No. 16-1282

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

SANTANDER HOLDINGS USA, INC., and Subsidiaries, f/k/a Sovereign Bancorp, Inc.,

Plaintiff-Appellee

v.

UNITED STATES,

Defendant-Appellant

ON APPEAL FROM THE JUDGMENT OF
THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MASSACHUSETTS

BRIEF FOR THE APPELLANT

CAROLINE D. CIRAOLO
Acting Assistant Attorney General

DIANA L. ERBSEN
Deputy Assistant Attorney General

GILBERT S. ROTHENBERG (202) 514-3361
RICHARD FARBER (202) 514-2959
JUDITH A. HAGLEY (202) 514-8126
First Circuit Bar No. 54285
Attorneys, Tax Division
Department of Justice
Post Office Box 502
Washington, D.C. 20044

Of Counsel:
CARMEN M. ORTIZ
United States Attorney

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GLOSSARY

Add	the addendum attached to this brief
HMRC	Her Majesty's Revenue & Customs, the U.K.'s taxing authority (previously known as Inland Revenue)
IRS	Internal Revenue Service
JA	the separately bound Joint Appendix
LIBOR	London Inter-Bank Offered Rate
Op/Add	the District Court's opinions, as paginated in the addendum attached to this brief
STARS	Structured Trust Advantaged Repackaged Securities
U.K.	the United Kingdom

JURISDICTIONAL STATEMENT

Taxpayer Santander Holdings USA, Inc., formerly known as Sovereign Bancorp,[1] filed suit in the United States District Court for the District of Massachusetts seeking a refund of approximately $233 million in tax, penalties, and interest for tax years 2003-2005. (JA30-51.) The court had jurisdiction under I.R.C. § 7422(a) and 28 U.S.C. § 1346(a)(1). On January 13, 2016, the court entered its judgment granting Sovereign a refund. (Add30.) The judgment is final, disposing of all claims of all parties.

The Government filed a timely notice of appeal on March 11, 2016. (JA2656; *see* 28 U.S.C. § 2107 and Fed. R. App. P. 4(a)(1)(B).) This Court has jurisdiction under 28 U.S.C. § 1291.

STATEMENT OF THE ISSUE

Whether the District Court erred in holding as a matter of law that a transaction designed to generate foreign tax credits, and which had no non-tax economic effect or purpose, should be respected for U.S. tax purposes under the economic-substance doctrine.

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[1] We refer to taxpayer as Sovereign, its name during the tax years at issue.

STATEMENT OF THE CASE

A. Procedural overview

This case concerns enormous tax benefits that Sovereign claimed as a result of its participation (through subsidiaries[2]) in a transaction referred to by its promoters as Structured Trust Advantaged Repackaged Securities (STARS) and deemed an abusive tax shelter by the IRS. After the IRS disallowed those benefits and imposed accuracy-related penalties, Sovereign paid the deficiency and then filed this suit for a tax refund. The District Court (Judge O'Toole) disagreed with the IRS's determination and granted Sovereign summary judgment. The United States has appealed.

B. Background: The STARS shelter

This case concerns a transaction designed to generate large foreign tax credits for U.S. taxpayers for a foreign tax that no one in substance had paid. (JA1022, 2153-2158.) By way of brief background, the United States taxes the income of its citizens, residents, and domestic entities on a worldwide basis. I.R.C. § 61(a). Therefore, when

[2] For simplicity, Sovereign and its related entities are referred to as "Sovereign."

calculating its income for U.S. tax purposes, a U.S. corporation must include income earned abroad, even though that foreign income may also be subject to foreign tax. Domestic taxpayers, however, may claim a dollar-for-dollar tax credit (the foreign tax credit) for income taxes they have paid to another country, subject to numerous technical rules and other limitations. I.R.C. §§ 901-909. As particularly relevant here, "'[e]ntitlement to foreign tax credits is predicated on a valid transaction.'" *Bank of N.Y. Mellon Corp. (BNY) v. Commissioner*, 801 F.3d 104, 108 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 1377 (2016) (citation omitted). A transaction is not valid for tax purposes if it lacks "economic substance" or "business purpose." *Schussel v. Werfel*, 758 F.3d 82, 97 (1st Cir. 2014); *BNY*, 801 F.3d at 108.[3]

A taxpayer normally would not be motivated to engage in a transaction in order to claim foreign tax credits because the credits are designed merely to offset U.S. tax on foreign income by tax paid to a foreign country in a genuine business transaction, and, therefore, create

[3] The long-standing economic-substance doctrine has been codified for transactions entered into after March 30, 2010. *See* I.R.C. § 7701(*o*).

an economic wash; $1 of foreign tax paid offsets $1 of U.S. tax owed. STARS, however, was designed to transform the foreign tax credit into economic profit, at the expense of the U.S. Treasury, by creating an arrangement whereby the U.S. taxpayer pays tax to the U.K., claims a foreign tax credit for that U.K. tax, and, at the same time, recoups most of its U.K. tax through its counterparty in the STARS transaction, Barclays, a U.K. bank (whose role as counterparty is described below). (JA666-670, 1022, 2153-2158, 2194-2195, 2213-2219.)

The STARS arrangement worked as follows. The U.S. taxpayer diverted income from U.S. assets (such as loans to U.S. borrowers) into and out of a Delaware trust that had a nominal U.K. trustee. (JA804-833, 1977-2013.) Circulating the U.S. income through the trust had no economic effect on that income, but, because the trustee was a U.K. resident, the trust's income became subject to U.K. tax, even though the income never left the United States or the U.S. taxpayer's control. (JA2175, 2226-2227, 2539-2566.) The U.S. taxpayer agreed to subject its U.S. income to U.K. tax because Barclays agreed to (i) recover most of that tax, (ii) return half of it to the U.S. taxpayer, and (iii) retain the rest as its share of the STARS tax benefits. (JA823, 876, 1022, 1121,

2237.) The U.S. taxpayer then claimed foreign tax credits for the full amount of the U.K. tax, ignoring that almost all of the tax was recovered by Barclays, which, in turn, returned half of the tax payment back to the U.S. taxpayer. (JA1022.) Barclays was able to recover the U.S. taxpayer's U.K. tax because STARS generated U.K. tax benefits for Barclays, including a U.K. tax credit for the U.K. tax paid by the U.S. taxpayer. (JA876, 1022, 2229-2230.)

STARS was designed so that the U.K. retained a small portion of the U.K. tax payment, as Barclays emphasized to the U.K. taxing authorities (HMRC) when it sought pre-approval for STARS's U.K. tax treatment. (JA1077-1079, 1138-1142, 1146, 1715-1717, 2084-2089.) STARS was tax "[a]dditive" for the U.K. (JA1077-1079, 1146, 1715, 2064), and HMRC did not challenge STARS under U.K. law.

To illustrate the STARS scheme, suppose a U.S. taxpayer circulates its U.S. income through a STARS Trust, which pays HMRC $22 in tax for every $100 of Trust income. (JA2154-2158.) For every $22 paid to HMRC in U.K. tax, the U.S. taxpayer claims $22 of foreign tax credits, which, in turn, produces a $22 reduction in its U.S. tax liability. At the same time, Barclays recovers $18.70 from the U.K. as a

result of the tax benefits generated by STARS, leaving HMRC with $3.30.[4] (JA302-305, 2154-2158.) Pursuant to the parties' agreement, Barclays splits the $18.70 with the U.S. taxpayer by returning $11 to the U.S. taxpayer, and Barclays keeps the rest as its fee for promoting STARS. (JA72-73, 2156.) The $22 of U.S. foreign tax credits thus funds the STARS benefits received by the U.S. taxpayer ($11), Barclays ($7.70), and HMRC ($3.30), all at the expense of the U.S. Treasury. (JA1022, 2154-2158, 2194-2197, 2216-2219.) *See BNY*, 801 F.3d at 111-112.

The form of STARS allows U.S. taxpayers to present the transaction as tax neutral; although the foreign tax credits reduce their U.S. tax by 22 percent, in form they pay a 22-percent tax to the U.K. (JA36.) In substance, however, STARS decreased the U.S. taxpayer's world-wide tax burden because "50%" of the U.K. tax is returned to the U.S. taxpayer by Barclays. (JA72, 1022, 2237.)

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[4] This example simplifies Barclays' U.K. tax benefits, which are not in dispute and are detailed at JA1688-1692. In addition, the example ignores certain relatively *de minimis* cash flows in the Trust.

To eliminate this abuse, the Treasury Department proposed regulations in 2007 (finalized in 2011) that precluded taxpayers from claiming foreign tax credits from STARS (and other similar) transactions after the regulations' effective date. 72 Fed. Reg. 15081 (2007). The regulations' preamble, however, emphasized that the IRS would scrutinize tax benefits claimed in STARS transactions before the regulations' effective date under certain anti-abuse doctrines, including the "economic substance doctrine." *Id.* at 15084.

Before the regulations were issued, Barclays entered into STARS transactions with six U.S. banks. The IRS disregarded those transactions under the anti-abuse doctrines, and four taxpayers (including the taxpayer here) challenged the IRS's determination in court. As described in the Argument, with the exception of the instant case, in every litigated case involving the STARS scheme, the claimed foreign tax credits have been disallowed. In the two cases that have been fully litigated, the Tax Court and the Court of Federal Claims determined that STARS lacked economic substance and business purpose, and disallowed the claimed foreign tax credits and related transaction-expense deductions. *BNY v. Commissioner*, 140 T.C. 15, *as*

amended by 106 T.C.M. (CCH) 367 (2013); *Salem Financial, Inc. v. United States*, 112 Fed. Cl. 543 (2013). Those determinations were affirmed on appeal. *BNY*, 801 F.3d 104; *Salem Financial, Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 2015), *cert. denied*, 136 S. Ct. 1366 (2016). The third STARS case, *Wells Fargo & Co. v. United States*, No. 09-2764 (D. Minn.), is scheduled for trial on October 31, 2016. *See Wells Fargo & Co. v. United States*, 2015 WL 6962838, at *11-16 (D. Minn. 2015) (denying taxpayer's motion for summary judgment because factual issues existed as to whether its STARS transaction had economic substance and business purpose).

C. Sovereign's STARS transaction

The details of Sovereign's complex STARS transaction are set forth in the expert declarations submitted by the Government in opposition to Sovereign's motion for summary judgment. (JA2145-2233.) Because the details are not relevant to the appeal, we summarily describe the transaction in simplified form. It was initiated in November 2003, supplemented in December 2004, and scheduled to last for 5 years until November 2008. (JA125-126.) Either party, however, could terminate STARS with 30 days' notice. (JA769.)

Sovereign terminated its STARS transaction early, in July 2007 (JA36, 126), because transactions that generated foreign tax credits (like STARS) had come under IRS scrutiny (JA2424-2425). *See* 72 Fed. Reg. 15081.

Sovereign's STARS transaction consisted of a Trust and a Loan. To generate the foreign tax credits, the parties used the Trust to create a series of instantaneous circular cash flows (described in more detail below) that began and ended with Sovereign and through which Sovereign cycled income generated from approximately $7 billion of its revenue-producing bank assets located in the United States (primarily pre-existing loans with U.S. borrowers). (JA66, 322, 2562.) By circulating its U.S. income through the Trust, Sovereign became liable for a U.K. tax on that income, even though it was immediately returned to Sovereign, because the Trustee (controlled by Sovereign) was a U.K. resident. (JA1121-1122, 2158-2159, 2196, 2566.) Sovereign agreed to subject its U.S. income to the U.K. tax in exchange for Barclays' agreement to pay Sovereign a fixed monthly amount — referred to in the transaction documents as the "Bx" payment (JA2190-2192, 2196) — that was calculated to equal "50%" of the U.K. "taxes" Sovereign

expected to pay on the Trust income. (JA2154-2155.) Sovereign's advisors described the Bx payments as "rebates" of the tax that Sovereign paid to the "UK Treasury." (JA1022.)

Barclays acquired a formal interest in the Trust by purchasing certain Trust units for $1.15 billion. (JA66 n.2.) That acquisition did not provide Barclays a real ownership interest in the Trust because the transaction documents required it to sell those units back to Sovereign for $1.15 billion when the transaction terminated. (JA244, 1556.) Barclays' formal interest in the Trust, however, allowed it to claim certain U.K. tax benefits (including a tax credit for the U.K. taxes paid by Sovereign) that permitted Barclays to recover Sovereign's U.K. tax payment and to realize a profit. (JA2222-2225.) Barclays' purchase of, and offsetting agreement to sell, the Trust units functioned as a Loan to Sovereign, as described below. (JA821.)

1. Trust

To generate the U.S. and U.K. tax benefits that Sovereign and Barclays claimed, the parties looped Sovereign's U.S. banking income in three circular cash flows. (JA2158-2162.) In the first cash flow, Sovereign distributed funds from its income-earning assets to the Trust,

in an amount sufficient to generate a pre-determined amount of U.K. taxes, and then, after setting aside an amount to pay those taxes, the Trust returned the remaining funds to Sovereign. (JA289-290, 2182, 2210-2212.) This cash flow subjected Sovereign's U.S.-source income to U.K. tax, without changing the character or substance of that income, or Sovereign's control over the assets or their income. (JA298-299, 2208-2212.) At no point during the STARS transaction were the assets outside the United States or Sovereign's control. (JA225.)

In the second cash flow, the Trust — before returning the funds to Sovereign in the first cash flow — distributed funds to the Barclays Blocked Account at Sovereign, which immediately returned those funds to the Trust. (JA2159, 2182-2183, 2212.) Barclays could not access the funds held — nominally and briefly — in its name in the Barclays Blocked Account. (*Id.*) This fleeting, circular cash flow allowed Barclays to claim a U.K. tax loss for the purported reinvestment of the Trust's income but had no economic effect. (JA2227-2228.)

Combining the first two circular cash flows created a loop of funds that began, and ended, with Sovereign, and had no economic effect on Sovereign's management, control, or receipt of the funds (other than

paying the tax to the U.K.). (JA2158-2162, 2208-2214.) Each month, a pre-determined amount of Sovereign's income from its U.S. assets would flow in a circle (i) from Sovereign to the Trust, (ii) from the Trust to the Barclays Blocked Account at Sovereign (after paying U.K. tax), (iii) from the Barclays Blocked Account back to the Trust, and (iv) from the Trust back to Sovereign. (*Id.*) These circular transfers took place during the same overnight process, were handled by Sovereign employees, and provided neither Sovereign nor Barclays any economic benefit, only transaction costs (including a $5.5 million fee to KPMG) and tax benefits. (JA862, 2015, 2158-2162.)

In the third circular cash flow, Sovereign used the Trust to pay a U.K. tax that (as Sovereign's advisors explained) Barclays would recover and rebate to Sovereign. (JA1022, 2215-2216.) To complete this circle, (i) the Trust paid the U.K. tax on the Trust's income to HMRC; (ii) HMRC returned almost all of that tax to Barclays (resulting from Barclays' claiming U.K. tax credits and deductions based on the Trust's circular cash flows); and (iii) Barclays returned an amount equal to 50 percent of the U.K. tax paid by the Trust back to Sovereign. (JA301-302, 1022, 2160-2162, 2215-2216.) These prearranged, integrated steps

— in which Sovereign's tax payment was cycled through HMRC to Barclays, and then back to itself — was the basis Sovereign used to claim foreign tax credits for a foreign tax that was not in substance paid. (*Id.*)

2. Loan

The STARS transaction included a $1.15 billion Loan from Barclays to Sovereign that was created through offsetting agreements that converted Barclays' purchase of the Trust interests into a Loan for U.S. tax purposes. (JA66 & n.2, 141-218.) The net effect of those agreements was that Barclays loaned Sovereign (i) $750 million in November 2003 at a floating monthly rate of LIBOR plus 50 basis points, and (ii) an additional $400 million in December 2004 at LIBOR plus 25 basis points (JA679), generating interest amounts that would be "netted" against the monthly Bx payments that Barclays owed Sovereign (JA120, 210, 664-666, 979).

