



Federal Tax ADVISORY ■

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Economic Substance Doctrine Cases

Things are heating up in the economic substance doctrine area, which could lead to a U.S. Supreme Court review of the IRS's aggressive arguments for the doctrine.

Certiorari Petitions

Salem Financial Inc. and Bank of New York Mellon Corporation have both petitioned for Supreme Court review of the Federal Circuit and Second Circuit decisions against them, and American International Group Inc. has also petitioned for review of the Second Circuit decision against it. In all three of these cases, the IRS denied the use of foreign tax credits, not because foreign taxes were not paid, but because the taxpayers got some ancillary economic benefit in the deal that generated the foreign tax credits. It is critically important to understand that in these cases the taxpayers' income was subject to both U.S. and foreign tax, and all the taxpayers did was claim the foreign tax credit to avoid double taxation.

The Salem and BNY cases involved what was called the "STARS transaction." The AIG case involved a different sort of transaction that had similar features. All three financial institutions received large loans. As an economic matter, the net interest they paid on the loans turned out to be substantially below market; in other words, the borrowings were good deals for these taxpayers.

The "price" of the good deals was subjecting some of their assets to foreign taxation in a venture with the lender, a foreign bank. That didn't cost the taxpayers anything, but provided a foreign tax benefit to the foreign banks for reasons that don't need to be detailed. The foreign banks shared their windfall with the taxpayers through payments that effected the reduced interest rates.

The IRS viewed the payments as offsetting dollar for dollar the taxpayers' foreign taxes, rather than as interest rate reductions, or even fees for facilitating a foreign tax avoidance scheme. There was no good explanation why the payments should be so treated aside from the smell of the transactions as structured deals resulting in less tax paid to the United States; but of course the less tax was not less tax owing by the taxpayers.

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Now all three of these taxpayers want the Supreme Court to review their losses. That is not surprising because they have, or claim they have, the best reason that an appellant can give to the Supreme Court: a split in the circuits. The split is with the decisions over a decade ago in cases involving IES and Compaq. The courts of appeal allowed them to claim foreign tax credits with respect to dividends on stock bought in the market and held for a short period of time. The IRS viewed the transactions as track shelters; the taxpayers viewed them as normal applications of the dividend and foreign tax credit rules.

The connection between the two sets of cases is that in each, the IRS wanted the profitability of the transactions to be determined by counting the foreign tax paid as an expense and not giving credit for the credit. It is readily apparent that such a method will tend to make all foreign investments uneconomic. The taxpayers have asserted the counting issue as the grounds for certiorari that reflects a conflict in the circuits.

However, the counting issue is not necessarily the cause of the taxpayers' losses. The appellate courts applied the economic substance doctrine to even get to the process of counting up profits. And unfortunately, the taxpayers did not attack that in their petitions, evidently for fear of confusing the issue they hoped would attract the attention of the Supreme Court.

Santander

Meanwhile, the U.S. district judge in Massachusetts has ruled for a taxpayer in another STARS case, *Santander Holdings USA v. United States* (D. Mass. 2015). The decision agreed with the taxpayer on every major point: the taxpayer entered the transaction to obtain a reduced price loan, the foreign lender did not "pay" the taxpayer's taxes, and the taxpayer did not escape any taxes but derived an economic benefit in a deal where it paid taxes on its income.

If the Supreme Court hears one of the pending cases, we likely will have an answer in this area long before the *Santander* case is concluded.

For additional information, call [Jack Cummings](#) at 919.862.2302.

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If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

Federal Tax Group

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481
sam.kaywood@alston.com

Edward Tanenbaum
Co-Chair
212.210.9425
edward.tanenbaum@alston.com

George Abney
404.881.7980
george.abney@alston.com

Scott Harty
404.881.7867
scott.harty@alston.com

Clay A. Littlefield
704.444.1440
clay.littlefield@alston.com

John F. Baron
704.444.1434
john.baron@alston.com

Brian D. Harvel
404.881.4491
brian.harvel@alston.com

Ashley B. Menser
919.862.2209
ashley.menser@alston.com

Henry J. Birnkrant
202.239.3319
henry.birnkrant@alston.com

L. Andrew Immerman
404.881.7532
andy.immerman@alston.com

Matthew Moseley
202.239.3828
matthew.moseley@alston.com

James E. Croker, Jr.
202.239.3309
jim.croker@alston.com

Stefanie E. Kavanagh
202.239.3914
stefanie.kavanagh@alston.com

Danny Reach
704.444.1272
danny.reach@alston.com

Jasper L. Cummings, Jr.
919.862.2302
jack.cummings@alston.com

Brian E. Lebowitz
202.239.3394
brian.lebowitz@alston.com

Heather Ripley
212.210.9549
heather.ripley@alston.com

ALSTON & BIRD

WWW.ALSTON.COM

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ATLANTA: One Atlantic Center ■ 1201 West Peachtree Street ■ Atlanta, Georgia, USA, 30309-3424 ■ 404.881.7000 ■ Fax: 404.881.7777
BEIJING: Hanwei Plaza West Wing ■ Suite 21B2 ■ No. 7 Guanghua Road ■ Chaoyang District ■ Beijing, 100004 CN
BRUSSELS: Level 20 Bastion Tower ■ Place du Champ de Mars ■ B-1050 Brussels, BE ■ +32 2 550 3700 ■ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ■ 101 South Tryon Street ■ Suite 4000 ■ Charlotte, North Carolina, USA, 28280-4000 ■ 704.444.1000 ■ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ■ 18th Floor ■ Dallas, Texas, USA, 75201 ■ 214.922.3400 ■ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ■ 16th Floor ■ Los Angeles, California, USA, 90071-3004 ■ 213.576.1000 ■ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ■ 15th Floor ■ New York, New York, USA, 10016-1387 ■ 212.210.9400 ■ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ■ Suite 400 ■ Durham, North Carolina, USA, 27703-85802 ■ 919.862.2200 ■ Fax: 919.862.2260
SILICON VALLEY: 1950 University Avenue ■ 5th Floor ■ East Palo Alto, California, USA, 94303-2282 ■ 650.838.2000 ■ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ■ 950 F Street, NW ■ Washington, DC, USA, 20004-1404 ■ 202.239.3300 ■ Fax: 202.239.3333