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

REPLY BRIEF FOR THE APPELLANT

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GLOSSARY

Atlantic-AmBr.	amicus brief filed by Atlantic Legal Foundation
Chamber-AmBr.	amicus brief filed by Chamber of Commerce
Financial-AmBr.	amicus brief filed by Financial Services Roundtable
FTC	foreign tax credit
Gov't-Br.	opening brief filed by the United States
IRS	Internal Revenue Service
JA	the separately bound Joint Appendix
Op/Add	the District Court's opinions, as paginated in the addendum attached to the United States's opening brief
Sovereign-Br.	answering brief filed by Sovereign
STARS	Structured Trust Advantaged Repackaged Securities
U.K.	the United Kingdom
U.S.-U.K. Tax Treaty	The Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains (July 24, 2001)

INTRODUCTION

This case involves a tax-avoidance transaction (STARS) that has been invalidated under the economic-substance doctrine by two appellate courts. *Bank of N.Y. Mellon Corp. (BNY) v. Commissioner*, 801 F.3d 104 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 1377 (2016); *Salem Financial, Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 2015), *cert. denied*, 136 S. Ct. 1366 (2016); *see also Wells Fargo & Co. v. United States*, 143 F. Supp. 3d 827, 834-846 (D. Minn. 2015) (denying the taxpayer's motion for summary judgment because factual issues existed as to whether its STARS transaction had economic substance and business purpose).

STARS was 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 income from U.S. operations (derived primarily from pre-existing loans to U.S. borrowers) 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, Sovereign paid the U.K. tax it purposely generated and its counterparty, Barclays Bank, recovered 85 percent of Sovereign's payment from the U.K. Barclays, pursuant to the parties' prearranged plan, then rebated to Sovereign (as Bx payments) 50 percent of the U.K. tax originally paid by Sovereign and retained the balance as its promoter's fee. Sovereign claimed foreign tax credits for the amount of its original U.K. tax payment, disregarding that 50 percent of that payment had been returned to it by Barclays as Bx payments, and that the bulk of the remainder was used to pay the fee Sovereign owed Barclays. *See* Gov't-Br. 3-6. In this manner, STARS transformed "economically meaningless activities" into a money-making "machine" for Sovereign and Barclays at the expense of the U.S. Treasury. *Salem*, 786 F.3d at 951-952, 954, 960; *accord BNY*, 801 F.3d at 121-123.

In our opening brief, we demonstrated that the Second and Federal Circuits correctly concluded that the STARS Trust lacked economic substance, and that the District Court provided no sound reason for this Court to go into conflict with the only two circuits that

have addressed the STARS transaction. In response, Sovereign contends (Sovereign-Br. 62) that, rather than follow the Second and Federal Circuits' decisions, this Court should instead follow decisions that address a wholly different transaction.

Sovereign's arguments for disregarding *BNY* and *Salem* are unavailing. Neither the Government nor the Second and Federal Circuits have "artificially manipulate[d] a transaction for tax purposes" (Sovereign-Br. 28) or substituted "[m]oral indignation" for "legal analysis" (Sovereign-Br. 58). Rather, the appellate courts in *BNY* and *Salem* have carefully evaluated the STARS Trust transaction, examining numerous factors, including that the transaction (i) is unprofitable before the disputed foreign tax credits are considered, (ii) lacks any economic effect, and (iii) has no business purpose.

Before turning to Sovereign's specific arguments, we first address a number of overarching errors made by Sovereign and its amici regarding the role and scope of the economic-substance doctrine, the U.S. tax benefits generated by STARS, and Congressional intent.

i. *Role of the economic-substance doctrine.* The judicial anti-abuse rules, including the "economic-substance doctrine," are the "'cornerstone

of sound taxation.'" *Southgate Master Fund, LLC v. United States*, 659 F.3d 466, 479 (5th Cir. 2011). Evaluating STARS under that doctrine does not "ride roughshod over Sovereign's entitlement to congressionally-conferred FTCs" (Sovereign-Br. 2; Atlantic-AmBr. 17); it determines whether Sovereign is actually entitled to those tax benefits by discerning whether the transaction is a genuine business transaction or a tax-motivated sham. This "extremely important" doctrine thus acts as a "preamble to the Code, describing the framework within which all statutory provisions are to function." Bittker & Lokken, *Federal Tax'n of Income, Estates & Gifts* ¶4.3.1 at 4-27 (3d ed. 1999).

When drafting tax rules, Congress and the Treasury Department generally assume that the underlying transaction has economic substance and business purpose; the economic-substance doctrine tests that assumption. If that assumption proves to be false, then the transaction is disregarded for tax purposes. Far from "rewrit[ing] the rules after the fact" (Sovereign-Br. 3), the doctrine makes a "threshold" determination as to whether the rules apply in the first place. *Gilman v. Commissioner*, 933 F.2d 143, 146 (2d Cir. 1991).

The amici's expressed concern about "predictability" in the tax laws (Chamber-AmBr. 15; Atlantic-AmBr. 32-33) ignores that the economic-substance doctrine has been a critical cornerstone of the tax laws for almost a century. *See Dewees v. Commissioner*, 870 F.2d 21, 29 (1st Cir. 1989) (observing that the doctrine originated in the 1930's). It also ignores that the doctrine's applicability was specifically predicted — and planned around — by Sovereign here. (JA979-980, 1026-1031.) As Sovereign knew before engaging in STARS, the IRS and the courts long have condemned tax shelters like the one promoted to it by Barclays and KPMG, which manipulate tax rules to generate large-scale tax benefits without any genuine economic activity.[1] *Accord Salem*, 786 F.3d at 960 (observing that BB&T's "executives were extremely skeptical of the tax benefits of the STARS transaction").

ii. *Scope of economic-substance doctrine*. The economic-substance doctrine is not limited to "some types of tax benefits" (Chamber-AmBr.

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[1] Before engaging in STARS, Sovereign also knew that the IRS was scrutinizing transactions that were designed to generate foreign tax credits, and that in determining whether such transactions had any pre-foreign-tax-credit profit, "foreign taxes will be treated as an expense." Notice 98-5: Foreign Tax Credit Abuse, 1998-1 C.B. 334, *superseded by* Notice 2004-19, 2004-1 C.B. 606.

15) or "uneconomic" tax benefits that "could be used to offset unrelated income" (Sovereign-Br. 22). *E.g.*, *Gregory v. Helvering*, 293 U.S. 465, 469-470 (1935) (disregarding transaction that did not generate uneconomic tax benefits, but instead attempted to transfer corporate funds at capital-gain, rather than ordinary-income, tax rate); *Commissioner v. Estate of Sanders*, __ F.3d __, 2016 WL 4447257, at *9-10 (11th Cir. Aug. 24, 2016) (holding that the economic-substance doctrine applied to determine whether U.S. taxpayers were bona fide residents of the U.S. Virgin Islands). As these and the cases cited in our opening brief demonstrate, the doctrine has been applied to a wide variety of tax benefits, and is — and must remain — flexible in order to address the ever-changing tax schemes conceived by tax-shelter promoters. *Blum v. Commissioner*, 737 F.3d 1303, 1311 (10th Cir. 2013).