The Loan was not necessary for generating the foreign tax credits, and, as originally designed, STARS did not include a loan to the U.S. taxpayer; Barclays simply offered the U.S. taxpayer the Bx payment as a payment related to the trust. (JA1086-1114, 1801, 2069-2070, 2163-

2166.) That transaction, however, raised concerns with tax advisors that the asserted "business purpose" would not "hold water." (JA1118.) Barclays added a loan to STARS, and applied the tax "rebates" to offset the interest owed on the loan, to disguise the true nature of the Bx payment and permit U.S. taxpayers to justify STARS as low-cost funding. (JA1022, 1027.)

The Loan itself provided Sovereign no economic benefit. (JA2396-2401.) When evaluating the economic benefit Sovereign expected to receive from STARS, the parties did not include the potential yield on the use of the Loan proceeds as an element of profit because Sovereign could have obtained the same proceeds from another funding source. (JA823, 2396-2401, 2419-2425.) Moreover, the Loan's interest rate was far more expensive than Sovereign's comparable funding, which generally was at or below LIBOR. (JA1121, 2180, 2193-2194, 2416.)

The Loan, however, was intended to provide Sovereign a business pretext for STARS of purported low-cost funding. (JA1026-1027, 1118, 2441-2443, 2544.) To be respected for tax purposes, STARS needed "economic substance" and a "business purpose," as Sovereign

understood from discussions with its advisors. (JA1026-1027, 2517-2523.)

To support STARS's low-cost-funding rationale, the parties artificially connected the Trust and the Loan by embedding the Bx payment in the lending component of STARS and applying the Bx payment that Barclays owed Sovereign from the Trust to reduce the interest expense that Sovereign owed Barclays on the Loan. (JA210, 2163, 2191-2194.) By characterizing the Bx payment as a negative component of "interest" and by "nett[ing]" the payment against the Loan's interest expense, they disguised an above-market loan as low-cost funding and the Bx payments as something other than tax "rebates." (JA210, 1022-1027.)

In analyzing STARS, however, Sovereign understood that its actual "interest" expense on the Loan was separate from the payment of "tax credits" it would receive back from Barclays. (JA139, 241, 256.) Sovereign further understood that the Bx payment had no relationship to the amount of the Loan, and was based on the amount of tax that Sovereign was expected to pay to the U.K. (JA1202, 1706-1707 & n.14, 2039.) As Sovereign explained to its banking regulators, the "benefit" it

received from Barclays was not "tied to interest rate movements, but rather to the amount of U.K. tax benefits that Barclays receives" for Sovereign's payment of U.K. tax. (JA139, 1126, 2038.)

To lend credibility to characterizing STARS as low-cost funding, Sovereign's advisors wanted to avoid "negative interest," that is, the situation where the monthly Bx payment that Barclays owed Sovereign exceeded the monthly interest payment that Sovereign owed Barclays, resulting in Barclays purportedly paying Sovereign to borrow the Loan proceeds. (JA794, 1712.) Negative interest would be inconsistent with STARS's financing "characterization," because lenders normally do not pay interest to borrowers. (JA794, 2193.) According to Sovereign's advisors, "if there's a negative amount[,] it calls into question the characterization of the transaction [because] there's obviously something else going on." (JA794.)

The parties, however, were unable to increase the amount of the Loan (and thus the amount of Loan interest) enough to avoid negative interest. (JA254, 1712.) Accordingly, Sovereign's "interest payments" were negative during 2003-2004, when Barclays paid Sovereign $21

million more in Bx payments than Sovereign owed in interest on the above-market Loan. (JA290, 692, 2039.)

D. District Court proceedings

Sovereign claimed over $400 million in foreign tax credits from its STARS transaction, with approximately $200 million claimed during the tax years at issue (2003-2005). (JA37, 79.) Sovereign commenced this refund suit after the IRS determined that its STARS transaction should not be respected for U.S. tax purposes, disallowed Sovereign's STARS tax benefits (foreign tax credits, interest-expense deductions, and professional-fee deductions), and imposed accuracy-related penalties. (JA38-40.)

During the proceedings, the parties disputed whether Sovereign's STARS transaction should be respected under certain common-law tax doctrines, including the economic-substance doctrine. (JA40, 103.) The economic-substance doctrine requires courts to analyze a transaction's economic reality and determine whether it serves any meaningful economic purpose beyond creating tax benefits.

Sovereign moved for partial summary judgment, arguing that the Bx payment that Sovereign received from Barclays must be treated as

economic income for purposes of determining whether it expected to receive a pre-tax profit from the STARS Trust transaction. (JA54.) For purposes of its motion, Sovereign "accept[ed]" the Government's position that the Trust and the Loan had to be analyzed separately under the economic-substance doctrine, and that the Loan (which was artificially attached to the Trust) could not provide an economic justification for the Trust transaction. (Doc. 127 at 16-17; Doc. 142 at 6.)

The Government opposed Sovereign's motion because it presented multiple genuine issues of material fact, including (i) whether (as the Government contended) the economic reality of the STARS Trust's circular cash flows evidenced that the Bx payments were not economic income but were merely tax effects, effectively rebates of U.K. tax claimed as foreign tax credits, and (ii) whether Sovereign engaged in STARS solely to obtain U.S. tax benefits. (Doc. 134.) To support its economic analysis, the Government submitted contemporaneous documents generated by Sovereign and its advisors, as well as expert declarations, demonstrating that:

- the circular cash flows through the Trust were economically meaningless (JA666-667, 807);

- the only economic benefit in STARS was a reduction in U.S. taxes achieved by claiming foreign tax credits for taxes that were not in substance paid to the U.K. (JA669-673, 839, 887-888, 1022, 1134);
- as an economic matter, the Bx payments were not non-tax income but were tax effects, representing a return to Sovereign by Barclays of 50 percent of the U.K. tax paid by Sovereign for which foreign tax credits were claimed (JA666-671, 684, 693-694, 700, 1022, 1121, 1130); and
- Sovereign's characterization of STARS as low-cost funding conflicted with the objective evidence because (i) the actual interest rate on the Loan was higher than comparable funding available to Sovereign, and (ii) the Bx payment was not a true component of interest (JA664-666, 677-681, 690-693, 887-888).

The District Court granted Sovereign's motion for partial summary judgment. (Op/Add1-13.) The court held that the Bx payments were non-tax income, and that if they were "included in the calculation of pre-tax profitability, then there was a reasonable prospect

of profit as to the trust transaction, giving it economic substance." (Op/Add11.) The court further held that the "need for a subjective inquiry" under the economic-substance doctrine did not "preclude summary judgment." (Op/Add12-13.)

In ruling that Sovereign's STARS Trust transaction had economic substance, the District Court held that the Government's economic analysis of the transaction (and the supporting fact and expert evidence) was irrelevant because the "Code and regulations contain explicit provisions addressing when a foreign tax may be considered rebated by the taxing authority." (Op/Add6.) In the court's view, the economic substance of a transaction was "not a question of fact" but was instead a "question of law," and therefore the experts' "opinions do not matter." (Op/Add7.) In so ruling, the court declined to follow the trial court decisions in *BNY* and *Salem*, which had concluded that, "as a matter of *fact*," the Bx payment was "'in substance' a 'tax effect.'" (Op/Add9.)

After the District Court's ruling, Sovereign moved for summary judgment. (JA2136-2137.) Sovereign argued (i) that the court's economic-substance ruling effectively invalidated the Government's

remaining arguments for disallowing the foreign tax credits, (ii) that it was entitled to deductions for interest expense and other transaction costs incurred in the STARS transaction, and (iii) that penalties were inapplicable. (Doc. 246.) Sovereign emphasized that its motion (like its prior motion for partial summary judgment) was predicated on analyzing the Loan and the Trust as separate transactions. (Doc. 251 at 30 n.106.)

The Government filed a cross-motion for partial summary judgment, arguing (among other things[5]) that the STARS transaction lacked economic substance even if the Bx payments were treated as non-tax income. (JA2141-2142.) As the Government explained, a complete computation of Sovereign's profit potential from the Trust required that the Bx-payment income be reduced by the costs incurred

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[5] The Government also argued (as an alternative to its economic-substance argument) that the foreign tax credits should be disallowed under another anti-abuse doctrine, the substance-over-form doctrine. Pursuant to that doctrine, a transaction can be recharacterized for tax purposes, even if it has economic substance and business purpose. (Doc. 250 at 17-23.) For example, a genuine business transaction that the taxpayer has characterized as a partnership can be recharacterized for tax purposes as a debt arrangement if that better reflects its substance. *See TIFD III-E, Inc. v. United States*, 459 F.3d 220, 231 (2d Cir. 2006).

to earn that income and that, for every $1 of Bx payment, Sovereign had to pay $2 of U.K. tax. (Doc. 250 at 47-49.) The Government further argued that a trial was necessary to determine whether the STARS Loan independently lacked economic substance and whether Sovereign was liable for accuracy-related penalties for the resulting tax underpayments.

The District Court granted Sovereign's motion for summary judgment and denied the Government's cross-motion for partial summary judgment. (Op/Add14-29.) The court held that the Trust had economic substance and should not be disregarded for tax purposes because (in the court's view) it generated a non-tax economic benefit. In so ruling, the court concluded that the U.K. tax that Sovereign was required to pay should not be treated as a cost of obtaining the Bx payments. (Op/Add17-19.) The court recognized that its decision conflicted with the Second Circuit's *BNY* decision and the Federal Circuit's *Salem* decision (Op/Add25-26), which both concluded that the U.K. tax was an actual economic cost for the Bx payment and that such cost precluded the Trust transaction from generating a pre-tax profit. The court also rejected the Government's substance-over-form

arguments, citing its "prior ruling" under the economic-substance doctrine. (Op/Add21.)

The District Court further held that the Loan, analyzed in isolation from the Trust, had economic substance. As the court explained, it was undisputed that the Loan was "real" and was "used in [Sovereign's] banking operations" and as such was a "substantive economic transaction," even if the Loan's interest rate was "higher than rates available to Sovereign" for non-STARS borrowing. (Op/Add16-17.) In so ruling, the court relied on the Second and Federal Circuit STARS decisions, which both analyzed the Loan separately from the Trust and held that the STARS Loan had economic substance even though the STARS Trust did not.[6] (*Id.*)

SUMMARY OF ARGUMENT

This case involves a transaction (STARS) that generated over $400 million in foreign tax credits claimed by Sovereign for foreign taxes that were not in substance paid. To generate those credits,

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[6] The Government is not appealing the District Court's determination that Sovereign is entitled to its claimed interest-expense deductions as long as the Loan is treated as a separate transaction rather than as an integrated part of the Trust transaction. *See*, below, pp. 70-71 n.17.

Sovereign agreed to subject its U.S. banking income to U.K. tax by cycling that income through a paper Trust with a U.K. trustee, in exchange for Barclays' agreement to return half of the U.K. tax to Sovereign (the Bx payment). Sovereign was thus able to reap immense "profits," at the expense of the U.S. Treasury, by claiming foreign tax credits for U.K. taxes that were returned to it by Barclays.

Four courts, including the Second and Federal Circuits, have addressed STARS, and each determined that the transaction designed to effectuate this raid on the Treasury failed under the economic-substance doctrine. The STARS Trust lacked economic substance, the courts concluded, because it consisted of meaningless circular cash flows that could not generate a pre-tax profit and did not expose the taxpayer's U.S. assets to any economic risk or genuine international activity. The Bx payments could not provide the U.S. taxpayer a pre-tax profit, because they (i) were properly characterized as tax gains — not economic gains — and (ii) were, in any event, far less than the foreign-tax costs incurred in obtaining those payments.

Rejecting the economic-substance analysis of the other courts that have addressed STARS, the District Court granted Sovereign summary

judgment, holding that its STARS Trust had economic substance. Critical to the court's holding is its determination that the Bx payments provided Sovereign a pre-tax profit. That determination is wrong as a matter of law.

1. As a threshold matter, the District Court erred in treating the Bx payments as economic income. The economic reality of the Bx payments is not (as the court wrongly supposed) a purely legal issue, and the Government submitted evidence that supports characterizing the Bx payments as nothing more than a partial return of U.K. tax that was funded by Sovereign's tax savings from the U.S. foreign tax credits. That the payments were not a "rebate" within the meaning of the Internal Revenue Code and related regulations, as the court emphasized, is beside the point. The very purpose of the economic-substance doctrine is to reach transactions that the drafters of legislation and regulations have not yet anticipated.

2. In any event, no matter how the Bx payments are characterized, the STARS Trust transaction could not generate a profit for Sovereign on a pre-tax basis. For every $1 of Bx payment received from Barclays, Sovereign was required to pay $2 of tax to the U.K. As a

matter of simple mathematics, and as the Second and Federal Circuits have held, STARS was a losing proposition without the foreign tax credits. The District Court's refusal to treat the U.K. tax as a STARS transaction cost for purposes of calculating profit under the economic-substance doctrine directly conflicts with the decisions of those two appellate courts, as well as with Congress's codification of the economic-substance doctrine, and is otherwise ill founded.

3. In addition to lacking any profit potential, the Trust also had no overall economic effect. The Government's unrebutted evidence demonstrates that Sovereign's Trust transaction — like the STARS Trust transaction rejected by the Second and Federal Circuits — generated nothing except foreign tax credits, an artificial U.K. tax liability, and Bx payments that were less than the U.K. tax liability. Because the Trust was profitless, and indisputably had no beneficial impact on Sovereign's business interests, this Court should reverse the judgment granted to Sovereign, and remand the case for the District Court to enter judgment for the Government as to the Trust's lack of economic substance and to determine the applicability of accuracy-related penalties.

4. Alternatively, the Court should reverse the judgment for Sovereign, and remand the case so that the jury may consider all the relevant evidence regarding Sovereign's STARS transaction, including evidence of Sovereign's true motivation for the Trust. In this regard, the District Court erred in dismissing the Government's evidence that Sovereign lacked any genuine business purpose for generating an artificial U.K. tax liability. The court compounded that error by accepting at face value Sovereign's professed business pretext for STARS, thereby improperly resolving on summary judgment a disputed issue of material fact.

ARGUMENT

The District Court erred as a matter of law in allowing Sovereign to claim over $400 million in foreign tax credits because the transaction that generated those credits lacked economic substance

Standard of review

The "general characterization of a transaction for tax purposes is a question of law subject to [de novo] review," and the "particular facts from which the characterization is to be made are not so subject." *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 n.16 (1978).

The District Court's order granting summary judgment to Sovereign, and denying partial summary judgment to the Government, is reviewed "de novo, drawing all reasonable inferences in favor of the non-moving party." *In re Neurontin Marketing & Sales Practices Litigation*, 712 F.3d 60, 66 (1st Cir. 2013).

A. Introduction

This case involves a transaction promoted to U.S. taxpayers as an "'FTC [foreign tax credit] trade'" that was designed to generate large-scale foreign tax credits "by subjecting [U.S.] income to economically meaningless activities." *Salem*, 786 F.3d at 952, 960. To secure those credits, Sovereign momentarily circulated its U.S.-source income into and out of a Delaware Trust with a shell U.K. trustee, thereby purposely subjecting its U.S.-source income to a U.K. tax. Sovereign did so, however, knowing that STARS allowed the parties to "recover" Sovereign's U.K. tax payments. *BNY*, 801 F.3d at 122. In this regard, STARS generated both a U.K. tax and an offsetting U.K. tax credit; pursuant to the prearranged plan, Sovereign paid the U.K. tax, and then Barclays claimed the offsetting U.K. tax credit and "pass[ed] approximately 50% of these tax credits to" Sovereign. (JA2000.) Those

cash flows were all funded by the U.S. Treasury, through the foreign tax credits that Sovereign claimed for the same U.K. tax. (JA1022.)

Like the other U.S. taxpayers that purchased the STARS tax-avoidance scheme, Sovereign was able to reap immense profits by "claiming a [U.S.] 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." *Salem*, 786 F.3d at 952. STARS thus allowed Sovereign "to obtain $2 of foreign tax credit for each $1 of expenditure." *BNY*, 801 F.3d at 122-123. STARS generated those foreign tax credits, but nothing else of any economic substance. *Id.* This exploitation of the U.S. foreign-tax-credit regime is wholly inconsistent with its purpose.

