The Foreign Tax Credit Diaries — Litigation Run Amok

by Kevin Dolan

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I don’t know why I’m writing an article. I’m supposed to be semi-retired, composing music that no one but me will ever hear. And I well understand that nothing anyone says at this point will matter. The government litigators certainly won’t change anything they are doing. From their perspective, they are in a holy war and have actually won a skirmish or two; judges presumably don’t read articles; and private sector litigators seem interested in making controversies into big cases that appear to be far more complicated than they really are.

But the current foreign tax credit litigations seem to have gotten so very far off the rails — frankly, on both sides. The parties and courts are manhandling an area of tax law — the FTC — that has stood the test of time and doesn’t deserve to be manhandled and tossed aside in the name of expediency. So one more article seems to have bubbled up to the surface.

The cases I’m talking about are what I call the FTC “borrowing” cases in which a U.S. taxpayer borrows from a foreign lender and incurs foreign tax in the process. BONY-Mellon has resulted in a Tax Court decision,\(^1\) the AIG case has resulted in a district court decision on a summary judgment motion,\(^2\) and similar cases are docketed or are otherwise moving through the pipeline.\(^3\)

In some situations, the U.S. borrower is already operating in the foreign lender’s country through a foreign subsidiary. The foreign subsidiary borrows from the foreign lender in a form that is treated as equity and, therefore, is nondeductible for foreign tax purposes. The U.S. borrower does that because the foreign lender gets a foreign tax break on what it earns (dividends for foreign tax purposes) and is willing to pass back some of its foreign tax savings to the U.S. borrower through a lower interest rate. But because it’s equity for foreign tax purposes, the U.S. borrower loses an interest deduction. So the foreign subsidiary’s foreign tax payments go up, and the U.S. borrower claims an FTC for that incremental tax.

In other situations, the U.S. borrower does not have a preexisting operating subsidiary in the foreign lender’s country. So the U.S. borrower sets up a local country subsidiary that borrows from the foreign lender and uses that funding to acquire assets off of its U.S. parent’s balance sheet — assets that the U.S. parent would otherwise own and for which it needs funding — or lends the proceeds to the U.S. parent to fund those assets. In that circumstance, the income generated from the assets funded with the borrowing becomes subject to foreign tax without the benefit of a foreign interest

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\(^3\) For reasons explained in note 29 infra, Hewlett Packard and Pritired are different, and the government’s successes in those (Footnote continued in next column.)
deduction because, again, the U.S. borrower borrows in a form that is nondeductible equity for foreign tax purposes.

In both situations, the U.S. borrower participates in various machinations designed by the foreign lender to give the foreign lender its foreign tax break. The essence of most structures is that the foreign lender invests in stock issued by the U.S. borrower’s foreign subsidiary that nominally pays dividends that are tax exempt to the foreign lender. But the arrangement is really a financing, because the U.S. borrower is required to purchase the stock at a later time from the foreign lender for an amount equal to the principal amount of the foreign lender’s investment in the stock plus the agreed-upon interest yield (with a credit for dividends paid).

We’ll go through a simple example later, but assume that the economics of the structure are somewhat like the following:

- Absent the foreign lender's foreign tax benefit, it would lend $1 billion at 5 percent. Because under the structure the foreign lender is tax exempt on what it earns, it instead lends at 4 percent. That’s an interest cost savings to the U.S. borrower of $10 million per year (1 percent x $1 billion).
- But the U.S. borrower doesn’t get the $50 million annual deduction (5 percent x $1 billion) for the interest that it would pay if it borrowed at 5 percent in a normal borrowing in which the foreign lender doesn’t get a foreign tax benefit.
- If we assume a foreign tax rate of 30 percent to make the math easy, the U.S. borrower incurs $15 million of incremental foreign tax per year (30 percent x $50 million) while receiving a $10 million annual interest savings. Obviously the U.S. borrower wouldn’t do that if it didn’t believe that it would receive an FTC for the $15 million of foreign tax.

So what is the government’s strategy in these cases? The starting point, as everyone should understand, is that the government lost Compaq and IES — in particular on the issue of whether foreign taxes have to be deducted in determining profit motive. Those cases both involved essentially simultaneous purchases and resales — as little as 15 minutes apart — by the U.S. taxpayer of American depositary receipts (ADRs) in dividend-paying stock of Dutch companies. The taxpayer purchased the ADRs from an investment bank for settlement before the dividend record date, giving it the right to receive dividends that were subject to Dutch withholding tax. A few minutes later, the taxpayer sold the ADRs back to the same investment bank, but for settlement after the dividend record date. Because the taxpayer purchased the ADRs pregnant with (and received) a dividend and sold the ADRs back without the right to the dividend, it had a loss on the resale equal to the net amount of the dividend (that is, the gross dividend net of the Dutch withholding tax). So the taxpayer included the gross dividend, claimed an FTC for the Dutch withholding tax, and claimed a loss approximating the net dividend.

The government might have prevailed had it focused on the taxpayer’s loss from the transactions and not on the FTC, worked harder to convince the courts that the 15-minute transactions were not real, and argued that the economic substance doctrine, as applied to Mrs. Goldstein, should be applied to deny the loss. Instead, the government decided to argue that foreign tax expenditures should be taken into account in reducing the pretax profit or benefit from a transaction (let’s call that “the Compaq issue”). The courts in those cases correctly resisted the government’s invitation to muck up the FTC rules, although they did so by concluding, with blinders on, that the underlying transactions were real.

In its more recent forays, the government has continued to pursue the Compaq issue in one form or another but has layered onto its Compaq argumentation a new theory, woven from thin air, that enables it potentially either to sidestep the Compaq issue or to soften judges up to the point at which they will buy into the government’s position on the Compaq issue (the government calls that new theory the “tax effect” argument).

As to the Compaq issue, the government’s case consists principally of wasting the taxpayers’ money to establish the obvious — that the transaction that caused the foreign tax to be imposed makes sense only if the taxpayer gets an FTC and that the taxpayer wouldn’t have done the transaction absent the FTC. In the words of the American adolescent, “No duh.” The government then argues that this monumental conclusion demonstrates that the taxpayer had an ill motive (that is, nonbusiness purpose) that requires the economic substance doctrine to step in and save the day. So the government’s strategy is to focus on the obvious — that the transaction wouldn’t happen without the FTC — translate that to “tax-motivated transaction,” and end the story there, so that the courts will be relieved from having to worry about what the law actually says. To that strategic end, the government has engaged in tactics reminiscent of Eliot Spitzer and littered its briefs with near-salacious snippets from e-mails and other taxpayer documents that make the taxpayer statements that an FTC was essential to the transaction appear to be ill motivation when they merely state reality.

