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No. 10-70

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

TIFD III-E, Inc., Tax Matters Partner for
Castle Harbour Limited Liability Company,

Plaintiff-Appellee

v.

UNITED STATES OF AMERICA,

Defendant-Appellant

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES
DISTRICT COURT FOR THE DISTRICT OF CONNECTICUT

BRIEF FOR THE APPELLANT

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GLOSSARY

CHLI	Castle Harbour Leasing, Inc.
FPAA	Notice of Final Partnership Administrative Adjustment
GECAS	General Electric Capital Aviation Services
GECC	General Electric Capital Corporation

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UNITED STATES OF AMERICA,

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ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF CONNECTICUT

BRIEF FOR THE APPELLANT

JURISDICTIONAL STATEMENT

On June 29, 2001, the Internal Revenue Service ("IRS") issued to TIFD III-E, as tax matters partner of Castle Harbour LLC ("Castle Harbour"), two notices of final partnership administrative adjustment ("FPAA"). (A2513-17, 2528-43.)[1] TIFD III-E paid its jurisdictional

[1] "A" refers to the Joint Appendix, and "SPA" refers to the Special Appendix. "Doc." refers to the District Court docket sheet entries in D. Conn. No. 01-01839.

deposit to the IRS as required by I.R.C. § 6226(e)(1) (26 U.S.C.). (A20, 32-33.)

On September 27, 2001, TIFD III-E timely filed two complaints in the District Court, challenging each of the FPAAs, and the cases were consolidated. (A15-40.) The District Court had jurisdiction under I.R.C. § 6226(e)(1).

On November 9, 2009, the District Court entered judgment in favor of TIFD III-E. (SPA130-31.) The judgment resolved all claims of all parties. On January 6, 2010, the Government timely filed a notice of appeal. (A70.) *See* Fed. R. App. P. 4(a)(1). This Court has jurisdiction under 28 U.S.C. §1291.

STATEMENT OF THE ISSUES

This case involves a purported partnership between two Dutch banks and United States subsidiaries of General Electric Company. The partnership agreement provided that 98% of the "Operating Income" of the partnership was allocable to the banks, who were not subject to United States tax. By way of other provisions in the agreement, however, the banks actually received a far smaller percentage of the partnership's income. In a previous appeal, this Court held that the Dutch banks did not have a bona fide equity

interest, and therefore were not partners, in the partnership, and it remanded the case to the District Court for consideration of other issues. The issues presented in this appeal are:

1. Whether the District Court erred in holding that the Dutch banks nevertheless were partners under the "family partnership" provisions of I.R.C. § 704(e)(1).

2. If the Dutch banks were partners, whether the District Court erred in holding that the allocations of "Operating Income" to the banks had "substantial economic effect" within the meaning of I.R.C. §704(b)(2).

3. Should this Court hold in favor of the Government with respect to either preceding issue, whether the District Court erred in ruling that accuracy-related penalties under I.R.C. § 6662 were not applicable.

STATEMENT OF THE CASE

TIFD III-E, on behalf of Castle Harbour, filed two complaints in the District Court challenging the IRS's proposed adjustments to its partnership returns for 1993 through 1996, and 1997 and 1998. The cases were consolidated. In an opinion reported at 342 F. Supp. 2d 94 (*Castle Harbour I*), the District Court (Underhill, J.) ruled in favor of TIFD III-E. It rejected all of the Government's alternative arguments,

i.e., that the transaction lacked economic substance; that the Dutch banks were not bona fide partners of Castle Harbour; and that, even if they were, the income allocations lacked substantial economic effect.

The Government appealed to this Court, which reversed. (2d. Cir. 05-0064.) In an opinion reported at 459 F.3d 220 (*Castle Harbour II*), the Court (Cardamone, Leval, and Sack, JJ.) held that the Dutch banks were not bona fide partners of Castle Harbour. The Court remanded the case for further proceedings consistent with its opinion, and it instructed that any subsequent appeal would be assigned to the same panel. TIFD III-E filed a petition for rehearing, which was denied.

On remand, the parties filed briefs addressing whether the Dutch banks qualified as partners under I.R.C. § 704(e)(1), and whether Castle Harbour was liable for penalties for the 1997 and 1998 tax years. Following oral argument, the District Court (Underhill, J.) ruled in favor of TIFD III-E in an opinion reported at 660 F. Supp. 2d 367. The Government brought this appeal.

STATEMENT OF FACTS

A. Overview

As this Court stated in *Castle Harbour II*, "[t]his appeal tests the power of the Internal Revenue Service to examine and recharacterize an interest which accords with its ostensible classification only in illusory or insignificant respects." (SPA54.) General Electric Capital Corporation ("GECC"), a subsidiary of General Electric Co., is in the business (among others) of leasing aircraft to airline companies. (A75-A76, 121.) At the end of 1993, GECC's total business assets were worth $118 billion, and its aircraft leasing business was worth $7 billion. (A255, 2176.) A number of the aircraft that GECC owned had been fully depreciated for tax purposes and thus were producing large amounts of taxable income. (A193.) The instant transactions sheltered that income from tax by, in effect, allowing GECC effectively to "re-depreciate" the aircraft. (SPA97.)

In broad outline, described in detail below, GECC created a separate entity, Castle Harbour, to which it contributed income-producing aircraft that were fully depreciated for tax purposes. Dutch banks, not subject to United States tax, were then solicited to invest in Castle Harbour as partners. The banks were allocated the majority of

the income of Castle Harbour, thus shifting the majority of the taxable income to them. The amount of income actually paid to the banks, however, was determined by subtracting book depreciation from gross operating income, such that the banks actually received only a small percentage of the income. Castle Harbour was designed to last for a predetermined number of years, with the banks gradually being bought out, effectively receiving a set rate of return on their investments.

B. Formation and operation of Castle Harbour

1. The underlying transactions

According to GECC, because of weakness in the airline industry, it determined in the early 1990s to reduce its risk by raising cash against the expected stream of income from its outstanding leases.[2] (A95-A99, 110-A112, 114, 133-145, 277-280.) GECC asserted that it was important to show that it could raise third-party capital against its

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[2] Despite any financial difficulties experienced by the aviation industry, GECC consistently was able to make a significant profit in the aircraft leasing business. (A84, 116-19, 151-52, 2145.) From 1981 to late 1993, GECC experienced an average return of 25%. (A2145.) In addition, GECC was credited with rescuing Guiness Peat Aviation, another company that leased aircraft, in May 1993, by purchasing $1.35 billion worth of GPA's aircraft, along with GPA's management company, and assuming control over the management of GPA's remaining aircraft fleet. (A109, 2128.) And, GECC's utilization of its aircraft was 97% in 1992 and 96% in 1993. (A2147.)

assets. (A103-05, 140-141.) GECC also asserted that because most of its aircraft were “Stage II” aircraft, older aircraft that did not meet regulatory requirements concerning noise, selling its aircraft was not feasible. (A79, 188.) And GECC asserted that borrowing was not feasible for two reasons: (1) in order to maintain its AAA credit rating, it could not borrow more than 8 times its common equity, and its debt-to-equity ratio was then 7.96 to 1, and (2) a number of its medium-term and long-term debt instruments contained “negative pledges” which prohibited it from using its assets to secure debt. (A106-07, 250-53.) GECC sent out to investment firms requests for proposals of how it could achieve its aims. (A1186, 1190, 2078-95, 2096-2124.) GECC ultimately agreed to proceed with a proposal submitted by the investment bank Babcock & Brown that tracked the broad outline described above. (A103-04, 148-49.) Babcock & Brown received a $9 million fee for its work. (A168.)

On July 26, 1993, GECC implemented Babcock & Brown’s proposal by forming a Nevada limited liability company, initially called GE-Capital Summer Street-I LLC, but later renamed Castle Harbour LLC. (A191, 2050-58.) Castle Harbour elected to be treated as a partnership for federal tax purposes. *See* 26 C.F.R. § 301.7701-3(c)

("Treas. Reg."). GECC, through three of its subsidiaries, TIFD III-E, TIFD III-M, and General Electric Capital AG, contributed to Castle Harbour assets totaling $590 million as follows: (1) the beneficial interests in 60 Stage II and 3 Stage III aircraft with a fair market value of $530 million, subject to $258 million in nonrecourse debt (net value of $272 million); (2) $22 million in rents receivable on the aircraft; (3) $296 million in cash; and (4) all of the stock in a GECC subsidiary with no value, initially called TIFD IV, but later renamed Castle Harbour Leasing, Inc. ("CHLI").[3] (A190-191, 207, 2050, 2707.) The airplanes contributed to Castle Harbour were subject to long-term leases with major airlines and were fully depreciated for tax purposes. (A193, 2633-37.)

In seeking investors for Castle Harbour, Babcock & Brown targeted only foreign entities who were exempt from United States tax. (A165-66, 171-72, 385, 1207-08, 1295-96.) After lengthy negotiations about guarantees and certain mechanisms to ensure the return of their investment plus interest, among other issues, two Dutch Bank

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[3] "TIFD" is a reference to GECC's Transportation and Industrial Financing Division, which was responsible for aircraft leasing. (A74-75.)

subsidiaries, ING Bank, N.V., and Rabo Merchant Bank, N.V. (hereinafter the "Dutch Banks" or "Banks"), agreed to participate as Class A partners, with TIFD III-M and TIFD III-E (the GECC entities) as Class B partners. (A170, 194-98, 572.) Under the provisions of the United States-Netherlands tax treaty and under I.R.C. § 861 *et seq*., the Dutch Banks were exempt from United States tax on income that was not effectively connected with the United States. *See* Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Neth., Dec. 18, 1992, *available in*, 93 TNI 106-16 (LEXIS). If, at any time, the Dutch Banks became subject to United States tax on the income Castle Harbour allocated to them, GECC agreed to indemnify them for any tax paid. (A1100 (§3), 1139-40 (§3).)

On October 6, 1993, one of the GECC subsidiaries (TIFD III-M) sold approximately $50 million of its interest in Castle Harbour to the Dutch Banks. (A198, 1310, 2045, 2047.) Another subsidiary (General Electric Capital AG) simultaneously sold its entire interest back to TIFD III-M for $6 million. (A1310, 1807-09, 2048.) The Dutch Banks then contributed approximately $67.5 million to Castle Harbour, bringing their joint total investment in Castle Harbour to $117.5

million. (A198-99, 597, 2044, 2046.) At closing, as "an inducement to the Investors to acquire the Class A interests," the GECC entities paid to each Dutch Bank a "transaction fee" of $910,996.50. (A865 (§2.1(d)), 2647-48, 2658.) The GECC entities also paid the Dutch Banks' legal fees, travel and hotel expenses incurred by the Banks and their attorneys during the negotiations and the closing, and other related expenses, which, together with the "transaction fees" paid to the Banks, totaled $13.7 million. (A332-33, 901 (§10.1), 2626, 2722.)

Ultimately, GECC, which had contributed $246 million in cash ($296 million initial contribution less the $50 million interest purchased by the Dutch Banks) and aircraft with a net value of $272 million, together with $22 million in rents receivable for a total of $540 million, owned through TIFD III-E and TIFD III-M approximately 82% of Castle Harbour. (A596-97, 2639, 2707.) The Dutch Banks, which had contributed $117.5 million, owned approximately 18% of Castle Harbour. (*Id.*) Most of the cash contributed by the parties was transferred immediately to CHLI. (A198-99, 233, 263.)

2. The Operating Agreement

The GECC entities and the Dutch Banks executed an Amended and Restated Operating Agreement. (A550-678.) Castle Harbour was

designed to be a self-liquidating partnership, under which the Banks' interests would be bought out over eight years. (A828; SPA6.) Each year, as is generally true with all partnerships, *see* I.R.C. § 702; Treas. Reg. § 1.704-1(b)(2)(iv), the Banks' capital accounts were to be debited or credited with the amount of their allocable shares of Castle Harbour's income or loss, and debited to reflect distributions of cash or property. (A568-70.) The Banks also were entitled to annual buyout payments, the amounts of which were set forth in a schedule contained in Exhibit E to the Operating Agreement, which also reduced the Banks' capital accounts ("Exhibit E" payments). (A828.) The Exhibit E payments were designed to pay cash annually to the Banks that, in the end, would return their investment along with an "Applicable Rate" of interest. (*Id.*; A214.) The Applicable Rate was 9.03587%, but if the Banks' interests terminated because of their own actions, the Applicable Rate was 8.53587%. (A564, 574-75.) If Castle Harbour missed an Exhibit E payment, the Banks unilaterally could force its dissolution. (A664-65 (§14.1(d)).)

Castle Harbour's making of an Exhibit E payment did not depend upon whether it earned a profit for the year. (*Id.*) Rather, the Dutch Banks were entitled to such payments whether or not there was

sufficient income on hand. (*Id*; A328 (Exhibit E payments were made even when the capital accounts would not have justified them).)

Under the Operating Agreement, the GECC entities were to receive annual guaranteed payments (called Class B payments) in the amount of $500,000 or $2 million.[4] (A572, 611-12 (§4.1).) Moreover, during 1993 through 1998, Castle Harbour distributed airplanes worth $41 million to the GECC entities after the airplanes came off lease. (A2691-692, 2709, 2713; SPA98.) Except for the distributions discussed above, the Operating Agreement did not permit any other distributions until the dissolution of Castle Harbour. (A614 (§4.5).)