International tax shelters are not immune from the economic-substance doctrine, as the amici suggest (Atlantic-AmBr. 16-17; Financial-AmBr. 6-8). The doctrine applies to *all* types of transactions, including those (like STARS) that generate foreign tax credits. *E.g.*, *BNY*, 801 F.3d at 114. STARS is only one example of the latest trend in

abusive tax shelters that have become "more sophisticated and international in scope." U.S. Government Accountability Office, *Abusive Tax Avoidance Transactions* (GAO-11-493) (May 2011). As Congress recognized, these "international" tax shelters — no less so than purely domestic tax shelters — "require[ ] constant vigilance." *Id.* Indeed, when it codified the economic-substance doctrine in 2010, Congress was aware that the IRS was utilizing the "economic substance doctrine" to deny foreign tax credits claimed in STARS and similar transactions, 72 Fed. Reg. 15081, 15084 (2007), but did not "create categorical exceptions to the doctrine for foreign tax credits," *BNY*, 801 F.3d at 114. Nor did it craft a "limited form of the economic substance doctrine" (Financial-AmBr. 15 n.6) — that focuses solely on whether foreign taxes are paid — to be applied when foreign tax credits are claimed.

The related suggestion that the economic-substance doctrine does not apply where the Government has "treaty obligations" or U.S. possessions are involved (Financial-AmBr. 6-8, 18-19) likewise lacks support and conflicts with the relevant authorities. *E.g., Sanders*, 2016 WL 4447257, at *9-10 (holding that the economic-substance doctrine

applies in a transaction involving a U.S. possession (U.S. Virgin Islands)); *Del Comm'l Props., Inc. v. Commissioner*, 251 F.3d 210, 214 (D.C. Cir. 2001) (holding that transactions that lack "sufficient business or economic purpose" are not recognized under U.S. tax treaties). Reversing the District Court does not require this Court to "second-guess the tax rulings of foreign governments" (Sovereign-Br. 28) or disavow U.S. treaty obligations with the U.K. (Financial-AmBr. 21-22).[2] *See Salem*, 786 F.3d at 955 (rejecting similar argument). Notably, the U.K. has not complained about the United States's litigating position in this (or any other) STARS case. On the contrary, the U.K. first alerted the United States to STARS, and suggested it could be an abusive U.S. tax shelter and recommended that the IRS investigate it.[3] *See* Fischl,

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[2] The amicus's reliance on the U.S.-U.K. Tax Treaty is misplaced. As the amicus acknowledges, the obligation to allow U.S. foreign tax credits is "subject to the limitations of the law of the United States" (Financial-AmBr. 21-22), and those "limitations" include the United States's "anti-abuse rules," including the economic-substance doctrine, Treasury Dep't, *Technical Explanation of the 2001 U.S.-U.K. Tax Treaty* 14, 77.

[3] The U.K.'s 2005 letter to the IRS (describing the foreign tax credits "artificially generated" by BNY's "Stars" scheme and the potential "tax credit abuse") is part of the Federal Circuit's record in *Salem* (No. 14-5027, Doc. 47-3, Joint Appendix 28604-28605), of which

(continued…)

Final Regulations & Administrative Guidance Limit Transactions Designed to Generate Foreign Tax Credits, 20 Journal of Int'l Taxation 57, 58 (2009).

iii. *STARS' U.S. tax benefits*. Sovereign claimed over $400 million in foreign tax credits from STARS. (JA79.) The suggestion that Sovereign nevertheless received *no* net tax advantage (Sovereign-Br. 56-57; Financial-AmBr. 24) disregards economic reality and the record evidence. STARS was promoted as an "'FTC [foreign tax credit] trade'" that provided "tax advantages" by allowing U.S. taxpayers to "claim[ ] a foreign tax credit equal to the entire amount of the Trust's U.K. taxes while 'getting back one-half of the U.K. tax' from Barclays." *Salem*, 786 F.3d at 952. Thus, Sovereign's actual "tax burden" on the Trust's income did not remain "the same" after STARS (Sovereign-Br. 56). Rather, as Sovereign understood from its advisors, engaging in STARS would allow it to "achieve a lower total tax paid." (JA1022; *see also* JA319.)

(…continued)
this Court may take judicial notice. *See McKinney v. Waterman S.S. Corp.*, 925 F.2d 1, 5 (1st Cir. 1991) (taking "judicial notice" of another court proceeding and the "documents filed therein").

The related contention that the Government's "proper target" is "*Barclays* rather than *Sovereign*" (Sovereign-Br. 56) is misconceived. Sovereign — not Barclays — claimed U.S. foreign tax credits based on economically meaningless activity in a transaction that fictionalized the concept of international trade. The Government has challenged the *U.S.* tax motivation of the *U.S.* STARS participant, not the "foreign tax motivation of the foreign lender" (Atlantic-AmBr. 28-29). *See* JA1715-1717, 2158 (explaining that STARS is a U.S. tax shelter, not a U.K. tax shelter, because the transaction was tax additive for the U.K.).

Nor does STARS "reduce[ ] the tax receipts of the U.S. Treasury, to the benefit of the U.K. Treasury" (Financial-AmBr. 5), as could occur in a genuine cross-border investment taxed in the U.K. Rather, STARS reduces U.S. tax receipts to the benefit of the STARS participants, like Sovereign and Barclays. *See BNY*, 801 F.3d at 111 (observing that the U.K. collected "little" tax revenue on STARS, only "$3.30" for every $22 paid); *Salem*, 786 F.3d at 938 (same). *See* Gov't-Br. 5-6. Sovereign's suggestion to the contrary (Sovereign-Br. 61) conflicts with this authority, as well as the record evidence, including Sovereign's contemporary analysis concluding that "most" of its U.K. tax payment

was "rebat[ed]" to "Barclays, who then "rebates" part back to Sovereign."[4] (JA1022; *see* JA302-305, 2154-2158.)

iv. *Congressional intent*. The Second and Federal Circuits' opinions are not inconsistent with the Congressional purpose for the foreign tax credit, as Sovereign contends (Sovereign-Br. 45). That Congress seeks to "encourage[ ] foreign investment abroad" (Sovereign-Br. 45) does not mean that it seeks to encourage transactions like STARS, where the U.S. taxpayer's assets remain invested in the United States (with all the domestic benefits that a U.S. investment provides). As the courts explained, Congress did not intend the foreign tax credit to apply to transactions that "'fictionalize[d]' the concept of international trade," *BNY*, 801 F.3d at 118, and "involv[ed] no commerce or bona fide business abroad and ha[d] no purpose other than

[4] That Barclays used its STARS U.K. tax benefits to "offset" the U.K. tax due on its non-STARS income does not mean that the U.K. retained all the tax paid in STARS, as Sovereign contends (Sovereign-Br. 61). Any amount that Barclays used to pay its non-STARS tax liabilities was not tax the U.K. retained from STARS; it was tax the U.K. obtained from a wholly separate transaction, unrelated to STARS, such as U.K. tax that Barclays owed on loans to U.K. borrowers. (JA1968-1970.)

to obtain foreign and domestic tax benefits," *Salem*, 786 F.3d at 954.[5] *See* JA322.

