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Memorandum

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subject: Proposed Disallowance of Foreign Tax Credits Attributable to Cross-Border Trust and Financing

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

<u>LEGEND</u>

U.S. Parent –
Taxpayer –

State A --
Bank --
Sub 1 --
Sub 2 –
InvestCo –
NewCo –
DelCo –
DelCo Sub –
Trust –
Initial Trustee –
Successor Trustee –

Manager –
Country X –
Country X Bank –
Accounting Firm –
Accounting Firm 2 –
Law Firm –
Year 1 –
Year 2 –
Year 3 --
Date 1 --
Date 2 –
Date 3 –
Amount 1 --
Amount 2 --
Amount 3 --
Amount 4 –
Amount 5 --
Amount 6 --
Amount 7 --
Amount 8 --
Amount 9 --
Amount 10 --
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Amount 58 --
Amount 59 –
Amount 60 –
Amount 61 --

Master Participation and Loan Servicing Agreement –

DelCo Security Agreement –

Class C, D, & E Unit Subscription Agreement –

Trust Agreement –

Trust Funding Agreement –

Service Agreements –

Zero Coupon Swap –

Forward Sale Agreement –

Credit Default Swap –

Bank Agreement –

Proposal Document –

Country X Tax Memo –

Meeting Notes –

Accounting Firm Memo –

Tax Opinions –

Initial Tax Opinion –

Tax Benefits Summary –

Bank Regulatory Response –

ISSUES

1. Should foreign tax credits claimed for foreign taxes imposed with respect to the income of Trust be disallowed because the Trust device lacks economic substance?

2. Alternatively, if the Trust device and financing are viewed as an integrated transaction, should foreign tax credits imposed with respect to the income of Trust be disallowed because the entire arrangement lacks economic substance?

3. Should Taxpayer's foreign tax credits be disallowed under section 269(a)(1) or (2) because Taxpayer formed a new subsidiary and transferred assets to that subsidiary with a principal purpose of avoiding U.S. income tax by securing the foreign tax credits, which Taxpayer would not otherwise have enjoyed?

CONCLUSIONS

1. Yes. The sole purpose for forming and transferring assets to Trust was to obtain foreign tax credits for foreign taxes imposed on the income generated by those assets. The Trust device amounted to a circular transfer of Taxpayer's income from its subsidiaries to Trust and back again. It did not increase Taxpayer's economic profit from its assets and resulted in substantial added costs. We conclude that the Trust device lacks economic substance because it served no legitimate non-tax purpose and was not reasonably expected to generate an economic profit for Taxpayer. Therefore, the foreign tax credits generated by the Trust device should be disallowed. Fees and other expenses attributable to the Trust device should also be disallowed.

2. Yes. The arrangement lacks economic substance when evaluated in its totality. The transaction steps in the arrangement are largely circular with no substantive effect or purpose. The purported financing element of the arrangement lacks economic substance because the costs of acquiring the financing, including the Country X taxes, substantially exceeded any reasonably expected benefits. The purported purpose of entering the arrangement – obtaining low-cost financing – is not credible because it ignores salient costs incurred in the transaction. Once all costs are properly considered, we conclude that Taxpayer entered the arrangement for the purpose of claiming foreign tax credits.

3. Yes. The foreign tax credits should be denied under section 269(a)(1) and (2) because Taxpayer formed a new subsidiary and transferred assets to that subsidiary with a principal purpose of avoiding U.S. income tax by securing the foreign tax credits, which Taxpayer would not otherwise have enjoyed.

FACTS

1. Background

U.S. Parent is a publicly-held State A corporation operating as a savings and loan holding company. U.S. Parent is the common parent of an affiliated group of corporations that files a consolidated U.S. Federal income tax return (hereinafter, the affiliated group of which U.S. Parent is the parent corporation is referred to as "Taxpayer"). U.S. Parent owns 100% of Bank, a federal stock savings bank. Sub 1 is a domestic corporation which is 100% owned by Bank, and Sub 2 is a domestic corporation which is 100% owned by Sub 1. Bank, Sub 1, and Sub 2 are all members of U.S. Parent's consolidated group.

At issue are foreign tax credits claimed by Taxpayer in connection with a strategy that resulted in substantial amounts of Country X tax. Prior to undertaking this strategy, Taxpayer had not paid foreign taxes in connection with its business operations and, consequently, had never claimed foreign tax credits.

Several entities unrelated to Taxpayer played significant roles in the strategy. Country X Bank is a publicly-traded Country X corporation primarily engaged in the banking business. Accounting Firm is a major U.S.-based public accounting firm. Country X Bank and Accounting Firm apparently worked together to develop and market the strategy to Taxpayer and others.[1] Country X Bank proposed the strategy to Taxpayer and was also a participant in the strategy. Accounting Firm provided Taxpayer with a tax opinion concluding that the transactions should have the U.S. tax effects sought by Taxpayer, most notably that Taxpayer should be entitled to claim foreign tax credits for income taxes paid to Country X with respect to the income of Trust. Law Firm and Accounting Firm 2 also analyzed the U.S. tax implications of the transactions for Taxpayer.

Taxpayer and Country X Bank implemented the strategy on or about Date 1. As described below, the strategy involved a series of steps, including the creation of multiple new entities owned and controlled by Taxpayer, the transfer of assets and funds among them, and the execution of various agreements between Taxpayer and Country X Bank. In substance, the series of transactions achieved two distinct results. First, Country X Bank transferred Amount 1 to Taxpayer for a period of up to five years (hereinafter, the "financing").[2] Second, Taxpayer contributed assets valued at Amount 2 to a wholly-owned trust that was subject to Country X tax. Taxpayer claimed Amount 3 of foreign tax credits in the two tax years at issue for Country X taxes imposed on

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[1] We are aware of five other taxpayers that undertook similar transactions.

[2] The fact that this memorandum uses the term financing to describe the transfer of Amount 1 to Taxpayer is not intended to imply that a bona fide loan was made for tax purposes. On the contrary, for the reasons explained below, we believe that the financing was undertaken by Taxpayer to obtain tax benefits and that the pre-tax costs incurred to obtain the financing significantly exceeded any reasonably expected non-tax benefits.

Trust's income.[3] Taxpayer's use of Trust to claim foreign tax credits is referred to in this memorandum as "the Trust device." Collectively, the financing and the Trust device are referred to in this memorandum as "the arrangement."

Taxpayer and Country X Bank undertook a second round of transactions in Year 3. As described more fully below, the second round increased the total amount of financing to Amount 4 and the total amount of assets held by Trust to approximately Amount 5. The memorandum generally refers to the facts of the first round of transactions in analyzing the issues, but the terms of the two rounds of transactions were identical except as expressly noted below.

In connection with the arrangement, Taxpayer paid fees of more than Amount 6 to outside accounting and law firms. The substantial majority of those costs were attributable to fees paid to Accounting Firm.[4] Substantial additional fees were paid to Law Firm, which received a fee of Amount 8 for its opinion that the arrangement should result in the desired tax treatment. Accounting Firm 2 and other service providers received substantially smaller fees. It is unclear how much additional expense was incurred by Taxpayer to pay its own employees for their efforts in implementing the transactions.

2. <u>Summary of the Arrangement</u>

This section summarizes the arrangement. The succeeding sections describe the arrangement and its consequences in greater detail.

Trust device. Taxpayer transferred Amount 9 of income-producing assets to a newly-formed, wholly-owned domestic entity (InvestCo). InvestCo contributed Amount 10 of the assets to a second newly-formed domestic entity (DelCo) in exchange for voting interests constituting 1.1 percent of the value of DelCo and non-voting interests constituting 98.9 percent of the value of DelCo. DelCo pledged Amount 11 of the assets it received as security for the financing. Delco contributed its remaining Amount 12 of assets to a newly-formed, wholly-owned domestic entity (DelCo Sub). InvestCo retained the voting shares in DelCo, but contributed the nonvoting shares in DelCo and its other Amount 13 of assets to Trust in return for the Class A and B units in Trust. As a result of these multiple contributions by Taxpayer, the income from Amount 2 of Taxpayer's assets was directly or indirectly payable to Trust.

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[3] Your request for advice is limited to Year 2 and Year 3. Because the transactions were undertaken at the end of Year 2, the Amount 3 of foreign tax credits at issue represents a little more than one year's worth of the sought-after tax benefits. The arrangement was designed to remain in effect for approximately five years.

[4] We understand that Country X Bank agreed to bear at least Amount 7 of the fees paid to Accounting Firm by Taxpayer. It is unclear why Country X Bank did not pay its share of such fees directly to Accounting Firm.

Taxpayer takes the position that Trust was subject to Country X tax on its income by virtue of the appointment of a trustee resident in Country X. Although virtually all of Trust's income was nominally distributable to Country X Bank, as detailed below Country X Bank was obligated to re-contribute all such amounts to Trust. Taxpayer had the only material economic interest in the Trust and the arrangement had no real effect on Taxpayer's economic interests in its assets. However, circulating the income on Taxpayer's assets through the Trust device resulted in a Country X tax liability for which Taxpayer claimed foreign tax credits and also resulted in an offsetting deduction claimed by Country X Bank on its re-contribution of the Trust distributions.

Financing. Country X Bank entered the arrangement by contributing Amount 1 to Trust in return for Class C, D, and E units. Trust used Amount 1 to redeem InvestCo's Class B units in Trust. InvestCo then transferred the Amount 1 to Taxpayer in satisfaction of a note issued by InvestCo to acquire a portion of the assets.

Over the term of the arrangement, the Class A units were entitled to 1% of the income and the Class D units received a return equal to the product of the amount paid for the Class D units, Amount 14, and an amount based on LIBOR. The Class C units were entitled to all Trust income after the payments on the Class A and the Class D units (i.e., substantially all of Trust's income), but the holder of the Class C units was obligated to re-contribute immediately to Trust any distributions on the Class C units. Thus, the only distributions that were payable to and retained by Country X Bank were the distributions on the Class D units.

InvestCo and Country X Bank also entered a Zero Coupon Swap Agreement under which InvestCo was required to make monthly payments to Country X Bank. The monthly payments were equal to the product of Amount 15 and LIBOR plus 100 basis points minus a fixed amount. InvestCo and Country X Bank also entered into a forward sale agreement with respect to all of the Class C, D, and E units. Pursuant to this agreement, InvestCo was obligated to purchase and Country X Bank was obligated to sell all of the Class C, D, and E units for Amount 1 on Date 2, approximately five years after the transactions were undertaken.

These steps resulted in the transfer of Amount 1 from Country X Bank to Taxpayer in exchange for periodic payments on a total of Amount 1 (through distributions on Amount 14 of Class D units and payments computed on Amount 15 under the Zero Coupon Swap Agreement) for five years and repayment of Amount 1 at the end of five years.

3. Transaction Steps

Step 1: Sub2 Purchase of Debt Securities

Prior to Date 1, Bank had an outstanding inter-company loan payable to Sub 1 of approximately Amount 16. Bank repaid approximately Amount 17 of this obligation shortly before Date 1. Sub 1 then contributed Amount 17 to Sub 2, which used the contribution to purchase publicly-traded debt securities (consisting of asset-backed securities). According to the tax opinion furnished by Accounting Firm, these and the other securities described in this memorandum represent debts of U.S. obligors.

Step 2: Formation and Funding of InvestCo

On Date 1, Bank formed InvestCo, a Delaware corporation. Bank received 100% of the stock of InvestCo in return for which it contributed Bank assets valued at approximately Amount 18. These assets consisted primarily of participation interests in a portion of Bank's portfolio of loan receivables valued at approximately Amount 19 and other debt securities valued at approximately Amount 20. According to the Tax Opinions provided to Taxpayer by Accounting Firm, the payors on these loans and securities were domestic and therefore, prior to undertaking the transactions at issue, the interest income from these assets was U.S. source income of Bank.

The loan participations contributed to InvestCo are described in a Master Participation and Loan Servicing Agreement between Bank and InvestCo. Under that agreement, Bank agreed to transfer all payments on the underlying assets to InvestCo, but retained "the sole right and obligation to manage the Assets and to perform, exercise and enforce all privileges and rights exercisable or enforceable by it with respect thereto. . . ."

Also on Date 1, InvestCo purchased assets valued at approximately Amount 21 from Sub 2 in return for a note. The purchased assets consisted of the securities purchased by Sub 2 in step 1, trust preferred securities, and mortgage-backed securities.

