TAX SHELTERS: STARS ECONOMIC SUBSTANCE RULING IN WELLS FARGO DOES NOT FOLLOW CONJUNCTIVE TEST

Posted on **June 1, 2017** by **Jim Malone**

The litigation over Wells Fargo's STARS transaction took another interesting turn last week, as the district court had to rule on the legal implications of the jury's verdict. *Wells Fargo & Co. v. United States*, No. 09-CV-2764 (PJS/TNL), 2017 U.S. Dist. LEXIS 80401 (D. Minn. May 24, 2017). The litigation focused on whether STARS was a sham transaction that should not be respected for tax purposes because it lacked economic substance.

STARS, an acronym for Structured Trust Advantaged Repackaged Securities, was a transaction promoted to U.S. banks by a British financial-services company. Under this arrangement, Wells Fargo placed assets in a trust managed by a trustee based in the United Kingdom, making the assets subject to U.K. tax. Wells Fargo offset the U.K. taxes through the use of foreign tax credits on its U.S. returns. Because the arrangement yielded tax benefits to the British counterparty, it compensated Well Fargo through a monthly payment. *Wells Fargo*, 2017 U.S. Dist. LEXIS 80401 at *1-*2. The STARS shelter had two distinct components: The trust, described above, and a loan.

At trial, the jury adopted the government's position that the two components of the transaction had to be analyzed separately to determine whether each component had economic substance and should be respected for tax purposes. *Id.* at *2. The jury concluded that the trust component lacked a non-tax business purpose and did not carry a reasonable possibility of a pre-tax profit, thereby establishing that the trust structure lacked economic substance. *Id.* at *3. In contrast, the jury concluded that the loan had objective economic substance but was entered into solely for a tax-related purpose. *Id.*

As the Eighth Circuit had not applied the economic substance doctrine to a case involving a transaction that had objective economic substance but lacked a non-tax business purpose, the court requested briefing on the deductibility of the interest under the loan prior to entering judgment. Before addressing the court's opinion, some context is necessary.

The economic substance doctrine is one of several judicial doctrines that courts have applied to transactions that may comply with the requirements of the Internal Revenue Code in a technical sense, but nonetheless appear to violate Congressional intent. While there is a general consensus that transactions lacking economic substance should not be respected for tax purposes, courts have differed over the appropriate test to apply, dividing along the following lines:

- One test, known as the "disjunctive test," is satisfied if the taxpayer demonstrates *either* that the transaction had a substantive business purpose *or* that it had a reasonable prospect for a pre-tax profit. *See Rice's Toyota World v. Comm'r,* 752 F.2d 89, 93-94 (4th Cir. 1985).
- There is also a conjunctive test, which requires that the taxpayer demonstrate *both* a legitimate business purpose *and* real economic effects. *See Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537, 544 (5th Cir. 2009).
- The Third Circuit adopted a different approach, holding that the objective economic impact of the transaction and the subjective business motivation of the taxpayer were "related factors" that should be analyzed to determine whether the transaction should be respected for tax purposes. *ACM P'ship v. Comm'r*, 157 F.3d 231, 247 (3d Cir. 1998).

In 2010, Congress codified the economic substance doctrine, electing to utilize the conjunctive test:

In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—

(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and

(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

I.R.C. § 7701(o)(1). The codified doctrine, however, was not applicable in *Wells Fargo*, as the case involved transactions that occurred before it was enacted. *Wells Fargo*, 2017 U.S. Dist. LEXIS 80401 at *6, n.5.

The *Wells Fargo* Court commenced its analysis by observing that the jury's verdict mirrored the results in three separate cases that had held the loan and the trust components of STARS should be analyzed separately. *Id.* at *4-*5 & n.4 (citing *Santander Holdings USA, Inc. v. United States*, 844 F.3d 15, 19 & n.4 (1st Cir. 2016); *Bank of New York Mellon Corp. v. Comm'r*, 801 F.3d 104, 121 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 1377 (2016); *Salem Fin., Inc. v. United States*, 786 F.3d 932, 940 (Fed. Cir. 2015), *cert. denied*, 136 S. Ct. 1366 (2016)). The court also emphasized that in each of these decisions, the court held that the loan had economic substance. *Id.* at *5 (citing *Santander*, 844 F.3d at 19 & n.4; *Bank of New York Mellon*, 801 F.3d at 123-24; *Salem*, 786 F.3d at 955-58).

Against this background, the *Wells Fargo* court rejected the government's contention that the loan could only be respected for tax purposes if it had objective economic substance *and* the taxpayer had some subjective, non-tax purpose for entering into the transaction. *Id.* Instead, the court concluded "that the Eighth Circuit is likely to treat the objective and subjective components of the sham transaction test as two factors in a single flexible analysis, rather than as two separate, rigid tests." *Id.* The court offered several reasons to support this conclusion:

- *First*, it observed that a flexible approach was appropriate, since the economic substance doctrine served to curb the "endless ingenuity" of taxpayers, whose skill "in exploiting the tax code," precluded Congress from legislating in a way

that would "anticipate and prevent all abuse." at *5-*6.

