No. 16-1282

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

SANTANDER HOLDINGS USA & SUBSIDIARIES,	)	On Appeal from the United States District Court for the District of Massachusetts
Plaintiff-Appellee,	)	
v.	)	
UNITED STATES OF AMERICA,	)	Docket No. 09-11043
Defendant-Appellant.	)	The Honorable George A. O'Toole, Jr. Judge Presiding

BRIEF OF APPELLEE SANTANDER HOLDINGS USA & SUBSIDIARIES

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Fed. R. App. P. 26.1, Santander Holdings USA, Inc. & Subsidiaries states that Banco Santander, S.A. is a parent corporation that owns 10% or more of its stock.

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REASON WHY ORAL ARGUMENT SHOULD BE HEARD

Pursuant to First Circuit Local Rule 34.0(a), Santander requests that this case be set for oral argument. This case presents important questions involving the Government's attempt to misapply the common-law "economic-substance" doctrine to override a taxpayer's statutory entitlement to tax credits for income taxes paid to a foreign government. The District Court correctly rejected the Government's arguments, in two thorough and well-reasoned opinions. Similar issues have been resolved by four Circuit Courts (Second, Fifth, Eighth and Federal Circuits), and they have split on how the economic-substance doctrine applies in this context. Oral argument would aid the decisional process.

STATEMENT OF THE ISSUES

Whether the District Court (O'Toole, J.) properly held that a transaction with ample non-tax economic effects should be respected for U.S. tax purposes under the "economic-substance" doctrine.

STATEMENT OF THE CASE

The Internal Revenue Service ("IRS") disallowed foreign tax credits ("FTCs"), interest deductions, and deductions for transaction costs on tax returns for 2003-2005, inclusive, filed by Sovereign Bancorp, Inc. ("Sovereign").[1] The credits arose from a structured loan transaction in which Sovereign borrowed $1.15 billion from Barclays Bank ("Barclays"), which it used in its business and was obligated to pay back.

Sovereign paid the assessment, including IRS-imposed penalties and interest, and sued for a refund. The District Court held that there were no genuinely disputed material facts and awarded summary judgment and a full refund to Sovereign.

[1] Appellee Santander Holdings USA acquired Sovereign in 2008, several years after Sovereign executed the Barclays transaction.

I. Introduction

At bottom, the question is whether a taxpayer that paid a foreign income tax properly levied by another country should be allowed a credit against its U.S. taxes to prevent double taxation, consistent with the applicable statute and rules. The Government does not dispute that Sovereign complied with U.S. statutory and regulatory rules for claiming foreign tax credits. Nevertheless, the Government invokes the judge-made "economic-substance" or "sham-transaction" doctrine in an attempt to ride roughshod over Sovereign's entitlement to congressionally-conferred FTCs.

The Government is wrong. In this Circuit, the economic-substance doctrine asks whether a transaction has a reasonable prospect for pre-tax profit. The District Court properly determined, on the undisputed facts of this case, that the Barclays transaction meets the pre-tax profit test.

This Court and the Supreme Court have instructed that the economic-substance doctrine must be applied to further statutory policies reflected in the finely reticulated foreign tax credit rules. In this case, the

Government seeks to do the opposite—to misapply the doctrine to frustrate the FTC scheme and to attribute to the Barclays transaction a different "substance" from the one designated by Congress.

The Government seeks to twist the economic-substance doctrine to justify its preferred outcome in this case. The Government's position (as described by the District Court) reflects an "undertone of indignation" and "moral judgment." Op/Add 28. "What seems to bother the government is not so much that Sovereign does not *qualify* for foreign tax credits as that it does not *deserve* them." *Id.* (emphases in original). But the economic-substance doctrine does not disallow transactions simply because the Government finds them objectionable. Taxpayers are entitled to rely on the rules in existence at the time they structure their economic affairs. This Court should reject the Government's attempt to rewrite the rules after the fact.

The Government falsely portrays the District Court's decision below as an outlier, citing cases involving other STARS transactions: *Bank of N.Y. Mellon Corp. v. Comm'r*, 140 T.C. 15, *as amended by* 106 T.C.M. (CCH) 367 (2013), *aff'd*, 801 F.3d 104 (2d Cir. 2015), *cert. denied*,

136 S. Ct. 1377 (2016) ("*BNY*"); *Salem Fin., Inc. v. U.S.*, 112 Fed. Cl. 543 (2013), *aff'd in part and rev'd in part*, 786 F.3d 932 (Fed. Cir. 2015), *cert. denied*, 136 S. Ct. 1366 (2016) ("*BB&T*").

But the District Court decision is not an outlier. The District Court considered all relevant precedent, followed holdings of the Fifth and Eighth Circuits that the Government largely ignores, and joined the Federal Circuit over the Second Circuit on a critical point: how to treat a payment by Barclays to the U.S. bank. Further, there are important differences between this case and the *BNY* and *BB&T* cases, and this Court can affirm the judgment below while accepting the outcomes of the *BNY* and *BB&T* cases.

II. The Material Undisputed Facts Are Sufficient To Affirm.

The Government seeks to inject a host of irrelevant factual issues into this appeal, by relying on mischaracterizations of evidence it would seek to present if this Court were to remand for a trial. The Government describes the Barclays transaction as an artificial "tax shelter" designed "to effectuate [a] raid on the Treasury." Govt.Br. at 2, 24. It contends that, although the transaction came to Sovereign as a single package, the deal

was actually two separate transactions (a Trust and a Loan), which the parties combined to "disguise" the "true nature" of the transaction. *Id.* at 14, 15, 66. And the Government relies heavily on its arguments about Sovereign's supposed "motivation."

Sovereign does not accept the accuracy of the Government's Statement of the Case, but it is irrelevant to the issues presented on appeal. For purposes of summary judgment in the District Court, Sovereign agreed to treat the Loan and Trust as separate components. And for purposes of this appeal, the Government has conceded that the Loan component is not a sham as long as the Loan is treated as a separate transaction. Govt.Br. 23 n.6, 70-71 n.17.

Thus, the only question presented is the economic substance of the Trust, which, in turn, depends on two legal issues: (1) whether a contractual payment that Barclays made to Sovereign (referred to as the "Barclays Payment") should be considered *income* to Sovereign or instead a *rebate* of U.K. income taxes; and (2) whether income *tax payments* that Sovereign made to the U.K. government should be treated as *non-tax expenses*, contrary to the treatment of U.S. domestic tax payments (which

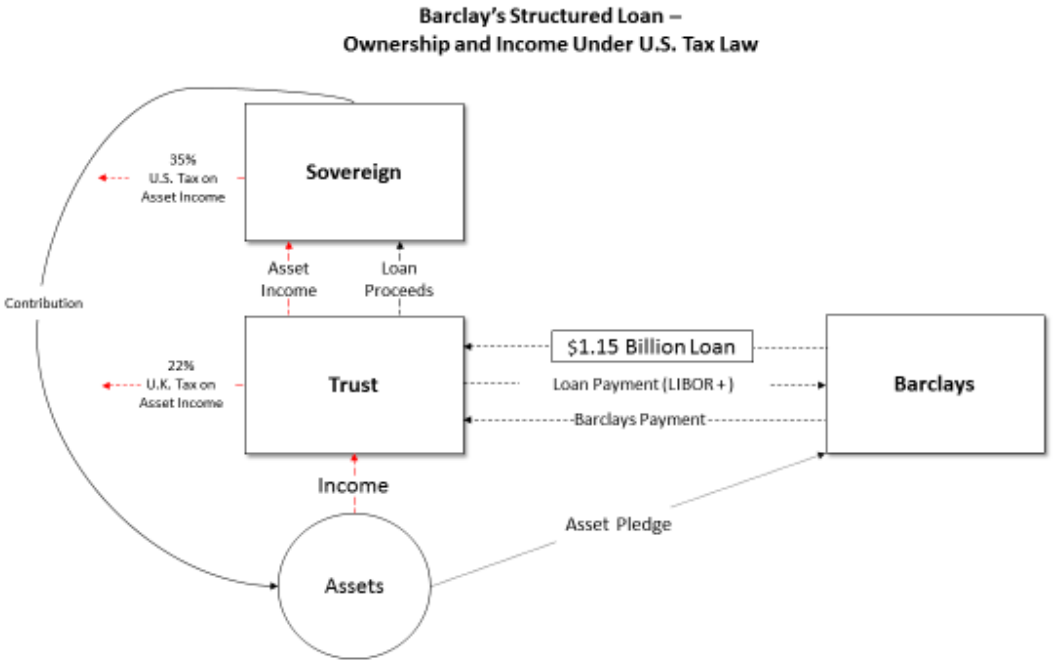
are not counted as "expenses," even under the Government's approach). No disputed facts are necessary to resolve these issues and affirm the District Court's judgment. Even under the Government's version of the facts, Sovereign is entitled to prevail.

Indeed, only three facts are material to the determination of whether the Trust transaction was a sham, and they are undisputed. First, as part of the Trust transaction, Barclays (and not the U.K. taxing authority) made monthly Barclays Payments to Sovereign. Second, Sovereign included each Barclays Payment in taxable income for U.S. federal tax purposes. Third, the amount of the Barclays Payment greatly exceeds all non-tax expenses Sovereign incurred related to the Trust transaction. Based solely on those three facts, the applicable law compels the conclusion that the Trust transaction provided Sovereign a reasonable prospect of pre-tax profit and, therefore, was not a sham.

III. The Barclays Transaction

A. The Transaction Structure.

To obtain the $1.15 billion financing, Barclays required Sovereign to participate in the Trust structure. The following diagram illustrates the transaction:



The transaction's essential aspects may be summarized as follows:

- Sovereign contributed approximately $6.7 billion of income-producing assets to the Trust, Op/Add 2, roughly $1.3 billion of which served as collateral. JA210-211, 266.

- The Trust's income was subject to U.K. income tax, which Sovereign paid, through the Trust. Op/Add 2. At the same time, Sovereign reported Trust income on its U.S. federal income tax

return, was subject to U.S. tax, and claimed the U.S. foreign tax credits at issue here. JA266.

- Barclays extended the initial financing to Sovereign by acquiring an interest in the Trust for $750 million, JA1674, which the Trust then used to redeem a portion of Sovereign's interest. JA299. Almost one year later, Barclays provided an additional $400 million in financing. JA663.

- Sovereign treated the $1.15 billion from Barclays as a loan on its consolidated financial statements, its U.S. federal income tax returns, and in all regulatory filings with the Securities and Exchange Commission and the Office of Thrift Supervision. JA35-36, 128, 216-217, 254, 262, 284, 763-771, 1134-35, 1556, 2039.