That Sovereign nominally paid a foreign tax as part of the STARS shelter does not mean that Congress intends it to obtain a foreign tax credit for that payment (Financial-AmBr. 5-6). There are numerous instances in which a taxpayer is not entitled to a foreign tax credit, although it may have paid a foreign tax. *E.g.*, I.R.C. §§ 901(j), (k), (l), (m); Treas. Reg. § 1.901-2(e)(5)(iv). As pertinent here, the Internal Revenue Code provides foreign tax credits only for taxes paid in "'a valid transaction'" that has "economic substance." *BNY*, 801 F.3d at 108 (quoting 12 Mertens *Law of Fed'l Income Tax'n* § 45D:62). Taxpayers are not automatically entitled to foreign tax credits merely because they formally pay a foreign tax, just as they are not entitled to

[5] The hundreds of millions of dollars that Sovereign employed in its STARS scheme never left its control, never left the United States, and never were put to any productive use in STARS. *See* Gov't-Br. 10-13, 18-19, 55-57. Instead, these funds were merely cycled in and out of the Delaware Trust in "economically meaningless" transactions. *BNY*, 801 F.3d at 117, 122; *Salem*, 786 F.3d at 960. The attempt by Sovereign and its amici to portray STARS as a legitimate *cross-border* or *foreign* business transaction, which Congress intended to encourage by means of the foreign tax credit, is thus wholly unfounded.

any other tax benefit merely because they make an out-of-pocket payment. *E.g., Knetsch v. United States*, 364 U.S. 361, 366 (1960) (disallowing interest deduction even though the taxpayer had made an out-of-pocket payment to the lender). Sovereign fully understood this "tax risk" when it chose to purchase the STARS tax shelter. (JA979-980, 1026-1031, 2532.)

Nor does disallowing the STARS-generated foreign tax credits result in "double-taxation" (Sovereign-Br. 22; Chamber-AmBr. 13). Although tax was formally paid to the U.K., "there was no real risk of *double* taxation," *BNY*, 801 F.3d at 116, because "most" of the U.K. tax paid by Sovereign in STARS was recovered by Barclays and used for Sovereign's benefit (JA1022).[6]

Sovereign and its amici fail to appreciate that "[a]llowing credits for taxes paid to other sovereigns 'is a privilege and a matter of Congressional grace.'" *Salem*, 786 F.3d at 954 (citation omitted). Moreover, the credits are "intended to remove the effect of foreign

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[6] Half of the U.K. tax originally paid by Sovereign was returned to it by Barclays as the Bx payment. The remainder of the U.K. tax recovered by Barclays was retained by it in satisfaction of the fee Sovereign owed it. *See* Gov't-Br. 5-6.

taxation from an investor's decisionmaking process and to facilitate purely economic decisions regarding business opportunities overseas." *Id.* Far from removing foreign tax from Sovereign's decisionmaking process, STARS made foreign tax and foreign tax credits paramount; in Sovereign's view, STARS was deemed "not worth doing" "[w]ithout the UK tax liability." (JA1130.) This was because the STARS Trust transaction, as the courts of appeals recognized in *BNY* and *Salem*, entailed no overseas business opportunity whatsoever.

ARGUMENT

A. Sovereign has failed to demonstrate that the Second and Federal Circuits erred in treating the artificial U.K. tax generated by the STARS Trust transaction as a cost of that transaction in applying the economic-substance doctrine

In our opening brief (Gov't-Br. 33-34, 47-50), we argued that the STARS Trust transaction — which required Sovereign to pay a U.K. tax on U.S.-source income in exchange for an amount equal to half of that tax (the Bx payment) — had no potential for generating any pre-foreign-tax-credit profit for Sovereign. As both the Second and Federal Circuits have held, the STARS Trust transaction could not generate a profit

because, no matter how the Bx payment is characterized,[7] the payment was far less than the U.S. taxpayer's foreign-tax expense of obtaining the payment. 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., In re CM Holdings, Inc.,* 301 F.3d 96, 104-105 (3d Cir. 2002) (disregarding transaction that "yields no appreciable financial benefit to the taxpayer absent tax deductions," and observing that the "point of the [economic-substance] analysis is to remove from consideration the challenged tax deduction, and evaluate the transaction on its merits, to see if it makes sense economically or is mere tax arbitrage"); *Dewees*, 870 F.2d at 31-32 (same).

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[7] In our opening brief (Gov't-Br. 35-47), we alternatively argued that the District Court erred in characterizing the Bx payment as non-tax income as a matter of law. Sovereign's response to this argument (Sovereign-Br. 29-43) is addressed below in Section E. We note, however, that if this Court agrees with the Second and Federal Circuits that the foreign-tax expense generated by STARS is properly treated as a transaction expense, then the Court need not address our alternative argument.

In response, Sovereign makes no attempt to defend the District Court's rationale for rejecting the Second and Federal Circuits' profitability analysis. In this regard, 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 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, *if the foreign tax credits are factored in*. (Op/Add18-19.) The court's reasoning is flawed, as we have explained (Gov't-Br. 51-52).

Rather than defend the District Court's flawed analysis, Sovereign instead contends that "foreign *tax*" is not "relevant at all to the computation of *pre-tax* profit" (Sovereign-Br. 44). That contention is misconceived. "[P]re-tax profit" does not mean "profit calculated prior to considering taxes," as Sovereign asserts (Sovereign-Br. 44 (emphasis deleted)). It means profit calculated prior to considering the U.S. tax benefit at issue, as the Second and Federal Circuits properly recognized. *See BNY*, 801 F.3d at 117 (explaining that the "'point of the economic substance doctrine . . . is to remove the challenged tax benefit and evaluate whether the relevant transaction makes economic sense'")

(citation omitted); *Salem*, 786 F.3d at 948 (explaining that the economic-substance doctrine "assess[es] a transaction's economic reality, and in particular its profit potential, independent of the expected tax benefits").

Sovereign has not — and cannot — dispute the settled principle that the profit analysis under the economic-substance doctrine properly takes into account a transaction's "costs and fees" (Sovereign-Br. 49). To demonstrate profitability, taxpayers must establish that they could "earn a non-tax based profit return in excess of the costs of the transaction." *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 172 (D. Conn. 2004), *aff'd*, 150 Fed. Appx. 40 (2d Cir. 2005). The costs of the STARS Trust transaction include foreign taxes, as the Second and Federal Circuits held. *BNY*, 801 F.3d at 119; *Salem*, 786 F.3d at 949. Sovereign's contention that the courts failed to justify that holding (Sovereign-Br. 50) ignores the Second Circuit's explanation that "'[e]conomically, foreign taxes are the same as any other transaction cost,'" and that treating foreign tax as an expense is particularly appropriate in the analysis of STARS' profitability because "'the foreign taxes giving rise to the foreign tax credits stemmed from

economically meaningless activity, *i.e.*, the prearranged circular cashflows engaged in by the trust.'" *BNY*, 801 F.3d at 117 (citation omitted). In this regard, Sovereign would have this Court ignore the undisputed fact that the amount of the Bx payment Barclays was obligated to pay it was a function of the amount of U.K. tax paid by Sovereign and was equal to 50 percent of such tax. *See* Gov't-Br. 9-10, 15-16, 66-67. The U.K. tax thus was a direct economic cost of the Bx payment that was double the amount of that payment. It therefore follows as a matter of simple arithmetic that the STARS Trust transaction could not have generated a profit for Sovereign (without taking into account the foreign tax credits that are at issue). *BNY*, 801 F.3d at 121; *Salem*, 786 F.3d at 949.

