14-0765-cv

United States Court of Appeals for the Second Circuit

AMERICAN INTERNATIONAL GROUP, INC., and its subsidiaries,

Plaintiff – Appellant,

v.

UNITED STATES OF AMERICA,

Defendant – Appellee

On Appeal from the United States District Court for the Southern District of New York

BRIEF *AMICUS CURIAE* OF ATLANTIC LEGAL FOUNDATION IN SUPPORT OF APPELLANT

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RULE 26.1 CORPORATE DISCLOSURE STATEMENT

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INTEREST OF *AMICUS CURIAE*[1]

The Atlantic Legal Foundation is a nonprofit, nonpartisan public interest law firm. It provides legal representation, without fee, to scientists, parents, educators, other individuals, small businesses and trade associations. The Foundation's mission is to advance the rule of law in courts and before administrative agencies by advocating for limited and efficient government, free enterprise, individual liberty, school choice, and sound science. The Foundation's leadership includes current and retired general counsels of some of the nation's largest and most respected corporations, partners in prominent law firms and distinguished legal scholars.

This case is of particular interest to the Foundation because the decision below puts in doubt the tax treatment of many kinds of cross-border business transactions that have long been deemed legitimate, impeding business planning. The uncertainty created by the district court's improper application of the "economic substance" rule to a specific and articulated statutory regime imposes unrealistic and amorphous contrary standards, is at odds with the rule applied in other circuits, and threatens to discourage business investment.

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[1] All parties consent to the filing of this brief. Pursuant to Federal Rule of Appellate Procedure 29(c)(5) and this Court's Rule 29.1, *amicus* affirms that no counsel for any party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief.

STATEMENT OF THE CASE

This is an appeal from a decision of the District Court denying a renewed motion for partial summary judgment of American International Group and certain subsidiaries (collectively "AIG") in a case involving the intersection of the Internal Revenue Code's "foreign tax credit" provisions and the judge-made "economic substance" doctrine.[2]

The foreign tax credits at issue on this motion were claimed by AIG in connection with six cross-border financing transactions entered into between 1993 and 1997 by AIG Financial Products Corp. ("AIG-FP"), a wholly-owned subsidiary of AIG.[3] AIG-FP entered into the transactions through one or more subsidiaries. (A1434-38; A1442-45; A1450-54; A1459-63; A1467-71; A1475-78)

In broad summary, the six transactions, which are referred to as "preferred repurchase transactions," all had the same structure. In each transaction, AIG-FP sold preferred stock in a foreign affiliate to a third-party foreign bank and simultaneously undertook a binding contractual obligation to repurchase the preferred stock from the

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[2] We summarize briefly the factual background, which is set forth in AIG's Brief, in the District Court's Opinion and Order filed March 29, 2013 (SPA2-3), 2013 WL 1286193, and the District Court's Certification Under 28 U.S.C. 1292(b) (SPA18-19), 2013 WL 7121184.

[3] AIG-FP was a global financial-services business, which included "spread banking", in which it sought to profit by borrowing funds at rates generally below LIBOR and investing those funds at rates generally above LIBOR. (A1425-28).

counterparty bank after an agreed term of years at the same price that the bank originally paid for the stock. (SPA18).

As a result of the six transactions at issue, AIG-FP was able to borrow a total of $1.6 billion from foreign banks at favorable interest rates, typically 150 to 200 basis points below LIBOR. (SPA18; SPA2; A 1436; A 1443-44; A 1451; A 1460; A1468; A1476). These favorable interest rates were made possible in part because of the favorable tax treatment accorded to the foreign banks under foreign law. (SPA15-16).

U.S. tax law treats an agreement to sell and repurchase stock as a loan of the purchase price secured by the stock, with the dividends on the stock treated as interest payments. By contrast, the home country law of the foreign banks treated the banks as the owners of the preferred stock notwithstanding AIG-FP's obligation to repurchase the stock, and the dividend payments made by the relevant AIG-FP affiliates to the foreign banks were regarded as dividends that were either exempt from foreign tax or subject to tax at a reduced rate. The favorable tax treatment of the foreign banks enabled them to lend funds to AIG-FP at a lower rate than they would have charged if the payments to them had been subject to income tax. AIG in effect shared the foreign banks' tax benefit with them by negotiating an interest ("dividend") rate below the return on the affiliates' investments. (SPA13).