- The Government does not dispute that Sovereign treated the amount as a loan for U.S. tax purposes. Govt.Br. 29. The Government concedes on appeal that the Loan has substance (if the transaction is bifurcated) and that Sovereign is entitled to a deduction for interest paid on it. Govt.Br. 23 n.6, 70-71 n.17.

- During the term of the Loan, Barclays received monthly distributions from the Trust that Barclays was required to re-contribute. Op/Add 3. Barclays claimed U.K. tax benefits (described in the next section below) on the basis of these distributions and re-contributions. JA132, 285, 800, 2038.

- Sovereign made interest payments to Barclays on the $1.15 billion. JA70, 78. At the same time, Barclays was required to make the Barclays Payment to Sovereign. *Id.* The Barclays Payment was a negotiated amount that was expressed as a percentage of the U.K. tax credits Barclays anticipated from its participation in the transaction and was netted against Sovereign's interest obligation. *Id.*; *see also* JA755, 784, 978, 2038-2039.

B. Barclays' U.K. Tax Benefit

Under U.K. tax law, Barclays was treated as an owner of an interest in the Trust. Op/Add 3. When Barclays took distributions from the Trust, it owed U.K. taxes on those distributions, but was entitled to a credit on its U.K. corporate income taxes for the taxes the Trust had already paid on this same income. JA131, 284, 797, 2127. This credit was less than the corporate income tax that Barclays incurred when it took a distribution, so the distribution left Barclays with a net tax liability. JA134, rows 6-12, 800, 2038. Under U.K. tax law, however, Barclays was entitled to deduct the amount of its re-contributions to the Trust. JA131, 799. This deduction exceeded Barclays' remaining tax liability from the distribution, creating a net tax deduction for Barclays that it could use to offset tax on other income unrelated to the transaction here. JA284, 800, 2038.

Because of this net U.K. tax deduction that offset unrelated income, Barclays was willing to make the Barclays Payment to Sovereign.

C. Sovereign's Tax Treatment of the Transaction.

Sovereign reported the income earned by the Trust on its U.S. federal income tax return and paid U.S. income tax at the rate of 35%. JA120, 1127. Sovereign also claimed FTCs under Section 901 of the Code, 26 U.S.C. § 901, for the U.K. income tax it paid (through the Trust) on the same income. JA1127.

D. The Barclays Transaction Did Not Reduce Sovereign's Overall Tax Liability.

It is undisputed that Sovereign's income tax payment to the U.K. was equal to the FTCs it claimed on its U.S. returns, meaning there was no overall reduction in Sovereign's actual tax payments. JA1126, 1501. Absent the transaction, the Trust assets would not have been subject to any foreign income tax, and Sovereign would have paid income tax of 35% of the income earned by the Trust to the U.S. Treasury. Because Sovereign paid U.K. income tax of 22% on the Trust income, the FTC provided a credit for that amount from the U.S. and required Sovereign to pay to the U.S. the difference between the U.S. income tax rate (35%) and the U.K. income tax rate (22%). In both circumstances—with and without the Barclays transaction—Sovereign paid tax of 35% on the

Trust income. Because of the transaction, however, Sovereign paid 22% to the U.K. and 13% to the U.S., rather than all 35% to the U.S.

E. The Foreign Tax Credits Were Necessary To Avoid Double Taxation.

Without FTCs, Sovereign would have been subject to double taxation. The U.S. taxes all of the income of U.S. taxpayers regardless of where it is earned. 26 U.S.C. § 61(a). Therefore, absent foreign tax credits, U.S. taxpayers are taxed twice on overseas income— once by the country where the income was earned, and again by the United States under Section 61(a). In this case, the U.K. taxed the Trust's income at 22%, and the U.S. taxed the same income at 35%. Disallowing Sovereign's FTCs would require it to pay 57% of the Trust's income in taxes.

IV. The Government's Descriptions of the Transaction Are Immaterial And Erroneous.

The Government's brief is littered with heated rhetoric and accusations about the Barclays transaction. To be clear, none of the Government's assertions is relevant to this appeal. Sovereign does not ask the Court to decide any disputed fact against the Government, and no trial is needed to affirm the District Court's judgment. Rather, we

respond to these points to illustrate the lengths to which the Government has gone to distract the Court from the question of whether Sovereign *qualifies* for FTCs by arguing "that it does not *deserve* them." Op/Add 28 (emphasis in original).

• The Government claims that the Loan "provided Sovereign with no economic benefit," Govt.Br. 14, and was used merely to "disguise[]" the purported tax shelter. *Id.* at 15. Judge O'Toole, however, held that the Loan was an economically substantive transaction that "furnished the bank with capital to invest in its business." Op/Add 17. The courts in both the *BB&T* and *BNY* cases held that the Loan was a substantive transaction. *BB&T*, 786 F.3d at 958; *BNY*, 801 F.3d at 124. Notwithstanding its rhetoric, the Government does not ask this Court to overturn Judge O'Toole's ruling that the Barclays Loan was an economically substantive transaction. Govt.Br. 23 n.6, 70-71 n.17.

• The Government claims that Sovereign had available funding "at or below LIBOR." Govt.Br. 14. But Sovereign was able to secure such rates only when it borrowed from the Federal Home Loan Bank ("FHLB") and provided home mortgages as collateral. JA2416. Sovereign could not

borrow exclusively from the FHLB, however, and needed alternative funding sources that would accept Sovereign's other assets (such as auto loans) as collateral. JA1499; 1530-1531, 1533, 1535, 2416, 2570, SA3, SA12. When Sovereign borrowed from other lenders, it paid as "high as 12%." JA2416, SA12. The Barclays Loan also allowed Sovereign to diversify its lending sources. Sovereign was particularly interested in borrowing from international lenders, which would limit its exposure in the event of a U.S. liquidity crunch and provide relationships offering future growth opportunities. JA805; 1499; 1533; 1535; SA4, SA17.

The documents cited by the Government purportedly to undermine the Loan's substance actually support Sovereign. *Compare* Govt.Br. 4 (citing JA823, 876, 1022, 1121) *with* JA809 (characterizing transaction as a method to secure "low cost funding"); JA866 ("structure involves Barclays providing funding to Sovereign at a substantial sub-libor rate"); JA1121 (explaining that Barclays Payment represents reduction of 380 basis points on the loan). *See also* JA755 ("Barclays will make a floating rate loan to [Sovereign subsidiary]"); JA794 ("business purpose = low cost

financing"). Overwhelming record evidence is to the same effect. JA209-210; 248; 855; 978; 1499-1501; 2037; 2085; 2419-2420; 2433; 2570.

- The Government claims that, before approaching Sovereign, Barclays sought counterparties for a transaction without a loan. Govt.Br. 13. But there is no evidence (and the Government cites none) that any non-loan transaction was ever offered to (or considered by) Sovereign. Govt.Br. 13-14 (citing JA1086-1114, 1801, 2069-2070); *see also* JA265, 975. To the extent Barclays may have proposed a non-loan transaction to other banks, the evidence shows they were uninterested in it. JA2069-2070.

- The Government cites (29 separate times in its brief) a presentation to Sovereign by Stevens & Lee, but fails to note that Stevens & Lee explained that the transaction "would permit Barclays to lend Sovereign $750 million at an interest rate of approximately 336 basis points *below* Sovereign's normal cost of funds." JA1012 (emphasis added). Stevens & Lee added that "[w]e think Sovereign should represent that: Sovereign's business purpose in entering into the subject transactions is

to achieve a lower interest rate on a credit facility made available by Barclays." JA1018.

The Government focuses on Stevens & Lee's prediction that "The IRS Will View the Transaction as Abusive." JA1022. But the presentation did not conclude that the IRS's view was correct—merely that the IRS would take such a position. In fact, the presentation noted that "in order for the IRS to be successful in attacking the transaction it must rely on established law and cases to present their theories" and did not identify any authority that would support the characterization of the transaction as abusive. *Id.*

V. The Procedural History of this Case.

The IRS disallowed the FTCs, interest expense deductions, and deductions for transaction costs, which Sovereign had claimed for tax years 2003-2005. JA38. The IRS also imposed penalties under 26 U.S.C. § 6662. JA43.

Sovereign timely paid all assessments and sought a refund of $233,920,833. JA45-48. In January 2016, the District Court entered a final judgment in favor of Sovereign. Add. 30. The judgment arose from

two separate orders: an order in October 2013, resolving a "linchpin" legal issue in Sovereign's favor, Op/Add 1, and a subsequent order in November 2015, granting summary judgment to Sovereign and awarding it a full refund. *Id.* at 14.

A. The October 2013 Order Holding That The Barclays Payment Was Income To Sovereign.

The District Court's October 2013 Order addressed the foundational issue whether the Barclays Payment "should be accounted for as revenue in assessing whether Sovereign had a reasonable prospect of profit in the transaction." Op/Add 1. Judge O'Toole explained that, "[i]f the [Barclays] payment is counted as pre-tax revenue, it is objectively clear that the transaction had economic substance for Sovereign." *Id.* at 2.

The Government contended that the Barclays Payment was not revenue but was, instead, an "effective rebate" of U.K. taxes. *Id.* at 4. Judge O'Toole found the Government's argument "wholly unconvincing." *Id.* at 6. He explained that the Code and accompanying regulations define "rebates," and the Barclays Payment did not qualify. In fact, "the government abjured any claim that the Barclays Payment was a subsidy

under these provisions." *Id*. He also noted that the Government could "point to no governing or precedential legal authority that support[ed] treating the private payment between Barclays and Sovereign as a payment from the U.K. treasury." *Id.* at 7.

The Government cited the "learned opinions of its putative expert witnesses." *Id.* at 7. The Court held, however, "that their opinions do not matter because the necessary question is not a question of fact . . . but rather a question of law." *Id.* The "facts of the transaction are not in dispute," Judge O'Toole concluded, leaving for the Court to decide whether the Barclays Payment should "be treated, as a matter of law, as if it were a rebate from the U.K. to Sovereign." *Id.*

The Court answered this legal question in the negative. Relying on "a hoary principle dating to the earliest days of the income tax," which "is still vital" today, the Court held "that payments between private parties, even if they are buying and selling tax credits, are income to be accounted for on a pre-tax basis." *Id.* at 10-11 (citing *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716, 729 (1929); *IES Indus., Inc. v. U.S.*, 253 F.3d

350, 354 (8th Cir. 2001); *Compaq Comput. Corp. & Subsidiaries v. Comm'r*, 277 F.3d 778, 784 (5th Cir. 2001)).

