, BB & T executives knew that Mr. Ruble and Sidley Austin were under investigation by the federal government, and that Mr. Ruble had been represented in the media as blessing tax shelter products of KPMG. Monger, Tr. 1382-85. After learning this information, BB & T requested and received assurances from Sidley Austin that the law firm would stand behind its STARS opinions. *Id.* at 1385-86.

Mr. Monger retired in October 2004, and Mr. Watson took over his position as STARS project director at BB & T. Watson, Tr. 3576-77. On April 6, 2006, Mr. Watson attended a meeting of the Trustee’s Board of Directors. USX 1855 at 2; Watson, Tr. 3579-81. At this meeting, Mr. Watson indicated to the directors that BB & T was interested in extending the STARS transaction. USX 1855 at 2; Watson, Tr. 3579-81. On May 11, 2006, the managers of InvestCo held their annual meeting, at which they adopted a resolution authorizing action to extend STARS. USX 1865; Watson, Tr. 3581-82.

Internal KPMG email correspondence dated May 18, 2006 discussed a potential extension of the STARS transaction with BB & T. USX 1869; Watson, Tr. 3576-79. The email explained that “[t]hey’ve [BB & T] been briefed about the potential impending bad publicity and been advised to consider diversifying their risk by looking at other strategies and counterparts. They seem to be undaunted and want to proceed.” USX 1869. As late as June 15, 2006, BB & T was considering an extension of the STARS transaction of up to five years. JX 272; USX 1879.

In November 2006, the IRS issued three Information Document Requests (“IDRs”) to BB & T related to the STARS transaction and the entities used to implement it. USX 1908-10; Watson, Tr. 3584-86. The IRS issued three additional IDRs to BB & T related to the STARS transaction in December 2006. USX 1923-25; Watson, Tr. 3586-88. In January 2007, a federal court decided against BB & T in litigation involving BB & T’s LILO transactions, which resulted in a significant tax impact to BB & T. *BB & T Corp. v. United States*, 2007 WL 37798 (M.D.N.C.2007); Watson, Tr. 3588-89.

G. Termination of BB & T STARS

Mr. Watson recognized that BB & T may need to terminate STARS early, in the event of an IRS challenge to the transaction or a change in U.S. or U.K. tax law. Watson, Tr. 3471. On March 30, 2007, the IRS published its proposed “Regulations on Transactions Designed to Artificially Generate Foreign Tax Credits.” 72 FR 15081, REG-156779-06, March 30, 2007. Some of KPMG’s clients terminated STARS because of the effect of these proposed Treasury regulations on their ability to claim foreign tax credits for the STARS transaction. Wilkerson, Tr. 1863.

BB & T terminated its STARS transaction as of April 5, 2007. Stip. ¶ 86; JX 168-171; JX 184; JX 193-201. Representatives of BB & T testified at trial that BB & T terminated STARS because it believed a potential change in U.K. tax law might cause Barclays to terminate STARS, and wanted to “terminate it at a good time for us [BB & T] to get financing somewhere else in the market.” Allison, Tr. 825; Watson, Tr. 2867-70.

To terminate the STARS transaction, InvestCo purchased Barclays' C and E Units by paying Barclays \$1,479,680,507. InvestCo purchased Barclays' D Unit by paying \$25,079,340. Stip. ¶ 87. Because the transaction was not terminated on a regular monthly STARS payment date, InvestCo had to pay mid-month interest: an additional \$4,680,507 over the principal amount for the C and E Units, and an additional \$79,340 over the principal amount for the D Unit. JX 36. Through these payments, InvestCo repaid the principal amount of the STARS transaction financing. Stip. ¶ 88. The Asteras preferred shares remained outstanding until June 15, 2007, at which time InvestCo redeemed the \$65 million in preferred shares issued to Asteras. Stip. ¶ 89.

H. Costs and Fees of BB & T STARS

1. Third Party Fees

As discussed above, KPMG and BB & T negotiated and agreed to a fixed fee of \$6.5 million, plus hourly assistance. JX 254. Of that amount, \$500,000 would be deferred for each of the five projected years of STARS. Monger, Tr. 1196; JX 254. Mr. Monger also negotiated with KPMG that it would render a minimum amount of services for no fee in the event of an IRS audit of the STARS transaction, not to exceed 350 hours. USX 470; Monger, Tr. 1156-1157; Watson, Tr. 3471-73, 3622-25; JX 254. Fees for examination assistance in excess of 350 hours were to be billed at mutually agreeable rates. JX 264. The \$6.5 million in fees was "by a significant margin" the most that BB & T had ever paid for a "tax solution." Monger, Tr. 1191; USX 2238 at 1-2.

Also as discussed above, BB & T retained the law firm of Sidley Austin to assist in tax matters. Monger, Tr. 1295; JX 243. Sidley Austin was to receive a flat fee of \$300,000 for tax matters, and monthly billing at the firm's standard rate for any corporate law work. JX 243 at ¶ 3. BB & T paid a total of \$1,355,929.91 to Sidley Austin for its various legal opinions and other advice provided with the transaction. USX 679 at 1, 4; USX 937 at 1-3; USX 1115; USX 1587; USX 1966; USX 2096. The total fees that BB & T paid to KPMG and Sidley Austin represented "52 or 53 basis points" on the \$1.5 billion financing. Monger, Tr. 699.

BB & T incurred fees for services rendered by PwC with respect to the STARS transaction from March 16, 2002 through May 15, 2003. BB & T paid PwC a total amount of \$117,085. USX 591.

BB & T did not pay Barclays a direct fee for its participation in the transaction. LaRue, Tr. 5322.

2. Internal Administrative Costs

BB & T executives and employees expended considerable time and resources reviewing and implementing STARS. Monger, Tr. 602; Allison, Tr. 894. Once BB & T entered into the STARS transaction, the BB & T general accounting department employed many steps to implement the transaction processes, some of which could take up to seven hours a day. Coffield, Tr. 4397-440.

The STARS Trust structure also required expenditures within BB & T. USX 2212 at 54-55. The Trust structure required the payment of administrative costs and fees, some of which would not have been incurred if not for the transaction. *Id.* at 54. Over the life of the transaction, the Trust would have service

fees of \$2.2 million. *Id.* BB & T also anticipated costs for incremental operating expenses, such as “salaries, benefits & other expenses,” as well as travel costs, amounting to \$87,000 annually. USX 933 at 5; USX 2212 at 54. Additionally, special purpose entities created specifically for the transaction required management fees possibly in excess of \$2.6 million. USX 2211 at 16; USX 2212 at 54-55, 106, 116-117.

I. Expert Witnesses

Thirteen expert witnesses testified at trial, seven called by BB & T and six called by the Government. The expert witnesses for BB & T were: (1) Mr. William Isaac, an expert in banking oversight and management; (2) Dr. Christopher James, an expert in banking and finance; (3) Dr. Thomas Lys, an expert in economics; (4) Mr. David Rosenbloom, an expert in international tax; (5) Mr. Jonathan Peacock, an expert in U.K. tax law; (6) Mr. Martin Brooks, an expert in U.K. tax administration; and (7) Mr. Kenneth Wild, an expert in U.K. accounting. The Government’s experts were: (1) Dr. Michael Cragg, an expert in economics and financial analysis; (2) Mr. Joel Finard, an expert in capital market analysis and structured finance analysis; (3) Dr. Ira Kawaller, an expert in economics and the use of derivative contracts; (4) Dr. David LaRue, an expert in economics, accounting and tax compliance; (5) Mr. Isaac Zailer, an expert in U.K. tax law; and (6) Mr. Michael Taub, an expert in U.K. accounting. While all of the experts were helpful to the Court in varying degrees, Dr. Cragg for the Government was the single most helpful expert in providing a comprehensive analysis of the STARS transaction.

Dr. Cragg analyzed the source of benefits in the STARS transaction. He testified that the benefits of STARS arose solely from artificially created U.K. taxes and foreign tax credits. He concluded that, as an economic matter, BB & T's voluntary action of subjecting its U.S.-sourced income to a U.K. tax was the source of the financial benefits to both BB & T and Barclays from STARS. Cragg, Tr. 4548-52. He noted that in return for BB & T circulating its income through a Delaware trust with a U.K. trustee, which subjected the income to a U.K. tax, Barclays agreed to make monthly payments labeled as the "Bx" to BB & T. *Id.* at 4463. The Bx payment represented a return or rebate by Barclays of 51 percent of the U.K. tax paid by BB & T. *Id.* at 4517; Demo. Ex. 103. By voluntarily paying U.K. taxes on U.S.-sourced income, BB & T was thereby able to claim U.S. foreign tax credits. Cragg, Tr. 4548-52.

Dr. Cragg also testified that the Bx payment was purely a tax effect and could not be considered a component of interest. *Id.* at 4583-84, 4601. His economic analysis showed that the netting of the Bx payments from Barclays with the monthly interest payments on the Loan resulted in an interest rate of approximately 300 basis points below LIBOR. *Id.* at 4588-89; Demo. Ex. 168. He observed that the netting of these two payment obligations could be expected to result in a "negative interest rate" owed by BB & T. Cragg, Tr. 4632; USX 2212 at 60-62. For the first 35 months of the Loan, the lender, Barclays, was paying the borrower, BB & T, to borrow its funds. Dr. Kawaller testified that it makes no economic sense for a lender to pay a borrower. Kawaller, Tr. 4632.

