

# TAX SHELTERS: THE GOVERNMENT PREVAILS AGAINST SANTANDER

Posted on [December 20, 2016](#) by [Jim Malone](#)



The IRS and the Tax Division of the Department of Justice have expended significant effort fighting tax shelters, and they have enjoyed many successes in that endeavor. One transaction that the government challenged was known as “STARS,” an acronym for Structured Trust Advantaged Repackaged Securities. STARS was a transaction that Barclays promoted to a number of U.S. banks; it gave Barclays tax benefits in the United Kingdom, while the U.S. counterparties claimed significant foreign tax credits with minimal risk.

The IRS and the Tax Division pursued a series of cases attacking the STARS transaction as a tax shelter. Deploying the economic substance doctrine, the government obtained favorable rulings in two cases:

- In *Bank of New York Mellon Corp. v. Commissioner*, 801 F.3d 104, 107 (2d Cir. 2015), the Second Circuit affirmed a Tax Court ruling disallowing the foreign tax credits associated with a STARS transaction on the basis of the economic substance doctrine.
- In *Salem Financial, Inc. v. United States*, 786 F.3d 932, 951, 954-55 (Fed. Cir. 2015), the Federal Circuit also upheld a lower court ruling disallowing foreign credits generated by a STARS transaction.

In a third case against Wells Fargo, the government defeated a summary judgment motion. *Wells Fargo & Co. v. United States*, 143 F. Supp. 3d 827, 842 (D. Minn. 2015). A jury trial was recently completed in that case; the jury’s special verdict indicated that STARS lacked economic substance.

The one blot on the government’s record was a case against Santander Holdings, the successor to Sovereign Bancorp. Initially, [the taxpayer had prevailed on a summary judgment motion in the trial court](#), but the First Circuit reversed late last week. [Santander Holdings USA, Inc. v. United States](#), No. 16-1282, 2016 U.S. App. LEXIS 22400, \*6-\*7 (1st Cir. Dec. 16, 2016), [rev’g](#) 144 F. Supp. 3d 239, 248 (D. Mass. 2015). Writing with the benefit of the prior Second Circuit and Federal Circuit opinions, the First Circuit issued a clear, concise, and convincing opinion.

The First Circuit made its views known from the outset: “Over the past decade, some banks have engaged in complicated transactions the very purpose of which was to generate a foreign tax credit in order to take advantage of the U.S. deductions, and have done so at the expense of the U.S. taxpayer.”

*Santander*, 2016 U.S. App. LEXIS 22400 at \*2. After reviewing the general background to the STARS controversy, as well as the procedural history of the case before it, the First Circuit turned to a summary of the transaction, which had the following salient features:

- Sovereign created a trust with a trustee based in the United Kingdom, a decision that subjected the trust to taxes in the United Kingdom at the rate of 22%. The trust, which was established in 2003, would be subject to U.S. income taxes at a 35% rate, but it could claim a credit for the U.K. taxes that it paid. Sovereign would contribute \$6.7 billion in its U.S.-located assets to the trust. at \*7.
- Barclays acquired an interest in the trust that Sovereign established. It initially acquired an interest worth \$750 million in November 2003, plus another worth \$400 million a year later. Barclays agreed to sell back this interest for \$1.15 billion at the end of the transaction. Sovereign treated the contributions to the trust by Barclays as a loan, and it paid interest to Barclays on it. at \*8.
- The trust then engaged in a series of circular transactions that generated tax benefits to Barclays. The trust distributed funds to a “blocked account” in Barclays’ name that gave it formal ownership without any entitlement to the funds, which Barclays then recontributed to the trust, generating a tax credit for the U.K. tax paid by the trust and another tax credit for trading losses on the funds it recontributed to the trust. at \*8-\*9.
- In return, Barclays made a monthly payment to Sovereign that was netted against its interest obligation to Barclays under the loan associated with Barclays’ contributions to the trust. The Barclays payment was calculated as 50% of the U.K. tax Sovereign paid on the trust’s income. at \*9.