Thus, Judge O'Toole concluded that the Barclays Payment was income to Sovereign, not an "effective" tax rebate, for purposes of determining whether the transaction had a reasonable prospect of profit.

B. The November 2015 Order Granting Final Judgment To Sovereign.

Based on the District Court's conclusion that the Barclays Payment was income as a matter of law, Sovereign moved for summary judgment on its claims for refunds for the 2003-2005 tax years. Judge O'Toole granted that motion, ruling: (i) that the Barclays Loan was not a sham, (ii) that the Government's renewed sham transaction argument regarding the Trust was meritless because foreign tax is not a pre-tax expense, and (iii) that the Government's alternative substance-over-form arguments failed for the same reasons as its arguments regarding the Barclays Payment.

The Court noted that the Tax Court and two federal appellate courts had reviewed similar transactions involving a Barclays Loan to other banks, and all three courts had concluded "it was a real loan"

because "it furnished the bank with capital to invest in its business that had to be paid back." *Id.* at 17 (citations omitted). On January 13, 2016, the Court entered judgment for Sovereign. *Id.* at 30.

SUMMARY OF ARGUMENT

Congress has defined the requirements for FTCs in a detailed statutory and regulatory scheme. The Government concedes that Sovereign complied with all requirements for claiming credits under that scheme. JA104-108. There is no dispute that Sovereign actually remitted payments to the U.K. taxing authority and claimed credits in the same amounts.

Nevertheless, the Government invokes the judge-made economic-substance or "sham-transaction" doctrine in an attempt to deny those credits. The economic-substance doctrine asks whether a transaction enjoys "a reasonable prospect of producing a genuine economic profit." *Dewees v. Comm'r*, 870 F.2d 21, 30 (1st Cir. 1989) (Breyer, J.). The District Court properly held that the Barclays transaction satisfies that test, and its judgment should be affirmed.

Although the Government claims it is pursuing "economic substance," in fact it seeks to manipulate and redefine the transaction in results-oriented and internally inconsistent ways to construct a pre-tax loss. Further, the Government does so in ways that conflict with specific provisions of the FTC scheme created by Congress. The Government would second-guess, or even negate, important elements of that scheme. Such efforts violate the fundamental principle that the economic-substance doctrine is designed to *further* rather than *displace* congressional intent. *See Gregory v. Helvering*, 293 U.S. 465, 469 (1935); *Dewees*, 870 F.2d at 35 (doctrine may be viewed "as an interpretive tool that helps courts . . . conform more precisely with Congressional intent"). And the Government violates this Court's instruction that the economic-substance doctrine may not be used to "chang[e] the rules retrospectively, without clear rationale, and on an *ad hoc* basis to foil one taxpayer." *Stone v. Comm'r*, 360 F.2d 737, 740 (1st Cir. 1966). Yet that is exactly what the Government seeks.

First, the Government insists that the Barclays Payment should be excluded from the consideration of whether the transaction had economic

substance because the payment supposedly represents an "effective rebate" of Sovereign's U.K. taxes and, therefore, a "tax item" to be excluded from economic-substance review. But the Government concedes that the Barclays Payment was not *in form or substance* an "effective rebate" under the governing statute and regulations (which require an assessment of the "substance" to determine whether a taxpayer receives an "effective rebate"). Thus, the Government seeks to divine a *different* "substance" from the one established by the FTC scheme created by Congress. The Government's argument violates the principle that the economic-substance doctrine is a method for *effectuating* congressional intent, not for *frustrating* it.

Second, the Government simultaneously and inconsistently contends that Sovereign's payment of U.K. taxes should be *included* in the economic-substance test. According to the Government, the Barclays Payment (which went from Barclays to Sovereign) should be treated as though it flowed from the U.K. government to Sovereign, while Sovereign's payment of taxes (which went from Sovereign to U.K. taxing authorities) should be redefined as though it were a non-tax "expense"

paid by Sovereign to a private party. Again, the Government seeks to use the economic-substance doctrine to *negate* rather than *promote* congressional intent. The Government's attempt to treat foreign taxes as pre-tax "expenses" runs afoul of the fundamental purpose underlying the FTC regime—*i.e.*, that foreign taxes and U.S. taxes should be treated the same for U.S. tax purposes, so that taxpayers are indifferent as to which they incur.

Third, the Government seeks to impute *Barclays*' motives to *Sovereign* and to punish *Sovereign* for *Barclays*' efforts to generate U.K. tax benefits. In fact, this case is unlike every other case in which the Government has succeeded in applying the economic-substance doctrine. In those cases, taxpayers reduced their overall tax burden by engaging in transactions that produced tax benefits (generally, deductions) that were uneconomic and could be used to offset unrelated income. Here, that did not happen. Sovereign did not reduce its overall tax burden. Instead, the Government seeks to double-tax the very same income, even though double-taxation is the very thing Congress enacted the FTC scheme to prevent.

The Government maintains, in effect, that the ends justify the means—that clever tax lawyers are always one step ahead, and so the IRS needs to twist the common-law "economic-substance" doctrine to deny FTCs when morally necessary. But even if the Rule of Law countenanced such a strategy (and it does not), the Government ignores the other tools at its disposal. In 2010, Congress directed the IRS to issue regulations implementing its codification of the economic-substance doctrine. 26 U.S.C. § 7701(o)(2)(B). The IRS has never exercised its authority to adopt regulations under this provision.

The Government urges this Court to follow the *BNY* and *BB&T* rulings. But the Government ignores important aspects of these rulings (aspects supporting Sovereign rather than the Government), key differences between this case and *BNY* and *BB&*T, and countervailing decisions by the Fifth and Eighth Circuits. Moreover, the Government fails to mention that the factual findings and decision by the Tax Court in *BNY* (the first decision in the Government's favor in STARS litigation) were rendered by a judge facing a disabling conflict of interest: she was simultaneously under investigation for tax fraud and indeed was

subsequently indicted and resigned from the bench. The Government cites her findings and decision more than two dozen times in its opening brief—without disclosing that they were rendered in favor of an agency (the IRS) with the power to affect whether the Tax Court judge would be criminally prosecuted.

The Government incorrectly claims that the District Court considered the Loan in its decision regarding the economic substance of the Trust component of the transaction. To the contrary: the District Court's October 2013 Order expressly assumed the bifurcation sought by the Government.

The Government also attempts to introduce the conclusory opinions of its expert witnesses that the transaction lacked "economic substance" and to seek a trial on Sovereign's "intent." In this Circuit, the economic-substance doctrine is an objective test, and undisputed facts resolve the issues here. The Government's arguments are beside the point.

The judgment below should be affirmed.

ARGUMENT

I. The District Court Properly Concluded That The Barclays Transaction Was Not a Sham.

A. The Statutory And Regulatory Scheme Of Foreign Tax Credits.

A taxpayer's entitlement to FTCs is governed by Section 901(b)(1) of the Internal Revenue Code, 26 U.S.C. § 901(b)(1), which provides that a "domestic corporation" may take a credit for "the amount of any income . . . taxes paid . . . to any foreign country . . . ."

Section 901 is accompanied by extensive implementing regulations, including detailed provisions governing:

- whether a "foreign levy" is a creditable "income tax," 26 U.S.C. § 901(b)(1); Treas. Reg. § 1.901-2(a)(1)-(3);
- whether the tax is compulsory, *see* Treas. Reg. § 1.901-2(e)(5);
- who is considered to have paid the tax, *see* Treas. Reg. § 1.901-2(f)(1);
- how much foreign tax was actually paid, *see* 26 U.S.C. § 901(b)(1), Treas. Reg. § 1.905-2(a)(2);

- the circumstances that constitute a "subsidy" to the taxpayer from the foreign government, which would nullify the credit, 26 U.S.C. § 901(i), Treas. Reg. § 1.901-2(e)(2); and,
- effective limits on the aggregate credit to the amount of U.S. tax imposed on the taxpayer's foreign income, 26 U.S.C. § 904(a).

The combined statutory and regulatory scheme has been described by leading practitioners as "a byzantine structure of staggering complexity." Boris Bittker & James Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 15.21[1][a] (7th ed. Supp. 2014).

There is no dispute that Sovereign complied with this scheme. JA104-108.

B. The Economic-Substance Doctrine Asks Whether A Transaction Has A Reasonable Prospect of Producing A Pre-Tax Profit.

The economic-substance doctrine is designed to further rather than displace congressional intent. *See Gregory*, 293 U.S. at 469 ("the question for determination [has been] whether what was done, apart from the tax motive, was the thing which the statute intended"). As the Supreme Court has explained, the economic-substance doctrine identifies

transactions where there is "*nothing* of substance to be realized . . . beyond a tax deduction." *Knetsch v. U.S.*, 364 U.S. 361, 366 (1960) (emphasis added). By contrast, "where . . . 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." *Frank Lyon Co. v. U.S.*, 435 U.S. 561, 583-84 (1978) (emphasis added).

Similarly, this Court uses the economic-substance doctrine to effectuate congressional intent. In *Dewees*, this Court explained that the doctrine can be viewed "as an interpretive tool that helps courts read tax statutes in a way that makes their technical language conform more precisely with Congressional intent," rather than "*always* taking a transaction outside its statutory framework." *Dewees*, 870 F.2d at 35 (emphasis in original).

This Court has opined that a transaction should not be deemed a sham where it enjoys "a reasonable prospect of producing a genuine

economic profit" and that "taxpayers may lawfully structure transactions that seek real gains in a way that also maximizes tax advantages." *Dewees*, 870 F.2d at 30, 32. The Government acknowledges that the "quintessential inquiry of the economic-substance doctrine is whether a transaction has a reasonable prospect of generating a significant profit" on a pre-tax basis. Govt.Br. 48. The District Court properly held that Sovereign met this test.

This Court has also held the economic-substance doctrine should not be twisted to justify the Government's preferred outcome in individual cases. The judiciary should not employ the doctrine by "changing the rules retrospectively, without clear rationale, and on an ad hoc basis to foil one taxpayer." *Stone v. Comm'r*, 360 F.2d 737, 740 (1st Cir. 1966). This Court has also explained that it is "clearly wrong" for the Government to artificially manipulate a transaction for tax purposes. *Thurber v. Comm'r*, 84 F.2d 815, 818 (1st Cir. 1936) (reversing Board of Tax Appeals).

