Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

How STARS Cases Apply Economic Substance Doctrine

Law360, New York (November 26, 2013, 1:42 PM ET) -- Three recent cases applied the economic substance doctrine, with quite different results, to the structured trust advantaged repackaged securities ("STARS") transaction, one of several "foreign tax credit generators" that the IRS is aggressively challenging. Most practitioners are very familiar with the "conjunctive vs. disjunctive vs. multifactor test" conflict over economic substance. These STARS cases illustrate that often what really drives the decisions are some of the nitty-gritty details of applying the applicable standard, which often allow courts a great amount of discretion. Some of the analysis in these cases was highly questionable. When the cases are appealed, we may get further clarification of how the economic substance doctrine should really work.

STARS Transaction

The STARS transaction was developed by KPMG and Barclays Bank to generate a net U.K. tax benefit for Barclays, and was marketed to U.S. banks as a way to obtain low-cost financing. In a typical STARS transaction, a U.S. bank forms a trust that is disregarded for U.S. income tax purposes. The trust has a U.K. resident as trustee, which causes the trust to be a U.K. resident and the trust income subject to U.K. tax.[1] The trust income is also subject to U.S. tax, but the bank is entitled to a foreign tax credit for the U.K. taxes paid on that same income. Unlike other foreign tax credit generators, the U.S. taxpayer in the STARS transaction bears the economic burden of the foreign taxes for which it claims a credit. If these were the only steps involved, the STARS transaction would not produce a benefit for the U.S. bank, as the U.S. bank still pays the same amount of total tax, with the only change being the country to which the tax was paid.

The benefit to the U.S. bank is a below-market loan from Barclays. Barclays purchases an interest in the trust, which the U.S. bank agrees to repurchase. For U.S. tax purposes, this arrangement is treated as a secured loan rather than an equity investment. The below-market interest rate is financed by tax benefits Barclays receives from its ownership interest in the trust. For U.K. tax purposes, Barclays owns an interest in the trust and receives monthly distributions of trust income, which Barclays is obligated to re-contribute to the trust. Barclays is also treated as having paid the U.K. taxes paid by the trustee, although the U.S. bank actually bears the economic burden of those taxes. This treatment creates a net tax benefit for Barclays, which Barclays shares with the U.S. bank through the below-market loan. This reduction in the amount otherwise payable by the U.S. bank on the loan is commonly referred to as the "Bx payment" and is computed based on the amount of tax benefits that Barclays receives from the transaction. Because the Bx payment was often larger than the amount of interest otherwise payable on the loan, Barclays might make a net payment to the U.S. bank on the loan.

Barclays does not bear the economic burden of these U.K. taxes, but it receives a credit for that payment under U.K. law. Although this might appear questionable, the U.K. tax authority agrees with this treatment of the transaction by Barclays. On the other hand, the U.S. bank's tax position properly reflects the economics of the transaction, in that it did bear the economic burden of the U.K. taxes paid. Nevertheless, in Bank of New York Mellon Corp. v. Commissioner[2] and Salem Financial Inc. v. United States[3], the courts agreed with the government that the tax benefits would be disallowed because the transactions lacked economic substance. In Santander Holdings USA v. United States[4], however, the court concluded that an essentially identical transaction did have economic substance.

Characterization of the Bx Payment

The characterization of the Bx payment has implications for several aspects of the analysis. But the courts disagreed on the proper characterization of that payment. BNY Mellon and Salem viewed the Bx payment as a tax effect embedded in the loan to serve as a “device for monetizing and transferring the value of anticipated foreign tax credits generated from routing income through the STARS structure.”[5] Thus, the below-market interest rate, while not a tax rebate in fact, was treated as a tax rebate in substance. These courts treated this as a fact issue.

In Santander, the court determined that whether the below-market interest rate was a tax effect was a question of law, not a question of fact. Looking to the Code, regulations and case law, the court found no authority for treating the interest reduction as “in substance” or “effectively” a tax rebate. Instead, the interest reduction should be treated as revenue under accepted and usual legal and accounting principles. Under those principles, payments between private parties — even if they are buying and selling tax credits — are income to be accounted for on a pre-tax basis. Thus, the Bx payment is properly treated as pre-tax income and not as a tax rebate.

Whether a payment from a private party is considered to be a tax rebate or income, and whether the determination is a fact issue or a legal issue, may have a significant effect on other transactions. The decisions by the trial courts set forth the disputing views; decisions on appeal may help clarify the answers.

The Transaction Tested for Economic Substance

For purposes of economic substance, the relevant transaction is the one that produces the disputed tax benefits, even if it is part of a larger set of transactions. The cases in which this principle developed involved attempts by taxpayers to avoid the doctrine by coupling a noneconomic transaction with legitimate transactions. In these cases, the noneconomic transaction is appropriately viewed as a separate transaction because there is no substantive connection between the noneconomic transaction and the legitimate transactions. That is, the taxpayer would and could have engaged in the noneconomic transaction without the legitimate transactions.