The purpose of the foreign tax credit is to neutralize the effect of U.S. taxes on decisions regarding where to invest or conduct business most productively by mitigating double taxation of foreign income, 56 Cong. Rec. App. 677 (1918), so that "investment-location decisions are governed by business considerations, instead of by tax law," Joint Committee on Taxation, *Impact of Int'l Tax Reform* 3 (JCX-22-06). Like all tax benefits, the foreign tax credit is available only for "'*purposive* activity,' not sham transactions built solely around tax arbitrage."

BNY, 801 F.3d at 114 (citation omitted). To ensure that that legislative purpose is not subverted, courts consistently have applied the economic-substance and other anti-abuse doctrines to foreign-tax-credit claims. *E.g.*, *id.* at 113-114.

The economic-substance doctrine requires disregarding, for tax purposes, transactions that comply with the literal terms of the tax rules but lack objective "economic substance" or subjective "business purpose."[7] *E.g.*, *Stobie Creek Invs. LLC v. United States*, 608 F.3d 1366, 1375-1380 (Fed. Cir. 2010); *Gilman v. Commissioner*, 933 F.2d 143, 146 (2d Cir. 1991); *see Dewees v. Commissioner*, 870 F.2d 21, 30-33 (1st Cir. 1989) (rejecting transaction that had no "reasonable prospect of producing a genuine economic profit," only "tax gains"). This threshold inquiry is essential for effective tax enforcement because virtually all sophisticated tax shelters like STARS are designed to satisfy the

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[7] As noted above (n.3), Congress has codified the economic-substance doctrine for transactions entered into after March 30, 2010. Pursuant to that codification, a transaction must be disregarded for tax purposes if, as an objective matter, it does not "change[ ] in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position," or if, as a subjective matter, the taxpayer lacks "a substantial purpose (apart from Federal income tax effects) for entering into such transaction." I.R.C. § 7701(*o*)(1).

relevant tax rules set forth in the Internal Revenue Code and Treasury regulations. But those rules apply only if "there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached." *Frank Lyon*, 435 U.S. at 583-584.

Several courts have applied the economic-substance doctrine to STARS transactions that are essentially the same as Sovereign's STARS transaction, and have in every case (with the exception of the District Court here) disallowed the claimed foreign tax credits and transaction-expense deductions related to the Trust transaction. After holding a trial, the Tax Court and the Court of Federal Claims determined that the STARS Trust lacked economic substance and business purpose. *BNY*, 140 T.C. at 31-47; *Salem*, 112 Fed. Cl. at 580-587. Those determinations were affirmed by the Second Circuit and the Federal Circuit, respectively. *BNY*, 801 F.3d at 121-123; *Salem*, 786 F.3d at 940-955. In so ruling, the courts determined that STARS (i) was a prepackaged tax-avoidance scheme, (ii) consisted of meaningless

circular, offsetting cash flows that had no economic effect on the taxpayer's business interests, (iii) was unprofitable on a pre-tax basis, given that the U.S. taxpayer was required to pay $2 to the U.K. for every $1 that it received from Barclays, and (iv) was contrary to Congressional purpose. As the Second Circuit explained, the foreign tax credit is designed for taxpayers engaged in "true 'business abroad' resulting in actual out-of-pocket tax payments," not transactions like STARS that "'fictionalize' the concept of international trade" and allow the parties to "recover the cost of [foreign] tax" from both the foreign government and the United States.[8] *BNY*, 801 F.3d at 113, 118.

In rendering its contrary determination with regard to Sovereign's STARS transaction, without even holding a trial, the District Court

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[8] The Tax Court and the Court of Federal Claims both determined that the Trust and the Loan should be analyzed separately because the Loan was not necessary to generate the foreign tax credits but was artificially attached to the Trust. As alternative holdings, the courts determined that the integrated STARS transaction also lacked economic substance. *See BNY*, 140 T.C. at 44-46; *Salem*, 112 Fed. Cl. at 588-589. In *BNY*, the Second Circuit did not address that alternative holding because it affirmed the Tax Court's determination that the Trust and the Loan should be analyzed separately. 801 F.3d at 121. In *Salem*, the Federal Circuit did not address the alternative holding because the taxpayer there abandoned any argument that the Trust and the Loan should be analyzed together. 786 F.3d at 940.

erred as a matter of law. As demonstrated below, the court's central holding that Sovereign had a reasonable prospect of obtaining a pre-tax profit from the STARS Trust transaction (i) conflicts with the Second and Federal Circuits' well-reasoned, contrary determinations, and (ii) is not supported by the authorities it cited. In addition, the court erroneously deemed irrelevant evidence that Sovereign lacked any business purpose for engaging in STARS and improperly resolved disputed factual issues on summary judgment.

B. The District Court erred in granting Sovereign summary judgment with regard to the economic substance of the STARS Trust transaction because Sovereign could not reasonably expect a pre-tax profit from that transaction

Four courts — the Tax Court, the Court of Federal Claims, the Second Circuit, and the Federal Circuit — have applied the economic-substance doctrine to the STARS transaction and have concluded (after extensive trials) that the Trust transaction lacked economic substance and was entered into solely for tax-avoidance reasons.[9] Critical to that conclusion was the courts' determination that the Trust transaction —

[9] Sovereign made no claim in the District Court that its version of the STARS transaction was materially different than the STARS transaction in *Salem* and *BNY*. *See*, below, p. 57.

which required the U.S. taxpayer to pay a U.K. tax in exchange for an amount equal to half of that tax (the Bx payment) — had no potential for generating any pre-tax profit for the U.S. participant. As the courts explained, the Trust could generate no economic profit because (i) the Bx payment either was not an item of income at all, but rather was only a tax effect whereby Barclays and the U.S. taxpayer effectively split the value of the U.S. foreign tax credits claimed for illusory tax cost, or, alternatively, (ii) no matter how the Bx payment is characterized, it could not generate a pre-tax profit because it was far less than the U.S. taxpayer's foreign-tax expense of obtaining the payment. *See BNY*, 801 F.3d at 121-122 (holding that the Trust was profitless because the Bx payment was merely a "tax effect" and, alternatively, the amount of that payment was far less than the "foreign taxes" incurred to obtain that payment); *Salem*, 786 F.3d at 946-949 (holding that the "Bx payments are income to BB&T" but were far less than the "large foreign tax expense" that was incurred to obtain the payments and that the "Trust transaction therefore is profitless before taking into account BB&T's expected foreign tax credits"). The District Court's contrary ruling cannot withstand scrutiny.

1. The District Court erred in treating the Bx payments as non-tax income as a matter of law[10]

The STARS Trust lacks any profit potential because it does not generate any economic income, but, rather, generates only tax benefits that are shared between the parties. In *Salem* and *BNY*, the trial courts analyzed the economic reality of the Bx payment, and its relationship to the other prearranged cash flows, and found that the Bx payments should be excluded from calculated pre-tax profit because they were not incremental income generated by STARS but were instead merely tax profit from the return to the U.S. taxpayer of a portion of its credited U.K. tax payment. *See Salem*, 112 Fed. Cl. at 585 (finding that 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"); *BNY*, 140 T.C. at 42-43 (finding that the Bx payment was a "tax effect" that was "embedded in the loan to serve as a device for monetizing and transferring the value of anticipated foreign tax

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[10] As discussed below in § B.3, pp. 47-50, the District Court's judgment for Sovereign cannot stand even if this Court were to agree with the District Court that the Bx payments should be treated as non-tax income.

credits generated from routing income through the STARS structure"). The Second Circuit concurred. 801 F.3d at 121-122.[11] As here (JA1022), the parties in those cases fully understood the true nature of the Bx payments, referring to them as the U.S. taxpayer's "'rebate from Barclays.'" *BNY*, 801 F.3d at 122 (citation omitted); *accord Salem*, 112 Fed. Cl. at 561.

The District Court erred in holding that the Bx payments were economic income as a matter of law. The "overall economic effect" of the Bx payments is a "question of fact." *BNY*, 801 F.3d at 119.[12] Whether the Bx payments were a monetization of the taxpayer's foreign tax credits (as the Government argued) or were instead payments for non-tax economic activity (as the court held) was disputed. The court's

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[11] The Federal Circuit rejected the trial court's determination that the Bx payment was merely a tax effect, *Salem*, 786 F.3d at 946, but nevertheless concluded that the Trust transaction was "profitless," *id.* at 949-952, as discussed below in § B.3.

[12] Nevertheless, the disagreement between the Federal Circuit and the Second Circuit as to whether the Bx payment constitutes an item of income or simply a tax effect was not based on any difference in the underlying operative facts of the two cases. Rather, the courts of appeals disagreed as to the legal effect of the undisputed facts. We would note in this regard that Sovereign's counsel has conceded that its version of STARS is "very similar" to BNY's version. (JA1909.)

rationale for treating this factual issue as a legal one is flawed, as demonstrated below in § B.2.

The Government submitted fact and expert evidence — similar to that submitted in *BNY* and *Salem* — demonstrating that the Bx payments, in substance, were a return to Sovereign of a portion of the tax that it paid to the U.K. for which it claimed foreign tax credits. (JA663-670, 677-683, 693-694, 700-702, 706, 823, 839, 876, 887-888, 1121, 1130.) For example, prior to entering into STARS, Sovereign's board of directors was advised that the benefits of STARS could be traced to the U.S. Treasury:

> The benefit achieved by Sovereign and Barclays is being funded by the US Treasury. . . . This transaction is taking money that was previously being paid to the US Treasury, redirecting it to the UK Treasury, the UK Treasury is effectively rebating most of it to Barclays, who then rebates part of the funds back to Sovereign in the form of lower interest [through the Bx payment].

(JA1022.) The result, Sovereign was told, was "a lower total tax paid." (JA1022.) Similarly, the promotional materials provided by Barclays to potential STARS purchasers (including Sovereign) represented that the benefit was a tax effect because the "benefit under STARS arises from the ability of both parties to obtain credits for the taxes paid in the

trust." (JA887, 2237; *see* JA1146, 1162.) As its Tax Director acknowledged, Sovereign's benefit from STARS was "predicated on an amount of tax that the Trust was going to pay," for which Sovereign would claim foreign tax credits, and was "50% of the UK taxes paid by the Trust." (JA839, 2155, 2157.) Far from being a real foreign business deal structured to minimize foreign tax liabilities, STARS was deemed "not worth doing" "[w]ithout the UK tax liability." (JA1130.)

Consistent with that fact evidence, the Government's expert declarations demonstrated that the Bx payments were not economic income but were only tax effects. (JA666-671, 2151-2158, 2180-2182, 2190-2197, 2213-2219, 2224-2226.) The experts analyzed the transaction's cash flows and concluded that STARS was designed and implemented to remove tax revenue from the U.S. Treasury, funnel most of it through the U.K. treasury to Barclays (leaving a small amount with the U.K. to immunize the transaction from challenge by the U.K. tax authorities (JA707, 1077-1079, 1146)), and then circulate half of the tax revenue back to Sovereign. (JA664-684, 693-694, 698-702.) Like Sovereign's own advisors (JA1022), the Government's experts concluded that, from an "economic perspective, the ultimate

source of 100% of the funding for the Barclays' Payments was the U.S. income tax savings that Sovereign derived from claiming U.S. foreign tax credits for the U.K. income taxes paid by the Trust." (JA700-701.) Properly understood in context, the Bx payment was not "incremental pre-tax revenue," but was simply one leg of a prearranged, integrated circular flow of cash that was funded entirely by Sovereign's U.S. tax savings. (JA694, 2154-2158.)

2. The legal authorities cited by the District Court do not preclude the Government's factual analysis of the economic reality of the Bx payments

The District Court erred in resolving the economic reality of the Bx payments on summary judgment. As described above, the Government submitted evidence that the payments were not items of economic income but were merely monetizations of Sovereign's foreign-tax-credit benefits. When faced with similar evidence in another STARS case, the district court in *Wells Fargo* denied the taxpayer's motion for summary judgment, holding that a "jury could find that Barclays did not merely pay Wells Fargo to create tax benefits for Barclays, but that Wells Fargo actually funded those benefits with tax revenues extracted from the U.S. treasury." 2015 WL 6962838, at *6.

As the court there further explained, a "jury could find that, as a practical matter, the Bx payment simply represented Wells Fargo's cut of the tax benefits achieved through a series of economically meaningless acts." *Id.* at *7. The same is true here.

The District Court's rationale for resolving the economic reality of the Bx payments without the benefit of fact-finding cannot withstand scrutiny. First, that the overall characterization of a transaction is a "legal question" does not mean that the characterization can be resolved properly without the benefit of fact-finding, as the court wrongly concluded (Op/Add7). Courts applying the economic-substance and other anti-abuse doctrines frequently make numerous findings upon which to base their overall characterization of a transaction. *E.g.*, *Frank Lyon*, 435 U.S. at 576-584 (observing that "[t]here is no simple device available to peel away the form of [a] transaction and to reveal its substance," and basing its characterization of the transaction's substance on numerous findings); *Fidelity Int'l Currency Advisor A Fund, LLC v. United States*, 661 F.3d 667, 672 (1st Cir. 2011) (observing that a transaction's "[p]urpose" under the economic-substance doctrine "is an issue of fact"); *Altria Group, Inc. v. United*

States, 658 F.3d 276, 288 (2d Cir. 2011) (observing that the "inquiry under *Frank Lyon*" is "wide-ranging and fact-intensive").

Similarly missing the mark is the District Court's conclusion that the Government's characterization of the Bx payments as tax effects under the economic-substance doctrine was precluded by "the Code and regulations" that "address[ed] when a foreign tax may be considered rebated by the taxing authority." (Op/Add6.) That ruling conflicts with binding precedent and misconstrues the role of the economic-substance doctrine. In the seminal economic-substance decision in *Gregory v. Helvering*, 293 U.S. 465, 468 (1935), the Supreme Court disregarded a transaction that complied with "every element required by" the relevant law. The taxpayer there had created a corporation for the sole purpose of transferring valuable stock to herself at the capital-gains tax rate, rather than at the higher ordinary-income tax rate. *Id.* at 467. The Court disregarded the corporation, holding that it "was nothing more than a contrivance" designed to transfer property at a reduced tax rate. *Id.* at 469; *accord Knetsch v. United States*, 364 U.S. 361, 366 (1960).

Applying the Supreme Court's general guidance in *Gregory*, *Knetsch*, and *Frank Lyon* to unique and ever-changing tax-avoidance

schemes, the courts of appeals have repeatedly rejected tax shelters that comply with technical tax rules but are economically meaningless. *E.g., Dewees*, 870 F.2d at 29; *WFC Holdings Corp. v. United States*, 728 F.3d 736, 742-743 (8th Cir. 2013); *Sala v. United States*, 613 F.3d 1249, 1253-1254 (10th Cir. 2010); *Winn-Dixie Stores, Inc. v. Commissioner*, 254 F.3d 1313, 1315-1316 (11th Cir. 2001); *ACM Partnership v. Commissioner*, 157 F.3d 231, 245-246 (3d Cir. 1998). As those decisions evidence, the inquiry under the economic-substance doctrine is separate and distinct from the inquiry under the technical tax rules.

The District Court failed to appreciate that the issue here is not whether the U.K. provided a rebate within the meaning of the technical tax rules, or how to characterize the Bx payment in isolation from the other Trust cash flows of which it was an integrated component. Rather, the issue is whether Sovereign and Barclays utilized economically meaningless transactions to create and monetize foreign tax credits using the U.K. as a "conduit," and whether the Bx payment is merely an offsetting cash flow in a circular arrangement. (JA320-321, 2215-2216.) And, as is usually the case with sophisticated tax shelters, that issue is not covered by the technical tax rules but is

properly addressed by the economic-substance doctrine, which, along with other judicial anti-abuse doctrines, serves as a critical back-stop to the statutory and regulatory rules. *See ASA Investerings Partnership v. Commissioner*, 201 F.3d 505, 513 (D.C. Cir. 2000) ("Even the smartest drafters of legislation and regulation cannot be expected to anticipate every [tax-avoidance] device."). A "strictly rule-based tax system cannot efficiently prescribe the appropriate outcome of every conceivable transaction that might be devised and is, as a result, incapable of preventing all unintended consequences," as Congress explained when it codified the economic-substance doctrine. H.R. Rep. No. 111-443, at 295 (2010).