The Operating Agreement divided income and loss into two categories: Operating Income (and Loss) and Disposition Gain (and Loss). (A568-69, 600-06 (§§3.1-3.3).) As the District Court noted, Operating Income was not "a simple measure of the net cash received by Castle Harbour in its normal operations," but rather was "a non-

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[4] Under I.R.C. § 707(c), a "guaranteed payment" is a payment, the amount of which is determined without regard to the partnership's income, to a partner for services the partner provides to the partnership or for the use of capital contributed by the partner. Because a guaranteed payment is treated as a payment to one who is not a partner in the partnership, it does not affect the partner's capital account.

obvious category of income, primarily because it includes as expenses items not clearly considered expenses, *e.g.*, Class B guaranteed payments, and excludes items that appear to be expenses, *e.g.*, debt payments and Exhibit E payments." (SPA14; *see* A590-91.) Operating Income consisted of rent payments from the leased aircraft and interest on investments, less expenses. Expenses consisted of Class B payments, administrative expenses, interest on aircraft acquisition debt, and—critically here—depreciation.[5] (A590-91.) Even though its fully depreciated aircraft had a tax basis of zero, Castle Harbour claimed additional depreciation deductions for *book* accounting purposes, in amounts the District Court labeled "aggressive," constituting 62-71% of annual Operating Income. (A1351 (1993: 67%); A1417 (1994: 63.5%); A1552 (1995: 62.7%); A1614 (1996: 70%); A1703 (1997: 71.0%); A1720 (1998: 71.8%).)

If Castle Harbour reported net Operating Income, it was allocated 98% to the Dutch Banks and 2% to the GECC entities. (A600 (§3.1).) If, however, Castle Harbour reported a net Operating Loss, (i) it was

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[5] GECC agreed that if Castle Harbour's Operating Income was insufficient to pay operating expenses, it would cover any remaining expenses. (A2650.)

allocated first to offset any cumulative Disposition Gains of the parties allocated in previous years; (ii) 98% to the Dutch Banks and 2% to the GECC entities until the Banks cumulatively had been allocated $3,854,493 in losses; and then (iii) 99% to the GECC entities and 1% to the Banks. (A600-01 (§3.2).) Castle Harbour never experienced an Operating Loss. (SPA84.)

A Disposition Gain or Loss was the difference between an asset's book value and its sale price. (A603-06 (§3.3(h),(j)).) Any income or loss from CHLI's investment or disposition of assets also was treated as Disposition Gain or Loss. (*Id.*) Disposition Gains and Losses were allocated as follows: (i) Disposition Gains were allocated first, as necessary, to offset prior Disposition and Operating Losses, while Disposition Losses were allocated to offset prior Disposition Gain; (ii) Disposition Gains and Losses were allocated 90% to the Dutch Banks and 10% to the GECC entities until the Banks cumulatively had been allocated $2,854,493; and (iii) any remainder was allocated 99% to the GECC entities and 1% to the Banks.[6] (*Id.*)

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[6] The interplay between the income allocations, the Exhibit E payments, and the capital accounts can be illustrated by what occurred in 1994. At the start of 1994, the Dutch Banks' capital accounts totaled

(continued...)

Since CHLI's income was considered Disposition Gain, the income from any asset, whether cash or aircraft, could be treated as Disposition Gain (which was allocated more favorably to the GECC entities than Operating Income) merely by moving that asset to CHLI. (A577-78, 586-89, 603 (§ 3.3(h)); A198-99, 233, 263.) As noted above, most of the cash invested in Castle Harbour was transferred to CHLI for investment, thus producing Disposition Gain. Any interest income earned thereon was "Disposition Gain," even though it would have been "Operating Income" in Castle Harbour's hands. (*Id.*; A338-39.) CHLI purchased four aircraft during the period 1993 through the end of 1998.[7] (A201, 245.) Any aircraft leasing income that CHLI received

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[6] (...continued)
approximately $112 million. During that year, Castle Harbour's Operating Income (as reduced by book depreciation) was approximately $9.8 million, of which $9.6 million was allocated to the Banks. The Banks received $40 million in Exhibit E payments. At the end of 1994, then, the Banks' capital accounts totaled approximately $82 million ($112 million plus $9.6 million minus $40 million). At the same time, the capital accounts of the GECC entities, which were allocated $200,000 of Castle Harbour's 1994 Operating Income, increased by that amount. This pattern was repeated each year of Castle Harbour's existence. (A1417, 1420-21; *see* A1301, 1346, 1546, 1608, 1697, 1714.)

[7] In an internal office memorandum, CHLI cited two reasons why it needed to purchase two aircraft: (i) CHLI "is required to own business assets (leased aircraft) other than its commercial paper so as to avoid
(continued...)

also was Disposition Gain. (A245.) CHLI invested most of its cash in GECC commercial paper. (A573, 586-88, 636-37 (§5.8(b)); A198-201, 233, 263.)

The Operating Agreement also required Castle Harbour to maintain an "Investment Account" for each Dutch Bank. (A570-72.) No cash was paid into these accounts. Instead, they were used to keep track of the balance that the Banks would receive upon dissolution of Castle Harbour. The opening balance of each account was the initial investment made by each Bank. The balance was recalculated as if the amount had been increased each year by the Applicable Rate, 9.03587%. Each balance was decreased by the Exhibit E payments made to the Bank. (A565, 570-72.) If Castle Harbour dissolved as the result of certain defined events (generally involving acts of the Banks), the balance of the Investment Accounts would be recalculated using a rate of 8.53587%. (A570-72.) If, at the dissolution of Castle Harbour, the cumulative adjustments to the Banks' Investment Accounts for all

[7] (...continued)
the IRS recharacterizing it as part of the business of the LLC," and (ii) "the IRS will more than likely impose accumulated earnings tax" if CHLI "simply accumulates passive income and does not invest in operating assets." (A2710-12.)

years of Castle Harbour's existence exceeded the Banks' capital accounts, the Banks would receive the balance of their capital accounts, plus an extra payment, which was called a "Class A" guaranteed payment, equal to the difference between the total adjustments to the Banks' Investment Accounts and the balance in their capital accounts (but not the 1% allocations of Operating or Disposition Loss, if any). (A568-71.)

GECC also executed a guaranty for the benefit of the Dutch Banks, under which it guaranteed the performance of the GECC entities and the payment of amounts due under the various agreements. (A1063, 1068.) As this Court recognized, the effect of the Investment Accounts and the guaranty was to ensure that the Dutch Banks effectively were guaranteed a return of their investment, plus interest of 9.03587% or 8.53587%. (SPA57, 59-60.)

The Operating Agreement prohibited CHLI from investing its assets as it desired, and required CHLI to keep high-grade commercial paper or cash, referred to as "Core Financial Assets," in an amount equal to 110% of the current value of the Investment Accounts, so as to ensure that, at all times, Castle Harbour had access to sufficient funds with which to return to the Dutch Banks their investment, plus

interest. (A573, 586-88, 636-37 (§5.8(b)).) CHLI satisfied this requirement by holding GECC commercial paper paying 3.22% to 5.93%. (A200.) In addition, the Operating Agreement also provided that the Dutch Banks were to be paid a premium if their investment was returned earlier than the Operating Agreement contemplated. (A580, 653-54.)

Upon dissolution, the Operating Agreement provided that if the partners' capital accounts had positive balances, the partners would receive the balance, but if their capital accounts had negative balances, the partners would have to restore the deficit. (A644 (§8.2(e)), 658 (§12.3), 659-60 (§12.7), 667-69 (§14.3(b)); A224.) As a practical matter, however, the Dutch Banks were protected from this provision by the Investment Accounts, which assured that they would receive back their investment, plus interest.[8] (A570-72; Doc. 52 (plaintiff's trial brief) at 20, n.12; SPA92-94.)

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[8] During negotiations, the Dutch Banks expressed concern about their liability if Castle Harbour's aircraft were involved in a catastrophic accident. The parties agreed that Castle Harbour would carry $300 million in insurance to cover such an event. (A173, 229-30, 625-26 (§5.5(a)), 1209.)

The Operating Agreement authorized GECC to purchase the Dutch Banks' interests at any time. (A651-52 (§10.8(a)).) The only penalty for early purchase of the Banks' interests was that GECC would owe each Bank an "Indemnification Premium," a small payment to compensate them for the early termination of their interests. (A580, 654.)

3. Management of Castle Harbour

Castle Harbour's day-to-day operations were outsourced to GE Capital Advisory Services, Ltd. until June 1994. (A352-53.) Such services were then contracted out to General Electric Capital Aviation Services ("GECAS"), in Shannon, Ireland. (A2204-32.) Castle Harbour paid GECAS an annual fee of about $50,000, plus a 10% mark-up. (*See e.g.*, A1351, 1417.)

Castle Harbour had three to four managers, all of whom were employees of GECC or related companies. (A1643, 2233, 2235, 2247, 2310, 2315, 2345.) The Operating Agreement provided that "all powers to control and manage the business and affairs of the Company shall be exclusively vested in the managers," and that "no member shall have any right or power to control or manage the business and affairs of the Company." (A618 (§5.2(b)).) Each manager worked part-time for

Castle Harbour for a small salary. (A617 (§5.1(f)); A288-89, 346-47, 364, 1459.) Castle Harbour did not pay its managers' or employees' salaries. Instead, under "seconding agreements," TIFD III-E treated the individuals as its own employees, paid their salaries, and allowed Castle Harbour to use their services on a part-time basis. (A287, 333-34, 2720, 2279-87.)

The GECC entities had sole authority under the Operating Agreement to select Castle Harbour's managers. (A616.) The Dutch Banks had no "right to elect a manager" and "no voting powers or voting rights." (*Id.*) Moreover, the Banks had "no right or power to take part in the management or control of [Castle Harbour] or its business and affairs or to act for, or bind [Castle Harbour] in any way." (A639 (§§6.1, 6.2).) Rather, the Operating Agreement only permitted the Dutch Banks to vote on amendments to the Operating Agreement. (A645-47 (§§9.1, 9.2).)

Castle Harbour's principal place of business initially was in Hong Kong, but in October 1993, it was moved to Bermuda. (A1358-60, 1372-81.) At no time did more than one or two part-time employees work in Castle Harbour's small Bermuda office. (A329-30, 2699-2703.)

4. The parties' accounting for the Castle Harbour transactions

The Dutch Banks' investment in Castle Harbour was reflected on GECC's consolidated financial statements for all relevant years as a "minority equity interest." (A200, 261, 2175, 2199-2200.) The Banks reported their investments as debt for both financial accounting and tax reporting purposes. (A439-42, 535-37.)

5. Allocation of income for federal income tax purposes

The allocation of income for tax purposes was the same as allocations for book accounting purposes. The Dutch Banks thus were allocated 98% of net Operating Income, 98% of net Operating Loss up to a maximum of $3,854,493 (although Castle Harbour never experienced an Operating Loss), and 90% of Disposition Gain and Loss, up to a maximum of $2,854,493. (A600-06 (§§3.1-3.3).) But critically here, because the aircraft contributed by GECC to Castle Harbour were fully depreciated for tax purposes, taxable income, unlike book income, was not reduced by depreciation. (A192-93, 2459.) Consequently, the Banks were allocated taxable income well in excess of the income they actually received. But because the Banks were not subject to United States tax, they were completely indifferent to the substantial

allocations of taxable income to them. (A171, 1207-08,1295.) To prevent Castle Harbour's lease income from being taxed in the United States, the Operating Agreement precluded the Banks from transferring their interests to a United States resident. (A647-49 (§§10.1-10.4).) Further, GECC agreed to indemnify the Banks if (absent any fault on their part) they incurred any United States tax liability. (A1093-1171.)

The large allocations of taxable income to the Dutch Banks enabled GECC to avoid a substantial income tax burden, while shifting very little book income to the Banks (primarily because of the substantial depreciation deductions claimed for book income purposes, which reduced significantly the Banks' share of income). The disparity between the book income and the taxable income allocated to the Dutch Banks can be illustrated as follows:[9]

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[9] The numbers in the chart are derived from A1354, A1420, A1555, A1617, A1705, A1722, and A2469-2471.

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Year	Book Income Allocated to the Dutch Banks	Taxable Income Allocated to the Dutch Banks
1993	$ 332,000	$ 16,073,452
1994	9,660,000	75,061,872
1995	6,548,000	62,406,532
1996	1,340,000	49,874,970
1997	2,258,000	50,776,164
1998	7,560,000	55,945,808
Total:	$27,698,000	$310,138,798

6. GECC's early termination of the Dutch Banks' investment

GECC terminated the Dutch Banks' interests in Castle Harbour on December 31, 1998, three years earlier than planned, by having two GECC subsidiaries purchase the Banks' interests. (A239-40, 1789, 1795.) The termination was occasioned by a change in federal tax law,[10] which potentially subjected the Dutch Banks to U.S. tax, and which would have triggered GECC's agreement to indemnify the Banks for any U.S. tax liability. (A1100, 2664-67, 2672-76.)

During 1993 through 1998, Castle Harbour collected $316 million in income, after expenses except depreciation and Class B guaranteed payments. After taking into account book depreciation and the Class B

[10] *See* Treas. Reg. § 1.894-1T, which became effective January 1, 1998.

payments, Castle Harbour's Operating Income for those years was reduced from $316 million to approximately $28.2 million, of which approximately $27.6 million (*i.e.*, 98%) was allocated to the Dutch Banks. (A1354; 1420; 1555; 1617; 1705; 1722.) During that period, Castle Harbour also disposed of a number of aircraft at a cumulative loss of $24 million, and it transferred aircraft with a value of $41 million to the GECC entities. (*Id*; A2624.) In December 1998, when GECC bought out the Banks' interests, the fair market values of the remaining airplanes held by Castle Harbour and of CHLI's stock exceeded their book values by $161 million, thus resulting in Castle Harbour reporting a total Disposition Gain of $137 million ($161 million less $24 million), of which approximately $4 million was allocated to the Banks. (A1791, 2644.) The remaining $133 million was allocated to the GECC entities. (*Id*; A1789, 1791-92,1795, 1797-98.) The Dutch Banks' total share of Castle Harbour's book Operating Income and Disposition Gain for 1993 through 1998 thus was approximately $31 million.

