

TAX SHELTERS: DENIED A CLAIM FOR FOREIGN TAX CREDITS, WELLS FARGO'S EFFORT TO CLAIM A DEDUCTION FAILS

Posted on [September 20, 2017](#) by [Jim Malone](#)



On September 15, 2017, the latest chapter in the [Wells Fargo/STARS saga](#) came to an end: Having earlier lost its claim for foreign tax credits associated with the STARS transaction, Wells Fargo's alternative argument that it could deduct the foreign taxes it paid was also rejected. [Wells Fargo & Co. v. United States](#), No. 09-CV-2764 (PJS/TNL), 2017 U.S. Dist. LEXIS 150064 (D. Minn. Sept. 15, 2017).

To summarize, STARS was a complex arrangement between Wells Fargo and a foreign bank comprised of two components: A trust structure in which income-producing assets were exposed to tax in the United Kingdom to generate foreign tax credits, and a loan to Wells Fargo. *Wells Fargo*, 2017 U.S. Dist. LEXIS 150064 at *1-*2. The case was a refund action brought after the IRS refused to respect the tax treatment that Wells Fargo applied to the transaction. At trial, the jury determined that the loan had a reasonable prospect of pre-tax profit, but lacked a business purpose, a ruling that created a legal issue on whether the loan had economic substance and should be respected for tax purposes. In contrast, it also determined that the trust portion of the transaction lacked a reasonable likelihood of pre-tax profit and lacked a business purpose, which meant that the trust was treated as a sham for tax purposes. *Id.* at *3.

After the jury verdict, the parties identified two issues that had to be resolved prior to entry of judgment: Whether Wells Fargo was subject to a negligence penalty under section 6662 of the Internal Revenue Code, and whether the loan component of the transaction should be respected for tax purposes. *Id.* at *4. After briefing, the court entered an order holding that the taxpayer was subject to a negligence penalty ([discussed here](#)), and ruling that the loan component of STARS was not a sham, which meant that Wells Fargo's claimed interest deduction was valid ([discussed here](#)). *Id.* at *4 n.3.

When the court directed the parties to submit a proposed form of judgment, another issue arose: Wells Fargo indicated that it was entitled to a deduction for the foreign taxes incurred as a consequence of the trust structure, even though it was a sham and the associated tax credits were disallowed. The government responded that the issue had been waived and that the taxpayer was not entitled to deduct the foreign taxes

associated with STARS in any event. *Id.* at *5. On Friday, the court sustained the government's position, concluding that Wells Fargo had waived the issue and that it was also not entitled to a deduction.

The waiver issue is not of general interest, as it turned on the specific procedural posture of the case. In contrast, the question whether Wells Fargo could claim a deduction merits discussion.

The court commenced its analysis with the basic proposition that a transaction that is deemed to be a sham is disregarded for tax purposes, a position that would bar any deduction. *Id.* at *8. While acknowledging that courts do not always disregard every aspect of a sham transaction, the court observed that the deduction for foreign taxes that Wells Fargo sought was directly tied to the trust transaction; it contrasted the foreign taxes with the deduction that it had permitted for interest associated with the loan transaction. *Id.* at *8-*9. Accordingly, the *Wells Fargo* court readily distinguished two of the cases that the taxpayer relied upon to support a deduction:

- The court noted that the Third Circuit had allowed deductions that were "economically substantive and separable from the sham aspects of the underlying transaction." *Id.* at *9 (quoting *ACM P'ship v. Comm'r*, 157 F.3d 231, 262 (3d Cir. 1998)).
- The court also indicated that the Fourth Circuit had allowed a deduction when it found "that a discrete portion of the transaction had economic substance." *Id.* (discussing *Rice's Toyota World, Inc. v. Comm'r*, 752 F.2d 89, 96 (4th Cir. 1985) (footnote omitted)).

While a third case, *Jacobsen v. Commissioner*, 915 F.3d 832, 840 (2d Cir. 1990) offered some supportive language, it had subsequently been clarified by the Second Circuit in *Lee v. Commissioner*, 155 F.3d 584 (2d Cir. 1998), where the court ruled that no deduction was available for "interest expenses derive[d] from economically empty transactions." *Id.* at 586 (citation omitted).

The court was not persuaded by Wells Fargo's effort to rely on statutory arguments. It rejected the taxpayer's plain language argument that it was entitled to deduct foreign taxes, noting that "[e]very taxpayer whose tax benefits are disallowed under the sham-transaction doctrine qualifies for the claimed benefits under the plain language of the tax code." 2017 U.S. Dist. LEXIS 150064 at *11. The court also rejected the taxpayer's argument that the existence of various provisions in section 901 of the Code authorizing the deduction of foreign taxes when a credit was unavailable evinced a general intent to permit a foreign tax deduction in every case; the court observed that Wells Fargo did not actually claim that it fit within any specific exception. In the court's view, the existence of specific exceptions in section 901 indicated "that Congress did not mean to override the sham-transaction doctrine in other circumstances." *Id.* at *11-*12.

The court's disposition of Wells Fargo's effort to claim a deduction appears to be sound. The taxpayer's arguments were clever, but ultimately not persuasive: The trust component of STARS was determined to be a sham, and the U.K. taxes that Wells Fargo sought to deduct were a central feature of the trust arrangement, as they were designed to generate foreign tax credits. Presumably, the next phase of this case will take place in the Eighth Circuit.

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](#)
>>



This entry was posted in [Blog](#) and tagged [economic substance](#), [foreign taxes](#), [sham transaction](#), [STARS](#), [tax shelters](#) by [Jim Malone](#). Bookmark the [permalink \[http://taxcontroversyposts.postschell.com/tax-shelters-denied-claim-foreign-tax-credits-wells-fargos-effort-claim-deduction-fails/\]](http://taxcontroversyposts.postschell.com/tax-shelters-denied-claim-foreign-tax-credits-wells-fargos-effort-claim-deduction-fails/) .