That there was no specific "legal authority" that treats the "private payment between Barclays and Sovereign as a payment from the U.K. treasury" (Op/Add7) — prior to the *BNY* and *Salem* decisions — is of no moment. The general economic-substance authorities cited above support such treatment. Moreover, and as the district court in *Wells Fargo* explained, that there is no "case (outside of the STARS context) holding that a payment made by one private party to another can be considered a tax benefit . . . does not mean, however, that the

government's position is necessarily erroneous. The endless ingenuity of taxpayers in attempting to avoid taxes means that there will be a first time for everything." 2015 WL 6962838, at *8.

That common-sense observation is illustrated by the offsetting-options tax shelter rejected in *Fidelity*, *Sala*, and *Stobie Creek*. Before decisions addressing that shelter, there was no specific authority for treating offsetting long and short options as a "single, unified transaction." *Stobie Creek*, 608 F.3d at 1377. Indeed, under the "tax code at that time," taxpayers were entitled to "treat these transactions separately." *Id*. The courts nevertheless refused to analyze each option in isolation from the transaction of which it was a prearranged part, and instead analyzed the "economic reality" of the offsetting options, concluding that under the economic-substance doctrine, the options were "properly treated as a single, unified transaction" for purposes of determining their profitability and substance. *Id*. at 1377-1378. So, too, here. Although, under the Code, the Bx payment, when analyzed in isolation, does not constitute a rebate from the U.K. within the meaning of I.R.C. § 901 and the related regulations (Op/Add6), that hardly is determinative of the tax treatment of the payment. On the contrary,

under the economic-substance doctrine, the Bx payment must be analyzed as part of a larger, prearranged cash flow through which tax is paid, credited, and recovered by Sovereign and Barclays acting together and using the U.K. as a conduit. (JA320-321, 2215-2216.) Pursuant to that economic reality, the Bx payment is properly deemed a tax effect — the monetization of Sovereign's foreign tax credits — and not as incremental economic income. *BNY*, 801 F.3d at 121-122.

Moreover, there is no authority that "affirmatively contradicts the government's position" that the Bx payment should be treated as an effective rebate under the economic-substance doctrine. *Wells Fargo*, 2015 WL 6962838, at *8. The authorities cited by the District Court (Op/Add8) — a later-reversed trial court decision and three nonprecedential private letter rulings — do not purport to address the economic-substance doctrine and therefore shed no light on whether a private-party payment may function, as a matter of economic reality, as a return of a tax payment. *See Doyon, Ltd. v. United States*, 214 F.3d 1309, 1311-1312 (Fed. Cir. 2000) (observing that the statute at issue expressly prohibited analysis of the transaction's "economic substance or business purpose"), *rev'g* 37 Fed. Cl. 10 (1996).

Nor does *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929), preclude the Government's factual analysis of the Bx payments under the economic-substance doctrine, as the District Court (Op/Add10) (and the Federal Circuit in *Salem*) wrongly concluded. That decision had nothing to do with the economic-substance doctrine or foreign taxes. The Court in *Old Colony* held that, when an employer pays U.S. tax owed by an employee, that payment constitutes income to the employee, just as if the employer had paid the same amount to the employee directly and the employee then paid his U.S. tax. *Id.* at 729. That principle (and the related regulations cited by the court (Op/Add10)) is inapplicable because here the U.K. tax, as a matter of economic reality, has not been paid by anyone; instead, Barclays and Sovereign used the HMRC as a conduit to funnel Sovereign's U.K. tax payments through HMRC to Barclays, which, in turn, returned a portion of that tax back to Sovereign. In substance, the Bx payment thus was nothing more than a tax effect.

In addition to citing inapposite authorities, the District Court also erroneously rejected the Government's reliance on "economists." (Op/Add7.) Expert evidence concerning a transaction's economic reality

is "highly relevant" under the economic-substance doctrine. *Stobie Creek*, 608 F.3d at 1376. Indeed, courts frequently rely on such evidence to determine the economic reality of complicated tax-avoidance schemes that are designed to look like legitimate business transactions, as the courts did in *Altria*, *BNY*, *Fidelity*, *Gilman*, *Salem*, *Stobie Creek*, and *WFC Holdings*. Moreover, the court's dismissal of the Government's evidence overlooked that the Government did not rely solely on expert evidence but had submitted corroborating contemporaneous evidence of the parties' understanding of the Trust's economic reality.

3. The Trust could not generate any pre-tax profit for Sovereign, even if the Bx payments are treated as non-tax income, because Sovereign had to pay $2 of U.K. tax to receive $1 of Bx payment, as the Second and Federal Circuits correctly held

Even if — contrary to Sovereign's own contemporaneous analysis and the Government's expert evidence — the Bx payments are not properly treated as a tax effect but, instead, are treated as non-tax income, the payments would nevertheless, as a matter of simple economics, be insufficient to provide Sovereign with a pre-tax profit from its STARS Trust transaction. Thus, even if this Court were to

agree with the District Court that the Bx payment constituted an item of income as a matter of law, the District Court's ruling that the Trust transaction had economic substance still would be wrong. *Salem*, 786 F.3d at 946-951. To determine whether a transaction has profit potential, the transaction's expected non-tax revenues must be compared to its expected "costs and fees." *Stobie Creek*, 608 F.3d at 1378. Here, for every $1 that Sovereign expected to receive from Barclays in Bx payments, Sovereign expected to pay $2 to the U.K. in foreign tax. The Bx payments merely reduced the cost of the U.K. tax by 50 percent, and thus Sovereign was still out of pocket the remaining 50 percent, plus the other substantial STARS transaction costs (JA2210). STARS can be considered profitable only if the disputed foreign tax credits are factored in, but the quintessential inquiry of the economic-substance doctrine is whether a transaction has a reasonable prospect of generating a significant profit *without* factoring in the disputed tax benefit. *E.g., Knetsch*, 364 U.S. at 366.

Applying that well-established principle to the STARS Trust transaction, the Second and Federal Circuits concluded as a matter of simple economics that the Bx payments could not generate a pre-tax

profit for the U.S. taxpayer. As the Second Circuit explained, "'regardless of how the [Bx payment[13]] is characterized'" — as either a tax effect (as the Government argues) or as economic income (as the District Court held) — "'the benefit of the [Bx payment] was more than offset by the additional transaction costs that [the taxpayer] incurred to obtain the [Bx payment].'" *BNY*, 801 F.3d at 122 (citation omitted); *accord Salem*, 786 F.3d at 949 (holding that the "Trust transaction" is "profitless before taking into account BB&T's expected foreign tax credits" because "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)"). That simple mathematical fact cannot be disputed.

Although this Court has not yet applied the economic-substance doctrine to a transaction like STARS, where the transaction's expected foreign-tax expense dwarfs its expected revenue, the Court has made clear that transactions designed to generate "tax gains" instead of "real gains" should be scrutinized under the economic-substance doctrine.

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[13] In *BNY*, the Bx payment was referred to as the "tax-spread." 801 F.3d at 121-122.

Dewees, 870 F.2d at 31. In *Dewees*, this Court determined that no rational investor would have undertaken the straddle transactions at issue there but for their tax advantages. *Id.* at 31-32. So, too, here. No rational investor would have entered into an arrangement that artificially created U.K. tax liabilities in return for a payment of only half of those liabilities, but for the claimed U.S. tax benefits generated by the transaction.

Unlike a genuine business transaction — which is designed to be profitable *despite* the payment of tax — STARS is profitable only *because* of the payment of tax. And, counterintuitively, the more U.K. tax paid, the more "profit" is generated in the STARS "money machine," all at the expense of the U.S. Treasury. *Salem*, 786 F.3d at 951. Indeed, unlike a genuine business transaction — where the elimination of taxation would be cheered by the taxpayer — STARS was deemed "not worth doing" without the "UK tax liability." (JA1130.)

4. The District Court's rationale for rejecting the treatment of foreign-tax expense by the Second and Federal Circuits in their STARS cases cannot withstand scrutiny

The District Court held that the Second and Federal Circuits erred in treating the U.K. tax as an expense attributable to Sovereign's

receipt of the Bx payments. According to the court, Sovereign's U.K. tax payments were not "an actual economic cost for the Barclays payment" because (in the court's view) the total amount of tax due on the Trust income was not "increased" as a consequence of Sovereign engaging in STARS but was merely "divided between two taxing authorities." (Op/Add18-19.) That rationale is flawed. STARS added a nominal 22-percent U.K. tax to the U.S. corporate rate of 35 percent. Sovereign's U.K. tax payments "wash" (Op/Add19) with its U.S. tax liability only if it is assumed that Sovereign is entitled to a foreign tax credit for the tax paid to the U.K. That assumption, however, begs the central question in this case.

Taxpayers are not automatically entitled to foreign tax credits merely because they purport to pay a foreign tax. To the contrary, "[a]llowing credits for taxes paid to other sovereigns 'is a privilege and matter of Congressional grace.'" *Salem*, 786 F.3d at 954 (citation omitted). Sovereign is not entitled to foreign tax credits for its U.K. tax payments unless it is able to demonstrate (among other requirements) that the payments were made in a transaction possessing economic substance and business purpose. And, every court, save the court

below, that has addressed STARS has held that the STARS Trust transaction is wholly devoid of economic substance and, consequently, the foreign tax credits claimed by the participants therein are invalid. *See*, above, pp. 31-32.

Indeed, the U.S. participants in the STARS transaction understood that the only real risk in the transaction was the tax risk that they would *not* be entitled to claim a foreign tax credit for the additional foreign tax that the transaction generated. *See Salem*, 786 F.3d at 960 (observing that "BB&T's executives were extremely skeptical of the tax benefits of the STARS transaction in light of the potential downside tax risks"). Before engaging in STARS, Sovereign's management was specifically advised about the "risk" that it would not be able to claim the foreign tax credit for the additional U.K. tax paid in the transaction. (JA979-980, 1025-1031.) Sovereign advised its U.S. banking regulators of that "United States tax risk." (JA2532.)

Equally lacking merit is the District Court's suggestion (Op/Add19-20) that, if the U.K. tax were treated as an expense of earning the Bx payment, then the U.S. foreign tax credit must be treated as revenue in the court's profitability analysis under the

economic-substance doctrine. That suggestion turns the economic-substance doctrine on its head and was properly rejected by the Second and Federal Circuits. As the Federal Circuit explained, the economic-substance doctrine "assess[es] a transaction's economic reality, and in particular its profit potential, *independent* of the expected tax benefits." *Salem*, 786 F.3d at 948 (emphasis added); *accord BNY*, 801 F.3d at 117-118 (holding that foreign-tax expense, but not the foreign tax credit, must be considered in the court's pre-tax-profitability analysis).

Critically, what the District Court failed to appreciate is that "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 promoters." *Salem*, 786 F.3d at 948. Indeed, the shelter at issue in *Dewees* was profitable if the tax effects were taken into account, but the Court rejected the transaction under the economic-substance doctrine precisely because it was designed to generate only "tax gains" and not "real," non-tax gains. 870 F.2d at 31-32. Consistent with this Court's analysis, the Second Circuit in *BNY* and the Federal Circuit in *Salem* properly took the STARS foreign-tax expense into account, while disregarding the related

U.S. foreign tax credits, in concluding that the Trust lacked any profit potential. The District Court's contrary analysis is wrong as a matter of law.

It bears noting that the approach taken by the Second and Federal Circuits, which the District Court criticized as "circular" and a "bootstrap position" (Op/Add20), was endorsed by Congress when it codified the economic-substance doctrine. Pursuant to that codification, any profitability analysis must disregard U.S. tax benefits, but may, at the same time, account for foreign-tax expense. In this regard, Congress expressly provided that a taxpayer must demonstrate that the transaction has both economic substance and business purpose "apart from Federal income tax effects." I.R.C. § 7701(*o*)(1)(A) & (B). Moreover, while directing that U.S. tax benefits be disregarded in determining pre-tax profit, Congress expressly provided that "foreign taxes" may be "treated as expenses in determining pre-tax profit." I.R.C. § 7701(*o*)(2)(B). The District Court has provided no reason for this Court to adopt a contrary approach for transactions like STARS engaged in prior to the codification's effective date.

C. The District Court erred in denying the Government's motion for partial summary judgment because, in addition to lacking profit potential, the STARS Trust transaction indisputably had no real economic effect on Sovereign's non-tax interests

As demonstrated above, this Court should determine, as did the courts of appeals in *BNY* and *Salem*, that Sovereign's STARS Trust transaction lacked profit potential as a matter of law; no matter how the Bx payment is characterized, the Trust is a profitless transaction. A lack of profit potential, however, "does not by itself end the economic-substance inquiry." *Salem*, 786 F.3d at 950; *accord BNY*, 801 F.3d at 119. As the Second and Federal Circuits recognized, certain "legitimate transaction[s]" — such as those involving "'nascent technologies'" — "'often do not turn a profit . . . unless tax benefits are accounted for.'" *Id.* (quoting *Salem*, 786 F.3d at 950). Therefore, a "court should also look to the overall economic effect of the transaction in determining objective economic substance." *Id.*

The Second and Federal Circuits concluded that the STARS Trust transaction lacked economic substance because — in addition to lacking profit potential — it also lacked any "'real economic effect.'" *BNY*, 801 F.3d at 122 (quoting *Salem*, 786 F.3d at 950). In this regard, the Trust

transaction (i) "did not increase the profitability of the STARS assets in any way," but "reduced their profitability by adding substantial transaction costs" as a result of "using the STARS structure," (ii) consisted of "circular cashflows or offsetting payments [that] had no non-tax economic effect," (iii) "had no effect on the income stream generated by the STARS assets," and (iv) "did not materially change" the U.S. taxpayer's "control and management over the STARS assets." *BNY*, 140 T.C. at 35-37; *accord Salem*, 112 Fed. Cl. at 585-587.

As in *BNY* and *Salem*, the undisputed facts here demonstrate that the STARS Trust transaction had no real economic effect on Sovereign's non-tax interests, as the Government's experts explained in support of the Government's cross-motion for partial summary judgment on the economic substance of the Trust transaction. (JA2146-2153, 2158-2165, 2174-2176, 2182-2185, 2188-2190, 2203-2215, 2224-2225.) The Trust transaction did not alter Sovereign's control over, or management of, its assets or the revenue-generating capabilities of those assets. (JA2208-2209.) Nor did the transaction involve any economic risk, as Sovereign's management understood, given that its assets utilized in STARS would never be "placed outside the U.S." or "outside of

Sovereign's control." (JA807.) Cycling Sovereign's U.S. income through a U.S. Trust with a nominal U.K. trustee created nothing for Sovereign except foreign tax liability and transaction costs, as detailed above in the Statement of the Case, § C.1.

Sovereign provided no contrary evidence in its opposition to the Government's motion, relying instead on purely legal arguments. (Doc. 251 at 29-40; JA2371-2393.) Moreover, at no point in this litigation has Sovereign argued that its STARS Trust transaction is materially different than the other STARS Trust transactions that have been rejected by the courts. Rather, Sovereign's counsel conceded that its transaction was "very similar" to that in *BNY*. (JA1909.) Given that concession, and the unrebutted evidence submitted by the Government here, there is no genuine dispute that Sovereign's STARS Trust, like the other STARS Trusts, objectively lacked economic substance. The District Court erred in denying the Government's motion for partial summary judgment.

