14-704-ag(L)

& 14-1394-ag(CON)

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

THE BANK OF NEW YORK MELLON CORP., as Successor-in-Interest to The Bank of New York Company, Inc.,

Petitioner-Appellant/Cross-Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee/Cross-Appellant

ON APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT
No. 26683-09 (Judge Diane L. Kroupa)

BRIEF FOR THE APPELLEE/CROSS-APPELLANT

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GLOSSARY

AmBr	Amicus brief filed by Chamber of Commerce
BNY	Bank of New York Mellon Corporation
Br	Opening brief filed by BNY
Code	Internal Revenue Code
Commissioner	Commissioner of Internal Revenue
HMRC	Her Majesty's Revenue & Customs, the U.K.'s taxing authority (previously known as Inland Revenue)
IRS	Internal Revenue Service
JA	Joint Appendix
LIBOR	London Inter-Bank Offered Rate
SPA	Special Appendix
STARS	Structured Trust Advantaged Repackaged Securities
U.K.	The United Kingdom

JURISDICTIONAL STATEMENT

On February 20, 2014, the Tax Court entered its decision. (SPA72-73.) The court had jurisdiction under §§ 6213(a)[1] and 7442. The appeal of the Bank of New York Mellon Corporation (BNY) was filed on March 5, 2014, within the 90 days allowed by § 7483. (JA10.) The Commissioner's cross-appeal was filed on April 30, 2014, within the 120 days allowed by § 7483. (JA11.) This Court has jurisdiction over both appeals. § 7482(a)(1).

STATEMENT OF THE ISSUES

Issue related to BNY's appeal:

1. Whether the Tax Court correctly determined that a transaction designed to generate foreign tax credits, and which had no non-tax economic effect or purpose, should be disregarded for U.S. tax purposes under the economic-substance doctrine.

[1] All § references are to the Internal Revenue Code (26 U.S.C.).

Issue related to the Commissioner's cross-appeal:

2. Whether the Tax Court erred in determining that BNY was entitled to deduct the interest paid on the above-market loan used to camouflage the transaction that generated the foreign tax credits.

STATEMENT OF THE CASE

A. Procedural overview

This case concerns enormous tax benefits that BNY claimed as a result of its participation (through subsidiaries[2]) in an abusive tax shelter referred to by its promoters as STARS. (SPA4.) After the Commissioner disallowed those benefits, BNY petitioned the Tax Court for a redetermination. (JA15-29,45-47.) The court (Kroupa, J.) upheld the Commissioner's determinations. (SPA1-55 (opinion reported at 140 T.C. 15 (2013)).) BNY petitioned for partial reconsideration, which the court granted. (SPA56-71.) BNY and the Commissioner have both appealed. (JA10-11.)

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[2] For simplicity, BNY and its related entities are referred to as "BNY."

B. Background: The STARS transaction

This case concerns a transaction designed to generate large foreign tax credits for U.S. taxpayers for a foreign tax that no one in substance had paid. (SPA45 & n.14; JA1206-1219,3175-3193.) By way of brief background, the United States taxes the income of its citizens, residents, and domestic entities on a worldwide basis. § 61(a). Therefore, when calculating its income for U.S. tax purposes, a U.S. corporation must include income earned abroad, even though that foreign income may also be subject to foreign tax. Domestic taxpayers, however, may claim a dollar-for-dollar tax credit (the foreign tax credit) for income taxes they have paid to another country, subject to numerous technical rules and other limitations. §§ 901-909. As particularly relevant here, "[e]ntitlement to foreign tax credits is predicated on a valid transaction." 12 Mertens Law of Fed'l Income Tax'n § 45D:62 (2014). A transaction is not valid for tax purposes if it lacks "economic substance" or "business purpose." *Gilman v. Commissioner*, 933 F.2d 143, 146-148 (2d Cir. 1991).

A taxpayer normally would not be motivated to engage in a transaction in order to claim foreign tax credits because the credits are

designed merely to substitute a tax paid to a foreign country for the taxpayer's U.S. tax in a genuine business transaction, and, therefore, create an economic wash; $1 of foreign tax paid offsets $1 of U.S. tax owed. STARS, however, was designed to transform the foreign tax credit into economic profit, at the expense of the U.S. Treasury, by creating an arrangement whereby the U.S. taxpayer pays tax to the U.K., claims a foreign tax credit for that U.K. tax, and, at the same time, recoups most of its U.K. tax through its counterparty in the STARS transaction, Barclays, a U.K. bank. (JA379,568-569,586,600,1168-1169,1206-1219,1359,3175-3193.)

The STARS arrangement works as follows. The U.S. taxpayer diverts income from U.S. assets (such as loans to U.S. borrowers) into and out of a Delaware trust that has a nominal U.K. trustee. (SPA6-9,16.) Circulating the U.S. income through the trust has no economic effect on that income, but, because the trustee is a U.K. resident, the trust's income becomes subject to U.K. tax, even though the income never leaves the United States or the U.S. taxpayer's control. (SPA18,32-36,52; JA94,99,115,371,664,678.) The U.S. taxpayer agrees to subject its U.S. income to U.K. tax because Barclays agrees to

(i) recover most of that tax, (ii) return half of it to the U.S. taxpayer, and (iii) retain the rest as its promoter "fee" for STARS. (JA664,1209, 1219,1347,1350,1405-1406,2513-2516.) The U.S. taxpayer then claims foreign tax credits for the full amount of the U.K. tax, ignoring that almost all of the tax was recovered by Barclays, which, in turn, returns half of the tax payment back to the U.S. taxpayer. (JA290,600,1511, 1525,1631,1643,3427-3428.) Barclays is able to recover the U.S. taxpayer's U.K. tax because STARS generates U.K. tax benefits for Barclays, including a U.K. tax credit for the U.K. tax paid by the U.S. taxpayer. (SPA21; JA1210,1347,1350,1405-1406,3426-3428.)

STARS was designed so that the U.K. retains a small portion of the U.K. tax payment, as Barclays emphasized to the U.K. taxing authorities (HMRC) when it sought pre-approval for STARS's U.K. tax treatment. (SPA20; JA457,965-976,3175,3178.) Because STARS was tax "additive" for the U.K., HMRC did not challenge STARS under U.K. law. (SPA20,44 n.13; JA272-273,977,2446,2892.)

To illustrate the STARS scheme, suppose a U.S. taxpayer circulates its U.S. income through a STARS Trust, which pays HMRC $22 in tax for every $100 of Trust income. (JA2894-2895,3175-3178.)

For every $22 paid to HMRC in U.K. tax, the U.S. taxpayer claims $22 of foreign tax credits, which, in turn, produces a $22 reduction in its U.S. tax liability. (JA296.) At the same time, Barclays recovers $18.70 from the U.K. as a result of the tax benefits generated by STARS, leaving HMRC with $3.30.[3] (JA296,464,2896,3178-3179.) Pursuant to the parties' agreement, Barclays splits the tax benefits with the U.S. taxpayer by returning $11 to the U.S. taxpayer (JA570,1511,1525,1631, 1643), and Barclays keeps the rest as its "fee" for promoting STARS (JA1219,1282-1283,3176). The reduction of U.S. taxes resulting from foreign tax credits thus funds the STARS benefits received by the U.S. taxpayer, Barclays, and HMRC, all at the expense of the U.S. Treasury. (JA569-570,664-665,3179,3190,3433-3434.)

The form of STARS allows U.S. taxpayers to present the transaction as tax neutral; although the foreign tax credits reduce their U.S. tax by 22 percent, in form they pay a 22-percent tax to the U.K. (JA363-364,1216,3358.) In substance, however, STARS decreases the

[3] This example simplifies Barclays' tax benefits, which are not in dispute (Br13) and are detailed at JA2883-2896. In addition, and consistent with BNY's use of the example (Br14 n.8), the example ignores certain relatively *de minimis* cash flows in the Trust.

U.S. taxpayer's world-wide tax burden because "50%" of the "UK tax" is returned to the U.S. taxpayer by Barclays, which recovered and retained most of the rest as its fee. (JA1211; *see* JA379,568,586,684-685,2513,2515,3177-3179,3427.) And, as noted above, that decrease is funded by the U.S. Treasury. (SPA45,49; JA569-570,3177-3179,3190, 3377-3378.)

To eliminate this abuse, the Treasury Department proposed regulations in 2007 (finalized in 2011) that precluded taxpayers from claiming foreign tax credits from STARS (and other similar) transactions after the regulations' effective date. 72 Fed. Reg. 15081 (2007). The regulations' preamble, however, emphasized that the IRS would scrutinize tax benefits claimed in STARS transactions before the regulations' effective date under certain anti-abuse doctrines, including the "economic substance doctrine." *Id.* at 15084.

Before the regulations were issued, Barclays entered into STARS transactions with six U.S. banks. (SPA19.) The IRS disregarded those transactions under the anti-abuse doctrines, and four cases (including this case) are pending in court. In the only other case that has been fully litigated, the Court of Federal Claims determined that STARS

lacked economic substance, and disallowed the claimed foreign tax credits, interest-expense deductions, and transaction-expense deductions. *Salem Financial, Inc. v. United States*, 112 Fed. Cl. 543 (2013), *appeal pending*, No. 14-5027 (Fed. Cir.). Two other cases are pending in district courts. *Wells Fargo & Co. v. United States*, No. 09-2764 (D. Minn.); *Santander Holdings USA, Inc. v. United States*, No. 09-11043 (D. Mass.).

C. Barclays and KPMG promote STARS to BNY

In 2001, KPMG worked with Barclays to promote STARS to a number of U.S. taxpayers, including BNY. (SPA4; JA333.) In June 2001, a KPMG tax specialist contacted BNY's tax director, John DeRosa, to determine whether BNY was interested in a "tax-advantaged transaction" that relied on foreign tax credits to generate a benefit for U.S. taxpayers. (SPA4; JA211,229,254,290,298,305-306,362-363,377,381,393,1168,1176,1210,1506,1514.) As KPMG explained, BNY would transfer its U.S. income to a U.K. trust, pay the resulting U.K. tax, receive a U.S. foreign tax credit for the U.K. tax, and, at the same time, receive a "portion of the U.K. tax credits obtained" by Barclays for the same tax. (JA313-314,1210; SPA5.) That portion would be

"rebated" to BNY, and would be used to reduce interest payments on a loan that BNY would borrow from Barclays. (JA1511.) The amount of the "rebate" (JA1525) would be "roughly equal to half of the tax that was paid in the trust" (JA314). Understanding that it "earns foreign tax credits for its participation" in STARS (JA1515,1612; SPA5) and referring to the transaction internally as "FTC [*i.e.*, foreign tax credit] revenue trades" (JA1169), BNY indicated that it was interested (SPA4-5; JA1178).

At that time, BNY owned a large pool of income-generating U.S. assets that could be utilized in the STARS strategy to produce the targeted amount of U.K. "tax." (SPA6; JA386-387,1273-1277,2052, 2530.) Participating in STARS would allow BNY to reduce the tax paid on that income because BNY would claim foreign tax credits for 100 percent of the U.K. tax it initially paid even though it received back from Barclays "50 percent of the [U.K.] tax." (JA387,570,586-588,665,684-685,1514,3175-3179.) As BNY understood, it would "derive[ ] an economic return/tax benefit" through "foreign tax credits," with the "total tax benefit [being] split 50/50 between Barclays and BoNY." (JA1514.) And, as BNY further understood, it could obtain

that tax benefit merely by circulating its U.S. income into, and out of, a Trust (which would subject the income to tax in the U.K.) without otherwise altering that income or BNY's management and control of its U.S. assets. (JA94,98-99,115,181-182,209,371,724,3356.) By claiming foreign tax credits for all of the tax that the Trust paid to HMRC, and at the same time receiving half of that tax back from Barclays, BNY anticipated receiving almost $50 million annually from STARS. (JA387,1277,2050.)

D. The parties implement STARS

The details of BNY's complex STARS transaction are set forth in the Tax Court's opinion (SPA5-24), and, like BNY, we summarily "describe the transaction in simplified form" (Br9). It was implemented in November 2001, and scheduled to last for 5 years. (SPA5,11,23; JA3514,3583.) Either party, however, could terminate STARS with 5-30 days' notice. (SPA19; JA252,282-283,457,1526,2052,3544.) BNY considered extending its STARS transaction, but ended it at maturity in November 2006 because transactions that generated foreign tax credits (like STARS) had come under scrutiny by the IRS and Congress. (SPA5,11,23; JA230,3583.)