Step 3: Formation of NewCo

InvestCo organized NewCo, a Delaware limited liability company. However, NewCo did not issue any membership interests until step 10, as set forth below.

Step 4: Formation and Funding of DelCo

InvestCo formed DelCo, a Delaware limited liability company. InvestCo contributed substantially all of its assets to DelCo in return for all of the interests in DelCo, retaining only certain trust preferred securities valued at approximately Amount 13.

The interests in DelCo consisted of two classes of shares: the Class 1 voting shares and the Class 2 non-voting shares. Other than the fact that the Class 1 shares held all of the voting rights in DelCo, the shares ranked pari passu. We understand that the Class 1 and Class 2 shares accounted for approximately 1% and 99%, respectively, of the value of DelCo.

DelCo also agreed to grant Country X Bank a first security interest in Amount 11 of its assets (or approximately 107% of Amount 1). These assets were retained by DelCo and not contributed to DelCo Sub under step 5 below.

Step 5: Formation and Funding of DelCo Sub

DelCo formed DelCo Sub, a Delaware limited liability company, and contributed all of its assets, except those subject to the DelCo Security Agreement, in exchange for 100% of the DelCo Sub member interests.

Step 6: Creation and Funding of the Trust

InvestCo formed Trust, a Delaware trust. InvestCo contributed all of its Class 2 non-voting shares in DelCo, valued at Amount 22, and other assets, valued at Amount 13, to Trust in return for all of the Class A and B units in Trust. InvestCo also agreed to subscribe to the Class C, D, and E units of Trust.

Each class of units in Trust entitled its holder to a particular share of Trust income. The Class A units were entitled to 1% of the income. Because the Class B interests were redeemed immediately after issuance (see step 9 below), no income was distributable on those units. The Class C units were entitled to all Trust income after the payments on the Class A and the Class D units. The Class D units received a return equal to the product of the amount paid for the units, Amount 14, and an amount based on LIBOR. The Class E units received no distributions. Thus, the substantial majority of Trust income (i.e., more than 98%) was payable to the holder of the Class C units.

Pursuant to the Class C, D, & E Unit Subscription Agreement, the holder of the Class C units was obligated to re-contribute immediately to Trust any distributions on the Class C units. In form, these contributions were made to acquire additional Class E units in Trust, but the Class E units were not entitled to any Trust income as noted above. Thus, the only distributions that were payable to and retained by the holder of the Class C, D, and E units were the distributions on the Class D units, which represented less than one half of one percent of Trust income.[5]

The Trust Agreement provided that Initial Trustee, a U.S. chartered bank and trust company, serve as the first trustee of Trust and Manager (see step 7). The Trust agreement also granted the holder of Class A units the sole right to nominate any successor trustee.

Step 7: Creation of Manager

[5] The transaction documents suggest that the retention of this small amount of Trust income by the holder of the Class C, D, and E units was adopted to help justify Trust's qualification for trust status under Country X tax law.

Bank formed and wholly-owned Manager, a Delaware corporation. The Trust Agreement provided that Manager, in exchange for a monthly management fee, would manage the investments of Trust, keep its books and records, and determine the payments to the holders of the various units in Trust. The Trust Agreement granted Manager the responsibility for managing the investments and distributions of Trust, including absolute discretion over the sale and acquisition of Trust assets, provided that any new investments were limited to certain broad asset categories.[6] Manager, in turn, entered a Service Agreement with Bank pursuant to which Manager paid a service fee to Bank with respect to its Trust activities (see discussion of Service Agreements below).

Step 8: Country X Bank Funding

InvestCo transferred its obligation under the Trust Funding Agreement to subscribe to Class C, Class D, and Class E units in Trust to Country X Bank in exchange for Country X Bank's agreement to fulfill InvestCo's subscription obligations. Accordingly, Country X Bank contributed Amount 1 in cash to Trust in exchange for all of the Class C, D, and E units of Trust.[7]

In addition, Country X Bank agreed to create and maintain a "blocked account" at Bank to which distributions on the Class C units were to be paid by the trustee. Under the Bank Agreement, Country X Bank irrevocably instructed Bank to remit any distributions received on the Class C units to Trust for the purported purpose of acquiring additional Class E units.[8] We further understand that amounts re-contributed to Trust were then transferred to DelCo in return for additional non-voting Class 2 shares.

Step 9: Redemption by Trust of InvestCo's Class B Units

Immediately following Trust's receipt of Country X Bank's original contribution, Trust distributed the entire amount to InvestCo in complete redemption of the Class B units of Trust. InvestCo then transferred the entire amount to Sub 2, satisfying virtually all of the note it had issued to Sub 2 in step 2.

Step 10: Creation and Funding of NewCo

[6] Manager was entitled to purchase assets from any of the following categories -- "debentures, debenture stock, bonds, notes, coupons, debt securities, trust interests, certificates of deposits, other debt obligations or Dollar, Sterling, or Euro deposits."
[7] Country X Bank's contribution also included a payment of Amount 7, which represented a portion of its share of fees payable to Accounting Firm in connection with the arrangement.
[8] We do not know whether, in form, the distributions to the blocked account and re-contributions to Trust were actually ever made or were deemed to occur by the parties.

InvestCo contributed one-half of its Class A units in Trust to NewCo, a Delaware limited liability company, in exchange for 100% of the NewCo member interests.

Step 11: Formation and Accession of Successor Trustee

InvestCo and DelCo Sub formed Successor Trustee, a Country X company. Each received 50% of the stock in Successor Trustee in return for contributions of Amount 23. Approximately one week after Date 1, InvestCo exercised its right to nominate a new trustee and Successor Trustee became the trustee of Trust.[9]

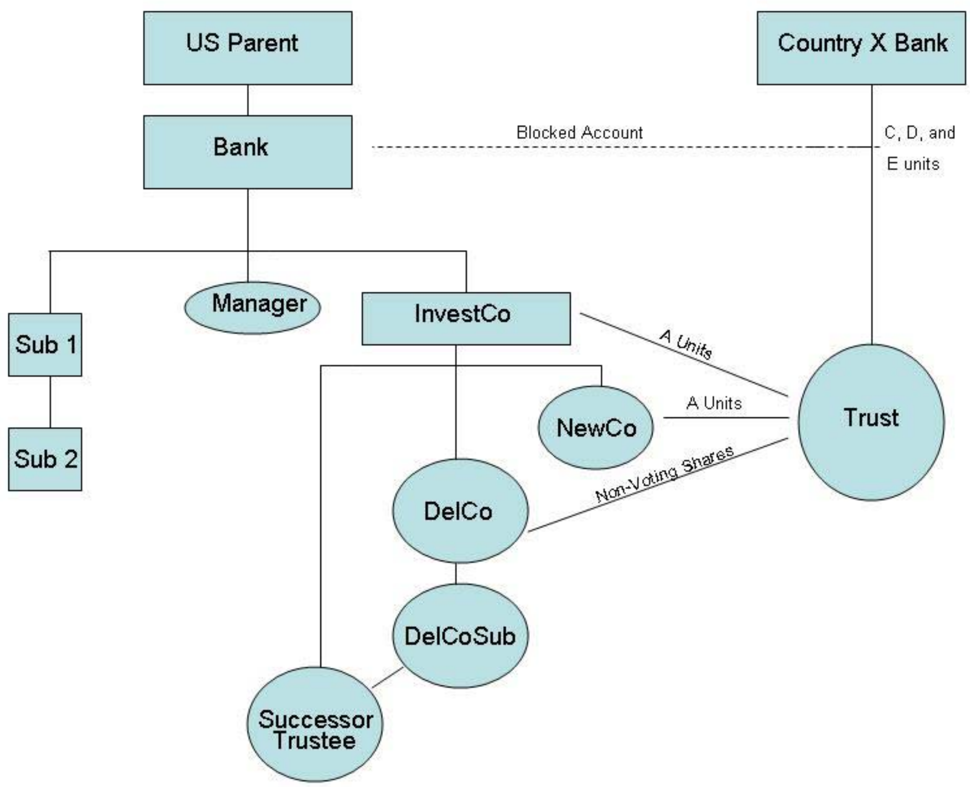
Results of Steps

After all of the foregoing steps, in form the following entities held the assets listed next to their name below.

Bank	100% of InvestCo and Manager
InvestCo	50% of the Class A units in Trust; all Class 1 (voting) shares of DelCo; 50% of Successor Trustee
Trust	Class 2 (non-voting) shares of DelCo; other debt securities valued at Amount 13.
DelCo	Amount 11 of debt securities pledged to Country X Bank; 100% of DelCo Sub
DelCo Sub	Loan participations and other debt securities valued at approximately Amount 12; 50% of Successor Trustee
NewCo	50% of Class A units in Trust
Country X Bank	Class C, D, and E units in Trust
Sub 2	Amount 1

[9] Taxpayer indicated that Initial Trustee was originally named as trustee to avoid certain Country X duties relating to transfers to Trust.

The resulting structure is represented by the following diagram:



4. Agreements

Simultaneous with the execution of the steps described above, Taxpayer and Country X Bank entered into several additional agreements in connection with the arrangement.

The Forward Sale Agreement

Country X Bank entered into a forward sale agreement with InvestCo with respect to all of the Class C, D, and E units. Under the terms of this agreement, InvestCo was obligated to purchase and Country X Bank was obligated to sell all of the Class C, D, and E units on Date 2, approximately five years after the transactions were undertaken. Both parties also had the right to accelerate the forward sale under certain conditions. The amount payable under the forward sale agreement was Amount 1 --

i.e., the amount initially contributed by Country X Bank to Trust for the Class C, D, and E units.[10]

The Zero Coupon Swap

InvestCo and Country X Bank also entered a Zero Coupon Swap Agreement under which InvestCo was required to make monthly payments to Country X Bank. The monthly payments were determined in two steps. First, a floating amount was calculated equal to the product of Amount 15 and LIBOR plus 100 basis points.[11] Second, from this amount a fixed amount of Amount 24 was subtracted during the first 44 months of the agreement and thereafter a slightly smaller amount (Amount 25) was subtracted from the LIBOR-based amount. Related agreements that explain the basis for the various payments indicate that the fixed reduction of the monthly payment was designed to compensate Taxpayer for approximately half of the Country X tax imposed with respect to the income of Trust (adjusted to take into account the time value of tax effects in Country X) and a portion of the fees paid to Accounting Firm that Country X Bank had agreed to fund.[12] It was possible according to the terms of the swap agreement that the floating component payable to Country X Bank would be smaller than the fixed amount, in which case Country X Bank was obligated to pay InvestCo the difference. Under these circumstances, even though Country X Bank provided capital to InvestCo over the term of the transactions, Country X Bank was required to pay InvestCo an additional amount that was not subject to repayment. This in fact occurred in Years 2 and 3. Taxpayer recorded the net monthly amounts on its books as "negative interest" and included them in income for U.S. tax purposes.[13]

Security Agreement

DelCo entered a DelCo Security Agreement with Country X Bank under which it pledged assets (the "DelCo Collateral") valued at an amount in excess of Amount 1 to Country X Bank as security for the capital contributed by Country X Bank. Other than the security interest granted under this agreement, the DelCo Collateral was required to remain unencumbered until InvestCo's obligations were satisfied. DelCo also agreed to deposit the DelCo Collateral in a custodial account of an unrelated U.S. bank and

[10] The Forward Sale Agreement also required InvestCo to pay Country X Bank an additional amount for the Class C and E units, but that amount was equal to and offset a payment obligation of Country X Bank to InvestCo under the Zero Coupon Swap Agreement. See note 13 below.

[11] Country X Bank received a return based on an adjusted LIBOR rate with respect to its entire Amount 1 contribution to Trust. The return on most of the contribution, Amount 15, was payable pursuant to the Zero Coupon Swap and the balance was paid in the form of distributions on the Class D units held by Country X Bank.

[12] See Formulae Appendix to the Zero Coupon Swap.

[13] Country X Bank was also obligated to make a fixed payment of approximately Amount 26 to InvestCo at the expiration of the Swap, but this payment was offset by a reciprocal agreement by InvestCo to pay the same amount under the Forward Sale Agreement described above. Thus, on a net basis these obligations had no economic effect.

agreed to leave all such assets and the income from such assets in that account until InvestCo had satisfied its obligations to Country X Bank.

Credit Default Swap

Bank also entered into a Credit Default Swap with Country X Bank. Under that agreement, Bank agreed to pay to Country X Bank an amount equal to any unpaid amount due to Country X Bank arising from the arrangement, including amounts owed by InvestCo under the Forward Sale Agreement and the Zero Coupon Swap, in exchange for a fee of 50 basis points per year on the principal amount of Amount 1.