Treating foreign tax as a "pre-tax" expense is neither "improper" nor "inconsistent with Congressional intent," as Sovereign contends (Sovereign-Br. 44-45). The Code treats "foreign tax" as an expense that — like other transaction costs — may be deductible from income. I.R.C. § 164(a)(3). Moreover, when Congress codified the economic-substance doctrine in 2010, it expressly authorized Treasury to "issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax

profit in appropriate cases." I.R.C. § 7701(*o*)(2)(B). And, in the absence of regulations, Congress expected courts to treat "foreign taxes" as an expense in "particular cases." Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010"* 155 n.357 (JCX-18-10). Although the Government has thus far proceeded case-by-case rather than through regulation, *see* IRS Notice 2010-62, 2010-40 I.R.B. 411, *as amplified by* Notice 2014-58, 2014-44 I.R.B. 746, Section 7701(*o*)(2)(B) reflects Congress's view that treating foreign taxes as a pre-tax expense is *not* improper.

These statutory provisions make clear that Congress has not "elected to treat all taxes (domestic or foreign) the same," as Sovereign further contends (Sovereign-Br. 46). Foreign taxes — but not U.S. taxes — (i) are deductible in a genuine business transaction, if the taxpayer does not instead elect to claim credits, §§ 164(a)(3), 275(a)(4), and (ii) are properly counted as a pre-tax cost in transactions being evaluated under the economic-substance doctrine, § 7701(*o*)(2)(B). Moreover, the 2010 codification also enumerated the requirements for a transaction to be deemed to have economic substance, one of which is that "the transaction changes in a meaningful way (*apart from Federal*

income tax effects) the taxpayer's economic position." I.R.C. § 7701(*o*)(1)(A) (emphasis added). That emphasized language refutes Sovereign's contention that Federal (*i.e.*, U.S.) and foreign taxes were to be treated the same, and supports the Second and Federal Circuits' decisions that only U.S. tax consequences, not foreign-tax consequences, should be excluded when determining whether a transaction has economic substance.

Finally, Sovereign's policy concern — that treating foreign tax as an expense "inappropriately stacks the deck against cross-border transactions" (Sovereign-Br. 44) — is unfounded. To begin with, there is no *cross-border* transaction in the STARS Trust transaction. Moreover, the Second and Federal Circuits recognized that a "legitimate transaction could conceivably lack economic profit" after foreign-tax expense is taken into account. *BNY*, 801 F.3d at 119; *Salem*, 786 F.3d at 950. With that in mind, the courts emphasized (as we did in our opening brief (Gov't-Br. 55)) that a lack of profit potential "does not by itself end the economic-substance inquiry." *Id.* Rather, it is necessary to "also look to the overall economic effect of the transaction," including whether it involves meaningless offsetting cash flows, artificial

features, or the absence of economic risk, as well as the transaction's intended "purpose." *BNY*, 801 F.3d at 119. Indeed, the Federal Circuit carefully delineated legitimate transactions that could be respected under the economic-substance doctrine (including one similar to the hypothetical posited by Sovereign (Sovereign-Br. 46-47)), despite being unprofitable due to foreign-tax cost. *Id*. at 949-950.

STARS bears no resemblance to such transactions. Unlike a genuine cross-border transaction — involving real international activity and other economic effects — the STARS Trust transaction only "'fictionalize[d]' the concept of international trade," *BNY*, 801 F.3d at 118, and "involv[ed] no commerce or bona fide business abroad and ha[d] no purpose other than to obtain foreign and domestic tax benefits," *Salem*, 786 F.3d at 954.

B. Sovereign's reliance on *Compaq* and *IES* is misplaced

Sovereign (Sovereign-Br. 50) relies on *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001), and *IES Indus., Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001), for the proposition that foreign tax should be excluded as an expense in the profitability analysis of STARS. That reliance is misplaced.

First, *Compaq* and *IES* are not "countervailing" decisions to *BNY* and *Salem* (Sovereign-Br. 23, 62) because — unlike *BNY* and *Salem* — they do not address the STARS transaction. Rather, they address a wholly different transaction, the tax benefits of which Congress decided were inappropriate, and Congress long ago eliminated them. *See IES*, 253 F.3d at 356 n.5 (noting 1997 legislative amendment).

Nor do *Compaq* and *IES* support excluding foreign tax in the factually "different" STARS context, as even the District Court here recognized (Op/Add18). In the *Compaq*/*IES* transaction, the taxpayers purchased interests in stock of publicly traded *foreign* corporations, and the foreign tax was imposed on dividend income. The foreign tax thus was an unavoidable consequence of obtaining that foreign income. In stark contrast, in STARS, the foreign tax was imposed on income from U.S. assets (primarily loans to U.S. borrowers) that Sovereign purposely made subject to U.K. tax by circulating it through a Delaware Trust with a U.K. trustee. That artificially generated foreign tax is properly treated as a STARS transaction expense, because Sovereign (unlike the taxpayers in *Compaq* and *IES*) could have obtained the same income

from its U.S. assets without incurring the U.K. tax on that income. (JA298-299.)

Moreover, if the Bx payment is to be treated as non-tax income, then the foreign tax necessarily must be treated as an expense of earning that income because the two items are economically and inextricably linked; Sovereign received the Bx payment precisely because it agreed to subject its U.S.-source income to the U.K. tax, and the amount of that payment was directly based on the amount of the U.K. tax it paid. That was not true in *Compaq* and *IES* — the dividend income received by the taxpayers in those cases was not tied to their foreign-tax payment; it was just the converse.

Sovereign does not even attempt to explain its purpose in voluntarily subjecting its U.S.-source income to U.K. tax by the artifice of circulating that income in and out of a Delaware Trust with a U.K. trustee (selected by Sovereign to create that U.K. tax liability). As the courts in *BNY* and *Salem* recognized, because STARS is designed to allow a U.S. taxpayer to claim $2 of foreign tax credits for every $1 of expenditure, the creation of an artificial foreign-tax liability is a critical step in the STARS scheme. Indeed, contrary to normal economic

principles, the larger the foreign-tax liability, the larger the "profit" for the U.S. taxpayer as well as Barclays. *Salem*, 786 F.3d at 951. That is why STARS was deemed "not worth doing" in the absence of a "UK tax liability" (JA1130), and why in *Salem* the Federal Circuit described STARS as a risk-free "money machine" of unlimited capacity. *Id*.