BNY's STARS transaction consisted of a Trust and a Loan. To generate the foreign tax credits, the parties used the Trust to create a series of instantaneous circular cash flows (described in more detail below) that began and ended with BNY and through which BNY cycled income generated from approximately $8 billion of its revenue-producing bank assets located in the United States (primarily loans with U.S. borrowers). (SPA6; JA209,405-406,2095,3516-3520.) By circulating the income through the Trust, BNY became liable for a U.K. tax on that income, even though it was immediately returned to BNY, because the Trustee (controlled by BNY) was a U.K. resident. (SPA16,20; JA2088-2089.) BNY agreed to subject its U.S. income to the U.K. tax in exchange for Barclays' agreement to pay BNY a fixed monthly amount — referred to in the transaction documents as the "bx" payment (JA186,947,1276,3170) — that was calculated to equal "50 percent" of the U.K. "taxes" BNY expected to pay on the Trust income. (SPA11-12,45 n.14; JA379; *see* JA112,186,372,381-382,387,503,558-559,1237,1381,2180,2456,2513,2515,3145-3146,3538-3543.) BNY referred to the payment as its "Tax 'Spread Adjustment' Benefit"

(hereinafter Tax-Spread) that was "rebated" to BNY from Barclays.[4] (JA1511,1525,1631,1643.)

Barclays acquired a formal interest in the Trust by purchasing certain Trust units for $1.5 billion. (SPA10.) That acquisition did not provide Barclays a real ownership interest in the Trust because the transaction documents required it to sell those units back to BNY for $1.5 billion when the transaction terminated. (SPA10; JA2292-2293,3180-3181,3532,3541.) Barclays' formal interest in the Trust, however, allowed it to claim certain U.K. tax benefits (including a tax credit for the U.K. taxes paid by BNY (JA2296)) that permitted Barclays to recover BNY's U.K. tax payment and to profit. (JA1347,1350,1405,2295-2296.) Barclays' purchase of, and offsetting agreement to sell, the Trust units functioned as a Loan to BNY, as described below. (SPA14.)

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[4] Shortly after STARS closed, the parties implemented a Stripping Transaction that increased BNY's Tax-Spread benefit by $44 million by manipulating the income from the Trust assets to generate $88 million in additional U.K. tax and foreign tax credits in 2001. (SPA5,16-18.) The additional Tax-Spread was paid to BNY during the first 14 months of the STARS transaction. (JA295,372-373,1168,1511, 1525,3538-3539,3560-3568.)

1. Trust

To generate the U.S. and U.K. tax benefits that BNY and Barclays claimed, the parties looped BNY's U.S. banking income in three circular cash flows. (JA3166-3193.) In the first cash flow, BNY distributed funds from its income-earning assets to the Trust, and then, after setting aside an amount to pay U.K. taxes on those funds, the Trust returned the remaining funds to BNY. (SPA21-22; JA3166-3169,3577.) This cash flow subjected BNY's U.S.-source income to U.K. tax, without changing the character or substance of that income, or BNY's control over the assets or their income. (SPA18,20-22; JA94,98-99,115,181-182,299,371,3168.)

In the second cash flow, the Trust — before returning the funds to BNY in the first cash flow — distributed funds to the Barclays Blocked Account at BNY, which immediately returned those funds to the Trust. (SPA22; JA2293,3169,3532.) Barclays could not access the funds held — nominally and briefly — in its name in the Barclays Blocked Account. (SPA11; JA299,3169,3532,3575.) This fleeting, circular cash flow allowed Barclays to claim a U.K. tax loss for the purported

reinvestment of the Trust's income but had no economic effect. (SPA21; JA244,299,453,2806-2809,2894.)

Combining the first two circular cash flows created a loop of funds that began, and ended, with BNY, and had no economic effect on BNY's management, control, or receipt of the funds (other than paying the tax to the U.K.). (SPA18,33,35-36; JA94,98-99,115,181-182,371,724,3182-3184,3356.) Each month, a pre-determined amount of BNY's income from its U.S. assets would flow in a circle (i) from BNY to the Trust, (ii) from the Trust to the Barclays Blocked Account at BNY (after paying U.K. tax), (iii) from the Barclays Blocked Account back to the Trust, and (iv) from the Trust back to BNY. (JA3166-3184.) These circular transfers took place during the same overnight process, were handled by BNY employees, and provided neither BNY nor Barclays any economic benefit, only transaction costs (including BNY's $6 million fee to KPMG) and tax benefits. (JA3182-3184,3531-3532,3871.)

In the third circular cash flow, BNY used the Trust to pay a U.K. tax that (as KPMG explained) BNY would recover from Barclays as a "reimbursement." (JA600; SPA22.) To complete this circle, (i) the Trust paid the U.K. tax on the Trust's income to HMRC; (ii) HMRC returned

almost all of that tax to Barclays (resulting from Barclays' claiming U.K. tax credits and deductions based on the Trust's circular cash flows); and (iii) Barclays returned an amount equal to 50 percent of the U.K. tax paid by the Trust back to BNY, which BNY referred to as its "Tax 'Spread Adjustment' Benefit." (SPA11-12,21-22,41,43-45; JA379,600,1511,1525,1622,1631.) These pre-arranged, integrated steps — in which BNY's tax payment was cycled through HMRC to Barclays, and then back to itself — allowed BNY to claim foreign tax credits for a foreign tax that was not in substance paid. (JA3186,3193.)

2. Loan

The STARS transaction included a $1.5 billion Loan from Barclays to BNY that was created through offsetting agreements that converted Barclays' purchase of the Trust interests into a Loan for U.S. tax purposes. (SPA10-14; JA3164-3165.) The net effect of those agreements was that Barclays loaned BNY $1.5 billion for the duration of STARS at a floating monthly rate of approximately one-month LIBOR plus 30 basis points, an amount that would be "netted" against

the monthly Tax-Spread that Barclays owed BNY.[5] (SPA14,24,45; JA1631,2593,3164-3165.) When it entered STARS, BNY did not need Barclays' funds because it had other sources of funds. (JA100,176,348,1185.) The Loan proceeds were held on deposit in BNY's Cayman Islands branch in one-month terms for the duration of STARS. (SPA15; JA3531.)

The Loan was not necessary for generating the foreign tax credits, and, as originally designed, STARS did not include a loan to the U.S. taxpayer; Barclays simply offered the U.S. taxpayer the Tax-Spread as a payment related to the trust. (JA265-266,584,600,3183.) Barclays added a loan to STARS in order to market it to U.S. taxpayers, and applied the tax "reimbursement" or "rebate" to offset the interest that the U.S. taxpayer owed on the loan. (JA266-269,600,1237,1525.)

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[5] The interest BNY owed Barclays was payable monthly under a zero coupon swap, and BNY's zero-coupon-swap payment equaled one-month LIBOR plus 30 basis points on a notional principal amount, less the Tax-Spread. (SPA12,59.) Barclays and BNY also entered into a credit default swap whereby BNY agreed to guarantee the Loan in return for Barclays' agreement to pay BNY a monthly amount equal to 10 basis points on the notional amount. (SPA12-13; JA2593.) Taking that separate agreement into account, the Tax Court sometimes referred to the Loan's interest rate as being LIBOR plus 20 basis points. (SPA14 n.6,60.)

The Loan itself provided BNY no economic benefit. (SPA46-47,50; JA574.) When evaluating the economic benefit it expected to receive from STARS, BNY did not include the potential yield on the use of the Loan proceeds as an element of profit because BNY could have obtained the same proceeds from another funding source. (SPA51 n.17; JA1168-1169,1200,1209,1599,1620-1621,2180,3303-3307.) Moreover, the Loan's interest rate was far more expensive than BNY's comparable funding, which generally was at or below LIBOR. (SPA46-47,50; JA349,574,730-731,3160,3233.) Because the Loan could be cancelled by Barclays at any time, it was comparable to short-term financing, even though the Loan's maximum term was five years. (SPA46; JA612,3186,3233, 3246,3293.)

The Loan, however, was intended to provide BNY a business pretext for STARS. (JA364,3183.) To be respected for tax purposes, STARS needed "economic substance" and a "business purpose," as BNY understood from its very first STARS discussion with KPMG. (JA311,377,1176.) KPMG suggested to BNY that "low cost funding" was the "business purpose" for STARS. (JA1176.) BNY then worked

with KPMG to develop a "good business purpose" for the transaction so that the "UK taxes" paid by BNY would be "creditable." (JA1327.)

To support the low-cost-funding rationale, the parties "embedded" the Tax-Spread "in the lending component" and applied the Tax-Spread that Barclays owed BNY from the Trust to reduce the interest expense that BNY owed Barclays on the Loan. (SPA45; JA379.) By "netting" the Tax-Spread against the Loan's interest expense, they made an above-market loan appear to be "low-cost funding" and the Tax-Spread appear to be something other than a tax "reimbursement" or "rebate." (JA600,1176,1511,1525,2593,3183.) In analyzing STARS, however, BNY understood that its actual "Interest expense" on the Loan was separate from the "Percentage of tax" it would receive from Barclays. (JA1211,1631,1643,2593.) BNY further understood that the Tax-Spread had no relationship to the amount of the Loan, and was based on the amount of tax that BNY was expected to pay to the U.K. (JA112,1179,1209-1211.)

3. Netting the Tax-Spread from the Trust against the interest due on the Loan generates negative interest

To enhance the credibility of characterizing STARS as low-cost funding, BNY's tax advisors wanted to avoid "negative interest," that is, the situation where the monthly Tax-Spread payment that Barclays owed BNY exceeded the monthly interest payment that BNY owed Barclays, resulting in Barclays purportedly paying BNY to borrow the proceeds of the Loan. (JA600,2671,3358.) Negative interest would be inconsistent with STARS's financing characterization, because banks normally do not pay interest to the borrower. (JA600,610,3321,3358.) According to Barclays, "negative interest" in a "financial" transaction was "very unusual," would look "strange" to BNY's "tax authorities," and could "cast doubt on the genuineness" of characterizing STARS as a "financing." (JA257.)

Before engaging in STARS, BNY "expressed a concern" that STARS would generate "a negative cost of funding." (JA2671.) As the parties discussed before finalizing the STARS transaction, "if we are saying it is a loan it looks better if there is positive cost of carry." (JA3358; *see* JA598-600,1277,3358-3359.) The parties, however, were

unable to increase the amount of the Loan (and thus the amount of Loan interest) enough to avoid negative interest. (SPA22-23,42.) Accordingly, BNY's cumulative "interest payments" were negative, with Barclays ultimately paying BNY $82 million more in Tax-Spread payments than BNY owed in interest on the above-market Loan. (SPA23; JA950.)

E. Tax Court proceedings

During 2001-2002 (the tax years at issue), BNY reported the income from its U.S. STARS assets as foreign-source income, and claimed foreign tax credits of approximately $200 million for payments made to HMRC. (SPA23.) The amount of the Tax-Spread that Barclays owed BNY in 2001-2002 exceeded the amount of interest (computed at LIBOR plus 30 basis points) that BNY owed Barclays. (SPA23.) For tax purposes, BNY netted the two payments, and reduced unrelated interest expense by the net Tax-Spread payments that BNY received from Barclays, effectively claiming an interest deduction for the interest it owed Barclays. (SPA24.) BNY also claimed almost $8 million in transaction-expense deductions related to STARS in 2001-2002. (SPA24.) BNY commenced this proceeding after the IRS determined

that its STARS transaction should not be respected for U.S. tax purposes, and disallowed BNY's STARS tax benefits (foreign tax credits, interest-expense deductions, and transaction-expense deductions). (SPA24; JA15-46.)

During the proceedings, the parties disputed whether BNY's STARS transaction should be respected under certain common-law tax doctrines, including the economic-substance doctrine. The economic-substance doctrine requires courts to analyze a transaction's economic reality and determine whether it serves any meaningful economic purpose beyond the satisfaction of the literal terms of the statute or the relevant regulations. (SPA26-29.)

BNY acknowledged that the economic-substance doctrine applied to its STARS transaction, but contended that STARS had economic substance because the U.S. income-producing assets utilized in STARS were "real business assets" that "generated real taxable income," and because the Loan from Barclays was "real." (JA75-76.) BNY further contended that it engaged in STARS for the "nontax business purpose" of "getting low-cost funding." (JA78.)