Dr. Cragg also demonstrated that the STARS Trust structure consisted of a series of economically meaningless circular cash flows, and that the STARS Trust was separable from the Loan and had no economic purpose. Cragg, Tr. 4493-94, 4658; Demo. Exs. 215-220. He showed that the Trust was artificially combined with the Loan, which, excluding the U.S. tax benefits derived from STARS, was high-cost relative to BB & T's alternative funding opportunities. Cragg, Tr. 4646-48; Demo. Ex. 205-206. According to Dr. Cragg, neither the Loan, nor the Trust, nor the combination of the two offered any possibility of non-tax profit for BB & T. Cragg, Tr. 4648-49, 4610, 4671-72; Demo. Exs. 179, 181, 208. Dr. Cragg demonstrated that ultimately the sole purpose of STARS was to transfer more than \$400 million from the U.S. Treasury to BB & T, Barclays, and the U.K. tax authority. Cragg, Tr. 4680; Demo. Ex. 230.

Mr. Finard testified that BB & T's stated business purposes for the STARS transaction were not consistent with the transaction's financial risks and rewards. Mr. Finard's capital markets analysis showed that STARS was not low-cost funding and that it did not provide liquidity risk management benefits. Finard, Tr. 5125, 5141; Demo. Ex. 80, 91. Mr. Finard concluded that, once stripped of its needless complexity, STARS consisted of two, simple unrelated transactions—the Loan and the Trust. The two components were artificially linked to enable BB & T to deduct U.S. tax benefits generated by the Trust structure from the cost of the Loan, thereby making the Loan appear to be low-cost funding. Finard, Tr. 5038-39, 5081-82, 5146-48; Demo. Ex. 19-21, 97-98.

Dr. Kawaller's analysis of the cash flows of STARS demonstrated that the Bx payments were a rebate of taxes, not an interest expense, and should not be considered in a pre-tax profitability analysis. Kawaller, Tr. 4898-900. He established that when the Bx payments were excluded, the STARS transaction was not profitable for BB & T. *Id.* at 4924-25.

Like Mr. Finard, Dr. LaRue determined that, from an economic and analytical perspective, the STARS transaction consisted of two functionally unrelated and discrete components, the Trust and the Loan. LaRue, Tr. 5286; Demo. Ex. 3-5. Dr. LaRue's analysis of the Trust structure demonstrated that the Trust was not intrinsically capable of generating any pre-tax economic profit. Although BB & T incurred substantial transaction costs in establishing the Trust, the only economic benefits were from the tax rebates. LaRue, Tr. 5306-08; Demo. Ex. 16-17.

Mr. Zailer testified about the risk that the U.K. tax authority would challenge the STARS transaction. Zailer, Tr. 2694. He observed that HMRC would most likely challenge a transaction when it loses money, not where it gains revenue, such as in STARS. *Id.* at 2725-29. Barclays' correspondence with HMRC was misleading because it suggested that Barclays was paying the extra tax. In fact, the extra revenue to HMRC was a residual payment from the Trustee. *Id.* at 2701-02.

Mr. Taub's analysis demonstrated that Barclays was not in compliance with U.K. Generally Accepted Accounting Principles ("GAAP") in its financial reporting of STARS. In particular, Barclays inappropriately accounted for the income on the monthly C Unit distributions because the funds were simply part of a circular flow of funds having no economic reality.

Taub, Tr. 2591-92, 2606; Demo. Ex. 10-11, 21; USX 2214 at 9.

Among Plaintiff's experts, Dr. Lys testified that STARS generated pre-tax profit for BB & T based on the assumption that the assets purchased by BB & T with the STARS proceeds were incremental. Lys, Tr. 4110-11. However, BB & T would have borrowed from other sources in the absence of STARS. Dr. Lys calculates the profitability of STARS as the return on the Loan proceeds, *id.* at 4109-11, but this testimony overlooks that BB & T would have had "loan proceeds" from any loan. This fact alone cannot provide a non-tax business purpose for the STARS transaction. The testimony of Dr. James suffers from the same shortcoming. James, Tr. 3633-36.

Mr. Isaac viewed STARS as low-cost funding that was strategically important to BB & T because it improved the bank's liquidity, provided greater loan diversity through international funding, and helped to fund the bank's asset growth. Isaac, Tr. 3256-57. However, the evidentiary record does not contain a single contemporaneous reference to these purported benefits except for the low-cost funding. *Id.* at 3390-91. Indeed, the record reflects that BB & T could have borrowed from other sources, such as the Federal Home Loan Bank Board ("FHLB"), at favorable loan rates. The unusually low financing created under STARS is made possible purely by the rebate of U.K. taxes. The Court commends Plaintiff's experts for their ingenuity, but no matter how one holds the STARS prism to the light, the benefits are driven solely by the sham circular cash flows of the Trust.

II. Discussion

A. Standards for Decision

A tax refund suit is a *de novo* proceeding, “not an appellate review of the administrative decision that was made by the IRS[.]” *Wells Fargo & Co. v. United States*, 91 Fed.Cl. 35, 75 (2010) (quoting *D’Avanzo v. United States*, 54 Fed.Cl. 183, 186 (2002)), *aff’d*, 641 F.3d 1319 (Fed. Cir.2011). Thus, in conducting its *de novo* review, the Court gives “no weight . . . to subsidiary factual findings made by the [IRS] in its internal administrative proceedings.” *Id.* (quoting *Cook v. United States*, 46 Fed.Cl. 110, 113 (2000)).

In addition, the plaintiff in a tax refund suit bears the burden of proving that it has overpaid its taxes for the year in question in the exact amount of the refund sought. *Id.* (citing, *inter alia*, *Lewis v. Reynolds*, 284 U.S. 281, 52 S.Ct. 145, 76 L.Ed. 293 (1932); *Dysart v. United States*, 169 Ct.Cl. 276, 340 F.2d 624 (1965)). This burden includes “both the burden of going forward and the burden of persuasion,” *Sara Lee Corp. v. United States*, 29 Fed.Cl. 330, 334 (1993), and must be met by a preponderance of the evidence, *Ebert v. United States*, 66 Fed.Cl. 287, 291 (2005). Accordingly, in order to fully or partially prevail in this suit, Plaintiff must demonstrate, by a preponderance of the evidence, its entitlement to the specific amount of the tax refund at issue.

B. Treatment of U.S. Foreign Tax Credits

The United States taxes the income of its citizens, residents, and domestic entities on a worldwide basis—*i.e.*, regardless of whether the income is earned domestically or internationally. Thus, a domestic corporation must include foreign source income on its

U.S. tax returns even though that income may also have been subject to foreign taxation. Since 1918, however, the United States has allowed domestic taxpayers in this circumstance to claim a dollar-for-dollar credit in the U.S. for income taxes they have paid in a foreign country. Revenue Act of 1918, Pub.L. No. 65-245, § 238(a), 40 Stat. 1057, 1080-81; current codification at 26 U.S.C. §§ 27, 901.

As courts consistently have recognized, the purpose of the foreign tax credit is to allow taxpayers to avoid double taxation on foreign income, and thus to “neutralize the effect of U.S. tax on the business decision of where to conduct business activities most productively.” *Bank of New York*, 140 T.C. at 46; see also *United States v. Goodyear Tire & Rubber Co.*, 493 U.S. 132, 139, 110 S.Ct. 462, 107 L.Ed.2d 449 (1989) (noting that the history of the credit “clearly demonstrates” that it was intended to eliminate “double taxation”); *Am. Chicle Co. v. United States*, 316 U.S. 450, 451, 62 S.Ct. 1144, 86 L.Ed. 1591 (1942); *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7, 52 S.Ct. 275, 76 L.Ed. 587 (1932); *Guardian Indus. Corp. v. United States*, 477 F.3d 1368, 1374 (Fed.Cir.2007); 56 Cong. Rec. App. 677-78 (1918) (statement of Rep. Kitchin); Joint Committee on Taxation, *The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S. Businesses* (JCX-22-06) (noting that “[a] resident has no incentive under a worldwide [tax] system either to move activities abroad or to keep them within the residence country Thus, investment-location decisions [by U.S. citizens, residents, and corporations] are governed by business considerations, instead of by tax law.”).

The purpose of the foreign tax credit is to permit substantive business decisions to be made largely independent of the tax consequences of the United States' worldwide system of taxation. Accordingly, it is well established that a taxpayer may structure its business transactions so as to minimize its tax liability. *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir.1934) ("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.") (Learned Hand, J.), *aff'd*, *Gregory v. Helvering*, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935); *Boulware v. United States*, 552 U.S. 421, 429 n.7, 128 S.Ct. 1168, 170 L.Ed.2d 34 (2008). Balancing this principle is the recognition that even if a transaction complies literally with the provisions of the Internal Revenue Code, it does not necessarily follow that Congress intended to cover every foreign transaction and allow a tax benefit. *Bank of New York*, 140 T.C. at 31 (citing, *inter alia*, *Knetsch v. United States*, 364 U.S. 361, 365, 81 S.Ct. 132, 5 L.Ed.2d 128 (1960)). Instead, the determinative question when assessing whether a party is entitled to particular tax benefit is "whether what was done, apart from the tax motive, was the thing which the statute [creating the benefit] intended." *Knetsch*, 364 U.S. at 365, 81 S.Ct. 132 (quoting *Gregory v. Helvering*, 293 U.S. 465, 469, 55 S.Ct. 266, 79 L.Ed. 596 (1935)). This substance-based analysis has spawned various judicial doctrines, such as the economic substance doctrine, that prevent the recognition of benefits from abusive tax shelters.

