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Tax Court Find Stars Transaction Lacks Economic Substance

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TAX COURT FIND STARS TRANSACTION LACKS ECONOMIC SUBSTANCE

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In *Bank of New York Mellon Corp. v. Commissioner*, the Tax Court found that a structured trust advantaged repackaged securities ("STARS") transaction entered into by BNY Mellon lacked economic substance, and disallowed foreign tax credits of $199 million as well as transactional expenses of $8 million.[2] BNY Mellon is the first test case to emerge from the IRS's attempts to disallow tax benefits to several financial institutions that participated in the STARS transaction.

The STARS transaction is one of a number of different transactions that the IRS refers to as "foreign tax credit generators." These transactions generally rely on inconsistent treatment of the same transactions under the tax law of different jurisdictions. The inconsistent treatment may relate to the classification of an entity, the distinction between debt and equity, timing of income recognition, or various other aspects.

Some foreign tax credit generators result in foreign tax credits being attributed to and used by a U.S. taxpayer who does not bear the economic burden of those taxes. In the STARS transaction, however, the U.S. taxpayer does bear the economic burden of the foreign taxes for which it claims a credit. The U.S. taxpayer also indirectly shares in the benefits the counterparty obtains in the U.K. tax system. The U.S. taxpayer's tax position properly reflects the economics of the transaction, and the U.K. tax authority agrees with the treatment of the transaction for U.K. tax purposes. Nevertheless, the IRS has challenged these transactions and disallowed the U.S. taxpayer's claimed foreign tax credits.

1. STARS Transaction

The STARS transaction was developed by KPMG and Barclays Bank to generate a net U.K. tax benefit. Barclays shares the tax benefit with the U.S. bank participating in the transaction, by providing below-market financing. A simplified version of the typical structure of a STARS transaction is as follows.[3]

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[2] *Bank of New York Mellon Corp. v. Comm'r*, 140 T.C. No. 2 (Feb. 11, 2013).

[3] The details in this article are derived from both the *BNY Mellon* opinion and the description of the typical transaction in CCA 200826036 (Jun. 27, 2008).

a. STARS Structure

The U.S. bank forms a Delaware trust that is disregarded for U.S. income tax purposes, and funds the trust with income producing assets in return for units in the trust. Barclays also contributes cash to the trust in return for a different class of units. Under a collateral repurchase agreement, the parties agree that in five years the U.S. bank will repurchase the trust units from Barclays. A wholly owned subsidiary of the U.S. bank is appointed as trustee of the trust. The subsidiary is a disregarded entity for U.S. federal income tax purposes, but a U.K. resident for U.K. tax purposes. Pursuant to the trust agreement, Barclays is entitled to 99% of the trust income but is also required to immediately re-contribute to the trust any distributions it receives. The trust distributes Barclays share of income, after U.K. taxes, to a blocked account to ensure that the funds are immediately returned to the trust. After the U.S. bank repurchases Barclays' units in the trust, it can access all of the accumulated trust income, net of U.K. taxes. Thus, the U.S. bank bears the economic burden of the U.K. taxes paid by the trust.

b. U.K. Tax Treatment

The trust is subject to tax at a rate of 22%, which the trust pays before distributing income to Barclays. Because Barclays must re-contribute all amounts distributed, the transaction has no net economic effect before taxes for Barclays, other than its below-market return on the repurchase agreement. But the combination of the distribution and re-contribution creates a net tax benefit for Barclays.

Barclays is subject to tax, at a rate of 30%, on its net income including distributions from the trust. The distribution is grossed-up, for Barclays' share of the tax paid by the trust, and Barclays is also treated as having paid that share of the trust's taxes. Barclays can also claim a deduction for the amounts that are re-contributed to the trust. As a result, Barclays incurs a small tax obligation related to the trust's income. But that small tax obligation is less than the amount of the trust's taxes that Barclays is deemed to have paid. Barclays thus receives a net tax benefit, for transactions which have no net economic effect. For example:[4]

Trust income	$1,000
Less taxes paid by the trust (22%)	(220)
Net amount to distribute	$780
Barclays' income	
Grossed-up distribution	$1,000
Deduction for re-contribution	(780)
Net income	$220
Tax liability (30%)	$66
Less taxes deemed paid as part of gross-up	(220)
Net tax benefit	$(154)

[4] For simplicity, this example ignores the 1% of trust income allocable to the U.S. taxpayer.