Service Agreements

InvestCo, DelCo, DelCo Sub, NewCo, and Manager entered separate Service Agreements with Bank which granted Bank the authority to conduct and manage the affairs of each such entity and take any actions necessary to manage their assets. Because these entities controlled all of the assets transferred by Taxpayer as part of the arrangement, the Service Agreements effectively preserved Bank's management of the transferred assets. These agreements were consistent with the Proposal Document provided by Country X Bank to Taxpayer, which promised that "[a]ll investment decisions will be taken by Bank" and "Bank will continue to be the servicer & manager of the assets."

5. Asserted Tax Treatment

Asserted Country X Tax Treatment

Taxpayer represents that the transactions at issue are subject to the following treatment under Country X tax law.[14] A trust such as Trust is regarded as a resident of Country X for Country X income tax purposes if its trustee is a Country X resident. A trustee is resident in Country X either if it is formed under Country X law or managed and controlled in Country X. Resident trusts are subject to a 22% trust-level tax on all trust income, which tax is payable by the trustee. Beneficiaries of a trust that are resident in Country X are also taxable on their share of trust income at a 30% rate, but are entitled to credits for any trust-level taxes imposed with respect to such income. Therefore, resident beneficiaries are effectively responsible for a residual tax on their share of Trust income of 8% (i.e., the 30% beneficiary rate less the credit for the 22% trust-level rate).

For Country X tax purposes, Taxpayer and Country X Bank take the position that the form of their agreements is respected. As a result, Country X Bank takes the position that it owned the Class C, D, and E units for Country X tax purposes and that it

[14] For purposes of this memorandum, we assume that Country X tax law operates as represented by Taxpayer and Country X Bank.

was required to take into income and pay the residual tax on the income attributable to those units. Similarly, Country X Bank takes the position that the re-contributions of its Class C distributions to Trust were additional investments in Trust. A memo prepared by Country X Bank indicates that such re-contributions were "treated as an expense for the purpose of calculating its trading profit under Schedule D Case 1."[15] Thus, the parties took the position that the nominal distribution to Country X Bank and immediate re-contribution to Trust gave rise to a liability for residual tax and an offsetting deduction for Country X tax purposes. The expected results of those offsetting Country X tax effects are described below in section 7 (Summary of Economic Effects and Claimed Tax Consequences).

Asserted U.S. Tax Treatment

For U.S. income tax purposes, Taxpayer asserts that the substance of the transactions is a secured below-market rate loan of Amount 1 from Country X Bank to InvestCo and that it is entitled to disavow the form of the transactions. Taxpayer characterizes Country X Bank's acquisition of the Class C, D, and E units, the redemption of InvestCo's Class B units, and the forward sale agreement as constituting a sale-repurchase transaction (a "repo") in which the temporary transfer of property (i.e., the Class C, D, and E units) for value is characterized for U.S. tax purposes as a secured lending arrangement.[16] Taxpayer characterizes its obligation to make LIBOR-based payments under both the Trust (with respect to the Class D units) and the Zero Coupon Swap as constituting its obligation to pay interest to Country X Bank on the loan proceeds and its obligations under the forward sale agreement as its commitment to repay the principal amount of the loan.

Because the transactions, according to Taxpayer, constitute a repo, Taxpayer asserts that it is the sole owner of Trust for U.S. tax purposes. Accordingly, Taxpayer elected to treat Trust as a disregarded entity of InvestCo for U.S. tax purposes. Taxpayer also elected disregarded entity treatment with respect to DelCo, DelCo Sub, NewCo, and Successor Trustee.[17]

Based on the claimed disregarded entity status of Trust, Taxpayer asserts that its consolidated subsidiary InvestCo is treated as having paid the Country X taxes imposed on Trust for foreign tax credit purposes.[18] Accordingly, Taxpayer claimed foreign tax

[15] Taxpayer also indicated that it was aware that Country X Bank was entitled to a deduction for Country X tax purposes upon re-contribution of the income to Trust.
[16] An Accounting Firm 2 technical memorandum concluded that the transactions should be viewed as a secured lending arrangement as described in Rev. Rul. 74-27, 1974-1 C.B. 24.
[17] Successor Trustee was jointly owned by InvestCo, a corporation, and DelCo Sub, its disregarded entity.
[18] This conclusion appears to be based on the argument that Successor Trustee paid the taxes as agent or nominee of Trust, which was treated as a branch of InvestCo. This memorandum does not address whether the Trust is the payor of the Country X taxes for purposes of section 901 because this issue does not affect our analysis or the conclusions reached herein.

credits of Amount 3 for the Country X taxes paid on behalf of Trust with respect to Year 2 and Year 3.[19]

6. Asserted Purposes for Transactions

Taxpayer maintains that the business purpose for entering the arrangement was to obtain low-cost financing from Country X Bank. Bank's Senior Vice-President and Director of Taxes stated in an interview with auditors that Bank generally borrowed from the Federal Home Loan Bank (FHLB) at the LIBOR floating rate. See Meeting Notes. According to Taxpayer, the loans from Country X Bank replaced some of the FHLB borrowing at a rate that was approximately Amount 27 basis points lower than LIBOR, saving Taxpayer approximately Amount 28 in interest expense annually.[20] Bank's Tax Director also indicated that the financing provided additional liquidity.[21] Taxpayer contended that the transactions were not undertaken to obtain tax benefits because the total taxes it paid to the United States and Country X in connection with the transaction actually increased modestly.[22]

Taxpayer's representatives also asserted in Tax Opinions and memoranda that the delivery of the Class C, D, and E units to Country X Bank was intended to secure the financing. For example, a technical memorandum by Accounting Firm 2 concluded that "Trust is a collateralization vehicle designed to provide protection to [Country X Bank] for its advance of funds." Accounting Firm Memo at 23.

7. Summary of Economic Effects and Claimed Tax Consequences

According to Accounting Firm's Tax Opinion, Taxpayer expected to circulate approximately Amount 29 of its income through Trust in the first twelve months of the arrangement.[23] The Country X income tax attributable to this income at the Trust level was approximately Amount 33.

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[19] The transaction was disclosed on Forms 8886 for Year 2 and Year 3 as a Reportable Transaction on the Taxpayer's consolidated tax returns.

[20] Taxpayer submitted a document entitled "Components of Interest Savings on Funding" to illustrate the financing benefits of the transaction. The document states that Bank's normal funding cost was LIBOR and that its savings was the sum of the floating payment under the Zero Coupon Swap (LIBOR + 100 basis points), less the Credit Default Swap fee (50 basis points), less the fixed amount under the Zero Coupon Swap.

[21] It is unclear from Taxpayer's statement to the effect that the financing enhanced its liquidity whether it meant simply that having the additional Amount 1 of financing served a meaningful business purpose or whether it viewed the arrangement as adding to its ability to obtain capital.

[22] According to Taxpayer, the increase in Country X tax offset the decrease in its U.S. tax through the use of the foreign tax credit, but its U.S. tax also increased because of the decrease in financing cost and, therefore, its interest deduction.

[23] This was based on an expected rate of return of Amount 30. Taxpayer also indicated that the actual average rate of return on all of the assets held by InvestCo, DelCo and DelCo Sub was Amount 31 in Year 2 and Amount 32 in Year 3. Consequently, the actual income and taxes attributable to the Trust were apparently slightly less than expected. The amount of income routed through Trust, however, was expected to increase annually because of the requirement that Country X Bank re-contribute its

Trust income was allocable to the unit holders as follows:

InvestCo (Class A units)	1% of Trust income (Amount 34)
Country X Bank (Class C units)	Trust income remaining after allocations on the Class A and D units (Approximately 98.6% or Amount 35)
Country X Bank (Class D units)	Adjusted LIBOR multiplied by the amount of the Class D units (Amount 7)

Distributions on the Class A and C units were paid net of the related Country X tax. Accordingly, Country X Bank was projected to receive approximately Amount 36 of distributions on the Class C units and InvestCo received approximately Amount 37 of distributions on the Class A units. Country X Bank's distributions were apparently deposited in the blocked account and immediately re-contributed to Trust, which then transferred the funds to Delco. Thus, of the approximately Amount 29 of projected annual Trust income, Country X Bank retained annually Amount 7 of distributions from Trust.[24] Taxpayer continued to manage the assets held directly and indirectly by Trust. Except for the relatively small amounts distributed to Country X Bank on the Class D units, Taxpayer's rights to the income circulated through Trust were essentially unchanged by the arrangement.

Pursuant to the Zero Coupon Swap, InvestCo was obligated to pay Country X Bank a floating amount equal to the product of Amount 15 and LIBOR plus 100 basis points minus a fixed amount of approximately Amount 24. The LIBOR-based payments under the Zero Coupon Swap and on the Class D units were purportedly payments for InvestCo's use of Country X Bank's transfer of Amount 1. However, on a net basis, during Years 2 and 3, Country X Bank was required to pay approximately Amount 38 of "negative interest" to InvestCo under the Zero Coupon Swap. Pursuant to the Forward Sale Agreement, Taxpayer was obligated to re-acquire all of the Trust units for Amount 1, the amount of Country X Bank's original contribution.

For Country X tax purposes, Country X Bank took the position that it was subject to an additional 8% income tax on its allocable share of Trust income. Accordingly, Country X Bank was projected to incur a Country X tax liability of approximately Amount 39 annually. However, Country X Bank simultaneously claimed a deduction for

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distributions on the Class C units to Trust (which were then re-transferred to DelCo). Thus, in the second twelve months of the arrangement, the assets generating the income that was routed through Trust included the amounts originally contributed to InvestCo and its subsidiaries <u>plus</u> virtually all of the after-Country X tax income generated in the first 12 month period. For simplicity, we refer to amounts based on projections for the initial twelve month period.

[24] It is not clear from the Trust Agreement whether the Trustee reduced the Class D distributions by their allocable share of Trust-level taxes.

Country X tax purposes for its re-contribution of the distributions on the Class C units. The current deduction offset income taxed at a 30% rate and therefore reduced Country X Bank's Country X income tax by approximately Amount 40, or roughly three times Amount 39. Thus, Country X Bank's projected tax reduction vastly exceeded its residual Country X tax liability on its purported share of Trust's income. The annual net Country X tax reduction for Country X Bank was approximately Amount 41.

For U.S. tax purposes, Taxpayer takes the position that the arrangement constitutes a secured below-market rate loan of Amount 1 from Country X Bank to InvestCo and that Taxpayer (through InvestCo) wholly owns Trust, a disregarded entity. Taxpayer characterizes its obligation to make LIBOR-based payments under both the Trust (with respect to the Class D units) and the Zero Coupon Swap as constituting its obligation to pay interest to Country X Bank on the loan proceeds and its obligations under the Forward Sale Agreement as its commitment to repay the principal amount of the loan. Accordingly, Taxpayer reported 100% of Trust's income on its return and claimed foreign tax credits for all of the Trust-level taxes. Taxpayer reported the payments received from Country X Bank pursuant to the Zero Coupon Swap as negative interest and included such amounts in income.

The arrangement purported to shift the primary taxing jurisdiction with respect to approximately Amount 29 of Taxpayer's income annually from the United States to Country X. This resulted in annual payments of tax to Country X of approximately Amount 33 (before considering the impact of offsetting deductions) and a corresponding reduction of U.S. income tax arising from the foreign tax credits claimed against Taxpayer's U.S. tax liability.

By using the Trust device to subject its income to the Country X tax regime, Taxpayer claimed entitlement to foreign tax credits substantially in excess of the amount of County X tax attributable to the arrangement. The annual combined amount of Country X tax imposed at the Trust and Country X Bank levels on the Trust income was Amount 42 (i.e., 30% of Amount 29). However, the concurrent re-contribution obligation created an offsetting Country X tax savings at the Country X Bank level of Amount 40 (i.e., 23.4% of Amount 29). This Country X tax savings offset the substantial majority of the Country X taxes imposed at the Trust and Country X Bank levels with respect to Trust's income. Once the value of the offsetting tax savings is taken into account, the annual Country X tax cost of the Trust device is reduced to approximately Amount 43 (or 6.6% of Amount 29). Thus, Taxpayer claimed U.S. foreign tax credits for the entire Amount 33 (22% of Amount 29) of Country X tax imposed at the Trust level even though the ultimate cost of Country X tax attributable to the Trust device was only Amount 43 (6.6% of Amount 29).