Although the transactions might be complicated in their details, their essence is simple – AIG was looking to obtain funding at the most favorable interest rate available.

The affiliates invested the money from the sales, paid taxes on the investment income to their host government, and made payments to the lending bank. AIG claims credits for the subsidiary foreign tax payments. From AIG's perspective, the benefit of the transactions was that they allowed AIG-FP to borrow funds at favorable interest rates which AIG was able to invest at above-LIBOR yields, yielding profits of more than $168.8 million over the life of the transactions. (SPA21-22).

It is undisputed that AIG complied with the complex regime of rules and regulations that govern a U.S. taxpayer's claim for foreign tax credits. It is also undisputed that disallowance of the credits would subject AIG to taxation on the same income in both the U.S. and in a foreign country, contrary to the legislative purpose of the foreign tax credit. The IRS nevertheless determined that the transactions giving rise to AIG's foreign tax credits lacked "economic substance" and the disallowed the $48.2 million in foreign tax credits claimed by AIG. (A515-62). The IRS assessed AIG for the additional tax, which AIG paid.

SUMMARY OF ARGUMENT

Congress intended through the foreign tax credit to avoid double taxation and Congress and the Treasury have carefully delineated the proper scope of the foreign tax credit through a complex and highly articulated set of statutes, regulations and rulings.

The Internal Revenue Code foreign tax credit sections and relevant Treasury regulations are designed to allow the U.S. taxpayer to structure its business transactions as it chooses, even if that choice subjects the taxpayer to foreign tax. The foreign tax credit is intended to make international business of U.S. companies "tax neutral." Congress has repeatedly supplemented and revised the foreign tax credit regime to address transactions that Congress determined to be problematic, and Courts should not apply the economic substance doctrine when the statute or regulation reflects a history of detailed consideration by Congress or the Treasury.

The economic substance doctrine has the effect of overriding statutory law through a *post hoc* judicial redetermination of tax consequences. The doctrine should apply only to a narrow category of cases, when the taxpayer entered into a transaction in which there was nothing of substance beyond a tax deduction can be realized, there is no reasonable possibility of profit and the taxpayer has no business purpose other than obtaining the tax deduction. In this case AIG had a clear and legitimate business purpose – to borrow funds at low interest rates and reinvest them at a higher return.

AIG was able to do this because of the different tax treatment of the transactions under U.S. law and the laws of the countries in which the lenders and the AIG affiliates which did the borrowing were located.

The U.S. foreign tax credit system is designed to make a U.S. taxpayer indifferent to whether it is subject to foreign tax if it is allowed to use a foreign tax credit, but the taxpayer must comply with very complex limitations that put a cap on the amount of credit that may be claimed. The U.S. tax law accommodates the imposition of foreign tax and treats it like a U.S. tax, so long as the U.S. taxpayer had legal liability to pay the foreign tax and in fact did so. In this case there is no dispute that AIG or its local affiliates paid the foreign taxes that AIG claims as credits.

The district court treated the foreign taxes as transaction costs that should be included in the "non-tax" analysis, contrary to the rationale of decisions of two other circuits, which concluded in analogous cases. The district court's reasoning imputed to AIG a higher interest cost – one "grossed up" to adjust for the lenders' foreign tax exemptions – than it could deduct under U.S. tax law. By requiring the foreign banks' dividends to be "grossed up" to approximate a comparable rate of taxable interest, the district court increased AIG's expenses and reduced its pre-tax profitability. It was inappropriate to "gross up" tax exempt income by computing a hypothetical equivalent amount of taxable income in determining the transactions' pre-tax profitability for purposes of the of the economic substance test where the direct

benefits of such exemption are not at issue and it is unprecedented for the *foreign* tax treatment of a third party who is not a U.S. taxpayer to affect the determination of whether an unrelated U.S. taxpayer had a reasonable expectation of earning a pre-tax profit.

Taxpayers need to minimize uncertainty in planning transactions, and uncertain application of the tax laws makes it impossible for taxpayers to plan for the future and they are generally entitled to make business plans in reliance on the tax laws as written, without being second-guessed because of their desire to structure the transaction in a way that minimizes their tax obligations.

To minimize the adverse impact on taxpayers and the economy, courts should be circumspect in their invocation of the "economic substance" doctrine.

