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Economic Substance, Foreign Tax Credits, Shams and Interest Deductions

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The IRS is smiling after the Second Circuit Court of Appeals handed the taxing agency two satisfying victories in refund cases. AIG was seeking over $300 million, while Bank of New York Mellon wanted $200 million. There was little joy for either company, although there is a silver lining for the bank. In contrast, the IRS's win is huge.

In *Bank of New York Mellon Corp.* [Case No. 14-704], the Second Circuit affirmed the application of the economic-substance doctrine to a STARS transaction. STARS—for those who wish to forget—stands for Structured Trust Advantaged Repackaged Securities. The companion case of *American International Group, Inc.* [Case No. 14-765] also involved foreign tax credits.

AIG argued that foreign tax credits, by their nature, are not reviewable for economic substance. The Second Circuit ruled that the economic-substance doctrine can be applied to disallow a claim for foreign tax credits. In calculating the pretax benefit AIG gained from its cross-border transactions, foreign tax credits and tax payments both count.

Both cases expand the economic-substance doctrine. Both cases lay to rest, at least for now, the applicability of the much-feared economic-substance doctrine to foreign tax credits.

The economic-substance doctrine is an anti-abuse doctrine. It was codified in 2010, but before that was based on common law. It allows a court to deny tax benefits arising from transactions that do not result in a meaningful change to the taxpayer's economic position, other than a purported reduction in federal income tax. The economic-substance analysis is a two-prong test that evaluates: (1) the objective economic substance of the transaction; and (2) the taxpayer's subjective business motivation. Several variations of this

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two-prong test have emerged, with different tests in different circuits.

Level Not Tilted

The Code allows companies to claim credits for income taxes paid to foreign governments. It is supposed to level the playing field and be fair. Yet ironically, the IRS has suggested that foreign tax credit abuse is one of its major compliance worries for sizable companies. Think of it as kind of the corporate tax version of the Earned Income Tax Credit!

Notably, both the *AIG* and *Bank of New York Mellon* cases were based on the law in effect before the economic-substance doctrine was codified. Even so, the IRS has to be happy at the pipeline of other cases that are likely to be influenced by these results. The only drawback for the IRS was the allowance of interest deductions to Bank of New York Mellon, which the IRS would have preferred the court to entirely disallow.

The *Bank of New York Mellon* case involved asserted tax deficiencies of approximately $215 million. The Tax Court conducted a trial on the ill-fated STARS loan product. The bank had purchased STARS, allegedly as a *bona fide* investment.

The bank did its best to convince the Tax Court that this was a real business deal and not about taxes. But after a three-week trial, the Tax Court held that the effect of foreign taxes is to be considered in the pre-tax analysis of economic substance. With that in mind, the court also held that STARS lacked economic substance.

That meant Bank of New York Mellon could not claim foreign tax credits associated with STARS. The Tax Court went on to hold that certain income from STARS was includible in the bank's income and that the bank could not deduct the offsetting interest expenses associated with STARS. However, on reconsideration, the Tax Court later reversed both these latter rulings.

Mechanics vs. Substance

On appeal, the Second Circuit upheld the Tax Court on the watershed issue that the economic-substance doctrine does apply to the foreign tax credit rules. The *AIG* case involved AIG's request for a $306.1 million tax refund. In that case, the district court had held that the economic-substance doctrine applies to foreign tax credits.

The district court also ruled that the pre-tax benefit AIG gained from its cross-border transactions must be calculated by taking foreign taxes into account. AIG had moved for partial summary judgment, which the district court denied. The case went to the Second Circuit on interlocutory appeal.

The Second Circuit ruled that economic substance applies to the foreign tax credits and that AIG's cross-border transactions were not substantive. AIG borrowed a whopping $1.5 billion to invest, hoping to get far higher returns than the interest was costing on the loan. This was all about earning income, the giant insurer argued. It wasn't about getting tax benefits.

But the Second Circuit was hardly sympathetic to this argument. The Appeals Court

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rejected the profit-motive appeal and was harsh on the mechanics. The court held that it was inappropriate to allow AIG to tally up all the foreign taxes it *paid*, but to then *exclude* the quite generous foreign tax credits AIG was getting.

Foreign tax credits are about leveling the international playing field, according to the court. The IRS is supposed to be indifferent whether a business transaction occurs in the United States or somewhere else. Thus, in calculating pretax profit, the court said, one must be fair.

When assessing the objective economic substance of a transaction, one simply cannot include the foreign taxes paid but exclude the foreign tax credits claimed! In calculating pre-tax profit, *both* must be tallied. The court noted that there were various objections to this approach, but it found the arguments against it unpersuasive.

The court found that the STARS transaction used by Bank of New York Mellon and the cross-border loan deals favored by AIG were both shams. Under the economic-substance doctrine, said the court, they just don't count. Thus, Bank of New York Mellon lost on the *bona fides* of its STARS transaction.

The court even said it lacked a subjective business purpose beyond tax avoidance. Even so, the $1.5 billion loan the bank obtained to fund the deal was a real loan.

It had independent economic substance according to the Second Circuit. And that meant that Bank of New York can deduct the considerable interest expense it has had on the loan.

Brewing Split

It is worth contrasting the *AIG* and *Bank of New York Mellon* cases with *Compaq Computer Corp.* [CA-5, 2002-1 USTC ¶50,144, 277 F3d 778] and *IES Industries Inc.* [CA-8, 2001-2 USTC ¶50,471, 253 F3d 350]. In both of these cases, the IRS lost. Given the law in other circuits, and the presence of district court cases that are being appealed, we may see more cases.

Perhaps there might even a U.S. Supreme Court case on these issues one day! Economic substance, after all, may be a bit like Justice Potter Stewart's view of pornography. The economic-substance doctrine is about ensuring that taxpayers are using allowed tax benefits in accordance with Congress's purpose.

And if that is not evident, the courts can probe deeper. Even so, the Second Circuit's holding in favor of Bank of New York Mellon on the interest deductions is a significant taxpayer victory, a kind of consolation prize. The IRS viewed the whole messy affair as equally tainted.

But the Second Circuit thought the debt was real and the cost of the money was real, and therefore allowed the deductibility of interest. That part of the deal actually did have economic substance. So how does one tell?

The court listed what has now come to be a common refrain. One should look at whether the taxpayer had an objectively reasonable expectation of profit, apart from tax benefits, from the transaction. In addition, the court said it would consider whether the taxpayer had a subjective nontax business purpose in entering the transaction.

The court noted that in the Second Circuit, its approach was a flexible analysis. That is, both of these factors were to be evaluated in an overall inquiry into a transaction's economic substance. The focus of the objective inquiry is whether the transaction "offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits" [*H. Gilman*, CA-2, 91-1 USTC ¶50,245, 933 F2d 143, 146].

Foreign taxes are economic costs and should be deducted when calculating pre-tax profit, said the court. But when looking at the outlay for foreign taxes paid, you cannot exclude the foreign tax credits claimed. The Second Circuit acknowledged that it was agreeing with the Federal Circuit in *Salem Fin., Inc.* [CA-FC, 2015-1 USTC ¶50,304, 786 F3d 932, 938]. And it was disagreeing with decisions of the Fifth and Eighth Circuits in *Compaq* and *IES Industries*, respectively.

But for the IRS, the case law is starting to shape up nicely. And for tax practitioners everywhere, the economic-substance doctrine has just become a little more important.