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Nicholas Giordano

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PUTTING THE SUBSTANCE BACK INTO THE ECONOMIC SUBSTANCE DOCTRINE

ABSTRACT

*The foreign tax credit, which saves U.S. taxpayers from paying both foreign and domestic income taxes on the same income, is critical to facilitating global commerce. However, as savvy taxpayers discover increasingly complicated ways to abuse the foreign tax credit regime through the structuring of business transactions, courts have become increasingly skeptical of the validity of those transactions. Using the economic substance doctrine, a common law doctrine codified in 2010 at I.R.C. § 7701(o), courts will disallow tax benefits stemming from a transaction that is not profitable absent its tax benefits, and which the taxpayer had no incentive to undertake except for its tax benefits. While the statute seems clear on its face, there is a deep split among the U.S. Courts of Appeals over what constitutes the exact transaction to be analyzed. In *Bank of New York Mellon Corp. v. Commissioner*, the U.S. Court of Appeals for the Second Circuit held that, while a court will not consider a foreign tax credit received as profit arising from a transaction, it will also deduct the costs of paying foreign taxes as a cost of the transaction. Conversely, the U.S. Courts of Appeals for the Fifth and Eighth Circuits consider tax credits earned as profit and subtract the costs of paying foreign taxes when applying the doctrine. This Note argues that the Second Circuit decision renders taxpayers all but powerless to survive economic substance scrutiny, and that the Supreme Court should create bright-line precedent defining what constitutes a transaction for economic substance purposes, more closely adhering to the Fifth and Eighth Circuit approaches.*

INTRODUCTION

Double taxation, the idea that a taxpayer would pay taxes on the same income more than once, seems to be inherently unfair. United States taxpayers conducting business in foreign countries and incurring tax obligations on income derived therefrom are especially susceptible to this kind of predicament. Indeed, the Internal Revenue Code contains protections against “the evil of double taxation.”¹ The relevant provisions, enacted in I.R.C. §§ 901–909, constitute what is known as the “foreign tax credit regime.”² These provisions provide, among other things, that a U.S. taxpayer that pays income taxes in another country will receive a tax credit against its U.S. tax liability for the amount of foreign taxes paid.³ Hence, foreign tax

1. *Bank of N.Y. Mellon Corp. v. Comm’r*, 801 F.3d 104, 107 (2d Cir. 2015) (citing *Burnet v. Chi. Portrait Co.*, 285 U.S. 1, 7 (1932)).

2. *See id.*; *see also* I.R.C. §§ 901–909 (2012).

3. *See* I.R.C. §§ 901–909.

credits are important to any taxpayer conducting business overseas, because they save the taxpayer from unfair double taxation.

However, while the statute is meant to facilitate global commerce,⁴ some taxpayers have found ways to abuse the system through disingenuous transactions meant only to create tax benefits and nothing more.⁵ To counter these abuses, the courts have adopted a test, the economic substance doctrine, to root out sham transactions, and they will disallow any foreign tax benefits that would normally occur in such a situation.⁶ Courts have established that “[a] transaction is a sham if it is fictitious or if it has no business purpose or economic effect other than the creation of tax deductions.”⁷ In other words, the transaction must have economic substance.

Under the economic substance doctrine, courts look at: (1) whether the transaction could objectively have turned a profit that was not a tax benefit (the objective prong);⁸ and (2) whether there was “a subjective non-tax business purpose for entering in the transaction” (the subjective prong).⁹ Some courts have applied the doctrine loosely,¹⁰ but all iterations center around these two prongs. Congress codified the economic substance doctrine as a part of the Health Care and Education Reconciliation Act in 2010.¹¹ The statute, codified as I.R.C. § 7701(o), is titled, “Clarification of economic substance doctrine,” and it provides for substantially the same two-prong inquiry that some courts previously utilized under the common law.¹²

On September 9, 2015, the U.S. Court of Appeals for the Second Circuit handed down an opinion that significantly impacted the landscape surrounding foreign tax credits and their permissibility in tax-structured transactions. In *Bank of New York Mellon Corp. v. Commissioner (BNY)*, the Second Circuit affirmed the Tax Court’s holding that tax benefits generated by an elaborate circular trust were inapplicable, because the transaction had no economic substance.¹³ The Second Circuit held, among other things, that “foreign taxes are economic costs and should . . . be deducted when calculating pre-tax profit” under the objective prong of the economic

4. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 118.

5. *See, e.g.*, *Gregory v. Helvering*, 293 U.S. 465, 470 (1935).

6. *Id.* at 469–70.

7. *DeMartino v. Comm’r*, 862 F.2d 400, 406 (2d Cir. 1988).

8. *Gilman v. Comm’r*, 933 F.2d 143, 149 (2d Cir. 1991) (“The Court’s conclusion that Gilman lacked a business purpose . . . reflected the fact that the tax benefits were the motivation: once the documentation established those benefits, Gilman was unconcerned about residual value. Even if the residual value was zero, the tax benefits made the arrangement attractive.”).

9. *Id.* at 147–48.

10. *See, e.g.*, *Altria Grp., v. United States*, 694 F. Supp. 2d 259, 282 (S.D.N.Y. 2010).

11. *See* Richard M. Lipton, *New Guidance Sheds Light on Economic Substance Doctrine and Related Penalties*, 121 J. TAX’N 266, 268 (2014).

12. The codified economic substance provides that a transaction has economic substance only if (A) “the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position,” and (B) “the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.” I.R.C. § 7701(o) (2012).

13. *See* *Bank of N.Y. Mellon Corp. v. Comm’r*, 801 F.3d 104, 124–25 (2d Cir. 2015).

substance doctrine, while any tax benefits from the suspect tax credits should not be counted toward the transaction's profitability.¹⁴

The transaction at issue in this case, a loan product called Structured Trust Advantaged Repackaged Securities (STARS), was the result of an elaborate transaction between a U.S. company, Bank of New York (BNY), and a U.K. company, Barclays Bank PLC (Barclays).¹⁵ Through the transaction, BNY sought to avoid paying taxes in the United Kingdom, receive foreign tax credits in the United States, and benefit from loan proceeds, all at the same time. Barclays loaned \$1.5 billion to BNY through a series of transactions involving BNY and its subsidiaries.¹⁶ Ultimately, the money was invested into a trust, which BNY created prior to effectuating the transaction.¹⁷ The trustee was a U.K. based subsidiary of BNY, subject to U.K. tax law.¹⁸ When dividends were paid out to the U.K. trustee, BNY covered the resulting U.K. tax liabilities;¹⁹ however, because Barclays received tax credits under U.K. tax law, it returned half of the resulting tax spread to BNY.²⁰ Effectively, BNY paid the full amount of U.K. taxes, received U.S. tax credits for that whole amount, and was subsequently reimbursed by Barclays for half the U.K. taxes it paid.²¹ In short, BNY circulated money through the STARS structure, incurred heavy foreign tax burdens, and used the resulting tax benefits under U.S. tax law to offset its U.S. tax bill.

The issue of how to analyze transactions under the objective and subjective prongs of the economic substance doctrine is not new and presents difficulties in its application to international business transactions. The Second Circuit acknowledged that its holding in *BNY* diverged from holdings in the Fifth and Eighth Circuits on the issue of calculating profitability in economic substance analyses.²² In *Compaq Computer Corp. v. Commissioner*, the Fifth Circuit held that “[i]f the effects of [a] tax law . . . 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.”²³ Under this less rigorous analysis, the Fifth Circuit found that a transaction Compaq entered into met the requirements of the economic substance doctrine.²⁴ In *IES Industries v. United States*, the Eighth Circuit joined the Fifth Circuit in

14. *Id.* at 124.

15. *Bank of N.Y. Mellon Corp. v. Comm’r*, 140 T.C. 15, 16 (2013).

16. *See id.* at 18.

17. *Id.* at 17–18.

18. *Id.* at 25.

19. *Id.* at 42 n.14.

20. *Id.*

21. *Id.*

22. *See generally* *Compaq Comput. Corp. & Subsidiaries v. Comm’r*, 277 F.3d 778 (5th Cir. 2001); *IES Indus., Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001).