In simplest terms, the Trust device was a strategy to pay Country X 6.6% on Taxpayer's income in order to reduce the U.S. tax on that income by 22%. The excess of the foreign tax credits (22%) over the substantially smaller amount of net Country X tax imposed as a result of the Trust device (6.6%) constituted the "benefit" achieved by the transaction (i.e., a 15.4% savings). The claimed U.S. tax savings arising from the foreign tax credits was shared by the parties. Country X Bank recovered the cost of the Trust-level taxes in the first instance by deducting, for Country X tax purposes, its re-contributions of the distributions on the Class C units. Country X Bank then transferred a pre-determined share of that value back to Taxpayer in the form of a set-off against the amount charged for Taxpayer's use of the Amount 1 transferred by Country X Bank. Country X Bank retained the remaining portion of this value as a fee for its various roles in the arrangement.

8. Second Set of Transactions

Taxpayer and Country X Bank undertook a second set of transactions on or around Date 3 on terms similar to the transactions described above, but with the following differences. The amounts involved in the second set of transactions were roughly half the size of those involved in the first set of transactions.[25] Thus, Bank contributed an additional Amount 44 to DelCo and Country X Bank funded an additional Amount 45. In addition, the formal means of effecting the transactions were simplified. For example, instead of having Country X Bank contribute funds through Trust, InvestCo and Country X Bank executed a typical loan agreement under which Country X Bank agreed to loan Amount 45 to InvestCo at a rate of LIBOR plus 75 basis points.[26] Another formal change reflected in the second set of transactions is that the parties memorialized in separate agreements the two offsetting amounts that were previously described in the Zero Coupon Swap. Thus, as noted above, the Loan Agreement required InvestCo to pay Country X Bank periodic amounts equal to the product of Country X Bank's "investment" and LIBOR plus 75 basis points. A separate "Fee Agreement" required Country X Bank to pay InvestCo a fixed monthly amount of Amount 46.

LAW AND ANALYSIS

1. Economic Substance Doctrine

The economic substance doctrine allows the government to disregard a transaction and the related U.S. tax consequences when the transaction has no economic substance aside from tax consequences. See, e.g., Black & Decker Corp. v. United States, 436 F.3d 431, 441 (4th Cir. 2006).[27] The courts determine whether a

[25] The proportions between the various amounts in the two sets of transactions were constant, however. Thus, the additional assets transferred to DelCo and DelCo Sub in the second set of transactions were approximately six times the amount of additional assets contributed by Country X Bank and the "fee" payable by Country X Bank to InvestCo was approximately half of the Trust-level taxes attributable to the additional assets.
[26] It is unclear why the base interest rate in the second set of transactions was lowered by 25 basis points from the original transaction.
[27] Transactions that lack economic substance are shams in substance. Such transactions are distinguishable from transactions that are shams in fact. A sham in fact is a transaction that did not

transaction lacks economic substance by examining two related issues -- whether the taxpayer had a bona fide non-tax business purpose for entering the transaction and whether the transaction had any economic effects other than the creation of tax benefits. See, e.g., ACM Partnership v. Commissioner, 157 F.3d 231, 247 (3d Cir. 1998); Bail Bonds by Marvin Nelson, Inc. v. Commissioner, 820 F.2d 1543, 1549 (9th Cir. 1987); Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985). The first inquiry focuses on whether the taxpayer was subjectively motivated to derive an economic advantage apart from securing a tax benefit. See, e.g., Goldstein v. Commissioner, 364 F.2d 734, 740 (2d Cir. 1966), *aff'g* 44 T.C. 284 (1965) ("the Tax Court was justified in concluding that petitioner entered into the . . . transactions . . . 'solely' in order to secure a large interest deduction . . . ."). The second inquiry focuses on an objective determination of whether "the transaction offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits." Gilman v. Commissioner, 933 F.2d 143, 146 (2d Cir. 1991); Long-Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 172 (D.C. Conn. 2004) (emphasizing "critical objective measurement demonstrating the taxpayer could not reasonably have expected to recoup his investment") (hereinafter "Long-Term Capital").

Certain courts treat the two factors as a rigid two-prong test in which a transaction is considered to lack economic substance only if there is no subjective business purpose other than obtaining tax benefits and no objective economic substance because there is no reasonable expectation of profit. See, e.g., Black & Decker, 436 F.3d at 441. However, most courts that have addressed economic substance stress that the two-part test is not rigid and that the two inquiries are closely related. For example, the Third Circuit has explained that "these [two] distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes." ACM Partnership, 157 F.3d at 237 (3d Cir. 1998); see also Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990); James v. Commissioner, 899 F.2d 905, 908-09 (10th Cir. 1990); Rose v. Commissioner, 868 F.2d 851, 854 (6th Cir. 1989). Similarly, several decisions clarify that a taxpayer's subjective belief concerning business purpose must be evaluated in light of objective considerations. For example, the Fourth Circuit, in Hines v. United States, 912 F.2d 736 (4th Cir. 1990), observed that "it bears repeating that a taxpayer's 'mere assertion' of subjective belief in the profit opportunity from a transaction 'particularly in the face of strong objective evidence that the taxpayer would incur a loss, cannot by itself establish that the transaction was not a sham.'" Id. at 740. The "ultimate determination of

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occur. If a transaction is a sham in fact a court will disregard the transaction for U.S. tax purposes, and will not inquire into whether the transaction is a sham in substance. See Mahoney v. Commissioner, 808 F.2d 1219, 1220 (6th Cir. 1987). It is unclear whether elements of the arrangement, in fact, occurred. For example, it is unclear whether any distributions on the C units were ever actually made. However, it appears that the non-voting interests in DelCo and other assets were in form transferred to Trust. If these elements of the arrangement in fact occurred, the Service's position is that the Trust was a sham in substance.

whether an activity is engaged in for profit is to be made . . . by reference to objective standards." Id.; see also Long-Term Capital, 330 F. Supp. 2d at 180 ("The absence of reasonableness sheds light on Long Term's subjective motivation, particularly given the high level of sophistication possessed by Long Term's principals in matters economic.").[28]

In applying the economic substance doctrine, the courts focus on the particular transaction that resulted in the disputed tax benefit. For example, in ACM Partnership, 157 F.3d at 231, the Third Circuit addressed whether a taxpayer was entitled to tax losses arising from a series of transactions involving the formation of a partnership, the purchase and sale of notes by the partnership, and the restructuring of taxpayer's outstanding debts. The court noted that the claimed losses arose because of timing rules applicable to installment sales with contingent sales prices. Those rules were triggered, reasoned the court, when the partnership bought and shortly thereafter sold certain notes in return for cash and other notes. Accordingly, the court limited the economic substance examination to that transaction and concluded that the short-lived purchase and sale were effected to recognize tax benefits and did not make any meaningful change in taxpayer's economic position. Similarly, the Federal Circuit in Coltec Indus. v. United States, 454 F.3d 1340 (Fed. Cir. 2006), rejected claimed tax losses that arose in connection with a strategy involving the contribution of assets and contingent liabilities to a special purpose entity and the sale of interests in that entity. The court focused the economic substance inquiry on the contribution of offsetting assets and liabilities to the special purpose entity on the grounds that "the transaction to be analyzed is the one that gave rise to the alleged tax benefit." Id. at 1357, *citing* Basic Inc. v. United States, 549 F.2d 740 (Ct. Cl. 1977); Ballagh v. United States, 331 F.2d 874 (Ct. Cl. 1964); Nicole Rose Corp. v. Commissioner, 320 F.3d 282, 284 (2d Cir. 2002); and ACM Partnership, 157 F.3d at 260 & n.57 (3d Cir. 1998). See also Black & Decker, 436 F.3d at 441 (the test "focuses not on the general business activities of a corporation, but on the specific transaction whose tax consequences are in dispute").

Once the relevant transaction is identified, the purposes for and the objective economic effects of the scrutinized transaction must be distinguished from those that may be achieved by other simultaneous or related transactions. In Coltec, for example, the court rejected the purported benefit of centralizing management of the taxpayer's contingent liabilities in a special purpose entity because the centralization did not require the contribution of assets and liabilities to the entity that gave rise to the claimed loss. The court reasoned that

> [t]he transfer of the liabilities in exchange for the note is separate and distinct from the fact that Garrison took a managerial role in administering the asbestos liabilities, as demonstrated by the fact that Garrison managed another entity's asbestos liabilities (Anchor's

[28] We need not resolve any differences in these approaches because, for reasons explained below, we conclude that Taxpayer had neither a subjective business purpose nor an objective reasonable expectation of profit.

> liabilities) without actually assuming Anchor's liabilities. The taxpayer has not demonstrated any business purpose to be served by linking Garrison's assumption of the liabilities to the centralization of litigation management.

Id. at 1358.

In Long-Term Capital, the court held that the transaction at issue did not possess economic substance where a more direct alternative offered the same benefits and fewer disadvantages than the transaction that the taxpayer adopted. The court concluded that

> it is the selection of the manner in which the investment was achieved - through OTC with attendant forfeiture of profit in exchange for no (or minimal) corresponding diminution in risk over a direct investment - that reveals the absence of objective economic substance and strongly suggests the sole focus as the creation of tax benefits. See Boca Investerings P'ship v. United States, 354 U.S. App. D.C. 184, 314 F.3d 625, 631 (D.C. Cir. 2003) ("defies common sense from an economic standpoint" to execute an investment indirectly through a partnership and not directly where indirect method diminishes profits by adding millions in transaction costs).

330 F. Supp. 2d at 183. Similarly, in ACM Partnership the Tax Court concluded that a business purpose should only be considered where the means chosen to effectuate it were "rationally related to a useful non-tax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions." T.C. Memo 1997-155, at 113 (1997), *aff'd*, 57 F.3d 231 (3d Cir. 1998) ("Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry.").

Applying these principles, circular cash flows are generally disregarded for U.S. tax purposes because they lack economic substance. See, e.g., Knetsch v. United States, 364 U.S. 361, 366 (1960) (offsetting payments on annuity bond and notes resulted in sham transaction); Medieval Attractions N.V. v. Commissioner, 72 T.C.M. (CCH) 924 (1996) ("The circular transfer of money through related parties to create the illusion of payment is an indication of sham transactions."); Bealor v. Commissioner, 72 T.C.M. (CCH) 730 (1996) (circular arrangements among affiliated partnerships lacked economic substance); Rev. Rul. 99-14, 1999-1 C.B. 835 (offsetting arrangements in LILO transaction lacked economic substance). These authorities stand for common sense proposition that a taxpayer is not generally entitled to tax benefits when it engages in circular transfers the net result of which is essentially nothing.

In several economic substance cases, the courts have also addressed whether Congress intended to make the disputed tax benefits available under the circumstances at issue. For example, in Gregory v. Helvering, 293 U.S. 465 (1935), the Supreme Court concluded that Congress did not intend the term reorganization to apply to transitory transfers intended to permit the distribution of assets to the shareholder for sale to a third party. Similarly, in Horn v. Commissioner, 968 F.2d at 1229, the D.C. Circuit addressed whether commodity dealers were permitted to deduct losses incurred on certain straddle transactions. The court observed that "the sham transaction doctrine seeks to identify a certain type of transaction that Congress presumptively would not have intended to accord beneficial tax treatment" and concluded that Congress had intended to permit such losses. See also In re CM Holdings, 301 F.3d 2002 (3d Cir. 2002) ("If Congress intends to encourage an activity, and to use taxpayers' desire to avoid taxes as a means to do it, then a subjective motive of tax avoidance is permissible.").

2. Application of Economic Substance Doctrine to the Trust Device (Issue 1)

We conclude that the Trust device lacks economic substance because it served no legitimate non-tax purpose and provided no reasonable expectation of economic profit. Therefore, the foreign tax credits generated by the Trust device should be disallowed.

The case law instructs that the focus of the economic substance inquiry must be on the transaction that gave rise to the disputed tax benefit. Therefore, the first step in an economic substance analysis is the identification of the transaction to be scrutinized. In this case, the tax benefit in dispute is the availability of foreign tax credits for Country X taxes imposed with respect to the income circulated through Trust. Trust only received that income because Taxpayer, through InvestCo, contributed the non-voting shares in DelCo and other assets to Trust. Virtually all income produced by the assets held by DelCo and DelCo Sub was distributed through Trust. Trustee was obligated to remit the Country X taxes imposed with respect to Trust's income. Taxpayer claimed foreign tax credits for the Country X taxes against its U.S. tax liability. Therefore, it was Taxpayer's use of the Trust device that generated the disputed foreign tax credits.

