Bank of New York Mellon Corp. v. Commissioner, 140 T. C. No. 2 (2013)

In a landmark ruling, the U. S. Tax Court invalidated the Structured Trust Advantaged Repackaged Securities (STARS) transaction used by Bank of New York Mellon Corp. to generate foreign tax credits. The court determined that the transaction lacked economic substance and was designed solely to exploit tax benefits, disallowing the bank's claimed foreign tax credits and deductions. This decision reinforces the economic substance doctrine's role in preventing tax avoidance schemes and highlights the judiciary's commitment to scrutinizing complex financial arrangements for their true economic impact.

Parties

The petitioner was Bank of New York Mellon Corporation, as successor in interest to The Bank of New York Company, Inc. , and the respondent was the Commissioner of Internal Revenue. The case was filed in the U. S. Tax Court under Docket No. 26683-09.

Facts

Bank of New York Mellon Corporation (BNY) and its subsidiaries, as an affiliated group, engaged in a Structured Trust Advantaged Repackaged Securities (STARS) transaction with Barclays Bank, PLC (Barclays). The STARS transaction involved transferring income-producing assets to a trust managed by a U. K. trustee, which was subject to U. K. tax. BNY claimed foreign tax credits and deductions on its 2001 and 2002 federal consolidated returns related to this transaction. The Commissioner of Internal Revenue challenged these claims, asserting that the STARS transaction lacked economic substance and should be disregarded for federal tax purposes.

Procedural History

The case was brought before the U. S. Tax Court after the Commissioner issued a deficiency notice to BNY, disallowing the foreign tax credits, deductions, and reclassifying the income as U. S. source income. The Tax Court, following the law of the Second Circuit as per Golsen v. Commissioner, applied a flexible analysis to assess the economic substance of the STARS transaction. The court ultimately held that the transaction lacked economic substance and upheld the Commissioner's adjustments.

Issue(s)

Whether the STARS transaction had economic substance under the economic substance doctrine, thereby entitling BNY to foreign tax credits and deductions?

Rule(s) of Law

The economic substance doctrine requires that a transaction have a genuine

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economic effect beyond the tax benefits it generates. The court must consider both an objective test (whether the transaction created a reasonable opportunity for economic profit) and a subjective test (whether the taxpayer had a non-tax business purpose for engaging in the transaction). The court may also consider whether the transaction aligns with Congressional intent in enacting the relevant tax provisions.

Holding

The U. S. Tax Court held that the STARS transaction lacked economic substance and was thus invalid for federal tax purposes. Consequently, BNY was not entitled to the foreign tax credits or deductions claimed in connection with the STARS transaction, and the income from the assets was to be treated as U. S. source income.

Reasoning

The court's reasoning focused on the following aspects:

– *Objective Economic Substance:* The STARS transaction did not increase the profitability of the assets transferred into the trust structure. Instead, it incurred additional transaction costs, including professional service fees and foreign taxes, which reduced the overall profitability. The circular cashflows within the STARS structure further indicated a lack of economic substance, as these flows had no non-tax economic effect. The court rejected BNY's argument that income from the STARS assets should be considered in evaluating economic substance, as these benefits were unrelated to the transaction itself.

– *Subjective Economic Substance:* BNY claimed that the STARS transaction was undertaken to obtain low-cost financing. However, the court found that the transaction lacked any reasonable relationship to this claimed business purpose. The loan was not low-cost, as the spread, which was integral to the loan's pricing, was derived from tax benefits and not from economic realities. The court concluded that BNY's true motivation was tax avoidance, not a legitimate non-tax business purpose.

– *Congressional Intent:* The court determined that the foreign tax credits claimed were not in line with Congressional intent. The credits were generated through a scheme that exploited inconsistencies between U. S. and U. K. tax laws, rather than arising from substantive foreign activity. The court found that Congress did not intend to provide foreign tax credits for such transactions.

– *Legal Tests Applied:* The court applied the economic substance doctrine as articulated by the Second Circuit, focusing on both objective and subjective prongs without treating them as rigid steps. The court also considered the relevance of the transaction's alignment with Congressional intent.

– *Policy Considerations:* The ruling reflects a broader policy concern with preventing tax avoidance through complex financial arrangements that lack economic substance. It underscores the judiciary's role in upholding the integrity of the tax

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system.

– *Statutory Interpretation:* The court interpreted the relevant tax provisions in light of the economic substance doctrine, emphasizing that tax benefits must be tied to genuine economic activity.

– *Precedential Analysis:* The court relied on precedent from the Second Circuit and other circuits to support its application of the economic substance doctrine, while also noting the flexibility in its application.

– *Treatment of Dissenting Opinions:* The decision was unanimous, and no dissenting or concurring opinions were presented in the case.

– *Counter-Arguments:* The court addressed BNY's arguments that the transaction had economic substance due to the income from the STARS assets and the potential for profit from investing the loan proceeds. These arguments were rejected as they did not relate directly to the STARS transaction itself.

Disposition

The U. S. Tax Court entered a decision for the respondent, disallowing BNY's claimed foreign tax credits and deductions and upholding the Commissioner's adjustments to treat the income as U. S. source income.

Significance/Impact

The Bank of New York Mellon Corp. v. Commissioner case is significant for its application and reinforcement of the economic substance doctrine in U. S. tax law. It sets a precedent for scrutinizing complex financial transactions designed primarily for tax avoidance, emphasizing that such transactions must have genuine economic effects to be respected for tax purposes. The decision has implications for multinational corporations engaging in cross-border tax planning and highlights the judiciary's role in ensuring compliance with tax laws. Subsequent cases have cited this decision to support the disallowance of tax benefits from transactions lacking economic substance, and it has influenced legislative efforts to codify the economic substance doctrine.

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