The total Exhibit E payments made to the Dutch Banks during Castle Harbour's existence was approximately $118.5 million.[11] (A828.) When GECC bought out the Banks' interests, the Banks had a positive balance in their capital accounts of $31 million, which exceeded the total adjustments to their Investment Accounts. Thus, the Banks were paid the balance of their capital accounts, and no Class A payments were triggered. (A1789, 1795.) The Banks also received an Indemnification Premium of $155,760. (*Id.*) The Banks therefore were paid almost $150 million ($118.5 million in Exhibit E payments, a buy-out payment of $31 million, and an Indemnification Premium of $155,760). The $150 million was equivalent to the Dutch Banks' investment plus an internal rate of return of 9.1%. (A377.) The GECC entities received approximately $728 million over the life of Castle Harbour, providing GECC with an internal rate of return of 5.5%. (A376, 1301, 1346, 1411, 1546, 1608, 1697, 1714; SPA98-99.)

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[11] The Exhibit E payments that Castle Harbour made to the Dutch Banks between 1993 and 1997 were as follows: (i) 1993: $5,856,789; (ii) 1994: $39,129,597; (iii) 1995: $42,846,678; (iv) 1996: $19,620,374; and (v) 1997: $10,991,784, for total payments of $118,443,222. (A1355, 1420, 1556, 1618, 1706.)

During 1993 through 1998, the Dutch Banks were allocated approximately $310 million of Castle Harbour's $316 million in taxable income, although they received actual Operating Income allocations of only $27.6 million. (A1338, 1437, 1589, 1641, 1689, 2469-71.) Had this income been allocated instead to the GECC entities, GECC's federal tax liability would have increased by $62 million. (A20, 33.) Instead, GECC's tax liability on the income it received from Castle Harbour was only $1.2 million (*i.e.,* $6 million taxable income x 20% tax rate).[12]

C. The IRS's audit of Castle Harbour and proposed adjustments

The IRS audited Castle Harbour's partnership returns for 1993 through 1998, and ultimately issued to TIFD III-E, as Castle Harbour's tax matters partner, two notices of final partnership administrative adjustment (FPAA), the first covering 1993 through 1996, and the second covering 1997 and 1998. (A2513-43.) Each FPAA proposed reallocations of Castle Harbour's income among the partners based on, as relevant here, three alternative theories: (i) the transactions lacked economic substance (A2519, 2535); (ii) no real partnership existed for

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[12] The 20% rate is used because the GE consolidated group was subject to the alternative tax during the years at issue, and thus subject to a 20% tax rate. (Doc. 51 at 20, n.15.)

tax purposes (A2521, 2537); and (iii) the allocations lacked "substantial economic effect" under I.R.C. § 704(b)(2) (A2523, 2539). For 1997 and 1998, the IRS also asserted accuracy-related penalties under I.R.C. § 6662.[13] (A2543.) Pursuant to I.R.C. § 6226(e)(1), TIFD III-E deposited with the IRS $62,212,010, *i.e.*, the maximum additional income tax that it would owe as a result of the proposed adjustments. (A20, A32-A33.) TIFD III-E filed suit in the District Court challenging the FPAAs. (A16-40.)

D. The District Court's first opinion

On November 2, 2004, the District Court issued an opinion in favor of GECC. (SPA1-50.) The District Court first found that Castle Harbour's formation was not a sham transaction because it had both economic effect and non-tax business purpose. (SPA26-30.) While the court agreed that, by way of the Investment Accounts, the Dutch Banks "were almost entirely certain of at least an 8.5% internal rate of return on their investment," the court opined that "a lack of risk is not enough

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[13] For tax years ending after August 5, 1997, penalties that relate to partnership items may be considered in partnership proceedings. I.R.C. § 6226(f), as amended by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1238(b)(1). For tax years ending before that date, the applicability of penalties must be determined in separate partner-level proceedings.

to make a transaction economically meaningless." (SPA28.) The court observed that "the Dutch Banks still participated in the – economically real – upside of the leasing business." (*Id.*) Regarding business purpose, the court noted that GECC executives testified that raising capital and demonstrating to investors and credit agencies that it could raise capital with respect to Stage II aircraft were significant motivations for the deal. (SPA29.) The court stated that "against the backdrop of the objective economic reality of the Castle Harbour transaction – i.e., that GECC *did* raise $117 million and increase its liquidity by retiring debt – I find the testimony of GECC's executives persuasive." (SPA30.)

The District Court then addressed the Government's argument that, under *Commissioner v. Culbertson*, 337 U.S. 733 (1949), the partnership should be disregarded because the parties did not join together with the intent of forming a true partnership. (SPA30-41.) The court stated that determining the validity of the partnership was the same as the economic substance analysis it had just undertaken, except that the focus is on the choice of the partnership form. (SPA30.) The court noted that it had previously "concluded that *the transaction that created Castle Harbour* was not a sham." (SPA34, emphasis in

original.) The court also considered the Government's argument that the debt-like nature of the Banks' interests indicated that the Banks were not bona fide partners, but the court opined that the Banks' interests were equity. (SPA36-41.)

Finally, the District Court considered whether the allocation of 98% of Operating Income to the Dutch Banks had substantial economic effect under I.R.C. § 704(b). (SPA41-48.) The Government argued that the allocation lacked substantial economic effect under the so-called "overall tax effect" test of Treas. Reg. § 1.704-1(b)(2)(iii)(a), which provides that an allocation's economic effect is not substantial if—

> at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement.

The baseline for determining what the allocation would have been if the allocation at issue were not contained in the partnership agreement is the partners' interests in the partnership. The Government asserted that Castle Harbour's allocation violated the regulation because it

enhanced the after-tax return of both the GECC entities and the Banks, without creating a concomitant tax burden for any partner. Thus, according to the Government, the only "loser" was the public fisc. Looking to Treas. Reg. § 1.704-1(b)(3)(ii)(a), the Government asserted that income should be reallocated according to the Banks' true interest in Castle Harbour, which was only 18% based on their capital contributions.

The District Court rejected the Government's argument. Under Treas. Reg. § 1.704-1(b)(3), the court stated, "[a] partner's interest in the partnership signifies 'the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated.'" (SPA43.) The court observed that "[t]he Operating Agreement explicitly allocates the Dutch Banks 98% of all the partnership's Operating Income," and that "[t]hroughout the existence of the partnership the Dutch Banks always received 98% of all the partnership's Operating Income." (*Id.*) The court concluded that "[i]t is therefore crystal clear that the Dutch Banks agreed to receive – and actually did receive – the economic benefit of 98% of all the Operating Income of Castle Harbour, making their 'partner's interest in the

partnership,' with respect to Operating Income, 98%." (SPA44.) With respect to the fact that the Banks only had contributed approximately 18% of Castle Harbour's capital, the court stated that "[c]ontribution of capital to the partnership is one factor that may be considered," but that "it has little weight in this case when balanced against the other factors." (SPA43.) The court, however, did not delineate what other factors it considered. The court concluded that, since there was no difference between the allocations made and each partner's actual interest in the partnership, the overall-tax-effect rule was not violated. (SPA47.) The court continued that, "even if applicable, the overall tax effect rule would have no effect because reassignment of income based on the partners' interests in the partnership would result in the same allocation actually made," since, in that case, the Operating Income would be allocated in accordance with the partners' interests in the partnership. (*Id.*)

E. This Court's reversal

The Government appealed to this Court. It argued that Castle Harbour was not a valid partnership under *Culbertson* and, even if it was, the 98% allocation of Operating Income to the Dutch Banks lacked

substantial economic effect under I.R.C. § 704(b).[14] This Court reversed.

The Court began its analysis by stating that "[t]his appeal tests the power of the Internal Revenue Service to examine and recharacterize an interest which accords with its ostensible classification only in illusory or insignificant respects." (SPA54.) The Court explained that "[i]n most respects . . . we have no quarrel with the district court's precise, thorough, and careful findings" (SPA56), but it ruled that the District Court's conclusion was "impaired" "by accepting at face value the appearances and labels created by the partnership rather than assessing the underlying economic realities" (SPA62). The Court held that "the allocation of partnership resources . . . compel[s] the conclusion that the IRS correctly determined that the Dutch banks were not bona fide equity participants in the partnership." (SPA55.) The interest of the Dutch Banks, the Court concluded, "was

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[14] In its opening brief on appeal, the Government stated that although it continued to believe the transactions lacked economic substance, it was not making that argument on appeal. In its opinion, this Court stated that its "disposition makes it unnecessary for us to consider whether the district court correctly determined that the characterization of the banks' interest as equity was not a sham." (SPA62, n.11.)

overwhelmingly in the nature of secured debt." (SPA58.) The Court explained that "[t]he partnership interests of the Dutch banks were designed to have a superficial appearance of equity participation, but in the end (in all but a negligible part) to function in the manner of a repayment of a secured loan." (*Id.*) Thus, "[w]hile their interest was not totally devoid of *indicia* of an equity participation in a partnership, those indicia were either illusory or insignificant in the overall context of the banks' investment," and, therefore, "[t]he IRS appropriately rejected the equity characterization." (SPA62.)

The Court further explained that the IRS "is entitled in rejecting a taxpayer's characterization of an interest to rely on a test less favorable to the taxpayer, even when the interest has economic substance," and, in this regard, held that the District Court erred as a matter of law by rejecting the Government's argument "that the Dutch banks' interest was not a bona fide equity partnership participation without examining the question under the all-facts-and-circumstances test of *Culbertson*." (SPA62.) The Court stated that "[t]he IRS's challenge to the taxpayer's characterization is not foreclosed merely because the taxpayer can point to the existence of some business purpose or objective reality in addition to its tax-avoidance objective." (SPA63.) The Court then

instructed that "[c]onsideration whether an interest has the prevailing character of debt or equity can be helpful in analyzing whether, for tax purposes, the interest should be deemed a bona fide equity participation in a partnership." (*Id.*) While the District Court made this inquiry, the Court held that the District Court "made errors of law, which undermined it conclusion." (*Id.*) The Court explained that "[i]n large part these errors consisted in accepting at face value artificial constructs of the partnership agreement without examining all the circumstances to determine whether powers granted to the taxpayer effectively negated the apparent interests of the banks." (*Id.*)

In determining whether the interests of the Dutch Banks were more in the nature of debt or equity, the Court first considered the Dutch Banks' share in the upside potential of Castle Harbour. The Court rejected the District Court's conclusion that the Banks had a meaningful share of the upside potential, stating that this conclusion "depended on the fictions projected by the partnership agreement, rather than on assessment of the practical realities," and noting that "[t]he realistic possibility of upside potential—not the absence of formal caps—is what governs this analysis." (SPA65.) The Court held that "the banks enjoyed only a narrowly circumscribed ability to participate

in profits in excess of their Applicable Rate of return," noting that, as the District Court had found, GECC had the power to transfer productive assets to CHLI, thereby reclassifying income from those assets as Disposition Gain rather than Operating Income.[15] (*Id.*) The Court further noted that Operating Income was drastically reduced by book depreciation and that GECC could terminate Castle Harbour at any time at a negligible cost. (SPA65-66.)

In considering the Dutch Banks' potential risk of loss, the Court stated that "features" of the partnership agreements provided the Banks with "an ironclad assurance that they would receive repayment of their principal at the Applicable Rate of return, regardless of the success of the Castle Harbour venture." (SPA70-71.) These features included (SPA71):

> (a) the Exhibit E payment schedules; (b) the Investment Accounts; (c) the Class A Guaranteed Payments; (d) the requirement for the benefit of the Dutch banks that CHLI maintain Core Financial Assets of 110% of the obligation owed to the Dutch banks; (e) the banks' ability to liquidate the partnership in certain circumstances and receive reimbursement at the Applicable Rate of return; (f) the $300 million worth of casualty-loss insurance, which was obtained

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[15] The Court rejected GECC's challenge to this finding, stating that "[w]e consider the taxpayer's argument that the district court's finding was clear error to be frivolous." (SPA65, n.14.)

> by Castle Harbour for the benefit of the Dutch banks; and, most importantly, (g) GECC's personal guaranty of the obligations owed by the partnership to the Dutch banks.

The Court also stated that the District Court had erred by giving little or no weight to the facts that: (i) the Dutch Banks had the power to enforce the payment of their principal and interest (SPA68-69), (ii) the Banks had no right to participate in the management of Castle Harbour (SPA69), (iii) the Banks repeatedly characterized their interests in Castle Harbour as debt for financial accounting and Dutch tax purposes (SPA69-70), and (iv) Castle Harbour was precluded from using the Banks' investment in the aircraft-leasing business as a result of the requirement that CHLI maintain 110% of the Banks' Investment Accounts in Core Financial Assets (SPA71).

The Court ultimately concluded that an analysis of the Banks' interests "under *Culbertson's* mandate to appraise the totality of the circumstances compels the conclusion that, for tax purposes, the banks were not bona fide equity partners in Castle Harbour," and therefore there was "no reason to remand for new findings." (SPA71.) The Court stated that "[t]he transaction consisted, as a practical matter, of an advance by the Dutch banks of $117.5 million," and "[t]he partnership undertook to repay the advance at an agreed rate of return, pursuant to

a previously agreed payment schedule." (*Id.*) Given all the facts and circumstances,"[t]he Dutch banks' interest was in the nature of a secured loan, with an insignificant equity kicker," and thus "for tax purposes, not a bona fide equity participation." (SPA72.)