Borrowing an illustration utilized by both the Second Circuit and the Federal Circuit, the court observed that the impact of the transaction for each \$100 of income received by the trust was as follows:

- For Barclays, it would owe U.K. income tax of \$30 on the \$100 in income, but it received a credit of \$22 due to the U.K. 22% trust tax. The trust would set aside \$22 to pay the tax owed by Sovereign, and the remaining \$78 would be sent to the blocked account and then recontributed to the trust, generating a trading loss for Barclays, which generated a deduction of \$23.40 at the 30% U.K. income tax rate. It would also generate a deduction of \$3.30 on its payment to Sovereign. at \*11.
- Sovereign benefited by receiving the Barclays payment of \$11 for every \$100 in income.

Although the U.K. collected only a limited amount of tax, Sovereign claimed the full tax credit for U.S. income tax purposes.

The First Circuit next discussed the history of the economic substance doctrine from the Supreme Court’s decisions in *Gregory v. Helvering*, 293 U.S. 465 (1935) and *Frank Lyon v. United States*, 435 U.S. 561 (1978) to its own decision in *Deweese v. Commissioner*, 870 F.2d 21 (1st Cir. 1989). The court described the doctrine as a tool designed to determine whether a transaction that appeared to comply with the Internal Revenue Code was nonetheless inconsistent with its intent. *Id.* at \*14 (citations omitted). The First Circuit indicated that the economic substance doctrine applies “when a transaction ‘is one designed to produce tax gains . . . [not] real gains.’” *Id.* at \*14 (quoting *Deweese*, 870 F.2d at 31) (alteration by the court). As an example, the court observed that “when the challenged transaction has no prospect for pre-tax profit—then it is an act of tax evasion that, even if technically compliant, lies outside the intent of the Tax Code and so lacks economic substance.” *Id.* at \*14-\*15.

Against that background, the First Circuit turned to the profit potential of the STARS transaction. Here the court concluded that the transaction lacked “a reasonable prospect for creating a profit without considering the foreign tax credits.” *Id.* at \*15. Consequently, the court held that STARS “is not a transaction for which Congress intended to give the benefit of the foreign tax credit.” *Id.* at \*15-\*16. The Court of Appeals explained that the STARS transaction was faulty because the \$11 that Sovereign received on every \$100 in trust income came at the cost of \$22 in U.K. taxes. *Id.* at \*16-\*17.

The First Circuit recognized that many investments that have economic substance may rely upon tax benefits to make them profitable, particularly in their initial stages. In the court's view, however, STARS did not fit that mold because it did not "meaningfully alter[] the taxpayer's economic position (other than with regard to the tax consequences)." *Id.* at \*20 (quoting *Salem*, 786 F.3d at 950) (alteration by the court). The court also indicated that its holding that the STARS transaction lacked economic substance was supported by the fact that the arrangement had no meaningful economic risk. *Id.*

The First Circuit concluded its analysis by focusing on the purpose of foreign tax credits, which were "designed to produce uniformity of tax burden" for U.S. taxpayers "whether they were engaged in *business* in the United States or engaged in *business* abroad." *Id.* at \*22-\*23 (quoting H.R. Rep. No. 83-1337 at 4103 (1954)) (emphasis by the court). Since the trust created under STARS generated no business for Sovereign and lacked economic substance, the court concluded that its use to generate foreign tax credits was not consistent with the intent of the Code. *Id.* at \*23.

This is a solid decision. The First Circuit applied its existing precedent in a logical fashion to determine that tax credits should not be available under STARS. The court also placed qualifications on its holding that should keep lower courts from overreacting and invalidating legitimate business transactions.



By: **Jim Malone**

Jim Malone is a tax attorney in Philadelphia. A Principal at Post & Schell, he focuses his practice on federal, state and local tax controversies. [Learn more about Post & Schell's Tax Controversy Practice >>](#)

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