Taxpayer's entitlement to the foreign tax credits therefore depends on whether the Trust device lacks economic substance because (1) Taxpayer was motivated by no business purpose other than obtaining tax benefits in creating the Trust device, and (2) the Trust device had no objective economic substance because there was no reasonable expectation of profit. The Trust device did not alter, in any meaningful way, Taxpayer's control or management of the assets directly and indirectly transferred to Trust or Taxpayer's right to the income generated by those assets. The sole function of the Trust device was to route income from Taxpayer's assets through Trust and, thereby, to generate foreign taxes that Taxpayer could claim as foreign tax credits. Accordingly, the Trust device served no legitimate non-tax purpose. The Trust device did not increase Taxpayers' economic profit from the assets and, in fact, resulted in substantially increased costs, including transaction costs in excess of Amount 6. Because the Trust device served no legitimate non-tax purpose and was reasonably expected to reduce Taxpayer's economic profit from the assets, the Trust device lacks economic substance.

As the marketing materials used by Country X Bank conceded, the Trust was structured to have no effect on Bank's control over or management of its assets. See Proposal Document. This result was achieved by maintaining Bank's control of all of the entities involved and the assets that they held. Delco and DelCo Sub held virtually all of the assets generating the income at issue and Trust held the remaining assets. Bank and its wholly-owned subsidiary InvestCo directly or indirectly held all voting rights with respect to DelCo and DelCo Sub. InvestCo and DelCo Sub controlled Successor Trustee and Bank controlled Manager. In addition, InvestCo, Manager, DelCo Sub, DelCo, and NewCo each executed a Service Agreement with Bank transferring to Bank control over the management of its activities and assets. Bank also retained control of the underlying loan assets through the participation agreements, which reserved Bank's right to exercise absolute discretion in the management of the loan assets.

Although Country X Bank nominally held the Class C, D, and E units of Trust, only the holder of the Class A units, InvestCo, had authority to nominate the trustee and Taxpayer effectively controlled all income-producing assets of Trust. Even distributions on the Class C units nominally payable to Country X Bank were payable to a blocked account controlled by Taxpayer and immediately re-contributed to Trust and then to DelCo for Taxpayer's use. Accordingly, both directly and indirectly Bank maintained control of the assets that generated Trust's income.

It is equally clear that the Trust did not affect Bank's rights to the income earned on the assets held directly and indirectly by Trust in any meaningful way. In excess of 99 percent of Trust's income was payable either to InvestCo on the Class A units or to the blocked account with respect to the Class C units.[29] The income paid to the blocked account was re-contributed to Trust and, in turn, to DelCo. The blocked account was maintained at Bank. Distributions from the blocked account were prohibited for any purpose other than immediate re-contribution to Trust. Accordingly, all amounts paid to the blocked account were re-contributed to Trust. Those amounts were, in turn, transferred to DelCo.

[29] The only distribution from Trust that Country X Bank had a right to retain were the distributions on the Class D units, which provided a LIBOR-based return on Amount 14. The amount of these distributions was insubstantial in comparison to the total amount of Trust income, representing only approximately one third of one percent of Trust income. The distributions were the equivalent of InvestCo's interest due on Amount 47 of the total financing. It appears that the reason for running a nominal proportion of the financing through Trust was that Country X Bank was concerned that Trust would not be respected under Country X tax law if Country X Bank was not allowed to retain a minimal portion of Trust distributions. The distributions on the Class D units apparently satisfied this concern, at least to Country X Bank's satisfaction. In any event, it cannot seriously be contended that the reason for creating Trust and transferring to Trust Amount 2 of assets was to fund an interest obligation on approximately half of one percent of that amount.

Accounting Firm explicitly recognized the artificiality of the Trust device in its initial Tax Opinion:

> [Country X] Bank will hold legal title to the Class C Unit and the Class E Unit, but it will not possess the significant economic benefits and burdens of ownership of those instruments. First, [Country X] Bank will have no right to an economic return from the Trust on its “investment” in the Class C Unit and Class E Unit because, under the Transaction Documents, it will be obligated to reinvest immediately all distributions made on the Class C Unit such that, ultimately, InvestCo will benefit from the accumulation in value of the Class C Unit and Class E Unit when it repurchases them. In fact, the distributions must be paid into the Blocked Account, from which they are required to be reinvested immediately to pay the subscription price for the Class E Unit that is then subject to the Forward Sale Agreement. While the purchase price payable to [Country X] Bank under the Forward Sale Agreement will increase over the term of transaction, [Country X] Bank’s obligation to pay the Fixed Amount under the Zero Coupon Swap will exactly offset the accretion in the purchase price and those amounts will be legally netted so that [Country X] Bank will never have a right to receive the accretion in value of the Class C Unit and the Class E Unit. . . . Thus, in addition to not being entitled to a return from the Trust, [Country X] Bank’s economic return will be unaffected by the return on the Trust’s assets. . . . Finally, it seems clear that InvestCo would never permit [Country X] Bank to acquire the Class C Unit for [Amount 48] absent the other Transaction Documents ensuring that [Country X] Bank will invest all distributions in the Trust and that InvestCo can reacquire the Class C Unit and Class E Unit because, given the entitlement of the Class C Unit to almost 99 percent of the Trust income, the Class C Unit would have a value substantially in excess of [Amount 48].

Initial Tax Opinion at p. 29.

From the inception of the arrangement, InvestCo held the right to purchase the Class C, D, and E units under the Forward Sale Agreement for a fixed amount limited to Country X Bank’s investment of Amount 1.[30] Thus, regardless of the amount of income generated by the assets held directly or indirectly by Trust over the term of the arrangement, InvestCo had the right to purchase all of Country X Bank’s Trust units for Amount 1. This effectively guaranteed Taxpayer the right to recover all of the re-contributed income at no additional cost.

[30] Periodic payments for the use of the Amount 1, as explained above, were paid primarily under the Zero Coupon Swap Agreement and, to a substantially lesser extent, in the form of distributions on the Class D units.

The Trust device ultimately resulted in a large circular flow of income from Taxpayer's assets. The income originated in the special purpose subsidiaries to which Bank had contributed the assets, was distributed by and through those subsidiaries to Trust, was then distributed in substantial part to Country X Bank's blocked account at Bank, was re-contributed to Trust, and finally re-invested in Bank's subsidiary DelCo. Economically, the use of the Trust had no substantive effect on the ownership and control of Taxpayer's assets or Taxpayer's right to the income from those assets.

Like the contrived, circular arrangements described in Knetsch, 364 U.S. at 361, and related authorities, the Trust device effected a series of offsetting payments with no ultimate non-tax consequence. All of the asset and income transfers -- from Bank to Taxpayer's other controlled entities, to Trust, then nominally to Country X Bank, and finally back to Trust and Taxpayer -- ultimately returned Taxpayer to essentially the same place it started. Therefore, it is clear that the Trust device was not motivated by a legitimate non-tax purpose and that the sole purpose for the Trust device was to generate foreign taxes that Taxpayer could claim as credits and, thereby, shelter its income on the assets from U.S. tax.

Taxpayer's contention that the Trust device actually increased its tax liabilities, and therefore that it could not have been tax-motivated, ignores the core of the tax planning behind the transaction – i.e., that the parties collectively could recover the substantial majority of Country X taxes that were imposed on the income of Trust. Once these recovered taxes are properly taken into account, it is plain that Taxpayer was attempting effectively to reduce its tax expense.

For the reasons discussed above, it is also clear that Taxpayer could not reasonably have expected the Trust device to generate an economic profit. Transferring the assets to Trust did not increase the amount of income generated by those assets. Moreover, Taxpayer incurred substantial additional costs as a result of the Trust device, including transaction costs in excess of Amount 6. Accordingly, the Trust device lacks economic substance.

Taxpayer's Asserted Purposes for the Trust Device

Taxpayer and its representatives assert that the Trust device served two purposes - it provided security to Country X Bank with respect to its investment of Amount 1 and it was required by Country X Bank as a condition of providing the low cost financing of Amount 1. We consider each of these arguments in turn.

Security. Taxpayer and its representatives appear to contend that the Trust device served as collateral for what was in substance a loan from Country X Bank to InvestCo. In describing the substance of the arrangement, Accounting Firm 2 opined that the transfer of Trust units to Country X Bank was in the nature of a sale-repurchase transaction in which the lender holds the collateral that supports a simultaneous lending transaction. See Accounting Firm Memo at 11. Under this argument, County X Bank's possession of the Class C, D, and E units effectively secured its financing to InvestCo.

This argument fails for several reasons. First, entirely independent of Trust, Country X Bank took several measures to secure its investment. It executed a Security Agreement directly with DelCo pursuant to which DelCo was obligated to maintain at a third-party financial institution a securities account which held collateral sufficient to satisfy all obligations to Country X Bank in connection with the financing. In addition, Country X Bank and Bank executed a Credit Default Swap agreement under which Bank agreed to make Country X Bank whole for any failure to pay Country X Bank amounts owed under the arrangement. Taxpayer has not suggested any way in which the use of Trust enhanced these more conventional security arrangements. Consistent with the authorities described above, Taxpayer cannot rely on benefits or purposes that it could (or in this case did) achieve without undertaking the scrutinized transaction (here, the Trust device). Therefore, we reject the argument that the Trust device provided any meaningful security for the financing.

Second, independent of the adoption of these security measures, the sheer size of Trust's assets belies the suggestion that the Trust device was intended to provide security. Most obviously, we are not aware of any plausible explanation why virtually any borrower, let alone a large and sophisticated financial institution such as Taxpayer, would agree to contribute assets valued at approximately Amount 2 to secure a loan less than one sixth that size or why any lender would require such security. A filing by Taxpayer with U.S. bank regulators explicitly recognized that the Trust device was used to generate tax benefits and that "assets significantly greater than the amount ordinarily required by [Country X Bank] as collateral on a loan made to a bank of [Taxpayer's] credit quality are provided by [Taxpayer] on an unsecured basis in the structure . . . ." Response to Bank Regulators, p. 1 (emphasis added). On this basis alone we conclude that the vast majority of Trust's assets cannot be justified as part of a security arrangement.

As to that part of Trust's assets that bears a plausible relationship to the amount of the financing, the Trust device did not vest in Country X Bank the sort of meaningful control that secured parties or participants in sale-repurchase transactions typically demand. The vast majority of the income-producing assets at issue continued to be held in the wholly-controlled subsidiaries of Bank – DelCo and DelCo Sub. The trustee of Trust was also wholly-owned by Bank's subsidiaries, and InvestCo, as holder of the Class A units, held the exclusive power to nominate a successor trustee. Manager was also wholly-owned by Bank. Finally, InvestCo, Manager, DelCo, and DelCo Sub each entered a Service Agreement that granted Bank the authority to conduct the affairs of such entities and manage their assets. Nothing in these agreements effectively limited Bank's control of the Trust assets. Indeed, this was expressly offered as a selling point of the strategy in the marketing materials provided to Bank. See Proposal Document. Given the absence of authority vested in Country X Bank vis a vis Trust, we conclude that the Trust device did not provide any meaningful security to Country X Bank. That

Country X Bank had agreed to more conventional and adequate means to secure InvestCo's obligations merely reinforces the conclusion that the Trust device did not provide any material security for the financing arrangement.

Low-cost financing. The primary justification for the Trust device asserted by Taxpayer is that it enabled InvestCo to obtain low-cost financing from Country X Bank. Bank's Senior Vice-President and Director of Taxes stated in an interview with auditors that Bank generally borrowed daily from the Federal Home Loan Bank (FHLB) at the LIBOR floating rate. According to Taxpayer, the loans from Country X Bank replaced some of the FHLB borrowing at a rate that was approximately Amount 27 basis points lower than LIBOR, saving Taxpayer approximately Amount 28 in interest expense annually.

Contrary to Taxpayer's assertion, however, there is no functional relationship between the Trust device and the financing. As explained by the Tax Court in ACM, a taxpayer cannot justify a tax benefit attributable to a transaction where the means adopted are not rationally related to its stated purported business purpose. For the reasons explained above, the use of the Trust device was not rationally related to Taxpayer's purported business objective of borrowing capital.[31] Therefore, the Trust device served no non-tax purpose and provided no economic benefit related to the financing.