The economic substance doctrine provides that technical compliance with the tax code notwithstanding, a taxpayer bears the burden of demonstrating that a given transaction carries both (1) the objective

possibility of realizing a pre-tax profit (objective economic substance), and (2) a non-tax business purpose (subjective economic substance). *Wells Fargo*, 91 Fed.Cl. at 81 (citing *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1352 (Fed. Cir.2006)); *Stobie Creek Investments LLC v. United States*, 608 F.3d 1366, 1375 (Fed.Cir.2010). This doctrine “seeks to distinguish between structuring a real transaction in a particular way to obtain a tax benefit, which is legitimate, and *creating* a transaction to generate a tax benefit, which is illegitimate.” *Stobie Creek*, 608 F.3d at 1375 (internal citations omitted) (emphasis in original).

In *ASA Investering Partnership v. Commissioner of Internal Revenue*, 201 F.3d 505 (D.C.Cir.2000), the D.C. Circuit eloquently described the requirement for a non-tax “business purpose:”

It is uniformly recognized that taxpayers are entitled to structure their transactions in such a way as to minimize tax. When the business purpose doctrine is violated, such structuring is deemed to have gotten out of hand, to have been carried to such extreme lengths that the business purpose is no more than a facade. But there is no absolutely clear line between the two. Yet the doctrine seems essential. A tax system of rather high rates gives a multitude of clever individuals in the private sector powerful incentives to game the system. Even the smartest drafters of legislation and regulation cannot be expected to anticipate every device. The business purpose doctrine reduces the incentive to engage in such essentially wasteful activity, and in addition helps achieve reasonable

equity among taxpayers who are similarly situated—in every respect except for differing investments in tax avoidance.

ASA Investerings, 201 F.3d at 513.

The economic substance doctrine applies in equal force to foreign tax credits. Courts have considered the specific issue of whether the substance doctrines apply to the availability of foreign tax credits, and have ruled in the affirmative.¹⁰ Indeed, the Tax Court recently applied the economic substance doctrine to a similar STARS transaction between Barclays and the Bank of New York. Emphasizing that the purpose of the foreign tax credit is to “alleviate double taxation arising from foreign business operations,” the court in *Bank of New York* held that:

[t]he STARS transaction was a complicated scheme centered around arbitraging domestic and foreign tax law inconsistencies. The U.K. taxes at issue did not arise from any substantive foreign activity. Indeed, they were produced through prearranged circular flows from assets held, controlled and managed within the United States. We conclude that Congress did not intend to provide foreign tax credits for transactions such as STARS.

¹⁰ See *Bank of New York*, 140 T.C. 15, at 46-47; *Am. Int'l Grp., Inc. v. United States*, No. 09-1871, 2013 WL 1286193, *4-5 (S.D.N.Y. March 29, 2013) (“AIG”); *Wells Fargo v. United States*, No. 09-2764 (D. Minn. June 14, 2013); *Pritired 1, LLC v. United States*, 816 F.Supp.2d 693, 740-41 (S.D.Iowa 2011); see also *IES Indus., Inc. v. United States*, 253 F.3d 350, 353-54 (8th Cir.2001); *Compaq Computer Corp. v. Comm'r*, 113 T.C. 214, 225 (1999).

140 T.C. at 46-47. Similarly, the Southern District of New York also recently applied the economic substance doctrine to disallow a claim for foreign tax credits in *AIG*:

Because Congress created the foreign tax credit for the taxpayer “who desires to engage in purposive activity,” 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 transaction caused the taxpayer to pay foreign tax.

2013 WL 1286193, at * 4(citation omitted) (quoting *Goldstein v. Comm’r*, 364 F.2d 734, 741, 742 (2d Cir.1966)).

The application of the economic substance doctrine to foreign tax credits is fully consonant with the purpose behind such credits: to establish neutrality through the elimination of double taxation that would arise in the absence of foreign tax credits. Thus, the requirements of the economic substance doctrine—namely, that a transaction be pre-tax profitable and have a non-tax business purpose—are fully compatible with the foreign tax credit regime. *See AIG*, 2013 WL 1286193, at *3 (“Congress intended the [foreign tax] credit to facilitate purposive business transactions, not by subsidy, but by restoring the neutrality of the tax system.”); *Pritired*, 816 F.Supp.2d at 741 (“[Foreign tax credits] are available to *prevent* double-taxation, not to generate an enhanced return on the basis of structuring transactions to increase the

available [foreign tax credits].”) (emphasis in original). Accordingly, there is no foreign tax credit exception to the economic substance doctrine.

C. Economic Substance of STARS

As noted above, a taxpayer bears the burden of proving that the challenged transaction had (1) objective economic substance and (2) a non-tax business purpose. *Wells Fargo*, 91 Fed.Cl. at 81 (citing, *inter alia*, *Coltec*, 454 F.3d at 1355-56). The objective inquiry focuses on whether the transaction created a reasonable opportunity of making a profit from the transaction. *Coltec*, 454 F.3d at 1356; *Bank of New York*, 140 T.C. at 34. The subjective, non-tax business purpose inquiry focuses on whether “the taxpayer’s sole subjective motivation is tax avoidance,” including whether the transaction is “shaped solely by tax-avoidance features.” *Coltec*, 454 F.3d at 1355, 1355 n.13 (quoting *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1978)). The transaction to be analyzed is the one that gave rise to the alleged tax benefit, *id.* at 1356, “even if it is part of a larger set of transactions or steps,” *Bank of New York*, 140 T.C. at 33 (citing, *inter alia*, *Nicole Rose Corp. v. Comm’r*, 320 F.3d 282, 284 (2d Cir.2002)). “Stated another way, the requirements of the economic substance doctrine are not avoided simply by coupling a routine transaction with a transaction lacking economic substance. A contrary application would undermine the flexibility and efficacy of the economic substance doctrine.” *Id.* (citation omitted); see also *Coltec*, 454 F.3d at 1356 (observing that a taxpayer cannot show a non-tax business purpose “simply by showing some factual connection . . . to an otherwise legitimate transaction”)

(quoting *Basic Inc. v. United States*, 212 Ct.Cl. 399, 409, 549 F.2d 740 (1977)).

The first step in the economic substance inquiry is to identify the transaction to be analyzed. The Government urges that the Trust and the Loan are economically distinct, and that as a matter of both law and economics, the Court should conduct an analysis of the Trust as a stand-alone transaction. Plaintiff opposes this view, arguing that STARS “must be analyzed as a single, integrated transaction because the so called ‘components’ . . . were linked by the business and commercial realities of the parties[.]” Pl.’s Br. 217. The Court agrees with the Government that the links between the Trust and Loan components of STARS are artificial, and further, that the disputed foreign tax credits are attributable solely to the Trust. Accordingly, the Court will bifurcate the STARS transaction and examine the Trust structure for economic substance, independent of the Loan. However, the Court also will apply the economic substance analysis through the lens of STARS as an integrated transaction. As demonstrated below, the STARS transaction also lacks economic substance when the Trust and the Loan are examined together.

D. Bifurcated Analysis

1. The STARS Trust Structure

The STARS Trust structure consisted of a number of newly created and one existing special purpose entities. BB & T used the Trust structure to subject its income from assets in the United States to tax in the United Kingdom without otherwise altering that income or its management and control of the assets. BB & T accomplished the U.K. tax effect by circulating the income among the STARS entities, and into and

out of a blocked account. The disputed foreign tax credits are entirely attributable to the Trust structure and not to the Loan. The creation of the Trust and the circulation of income were not required to activate a loan from Barclays to BB & T, and the existence of a loan was not required for the STARS Trust to generate the tax credits at issue. In fact, the Court notes that STARS initially was designed to generate the same foreign tax credits without any loan component. In the early iterations of STARS, the Bx payment served simply to enhance the revenue being earned on the Trust assets. Peacock, Tr. 2309.

The STARS Trust consisted of three principal circular cash flows. A circular cash flow is a set of offsetting cash entries that lack economic importance. “Courts have consistently recognized that the presence of circular cashflows strongly indicates that a transaction lacks economic substance.” *Bank of New York*, 140 T.C. at 36; *see also Consol. Edison Co. v. United States*, 703 F.3d 1367, 1375 (Fed.Cir.2013) (“[W]e easily concluded that the court was ‘left with purely circular transactions that elevate[d] form over substance.’”) (quoting *Wells Fargo & Co. v. United States*, 641 F.3d 1319, 1330 (Fed.Cir.2011)). It hardly requires mention that no profit and no risk will occur in a circular cash flow. Wild, Tr. 2354.¹¹

In the first circular cash flow, BB & T caused an entity called DelCo to make monthly distributions to the Trust which the Trust immediately returned to DelCo. Cycling the income from DelCo to the Trust had the effect of subjecting the income to U.K. tax without

¹¹ When asked if two people could make a profit “if I agree to give you \$10 and you agree to give me \$10, and we do that repeatedly once a month for five years,” Mr. Wild answered “[w]e would not make a profit from doing that.” Wild, Tr. 2534.

changing the substance or character of the income. In the second circular cash flow, BB & T cause the Trust to deposit a predetermined amount into a blocked account, and then to withdraw that amount immediately. This circular cash flow was necessary to allow Barclays to claim a U.K. tax loss for the purported reinvestment of the 99 percent portion of the Trust's income. Barclays was nominally entitled to this amount, but the transaction had no economic effect. In the third circular cash flow, BB & T cycled tax through the U.K. taxing authority, then to Barclays, and then back to itself. This cash flow also was meaningless from an economic perspective. The final step in the process was the payment of the Bx. The Trust structure's primary activity was executing these meaningless monthly transfers, none of which had any economic substance.