The courts identified two different components of STARS: the “trust” or “STARS structure” (placing income-generating assets in the trust to subject the income to U.K. tax) and the “loan” (the secured loan by Barclays to the U.S. bank, including the Bx payment). The BNY Mellon and Salem courts decided that these two components were unrelated and that only the profitability of the trust mattered because the disputed foreign tax credits stem from the STARS structure. Santander, on the other hand, looked at the entire STARS transaction in evaluating profitability.[6]

Case law does not support bifurcating a transaction into two separate transactions when commercial realities make clear that the transactions are interrelated, like the STARS structure and the loan. The U.S. bank does not derive any benefit from entering into just the STARS structure. The foreign tax credits generated by the STARS transaction prevent double taxation, but do not provide the U.S. bank a net benefit — the U.S. bank pays the same amount of tax.[7] The U.S. bank uses the STARS structure only because of the Bx payment, and Barclays is only willing to make the Bx payment because of the bank’s participation in the STARS structure. Treating the STARS structure as the relevant transaction and ignoring the loan, forces the taxpayer to defend a fictional transaction that the taxpayer would not have entered into.

This approach has broad implications outside of the STARS context. In effect, the IRS and courts are sometimes carving up interdependent parts of a transaction in order to support a conclusion that a single part lacks economic substance. They argue that the taxpayer could pursue one part without the other, while ignoring the reality that the taxpayer would not do so. Further clarification of this principle by the appellate courts would be very helpful.

Determining Profitability

A key question in analyzing economic substance is whether the relevant transaction created a reasonable opportunity for profit exclusive of the tax benefits claimed. The cases analyzed some aspects of this question differently.

BNY Mellon explicitly included the foreign taxes paid by the U.S. bank as part of the costs of the transaction, despite authority that both U.S. taxes and foreign taxes should be ignored in the evaluation of pre-tax profitability. However, BNY Mellon and Salem did not include the income from the Bx payment in their analysis of profitability, because they had characterized that payment as a tax effect. These positions seem inconsistent to say the least.[8] Santander apparently took exactly the opposite approach. Because it concluded that the Bx payment was not technically a tax rebate by the foreign government, Santander treated it as income for purposes of the profitability analysis, resulting in a determination that the integrated transaction created a reasonable opportunity for profit.

Salem also concluded that the loan component lacked economic substance, although in our opinion this conclusion was incorrect. The court pointed out that the interest rate on the loan, absent the Bx payment, was significantly higher than on comparable funding sources. But the court also declined to consider the income from the bank's use of the loan proceeds. Taxpayers cannot take into account the money they might earn from the tax savings itself. But banks borrow money only because they can make more money by lending it to others. If this conclusion in Salem were correct, any transaction by a bank to raise funds in furtherance of its core business objective would lack economic substance and the bank could not deduct related interest expense. Salem made no attempt to show that the bank would have been unable to make money on the Loan because it could not earn a higher interest rate by loaning the money out.

Conclusion

These decisions likely foreshadow a fight in the circuit courts over the STARS transaction and the economic substance doctrine. BNY Mellon says that it will appeal the court's decision to the Second Circuit. Given the amounts involved, appeals of Salem (to the Federal Circuit) and Santander (to the First Circuit) are very likely. In addition, the Wells Fargo v. United States case is currently scheduled for trial in July 2014 and would be appealed to the Eighth Circuit. These cases may play an important role in clarifying the application of the economic substance doctrine.

—By Robert D. Probasco and Lee S. Meyercord, Thompson & Knight LLP

Robert Probasco is a partner and Lee Meyercord is an associate in the firm's Dallas office.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] For a more detailed overview of how the STARS transaction works, see Robert D. Probasco & Lee S. Meyercord, Tax Court Finds STARS Transaction Lacks Economic Substance, Texas Tax Lawyer (Spring 2013), available at http://www.texastaxsection.org/LinkClick.aspx?fileticket=pLup%2bNX6AnA%3d&tabid=80 .

[2] 140 T.C. 15 (2013).

[3] 112 A.F.T.R.2d (RIA) 2013-6168 (Fed. Cl. 2013). Salem Financial is the successor-in-interest to BB&T Bank.

[4] 112 A.F.T.R.2d (RIA) 2013-6530 (D.Mass. 2013). Santander Holdings USA was formerly known as Sovereign Bancorp. Unlike BNY Mellon and Salem, this decision did not entirely dispose of the case. The court granted partial summary judgment on the economic substance issue. The parties were requested to brief the question of whether that decision also necessarily would reject the government's other arguments, including the step transaction doctrine and substance over form.

[5] Bank of New York Mellon Corp., 140 T.C. at 42 – 43.

[6] Salem also looked at the entire transaction as an alternative position, but the court's analysis was perfunctory at best and did not adequately address the question of whether the U.S. bank actually had a reasonable opportunity for profit from the transaction.

[7] The decisions in BNY Mellon and Salem do not clearly acknowledge this, but Santander does. "Sovereign's payment of the U.K. tax and claiming of the U.S. foreign tax credit did not produce an improper tax benefit; rather, it was simply a wash. ... that transfer produced no advantage to Sovereign. It was still out the same amount of tax, regardless of which country it was paid to." Santander Holdings USA, Inc., 112 A.F.T.R.2d at 2013-6534.

[8] In a supplemental ruling, Bank of New York Mellon Corporation v. Commissioner, T.C. Memo 2013-225, the court concluded that the Bx payment "arose from the STARS structure, a transaction we found ... to lack economic substance." Therefore, the taxpayer could deduct its gross interest expense before the Bx payment (because only the STARS Structure was disregarded) but did not have to include the Bx payment in income (because it arose from the STARS Structure).