Santander Holdings USA Asks the Supreme Court to Address Economic Substance Doctrine

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From 2003 to 2007, Sovereign Bancorp, Inc. (Sovereign) – now known as Santander Holdings USA, Inc. (Santander) – engaged in a so-called STARS transaction with Barclays Bank. According to Santander, “[b]y engaging in the STARS transaction, Sovereign transferred some of its income tax liability from the United States to the United Kingdom,” it “secured a loan of $1.15 billion,” and it received a payment “which effectively reduced its lending costs.” On its Federal corporate income tax returns for those years, Sovereign claimed foreign tax credits (FTCs) for UK taxes it paid in connection with the STARS transaction. It also claimed deductions for the interest paid on the $1.15 billion loan.

In 2009, the Internal Revenue Service (IRS) issued a Notice of Deficiency disallowing Sovereign’s FTCs and its deductions for interest paid on the $1.15 billion loan. The IRS did not challenge Sovereign’s compliance with the statutory and regulatory rules governing FTCs, instead arguing that Sovereign’s STARS transaction lacked “economic substance.” Sovereign paid the deficiency and sued for a refund in the US District Court for the District of Massachusetts. When the district court held for Sovereign on both issues, the IRS appealed to the US Court of Appeals for the First Circuit, but only with respect to the FTC issue. The crux of the issue was how to treat the UK taxes and the related FTCs for purposes of the “economic substance” analysis. Relying on Salem Financial, Inc. v. U.S., 786 F.3d 932 (Fed. Cir. 2015), and Bank of New York Mellon Corp. v. Comm’r, 801 F.3d 104 (2d Cir. 2015), the IRS argued that the UK taxes should be treated as an expense but that the related FTCs should be ignored in determining pre-tax profit. Citing IES Indus., Inc. v. U.S., 253 F.3d 350 (8th Cir. 2001), and Compaq Computer Corp. v. Comm’r, 277 F.3d 778 (5th Cir. 2001), Sovereign argued that either both should be included in the profit analysis or both should be ignored. The First Circuit held that Sovereign’s STARS transaction lacked “economic substance,” and upheld the disallowance of the FTCs at issue. In doing so, it treated the UK taxes as expenses that reduced pre-tax profit and ignored the related FTCs, following the Federal and Second Circuit’s approach. Santander Holdings USA, Inc. v. U.S., 844 F.3d 15 (1st Cir. 2016).

On March 16, 2017, Santander filed a petition for certiorari asking the US Supreme Court to resolve a conflict between and among the circuits regarding the application of the “economic substance” doctrine. Santander noted that “the transactions in Compaq and IES would have been decided differently had they arisen in the First, Second or Federal Circuits.” Likewise, “if this case had arisen in the Fifth or Eighth Circuits, the foreign tax expense incurred by Sovereign would have been excluded from the calculation of the transaction’s profit,” with the result that the transaction “would have been deemed to generate substantial pre-tax profit.” “It is intolerable,” Santander posited, “for the availability of federal tax credits to turn on the fortuity of the circuit in which the taxpayer resides.”

Santander’s argument for certiorari is not limited to the application of the “economic substance” doctrine to FTC-related cases. It also notes a dichotomy between circuits that “have applied the economic substance doctrine as a stand-alone requirement that must be satisfied independent of-and in addition to-any requirement imposed by the Internal Revenue Code,” and “those that apply it as a traditional tool of statutory construction.” Santander contrasts the former category, which it characterizes as “an unbounded and amorphous analysis, the goal of which is to ascertain whether the transaction ‘lack[ed] economic reality,’” with the latter, which applies “a text-bound analysis, consistent with other canons of statutory construction, to discern economic substance.”
Santander cites in particular the Sixth Circuit’s recent opinion in *Summa Holdings, Inc., v. Comm’r*, 2017 WL 631663 (6th Cir. Feb. 16, 2017), as an exemplar of what it argues is the proper approach to “economic substance.”

Finally, Santander turned to the fact that the Supreme Court has already denied *certiorari* in two prior STARS cases—*Salem Financial* and *Bank of New York Mellon*. Both taxpayers’ petitions were denied on March 7, 2016, along with that of American International Group, which was seeking Court review of the “economic substance” doctrine in a non-STARS case decided by the Second Circuit. These denials, Santander maintains, “should not dissuade the Court from granting review in this case.” First, Santander claims, its case is a “better vehicle” than the earlier cases because it “presents the circuit split as part of the broader disagreement among the circuits as to the purpose and elements of judicial anti-abuse doctrines.” While the earlier cases were focused narrowly on the application of “economic substance” to FTCs, Santander’s case, “would allow the Court to address the broader principles discussed in the Sixth Circuit’s recent decision in *Summa Holdings*... which makes clear that the circuit conflict is much more fundamental.” Santander also argues that the IRS’s arguments for denial of *certiorari* in *Salem Financial* and *Bank of New York Mellon* “have not withstood the test of time.”

The IRS’s response to Santander’s petition is due on or before April 19, 2017.

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