23. *Compaq Comput. Corp.*, 277 F.3d at 785.

24. *Id.* at 788.

its broader calculation of profitability, holding that the transaction at issue in that case needed to be viewed as a whole.²⁵

The problem with the codified economic substance doctrine today, as this Note highlights, is that Circuits are applying the doctrine inconsistently, counteracting the apparent goal of its codification.²⁶ The ramification is that decisions on whether tax benefits will be allowed where the Internal Revenue Service (IRS) challenges a transaction under the economic substance doctrine are unpredictable. Furthermore, as this Note argues, the current, stringent application of the codified doctrine renders it almost impossible for the taxpayer to overcome economic substance scrutiny.

This Note argues that, while the Second Circuit was ultimately correct in its *BNY* holding that STARS-like transactions do not have economic substance,²⁷ it erred in bifurcating the transaction at issue. Additionally, this Note argues that the Second Circuit should have considered the foreign tax benefits *BNY* received as profit from the transaction, because Congress intended the courts to formulate a unified method of applying the economic substance doctrine that comports with the statutory intent behind permitting tax benefits. Thus, the Supreme Court should solve the problems with application of the economic substance doctrine by crafting a bright-line rule in accordance with these arguments.

Part I of this Note gives an in-depth explanation of the complicated transaction and proceedings of *BNY*. Parts II and III explain the history of economic substance jurisprudence, both before and after codification of the economic substance doctrine. Part III further explains why the issues surrounding the doctrine have persisted even after its codification. Part IV argues the Second Circuit erred in bifurcating the \$1.5 billion Barclays loan from the STARS transaction in *BNY*, because the Court relied on tenuously connected case law, thereby vitiating the concept of two-pronged economic substance scrutiny, and producing precedent that will unduly militate against taxpayers in the future. Part V argues the Second Circuit erred in discounting the tax benefits attributed to the STARS transaction as separate and apart from the transaction when, in reality, they contributed to its objective profitability, which undermines the purpose of the foreign tax credit regime and creates a windfall for the IRS and the government. Finally, Part VI explains how Congress invited the courts to use common law application of the doctrine to allow statutorily intended tax benefits and disallow unintended benefits. Without the Supreme Court's intervention, this goal cannot be achieved.

25. *IES Indus., Inc.*, 253 F.3d at 356.

26. Compare *Compaq Comput. Corp.*, 277 F.3d at 785 (applying a more taxpayer-friendly economic substance scrutiny), with *Bank of N.Y. Mellon Corp.*, 140 T.C. at 35 n.9 (disagreeing with the *Compaq* court and applying a more stringent version of economic substance scrutiny).

27. *Bank of N.Y. Mellon Corp. v. Comm'r*, 801 F.3d 104, 124–25 (2d Cir. 2015).

I. THE PRINCIPAL CASE: BNY

BNY was a wholly owned subsidiary of the Bank of New York Company, Inc. (BNY Parent), when BNY Parent merged with Mellon Financial Corp.²⁸ BNY transacted business globally, and in 2001 agreed to enter into a STARS transaction with U.K.-based Barclays.²⁹ The term of the transaction lasted from 2001 until 2006.³⁰ For the years 2001 and 2002, as a result of the STARS transaction, BNY enjoyed foreign tax credits in the amounts of \$98,607,973 and \$100,285,767 each respective year.³¹ Barclays and a tax advisory firm, KPMG, enticed BNY to enter into the STARS transaction to obtain a low-cost loan in the amount of about \$1.5 billion.³² Barclays was to serve as the U.K. counterparty, which would achieve the desired tax benefits that allowed Barclays to loan the money at a low rate.³³

The steps to achieve the transaction occurred as follows: First, BNY contributed \$6.46 billion worth of assets to BNY REIT Holdings, Inc.³⁴ Next, BNY organized BNY Investment Holdings LLC (InvestCo), and REIT Holdings capitalized the company with \$10.409 billion in assets.³⁵ Then, BNY organized BNY Delaware Funding, LLC (DelCo), and InvestCo capitalized DelCo with \$9.243 billion in assets.³⁶ In return, DelCo issued two classes of stock to InvestCo, which effectively gave InvestCo all voting rights and the right to nearly all asset distributions DelCo would make.³⁷ Then, BNY formed the BNY STARS Trust (the Trust).³⁸ InvestCo transferred the remaining \$1.2 billion in STARS assets to the Trust. Finally, BNY formed BNY NewCo Funding, LLC (NewCo), and gave InvestCo a complete ownership interest in NewCo through a series of exchanges.³⁹

After the formation of these companies, Barclays made a series of transactions, which had the effect of loaning BNY \$1.5 billion at LIBOR⁴⁰ plus twenty basis points.⁴¹ To give the STARS transaction its intended purpose, BNY and its counterparty Barclays replaced the U.S. trustee of the Trust with the Bank of New York Trust and Depository Company Limited, a U.K. trustee that paid U.K. taxes, not U.S. taxes.⁴² Importantly, BNY

28. *Bank of N.Y. Mellon Corp.*, 140 T.C. at 17.

29. *Id.* at 16–17.

30. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 110.

31. *Bank of N.Y. Mellon Corp.*, 140 T.C. at 29–30.

32. *Id.* at 17.

33. *Id.*

34. *Id.* at 18.

35. *Id.*

36. *Id.* at 19.

37. InvestCo held 99% of the DelCo shares. *Id.*

38. *Id.*

39. *Id.* at 20.

40. “LIBOR” stands for “London Interbank Offering Rate.” *Id.* at 19 n.5.

41. *Id.* at 23–24.

42. *Id.* at 25–26.

completely owned the U.K. trustee, which was a BNY subsidiary.⁴³ Through a series of transactions, BNY accelerated the Trust's generation of tax obligations by creating lump-sum payments from the Trust, resulting in \$402 million of taxable income in the United Kingdom.⁴⁴

Due to the nature of this transaction, and its interaction with U.K. tax law, Barclays received a tax credit for 22% of its 30% tax rate, among other tax deductions.⁴⁵ Regardless of the amount owed, BNY agreed to pay the total tax liability Barclays incurred, for which BNY then received a tax credit, as well as a reimbursement for half of the tax amount from Barclays.⁴⁶ Thus, economically, the transaction served both Barclays and BNY well, especially given the foreign tax credits BNY claimed it was entitled to. However, the IRS found that there were tax deficiencies totaling approximately \$215 million in BNY's federal income tax for the years 2001 and 2002, as a result of the claimed foreign tax credits.⁴⁷ BNY contended that it was entitled to the tax credits, and thus there were no deficiencies in its tax liabilities.⁴⁸ The Tax Court ruled against BNY and the Second Circuit affirmed the Tax Court's decision.⁴⁹

The Tax Court conducted an analysis of the case under the aforementioned economic substance doctrine, and conducted a bifurcation of BNY's transaction.⁵⁰ The Tax Court held that the STARS transaction lacked economic substance and, therefore, BNY was not entitled to claim foreign tax credits resulting from the transaction.⁵¹ As previously discussed, the economic substance doctrine analysis has two prongs: an objective prong (whether there was profitability in the transaction aside from tax benefits) and a subjective prong (whether there was a non-tax business rationale for entering the transaction).⁵²

First, the Tax Court concluded that under the economic substance analysis the court ought to bifurcate the transaction and look only at the

43. *Id.* at 25.

44. *Id.* at 25–26.

45. *Id.* at 28.

46. *Bank of N.Y. Mellon Corp. v. Comm'r*, 801 F.3d 104, 111 (2d Cir. 2015) (“Each month, for every \$100 of trust income, the trust would set aside \$22 to pay U.K. taxes, with \$78 remaining for distribution. Because the \$78 was first transferred to Barclays’ blocked account and then back to the trust, Barclays could treat the re-contributed \$78 as a trading loss and claim a trading loss deduction under U.K. tax law. At the 30% corporate tax rate, the deduction translated to a \$23.40 reduction in Barclays’ U.K. taxes (\$78 x 30%) . . . Barclays would pay the \$11 tax-spread to BNY—half the trust’s U.K. tax bill of \$22. Because Barclays would deduct the cost of the tax-spread from its U.K. corporate taxes, it gained an additional \$3.30 in tax benefit (\$11 x 30%). In the end, this left Barclays with \$7.70 in total tax benefit for each \$100 of trust income (\$15.40 minus the tax-spread payment of \$11, plus the tax-spread deduction of \$3.30)). *Id.*

47. *Bank of N.Y. Mellon Corp.*, 140 T.C. at 16.