The Bx payments under STARS simply represented a rebate to BB & T of one-half of the U.K. taxes to which BB & T voluntarily subjected itself. The rebates embodied in the Bx payments were directly proportional to the amount of U.K. taxes paid. The greater the amount of revenue produced by the C Unit distributions of the Trust, the higher the U.K. taxes would be, and the higher the Bx payments would be to BB & T. STARS thus had the counterintuitive result that the greater the amount of foreign taxes paid by the taxpayer, the greater the amount of profit realized from the Bx rebate payments.

In evaluating a transaction for pre-tax profit, a court must determine which aspects are real economic effects and thus non-tax items, and which are tax effects. *See In re CM Holdings, Inc.*, 301 F.3d 96, 103 (3d Cir.2002) ("The main question these different formulations address is a simple one: absent tax

benefits, whether the transaction affected the taxpayer's financial position in any way."); *see also Coltec*, 454 F.3d at 1356 n.16; *Wells Fargo*, 91 Fed.Cl. at 82 (collecting cases). Courts must isolate tax effects and examine the aspects of the transaction that are economically substantive absent the tax. *See Frank Lyon Co. v. United States*, 435 U.S. 561, 573, 98 S.Ct. 1291, 55 L.Ed.2d 550 (1978) (holding that the objective economic reality controls rather than the form chosen by the parties); *BB & T Corp. v. United States*, 523 F.3d 461, 471 (4th Cir.2008) (noting "[a] taxpayer may not . . . claim tax benefits . . . by affixing labels to its transactions that do not accurately reflect their true nature."); *Wells Fargo*, 91 Fed.Cl. at 75-76.

In the *Bank of New York* case, the Tax Court referred to the Bx payment as the "spread," holding:

The spread artificially reduced the loan's cost and lacked economic reality. In substance the spread was contingent on the parties' anticipated tax treatment and was unrelated to the time value of money or the attendant risks associated with the loan. We conclude, on the record as a whole, that the spread was in substance not a component of loan interest. The spread rather was a tax effect. It was embedded in the loan to serve as a device for monetizing and transferring the value of anticipated foreign tax credits generated from routing income through the STARS structure.

Bank of New York, 140 T.C. at 42-43. By design of the STARS transaction, the value of BB & T's U.K. tax payment ends up in the hands of Barclays. Barclays then paid BB & T for subjecting itself to a U.K. tax. However, the return to BB & T of one-half of its U.K. tax did not constitute profit for BB & T. The Bx

payment simply reimbursed BB & T for one-half of its out-of-pocket U.K. tax costs on the transaction. The transaction became immensely profitable to BB & T when it claimed U.S. foreign tax credits for a U.K. tax cost that it had not in substance paid.

BB & T's artificial pairing of Barclays' Bx payments (representing in substance a rebate of its U.K. tax payments) with BB & T's interest payments to Barclays, does not reflect economic reality. The economic nature of the Bx payments simply is a tax effect, and in particular a U.S. tax effect, and not that of a reduction of interest income as BB & T would have the Court view them.

Income from BB & T's pre-existing assets cycled through the STARS Trust was not profit from STARS. The economic substance inquiry "focuses on whether there was a reasonable possibility of making a profit from the transaction." *Stobie Creek*, 608 F.3d at 1376-77. This inquiry focuses on what a reasonably prudent investor would have found from looking at the transaction prospectively. *Id.* (citing *Gilman v. Comm'r*, 933 F.2d 143, 146-47 (2d Cir.1991)); *Fidelity Int'l Currency Advisor A Fund, LLC v. United States*, 747 F.Supp.2d 49, 231-32 (D.Mass.2010), *aff'd*, 661 F.3d 667 (1st Cir.2011). Applying this test, courts have found that transfers of income-producing assets to controlled entities do not imbue an arrangement with substance if the transfer has no incremental effect on the taxpayer's activities. *Gregory*, 293 U.S. at 469, 55 S.Ct. 266 (holding that a contribution of assets to a special purpose entity did not imbue a transaction with substance); *Southgate Master Fund v. United States*, 659 F.3d 466, 491-92 (5th Cir.2011) (disregarding partnership used to acquire loan receivables); *Coltec*, 454 F.3d at 1354 (disregarding management

benefits that were available without undertaking contributions to a special purpose entity); *ACM P'ship v. Comm'r*, 157 F.3d 231, 249-52 (3d Cir.1998) (disregarding returns on Citicorp notes where economic returns on capital were unaffected by the transaction); *Zmuda v. Comm'r*, 731 F.2d 1417, 1421 (9th Cir.1984) (disregarding contribution of income-producing assets to foreign trusts); *Gerdau Macsteel, Inc. v. Comm'r*, 139 T.C. 67, 173-74 (2012) (only incremental cash flows that the taxpayer would not have obtained in the absence of the transaction should be considered in testing whether there is a reasonable expectation of non-tax benefits).

The Court concludes that the STARS Trust must be disregarded as a sham structure. Under both the economic substance and substance-over-form doctrines, the creation and use of sham structures to achieve tax benefits are disregarded for federal tax purposes. *Southgate Master Fund*, 659 F.3d at 491-92; *Schell v. United States*, 589 F.3d 1378, 1382 (Fed.Cir.2009); *Fidelity Int'l Currency Advisor*, 747 F.Supp.2d at 233 (“If a partnership is found to be a sham, the partnership should be disregarded, and the partnership’s activities are deemed to be engaged in by one or more of the partners.”). A sham structure that lacks a non-tax business purpose and is “unreal” or “a bald and mischievous fiction” must also be disregarded. *Moline Props., Inc. v. Comm'r*, 319 U.S. 436, 439, 63 S.Ct. 1132, 87 L.Ed. 1499 (1943).

The STARS Trust had no non-tax business purpose. Its sole function was to self-inflict U.S.-sourced BB & T income in order to reap U.S. and U.K. tax benefits. The case law is quite clear that “whether the ‘sham’ be in the entity or the transaction . . . the absence of a nontax business purpose is fatal.” *ASA Investering*,

201 F.3d at 512; *see also Andantech LLC v. Comm'r*, 331 F.3d 972, 978 (D.C.Cir.2003).

2. The STARS Loan

The STARS Loan lacked economic substance because it was not structured to make a profit, but instead was devised to provide BB & T with a pretext for a purported business purpose for engaging in a sham transaction. The Loan simply was a method by which to camouflage Barclays' rebate of a portion of BB & T's U.K. tax payments, through payment of the Bx. Absent the tax benefits, the cost of the Loan was considerably higher than BB & T's normal cost of borrowing for similar loans. The record supports the conclusion that BB & T chose to terminate the transaction when the tax benefits associated with STARS were threatened. The Loan in reality had no non-tax business purpose and had no possibility of pre-tax profit.

The pre-tax profit test requires an objective analysis from the perspective of a prudent investor of whether there was a reasonable possibility of making a profit from the transaction apart from tax considerations. *Stobie Creek*, 608 F.3d at 1376-77. It is quite true that STARS improved BB & T's bottom line based solely on tax benefits. However, the Bx payment cannot be considered pre-tax profit on the Loan because it was generated by circular cash flows designed for tax purposes and thus is purely a tax effect of the transaction.

Excluding the Bx payment, the cost of borrowing on the STARS Loan was LIBOR + 25 basis points. This rate was significantly higher than rates on comparable sources of funds available to BB & T by a magnitude of 30 basis points or more. *Finard, Tr.* 5124-25. BB &

T had plenty of less expensive funding resources available during the years in question. Cragg, Tr. 4621-22; USX 1002. Absent strong economic reasons, large commercial banks do not engage in financing transactions at rates of 25 to 35 basis points higher than their market sources of funding, particularly as to loans over \$1 billion. BB & T has not demonstrated the presence of such economic reasons.

BB & T argues that its interest rate for the STARS Loan should be compared to its interest rates for long-term funding, but this assertion is incorrect. The term of the funding, like the pricing, must be considered absent the tax benefits. The agreement with Barclays was that the Loan rate would be based on a 30-day LIBOR rate, and either party had the right to terminate the transaction within 30 days. The only reason to continue the Loan for the five-year life of STARS was because of the purported low-cost funding. However, the low-cost funding was entirely the product of the tax benefit, not because of any economic benefit. Absent the tax benefits, BB & T would have terminated the transaction immediately, which it in fact did in April 2007 when there was concern that the tax benefits would disappear.

In examining the profitability of the STARS transaction, the Court declines to consider the income from BB & T's use of the Loan proceeds. Although BB & T surely would use the Loan proceeds to generate revenue, this fact is irrelevant for purposes of the economic substance analysis. See *Schering Plough Corp. v. United States*, 651 F.Supp.2d 219, 265-67 (D.N.J.2009) (“[T]he use for which a disputed transaction is put is not relevant in determining whether the transaction itself has sufficient substance.”), *aff'd sub nom. Merck & Co. v. United States*, 652 F.3d 475 (3d

Cir.2011); *see also In re CM Holdings, Inc.*, 254 B.R. 578, 638-39 (D.Del.2000) (“The Court must focus on the purpose of the underlying transaction at issue here, not what [the taxpayer] intended to do with the proceeds. . . . What the cash flows derived from this transaction were to be used for is irrelevant for ... the economic substance analysis.”), *aff’d*, 301 F.3d 96 (3d Cir.2002); *Am. Elec. Power Co., Inc. v. United States*, 326 F.3d 737, 744 (6th Cir.2003) (“Money generated by means of abusive tax deductions can always be applied to beneficial causes, but the eventual use of the money thus generated is not part of the economic-sham analysis.”); *Winn-Dixie Stores, Inc. v. Comm’r*, 113 T.C. 254, 287 (1999) (rejecting taxpayer’s claim that funding employee benefits with tax savings was legitimate non-tax business purpose because “[i]f this were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, every sham tax-shelter device might succeed.”), *aff’d*, 254 F.3d 1313 (11th Cir.2001).