ARGUMENT

I. The Economic Substance Doctrine Should Not Be Applied Because Congress Has Expressed Its Clear Intent Regarding Foreign Tax Credits.

The decision below rests entirely on the District Court's application of the judge-made "economic substance" doctrine, under which, even if a taxpayer complies with every statutory and regulatory requirement of the tax laws, a court may later deprive it of benefits to which it would otherwise be entitled. (SPA3). If applied broadly, the economic substance doctrine would necessarily create great uncertainty for taxpayers.

A. The Economic Substance Doctrine Is Inapplicable to the Foreign Tax Credit Because Congress Has Expressed a Clear Intention To Avoid Double Taxation of Foreign Income.

The tax benefit at issue in this case is a foreign tax credit claimed by AIG. The effect of the claimed credit was to prevent AIG from being subject to double taxation – once by the country in which its foreign affiliate was domiciled and once by the United States. It is undisputed that AIG actually paid taxes on the relevant income in the foreign countries and complied with the statutory and regulatory requirements to receive the tax credit. (*See* AIG Brief at 11.)

The Supreme Court and this Court have repeatedly held that Congress intended through the foreign tax credit to avoid double taxation. *See*, *e.g.*, *United States v. Goodyear Tire & Rubber Co.*, 493 U.S. 132, 135 (1989) ("[T]he primary design of

the [foreign tax credit] was to mitigate the evil of double taxation."); *see also PPL Corp. v. Comm'r*, 133 S. Ct. 1897, 1901 n.2 (2013); *Kraft Gen. Foods v. Iowa Dep't of Rev. & Fin.*, 505 U.S. 71, 73 (1992) ("[T]he foreign tax credit is intended to mitigate multiple taxation of corporate earnings."); *United States v. Goodyear Tire & Rubber Co.*, 493 U.S. 132, 139 (1989) (the "credit was intended to protect a domestic parent from double taxation"). "[T]he credit protects domestic corporations that operate through foreign subsidiaries from double taxation of the same income.", *United States v. Campbell*, 351 F.2d 336, 339 (2d Cir. 1965) ("The purpose of the foreign tax credit is to prevent double taxation of income which United States citizens earn abroad." (internal quotation marks omitted)).

Congress and the Treasury have carefully delineated the proper scope of the foreign tax credit through a complex and highly articulated set of statutes, regulations and rulings. *See, e.g.*, 26 U.S.C. § 901(b)(1); Treas. Reg. § 1.901-2(a)(1)-(3); Treas. Reg. § 1.901-2(e)(5); Treas. Reg. § 1.901-2(f)(1); Treas. Reg. § 1.905-2(a)(2). The foreign tax credit code sections and Treasury regulations have been described by one scholar as "a byzantine structure of staggering complexity." *See* Boris I. Bittker & James Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 15.21[1][a] (7th ed. Supp. 2014).

The Internal Revenue Code Internal foreign tax credit sections and relevant Treasury regulations are designed to allow the U.S. taxpayer to structure its business

transactions as it chooses, even if that choice subjects the taxpayer to foreign tax. Indeed, the foreign tax credit is intended to make international business of U.S. companies "tax neutral."[4] The Joint Committee on Taxation's explanation of the "economic substance" rules adopted in 2010, section 7701(o), makes clear that a U.S. taxpayer is free to operate through a foreign subsidiary and to fund its activities from sources that may be nondeductible for foreign tax purposes.[5] From a U.S. tax law perspective it is not problematic for a U.S. borrower to use a foreign subsidiary to obtain funding from a foreign lender, without the benefit of an interest deduction, and then to invest the proceeds, even though the income from the investment becomes subject to foreign taxation.[6] As this Court observed," Congress never intended for the

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[4] "A taxpayer is not required to alter its form of doing business, its business conduct or the form of any business transaction in order to reduce its liability under foreign law for tax." Reg. section 1.901-2(e)(5)(i).

[5] "The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, *merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages*. Among these basic transactions are (1) the choice between capitalizing a business enterprise with debt or equity; (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment." Joint Committee on Taxation, "Technical Explanation of the Revenue Provisions of the Reconciliation Act of 2010, as Amended, in Combination with the Patient Protection and Affordable Care Act," JCX-18-10, at 152-153 (2010) (emphasis supplied, footnotes omitted).

