New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

WWW.NYLJ.COM

An ALM Publication

VOLUME 254—NO. 97

THURSDAY, NOVEMBER 19, 2015

Tax Litigation Issues

Expert Analysis

The Economic Substance Of Foreign Tax Credits

U.S. taxpayers pay taxes on all of their income, regardless of where it is earned. Congress has recognized that this basic principle of the Internal Revenue Code may result in "double taxation" of income earned outside the United States. Thus, the Code provides a foreign tax credit, which equalizes the tax burden by "treat[ing] the taxes imposed by the foreign country as if they were imposed by the United States,"[1] and providing a dollar-for-dollar credit on the taxpayer's U.S. liabilities.

While the foreign tax credit regime seeks to eliminate the perceived unfairness of taxing income that was previously taxed by another country, as commerce has become increasingly international and complex, the Internal Revenue Service has become concerned that the foreign tax credit's laudable goals are subject to abuse by sophisticated corporations engaging in transactions designed to create a tax arbitrage. In recent years, taxpayer claims for foreign tax credits have faced increasing government scrutiny,[2] and the IRS has challenged several such claims under the common law "economic substance" doctrine.

As this column has previously discussed, the economic substance doctrine has proven to be broad and flexible, with its standard evolving to address new transactions the government claims are illegitimate.[3] Courts, however, have split on the application of the economic substance doctrine to transactions designed to take advantage of foreign tax credits. In *Bank of New York Mellon Corporation v. Commissioner of Internal Revenue*,[4] decided this past September, the U.S. Court of Appeals for the Second Circuit raised the bar for taxpayers claiming foreign tax credits, making it increasingly unlikely that transactions designed to generate such credits will pass muster under the economic substance doctrine.

Economic Substance Doctrine

The economic substance doctrine, originally a common law creation, "allows courts to question the validity of a transaction and deny taxpayers benefits to which they are technically entitled

By
Jeremy H. Temkin

under the Code if the transaction at issue lacks 'economic substance.'"[5] To determine whether a transaction had economic substance, courts apply a two-part test, examining both whether a taxpayer had "an objectively reasonable expectation of profit, apart from tax benefits," and whether the taxpayer had a "non-tax business purpose" for engaging in the transaction.[6] In *Bank of New York Mellon*, the Second Circuit affirmed two separate

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lower court decisions that relied on the economic substance doctrine to reject corporate taxpayers' attempts to claim tens of millions of dollars in foreign tax credits based on a series of complex transactions.

The first taxpayer, American International Group (AIG), had entered into a series of cross-border transactions through a subsidiary. In each transaction, the AIG subsidiary sold preferred shares of a special purpose vehicle (SPV) to a foreign bank, committing to repurchase those shares in the future at the original sale price. The SPV used the proceeds received from the foreign bank to purchase investments, paying taxes to foreign governments based on the income generated by those investments. The SPV then paid the net proceeds of the investment to the foreign bank as a divided. On its U.S. returns, AIG treated the transaction as a loan from the foreign bank, and the dividends paid to the bank as a deductible interest expense. AIG then claimed credits for the foreign taxes paid by the SPV.

Upon reviewing the transactions, the IRS, inter alia, disallowed $48.2 million in tax credits. AIG paid the tax and brought an action in federal district court seeking a refund. After fact discovery, the district court rejected AIG's motion for partial summary judgment, concluding that the foreign tax credit regime is subject to the economic substance doctrine, and that taxes paid to foreign governments are to be treated as costs in assessing the profitability of cross-border transactions.[7] The district court, however, certified its decision for interlocutory appeal.

In the second case decided by the Second Circuit, Bank of New York Mellon Corp. (BNY) sought to take advantage of foreign tax credits generated through a loan product known as the "Structured Trust Advantaged Repackaging Securities" (STARS), which had been marketed by Barclays Bank, PLC and KPMG. In connection with the transaction, BNY contributed $7.8 billion in income-producing assets to a newly formed trust, which was subject to U.K. taxation by virtue of its having a U.K. resident as its trustee. Barclays, however, made monthly payments to BNY of approximately half of the U.K. taxes. Barclays then purchased shares in the trust, which effectively constituted a loan to BNY.