Nor is the economic-substance doctrine an excuse for the courts to second-guess the tax rulings of foreign governments. *See Riggs Nat'l*

Corp. v. Comm'r, 163 F.3d 1363, 1369 (D.C. Cir. 1999) (for purpose of U.S. foreign tax credits, act of state doctrine required IRS to accept Brazilian Minister of Finance's ruling as to Brazilian taxes); *Riggs Nat'l Corp. v. Comm'r*, 295 F.3d 16, 20 (D.C. Cir. 2002) (receipts submitted by taxpayer sufficient to establish entitlement to FTCs).

Twisting the economic-substance doctrine on an ad hoc basis to recharacterize the treatment of various payments is precisely what the Government seeks. Only by manipulating the transaction and mischaracterizing its constituent parts is the Government able to argue that it generates more expenses than revenue.

C. The District Court Properly Treated The Barclays Payment As Income To Sovereign.

The linchpin of the Government's attack on the transaction is the Barclays Payment—a monthly payment from Barclays to Sovereign, which Sovereign treated as a reduction of interest expense for regulatory, accounting, financial reporting, and federal tax purposes, thereby increasing Sovereign's taxable income. *See* p.8, *supra*.

The Government argues that the Barclays Payment should be excluded from revenue for purposes of calculating pre-tax profit under

the economic-substance doctrine. It attempts to transmute the Barclays Payment from a payment between private parties into an "effective rebate" of Sovereign's U.K. taxes and a "mere[] tax effect[]." Op/Add 18, 45. On the basis of this alchemy, the Government insists that the Barclays Payment is really a tax item that should be excluded from revenue.

Judge O'Toole correctly rejected the Government's argument, a decision since validated by the Federal Circuit's holding in *BB&T* that "the [Barclays] payments are income," *BB&T*, 786 F.3d at 946, even if characterized as a "fee[]" for services rendered in the transaction. *Id.* at 945.

In addition, the Government's position on appeal contradicts its concession in the District Court that the Barclays Payment was not *in form or substance* an "effective rebate" under the governing statute and regulations. However, even if viewed as reimbursements of Sovereign's U.K. tax expenses (as the Government seeks), the Barclays Payment would still be income to Sovereign. As recognized by Fifth, Eighth, and Federal Circuits, the Supreme Court's decision in *Old Colony*, 279 U.S.

at 729, requires that such payments be treated as an economic benefit and includible in a taxpayer's income.

1. The *Old Colony* Principle Requires That The Barclays Payment Be Treated As Income To Sovereign.

The Government characterizes the Barclays Payment as "nothing more than a partial return of U.K. tax" paid by Sovereign. Govt.Br. 25. Assuming, *arguendo*, that characterization is appropriate, the Barclays Payment still must be treated as pre-tax income, and the transaction passes muster under the economic-substance test.

Under "hoary principle[s] dating to the earliest days of the income tax," reimbursement of a tax is an economic benefit that represents *income*, not a tax rebate. Op/Add 10 (citing *Old Colony*, 279 U.S. at 729). "The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed," so that the employer's payment of the income tax "constituted income to the employee." *Old Colony*, 279 U.S. at 729; *see also Diedrich v. Comm'r*, 457 U.S. 191, 195-197 (1982) ("[T]he donor realizes an immediate economic benefit by the donee's assumption of the donor's legal obligation to pay the gift tax.").

As Judge O'Toole correctly held, *Old Colony* requires that "Barclays' assumption of part of Sovereign's tax liability [through the Barclays Payment] is properly regarded as income to Sovereign." Op/Add 10. The Federal Circuit reached the same conclusion in *BB&T*, 786 F.3d at 945 ("Like the taxpayer in *Old Colony*, BB&T realized an immediate economic benefit by receiving the [Barclays] payments from Barclays, which payments effectively repaid half of BB&T's U.K. tax expenses.").

The Fifth and Eighth Circuits also reached the same conclusion in cases similar to this one. *See Compaq*, 277 F.3d at 785; *IES*, 253 F.3d at 351. In the transactions at issue in *Compaq* and *IES*, U.S. companies bought shares in Dutch companies just before the dividend record date (purchasing stock that was pregnant with immediately forthcoming dividends), collected the dividend, and then immediately sold the shares at a loss. The companies claimed foreign tax credits for taxes they paid to the Netherlands to offset their U.S. tax on the dividend income, and used the loss on the sale of shares to offset unrelated capital gains. The government challenged the foreign tax credits, but both Circuits relied on *Old Colony* to reject the government's argument. *See Compaq*, 277

F.3d at 784 ("[T]he payment of Compaq's Netherlands tax obligation by Royal Dutch was income to Compaq."); *IES*, 253 F.3d at 354 ("[I]ncome was realized by the payment of IES's foreign tax obligation by a third party."). Both courts were troubled by the inherent contradiction of the Government's position—that a payment of the taxpayer's foreign tax liability must be ignored when determining a transaction's pre-tax profit but must be treated as income when computing the taxpayer's U.S. tax liability. *See, e.g.*, *IES*, 253 F.3d at 354. As the Eighth Circuit explained, the foreign tax situation "is no different from an employer withholding and paying to the government income taxes for an employee: the full amount before taxes are paid is considered income to the employee." *Id.*

Thus, there can be no dispute that, if Barclays had simply paid half of Sovereign's taxes on Sovereign's behalf, that amount would have been income to Sovereign. Treating the Barclays Payment as revenue to the taxpayer is not a manipulative distortion of tax principles but rather fully consistent with long-established case-law.

The Government responds that *Old Colony* and its progeny involved transactions with "economic reality," and Sovereign's

transaction supposedly does not. Govt.Br. 46. But that argument assumes its own conclusion. In order to determine whether this transaction had economic substance, the Court must characterize the Barclays Payment. Because the Government collects tax on the income realized through payments made to reimburse tax expense, those payments must also be treated as income for purposes of testing economic substance. Under *Old Colony*, the Payment must be considered "income" as a matter of law—and hence the transaction passes the pre-tax profit test.

2. The Government Concedes That The Barclays Payment Was Not A "Rebate" Under The Governing Statute And Regulations.

The preceding section assumed the Government's premise that the Barclays Payment was a partial return or effective rebate of Sovereign's U.K. taxes. But that premise is wrong. The Government concedes (as it conceded below, JA107) that the Barclays Payment was "not a 'rebate' within the meaning of the Internal Revenue Code and related regulations." Govt.Br. 25. This concession dooms the Government's argument under the economic-substance doctrine, because the relevant

rules require an assessment of the "substance" to determine whether a taxpayer receives an "effective rebate."

The FTC regime addresses what counts as a "rebate" of foreign taxes for purposes of the foreign tax credit as a matter of *substance*. Section 901(i) provides that a foreign tax is not considered paid—and hence not creditable—to the extent "(1) the amount of such tax is used (*directly or indirectly*) by the country imposing such tax to provide a subsidy *by any means* to the taxpayer . . . *or any party to the transaction* or to a related transaction, and (2) such subsidy is determined (directly or indirectly) by reference to the amount of such tax, or the base used to compute the amount of such tax." (emphasis added).

The regulations expressly mandate that *"[s]ubstance and not form* shall govern in determining whether a subsidy exists." Treas. Reg. § 1.901-2(e)(3)(ii) (emphasis added). The regulations broadly define a "subsidy" to include "any benefit conferred, directly or indirectly, by a foreign country," *id*. § 1.901-2(e)(3)(ii), and list examples of subsidies as including "a rebate, refund, a credit, a deduction, a payment, a discharge of an obligation, or any other method." *Id*. § 1.901-2(e)(3)(i).

Hence, Section 901(i) and the regulations require an analysis into the *substance* of a transaction to determine whether foreign taxes have been rebated. Congress intended that Section 901(i) would apply when a taxpayer does not receive a direct rebate or refund but instead pays foreign taxes which, "while ostensibly imposed, are *effectively rebated*." H.R. REP. No. 99-426, at 351 (1985) (emphasis added); *see also Norwest Corp. v. Comm'r*, 69 F.3d 1404, 1409 (8th Cir. 1995) (test involves whether "the foreign tax … has in substance been paid"); *Amoco Corp. v. Comm'r*, 138 F.3d 1139, 1145 (7th Cir. 1998) ("[I]t is easy to envision circumstances in which a third party pays foreign tax on behalf of a U.S. taxpayer and then receives a refund of that same payment. … [I]t seems to us that this is precisely what the indirect subsidy rule of § 1.901-2(e)(3) was designed to cover.").

The Government's concession that the Barclays Payment was not *in substance* a "rebate" within the meaning of the Code and related regulations makes it inappropriate for the Government to argue that the Payment constitutes *in substance* a "rebate" under the judge-made economic-substance doctrine. The Government maintains that mere

"compl[iance] with technical tax rules" is irrelevant under the "separate and distinct . . .inquiry" required by the economic-substance doctrine. Govt.Br. 41-42. The Government ignores, however, that the pertinent regulations specifically incorporate a *substance-over-form* requirement. They are not merely "technical" tax rules, but an authoritative definition of what constitutes a subsidy or rebate *in substance*.

The economic-substance doctrine should not be misapplied to clash with (rather than effectuate) the congressional scheme. The doctrine is not an excuse for "taking a transaction entirely outside its statutory framework," *Dewees*, 870 F.2d at 35—much less for creating a conflict with that framework. The Government impermissibly seeks to use the economic-substance doctrine to divine an economic "substance" *different* from the one designated by the congressionally created tax scheme. The sham-transaction doctrine is a method "for divining and effectuating congressional intent, not for supplanting it." *Horn v. Comm'r*, 968 F.2d 1229, 1234 (D.C. Cir. 1992); *Granite Trust Co. v. U.S.*, 238 F.2d 670, 675 (1st Cir. 1956) (rejecting sham transaction argument where "the

legislative history of [the relevant statute] tends to support the position of the taxpayer").

The *substance* of the Barclays Payment should not change depending upon whether it is analyzed under Section 901(i) of the Code or judicial doctrines. *See, e.g.*, *Glass v. Comm'r*, 87 T.C. 1087, 1163, 1175-76 (1986) (analyzing concurrently the "substance" of the transaction under both the economic-substance doctrine and the governing regulation); *DeMartino v. Comm'r*, 862 F.2d 400, 406 (2d Cir. 1988) (performing a concurrent substance analysis under *Gregory*, 293 U.S. at 469-70, and the governing regulation).