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4Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001); IES Industries Inc. v. United States, 253 F.3d 350 (8th Cir. 2001).

5Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966).
The government has reinforced its tax motivation argument by making specific aspects of the transactions, which are clearly not problematic under the FTC rules and should be "so what's," sound nefarious and perhaps even conspiratorial.

The government argues that borrowing in a form that doesn't give the U.S. borrower a foreign interest deduction is a self-inflicted wound. But, as discussed below, the FTC rules explicitly do not require taxpayers to avoid affirmatively subjecting themselves to foreign taxation — one is allowed to "break into jail." And here the U.S. borrower is suffering incremental foreign tax for a good reason — to get lower-cost funding.

The government argues that the transactions are tax motivated because the U.S. borrower is participating in all sorts of shenanigans merely to enable the foreign lender to get a foreign tax break. And to make matters worse, the foreign tax treatment is inconsistent with the U.S. tax characterization of the transaction. But, as discussed below, helping the foreign lender achieve a foreign tax break cannot make a transaction tax motivated for U.S. tax purposes, and the fact that U.S. tax law characterizes the transaction differently from foreign tax law is irrelevant and merely reflects the foreign lender's foreign tax motivation.

The government's coup de grâce is its new tax effect argument — that the transaction is nothing but a plot, motivated solely by tax, whereby the U.S. taxpayer pays foreign tax, its foreign counterparty gets that foreign tax back, and then the foreign counterparty splits the tax it gets back with the U.S. taxpayer. Thus, the U.S. taxpayer's interest savings is merely a kickback or rebate of the foreign tax paid by the U.S. taxpayer. The follow-ons from the tax effect argument are several:

- No tax ends up having been collected by the foreign government. Therefore, no tax has been paid to the foreign government. Therefore, there is no tax to be claimed by the U.S. borrower as an FTC.
- If the U.S. borrower's interest saving is merely a pass-back of a refund of the foreign tax paid by the U.S. borrower, by definition that amount is not really an interest savings and therefore can't be taken into account in determining whether the U.S. borrower has a pretax profit or benefit. The economic benefit (the interest savings) that the U.S. taxpayer has been relying on to demonstrate the nontax purpose of the transaction becomes tainted as a "tax effect" and, as such, can be ignored.
- Although more amorphous, the government seems to be saying that the fact that the transaction has been intentionally structured to reduce the foreign counterparty's tax and to pass back to the U.S. taxpayer a portion of the foreign counterparty's tax benefit demonstrates that the transaction is tax motivated, and, for that reason, requires the disallowance of the FTC.

What the government is really doing with its tax effect argument is pushing a novel approach for measuring pretax profit under the economic substance test in a way that allows it to sidestep the Compaq issue as to the treatment of foreign taxes. If the government cannot win the economic substance issue — the for-profit test — by arguing that the foreign tax should be treated as an expense in computing the taxpayer's pretax profit or benefit from a transaction, perhaps it can win if it convinces a court to disregard the interest savings in computing the pretax profit or benefit.

At least a couple of courts appear to have taken the government's bait — hook, line, and sinker. Once a judge buys into the notion that accommodating the foreign counterparty's foreign tax planning and sharing in the foreign counterparty's foreign tax saving is nefarious, the case becomes easy. The court can simply conclude that the transaction is tax motivated (even though the tax motivation is a foreign tax motivation of the foreign lender). And to counter a taxpayer argument that it satisfies the economic substance test adopted in Compaq and IES, the court can ignore the economics of the U.S. taxpayer's interest savings as a "tax effect." It can all be made to look so bad that the courts don't even have to bother trying to parse through the law. But if they can get past the government's histrionics and make the effort to parse through the law, they would have to conclude that the emperor has no clothes. It's much easier to simply conclude that the taxpayer is doing evil things, apply the economic substance doctrine, and call it a day.

How the government goes about fixing a problem is important. The government is supposed to be the protector of the integrity of the tax system. As some folks told the government over a decade ago, the appropriate way to address FTCs arising in borrowing transactions is to fix the FTC limitations. The government essentially did that in the withholding tax area following its losses in Compaq and IES. For other foreign taxes, it instead issued prospective regulations that have no underlying conceptual or legal construct and essentially say that if a transaction has too many features that the government doesn't like, it's bad, even if none of those features is itself problematic. For existing cases, someone who had the power to make the call apparently decided to throw them into the courts, using that same approach, and let come what may.

The "come what may" is that the government litigators are obfuscating the real issue by throwing up a

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6Section 901(j) simply makes dividend withholding taxes non-creditable in some circumstances instead of subjecting those taxes to the FTC limitation, under which foreign taxes that are not used as credits in the current year can be carried over to other tax years.

haze of irrelevant nonsense based on meritless legal arguments to make these cases appear so stinky that the courts will whack them with the economic substance doctrine. The government lawyers shouldn't be faulted for what they are doing. Their mandate is to win cases, and to their credit, their briefs are really good to the point that taxpayers should be very worried. It's up to the courts to understand that the government's position has no underlying conceptual integrity and that buying into it will lead to result-oriented decisions that mangle the tax law. But at least some courts have been unable to see through the smoke or are so result-oriented that they haven't tried.

For the most part, the taxpayers' litigation counsel don't seem to be helping matters. They are participating in litigating factual issues that are irrelevant (instead of conceding them), have been unsuccessful in getting courts to understand that the factual issues are irrelevant and that it's all about the law, or are trying to win the war by arguing that economic substance can never apply to the FTC under any circumstance instead of arguing that it shouldn't be applied to the case before them. They seem to let the government control the dialogue by going tit for tat with the government on an endless number of micro-issues, and addressing the government's arguments with lengthy law review quality responses that give them more merit than they deserve, rather than stepping back and trying to get the courts to understand in simple terms what is really going on in these cases. If a court is told that there are complex factual issues and dozens of legal issues that have to be resolved before a taxpayer can win a case, the court might reasonably assume that the taxpayer must have done something wrong. Otherwise why would a taxpayer's counsel feel the need to file hundreds of pages of substantive briefs trying to convince the judge that the taxpayer is right? Where there's smoke . . .