[6] In 2003 the IRS chief counsel stated: "We all know that cross-border activities are vital to our economy. They necessarily involve two tax authorities and we can expect from time to time inconsistent treatment of tax items or structures by

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"entire [Internal Revenue] Code," *sub silentio*, "to deprive the taxpayer in each case of freedom to choose between legal forms similar in a broad economic sense but having disparate tax consequences." *Nassau Lens Co. v. Comm'r*, 308 F.2d 39, 44-46 (2d Cir. 1962).

Congress has repeatedly supplemented and revised the foreign tax credit regime to address transactions that Congress determined to be problematic. *See* Bittker & Eustice, *supra*, ¶ 15.21[1][a]. Courts should not apply the economic substance doctrine when the statute or regulation reflects a history of detailed consideration by Congress or the Treasury and frequent revisions to accommodate new situations.[7]

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[6](...continued)
the Internal Revenue Code as compared to the tax law of a foreign country. We are confident in the principles and integrity of our tax law and, unless the law requires otherwise, we will determine the appropriate tax treatment of an item based solely on the application of U.S. tax law. In certain cases, Congress has provided that the U.S. tax treatment of a transaction be determined through an analysis that, to some degree, takes into account the foreign tax treatment of the transaction. . . .Where there is no statutory mandate, however, we will determine the U.S. treatment of the transaction by applying the appropriate U.S. tax principles. B. John Williams, Jr., Chief Counsel, IRS, ''Selected International Tax Issues,'' at 9-10 (Mar. 20, 2003)

[7] The courts "are bound by the meaning of the words used by Congress, taken in light of the pertinent legislative history," *Hanover Bank v. Commissioner*, 369 U.S. 672, 682 (1962), and it "is not within [the judiciary's] province" "to do what the legislative branch. . . failed to do or elected not to do."). *Id*. at 688. If these borrowing transactions are a problem, the appropriate way to address foreign tax credits in such transactions is to amend the law so as to adjust the foreign tax credit regulations. Congress essentially did that in the withholding tax area following *Compaq* and *IES*.

Congress would not have granted broad judicial discretion to negate the foreign tax credit's fundamental purpose and impose double taxation by using an "economic substance" analysis to fundamentally alter such an articulated statutory regime. Courts, like administrative agencies, should "exercise discretion only in the interstices created by statutory silence or ambiguity; they must always 'give effect to the unambiguously expressed intent of Congress.'" *Utility Air Regulatory Group v. Environmental Protection Agency, et al.*, 573 U.S. ___, slip. op. at 24 (June 23, 2014) (citation omitted).

The District Court's application of the economic substance doctrine to override the clearly expressed congressional intent to avoid double taxation was inappropriate. The economic substance doctrine is a rule of statutory construction whose purpose is to further legislative intent – to assess "whether what was done . . . was the thing which the statute intended." *Gregory v. Helvering*, 293 U.S. 465, 469 (1935); *see also Frank Lyon Co. v. United States*, 435 U.S. 561, 583-84 (1978).

The economic substance doctrine has the effect of overriding statutory law through a *post hoc* judicial redetermination of tax consequences. The Supreme Court and this Court have confirmed that the doctrine should apply only to a narrow category of cases, when the taxpayer entered into a transaction in which there was "*nothing* of substance to be realized" "beyond a tax deduction." *Knetsch v. United States*, 364 U.S. 361, 366 (1960) (emphasis added). This Court has held that for a

transaction to lack economic substance, there must be "*no* reasonable possibility" of profiting from it; the taxpayer must have "*no* business purpose" for engaging in it; the transaction "*can not* with reason be said to have purpose, substance, or utility apart from [its] anticipated tax consequences"; or the transaction must not have "*any* practicable economic effects other than the creation of income tax losses." *United States v. Coplan*, 703 F.3d 46, 90-92 (2d Cir. 2012), *cert. denied*, 134 S. Ct. 71 (2013) (emphases added) (quoting *Lee v. Comm'r*, 155 F.3d 584, 586 (2d Cir. 1998) and *Jacobson v. Comm'r*, 915 F.2d 832, 837 (2d Cir. 1990)).