D. Alternatively, the District Court erred in granting Sovereign summary judgment because Sovereign's purpose for engaging in STARS is a relevant consideration under the economic-substance doctrine and requires a trial to resolve disputed factual issues

If this Court determines — consistent with the Second and Federal Circuits — that the STARS Trust lacks economic substance because it could not, as a matter of economic reality and simple mathematics, generate any pre-tax profit and had no other beneficial economic effect, then the Court should reverse the District Court's judgment allowing Sovereign's claimed foreign tax credits and related transaction-expense deductions, and remand the case for the District Court to grant the Government judgment as to the foreign-tax-credit issue and to hold trial solely with regard to Sovereign's liability for accuracy-related penalties. Where — as here — "the objective features of the situation are sufficiently clear, [the] court has the legal power to say that self-serving statements from taxpayers [regarding their subjective motivations for engaging in a transaction] could make no legal difference." *Dewees*, 870 F.2d at 35. Given that Sovereign engaged in a transaction, whereby it agreed to pay $2 of U.K. tax in exchange for $1 of Bx payment, and which otherwise consisted entirely

of economically meaningless circular flows of its funds, any self-serving claim by Sovereign that it engaged in the transaction to obtain a profit unrelated to the foreign tax credits cannot save its Trust transaction under the economic-substance doctrine.

Even if, however, this Court were to reject the economic-substance analysis of the Second and Federal Circuits (as well as that of the Tax Court and the Court of Federal Claims), it nevertheless should reverse the judgment for Sovereign. Before a court determines that a transaction can be respected for tax purposes under the economic-substance doctrine, it should consider all the facts and circumstances, including evidence that the taxpayer was motivated solely by tax benefits. *E.g.*, *BNY*, 801 F.3d at 119.

In opposing Sovereign's motion for partial summary judgment, the Government argued that Sovereign lacked a business purpose for the Trust (Doc. 134 at 34-35) and submitted evidence demonstrating that Sovereign was motivated solely by tax benefits. *See* JA698-699, 887-888, 978-980, 1022, 1057-1058, 1130-1134, 1162. Sovereign, in reply, contended that "Sovereign's business purpose is irrelevant in deciding whether the Trust is a sham transaction." (Doc. 142 at 6.)

In granting Sovereign's motion for partial summary judgment, and holding that its STARS Trust should be respected under the economic-substance doctrine, the District Court determined that it need not consider Sovereign's "subjective purpose or motivation" for engaging in STARS. (Op/Add12-13.) That ruling is incorrect. To be respected for tax purposes, a taxpayer must demonstrate (among other things) that its transaction is "imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features." *Frank Lyon*, 435 U.S. at 583-584. The court's contrary determination that "tax-independent considerations" are not required cannot be squared with *Frank Lyon*. *See id.* at 570, 582 (respecting transaction where the taxpayer had "mixed [*i.e.*, business and tax] motivations for entering into the transaction").

This Court's precedent is not to the contrary. In *Fidelity*, the Court affirmed the applicability of penalties to a transaction disregarded under the economic-substance doctrine, and, in doing so, observed that a taxpayer's "[p]urpose" for a transaction — which the Court described as "an issue of fact" — was relevant to the economic-substance inquiry. 661 F.3d at 672. As the district court in *Fidelity*

explained, "[t]he First Circuit appears to have adopted a version of the economic substance doctrine that looks to both the subjective and objective features of the transaction, without a rigid two-part test." *Fidelity Int'l Currency Advisor A Fund, LLC v. United States*, 747 F. Supp. 2d 49, 228 (D. Mass. 2010) (citing *Dewees*), *aff'd*, 661 F.3d 667 (1st Cir. 2011). In *Dewees*, the Court did not have occasion to address whether a court should consider a taxpayer's purpose for engaging in a transaction that *appeared to have* economic substance, because the transaction at issue there so clearly *lacked* economic substance. The Court did, however, consider evidence of the taxpayer's purpose for engaging in the transaction. *See Dewees*, 870 F.3d at 31-32 (noting how the transaction was marketed to taxpayers in "brochures," "advertisements," and other "promotional materials [that] stressed tax benefits" as evidence of the transaction's "purpose"). As in *Dewees*, the manner in which STARS was marketed to taxpayers provides significant insight regarding the real source of benefits in STARS and why a taxpayer would be motivated to engage in it. *E.g., Salem*, 786 F.3d at 952, 954.[14]

[14] In the District Court, Sovereign argued that this Court — (continued…)

Consistent with the Supreme Court's guidance in *Frank Lyon*, other circuits also consider both a taxpayer's subjective motivations and the transaction's objective economic reality. *E.g.*, *BNY*, 801 F.3d at 115; *Winn-Dixie*, 254 F.3d at 1316; *ACM*, 157 F.3d at 247; *Casebeer v. Commissioner*, 909 F.2d 1360, 1363 (9th Cir. 1990). As these courts recognize, evaluating both objective and subjective evidence provides the best means of confirming whether a transaction is part of a legitimate business activity or is simply a façade designed to avoid tax. *Stobie Creek*, 608 F.3d at 1379. And, as described above (n.7), when Congress codified the economic-substance doctrine, it required taxpayers to demonstrate both objective economic effect and subjective business purpose.

(…continued)
unlike every other circuit — deems a taxpayer's motive "wholly irrelevant" under the economic-substance doctrine, citing decisions that pre-date *Frank Lyon* and modern economic-substance jurisprudence. (Doc. 127 at 15-16.) The District Court noted, but did not adopt, that argument, holding instead that "consideration of subjective factors" may sometimes be "necessary or appropriate." (Op/Add12-13.) The decisions cited by Sovereign do not prohibit consideration of a taxpayer's purpose. For example, in *Stone v. Commissioner*, 360 F.2d 737, 740 (1st Cir. 1966), the Court, in ruling for the taxpayer there, relied on the taxpayer's "three other [*i.e.*, non-tax] purposes" for the transaction at issue.

Although the District Court deemed it "fanciful to say that Sovereign had a U.S. tax motive" for engaging in STARS (Op/Add23), two trial courts reached that very conclusion after considering all of the evidence. *See Salem*, 112 Fed. Cl. at 587, 594 (finding that the "STARS Trust had no non-tax business purpose" and that "tax avoidance was singularly and precisely the goal pursued in execution of the STARS transaction"); *BNY*, 140 T.C. at 37-38 (rejecting taxpayer's argument that it engaged in STARS to obtain "low cost financing" and finding that taxpayer's "true motivation was tax avoidance"). Moreover, those tax-motive findings were affirmed on appeal. *See Salem*, 786 F.3d at 954 (affirming "finding that the STARS Trust lacked a bona fide business purpose"); *BNY*, 801 F.3d at 122 (affirming "finding that STARS lacked a subjective business purpose beyond tax avoidance"). Far from being fanciful, the evidence indicates that Sovereign engaged in STARS — a transaction promoted as an "FTC trade" — for the same illegitimate reason that other U.S. taxpayers engaged in STARS. (*E.g.*, JA1022.) At a minimum, the Government is entitled to have a fact-finder decide that question after hearing all of the relevant evidence.

E. The District Court erred in relying on the STARS Loan to buttress its decision that the STARS Trust had economic substance

The District Court compounded its error of disregarding the Government's tax-motivation evidence by accepting at face value Sovereign's purported business purpose for engaging in STARS. In this regard, the court found that Sovereign had a "genuine non-tax, business purpose" for participating in STARS because it "was interested in lower cost borrowing." (Op/Add23.) That finding, however, was disputed by the Government and conflicts with (i) evidence that Sovereign was motivated only by tax concerns, and (ii) evidence that the Loan's interest rate was above-market.

Not only was the disputed business-purpose finding inappropriate in the summary-judgment context, but it was also otherwise misconceived. First, in relying on the purported economic value of the Loan to provide the Trust a "business purpose" (Op/Add23), the District Court disregarded Sovereign's concession (for purposes of seeking summary judgment) that the Trust and the Loan were to be treated

separately in evaluating their economic substance.[15] *See* Doc. 142 at 6; Doc. 251 at 30 n.106.

Further, the District Court's characterization of STARS as low-cost financing (Op/Add23, 25) conflicts with the Government's unrebutted evidence that the cost of the STARS Loan was higher — not "lower" (Op/Add23) — than Sovereign's "normal cost of funds." (JA1121, 2180, 2193-2194, 2399-2401, 2416.) The actual interest rate on the STARS Loan was 25-50 basis points above LIBOR, and Sovereign's "normal cost of funding" was no more than "LIBOR flat," as Sovereign's Tax Director admitted. (JA2416.) Indeed, when Sovereign prematurely terminated its STARS transaction after the Treasury Department proposed regulations that eliminated STARS's tax benefits, it made no attempt to retain the high-cost STARS Loan. (JA2424-2425.)

Finally, the District Court's characterization of STARS as low-cost financing conflicts with the contrary determinations made by the Tax Court and Second Circuit in *BNY* and the Court of Federal Claims in

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[15] The District Court recognized this concession in its initial summary-judgment opinion. (Op/Add4 n.3.)

Salem.[16] *See BNY*, 801 F.3d at 122 (rejecting argument that STARS Loan was "low-cost" and explaining that the Bx payment should not be considered a true "component of the loan interest" because, although "netted against the interest BNY owed on the loan, there was no real relationship between the two"); *Salem*, 112 Fed. Cl. at 586-587 (same). Those courts correctly recognized that the true interest rate on the STARS Loan (without the artificial netting of the Bx payment against the Loan's interest cost) was an above-market rate for a large U.S. bank and, therefore, the Loan itself was an economic detriment, not an economic benefit, for the U.S. taxpayer. Similarly, here, the parties to Sovereign's STARS transaction attempted to disguise the true nature of the Bx payment, and to make it appear that the interest rate on the Loan was highly favorable to the U.S. bank, by artificially treating the Bx payment as a negative component of the interest owed on the Loan even though it is undisputed that there was absolutely no relationship between the amount of the Bx payment and the amount of the Loan.

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[16] The Federal Circuit had no occasion to consider this issue because the taxpayer in *Salem* abandoned on appeal its claim that the STARS Loan provided low-cost financing. 786 F.3d at 940, 952.

See, above, Statement of the Case § C.2. As Sovereign's Tax Director acknowledged, the Bx payment was "predicated on an amount of tax that the Trust was going to pay" — not on the amount of the Loan — and was designed to be "50% of the UK taxes paid by the Trust." (JA2155, 2157.) That tax-based payment from Barclays, he further acknowledged, was then "netted" against the LIBOR-based payments from Sovereign. (JA839.) To view the Bx payment as a legitimate component of the Loan's interest (as the District Court did) would require this Court to accept the absurd proposition that Barclays paid Sovereign over $20 million as "negative interest" to borrow its funds (*see*, above, pp. 16-17).

That STARS, as designed by its promoters KPMG and Barclays, artificially combined two unrelated items, and thereby treated the Bx payment as part of the interest component of the Loan, so that Sovereign could claim that the Loan provided "low-cost funding," did not warrant the District Court's treatment of the Bx payment as a negative component of the interest rate on the Loan. Tax-shelter purchasers and promoters frequently attempt to camouflage their transactions as legitimate business deals. *E.g., WFC Holdings*, 728

F.3d at 740, 747-749; *Swartz v. KPMG LLP*, 476 F.3d 756, 759 (9th Cir. 2007). As Sovereign's advisors candidly assessed STARS, "[t]ypically, borrowing funds at a reduced cost would undoubtedly constitute a valid business purpose. However, in this transaction, economically the lower interest rate was merely the vehicle chosen by the parties through which to pass along a portion of the tax savings achieved by the transaction." (JA1027.)

Rather than accepting the undisputed reality that the Bx payment had nothing to do with the Loan (JA690-693), and the decisions so holding in *BNY* and *Salem*, the District Court instead accepted, without any analysis, the parties' labeling of the Bx payment as a negative component of the interest rate. That acceptance conflicts with binding precedent. *E.g., Frank Lyon*, 435 U.S. at 576-584.

Moreover, far from being an isolated mistake, the District Court's error infected its entire summary-judgment opinion. *See* Op/Add16 ("It is an obvious and fair conclusion that it was the economic value of the loan that attracted [the banks'] attention."); Op/Add16 n.2 (finding that the "Barclays payment" was part of the Loan's "effective rate"); Op/Add23 (finding that "the bank counterparty was interested in lower

cost borrowing"); Op/Add25 (finding that Sovereign "borrowed money at a cost that was in the end advantageous"). This error alone merits reversal of the court's summary-judgment ruling.

As argued above, in the event this Court agrees with the decisions of the courts of appeals in *BNY* and *Salem*, it could determine, as those courts did, that the STARS Trust transaction lacks economic substance as a matter of law because it could not provide Sovereign a pre-tax profit and lacked any other non-tax economic effect. In that case, the Government would be entitled to a ruling from the Court that Sovereign's foreign tax credits (and related transaction-expense deductions) are invalid, and the only matter to be resolved on remand would be the applicability of penalties to the underpayment of tax from those disallowed tax benefits. If, however, this Court were to hold that a trial was necessary to determine whether Sovereign had a legitimate, non-tax purpose for engaging in the profitless Trust transaction, Sovereign would be free to argue that it did so to obtain the STARS Loan (its concession that the Trust and Loan should be analyzed separately was made solely for purposes of summary judgment only). But the District Court, we respectfully request, should be instructed

that Sovereign is to be limited to relying on the Loan's true interest rate, not a rate artificially reduced by the Bx payments, in making any claim that it engaged in the STARS transaction to obtain the Loan. The undisputed evidence — including an admission by Sovereign's Tax Director — demonstrates that the Bx payments had absolutely nothing to do with the Loan and were merely artificially netted against the interest that Sovereign owed Barclays.[17] (JA839, 2155, 2157, 2176-

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[17] If Sovereign were to argue on remand that the Trust and Loan should be analyzed together as one integrated transaction, then the Government would be free to argue that (i) STARS lacks economic substance on an integrated basis (as the Tax Court and Court of Federal Claims have held, *see*, above, n.8), and (ii) in that situation, all transaction-expense deductions — including any deductions claimed for interest paid on the integrated STARS transaction — should be disallowed. *E.g.*, *Kirchman v. Commissioner*, 862 F.2d 1486, 1490 (11th Cir. 1989) (holding that "expenses or losses incurred in connection with [a] transaction [lacking economic substance] are not deductible"). In holding that Sovereign was entitled to the interest deduction, the District Court purported to analyze the Trust and Loan separately, and followed the loan analysis of the Second and Federal Circuits in *BNY* and *Salem*, respectively. (Op/Add16-17.) Those courts held that, if the Loan were analyzed separately from the Trust, then the taxpayer was entitled to its claimed interest deductions because they were not a transaction expense of the sham Trust, and the Loan in and of itself was not an economic sham (despite its above-market interest rate). *See BNY*, 801 F.3d at 123-124; *Salem*, 786 F.3d at 957-958. They did not, however, hold that taxpayers were entitled to interest deductions if the Loan were viewed as an integrated component of the sham Trust transaction. In that circumstance, the interest paid on the Loan would

(continued…)

2179, 2189-2194, 2204-2207, 2225-2226.) The District Court's contrary findings are clearly erroneous and should be vacated. *See BNY*, 801 F.3d at 122-123.

Finally, we note that the District Court's alternative substance-over-form ruling was predicated on (i) its economic-substance ruling that the Bx payment "was not 'in substance' a rebate of U.K. taxes" (Op/Add21), and (ii) its resolution of a disputed factual issue regarding whether Sovereign had a "genuine non-tax, business purpose for [its] participation in the STARS transaction" (Op/Add23). A reversal of the court's economic-substance and business-purpose rulings would also require vacatur of the court's substance-over-form ruling.

(…continued)
be another transaction cost of the Trust, and, as such, the interest deductions should be disallowed like the other Trust transaction-expense deductions. As indicated, it is our position, as the applicable courts held in *BNY* and *Salem*, that the Loan and the Trust should be analyzed separately for all purposes of this case and that *only if* so analyzed is Sovereign entitled to its claimed interest deductions.

CONCLUSION

The judgment for Sovereign should be reversed as to the foreign-tax-credit issue, and affirmed as to the interest issue, and the case should be remanded for the District Court to grant the Government judgment as to the economic substance of the STARS Trust and to hold trial solely with regard to Sovereign's liability for accuracy-related penalties. In the alternative, the court's judgment should be reversed, and the case remanded for trial as to the economic substance of the Trust and as to Sovereign's liability for penalties.