There is no evidence that BB & T took into account the use of the Loan proceeds in deciding whether to enter the STARS transaction. Under any circumstance, BB & T would have used the Loan proceeds to generate revenue for the bank, regardless of where it obtained the Loan proceeds. The evidence shows that BB & T viewed the Bx payments as its source of profit on the STARS transaction. However, a taxpayer must establish with contemporaneous evidence that it objectively anticipated a profit from the transaction *apart from the tax benefits*. *See Goldstein v. Comm’r*, 364 F.2d 734, 739 (2d Cir.1966) (disallowing deductions where taxpayers’ contemporaneous evidence failed to establish any anticipated profit potential apart from tax consequences of transactions); *ACM P’ship*, 157 F.3d at 257 (Colgate’s “failure to conduct a

contemporaneous profit analysis support[s] the Tax Court's conclusion that ACM's transactions were not designed or reasonably anticipated to yield a pre-tax profit").

Here, the contemporaneous documents show that Barclays, KPMG, and BB & T all considered the profit on STARS to come solely from Barclays' rebate of the U.K. taxes, with BB & T then claiming foreign tax credits for the amount rebated. The Loan proceeds should not be taken into account in a profit calculation because such proceeds would have been available in any alternative funding scenario. Due to the complexity of STARS, BB & T's costs on the STARS Loan are much higher than they would have been on simpler, alternative funding. STARS did not provide BB & T with any incremental economic benefits on the Loan.

E. Integrated Transaction Analysis

BB & T contends that the Court should review the STARS transaction as a single integrated agreement, and thereby evaluate the business purpose of STARS with the Trust and the Loan together. BB & T argues that the existence of the Trust permits Barclays to offer BB & T a \$1.5 billion loan at very favorable interest rates. Viewed in this way, the STARS transaction simply creates a method in which Barclays and BB & T can use foreign tax credits to provide a sizable loan at 300 basis points below LIBOR.

Case law instructs the Court to consider the economic realities of a transaction instead of the form of agreement that the parties employed. In *Frank Lyon Co.*, the Supreme Court ruled:

In applying this doctrine of substance over form, the Court has looked to the *objective economic realities* of a transaction rather than to the particular form the parties employed. The Court has never regarded “the simple expedient of drawing up papers” as controlling for tax purposes when the objective economic realities are to the contrary. “In the field of taxation, administrators of the law and the courts are concerned with *substance and realities*, and formal written documents are not rigidly binding.”

435 U.S. at 572-73, 98 S.Ct. 1291 (emphasis added) (citations omitted) (quoting *Comm’r v. Tower*, 327 U.S. 280, 291, 66 S.Ct. 532, 90 L.Ed. 670 (1946); *Helvering v. Lazarus & Co.*, 308 U.S. 252, 255, 60 S.Ct. 209, 84 L.Ed. 226 (1938)). Similarly, in *Coltec*, the Federal Circuit observed:

First, although the taxpayer has an unquestioned right to decrease or avoid his taxes by means which the law permits, *Gregory*, 293 U.S. at 469, 55 S.Ct. 266, the law does not permit the taxpayer to reap tax benefits from a transaction that lacks *economic reality*.

* * *

Third, the economic substance of a transaction must be viewed objectively rather than subjectively. The Supreme Court cases and our predecessor court’s cases have repeatedly looked to the *objective economic reality* of the transaction in applying the economic substance doctrine.

454 F.3d at 1355, 1356 (emphasis added). More recently, in *Consolidated Edison*, involving a LILLO transaction, the Federal Circuit similarly stated:

As we stated in *Coltec*, judicial anti-abuse doctrines “prevent taxpayers from subverting the legislative purpose of the tax code.” One such doctrine is the substance-over-form doctrine. Under this doctrine, courts determine “the tax consequences of a transaction . . . based on the underlying substance of the transaction rather than its legal form.” “The major purpose of the substance-over-form doctrine is to recharacterize transactions in accordance with their *true nature*.”

703 F.3d at 1374 (emphasis added) (citations omitted) (quoting *Southgate Master Fund*, 659 F.3d at 491-92; *Wells Fargo*, 641 F.3d at 1325; *Coltec*, 454 F.3d at 1354).

Applying these principles here, the STARS transaction must be seen for what it really is. By creating a trust arrangement with nothing but circular cash flows, and momentarily placing funds in the hands of a U.K. trustee before it is returned, Barclays and BB & T artificially caused a U.K. tax on U.S. – sourced revenue. There was no substantive economic activity occurring in the U.K. to warrant a U.K. tax. Yet, by subjecting the Trust funds to a U.K. tax, Barclays and BB & T were able to share the benefits of foreign tax credits, which resulted in a 51 percent rebate of a Bx payment to BB & T. The surprisingly low interest rate to BB & T on the \$1.5 billion Loan, 300 basis points below LIBOR, was made possible solely because of the fruits of the Trust arrangement. In reality, the U.S. Treasury is funding the monetary benefits realized by BB & T, Barclays,

and the U.K. Treasury. No aspect of the STARS transaction has any economic reality.

F. Penalties

“The Federal tax system is primarily one of self-assessment, whereby each taxpayer computes the tax due and then files the appropriate form of return along with the requisite payment.” *United States v. Galletti*, 541 U.S. 114, 122, 124 S.Ct. 1548, 158 L.Ed.2d 279 (2004) (internal quotation marks omitted). When a taxpayer underpays his taxes due to, *inter alia*, negligence or a substantial understatement of tax, the Internal Revenue Code assesses penalties. 26 U.S.C. § 6662. Section 6662 imposes a 20 percent penalty on any portion of an underpayment that is attributable to “[n]egligence or disregard of rules or regulations” or “[a]ny substantial understatement of income tax.” § 6662(b)(1-2). These accuracy-related penalties are not cumulative; therefore, the maximum accuracy-related penalty imposed on any portion of an understatement is 20 percent. Treas. Reg. § 1.662-2(c); *Alpha I, L.P. v. United States*, 93 Fed.Cl. 280, 301 (2010). As will be discussed below, § 6664(c)(1) provides an absolute defense to accuracy-related penalties assessed for an underpayment “if it is shown that there was reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.”

The Government asserts that BB & T is subject to penalties for negligence and substantial understatement of income tax. Plaintiff asserts the defenses of substantial authority, reasonable reliance on tax professionals, adequate disclosure, and reasonable cause and good faith.

1. Negligence

Section 6662 imposes an accuracy-related penalty of 20 percent for any portion of the underpayment which is attributable to “[n]egligence or disregard of rules or regulations.” § 6662(b). For purposes of this penalty, “the term ‘negligence’ includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term ‘disregard’ includes any careless, reckless, or intentional disregard” of tax rules and regulations. § 6662(c). “Negligence is strongly indicated where . . . [a] taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return which would seem to a reasonable and prudent person to be ‘too good to be true’ under the circumstances.” Treas. Reg. § 1.6662-3(b)(1)(ii). “[W]hen a taxpayer is presented with what would appear to be a fabulous opportunity to avoid tax obligations, he should recognize that he proceeds at his own peril.” *Alpha I*, 93 Fed.Cl. at 302 (quoting *Neonatology Assocs., P.A. v. Comm’r*, 299 F.3d 221, 234 (3d Cir.2002)) (internal quotation marks omitted).

A taxpayer is not negligent when there is a reasonable basis for the position taken. Treas. Reg. § 1.6662-3(b)(1). The reasonable basis standard is relatively high, and “is not satisfied by a return position that is merely arguable or that is merely a colorable claim.” *Id.* at § 1.6662-3(b)(3). Good faith reliance on professional advice may provide a reasonable basis, but such reliance “must be objectively reasonable; taxpayers may not rely on someone with an inherent conflict of interest. . . .” *Stobie Creek*, 82 Fed.Cl. 636, 709 (2008) (quoting *Chamberlain v. Comm’r*, 66 F.3d 729, 732 (5th Cir.1995)). Thus, “the defense of reliance on professional advice prevails only

if, under all the circumstances, (1) the advice itself is reasonable . . . and (2) the taxpayer's reliance thereon is reasonable." *Stobie Creek*, 82 Fed.Cl. at 712.

a. Reasonableness of the advice

In determining whether the professional advice itself was reasonable, courts look to whether the advice is based on accurate information and representations supplied by the taxpayer, whether there was a reasonable investigation into the transaction, and whether it contains any unreasonable or unsupported assumptions. *Id.* Here, KPMG was the principal marketer of STARS, and provided BB & T with advice as to the viability and profitability of the transaction. As discussions between KPMG and BB & T progressed, BB & T became concerned that if challenged, the IRS may determine that STARS lacked economic substance. KPMG advised BB & T that the possibility of a court finding BB & T to have engaged in a sham transaction was "so remote as to not need to be considered." USX 564. KPMG further advised that even if STARS was found to lack economic substance, BB & T would nevertheless be allowed a deduction for the U.K. taxes. *Monger, Tr.* 1253-55. The Court finds this assertion (and BB & T's reliance thereon) to be unreasonable and unsupported. KPMG's assumption that BB & T could claim a deduction for U.K. taxes even if STARS was found to lack economic substance flies in the face of the accepted principle that a transaction lacking in economic substance is disregarded for tax purposes. *See, e.g., Coltec*, 454 F.3d at 1355. KPMG's overarching advice was that BB & T should engage in an economically meaningless transaction to achieve foreign tax credits for taxes BB & T had not in substance paid. Thus, because KPMG's advice was

based on unreasonable and unsupported assumptions, the Court finds KPMG's advice unreasonable.