Given the smoke bombs (and stink bombs) that the government has been setting off and the private sector litigators' failure to clear the air, it's hard to simplify the current discourse. But let's try to do that in a pretend brief written by an imaginary litigator who tries to explain to an imaginary judge what's really going on. In an effort to make the discussion a bit less turgid, let's make our imaginary litigator a brash young attorney — an Owen Meany-type character, who speaks at the top of his lungs, writes in an inappropriately informal style, doesn't have much of a filter, and occasionally goes a bit over the top. In the end, though, it all boils down to the Compaq issue and the government's loss on that issue, which is the reason why the government is working so hard to make it appear that it's not really all about Compaq.

Dear Judge,

To try to ferret through all of this, let's focus on a simplified factual scenario, which is the essence of most of the FTC borrowing cases. A U.S. taxpayer is borrowing money to fund its day-to-day business operations. The government may be arguing that borrowing for this purpose is not a purposeful business activity, but can we all please agree that it is? (I'm not talking about borrowing to put the cash proceeds in a box to buy passive investments that the taxpayer doesn't want.) Although the transactions can be quite complicated in their detail, they are not complicated in their essence — the U.S. taxpayer is simply looking to obtain funding at the most favorable interest rate available. In a global economy, that means evaluating potential borrowing sources worldwide.

Preliminaries

There is only one real issue in this whole controversy, and it is a legal question: How does the economic substance "for profit" test apply to the FTC, if indeed it should apply to the FTC? More specifically, the question is whether foreign tax should be treated as an expense in computing the taxpayer's pretax profit or benefit. If you don't mind, I will refer to this as the "Compaq issue," since that was the issue decided in favor of the taxpayer in Compaq, as well as in IES. But the government has made, and continues to make, a number of ancillary arguments that are intended to make it look like the taxpayer is doing something really bad, so that you may never have to even get to the Compaq issue or, if you do, you will be ready to do anything to make sure that the taxpayer loses — including adopting a for-profit test that would deem non-profitable all transactions conducted in international commerce when a foreign tax is involved. So let's try to get those preliminary issues out of the way so that when we get to the main event, you will hopefully approach it with an open mind and realize that the only real issue in these cases is the Compaq issue and decide that the Fifth Circuit (in Compaq) and the Eighth Circuit (in IES) got it right as a matter of law.

Let's make this simple and assume that a foreign lender located in a real country with a real tax system (let's just randomly pick a country — say, the United Kingdom) proposes a magical structure to provide funding to a U.S. borrower that gives the foreign lender a U.K. tax break. In most cases, that tax break is a full or partial exemption, in one form or another, of the yield earned by the foreign lender on the funding. The foreign lender is very much like a U.S. investor in preferred stock in a domestic corporation who gets a partial tax exemption on dividends (through the dividends received deduction (DRD)) and passes some of that tax benefit back to the domestic issuer in the form of a lower coupon. What happens to the domestic issuer? It loses its interest deduction and pays more tax because it issues stock instead of debt.

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8Compaq, 277 F.3d 778.
9IES, 253 F.3d 350.
Similarly, the magical structure requires that the funding from the foreign lender be provided to a local borrower — that is, a subsidiary of the U.S. borrower that is located in the United Kingdom — in a form that doesn’t give the U.S. borrower’s U.K. subsidiary a foreign tax deduction for the yield paid on that funding. The reason for that typically is that, in order to get its foreign tax break, the foreign lender wants to be treated as owning stock in, and getting a dividend from, a local company that is receiving the funding. So the foreign lender buys preferred stock in the U.S. borrower’s U.K. subsidiary (U.K. CFC). The consequence of doing so in most borrowing transactions is that earnings on the foreign subsidiary’s (the U.S. borrower’s) investment of the funds obtained from the foreign lender are subject to foreign tax, and the amounts paid to the foreign lender (which are considered dividends for foreign tax purposes) don’t result in a foreign tax deduction that would reduce that tax.

**Government’s Self-Infliction Argument**

Foreign income taxes can be costly, so the U.S. borrower has to evaluate the U.S. tax consequences of incurring and paying that foreign tax. So the first question to be answered is whether it’s a problem that the U.S. borrower becomes subject to foreign tax (principally because it gets no foreign tax deduction for its funding cost) as a consequence of agreeing to this magical structure as a condition imposed by the foreign lender in order for the foreign lender to get its foreign tax benefit, which, in turn, is the only reason it’s willing to offer low-rate financing. The government calls this “self-infliction.”

The good news is that U.S. tax law contains an FTC system that generally is intended to make a U.S. taxpayer indifferent to whether it is subject to foreign tax — at least as to foreign taxes it is allowed to use under the really (and I mean really) complex limitations in the FTC rules. These limitations govern the amount of the permissible credit and are intended to address the precise “problem” that the government is attacking with the economic substance doctrine. In other words, the U.S. tax system accommodates the imposition of foreign tax, and treats it just like a U.S. tax, so long as the U.S. taxpayer has “room” to use the foreign tax as a credit once it applies the various limitations of the FTC regime that put a cap on the amount of credit that may be claimed by the taxpayer. Once foreign taxes are capped by those complex limitations, under the FTC rules enacted by Congress, that is the end of the matter.10

But is there some technical or policy reason outside the FTC rules why the U.S. taxpayer should not receive an FTC for an foreign tax that has run the gamut of the limitations established by Congress in those rules? These limitations have been written, analyzed, evaluated, and rewritten any number of times. Professionals spend entire careers mastering those rules. It would be hard to argue that they are not thorough and comprehensive.

It can’t matter that the foreign lender’s willingness to provide funding at a low rate depends on the foreign lender receiving a foreign tax benefit through the magical structure, even if the structure is to the U.S. borrower’s tax detriment. That happens all the time in the United States when a U.S. company issues nondeductible preferred stock instead of debt to domestic investors who are taxed beneficially on dividends. It doesn’t matter that the U.S. issuer is worse off from a U.S. tax perspective than if it had issued debt and obtained an interest deduction.