Respectfully submitted,

CAROLINE D. CIRAOLO
Acting Assistant Attorney General

DIANA L. ERBSEN
Deputy Assistant Attorney General

/s/ Judith A. Hagley

GILBERT S. ROTHENBERG
First Circuit Bar No. 11486
RICHARD FARBER
First Circuit Bar No. 18360
JUDITH A. HAGLEY
First Circuit Bar No. 54285
Judith.a.hagley@usdoj.gov
Attorneys, Tax Division
Department of Justice

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Case No. 16-1282

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Attorney for Appellant United States

Dated: June 9, 2016

CERTIFICATE OF SERVICE

I hereby certify that on June 9, 2016, I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the First Circuit by using the appellate CM/ECF system. Participants in the case who are registered CM/ECF users will be served by the appellate CM/ECF system.

/s/ Judith A. Hagley
Attorney for the United States

ADDENDUM

Addendum Document **Addendum Page No.**

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

CIVIL ACTION NO. 09-11043-GAO

SANTANDER HOLDINGS USA, INC. & SUBSIDIARIES,
Plaintiff,

v.

UNITED STATES OF AMERICA,
Defendant.

OPINION
October 17, 2013

O'TOOLE, D.J.

Santander Holdings USA, Inc., formerly known as Sovereign Bancorp, Inc., and referred to in this opinion as "Sovereign," has sued to recover approximately $234 million in federal income taxes, penalties, and interest that it claims were improperly assessed and collected by the Internal Revenue Service for tax years 2003, 2004, and 2005 as a consequence of the IRS's disallowance of foreign tax credits claimed by Sovereign for those years. The United States defends the disallowance on the ground that the transaction in which Sovereign incurred and paid the foreign taxes against which the credit was taken was a "sham" conducted not for its real economic value but rather as a contrived means of generating the tax benefit provided by the foreign tax credit.

Sovereign recently moved for partial summary judgment on a linchpin issue: whether a payment Sovereign received in the transaction from its counterparty, Barclays Bank PLC ("Barclays"), should be accounted for as revenue to Sovereign in assessing whether Sovereign had a reasonable prospect of profit in the transaction. It is the government's position that the payment should be excluded from a calculation of Sovereign's pre-tax profit as a "tax effect"

because the payment is an "effective rebate" of U.K. taxes paid by Sovereign. If the payment is excluded, as the government contends it should be, then the transaction at issue does not show a reasonable prospect of profit, but if it is included, as Sovereign contends, it shows a substantial profit to Sovereign from the transaction. This basic binary fact is not genuinely disputed. The existence or not of a reasonable prospect of profit is critical in determining whether the transaction had objective economic substance for purposes of assessing whether it was a "sham" or not. If the payment is counted as pre-tax revenue, it is objectively clear that the transaction has economic substance for Sovereign.

The parties submitted voluminous briefing on the matter and were heard in extended oral argument. At a pretrial conference on September 25, 2013, I announced from the bench that Sovereign's motion for partial summary was being granted. I gave a brief oral statement of my reasoning, promising a more detailed written opinion to come. This is that opinion, and it supersedes the brief oral statement of reasons.

I. The STARS Transaction

Barclays is chartered by the United Kingdom. Together with its adviser, KPMG, Barclays developed and proposed to several U.S. banks, including Sovereign, a "Structured Trust Advantaged Repackaged Securities" ("STARS") transaction. Viewed from 30,000 feet, the STARS transaction was designed to give Barclays substantial benefits under U.K. tax laws, in light of which Barclays could and would offer to lend funds to U.S. banks at a lower cost than otherwise might be available to them. The banks could relend the money in their normal banking operations, using the lower cost either to obtain a competitive advantage or to increase their marginal return on lending or both. Up close, however, the transaction was surpassingly complex and unintuitive; the sort of thing that would have emerged if Rube Goldberg had been a tax

accountant. The government might be forgiven for suspecting that the designers of anything this complex must be up to no good, but that understandable instinctive reaction is not a substitute for careful analysis, and on careful analysis, the government's position does not hold up.

A very brief overview of the transaction is sufficient for present purposes. Sovereign created a trust to which it contributed $6.7 billion of income generating assets. The trustee of the trust was purposely made a U.K. resident, causing the trust's income to be subject to U.K. income taxation at a rate of 22 percent. The trust income was also subject to U.S. income taxation and was attributed to Sovereign, but with a credit available for the amount paid in U.K. income taxes under section 901 of the Internal Revenue Code ("the Code"). 26 U.S.C. § 901. Sovereign paid U.K. taxes and then claimed credits for the amounts paid in calculating its U.S. income tax liability for the tax years in question.

The transaction included a number of contrived structures and steps that, each viewed in isolation, would make little or no sense. For example, Barclays had an ownership interest in the trust and as a result received monthly distributions from the trust, which, under the terms of the transaction, it was required immediately to re-contribute to the trust. Standing in isolation, this circular movement of distributions would make no sense. In the context of the entire transaction, however, it was crucial to Barclays' obtaining favorable tax treatment under U.K. law, which gave it the ability to lower its effective lending rate to a U.S. bank. The result of the STARS transaction for Barclays was a net tax *gain*, which it was able to use to reduce other U.K. tax liabilities that it owed. [1]

[1] Whether Barclays' maneuvers abused any U.K. tax laws is not an issue here. In any event, it appears from the record that the U.K. tax authorities were well aware of the STARS transaction and made no objection.

The loan aspect of the transaction was also highly structured in an idiosyncratic way, although it was consistently treated by Sovereign for accounting and regulatory purposes as a secured loan, acceptably to regulating agencies, including the Securities and Exchange Commission and the Office of Thrift Supervision. One feature of the loan arrangements was what was denominated the "b_x payment," or the "Barclays payment."[2] It was calculated as approximately one-half of the amount Sovereign paid in taxes to the U.K. on the income earned by the trust. While in the intricacies of the transaction it was actually a monthly credit to Sovereign figured into its interest costs, the government refers to it as an affirmative payment in support of its "effective rebate" argument, and Sovereign accepts that characterization for purposes of this motion.[3]

II. Discussion

There is no dispute that for the years in question Sovereign incurred and paid U.K. taxes on the trust income, also reported the income on its U.S. tax returns, but claimed a foreign tax credit for the amount it paid to the U.K. There is no claim by the government that the foreign tax credit was improperly calculated or that Sovereign failed to comply with any applicable provision of statute or regulation relative to it. Rather, the government's position is that Sovereign did not *in substance* pay the U.K. taxes claimed because the Barclays payment was an "effective rebate" of one-half of Sovereign's U.K. taxes. In other words, the Barclays payment effectively relieved Sovereign of half the burden of its U.K. taxes.

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[2] The term "b_x" comes from the elaborate formulae used by the parties to the transaction to calculate various values. (See, e.g., Pl.'s Mem. in Supp. of Mot. for Partial Summ. J., Ex. 7 (dkt. no. 125-7) ("Amended and Restated Formulae Letter,").)

[3] Sovereign also accepts, for purposes of the motion only, that the STARS transaction can be bifurcated into trust and loan transactions, so that the trust transaction can be evaluated without including the loan transaction. Its broader view in the litigation is that the trust and loan components must be evaluated together.

In order to challenge what would otherwise be a valid claim of a foreign tax credit, the government reaches for its trump card – the "economic substance" doctrine. Cf. In re CM Holdings, Inc., 301 F.3d 96, 102 (3d Cir. 2002) (referring to the economic substance doctrine as the government's "trump card"). Literal compliance with the letter of the Code and regulations may be disregarded if it appears that the transaction in question had no economic substance but was simply a tax-avoiding contrivance. Gregory v. Helvering, 293 U.S. 465, 470 (1935). The same principle has been articulated variantly as the "substance over form" doctrine, see Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978), the "sham transaction" doctrine, see IES Indus., Inc. v. United States, 253 F.3d 350, 353 (8th Cir. 2001), and even the "sham in substance" doctrine, see Dewees v. C.I.R., 870 F.2d 21, 29 (1st Cir. 1989). The principle is the same regardless of the label: if a transaction has no legitimate, non-tax business purpose and thus, apart from expected tax benefits, has no genuine economic substance, it may be disregarded for purposes of assessing taxes. See CM Holdings, 301 F.3d at 103 ("The main question these different formulations address is a simple one: absent the tax benefits, whether the transaction affected the taxpayer's financial position in any way."). A transaction will be found to have economic substance if it had "a reasonable possibility of a profit." Fid. Int'l Currency Advisor A Fund, LLC, by Tax Matters Partner v. United States, 747 F. Supp. 2d 49, 231 (D. Mass. 2010), aff'd sub nom. Fid. Int'l Currency Advisor A Fund, LLC ex rel. Tax Matters Partner v. United States, 661 F.3d 667 (1st Cir. 2011).

The government says the Barclays payment was not "in substance" a payment by Barclays at all, but rather it was "effectively" a rebate of taxes originating from the U.K. tax authorities. The theory is that Barclays was only able to make the payment because of the tax credits *it* had received from the U.K.

The argument is wholly unconvincing. In the first place, the Code and regulations contain explicit provisions addressing when a foreign tax may be considered rebated by the taxing authority and when a taxpayer may be considered to have received a subsidy (a rebate is a type of subsidy) from a foreign source to pay its foreign taxes. Under the Code,

> 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.

26 U.S.C. § 901(i)(1)-(2). Treasury Regulations provide:

> 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.

26 C.F.R. § 1.901–2(e)(2). Further,

> **(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 . . . , 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) (emphasis added). In pretrial discovery, the government abjured any claim that the Barclays payment was a subsidy under these provisions. (See Pl.'s Mem. in Supp.

of Mot. for Partial Summ. J., Ex. 4 at 16 (dkt. no. 125-4) ("Response to Interrogatory No. 41").) As the emphasized sentence indicates, that concession must be understood to mean that the Barclays payment was not "in substance" a subsidy.

Nevertheless, the government presses its argument that the Barclays payment was "in substance" a rebate from the U.K. But the government can point to no governing or precedential legal authority that supports treating the private payment between Barclays and Sovereign as a payment from the U.K. treasury, because there is none. It has some decisions at the first-instance level that have generally accepted its theory about the STARS transaction, but as this opinion explains, I find those decisions unpersuasive.

Lacking compelling legal authority, the government proffers the learned opinions of its putative expert witnesses. The problem is that their opinions do not matter, because the necessary question is not a question of fact – What happened? – but rather a question of law – How should what happened be classified for purposes of applying the law? That is why this issue is amenable to resolution on a motion for summary judgment. The facts of the transaction are not in dispute. There is no material factual issue about how the credits and debits worked their labyrinthine way through the Goldbergian apparatus. The question is, Should the Barclays payment be treated, as a matter of law, as if it were a rebate from the U.K. to Sovereign? That is a legal question, to be answered by judges, not economists. See IES, 253 F.3d at 351 ("The material facts are undisputed; the question of law before us is the general characterization of a transaction for tax purposes.").

The Barclays payment was certainly not an *actual* rebate by the U.K.[4] Nor is there any reason to treat it as an "effective" or constructive rebate. There is no authority to do so. On the contrary, the terms "taxes" and "tax credits" are properly understood to refer to transactions between a taxpayer and a taxing authority, not transactions between private parties, even if the "effect" is to lessen for a taxpayer the economic burden of having paid the tax. See Doyon, Ltd. v. United States, 37 Fed. Cl. 10, 22-24 (1996), rev'd on other grounds, 214 F.3d 1309 (Fed. Cir. 2000). In Doyon, the Court of Federal Claims rejected a taxpayer's argument that certain payments to it from other private parties should have been allowed as an adjustment to its net book income for tax purposes because the payments were effectively the same as a tax item in substance. Contrary to its argument in this case, the government contended in Doyon that "amounts paid between private parties pursuant to private contracts are not and cannot be 'federal income taxes'" within the meaning of the applicable Code provision and related regulations. Id. at 17 (summarizing the government's contention). The court there agreed with the government that private payments were not tax items, concluding that "an item of federal tax benefit is an abatement of liability under the revenue laws," and further that even if the federal Treasury could be regarded as the "ultimate source" of the private party payment, the payment was still private and therefore not a tax item. Id. at 22-23. Sovereign also cites some private letter rulings that similarly look to whether the taxing authority was actually a party to a transfer of a payment or credit, and not to the economic substance of the event, to determine whether the matter was a tax item or a private transaction. See I.R.S. Priv. Ltr. Rul. 2009-51-024 (Dec. 18, 2009); I.R.S. Priv. Ltr. Rul. 2003-48-002 (Nov. 28, 2003); I.R.S. Priv. Ltr. Rul. 87-42-010 (July 10, 1987).

[4] There is no dispute that the U.K. tax authorities did not authorize or participate in any way in the actual calculation or execution of the Barclays payment.

Slight as this authority may be, it is enough to outweigh the government's authority for its proposition that a private payment may be recharacterized into a tax item, which is nil. The recent decisions in similar STARS cases do not discuss the issue. See Salem Fin., Inc. v. United States, -- Fed. Cl. --, 2013 WL 5298078, at *39-40 (Sept. 20, 2013); Bank of N.Y. Mellon Corp. v. C.I.R., 140 T.C. 15, 40-43 (Feb. 11, 2013). Those cases appear to deal with the question whether the Barclays payment was "in substance" a "tax effect" as a matter of *fact*, rather than as a matter of *law*, as I conclude is proper. In other words, they accept the testimony of the government's experts and make a factual finding that the Barclays payment was an effective U.K. tax rebate and consequently a U.S. tax effect. Salem Fin., 2013 WL 5298078, at *40; Bank of N.Y., 140 T.C. at 43. Notably, they do not address the legal question whether a private party payment between Barclays and the relevant bank can properly be classified as a tax effect because it is so much like one in substance, a question that Doyon and the private letter rulings answer in the negative.

Moreover, the Code and regulations have addressed the issues of rebates and subsidies and stopped short of any concept of "constructive" or "effective" rebate. If there were to be such a new principle adopted, and it would be a new principle, it would be better done through the legislative and rulemaking processes where the focus is broad, rather than through adjudication where the focus is particular and possibly outcome-driven.

The economic substance doctrine allows the government to look beyond technical compliance with the Code to ascertain the real nature of the transaction at issue. However, economic substance still must be assessed in adherence to accepted and usual legal and accounting principles. See Compaq Computer Corp. & Subsidiaries v. C.I.R., 277 F.3d 778, 784-86 (5th Cir. 2001). Otherwise, the government's "trump card" would acquire too much potency.

Here, treating the Barclays payment as revenue to the taxpayer is not a manipulative distortion of the tax rules to achieve merely technical compliance, but rather is fully consistent with not only the letter but the substance of the IRS's own regulations and existing case law. See Compaq Computer Corp. & Subsidiaries, 277 at 784-85 (collecting cases); IES Indus., Inc., 253 F.3d at 354; 26 U.S.C. § 61(a)(12); 26 C.F.R. § 1.901–2(f)(1)-(2)(i).

Barclays' assumption of part of Sovereign's tax liability is properly regarded as income to Sovereign. It is a hoary principle dating to the earliest days of the income tax that taxes paid on behalf of a taxpayer are counted as income to the taxpayer. Old Colony Trust Co. v. C.I.R., 279 U.S. 716, 729 (1929). It is still vital. See IES Indus., Inc. v. United States, 253 F.3d 350, 354 (8th Cir. 2001); accord Compaq Computer Corp. & Subsidiaries, 277 F.3d at 784.

This principle is also reflected in the IRS's own regulations. Treas. Reg. § 1.901-2(f)(1) provides:

> 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. . . . [T]he person on whom foreign law imposes such liability is referred to as the "taxpayer."

Further, Treas. Reg. § 1.901-2(f)(2) provides:

> 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 government makes no attempt to explain why the Old Colony principle or these regulations should not apply. See Compaq Computer Corp. & Subsidiaries, 277 F.3d at 784 (finding economic substance based on the Old Colony principle; "the payment of Compaq's Netherlands tax obligation by Royal Dutch was income to Compaq."). Rather, it apparently asks the Court to apply a new ad hoc theory to the STARS transactions, even if that means ignoring long established principles, including those it has embraced in its regulations and advocated in

prior cases. Those principles hold that payments between private parties, even if they are buying and selling tax credits, are income to be accounted for on a pre-tax basis. Under those principles, the Barclays payment is properly accounted for as pre-tax income to Sovereign, and not as a tax rebate.