In light of its ruling, the Court did not reach the Government's argument that the 98% allocation lacked substantial economic effect under I.R.C. § 704(b). (SPA55, n.1.) It also did not consider GECC's argument that the Dutch Banks could qualify as partners under I.R.C. § 704(e)(1), the "family partnership" provision, an issue that had not been addressed by the District Court. (SPA72, n.19.) The District Court also had not addressed the Government's penalty claims. Accordingly, the case was "remanded for further proceedings consistent with this opinion." (SPA72.) Finally, the Court stated that "[i]n the event of a subsequent appeal, the matter will be assigned to this panel."[16] (*Id.*)

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[16] GECC filed a petition for rehearing en banc in which it argued that this Court misconstrued the guaranty given the Dutch Banks by GECC. (2d. Cir. 05-0064, 9/18/06.) The petition was denied. (2d. Cir. 05-0064, 10/6/06.)

F. The District Court's opinion on remand

On remand, the Government argued that this Court's decision that the Dutch Banks were not bona fide equity partners in Castle Harbour compelled the conclusion that they did not qualify as partners under I.R.C. § 704(e)(1). As relevant here, I.R.C. § 704(e)(1) provides that "[a] person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person." The Government further argued that penalties for substantial understatement of tax and negligence applied. The District Court disagreed on both counts.[17]

The District Court began its analysis by rejecting the Government's argument that this Court's opinion required the conclusion that the Dutch Banks did not qualify as partners under

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[17] In a footnote at the beginning of its opinion, the District Court took issue with this Court's statement that the District Court had failed to apply the *Culbertson* test, stating that while it did not focus on "whether the Banks' interest was bona fide equity participation," that was because "[t]he phrase 'bona fide equity participation' does not appear in any federal case law outside of *Castle Harbour II*." (SPA74, n.1.) The court later stated that the "Second Circuit pointed to no case in support of its suggestion that a partnership, although not a sham, might nevertheless fail the *Culbertson* analysis, and it is difficult to imagine one." (SPA103.)

I.R.C. § 704(e), stating that "if the question of the Dutch Banks' status under section 704(e) were closed, the Second Circuit would not have remanded this case with instructions to consider that question." (SPA100.) "[M]ore importantly," the court stated, "the Second Circuit's holding that '[t]he Dutch banks' interest was in the nature of a secured loan, with an insignificant equity kicker,' does not necessarily distinguish the Banks' interests from other debt-like instruments that, despite appearances, are not considered debt for tax purposes." (*Id.*) In this regard, the court cited to *Jewel Tea Co. v. United States*, 90 F.2d 451 (2d Cir. 1937), and *Commissioner v. O.P.P. Holding Corp.*, 76 F.2d 11 (2d Cir. 1935), as cases recognizing that debt-like instruments, such as preferred stock, nevertheless may qualify as equity for tax purposes. (SPA100-01.) Thus, the court held that "the government is mistaken in its assertion that, because the Second Circuit has held that the Dutch Banks' interests in Castle Harbour are 'debt-like,' I must conclude that those interests are also debt." (SPA104.)

The District Court next held that, notwithstanding that I.R.C. § 704(e) is titled "Family partnerships," the provision is not so limited, but applies to all partnerships. (SPA105-06.) The court stated that I.R.C. § 704(e)(1) "sets forth an objective test for determining a putative

partner's status: if a person (an individual or business organization) (1) owns (2) a capital interest in (3) a partnership in which capital is a material income-producing factor, then that person is a partner and is taxed as one." (SPA106.) The court also opined that I.R.C. § 704(e) may have replaced the *Culbertson* test, or at least provided an alternative test, such that a decision based on *Culbertson* was not dispositive of whether the Banks were partners under I.R.C. § 704(e). (SPA116-18.)

In determining whether the Dutch Banks owned their interests in Castle Harbour, the District Court looked to Treas. Reg. § 1.704-1(e)(1)(iii), which provides:

> A donee or purchaser of a capital interest in a partnership is not recognized as a partner under the principles of section 704(e)(1) unless such interest is acquired in a bona fide transaction, not a mere sham for tax avoidance or evasion purposes, and the donee or purchaser is the real owner of such interest. To be recognized, a transfer must vest dominion and control of the partnership interest in the transferee.

The court noted that, in *Castle Harbour I,* it had "found that the transaction by which the Dutch Banks joined Castle Harbour was not a sham transaction entered into solely for tax avoidance or evasion purposes," and opined that this Court had not disturbed that finding.

(SPA106 & n.36.) Because there was no sham transaction, the court stated, "the relevant question under section 704(e)(1) is whether the Dutch Banks were the 'real owners' of their interests in the partnership." (SPA107.)

The District Court held that the Banks were the real owners of their interests in Castle Harbour. The court stated that "[b]ecause the Banks had the right to force a liquidation, GECC did not control the Banks' interests in Castle Harbour, even if GECC did primarily control and manage the partnership." (SPA108.) The court next stated that "the Dutch Banks participated in the management of the Castle Harbour entity," as they "participated in person at annual member meetings and by phone at quarterly manager meetings," and that "the Banks' consent was necessary for Castle Harbour to enter into certain transactions" and "on at least some occasions, Castle Harbour did seek the Banks' consent before acting." (SPA108-09.) The court further stated that the Banks regularly "received distributions, for their sole use and benefit, of their distributive shares of Castle Harbour's income." (SPA109.)

The District Court next considered whether the Banks' interests were capital interests. The court observed that Treas. Reg. § 1.704-

1(e)(1)(v) provides that "a capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership." (SPA110.) The court focused its analysis on whether the Banks could be required to restore negative capital account balances upon liquidation, which turned on the Banks' exposure to loss. (SPA111-13.) In this regard, the court held that the Banks "were exposed to risk" because, had Castle Harbour experienced any losses, the Banks would have been allocated 1% of losses exceeding $7 million, and 100% of losses exceeding $541.5 million. (SPA94-95.) Thus, the court stated that "although the Exhibit E payments reduced the Banks' share of the partnership's capital, the possibility still existed that, as holders of capital interests in Castle Harbour, the capital accounts of the Dutch Banks would be negative upon dissolution. In that case, the Banks would have owed money to the partnership." (SPA112.) The court concluded that "the Banks' capital accounts reflected their capital stake in Castle Harbour," as evidenced by "the Banks' receipt of $31 million from their capital accounts upon liquidation." (*Id.*) The court opined that "the performance guarantee of GECC did not insulate the Dutch Banks against loss of their capital

investment in the partnership," and thus, "the Dutch Banks' return on their capital investment (and risk of loss) was tied to the availability of partnership capital." (SPA113.)

The District Court then held that capital was a material income-producing factor in Castle Harbour. (SPA 114-16.) Accordingly, the court concluded that the Dutch Banks satisfied the criteria for partner status under I.R.C. § 704(e)(1). (SPA119.)

Finally, the District Court held that, even if it was wrong on the merits, no penalties should be imposed. Regarding the substantial understatement penalty, the court observed that the penalty did not apply if there was substantial authority supporting Castle Harbour's tax reporting, unless the transaction was a tax shelter. (SPA121.) *See* I.R.C. § 6662(d). The court first held that Castle Harbour had substantial authority for its position, as was reflected in both of the District Court's opinions. (SPA122-23.) Citing *Slifka v. Commissioner*, 182 F.2d 345 (2d Cir. 1950), and *Dyer v. Commissioner*, 211 F.2d 500 (2d Cir. 1954), the court stated that, since *Culbertson*, this Court has held that "if a partnership has economic substance or a valid business purpose, parties to that partnership are partners and should be treated as having equity interests for tax purposes." (SPA123.) The court

thought that was the case here, stating that "the Second Circuit did not disturb my factual finding that the transactions resulting in the formation of Castle Harbour were not sham transactions; neither did the Second Circuit disturb my factual findings that valid business purposes, such as improving GECC's debt-to-equity ratio, factored into the relationships that the various Castle Harbour entities entered into." (SPA125.) The court also opined that "[t]he Second Circuit's holding that the IRS 'is entitled in rejecting a taxpayer's characterization of an interest to rely on a test less favorable to the taxpayer, even when the interest has economic substance,' states a novel proposition of law," such that "the holding of *Castle Harbour II* was not the established law of this Circuit prior to 1998." (SPA124.) The court also cited *Jewel Tea* and *O.P.P. Holding* as authority for the proposition that even though the Dutch Banks' interests were debt-like, that did not preclude those interests from being equity. (SPA126.)

The District Court next held that Castle Harbour was not a tax shelter. The court reiterated that "[t]he Second Circuit, in *Castle Harbour II*, did not disturb my factual findings that, despite Castle Harbour effectively sheltering significant income from taxes, the partnership had 'bona fide purposes' and 'some genuine economic

effect,'" and it stated that "[n]owhere in *Castle Harbour I* or *Castle Harbour II*, is there a factual finding or legal conclusion that tax savings were the principal purpose of the Castle Harbour transaction." (SPA128.) Because there was no tax shelter, the court found it unnecessary to "reach the question of whether a 'reasonable belief' defense shields the Castle Harbour partners from tax shelter liability." (*Id.*) The District Court concluded by holding that, as Castle Harbour's position was substantially justified, the negligence penalty likewise did not apply. (SPA128-29.)

SUMMARY OF ARGUMENT

1. The District Court erred in concluding that the Dutch Banks were partners of Castle Harbour because they owned "capital interests" in Castle Harbour within the meaning of I.R.C. § 704(e)(1). At the outset, I.R.C. § 704(e)(1) deals with a transfer of an interest in a valid, existing partnership and, thus, is inapplicable here *ab initio*. On its face, I.R.C. § 704(e)(1) has nothing to do with determining whether a partnership exists. Rather, it assumes the existence of a partnership and provides a rule for determining whether a particular person is one of the partners. The issue here, by contrast, is whether Castle Harbour was a valid partnership from its inception.

But even if I.R.C. § 704(e)(1) applies, this Court's holding that the Banks' interests in Castle Harbour were not equity is dispositive. A capital interest is synonymous with an equity interest, and, therefore, the District Court's ruling is diametrically opposed to this Court's holding. Moreover, the District Court's ruling was based on the false premises that the Banks faced a meaningful risk of loss, such that they could be required to restore negative capital accounts upon liquidation of Castle Harbour, and that their return ultimately was tied to the overall performance of Castle Harbour. These conclusions are not supported by the record, and they directly conflict with this Court's interpretation of the facts in *Castle Harbour II*.

2. Even if the Dutch Banks qualified as partners, the District Court erred in ruling that the allocation of 98% of Operating Income to the Banks had substantial economic effect under I.R.C. § 704(b). The allocation lacked substantial economic effect because it enhanced the after-tax returns of both GECC and the Banks, without creating a concomitant tax burden for any partner. The 98% allocation saved GECC $52 million in taxes, though GECC enjoyed the lion's share of Castle Harbour's actual income. The Dutch Banks bore no increased

tax burden as a result of the allocation because they were not subject to U.S. tax. Thus, the only loser was the public fisc.

Consequently, I.R.C. § 704(b) requires that Castle Harbour's income be reallocated according to the partners' interests in the partnership. The District Court erred in ruling that the Banks' interest in Castle Harbour was 98%. It focused solely on whether the Banks received 98% of Operating Income, as opposed to whether the Banks received 98% of Castle Harbour's *actual* income, unreduced by book depreciation of the aircraft, and it failed to consider other relevant factors set forth in the pertinent Treasury regulation. When those factors are considered, it is clear that the Banks' combined interest in Castle Harbour was no more than 18%.

3. Finally, the District Court erred in holding that penalties for substantial understatement of tax and negligence did not apply. It is clear from the structure and actual workings of the deal, when viewed in its entirety, that the Dutch Banks agreed to facilitate, for a fee, the sheltering of aircraft lease income to be received by GECC that would otherwise no longer be sheltered by depreciation deductions. GECC's business reasons were merely window dressing. And contrary to the District Court's view, this Court did not ratify the District Court's

finding of economic substance. Rather, this Court explicitly stated that its disposition under *Culbertson* made it unnecessary to review that determination.

In rejecting application of the penalties, the District Court erred in ruling that the Castle Harbour transaction was not a tax shelter and that there was substantial authority for treating the Banks as partners. As this Court stated, the District Court essentially acknowledged that the Castle Harbour transaction was largely tax-motivated. Moreover, there simply is no authority, let alone substantial authority, for the proposition that the partnership provisions can be manipulated as they were in this case. Though the District Court ruled in favor of GECC twice, it did so, in this Court's words, only "by accepting at face value the appearances and labels created by the partnership, rather than assessing the underlying economic realities." (SPA62.)

Finally, despite having the burden of proof, GECC made no effort below to establish that it met the reasonable-cause exception from the penalties. GECC successfully objected to the introduction of any of the tax advice it received, and it did not show that it engaged in any independent analysis of its tax position.

Accordingly, the District Court's judgment should be reversed.

ARGUMENT

I

The District Court erred in holding that the Dutch Banks were partners of Castle Harbour under I.R.C. § 704(e)(1)

Standard of review

The District Court's interpretation of I.R.C. § 704(e)(1) is a legal question reviewed *de novo*. The District Court's application of I.R.C. § 704(e)(1) to its earlier findings of fact and to this Court's interpretation of such facts also is a legal determination that is reviewed *de novo*. *See Vasquez v. GMD Shipyard Corp.*, 582 F.3d 293, 297 (2d Cir. 2009).

A. I.R.C. § 704(e)(1) and its inapplicability in this case

I.R.C. § 704(e)(1) states:

> (e) FAMILY PARTNERSHIPS.—
>
> (1) RECOGNITION OF INTEREST CREATED BY PURCHASE OR GIFT.—A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

The Treasury regulations define "a capital interest in a partnership" as "an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership." Treas. Reg. § 1.704-1(e)(1)(v). The regulations also set forth a list of non-exhaustive factors to be considered in determining whether a person is the real owner of a capital interest. Treas. Reg. § 1.704-1(e)(2).