Under the terms of this second transaction, BNY was obligated to make interest payments to Barclays, thereby reducing Barclays' net monthly payments to BNY. The transaction resulted in a circular cash flow, which provided net tax benefits to both Barclays (in the U.K.) and BNY (in the U.S.). The IRS disallowed, inter alia, the foreign tax credits claimed by BNY, which filed a petition in Tax Court. After a bench trial, the court concluded that, after considering the U.K. taxes paid, the STARS transaction lacked a reasonable possibility of generating a profit, and that BNY did not have any non-tax business purpose for entering into the transaction.[8]

The Second Circuit's Approach

On appeal, the Second Circuit affirmed both the district court's rejection of AIG's motion for partial summary judgment and the Tax Court's post-trial finding that BNY's transaction lacked economic substance.

As an initial matter, the court firmly rejected AIG's argument that, given Congress's intent that foreign tax credits be available to prevent double taxation, the economic substance doc-

JEREMY H. TEMKIN *is a principal in Morvillo Abramowitz Grand Iason & Anello P.C.*. NICOLE BUSEMAN, *an associate at the firm, assisted in the preparation of this article.*

trine could not be used to disallow foreign tax credits that met the requisite statutory and regulatory requirements. Writing for the court, Judge Denny Chin stressed that the "doctrine exists to provide courts a 'second look' to ensure that particular uses of tax benefits comply with Congress's purpose in creating that benefit," and thus that it was "entirely appropriate for a court to ask…whether a taxpayer's claim to foreign tax credits is tied to true 'business abroad' resulting in actual out-of-pocket tax payments."[9] In this regard, the court stressed that foreign tax credits are intended "to prevent double taxation of taxpayers conducting *business* in the United States and abroad," as opposed to "sham transactions built solely around tax arbitrage."[10]

The court also looked to the recent codification of the economic substance doctrine, which it viewed as a recognition by Congress that "[a] strictly rule-based tax system cannot efficiently prescribe the appropriate outcome of every conceivable transaction that might be devised," and noted that the statute "did not create categorical exceptions to the doctrine, for foreign tax credits or otherwise."[11]

The Second Circuit next applied the economic substance doctrine to the specific transactions at issue, noting that the calculation of profit in connection with transactions that generate foreign tax credits was an issue of first impression in the circuit. Recognizing a split on the circuit courts that have considered the issue, the court concluded that foreign taxes paid to generate the credits should be treated as a cost when calculating a transaction's pre-tax profitability.

While recognizing that this approach made a given transaction "less likely to appear profitable under the objective prong of the economic substance test,"[12] the court emphasized that the "purpose of calculating pre-tax profit in this context is not to perform mere financial accounting, subtracting costs from revenue on a spreadsheet." Instead, the economic substance doctrine should be used to determine "as a matter of law, whether a transaction meaningfully alters a taxpayer's economic position other than with respect to tax consequences."[13] This formulation emphasizes the Second Circuit's view that courts must play a more rigorous role than merely checking for signs of profit, but should scrutinize the facts of the transaction.

In reaching its conclusion, the Second Circuit cited the U.S. Court of Appeals for the Federal Circuit's decision in *Salem Financial v. United States*, which concluded that a STARS transaction lacked a reasonable profit potential based on treating the foreign taxes paid as a cost, without offsetting that cost with the credits that the tax payments generated.[14] In support of its computation, the Federal Circuit noted that the "critical question is not whether the transaction would produce a net gain after all tax effects are taken into consideration," but instead "whether the transaction has real economic effects apart from its tax effects, whether the transaction was motivated only by tax considerations, and whether the transaction is the sort that Congress intended to be the beneficiary of the foreign tax credit provision."[15]

Fifth and Eight Circuits

The Second and Federal Circuits' approach to the calculation of profit potential in foreign tax credit transactions is at odds with the approach taken by the Fifth and Eighth Circuits. Thus, in *Compaq Computer Corp. v. Commissioner*,[16] and *IES Industries v. United States*,[17] those courts applied the objective test of profitability without regard to either foreign taxes paid or the benefits derived from the credits those payments generated.

Unlike the complex transactions addressed by the Second Circuit, *Compaq* and *IES* examined relatively straightforward transactions involving American Depositary Receipts (ADRs), in which the taxpayer purchased shares of a foreign corporation immediately before it paid out dividends that were subject to foreign taxes. The shares were purchased at market prices that discounted the value of the dividend by the foreign taxes that would be due on the dividends. The taxpayer sold the shares immediately after the dividend was paid, thereby generating both a capital loss on the sale of the shares and a credit based on the foreign taxes paid.