The U.S. foreign tax credit system is designed to make a U.S. taxpayer indifferent to whether it is subject to foreign tax if it is allowed to use a foreign tax credit, but the taxpayer must comply with very complex limitations that put a cap on the amount of credit that may be claimed. In other words, the U.S. tax system accommodates the imposition of foreign tax and treats it like a U.S. tax, so long as the U.S. taxpayer had legal liability to pay the foreign tax and in fact did so. The taxpayer can then use the foreign tax as a credit once the various limitations of the foreign tax credit regime are applied. In this case there is no dispute that AIG's foreign affiliates paid foreign taxes. (A356-58; A4652-53). There also is no dispute that AIG reported the income from these same transactions for U.S. tax purposes, measured in accordance with federal tax law. (A5863; A5871; A5880-81; A5888-89; A5896;

A5903-04). The Government argues that the foreign tax was indirectly "refunded" to AIG through a reduced interest rate charged by the foreign bank.

II. The District Court Erred In Considering Foreign Taxes Paid As "Costs" In Calculating Whether A Transaction Is Profitable.

In its economic substance analysis, the core question that the District Court should have examined was whether the transactions created a reasonable opportunity for economic profit. The key to the transactions was the disparate treatment of the sales of the preferred shares: while they were treated as loans for U.S. tax purposes, they were treated as sales by tax laws of the foreign jurisdictions in which the lenders (and AIG's affiliates) were located.

The District Court held that AIG's calculation of anticipated profit "does not, however, exclude the effects of the tax-exempt status of the lender's dividend" and "the lender bank shared this benefit with AIG-FP by giving AIG-FP a more favorable dividend rate." (SPA13). The District Court then noted that the Government's expert's analysis concluded that "AIG-FP's ability to 'borrow' at sub-market rates" was the result of "transaction terms which included AIG-FP paying the counterparties a tax-affected dividend rate" (SPA14) and that AIG-FP's cost of borrowing would have roughly equaled its return on the investment income if the AIG affiliate's distribution had been taxable, "netting no gain" for AIG. (SPA14-15). The District Court then found that the tax-exempt treatment of payments to the lending banks

"shaped the transactions" (SPA15) and AIG would have enjoyed no profit from the transactions if the distributions had been taxable. (SPA-16). But this is not the same as proof that the transaction "'has no business purpose or economic effect other than the creation of tax' benefits." (SPA10-11, citing *Nicole Rose Corp. v. Comm'r*, 320 F.3d 282, 284 (2d Cir. 2003)).

We submit that the district court incorrectly ignored the economics of the AIG's interest savings as a "tax effect" and incorrectly applied U.S. tax principles. Implicit in the district court's analysis is the belief that "foreign taxes" are "transaction costs" that should be *included* in the "non-tax" analysis. This, however, is inconsistent with the rationale of *Compaq Computer Corp. v. Comm'r*, 277 F.3d 778 (5th Cir. 2001) and *IES Indus., Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001)).[8]

The Fifth and the Eighth Circuits rejected the Government's argument that pre-tax profit should be computed using the dividend amount net of the withholding tax,

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[8] Both *Compaq* and *IES* concluded that the taxpayer had earned a pre-tax profit from its purchase and sale of American Depository Receipts ("ADRs"), notwithstanding the Government's argument that the taxpayer's profit calculation reflected a reduced purchase price attributable to the seller's tax-exempt status. The taxpayers in *Compaq* and *IES* effectively bought foreign securities at a discount, because the purchase price reflected the economic effect of paying foreign withholding tax but not the effect of U.S. tax benefits (because the ADR sellers, which were tax exempt entities, would not have been able to claim credits for that foreign tax).

because the taxpayers were legally entitled to the entire dividend and were required to treat the entire dividend as income on their income tax returns. *See IES*, 253 F.3d at 354; *Compaq*, 277 F.3d at 784. The courts in those cases held that the entire amount of the dividend was likewise income for purposes of the pre-tax-profit calculation because the entire amount of the dividend had to be reported as income for U.S. tax reporting purposes. *See, e.g., IES*, 253 F.3d at 354.