The legislative history of I.R.C. § 704(e)(1) states that it was intended to "make clear the fundamental principle that, where there is a real transfer of ownership, a gift of a family partnership interest is to be respected for tax purposes without regard to the motives which actuated the transfer." H. Rep. No. 586, at 33, 82d Cong., 1st Sess. (1951). As the House Report explains, "[m]any court decisions" since *Commissioner v. Culbertson*, 337 U.S. 733 (1949), had invalidated transfers of family partnership interests where there was no evidence of intent to benefit the partnership in some way. *Id.* at 32-33. Congress sought to dispel the "confusion" by "harmoniz[ing] the rules governing interests in the so-called family partnership with those generally applicable to other forms of property or business," *i.e.,* by making "it clear that, however the owner of a partnership interest may

have acquired such interest, the income is taxable to the owner, if he is the real owner." *Id.* The House Report further states that "[t]he amendment leaves the Commissioner and the courts free to inquire in any case whether the donee or purchaser actually owns the interest in the partnership which the transferor purports to have given or sold him," and that "[t]ransactions between persons in a close family group, whether or not involving partnership interests, afford much opportunity for deception and should be subject to close scrutiny." *Id.* at 33. Thus, the House Report states, "[a]ll the facts and circumstances at the time of the purported gift and during periods preceding and following it may be taken into consideration in determining the bona fides or lack of bona fides of a purported gift or sale." *Id.* *See also* S. Rep. No. 781, at 38-41, 82d Cong. 1st Sess. (1951).

The Treasury regulations and legislative history make clear that I.R.C. § 704(e)(1) is not intended to legitimize tax avoidance transactions. The regulations state that a "donee or purchaser of a capital interest in a partnership is not recognized as a partner under the principles of section 704(e)(1) unless such interest is acquired in a bona fide transaction, not a mere sham for tax avoidance or evasion purposes, and the donee is the real owner of such interest." Treas. Reg.

§ 1.704-1(e)(1)(iii); *see* H. Rep. No. 586, at 33 ("Cases will arise where the gift or sale is a mere sham."). In determining whether a transferee is the real owner, "all the facts and circumstances are taken into account." Treas. Reg. § 1.704-1(e)(1)(iii). The "reality" of ownership "is to be determined in the light of the transaction as a whole," and not based on "formal compliance" with "mechanical or formal tests." Treas. Reg. § 1.704-1(e)(2)(i) & (vi). Moreover, "[a] partnership may be recognized for income tax purposes as to some partners but not as to others." Treas. Reg. § 1.704-1(e)(1)(iii).

Although the District Court here observed that the language of I.R.C. § 704(e)(1) is not limited to family partnerships (SPA105), the plain language of the statute makes clear that it applies to transfers of interests in *existing* partnerships, and not to the formation of partnerships. Thus, the subsection is entitled "Recognition of interest created by purchase or gift," and states that "[a] person shall be recognized as a partner . . . if he owns a capital interest in a partnership . . . whether or not such interest was derived by purchase or gift from any other person." I.R.C. § 704(e)(1).

Moreover, the history and context of the provision establish that it was intended to address a situation where an interest in an existing

partnership is transferred in a non-arm's length transaction. Thus, the legislative history and the Treasury regulations focus on determining whether a purported partner is the real owner and whether there was a bona fide transfer. *See* H. Rep. No. 586, at 33; Treas. Reg. § 1.704-1(e)(1)(iii), (e)(2). Indeed, the primary cases cited by the District Court involved the transfer of an interest in a valid, existing partnership to a person closely related to the transferor. *See Evans v. Commissioner*, 447 F.2d 547 (7th Cir. 1973) (transfer of family partnership interest to partner's wholly-owned corporation); *Pflugradt v. United States*, 310 F.2d 412 (7th Cir. 1962) (transfer of limited partnership interests to minor children); *see also Bateman v. United States*, 490 F.2d 549 (9th Cir. 1973) (transfer of limited partnership interests to trusts created for children's benefit).

Because this case does not involve the transfer of a partnership interest in a valid, existing partnership, I.R.C. § 704(e)(1) has no application here. Rather, this case involves the formation of a partnership and whether it was a bona fide partnership from its inception. Moreover, there is no precedent for applying I.R.C. § 704(e)(1) to a multi-million dollar transaction involving large, sophisticated corporations acting at arm's-length. Indeed, the only

court ever to do so was reversed on appeal. *See Boca Investerings P'ship v. United States*, 167 F. Supp. 2d 298, 372 (D.D.C. 2001), *rev'd*, 314 F.3d 625 (D.C. Cir. 2003) (applied *Culbertson* in reversing finding of valid partnership); *see also ASA Investerings P'ship v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000) (applied *Culbertson* in ruling there was no valid partnership between AlliedSignal and Dutch bank).

The District Court also was wrong in opining that I.R.C. § 704(e)(1) may have replaced *Culbertson* as the relevant standard for determining whether a valid partnership exists or, at least, provides an alternative test. As one commentator aptly observed, "the idea that section 704(e) is an alternative to *Culbertson* came from the taxpayer's brief – the case law does not say this." Lee Sheppard, *News Analysis – Subchapter K's Attractive Nuisance*, 126 Tax Notes 131, 135 (Jan. 11, 2010). Again, I.R.C. § 704(e)(1), by its very terms, does not apply to the formation of a partnership, but applies to a transfer of an interest in an existing, valid partnership. Although the Seventh Circuit has opined that I.R.C. § 704(e)(1) replaced *Culbertson*'s subjective intent inquiry in the family-partnership context, *see Evans, Pflugradt, supra*, nothing suggests that I.R.C. § 704(e)(1) now supplies the test for determining whether a partnership is valid in the first instance. Nothing in the

legislative history of I.R.C. § 704(e)(1) purports to overrule *Culbertson*, *see* H. Rep. No. 586 at 33, and courts addressing the validity of family partnerships for tax purposes have continued to apply *Culbertson*. *See Bayou Verret Land Co. v. Commissioner*, 450 F.2d 850, 862-63 (5th Cir. 1971); *C.W. Payton v. United States*, 425 F.2d 1324, 1327 (5th Cir. 1970); *Spiesman v. Commissioner*, 260 F.2d 940, 948 (9th Cir. 1958); *Estate of Winkler v. Commissioner*, 73 T.C.M. (CCH) 1657, 1662 (1997). As the Ninth Circuit stated with respect to I.R.C. § 704(e)(1), "[t]he law was not changed in any respect as to the requirement existing under the Culbertson case . . . that the courts carefully scrutinize such transactions [and] determine the bona fides thereof." *Spiesman*, 260 F.2d at 948; *see Bayou Verret Land*, 450 F.2d 850, 863 n.24 (Fifth Circuit noted that possession of "a capital interest does not of itself mean that the partnership, although valid under state law, is valid for income tax purposes," citing *Culbertson*). Notably, no court, other than the District Court here, has ever held that a partnership that failed to satisfy the *Culbertson* test was rescued by I.R.C. § 704(e)(1).

B. The District Court's ruling that the Dutch Banks had capital interests in Castle Harbour is inconsistent with this Court's ruling that the Banks were not bona fide equity partners

Even if I.R.C. § 704(e)(1) applies in this case, the District Court erred in ruling that the Dutch Banks held capital interests in Castle Harbour. It is clear from the District Court's opinion that the court correctly understood a capital interest to mean an equity interest in Castle Harbour. (SPA100-04.) This Court concluded, however, with no room left for any dispute, that the Dutch Banks did *not* have a bona fide equity interest in Castle Harbour. That question, therefore, should have been considered settled. *See Burrell v. United States*, 467 F.3d 169, 165 (2d Cir. 2006) ("where issues have been explicitly or implicitly decided on appeal, the district court is obliged, on remand, to follow the decision of the appellate court"); *United States v. Minicone,* 994 F.2d 86, 89 (2d Cir. 1993) (same); *United States v. Cirami*, 563 F.2d 26, 33 n.6 (2d Cir. 1977) (same). Indeed, this Court remanded the case to the District Court for "proceedings consistent with" its opinion. (SPA72.) The District Court's decision that the Dutch Banks had capital interests in Castle Harbour simply is *not* consistent with this Court's opinion. To the contrary, it is diametrically opposed.

The District Court felt free to revisit the issue for two reasons. First, it questioned why this Court remanded the case if it did not want the matter revisited in the context of I.R.C. § 704(e)(1). (SPA100.) To be sure, GECC had raised the applicability of I.R.C. § 704(e)(1) in the first appeal, but the parties devoted very little of their extensive briefs to the issue. GECC addressed the issue in a rather cursory and conclusory manner, and the Government responded in like manner. (2d Cir. 05-0064, Appellee Br. 63-65 & Reply Br. 14-15.) Under these circumstances, it is hardly surprising that this Court chose to allow the District Court to consider the matter in the first instance. But it did so instructing that the remand proceedings be "consistent with" its decision. Thus, the remand should not have been seen as an invitation to reopen what was settled. Indeed, this Court expressly considered whether it needed to remand the question whether the Dutch Banks had a bona fide equity interest and concluded that it did not. (SPA71.)

The District Court also stated that this Court's holding that the Banks' interest was in the nature of a secured loan with an insignificant equity kicker did not distinguish that interest from other debt-like interests, such as preferred stock, that are considered equity, and thus did not preclude it from determining on remand that the

Banks' interest was equity. (SPA100-04.) But, irrespective of the fact that a debt-like interest may yield equity in some circumstances, this Court had already decided that the interest at issue *here* was not equity. It stated unequivocally that "[t]he IRS appropriately rejected the equity characterization." (SPA62.) And in so ruling, this Court had considered the very point made by the District Court. In the first appeal, GECC argued that debt-like interests, such as preferred stock, may be considered equity, and GECC likened the Dutch Banks' interest to such instruments. This Court plainly did not agree under the circumstances of this case. Moreover, this Court was aware of the cases cited for support by the District Court (*Jewel Tea* and *O.P.P. Holding*), as this Court cited both cases in its opinion. (SPA63, 70.)

As evidenced by the District Court's misplaced emphasis on whether or not the Dutch Banks' interest was actually debt, the court failed to come to terms with this Court's ultimate holding. The gist of this Court's opinion was that the Banks were not bona fide partners in Castle Harbour under all of the facts and circumstances and that, taking into account the practical and economic realities, there was no valid partnership between GECC and the Banks. The absence of a

valid partnership between GECC and the Banks is indeed dispositive of the question whether the Banks were partners under I.R.C. § 704(e)(1).

C. In any event, the Dutch Banks did not have capital interests in Castle Harbour within the meaning of I.R.C. § 704(e)(1)

In any event, even if the District Court did not err by ignoring this Court's holding that the Dutch Banks did not have a bona fide equity interest in Castle Harbour, the court erred in concluding that the Banks had a capital interest in Castle Harbour. It is clear from the structure and actual workings of the deal, when viewed in its entirety, that the Dutch Banks did not acquire capital interests in Castle Harbour. Instead, the Dutch Banks agreed to facilitate, for a fee, the sheltering of aircraft lease income to be received by GECC that would otherwise no longer be sheltered by depreciation deductions. In holding otherwise, the District Court repeated the same central mistake this Court concluded it made in its first opinion—it ignored the practical realities of the transaction. The District Court's analysis of whether the Banks owned capital interests in Castle Harbour ignores many of this Court's essential conclusions in the first appeal. The District Court held fast to the "illusory [and] insignificant" "indicia" of equity (SPA62) that were rejected by this Court as "window dressing" (SPA67). In

particular, the court's ruling was based on the false premises that the Banks faced a real risk of loss and, thus, the possibility of restoring negative capital accounts; that the capital accounts reflected the Banks' true stake in Castle Harbour; and that the amount the Banks would receive upon liquidation ultimately depended on the performance of Castle Harbour as a whole.

1. There was no meaningful risk of loss and, thus, no realistic possibility that the Banks would have to restore negative capital accounts

The central pillar of the District Court's ruling was its determination that the Dutch Banks were exposed to risk of loss and, thus, "incurred real risk that their capital accounts would run negative." (SPA113.) At the outset, the District Court viewed this Court as having only addressed "the Banks' potential gains, not their exposure to loss," and, thus, it did not consider this Court's opinion to "compel a holding that the Banks were not potentially exposed to loss on their investment in Castle Harbour." (SPA95, n.30.) The District Court apparently disregarded this Court's unequivocal statements that "there was no realistic chance that the Dutch banks would receive less than the reimbursement of their initial investment at the Applicable Rate of annual return" (SPA59), that they were "fully protected against

risk of loss, except as to a tiny amount in highly unlikely circumstances" (SPA60), and that the Banks thus "incurred no meaningful downside risk" (SPA59).

This Court was correct. The Exhibit E payments that the Banks received every year provided them with both the return of part of their investment and interest. Moreover, the Exhibit E payments were front-loaded so that the Banks were repaid nearly $88 million of their $117.5 million investment during the first three years of the arrangement. *See* n.11, *supra*. (A828.)

The Banks also were assured that they would receive the targeted yield by the Investment Accounts and the Class A payments. The Investment Accounts kept track of the balance that the Banks would receive on dissolution of Castle Harbour. The opening balance of each account was the initial investment made by each Bank. The balance was recalculated as if the amount had been increased each year by a defined Applicable Rate, which was 9.03587%. Each balance was decreased by the Exhibit E payments made to the Bank. (A565, 570-72.) At dissolution, if the dissolution was caused by certain defined events (generally involving acts of the Banks), the balance of the Investment Accounts would be recalculated using a rate of 8.53587%.

