S.T.A.R.S. TRANSACTIONS – JURY IS IN, FOREIGN TAX CREDIT DISALLOWED

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Over the past decade, several U.S. banks have engaged in complex Structured Trust Advantaged Repackaged Securities ("S.T.A.R.S.") transactions promoted by U.K. banks, predominantly Barclays Bank, PLC ("Barclays"). Under these agreements, U.S. banks voluntarily subject certain income-producing assets to U.K. taxation by creating a trust that is deemed to be a U.K. tax resident. Foreign tax credits are then claimed in the U.S. to offset payments made abroad. Treasury regulations under Code §901, proposed in 2007 and finalized in 2011, prohibit S.T.A.R.S. transactions – but not retroactively. Cases involving S.T.A.R.S. transactions that took place prior to the implementation of the regulations have been examined by both the I.R.S. and the courts.

So far, four cases involving S.T.A.R.S. transactions have been published. In all final decisions, the courts held that the very purpose of the S.T.A.R.S. transactions was to generate a foreign tax credit and take advantage of U.S. deductions. Thus, the transactions failed to meet the economic substance requirement for a foreign tax credit to be allowed.

Two notable recent cases involve Wells Fargo & Company ("Wells Fargo") and Santander Holding U.S.A. Inc. ("Santander"). In *Santander*,[1] the District Court in Massachusetts ruled for the taxpayer, allowing the tax bill to be offset by the foreign taxes paid. This was the only S.T.A.R.S. case where a taxpayer prevailed on that issue and a court pushed back a bit against the economic substance doctrine. However, upon appeal to the U.S. Court of Appeals for the First Circuit, the taxpayer lost and the court ruled in favor of the I.R.S., reaffirming and uniting the courts' position that S.T.A.R.S. transactions lack economic substance.

BACKGROUND

S.T.A.R.S. transactions were first explained in our July 2015 edition[2] in which we also covered *Salem Financial, Inc. v. United States*.[3] In *Salem*, the court upheld the I.R.S.'s position on disallowing foreign tax credits resulting from S.T.A.R.S. transaction but allowed the taxpayer to deduct interest expense on borrowings that formed part of the transaction.

The complicated structure and the cash flow in a S.T.A.R.S. transaction is best illustrated by tracing the movement of $100 of trust income. In the following example,

1. *Santander Holding USA, Inc. v. United States*, 144 F. Supp. 3d 239 (D. Mass. 2015).
2. Stanley C. Ruchelman and Christine Long, "S.T.A.R.S. Transactions – Interest Deduction Allowed but Foreign Tax Credit Disallowed," *Insights* 6 (2015).
3. *Salem Financial, Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 2015).

taken from the recent *Wells Fargo* case, both Barclays and a U.S. bank held interests in the trust.

For every $100 in income received by the trust, the U.S. bank would pay approximately $22 in U.K. taxes and then claim a $22 foreign tax credit in the U.S. Barclays would be allocated the trust income and thus report the $100 as income on its U.K. tax return. Barclays would pay 30% in taxes on that $100 income but would also be entitled to a $22 tax credit for the tax that the trust had already paid to the U.K. Thus, effectively, Barclays would pay $8 in U.K. taxes on each $100 of income generated by the trust. Barclays would then "reinvest" the $78 back into the trust in return for additional units that had no value. Because the additional units had no value, Barclays would be able to deduct the $78 as "loss" on its U.K. tax return. Given a 30% tax rate, Barclays would achieve a tax savings of $23.40 on a $78 deduction. In addition, every month Barclays would make a "Bx payment" to the U.S. bank. The monthly Bx payment would amount to $10.45 on each $100 of trust income, thereby reducing the income subject to 30% tax and resulting in an additional $3.14 in tax savings. Thus, Barclays' effective tax rate on a S.T.A.R.S. transaction would be zero and, in fact, would result in a tax benefit of $8.09 for each $100 in trust income – $23.40 in tax savings resulting from the loss deduction, minus $8 in taxes paid to the U.K., minus the $10.45 Bx payment, plus the additional $3.14 in tax savings resulting from the deduction of the Bx payment.[4] The U.K. treasury would collect a net $3.46 in taxes – $22 from the U.S. bank, plus $8 from Barclays, minus the $23.40 and $3.14 in Barclays' tax savings. Lastly, while the U.S. bank would pay $22 in taxes to the U.K., it would also cut its U.S. tax bill by $22 through claiming a foreign tax credit.[5]