The Code and regulations address the topic of "rebates" in great detail and incorporate the same inquiry as the economic-substance doctrine, making it unnecessary and inappropriate to create a judge-made concept of "effective" or "constructive" rebate that would run counter to Congress' handiwork. *See City of Milwaukee v. Ill. & Mich.*, 451 U.S. 304, 317 (1981) (court must "start with the assumption that it is for Congress, not federal courts, to articulate the appropriate standards to be applied as a matter of federal law").

3. The Government's Argument That The Barclays Payment Was An "Effective Rebate" Is Wrong.

Even assuming the Code left room for a common-law conception of an "effective tax rebate," the Barclays Payment would not qualify. Sovereign received the Payment from Barclays, not from the U.K. government. Sovereign's tax payment was not "cycled through" the U.K. taxing authority or converted into tax benefits for Barclays, as the Government incorrectly states. Govt.Br. 13. Indeed, even the Federal Circuit did not accept the Government's argument, concluding that it is "impossible to identify the exact source of the [Barclays] payments, much less to link the [Barclays] payments directly to [the bank's] payments of U.K. taxes." *BB&T*, 786 F.3d at 946.

The calculation of the Barclays Payment by reference to Barclays' expected U.K. tax credit does not convert the payments into a rebate or tax effect. *See* Govt.Br. 9-10, 38. Private parties regularly plan for and share tax benefits when pricing transactions.[2] The Government's own

[2] Victor Fleischer & Nancy Staudt, *The Supercharged IPO*, 67 VAND. L. REV. 307, 310 n.4 (2014) ("That the sharing of tax benefits and liabilities occurs both implicitly and explicitly is widely understood and extensively studied.").

contracts often expressly agree to split tax benefits accruing to private taxpayers. *See, e.g.*, *Centex Corp.v. U.S.*, 49 Fed. Cl. 691, 708 (2001) (FSLIC and taxpayer "agreed to a fifty-fifty split of the benefits derived from the covered asset loss deduction").

Moreover, the Government's attempt to treat the Barclays Payment as a tax item conflicts with the position it took in *Doyon, Ltd. v. United States*, 37 Fed. Cl. 10, 22-24 (1996), *rev'd on other grounds*, 214 F.3d 1309 (Fed. Cir. 2000), where the Government contended that "amounts paid between private parties pursuant to private contracts are not and cannot be 'federal income taxes'" within the meaning of the applicable Code provision and related regulations. *Id.* at 17. The court there agreed with the Government that private payments were *not* tax items, concluding that "an item of federal tax benefit is an abatement of liability under the revenue laws." Further the court rejected the notion—raised by the Government here (Govt.Br. 38-39)—that the characterization of a private party payment depends upon its "ultimate source." *Id.* at 23. Instead, the character of the Barclays Payments turns on their "*immediate, actual and sole* source[]," which was Barclays. *Id.* (emphasis in original).

The Government's position here also conflicts with its own published rulings defining what constitutes a tax. *See* Rev. Rul. 81-192, 1981-2 C.B. 49 ("[I]t is the position of the Service that a tax must be paid to a government levying the tax, to certain public benefit corporations created by that government for a public purpose, or to their agents."); I.R.S. Priv. Ltr. Rul. 87-42-010 (July 10, 1987) (rejecting claim by taxpayer that purchase of tax credits should be treated as a tax payment because payment was to private party and was not "exacted pursuant to legislative authority in the exercise of the taxing power"); I.R.S. Priv. Ltr. Rul. 2009-51-024 (Dec. 18, 2009) ("a payment for the purchase of a transferable tax credit is not a payment of tax or a payment in lieu of tax"); I.R.S. Priv. Ltr. Rul. 2003-48-002 (Nov. 28, 2003) (purchase of state tax credit is not a payment of tax).

4. The Characterization Of The Barclays Payment Is A Question Of Law.

As a last-ditch argument, the Government contends that the proper treatment of the Barclays Payment is a matter of fact, not law. Govt.Br. 36. The District Court correctly rejected this argument and deemed irrelevant the Government's expert opinions because "[t]he facts of the

transaction are not in dispute." Op/Add 7. "[T]he necessary question is not a question of fact – What happened? – but rather a question of law – How should what happened be classified for purposes of applying the law?" *Id.*

The Government's argument is foreclosed by governing Supreme Court precedent: "The general characterization of a transaction for tax purposes is a question of law subject to review." *Frank Lyon*, 435 U.S. at 581 n.16. The Federal Circuit in *BB&T* also treated the issue as a matter of law. *See BB&T*, 786 F.3d at 945-46 (reversing the trial court and holding as a matter of law that the Barclays Payment must be treated as economic income because "[p]ursuant to *Old Colony* and its progeny, the Bx payments are income to BB&T.").

Other cases cited by the Government recognize that "[t]he ultimate determination of whether a transaction lacks economic substance is a question of law." *Sala v. U.S.*, 613 F.3d 1249, 1252 (10th Cir. 2010); *see also Stobie Creek Invs. LLC v. U.S.*, 608 F.3d 1366, 1375 (Fed. Cir. 2010) ("How a transaction is characterized is a question of law").

The Government identifies no disputed *fact* relevant to the legal characterization of the Barclays Payment. The Government simply relies on the Second Circuit's decision in *BNY*. Govt.Br. 35-37. But the Government does not acknowledge that (contrary to *Frank Lyon*) the Second Circuit incorrectly considers economic substance to be a question of fact, reviewed for clear error. *Jacobson v. Comm'r*, 915 F.2d 832, 837 (2d Cir. 1990). Thus, the Tax Court excluded the Barclays Payment from revenue based on a *factual determination*. *See BNY*, 140 T.C. at 33. The Second Circuit affirmed on clear-error review applicable to factual findings, 801 F.3d at 121. The Federal Circuit as well as the District Court below properly treated the issue as a *question of law*. Moreover, as explained in Part II-C-1, *infra*, the factual findings of the Tax Court are tainted because the judge rendering them was operating under a disqualifying conflict of interest.

D. The District Court Properly Held That Foreign *Tax* Is Not A *Pre-Tax* Expense.

The Government retreats to the argument that, even if the Barclays Payment is treated as revenue, the transaction still fails the pre-tax profit test because "Sovereign had to pay $2 of U.K. tax to receive $1 of

Bx payments." Govt.Br. 47 (quoting heading). The Government, however, fails to explain why the payment of a foreign *tax* should be relevant at all to the computation of *pre-tax* profit. Rather, the Government simply makes the illogical assertion that *pre*-tax profit (*i.e.*, profit calculated *prior* to considering *taxes*) should be reduced by foreign *taxes*. Govt.Br. 48.

In fact, treating foreign tax as a pre-tax expense is improper. It ignores the *pre*-tax nature of the inquiry and inappropriately stacks the deck against cross-border transactions, in direct contravention of the legislative history and the purpose of the foreign tax credit.

Moreover, the Government's argument cannot be reconciled with its treatment of the Barclays Payment. On the one hand the Government argues that the Barclays Payment should be *excluded* from the pre-tax profit calculation because, according to the Government, it represented the *indirect effect* of Sovereign's payment of U.K. tax. Govt.Br. 35. On the other hand, it claims Sovereign's *actual and direct* payment of U.K. taxes should be *included* on the expense side of the calculation. That logically untenable position reveals the Government's true aim: to "count" taxes

only when they help the Government's litigation strategy by subtracting from cash flow.

1. Treating Foreign Taxes as Pre-Tax "Expenses" Is Inconsistent with Congressional Intent That Foreign and Domestic Taxes Be Treated As Equivalent.

There is no dispute that, under the economic-substance doctrine, the pre-tax profit of a transaction is calculated by ignoring U.S. taxes. The Government, however, proposes to reduce pre-tax profit in the amount of any *foreign* tax payments. That would violate the very purpose of the FTC regime: treating foreign and domestic taxes as equivalent. As we have noted previously, the pre-tax profit test is merely a tool to aid a court in statutory construction. *Gregory*, 293 U.S. at 469; *Dewees*, 870 F.2d at 30, 36. Once again, the Government's approach violates this cardinal principle.

Congress enacted the FTC to "encourage[] foreign investment abroad" by ensuring that "a dollar anywhere should be subject to the same tax . . . ." S. Rep. No. 86-1393, at 24 (1960). As the Government acknowledges, the FTC represents Congress' effort to "neutralize the effect of U.S. taxes on decisions where to invest or conduct business most

productively," Govt.Br. 29, by "in effect *treat[ing] the taxes imposed by the foreign country as if they were imposed by the United States*." H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 76 (1954) (emphasis added). Accordingly, Congress elected to treat all taxes (domestic or foreign) the same, to create parity between U.S. and foreign taxes so far as the U.S. income tax laws are concerned. In that way, "[r]elief from double taxation is not so much an act of grace as one of justice in determining the true net income of the taxpayer." *Gentsch v. Goodyear Tire & Rubber Co.*, 151 F.2d 997, 1000 (6th Cir. 1945).

The Government concedes that creating neutrality between foreign and domestic transactions is "[t]he purpose of the foreign tax credit." Govt.Br. 29. But it seeks to evaluate the profitability of foreign transactions after deducting foreign tax, while evaluating domestic transactions as if they were tax-free. As illustrated by a simple example, the Government's test inappropriately discriminates against foreign transactions.

Suppose a U.S. bank borrows $1,000 at a 3-percent interest rate, then makes a $1,000 loan with a 4-percent interest rate to a U.S.

borrower. The bank reasonably expects to make a profit of $10 before taxes ($40 interest income less $30 interest expense). This transaction undisputedly produces a pre-tax profit of $10 and has economic substance.

Assume instead that the U.S. bank makes a $1,000 loan to a foreign rather than domestic borrower, charging the same 4-percent interest rate. The $40 of interest income is subject to foreign tax at a 30-percent rate, and thus the U.S. bank would owe a foreign tax of $12. Although nearly identical to the domestic transaction described above, this cross-border transaction would lack economic substance under the Government's test; the U.S. bank receives income of $40 but has "pre-tax" expenses of $42 ($30 of interest plus $12 of foreign tax). The Government's rule would thus treat a broad range of ordinary business transactions as lacking in economic substance merely because those transactions are cross-border, precisely contrary to the result Congress intended.

To properly "neutralize" the effect of the United States' worldwide taxation system on decisions regarding where to invest, cross-border and

domestic transactions must be subject to the same test. Excluding foreign tax from the test merely insures that the Government does not "stack the deck against finding the [cross-border] transaction profitable." Op/Add at 19 (quoting *Compaq*, 277 F.3d at 785).