The Commissioner contended that BNY's STARS transaction should be disregarded under the economic-substance doctrine because its only purpose and effect was to generate U.S. foreign tax credits for illusory tax costs.[6] (JA748.) In this regard, the Commissioner asserted that the Tax-Spread was not economic income but was merely a tax effect, effectively a rebate of U.K. tax claimed as foreign tax credits. (JA749.) To support his argument that STARS served no meaningful economic purpose, the Commissioner submitted expert testimony demonstrating that:

- the circular cash flows through the Trust were economically meaningless (JA3156-3193,3362-3378);
- the only economic benefit in STARS was a reduction in U.S. taxes achieved by claiming foreign tax credits for taxes that were not in substance paid to the U.K. (JA568,661-662,664-666,3175-3179,3377-3378);
- as an economic matter, the Tax-Spread was funded by the U.S. Treasury and represented a rebate by Barclays to BNY of 50

[6] The Commissioner made several alternative arguments that the Tax Court found unnecessary to address. (SPA25 n.7.)

percent of the U.K. tax paid by BNY (JA570-571,587-588,661-662,664-666,3170-3172); and

- BNY's characterization of STARS as low-cost funding conflicted with the objective evidence (JA569-570,3159-3160,3175,3177-3179,3186-3192,3303-3307,3363-3364,3374,3378).

With regard to the low-cost-funding claim, the Commissioner's experts demonstrated that the Loan (i) was comparable to short-term funding because Barclays could terminate the Loan at any time for any reason, and (ii) was more expensive than comparable funding that was available to BNY. (JA612,615-616,622-623,3159-3160,3233,3246-3247,3303-3310.) They further demonstrated that the Tax-Spread, in substance, was not a component of interest.[7] (JA569,573,588,3170-3171,3182-3183.)

[7] During the trial, the Tax Court excluded, as irrelevant, evidence submitted by the Commissioner addressing the promoters' development of STARS and how a loan was added to give STARS the appearance of a business purpose. (SPA75-138.) The Commissioner has challenged that ruling in his cross-appeal. *See*, below, Section II.D.

1. Initial Tax Court opinion

The Tax Court ruled for the Commissioner, determining that BNY was not entitled to any of the STARS tax benefits. (SPA25.) Applying this Court's case law to the record evidence, and endorsing the economic analysis provided by the Commissioner's experts, the court determined that BNY's STARS transaction must be disregarded for U.S. tax purposes under the economic-substance doctrine because it was merely a "subterfuge for generating, monetizing and transferring the value of foreign tax credits among the STARS participants." (SPA25.)

The Tax Court first determined that the STARS Trust structure and the Loan should be analyzed separately. (SPA29-31.) In so ruling, the court found that the Loan was not necessary to produce the disputed foreign tax credits, which were generated by circulating income through the Trust (SPA31), and that the Tax-Spread, which was based on the Trust's taxes, "artificially reduced the [L]oan's cost" (SPA45). As the court explained, the relevant transaction to be tested is the one that produced the disputed tax benefit, even if it is part of a larger set of transactions, because the requirements of the economic-substance doctrine cannot be avoided simply by coupling a routine

transaction with a transaction lacking economic substance. (SPA30 (citing *Nicole Rose Corp. v. Commissioner*, 320 F.3d 282, 284 (2d Cir. 2003)).)

The Tax Court then determined that the STARS Trust structure lacked economic substance as an objective matter because it did not create a reasonable opportunity for a non-tax profit. (SPA31-32.) In so ruling, the court found that the Trust (i) did not increase the profitability of the STARS assets; (ii) but, rather, decreased their profitability by adding substantial expenses; and (iii) consisted of circular cash flows and offsetting payments that had no non-tax economic effect. (SPA32-36.) In this regard, the court found that the Tax-Spread was not non-tax income, because it served "as a device for monetizing and transferring the value of anticipated foreign tax credits" from the transaction by returning to BNY "one-half the present value of the U.K. taxes the trust was expected to pay" and thus was a "tax effect" that was "effectively funded by the foreign tax credits."[8]

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[8] The Tax Court alternatively determined that even if the Tax-Spread were not characterized as a tax effect, it nevertheless could not provide BNY any non-tax profit because it "was more than offset by the

(continued…)

(SPA41,45,49.) The court rejected BNY's argument that income generated by BNY's U.S. assets utilized in STARS should be counted as income generated by STARS. (SPA35.) As the court explained, the STARS assets would have generated the same income regardless of being circulated through the Trust, and, therefore, that income was not attributable to STARS. (SPA35-36.)

The Tax Court further determined that BNY "failed to establish a valid business purpose [for the Trust] and BNY's true motivation was tax avoidance." (SPA36-47.) In this regard, the court rejected BNY's claim that it entered into the Trust structure in order to obtain low-cost funding. (SPA40-47.) The court found that, absent the Tax-Spread, the Loan's interest rate was "above the market benchmark loan," and that "BNY could have obtained comparable financing in the market place at substantially less economic cost than that obtained through STARS." (SPA46-47.)

(…continued)
additional transaction costs that BNY incurred to obtain the spread," including the foreign taxes paid on the Trust's income. (SPA46-47 n.15.)

Recognizing that the parties had treated the Tax-Spread as a component of interest in the parties' formula for computing interest payments under the zero-coupon swap, the Tax Court found that, in substance, the Tax-Spread was a "tax effect," not a component of Loan interest, that was "artificially" "embedded in the loan" to transfer "the value of anticipated foreign tax credits generated from routing income through the STARS structure." (SPA45.) The court thus concluded that the parties' use of the "tax savings" from the "foreign tax credits" to "offset the cost of the loan did not provide a valid non-tax purpose" for STARS. (SPA45.)

The Tax Court further determined that the STARS transaction lacked economic substance even if the Trust and the Loan were evaluated together. (SPA47-51.) The court rejected in this regard the profitability calculation generated by BNY's expert during the litigation because it included cash flows that were not generated by STARS and treated the Tax-Spread as "pre-tax income." (SPA47-50.) Because the STARS transaction was disregarded for tax purposes, the court held

that all expenses incurred in furtherance of the transaction, including the Loan's interest expense, were not deductible.[9] (SPA53.)

2. Tax Court's supplemental opinion

BNY petitioned the Tax Court to reconsider its interest-expense ruling. (SPA64.) Granting the petition, the court held that BNY was entitled to the interest-expense deductions, even though the Loan was "overpriced," because the Loan was "real" and was not (in the court's view) used to "finance, secure or carry out the STARS structure." (SPA66-67.) The court further held that the Tax-Spread was not includible in BNY's income because the Tax-Spread was paid in connection with the Trust transaction and that transaction had been disregarded for tax purposes under the economic-substance doctrine. (SPA68-69.)

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[9] The Tax Court also rejected BNY's alternative argument that it was entitled to deduct the U.K. taxes paid on the Trust's income. (SPA52-53.) BNY has not renewed that argument in its opening brief (Br23-56), and has thus waived the argument on appeal. *See Ozaltin v. Ozaltin*, 708 F.3d 355, 371 (2d Cir. 2013).

SUMMARY OF ARGUMENT

This case involves a transaction — referred to by BNY as "FTC revenue trades" (JA1169) and by its promoters as STARS — that generated over $500 million in tax benefits, primarily in foreign tax credits claimed by BNY for foreign taxes that were not in substance paid. To generate those credits, BNY agreed to subject its U.S. banking income to U.K. tax by cycling that income through a paper Trust with a U.K. trustee, in exchange for Barclays' agreement to return half of the U.K. tax to BNY. BNY was thus able to reap immense "profits," at the expense of the U.S. Treasury, by claiming foreign tax credits for U.K. taxes that were returned to it by Barclays. BNY claimed it engaged in STARS to obtain a low-cost Loan from Barclays, not to obtain the foreign tax credits. The Tax Court correctly rejected that claim and determined that the transaction designed to effectuate this raid on the Treasury failed under the economic-substance doctrine.

1. Applying this Court's economic-substance precedent to the extensive record evidence, the Tax Court correctly determined that BNY's STARS transaction lacked economic substance and business purpose based on numerous findings, all of which are amply supported

by the record. BNY's trial concessions, contemporaneous documents, and the Commissioner's expert testimony demonstrate that the only benefits generated by STARS were foreign tax credits and the Tax-Spread. The Tax-Spread — which BNY referred to as a rebate equal to 50 percent of the U.K. tax — was not non-tax income, but rather was only a tax effect whereby Barclays and BNY effectively split the value of the U.S. foreign tax credits claimed for illusory tax costs. Although BNY papered the transaction to make STARS appear to be "low-cost funding," the Tax Court correctly pierced through that facade to reveal the transaction's substance, finding that the actual interest on the Loan was above-market, and that the "low-cost funding" was the result of artificially netting the Tax-Spread against the Loan's interest. Accordingly, the court correctly disallowed BNY's claimed foreign tax credits and related transaction-expense deductions.

2. The Tax Court erred, however, in allowing BNY to deduct the interest expense on the above-market Loan that BNY used to embed the Tax-Spread and thereby camouflage the true nature of the STARS transaction. The Loan lacked economic substance because BNY could have obtained the same funds for far less cost, as the court found, and

the only reason BNY agreed to the expensive STARS Loan was to use it as a device to disguise the true nature of the Tax-Spread. The Loan merely provided the pretext of a business purpose for STARS, as the evidence — including evidence regarding STARS's development that was erroneously excluded as irrelevant by the court — demonstrates.

ARGUMENT

I

The Tax Court correctly determined that BNY's STARS transaction should be disregarded for U.S. tax purposes under the economic-substance doctrine

Standard of review

The "general characterization of a transaction for tax purposes is a question of law subject to [*de novo*] review," and the "particular facts from which the characterization is to be made are not so subject." *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 n.16 (1978).

A. Introduction

This case involves an "FTC revenue trade[ ]" (JA1169) designed to generate large-scale foreign tax credits for a foreign tax that was not in substance paid. To secure those credits, BNY circulated its U.S.-source income through a Delaware Trust with a shell U.K. trustee, thereby purposely subjecting its U.S.-source income to a U.K. tax. BNY did so,

however, knowing that STARS allowed the parties to recoup BNY's U.K. tax payments. In this regard, STARS generated both a U.K. tax and an offsetting U.K. tax credit; pursuant to the prearranged plan, BNY paid the U.K. tax, and then Barclays claimed the offsetting U.K. tax credit and "share[d]" it with BNY. (JA2527.) Those cash flows were all funded by the U.S. Treasury, through the foreign tax credits that BNY claimed for the same U.K. tax. (JA3178-3179,3190,3377-3378,3433-3434.) BNY was able to reap immense profits by claiming U.S. foreign tax credits for the U.K. tax payments it ultimately received back from Barclays. STARS generated those foreign tax credits, but nothing else of any economic substance. This exploitation of the U.S. foreign-tax-credit regime is wholly inconsistent with its purpose.

The purpose of the foreign tax credit is to neutralize the effect of U.S. taxes on decisions regarding where to invest or conduct business most productively by mitigating double taxation of foreign income, 56 Cong. Rec. App. 677 (1918), so that "investment-location decisions are governed by business considerations, instead of by tax law," Joint Committee on Taxation, *Impact of Int'l Tax Reform* 3 (JCX-22-06). To ensure that that legislative purpose is not subverted, courts

consistently have applied the economic-substance and other anti-abuse doctrines to foreign-tax-credit claims. *E.g., Salem*, 112 Fed. Cl. 543; *Pritired 1, LLC v. United States*, 816 F. Supp. 2d 693 (S.D. Iowa 2011); *InterTAN, Inc. v. Commissioner*, 2004 WL 25249 (T. Ct.), *aff'd*, 117 Fed. Appx. 348 (5th Cir. 2004); *Compaq Computer Corp. v. Commissioner*, 113 T.C. 214 (1999), *rev'd on other grounds by* 277 F.3d 778 (5th Cir. 2001). As these courts recognize, applying the economic-substance doctrine to transactions that generate foreign tax credits is "consonant with the purpose of the foreign tax credit, because Congress intended the credit to facilitate purposive business transactions, not by subsidy, but by restoring the neutrality of the tax system." *Am. Int'l Group, Inc., v. United States*, 2013 WL 1286193, at *3 (S.D.N.Y. 2013), *appeal pending*, No. 14-765 (2d Cir.).

Before turning to the Tax Court's economic-substance analysis of STARS, we first address certain overarching errors made by BNY and its amicus. That BNY's STARS transaction may have "satisfied all statutory and regulatory requirements in place at the time," as BNY contends (Br31-32), misses the point. As this Court repeatedly has held, "even if a transaction's form matches 'the dictionary definitions of

each term used in the statutory definition' of the tax provision, 'it does not follow that Congress meant to cover such a transaction' and allow it a tax benefit." *Altria Group, Inc. v. United States*, 658 F.3d 276, 284 (2d Cir. 2011) (rejecting LILO/SILO lease shelter under substance-over-form doctrine, even though it was designed to satisfy detailed IRS leasing guidelines) (citation omitted);[10] *see TIFD III-E, Inc. v. United States*, 459 F.3d 220, 239 (2d Cir. 2006) (rejecting formal characterization of transaction as a partnership interest under substance-over-form doctrine even though the parties "had taken pains in the design of the partnership" to comply with the tax rules for partnerships); *DeMartino v. Commissioner*, 862 F.2d 400, 407 (2d Cir. 1988) (rejecting loss generated by straddle transaction under economic-substance doctrine even though it complied with the "words of the statute").