THE WELLS FARGO CASE

The U.S. District Court for the District of Minnesota addressed the same issues that had been examined in two previous cases[6] and drew its own reasoning based upon the previously-published opinions. The District Court submitted two issues to a fact-finding jury based on the bank's request. The issues presented to the jury were (i) whether the Bx payment was pre-tax income or a tax benefit, and (ii) whether the S.T.A.R.S. trust and the loan were sham transactions. The jury issued a verdict on November 17, 2016.

The Sham Transaction Doctrine

Under the sham transaction doctrine, a court must disregard a transaction that a taxpayer enters into without a valid business purpose in order to claim tax benefits not contemplated by a reasonable application of the language and purpose of the Code or the regulations.[7] A sham transaction must be disregarded even when the transaction otherwise complies with the literal terms of the relevant statutes and regulations that allow the tax benefits.[8]

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4 *Wells Fargo & Company v. United States*, No. 0:09-cv-02764 (2016).

5 *Id.*

6 *Bank of N.Y. Mellon Corp. v Commr.*, 801 F.3d 104 (2nd Cir. 2015); see also *Salem Financial, Inc. v. United States*, *supra* note 2.

7 *WFC Holdings Corp. v. United States*, 728 F.3d 736, 742 (8th Cir. 2013).

8 *Id.*

In determining whether a particular transaction is a "sham," the Eighth Circuit has traditionally applied the two-prong test set forth in *Rice Toyota World, Inc*.[9] Under that test, a transaction is a sham and should be disregarded for tax purposes if

- it lacks economic substance because no real potential for profit exists apart from tax benefits, and
- it is not motivated by any economic purpose outside of tax considerations.[10]

The first prong of this test is objective and requires that a transaction has "economic substance," while the second prong is subjective and seeks to determine whether the taxpayer has a "business purpose."

In Wells Fargo, in order to decide whether the transaction was a sham, the jury had to determine whether the loan transaction and the trust transaction were parts of one singular transaction or two unrelated transactions. Wells Fargo argued that there was only one transaction, while the I.R.S. argued that these were two separate transactions that were artificially linked to lower Wells Fargo's U.S. tax liability. The jury agreed with the I.R.S. and found that these were two separate transactions, and thus may be treated differently. The jury also found that while the loan transaction had no purpose outside of tax considerations, it did have a "reasonable possibility of pre-tax profits." However, with respect to the trust transactions, the jury found that the structure failed on both prongs of the test, having no non-tax business purpose as well as no "reasonable possibility of pre-tax profit."

"Historically, the First Circuit has been particularly wary of inquiring into the subjective motivations of taxpayers."

THE SANTANDER CASE

Shortly after the *Wells Fargo* decision was published, the Court of Appeals for the First Circuit found that the S.T.A.R.S. transaction in the *Santander* case lacked a legitimate business purpose and that the transaction had no objective economic benefit other than generating a foreign tax credit. With that, the Court of Appeals reversed the decision of the lower court, which had held for the taxpayer and found that the taxpayer had properly claimed both the foreign tax credits and the interest deductions generated by the S.T.A.R.S. transaction. No other lower court decision discussing S.T.A.R.S. transactions had ruled for the taxpayer on its foreign tax credit claim.