The Government errs in criticizing the District Court for stating in dicta that if foreign tax is treated as an expense, "then the U.S. foreign tax payment must be treated as revenue." Govt.Br. 52. The District Court meant only that the test should be neutral: "the analysis should either count all tax effects or not count any of them." Op/Add at 19-20 (quoting *Compaq*, 277 F.3d at 785). The Government is the one seeking to stack the deck and to have it both ways—by *including* the U.K. taxes as "expenses" of the transaction while *excluding* all other tax considerations. If the pre-tax profit test is conducted by *excluding both* U.K. taxes paid by Sovereign *and* the FTCs, then the transaction passes muster, as the District Court properly concluded.

2. The Government's Test Creates an Inappropriate Mismatch Between Taxable Income and Pre-Tax Profit.

The Supreme Court's decision in *Old Colony* fortifies the conclusion that tax payments should not be treated as pre-tax "expenses." Under *Old Colony*, Sovereign undisputedly was required to report as taxable U.S. income the full amount of the income earned on the assets in the Trust unreduced by foreign tax expense. *See* 279 U.S. at 729. There is no principled basis for treating foreign taxes differently in computing pre-tax profit under the economic-substance test. Instead, as the Fifth and Eighth Circuits recognized, the IRS should not be allowed on one hand to tax the full amount of that income and on the other require that pre-tax profit be reduced by foreign tax paid. *Compaq*, 277 F.3d at 783; *IES*, 253 F.3d at 354.

The Government glosses over the question of why *foreign tax* should be treated as a *pre-tax* expense, offering merely that the pre-tax profit of a transaction should be reduced by its expected "costs and fees." Govt.Br. 48 (citing *Stobie Creek*, 608 F.3d at 1378). The case the Government cites for support, however, does not even address the treatment of foreign

taxes in the economic-substance doctrine. And although the Second and Federal Circuits each held that pre-tax profit should be reduced by foreign taxes, neither court offered any authority or justification for its position. *See BNY*, 801 F.3d at 118; *BB&T*, 786 F.3d at 948-49. Instead, those courts ignored the question of whether to include foreign tax expense in pre-tax profit and improperly skipped to whether FTCs should be included in that calculation.

In contrast, to the Second and Federal Circuits, the Fifth and Eighth Circuits have each taken a more analytical approach to the treatment of foreign taxes under the economic-substance doctrine. Each has concluded that foreign taxes are properly excluded from the pre-tax profit calculation. *Compaq*, 277 F.3d at 784; *IES*, 253 F.3d at 354. As the Fifth and Eighth Circuits recognized, *Old Colony* establishes that "[t]he discharge by a third person of [a taxpayer's] obligation" is "equivalent to receipt by the person taxed." *Compaq*, 277 F.3d at 783; *see also IES*, 253 F.3d at 354. The Fifth and Eighth Circuits held that this "venerable principle" applies to foreign taxes: when a taxpayer earns income subject to a foreign tax, "the economic benefit to [the taxpayer] [is] the amount

of . . . *gross* [income], before the foreign taxes are paid." *IES*, 253 F.3d at 354; *Compaq*, 277 F.3d at 784 ("Pre-tax income is pre-tax income regardless of the timing or origin of the tax."). In disagreeing with the Fifth and Eighth Circuits, the Federal and Second Circuits failed to address this fundamental point.

In its argument that foreign tax should be treated as an expense, the Government fails to even mention *Compaq* and *IES*, much less respond to their analysis. Judge O'Toole, on the other hand, considered both points of view on this issue. Acknowledging that the instant "transaction is different from the transactions at issue in [*Compaq* and *IES*]," Judge O'Toole nevertheless determined that the reasoning of the Fifth and Eighth Circuits was relevant here and was more compelling than the sparse "analysis" offered by the Second and Federal Circuits. Op/Add 18. Judge O'Toole was correct, and the Government's approach defeats rather than promotes congressional intent.

3. The 2010 Codification Supports Sovereign.

The Government claims that the 2010 codification of the economic-substance doctrine in 26 U.S.C. § 7701(o)(2)(B) supports its contention

that the Court should "disregard U.S. tax benefits, but may, at the same time, account for foreign-tax expense." Govt.Br. 54. That statute, however, governs only transactions entered into on or after March 20, 2010, and thus cannot apply here. Govt.Br. 3 n.3. Moreover, the statute's text and history support Sovereign.

In adopting § 7701(o)(2)(B), Congress acted against the backdrop of the *Compaq* and *IES* decisions, which established that foreign taxes should *not* be considered "expenses" when calculating pre-tax profit under the economic-substance doctrine. When Congress acted in 2010, no circuit court had disagreed with that principle. Kevin Dolan, *The Foreign Tax Credit Diaries –Litigation Run Amok*, 71 Tax Notes 831, 832-34 (Aug. 26, 2013).

One proposal, which the House Ways and Means Committee passed, would have expressly overruled the *Compaq* and *IES* cases, stating that "foreign taxes shall be taken into account as expenses in determining pre-tax profit." H. Conf. Rept. No. 111-299 at 61 (2009) (proposed section 452(o)(2)(B)). But this language was omitted from the final statute, which directed the Secretary of the Treasury to "issue

regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in *appropriate cases*." 26 U.S.C. § 7701(o)(2)(B) (emphasis added). And, notably, in its contemporaneous report on the enactment of Section 7701(o), the Joint Committee on Taxation cited *Compaq* approvingly without suggesting that the decision was no longer good law. Staff of the J. Comm. on Tax'n, 111th Cong., 2d Sess., Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act," 155 n.357 (JCX-18-10) (Comm. Print Mar. 21, 2010).

Hence, Congress rejected the House proposal to categorically overrule *Compaq* and *IES*. Instead, Congress made the common-law principle subject to revision through a properly promulgated rule to govern "appropriate cases." The Secretary has not issued regulations to implement § 7701(o)(2)(B). Accordingly, there is no statutory or regulatory basis for the Government's attempt to treat foreign taxes as expenses in this case.

Indeed, Congress' decision *not* to legislate the treatment of foreign taxes must be understood as reaffirming the validity of the prevailing common-law norms at the time of the codification. *See U.S. v. Lahey Clinic Hosp., Inc.*, 399 F.3d 1, 16 (1st Cir. 2005) (when Congress legislates in an area previously covered by the common law, "courts may take it as a given that Congress has legislated with an expectation that the common law principle will apply except 'when a statutory purpose to the contrary is evident'") (*quoting U.S. v. Texas*, 507 U.S. 529, 534 (1993) and *Astoria Fed. Sav. & Loan Ass'n. v. Solimino*, 501 U.S. 104, 108 (1991)). This principle has particular force here because Congress expressly recognized the continuing vitality of the doctrine's common-law requirements. 26 U.S.C. § 7701(o)(5)(C) ("The determination of whether the economic-substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted."); *id.* § 7701(o)(5)(A) (defining the economic-substance doctrine as "*the common law doctrine* under which tax benefits . . . are not allowable").

The common-law rule at the time of the codification was reflected in *Compaq* and *IES*, the only appellate court decisions addressing the

issue. The legislative history makes clear that Congress rejected a black-letter rule that foreign taxes *always* be treated as expenses under the economic-substance doctrine. The codification thus preserved the holdings in *Compaq* and *IES* until such time as the Secretary issues regulations identifying "appropriate" cases for treating foreign tax payments as expenses.

II. The Government's Attacks On The District Court's Decision Are Misplaced.

A. The Government Misapplies The Economic-Substance Doctrine Because It Confuses Barclays With Sovereign.

This case is different from every other case in which the Government has successfully applied the economic-substance doctrine. In those cases, taxpayers reduced their overall tax burden by engaging in transactions that produced tax benefits (generally, deductions) that were uneconomic and could be used to offset unrelated income.[3]

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[3] *See, e.g., Coltec Indus., Inc. v. U.S.*, 454 F.3d 1340 (Fed. Cir. 2006) (uneconomic tax loss generated by taxpayer's transfer of liabilities to a related party in exchange for a note used to offset other taxable gains); *Winn-Dixie Stores, Inc. v. Comm'r*, 254 F.3d 1313, 1316 (11th Cir. 2001) (net interest deductions with no cash outlay reducing taxable income); *ACM P'ship v. Comm'r*, 157 F.3d 231, 251 (3d Cir. 1998) (uneconomic

Here, the Barclays transaction had no such effect. Sovereign's tax burden remained the same, with the only difference being that a portion of that tax was paid to the U.K. rather than the U.S. Some courts have held that it is inappropriate to apply the sham-transaction doctrine where such circumstances do not exist. *See United Parcel Serv. of Am., Inc. v. Comm'r*, 354 F.3d 1014, 1019 (11th Cir. 2001) ("These circumstances distinguish UPS's case from the paradigmatic sham transfers of income, in which the taxpayer retains the benefits of the income it has ostensibly foregone.").

This Court need not adopt a categorical rule regarding the scope of the economic-substance doctrine in order to conclude that the Government has misapplied the doctrine in this case. The Government's own arguments show that its proper target is *Barclays* rather than *Sovereign*. For example, the Government complains that "STARS is profitable only *because* of the payment of tax," Govt.Br. 50 (emphasis in

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losses resulting from "fleeting and economically inconsequential investment"); *Jade Trading, LLC v. U.S.,* 80 Fed. Cl. 11 (2007) (uneconomic tax losses resulting from artificially high basis); *H.J. Heinz Co. v. U.S.,* 76 Fed. Cl. 570 (2007) (same).

original). But the payment of U.K. tax did not generate any benefit for *Sovereign*. *Sovereign* did not reduce its overall tax burden by participating in the transaction. As Judge O'Toole explained, "Sovereign effectively paid the same total amount in income taxes as it would have without the STARS transaction. It is just that as a result of the transaction, it paid that same amount to two different taxing authorities. It did not avoid any tax or reduce its income tax cost." Op/Add 23-24. The result of the FTCs on Sovereign's tax burden was "a wash." *Id.* at 24. The FTCs merely enabled Sovereign to avoid paying double taxes (to both the U.S. and U.K.) on the same income.

Barclays, however, *did* enjoy considerable U.K. tax benefits because of the transaction. As Judge O'Toole observed, "*Barclays* was interested in tax benefits that it could obtain under U.K. law, in exchange for which it was prepared to pay a U.S. bank counterparty for its cooperation in a transaction that would produce those benefits." *Id.*at 23 (emphasis added).