The government also advances a more generalized "sham" argument, as it did in the Bank of New York and Salem Financial cases. Under this broad view, the whole STARS transaction was concocted to manufacture a bogus foreign tax credit for Sovereign. There was no legitimate business purpose or economic substance to the transaction, the argument goes, except to create the conditions under which Sovereign could claim the foreign tax credit on its U.S. returns. The courts in the other cases apparently were persuaded to that position, but I am not. In part the argument is foreclosed by what has just been explained. If the Barclays payment is included in the calculation of pre-tax profitability, then there was a reasonable prospect of profit as to the trust transaction, giving it economic substance. But in any event, unless the "effective rebate" theory is credited, Sovereign's payment of the U.K. tax and claiming of the U.S. foreign tax credit did not produce an improper tax benefit; rather, it was simply a wash. Even if the Barclays payment was intended to be and was the assumption of part of Sovereign's U.K. tax burden (which Sovereign concedes for the purposes of this motion), Sovereign is nonetheless treated as having paid the full U.K. tax for purposes of the foreign tax credit. See Treas. Reg. § 1.901-2(f)(1), (2). It was thus entitled to claim the foreign tax credit on its U.S. returns. It is true that the U.K. received an amount in taxes from Sovereign that but for the transaction would have gone to the U.S. Treasury, but that transfer produced no advantage to Sovereign. It was still out the same amount of tax, regardless of which country it was paid to.

One final matter. It might be suggested that the "economic substance" or "substance over form" test requires, in addition to an assessment of the objective economic realities of a transaction, an inquiry into the subjective motivation or purpose of the taxpayer, and that this need for a subjective inquiry raises fact issues that should preclude summary judgment. I disagree.

It is clear that cases dealing with the economic substance question *always* assess the objective economic reality of the transaction to determine whether it is in actuality a legitimate or a "sham" transaction. *Sometimes* the cases also assess the taxpayer's subjective purpose or motivation, and they often give that assessment different degrees of significance in their ultimate judgment. Older First Circuit cases seem to emphasize reliance on objective assessment virtually to the exclusion of subjective assessment. Stone v. C.I.R., 360 F.2d 737, 740 (1st Cir. 1966); Fabreeka Prods. Co. v. C.I.R., 294 F.2d 876, 878-79 (1st Cir. 1961); Granite Trust Co. v. United States, 238 F.2d 670, 678 (1st Cir. 1956). Both parties try to find advantage in then-Judge Breyer's opinion in Dewees v. C.I.R., 870 F.2d 21 (1st Cir. 1989), Sovereign arguing that a close reading shows that the court confirmed the Circuit's prior objective-only approach, the government, relying on the opinion of Judge Saylor in Fid. Int'l Currency Advisor A Fund, LLC, 747 F. Supp. 2d at 228-31, arguing that a more expansive reading indicates that Dewees "effectively" (there is that word again) overruled the prior cases. I find neither position completely persuasive. The "sham in substance" doctrine was not a central focus of the decision in Dewees, and my own reading of the opinion does not leave me with the sense that the court was trying to lay out a full statement of the doctrine, either in light of the prior cases or in spite of them.

If the First Circuit has occasion to address the doctrine again (as I suspect it will), I would guess that it would perhaps move a bit away from a rigid "objective only" test to one that is primarily objective but has room for consideration of subjective factors where necessary or appropriate. Nonetheless, in the circumstance where it found that the objective assessment established that the transaction *lacked* economic substance independent of tax considerations, the court did say that a subjective inquiry may be dispensed with. Dewees, 870 F.2d at 35 ("Where the objective features of the situation are sufficiently clear, [the Tax Court] has the legal power to say that self-serving statements from taxpayers could make no legal difference . . . ."). In light of that dispensation, I would not expect it to insist on consideration of the subjective intent of a taxpayer where the transaction is objectively judged *to have had* economic substance. More specifically, I have no reason to think that the First Circuit would be inclined to follow the Sixth Circuit's proposition stated in Dow Chem. Co. v. United States, that "[i]f the transaction has economic substance, 'the question becomes whether the taxpayer was motivated by profit to participate in the transaction.'" 435 F.3d 594, 599 (6th Cir. 2006) (quoting Illes v. C.I.R., 982 F.2d 163, 165 (6th Cir. 1992)).[5] Obviously, I do not follow that proposition here. For this reason, there is no need for a trial to conduct a subjective inquiry.

For the foregoing reasons, Sovereign's motion for partial summary judgment (dkt. no. 124) has been granted.

/s/ George A. O'Toole, Jr.
United States District Judge

[5] The Sixth Circuit's position in this respect is of dubious provenance. It traces back to a rather summary opinion in Mahoney v. C.I.R., 808 F.2d 1219 (6th Cir. 1987), which, like Dewees, was concerned with the "entered into for profit" language of Code § 165(c). The Mahoney court apparently thought that statutory phrase required consideration of a subjective motive. That will not always be necessary, and perhaps even never so, in the broader, Gregory-based inquiry into economic substance.

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

CIVIL ACTION NO. 09-11043-GAO

SANTANDER HOLDINGS USA, INC. & SUBSIDIARIES,
Plaintiff,

v.

UNITED STATES OF AMERICA,
Defendant.

OPINION AND ORDER
November 13, 2015

O'TOOLE, D.J.

Santander Holdings USA, Inc., formerly known as Sovereign Bancorp, Inc., and referred to in this opinion as "Sovereign," has sued to recover approximately $234 million in federal income taxes, penalties, and interest that it claims were improperly assessed and collected by the Internal Revenue Service for tax years 2003, 2004, and 2005 as a result of the IRS's disallowance of foreign tax credits claimed by Sovereign for those years. The tax credits were claimed as a consequence of Sovereign's participation in a "Structured Trust Advantaged Repackaged Securities" ("STARS") transaction that was sponsored by Barclays Bank PLC. The STARS transaction has been summarized by this Court, see Santander Holdings USA, Inc. & Subsidiaries v. United States, 977 F. Supp. 2d 46, 48-49 (D. Mass. 2013), and other courts, see Bank of N.Y. Mellon Corp. v. Comm'r, 801 F.3d 104, 110-12 (2d Cir. 2015), *petitions for cert. filed* (U.S. Oct. 13, 2015) (No. 15-478); (U.S. Nov. 2, 2015) (No. 15-572); Salem Fin., Inc. v. United States, 786 F.3d 932, 937-39 (Fed. Cir. 2015), *petition for cert. filed* (U.S. Sept. 29, 2015) (No. 15-380); Wells Fargo & Co. v. United States, No. 09-CV- 2764, 2015 WL 6962838 (D. Minn. Nov. 10, 2015), and there is no need to repeat the description here. Familiarity with those summary descriptions is assumed.

This Court previously granted Sovereign's motion for partial summary judgment as to whether the "Barclays payment" (also known as the "b_x payment") should be accounted for as revenue to Sovereign in assessing whether Sovereign had a reasonable prospect of profit in what the parties refer to as the "trust transaction." I agreed with Sovereign that the Barclays payment should be accounted for as pretax revenue, which meant that the trust transaction showed a reasonable prospect of profit and therefore did not, as the government had argued, lack economic substance. In reaching that conclusion, I rejected the government's argument that the Barclays payment should be treated as an "effective rebate" of U.K. taxes paid by Sovereign and thus a "tax effect" that should not be taken into account in determining Sovereign's pretax revenues from the trust transaction and consequently the transaction's prospect of profit. Santander Holdings, 977 F. Supp. 2d at 50-53.

Thereafter, Sovereign moved for summary judgment on Counts One, Two, Three, and Seven of its Amended Complaint. Counts One through Three are claims for refunds of taxes paid in 2003, 2004, and 2005, respectively, and Count Seven is a claim for a refund of deficiency interest assessed by the IRS.[1]

The government opposed Sovereign's motion and cross-moved for partial summary judgment in its favor on the following issues: "(1) whether the step transaction doctrine applies to require some or all of the steps of Sovereign's STARS Trust be disregarded for federal income tax and for U.S.-U.K. Tax Treaty purposes; (2) whether the conduit doctrine applies to require the Sovereign's STARS Trust be treated as a mere conduit, and, as a consequence, be disregarded for federal income tax and for U.S.-U.K. Tax Treaty purposes[;] and (3) whether a full computation

[1] If Sovereign succeeds on the first three Counts, it acknowledges that Counts Four, Five, and Six, which present alternative claims, will be moot.

of Sovereign's potential profit from the STARS transaction requires . . . [the income from the Barclays payment to] be reduced by the costs incurred to earn it, most notably, Sovereign's payment of U.K. trust tax." (United States' Cross Mot. for Partial Summ. J. at 1 (dkt. no. 249).) The government also objected that summary judgment in Sovereign's favor was inappropriate because there remained issues of fact as to whether the STARS loan transaction lacked economic substance. I address these issues in reverse order.

I. The Economic Substance of the Loan Transaction

There is no factual dispute that in the STARS loan transaction, Sovereign borrowed from Barclays over a billion dollars that it used in its banking operations. I agree with both the Second and Federal Circuits, as well as the Tax Court, that this fact by itself is sufficient to reject the claim that the loan lacked economic substance, even when the loan transaction is considered apart from the trust transaction. See Bank of N.Y. Mellon, 801 F.3d at 123-24 (affirming Bank of N.Y. Mellon Corp. v. Comm'r, 106 T.C.M. (CCH) 367 (T.C. 2013)); Salem Fin., 786 F.3d at 957.

As the Federal Circuit noted, the STARS transaction as originally designed was marketed to non-bank businesses and did not include a loan transaction, and Barclays was unsuccessful in attracting interested companies. Salem Fin., 786 F.3d at 936, 957. The design was modified to include a loan transaction, and banks then became interested, as these cases demonstrate. It is an obvious and fair conclusion that it was the economic value of the loan that attracted their attention.

The government points out that the nominal loan interest rates on both the original borrowing and the extension were higher than rates available to Sovereign for conventional (that is to say, non-STARS) borrowing. Even so, to say that the loan was priced too high[2] is not the

[2] Of course, the loan can only be considered to be priced too high if one looks only at its nominal rate, and not at its effective rate if the Barclays payment is included in the analysis. But even

equivalent of saying that it lacked any economic substance. As both the Second and Federal Circuits recognized, see Bank of N.Y. Mellon, 801 F.3d at 123-24; Salem Fin., 786 F.3d at 957, it was a real loan. It furnished the bank with capital to invest in its business that had to be paid back. It was a substantive economic transaction.[3]

II. Economic Substance of the Trust Transaction, Redux

In ruling on the prior motion for partial summary judgment, I concluded that the Barclays payment should be accounted for as revenue to Sovereign in assessing whether there was a reasonable prospect of profit in the trust transaction because the payment was properly regarded as income under the principle established in Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 729 (1929). Santander Holdings, 977 F. Supp. 2d at 52-53. In doing so I rejected the government's argument that the Barclays payment should be excluded from a pretax profit analysis because it was in substance a rebate of part of Sovereign's U.K. taxes and thus a "tax effect" properly omitted from pretax evaluations.

The government also argued that Sovereign's U.K. tax payments should be factored into the pretax profitability assessment not because they were taxes but because they were an economic cost. (See Def. United States' Resp. in Opp'n to Pl.'s Mot. for Partial Summ. J. at 48-49 (dkt. no. 134).) That argument was also implicitly rejected, although it was not specifically addressed in the opinion. The government renews the argument here, and I now explain why I reject it.

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viewed through the lens of bifurcation, price is not the only measure of whether there was a transaction with genuine economic substance.

[3] "The general characterization of a transaction for tax purposes is a question of law subject to review." Frank Lyon Co. v. United States, 435 U.S. 561, 581 n.16 (1978); accord IES Indus., Inc. v. United States, 253 F.3d 350, 351 (8th Cir. 2001).

It is true, as the government argues, that the STARS transaction is different from the transactions at issue in Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001), and IES Industries, Inc. v. United States, 253 F.3d 350 (8th Cir. 2001), which were discussed in the prior ruling regarding the inclusion of the Barclays payment as income in assessing the prospect of pretax profitability. The tax payments at issue in those cases were payments of Netherlands withholding taxes on dividends received by the taxpayers. In other words, they were the taxes paid as a direct consequence of the taxable events that occurred in the course of the arbitrage transactions. In contrast, Sovereign's U.K. tax payments were not occasioned by the receipt of the Barclays payment; they were income taxes incurred by reason of Sovereign's contribution of income-earning assets to the STARS trust, thus subjecting the trust income to U.K. taxation because the trustee was deemed to be a U.K. resident under U.K. law (and the U.S.-U.K. tax treaty). So the government is correct that the Compaq and IES cases do not directly answer the question of whether to treat the payment of U.K. taxes as an expense attributable to the receipt of the Barclays payment.

That said, Sovereign's U.K. tax payments are not properly regarded as an actual economic cost for the Barclays payment to be figured in a profitability assessment. The assets Sovereign contributed to the trust were earning income and Sovereign was being taxed on that income before the STARS transaction. After the contribution of the assets to the STARS trust, they continued to earn income and Sovereign continued to be taxed on that income. Sovereign's tax burden with respect to the income produced by the trust assets was not affected by the contribution of the assets to the trust. What was changed was that Sovereign was paying taxes on the income from the contributed assets to the U.K. rather than to the U.S. Indeed, it is one of the government's rhetorical flourishes that the STARS transaction "diverted" to the U.K. tax payments that should have gone

to the U.S. Treasury, as if the whole point of the purported tax avoidance scheme was to generate an undeserved foreign tax credit and thus to avoid paying a certain amount in taxes to Uncle Sam by paying an equal amount to John Bull. In other words, there is no dispute that Sovereign's overall income tax payments were not increased as a consequence of the transaction. Cf. Wells Fargo, 2015 WL 6962838, at *3 (describing bank's combined tax payments as a "wash"). Put another way, there was no increased *income tax cost* as a consequence of Sovereign entering into the STARS transaction. The cost was simply divided between two taxing authorities, rather than going all to one.

It is therefore inaccurate to say that Sovereign "paid for" the Barclays payment by paying taxes to the U.K. It is certainly true that Sovereign's subjecting the assets contributed to the trust to U.K. taxation was one of the necessary conditions to the generation of Barclays' U.K. tax savings and therefore to the ultimate receipt by Sovereign of the Barclays payment. But the condition was not that Sovereign pay any additional amount in income taxes but rather that it pay income taxes *to the U.K.* The condition was not economic in its essence, but jurisdictional.[4] The only true economic cost to Sovereign of establishing that necessary jurisdictional condition would have been the transaction costs incurred in negotiating and executing the deal. They were not large enough to alter the prospect of profit in the trust transaction.

Lastly, even if the U.K. taxes were to be treated as an expense to be properly considered in a profitability analysis, it would then be necessary also to consider the effect of the offsetting U.S. foreign tax credit. To do otherwise "is to stack the deck against finding the transaction profitable." Compaq, 277 F.3d at 785. "To be consistent, the analysis should either count all tax effects or not

[4] Cf. Salem Fin., 786 F.3d at 945 ("The [Barclays] 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.").

count any of them." Id. The government's argument is circular; it assumes what it seeks to prove: The foreign tax credit should be ignored for purposes of the profitability analysis. Ignoring it, but considering the U.K. taxes paid, the analysis shows lack of a prospect of profit. The transaction thus lacked economic substance. Therefore the foreign tax credit should be ignored. [5] Put bluntly, the government's bootstrap position is that the tax payment should be included and the tax credit excluded because if that is done, the transaction appears to lack economic substance. It seems that the Second Circuit was persuaded by that argument. See Bank of N.Y. Mellon, 801 F.3d at 118-19.[6] I am not, and apparently the Federal Circuit was not either. See supra note 4.

For these reasons, the amounts paid to the U.K. in taxes by Sovereign should not be included as offsetting costs in an analysis of the prospect of pretax profitability of the trust transaction.