48. *Id.* at 16.

49. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 124.

50. *Bank of N.Y. Mellon Corp.*, 140 T.C. at 16.

51. *Id.*

52. *Id.* at 32.

STARS tax spread and Trust structure when determining the objective profitability of the STARS transaction.⁵³ Consequently, the court disregarded the \$1.5 billion Barclays loaned BNY.⁵⁴ The Tax Court held that the STARS transaction had no chance of profitability and therefore failed the objective prong of the economic substance analysis.⁵⁵ Moreover, the court disagreed with BNY's argument that the court should have at least looked at the income the loan transaction generated.⁵⁶

Second, the Tax Court found that the transaction did not have subjective economic substance, because BNY had no "legitimate non-tax business purpose for the use of the STARS structure."⁵⁷ Interestingly, having bifurcated the transaction, the Tax Court rejected BNY's argument that the STARS transaction was a way to obtain a low-cost loan from Barclays.⁵⁸ It also rejected BNY's argument that the only way Barclays would agree to the \$1.5 billion loan was if BNY also agreed to form the STARS structure.⁵⁹ In sum, through a drawn out analysis the Tax Court refused to consider any profit that BNY might have obtained by entering into Barclay's STARS-related loan.⁶⁰ Hence, the Tax Court found that the only motivation behind the transaction was obtaining tax-benefits, and thus that the transaction had no economic substance.⁶¹

On appeal, the Second Circuit agreed with the entirety of the Tax Court's decision, including its bifurcation of the transaction.⁶² Critically, the Second Circuit held that, "in calculating pre-tax profit, [it is appropriate] for a court both to include the foreign taxes paid and to exclude the foreign tax credits claimed."⁶³ The Second Circuit also held, in looking at the \$1.5 billion loan as a separate transaction, that the transaction *did* have economic substance, and the court allowed BNY to deduct expenses paid on proceeds from that loan.⁶⁴ BNY, however, continued to insist on appeal that the only reason it was able to obtain the loan at an affordable rate from Barclays was by employing the STARS structure.⁶⁵ That the court bifurcated the transaction seemed unfair to BNY, because the money that BNY stood to make from the entire transaction was income produced by the loan from Barclays.⁶⁶ Moreover, the fact that the Second Circuit and the Tax Court construed the

53. *Id.* at 33–34.

54. *Id.*

55. *Id.* at 35.

56. *Id.* at 37.

57. *Id.*

58. *Id.* at 37.

59. *Id.* at 39.

60. *Id.* at 44–46.

61. *Id.*

62. *Bank of N.Y. Mellon Corp. v. Comm'r*, 801 F.3d 104, 124–25 (2d Cir. 2015).

63. *Id.* at 124.

64. *Id.* at 125.

65. *Id.* at 122–23.

66. *Id.*

tax payments and benefits in the least beneficial light for BNY made it difficult for BNY to prove any kind of profitability from the transaction.⁶⁷

II. A BRIEF HISTORY OF THE ECONOMIC SUBSTANCE DOCTRINE

The modern, common law economic substance doctrine consists of three inquiries: (1) whether the taxpayer had a non-tax business purpose for performing the transaction; (2) whether the transaction placed the taxpayer in a better business position in ways other than the generation of tax benefits; and (3) whether the tax benefits the taxpayer stands to receive are what Congress intended.⁶⁸ The courts analyzed economic substance as a common law doctrine from the 1930s⁶⁹ until it was codified into statutory law as I.R.C. §7701(o) in 2010.⁷⁰

The popular belief is that the economic substance doctrine finds its roots in the 1935 Supreme Court case *Gregory v. Helvering*.⁷¹ In that case, the taxpayer owned a corporation, which held 1000 shares of another corporation's stock.⁷² The taxpayer formed a third corporation, transferred the 1000 shares to the newly formed entity, and liquidated that new corporation three days later.⁷³ The effect was that, under the applicable tax code, the taxpayer claimed a large amount of tax-exemptions while, if she had not pointlessly reorganized the corporations, she would have been subject to a much higher tax liability and would have had fewer exemptions.⁷⁴

Justice Sutherland opined that it is the taxpayer's prerogative and right to use whatever tax write-offs they are entitled to under the law, "[b]ut the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."⁷⁵ Looking at the transaction apart from tax benefits, the Court found that the transaction had no business purpose, as it did not affect the taxpayer's business other than by creating tax deductions.⁷⁶ However, some scholars have argued that the

67. The Tax Court disregarded the payments made to BNY by Barclays for the taxes (the "tax spread"), disregarded the tax benefits BNY received as a result of those payments, and disregarded any income to be made on the loan it received from Barclays. *Id.* at 121–25.

68. Jeff Rector, *A Review of the Economic Substance Doctrine*, 10 STAN. J.L. BUS. & FIN. 173, 174–78 (2004).

69. *See Gregory v. Helvering*, 293 U.S. 465, 469–70 (1935).

70. I.R.C. § 7701(o) (2012).

71. *See Gregory*, 293 U.S. at 469–70.

72. *Id.* at 467.

73. *Id.* at 467–68.

74. *Id.* at 469–70.

75. *Id.*

76. *Id.*

Second Circuit's earlier opinion in *Gregory*,⁷⁷ penned by Judge Learned Hand, is the more important and influential opinion.⁷⁸

The next formative case in the history of the economic substance doctrine was *Gilbert v. Commissioner*.⁷⁹ Judge Hand reappears in *Gilbert*, this time writing a dissenting opinion that the Supreme Court would later adopt.⁸⁰ In Hand's *Gilbert* dissent, he shifts the test for economic substance from a question of law, as it was in *Gregory*,⁸¹ to a question of fact.⁸² The *Gilbert* economic substance analysis asks, then, whether the transaction will "appreciably affect [the taxpayer's] beneficial interest," apart from providing a tax benefit.⁸³ In other words, the question *Gilbert* asks is whether a taxpayer hoped to get anything out of the transaction at issue aside from tax benefits.⁸⁴ This differs significantly from *Gregory*, as the burden shifted to the taxpayer to show that there was some hope of profitability in the transaction, which is one of the current economic substance doctrine prongs.⁸⁵ The Supreme Court adopted Hand's *Gilbert* test in the 1960 case *Knetsch v. United States*.⁸⁶

However, it was not until 1978 that the Supreme Court formally adopted the modern economic substance doctrine.⁸⁷ In *Frank Lyon Co. v. United States*, Frank Lyon entered into a sale-leaseback agreement in which it bought a building from Worthen Bank, with the express agreement that it would lease the building back to Worthen.⁸⁸ Frank Lyon was able to claim tax deductions from depreciation on the building, interests it paid on construction loans, as well as other expenditures.⁸⁹ However, it also stood to profit from the transaction, because it over-paid for the building by \$500,000 more than the mortgage financing, claiming it was essentially an investment.⁹⁰ According to Frank Lyon, it would receive a rate of return on the investment of six percent.⁹¹ The IRS disallowed the tax benefits, claiming that the transaction was a sham and could have been completed as a simple

77. See generally *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934).

78. See, e.g., Rector, *supra* note 68, at 175 (arguing that Judge Learned Hand's opinion is now the most influential and most quoted in modern economic substance doctrine opinions); see also William J. Kolarik II & Stephen N.J. Wlodychak, *The Economic Substance Doctrine in Federal and State Taxation*, 67 TAX L. 715, 716–17 (2014) (arguing that Judge Learned Hand is responsible for developing the modern economic substance known today).