In this case, as in *Compaq* and *IES*, the amounts that AIG included in its pre-tax profit calculation are the amounts it was legally entitled to receive and legally required to pay as a result of the transaction. These are also the amounts it was required to report on its U.S. tax return. AIG was entitled to deduct only its actual interest expense, not the amount the lender banks *might have* charged if the dividends had been taxable to them. *See* 26 U.S.C. § 163(a) (interest deduction limited to amount of interest "paid or accrued"). The district court's reasoning, however, imputed to AIG a higher interest cost – one "grossed up" to adjust for the lenders' foreign tax exemptions. That sort of inconsistent treatment was rejected by the circuit courts in *Compaq* and *IES.*

The district court found that the payment of tax-exempt dividends to the foreign banks, as opposed to taxable interest, resulted in a "tax impact" that had to be removed from the transaction in determining pre-tax profit. Since the "tax impact" was derived from additional foreign tax paid by AIG's affiliates, eliminating the "tax

impact" effectively required AIG to deduct foreign taxes as "costs" in determining pre-tax profit.[9]

The district court held that the calculation of "profit" should exclude the effects of the tax exempt status of the lender's dividend. (SPA 13-15). Quoting at length from deposition testimony by an AIG employee, the court reasoned that the parties contemplated that the dividend rate was lower than the rate that AIG would have been required to pay the foreign bank as taxable interest and that this savings was shared between the parties, allowing AIG to earn a profitable pre-tax spread. *Id*. The court held that this was a "tax impact" that shaped the transaction and needed to be removed in considering pre-tax profit.[10]

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[9] New Section 7701(o)(2)(B), which was not applicable when the transactions at issue in this case were consummated, provides that "[t]he Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases," but no regulations have been issued.

[10] Virtually all complex, sophisticated corporate transactions involve consideration of tax effects. The fact that the taxpayer calculates the tax implications and benefits early on in designing the transaction should not defeat a business purpose claim. *See* S. Trivedi, *Practitioners Examine Economic Substance in Tax Shelter Cases*, 394 Tax Notes 392 (January 23, 2012). Any transaction that involves tax planning is likely to have one or more aspects or elements that are tax motivated and serve no non-tax purpose even though the transaction as a whole serves legitimate business purpose and achieves non-tax benefits for the taxpayer. S*ee* J. F. Prusiecki, *Coltec: A Case of Misdirected Analysis of Economic Substance*, 112 Tax Notes 524, 527 (Aug. 7, 2006). Tax planning by sophisticated taxpayers, including most large companies, frequently involves structuring economically significant transactions to minimize tax burdens and to reap non-tax economic benefits, and it is a taxpayer's "legal right. . .to decrease the amount of what otherwise would be his
(continued...)

For the purposes of deciding AIG's motion for partial summary judgment, the district court credited the Government's expert's conclusion that, absent the foreign banks' tax savings, AIG's cost of borrowing would have roughly equaled its return on investment and the transactions resulted in no net gain. The district court in effect required the pre-tax profit of the transactions to be measured by reference to the hypothetical result that *might have* occurred had foreign tax characterization of the transactions been the same as the U.S. tax law characterization of them. Thus the tax impact was analyzed based on third parties' tax liability, not on AIG's own tax liability.[11]

We believe it is incorrect and unprecedented for the *foreign* tax treatment of a third party who is not a U.S. taxpayer to affect the determination of whether an unrelated U.S. taxpayer had a reasonable expectation of earning a pre-tax profit.

Further, it was inappropriate to "gross up" tax exempt income (by computing an economically equivalent amount of taxable income) in determining the transactions' pre-tax profitability for purposes of the objective test of economic

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[10](...continued)
taxes, or altogether avoid them, by means which the law permits. . . ." *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

[11] The district court determined that there was a genuine dispute as to whether AIG had a pre-tax profit and denied AIG's summary judgment motion.

substance, particularly where the direct benefits of such exemption are not at issue.[12] By requiring the foreign banks' dividends to be "grossed up" to approximate a comparable rate of taxable interest, the district court increased AIG's expenses and correspondingly reduced its pre-tax profitability. In prior cases, the question of whether to gross up tax-exempt income has arisen where the taxpayer was the recipient of such income and grossing up would benefit the taxpayer by increasing its pre-tax profits. At least one court has ruled that, in the area of employer-owned life insurance plans, it is inappropriate to gross up a taxpayer's tax-exempt receipts in determining whether the plan at issue "makes sense economically." *In re CM Holdings*, 301 F.3d 96, 105 (3d Cir. 2002). Neither the exempt nature of the underlying investments nor the benefits received by the taxpayer from them were in question, and the Third Circuit noted that the "point of the analysis is to remove from consideration the challenged tax deduction." *Id*.