Similarly, it cannot be problematic that the U.S. borrower decides to use a foreign subsidiary to obtain funding from the foreign lender and invest the proceeds, even though the income from the assets funded with the proceeds of that funding becomes subject to foreign taxation without the benefit of an interest deduction. The FTC regulations tell us that the taxpayer is free to structure its affairs however it chooses, even if that choice subjects the taxpayer to foreign tax.11 And the Joint Committee on Taxation’s explanation of the economic substance rules adopted in section 7701(o) in 2010 makes clear that a U.S. taxpayer is free to operate in a foreign subsidiary if it so chooses and to fund itself with nondeductible funding for foreign tax purposes.12 So there can’t be any fundamental reason why a U.S. borrower cannot borrow in a foreign subsidiary on a nondeductible basis and use the borrowed funds in that foreign subsidiary either to purchase assets that are relevant in the U.S. borrower group’s business or to make an intercompany loan to the U.S. borrower group to fund its business operations.

10This assumes that the U.S. borrower had legal liability to pay the foreign tax and in fact did so. While those are indeed the facts, the government has made arguments to the effect that the foreign tax was indirectly refunded to the U.S. borrower. We’ll come back to that.

11"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).

12"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." JCT, “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) (footnotes omitted).
Government’s Smoke and Mirrors Argument

The government argues that by entering into the magical structure, the U.S. borrower has helped to manufacture a foreign tax benefit to the foreign lender using a series of transactional steps that are smoke and mirrors, even though the U.S. borrower ignores the smoke-and-mirror steps for U.S. tax purposes. What’s more, because the smoke and mirrors are somehow not ignored for foreign tax purposes, the U.S. and foreign tax treatments of the transaction are different. All of this demonstrates that the transaction is tax motivated.

With all deference, Your Honor, do we really need to discuss this? For sure the smoke and mirrors constitute tax planning that is being done for tax reasons — but it’s foreign tax planning for the foreign lender, not U.S. tax planning for the U.S. borrower.

In our simplified illustration, the foreign lender needs to be treated for foreign tax purposes as receiving dividends from the U.S. borrower’s U.K. CFC and not as receiving interest from the U.S. borrower, because the foreign lender doesn’t get a foreign tax break on interest income. But as a commercial matter, the foreign lender wants to be a lender. Its magical structure accomplishes both its tax and commercial objectives by making it appear to be an investor in preferred stock in the U.S. borrower’s U.K. CFC for foreign tax purposes, while preserving from a commercial and economic perspective the reality that it is just lending money to the U.S. borrower — in one form or another, the foreign lender has creditors’ rights with full recourse against the U.S. borrower.13 From a U.K. tax perspective, the foreign lender is considered to receive dividends on the U.K. CFC preferred stock. From a commercial, accounting, and U.S. tax perspective, however, the U.S. borrower has borrowed money from the foreign lender and is paying interest to the foreign lender.14

The magical structure is certainly tax motivated, but it is the foreign tax motivation of the foreign lender.

The smoke and mirrors don’t relate to U.S. tax planning or to a U.S. tax motivation on the part of the U.S. borrower. The U.S. borrower’s only “tax” motivation, if you can call it that, is that it would like to have U.S. interest deduction for its borrowing — which is certainly fair game, since the transaction is indeed a borrowing, notwithstanding the magical structure. The differential tax treatment that results from the structure is simply a manifestation of the fact that the foreign lender has succeeded by using smoke and mirrors to have the loan treated for foreign tax purposes as something else, while the U.S. tax system and the accounting world ignore the smoke and mirrors and treat the arrangement in a manner consistent with its commercial and economic reality — that is, as a loan. The U.S. borrower ignores the flaky pieces of the transaction that don’t have substance from the U.S. tax perspective and does what it’s supposed to do — report the transaction for U.S. tax purposes consistent with the reality of what is happening.

The government has characterized the U.S. borrower’s willingness to engage in machinations relevant to the foreign lender’s foreign tax objectives as an indication that the transaction is tax motivated. The government turns the U.S. borrower’s disregard of the smoke and mirrors on its head and argues, “See, even the U.S. taxpayer ignores this flakiness, so it must be conceding that the transaction is tax motivated and lacks substance.” What perverse logic. It simply cannot be a problem that the U.S. borrower is doing flaky things to get the foreign lender a foreign tax benefit so long as the U.S. borrower is not treating those flaky things as real for U.S. tax purposes. Helping the foreign lender achieve a foreign tax break does not make a transaction tax motivated. But the government would have you believe that it does, and a couple of courts appear to have swallowed that argument.

But we know that helping a foreign lender achieve a foreign tax benefit through smoke and mirrors — and the differential U.S. and foreign tax treatment that results from that — can’t be a problem. The IRS itself has said so.15 It signed off on that issue decades ago in that it needs to pony up when it purchases the CFC preferred stock at the end of the forward arrangement.

13 The essential ingredient of the magical structure to accomplish all of that is the investment by the foreign lender in preferred stock issued by the U.S. borrower’s U.K. CFC and a forward purchase/sale agreement with the U.S. borrower, whereby the U.S. borrower agrees to purchase the U.K. CFC preferred stock for an amount equal to the principal amount of the foreign lender’s investment in the preferred stock plus an interest yield. To the extent that the foreign lender receives dividends on the preferred stock, they will be considered to satisfy the U.S. borrower’s interest obligation. If the dividends don’t get paid, the U.S. borrower will have to pony up the interest when it later purchases the preferred stock. The foreign lender has maintained its commercial and legal position as a lender because it has creditors’ rights against the U.S. borrower as to the latter’s obligations under the forward arrangement.

14 From a U.S. tax perspective, the U.S. borrower is considered to own the U.K. CFC preferred stock, to receive dividends on that stock, and then to pay interest to the foreign lender equal to the amounts received by the foreign lender in the form of dividends, if any, plus whatever amounts in addition to principal

(Footnote continued in next column.)
the international leasing context. In that situation, the U.S. borrower is borrowing against tangible assets — for example, an airplane, which it provides as collateral for the loan. The foreign lender doesn’t really want to own the airplane. From a commercial perspective, it just wants to be a secured lender, and the U.S. borrower is happy, as the owner of the airplane, to enjoy depreciation deductions (and in the old days perhaps an investment tax credit). But the foreign lender wants to pretend that it purchases the airplane and then leases it back to the U.S. borrower so that it can “own” the airplane for foreign tax purposes and claim depreciation or whatever other write-offs are available to it in its home country.