79. See generally *Gilbert v. Comm'r*, 248 F.2d 399 (2d Cir. 1957).

80. See generally *Knetsch v. United States*, 364 U.S. 361 (1960).

81. *Gregory v. Helvering*, 293 U.S. 465, 469–70 (1935).

82. See Kolarik II & Wlodychak, *supra* note 78, at 741.

83. *Gilbert*, 248 F.2d at 411.

84. *Id.*

85. See generally *Gregory*, 293 U.S. at 465; see also I.R.C. § 7701(o)(1)(A) (2012).

86. See generally *Knetsch v. United States*, 364 U.S. 361 (1960).

87. See *Frank Lyon Co. v. United States*, 435 U.S. 561, 583–84 (1978).

88. See *id.* at 564–67.

89. See *id.* at 567.

90. See *id.*

91. See *id.*

financing transaction.⁹² It further claimed that Worthen, in fact, never relinquished ownership of the building at all.⁹³

In upholding Frank Lyon's right to the tax deductions, Justice Blackmun gave explicit effect to the two-part economic substance doctrine known today:

Where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.⁹⁴

The benefit of having a case such as *Frank Lyon* is that it clearly lays out the economic substance doctrine and the inquiry it necessitates. However, the holding in the case does not *explicitly* say that there is a two-prong test. After *Frank Lyon*, the Circuits deeply split over how exactly to apply the economic substance doctrine.⁹⁵

First, Circuits split over whether the economic substance doctrine carries a pass or a fail presumption.⁹⁶ The Third, Fourth, and Seventh Circuits presume that a suspect transaction has economic substance if only one of the economic substance prongs have been satisfied.⁹⁷ The remaining Circuits except for the First and Fifth, which have yet to address the question directly, presume the transaction to fail under the same circumstances.⁹⁸ Second, the Circuits have also split over whether or not *Frank Lyon* sets forward a two-prong inquiry to begin with.⁹⁹ Some Circuits have decided that no case has explicitly set forth today's two-prong analysis.¹⁰⁰ Those courts use the two prongs of the test as factors to consider, not prongs to be satisfied.¹⁰¹ However, the problem with the precedent regarding the economic substance doctrine is that a statute that is ambiguous in its own right has superseded it.

III. CODIFICATION OF THE ECONOMIC SUBSTANCE DOCTRINE: MORE PROBLEMS

Congress codified the economic substance doctrine as a part of the Health Care and Education Reconciliation Act in 2010.¹⁰² The statute, codified at

92. *See id.* at 573.

93. *See id.*

94. *Id.* at 583–84.

95. *See, e.g.,* Rector, *supra* note 68, at 177–78 (arguing that the Circuit Court decisions have varied widely on how to apply the economic substance doctrine).

96. *Id.* at 178.

97. *Id.*

98. *Rice's Toyota World, Inc. v. Comm'r*, 752 F.2d 89, 91 (4th Cir. 1985).

99. Rector, *supra* note 68, at 178.

100. *See, e.g.,* Gilman v. Comm'r, 933 F.2d 143, 148 (2d Cir. 1991).

101. *Id.*

102. Lipton, *supra* note 11, at 268.

I.R.C. § 7701(o), is titled, “Clarification of economic substance doctrine,” and it provides for substantially the same two-prong inquiry that some Circuits utilized under the common law.¹⁰³ Importantly, the statute codified the form of the economic substance inquiry that has a fail presumption built into it.¹⁰⁴

In fact, when comparing the statute with the previously discussed history of the economic substance doctrine, one sees that Congress has enacted the toughest possible form of the doctrine. The statute not only has the fail presumption, but also provides the rigid two-prong test.¹⁰⁵ It allows no wiggle room for situations where application of the statute may allow an unfair result. Instead, the statute makes it more difficult for a taxpayer to prove a transaction is valid. Unfortunately, the statute does not provide clarification as to how the courts are supposed to apply this two-prong test. Since the codification of the economic substance doctrine, some scholars have suggested looking to congressional intent to resolve this issue, because Congress has not provided any express guidance as to what constitutes a “transaction” for economic substance doctrine purposes.¹⁰⁶

Following *BNY*, the statutory economic substance doctrine renders it even more difficult for a taxpayer paying foreign taxes to prove that a transaction has economic substance. In relevant portion, I.R.C. § 7701(o)(2)(B) provides that “[t]he Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.”¹⁰⁷ With this subsection, Congress seemed to be directly targeting STARS-like transactions and wanted to make it more difficult for a company such as *BNY* to be able to justify a circular transaction.¹⁰⁸ However, Congress failed to provide clarification in a crucial area of the economic substance doctrine debate, which may be causing more problems than the purported strength or weakness of the doctrine itself.

Unfortunately, Congress enacting the economic substance doctrine into legislation has not alleviated the problems with its inconsistent application, because the statute does not give any guidance on how courts should apply the prongs of the test. Congress provides guidance to courts and the IRS on how to adjudge whether a transaction has economic substance, yet does not tell them how to decipher what the transaction to be evaluated is. While this may not have posed a significant problem in simpler fact patterns, such as

103. I.R.C. § 7701(o)(1) (2012).

104. *Id.* § 7701(o)(1)(A)–(B).

105. *Id.*

106. See, e.g., Charlene D. Luke, *The Relevance Games: Congress’s Choices for Economic Substance Gamemakers*, 66 TAX L. 551, 554–56 (2013) (arguing that the long period of legislative history that preceded the codification of the economic substance doctrine is the key to understanding how the doctrine is to be applied post-codification).

107. I.R.C. § 7701(o)(2)(B).

108. *Bank of N.Y. Mellon Corp. v. Comm’r*, 801 F.3d 104, 121–23 (2d Cir. 2015).

one finds in *Gregory*, financial transactions have become significantly more complicated over the years.¹⁰⁹

Take, for example, *ACM Partnership v. Commissioner*,¹¹⁰ which is a salient indicator of the problem with application of the economic substance doctrine as it has developed since the 1930s. In *ACM*, the Colgate-Palmolive Company (Colgate) used a Contingent Installment Sale (CINS) transaction, to take advantage of the “ratable basis recovery rule.”¹¹¹ The transaction, marketed by Merrill-Lynch as a tax shelter, generated capital losses in excess of \$84 million, the tax deductions of which were used to offset taxes Colgate incurred through the sale of a subsidiary company (in the amount of about \$105 million).¹¹² Essentially, Colgate entered into a partnership with a non-U.S. taxpayer and the partners used newly formed companies to accrue debt, contribute equity to the partnership, and circulate debts and notes, selling assets for a loss.¹¹³ Payments were bred to come under the guise of the ratable basis recovery rule and enabled Colgate to claim tax deductions from capital losses.¹¹⁴

In reality, the shifting of funds was much more complicated, but the gist of the entire transaction was to generate tax benefits through farming capital losses. Both the Tax Court and the District Court denied the tax benefits,¹¹⁵ finding that the partnership was “not entitled to recognize a phantom loss from a transaction that lacks economic substance.”¹¹⁶ In *ACM*, the Eleventh Circuit looked at each step in the creation of the benefits as a series of transactions, starting at the creation of the partnership.¹¹⁷ Looking at the transaction through this lens, the court held that the funds did not actually change the economic position of the taxpayer, and purposefully so.¹¹⁸ The reasoning was clear, because ACM caused assets and debts to be sold only in a way that made certain the principal value of the sold equity or debt remained as close to constant as possible, so that interest payments made from the partnership would remain fixed.¹¹⁹ Upon finding that ACM had not satisfied the objective prong of the economic substance inquiry, the court rejected ACM’s subjective prong arguments for the merits of the

109. See, e.g., *ACM P’ship v. Comm’r*, 157 F.3d 231 (3d Cir. 1998) (The transaction in *ACM Partnership v. Commissioner* involved multiple steps, partners, and circulation of debt, notes, and currency through a partnership.); see also *Bank of N.Y. Mellon Corp.*, 801 F.3d at 110–11 (noting that the STARS transaction is itself convoluted).

110. See generally *ACM P’ship*, 157 F.3d at 231.

111. Kolarik II & Wlodychak, *supra* note 78, at 753.

112. *ACM P’ship*, 157 F.3d at 233, 243.

