Bank of N. Y. Mellon Corp. v. Comm'r, 140 T. C. 15 (U. S. Tax Ct. 2013)

In Bank of N. Y. Mellon Corp. v. Comm'r, the U. S. Tax Court ruled that the Bank of New York Mellon's participation in a Structured Trust Advantaged Repackaged Securities (STARS) transaction with Barclays lacked economic substance and was thus invalid for federal tax purposes. The court disallowed foreign tax credits and deductions claimed by the bank, holding that the transaction was designed solely to generate tax benefits without any legitimate business purpose or economic effect. This decision underscores the IRS's efforts to combat tax shelters and reaffirms the application of the economic substance doctrine in evaluating complex tax arrangements.

Parties

The petitioner, Bank of New York Mellon Corporation (BNY Mellon), as successor in interest to The Bank of New York Company, Inc. , sought review of a deficiency notice issued by the respondent, the Commissioner of Internal Revenue. BNY Mellon was the plaintiff at the trial level, appealing the Commissioner's determination of tax deficiencies for the tax years 2001 and 2002.

Facts

BNY Mellon, through its subsidiary The Bank of New York (BNY), entered into a Structured Trust Advantaged Repackaged Securities (STARS) transaction with Barclays Bank, PLC (Barclays) in November 2001. The STARS transaction involved the creation of a complex structure to shift income and generate foreign tax credits. BNY contributed approximately $6. 46 billion in assets to a trust managed by a U. K. trustee, which was subject to U. K. taxation. The transaction included a $1. 5 billion loan from Barclays to BNY, with the interest rate adjusted by a spread contingent on the U. K. tax benefits. BNY claimed foreign tax credits of $98. 6 million and $100. 3 million for 2001 and 2002, respectively, and sought to deduct related expenses and interest. The Commissioner determined that the STARS transaction lacked economic substance and disallowed the claimed tax benefits.

Procedural History

The Commissioner of Internal Revenue issued a notice of deficiency to BNY Mellon, asserting deficiencies of $100 million and $115 million for the tax years 2001 and 2002, respectively. BNY Mellon filed a petition with the U. S. Tax Court to challenge these determinations. The court's standard of review was de novo, with the burden of proof on BNY Mellon to show that the STARS transaction had economic substance and was entitled to the claimed tax benefits.

Issue(s)

Whether the STARS transaction had economic substance such that BNY Mellon was entitled to foreign tax credits under 26 U. S. C. § 901 and deductions for expenses

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incurred in furtherance of the transaction?

Whether the income attributed to the trust with a U. K. trustee was U. S. source income rather than foreign source income?

Rule(s) of Law

The economic substance doctrine, as articulated in cases such as *Frank Lyon Co. v. United States*, 435 U. S. 561 (1978), and codified in 26 U. S. C. § 7701(o), requires a transaction to have both objective economic substance and a subjective non-tax business purpose to be respected for tax purposes. The doctrine allows the IRS to disregard transactions that are designed solely to generate tax benefits without any legitimate business purpose or economic effect.

Holding

The U. S. Tax Court held that the STARS transaction lacked economic substance and was therefore disregarded for federal tax purposes. Consequently, BNY Mellon was not entitled to the foreign tax credits under 26 U. S. C. § 901, nor could it deduct the expenses incurred in furtherance of the transaction. Additionally, the court held that the income attributed to the trust was U. S. source income, not foreign source income.

Reasoning

The court applied the economic substance doctrine, evaluating both the objective and subjective prongs. Objectively, the STARS transaction did not increase the profitability of the assets involved and was characterized by circular cashflows, indicating a lack of economic substance. The court found that the transaction's primary purpose was to generate foreign tax credits without any incremental economic benefit. Subjectively, BNY Mellon's claimed business purpose of obtaining low-cost financing was rejected, as the transaction was not economically rational without the tax benefits. The court also found that the spread, which was used to reduce the loan's cost, was contingent on the tax benefits and not a legitimate component of interest. The court concluded that the transaction was designed solely for tax avoidance and did not align with Congressional intent for the foreign tax credit.

The court further reasoned that expenses incurred in furtherance of a transaction lacking economic substance are not deductible. The STARS transaction's lack of economic substance meant that BNY Mellon could not deduct the claimed transactional expenses, interest, or U. K. taxes paid on trust income. Finally, the court held that because the transaction was disregarded, the income from the trust assets was treated as U. S. source income, and the U. S. -U. K. tax treaty did not apply.

Disposition

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The U. S. Tax Court entered a decision for the Commissioner of Internal Revenue, disallowing the foreign tax credits and deductions claimed by BNY Mellon in connection with the STARS transaction.

Significance/Impact

The decision in *Bank of N. Y. Mellon Corp. v. Comm'r* is significant for its reaffirmation of the economic substance doctrine as a tool to combat tax shelters. It underscores the IRS's and courts' willingness to scrutinize complex tax arrangements and disregard those that lack economic substance. The case has implications for the structuring of international tax transactions and the application of the foreign tax credit, emphasizing that tax benefits must be derived from transactions with genuine economic substance and business purpose. Subsequent courts have relied on this decision in similar cases involving tax shelters and the economic substance doctrine.

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