So the U.S. borrower in the old leasing deals bent over backward to structure its borrowing as a sale of the airplane to the foreign lender and a leaseback of the airplane from the foreign lender. It’s been a long time, Your Honor, but you can’t believe how complicated some of those deals were — enough smoke to choke on. But the U.S. borrower reported those transactions consistent with their substance as borrowings, and no one gave a second thought to whether the U.S. borrower was doing something nefarious. No one argued that the U.S. borrower shouldn’t get depreciation deductions or investment tax credits in the United States, notwithstanding everything it was doing tax planning-wise to give the foreign lender foreign tax benefits — and notwithstanding that those foreign tax benefits constituted a “double dip.”

Of direct relevance, the IRS also signed off on differential U.S. and foreign tax treatment in debt financing arrangements — both where the differing treatment results in different characterization of a hybrid financial instrument as debt or equity and, as here, where the differing treatment results from different principles of tax ownership. The IRS even effectively signed off on differential U.S. tax and accounting treatment in the MIPS and TOPRS structures, in which a form of financing was treated as an equity investment for purposes of U.S. GAAP but as debt for U.S. tax purposes.

The magical structure in this case is no different from what the IRS has already blessed. Just as in cross-border “double-dip” leases and some of the cross-border hybrid financial arrangements, the differing foreign and U.S. tax characterizations in this case result from the application of different tax ownership principles — that is, who owns the U.K. CFC preferred stock. It doesn’t matter that the U.S. borrower is bending over backward to help the foreign lender get the foreign tax treatment it wants or that the foreign tax treatment and foreign tax consequences of the magical structure are different from the U.S. tax characterization and U.S. tax consequences of the structure. It is only important that the U.S. tax consequences to both the U.S. borrower and the foreign lender be determined based on the U.S. tax characterization of the transaction.

**Government’s ‘Tax Effect’ Argument**

The most novel aspect of the government’s more recent efforts is its tax effect argument that, because the reduction in the funding rate — let’s call that a “premium” — is a share of the foreign lender’s foreign tax benefit that was explicitly negotiated by the parties as a percentage of that benefit, the foreign tax paid by the U.S. borrower should be treated as refunded, and the U.S. borrower’s interest savings should not be treated as an economic benefit in applying the profitability test under the economic substance doctrine.

The government bases its tax effect argument on expert testimony that, as a result of the magical structure, the U.S. borrower’s foreign tax went up, the foreign lender’s foreign tax went down, and the “premium” or interest rate saving was an explicitly negotiated sharing of the foreign lender’s foreign tax benefit that partially offset the incremental foreign tax burden borne by the U.S. borrower. We know all of that, so why do we need a Fulbright scholar to tell us that? Because the government’s economic experts are taking their argument a step further — that the foreign government gave back (reduced) the tax paid by the U.S. borrower to the foreign lender (through its foreign tax benefit), and the foreign lender then rebated (or to make it sound worse, “kicked back”) an explicitly negotiated portion of the reduced tax to the U.S. borrower in the form of a lower interest rate on the borrowing (or by making payments that net against or offset the U.S. borrower’s interest payments).

The dual consequences that the government asserts follow from its argument are that:

- The U.S. borrower should not receive an FTC because the foreign tax paid by it was refunded (economically if not actually) to the foreign lender.

20The government argues that the U.S. borrower should lose 100 percent of the FTC even though it didn’t receive a rebate of 100 percent of the foreign tax it paid because:

- once a transaction lacks economic substance, the transaction is disregarded in its entirety; and/or
- the foreign government gave back 100 percent of the foreign tax paid by the U.S. borrower — it doesn’t matter that half of it was kept by the foreign lender.
If the interest rate reduction is merely a rebate (kickback) by the foreign lender of a portion of the refund received by the foreign lender of the U.S. borrower’s foreign tax, then by definition that rebate doesn’t reduce the U.S. borrower’s interest cost—it reduces its foreign tax payment. Therefore, the U.S. borrower must be considered to have paid a gross amount of interest to the foreign lender that is unreduced by any reduction in interest rate that is a sharing of the foreign lender’s foreign tax benefit. You should just assume, Your Honor, that, if you were to agree with the government on this argument, the U.S. borrower would likely not satisfy the economic substance for-profit test regardless of where you come out on the Compaq issue.

I will have to admit. Your Honor, that I did not see this one coming. This whopper falls into the “What are you talking about?” category and should be subject to the “You can’t just make stuff up” rule. The government is not merely making an argument that the foreign lender’s tax has been economically shifted to the U.S. borrower (which itself is irrelevant), but is taking a further humongous leap and saying that no foreign tax was paid by anybody because the foreign lender got a tax break equal to the U.S. borrower’s tax payment. If the foreign government has no incremental tax revenue, then how can the U.S. borrower claim to have paid any foreign tax?

There are just so many things wrong with this that it’s hard to know where to begin. But let’s start with common sense:

When a payer makes a deductible payment to a payee who has income from that payment (for example, interest or a service fee), we don’t say that the payer has gotten a refund of the tax paid by the payee just because the payer has gotten a deduction in the same amount as the payee’s income inclusion.

But that’s precisely what the government is arguing here—the foreign lender’s foreign tax reduction that results from the exempt status of its dividend is a refund of the U.S. borrower’s incremental foreign tax cost that results from paying a dividend (for foreign tax purposes) instead of deductible interest.

Let’s break this down into baby steps. We certainly know without the benefit of a rocket scientist that the economic incidence of foreign tax shifts from the foreign lender to the U.S. borrower under the magical structure because the U.S. borrower was funded in a form that wasn’t debt for foreign tax purposes. And we know that the incidence of that tax burden partially shifts back from the U.S. borrower to the foreign lender as a result of the interest rate reduction. But all of that is a big “So what?” It just doesn’t matter!