III. Substance over Form Doctrines

It is undisputed that because the trustee of the STARS trust was a resident of the U.K., the trust's income was subject to U.K. taxation. It is undisputed that for the years in question Sovereign actually paid taxes on the trust's income to the U.K.[7] It is undisputed that the U.K. tax authorities

[5] The court in Wells Fargo seems to make the same circularity error. In describing the STARS transaction in the beginning of its order, the court starts with the observations that "Wells Fargo effectively shifted some of its tax payments out of the U.S. treasury and into the U.K. treasury," 2015 WL 6962838, at *2, that "STARS took money out of the pocket of the U.S. treasury and put that money into the pockets of Wells Fargo, Barclays, and U.K. treasury," id. at *3, and that "the U.S. treasury funded all of the profits of the STARS transaction," id. at *4. Those characterizations seem more appropriate to the end of the analysis than the beginning.

[6] With all respect, the court's statement that "the trust transaction in BNY had little to no potential for economic return apart from the tax benefits," id. at 119, is not a reason for including tax payments and excluding tax credits but rather a conclusion about what happens *if* the payments are included and the credits are excluded.

[7] It is also undisputed that Sovereign, the parent, disregarded subsidiary entities, including the trust, for U.S. tax purposes, and that it treated the trust income as income to it, and paid both the U.K. and U.S. taxes on that income.

did not rebate any portion of the taxes paid, and I have ruled that the Barclays payment is not properly regarded as an "effective rebate" by Barclays of the trust's U.K. taxes. Santander Holdings, 977 F. Supp. 2d at 51-53. Accordingly, it is established that, at least as a prima facie matter, Sovereign was entitled to claim a foreign tax credit under Section 901 of the Internal Revenue Code and related statutory and regulatory provisions for the amounts of foreign tax actually paid to the U.K. for the years in question. 26 U.S.C. § 901 et seq.

Because, as I have said, the Barclays payment was not "in substance" a rebate of U.K. taxes, it was not, therefore, a tax item or effect. A necessary reciprocal corollary of that prior ruling is that Sovereign "in substance" paid all its U.K. income taxes. Payment of foreign taxes is the essential prerequisite to its claim of a foreign tax credit in like amount against its U.S. tax obligations. As Sovereign has pointed out, the government has not proffered any statutory, regulatory, or judicial authority supporting the denial of a credit under Section 901 when as a matter of fact the taxpayer has "in substance"—i.e., actually—paid a foreign tax of the kind designated as eligible for the credit.

Ironically, the government invokes two "substance over form" doctrines—the "step transaction" and the "conduit" doctrines—to support its argument that the substance of Sovereign's actual payment of U.K. taxes should be ignored in assessing whether Sovereign properly claimed foreign tax credits. Briefly, those doctrines hold that transactions that proceed through multiple steps or involve the interaction of a sequence of multiple entities ("conduits") or both can be examined at each step and as to each entity to see whether the step or the entity is included for a genuine business or economic non-tax reason or whether the step or entity is employed only to contrive a tax benefit that a more direct transaction would not yield. The doctrines cannot help the government as it proposes.

First, for purposes of Sovereign's payment of its U.S. taxes, the doctrines are beside the point. The STARS trust created by Sovereign was "disregarded" for U.S. tax purposes, as authorized under Treasury Regulation § 301.7701-2(a). (Pl.'s Mem. of Law in Supp. of Mot. for Partial Summ. J. Ex. 4 (Aff. Of Kurt J. Swartz) at 3 (dkt. no. 127-5).) Consequently, all of the trust's income, expenses, liabilities, and assets were treated for tax purposes as owned directly by Sovereign. Accordingly, for U.S. tax purposes, there are no steps to collapse or conduits to ignore. Neither the existence of the trust nor the fact that its trustee was a U.K. resident factored into the computation of Sovereign's U.S. tax obligations.

Nor do the step transaction and conduit doctrines provide a basis for disregarding Sovereign's actual payment of U.K. taxes. The doctrines permit ignoring unnecessary steps or entities. Their justification—that the real, and not artificial, nature of transactions is to be evaluated—does not extend to disregarding events with real economic consequences such as Sovereign's actual payment of real money in taxes to the U.K.

It is understandable that the circular STARS trust-Barclays distributions and recontributions that led to Barclays' obtaining a substantial benefit under U.K. tax laws have aroused instincts of disapproval in people familiar with how American judicial anti-abuse doctrines operate as a bulwark against the manipulation of the U.S. tax code to produce unintended tax benefits. But there is nothing in this case that suggests that Barclays' obtaining of that substantial benefit was anything other than fully in accord with U.K. tax law, or that that country's tax law was abusively manipulated. Apparently, unlike U.S. law, U.K. tax law tends primarily to recognize the *form* of a transaction, and does not generally engage in substance over form recharacterization. It is undisputed in this case that the U.K. tax authorities did not challenge the Barclays-trust machinations as illegitimate under U.K. law.

What the government argues for is application of U.S. judicial doctrine to examine the computation of Barclays' U.K. tax liability. The argument itself is a bit of misdirection. As noted, the steps and conduits involved in the STARS transaction affected *Barclays'* U.K. tax liabilities (and benefits), not Sovereign's. It should be remembered that the STARS transaction was developed by Barclays and marketed to U.S. banks, including Sovereign. It was Barclays that was interested in obtaining tax benefits under its own domestic law. The STARS transaction was not developed because U.S. taxpayers were looking for ways to game the U.S. tax code. The participating banks simply counted on the foreign tax credit to assure tax neutrality.

Moreover, unlike many circumstances in which the anti-abuse doctrines are used to collapse or ignore meaningless steps and conduits, the participants in the STARS trust-Barclays transaction were arm's length counterparties, not related entities. They had their own distinct interests. Barclays was interested in tax benefits it could obtain under U.K. law, in exchange for which it was prepared to pay a U.S. bank counterparty for its cooperation in a transaction that would produce those benefits. Separately, the bank counterparty was interested in lower cost borrowing. In other words, the act of voluntarily "subjecting itself" to U.K. taxes was Sovereign's quid for Barclays' quo.[8] There was a genuine non-tax, business purpose for Sovereign's participation in the STARS transaction.

The government argues that Sovereign agreed with Barclays to participate in the STARS transaction in order to "generate" a foreign tax credit under Section 901. But it is fanciful to say that Sovereign had a U.S. tax motive. In the first place, as already noted, Sovereign effectively paid the same total amount in income taxes as it would have without the STARS transaction. It is just that as a result of the transaction, it paid that same amount to two different taxing authorities.

[8] See supra note 4.

It did not *avoid* any tax or reduce its income tax cost. Similarly, it makes no sense to say that Sovereign's motive was to "divert" tax payments from the U.S. to the U.K., just so that it could get an aliquot credit against its U.S. tax bill. Not only would that wash flow be pointless in and of itself, but transaction costs would necessarily make it uneconomical.

Of course Sovereign took into account in deciding to participate in the STARS transaction that the U.S. tax code provides a credit for amounts of foreign income taxes paid, and *of course* it would not likely have participated in the transaction if it expected to be doubly taxed on the trust's income. The fact that it considered the credit does not mean that its motive was simply to obtain the credit. What keeps tax lawyers in business is that people have to consider the tax consequences of the actions they take. See Frank Lyon Co. v. United States, 435 U.S. 561, 580 (1978) ("The fact that favorable tax consequences were taken into account by Lyon on entering into the transaction is no reason for disallowing those consequences. We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction."). A person making an economic decision about whether to rent or buy a house may consider that the mortgage interest deduction makes buying more financially attractive. Expecting the tax benefit does not make deciding to buy a house a tax-motivated decision. It is likely that every U.S. taxpayer that has foreign income subject to foreign taxation considers the benefit of the foreign tax credit before undertaking the transaction that will generate that income. The characterization the government uses to condemn Sovereign's actions in the STARS transaction is not limited to the STARS transaction; it logically applies any time a business intentionally "subjects itself" to foreign taxation in the course of its business operations.

Moreover, the objection that Sovereign did not engage in "purposive activity" is incorrect. As has been discussed, it borrowed money at a cost that was in the end advantageous, and as previously discussed, the STARS transaction, taken either as bifurcated or as a whole, had substantial economic value to Sovereign.

As the foregoing indicates, I take a substantially different view of the issues from that taken by other courts that have considered the government's arguments about whether the STARS transaction should be declared abusive insofar as U.S. tax law is concerned. Let me recap my principal (and principle) disagreements with those cases. First, I do not regard it to be an abuse under U.S. tax law for an American taxpayer to voluntarily cause U.S. source income to become foreign source income when that is done for real non-tax business reasons, as I have explained. The Salem Financial court apparently thought that "the Trust transaction reflected no meaningful economic activity" by the bank in that case. 786 F.3d at 951. I think that statement is inconsistent with the court's earlier statement, quoted in footnote 4 supra, that the bank made the Barclays payment "in consideration of [the bank's] services rendered under the STARS transaction." Id. at 945. Being compensated for services rendered seems like "meaningful economic activity" to me.

I also disagree with the breadth of the Salem Financial court's statement that "the Trust transaction was a contrived transaction performing no economic or business function other than to generate tax benefits." Id. at 951. That characterization is perhaps true as applied to Barclays, but not to Sovereign, for the reasons I have explained.

And finally, for the same reasons, I disagree with the Salem Financial court that "the STARS Trust had no non-tax business purpose, and that, instead, its sole function was 'to self-inflict U.S.-sourced [bank] income in order to reap U.S. and U.K. tax benefits.'" Id. (quoting Court

of Federal Claims' finding in Salem Fin., Inc. v. United States, 112 Fed. Cl. 543, 587 (2013)). The trust transaction brought Sovereign the Barclays payment, a substantial economic benefit.

Similarly, I think the court in Bank of New York Mellon did not properly distinguish the separate interests of the participating bank and Barclays and the differing significance of the STARS transaction for each. It apparently agreed with the Tax Court's finding "that the transaction's circular cash flow strongly indicated that its main purpose was to generate tax benefits for [the bank] and Barclays." 801 F.3d at 122. The "circular flows" did not generate any tax benefit for the bank, though they did for Barclays. The bank, in this case Sovereign, did not get *any* U.K. tax benefits; it *paid* U.K. taxes that were not rebated by the U.K. And its U.S. tax benefit was limited to the ability to offset otherwise due U.S. taxes by a foreign tax credit under Section 901, a benefit that is a product of the Internal Revenue Code, not the STARS transaction.

Second, I do not think it is necessary or appropriate to apply American judicial anti-abuse doctrines to analyze Barclays' structuring of its U.K. tax liabilities so as to obtain benefits that are so far as appears entirely proper under U.K. law when that structuring itself had no effect on Sovereign's overall tax liabilities.

The Salem Financial, Bank of New York Mellon, and Wells Fargo cases illustrate, I think, that the judicial anti-abuse doctrines—whether substance over form or economic substance—can themselves be susceptible to abuse. Both circuit courts outlined what the latter opinion called "the core principles of the economic substance doctrine":

> The critical question is not whether the transaction would produce a net gain after all tax effects are taken into consideration; instead the pertinent questions are [1] whether the transaction has real economic effects apart from its tax effects, [2] whether the transaction was motivated only by tax considerations, and [3] whether the transaction is the sort that Congress intended to be the beneficiary of the foreign tax credit provision.

Bank of N.Y. Mellon, 801 F.3d at 117 (quoting Salem Fin., 786 F.3d at 948). In the discussion above, I have addressed the first two principles. Those principles can be evaluated by objective analysis of the facts of the case. The third principle can turn in large part on whether a court subjectively thinks the transaction being examined is "the sort that Congress intended to be the beneficiary of the foreign tax credit provision." See id.

There is no need to speculate here. We know what Congress intended in authorizing the foreign tax credit. As the government has acknowledged in its briefing, Congress intended to provide relief against possible double taxation and thus "to neutralize the effect of U.S. taxes on decisions regarding where to invest or conduct business." (United States' Reply in Supp. of Cross Mot. for Partial Summ. J. at 5 (dkt. no. 258).)[9] The government asserts that "it is an abuse of the foreign tax credit if the taxpayer uses it solely to choose where to pay tax." (Id.) Maybe. But that *reductio ad absurdum* does not accurately describe the STARS transaction. Sovereign did more than solely decide where to pay tax. It chose to enter an arm's length transaction with a foreign counterparty that had, as described above, genuine economic substance that produced real value to Sovereign. As a consequence of entering the transaction with a foreign counterparty, Sovereign incurred and paid foreign income taxes for the years in question. Application of the foreign tax credit to its U.S. tax liability would avoid what it is quite clear Congress intended should be avoided: double taxation of the same income. It is the government's position that is not aligned with congressional intent. What the government is actually defending in these STARS cases is double taxation.

[9] (See also Pl.'s Mem. of Law in Supp. of Mot. for Summ. J. at 11 & n.25 (dkt. no. 246).)

Throughout the government's arguments in this case there has been an undertone of indignation, suggesting that the issues in the case are as much a matter of moral judgment as legal. The "flexible" anti-abuse doctrines, Bank of N.Y. Mellon, 801 F.3d at 115, are invoked to make complicated what can rationally be seen as rather simple: if you have actually paid a foreign income tax properly levied by another country, you are entitled to a credit against your U.S. taxes on the same income consistent with the applicable statutes and rules. What seems to bother the government is not so much that Sovereign does not *qualify* for foreign tax credits as that it does not *deserve* them. It is almost as if the government thinks that, under a sort of aiding and abetting theory, Sovereign should be punished by taking away its credit for helping Barclays manipulate *its* benefits under the U.K. tax laws.

The judicial anti-abuse doctrines are important, but their employment should be analytical and not visceral. Among other things, too-ready resort to the government's "trump card," see In re CMI Holdings, Inc., 301 F.3d 96, 102 (3d Cir. 2002) (describing the economic substance doctrine as the government's "trump card"), may lead to the ad hoc development of novel principles of judgment solely on the basis of their utility for the particular case at hand. One serious risk is that the ultimate standard of decision becomes a kind of smell test, with the judge's nose ending up the crucial determinant of the outcome. The more that is the case, the less predictability there is in the law, and predictability is a high value in tax law.

IV. Summary of Conclusions and Order

As set forth in section I above, the loan transaction was legitimate, and Sovereign was entitled to deduct the interest expense for the loan.

As set forth in sections II and III above, the government's economic substance and substance over form arguments are unpersuasive. What may appear horribly complicated is really

quite simple. Sovereign incurred and paid income taxes to the U.K. for the years in question as a result of a business transaction with a U.K. counterparty, and under Section 901 and related provisions it is entitled to a credit against its U.S. income taxes for those years.

Because the foreign tax credits and the interest deductions were properly claimed, Sovereign should not be assessed penalties and may recover those.

Accordingly, Sovereign's Motion for Summary Judgment (dkt. no. 245) is GRANTED. The government's Cross Motion for Partial Summary Judgment (dkt. no. 249) is DENIED.

Sovereign shall submit a proposed form of judgment within twenty-one (21) days of the entry of this order.

It is SO ORDERED.

/s/ George A. O'Toole, Jr.
United States District Judge

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

SANTANDER HOLDINGS USA, INC. & SUBSIDIARIES
Plaintiff

v. CIVIL ACTION NO. 09-11043-GAO

UNITED STATES OF AMERICA
Defendant

JUDGMENT IN A CIVIL CASE

O'TOOLE U.S.D.J.

X **Decision by the Court**. This action came to hearing before the Court. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED:

Pursuant to the Court's opinions dated October 17, 2013, and November 13, 2015, it is ordered and adjudged that judgment shall enter in favor of Plaintiff under Counts One, Two, Three, and Seven of the Amended Complaint. Plaintiff's alternative claims for relief set forth in Counts Four, Five, and Six of the Amended Complaint are therefore moot. Defendant is ordered to issue Plaintiff a refund of $161,511,184 in tax, $31,422,460 in penalties, $38,175,117 in assessed interest, reflecting Plaintiff's post-decision computations, and statutory interest thereon pursuant to 26 U.S.C. § 6611, together with taxable costs.

ROBERT M. FARRELL
CLERK OF COURT

DATED: January 13, 2016

BY: /s/ Paul S. Lyness
Deputy Clerk