Virtually all sophisticated tax shelters like STARS are designed to satisfy the relevant tax rules, but courts nevertheless consistently reject

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[10] Having participated in over 100 LILO/SILO shelters that were rejected by the IRS under the anti-abuse doctrines, BNY should be familiar with this well-established principle. (JA343-344,1755-1756.)

these shelters under the anti-abuse doctrines, as this Court did in *Altria*, *DeMartino*, and *TIFD*. *See Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006). As those decisions make clear, the "analysis of whether [the transaction] is a sham . . . must occur before" any statutory or regulatory analysis because those rules do "not apply where the transactions involved are shams," *Kirchman v. Commissioner*, 862 F.2d 1486, 1491 (11th Cir. 1989), no matter how "detailed" the relevant rules are (Br47 n.22). Therefore, that the Government has not challenged BNY's STARS transaction under § 901(i) or the related regulations — which disallow foreign tax credits when the foreign country has chosen to subsidize the taxpayer's activity by providing a tax rebate — as BNY observes (Br47 n.22), in no way precluded the Tax Court's analysis of STARS under the economic-substance doctrine. The question before the Tax Court was whether the sham Trust and its meaningless circular cash flows, the above-market Loan used to camouflage those cash flows, and the collusion by BNY and Barclays to pay and then recover the U.K. tax should be respected for U.S. tax purposes. Those inquiries required by the economic-substance doctrine are distinct from the inquiries required by the

foreign-tax-credit rules. Simply stated, the foreign-tax-credit rules are not dispositive here because BNY's STARS transaction served no purpose beyond generating tax benefits, as the Tax Court correctly determined.

Although BNY purports to rely on a pending appeal to this Court in which the taxpayer has argued that "the economic-substance doctrine cannot be applied to disallow foreign tax credits that comply with all statutory and regulatory requirements" (Br31 n.15), BNY did not make that argument in the Tax Court, does not develop it on appeal, and, accordingly, it is waived. In any event, that argument conflicts with every decision that has addressed the issue, *see*, above, pp. 32-33, and BNY cites no evidence that either Congress or the Treasury intended the foreign-tax-credit rules to be exempt from the application of the economic-substance doctrine. The economic-substance doctrine applies to *all* tax benefits, including foreign tax credits, unless Congress has expressly provided to the contrary. *See Astoria Fed. Sav. & Loan Ass'n v. Solimino*, 501 U.S. 104, 108 (1991) ("where a common-law principle is well established," "the courts may take it as given that Congress has legislated with an expectation that the principle will apply except 'when

a statutory purpose to the contrary is evident'") (citation omitted). Congress has not provided to the contrary, as evidenced by the generally applicable codification of the economic-substance doctrine in 2010, § 7701(o). By the time of that codification, the IRS was actively litigating economic-substance challenges to tax benefits claimed in STARS and similar transactions, and the Treasury Department had issued proposed regulations that included a preamble statement specifically emphasizing that the IRS will challenge foreign tax credits in abusive, circular transactions under the "economic substance doctrine." 72 Fed. Reg. at 15084. Tellingly, § 7701(o) contains no foreign-tax-credit exception.

Similarly lacking merit is BNY's repeated contention (Br1-2,17,22,32,56) — echoed by the amicus (AmBr17-18) — that the Tax Court's decision subjects it to "double taxation." That contention ignores the economic reality that the U.K. tax paid by BNY was recovered by Barclays and used for BNY's benefit.[11] Although (as BNY

[11] Half of the U.K. tax was returned to BNY as the Tax-Spread. (JA314,379,600,1511,1525.) The other half was used by Barclays to pay (continued…)

observes (Br47 n.22)) the foreign-tax-credit rules allow a taxpayer to claim a foreign tax credit even if someone else has borne the "economic burden" of the foreign tax, those rules assume that *someone* has, in substance, paid the tax. It is inconsistent with the purpose of the foreign-tax-credit rules to permit a taxpayer to claim a foreign tax credit where — as in STARS — *no one* has borne the economic burden of the foreign tax.

That neither Congress nor the Treasury anticipated the specific economically meaningless transactions that Barclays and KPMG created to generate foreign tax credits for illusory foreign-tax costs using the U.K. as a conduit hardly gives BNY a free pass under the economic-substance doctrine. BNY's observation that "Congress and the Treasury Department are free to amend the rules that govern the foreign tax credit" (Br56) is irrelevant. The entire point of the economic-substance doctrine and the other judicial anti-abuse doctrines is to be a back-stop to the statutory and regulatory rules for

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its promoter "fee" and to ensure that the U.K. did not challenge the STARS transaction. (JA272-273,965-977,1219,2446,2892.)

transactions that subvert Congressional intent. What the courts understand — and BNY ignores — is that "[e]ven the smartest drafters of legislation and regulation cannot be expected to anticipate every [tax-avoidance] device." *ASA Investerings Partnership v. Commissioner*, 201 F.3d 505, 513 (D.C. Cir. 2000). A "strictly rule-based tax system cannot efficiently prescribe the appropriate outcome of every conceivable transaction that might be devised and is, as a result, incapable of preventing all unintended consequences," as Congress explained when it codified the economic-substance doctrine. H.R. Rep. No. 111-443, at 295 (2010).

The amicus's concern regarding "predictable" tax rules for "ordinary business planning" (AmBr1) is not implicated by the Tax Court's decision. Far from being a routine business transaction, STARS admittedly was an "out of the ordinary, complex and unique transaction" (JA341) that BNY referred to internally as a "Structured Tax Trade[ ]" (JA1514). Moreover, the well-established anti-abuse doctrines are not only predictable and part of the "settled rules" for "tax planning" (AmBr6), but they are also the "'cornerstone of sound taxation,'" *Southgate Master Fund, LLC v. United States*, 659 F.3d 466,

479 (5th Cir. 2011) (citation omitted). Since the inception of the federal income tax, courts have applied these common-sense doctrines to ensure that taxpayers receive only the tax benefits Congress intended so that all taxpayers bear their fair share of the national tax burden. *Altria*, 658 F.3d at 283-284. That this Court may take a "cautious approach" to applying those doctrines does not mean that it will respect any transaction that complies with "the tax laws as written" (as the amicus (AmBr12) and BNY (Br27) suggest); rather, it means only that the Court will carefully and thoroughly analyze all of the relevant facts to determine a transaction's economic reality and substance, as it did in *Altria*, *DeMartino*, *TIFD*, and numerous other cases.

Consistent with that approach, the Tax Court carefully and thoroughly analyzed all of the facts and correctly determined that STARS generated no non-tax benefit for BNY, only the opportunity to "earn[ ] foreign tax credits" (JA1515,1612) for a U.K. tax that was "rebated" by Barclays to BNY (JA1511,1525,2530), as demonstrated below in Section I.B. The court correctly disallowed the foreign tax credits and the related transaction-expense deductions because to do otherwise "would encourage transactions that have no economic utility

and that would not be engaged in but for the system of taxes imposed by Congress."[12] *Goldstein v. Commissioner*, 364 F.2d 734, 742 (2d Cir. 1966). In Section II, we demonstrate that BNY is not entitled to the interest-expense deductions from the above-market Loan that it used to embed the Trust's abusive tax rebate.

B. BNY's STARS transaction lacked business purpose and economic substance

The economic-substance doctrine requires disregarding, for tax purposes, transactions that comply with the literal terms of the tax rules but lack objective "economic substance" or "subjective profit motive." *Gardner v. Commissioner*, 954 F.2d 836, 838-839 (2d Cir. 1992) (disregarding straddle transaction); *e.g.*, *Gilman*, 933 F.2d at 148-149 (disregarding leasing transaction that lacked profit potential); *Goldstein*, 364 F.2d at 740 (disallowing interest-expense deduction for a loan entered into "without any realistic expectation of economic profit

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[12] If this Court were to disagree with the Tax Court's economic-substance determination, a remand would be necessary to allow the court to address the Government's alternative arguments. *See*, above, n.6. In addition, the amount of the Tax-Spread — which the court excluded from BNY's income under its economic-substance ruling (SPA69-70) — would need to be included in BNY's income.

and 'solely' in order to secure a large interest deduction"). After an extensive trial, the Tax Court concluded that use of the Trust structure should be disregarded for tax purposes under the economic-substance doctrine. In so ruling, the court did not adopt a "broad" (AmBr13) interpretation of the doctrine but simply applied this Court's precedent to the unique facts of the STARS transaction.

As the Tax Court correctly recognized (SPA30 (citing *Nicole Rose*)), "the relevant inquiry is whether the transaction that generated the claimed deductions . . . had economic substance." *Nicole Rose*, 320 F.3d at 284; *accord Coltec*, 454 F.3d at 1356-1358. *See* SPA29-31 (collecting cases). Here, the Loan was unnecessary to produce the disputed foreign tax credits, which BNY generated by looping its U.S.-source banking income through the Trust. BNY is not entitled to those credits (or the related transaction-expense deductions) unless the Trust structure itself had economic substance, as the court correctly determined. (SPA30-31.) In *Salem*, the Court of Federal Claims similarly concluded that the STARS Trust and Loan should be analyzed separately, 112 Fed. Cl. at 584-585, and that conclusion has not been challenged by the taxpayer there on appeal.

BNY contends (Br49-52) that the Tax Court erred in considering the Trust and Loan separately because the parties had integrated the two components in the transaction documents, and that its only motive for engaging in the Trust was to obtain the Loan "at the favorable rate." BNY's contention, however, depends on the fiction depicted in the transaction documents that the Tax-Spread generated by the Trust was a true component of the Loan's interest rate. *See TIFD*, 459 F.3d at 234 (reversing district court determination that "depended on the fictions projected by the partnership agreement, rather than on assessment of the practical realities"). As demonstrated below, the Tax Court correctly assessed the practical realities and found that (i) the Tax-Spread "artificially reduced the [L]oan's cost" (SPA45) and was not, in substance, part of the Loan's interest rate (SPA41-46), and (ii) the Loan's actual interest rate was "not 'low cost'" (SPA46-47). Indeed, to view the Tax-Spread as a legitimate component of the Loan's interest would require this Court to accept the absurd proposition that Barclays paid BNY $82 million as "negative interest" to borrow its funds (*see*, above, pp. 19-20). In any event, BNY's contention that the court erred in analyzing the Trust separately from the overpriced Loan is irrelevant

because the court further correctly determined that STARS lacked economic substance, whether the Trust and the Loan were analyzed separately or together, because neither component provided BNY a non-tax benefit. (SPA47-51.)

The Tax Court's decision is consistent with that of the only other court to consider STARS based on a fully developed trial record. *See Salem*, 112 Fed. Cl. at 588-589 (disallowing all STARS tax benefits because "[n]o aspect of the STARS transaction has any economic reality" or non-tax purpose). The contrary interlocutory ruling by the district court in *Santander*[13] — based on a truncated summary-judgment record — casts no doubt on the Tax Court's and the Court of Federal Claims's well-supported decisions. The district court erroneously concluded that STARS had economic substance because it was consistent with "the Code and regulations" regarding "rebate[s] by the taxing authority."[14] *Santander Holdings USA v. United States*, 977

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[13] The district court in *Santander* has not yet addressed the Government's alternative arguments for disallowing the STARS tax benefits.

[14] The district court in *Wells Fargo* has not yet decided whether STARS has business purpose or economic substance. A recent Special

(continued…)

F. Supp. 2d 46, 50 (D. Mass. 2013). That conclusion (embraced by BNY (Br46-47)) conflicts with (among other things) this Court's contrary decisions in *DeMartino*, *Gardner*, *Gilman*, and *Goldstein*, which hold that transactions that comply with the formal tax rules nevertheless should be disregarded for tax purposes if they lack business purpose or economic substance.

1. BNY sought — and Barclays/KPMG promoted — a prepackaged and contrived tax-avoidance scheme

The Tax Court found that BNY's sole purpose for engaging in STARS was "tax avoidance." (SPA36,50-51.) A finding that a transaction was not motivated by business reasons can be supported by evidence that it was a prepackaged strategy promoted by tax advisors. *E.g.*, *Goldstein*, 364 F.2d at 736, 740; *Stobie Creek Invs. LLC v. United States*, 608 F.3d 1366, 1379 (Fed. Cir. 2010). Such is the case here.