The market always adjusts transactional terms to reflect the tax position of the parties. In normal markets in which interest rates are not near zero, the dividend rate on U.S. DRD preferred stock is lower than interest rates because the U.S. tax burden shifts from the domestic investor (whose dividend is tax preferred) to the distributing domestic corporation (which forgoes an interest deduction) relative to what happens with debt, and the holder of the preferred stock gives part of its tax benefit back to the U.S. issuer through a lower coupon rate. The same obvious phenomenon occurs in cross-border transactions. A U.S. lender that receives interest from a foreign borrower and is subject to foreign withholding tax will lend at a lower rate if it receives a U.S. FTC for the foreign withholding tax than if it does not. Similarly, a foreign lender that receives a foreign tax break on a loan to a U.S. lender will lend at a lower rate. That is what is happening here. When would one expect that not to occur?

The FTC rules recognize that economic reality. Congress and the courts have understood that the foreign tax burden of a transaction will likely be shared economically between the parties, and it’s too hard to tell how much ends up being borne by the U.S. party. So we don’t even bother trying to figure that out. Instead we give an FTC to whomever has legal liability for the tax and actually pays the tax. So it’s not a problem that as a consequence of the magical structure, an economist might say that the foreign lender’s tax burden has been shifted to the U.S. borrower.

Nor is it a problem that the foreign lender absorbs a portion of the U.S. borrower’s tax burden by giving the U.S. borrower a lower interest rate—or even makes a cash payment equal to an explicitly negotiated portion of the foreign lender’s tax reduction. The U.S. borrower gets a credit because it paid the tax—that is.

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21In government parlance, that partial rebate is a “tax effect” that cannot be a source of profit and therefore cannot be treated as an offset to the interest paid by the U.S. borrower on its loan.

22This popular Elizabeth Owens quote makes it into most of taxpayers’ briefs in these cases:

Either economic incidence should be taken into account in all cases, whether the claimant of the credit is the technical taxpayer or not, or it should be disregarded in all cases. It is disregarded in the operation of the tax credit system in the sense that no attempt is made to trace the economic incidence of a creditable tax beyond the technical taxpayer. From the administrative standpoint, moreover, it is the only feasible one; it would be very difficult for courts to decide in individual cases where the burden of many taxes ultimately falls, and even if they could make this decision, opening the question would add enormously to the uncertainty of the law.


23The person by whom tax is considered paid for purposes of sections 901 and 903 is the person on whom foreign law imposes legal liability for such tax. Reg. section 1.901-2(b)(1).
doesn’t bear the economic burden of the tax is irrelevant. It would be impossible for the FTC regulations to make that more clear.24

But the government’s argument is not merely that the U.S. borrower is paying the foreign lenders’ tax, but that no one is paying any tax. It’s saying that, because the U.S. borrower paid tax and the foreign lender got a tax break, the foreign government effectively gave back — that is, refunded — to the foreign lender the tax paid by the U.S. borrower. In the government’s view, that makes the U.S. borrower’s tax non-creditable without regard to whether the foreign lender gives some of that back to the U.S. borrower through a rate reduction — because if the foreign government didn’t keep the tax, no tax can be considered ever to have been paid. This refund argument sets the stage for the second part of the government’s tax effect argument, which is that, if the U.S. borrower’s interest rate savings is nothing but a rebate or kickback of a portion of that refund, it is not an interest rebate that reduces its borrowing costs for purposes of calculating its economic benefit from the transaction under the for-profit test of the economic substance doctrine.

To repeat the commonsensical response to this silliness, it cannot be that a recipient of a payment that is income to it is not considered to pay tax on that income merely because the payer of that payment gets a tax deduction. And what the parties do between themselves to share the tax benefit or the tax burden from that payment is neither here nor there. But that is what the government is arguing here when the payer pays the tax and the payee gets the tax benefit.

In any event, the FTC provisions address this “no tax was paid” argument with the subsidy rules, which have been around for almost 30 years and have been statutory for almost as long. For foreign tax paid by the U.S. borrower to be considered to be given back to the foreign lender (and then partially rebated to the foreign borrower through the rate reduction), the foreign government has to be in on the scheme and cut those parties a special deal.25 It is irrelevant that the government’s net take doesn’t increase by the tax paid by the U.S. taxpayer because a payment results in offsetting amounts of income and deduction to the parties, at least so long as that result is a function of the general operation of the foreign tax law. That is all that is happening here — the U.S. borrower is subject to foreign tax because it doesn’t receive an interest deduction for what it pays to the foreign lender, and the foreign lender is exempt on its income because that income is treated as a dividend. The government characterizes this as a “collusive arrangement to recover an amount of tax paid by one of the parties.” But the government is really reverting to the argument that the U.S. borrower cannot enter into the magical structure to give the foreign lender a foreign tax benefit if that is to the U.S. borrower’s foreign tax detriment.

On this one, the government is defying both common sense (offsetting income and expense of two parties doesn’t mean the government isn’t collecting tax from anyone) and the law (the subsidy rules). The government’s tax effect argument is a series of non sequiturs, simply made-up hokum, that the government is throwing at the wall in hopes that something will stick. Amazingly enough, this one seems to have stuck somewhat. It was astounding that the government succeeded in selling this line of non-reasoning in a couple of recent litigations. Perhaps it’s hats off to the government for doing an effective job in crafting and packaging its message. But its successes are very disturbing, because they demonstrate that the government is capable of securing uncritical acceptance of its made-up stuff by spinning elements of the transactions, none of which are problematic, into what looks like a three-party conspiracy between the borrower, the lender, and the foreign government.

**Government’s Foreign Tax Generator Argument**

The result of inconsistent characterization under U.S. and foreign tax law can be, as here, that the U.S. borrower incurs foreign tax without having an equivalent amount of income for U.S. tax purposes. In our facts, it’s because the U.S. borrower gets a U.S. interest deduction that it doesn’t get for foreign tax purposes under the magical structure.

But we know that an FTC is available even though what the foreign government taxes is not subject to U.S. tax. The FTC regulations have been clear for more than 30 years that a foreign tax is a creditable income tax even if imposed on something that is not income.