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In *IES*, the U.S. Court of Appeals for the Eighth Circuit reversed the lower court's decision and determined the transaction had economic substance because "the economic benefit to IES was the amount of the *gross* dividend, before the foreign taxes were paid."[18] In *Compaq*, the U.S. Court of Appeals for the Fifth Circuit went further and criticized the lower court's analysis of profitability that treated the foreign tax paid as a cost, which reduced the profit potential, while excluding the U.S. tax consequences.

As the Compaq court stated, "the analysis should either count all tax law effects or not count any of them. To count them only when they subtract from cash flow is to stack the deck against finding the transaction profitable."[19] Thus, "[i]f the effects of tax law, domestic or foreign, are to be accounted for when they subtract from a transaction's net cash flow, tax law effects should be counted when they add to cash flow."[20]

Looking Forward

The two lines of foreign tax credit cases present different views of the economic substance scrutiny that should be applied to transactions that generate foreign tax credits. The Fifth and Eighth Circuits acknowledge that foreign tax credits and other tax benefits may influence the structure of a taxpayer's cross-border transactions, but give more weight to the congressional goal of preventing double taxation. By contrast, the Second and Federal Circuits express greater skepticism and employ a more searching examination of the economic motivation for the transactions.

Going forward, the Second Circuit's focus on the "overall economic effect" provides greater latitude for courts to examine transactions. Indeed, the court approved a more rigorous analysis when it upheld the lower court's view of the circular cash flow as "strongly indicat[ing] that its main purpose was to generate tax benefits,"[21] even though the nature of the cash flows would not have been contemplated by a profit-based examination.

However, as AIG argued in seeking Supreme Court review of the Second Circuit's decision, including foreign taxes as expenses in computing pre-tax income under the objective test "would make most foreign investments look like they lack economic substance and thus disqualify them from a foreign tax credit."[22] Indeed, the approach taken by the Second and Federal Circuits could cause uncertainty as to the overall economic effect of a broad range of cross-border transactions. Absent Supreme Court review, the impacts of the economic substance doctrine on the ability of taxpayers to claim foreign tax credits will continue to be uncertain.

1. H.R. Rep. No. 83-1337, at 76 (1954).
2. Treasury Inspector General for Tax Administration, Improvement is Needed in Compliance Efforts to Identify Unsupported Claims for Foreign Tax Credits, July 16, 2015.
3. See Jeremy H. Temkin, "Redefined Role of Profit in Economic Substance Doctrine," N.Y.L.J. (Nov. 21, 2014).
4. 801 F.3d 104 (2d Cir. 2015).
5. Id. at 113 (citing *Gregory v. Helvering*, 293 U.S. 465, 468-70 (1935)).
6. Id. at 115 (citing *Gilman v. Comm'r*, 933 F.2d 143, 147-48 (2d Cir. 1991)).
7. *Am. Int'l Grp. v. United States*, No. 09 CIV. 1871 (LLS), 2013 WL 1286193, at *5 (S.D.N.Y. March 29, 2013).
8. *Bank of New York Mellon Corp. v. C.I.R.*, 140 T.C. 15, 35-37, 48 (2013) supplemented, 106 T.C.M. (CCH) 367 (T.C. 2013).
9. *Bank of New York Mellon Corp.*, 801 F.3d at 113.
10. Id. at 114. (emphasis in original) (citing *Goldstein v. C.I.R.*, 364 F.2d 734, 741 (2d Cir. 1966)).
11. Id. (alteration in original).
12. Id. at 116.
13. Id. at 118.
14. 786 F.3d 932 (Fed. Cir. 2015).
15. Id. at 948.
16. 277 F.3d 778 (5th Cir. 2001).
17. 253 F.3d 350 (8th Cir. 2001).
18. *IES Indus.*, 253 F.3d at 354 (emphasis in original).
19. *Compaq Computer Corp.*, 277 F.3d at 785.
20. Id.
21. *Bank of New York Mellon Corp.*, 801 F.3d at 122.
22. *American Int'l Gp. v. United States*, 801 F.3d 104 (2d Cir. 2015), petition for cert. filed, No. 15-478, at *15 (U.S. Oct. 13, 2015).