In addition to being inapposite (Op/Add18), *Compaq* and *IES*'s treatment of foreign tax is misconceived. Those decisions ignore the fact that foreign tax is an economic cost, like any other transaction expense, and is treated as such under the Code. No court has followed the treatment of foreign taxes in *Compaq* and *IES*. Indeed, this aspect of the Fifth Circuit's *Compaq* decision has been criticized by a "leading" tax commentator (Sovereign-Br. 26) as being "highly formalistic" because "the inquiry [under the economic-substance doctrine] is only made for the purpose of determining U.S. tax liability," and, therefore, "'reasonable possibility of profit . . . apart from tax benefits' should be read to refer only to U.S. tax benefits. There is no relevant difference between the foreign withholding taxes [imposed in *Compaq*] and other costs of the transactions" that "must be subtracted out in ascertaining a reasonable possibility of profit apart from tax benefits." Bittker &

Lokken, *Federal Tax'n of Income, Estates & Gifts* ¶72.5.3 at 72-48 (rev. 3d ed. 2005). Numerous other commentators have criticized the *Compaq* and *IES* decisions, including the tax-bar commentator (Kevin Dolan) cited by Sovereign (Sovereign-Br. 52). *See* Dolan, *Foreign Tax Credit Generator Regs: The Purple People Eater Returns*, 115 Tax Notes 1155, 1159 (2007) (observing that "*Compaq*" and "*IES*" are "unprincipled decisions that any future court would likely try to distinguish" and arguing that the IRS should rely on the "economic substance doctrine," not regulations, to attack abusive foreign-tax-credit generators); *Salem*, 786 F.3d at 948 n.6 (listing commentators critical of *Compaq* and *IES*).

Finally, *Compaq* and *IES*'s treatment of foreign tax was not the "common-law rule at the time of the codification" of the economic-substance doctrine in 2010 (Sovereign-Br. 54). As the Joint Committee on Taxation emphasized in explaining the doctrine's codification, until Treasury issues regulations on the subject, courts are free "to consider the appropriate treatment of foreign taxes in particular cases, as *under present law*." *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010"* 155 n.357 (JCX-18-10) (emphasis added).

The Joint Committee's statement that courts "under present law" could "consider the appropriate treatment of foreign taxes in particular cases," *id.* at 155 n.357, is wholly inconsistent with the notion posited by Sovereign that *Compaq* and *IES* were somehow the governing "common-law rule" (Sovereign-Br. 54).[8] *See Pritired 1, LLC v. United States*, 816 F. Supp. 2d 693, 739-740 (S.D. Iowa 2011) (treating foreign tax as an expense under the economic-substance doctrine in a transaction entered into prior to the codification's effective date); Notice 98-5: Foreign Tax Credit Abuse, 1998-1 C.B. 334 (treating "foreign taxes" as "an expense").

C. Sovereign has not shown that the STARS Trust transaction did anything more than generate an artificial U.K. tax and a partially offsetting Bx payment and therefore is unable to show that it had any economic effect on its business interests

In our opening brief (Gov't-Br. 55-57), we argued that, in addition to lacking profit potential, the STARS Trust transaction also lacked any

[8] The Joint Committee did not cite *Compaq* "approvingly" (Sovereign-Br. 53) — or otherwise — for its treatment of foreign-tax expense. Rather, the Joint Committee cited *Compaq* as an example of the "lack of uniformity regarding the type of non-tax economic benefit a taxpayer must establish in order to demonstrate that a transaction has economic substance." *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010"* at 144-145 & n.312 (JCX-18-10).

"'real economic effect.'" *BNY*, 801 F.3d at 122 (quoting *Salem*, 786 F.3d at 950). In this regard, Sovereign's Trust transaction — like the Trust transactions in *BNY* and *Salem* — (i) consisted of three meaningless, circular cash flows that had no impact on Sovereign's underlying U.S. business assets other than to expose them to an artificial U.K. tax, (ii) did not alter Sovereign's control over, or management of, its assets or the revenue-generating capabilities of those assets, and (iii) did not involve any economic risk. *See* Gov't-Br. 10-13, 18-19, 55-57. Sovereign does not dispute any of these well-supported facts, noting only that the Trust generated a U.K. tax and a partially offsetting Bx payment. *See* Sovereign-Br. 66-69. Consistent with the Second and Federal Circuits, this Court should conclude that the STARS Trust transaction had no genuine economic effect and, as such, lacks economic substance.

Attempting to deflect attention from the Trust's artificial features, Sovereign contends that the "circular cash flows" are "legally irrelevant" because they "were not relied upon by Sovereign in its tax treatment" (Sovereign-Br. 68). That is incorrect. In claiming over $400 million in foreign tax credits from its STARS transaction, Sovereign relied on the momentary circulation of its U.S.-source income into and out of the

Trust; without that economically meaningless circulation, Sovereign could not assert that it (i) owed a U.K. tax on the circulated U.S.-source income; (ii) was entitled to foreign tax credits for that tax; and (iii) satisfied I.R.C. § 904 (which limits the foreign tax credit to tax on foreign-source income) through the use of the U.S.-U.K. Tax Treaty. (JA1199, 1473, 2465-2466, 2480-2484.) *See BNY*, 801 F.3d at 117 (observing that "'the foreign taxes giving rise to the foreign tax credits stemmed from economic meaningless activity, *i.e.*, the prearranged circular cashflows engaged in by the trust'") (citation omitted).

D. The Second and Federal Circuits' opinions are neither tainted nor distinguishable, as Sovereign contends

Unable to demonstrate any error in the Second and Federal Circuits' conclusion that the STARS Trust transaction was incapable of generating a pre-tax profit and lacked any genuine economic effect, Sovereign contends that this Court should nevertheless disregard that conclusion because (i) the Tax Court's "factual findings" in *BNY* are "tainted" (Sovereign-Br. 43); and (ii) Sovereign's STARS transaction is "distinguishable" from those at issue in *Salem* and *BNY* (Sovereign-Br. 64-66). Both contentions are meritless.

i. Sovereign contends (Sovereign-Br. 62-64) that this Court should "not follow" the Tax Court's decision in *BNY* because the judge who issued the decision (former Judge Diane Kroupa) was "under audit" during the *BNY* Tax Court proceedings and was "subsequently" indicted for tax fraud.[9] That contention is utterly misconceived. First, the Government is not asking this Court to "follow" the Tax Court; the Government is asking this Court to follow the Second and Federal Circuits, and there is no suggestion that the judges on those circuit panels were in any way disqualified.