(…continued)
Master's report in *Wells Fargo* concluded that the Tax-Spread in STARS is non-tax income for purposes of applying the economic-substance doctrine, a conclusion contrary to that reached by the Tax Court and the Court of Federal Claims. *See*, below, Section I.B.5. The Government has objected to the report.

BNY first learned about STARS in June 2001, when a tax professional from KPMG contacted BNY's Tax Director, DeRosa, to discuss BNY's interest in a "tax-advantaged transaction" — which BNY called "FTC revenue trades" (JA1169) — that relied on foreign tax credits to generate a benefit for U.S. taxpayers. (JA211,229,254,290, 298,305-306,362-363,377,393,1168,1174-1176,1210,1506,1514,2297.) Emphasizing in that first discussion with DeRosa that the transaction would need a "business purpose" to be respected for tax purposes (JA377,1176), KPMG referred to STARS as "low cost funding" (JA1176), but made clear that tax savings created the "low cost" because (i) Barclays and BNY would both "claim tax credits" for the U.K. tax paid by BNY (JA1176), and (ii) Barclays would reduce BNY's interest payment through a Tax-Spread that was "roughly equal to half of the tax that was paid in the trust" (JA314), as DeRosa conceded at trial (JA372,387). As BNY's Treasurer testified, STARS was a "windfall" or "home run" that provided "tax benefits" to BNY. (JA109,118-119.) This windfall, however, was at the expense of the U.S. Treasury because it allowed BNY to claim foreign tax credits for the entire amount of tax paid to the U.K., even though BNY understood that Barclays would

recover it and return "50 percent of the tax" to BNY. (JA387,1216-1217,1511,1525.)

The Tax Court's no-business-purpose finding is further supported by evidence that STARS "would not be engaged in but for the system of taxes imposed by Congress." *Goldstein*, 364 F.2d at 742; *accord Stobie Creek*, 608 F.3d at 1379. In this regard, BNY's analysis of STARS's profitability was predicated on the foreign tax credits and the Tax-Spread, and did not include any benefit that BNY might receive from the Trust assets or the Loan. (JA369,1168-1169,1216-1217,1515,1525, 2530.) In analyzing STARS, BNY (i) understood that its earnings from the Trust assets would be the same with or without STARS (JA950,1216-1217), and (ii) assumed that the Loan proceeds would be invested "in a BNY offshore" deposit earning interest "identical to the rate being paid to Barclays by the Trust" (JA1200). As BNY's profitability analysis recognized, only incremental income would constitute profit from STARS, and income generated by the Trust assets or the Loan proceeds would not be incremental because BNY would have received the income from the Trust assets without engaging in STARS (and without the enormous transaction costs that STARS

entailed (JA3531-3532,3871)), and could have obtained a loan from another funding source. DeRosa conceded that BNY would not have been interested in STARS without the foreign tax credits. (JA363,391.)

2. BNY has failed to identify any non-tax purpose for the STARS Trust structure

Ignoring the evidence that BNY itself viewed STARS as an "FTC revenue trade[ ]" and "tax-advantaged transaction," BNY contends (Br32) that it "did not enter the transaction to escape taxation," citing the fact that its witnesses unanimously testified that it entered STARS to obtain a loan at a "'very advantageous' price." That contention ignores the crucial point that the Loan became "advantageous" only when the Tax-Spread payments Barclays owed to BNY were artificially netted against the interest that BNY owed Barclays. As BNY's witnesses understood, the benefit provided in STARS stemmed from the fact that "BNY earns foreign tax credits [for the U.K. tax that the Trust paid] for its participation" in "STARS" (JA1515), and, at the same time, received "50 percent of the tax" back from Barclays as a "reduction in borrowing cost" (JA387,1216-1217,1279,1511,1525). Indeed, the document that BNY cites (Br33) for the proposition that it expected to earn "millions" in "net interest income" is DeRosa's analysis of STARS

showing that the "net interest income" was nothing more than "BNY['s] Share of Credits" (JA2180; *see* JA1514).

That BNY and Barclays treated the Tax-Spread as part of the interest component of the Loan in order to claim that the Loan provided "low-cost funding" does not mean that the Tax Court was required to accept that treatment at face value. Tax-shelter purchasers and promoters frequently attempt to camouflage their transactions as legitimate business deals. *E.g., WFC Holdings Corp. v. United States,* 728 F.3d 736, 740, 747-749 (8th Cir. 2013) (rejecting purported business purpose that KPMG developed with taxpayer's executives); *Swartz v. KPMG LLP*, 476 F.3d 756, 759 (9th Cir. 2007) (describing how KPMG designed basis-inflating tax shelter to have "the appearance of a legitimate business"). The court here correctly looked past BNY's low-cost-funding label, and concluded that STARS — in reality — was an "FTC revenue trade[ ]" and "Structured Tax Trade[ ]," as BNY candidly acknowledged in its internal documents. (JA1169,1514.)

The Tax Court found that BNY's purported low-cost-funding business purpose for the Trust, which was predicated on "artificially" treating the Tax-Spread as a component of the Loan's interest rate, was

not credible. (SPA36-37,45.) That finding is fully supported by the record. *See Salem*, 112 Fed. Cl. at 586 (holding that "BB&T's artificial pairing of Barclay's Bx payments (representing in substance a rebate of its U.K. tax payments) with BB&T's interest payments to Barclays, does not reflect economic reality").

BNY knew that the Tax-Spread was not a true component of the Loan interest rate as it had no relationship to the time-value of money or the Loan's amount. (JA1179.) As Barclays explained to DeRosa when STARS was first promoted to BNY, the Tax-Spread was a "function of the UK taxes paid," and the "higher the income flowing through [the Trust], the more cash taxes paid, and the greater the benefit available for allocation." (JA382,1179.) Similarly, KPMG's promotion of the STARS benefits illustrated that the "annual interest expense deduction" was a "function of the amount of tax that's paid by the trust." (JA314,1216-1217; *see* JA598.) Consistent with those explanations, DeRosa conceded at trial that "the spread below our normal cost of funds was going to be based on a percentage of the taxes that were paid in the trust" (JA379), and was "not tied to the loan amount" but was "based on the amount of income that's run through the

trust entity" (JA382; *see* JA1279). Indeed, shortly before the STARS transaction closed, BNY decided to increase the amount of the targeted Tax-Spread, and the parties did so without changing the amount of the Loan. (JA389.) And shortly after the transaction closed, BNY engaged in the Stripping Transaction (*see*, above, n.4), which further increased the Tax-Spread without changing the amount of the Loan. (SPA5,16-17; JA295,372-373,974-975,2058,2069,3170-3171.)

BNY's contemporaneous analysis of STARS further demonstrates that the Tax-Spread was not a true component of the Loan's interest but was a separate obligation that was artificially "netted" against the Loan's interest. (JA2593.) BNY's analysis explained that the "rebate" (JA1525) BNY received from Barclays would be received "through the reduced rate of interest" (JA1511,2530), and, to isolate the amount of that rebate, BNY calculated the "Tax 'Spread Adjustment' Benefit" separately from the "Cost of $1.475B Funds" (JA1631,1643). *See* JA2179-2180 (DeRosa's analysis separately calculates BNY's interest "expense" and "BNY Share of Credits" under "KPMG strategy").

Further supporting the Tax Court's rejection of BNY's purported low-cost-funding business purpose is expert testimony that:

- the Tax-Spread was not a component of interest (JA569,573,586,588,610,3170-3171,3182-3183);
- the Loan's actual interest rate was above-market for comparable loans (JA574,3160,3233,3307-3310);
- the Trust was not needed to secure the Loan and did not serve any other financing purpose (JA569,640-641,3233-3236,3317,3324-3325,3351);
- the purported low-cost-funding benefit depended on the foreign tax credits (JA581-582,3175-3179,3193,3363-3364,3376-3378); and
- STARS decreased BNY's global taxes on the income from the Trust assets (JA586-587,684-685,3177-3179,3363-3364,3374-3378).

Unable to refute the experts' testimony, BNY instead contends (Br32 n.16) that the Tax Court "erred in relying on that testimony."[15]

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[15] BNY essentially ignores its own analysis of the cost of the STARS Loan, discussed above, which confirms that BNY was well aware that the Tax-Spread was not a true component of the Loan interest. Indeed, the Tax Court's determination that the Loan did not provide low-cost funding — the same conclusion reached by the Court of (continued…)

BNY is wrong. *See Nicole Rose*, 320 F.3d at 284 (affirming Tax Court finding, "based on the testimony of the Commissioner's expert, [that] the transaction 'lacked business purpose and economic substance'"). The expert testimony cited by the Tax Court demonstrates that BNY's characterization of STARS as low-cost funding, which was dependent on its treatment of the Tax-Spread as a component of interest, was artificial and unreasonable. "The absence of reasonableness sheds light on [a taxpayer's] subjective motivation, particularly" where — as here — the taxpayer has a "high level of sophistication" in "matters economic." *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 186 (D. Conn. 2004), *aff'd by unpublished order*, 150 Fed. Appx. 40 (2d Cir. 2005); *Stobie Creek Invs., LLC v. United States*, 82 Fed. Cl. 636, 693-694 (2008) (relying on "expert reports" to evaluate credibility of the taxpayer's asserted "profit-motive business purpose"), *aff'd*, 608 F.3d 1366 (Fed. Cir. 2010). As these decisions evidence, an expert's analysis of a taxpayer's purported business purpose allows a court to

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(…continued)
Federal Claims in *Salem* — is unassailable on the record here without regard to the testimony of the Commissioner's experts.

contextualize and make inferences about the taxpayer's purported business purpose by "provid[ing] a realistic picture of what the reasonable investor would have believed" at the time the taxpayer engaged in the transaction. *Gilman*, 933 F.2d at 149. *See* JA670.

3. The Trust's circular cash flows generated no non-tax benefits

The Tax Court further found that the Trust lacked economic reality because its "circular cashflows or offsetting payments had no non-tax economic effect." (SPA33.) That finding is fully supported by the record (JA225,371,729,3163,3175,3179) and has been noted — but not challenged — by BNY (Br42,44). As the court correctly recognized, the "presence of circular cashflows strongly indicates that a transaction lacks economic substance," because it is a "common sense proposition that a taxpayer is not entitled to benefits from circular transfers the net result of which is effectively nothing." (SPA33-34.) *See Altria*, 658 F.3d at 289 (observing that "'off-setting, circular payments'" "'strongly indicate'" that a transaction "'has little substantive business purpose other than generating tax benefits'") (citation omitted); *Merryman v. Commissioner*, 873 F.2d 879, 882 (5th Cir. 1989) (disregarding tax

structure where "money flowed back and forth but the economic positions of the parties were not altered").

Cycling BNY's U.S. income through a U.S. Trust with a nominal U.K. trustee created nothing for BNY except foreign tax credits and transaction costs, as detailed above in the Statement of the Case, Section D.1. As BNY's CEO conceded at trial, STARS had "no operational effect" on the Trust's assets. (JA729.) Similarly, BNY's Treasurer conceded that STARS had no "impact on the ability of the bank to earn a greater amount on any asset that was put into the STARS transaction," and that the circular cash flows used to generate the tax benefits were "invisible" to the actual "managers of these assets." (JA99.)

Ignoring the artificial nature of the Trust's circular and offsetting cash flows, BNY compares STARS to a hypothetical business transaction in which a business is moved to the U.K. to save costs (Br44). That comparison is inapt and highlights that STARS was nothing but a tax-avoidance scheme. The "cost-savings" in STARS is funded by the U.S. Treasury, and did not result from any substantive business activity in the U.K. (SPA52.) *Accord Salem*, 112 Fed. Cl. at

589. Moreover, in substantive business transactions, like that posited in the hypothetical, the payment of foreign taxes is merely an unavoidable consequence of a business decision to conduct activities or invest overseas. In STARS, in sharp contrast, subjecting U.S.-source income to foreign taxes was at the heart of the STARS transaction; BNY's STARS benefit was directly correlated with the amount of U.K. taxes paid, creating the anomalous incentive that BNY was "interested in more" — not less — foreign "tax being paid by the trust." (JA373.) Hence, BNY engaged in the Stripping Transaction (*see*, above, n.4) to increase the amount of its U.K. tax payments because STARS was designed to create $1 of foreign tax credits for BNY at a cost of 50¢ per credit.