Based on KPMG's recommendation, BB & T also selected the law firm of Sidley Austin, and in particular, Raymond J. Ruble, to provide tax advice and a formal opinion on STARS. BB & T did not formerly engage Sidley Austin until May 7, 2002. JX 264. However, on April 30, 2002, Mr. Ruble forwarded to BB & T a redacted tax opinion endorsing the STARS transaction, which had been prepared for another client. USX 599; Monger, Tr. 927. This tax opinion detailed a very similar STARS transaction, with the exact same entity names, such as Invest Co, Manager, NewCo, and DelCo. USX 599; Monger, Tr. 927-28. Although the final BB & T STARS tax opinion was tailored in part to BB & T specifically, a review of Mr. Ruble's other legal tax opinions on the STARS transaction reveals that his favorable opinions were largely pre-fabricated and predetermined. *Compare* PX 174 *with* USX 1502 *and* USX 464. Similar to the advice of KPMG, Sidley Austin's advice and opinion letters endorsed and advocated the promulgation of economically meaningless transactions. Because Sidley Austin's tax opinion was premised on the unreasonable and unsupported assumption that technical compliance with U.S. tax law would allow the IRS to give its imprimatur to an economically meaningless transaction, the Court finds Sidley Austin's advice unreasonable.

b. Reasonableness of the reliance

In determining whether a taxpayer's reliance on professional advice was reasonable, courts evaluate any potential conflict of interest, the taxpayer's knowledge and expertise, and whether the transaction

seems “too good to be true.” *See, e.g., Stobie Creek*, 82 Fed.Cl. at 712; *Neonatology*, 299 F.3d at 233-34. As mentioned above, KPMG was the principal promoter of STARS to BB & T. KPMG marketed the STARS transaction to BB & T, and would not receive any of its \$6.5 million fee unless and until BB & T closed on the STARS transaction. Prior to the closing date of STARS, BB & T knew that KPMG was involved in the design of the STARS structure and that KPMG reviewed Barclays’ design of the STARS transaction. Monger, Tr. 614-19. BB & T also was aware that KPMG was “on both sides” of the transaction between Barclays and BB & T, and that KPMG thus had a blatant conflict of interest. PX 67. Indeed, the head of KPMG’s Department of Professional Practice for tax matters expressed concern about KPMG’s ability to issue a “should-level” opinion. DeLap Dep., 62-67, 75-76; USX 241; USX 243. Despite knowing that KPMG had prior involvement with the STARS transaction, BB & T did not seek an independent tax opinion. Watson, Tr. 2845.¹²

Similarly, at the time BB & T received Sidley Austin’s tax opinion and subsequently retained the law firm (on KPMG’s recommendation), BB & T was aware that Sidley Austin was a co-developer of STARS and that it had previously provided a favorable tax opinion of STARS to another bank. Monger, Tr. 615-16; JX 255. Thus, both KPMG and Sidley Austin stood to profit considerably from BB & T’s adoption of the

¹² The Court finds it remarkable that BB & T would retain KPMG for \$6.5 million in fees for tax advisory services, given KPMG’s conflict of interest in also promoting STARS on behalf of Barclays, and receiving fees from Barclays upon the closing of each new STARS transaction. *See, e.g., USX 278* at 4 (“STARS is a joint venture between KPMG and Barclays.”)

transaction, and BB & T knew or should have known that their advice would not be impartial and independent. In agreeing to Sidley Austin's engagement letter, BB & T was asked to waive any conflicts that Sidley Austin had with Barclays, but BB & T did not even inquire about the services that Sidley Austin was or had been performing for Barclays. Monger, Tr. 1297-99. As the Third Circuit stated in *Neonatology*:

It may well be that reliance on the advice of a professional should only be a defense when the professional's fees are not dependent on his opinion. For example, it is not immediately evident why a taxpayer should be able to take comfort in the advice of a professional promoting a tax shelter for a fee. After all, that professional would have an interest in his opinion.

299 F.3d at 234 n.22. Because both KPMG and Sidley Austin¹³ had a significant interest in convincing BB & T to engage in the STARS transaction, the Court cannot say that BB & T acted reasonably in relying on their advice. *See Alpha I*, 93 Fed.Cl. at 316 ("It is well established that taxpayers generally cannot reasonably rely on the professional advice of a tax shelter promoter.") (quoting *Edwards v. Comm'r*, 84 T.C.M. (CCH) 24 (2002)); *Pasternak v. Comm'r*, 990 F.2d 893, 903 (6th Cir.1993) (upholding negligence

¹³ Mr. Ruble's incentive to issue favorable STARS tax opinions is further highlighted in his 2001 internal memorandum regarding his law firm compensation package. USX 85 at 4. In this memorandum, Mr. Ruble stated "I intend to continue to exploit ties with KPMG ... in connection with the development of structured tax products." *Id.* He further noted that "the success of this practice is highly dependent upon the absence of anti-shelter legislation and similar IRS positions." *Id.*

penalty where “the purported experts were either the promoters themselves or agents of the promoters. Advice of such persons can hardly be described as that of ‘independent professionals.’ ”). Here, Sidley Austin sent BB & T a favorable draft opinion letter about STARS before BB & T had even engaged this law firm. Monger, Tr. 1265-67.

BB & T’s engagement with PwC is insufficient to remove the taint of unreasonableness from the professional tax advice relied upon. PwC’s involvement in the STARS transaction does not create a reasonable basis for BB & T’s tax position because: (1) BB & T reported only Barclays, KPMG, and Sidley Austin as its tax advisors to the STARS transaction, JX 234; (2) PwC explicitly informed BB & T that it “in no way [was] providing an Opinion” regarding STARS, JX 259; and (3) PwC’s audit advice was informed by the unreasonable and unsupported representations made by KPMG and Sidley Austin, Boss, Tr. 2042-46; USX 568; JX 859. Moreover, PwC ultimately arrived at a “less than should” level of comfort that the IRS would accept the STARS transaction. Boss, Tr. 2098, 2117-18; USX 951A at 7183-84; USX 553, 601, 611. During exceptional cross-examination by Defendant’s counsel, PwC’s Mr. Boss was evasive and had few answers for the glaring weaknesses that PwC should have seen in the STARS transaction. Boss, Tr. 2131-41.

Additionally, the BB & T executives that reviewed the economic and tax effects of the STARS transaction are highly educated and well-versed in banking transactions and financing deals. These individuals knew or should have known that claiming nearly \$500 million in foreign tax credits by subjecting income to economically meaningless activities was “too good to be true.” Indeed, the evidence shows that BB & T

executives were extremely skeptical of the tax benefits of STARS, as the potential downside tax risks were the subject of much correspondence and presentation. Monger, Tr. 1102-04, 1126-37; Watson, Tr. 3466-69. Moreover, Mr. Monger generated many spreadsheet analyses calculating BB & T's potential economic return on STARS in the event that the IRS disallowed the foreign tax credits. USX 437.

BB & T's concern over the tax risk was significantly reflected in the negotiations and eventual fee arrangement with KPMG. In a meeting with KPMG, BB & T representatives expressed a "concern[] that KPMG needs to have some of the fee at risk[]" and a desire to "reduce [BB & T's] exposure in the event of an early termination of the transaction." Monger, Tr. 1156-57; USX 470. BB & T negotiated that KPMG would provide audit assistance if the IRS challenged the transaction. JX 254. This skepticism on the part of BB & T was well-founded, because as a successful financial holding company with banking subsidiaries in over twelve states, JX 209, it surely would have recognized that the ability to claim nearly \$500 million in foreign tax credits merely by subjecting its assets to U.K. taxation was too good to be true. *See Neonatology*, 299 F.3d at 234 ("When, as here, a taxpayer is presented with what would appear to be a fabulous opportunity to avoid tax obligations, he should recognize that he proceeds at his own peril.").

Thus, the fact that BB & T relied on the advice of promoters of the STARS tax shelter despite having ample capacity to recognize that the transaction was "too good to be true," thoroughly vitiates any reasonable basis for BB & T's tax position. Accordingly, Plaintiff is liable for the 20 percent

negligence penalty, unless it can establish reasonable cause and good faith, a defense addressed below.

2. Substantial Understatement

Under § 6662, an understatement is substantial if it exceeds the lesser of 10 percent of the tax required to be shown on the return for the taxable year or \$10,000,000.¹⁴ § 6662(d)(1)(B). The amount of any understatement can be reduced for any portion as to which the taxpayer can either establish substantial authority for the position the taxpayer took or demonstrate a reasonable basis for the claimed tax treatment, coupled with adequate disclosure. § 6662(d)(2)(B). For the tax years at issue, these defenses are modified when a tax shelter is involved. *See, e.g.*, § 6662(d)(2)(C); *Stobie Creek*, 82 Fed.Cl. at 705.1¹⁵

To avoid the penalty in the case of a corporate tax shelter, the taxpayer must establish (1) that there was substantial authority for the tax treatment and (2) that the taxpayer reasonably believed that the reported treatment of an item was more likely than not the proper treatment. Treas. Reg. § 1.6662-4(g)(1); *see also* § 6662(d)(2)(C)(i); *Alpha I*, 93 Fed.Cl. at 321.¹⁶

¹⁴ Section 6662 was amended in 2004. For the years 2002 and 2003, an understatement is substantial if it exceeds the greater of 10 percent of the tax required to be shown on the return or \$10,000.