(*Id.*) If, at the dissolution of Castle Harbour, the Investment Accounts exceeded the Banks' capital accounts, the Banks would receive the balance of their capital accounts, together with the Class A payments, which equaled the difference between the total adjustments to the Banks' Investment Accounts and the balance in their capital accounts. (A568-71.) Accordingly, as the District Court acknowledged (SPA92), the effect of the Investment Accounts and Class A payments was to ensure that the Banks would receive the return of their investment, plus interest of 9.03587% or 8.53587%.[18]

Furthermore, the "Core Financial Assets" requirement ensured that the Dutch Banks would be repaid their investment plus interest. Under the Operating Agreement, CHLI was required to hold high-grade commercial paper or cash, referred to as Core Financial Assets, in an amount equal to 110% of the current value of the Investment Accounts, so as to ensure that, at all times, Castle Harbour had access to sufficient funds with which to return to the Banks their investment

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[18] Only in the highly unlikely event that Castle Harbour suffered cumulative Operating Losses in excess of $3,854,493 or Disposition Losses in excess of $2,854,493, would the return of the Dutch Banks be somewhat lessened, as 1% of such excess was allocable to them and was not covered by the Investment Accounts. *See* pp. 13-14, *supra*.

plus interest. (A573, 586-88, 636-37 (§5.8(b)).) And the Banks received additional protection from any risk of loss by GECC's having personally guaranteed the performance (including the obligations to make payments) of the GECC entities, CHLI, and the managers of Castle Harbour (A1068), and by Castle Harbour maintaining $300 million of insurance covering casualty losses (A625-26 (§5.5(a)(ix)); A173, 229-30, 1209). Together, these mechanisms effectively immunized the Banks from any risk of loss.

Indeed, the District Court itself acknowledged that the Banks were exposed to "little more than . . . a total risk of just over $7 million," because the Operating Agreement allocated only 1% of losses exceeding $7 million to the Banks. (SPA91-92.) The court further stated that the Banks "were actually protected against the possibility of even that $7 million in losses by their Investment Accounts." (SPA92.) The court explained that the Banks "would only have received less than the amount in their Investment Accounts if Castle Harbour had done badly enough to cause losses to be allocated to the Dutch Banks," stating that "[e]ven then, the effect in most scenarios would be minimal because the Banks would be allocated only 1% of losses until losses allocated to GECC exceeded $541.5 million, at which point the Banks

would be allocated 100% of losses until their capital accounts were eliminated." (SPA93-94.) The court characterized the latter scenario as "highly unlikely to come into play" and "not relevant to this case." (SPA84, n.18; SPA86, n.20.)

But the District Court then—inexplicably—concluded that, upon liquidation, "[e]ach Bank was entitled to the distribution of Castle Harbour's assets equal to the Bank's capital account balance, *not* the Bank's actual capital investment" (SPA96), seemingly forgetting that the Investment Accounts guaranteed against such a result except in the most remote of circumstances. Retreating from its previous assessment of the risk of loss, the District Court concluded that the Banks "were exposed to risk; a possibility existed that the Banks' capital investment in Castle Harbour would not be fully repaid," and that "overall downside risk was minimal, but still possible, and therefore not meaningless." (SPA95.) This thin reed became the basis for the District Court's determination that "the possibility . . . existed that, as holders of capital interests in Castle Harbour, the capital accounts of the Dutch Banks would be negative upon dissolution." (SPA112.) In so holding, the District Court once again "depended on the fictions

projected by the partnership agreement, rather than on an assessment of the practical realities." (SPA65.)

The District Court attempted to bolster its conclusion that the Banks might lose their capital investment and be forced to restore negative capital accounts by adding that "Castle Harbour's creditors had priority over the Dutch Banks" (SPA95-96) and that "the performance guarantee of GECC did not insulate the Dutch Banks against loss of their capital investment in the partnership" (SPA113). Both statements, however, are in direct conflict with this Court's conclusions in the first appeal. In the first appeal, this Court acknowledged that Castle Harbour's creditors technically had priority over the Banks upon liquidation, but it held that "[u]pon consideration of all the facts and circumstances it is clear that, far from being subordinate to the general creditors, the Dutch banks were secured in such a manner that they would be repaid in full with interest from a source to which general creditors had no access." (SPA68.) This Court labeled the "apparent subordination" a "fiction." (*Id.*)

With respect to the GECC guaranty, this Court pointed to the guaranty as an indication that repayment of the Banks' investment at the Applicable Rate of return was securely protected and effectively

assured. (SPA57, 59, 60, 68, 70-71.) On remand, however, the District Court stated that the guaranty "did not in any way insulate the Dutch Banks from the possibility of losses in excess of their capital investments," but merely "guaranteed that [the GECC entities] would perform their obligations under the partnership agreement." (SPA113.) Not only does the District Court's interpretation conflict with this Court's opinion, but it conflicts with the plain language of the guaranty. The guaranty, which is a "Performance and Payment Guaranty," explicitly guarantees the "due and punctual performance *and payment*" of all "covenants, obligations and indemnities, whether direct or indirect, absolute or contingent, due or to become due" under all of the operative agreements. (A1068, emphasis added.) It states that "[s]uch guaranty of *payment* is an absolute, present and continuing guaranty of payment . . . and is in no way conditioned or contingent upon any other action, occurrence or circumstance whatsoever."[19] (*Id.*, emphasis added.)

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[19] It should be noted that GECC made the very argument accepted by the District Court in its petition for rehearing from this Court's opinion (2d Cir. 05-0064, Pet. for Reh'g 3-6), which this Court denied.

In short, the District Court's determination that the Banks incurred a real risk of loss and, thus, the possibility of restoring negative capital accounts was wrong. The court once again erred by "accepting at face value the appearances and labels created by the partnership, rather than assessing the underlying economic realities." (SPA62.)

2. The capital accounts essentially were meaningless

The District Court also elevated form over substance in ruling that "the Banks' capital accounts reflected their capital stake in Castle Harbour." (SPA112.) Although Castle Harbour complied with the formal requirements to maintain capital accounts for each partner, the Banks' return was not dependent on the capital accounts. Rather, the allocation of 98% of Operating Income, the Disposition Gain formula, and the Investment Accounts were finely tuned to ensure that the Banks would receive, through Exhibit E and Class A payments (if necessary), a target yield of 9.03587% on their investment. And when

all was said and done, the Banks' return (9.1%) varied only insignificantly from that target yield.[20]

The District Court believed that because the capital accounts might fluctuate based on Castle Harbour's performance, so too could the Banks' return. (SPA112-14.) As previously discussed, however, there was no realistic possibility that the Banks would lose their investment. There was likewise little chance that the Banks would earn a return beyond the repayment of their $117.5 million contribution plus interest. Castle Harbour's income was highly predictable, as the airplanes that GECC contributed were subject to existing leases, and if Castle Harbour earned more lease income than projected, the Operating Agreement provided an easy means for GECC to direct that income to itself. Disposition Gain was allocated between the Banks and the GECC entities far differently than Operating Income: after the Banks had been allocated combined Disposition Gain of $2.8 million, 99% of Disposition Gain would go to GECC. And, all

[20] The variation was caused by the termination of the Banks' interests after only five years, instead of the eight years contemplated in the Operating Agreement, which required GECC to pay the Banks an Indemnification Premium. (A1789, 1795.) The early termination was due to changes in the U.S. tax laws that may have subjected the Dutch Banks to U.S. tax. (A2664-67, 2672-76.)

income generated by CHLI, whether lease income or gain from the sale of aircraft, was treated as Disposition Gain. Accordingly, as this Court recognized (SPA65), GECC could convert Operating Income to Disposition Gain simply by transferring aircraft or income from Castle Harbour to CHLI. GECC also could control the Banks' return by repurchasing the Banks' interests at any time, incurring only a small premium, as it ultimately did in 1998.

On remand, the District Court thought it was significant that if the Banks' capital accounts exceeded their Investment Accounts upon liquidation, they would receive the amount in their capital accounts, and it emphasized that that is what actually occurred. (SPA112.) However, the court ignored the fact that Castle Harbour was structured so as to allow GECC effectively to control the Banks' capital accounts. Indeed, the financial statements for Castle Harbour's last year (1998) show that the Banks' capital account balances totaled $23,746,000, and the Investment Account balances totaled $30,922,000. (A1722-23.) The capital account balances were later increased to $31,004,000 to reflect "agreed" increases in the fair market value of Castle Harbour's assets (*i.e.,* airplanes and CHLI stock). (A1795, 1789.) After these expedient adjustments, the Banks' capital accounts exceeded the Investment

Accounts by a mere $82,000, such that the Banks received the balance in their capital accounts. Thus, the Banks effectively received the balance of their Investment Accounts, only it was denominated a payout from the capital accounts. In the end, the total amount the Banks received over the life of Castle Harbour (approximately $150 million) reflects a 9.1% return on their money, exactly what they were promised. The District Court wholly failed to grasp that what the Banks received upon liquidation was precisely what they were guaranteed to receive from the inception of the deal.

In short, the Banks' capital accounts essentially were irrelevant and, contrary to the District Court's holding (SPA112), "the Banks' ultimate payout" was *not* "tied to their share of the partnership's capital." As a practical matter, the Banks were guaranteed to receive upon liquidation at least the balance of their Investment Accounts, regardless of the balance of their capital accounts.

3. The Banks' return was not tied to Castle Harbour's overall performance

The District Court also erroneously believed that "any payments that the Banks would and did receive" from their capital accounts "depended on the performance of Castle Harbour as a whole."

(SPA113.) As discussed above, this simply ignores the practical realities of the transactions. Furthermore, this interpretation of the facts is untenable in light of this Court's conclusion that "features of the Castle Harbour agreements combined to provide the Dutch banks with . . . an ironclad assurance that they would receive repayment of their principal at the Applicable Rate of return, *regardless of the success of the Castle Harbour venture*." (SPA70-71 (emphasis added)); *see also* SPA57 ("The scheduled reimbursement of the Dutch banks . . . was in no way dependent on partnership performance."); SPA59 ("reimbursement at a minimum of the Applicable Rate of return was assured independent of the operating results of the partnership."); SPA72 ("Only in negligible fashion was their well-secured interest intertwined with the fortunes of the business."). Though this Court repeatedly stated that the Banks' return was *not* tied to Castle Harbour's performance, the District Court inexplicably maintained that the Banks' ultimate distribution on liquidation "would have fluctuated (and might have been negative) had Castle Harbour, as a whole, performed differently." (SPA114.) Contrary to the District Court's view, the return of the Banks' investment was indeed "pre-ordained" (SPA112).

4. The District Court's treatment of other relevant factors is inconsistent with this Court's opinion

In ruling that the Dutch Banks owned capital interests in Castle Harbour, the District Court failed to give effect to two relevant points made by this Court in the first appeal. Specifically, despite this Court's rulings to the contrary, the District Court concluded that the Dutch Banks participated in management, and that the Banks contributed true capital to Castle Harbour.

In its first opinion, the District Court recognized that the Banks' right to participate in management was minimal, and ultimately opined that it was irrelevant to the analysis. (SPA18, 39-40.) This Court, after acknowledging that the Banks participated in annual meetings and exercised some negative control, likewise viewed the Banks as having "no right to participate in management" as a practical matter. It held that this factor supported rejecting the equity characterization. (SPA69.) On remand, however, the District Court concluded that the Banks' participation in management was "real" and that it supported a finding that the Banks owned capital interests. (SPA109.) But this Court had it right. The record establishes that GECC controlled the operations and management of Castle Harbour,

selected all of the managers, who were employed by GECC or related entities, and outsourced Castle Harbour's daily operations to a related entity. *See* pp. 19-20, *supra*.

In addition, the Banks' contribution cannot fairly be described as "capital" in the hands of Castle Harbour. On remand, the Government argued that the Dutch Banks' contributions to Castle Harbour were not incoming-producing capital because CHLI was required to maintain 110% of the Banks' contribution in Core Financial Assets. This Court had made the same observation, stating that "[f]or the Dutch banks' benefit, the Operating Agreement required that CHLI maintain 110% of the Dutch Banks' Investment Accounts in Core Financial Assets, thereby precluding the partnership from using the banks' investment in the partnership's aircraft-leasing business." (SPA71.) In support of the argument on remand, the Government cited to *Poggetto v. United States*, 306 F.2d 76, 79 (9th Cir. 1972), in which the Ninth Circuit held that the taxpayer's daughter was not a partner in the family partnership under I.R.C. § 704(e)(1) because, among other things, her "investment was without benefit to the income-producing capacity" of the partnership.

The District Court rejected the Government's argument, stating that nothing in the regulations under I.R.C. § 704(e)(1) requires a partner's capital contribution to be income-producing and that, in any event, Castle Harbour utilized capital to purchase commercial jets for leasing. (SPA114-16.) In so holding, the District Court once again failed to see the forest for the trees. Though the Treasury regulations do not specifically require that a partner's contribution be income-producing, they do require an examination of all of the relevant facts and circumstances. As this Court recognized, the fact that GECC did not need or use the Dutch Banks' contribution in the continued operation of its established aircraft-leasing business is a further indication that the Banks were not genuine partners in Castle Harbour.

In conclusion, the District Court erred in determining that, despite this Court's previous rulings, the Dutch Banks nevertheless qualified as partners of Castle Harbour under I.R.C. § 704(e)(1).

II

Even if there was a genuine partnership, the District Court erred in holding that the allocation of 98% of Operating Income to the Dutch Banks had substantial economic effect as required by I.R.C. §704(b)(2)

Standard of Review

This Court reviews *de novo* the legal conclusion of the District Court that the allocation of 98% of Operating Income to the Dutch Banks had substantial economic effect. *Bausch & Lomb, Inc. v. Commissioner*, 933 F.2d 1084, 1088 (2d Cir. 1991).