The Government seeks to blame Sovereign for Barclays' efforts to reduce its U.K. tax liabilities. But as Judge O'Toole explained, it is

neither "necessary [n]or appropriate to apply American judicial anti-abuse doctrines to analyze Barclays' structuring of its U.K. tax liabilities." Op/Add 26. "Sovereign should [not] be punished by taking away its credit for helping Barclays manipulate its benefits under the U.K. tax laws." *Id.* at 28. Moral indignation cannot substitute for legal analysis, and this Court should not distort the economic-substance doctrine to cover ground where other cases have not tread.

B. The Government's Arguments That Sovereign Does Not "Deserve" FTCs Are Irrelevant and Wrong.

Judge O'Toole correctly rejected the Government's attempts to transform the economic-substance doctrine into "a kind of smell test." Op/Add 28. Many of the Government's attacks on the District Court are legally irrelevant or directly contradict the FTC regime, in violation of the principle that the economic-substance rest is an aid to statutory construction rather than a tool for subverting congressional intent.

1. The Government complains that the U.S. Treasury received less tax revenue as a result of the Barclays transaction. *E.g.*, Govt.Br. 24. That argument, however, proves too much. By crediting taxes paid to a foreign jurisdiction, Section 901 *always* reduces domestic tax collection.

It does so in service of the congressional policy that all income, domestic or foreign, should be taxed only once.

2. The Government argues that Sovereign voluntarily subjected itself to U.K. tax, and therefore should not be allowed to claim FTCs. Govt.Br. 4. Regulations interpreting Section 901 determine when and to what extent a foreign tax is non-compulsory or "voluntary." *See* Treas. Reg. § 1.901-2(e)(5)(i). These regulations do not require a taxpayer "to alter its form of doing business, its business conduct, or the form of any business transaction in order to reduce its liability under foreign law for tax." *Id.* Instead, the regulations require only that the taxpayer determine the proper amount of its foreign tax liability and take reasonable actions under foreign law to reduce its foreign tax burden. *Id.* The question of whether Sovereign "voluntarily" incurred U.K. tax is, therefore, irrelevant.

3. The Government suggests that Sovereign did not "in substance" pay U.K. tax because one-half of the tax payment was "returned" to Sovereign. Govt.Br. 2, 4, 6, 13. But the Government conceded in the District Court that Sovereign's subsidiary "transfer[red] cash to the U.K.

tax authorities in full satisfaction of the U.K. income tax liability" of the Trust. JA108.

The Government's complaint about the "substance" of tax payments rests on the Government's flawed argument that the Barclays Payment should be viewed as an effective "rebate" of Sovereign's U.K. tax liability, to which we have already responded. *See* Part I-C, *supra.* Moreover, Sovereign was not required to bear the economic burden of the foreign tax to claim an FTC. *See Biddle v. Comm'r,* 302 U.S. 573, 580-82 (1938) (rejecting taxpayer's argument that she should be able to claim FTCs where she bore the burden of the foreign tax). Consistent with *Biddle*, the FTC regulations have long declared that "[t]ax is considered paid by the taxpayer *even if another party to a direct or indirect transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer's foreign tax liability*." Treas. Reg. § 1.901-2(f)(2)(i) (emphasis added). To be clear, Barclays could have paid Sovereign's U.K. tax liability in its entirety, and Sovereign would nonetheless have been entitled to an FTC so long as Sovereign was legally liable for the tax, and there is no dispute that it was.

4. The Government argues that Sovereign's payment of a U.K. tax was "illusory," Govt.Br. 34, because "almost all of the tax was recovered by Barclays," *id.* at 5. This argument is barred by the Government's concession that Sovereign did not receive a subsidy (*i.e.*, an effective rebate). *See* Part I-C-2, *supra.* It is also incorrect. There is no suggestion that Sovereign or Barclays ever received an actual rebate. The U.K. taxes paid by Trust and Sovereign never left the U.K. Exchequer. The Trust paid taxes on its income; when that income was distributed to Barclays, such income was taxable again in the hands of Barclays under U.K. corporate tax rules. Barclays was entitled to a credit for the taxes that the Trust had already paid on the same income to offset those additional U.K. income taxes, and that credit was less than the applicable corporate tax. Barclays then also received a trading loss deduction for its re-contributions. That trading loss deduction resulted in a net tax deduction to Barclays that Barclays used to offset a portion of its unrelated banking income. *See BB&T*, 786 F.3d at 938. All the while, the U.K. taxes that the Trust had paid remained in the U.K. Exchequer. Accordingly, there was no "recovery" of the Trust taxes.

C. The Government's Appeal To Out-Of-Circuit Precedent Is Unavailing.

The Government urges this Court to follow *BNY* and *BB&T*. But the Government ignores the countervailing decisions by the Fifth and Eighth Circuits in *Compaq Computer* and *IES Indus.* *See* pp. 32-33, 50-51, *supra*.

The Government also overlooks important aspects of the *BNY* and *BB&T* decisions, such as the Federal Circuit's holding in *BB&T* that the Barclays Payment should be treated as revenue. 786 F.3d at 945-46. In fact, the Federal Circuit cited the same seminal case of *Old Colony Trust* on which Judge O'Toole relied. *See* pp. 30, 32, *supra.*

Although the *BNY* decision came to a different conclusion regarding the Barclays Payment, it is not persuasive because it incorrectly treated the issue as a "factual one," as discussed in Part I-C-4, *supra*.

1. This Court Should Not Follow The Tax Court's Decision, Rendered By A Judge Subsequently Indicted For Tax Fraud.

The Tax Court's decision in *BNY* (and the Second Circuit's affirmance of that decision) is not entitled to weight for a further reason: it has recently come to light that the judge in that case—Judge Kroupa—

faced a disabling conflict of interest when she rendered the *BNY* decision. In April 2016, Judge Kroupa was indicted for tax fraud on the ground that she purposely understated her taxable income by approximately $1 million and purposely understated the amount of tax she owed by at least $400,000.[4] The unsealed indictment reveals that at the same time she was considering the *BNY* case, she was under audit by the IRS and allegedly committing further tax fraud. It is obvious that she might have had an interest in currying favor with the IRS, the very agency helping to decide whether she would be criminally prosecuted. Judge Kroupa's alleged misconduct "directly implicate[d] the character and integrity of the judge." *U.S. v. Jaramillo*, 745 F.2d 1245, 1248-49 (9th Cir. 1984), *cert. denied*, 471 U.S. 1066 (1985) (upholding recusal of judge charged with bribery, fraud, and tax evasion).

[4] U.S. Dep't of Justice, *Former United States Tax Court Judge and Husband Indicted for Conspiracy to Commit Tax Evasion and Obstruction of an IRS Audit*, JUSTICE NEWS (Apr. 4, 2016), https://www.justice.gov/opa/pr/former-united-states-tax-court-judge-and-husband-indicted-conspiracy-commit-tax-evasion-and (last visited Aug. 14, 2016).

Recognizing Judge Kroupa's inherent conflict of interest in any tax case, the Tax Court has already permitted one taxpayer to move for reconsideration more than three years out of time. Order, *Eaton Corp. v. Comm'r*, Docket No. 5576-12 (T.C. June 29, 2016). Yet the Government did not disclose Judge Kroupa's indictment in its opening brief, even though the Tax Court's decision in *BNY* case is one of the Government's primary authorities, cited more than *two dozen* times.

The cumulative impact of Judge Kroupa's decision in *BNY* is troubling. Her decision was the first to accept the Government's position in a STARS case, and the Government used it successfully as favorable precedent in subsequent litigation. The Second Circuit affirmed Judge Kroupa's decision based on deference to her fact-finding. *BNY*, 801 F.3d at 110, 119, 121-22. The trial court in *BB&T* cited Judge Kroupa's decision nearly a dozen times, and heavily relied on its factual findings. 112 Fed. Cl. at 583. That fact-finding, and the precedent that it spawned, should be accorded no persuasive value in this Court.

2. Sovereign's Claim Is Distinguishable From Those Of BNY And BB&T.

Further, the *BNY* and *BB&T* decisions are distinguishable. This Court can decline to follow them without creating a conflict with their holdings.

In contrast to Sovereign, BB&T expressly abandoned any argument regarding the transaction's impact on its business. *See BB&T*, 786 F.3d at 952 ("Significantly, although BB&T argued in the Court of Federal Claims that the purpose of the STARS transaction, including the Trust, was to obtain financing, BB&T does not make that argument in this court."). Instead, BB&T claimed to have participated in the transaction solely to profit from the Barclays Payment and to assist Barclays in securing tax benefits. *Id.*at 940, 952-53.

BNY's transaction is also distinguishable. BNY manipulated the trust to accelerate and maximize the trust's payment of U.K. taxes. *See BNY*, 140 T.C. at 25 *aff'd*, 801 F.3d 104. In particular, BNY used the trust to secure tax-related benefits by engaging in a "stripping transaction." *Id*. at 25-26. As the Tax Court explained, the stripping transaction involved BNY selling the rights to future trust income to related entities. "[B]ecause the sale of the interest rights was funded by BNY and between

entities within the STARS structure, the stripping transaction had no potential to generate a non-tax economic profit on the aggregate." *Id.* at 36. Using this "stripping" device, BNY deliberately increased the trust's U.K. tax liability by $88 million in 2001, even though the trust income did not change. *Id.* at 26. BNY therefore sought an additional $88 million in FTCs on its U.S. tax return in 2001, and secured additional payments from Barclays of approximately $44 million. *Id.*

The "stripping transaction" thus allowed BNY to use the Trust as an independent and separate source of revenue. Sovereign, by contrast, disregarded the Trust entirely for U.S. tax purposes and treated the Barclays Loan as a loan for all tax and regulatory purposes. JA210, 254, 763-771, 1134-35, 1556. Unlike BNY, Sovereign did not manipulate the Trust to increase the Trust's taxes and secure additional financial benefits.

BNY and *BB&T* are therefore distinguishable.

III. There Is No Need To Reach The Government's Argument About The "Overall Economic Effect" Of The Transaction.

The Government maintains that, even if a transaction fails the pre-tax profit test, it can still qualify as possessing economic substance based

on an assessment of "the overall economic effect of the transaction." Govt.Br. 55 (citation and internal quotation marks omitted). As the Government acknowledges, however, that vague test is relevant only if the Court determines that the transaction had no reasonable prospect of pre-tax profit. *Id.* Because the District Court properly held that the transaction met the pre-tax profit test, there is no need to consider the arguments at Govt.Br. 55-57.

If the Government's test were considered, however, it would support Sovereign. It is undisputed that Barclays made monthly Barclays Payments to Sovereign, which Sovereign included in its taxable income for U.S. federal tax purposes. It is also undisputed that the Barclays Payment greatly exceeded all non-tax expenses Sovereign incurred related to the transaction. In short, the transaction in this case involved genuine transfers of payments and actual economic consequences for the parties.