- *Second,* the court reasoned that a flexible approach to the analysis of economic substance cases was appropriate in view of the Supreme Court's formulation of the economic substance doctrine in *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978). In the *Wells Fargo* Court's view, the operative language from *Frank Lyon* "reads more like a list of factors to weigh than a series of boxes to check." *Wells Fargo*, 2017 U.S. Dist. LEXIS 80401 at *6.
- *Third,* the court posited that a flexible approach to the economic substance doctrine was consistent with the Supreme Court's prior observations that taxpayers were "allowed to engage in tax planning." at *7 (citing *Gregory v. Helvering*, 293 U.S. 465, 469 (1935)). The court reasoned that imposing a rigid requirement that every taxpayer have a non-tax motive for entering into a transaction would undercut taxpayers' ability to engage in planning. *Id.* The court also posited that a strict requirement that each taxpayer have a subjective non-tax purpose would lead to absurd results as the same transaction could be treated differently due to the differing mental states of particular taxpayers. *Id.*
- *Fourth*, in the court's view, a flexible approach to the economic substance doctrine would treat the subjective mental state of the taxpayer in an appropriate way: "Contemporaneous evidence that a taxpayer was motivated solely by tax benefits reinforces other objective evidence that the transaction lacked a real potential for pre-tax profit or had any utility aside from tax avoidance." at *7-*8.
- *Fifth,* the *Wells Fargo* Court noted that most courts actually apply a flexible approach in practice. While noting that some courts have articulated a test for economic substance that made the absence of a non-tax business purpose conclusive, the court observed that the government could not identify a case "in which a court disregarded a transaction that had real and substantial economic substance for the sole reason that the taxpayer's subjective purpose in entering into the transaction was to avoid taxes." at *8.

After reviewing several concrete examples to support its thesis that courts actually apply a flexible approach to their analysis of economic substance cases, the *Wells Fargo* court opined that its approach was consistent with prior Eighth Circuit precedent, noting that "the Eighth Circuit has said that '[m]odest profits relative to substantial tax benefits are insufficient to imbue an otherwise dubious transaction with economic substance.'" *Id.* at *11 (quoting *WFC Holdings Corp. v. United States*, 728 F.3d 736, 746 (8th Cir. 2013)).

Having settled on a flexible approach, the court then reached its conclusion, holding that the loan component of STARS was not a sham: "As the jury found, the $1.25 billion loan was a real transaction that had substantial, non-tax related economic effects on the parties. The fact that Wells Fargo would not have entered into the loan but for the opportunity to gain unrelated tax benefits does not change that fact." *Id.* at *11-*12.

This is a well-reasoned opinion that takes a sensible approach to a difficult issue. Although the conjunctive test's requirement that a taxpayer demonstrate both a subjective business purpose and objective economic substance has been endorsed by a number of courts, the case for disregarding a transaction that has real economic effects due to the taxpayer's motive is actually quite weak. In *Gregory v. Helvering*, the Supreme Court rejected the idea that motive played a role. 293 U.S. at 469 ("It is quite true that if a reorganization in reality was effected . . . , the ulterior purpose mentioned will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.") (citations omitted). Similarly, in *Frank Lyon*, the Supreme Court observed that a subjective motive to reap tax benefits was not sufficient to invalidate a transaction under the economic substance doctrine: "The fact that favorable tax consequences were taken into account by Lyon on entering into the transaction is no reason for disallowing those consequences. We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction." 435 U.S. at 580 (footnote and citation omitted).

The problem, as the *Wells Fargo* Court recognized, is that application of a flexible approach is technically inconsistent with the language of the codified economic substance doctrine under section 7701(o) of the Code. While the codified doctrine was not applicable to the STARS transaction, the fact that Congress

adopted the conjunctive test is hard to ignore. The court addressed the codified doctrine in a footnote, but its discussion frankly appears to confuse rather than illuminate.

The court acknowledged that Congress adopted the conjunctive test, but it then indicated that "the statute states that it applies '[i]n the case of any transaction to which the economic substance doctrine is relevant.'" *Wells Fargo*, 2017 U.S. Dist. LEXIS 80401 at *6 n.5. (quoting I.R.C. § 7701(o)(1). Noting that section 7701(o)(5)(C) called for the determination of the doctrine's relevance to be determined under common law, the *Wells Fargo* court concluded that "[t]his suggests some flexibility in determining a threshold requirement of relevance before applying the doctrine." *Id.* The flaw in this analysis is that there was no question *whether* the economic substance doctrine was relevant to the STARS transaction; instead the parties disputed *how* it should be applied. This represents a minor flaw in an opinion that is otherwise quite sound analytically.

In addition to its discussion of the economic substance doctrine, the *Wells Fargo* Court also addressed an interesting issue on how to apply the negligence penalty, concluding that it was insufficient for Well Fargo to demonstrate that its position on its returns was objectively reasonable under relevant authority; instead, the court held that a taxpayer must show that it took active measures to ascertain whether its return position was reasonable under relevant authority. *Id.* at*14-*15. This holding has significant ramifications for a broad range of tax cases. I will endeavor to address it separately.

By: Jim Malone

Jim Malone is a tax attorney in Philadelphia. A Principal at Post & Schell, he focuses his practice on federal, state and local tax controversies. Learn more about Post & Schell's Tax Controversy Practice >>

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