BNY does not contest the Tax Court's findings that the STARS "assets would have generated the same income regardless whether they were placed in the Trust" (Br42) or that doing so had no impact on the "assets' management or operation" (Br44). Instead, BNY contends that the Trust's circular cash flows should be respected for tax purposes because the underlying pre-existing Trust assets were profitable (Br37-45), BNY was able to invest the Loan proceeds (Br49-56), and the Tax-

Spread was non-tax income (Br45-49). As demonstrated below, BNY's contentions lack merit.

4. The Tax Court correctly determined that the income earned from the pre-existing Trust assets or from the Loan proceeds was not an economic benefit generated by STARS

To determine whether a transaction has economic substance, benefits that a taxpayer would have received without the transaction cannot — as a matter of both law and economics — be attributed to that transaction. *Gregory v. Helvering*, 293 U.S. 465 (1935); *Coltec*, 454 F.3d at 1356-1358; *ACM Partnership v. Commissioner*, 157 F.3d 231, 260 & n.57 (3d Cir. 1998). In *Gregory*, for example, the taxpayer had created a corporation for the sole purpose of transferring valuable stock to herself at the capital-gains tax rate, rather than at the higher ordinary-income tax rate. The Supreme Court disregarded the corporation, holding that it "was nothing more than a contrivance" designed to transfer property at a reduced tax rate. 293 U.S. at 469. That the underlying asset (stock) generated a profit for the taxpayer did not imbue the corporate transaction with economic substance, because the taxpayer could just as readily have transferred the stock to herself and generated the same profit without the corporation. *Id*. at 469-470. Similarly, in *Nicole*

Rose, this Court rejected a taxpayer's attempt to attribute profit from an asset sale to another transaction (a lease transfer) that generated the tax benefits at issue. 320 F.3d at 284. And, in *WFC Holdings*, the Eighth Circuit held that a profitable property transfer could not give the transaction at issue (the creation and sale of stock) economic substance, even though the property transfer and the stock sale were integrated by the parties, because the taxpayer could have transferred the property without creating and selling the stock. 728 F.3d at 745-746. *See also Boca Investerings Partnership v. United States*, 314 F.3d 625, 631 (D.C. Cir. 2003) (disregarding partnership where the taxpayer's "participation in the partnership defies common sense from an economic standpoint, since it could have purchased the PPNs and the LIBOR notes directly, and avoided millions in transaction costs").[16]

Consistent with this case law, the Tax Court correctly found that the income generated by the STARS assets could not properly be considered a benefit of STARS because BNY could have obtained that

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[16] The cases cited by BNY (Br42-43) are not to the contrary, and do not address how to measure a transaction's profitability for purposes of the economic-substance doctrine.

same income — with far fewer fees and expenses (JA3871) — if it had not cycled that income through the STARS Trust. (SPA35-36.) And, even if the STARS Trust and Loan are viewed on an integrated basis, the court also correctly found that any income from investing the loan proceeds was not a benefit attributable to STARS. (SPA49.)

The Tax Court's findings are fully supported by the record. BNY's own contemporaneous analyses of STARS confirm that the only benefits attributable to STARS were the foreign tax credits and the Tax-Spread:

- A spreadsheet developed by DeRosa to demonstrate "what the benefit is from the [STARS] transaction in real terms" identifies STARS's only benefit as "Tax Credits." (JA372,2180.)
- Another analysis created by BNY to demonstrate the "profitability of the Stars transaction" expressly did "not attempt to quantify the benefit to the Bank of the income generated on the use of the $1.5bln deposit" because the analysis was limited to that profit "due to the Stars transaction." (JA1620-1621; *see* JA189.)
- The evaluation of STARS by BNY's Treasurer does not project any profit from the Trust assets or the Loan, and simply assumed that BNY would deposit the Loan in "a BNY offshore 5 year deposit

obligation wherein the rate of interest is identical to the rate being paid to Barclays by the Trust" (absent the Tax-Spread). (JA1200.)[17]

- BNY's "Strategic Plan" analyzed the revenue generated by STARS, and concluded that the revenue from this "FTC revenue trade[ ]" was limited to the Tax-Spread it received from Barclays (JA213,1155,1168-1169), an amount BNY computed to equal approximately $292 million over the term of its STARS transaction (including the $44 million generated by the Stripping Transaction) (JA1519,1599,1605-1606). That calculated revenue did not include any income from the Trust assets or the Loan proceeds.
- And when STARS terminated, BNY's controller told BNY's senior executives that "we would lose a monthly benefit of $4.1 million,"

[17] Consistent with his contemporaneous document, BNY's Treasurer conceded at trial that BNY's "benefit" from STARS depended on the amount of income circulated through the Trust "structure" (JA112), and that "the revenue of the STARS transaction" would not "include the income that was earned on the assets that were put through the STARS structure" (JA124).

which he calculated by taking the "48 million annual benefit" from the Tax-Spread and "divid[ing] that by 12." (JA149-150.)

Thus, BNY's own internal analysis of STARS recognized that the only incremental cash flows resulting from the STARS transaction were BNY's payment of U.K. taxes, Barclays' offsetting payment to BNY of the Tax-Spread, and the U.S. foreign tax credits which funded both those cash flows.

The Tax Court's analysis of STARS's benefits is also consistent with how Barclays promoted the transaction. Barclays informed BNY that the "*Total* BONY Benefit" would equal 50 percent of the "UK Credits" provided for the U.K. tax paid by the Trust. (JA1237 (emphasis added).) *See* JA690-694 (Barclays' testimony that the only benefit attributable to STARS is the Tax-Spread that results from two parties claiming credits for the single payment of U.K. tax). In demonstrating the benefits of STARS, Barclays excluded the cash flows from the pre-existing Trust assets and the use of the Loan proceeds, recognizing that BNY would receive the income from the Trust assets whether or not it engaged in STARS and that BNY could obtain any needed funding from another source. (JA1237,3237.) As Barclays

explained to other STARS purchasers, to calculate a U.S. taxpayer's "real benefit from STARS," one would "have to deduct the Asset Income (which would be received [by the taxpayer] anyway)." (JA2514,2516.)

Finally, the Tax Court's analysis of STARS's benefits is also supported by expert testimony. As the Commissioner's economics expert (Michael Cragg) explained, to "isolate the economic benefits that result from STARS," one must examine "the incremental economic benefits or cash flows that arise from the STARS Transaction." (JA3232; *see* JA571,575-576). The value of cash flows arising from the pre-existing Trust assets does not arise from STARS. (JA579,3236; *see* JA683,3367 n.13 (similar testimony from the Commissioner's financial-economics expert).)

Cragg also testified that any income generated by investing the Loan proceeds would not be attributable to STARS, a purported financing transaction. (JA571,579-580.) How BNY chose to use the Loan proceeds would be attributable to a separate investment decision, as Cragg explained and BNY's executives confirmed. (JA111,150,208, 358,571,580,3182,3232,3237-3242.) As Cragg further explained, to determine STARS's value as a financing transaction (which BNY

claimed it to be), the Loan's cost had to be evaluated separately from how BNY chose to use the Loan's proceeds, and that the cost of the Loan — but not its use — was attributable to STARS. (JA3237-3242.)

Given the overwhelming evidence supporting the Tax Court's analysis, the court did not clearly err in rejecting as "flawed" (SPA47-50) the contrary profitability analysis proffered by BNY's expert (cited by BNY (Br33)). His analysis inappropriately "includes non-incremental preexisting cash flows" from the Trust assets and the projected yield from the Loan proceeds, as Cragg testified. (JA570-571,3237.) Income from "pre-existing assets cycled through the STARS Trust" and from "use of the Loan proceeds" is "not profit from STARS." *Salem*, 112 Fed. Cl. at 586, 588.

5. The Tax Court's profitability analysis correctly disregarded the Tax-Spread payments

In evaluating whether STARS provided BNY with a non-tax economic benefit, the Tax Court determined that the Tax-Spread payments that BNY received from Barclays were not an economic component of the transaction but were merely a "tax effect," attributable to "monetizing and transferring the value of anticipated foreign tax credits." (SPA41,45,49.) That determination is supported

by the record (JA570,588,664-665,1511,1525,3159,3175-3179,3186,3374-3378), and by the *Salem* decision. *See* 112 Fed. Cl. at 585-586 (holding that STARS generated no non-tax income because the "Bx payments [*i.e.*, the Tax-Spread] under STARS simply represented a rebate to BB&T of one-half of the U.K. taxes to which BB&T voluntarily subjected itself").[18]

The transaction's only "profit" derived from the foreign tax credits that BNY received for U.K. taxes that in substance had not been paid. (SPA45,47-49; JA588,1511,1525,3159,3175-3179,3186,3188-3189,3374-3378.) That fact is illustrated by the parties' $100 example. For every

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[18] If, as the Tax Court and the Court of Federal Claims correctly concluded, the Tax-Spread should be disregarded in calculating STARS's profitability, it is irrelevant whether foreign taxes are properly treated as a transaction cost; without the Tax-Spread, the Trust transaction increased BNY's non-tax costs — such as the $6 million KPMG fee — without adding any non-tax income. Therefore, the court's decision can be affirmed without addressing BNY's (Br38-42) and the amicus's (AmBr18-21) argument that foreign taxes are not properly considered a STARS transaction cost. In any event, and as demonstrated in the following section, the court correctly determined, as an alternative holding, that (i) if the Tax-Spread were treated as non-tax income, then the U.K. tax paid to acquire that income is properly treated as a transaction cost, and (ii) the transaction so viewed remained unprofitable because the Tax-Spread was only 50 percent of the foreign-tax cost.

$100 of Trust income, BNY paid $22 in tax to HMRC and claimed a foreign tax credit of $22; HMRC, however, retained only $3.30, paying $18.70 in net tax benefits to Barclays; and Barclays rebated $11 of those benefits to BNY as the Tax-Spread. Those cash flows were all funded by the U.S. tax savings resulting from BNY's foreign tax credits, as the Tax Court found (SPA45 & n.14,49), the record supports (JA569-570,588,3178-3179,3190,3377-3378), and BNY ignores but does not dispute (Br23-56).[19] Accordingly, the Tax-Spread was in no way an "economic benefit" (Br45-47). Indeed, BNY itself knew that it was nothing more than a tax "rebate" (JA1525; *see* JA387,1216-1217,1511,2530) funded by the foreign tax credits that BNY claimed from the U.S. Treasury (JA569-570,588,3178-3179,3190,3377-3378).

Seeking to avoid this economic reality, BNY contends (Br45-49) that the facts and the law preclude the Tax Court's finding that the Tax-Spread payment was a "tax effect" that should be disregarded in the profitability analysis. BNY is wrong.

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[19] The Trust generated no non-tax income for Barclays to fund the Tax-Spread payments it made to BNY. Rather, those payments were unwittingly funded by the U.S. Treasury. (SPA49; JA569-570,588,3178-3179,3190,3377-3378.)

a. The record overwhelmingly supports the Tax Court's finding that the Tax-Spread payment was derived from tax benefits and was not in substance a component of interest, as evidenced by BNY's own contemporaneous statements, as well as BNY's trial concessions. *See Goldstein*, 364 F.2d at 739 (relying on taxpayer's "contemporaneous[ ]" documents to determine transaction's substance and rejecting taxpayer's contrary litigating position); *Merck & Co. v. United States*, 652 F.3d 475, 482 (3d Cir. 2011) (same). In its "STARS Transaction Benefit Analysis," BNY separately calculated its "Cost of $1.475B Funds" that it owed Barclays, and the "BNY Tax 'Spread Adjustment' Benefit" (JA1622,1631,1643) that was "rebated" from Barclays (JA1511,1525). The "rebate" — to use BNY's contemporaneous term (JA1525) — was "50 percent" of the U.K. "tax" it expected to pay in STARS, and the economic benefit derived from STARS was based on the projected foreign tax credits it would receive for rebated U.K. tax expense. (JA372,379-380,387,1169,1209-1210,1511,1514-1515,1525,3427.) Moreover, DeRosa conceded at trial that Barclays would provide BNY "with 50 percent of" the "amount of taxes that were paid in the trust," and that BNY's STARS benefit was "50 percent of the

taxes paid." (JA379.) As DeRosa illustrated, if "36 of taxes [were] generated" in STARS, then "Barclays would give us 50 percent share through the reduced funding cost of 18" (JA372), and, at the same time, BNY "would be getting a foreign tax credit" for the "36" (JA380). *See* JA2180. Thus, in substance, the Tax-Spread was nothing more than a tax effect — a split of U.S. tax benefits calculated as half of BNY's illusory foreign-tax expense — as BNY fully understood.