A. The substantial economic effect requirement of I.R.C. § 704(b)(2)

Because a partnership is not a taxable entity, I.R.C. § 702(a) requires each partner to report his distributive share of the partnership's income, loss, gain, deduction, and credit. While the amount of a partner's distributive share generally is based on the allocations contained in the partnership agreement, *see* I.R.C. §704(a), I.R.C. § 704(b)(2) provides that the partnership agreement will be controlling as to the allocation of a particular partnership item only if the allocation has "substantial economic effect." If an allocation lacks substantial economic effect, then the partner's distributive share "shall

be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances)." I.R.C. § 704(b).

The substantial economic effect test seeks to prevent tax avoidance by analyzing whether an allocation's tax consequences are consistent with its economic consequences. *See* Arthur B. Willis et al., PARTNERSHIP TAXATION, ¶10.02[1] (6th ed. 2010) ("The partner who receives the economic benefits of the operation, i.e., income or gain, must be allocated the related tax burdens[.]"). Prior to 1976, I.R.C. § 704(b)(2) provided that partnership allocations would not be respected where "the principal purpose of any provision in the partnership agreement with respect to the partner's distributive share of such item is the avoidance or evasion of any tax imposed by this subtitle." The predominant test for determining whether an allocation had a tax-avoidance purpose was the substantial economic effect test set forth in then-existing Treasury regulations. *See Estate of Carberry v. Commissioner*, 933 F.2d 1124, 1128-29 (2d Cir. 1991); *Ogden v. Commissioner*, 788 F.2d 252, 260 (5th Cir. 1986). In 1976, Congress revised I.R.C. § 704(b)(2) to make the substantial economic effect test explicit and to expand its applicability. S. Rep. No. 94-938, at 98-101

(1976); *see Vecchio v. Commissioner,* 103 T.C. 170, 188-89 (1994). Congress included the revision among a number of "tax shelter provisions," stating that "[t]he provisions relating to various deductions and exclusions in the case of partnerships are tightened so that the deductions or exclusions cannot be allocated among the various partners according to whomever can maximize the tax benefits unless such allocation also has substantial economic effect." S. Rep. No. 94-938, at 9. The provision "seek[s] to prevent the use of special allocations for tax avoidance purposes, while allowing their use for bona fide business purposes."[21] *Id.* at 100; *see* H.R. Conf. Rep. 94-1515, at 422 (1976).

An allocation will satisfy the substantial economic effect test only if the allocation has "economic effect," and such economic effect is "substantial." Treas. Reg. §1.704-1(b)(2)(i) (1998).[22] Under Treas. Reg.

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[21] A "special allocation" is an allocation of income, gain, loss, or deduction among partners in a manner that is disproportionate to the partners' capital contributions. S. Rep. No. 94-938, at 98.

[22] Although the Government focused its attention below on the "substantiality" factor, and did not make a separate argument concerning the "economic effect" prong, we note that there is considerable evidence that the 98% allocation lacked economic effect. For allocations to have economic effect, the partnership agreement

(continued...)

§ 1.704-1(b)(2)(iii)(a), the economic effect of an allocation is *not* substantial if:

> at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement.

In other words, for the economic effect of an allocation to be substantial, "it must affect the partners' dollar distributions from the partnership and may not benefit the after-tax results of some partner(s) unless it also hurts the after-tax results of another partner. If some partner gains from the allocation, the government may not be the only loser." Willis, PARTNERSHIP TAXATION ¶10.04[4][a]. The baseline for comparison is the consequences that would result if the allocation

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[22] (...continued)
must, among other things, provide that (i) any liquidating distributions will be made in accordance with positive capital account balances, and that (ii) a partner will make up a deficit balance in its capital account upon liquidation of the partnership. Treas. Reg. §1.704-1(b)(2)(ii)(b). As we explained on pp. 60-70, *supra*, the Banks' distribution on liquidation was not, as a practical matter, based on their capital accounts, and there was no realistic possibility that the Banks would have to restore negative capital account balances upon liquidation.

"were not contained in the partnership agreement," *i.e.*, the consequences that would result from an allocation that is based on the "partner's interest in the partnership." Treas. Reg. § 1.704-1(b)(1)(i).

A "partner's interest in the partnership" means "the manner in which the partners have agreed to share in the *economic benefit or burden* (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated." Treas. Reg. § 1.704-1(b)(3)(i) (emphasis added). "All partners' interests in the partnership are presumed to be equal (determined on a per capita basis)," but the "presumption may be rebutted by the taxpayer or the Internal Revenue Service by establishing facts and circumstances that show that the partners' interests in the partnership are otherwise." *Id.* "The determination of a partner's interest in a partnership shall be made by taking into account all facts and circumstances relating to the economic arrangement of the partners," including the following four factors:

> (a) The partners' relative contributions to the partnership,
>
> (b) The interests of the partners in economic profits and losses (if different than that in taxable income or loss),
>
> (c) The interests of the partners in cash flow and other non-liquidating distributions, and

(d) The rights of the partners to distributions of capital upon liquidation.

Treas. Reg. § 1.704-1(b)(3)(i) & (ii).

Under the presumption set forth in the regulation, each of the four partners of Castle Harbour (*i.e.,* two GECC entities and the two Dutch Banks) is presumed to have a 25% interest in the partnership. Thus, as a starting point, the Banks are presumed to have a combined interest of 50%. Yet, Castle Harbour allocated 98% of the Operating Income to the Banks. As demonstrated below, application of the factors set forth in Treas. Reg. § 1.704-1(b)(3) establishes that the 98% Operating Income allocation to the Banks far exceeded their interests as partners in Castle Harbour and that such allocation therefore lacked substantial economic effect. Rather, the Banks' interest was, at most, 18%.

B. The allocation of 98% of Operating Income to the Dutch Banks lacked substantial economic effect

1. Under Treas. Reg. § 1.704-1(b)(3)(ii), the Dutch Banks' interest in Castle Harbour's income was nowhere near 98%

a. Capital contributions

As this Court acknowledged (SPA58), and as explicitly set forth in the Operating Agreement (A597), GECC's interest in Castle Harbour based on its capital contributions was 82.2%, and the Dutch Banks'

interest was 17.8%. Specifically, GECC contributed $540 million of Castle Harbour's total capital (*i.e.,* aircraft subject to leases with a net value of $272 million, $22 million in rents receivable on the aircraft, and $246 million in cash), and the Dutch Banks collectively contributed $117.5 million of Castle Harbour's total capital. *See* p.10, *supra.*

An alternative method of measuring the parties' capital ownership interests is to consider their ownership interest on an annual basis during the period in which the Dutch Banks invested in Castle Harbour. This comparative approach reflects the fact that the Banks' interests were designed to be self-liquidating. In other words, over Castle Harbour's expected life, the Banks' interests in Castle Harbour were retired gradually with the annual Exhibit E payments, each of which returned a portion of the Banks' underlying investment and reflected 9.03587% in interest. During each year of the Banks' participation, the Banks' interest in Castle Harbour therefore decreased. Upon the final payment, the Banks' investment was fully repaid, together with slightly more than the targeted yield of 9.03587% (due to the premium paid by GECC for its early buy-out of the Banks' interests).

The Banks' capital investment (as a percentage of Castle Harbour's total assets) gradually declined during 1993 through 1998 as follows:

Year	Remaining Investment	Ownership %
1993	$117,500,000	17.8%
1994	114,924,000	17.6%
1995	86,170,000	15.3%
1996	51,100,000	7.8%
1997	36,098,000	5.5%
1998	28,366,000	4.3%

(A1354, 1420, 1617, 1705, 1722.)

Whether one uses the Dutch Banks' initial capital contributions, which reflect their ownership interest as being 17.8% at all times, or the comparative method to determine their ownership interest as ranging from 4.3% to 17.8%, neither method yields a result that provides support for an allocation anywhere near 98%.

b. Interest in economic profits and losses

The Dutch Banks' interest in the economic profits and losses of Castle Harbour also was not commensurate with their 98% share of Operating Income. As this Court stated, "[w]hen it came to the *actual* division of the assets, revenues, and losses, the partnership did not credit the Dutch banks' capital accounts with [ ] 98% of the taxable Operating Income [ ], but rather with 98% of a much smaller figure,

drastically reduced by depreciation charged against the already fully depreciated aircraft." (SPA57.) Indeed, approximately 70% of the income ostensibly allocated to the Banks was reduced by book depreciation, an amount labeled "aggressive" by the District Court. (SPA15; A1351, 1417, 1552, 1614, 1703, 1720.) Furthermore, the Class B payments made to the GECC entities were subtracted as an expense, with the result that the Dutch Banks effectively received far less than 98% of Castle Harbour's lease income. (A590-91; SPA14.) In addition, all income earned by CHLI, whether interest or lease income, was considered Disposition Gain, which, after an initial allocation of $2,854,493 to the Banks, was allocated 99% to the GECC entities. (A603-06.) And, as this Court recognized (SPA65), GECC could control the amount of income to be paid to the Banks by moving assets to CHLI. *See* pp. 15-16, *supra*.

Comparisons of the income the Dutch Banks actually received with Castle Harbour's total income show that the Banks' share of the economic profits was far less than 98%. During 1993 through 1998, Castle Harbour reported taxable income of approximately $316 million. And while the Dutch Banks were allocated approximately $310 million of that taxable income, they only actually received approximately $28

million of it.[23] *See* p.23, *supra*. The Dutch Banks' share thus amounted to 8.8% of Castle Harbour's taxable income. After redepreciating the aircraft, Castle Harbour had book income of $165.2 million. (*See* A2644.) The Dutch Bank's actual share of that income was only 16.9%.

Moreover, the notion that the Dutch Banks actually shared in the economic profits and losses of Castle Harbour is a fiction that was rejected by this Court. As previously discussed, the Banks' return was predetermined based on the Investment Accounts and, as this Court stated, "was in no way dependent on partnership performance." (SPA57.) The fact that $28 million of the Banks' "scheduled reimbursement" (*id.*) can be traced to a share of Operating Income is of no moment. Labeling a portion of the Banks' guaranteed return as a payment of Operating Income does not alter the fundamental fact that the Banks' return was not tied to the economic profits or losses of Castle Harbour.

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[23] The Banks' share of Operating Income was $28 million. They also were credited $4 million in Disposition Gain upon liquidation based on adjustments to the fair market value of Castle Harbour's assets.

c. Right to cash flow and liquidation rights

The last two factors of Treas. Reg. §1.704-1(b)(3)(ii) focus on the amount of cash that a partner can expect to receive over the life of the entity. As this Court recognized, the Dutch Banks could expect to receive, with virtual certainty, "the reimbursement (according to a previously agreed eight-year schedule) of their initial investment of $117.5 million at an annual rate or return of 9.03587% (or, in some circumstances, 8.53587%)." (SPA57.) There was no realistic possibility that the Banks' return would vary significantly from that predetermined amount. And as discussed above, *see* pp. 60-70, on liquidation, the Banks could expect to receive the balance of their Investment Accounts, thus assuring repayment of the Banks' investment at the Applicable Rate of return.

Over the life of Castle Harbour, the Dutch Banks received total payments of approximately $150 million. (SPA23.) The GECC entities received approximately $728 million ($6 million in Class B payments, $20 million in distributions, distributions of aircraft worth $41 million, and $692 million in Castle Harbour's and CHLI's assets, less the $31 million paid to the Banks to buy out their interests). (SPA24.) The Banks' predetermined return therefore reflected 17% of Castle

Harbour's total cash distributions and liquidation payments. As with the other factors, the Banks' liquidation rights and rights to cash flow do not support the 98% allocation.

In short, based upon the four factors set forth in Treas. Reg. §1.704-1(b)(3)(ii), the Dutch Banks' combined interest in Castle Harbour ranged from a low of 4.3% to a high of 17.8% and, at all events, was far below the 98% allocation set forth in the Operating Agreement.[24]

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[24] Application of other factors that the 1976 Senate Report indicated "could possibly relate to the determination of the validity of an allocation" further demonstrates that Castle Harbour's allocation of 98% of Operating Income to the Dutch Banks was invalid. *See* S. Rep. No. 94-938, at 100. First, there was no real business purpose for the allocation; instead, the real purpose was tax avoidance. In addition, related items from the same source were not subject to the same allocation. In particular, while Operating Income was allocated 98/2 to the Dutch Banks and the GECC entities, respectively, Disposition Gains and Losses were allocated very differently. After the Banks were allocated about $2.8 million of cumulative Disposition Gains or Losses, they would only be allocated 1% thereafter, with the GECC entities to receive 99%. Also, the allocation scheme clearly was not based on normal business factors. Rather, it was designed in advance to produce a specific result—huge tax savings—and to ensure that the Banks received no more and no less than a specified return. And the allocation scheme was to continue until the Banks were repaid their investment in full, plus interest. Finally, the overall tax consequences of the allocation were to provide GECC with millions of dollars in tax savings, while imposing no corresponding tax burden on the Banks, who were exempt from U.S. tax.

2. The 98% Operating Income allocation fails the substantiality requirement

The allocation contained in the Operating Agreement clearly failed to satisfy the "substantiality" prong of the substantial economic effect test. Each partner's after-tax economic consequences were enhanced by the 98% Operating Income allocation—as compared to the consequences that would have resulted if Operating Income had been allocated based on each partner's interest in the partnership—but no partner's after-tax economic consequences were substantially diminished. *See* Treas. Reg. § 1.704-1(b)(2)(iii)(a).