The IRS and the court below concluded that the only reason AIG was willing to enter into the transactions in which it received a substantial interest saving and paid an incremental foreign tax was that AIG counted on a foreign tax credit for the

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[12] In *Coplan*, 703 F.3d 46, 91-92 this Court reaffirmed that the relevant question is whether the transaction had a purpose "apart from [its] anticipated tax *consequences*." (quoting *Lee v. Comm'r*, 155 F.3d 584, 586; emphasis supplied). There is no basis for the Tax Court to subdivide "tax consequences" into "benefits" that can trigger the economic substance doctrine and "costs" that it can ignore. *See Compaq*, 277 F.3d at 785.

foreign tax it paid because without the foreign tax credit the transactions would not be economic. Even if that were the case, it doesn't mean that the transactions were "tax motivated."

Should a transaction be considered "tax motivated" if it would be non-economic without the foreign tax credit? One obvious answer is "When would that ever *not* be the case?" If without the foreign tax credit the transaction would result in a loss, a rational taxpayer would not enter into it, or the transaction would be restructured. A transaction is not "tax motivated" and should not be disallowed under the "economic substance" rule simply because the taxpayer would not do it without a foreign tax credit. The district court's analysis would eviscerate the central purpose of the foreign tax credit.

Should the U.S. borrower's pre-tax benefit be reduced by the foreign tax paid under the economic substance "for-profit test," as the district court did in this case? We submit it should not, because that approach is inconsistent with the tax-neutrality principles underlying the foreign tax credit provisions of the Code.

It was the stated intent of Congress to treat foreign income taxes as if they had been imposed by the United States; the House Ways and Means Committee explained that the foreign tax credit "*in effect treats the taxes imposed by the foreign country as if they were imposed by the United States*" (H.R. Rep. No. 83-1337 at 76 (1954) (emphasis supplied). Foreign tax is the equivalent of, and a surrogate for, U.S. tax.

To the extent a foreign tax survives the limitations and other restrictions in the foreign tax credit regime, that foreign tax should be treated no differently from a U.S. tax for which it is viewed as a creditable substitute.

Foreign taxes should not be treated as a pre-tax cost of a transaction under the economic substance doctrine because U.S. taxes are not so treated. To be consistent, the analysis should either count all tax law effects or not count any of them. If the effects of tax law, domestic or foreign, are to be accounted for when they subtract from a transaction's net cash flow, tax law effects should be counted when they add to net cash flow. Both *Compa*q and *IES* concluded that profit motive and business purpose are determined by treating foreign tax in the same manner as U.S. tax, because foreign tax is appropriately treated as a surrogate or substitute for U.S. tax. The Fifth and Eighth Circuits held that courts must calculate pre-tax profitability before deducting any taxes, regardless of whether they are U.S. or foreign taxes. *Compaq*, 277 F.3d at 784-86; *see also IES Indus., Inc. v. United States*, 253 F.3d 350,

354 (8th Cir. 2001).[13] To count foreign taxes only when they subtract from cash flow stacks the deck against finding a transaction profitable. *Id*.

The essence of those decisions is that U.S. tax law measures profitability based on whether there is taxable income using general tax principles; those principles do not treat U.S. taxes as a cost and foreign taxes that substitute for U.S. taxes should not treated as a cost. The Fifth Circuit explicitly rejected the inconsistent treatment of the U.S. tax and the foreign tax in applying the profit test. This Court should decide this issue as the Fifth and Eighth circuits did. We have found no case law, prior to the district court's decision below, that has used "taxable income" as determined under U.S. tax principles as a measure of pre-tax profit.