113. *Id.* at 238–42.

114. *Id.*

115. *Id.* at 244–45.

116. *Id.* at 245 (citing *ACM P’ship v. Comm’r*, 73 T.C.M. (CCH) 2189, 2215 (T.C. 1997)).

117. *Id.* at 251–52.

118. *Id.*

119. *Id.*

transaction.¹²⁰ Today, the fail-presumptive nature of the statute means that ACM would have lost solely on the objective inquiry holding.¹²¹

Transactions such as the CINS transaction at issue in *ACM* have become commonplace for corporate taxpayers looking to offset their tax burdens today.¹²² Although the economic substance doctrine is now codified, courts must still decide the scope of the transaction to undergo economic substance scrutiny. However, the problem of framing the transaction to be analyzed persists, because courts are broadening or narrowing the scope of a transaction in a manner that best suits the court's respective views on the merits of the transaction. For example, in *United Parcel Service of America, Inc. v. Commissioner* the Eleventh Circuit chose to look at the suspect transaction as the sum of its parts,¹²³ while the Federal Circuit has held that only the single transaction that created the tax benefits at issue is relevant to economic substance scrutiny.¹²⁴

Hence, the underlying problem surrounding the current statutory economic substance doctrine is not that the statute is wrong or that it inherently causes unfair results. Rather, the problem lies in determining the transaction to be tested, most often under the objective prong of the analysis. The result of statutory silence and disagreement among the Circuits regarding the framing of transactions is that courts and the federal government have too much power to invalidate transactions as they see fit. By narrowing a transaction to only one part of what in reality is a series of connected transactions, a court may all but explicitly preclude a taxpayer from defending the transaction as it actually took place. For this reason, this Note argues that it is upon the Supreme Court to supply a bright-line rule interpreting the statutory economic substance doctrine and disallowing the courts from narrowing their focus on a single part of a series of transactions. *BNY* is a prime example of this type of narrow analysis, because the Second Circuit narrowed the transaction in multiple ways, all of which were meant to foist the weight of the economic substance doctrine onto the shoulders of the taxpayer.

120. *Id.* at 252–54.

121. I.R.C. § 7701(o)(1)(A)–(B) (2012).

122. *See, e.g., Bank of N.Y. Mellon Corp. v. Comm'r*, 801 F.3d 104, 122–25 (2d Cir. 2015).

123. In *United Parcel Service of America, Inc. v. Commissioner*, United Parcel Service (UPS) used a foreign insurance company to avoid taxation on income it collected from its “excess value charge program.” *UPS of Am. v. Comm'r*, 254 F.3d 1014, 1016–17 (11th Cir. 2001). The Eleventh Circuit held in favor of UPS, stating that “the tax court’s narrow notion of ‘business purpose’ . . . stretches the economic-substance doctrine farther than it has been stretched. A ‘business purpose’ does not mean a reason for a transaction that is free of tax considerations. Rather, a transaction has a ‘business purpose’ . . . as long as it figures in a bona fide, profit-seeking business.” *Id.* at 1019.

124. *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1343 (Fed. Cir. 2006) (Where a company undertook a three-step transaction to generate capital losses and offset its tax liabilities, the court disallowed the tax benefits stating that the only portion of a transaction to be considered under economic substance review is “the one that gave rise to the alleged tax benefit.”).

IV. THE BURDENS OF BIFURCATION: ILL EFFECTS ON TAXPAYERS

The Second Circuit erred in its framing of the STARS transaction in *BNY* by bifurcating it into the Trust structure and the loan structure.¹²⁵ The Supreme Court should explicitly disallow such an analysis in analogous cases. In *BNY*, the Second Circuit concluded that the Tax Court correctly bifurcated the transaction.¹²⁶ In refusing to view both the \$1.5 billion loan and the Trust as parts of the same series of transactions, the court focused its economic substance inquiry solely on the Trust.¹²⁷ In doing so, the court found support in *Nicole Rose Corp. v. Commissioner*,¹²⁸ where the Second Circuit held that “[t]he relevant inquiry is whether the transaction that generated the claimed deductions . . . had economic substance.”¹²⁹ However, this type of bifurcation is incorrect. First, *Nicole Rose* is a factually different scenario from *BNY* and its holding should not apply. Second, allowing a court to pick apart a transaction eviscerates the idea of objective and subjective prongs, which is inherent in economic substance scrutiny. Third, applying the Second Circuit’s approach to other cases leads to clearly unfair results. Finally, the Second Circuit did not need to bifurcate the transaction to prove that STARS-like transactions do not pass economic substance scrutiny.

The circumstances under which the Second Circuit bifurcated the transaction at issue in *Nicole Rose* are entirely different from those in *BNY*, where bifurcation was improper.¹³⁰ In *Nicole Rose*, the Second Circuit applied the economic substance doctrine to what was essentially a sale-leaseback transaction.¹³¹ In that transaction, Nicole Rose claimed approximately \$22 million in business expense deductions from a lease involving computer equipment.¹³² Brussels Airport “purchased computer equipment from ABN, a commercial Dutch bank, and then leased the equipment back to ABN.”¹³³ Brussels Airport funded its purchase of the equipment through a loan from one of ABN’s subsidiary companies.¹³⁴ ABN then assigned its lease to Atrium Finis, another company, which then subleased the equipment back to ABN once more.¹³⁵ ABN prepaid \$25 million on the sublease, which it placed into a trust account in order to secure repayment on the initial loan to Brussels Airport.¹³⁶

125. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 120–21.

126. *Id.*

127. *Id.* at 120–23.

128. *See generally* *Nicole Rose Corp. v. Comm’r*, 320 F.3d 282 (2d Cir. 2003).

129. *Id.* at 284.

130. *See Bank of N.Y. Mellon Corp.*, 801 F.3d at 115.

131. *Nicole Rose Corp.*, 320 F.3d at 283.

132. *Id.*

133. *Id.*

134. *Id.*

135. *Id.*

136. *Id.*

The parties to this transaction, with help from Nicole Rose, restructured ABN's leaseback into a residual value certificate.¹³⁷ As a result, ABN would make payments to Nicole Rose of 200% of the value of the equipment.¹³⁸ Nicole Rose, through a series of transfers of Atrium's rights under the lease agreement, transferred its newfound interests to a Dutch bank, along with \$400,000 cash and some stock in an unrelated company.¹³⁹ As a result, Nicole Rose claimed a \$22 million loss, which included \$21,840,660 in business expenses related to the sale-leaseback transaction.¹⁴⁰ Nicole Rose applied the resulting tax deductions to an unrelated sale of Quintron Corporation, which Nicole Rose acquired shortly beforehand.¹⁴¹

When the IRS challenged the deductions, Nicole Rose claimed the transaction had economic substance, and pointed to the purchase and sale of Quintron as the source of the transaction's profitability.¹⁴² The Second Circuit summarily rejected this argument,¹⁴³ holding that only the transaction that generated the tax benefits (in this case the sale-leaseback) was relevant to the economic substance inquiry. Upon comparison, it is clear that this holding is inapplicable to the STARS transaction that took place in *BNY*.

In *BNY*, while the court and this Note have referred to the \$1.5 billion that Barclays gave BNY as a loan,¹⁴⁴ this is simply the simpler way of explaining the transaction. What actually took place is that Barclays contributed the \$1.5 billion to the Trust by purchasing \$1.5 billion worth of shares in the Trust.¹⁴⁵ In fact, while Barclays promoted the STARS transaction as a low-cost loan, it could only be achieved by routing the funds as an investment in the STARS Trust structure.¹⁴⁶ Whereas in *Nicole Rose* the acquisition and sale of Quintron Corporation had nothing to do with the sale-leaseback of electronics equipment to Brussels Airport,¹⁴⁷ in *BNY* the Trust had to be, and was intended to be, connected to the \$1.5 billion loan from Barclays.¹⁴⁸ Thus, the transaction in *Nicole Rose* is highly distinguishable from the transaction in *BNY*.