This Court has instructed that the judiciary must respect transactions that are not "so lacking in substance as to be anything

different from what they purported to be." *Granite Trust*, 238 F.2d at 678. The transactions here meet that test, based on the undisputed facts.

The Government's argument relies on Judge Kroupa's defective factual findings, made in a tainted proceeding in which Sovereign did not participate. *See* Govt.Br. 55 (citing *BNY*, 140 T.C. at 35-37). Those findings should be given no weight here.

The Government also argues that the transaction had a complex structure with multiple purported "circular cash flows." *E.g.*, Govt.Br. 10-13, 55. But the Government's argument is legally irrelevant to the economic-substance test, because the features of the transaction that offend the Government were not relied upon by Sovereign in its tax treatment. The distributions to and from the Trust were undertaken for Barclays' U.K. tax purpose and *affirmatively disregarded* by Sovereign for all U.S. tax purposes. Op/Add 22. Accordingly, those "circular cash flows" created no U.S. tax consequences, let alone U.S. tax benefits, for Sovereign. *Id.* at 23.

Hence, there is no need to reach the Government's argument about the "overall economic effect" of the transaction, but in any event it would support Sovereign.

IV. The Government Is Wrong In Arguing That The District Court Relied On The Loan In Finding That Sovereign Met The Economic-Substance Test.

A. The District Court Found The Economic-Substance Test Met Without Considering The Loan.

The Government incorrectly argues that the District Court relied on the Barclays Loan to "buttress" its conclusion that the transaction met the economic-substance test. Govt.Br. 64. As the Government ultimately concedes in a footnote (*id.* at 65 n.15), the October 2013 Order accepted the Government's bifurcation premise that the Loan should not be considered as part of the economic-substance test. Op/Add 4 n.3.

Apparently the Government's quarrel is with the District Court's *second* summary judgment decision, (Op/Add 14-29), which contains passing references to the Loan regarding arguments raised by the Government *as an alternative* to its primary economic-substance challenge. *Id.* at 21-25. The Government fails to show that these passing references made any difference. The Court's earlier (October 2013) order

had *already* resolved the linchpin issue of the tax treatment of the Barclays Payment, which in turn dictated that the transaction met the pre-tax profit test. Judge O'Toole's determination that Sovereign had a requisite business purpose (to the extent any is required) was premised solely on the potential profitability of the bifurcated Trust. Op/Add 13.

B. In Any Event, The Loan Would Provide An Independent Reason That Sovereign Meets The Economic-Substance Test.

Sovereign accepted bifurcation of the Loan and Trust for purposes of the summary judgment motion in the District Court. Govt.Br. 64-65.[5] On appeal, Sovereign continues to believe that the judgment below should be affirmed on the basis of the Trust's economic substance, and the Court should not reach the Government's argument about the Loan.

However, to the extent the Government seeks to use the Loan to impeach the District Court's judgment, that attempt backfires: If the

[5] Sovereign's position on bifurcation in the District Court was carefully defined and did not constitute an unlimited waiver. The District Court made clear that Sovereign's "broader view in the litigation is that the trust and loan components must be evaluated together." Op/Add 4 n.3.

Loan were considered (which it need not be), it would provide an independent basis for affirming the District Court.

Sovereign borrowed over $1 billion for five years, used the funds in its business, and then paid them back. There was significant commercial risk in the transaction, as in any financing, and there was certainly no "sham." JA2069-2070. Judge O'Toole noted: "As both the Second and Federal Circuits recognized, it was a real loan. It furnished the bank with capital to invest in its business that had to be paid back. It was a substantive economic transaction." Op/Add 16-17. There is no dispute that Sovereign characterized the Loan as a secured loan for U.S. federal income tax purposes and reported it as a secured loan internally, to the SEC, and to its banking regulator. JA210, 262, 2039.

The Government claims the purpose of the Loan was to "disguise the true nature of the [Barclays Payment]." Gov't Br. 66. Nothing was "disguise[d]." The Loan was recognized by Sovereign for all purposes as a loan, and its "substance and effect" was to provide financing for Sovereign's business.

The Government's reliance on *WFC Holdings Corp. v. United States*, 728 F.3d 736, 740, 747-49 (8th Cir. 2013) (Govt.Br. 67) is misplaced. There, the taxpayer took a $423 million loss on a lease transaction that created no actual loss. *Id.* at 741-42. The transaction "had no practical effects" beyond tax consequences, and the taxpayer offered only after-the-fact non-tax rationalizations, including easing regulatory burdens and creating management efficiencies. *Id.* at 748. This case is totally different. Unlike the taxpayer in *WFC Holdings*, Sovereign did not back-fill a tax-based transaction with a non-tax justification.

The Government also cites *Swartz v. KPMG LLP*, 476 F.3d 756, 759 (9th Cir. 2007) (Govt.Br. 67-68), but that case is inapposite. In *Swartz*, a taxpayer established a holding company intended to artificially create losses to offset a large capital gain from the sale of a business. *Id.* at 757. In an attempt to create "the appearance of a legitimate business," the holding company engaged in "two foreign currency transactions" before it was dissolved and its "losses" absorbed by the taxpayer. *Id* at 759. Nothing like that happened here.

V. The Government's Alternative Request For A Trial On Remand Should Be Rejected.

The Government argues in the alternative for a trial on remand to address supposed "factual" issues, including the "substance" of the transaction and Sovereign's "motivation." Govt.Br. 59. No remand is necessary, because the proper characterization of the transaction under the economic-substance doctrine is a matter of law, not fact. *See also* Part I-C-4, *supra.*

Further, this Circuit has repeatedly held that a taxpayer's motive is irrelevant. *See Granite Trust*, 238 F.2d at 677 ("Why the parties may wish to enter into a sale is one thing, but that is irrelevant under the *Gregory* case so long as the consummated agreement was no different from what it purported to be."); *Fabreeka Prods. Co. v. Comm'r*, 294 F.2d 876, 878 (1st Cir. 1961) ("[U]nless Congress makes it abundantly clear, we do not think tax consequences should be dependent upon the discovery of a purpose, or a state of mind, whether it be elaborate or simple."); *Bornstein v. Comm'r*, 334 F.2d 779, 780 (1st Cir. 1964) (disregarding the subjective intent of the taxpayer as the "necessary converse of the principle that if a transaction has bona fide substance, the taxpayer's

motives are immaterial"). The Supreme Court has rejected economic-substance challenges where "[t]ax considerations well may have had a good deal to do with the specific terms" of the challenged transaction, *U.S. v. Consumer Life Ins.*, 430 U.S. 729, 739 (1977), and even where an "acknowledged purpose" of the transaction was to achieve particular tax results. *Cottage Sav. Ass'n v. Comm'r*, 499 U.S. 554, 557 (1991).

The Government ignores this Court's precedent, claiming it lacks value because it "pre-date[s] *Frank Lyon* and modern economic-substance jurisprudence." Govt.Br. 62 n.14. A decade after *Frank Lyon* was decided, however, this Court reaffirmed that taxpayer motive is not relevant to the sham transaction doctrine. *See Dewees*, 870 F.2d at 29 ("examin[ing] only the transaction on its face, not the motives of the taxpayer") (citing *Gregory*, 293 U.S. at 469); *id.* at 35 ("sham transaction" doctrine does not require hearing into "subjective profit motive").

The Government misreads *Dewees*, arguing that this Court *sub silentio* overruled all of its prior economic-substance decisions in that case. Govt.Br. 61 (citing *Fid. Int'l Currency Advisor A Fund, LLC v. U.S.*,

747 F. Supp. 2d 49, 228 (D. Mass. 2010)).[6] The Government's proposed reading of *Dewees* is unsupportable, as this Court never purported to overrule its prior precedent on the objective nature of the inquiry. Indeed, as the Government concedes, this Court in *Dewees* did not even "consider [the] taxpayer's purpose for engaging in the transaction." Govt.Br. 61. The *Dewees* Court did reference "brochures" and "promotional materials," but used those solely to determine whether any investor objectively had a reasonable prospect for profit and not to determine taxpayer purpose or motive. 870 F.3d at 31-32.

Even if Sovereign's motive were relevant (and it is not),[7] there can be no dispute that Sovereign had a valid business purpose. The Barclays transaction objectively provided Sovereign with the reasonable prospect

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[6] Notably, the taxpayer did not appeal the District Court's erroneous reading of *Dewees*. *See Fid. Int'l Currency Advisor A Fund, LLC ex rel. Tax Matters Partner v. U.S.*, 661 F.3d 667, 671 (1st Cir. 2011) ("Fidelity's present appeal is narrow. . . . [I]ts arguments are directed only to the 40 percent penalty.").

[7] Judge O'Toole anticipated that this Court "would perhaps move away from a rigid 'objective only' test to one that is primarily objective but has room for consideration of subjective factors where necessary or appropriate," holding that Sovereign would satisfy even that more flexible test. Op/Add 13.

of making a pre-tax profit. There is no better evidence of a non-tax reason for a transaction than its non-tax profit potential. The Government confuses *Barclays'* motives with *Sovereign's*.

Sovereign is aware of no cases—and the Government cites none—in which a taxpayer with a reasonable prospect of pre-tax profit was held to lack a business purpose. Indeed, the Fifth Circuit has held that where a transaction gives a taxpayer the chance to earn a pre-tax profit, "the transaction had a sufficient business purpose independent of tax considerations." *Compaq*, 277 F.3d at 787; *see also United Parcel Serv.*, 354 F.3d at 1019 ("[A] transaction has a 'business purpose,' . . . as long as it figures in a bona fide, profit-seeking business."). Accordingly, it makes no sense "to insist on consideration of the subjective intent of a taxpayer where the transaction is objectively judged *to have had* economic substance." Op/Add 13 (emphasis in original).

There is no basis for a remand to examine the irrelevant "factual" issues the Government seeks to raise.

CONCLUSION

The District Court's judgment should be affirmed.

Respectfully submitted.

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CERTIFICATE OF COMPLIANCE

This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because this brief contains 13,940 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii). This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in 14-point font using New Century Schoolbook LT Std, a proportionally spaced typeface.

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CERTIFICATE OF SERVICE

I hereby certify that on August 15, 2016, I electronically filed the foregoing document with the United States Court of Appeals for the First Circuit by using the CM/ECF system. I certify that Defendant-Appellant United States of America and its counsel of record are registered as ECF Filers and that they will be served by the CM/ECF system.

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