The Tax Court's Tax-Spread-as-tax-effect finding is also supported by the promotional materials. Barclays represented to potential STARS purchasers that the "benefit under STARS arises from the ability of both parties to obtain credits for the taxes paid in the trust," and that the benefit was "equal to 50% of [the Trust's] taxes." (JA2513,2515, 3427; *see* JA692,694,700.) Similarly, KPMG represented that STARS was profitable because "[b]oth banks claim tax credits for the same tax on income earned through a Delaware trust" (JA1176), and then, in addition to claiming the U.S. foreign tax credits, BNY would also receive a "shar[e] of U.K. tax credits attributable to U.K. taxes" that BNY paid (JA1209). Thus, as KPMG illustrated, the Tax-Spread

represented a tax reduction because "50%" of the "UK tax" is returned to BNY by Barclays. (JA1211.)

Finally, the Tax Court's finding is supported by expert testimony. For example, Cragg explained that, from an economic perspective, the Tax-Spread was an effective "rebate" of the U.K. taxes, with BNY and Barclays colluding to use HMRC as a conduit to return the U.K. tax payment to BNY. (JA587-588,3175-3179.)

BNY has failed to demonstrate any error — let alone clear error — in the Tax Court's factual characterization of the Tax-Spread payment. In this regard, the court did not disregard the Tax-Spread as a "tax effect" simply because "it reflected Barclays's U.K. tax benefits," as BNY contends (Br47). To the contrary, the court disregarded the Tax-Spread as a "tax effect" because it also reflected BNY's U.S. "foreign tax credits." (SPA45.) As the court explained, (i) the Tax-Spread, calculated as "one-half the present value of the U.K. taxes the trust was expected to pay," was "effectively funded by the foreign tax credits," and thus was a "tax effect," not non-tax income, and (ii) "Barclays' U.K. tax benefit could not be achieved without BNY achieving its U.S. tax benefit." (SPA41,45 n.14,49.) Thus, contrary to BNY's suggestion,

STARS was *not* funded by the U.K. treasury; STARS was tax additive for the U.K. — the benefits provided to BNY, Barclays, and the U.K. were all funded by U.S. foreign tax credits, *i.e.*, by the *U.S.* Treasury. (SPA20,45.)

This distinction is illustrated by the hypothetical posited by BNY (Br48) in which a U.S. bank provides a high-interest loan to a U.K. manufacturer that receives U.K. tax credits for producing solar panels. The hypothetical presumes that the high interest is funded in part by the value of the borrower's solar tax credits. Unlike STARS, however, the interest in the hypothetical is not attributable to any foreign tax paid, or U.S. tax benefits claimed, by the U.S. lender. Accordingly, the interest is not a "tax effect" to the U.S. lender because it has nothing to do with taxes paid or avoided by the U.S. lender. The STARS Tax-Spread, in contrast, is properly disregarded as a tax effect because it reflects the monetized value of U.S. foreign tax credits for U.K. tax paid and recovered by BNY.

b. The Tax Court's disregard of the Tax-Spread payment for purposes of evaluating STARS's pre-tax profitability does not conflict with the authorities cited by BNY (Br40,45-48). BNY refers (Br40) to

the "'venerable principle'" articulated in *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 728-729 (1929), that, if a third party pays a taxpayer's tax liability, that payment is treated as income to the taxpayer. That principle, however, is inapplicable here because Barclays did not pay BNY's U.K. tax liability but, instead, simply returned to BNY a portion of the U.K. tax that BNY itself had paid. In substance, the Tax-Spread was part of a meaningless circular cash flow and, thus, was not pre-tax income.

Similarly, the Tax Court did not disregard what "'actually occurred'" (Br45-46 (citation omitted)) by treating the Tax-Spread as a tax effect. What the court recognized, and BNY ignores, is that what "actually" occurs in structured tax-avoidance transactions like STARS is not the same as the parties' formal papering of the transaction. *E.g.*, *TIFD*, 459 F.3d at 224-225 (rejecting taxpayer's argument that banks qualified as partners, even though "documents of the partnership characterize the Dutch banks as equity partners"); *Altria*, 658 F.3d at 282 (observing that the taxpayer "was aware that for tax purposes it needed to maintain a genuine ownership" in the property at issue and rejecting taxpayer's ownership claim despite paperwork created to

sustain appearance of ownership). By analyzing the economic reality of STARS, and looking past the transaction's formal labels, the court *did* give STARS its tax effect in accord with what "'actually occurred'" (Br45 (citation omitted)). What actually occurred is that Barclays "rebated" — to use BNY's term (JA1511) — 50 percent of BNY's U.K. tax through the Tax-Spread, thereby implementing the parties' split of U.S. tax benefits based on credits for U.K. tax that was not in substance paid. The court was not "obligated" to accept the parties' formal embedding of the Tax-Spread as part of the formula for computing the "interest" that BNY owed Barclays on the Loan, as BNY contends (Br46). To the contrary, the very purpose of the anti-abuse doctrines is to "bypass appearances and focus instead on practical realities." *TIFD*, 459 F.3d at 236. The court's characterization of the Tax-Spread as a tax effect, rather than a component of interest expense, thus reflects its economic reality (and is consistent with how the parties actually viewed the Tax-Spread, *see*, above, pp. 50-51).

BNY's reliance (Br47) on the contrary summary-judgment ruling in *Santander* is misplaced. The district court's rationale for treating the Tax-Spread there as non-tax income cannot withstand scrutiny. First,

the court's conclusion that the characterization of the Tax-Spread was a purely "legal" question, *Santander*, 977 F. Supp. 2d at 51, is contrary to binding precedent. *E.g., Altria*, 658 F.3d at 288 (observing that the "inquiry under *Frank Lyon*" is "wide-ranging and fact-intensive"). Second, the court's conclusion that the Government was precluded from treating the Tax-Spread as a tax effect because "the Code and regulations have addressed the issues of rebates and subsidies and stopped short of any concept of 'constructive' or 'effective' rebate," *Santander*, 977 F. Supp. 2d at 52, also misses the mark. The very purpose of the anti-abuse rules is to reach transactions that the "drafters of legislation and regulation" have not yet "anticipate[d]." *ASA*, 201 F.3d at 513. Finally, the court's conclusion that a private-party payment cannot be recharacterized under the economic-substance doctrine as an effective return of tax, *Santander*, 977 F. Supp. 2d at 51-52, is not supported by the cited authorities (which did not address the economic-substance doctrine) and fails to appreciate the "flexible nature" of the economic-substance inquiry, *Gilman*, 933 F.2d at 148.[20]

[20] Contrary to the amicus's complaint (AmBr3), the doctrine is — (continued…)

6. The Trust did not generate any non-tax profit for BNY, even if — contrary to the Tax Court's determination — the Tax-Spread is considered non-tax income

Even if — contrary to BNY's own contemporaneous analysis, other record evidence, and the Tax Court's determination — the Tax-Spread payments were not properly viewed as a tax effect, the Tax-Spread payments would nevertheless be insufficient to provide BNY with a non-tax profit. (SPA46 n.15.) To determine whether a transaction has profit potential, the transaction's "expected" return from non-tax revenues must be compared to its expected "costs and fees." *Stobie Creek*, 608 F.3d at 1378. Here, for every $50 that BNY expected to receive from Barclays in Tax-Spread payments, BNY expected to pay $100 to the U.K. in foreign tax. The Tax-Spread payment merely reduced the cost of the U.K. tax by 50 percent, and thus BNY was still out of pocket the remaining 50 percent, plus the other substantial STARS transaction costs. STARS can be considered profitable only if

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(…continued)
and must be — flexible and requires courts to engage in a "pragmatic total inquiry" in order to effectively analyze the ever-changing fact pattern of tax-avoidance schemes. *Reddam v. Commissioner*, 755 F.3d 1051, 1061 (9th Cir. 2014).

the disputed foreign tax credits are factored in (as BNY did when evaluating STARS's profitability), but the essential inquiry of the economic-substance doctrine is whether a transaction has a reasonable prospect of generating a significant profit *without* factoring in the disputed tax benefit. *E.g., Gilman*, 933 F.2d at 148. Even if the Tax-Spread were a non-tax "economic benefit," as BNY contends (Br46), the Tax-Spread could not generate a non-tax profit because it was far less than BNY's foreign-tax expense.[21] (JA593,3232.)

BNY (Br38-40) and the amicus (AmBr18-21) rely on *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001), and *IES Indus., Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001), for the proposition that foreign tax should be excluded as an expense in the profitability analysis under the economic-substance doctrine. That reliance is misplaced. There is no across-the-board rule precluding foreign tax from being treated as an expense, as Congress made clear when it codified the economic-substance doctrine in 2010 and directed

[21] Given that Barclays' reimbursement of 50 percent of BNY's foreign-tax expense ultimately was funded entirely by the foreign tax credits, it is nonsensical for BNY to claim that the Tax-Spread it received from Barclays constituted non-tax, economic income.

Treasury to "issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases." § 7701(o)(2)(B); *see Pritired*, 816 F. Supp. 2d at 739-740 (treating foreign tax as an expense under economic-substance doctrine).

Putting aside whether foreign tax was appropriately excluded from pre-tax costs in *Compaq* and *IES*,[22] those decisions do not support excluding foreign tax in the starkly different STARS context. In the *Compaq*/*IES* transaction, the taxpayers purchased stock of publicly traded foreign corporations, and the foreign tax was imposed on foreign-source dividend income. In stark contrast, in STARS, the foreign tax was imposed on U.S.-source income that BNY purposely made subject to U.K. tax by placing U.S. assets in a Trust with a U.K. trustee. The STARS foreign tax is properly viewed as a transaction expense, because BNY (unlike the taxpayers in *Compaq* and *IES*) could have obtained the "same income" from its Trust assets without incurring the U.K. tax on that income, as BNY concedes (Br42). Moreover, if the Tax-Spread is to

[22] The Fifth and Eighth Circuit decisions have been the subject of much criticism. *E.g.*, Bittker & Lokken, *Federal Tax'n of Income, Estates & Gifts* ¶ 72.5.3 at 72-48 (rev. 3d ed. 2005).

be treated as non-tax income, then the foreign tax necessarily must be treated as an expense of earning that income because the two items are economically and inextricably linked; BNY received the Tax-Spread payment precisely because it agreed to pay the U.K. tax, and the amount of that payment was directly based on the amount of the U.K. tax. That was not true in *Compaq*/*IES* — the dividend income received by the taxpayers in those cases was not tied to their foreign-tax payment; it was just the converse.

BNY's reliance (Br33) on the testimony of the Commissioner's banking expert (Anthony Saunders) is misplaced. Although Saunders testified that STARS "was a very profitable transaction" for BNY because it allowed them to "borrow[ ] money at a negative interest rate" (JA611), he did not conclude that that benefit was pre-tax. On the contrary, Saunders testified that the "major economic driver" in STARS "was tax-driven." (JA610.) Moreover, Saunders was not tasked with analyzing the source of the negative interest rate generated by STARS. In contrast, the Commissioner's financial-economics expert, David Ross, was tasked with analyzing the "source of the expected benefits" (JA661), and he concluded that the "sole source of those benefits would be a

reduction in United States tax payments, offset by partially an increase in U.K. tax payments" (JA661-662,664-665).

II

The Tax Court erroneously held that BNY was entitled to claim interest-expense deductions from the above-market Loan used to camouflage the sham Trust

Standard of review

The Tax Court's determination that the Loan had sufficient substance and non-tax purpose to sustain interest-expense deductions is a "question of law" reviewed *de novo*. *Frank Lyon*, 435 U.S. at 581 n.16. The court's evidentiary rulings are reviewed for "an abuse of discretion." *Ulfik v. Metro-North Commuter Railroad*, 77 F.3d 54, 57 (2d Cir. 1996).

A. Introduction

The Tax Court erroneously determined on reconsideration of its original opinion that BNY was entitled to its claimed interest-expense deductions. Interest expense incurred in transactions that lack economic substance or non-tax purpose is not deductible. *Lee v. Commissioner*, 155 F.3d 584, 586 (2d Cir. 1998). BNY's interest expense from the Loan is not deductible because the STARS Loan

(i) "was not structured to make a profit," and (ii) was "devised to provide [U.S. taxpayers] with a pretext for a purported business purpose for engaging in a sham transaction." *Salem*, 112 Fed. Cl. at 587 (disallowing STARS interest-expense deductions). The court's revised legal conclusion that BNY's interest expense is deductible conflicts with its factual findings, including its findings that the "loan was overpriced and therefore not profitable on a pre-tax basis" (SPA50) and that the purpose of the "significantly overpriced" (SPA36) Loan was to "embed[ ]" the Tax-Spread so as to "artificially" connect the Trust and the Loan (SPA45). The court's rationale for disregarding its findings cannot withstand scrutiny.