In *Nicole Rose*, the Second Circuit made a logical conclusion: the point of bifurcating the sale-leaseback and refusing to consider the Quintron sale as contributing profitability to the transaction is that the sale was not related to the sale or lease of electronic equipment in any way.¹⁴⁹ However,

137. *Id.*

138. *Id.*

139. *Id.* at 283–84.

140. *Id.* at 284.

141. *Id.*

142. *Id.*

143. *See Bank of N.Y. Mellon Corp. v. Comm'r*, 801 F.3d 104, 115 (2d Cir. 2015).

144. *Id.* at 112–15.

145. *Id.* at 112.

146. *Id.*

147. *Nicole Rose Corp.*, 320 F.3d at 283–85.

148. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 112.

149. *Nicole Rose Corp.*, 320 F.3d at 283–85.

applying the holding in *Nicole Rose* to *BNY*, looking only at “the transaction that generated the claimed deductions”¹⁵⁰ must require consideration of the \$1.5 billion payment from Barclays, because it generated the tax benefits via circulation through the Trust.¹⁵¹ In fact, Barclays promoted the STARS transaction exactly as such.¹⁵²

To extend the application of the Second Circuit’s holding in *Nicole Rose* beyond limited and closely analogous scenarios would eviscerate the concept of separate subjective and objective prongs of the economic substance doctrine. The economic substance doctrine, both before¹⁵³ and after¹⁵⁴ codification, has included a subjective and objective prong. Allowing the courts to bifurcate challenged transactions where improper or unnecessary makes the subjective prong difficult, if not impossible, to satisfy, and renders the objective prong actually subjective at the mercy of the court.

The subjective prong of the economic substance doctrine asks whether or not the taxpayer had a non-tax business purpose for entering into the transaction. In *BNY*, *BNY* argued that the STARS transaction had subjective economic substance, as its non-tax business purpose for entering into the transaction was to obtain a low-cost loan, as advertised by Barclays.¹⁵⁵ Using the holding in *Nicole Rose*,¹⁵⁶ however, the Second Circuit discounted the \$1.5 billion loan from consideration under economic substance scrutiny.¹⁵⁷ Under these circumstances, *BNY* had no chance to defend itself, as the only other discernable motivation for entering the transaction related to the tax benefits *BNY* received. The transaction entailed sharing tax benefits between *BNY* and Barclays in exchange for the Barclays \$1.5 billion contribution to the Trust—essentially a low-interest loan.¹⁵⁸ Because *BNY* could not use the loan as its business purpose, the only other benefits it received were from the taxes it paid.¹⁵⁹ Hence, in broadly interpreting and applying the holding in *Nicole Rose*, the Second Circuit unfairly ensured that *BNY* would not be able to satisfy the subjective prong of the economic substance doctrine. Under today’s law, *BNY* would have lost its appeal without further inquiry because the codified economic substance doctrine’s two prongs must *both* be satisfied.¹⁶⁰

However, this improper application not only affects the subjective portion of economic substance inquiry, but it also impacts the objective

150. *Id.* at 284.

151. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 112.

152. *Id.*

153. Rector, *supra* note 68, at 174–78.

154. I.R.C. § 7701(o) (2012).

155. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 121.

156. *Nicole Rose Corp. v. Comm’r*, 320 F.3d 282, 284 (2d Cir. 2003).

157. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 121.

158. *Id.*

159. *Id.*

160. I.R.C. § 7701(o)(1)(A)–(B) (2012).

prong.¹⁶¹ In *BNY*, the Second Circuit agreed with the Tax Court that, without considering any profit that may have resulted from investing the \$1.5 billion from Barclays, there was no way the STARS transaction could have been profitable for BNY.¹⁶² Of course, in engaging in the STARS transaction, which coupled the loan and benefit into one, BNY's only method of making a profit would be to invest the loan after it had run its course through the Trust structure per the two parties' STARS arrangement.¹⁶³

In bifurcating away the only profitable portion of the transaction from the portion of the transaction that generated the tax benefits, the Second Circuit also rendered it impossible for BNY to show any kind of profitability whatsoever. In so interpreting and applying the holding in *Nicole Rose* to the STARS transaction in *BNY*, the Second Circuit effectively, and unfairly, precluded BNY from offering any evidence or argument showing that the STARS transaction had either subjective or objective economic substance. Therefore, in light of the unfairness and inequity in bifurcating transactions such as the STARS transaction in *BNY*, the Supreme Court should disallow bifurcation except in closely analogous transactions to the one in *Nicole Rose*, where the alleged separate transactions to be bifurcated were not represented as part of one transaction and in reality bore no relation to one another.

A possible counterargument is that STARS-like transactions exploit loopholes in the existing tax laws, and on principle therefore should not be given the benefit of the doubt under economic substance scrutiny. However, the economic substance doctrine does not only affect STARS transactions, and giving the IRS a windfall through bifurcation can result in unfair proceedings against legitimate transactions. For example, if a taxpayer enters into a transaction for profit, but slightly modifies the transaction so as to maximize the tax benefits the tax law affords, it seems unfair to strip such an entity of any defense it might have under economic substance scrutiny. If there were, in such a case, a compelling hope for profitability, under *BNY* precedent a court might easily pick apart the transaction and examine solely the portion related to tax benefits, hindering any defense of the otherwise legitimate transaction. If a business actor can legally structure its transaction to achieve maximum tax benefits as an addendum to its goal of earning profit, it ought to be allowed to do so, and should not be left defenseless if the IRS challenges the benefits.

Finally, the Second Circuit erred in going so far as to bifurcate the STARS transaction, because STARS transactions cannot pass economic scrutiny even when the loan portion and trust are viewed as the same transaction. There is valuable insight into this contention in *Salem Financial, Inc. v. United States*.¹⁶⁴ In *Salem*, BB&T Bank and its subsidiary Salem

161. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 115–17.

162. *Id.* at 121.

163. *Id.* at 121–22.

164. *See generally Salem Fin., Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 2015).

Financial, Inc. sued the United States in the Federal Court of Claims to recover a tax refund the bank felt it was owed through the bank's participation in a STARS transaction.¹⁶⁵ While the parties stipulated before the Federal Circuit on appeal that the court would bifurcate the transaction for trial purposes,¹⁶⁶ the Court of Federal Claims considered the transaction at issue both with and without bifurcating the transaction.¹⁶⁷

In *Salem*, the IRS called into question the same type of STARS transaction at issue in *BNY*.¹⁶⁸ BB&T Bank entered into the STARS transaction with Barclays, for a span of five years from 2002 through 2007.¹⁶⁹ The Court of Federal Claims held that “[r]egardless of whether the Court views the trust and the loan separately or together as one integrated STARS transaction, the Court concludes that the entire arrangement must be disregarded for lack of economic substance.”¹⁷⁰ The Court of Federal Claims then proceeded to analyze the transaction with and without bifurcating the loan and the trust portions.¹⁷¹ In separating the transaction, the court found the trust had no objective economic substance because the funds that cycled through the trust existed before the trust was formed and were not profits resulting from the trust.¹⁷² Barclays' payment to BB&T of one-half of the U.K. taxes it paid were clearly not profit, as Barclays simply reimbursed BB&T for the taxes it paid on behalf of Barclays.¹⁷³ Thus, as the court pointed out, the only profit BB&T earned as a result came not from actual income but from deductions resulting from taxes BB&T had, in effect, not paid.¹⁷⁴

In analyzing the transaction without bifurcating the loan and trust portions, however, the court concluded that much the same argument stood true.¹⁷⁵ Whether or not the court considered the loan as a part of the transaction, this had no bearing on the fact that the transaction was based on a circular cash flow.¹⁷⁶ The court focused on BB&T's argument that the loan, which Barclays offered at a very low interest rate, was only possible as a result of the tax rebates Barclays stood to receive.¹⁷⁷ The two parties to the transaction incurred U.K. tax liabilities by appointing a U.K. trustee and by placing the trust payments into the U.K. trustee's account.¹⁷⁸ However, immediately after this placement, BB&T removed the money to its own

165. *Salem Fin., Inc. v. United States*, 112 Fed. Cl. 543, 548–49 (2013).