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24. “Tax is considered paid by the taxpayer even if another party to a direct or indirect transaction with the taxpayer agrees, as part of the transaction, to assume the taxpayer’s foreign tax liability.” Reg. section 1.901-2(f)(2)(i). The most obvious example of that is what is called a “net loan.” In a net loan by a U.S. lender to a foreign borrower, the foreign borrower is required to gross up the amount of interest paid so that the U.S. lender receives a specified amount of net interest after taking into account foreign withholding tax imposed on the interest income received by the U.S. lender. The U.S. lender pays the foreign tax and therefore receives an FTC even though it bears absolutely none of the economic burden of the foreign tax, which has been shifted contractually back to the foreign borrower.

25. The subsidy rules were essentially a response to the Brazilian subsidy issue, in which the Brazilian government gave an explicit subsidy of withholding tax paid by U.S. lenders to the Brazilian borrower. That issue was initially addressed by the IRS.

(Footnote continued in next column.)
for U.S. tax purposes. The FTC regulations didn’t invent this notion — they reflected prior law. So it doesn’t matter that there is in fact no double taxation in the particular instance and that the U.S. borrower pays foreign taxes that are not used to offset U.S. tax on income from the transaction generating the foreign taxes. These are sometimes called “excess” FTCs. The IRS has labeled borrowing transactions such as ours as “FTC generators,” as if the transactions did nothing other than manufacture excess FTCs, even though they result from a real transaction.

The FTC rules contemplate the existence of “excess” FTCs and allow them to be used to offset U.S. tax on other, unrelated, foreign-source income, provided that the foreign taxes survive complex limitations in the FTC rules. The use of FTCs to offset U.S. tax on unrelated income is sometimes called “cross-crediting.” We know that the cross-crediting of foreign taxes is permissible so long as a U.S. taxpayer abides by the complex limitations placed on cross-crediting by the FTC rules. Congress has told us that. If a U.S. taxpayer pays a foreign tax and subjects the foreign tax to the various limitations imposed by the FTC rules, it is okay to claim a credit, even if the credit is not needed to offset U.S. tax on the transaction that caused the foreign tax. I’m sorry that the government doesn’t like the way the FTC regime works, but the point is that it’s not an accident. Congress thought all of this through very carefully. Who is the IRS to say that the regime should not be allowed to function as Congress intended?

**A Final Litmus Test**

Before getting to the main event, perhaps I can leave you with a rhetorical litmus test for what I call the government’s preliminary arguments:

- As above, let’s assume that the foreign lender is trying to lend in a form that will give it tax-exempt dividends while preserving its commercial position as a lender. But let’s also assume that the foreign law would accommodate a simpler version of the magical structure whereby the foreign lender purchases preferred stock in the U.S. borrower’s foreign subsidiary for a term of, say, 10 years, builds into the terms of the preferred stock the right to sue the foreign subsidiary at the end of 10 years for the amount invested plus unpaid dividends, and requires the U.S. borrower to guarantee the foreign subsidiary’s obligation to make those payments in year 10.

- The preferred stock is treated as stock for foreign tax purposes, so that the foreign lender receives tax-exempt dividends, even though it has maintained its commercial position as a creditor through its right to sue both the U.S. borrower and its foreign subsidiary in year 10.

- The U.S. borrower’s foreign subsidiary gets no interest deduction under foreign law because its payments are not interest for foreign tax purposes, although we may well conclude that, given the foreign lender’s rights under the instrument, the preferred stock is debt for U.S. tax purposes.

- As in the case of DRD preferred stock in the United States, the foreign lender passes back to the U.S. borrower a portion of its foreign tax benefit through a lower coupon on the foreign subsidiary preferred stock.

The above illustration is quite the same as the magical structure we have been discussing. The only difference is that, in the magical structure, the foreign lender preserves its creditors’ rights through a forward purchase/sale arrangement instead of under the terms that the overall limitation was consistent with the integrated nature of U.S. multinational operations abroad.

Congress believed that the averaging of foreign tax rates [which means “cross-crediting”] generally should continue to be allowed.

of the preferred stock. The U.S. borrower’s foreign sub-
sidiary pays foreign tax on the gross amount of its
earnings because it doesn’t receive an interest deduc-
tion for foreign tax purposes. The government would
tell you that the foreign tax is not creditable for the
reasons we have discussed. If your view is “That can’t possibly be!” read on. If your reaction is that the gov-
ernment may be correct, I’m not sure what else to say.

The Main Event — The Compaq Issue

So, Your Honor, we have finally come to the main
event: how the economic substance test should be ap-
plied to the FTC cases, if indeed it should be applied at
all. Apologies that it took so long to get here, but
you can see that the government has succeeded in con-
trolling the dialogue with all of its baseless, sometimes
even silly, arguments that distract us from the real issue
in this case. Perhaps I have fallen into the same trap as
other litigation counsel by spending too much time bat-
ting down all of the government’s meritless arguments
and, in the process, giving them respect they don’t de-
serve. Given the success that the government has had
in getting at least a couple of judges to take these argu-
ments seriously, however, it seems risky to ignore them.
But please don’t get suckered by the government’s
strategy of pretending that this is not all about Compaq,
because it really is. So let’s ignore all of the govern-
ment’s peripheral arguments and talk instead about
whether and how one should apply the quantitative
for-profit test of the economic substance doctrine in the
context of FTCs.

Now I’m probably not the right person to argue that
the economic substance requirement can never apply to
an FTC. It may well be that the FTC rules allow a
credit without regard to whether the taxpayer is en-

gaged in a purposeful activity, but I’m not sure that I
have seen that case.29 So I’m a “never say never” kind
of fellow, although I do believe that it’s inappropriate
to apply economic substance in this case because bor-
rowing is a purposeful activity and the FTC limitation
is supposed to deal with whatever excess FTCs result.

But if one assumes that the economic substance re-
quirement could apply to an FTC, the economic sub-
stance test, whatever its formulation, asks whether a
transaction had a nontax motive, which translates to
whether it had a business purpose, which in turn trans-
lates in most cases, as here, to whether the transaction
had a pretax profit. The bottom-line question (and
really the only question, having hopefully disposed of
the government’s made-up tax effect argument as to
the interest reduction) then becomes whether the for-

ter tax cost is a pretax expense in determining the
U.S. taxpayer’s pretax profit.