¹⁵ The 2004 amendment completely eliminated any reduction under § 6662(d)(2)(B) in the case of tax shelters. *See* American JobsCreation Act of 2004, Pub.L. No. 108-357, § 812(d), 118 Stat. 1418, 1577-81.

¹⁶ Thus, in the situation of a tax shelter, the defenses of adequate disclosure or substantial authority (standing alone), are insufficient to avoid the imposition of penalties.

The substantial authority standard is an objective standard, which is met only if the “weight of the authorities supporting the treatment is substantial in relation to the weight of the authorities supporting contrary treatment.” Treas. Reg. § 1.6662-4(d) (3)(i). The weight given to each authority depends on its relevance, persuasiveness, and source. *Id.* § 1.6662-4(d)(3) (ii). “Conclusions reached in treaties, legal periodicals, legal opinions, or opinions rendered by tax professionals are not authority.” *Id.* at § 1.6662-4(d)(3)(iii); *Alpha I*, 93 Fed.Cl. at 322 (“Reliance on advice by tax professionals is specifically excluded in deciding whether substantial authority exists for a particular tax treatment.”). When a transaction is found to lack economic substance, no authority, much less substantial authority, supports the claimed tax treatment. *Stobie Creek*, 82 Fed.Cl. at 706, 706 n.64, (finding that transactions lacked economic substance precluded plaintiffs from establishing existence of substantial authority to support tax treatment).

As discussed in detail above, the STARS transaction lacked economic reality because it was unsupported by a tax-independent business purpose. Thus, because the transaction’s significant purpose was “the avoidance or evasion of Federal income tax,” STARS falls within the statutory definition of a “tax shelter.” § 6662(d)(2)(C)(iii). Not only was the STARS transaction a tax shelter, but it was also an economically meaningless transaction. The STARS transaction was no more than a circular redirection of cash flows from the U.S. Treasury to BB & T, Barclays, and the U.K. Treasury. The Court’s determination that STARS lacked economic substance precludes Plaintiff from establishing the first prong of its defense, as there is no authority, much less substantial, that supports “a

subterfuge for generating, monetizing and transferring the value of foreign tax credits. . . .” *Bank of New York*, 140 T.C. at 31; see *Stobie Creek*, 82 Fed.Cl. at 706 n.64 (“[N]o substantial authority exists to support recognition of tax results that are premised on transactions with no appreciable business purpose beyond conferring tax benefits.”); *Long Term Capital Holdings v. United States*, 330 F.Supp.2d 122, 204-05 (D.Conn.2004) (holding that taxpayer cannot cite authority to support tax treatment once transaction is deemed to lack economic substance). Because the Court finds that substantial authority does not support the tax treatment claimed by BB & T, the Court need not address whether BB & T reasonably believed that the tax treatment claimed was more likely than not the proper treatment. Plaintiff is liable for the 20 percent substantial understatement penalty. Whether the reasonable cause and good faith exception provides BB & T with a valid defense to the substantial understatement penalty is addressed below.

3. Reasonable Cause and Good Faith

Section 6664(c)(1) provides an absolute defense to the imposition of any accuracy-related penalty:

No penalty shall be imposed under section 6662 or 6663 with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

The taxpayer bears the burden of showing that this exception applies. *Stobie Creek Invs. LLC v. United States*, 608 F.3d 1366, 1381 (Fed. Cir.2010) (citing *Conway v. United States*, 326 F.3d 1268, 1278 (Fed.

Cir.2003)). Reliance on professional advice may constitute reasonable cause and good faith “if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.” Treas. Reg. § 1.6664-4(b)(1). In determining whether a taxpayer has reasonably relied in good faith on advice as to the tax treatment, all facts and circumstances must be taken into account, including but not limited to “the taxpayer’s education, sophistication, and business experience[.]” *Id.* at § 1.6664-4(c)(1). Additionally, the advice “must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances[.]” “must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) [.]” and “must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person.” *Id.* The satisfaction of these requirements will not necessarily establish that the taxpayer reasonably relied on the advice in good faith. *Id.* Reliance is not reasonable, for example, if the adviser has an inherent conflict of interest about which the taxpayer knew or should have known, or if the taxpayer knew or should have known that the transaction was “too good to be true.” *Stobie Creek*, 608 F.3d at 1382-83 (citing, *inter alia*, Treas. Reg. § 1.6664-4(c)).

As discussed above, the unsupported assumptions upon which the promoters’ advice was based, the conflicts of interest of the STARS promoters, and the BB & T’s executives’ high level of knowledge and expertise preclude a finding of reasonable reliance on professional advice. Similarly, the weight of the evidence shows that tax avoidance was singularly and precisely the goal pursued in execution of the STARS transaction. Consequently, the Court finds that BB & T did not act with reasonable cause and good faith

with regard to any portion of the underpayment determined.

For the foregoing reasons, the Court finds that Plaintiff was engaged in an economically meaningless tax shelter, that the negligence accuracy-related penalty of § 6662(b)(1) and the substantial understatement accuracy-related penalty of § 6662(b)(2) apply, and that the defenses of reasonable basis, substantial authority, and reasonable cause and good faith are not available to Plaintiff.

III. Conclusion

The Court finds in favor of Defendant on all grounds. Plaintiff's claims for tax refund are DENIED in their entirety. Before entering final judgment, the Court will conduct a conference with counsel of record on a mutually agreeable date to confirm the proper amount and terms of the judgment.

Pursuant to Rule 54(d), the Court awards costs to Defendant as the prevailing party.

IT IS SO ORDERED.

APPENDIX D**26 U.S.C. § 901. Taxes of foreign countries
and of possessions of the United States—
Selected Sections****Section 901(a)-(b)(1)**

(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. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year. The credit shall not be allowed against any tax treated as a tax not imposed by this chapter under section 26(b).

(b) Amount allowed. Subject to the limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):

(1) Citizens and domestic corporations.—In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and

* * *

Section 901(b)(5)

(5) Partnerships and estates.—In the case of any person described in paragraph (1), (2), (3), or (4), who is a member of a partnership or a beneficiary of an estate or trust, the amount of his proportionate

share of the taxes (described in such paragraph) of the partnership or the estate or trust paid or accrued during the taxable year to a foreign country or to any possession of the United States, as the case may be. Under rules or regulations prescribed by the Secretary, in the case of any foreign trust of which the settlor or another person would be treated as owner of any portion of the trust under subpart E but for section 672(f), the allocable amount of any income, war profits, and excess profits taxes imposed by any foreign country or possession of the United States on the settlor or such other person in respect of trust income.

* * *

Section 901(i)

(i) Taxes used to provide subsidies.—Any income, war profits, or excess profits tax shall not be treated as a tax for purposes of this title to the extent—

(1) the amount of such tax is used (directly or indirectly) by the country imposing such tax to provide a subsidy by any means to the taxpayer, a related person (within the meaning of section 482), or any party to the transaction or to a related transaction, and

(2) such subsidy is determined (directly or indirectly) by reference to the amount of such tax, or the base used to compute the amount of such tax.

* * *

APPENDIX E**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)**

(a) Definition of income, war profits, or excess profits tax—(1) In general. Section 901 allows a credit for the amount of income, war profits or excess profits tax (referred to as “income tax” for purposes of this section and §§ 1.901-2A and 1.903-1) paid to any foreign country. Whether a foreign levy is an income tax is determined independently for each separate foreign levy. A foreign levy is an income tax if and only if-

- (i) It is a tax; and
- (ii) The predominant character of that tax is that of an income tax in the U.S. sense.

Except to the extent otherwise provided in paragraphs (a)(3)(ii) and (c) of this section, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax. Paragraphs (a), (b) and (c) of this section define an income tax for purposes of section 901. Paragraph (d) of this section contains rules describing what constitutes a separate foreign levy. Paragraph (e) of this section contains rules for determining the amount of tax paid by a person. Paragraph (f) of this section contains rules for determining by whom foreign tax is paid. Paragraph (g) of this section contains definitions of the terms “paid by,” “foreign country,” and “foreign levy.” Paragraph (h) of this section states the effective date of this section.

- (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.

* * *

Section 1.901-2(e)(1) and Selected Portions of Section 1.901-2(e)(2)

(e) Amount of income tax that is creditable—(1) In general. Credit is allowed under section 901 for the amount of income tax (within the meaning of paragraph (a)(1) of this section) that is paid to a foreign country by the taxpayer. The amount of income tax paid by the taxpayer is determined separately for each taxpayer.

(2) Refunds and credits--(i) In general. An amount is not tax paid to a foreign country to the extent that it is reasonably certain that the amount will be refunded, credited, rebated, abated, or forgiven. It is not reasonably certain that an amount will be refunded, credited, rebated, abated, or forgiven if the amount is not greater than a reasonable approximation of final tax liability to the foreign country.

* * *

Section 1.901-2(e)(3)

(3) Subsidies—(i) General rule. An amount of foreign income tax is not an amount of income tax paid or accrued by a taxpayer to a foreign country to the extent that—

(A) The amount is used, directly or indirectly, by the foreign country imposing the tax to provide a subsidy by any means (including, but not limited to, a rebate, a refund, a credit, a deduction, a payment, a discharge of an obligation, or any other method) to the taxpayer, to a related person (within the meaning of section 482), to

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any party to the transaction, or to any party to a related transaction; and

(B) The subsidy is determined, directly or indirectly, by reference to the amount of the tax or by reference to the base used to compute the amount of the tax.