166. *Salem Fin., Inc.*, 786 F.3d at 940.

167. *Salem Fin., Inc.*, 112 Fed. Cl. at 585–90.

168. *Id.* at 549.

169. *Id.* at 548–49.

170. *Id.* at 550.

171. *Id.* at 585–89.

172. *Id.* at 586.

173. *Id.* at 587.

174. *Id.*

175. *Id.* at 588–89.

176. *Id.*

177. *Id.* at 588.

178. *Id.* at 567–68.

custody.¹⁷⁹ This, in the Court's opinion, created U.K. tax liabilities on income that was never actually earned through the STARS transaction.¹⁸⁰ Because this artifice was the only reason Barclays offered a low-interest loan, the court held that that the economic reality of the entire transaction was objectively profitless.¹⁸¹

Although this Note argues that the Second Circuit improperly bifurcated the *BNY* STARS transaction, this is not to say that STARS transactions themselves have economic substance. The Second Circuit could easily have made this same argument, and invalidated the STARS transaction based on the circular cash flows and artifice that the STARS transaction necessitated. Therefore, this Note's contention that STARS-like transactions do not have economic substance is amenable to the argument that the *BNY* court should not have bifurcated the transaction.

V. TAX BENEFITS AS PROFIT: BALANCING THE SCALES

Under the codified economic substance doctrine, Congress has instructed that “[t]he Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.”¹⁸² In *BNY*, decided under the common law economic substance doctrine, the Second Circuit held that it was appropriate to treat the foreign taxes *BNY* paid as expenses, but it also held that any foreign tax credits should be discounted when calculating the pre-tax profitability of the transaction.¹⁸³ However, the court also noted that its holding on this issue was at odds with two other Circuits,¹⁸⁴ stating that it was not bound by non-Second Circuit precedent.¹⁸⁵

The Second Circuit, however, went too far in discounting foreign tax credits yet counting them as expenses when determining the profitability of the transaction in accordance with the objective prong of the economic substance doctrine. Foreign tax credits should be counted toward the profitability of the transaction at issue because: (1) if not so, the purpose of the foreign tax credit regime is thrown to the wayside; (2) declining to do so gives the IRS even more of an advantage in a foreign tax case than it already has; (3) it can be done in compliance with the codified economic substance doctrine; and (4) if the credits are discounted, in conjunction with a court's broad power to bifurcate transactions, the economic substance doctrine is far too powerful and the taxpayer has almost no chance of satisfying the doctrine.

179. *Id.*

180. *Id.* at 589.

181. *Id.* at 588–89.

182. I.R.C. § 7701(o)(2)(B) (2012).

183. *Bank of N.Y. Mellon Corp. v. Comm’r*, 801 F.3d 104, 118 (2d Cir. 2015).

184. *See, e.g., Compaq Comput. Corp. & Subsidiaries v. Comm’r*, 277 F.3d 778 (5th Cir. 2001); *see also IES Indus., Inc. v. United States*, 253 F.3d 350, 356–57 (8th Cir. 2001).

185. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 117–18.

In *BNY*, the court acknowledged that the reason Congress created foreign tax credits was to mitigate the problem of double taxation.¹⁸⁶ However, as illustrated in *Compaq*¹⁸⁷ and *IES Industries*,¹⁸⁸ under the *BNY* holding courts would fail to achieve this goal.¹⁸⁹ In *Compaq*, Compaq Computer was purchasing foreign stocks on the U.S. stock exchanges using American Depository Receipts (ADRs), which represent foreign stocks.¹⁹⁰ Compaq would buy the ADRs before they were set to pay out a dividend, receive the dividend, and then immediately resell the stock.¹⁹¹ The result, while the stock sold at a slightly lower price, was that Compaq used tax benefits gained from both the tax implications of the sale and the tax implications of reporting a capital loss to offset some of its U.S. tax liabilities.¹⁹² The lower court's calculation of profitability in *Compaq* closely resembles the method the Second Circuit used in *BNY*. The lower court found that the objective prong of the economic substance doctrine was not satisfied, because there was no hope of the transaction being profitable.¹⁹³ The lower court "assessed neither the transaction's pre-tax profitability nor its post-tax profitability. Instead, the court assessed profitability by looking at the transaction after Dutch taxes had been imposed, but before considering U.S. income tax consequences."¹⁹⁴

On appeal, the *Compaq* court relied on the persuasive precedent of *IES Industries*, which had previously analyzed almost identical ADR transactions.¹⁹⁵ The *IES Industries* court held that the gross dividend (pre-tax) should be the indicator of whether a transaction was profitable, not the net dividend (after-tax).¹⁹⁶ Therefore, the Fifth Circuit reversed the lower court in *Compaq*, and included the foreign tax credits the company received when contemplating the transaction's objective profitability.¹⁹⁷ Both the *Compaq* and *IES Industries* courts approached the argument from the point of view of fairness.¹⁹⁸ In *Compaq*, the court opined that a fair consideration of the objective profitability of a transaction must include tax benefits' added value if it is going to count the foreign taxes paid against the transaction's profitability, using the holding from *IES Industries* to support its view.¹⁹⁹

186. *Id.* at 107.

187. *Compaq Comput. Corp.*, 277 F.3d at 778.

188. *See generally IES Indus., Inc.*, 253 F.3d at 350.

189. *See Compaq Comput. Corp.*, 277 F.3d at 778; *IES Indus., Inc.*, 253 F.3d at 356–57.

190. *Compaq Comput. Corp.*, 277 F.3d at 779.

191. *Id.*

192. *Id.* at 779–80.

193. *Id.* at 782.

194. *Id.*

195. *See id.* at 782–83; *see also IES Indus., Inc. v. United States*, 253 F.3d 350, 351–53 (8th Cir. 2001).

196. *IES Indus., Inc.*, 253 F.3d at 356–57.

197. *Compaq Comput. Corp.*, 277 F.3d at 785.

198. *Id.*

199. *Id.*

Importantly, in *Compaq*, the Fifth Circuit highlighted the fact that, if the company's foreign tax credits were disallowed, then it would have to pay taxes both to the Netherlands and to the United States on the same dividend income.²⁰⁰ That result would blatantly contradict the base purpose of foreign tax credits.²⁰¹ However, by discounting the foreign tax credit toward the transaction's profitability, as well as treating the taxes that Compaq paid as expenses, the Fifth Circuit would have stacked the deck against Compaq's transaction being found profitable.²⁰² Instead, that court held that, if the foreign taxes paid in a transaction count against its profitability, then the foreign tax implications (i.e., tax credits) should count toward the transaction's profitability under economic substance scrutiny.²⁰³ Without doing so, the Fifth Circuit acknowledged that Compaq, as well as IES Industries before it, would likely have lost their challenge under economic substance scrutiny, regardless of the fact that, if *all* tax implications were counted, the transaction was profitable.²⁰⁴ The point of counting either all or none of the tax implications in deducing the profitability of a transaction is fairness. The analysis cannot be fair if the court is subtracting as much money as it can in determining the profitability of a transaction, and thereby swaying the inquiry strongly in favor of the IRS.

Moreover, it is important to understand that this Note's argument can in fact coexist with the statutory language of § 7701(o)(2)(B), which instructs only that foreign taxes should be counted as business expenses when calculating profitability.²⁰⁵ This statute is silent on whether or not the tax implications should be considered, and this issue seems to have remained a matter of common law.²⁰⁶ Thus, the Supreme Court could in fact create precedent to this effect.

Finally, the fact that Compaq would win under this proposed rule does not imply that BNY would also win, as the two cases are factually different. The *BNY* court, by bifurcating the transaction, subtracting foreign taxes as economic costs, and refusing to consider foreign tax effects in contemplation of the transaction's profitability,²⁰⁷ crafted an economic substance inquiry that unduly militates against the taxpayer. In *BNY*, the money that funded the STARS transaction never actually left BNY's hands;²⁰⁸ the money would simply proceed circularly through the Trust, pay out as a dividend, and be put

200. *Id.*

201. *See* *Burnet v. Chi. Portrait Co.*, 285 U.S. 1, 7 (1932) (holding that the congressional intent behind the foreign tax credits is clearly to "mitigate the evils of double taxation").