The real purpose of the Trust device was to generate an amount of Country X tax at the Trust level in excess of the aggregate Country X tax attributable to the Trust device. This allowed Taxpayer to obtain foreign tax credits in excess of the amount of Country X taxes attributable to the Trust device. What Taxpayer characterizes as below-market interest was merely the mechanism used by the parties to reimburse Taxpayer for a substantial portion of the Trust-level Country X taxes, which in substance were recovered by Country X Bank.

The use of Trust as a portal through which Bank circulated the income on its assets had the following Country X tax consequences: (1) Successor Trustee remitted Country X taxes equal to 22 percent of Trust's income (which Taxpayer claimed as foreign tax credits); (2) Country X Bank owed an additional 8 percent Country X tax on approximately 99 percent of Trust's income, but also claimed deductions for Country X tax purposes for distributions on the Class C units that Country X Bank re-contributed to Trust. The Country X tax savings resulting from Country X Bank's deductions (23.4%) offset the substantial majority of the aggregate cost of the Country X taxes paid on Trust income at the Trust-level (22%) and the Country X Bank level (8%). Thus, by acting in concert with Country X Bank, Taxpayer was able to reduce its U.S. tax liability by

[31] In fact, the relationship between the financing and the Trust device was so tenuous that there is no obvious reason why the Trust device might not have been undertaken as an entirely independent activity. The financing and the Trust device may have been paired to give the latter transaction some sense of legitimacy for both Country X and U.S. tax purposes, but there does not appear to be any plausible non-tax reason for using the Trust device as a means of obtaining the financing.

claiming foreign tax credits for amounts that greatly exceeded the net amount of the foreign taxes attributable to the arrangement and recovering approximately half of the recovered Country X taxes under the Zero Coupon Swap.[32]

Specifically, the annual combined amount of Country X tax imposed at the Trust and Country X Bank levels on the Trust income was Amount 42 (i.e., 30% of Amount 29). However, the annual Country X tax savings at the Country X Bank level was Amount 40 (i.e., 23.4% of Amount 29). Thus, the true cost of Country X tax attributable to the Trust device annually was only Amount 43 (or 6.6% of Amount 29). Notwithstanding this, Taxpayer claimed U.S. foreign tax credits of more than three times that amount. This reduced the amount of U.S. tax due by Taxpayer on its income from the assets involved from 35 percent to 13 percent.

What Taxpayer characterizes as “below-market financing” was, in substance, Taxpayer’s share of the recovered cost of the Country X taxes for which Taxpayer claimed foreign tax credits. Country X Bank first recovered the value of the Trust-level Country X taxes by claiming deductions attributable to its re-contributions to Trust. Country X Bank then passed a pre-determined share of the recovered Country X tax expense back to Taxpayer in the form of a reduction to Taxpayer’s obligation under the the Zero Coupon Swap. In the second round of financing, the parties in fact abandoned the pretense that the recovered tax expense reduced the financing cost and memorialized the benefit remitted to InvestCo in a separate Fee Agreement. Country X Bank, which had developed the strategy and served as an accommodation party[33] by recovering the value of the Country X taxes, also retained a portion of the recovered tax cost.

Taxpayer misleadingly asserts that the essential benefit of its planning was a Country X tax benefit realized by Country X Bank, the value of which provided the basis for the reduction of Taxpayer’s financing costs. By focusing on only Country X Bank’s tax position, however, Taxpayer obscures essential aspects of the transaction and its resulting tax effects. All aspects of the disputed transaction must be considered in assessing its economic substance. See Weller v. Commissioner, 270 F.2d 294, 297 (3d Cir. 1959) (transactions must be viewed "as a whole, and each step, from the

[32] This transaction is distinguishable from a typical, commercially-motivated transaction between unrelated parties. In that context, we generally would not view the tax imposed on the income recognized by one party as offset by a corresponding deduction realized by the other party because both parties are engaged in independent commercial activities and the deduction taken by the second party is a cost of generating income for that party that will also be taxed. In this transaction, in contrast, there is a single activity that is conducted in relation to Trust and taxed in Country X – i.e., the generation of income from Taxpayer’s assets. That income nominally flows through Trust to the blocked account of Country X Bank and ultimately back to Taxpayer. Since all of the Country X tax effects necessarily relate to that single activity, it is appropriate to net the tax effects on Taxpayer and its counterparty, Country X Bank.

[33] The description of Country X Bank as an accommodation party is not intended to suggest that it was not responsible for developing and marketing the arrangement to Taxpayer. However, because Country X Bank had no substantive interest in the Trust that generated the disputed foreign tax credits, it is most appropriately viewed as facilitating Taxpayer’s plan to reduce its U.S. tax.

commencement . . . to the consummation . . . is relevant"); accord Commissioner v. Court Holding Co., 324 U.S. 331 (1945). Once all aspects of the transaction are considered, it becomes plain that the transaction resulted in a net increase in Country X taxes. While Country X Bank was apparently entitled to realize a reduction in its income tax obligations, that "benefit" was only achieved by simultaneously incurring a more than offsetting amount of Country X tax. On an annual basis the transaction was projected to incur a net Country X tax cost of approximately Amount 43. Thus, contrary to Taxpayer's assertion, there simply was no Country X tax benefit once all aspects of the transaction are taken into account.

In summary, once the tax effects of the Trust device are properly considered, it is clear that the sole benefit from the Trust device was Taxpayer's purported ability to claim foreign tax credits substantially in excess of the parties' true expenses. The foreign tax credits resulted in a reduction of U.S. tax equal to 22 percent of Trust income. A small part of the total U.S. tax savings (less than 20%) was paid to Country X and not recovered by the parties. The vast majority of the U.S. tax savings was divided between Taxpayer, Country X Bank, and their various tax and legal advisors.

Congressional Intent

We also consider whether Congress intended to bestow the benefit of the foreign tax credit in this type of case. The purpose of the foreign tax credit is to mitigate the double taxation of foreign income. See United States v. Goodyear Tire and Rubber Co., 493 U.S. 132, 139 (1989); American Chicle Co. v. United States, 316 U.S. 450 (1942); Burnet v. Chicago Portrait Co., 285 U.S. 1 (1932). During the floor debate surrounding the enactment of the foreign tax credit, the Chairman of the Ways and Means Committee explained the credit's rationale as follows:

> That [the foreign tax credit] is not only a just provision, but a very wise one. It is wise from the standpoint of the commerce of the United States, of the expansion of business in the United States . . . . We would discourage men from going out after commerce and business in different countries if we maintained this double taxation.

56 Cong. Rec. App. 677 (1918) (statement of Mr. Kitchin). Congress thus intended the foreign tax credit to neutralize the impact of U.S. taxes on businesses' decision where to most productively conduct their activities. Cf. The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S. Businesses, Joint Committee on Taxation (JCX-22-06) ("A resident has no tax incentive under a worldwide tax system either to move activities abroad or keep them within the residence country. . . . Thus, investment-location decisions are governed by business considerations, instead of by tax law.").

None of these purposes is fulfilled in this transaction. The ability to claim a foreign tax credit equal to 22 percent of Trust income when actual foreign tax costs are substantially less than that amount would (and did) dramatically distort the Taxpayer's business considerations of how to finance its activities and structure its affairs. In the instant case, application of the foreign tax credit affirmatively subsidizes Taxpayer for routing its income through Trust and thereby subjecting itself to foreign tax. Rather than create the intended level playing field described above, making the foreign tax credit available in such cases would plainly drive U.S. taxpayers to arrange their financing with Country X counterparties and disadvantage domestic alternatives. At the same time, the underlying economic activity of Taxpayer – all of which occurs in the United States -- was unchanged. Thus, making the foreign tax credit available here would both disadvantage domestic transactions and result in no improvement to the underlying business activities of Taxpayer. Under these circumstances, Congress could not have "intended to accord beneficial tax treatment." Horn, 968 F.2d at 1229.

Conclusion

We conclude that Taxpayer's interposition of Trust between itself and its assets was without economic substance and the foreign tax credits attributable to the transaction should be disallowed. The Trust device served no non-tax business purpose. The various business purposes articulated to try to justify the transaction are inconsistent with the facts and are not credible. The Trust did not serve as collateral for the financing. Nor did the Trust device increase Taxpayer's economic profit from its assets. At the same time, the Trust device resulted in substantial additional costs to Taxpayer, including transaction costs of more than Amount 6. The purported economic benefit from the Trust device – the reduction in Taxpayer's borrowing costs -- in substance amounted to no more than a disguised recovery of the Country X tax expense for which Taxpayer claimed foreign tax credits. Therefore, the foreign tax credits generated by the Trust device should be disallowed and fees and other expenses attributable to the Trust device should also be disallowed.

We also note that other authorities support disregarding the Trust device and its purported tax consequences. Like the economic substance case law discussed above, these substance over form authorities may be invoked to deny tax benefits arising from purely formal structures on the premise that Congress did not intend to make tax benefits available in such cases. Ultimately all of these doctrines reflect the fundamental concern identified in Gregory v. Helvering that tax laws, like any statute, must be construed consistently with the intent of their drafters. See Gregory, 293 U.S. at 469 ("the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended"); cf. Coltec Indus. v. United States, 454 F.3d 1340, 1343 (Fed. Cir. 2006), *cert. denied*, 127 S. Ct. 1261 (2007) ("From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit.").

Under the step transaction doctrine, for example, meaningless intermediary steps in a series of transactions are disregarded for tax purposes. E.g., Minnesota Tea Co. v

Helvering, 302 U.S. 609, 613 (1938) ("given result at the end of a straight path is not made a different result because reached by following a devious path"); Del Commercial Properties, Inc. v. Commissioner, T.C. Memo 1999-411, *aff'd*, 251 F.3d 210 (D.C. Cir. 2001) (subsidiary that carried on minimal business activities was a conduit in borrowing and re-loaning money). For the reasons explained above, we conclude that the Trust device was merely a "devious path" toward what, at best, amounted to a financing directly between Country X Bank and Taxpayer. The contractual undertakings of the parties at the inception of the arrangement ensured that the Trust device had no commercial significance. For the reasons explained above, Congress did not intend to make foreign tax credits available in such cases. Therefore, because the Trust device was, at best, a meaningless step in a financing arrangement, it should be disregarded for tax purposes.

3. Application of the Economic Substance Doctrine to the Arrangement (Issue 2)

You also asked us to consider whether the foreign tax credits should be disallowed if the arrangement were regarded as an integrated transaction. Under this characterization, the financing and Trust device aspects of the arrangement would be treated as elements of a single transaction for economic substance purposes. We conclude that the arrangement lacks economic substance even when treated as a single transaction because it provided no reasonable expectation of profit and served no legitimate non-tax purpose. Therefore, the tax consequences generated by the arrangement – including the foreign tax credits -- should be disallowed.

As described above in Issue 1, most of the transaction steps within the arrangement are transparently circular and, therefore, cannot possibly provide the basis for a pre-tax profit or business purpose. Specifically, the Trust device had no meaningful impact on Taxpayer's control or management of the assets directly and indirectly transferred to Trust or Taxpayer's right to the income generated by those assets. The sole function of the Trust device was to route income from Taxpayer's assets through Trust and, thereby, to generate foreign taxes that Taxpayer could claim as foreign tax credits. Because the use of Trust accomplished nothing of substance, it necessarily could not generate any profit or other advantage for Taxpayer.

The remaining aspect of the arrangement – the financing – was equally devoid of any potential to generate either a pre-tax profit or provide a non-tax business purpose for the transaction. Whether there is a reasonable expectation of profit is determined by comparing the expected costs and returns of a transaction based on "the standpoint of a prudent investor." Gilman, 933 F.2d at 147.

Expected Costs. The principal costs incurred in connection with the arrangement were Taxpayer's adjusted LIBOR-based obligation under the Zero Coupon Swap and the Class D units, the administrative and transaction costs incurred in undertaking the arrangement, and the Country X tax obligations imposed on Trust. Each of these costs is discussed in turn.

Adjusted LIBOR-Based Obligations. Taxpayer was obligated to pay financing charges to Country X Bank primarily under the Zero Coupon Swap Agreement. Those charges equaled the product of the amount of financing and LIBOR plus 50 basis points,[34] reduced by a fixed amount of Amount 24 per month. At the time the arrangement was entered, LIBOR was near its historic low at approximately Amount 49. Nonetheless, the parties expected LIBOR to increase significantly over the term of the arrangement. The Initial Tax Opinion assumed that the average adjusted LIBOR rate (i.e., LIBOR as adjusted by the variable and fixed components of Taxpayer's payment obligation) over the term of the arrangement would equal Amount 50.[35] Thus, based on the assumption used by Accounting Firm to analyze Taxpayer's expected profit from the arrangement, Taxpayer's annual finance charge for the use of Amount 1 was expected to be approximately Amount 52.