(ii) Subsidy. The term “subsidy” includes any benefit conferred, directly or indirectly, by a foreign country to one of the parties enumerated in paragraph (e)(3)(i)(A) of this section. Substance and not form shall govern in determining whether a subsidy exists. The fact that the U.S. taxpayer may derive no demonstrable benefit from the subsidy is irrelevant in determining whether a subsidy exists.

(iii) Official exchange rate. A subsidy described in paragraph (e)(3)(i)(B) of this section does not include the actual use of an official foreign government exchange rate converting foreign currency into dollars where a free exchange rate also exists if—

(A) The economic benefit represented by the use of the official exchange rate is not targeted to or tied to transactions that give rise to a claim for a foreign tax credit;

(B) The economic benefit of the official exchange rate applies to a broad range of international transactions, in all cases based on the total payment to be made without regard to whether the payment is a return of principal, gross income, or net income, and without regard to whether it is subject to tax; and

(C) Any reduction in the overall cost of the transaction is merely coincidental to the broad structure and operation of the official exchange rate.

In regard to foreign taxes paid or accrued in taxable years beginning before January 1, 1987, to which the Mexican Exchange Control Decree, effective as of December 20, 1982, applies, see Rev. Rul. 84-143, 1984-2 C.B. 127.

(iv) Examples. The provisions of this paragraph (e)(3) may be illustrated by the following examples:

Example 1. (i) Country X imposes a 30 percent tax on nonresident lenders with respect to interest which the nonresident lenders receive from borrowers who are residents of Country X, and it is established that this tax is a tax in lieu of an income tax within the meaning of § 1.903-1(a). Country X provides the nonresident lenders with receipts upon their payment of the 30 percent tax. Country X remits to resident borrowers an incentive payment for engaging in foreign loans, which payment is an amount equal to 20 percent of the interest paid to nonresident lenders.

(ii) Because the incentive payment is based on the interest paid, it is determined by reference to the base used to compute the tax that is imposed on the nonresident lender. The incentive payment is considered a subsidy under this paragraph (e)(3) since it is provided to a party (the borrower) to the transaction and is based on the amount of tax that is imposed on the lender with respect to the transaction. Therefore, two-thirds (20 percent/30 percent) of the amount withheld by the resident

borrower from interest payments to the nonresidential lender is not an amount of income tax paid or accrued for purposes of section 901(b). Example 2. (i) A U.S. bank lends money to a development bank in Country X. The development bank relends the money to companies resident in Country X. A withholding tax is imposed by Country X on the U.S. bank with respect to the interest that the development bank pays to the U.S. bank, and appropriate receipts are provided. On the date that the tax is withheld, fifty percent of the tax is credited by Country X to an account of the development bank. Country X requires the development bank to transfer the amount credited to the borrowing companies.

(ii) The amount successively credited to the account of the development bank and then to the account of the borrowing companies is determined by reference to the amount of the tax and the tax base. Since the amount credited to the borrowing companies is a subsidy provided to a party (the borrowing companies) to a related transaction and is based on the amount of tax and the tax base, it is not an amount paid or accrued as an income tax for purposes of section 901(b).

Example 3. (i) A U.S. bank lends dollars to a Country X borrower. Country X imposes a withholding tax on the lender with respect to the interest. The tax is to be paid in Country X currency, although the interest is payable in dollars. Country X has a dual exchange rate system, comprised of a controlled official exchange rate and a free exchange rate. Priority transactions such as exports of merchandise, imports of merchandise, and payments of principal and interest on foreign

currency loans payable abroad to foreign lenders are governed by the official exchange rate which yields more dollars per unit of Country X currency than the free exchange rate. The Country X borrower remits the net amount of dollar interest due to the U.S. bank (interest due less withholding tax), pays the tax withheld in Country X currency to the Country X government, and provides to the U.S. bank a receipt for payment of the Country X taxes.

(ii) The use of the official exchange rate by the U.S. bank to determine foreign taxes with respect to interest is not a subsidy described in paragraph (e)(3)(i)(B) of this section. The official exchange rate is not targeted to or tied to transactions that give rise to a claim for a foreign tax credit. The use of the official exchange rate applies to the interest paid and to the principal paid. Any benefit derived by the U.S. bank through the use of the official exchange rate is merely coincidental to the broad structure and operation of the official exchange rate.

Example 4. (i) B, a U.S. corporation, is engaged in the production of oil and gas in Country X pursuant to a production sharing agreement between B, Country X, and the state petroleum authority of Country X. The agreement is approved and enacted into law by the Legislature of Country X. Both B and the petroleum authority are subject to the Country X income tax. Each entity files an annual income tax return and pays, to the tax authority of Country X, the amount of income tax due on its annual income. B is a dual capacity taxpayer as defined in § 1.901-2(a)(2)(ii)(A). Country X has agreed to return to the petroleum authority

one-half of the income taxes paid by B by allowing it a credit in calculating its own tax liability to Country X.

(ii) The petroleum authority is a party to a transaction with B and the amount returned by Country X to the petroleum authority is determined by reference to the amount of the tax imposed on B. Therefore, the amount returned is a subsidy as described in this paragraph (e)(3) and one-half the tax imposed on B is not an amount of income tax paid or accrued.

Example 5. Assume the same facts as in Example 4, except that the state petroleum authority of Country X does not receive amounts from Country X related to tax paid by B. Instead, the authority of Country X receives a general appropriation from Country X which is not calculated with reference to the amount of tax paid by B. The general appropriation is therefore not a subsidy described in this paragraph (e)(3).

(v) Effective Date. This paragraph (e)(3) shall apply to foreign taxes paid or accrued in taxable years beginning after December 31, 1986.

* * *

Selected Portions of Section 1.901-2(e)(5)

(5) Noncompulsory amounts—(i) In general. An amount paid is not a compulsory payment, and thus is not an amount of tax paid, to the extent that the amount paid exceeds the amount of liability under foreign law for tax. An amount paid does not exceed the amount of such liability if the amount paid is determined by the taxpayer in a manner that is con-

sistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law (including applicable tax treaties) in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law for tax, and if the taxpayer exhausts all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer's liability for foreign tax (including liability pursuant to a foreign tax audit adjustment). Where foreign tax law includes options or elections whereby a taxpayer's tax liability may be shifted, in whole or part, to a different year or years, the taxpayer's use or failure to use such options or elections does not result in a payment in excess of the taxpayer's liability for foreign tax. An interpretation or application of foreign law is not reasonable if there is actual notice or constructive notice (e.g., a published court decision) to the taxpayer that the interpretation or application is likely to be erroneous. In interpreting foreign tax law, a taxpayer may generally rely on advice obtained in good faith from competent foreign tax advisors to whom the taxpayer has disclosed the relevant facts. A remedy is effective and practical only if the cost thereof (including the risk of offsetting or additional tax liability) is reasonable in light of the amount at issue and the likelihood of success. A settlement by a taxpayer of two or more issues will be evaluated on an overall basis, not on an issue-by-issue basis, in determining whether an amount is a compulsory amount. A taxpayer is not required 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.

* * *

Section 1.901-2(f)(1) and Selected Portions of Section 1.902-2(f)(2)

(f) Taxpayer—(1) In general. The person by whom tax is considered paid for purposes of sections 901 and 903 is the person on whom foreign law imposes legal liability for such tax, even if another person (e.g., a withholding agent) remits such tax. For purposes of this section, § 1.901-2A and § 1.903-1, the person on whom foreign law imposes such liability is referred to as the “taxpayer.” A foreign tax of a type described in paragraph (a)(2)(ii)(C) of this section is considered to be imposed on the recipients of wages if such tax is deducted from such wages under provisions that are comparable to section 3102(a) and (b) of the Internal Revenue Code.

(2) Party undertaking tax obligation as part of transaction—(i) In general. Tax is considered paid by the taxpayer even if another party to a direct or indirect transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer’s foreign tax liability. The rules of the foregoing sentence apply notwithstanding anything to the contrary in paragraph (e)(3) of this section. See § 1.901-2A for additional rules regarding dual capacity taxpayers.

(ii) Examples. The provisions of paragraphs (f)(1) and (2)(i) of this section may be illustrated by the following examples:

* * *

Section 1.901-2(f)(2)(ii), Example 3

Example 3. Country X imposes a tax called the “country X income tax.” A, a United States person engaged in construction activities in country X, is subject to

that tax. Country X has contracted with A for A to construct a naval base. A is a dual capacity taxpayer (as defined in paragraph (a)(2)(ii)(A) of this section) and, in accordance with paragraphs (a)(1) and (c)(1) of § 1.901-2A, A has established that the country X income tax as applied to dual capacity persons and the country X income tax as applied to persons other than dual capacity persons together constitute a single levy. A has also established that that levy is an income tax within the meaning of paragraph (a)(1) of this section. Pursuant to the terms of the contract, country X has agreed to assume any country X tax liability that A may incur with respect to A's income from the contract. For federal income tax purposes, A's income from the contract includes the amount of tax liability that is imposed by country X on A with respect to its income from the contract and that is assumed by country X; and for purposes of section 901 the amount of such tax liability assumed by country X is considered to be paid by A. By reason of paragraph (f)(2)(i) of this section, country X is not considered to provide a subsidy, within the meaning of paragraph (e)(3) of this section, to A.