202. *Compaq Comput. Corp.*, 277 F.3d at 785.

203. *Id.* at 785–86.

204. *Id.* at 784.

205. I.R.C. § 7701(o)(2)(B) (2012).

206. *Id.*

207. *Bank of N.Y. Mellon Corp. v. Comm'r*, 801 F.3d 104, 121–23 (2d Cir. 2015).

208. *Id.* at 110–12.

back into the Trust to generate greater tax benefits.²⁰⁹ In *Compaq*, legitimate transactions took place *outside* of a closed universe inhabited by one or two companies. Instead, Compaq traded on the open market and, in terms of gross dividends, the transaction was in fact profitable.²¹⁰

Applying the Fifth Circuit's method of the objective economic substance analysis, BNY's STARS transaction would still fail, because, as multiple courts have held, it is the overall economic effect of the transaction that ultimately decides the economic substance inquiry.²¹¹ In *BNY*, even if the court included the foreign tax credits BNY stood to receive, the transaction would have failed under the subjective economic substance inquiry, because the circular nature of the transaction strongly indicates that the sole motive for the transaction was tax related. Hence, the Supreme Court should create a common law, bright-line rule regarding the application of the economic substance doctrine that mandates inclusion of foreign tax effects in considering the profitability of a transaction under the doctrine.

VI. CONGRESSIONAL INTENT: SUPPLEMENTING THE COMMON LAW

At the start of its opinion in *BNY*, the Second Circuit took judicial notice of the fact that the original intent of "the foreign tax credit regime was to facilitate business abroad and foreign trade."²¹² However, the court's application of the economic substance doctrine is likely to hinder, not facilitate, foreign commerce. Moreover, current guidance on the interpretation and application of the economic substance doctrine from Congress indicates its intention was to tighten the leash on the use of doctrine, perhaps out of a realization of its power.²¹³ The Joint Committee on Taxation (JCT) has remarked that the codified economic substance doctrine "is not intended to alter the tax treatment of certain basic business transactions . . . merely because the choice . . . is largely or entirely based on comparative tax advantages," including "a U.S. person's choice [to utilize] a foreign corporation . . . to make a foreign investment."²¹⁴ However, the true problem lies in the courts' application of the doctrine, not with the legislation or its

209. *Id.* at 110–11.

210. *Compaq Comput. Corp. & Subsidiaries v. Comm'r*, 277 F.3d 778, 783 (5th Cir. 2001).

211. *See Frank Lyon Co. v. United States*, 435 U.S. 561, 576 (1978) (holding that courts should consider the overall economic effect of the transaction); *see also Bank of N.Y. Mellon Corp.*, 801 F.3d at 119.

212. *Bank of N.Y. Mellon Corp.*, 801 F.3d at 107.

213. *See Lipton*, *supra* note 11, at 266–68 (describing the ways in which Congress is trying to restrain the application of the economic substance doctrine throughout its new publications regarding the doctrine).

214. *See, e.g.*, STAFF OF JOINT COMM. ON TAX'N, 111TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 111TH CONGRESS 379 (Comm. Print 2011) [hereinafter EXPLANATION OF TAX LEGISLATION].

corresponding guidance, and it is incumbent upon the Supreme Court to control that application so as to comport with legislative intent.

In fact, Congress invited the courts to do so by including language in the codified doctrine deferring to the courts' discretion in deciding whether or not to apply the doctrine to a transaction.²¹⁵ Hence, the Supreme Court must now rule on how the courts are to apply the economic substance doctrine such that the odds are not stacked against the taxpayer, but also such that abusive sham transactions can be identified. Making determinations on when and how to bifurcate transactions or whether or not to consider tax effects as profit are both efficient methods for the Supreme Court to strike a much-needed balance. The legislative history and intent surrounding the doctrine show that the Supreme Court's intervention is required to implement these measures.

First, the legislative history preceding the codification of the economic substance doctrine points to Congress' intention that the doctrine be used to invalidate pervasive exploitations of existing tax loopholes, such as the STARS structure, which are economic farces attempting to fit within formal provisions of the Tax Code. It does not point to a desire to invalidate transactions that comport with the statutory intent of the tax benefits. Since 1999, Congress had attempted to codify the economic substance doctrine in approximately seventy bills before it settled on the current version.²¹⁶ While some scholars have focused on the "relevance" provision of the codified doctrine, found at § 7701(o)(5)(C),²¹⁷ it is also important to note that Congress wanted the courts to decide how to apply the doctrine in a manner that suits its intentions.

To this effect, in March 2011 the JCT published a report titled, "General Explanation of Tax Legislation Enacted in the 111th Congress," which provides clarification on the application of the economic substance doctrine.²¹⁸ In relevant part, the JCT clarified that "the provision is not intended to alter or supplant any other rule of law, including any common-law doctrine."²¹⁹ Coupled with the JCT's comment earlier in the report that the provision "does not change present law standards in determining when to utilize an economic substance analysis,"²²⁰ the legislature clearly intended that the application of the economic substance doctrine remain under the purview of the courts. Furthermore, the JCT provided examples of "basic business transactions" in its report that the legislature did not intend to modify, one of which is the choice of using a foreign or domestic corporation

215. I.R.C. § 7701(o)(5)(A) (2012).

216. Luke, *supra* note 106, at 563.

217. *Id.* at 554–57 (arguing that the relevance provision of the codified economic substance doctrine precludes courts from applying the doctrine to transactions that clearly comport with the statutory intention of the tax benefits, while also allowing courts to have the final decision on whether a transaction has economic substance).

218. EXPLANATION OF TAX LEGISLATION, *supra* note 214, at 369–82.

219. *Id.* at 381.

220. *Id.* at 378.

to invest in a foreign country.²²¹ While the JCT report provides certain areas that Congress did not intend the economic substance doctrine to affect, it makes clear that the application of the codified doctrine is left to the courts to decide and develop, including the issue of bifurcation for economic substance scrutiny purposes.²²²

Therefore, not only did Congress itself recognize the power of the economic substance doctrine and attempt to limit its use, but it also intended the courts to take charge and decide how best to apply the doctrine in a manner that does not affect legislatively intended tax benefits. However, because the Circuits are split on the application of the doctrine,²²³ courts have applied and will continue to apply the doctrine inconsistently. As evidenced by the aforementioned issue of bifurcation, the courts must formulate a set rule on how to frame and test transactions, so as not to treat taxpayers in one Circuit differently than those in another.

CONCLUSION

The current application of the economic substance doctrine is inconsistent and as such produces inconsistent rulings, which negatively affect taxpayers who conduct business overseas and exercise their right to reduce their own tax burdens. In *BNY*, the Second Circuit made two errors. First, it improperly bifurcated the STARS transaction and allocated too much power to the economic substance doctrine, and thus to the IRS. Second, it erred in discounting earned tax benefits when considering the profitability of the transaction. The court could and should have found that the STARS transaction lacked economic substance using a less overpowering application of the economic substance doctrine.

Moreover, in codifying the economic substance doctrine, Congress intended the courts to decide on how to apply the doctrine such that it comports with legislative intent. The Second Circuit failed in this regard. It is clear, given the deep Circuit split on the issue, that the Supreme Court should settle the split by creating bright line rules directing the courts on how to apply the doctrine in light of these arguments. This will allow pervasive tax-avoidance schemes to be uncovered and stopped, allow for a fair consideration of all challenged doctrines, and prevent a windfall to the IRS.

221. *Id.* at 379.

222. *Id.* at 379–80 (stating that “the provision reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax avoidance objectives in order to disallow those tax-motivated benefits”).

223. *See, e.g., Bank of N.Y. Mellon Corp. v. Comm’r*, 801 F.3d 104, 117 (2d Cir. 2015) (The Second Circuit notes that its application of the economic substance doctrine is inconsistent with Fifth and Eighth Circuit precedent.).

*Nicholas Giordano**

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