The district court's decision effectively requires the taxpayer to deduct foreign taxes in determining pre-tax profit, based on a novel analysis looking at the non-U.S. tax treatment of non-U.S. taxpayers whose liabilities are not at issue in the case. If the decision stands, it would represent a new and significant complication for taxpayers

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[13] The courts in *In re CM Holdings, Inc*., 301 F.3d 96, 106 (3d Cir. 2002); *Am. Elec. Power Co. v. United States*, 326 F.3d 737, 743-44 (6th Cir. 2003) applied the economic substance doctrine in the context of interest deductions claimed by corporate taxpayers in connection with corporate-owned life-insurance transactions. The taxpayers involved argued that certain receipts should be "grossed-up" to adjust for the fact that they were exempt from tax. That argument was rejected because "grossing up tax-favored income is not a correct financial method to analyze the economic substance of the transaction because a gross-up does not reflect the actual cash flows of an investment." *In re CM Holdings*, 301 F.3d at 105.

considering transactions that generate excess foreign tax credits or any transaction that involves tax benefits for unrelated participants.

III. The District Court's Application Of The "Economic Substance" Doctrine Vitiates The Predictability In Application Of The Tax Laws On Which Taxpayers Are Entitled To Rely.

Taxpayers are generally entitled to make business plans in reliance on the tax laws as written, without being second-guessed because of their desire to structure the transaction in a way that minimizes their tax obligations. *See Gregory v. Helvering*, 293 U.S. 465, 469 (1935) ("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."). A broad interpretation of the economic substance doctrine, in contrast, would "empower the Commissioner. . .to make *ad hoc* attacks on a whole variety of transactions" that are within the letter of the law. *Nassau Lens Co.*, 308 F.3d 39, 46 (2d Cir. 1962).

Taxpayers need to minimize uncertainty in planning transactions, and uncertain application of the tax laws makes it impossible for taxpayers to plan for the future. To minimize the adverse impact on taxpayers and the economy, courts should be circumspect in their invocation of the "economic substance" doctrine. The Supreme Court has recognized the need for taxpayers to have certainty and predictability in the application of tax laws. "[I]n tax law," the Supreme Court has emphasized, "certainty is desirable." *United States v. Generes*, 405 U.S. 93, 105 (1972); *see also Thor Power*

Tool Co. v. Comm'r, 439 U.S. 522, 543 (1979). The Supreme Court has recently recognized that businesses find predictability "valuable [when] making business and investment decisions." *Hertz Corp. v. Friend*, 559 U.S. 77, 94 (2010); *Daimler AG v. Bauman*, 134 S.Ct. 746, 760 (2014) (in the context of jurisdictional rules).

The Treasury Department acknowledged in a report to Congress that courts have applied the economic substance principle "unevenly" and that "a great deal of uncertainty exists as to when and to what extent these standards apply, how they apply, and how taxpayers may rebut their assertions" and that the principle (as applied) is subjective. Dep't of the Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals* 94 (July 1999), *available at* http://www.treasury.gov/resource-center/tax-policy/ Documents/ctswhite.pdf. One commentator has described the economic substance doctrine as akin to a "smell test." *See* L. Lederman, *W(h)ither Economic Substance?*, 95 Iowa L. Rev. 389, 392 (2010). A leading treatise on tax law described the economic substance and related doctrines as "exquisitely uncertain." Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 4.3.1 & n.8 (2013).

The district court's expansive and amorphous standard, combined with the contrary application of the doctrine by the Fifth and Eighth circuits, creates legal uncertainty that has a deleterious effect on business, commerce and investment.

CONCLUSION

For the foregoing reasons, *amicus curiae* urges the Court to reverse the order of the district court and remand for the entry of partial summary judgment in AIG's favor.

July 7, 2014

Respectfully submitted,

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Certificate of Compliance with Federal Rule of Appellate Procedure 32(a)

American International Group v. United States, No. 14-0765-cv

I certify that this brief complies with the type-volume limits set forth at Rule 32(a)(7)(B) of the Federal Rules of Appellate Procedure, and contains **6,112** words, excluding the parts of the brief exempted by the rule. as determined by WordPerfect X5, the computer program used to prepare this brief.

This brief complies with the typeface requirements of FRAP 32(a)(5) and the type-style requirements of FRAP 32(a)(6); it has been prepared in proportionately spaced typeface using WordPerfect X5 in 14-point Times New Roman font.

Dated: July 7, 2014

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CERTIFICATE OF SERVICE

American International Group v. United States, No. 14-0765-cv

I hereby certify that on July 7, 2014 I electronically filed the foregoing Brief *Amicus Curiae* of Atlantic Legal Foundation in Support of Plaintiff-Appellant with the Clerk of the Court for the United States Court of Appeals for the Second Circuit by using the appellate CM/ECF system.

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