Second, Sovereign's baseless speculation that Judge Kroupa "might have had an interest in currying favor with the IRS" (Sovereign-Br. 63) during the *BNY* Tax Court proceedings conflicts with the facts. Far from currying favor with the IRS, Judge Kroupa ruled (on reconsideration) against the IRS on BNY's interest-deduction claim —

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[9] The Tax Court issued its original opinion in *BNY* in February 2013 and a revised opinion (granting BNY's motion for reconsideration) in September 2013. The following year, Judge Kroupa resigned from the Tax Court. Then, in April 2016, more than three years after the original *BNY* opinion, Judge Kroupa was indicted for fraudulently claiming personal expenses as business expenses on her federal income tax return, according to the Justice Department press release cited by Sovereign (Sovereign-Br. 63 n.4).

which reduced BNY's tax deficiency by $70 million — even though the Court of Federal Claims had previously ruled for the Government on that same issue. *Compare BNY v. Commissioner*, 2013 WL 5311057 (T.Ct. 2013), *with Salem Financial, Inc. v. United States*, 112 Fed. Cl. 543, 587-589 (2013). Indeed, in ruling for BNY on the interest issue, Judge Kroupa exercised her "discretion" and considered BNY's "newly minted arguments," even though such "new theories" are "generally" not "appropriate" on a motion for reconsideration. *BNY*, 2013 WL 5311057, at *2. Exercising discretion to consider, and then granting, a taxpayer's belated claim for a $70 million tax reduction is wholly inconsistent with Sovereign's speculation that Judge Kroupa was "currying favor" with the IRS in upholding its disallowance of the foreign tax credits.

Third, Sovereign has failed to demonstrate that Judge Kroupa was operating under a disqualifying conflict of interest during the *BNY* Tax Court proceeding. Although Judge Kroupa may have been "under audit" during the *BNY* proceeding, Sovereign cites no authority (and

our research has found none[10]) concluding that *any* judge must recuse himself or herself if under IRS audit during a proceeding involving the IRS, much less a *Tax Court* judge, who (following the logic of Sovereign's argument) would have to cease work altogether while under audit because every proceeding involves the IRS. *United States v. Jaramillo*, 745 F.2d 1245 (9th Cir. 1984), cited by Sovereign (Sovereign-Br. 63), does not support its argument. There, the court affirmed a "trial judge's determination that it [was] inappropriate" to continue presiding over a criminal case "*after* he has been indicted." *Id.* at 1248 (emphasis added). Here, in contrast, Judge Kroupa presided over the *BNY* case more than three years *before* she was indicted, as noted above (n.9).

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[10] The only case that we have discovered involving a judge who was audited by the IRS concluded that the judge — who had been audited by one of the parties (Richey), a former IRS agent — "did not abuse his discretion by not recusing himself *sua sponte* from Richey's case." *United States v. Richey*, 924 F.2d 857, 858 (9th Cir. 1991). As the Ninth Circuit explained, the "mere possibility" that a "taxpayer who has been meticulously audited by the Internal Revenue Service will carry a scar and bear grudge" does not merit a "rule that every judge in his circumstance is automatically disqualified from presiding." *United States v. Richey*, 874 F.2d 817 (9th Cir. 1989) (unpublished opinion).

Fourth, and even if Judge Kroupa's "factual findings" were somehow "tainted" (Sovereign-Br. 43), those findings were not dispositive of the central issue on appeal, *i.e.*, the profitability of STARS.[11] The holding of the Second Circuit in *BNY* that the STARS Trust transaction was inherently profitless did not turn on the Tax Court's findings; it turned on a legal ruling.[12] As the Second Circuit explained, "in light of our holding that, *as a matter of law*, foreign taxes should be deducted when calculating pre-tax profit, the Tax Court did not err in considering foreign taxes paid by BNY on behalf of the trust and in concluding that the trust did not offer a reasonable opportunity for economic profit." *BNY*, 801 F.3d at 121 (emphasis added).

Indeed, Sovereign previously acknowledged that the Tax Court's profitability analysis ultimately rested on a legal holding, not a factual

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[11] Judge Kroupa's findings are entirely consistent with the findings made by the trial judge in the similar *Salem* case. 112 Fed. Cl. 543.

[12] The Second Circuit's legal ruling that "foreign taxes are properly deducted in assessing a transaction's pre-tax profitability" applied not just to BNY, but also to another taxpayer (American International Group), whose interlocutory appeal from a district court ruling was consolidated with BNY's appeal from the Tax Court. *BNY*, 801 F.3d at 120.

finding. During the District Court proceeding, counsel for Sovereign criticized *BNY* because of its "fundamental legal flaws," not because of its fact-finding. (JA1909.) As Sovereign's counsel stated to the District Court, the Tax Court in *BNY* was legally bound to follow its "earlier" precedent from 1999 (JA1909) holding that foreign taxes are treated as an expense under the economic-substance doctrine. *See BNY v. Commissioner*, 140 T.C. 15, 35 n.9 (2013) ("We have previously held that foreign taxes are economic costs for purposes of the economic substance doctrine."). That earlier, binding precedent dictated that Judge Kroupa conclude that "BNY did not have a reasonable expectation that it would make a non-tax economic profit from using the STARS structure" because of the "foreign taxes incurred as [a] result of using the STARS structure." *Id.* at 35. Therefore, Judge Kroupa's no-profitability conclusion resulted from following precedent, not "currying favor" (Sovereign-Br. 63).

Finally, the Tax Court has not "recognize[ed] Judge Kroupa's inherent conflict of interest in any tax case," as Sovereign contends, citing an order in a pending case (*Eaton Corp. v. Commissioner*) that was originally assigned to Judge Kroupa (Sovereign-Br. 64). In *Eaton*,

the Tax Court judge who replaced Judge Kroupa after she resigned allowed a taxpayer to file out of time a motion for reconsideration of an earlier interlocutory order issued by Judge Kroupa. In permitting the out-of-time filing, however, the Tax Court did not recognize Judge Kroupa's alleged "inherent conflict of interest in any tax case," as Sovereign contends (Sovereign-Br. 64); rather, the court simply "decided to consider petitioner's lodged motion for reconsideration" in the "exercise of its discretion." *Eaton Corp. v. Commissioner*, No. 5576-12, Order at 1 (T.Ct. June 29, 2016).

ii. Unable to discredit the other STARS decisions, Sovereign alternatively argues that the decisions are "distinguishable" (Sovereign-Br. 64-66). That argument, too, is unavailing.

Sovereign contends (Sovereign-Br. 65) that *Salem* is distinguishable because, there, "BB&T expressly abandoned any argument" that it engaged in "the Trust" to "obtain financing." BB&T's litigation strategy, however, does not set the two cases apart. The relevant operative facts of all the STARS cases are essentially the same. Sovereign, too, for purposes of its summary-judgment motion, accepted the Government's position that the Trust must be analyzed separately

from the Loan, and therefore cannot rely on the Loan to defend the District Court's decision that the Trust transaction had economic substance. *See* Gov't-Br. 64-65.

Nor is *BNY* distinguishable because it included a "stripping transaction" to "accelerate" the Trust's payment of taxes, as Sovereign further contends (Sovereign-Br. 65). That ancillary fact was not even mentioned in the Second Circuit's opinion. *See BNY*, 801 F.3d at 110-111 (summarizing the "basic operation" of STARS). Rather, the Court there concluded that BNY's STARS transaction was the "same" STARS transaction as in "*Salem*," *id*. at 116, which (as here) did not include a stripping transaction. Moreover, Sovereign's argument on appeal conflicts with its counsel's concession in the District Court that "Sovereign's STARS transaction" was "very similar" to the STARS transaction in *BNY* (JA1909), a concession noted in our opening brief (Gov't-Br. 57) and ignored in Sovereign's answering brief.