In the context of borrowings, both sides often start
appropriately with the interest cost savings to the U.S.
borrower from the transaction and ask whether the
U.S. borrower had a pretax benefit from the transaction.
Let’s assume, for easy math that is illustrative of the
actual facts, that the foreign lender is lending $1 billion
to the U.S. borrower. The foreign lender is happy to
lend on a taxable basis at 5 percent, which happens to
also be the U.S. borrower’s normal borrowing rate. As-
sume that the U.K. corporate tax rate is 30 percent and
that the foreign lender would therefore save $15 million
in U.K. tax per year (30 percent x 5 percent x $1 bil-

29The courts in Hewlett-Packard and Pritired applied the eco-
nomic substance principle to the FTC, but those cases really have
nothing to do with this issue or with this case. In those cases, the
U.S. taxpayers provided funding to a foreign borrower in the
form of equity for U.S. tax purposes so that they could claim
that they owned an interest in the funded vehicle and, as a par-
tial owner, could claim as credits foreign taxes incurred by the
funded vehicle. But these cases are much like the ACM and ASA
tax shelter cases in reverse. ACM Partnership v. Commissioner, T.C.
Memo. 1997-115, aff’d, 157 F.3d 231 (3d Cir. 1998); ASA Invest-
ings Partnership v. Commissioner, 201 F.3d 505, 513 (D.C. Cir.
2000). In those cases, a foreign lender pretended that it owned
equity in a partnership so that it could absorb some phantom
income and leave the U.S. partners with a phantom loss. The
courts in those cases basically said that the foreign lenders really
were just lenders. Similarly, the courts in Hewlett-Packard and
Pritired said that the U.S. taxpayers in those cases were really
lenders, and not equity owners, and used economic substance
principles to support their debt-equity analysis. I frankly don’t
find that so offensive.

30If the borrowing is funding assets that would not otherwise
be owned in the United Kingdom, the government presumably
would argue that the entire $18 million of U.K. tax is the incre-
mental foreign tax cost.
the U.S. borrower was willing to enter into a transaction in which it gets a $10 million interest saving and pays an incremental $15 million of foreign tax is because the U.S. borrower was assuming that it would get an FTC for the $15 million of foreign tax. Without the FTC, those erudite experts conclude, the transaction would not be economic.

Now, Your Honor, I don’t mean to sound like Rodney Dangerfield, and I’ll keep it clean, but I’m having a “No joke, Sherlock” moment here. Do we really have to spend time arguing with economic experts about the obvious? Let’s all agree that the U.S. borrower’s borrowing would be noneconomic and would be a stupid thing to do if the U.S. borrower were wrong in its assumption that it would receive an FTC for its foreign tax cost. But that doesn’t mean that the transaction is tax motivated. The economic experts draw that conclusion, but that’s not their call. It boils down to a purely legal issue of whether a transaction should be considered tax motivated if it would be noneconomic if foreign tax paid in the transaction were noncreditable.

The first obvious response to that question is, “When would that ever not be the case?” I don’t like to use legalistic phrases, but this one really does prove too much. Even if noncredibility of a foreign tax wouldn’t result in a loss, it would still be the case that, in all but the rarest of circumstances, a taxpayer wouldn’t enter into a transaction without an FTC — or it would radically alter the transaction — because it would be noneconomic given its available alternatives. So it can’t be that a transaction is tax motivated just because the taxpayer wouldn’t do the transaction without an FTC. But, Your Honor, that’s precisely what the government is trying to talk you into here.

Let’s get away from the common-sense answer and talk about the law for a moment. Should the U.S. borrower’s pretax profit, or in this case its pretax benefit, be reduced by the foreign tax cost as a legal matter under the economic substance’s for-profit test? The answer is no, and we have already been given that answer by two circuit courts.

The case law has used as a measure of pretax profit “taxable income” as determined under U.S. tax principles. U.S. tax is never included in the computation of taxable income or pretax profit. Foreign tax is the equivalent of — indeed a surrogate for — U.S. tax. At least to the extent a foreign tax survives the limitations and other restrictions in the FTC regime, that foreign tax should be treated no differently from a U.S. tax for which it is viewed as a creditable substitute.

That is the right answer from a legal perspective, but it’s also the right answer from a policy perspective, notwithstanding government arguments to the contrary. The House Ways and Means Committee explained long ago that the FTC “in effect treats the taxes imposed by the foreign country as if they were imposed by the United States” (emphasis added). Since it was the stated intent of Congress to treat foreign income taxes as if they had been imposed by the United States, foreign taxes can no more be treated as a pretax cost of a transaction under the economic substance doctrine than U.S. taxes.

If there was any doubt on how foreign tax should be treated in measuring profitability under the economic substance requirement, the Fifth and Eighth circuits in *Compaq* and *IES* answered that question. The essence of the conclusions reached in those decisions is that U.S. tax law measures profitability based on whether there is taxable income using general tax principles, which do not include treating U.S. tax as a cost and also should not treat foreign taxes that substitute for U.S. tax as a cost. The Fifth Circuit explicitly rejected the government’s inconsistent treatment of the U.S. tax and the substituted foreign tax in applying its profit test:

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 cash flow. To be consistent, the analysis should either count all tax law effects or not count any of them. To count them only when they subtract from cash flow is to stack the deck against finding the transaction profitable.

Both cases 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.

So, Your Honor, despite the government’s diversions and distractions, this is really the only matter you need to decide, and it’s an up-or-down legal question and not a factual issue. You should assume that the transactions at issue would be noneconomic without the FTC and tell us whether you really think that matters. I am...
saying that it just can’t be, because everything becomes noneconomic without an FTC.

In thinking about this, you really need to push aside all of the government’s histrionics. The issue of whether foreign tax is a pretax expense in measuring pretax profit is an understandable question for which there is a yes-or-no answer. But the government’s other arguments — the “preliminaries” in my nomenclatures — are another matter. I don’t mean to sound like a know-it-all, but I have been paying attention to the FTC for a fair amount of time. The government is making arguments based on some alternative legal system in some parallel universe that I just don’t recognize. With all due respect, I truly don’t think that it would be appropriate for you to condone an exercise in “making stuff up.” If I were a judge, I would simply decide the *Compag* issue as the Fifth and Eighth circuits did and tell the government to go away. That’s what I honestly believe you should do.

Respectfully submitted,
An Imaginary Litigator