BUCKING A TREND: SANTANDER STARS SHELTER UPHELD

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Structured Trust Advantaged Repackaged Securities, or STARS, a tax shelter, has been the subject of significant litigation. STARS was a trust transaction that provided tax benefits to Barclays Bank PLC (its promoter) and foreign tax credits to U.S.-based participants. The government has argued that STARS lacked economic substance, and it has had partial wins in *Bank of New York Mellon Corp. v. Commissioner*, No. 14-704-ag(L), 2015 U.S. App. LEXIS 15993 (2d Cir. Sept. 9, 2015), and in *Salem Financial Inc. v. United States*, 786 F.3d 932, 937 (Fed. Cir. 2015), decided in May. Last week, another decision was issued, denying a summary judgment motion by another STARS participant. *Wells Fargo & Co. v. United States*, No. 09-CV-2764 (PJS/TNL), 2015 U.S. Dist. LEXIS 152660 (D. Minn. Nov. 10, 2015).

A fourth STARS case has been less successful. In 2013, a district judge in Massachusetts ruled that one component of STARS, a payment from Barclays to its U.S. counterparty, Sovereign Bancorp, Inc., constituted income that needed to be considered as a part of the analysis of the economic substance of the transaction. *Santander Holdings USA, Inc. v. United States*, Civil Action No. 09-11043-GAO, 977 F. Supp. 2d 46, 52-53 (D. Mass. 2013). Last week, the court granted summary judgment to the taxpayer on its refund claims. *Santander Holdings USA, Inc. v. United States*, Civil Action No. 09-11043-GAO, 2013 U.S. Dist. LEXIS 153928, *25 (Nov. 13, 2015).

The STARS transactions were quite complex. Barclays developed the transactional structure and then entered into a series of the transactions with various U.S.-based financial institutions. Each STARS transaction had a trust component and a loan component. *Salem Fin.*, 786 F.3d at 937.

Each of the transactions had the following basic structure:

- A financial institution based here would contribute assets to a trust that was managed by a trustee based in the United Kingdom, which subjected the trust's income to U.K. tax.
- Barclays would then make a loan for the benefit of the U.S. bank and receive equity interests in the trust in return. The U.S. bank would retain control over the trust, and Barclays was obligated to sell its entire interest in the trust on demand at a fixed price. *Id.*
- The bulk of the trust income was allocated to Barclays; the funds were cycled through an account controlled by the U.S. counterparty. Barclays was required to use the funds to purchase additional interests in the trust. *Wells Fargo*, 2015 U.S. Dist. LEXIS 152660 at *8.
- The additional interests in the trust were worthless because Barclays was already obligated to sell all of its interests at a fixed price no matter how many interests it held. Consequently, Barclays could claim trading losses under U.K. tax law. *Id.*
- The U.S. counterparty would then receive payments from Barclays that were equal to a percentage of the tax benefits obtained by Barclays from the circular flow of funds in and out of the trust. The U.S. bank would also benefit because the arrangement generated foreign tax credits.

The basic impact of the arrangement was that for every $100 of trust income, the U.S. counterparty paid $22.00 in U.K. taxes. The U.K. treasury only retained a small portion of that revenue, because of offsetting tax benefits received by Barclays. In *Salem Financial*, the structure of the transaction yielded a net tax of $3.30 to the U.K. treasury, as Barclays claimed $18.70 in tax benefits from its trading losses and other deductions associated with the arrangement. Meanwhile, the U.S. counterparty received a $22.00 foreign tax credit, *plus* an $11.00 payment from Barclays. 786 F.3d at 938. The only loser was the U.S. Department of Treasury.

In *Salem Financial* and *Bank of New York Mellon*, the courts concluded that the loan component of STARS had economic substance, while the trust component did not. *See Salem Financial*, 786 F.3d at 950-51, 957; *see also Bank of New York*, 2015 U.S. App. LEXIS 15993 at *46-*47, *49-*50. And in *Wells Fargo*, the court determined that there was sufficient evidence to necessitate a trial on the question whether the entire arrangement lacked economic substance. 2015 U.S. Dist. LEXIS 152660 at *16-*20, *40-*45.

In contrast, the *Santander* Court explicitly broke with the other STARS rulings in addressing a transaction that Barclays entered into with Sovereign. It indicated that analysis of economic substance could not ignore events with real economic consequences, "such as Sovereign's actual payment of real money in taxes in the U.K." 2015 U.S. Dist. LEXIS 153928 at *14. Moreover, the *Santander* court concluded that the government was attempting to apply U.S. judicial doctrines to Barclay's tax liability under U.K. law, which it viewed as improper. The court also emphasized that

the relationship between Barclays and Sovereign was at arms' length and that Sovereign's interest in borrowing at a relatively low rate drove the transaction. *Id.* at *16.

The *Santander* Court bluntly acknowledged that it differed from the other courts that had considered STARS: "I take a substantially different view of the issues from that taken by other courts that have considered the government's arguments about whether the STARS transaction should be declared abusive insofar as U.S. tax law is concerned." *Id.* at *19. In the end, the court's decision to grant summary judgment appears to rest upon its philosophical discomfort with the economic substance doctrine: "[t]he *Salem Financial, Bank of New York Mellon*, and *Wells Fargo* cases illustrate, I think, that the judicial anti-abuse doctrines—whether substance over form or economic substance—can themselves be susceptible to abuse." *Id.* at *21.

Presumably, the government will appeal, and it will be interesting to see how the First Circuit views the case. The flexibility of the economic substance doctrine has historically divided the judiciary. While some judges view the doctrine's flexibility as vital, others have expressed concern that its flexibility could result in unprincipled decisions: "I can't help but suspect that the majority's conclusion . . . is, in its essence, something akin to a 'smell test.' If the scheme in question smells bad, the intent to avoid taxes defines the result as we do not want the taxpayer to 'put one over.'" *ACM P'ship v. Comm'r,* 157 F.3d 231, 265 (3d Cir. 1998) (McKee, J. dissenting).

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