E. Sovereign's defense of the District Court's flawed treatment of the Bx payments lacks merit

In our opening brief (Gov't-Br. 35-47), we argued that the District Court erred in its refusal to analyze the economic reality of the Bx payments, and in its conclusion that they must be treated as economic

income. We argued that the Bx payments were U.S. tax effects that should be excluded from any pre-tax-profit analysis, citing fact and expert evidence that "100% of the funding for the [Bx] Payments was the U.S. income tax savings that Sovereign derived from claiming U.S. foreign tax credits." (JA700-701; *see* JA1022.) We further argued that the legal authorities cited by the District Court do not preclude the Government's factual analysis of the Bx payments under the economic-substance doctrine.

In response, Sovereign essentially repeats the District Court's analysis and ignores the record evidence supporting the Government's position. In doing so, Sovereign misconstrues the analysis required by the economic-substance doctrine. Sovereign cites the principle that the "'general characterization of a transaction'" under the economic-substance doctrine "'is a question of law,'" (Sovereign-Br. 42 (quoting *Frank Lyon*)), but disregards the corresponding principle that the "characterization is to be made" from the transaction's "particular facts," *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 n.16 (1978). As demonstrated below, the authorities cited by Sovereign do not displace the factual analysis required by *Frank Lyon*, as the Second

Circuit in *BNY* and the district court in *Wells Fargo* — a STARS case ignored by Sovereign — correctly concluded.[13] *See* Gov't-Br. 35-36, 39-40.

Sovereign's reliance on *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929), and its progeny (Sovereign-Br. 31-34) is misplaced. In *Old Colony*, the Court held that a third party's payment of a taxpayer's tax liability is taxable income to the taxpayer. That simple fact pattern bears no resemblance to STARS' circular cash flow, as we have explained (Gov't-Br. 46). In STARS, unlike the situation in *Old Colony*, the taxing authority (the U.K.) did not retain the tax at issue (the U.K. tax), which was paid by Sovereign and recovered by Barclays. Moreover, in STARS, unlike the situation in *Old Colony*, the payment at issue (the Bx payments) was funded by the U.S. Treasury, through the U.S. tax benefits claimed by Sovereign for the U.K. tax that was

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[13] Sovereign's suggestion (Sovereign-Br. 43) that the Second Circuit's *BNY* decision conflicts with *Frank Lyon* lacks merit. As the Second Circuit correctly determined — quoting *Frank Lyon* — the "'general characterization of a transaction for tax purposes is a question of law,'" but that characterization requires a number of "factual" inquiries, including the transaction's "overall economic effect" and "purpose." *BNY*, 801 F.3d at 112, 119.

recovered by Barclays. *Old Colony* sheds no light on how to characterize that circular cash flow. In this regard, the Bx payments are not mere "reimbursements" of Sovereign's U.K. tax expense (Sovereign-Br. 30); they are payments by Barclays to Sovereign that are funded by the U.S. Treasury, as reflected in the record evidence (JA700-701, 1022). It is that distinction — Treasury's funding of the Bx payments — that makes them tax effects, rather than economic income, and that sets them apart from the payments in the *Old Colony* line of cases cited by Sovereign (Sovereign-Br. 31-33).[14]

Sovereign's contention that its U.K. tax payment was not "cycled through" the U.K. taxing authority (Sovereign-Br. 39) conflicts with the record evidence, including its own candid assessment of STARS' economic realities. *See* Gov't-Br. 37-39. According to that assessment:

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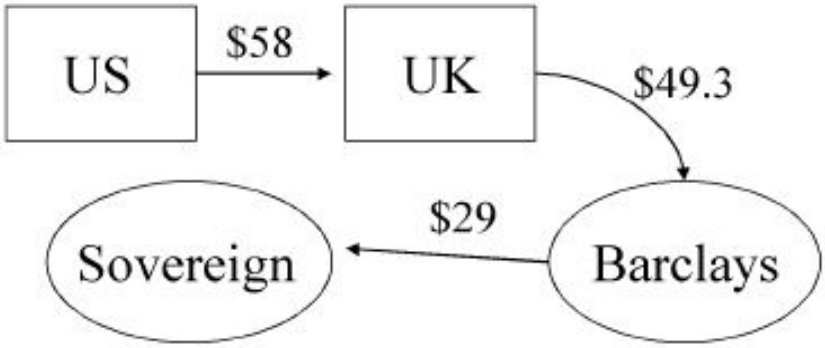
[14] The other authorities cited by Sovereign (Sovereign-Br. 40-41) are also inapposite because they do not purport to address the economic-substance doctrine, as noted in our opening brief (Gov't-Br. 45).

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.



(JA1022.) As this depiction vividly illustrates, Sovereign's tax payment *was* being cycled through the U.K. Although (as Sovereign observes (Sovereign-Br. 39)) the Federal Circuit in *Salem* rejected this argument because it could not identify the "exact source" of the Bx payments, given that Barclays received several U.K. tax benefits in STARS, 786 F.3d at 946, the Government's argument does not require this Court to trace the Bx payments to any particular U.K. tax benefit. What is critical to the Government's argument (and what we failed to explain adequately to the Federal Circuit[15]) is that the Bx payment is a tax

[15] The Federal Circuit nevertheless reached the same ultimate conclusion as the Second Circuit in *BNY* — the STARS Trust transaction is an inherently profitless transaction that is devoid of economic substance. *Salem*, 786 F.3d at 949-951.

effect because (as the Federal Circuit found) it was paid "out of" Barclays' "net" U.K. tax benefits, *id.*, and those net U.K. tax benefits were (i) funded by "the U.S. Treasury," *id.* at 951, and (ii) "depended on the Trust's U.K. tax payments," *id.* at 944. *See* JA210, 321 n.26, 800, 887.

There is no inconsistency, as Sovereign contends (Sovereign-Br. 44), between the Government's exclusion of the Bx payment as a U.S. tax effect in determining the Trust's profitability and its inclusion of the U.K. tax as an expense. In this regard, the Government does not exclude the Bx payment because it represents the "indirect effect of Sovereign's payment of U.K. tax" (Sovereign-Br. 44 (emphasis deleted)); rather, the Government excludes the Bx payment because it represents the monetization of the U.S. foreign tax credits, as Sovereign understood when it entered into STARS (JA1022). *See* Gov't-Br. 35-39.