The U.K. tax authority has reviewed and approved the tax treatment of the STARS transaction by Barclays and the trust. Although in effect the tax authority pays out $154 to Barclays, that is still less than the $220 it receives from the trust. To the extent that this treatment encourages more income-producing assets being invested in the U.K., it may be beneficial not only to Barclays but also to the U.K. tax system.

c. U.S. Tax Treatment

Barclays' initial contribution to the trust combined with the repurchase agreement are treated as a secured loan rather than an equity investment. Thus, the U.S. bank is treated as owning 100% of the trust. It is taxable on the trust's income, which is treated as foreign source income under the U.S.-U.K. income tax treaty because it was subject to U.K. tax. Because the trustee is legally liable for the U.K. tax, the trustee is the taxpayer under Section 901 and the U.S. bank is entitled to a credit for the foreign taxes paid. This is consistent with the substance of the transaction. In the example above, the U.S. bank must include $1,000 in its taxable income but the accumulated assets in the trust are only $780. The bank has borne the economic burden of the $220 of U.K. tax paid by the trust.

d. Sharing the Benefits

The foreign tax credits claimed by the U.S. bank are consistent with its actual direct economic burden for the U.K. taxes.[5] Barclays receives a net tax benefit, and shares some of that benefit indirectly. The terms of the repurchase agreement are equivalent to a below-market rate secured loan from Barclays to the U.S. bank.

2. Bank of New York Mellon Corp. v. Commissioner

Bank of New York Mellon Corporation v. Commissioner involved a typical STARS transaction. BNY Mellon contributed $7.68 billion of income-producing assets to a trust with a U.K. trustee, and Barclays purchased trust units for approximately $1.5 billion, which BNY Mellon agreed to buy back in five years. This arrangement, along with a zero coupon swap and security arrangement, converted Barclays' purchase of the trust units into a $1.5 billion below-market secured loan from Barclays to BNY Mellon. The trust was subject to tax in the U.K., and BNY Mellon claimed foreign tax credits for $199 million in U.K. taxes paid in 2000 and 2001. Part of the tax was on income that was accelerated for U.K. tax purposes, but not yet subject to tax in the U.S. BNY Mellon also deducted approximately $8 million in transaction costs.

The Tax Court found that the STARS transaction was an "elaborate series of pre-arranged steps designed as a subterfuge for generating, monetizing and transferring the

[5] The amount of accumulated trust income the U.S. bank eventually recovers is net of the U.K. taxes *paid by the trust* ($220 in the example above). The *net* amount received by the U.K. tax authority, though, is only $66. The U.S. bank does not directly recover any of the net tax benefit to Barclays.

value of foreign tax credits among the STARS participants."[6] The court first identified the STARS transaction as the relevant transaction to be tested for economic substance, rejecting BNY Mellon's argument that the relevant transaction is the $1.5 billion below-market loan.

The court applied the Second Circuit's articulation of the economic substance doctrine because any appeal would be heard by the Second Circuit. The Second Circuit requires a flexible analysis of both the objective economic substance of the transaction and the taxpayer's subjective business purpose for engaging in the transaction.[7] The court concluded that the STARS transaction lacked objective economic substance because the circular cash flows of the STARS structure did not increase the profitability of the contributed assets. In fact, the structure reduced profitability by adding substantial transaction costs.

Further, the court held that BNY Mellon lacked a non-tax business purpose for engaging in the STARS transaction. The court rejected BNY Mellon's argument that it used the STARS transaction to obtain low-cost financing because there was no reasonable connection between the STARS structure and the low-cost loan. According to the court, "[m]aking a routine business transaction contingent on an economically meaningless transaction, like the STARS structure, is insufficient to establish that the nexus between the two is reasonable."[8] The court's decision has been criticized by practitioners as a vague expansion of the economic substance doctrine.[9]

BNY Mellon is likely only the beginning of the STARS saga. BNY Mellon says they will appeal the court's decision to the Second Circuit.[10] On April 2, 2013, the Court of Federal Claims concluded trial on a STARS transaction involving BB&T.[11] In addition, at least five other banks participated in the STARS transaction with Barclays, and the IRS has indicated that billions in tax revenue is at stake.[12]

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[6] *Bank of New York Mellon Corp.*, 140 T.C. No. 2, slip op. at 25.

[7] *See, e.g., Gilman v. Comm'r*, 933 F.2d 143, 147–48 (2d Cir. 1991), *aff'g* T.C. Memo 1989-684 (finding that the economic substance doctrine required a flexible analysis of both the business purpose and objective economic substance of a transaction).

[8] *Bank of New York Mellon Corp.*, 140 T.C. No. 2, slip op. at 40.

[9] *Practitioners Criticize Dicta Condemning Use of FTCs for Tax Avoidance*, 2013 TAX NOTES TODAY 68-1 (Apr. 9, 2013).

[10] Andrew Zajac, *BNY Mellon Barred from $199 Million of Foreign Tax Credit*, BLOOMBERG (Feb. 12, 2013).

[11] *Salem Financial v. United States*, Docket No. 1:10-cv-00192 (Ct. Fed. Cl.). Salem Financial is successor-in-interest to BB&T. Other cases include *Sovereign Bancorp, Inc. v. United States*, Docket No. 1:09-cv-11043 (D. Mass.) and *Wells Fargo & Co. v. United States*, Docket No. 09-cv-02764 (D. Minn.).

[12] Vanessa Houlder, Megan Murphy & Jeff Gerth, *Tax Wars: A Fight Worth Billions*, FINANCIAL TIMES (Sept. 25, 2011).