Transaction Costs. In connection with the arrangement, Taxpayer paid fees of more than Amount 6 to outside accounting and law firms. Therefore, on an annualized basis, Taxpayer incurred transaction costs of at least Amount 53. As noted above, the substantial majority of those costs were attributable to fees paid to Accounting Firm, but significant fees were also paid to Law Firm, Accounting Firm 2, and other service providers. It remains unclear how much additional expense was incurred by Taxpayer to pay its own employees for their efforts in implementing the arrangement.

Country X Taxes. The largest added expense of the arrangement was the 22% Country X tax imposed on the income funneled through the Trust. The Initial Tax Opinion projected that the assets contributed to Trust would earn an average rate of return of Amount 30. See Initial Tax Opinion at n. 223 and accompanying text. Given the valuation of the Trust assets at Amount 2, the expected annual income stream was Amount 29 and the resulting projected Country X taxes were approximately Amount 33 per year.

In sum, the aggregate annual costs from entering the arrangement were expected to be approximately Amount 54. In reaching this conclusion, we have treated the Country X taxes incurred as a result of the arrangement as a cost that must be accounted for in determining the expected pre-tax profit for economic substance purposes. This follows from the essential purpose of the economic substance inquiry, which is to determine whether a taxpayer would have entered the transaction in the absence of the disputed U.S. tax benefits. Where the courts determine that a taxpayer's sole motivation for entering the transaction was to obtain U.S. tax benefits, the transaction must be disregarded for tax purposes and the claimed benefits denied. In any such inquiry, all of a taxpayer's items of income and expense other than the U.S. tax treatment must be taken into account. Economically, a foreign tax is no different

[34] This nets the stated rate of LIBOR plus 100 basis points under the Zero Coupon Swap and the 50 basis point fee payable under the Credit Default Swap.

[35] Initial Tax Opinion at 76, n. 223. This appears to be based on the assumption that LIBOR would be approximately Amount 51 over the five-year term of the arrangement.

from any other expense, and therefore foreign taxes are properly treated as a cost that reduces economic profit. If a taxpayer's return is negative before U.S. tax consequences are taken into account, as is the case here, it necessarily follows that the benefit of the foreign tax credit provided the impetus for the transaction.

The position that foreign taxes are costs for economic substance purposes is at odds with two decisions addressing the availability of foreign tax credits arising from a transaction in which taxpayers purported to acquire certain dividend paying instruments. See Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001); IES Indus. v. United States, 253 F.3d 350 (8th Cir. 2001). These decisions reversed the Tax Court and district court, respectively, and concluded that it was inappropriate to deduct the cost of foreseeable foreign taxes imposed on the transaction in determining the expected pre-tax profit of a transaction. Neither the Supreme Court nor any other Circuit Court has considered this issue. We note that Taxpayer resides in a circuit which is not bound to follow the positions of the Fifth and Eighth Circuit decisions in Compaq and IES.

The Service continues to assert that the failure of those courts to subtract the economic cost of foreign taxes undermines the test's purpose of determining whether the taxpayer had a real potential for profit apart from the transaction's U.S. tax benefits. The decisions of the Fifth and Eighth Circuits have been widely criticized by both academics and practitioners. See, e.g., Daniel N. Shaviro and David A. Weisbach, The Fifth Circuit Gets It Wrong In Compaq v. Commissioner, 2002 TNT 19-31; David P. Hariton, The Compaq Case, Notice 98-5, and Tax Shelters: The Theory is All Wrong, 2002 TNT 19-30 ("The Fifth and the Eighth Circuits . . . found (incorrectly, in my view) that the government was 'wrong' . . . ." that the transaction failed to produce profit because, in part, foreign taxes should be treated as a cost.).[36]

Moreover, the facts under consideration are distinguishable from those in Compaq and IES. The appeals courts in those cases placed significant weight on the fact that the transaction at issue – the purchase and sale of a security – occurred on a public market between unrelated parties and was subject to attendant market risks. In this case, in contrast, the foreign tax arose neither from any new purported investment, nor from one occurring on a public exchange. Rather, the disputed credits in this case arose purely from certain formalistic manipulations of the taxpayer's existing investments. Furthermore, although Country X Bank and Taxpayer are unrelated, the foreign taxes arose solely from the circular Trust device in which Country X Bank played no substantive role. In sum, this case is distinguishable from Compaq and IES because the foreign taxes in this case resulted from an entirely artificial transaction that lacked any substantive involvement of third parties or market risks. Accordingly, we conclude it

[36] Even practitioners who have criticized Service efforts to stem abusive foreign tax credit transactions reject the courts' reasoning in those decisions. See Dolan, Foreign Tax Credit Generator Regs: The Purple People Eater Returns, 2007 TNT 118-33 ("[IES and Compaq] are unprincipled decisions that any future court would likely try to distinguish").

is appropriate to consider all pre-U.S. tax costs (and benefits) in assessing the arrangement's economic substance.

Expected Benefits. Given that the Trust device had no substantive effect, Taxpayer's expected benefit was limited to the return it expected to earn from the use of the financing. The Initial Tax Opinion assumed that Taxpayer's rate of return on the Trust assets attributable to Country X Bank's "investment" of Amount 1 would be Amount 30.[37] This estimate may have been unrealistically optimistic,[38] but even at that rate of return the arrangement was expected to generate no more than Amount 55 per year.

The Initial Tax Opinion also suggested that all of the income generated by the Amount 2 of assets nominally transferred to Trust should be taken into account in determining whether Taxpayer reasonably expected to derive a profit from the arrangement. It is nonsensical to suggest that income that Taxpayer would have earned had it never entered the arrangement can be used to justify its decision to implement the arrangement. This position is plainly contrary to Gregory and its progeny, which focus on whether the transaction at issue generated non-tax benefits. If such extraneous benefits could be used to support the disputed transaction, then it should have followed, in Gregory, that the taxpayer's intent to sell assets would have justified the purported reorganization used to transfer those assets in anticipation of their sale. Similarly, the Federal Circuit in Coltec rejected a proffered business purpose of centralizing the management of liability claims on the basis that such a purpose was achievable without undertaking the contribution of assets and liabilities that resulted in a sought-after capital loss. See also ACM Partnership, 157 F.3d 231 (3d Cir. 1998) (interest income earned on a note was not sufficient to establish economic profit where the rate of interest was substantially similar to the amount of interest the cash used to purchase the notes had been previously earning in a bank account). These cases stand for the proposition that benefits which arise independently from the disputed transaction are appropriately ignored in assessing the economic substance of that transaction. Accordingly, the only income or other benefits that can be considered in evaluating the arrangement are those that arise from the transaction.

Therefore, the reasonably anticipated costs of the arrangement outweighed the expected benefits of the arrangement by a margin of approximately 1.5:1. It follows that Taxpayer undertook the arrangement for the purpose of claiming foreign tax credits of approximately Amount 33 per year. The value of that tax benefit would have more than made up for the annual pre-tax loss of approximately Amount 56 and, therefore, provided the impetus for entering the arrangement.

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[37] This estimate was based on the total expected return on assets which was circulated through Trust. These assets included both the Amount 17 worth of publicly-traded debt securities acquired by Taxpayer at the time of the arrangement and pre-existing assets of Taxpayer.

[38] See n. 24 (actual return on assets was significantly lower than Amount 30).

That the arrangement was undertaken solely for tax reasons is further illustrated by comparing the costs of the arrangement to a conventional financing arrangement. Taxpayer indicated that it typically borrowed at LIBOR from the FHLB and that the financing by Country X Bank substituted for some of that borrowing. Using Taxpayer's assumption of a LIBOR rate of Amount 51 over the term of the arrangement and a rate of return on the borrowing of Amount 30, the conventional loan would have earned Taxpayer net income of approximately Amount 57 per year without incurring substantial additional transaction costs or any Country X tax. That Taxpayer abandoned this approach in favor of one with dramatically higher costs and no added benefits confirms that the arrangement was entered to secure tax rather than economic benefits. See Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 183 (D. Conn. 2004), aff'd on other grounds, 150 Fed. Appx. 40 (2d Cir. 2005) ("the loan to OTC and a potential direct investment in Portfolio were from an objective standpoint identical investments, and it is the selection of the manner in which the investment was achieved - through OTC with attendant forfeiture of profit in exchange for no (or minimal) corresponding diminution in risk over a direct investment - that reveals the absence of objective economic substance and strongly suggests the sole focus as the creation of tax benefits."); see also ASA Investerings Pshp. v. Commissioner, 201 F.3d 505, 516 (D.C. Cir. 2000) (noting that there was no reason to believe taxpayer could not have realized the economic benefits it sought at far, far lower transaction costs without the use of the partnership at issue in the case).

The facts of this case are analogous to those in Goldstein v. Commissioner*,* 364 F.2d 734*,* 740 (2d Cir. 1966), *aff'g* 44 T.C. 284 (1965), in which the taxpayer claimed deductions for prepaid interest on certain loans used to fund the acquisition of Treasury bonds. The Second Circuit upheld the disallowance of the interest deductions on the ground that the transaction had "no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of the interest deduction; and a good example of such purposeless activity is the borrowing of funds at 4% in order to purchase property that returns less than 2% and holds out no prospect of appreciation sufficient to counter the unfavorable interest rate differential." Id. at 741-42. As in Goldstein, the Taxpayer in this case purported to finance assets expected to produce a lower rate of return than the economic cost of the borrowing. While on these facts the bulk of the financing cost took the form of a foreign tax for which taxpayer sought foreign tax credits instead of stated interest expense, the relationships between the costs and benefits in this case and Goldstein are indistinguishable. In both cases it is evident that the purported financing would not have been undertaken without the sought-after tax benefit. Such transactions are the kind of "purposeless activity" that the Tax Code was not intended to respect or reward.[39]

[39] We also note that the arrangement represented a significant departure from Taxpayer's historic business practices. Taxpayer indicated that it typically borrowed in the U.S. at LIBOR and that, prior to undertaking the arrangement, it had never entered a transaction that had resulted in the imposition of foreign taxes. Other aspects of the transaction also appear to significantly depart from Taxpayer's typical profit-seeking activities. For example, the facts disclosed to date indicate that, at the time of the first round of transactions, Taxpayer spent approximately two thirds of Amount 1 to acquire publicly-traded

Taxpayer's Asserted Purpose for the Arrangement

The only material justification offered by Taxpayer to support the arrangement is that it enabled it to lower its typical borrowing cost. For the reasons stated above, however, this ignores the fact that Taxpayer was compelled to incur additional foreign taxes substantially in excess of any reduction in its financing costs. Thus, although the fixed component of the financing charge nominally offset Taxpayer's finance charges by approximately Amount 58 per year, the costs of securing that "reduction" included an additional foreign tax of more than twice that amount. Therefore, rather than reduce Taxpayer's pre-U.S. tax finance costs, the arrangement in fact increased the financing expenses by at least Amount 59 per year. We therefore conclude that the proffered justification for the transaction is not credible.[40]

Congressional Intent

For the reasons expressed above, we conclude that Congress did not intend to make the foreign tax credit available in circumstances where parties execute formal documentation in an attempt to shift income from U.S. activities and assets to a foreign jurisdiction and the substantial majority of the foreign taxes at issue are effectively recovered by the parties.

Conclusion

The arrangement lacks economic substance even if it is viewed as an integrated transaction or series of transactions. Most of the transactions that comprise the arrangement were circular and had no substantive effects beyond the creation of desired tax benefits. The only potentially viable rationale for the arrangement was that it provided below-market rate financing for Taxpayer, but even that purpose does not withstand scrutiny because the costs assumed by Taxpayer to obtain the financing substantially exceeded its non-tax benefits. Even accepting the assumptions used by Accounting Firm to justify the transaction, we can only conclude that Taxpayer would never have entered the arrangement without the expectation that it could claim the disputed foreign tax credits. Because the arrangement lacked any reasonable

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debt and pledged those assets to secure the repayment of the financing. It remains unclear if such an investment was typical of Taxpayer's business practice generally or its use of loan proceeds specifically.