Like its reliance on *Old Colony*, Sovereign's reliance on the subsidy rule is misplaced. The Government has conceded that the Bx payments are not "subsidies" within the meaning of I.R.C. § 901(i) and related regulations, which analyze the "substance" of a payment of foreign tax. That concession, however, does not "doom[ ]" its economic-

substance argument (Sovereign-Br. 34-35). *See Salem*, 786 F.3d at 941-942 (rejecting similar argument). Those rules analyze a transaction's "substance" *only* for purposes of determining whether the *foreign country* subsidized a foreign-tax liability, and disallow foreign tax credits in that circumstance, because it would be inappropriate for Treasury to "bear the cost of tax subsidy programs instituted by foreign countries." Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* at 871 (May 1987). STARS, however, was not "instituted *by*" the U.K. — it was instituted by Barclays and KPMG as a scheme that allowed private parties to use the U.K. as a "conduit" so that the Treasury would bear the cost of a tax-avoidance scheme instituted by private parties that is run through a foreign country. The substance-over-form analysis under the Code and regulations addresses only *one* particular abuse of the foreign tax credit and does not preclude the Government's use of the economic-substance doctrine to address a *different* abuse.[16] That Congress and Treasury shut down one abuse —

[16] The economic-substance doctrine and the substance-over-form doctrine are separate doctrines employed by the IRS and the courts to combat tax-avoidance schemes. *See* Gov't-Br. 21 n.5.

claiming credits for taxes rebated by a foreign country's subsidy program — does not mean that they blessed a different abuse whereby private parties manipulate tax rules to reach a similar result. *See Winn-Dixie Stores, Inc. v. Commissioner*, 254 F.3d 1313, 1316 (11th Cir. 2001).

Finally, there is no merit to Sovereign's claim (Sovereign-Br. 29) that the Bx payments must be treated as economic income under the economic-substance doctrine because, on its tax returns, it "treated [them] as a reduction of interest expense" and "thereby increase[ed] [its] taxable income." A taxpayer's tax reporting never dictates the outcome under the economic-substance doctrine. For example, in *Knetsch*, the taxpayer reported interest payments as real, deductible costs; that tax reporting did not require the Supreme Court to respect the loan as having economic substance. Similarly, here, that Sovereign reported the Bx payments as an offset to interest expense — when it is undisputed that those payments had absolutely nothing to do with the

Loan, *see* Gov't-Br. 15-17, 65-68 — does not mean that this Court must accept that artificial labeling.[17]

F. Sovereign's contention (echoed by its amici) that it engaged in STARS to obtain low-costing funding raised a disputed factual issue that should not have been resolved on summary judgment

In our opening brief (Gov't-Br. 58-71), we argued that the District Court erred by disregarding the Government's tax-motivation evidence and compounded that error by accepting at face value Sovereign's purported business purpose for engaging in STARS in granting summary judgment to Sovereign. In this regard, we pointed out (Gov't-Br. 68-69) that the court had made findings as to disputed facts, *i.e.*, that Sovereign entered STARS because it "was interested in lower cost borrowing," and that such a motive was a "genuine non-tax, business purpose." (Op/Add23.) The District Court's resolution of these

[17] If this Court concludes — as we contend — that the STARS Trust lacks economic substance and should be disregarded for tax purposes, then the Trust-generated Bx payments will be disregarded in the calculation of Sovereign's taxable income, as occurred in the other STARS cases. *E.g.*, BNY, 801 F.3d at 112.

contested issues of fact in the context of granting Sovereign's motion for summary judgment was improper.[18]

In response, Sovereign does not dispute that the District Court made these findings. Instead, Sovereign contends (Sovereign-Br. 69) that the court's reliance on the Loan as a business justification for the Trust was limited to the court's analysis of the Government's "alternative" substance-over-form challenges. That contention is incorrect. *See* Gov't-Br. 68-69. But, in any event, relying on the Loan to support *any* part of its rationale for granting Sovereign summary judgment with regard to the Trust was reversible error because the parties had agreed that — for purposes of summary judgment — the two STARS components were to be evaluated separately. *See* Gov't-Br. 21. Although Sovereign suggests (Sovereign-Br. 12-15) that its Loan — unlike the Loan in *BNY* and *Salem* — provides its Trust a business

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[18] As explained in our opening brief (Gov't-Br. 64-69), if this Court agrees with the courts in *BNY* and *Salem* that the economic substance of the STARS Trust transaction should be determined separately from the STARS Loan transaction, then the Court should reverse the District Court's decision as to the foreign tax credits without regard to whether the Loan — at its true interest rate, lacking the artificial netting of the Bx payment — was economically beneficial to Sovereign, and should remand the case solely for consideration of the applicability of penalties.

purpose, that argument raises a disputed factual issue that cannot be resolved without fact-finding.[19]

Sovereign alternatively contends that fact-finding regarding Sovereign's purported business purpose for the Trust transaction would be "irrelevant" under the economic-substance doctrine (Sovereign-Br. 73). That is incorrect. Before a court can conclude that a transaction has economic substance, it should consider whether the taxpayer had a non-tax reason for engaging in the transaction, as this Court did in *Stone v. Commissioner*, 360 F.2d 737, 740 (1st Cir. 1966). *See* Gov't-Br. 61-62 n.14. To be respected for tax purposes, a transaction must have been motivated by "tax-independent considerations." *Frank Lyon*, 435 U.S. at 583-584. The District Court's failure to consider the Government's evidence that Sovereign lacked "tax-independent considerations" is reversible error.

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[19] The amici predicate their economic-substance analysis on the assumption that U.S. taxpayers engaged in the STARS Trust to obtain a "favorable" Loan (Chamber-AmBr. 3; Atlantic-AmBr. 6-7; Financial-AmBr. 6), a notion discredited in *BNY* and *Salem* and disputed here (Gov't-Br. 13-17, 59, 64-68).

Sovereign contends that it "makes no sense" to consider subjective intent "'where the transaction is objectively judged to have had economic substance'" (Sovereign-Br. 76 (citation and emphasis omitted)). Sovereign has our argument backwards. *See* Gov't-Br. 58-59. We have argued that, *before* a court can properly conclude that a transaction objectively has economic substance, it should consider the evidence of subjective motivation because that evidence can put the objective evidence in context. *E.g., Humboldt Shelby Holding Corp. v. Commissioner*, 2014 WL 1041485, at *6 (T.Ct. 2014) (holding that a transaction lacked economic substance, even though it could have "generated a $510,000 profit independent of tax considerations," because the taxpayer entered into the transaction "solely to generate tax losses"), *aff'd*, 606 Fed. Appx. 20 (2d Cir. 2015). In this case, a fact-finder could conclude that the transaction designed to look like a financing, in fact "lacked a bona fide business purpose," and was nothing more than an "FTC [foreign tax credit] trade" that utilized U.S. tax benefits as fuel for its "money machine." *Salem*, 786 F.3d at 951-952, 954.

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.

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CERTIFICATE OF COMPLIANCE

With Type-Volume Limitation, Typeface Requirements, and Type Style Requirements

Case No. 16-1282

1. This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B), as modified by this Court's Order dated September 15, 2016, because:

[X] this brief contains 9,117 words (including the 54 words contained in the graphic on page 39 that were not picked up by Microsoft Word's word-count program), excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii), or

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(s) /s/ Judith A. Hagley

Attorney for Appellant United States

Dated: Sept. 15, 2016

CERTIFICATE OF SERVICE

I hereby certify that on September 15, 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