The Economic Substance Doctrine

Reversing the District Court's decision to allow tax benefits resulting from a S.T.A.R.S. transaction, the First Circuit ruled that the economic substance doctrine – a judicially-developed doctrine that began with *Gregory v. Helvering*[11] – prevails over a formalistic meeting of the requirements of the law. In *Helvering*, the Supreme Court looked beyond the fact that the transaction technically complied with the statutory requirement and found that it lacked economic substance. Historically, the First Circuit has been particularly wary of inquiring into the subjective motivations of taxpayers, saying "unless Congress makes it abundantly clear, we do not think tax consequences should be dependent upon the discovery of a purpose,

[9] *Rice's Toyota World, Inc. v. Commr.*, 752 F.2d 89, 91-92 (4th Cir. 1985).

[10] *WFC Holdings Corp. v. United States*, *supra* note 6, at 742-743.

[11] *Gregory v. Helvering*, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596 (1935).

or a state of mind, whether it be elaborate or simple."[12] However, in this appeal the court found that the S.T.A.R.S. transaction itself did not have a reasonable prospect of creating a profit without considering the foreign tax credits, and thus it was not a transaction to which Congress had intended to apply the benefit of the foreign tax credit.

In *Santander*, the court did not see the need to address the government's characterization of the Bx payment as a rebate rather than as income and relied on the reasoning in the *Salem* case when it found that the trust structure was put in place solely for tax avoidance reasons and that the structure lacked a *bona fide* business purpose.[13]

The court further stated that the S.T.A.R.S. transaction was profitless because each $1 of profit came with $2 of expense. To return briefly to the $100 hypothetical, even if Santander received a Bx payment of $11 from Barclays (half of the $22 paid by Santander to the U.K. at its 22% tax rate), the trust still lacked a reasonable potential (or any potential) of generating a profit because the $11 Bx payment accompanied an expense of $22 in U.K. tax. In other words, every $1 the trust earned through Bx payments cost $2 in transaction costs from subjecting the trust to U.K. tax. When the primary transaction costs – the U.K. taxes – are factored into the pre-tax profitability calculation, the S.T.A.R.S. transaction is plainly profitless. Santander's "profit" came from the foreign tax credits it claimed for the U.K. taxes combined with a Bx payment calculated as half its U.K. tax liability.[14]

Accordingly, the court concluded that the S.T.A.R.S. transaction had no business objective and no non-tax economic benefit, and that Congress, in creating the foreign tax credit regime, did not intend that it would cover this type of foreign-tax-credit-generator transaction. Exposure to U.K. taxation for the purposes of generating U.S. foreign tax credits was the S.T.A.R.S. transaction's whole function.[15]

CONCLUSION

The Court of Appeals' decision in *Santander* and the jury's decision in *Wells Fargo* both largely agreed with and relied upon the court's decision in *Salem*[16] to allow interest deductions on the loan part of the transaction and reject claims that the S.T.A.R.S. transactions had economic substance, thus disallowing the tax offset provided by the credit for foreign income tax.

When dealing with the economic substance test, the Eighth Circuit applies the two-prong test. However, the court has not yet addressed whether the two-prong test operates conjunctively or disjunctively. While the disjunctive test would be favorable to the taxpayer and may motivate Wells Fargo to appeal the case, it still seems doubtful that the Eighth Circuit would rule for the taxpayer. The government's win in the *Santander* case displayed unanimity among the circuits. All circuits agree that the S.T.A.R.S. transactions lacked economic substance and were not legitimate

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12 *Santander Holding USA, Inc. v. United States*, 2016 U.S. App. (1st Cir. Mass.).

13 *Id.*

14 *Id.*

15 *Id.*

16 *Salem Financial, Inc. v. United States*, *supra* note 2.

business transactions that would entitle the taxpayers to the benefit of foreign tax credits. In two cases involving S.T.A.R.S. transactions,[17] a writ of certiorari was filed with the Supreme Court, arguing that the appeal courts' decisions conflict with earlier cases from the early 2000's. The Supreme Court has thus far denied the consideration of this issue, and in light of government's recent winning streak and the courts unanimity, it is difficult to see a reason for the Supreme Court to do so.

[17] *Id.*; see also *Bank of New York Mellon Corp. v. Commr.*, *supra* note 5.

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