[40] Taxpayer also asserted during an interview by Exam that the arrangement provided needed liquidity. Taxpayer has not presented any analysis – contemporaneous or post hoc – to justify its assertion that the arrangement provided needed liquidity for business operations. In fact, in the same interview in which it made this assertion, Bank's Tax Director explained that Bank met its normal liquidity needs by borrowing from the FHLB. Taxpayer also stated that the funds provided by Country X Bank displaced, rather than supplemented, its normal borrowing practices. We also note that in the several hundreds of pages of Tax Opinions and technical memoranda that were provided to Taxpayer by Accounting Firm and Accounting Firm 2 to justify the sought-after tax results, there is no reference to enhanced liquidity as a potential justification for the strategy. For these reasons we do not find it credible that the arrangement was undertaken to enhance Bank's liquidity or actually had that effect.

expectation of profit or business purpose apart from the foreign tax credit benefits, it lacked economic substance and should be disregarded for U.S. income tax purposes.

4. Principal Purpose to Avoid or Evade Tax (Issue 3)

The foreign tax credits should be disallowed under section 269(a)(1) and (2). Taxpayer formed and acquired control of InvestCo (and InvestCo acquired, in a section 351 transaction, the assets generating the income on which the Country X taxes were imposed) and the principal purpose of such acquisition was to generate foreign tax credit benefits that Taxpayer would not otherwise enjoy.

Section 269(a) provides that, in general, if:

> (1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or
>
> (2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,
>
> and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or allowance. For purposes of paragraphs (1) and (2), control means ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

Section 269(a); see also Treas. Reg. §1.269-1(c).

Application of Section 269(a)(1)

There are three conditions for the application of section 269(a)(1): (1) a person or persons acquire, directly or indirectly, control of a corporation; (2) the principal purpose for the acquisition is to evade or avoid Federal income tax; and (3) the acquisition results in the taxpayer securing the benefit of a deduction, credit, or other allowance that would not otherwise be enjoyed.

Acquisition of Control. The first requirement is that a person or persons must acquire control of a corporation. As a threshold matter, the term "person" is broadly defined to include an individual, trust, estate, partnership, association, company, or corporation. Section 7701(a)(1); Treas. Reg. §1.269-1(d). Acquisition of the controlling stock of a newly-organized corporation is considered to be an acquisition of control of that corporation under section 269(a)(1). Treas. Reg. §1.269-1(c); James Realty Co. v. United States, 280 F.2d 394 (8th Cir. 1960). InvestCo was such a newly organized corporation. Formation of InvestCo therefore satisfies the acquisition of control requirement of section 269(a)(1) because Bank owned all of the outstanding stock of InvestCo immediately after the acquisition.

Principal Purpose to Evade or Avoid Tax by Securing the Benefit of a Deduction, Credit, or Other Allowance That Would Not Otherwise Be Enjoyed. The second and third requirements are that the acquisition must have had as its principal purpose the evasion or avoidance of Federal income tax and that the acquisition results in the taxpayer securing the benefit of a deduction, credit, or other allowance that would not otherwise be enjoyed. To constitute the principal purpose, the purpose to evade or avoid Federal income tax must outrank, or exceed in importance, any other purpose. Canaveral Int'l Corp. v. Commissioner, 61 T.C. 520, 536 (1974); Treas. Reg. §1.269-3(a). The principal purpose of a particular acquisition is a question of fact and must be determined by examining all events surrounding the transaction. J.T. Slocomb Co. v. Commissioner, 38 T.C. 752, 764 (1962), *aff'd*, 334 F.2d 269 (2d Cir. 1964); see also S. Rept. No. 627, 78th Cong., 1st Sess., p. 59 (1944 C.B. 1017).

The fact that tax avoidance was considered does not establish that as the principal purpose of the acquisition. However, the magnitude of the recognized tax saving does have a bearing on its importance. See Stange Co. v. Commissioner, 36 T.C.M. (CCH) 31 (1977).

Based on all of the circumstances in this case, tax avoidance is to be clearly inferred as the principal purpose. See Army Times Sales Co. v. Commissioner, 35 T.C. 688, 704 (1961). Facts that particularly support tax avoidance as the principal purpose include: (1) Taxpayer's purported tax savings realized through the foreign tax credits of Amount 3 over the two years at issue, and total projected tax savings of several times that amount over the life of the arrangement; (2) the parties' admissions that the formation of the complex structure – InvestCo and the disregarded entities – was necessary to subject Taxpayer's income to Country X tax and permit Country X Bank to recover the substantial majority of that tax cost and share the resulting "savings"; (3) that Country X Bank effectively reimbursed Taxpayer for approximately half of the Country X taxes for which Taxpayer claimed foreign tax credits; (4) the lack of non-tax purpose and substance surrounding the arrangement and the circular Trust device; (5) that the transaction was documented in a manner to impose a Country X tax on assets that previously were, and continued throughout the arrangement to be located, managed, and controlled in U.S. by Taxpayer; (6) that Taxpayer retained the same rights to those assets and the income thereon as if the Trust device had not been implemented; (6) that the claimed foreign tax credits would have reduced Taxpayer's income tax by approximately three times the Country X tax attributable to the Trust device; and (7) that the costs incurred in undertaking the arrangement substantially exceeded both the expected non-tax benefits of the arrangement and the costs associated with conventional financing. Therefore, it can be clearly inferred that InvestCo was organized to be used for the arrangement for the principal purpose of tax avoidance by claiming foreign tax credits of Amount 3.

The facts described above demonstrate that the acquisition was devoid of any substance[41] and purpose other than the securing of foreign tax credits. However, even if a court determined that there was some purpose other than tax avoidance for the acquisition, it is nevertheless clear that tax avoidance was the principal purpose See Army Times Sales Co., 35 T.C. at 704, 705; Stange, 36 T.C.M. (CCH) at 31. Taxpayer indicated that the transaction substantially departed from its typical borrowing practice and that it undertook the formation of InvestCo and the Trust device solely to facilitate the tax planning proposed by Country X Bank. While Taxpayer characterizes the results of that planning as allowing it to obtain a better-than-market interest rate, we have previously explained that the only real benefit of the tax planning was the reduction of U.S. tax generated by claiming foreign tax credits. Accordingly, even if Taxpayer was, in part, motivated to borrow funds from Country X Bank, we nonetheless conclude that it only established InvestCo and the circular Trust device in order to claim the substantial foreign tax credits at issue.[42] We therefore conclude that tax avoidance was the principal purpose of the acquisition.

Furthermore, the facts show that even Taxpayer's stated purpose for the overall arrangement, to secure "low-cost financing," represented nothing more than tax avoidance for Taxpayer to secure foreign tax credits that it would not otherwise enjoy.

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[41] The lack of substantive effect on Taxpayer's assets was acknowledged in several documents, including bank regulatory filings of Taxpayer, the Tax Opinions, and the marketing materials provided by Country X Bank.

[42] Only by structuring InvestCo and the Trust device could Taxpayer attempt to claim any foreign tax credits on the income-producing U.S. assets transferred to InvestCo and circularly routed from DelCo to the Trust device and back to DelCo. Also, of those foreign tax credits claimed, almost half represented Country X taxes that Taxpayer paid, but which were effectively reimbursed. Note that if Taxpayer directly borrowed Amount 1 at LIBOR (without using the tax avoidance arrangement) and LIBOR approximated Amount 51 over the 5-year term, Taxpayer would have paid an average of approximately Amount 56 in finance charges annually. (As discussed above, the Initial Tax Opinion indicates LIBOR was expected to approximate Amount 51 over the five-year term of the arrangement.) Under the arrangement, Taxpayer instead borrowed Amount 1 at LIBOR plus 100 basis points and paid an average of approximately Amount 61 in finance charges annually during the five-year term. However, Taxpayer offset the finance charge of Amount 58 with the effective annual Country X tax reimbursement of approximately Amount 58. This effective reimbursement of Country X taxes – and the corresponding amount of foreign tax credits -- exceeded the amount of annual interest charges that Taxpayer would have paid if it directly borrowed Amount 1 at LIBOR. Furthermore, the entire amount of foreign tax credits claimed by Taxpayer annually as a result of the Trust device was almost two and one-half times the amount of annual interest charges that Taxpayer would have paid it if borrowed Amount 1 in a non-tax driven transaction.

Taxpayer stated that it typically borrowed at LIBOR and that the financing under the arrangement substituted for some of that borrowing. Taxpayer also indicates that obtaining "low-cost financing" was the purpose for the arrangement. The purportedly low-cost financing charge was derived through a formula in which Taxpayer's financing charge was LIBOR plus 100 basis points, but Taxpayer was to net against this higher financing rate the effective Country X tax reimbursement amount. In other words, Taxpayer was to derive its "low-cost financing" by being reimbursed for approximately half of the Country X taxes paid, and by claiming U.S. foreign tax credits as if Taxpayer paid the entire amount of Country X taxes without reimbursement. Furthermore, even if Taxpayer typically borrowed at LIBOR plus 100 basis points (which is inconsistent with Taxpayer's admissions), Taxpayer was still to derive the purported "low-cost financing" only through this reimbursement of approximately half of the Country X taxes paid and the claiming of the entire amount of Country X taxes paid as U.S. foreign tax credits.

That Taxpayer's stated purpose for the arrangement represented nothing more than tax avoidance and the securing of foreign tax credits is also evident from the second round of financing. As noted above, the stated interest rate on the promissory note in the second round of financing was LIBOR plus 75 basis points. Taxpayer purportedly obtained "low-cost financing" only after taking into account the "fee" it received, which effectively reimbursed Taxpayer for a portion of the recovered Country X tax amounts.[43]

In addition, as noted below in Taxpayer's argument, it appears that it was necessary to use a newly-formed subsidiary of Bank to receive the assets and the income on the assets under the arrangement. Therefore, the facts show that Taxpayer's principal purpose was tax avoidance by securing foreign tax credits that would not otherwise be enjoyed. This satisfies the second and third requirements of section 269(a)(1).

Application of Section 269(a)(2)

Section 269(a)(2) applies in instances where (1) a corporation acquires property of another corporation, (2) immediately before the acquisition the transferor corporation is not controlled, directly or indirectly, by the acquiring corporation or its shareholders, (3) the acquiring corporation's basis in such property is determined by reference to the

[43] For example, Taxpayer's memorandum to bank regulators states as follows. "

basis in the hands of the transferor, (4) the principal purpose for the acquisition is to evade or avoid Federal income tax, and (5) the acquisition results in the taxpayer securing the benefit of a deduction, credit, or other allowance that such corporation would not otherwise enjoy.

In this case, requirement (1) is satisfied because InvestCo acquired the income-producing assets from Bank. The transferor corporation, Bank, is not controlled directly or indirectly by the acquiring corporation, Investco, or its shareholder (Bank). Therefore, requirement (2) is satisfied. The transaction appears to qualify under section 351 and InvestCo's basis in the assets received from Bank is determined by reference to the basis of such assets in the hands of Bank. Therefore, requirement (3) is met. The principal purpose requirement and requirement that the Taxpayer secure a tax benefit that would not otherwise be enjoyed are virtually identical to that discussed above (except that the focus under section 269(a)(2) is on the assets acquired by InvestCo) and are, therefore, also satisfied.

Taxpayer's Argument. Taxpayer's stated business reason for organizing InvestCo was that Taxpayer could obtain financing from Country X Bank at a lower rate and that InvestCo was used instead of existing subsidiaries for state tax reasons and to simplify the FHLB approval process. The evidence of business purpose must be weighed against the significant tax savings produced by the transaction, which, in this case, totaled Amount 3 in the years at issue. In addition, Taxpayer argues, citing Cromwell Corp. v. Commissioner, 43 T.C. 313, 320 (1964), that section 269 should not be applied because the acquisition of control of InvestCo was not necessary to reach the desired result, arguing that it could have used an existing subsidiary in the arrangement. However, Taxpayer has not substantiated its claim that it was feasible to use one of its existing subsidiaries in the transaction (rather than forming a new corporation). Also, section 269(a)(2) applies to an acquisition whether the transferee corporation is newly-formed or not, as long as there is a transfer of property to which it otherwise would apply.[44]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

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[44] The income-producing assets are transferred from Bank to newly-formed InvestCo. For U.S. tax purposes, DelCo, DelCo Sub, NewCo, Successor Trustee, and Trust, as disregarded entities, are all divisions of InvestCo. It is by means of InvestCo's formation and acquisition of the income-producing assets that the assets then purportedly generate foreign-source income and taxes in Country X, and foreign tax credits in the U.S. that Taxpayer would not otherwise enjoy.

[redacted]

[redacted]

[redacted]

[redacted]

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[redacted]

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Please call (202) 622-3850 if you have any further questions.

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