B. That the Loan was real, and its proceeds available for use by BNY, does not immunize it from analysis under the economic-substance doctrine

The Tax Court found that (i) the Loan — "cancellable within 5 to 30 days" by Barclays — was comparable to "short-term financing," (ii) "BNY could have obtained comparable financing in the market place at substantially less economic cost," (iii) the Loan was "not profitable on a pre-tax basis" because it "was overpriced," and (iv) the Loan was used to "embed[ ]" the Tax-Spread and thereby "artificially" connect the

Trust and the Loan. (SPA45-47,50.) Those findings are supported by the record. (JA102,349,574-578,611-612,615-616,622-623,3159-3160,3233,3240,3246-3247,3303-3310.) Based on its well-supported findings, the Tax Court should have concluded that the Loan lacked any non-tax purpose and could not sustain interest deductions.

That the Loan was "real" and "used for economically substantive activity" does not immunize it from analysis under the economic-substance doctrine, as the Tax Court wrongly supposed. (SPA67.) Even "real" loans are disregarded for tax purposes if they do not, and were not intended to, "'appreciably affect'" the taxpayer's "'beneficial interest.'" *Knetsch v. United States*, 364 U.S. 361, 366 (1960) (citation omitted); *accord Lee*, 155 F.3d at 587; *Goldstein*, 364 F.2d at 740. If a bank uses a loan to earn 7 percent, and is offered a loan with a 5-percent interest rate and a loan with a 4-percent interest rate, it would be "economically irrational to take the more costly 5 percent loan," even though both loans would generate net interest income, as Cragg explained. (JA3238.) *See ASA*, 201 F.3d at 516 (determining that fact that taxpayer could accomplish its purported business goal "at far, far lower transaction costs" evidences that transaction lacks economic

substance); *ACM*, 157 F.3d at 257, 258 n.52 (determining that "significant transaction costs" supported no-economic-substance determination because taxpayer "could have made greater profits with less risk by pursuing alternative investments"). Given the Loan's above-market cost, it could not have been beneficial to BNY's interests. Rather, the Loan harmed those interests because BNY "could have obtained comparable financing in the market place" at a lower rate, with lower transaction costs, as the Tax Court found. (SPA46-47.) But for the foreign tax credits generated by STARS, BNY never would have engaged in this expensive financing, which demonstrates that BNY engaged in the Loan only for tax-avoidance purposes to camouflage the Tax-Spread.

That the loan proceeds "were available for use in [BNY's] banking business" (SPA67) does not mean that obtaining the Loan was a business decision rather than a tax-avoidance decision. The Tax Court found (and BNY does not dispute (Br23-56)) that BNY did not actually use the overpriced Loan for the purpose that BNY purportedly obtained it, *i.e.*, to purchase long-term "asset-backed securities." (SPA48,50-51 & n.17.) But, even if BNY had actually used the funds as it purportedly

intended to do, a loan hardly can be considered beneficial, or to serve a non-tax purpose, if the borrower had alternative sources of financing that would have been less costly, as BNY did. To evaluate a financing transaction, a sophisticated borrower, such as BNY, would compare the cost of the loan at issue with that of comparable, available funding, as Cragg explained and BNY's Treasurer acknowledged. (JA111,3186, 3237-3238.) Compared to comparable funding, the Loan caused BNY to lose "$26 million" due to the "high interest rate charged by Barclays" and the related transaction costs, as Cragg explained. (JA574,577-578,3188-3189.)

The Tax Court's failure to evaluate the Loan's cost in its supplemental opinion conflicts with this Court's precedent, which applies the economic-substance doctrine "from the standpoint of the prudent investor." *Gilman*, 933 F.2d at 146-147. A "prudent investor" would analyze a transaction's "price," which was "highly relevant" to the economic-substance doctrine's profit analysis. *Stobie Creek*, 608 F.3d at 1376. In *Kerman v. Commissioner*, 713 F.3d 849, 864-867 (6th Cir. 2013), the Court applied this principle to a loan and determined that a purported financing transaction lacked economic substance

because (i) the taxpayer did not have unfettered access to the funds, and (ii) even if the taxpayer had such access, the loan was expensive relative to the taxpayer's normal financing. In so ruling, the court rejected the view — adopted by the Tax Court here (SPA66) — that the loan's cost was irrelevant, explaining that "calculating the actual cost of financing and comparing it against the market rate" is "'relevant'" to the profit-potential question. *Id.* at 867 (citation omitted). As the court explained, "regardless of what investment [taxpayer] planned to use the loan proceeds for," overpriced financing could not provide a "reasonable possibility of profit" because a reasonably prudent investor would not "finance investments, even good investments, with bad loans."[23] *Id.* at 865; *accord Salem*, 112 Fed. Cl. at 587; *see Long Term Capital*, 330 F. Supp. 2d at 181-183. The cost of the Loan was particularly relevant here because BNY posited that it participated in STARS to obtain low-cost funding.

[23] The cases involving loans cited by BNY (Br54) are not to the contrary.

C. The overpriced Loan had no non-tax purpose

The Tax Court failed to identify any credible non-tax purpose for BNY's agreeing to the overpriced Loan or using it as a device to embed the Tax-Spread. BNY could have borrowed the same funds at a lower rate and with far lower transaction costs, as the Tax Court itself found (SPA46-47), and the record supports (JA612,615-616,3159-3160,3233,3246-3247,3303-3310). The only purpose for the Loan was to provide a "device" to "embed[ ]" the Tax-Spread and thereby "artificially" connect the Trust and the Loan, as the Tax Court further found. (SPA45.) But, as Cragg explained, there was "no non-tax" reason to "embed" the Tax-Spread from the Trust in the Loan or to treat the Tax-Spread as a component of the Loan's interest rate. (JA3183.) The only reason to engage in this economically irrational behavior was to create the pretext that the purpose of STARS was to obtain low-cost funding and to "camouflage Barclays' rebate of a portion of [the U.S. taxpayer's] U.K. tax payments" as a component of Loan interest, as the Court of Federal Claims correctly determined in *Salem*, 112 Fed. Cl. at 587.

The *Salem* determination regarding the purpose of the Loan is confirmed by STARS's history. As initially designed, STARS did not contain the Loan. (JA265-266.) *See Salem*, 112 Fed. Cl. at 556. Standing alone, however, the Trust and its meaningless circular cash flows were too obvious a tax-avoidance scheme to be a viable tax product that the promoters could sell. As the promotional materials emphasized, the Trust would not be respected for tax purposes unless it had a "business purpose." (JA311,377,1176.) Accordingly, the promoters added a loan component, which provided a mechanism for returning the U.S. taxpayer's U.K. tax payments in a manner that obscured the fact that the payments effectively were rebates (JA1511,1525), and advised taxpayers that "low cost funding" could be touted as STARS's "business purpose" (JA1176).

Further demonstrating that the purpose of the Loan was to create a business-purpose pretext is the fact that BNY tried (unsuccessfully) to avoid "negative interest." (JA600.) *See*, above, pp. 19-20. As the STARS promoters and participants recognized, if the interest were negative, treating the Tax-Spread payment as a component of interest would make the Loan "look[ ] less and less like a loan" and not "natural

from a U.S. tax standpoint." (JA600,2671,3358.) There would have been no reason, however, to care about negative interest or how things "look[ed]" from a "U.S. tax standpoint" unless the Loan were being utilized as "business purpose" camouflage for the sham Trust.

Finally, there is no other explanation as to why a major commercial bank would (i) engage in needlessly expensive financing, or (ii) treat the Tax-Spread payment, which BNY knew had nothing to do with interest (JA379,1179), as a reduction in its Loan-interest rate. "Absent strong economic reasons" not present here, "large commercial banks do not engage in financing transactions at rates of 25 to 35 basis points higher than their market sources of funding, particularly as to loans over $1 billion." *Salem*, 112 Fed. Cl. at 587.

This Court's decisions cited by the Tax Court (SPA66) do not support its interest-expense ruling. In *Lee* and *Goldstein*, the claimed interest-expense deductions were *disallowed* because — as here — the taxpayer had not engaged in the loan transaction for a non-tax purpose. That the taxpayers in *Lee* and *Goldstein* pursued the loans to obtain interest-expense deductions, whereas BNY obtained the Loan to disguise the sham transaction that generated its foreign tax credits,

does not meaningfully set this case apart, as the Tax Court erroneously concluded (SPA66). What is crucial is that in all three cases, the taxpayer had only tax reasons for obtaining the loan. The Tax Court's observation that the Loan was "not necessary" to "produce the disallowed foreign tax credits" and was not used "to "finance" the "STARS structure" (SPA66) misses the point. The sole purpose of the Loan was to disguise the Tax-Spread as an interest component and thereby create the pretext that STARS had a business purpose — low-cost funding — a pretext that the Tax Court itself refuted. The Loan therefore lacked economic substance and cannot sustain interest deductions.

D. Evidence regarding STARS's development erroneously excluded by the Tax Court on relevancy grounds reinforces that the overpriced Loan was used as tax camouflage

During the trial, the Tax Court excluded, on relevancy grounds, evidence proffered by the Commissioner that further demonstrates that the overpriced Loan was utilized to camouflage a sham Trust. (SPA128-129.) The excluded evidence relates to Barclays' development of the STARS transaction, including the addition of a loan component. (SPA126-127.) In so ruling, the court abused its discretion. Rule 401 of

the Federal Rules of Evidence (which apply to the Tax Court, *see* § 7453; Tax Ct. Rule 143) provides that evidence is "relevant" so long as it has "*any tendency* to make a fact more or less probable than it would be without the evidence." Fed. R. Evid. 401 (emphasis added). The Tax Court did not — and could not — find that the excluded evidence had *no tendency* to make more probable that the Loan was added to camouflage the sham Trust.

As noted above, STARS originally did not include the Loan, as Barclays' chief architect of the STARS transaction testified. (JA265-266.) Several of the excluded documents amplify that testimony. (JA978-1082,2181-2195.) The original STARS was designed so that the U.S. taxpayer and Barclays both received tax credits for the U.K. tax paid by the Trust (JA1001-1002,2184) as in BNY's STARS, but Barclays rebated the U.K. tax back to the U.S. taxpayer as a "fee" (JA1001,2184,2640-2641) rather than a Tax-Spread netted against loan interest. The original STARS was characterized as providing the U.S. taxpayer a "yield enhancement on either an existing or a new portfolio of assets" (JA1012), rather than low-cost funding (JA1225), with the

STARS "[f]ee" being "treated as part of the enhanced return on the underlying portfolio" (JA1022).

That original version of STARS was promoted by Barclays and KPMG to U.S. corporate taxpayers "with excess cash" that could be used to purchase an income-producing portfolio. (JA990,999.) KPMG, however, warned Barclays that the original version of STARS exposed U.S. taxpayers to the risk that the "US FTC [*i.e.*, foreign tax credits] might be denied by application of a common law anti-abuse rule" in that "there was no purpose for the US participant to run the transactions through the UK taxing jurisdiction other than tax avoidance." (JA1027.) Indeed, given the high transaction costs STARS imposed on the U.S. taxpayer, KPMG concluded that STARS "results in a lower pre-U.S. tax return on investment than if the US Participant continued to hold the Portfolio directly." (JA1058.) After U.S. taxpayers and KPMG expressed their concern "about the economic substance argument" (JA1029) with regard to the original STARS "investment product," Barclays began to market STARS as a "funding" product (JA1070).

The Tax Court erred in excluding the above-described evidence regarding the inclusion of a Loan component in STARS because it "has

the capacity to make the fact at issue" — whether the Loan was utilized in STARS as tax-shelter camouflage — "more probable than it would be without the evidence." *Ulfik*, 77 F.3d at 57 (reversing decision to exclude evidence on relevancy grounds).

CONCLUSION

The Tax Court's decision should be affirmed with regard to the disallowance of BNY's foreign tax credits and transaction-expense deductions and reversed with regard to the allowance of BNY's interest-expense deductions.

Respectfully submitted,

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(s) /s/ Judith A. Hagley
Attorney for Appellee/Cross-Appellant Commissioner of Internal Revenue

Dated: September 25, 2014

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I hereby certify that, on September 25, 2014, (i) six paper copies of this brief were mailed to the Court, and (ii) the foregoing brief was filed electronically with the Clerk of the Court for the United States Court of Appeals for the Second Circuit using the CM/ECF system. All parties to the case are registered with the ECF system.

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