Castle Harbour's taxable income totaled over $316 million. Of this, the Dutch Banks received only $28 million (*i.e.,* 98% of $28.2 million of Operating Income). GECC received ten times that amount, $288 million, chiefly lease income that was excluded from "Operating Income" as a result of book depreciation, as well as 2% of Operating Income ($564,000). GECC thus enjoyed the lion's share of Castle Harbour's income, but had a tax liability of only about $1.2 million as a result of the 98% allocation. *See* p.26, *supra.* If GECC's share of Operating Income had been based on, for example, its 82% ownership of capital, GECC's income would have increased by approximately $23

million (*i.e.,* 82% of $28.2 million Operating Income). However, GECC's share of Castle Harbour's taxable income likewise would have been 82%, resulting in an increased tax liability of approximately $52 million (*i.e.,* 82% of $316 million x GECC's 20% tax rate).[25] Overall, GECC would have been *worse* off by about $30 million. Thus, by way of the 98% Operating Income allocation, GECC was far better off after-tax than if Operating Income had been allocated in accordance with the partners' interests in the partnership.

The 98% allocation likewise resulted in enhanced economic consequences for the Dutch Banks. Instead of receiving about $5 million in Operating Income (*i.e.,* 18% of $28.2 million), they received $28 million. This increase in income did not, however, diminish the Dutch Banks' after-tax economic consequences at all because none of the Banks' income was subject to U.S. tax. The after-tax economic burden of the 98% allocation thus falls squarely on the public fisc.

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[25] If the comparative method of determining GECC's interest were used, *see* p.82, *supra*, then GECC's increased tax liability would be $56 million. Also, these amounts differ from the increased tax liability of $62 million that would result if the Banks were not considered partners at all because, under that scenario, all of Castle Harbour's income would be reallocated to the GECC entities.

The bottom line here is that the allocation resulted in exactly what Congress sought to prevent in enacting I.R.C. § 704(b), *namely*, tax avoidance. *See* pp. 76-77, *supra*. The sole result of the transactions was to provide GECC with the means to avoid taxation on approximately $316 million in taxable income from its aircraft leasing business. Accordingly, the 98% Operating Income allocation violates both the letter and the spirit of I.R.C. § 704(b)(2).

C. The District Court's opinion does not withstand scrutiny

In applying the substantial economic effect test, the District Court erred in determining that the Dutch Banks' "interest in the partnership" was 98%. (SPA44.) Significantly, the court failed to consider the factors listed in Treas. Reg. §1.704-1(b)(3). The court addressed only tangentially the first factor pertaining to a partner's capital contributions, stating that it "is one factor that may be considered, but it has little weight in this case when balanced against the other factors." (SPA43.) The court did not delineate the "other factors" to which it referred. Rather, the court went on to hold—"in an astonishing display of circular reasoning," as one commentator has put it (*see* Darryll K. Jones, *Castle Harbour and the Hobgoblins of Little*

Minds, 106 Tax Notes 605 (Jan. 31, 2005))—that because (i) the partnership agreement provided that 98% of Operating Income would be allocated to the Dutch Banks; (ii) the Dutch Banks actually received allocations of 98% of Operating Income throughout the time they held interests in Castle Harbour; and (iii) their liquidating distributions reflected the allocations of 98% of Operating Income, the Dutch Banks' interests in Castle Harbour likewise equaled 98%.[26] (SPA43-44). In so holding, the court focused solely on the "artificial constructs of the partnership agreement" (SPA63) and did not consider any facts or circumstances pertaining to the overall economic reality. By focusing narrowly on whether the Banks were allocated 98% of the Operating Income, without regard to the parties' relative economic benefits and burdens, the court simply missed the point of the substantial economic effect test.

Moreover, the court's conclusion that the Dutch Banks received the "economic benefit" of 98% of Castle Harbour's income is directly

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[26] Another commentator observed that "in applying the partners' interest standard, the [district] court adopted a circular approach that would make it virtually impossible to violate the overall test, because the 'default' allocations and the actual allocations would be identical." Karen C. Burke, *Castle Harbour: Economic Substance and the Overall-Tax-Effect Test,* 107 Tax Notes 1163, 1164 (May 30, 2005).

contrary to the court's own findings of fact. Under the heading of "Operating Income vs. Actual Income," the court recognized that Operating Income did not reflect the economic performance of Castle Harbour, stating that Operating Income was a "non-obvious category of income primarily because it includes as expenses items not clearly considered expenses, e.g., Class B Guaranteed Payments, and excludes items that appear to be expenses, e.g., debt payments and Exhibit E payments." (SPA14.) The court understood that Operating Income did not reflect "a simple measure of the net cash received by Castle Harbour in its normal operations." (*Id.*) Regarding the treatment of aircraft depreciation as an expense, the court acknowledged that the depreciation schedule "was fairly aggressive, usually coming out to between 60 and 70 percent of the rental income for a given year," and stated that "[t]he effect of this depreciation was that a large portion of the cash that came into Castle Harbour was not reflected in Operating Income." (SPA15.) And yet, the court ultimately held that "there is simply no ground from which to argue that the partners had any other interest than the 98% and 2% assigned by the agreement." (SPA47.) The court simply failed to give effect to its own assessment of the facts in ruling that the 98% allocation had substantial economic effect.

In short, the allocation of 98% of Operating Income to the Dutch Banks lacked substantial economic effect. Pursuant to I.R.C. § 704(b), Operating Income must be reallocated in accordance with each partner's interest in the partnership, *i.e.,* no more than 17.8% to the Banks, and the remainder to the GECC entities.

III

The District Court erred in ruling that penalties were not warranted

Standard of review

The District Court's determination that substantial authority supported treating the Dutch Banks as partners is a legal question reviewed *de novo*. *Estate of Kluener v. Commissioner*, 154 F.3d 630, 637 (6th Cir. 1998); *Norgaard v. Commissioner*, 939 F.2d 874, 877-78 (9th Cir. 1991). The District Court's determination that the penalties did not apply is reviewed for clear error. *Goldman v. Commissioner*, 39 F.3d 402, 406 (2d Cir. 1994); *Normandie Metal Fabricators, Inc. v. Commissioner*, 10 Fed. Appx. 26 (2d Cir. 2001).

A. Penalties for substantial understatement of tax and negligence under I.R.C. § 6662

For Castle Harbour's 1997 and 1998 tax years, the IRS asserted the 20% substantial understatement of tax penalty set forth in I.R.C.

§ 6662(b)(2) and (d), and the 20% negligence penalty set forth in I.R.C. § 6662(b)(1) and (c).[27] The District Court erred in holding that neither applied.

As relevant here, the amount of the taxpayer's understatement of tax (for purposes of computing the penalty) is reduced by that portion of the understatement which is attributable to the tax treatment of any item by the taxpayer if there is "substantial authority" for such treatment. I.R.C. § 6662(d)(2)(B)(i). In the case of any item attributable to a "tax shelter," that reduction is not permitted unless the taxpayer "reasonably believed that the tax treatment was more likely than not the proper treatment." Treas. Reg. § 1.6662-4(g)(i).[28]

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[27] Because these penalties may not be stacked, *see* Treas. Reg. § 1.6662-2(c), even if both would otherwise apply, only one may be imposed.

[28] I.R.C. §6662(d) was amended in 2004 to make the reduction provisions of I.R.C. § 6662(d)(2)(B) wholly inapplicable in the case of any item attributable to a tax shelter. Pub. L. No. 108-357, § 812(d). Treas. Reg. § 1.6662-4(g)(ii)(A) provides that the substantial authority exception generally is not available to corporate taxpayers engaged in tax shelter transactions. Treas. Reg. § 1.6662-4(g)(ii)(B) provides a special rule for transactions occurring prior to December 9, 1994, that allows corporations that in engage in tax shelter transactions to rely on the substantial authority exception. As the transactions at issue here occurred in October 1993, GECC can rely on the substantial authority exception.

During the years at issue, a tax shelter was defined as a partnership, entity, plan, or arrangement “if the principal purpose of the entity, plan or arrangement, based on objective evidence, is to avoid or evade Federal income tax.” Treas. Reg. § 1.6662-4(g)(i)(A) (1997). The principal purpose is tax avoidance or evasion “if that purpose exceeds any other purpose.” *Id.*

There is substantial authority for the tax treatment of an item only if the weight of authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. Treas. Reg. § 1.6662-4(d)(3)(i). The authorities that may be relied on include the Internal Revenue Code, regulations, revenue rulings and proceedings, judicial decisions, private letter rulings, and IRS technical advice memoranda. Treas. Reg. § 1.6662-4(d)(3)(iii). Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not “authorities,” although the authorities cited in support of the conclusions reached therein may constitute substantial authority. *Id.* A taxpayer meets the “reasonable belief” standard by establishing that it reached its determination after conducting a good faith analysis of the pertinent facts and legal

authorities or that it relied in good faith on the opinion of a professional tax advisor. Treas. Reg. § 1.6662-4(g).

I.R.C. § 6662(b)(1) imposes a 20% penalty for "[n]egligence or disregard of rules or regulations." Negligence includes "any failure to make a reasonable attempt to comply with" the Internal Revenue Code, and the term disregard includes "any careless, reckless or intentional disregard." I.R.C. § 6662(c). Negligence is indicated where a taxpayer claims tax benefits that a reasonable person would consider "too good to be true" under the circumstances. Treas. Reg. § 1.6662-3(b)(1)(ii). A return position that has a reasonable basis is not attributable to negligence. Treas. Reg. § 1.6662-3(b)(1). The reasonable-basis standard is less stringent than the substantial-authority standard. Treas. Reg. § 1.6662-3(b)(3).

A taxpayer can avoid both the substantial understatement and negligence penalties if it establishes "that there was a reasonable cause for such [underpayment] and that the taxpayer acted in good faith with respect to such [underpayment]." I.R.C. § 6664(c). GECC bore the burden of proof to establish that neither penalty applied and, if they did apply, that the reasonable cause exception of I.R.C. § 6664 applied. *Higbee v. Commissioner*, 116 T.C. 438, 446-47 (2001); *see Long Term*

Capital Holdings v. United States, 330 F. Supp. 2d 122, 199 (D. Conn. 2004).

B. The District Court erred in ruling that neither penalty applied

1. The substantial understatement of tax penalty

In ruling that the substantial understatement penalty did not apply, the District Court held that the Castle Harbour transaction was not a tax shelter, and that there was substantial authority for treating the Dutch Banks as partners. Both of these conclusions were wrong.

First, in concluding that there was no tax shelter, the District Court relied on the fact that this Court "did not disturb [its] factual findings that, despite Castle Harbour effectively sheltering significant income from taxes, the partnership had 'bona fide purposes' and 'some genuine economic effect.'" (SPA128.) The court further stated that "[n]owhere in *Castle Harbour I* or *Castle Harbour II* is there a factual finding or legal conclusion that tax savings were the principal purpose of the Castle Harbour transaction." (*Id.*)

To the contrary, this Court observed that the District Court "essentially acknowledged that the creation of the partnership was largely tax-motivated" (SPA 55), and referred to "the strong and

obvious tax motivations" of the deal (SPA62). Although it did not explicitly address business purpose, this Court expressed skepticism that the Dutch Banks' participation was necessitated by genuine business reasons, stating that the Banks' "apparent 98% share of partnership income . . . was more in the nature of window dressing designed to give ostensible support to the characterization of equity participation, which was essential to *the dominant tax objective*, than a meaningful stake in the profits of the venture." (SPA67, emphasis added.) It also stated that "[t]he *taxpayer's $60 million tax objective* depended on successfully characterizing the interest of the Dutch banks as an equity partnership participation," and that "[t]here could be no conceivable doubt that the taxpayer . . . had taken pains in the design of the partnership to promote that characterization." (SPA70, emphasis added).

In any event, the record establishes that there was no significant non-tax purpose for the transaction. Castle Harbour did not spread the risk of the aircraft leasing business to the Dutch Banks as the Banks were assured a set pay-out. The transaction did not increase the leasing business's liquidity because 110% of the Banks' investment had to be kept in Core Financial Assets. And, contrary to the finding of the

District Court, no debt was retired. CHLI held the Core Financial Assets in GECC commercial paper, received interest payments therefrom, and paid taxes on that interest. Furthermore, the facts that only non-U.S. taxpayers were considered as partners and the entire venture was terminated once the Dutch Banks might be subject to U.S. tax speak strongly to the fact that a tax shelter was involved, and nothing more. It is clear from the record that GECC's tax avoidance purpose exceeded all of its ostensible business purposes.

Second, the District Court erred in concluding that there was "substantial authority" for treating the Dutch Banks as partners. The District Court opined that this Court's opinion in *Castle Harbour II* stated a new proposition of law in holding that "the parties' good faith intention or valid business purpose in forming a partnership was not sufficient to support a conclusion of partnership status for tax purposes." (SPA123.) The court stated that it was aware of "no case where joint venturers were held not to be partners despite a valid business purpose or good faith intention." (SPA124.) Instead, the District Court thought that substantial authority supported GECC, citing to *Slifka*, *Dyer, Jewel Tea,* and *O.P.P. Holding*. (SPA123, 126.) Finally, the court stated that this Court "did not disturb my factual

finding that the transactions resulting in the formation of Castle Harbour were not sham transactions." (SPA125.)

In the first place, contrary to the District Court's suggestion, this Court did not ratify the District Court's findings of economic substance. Nowhere in its opinion did the Court suggest that it agreed with or accepted the District Court's findings in that regard. Instead, this Court stated that its disposition made it "unnecessary" to review that determination. (SPA62, n.11.)

Furthermore, as discussed above, it is clear from the structure and actual workings of the deal, when viewed in its entirety, that the Dutch Banks agreed to facilitate, for a fee, the sheltering of aircraft lease income to be received by GECC that would otherwise no longer be sheltered by depreciation deductions. GECC's business reasons were merely window dressing. There simply is no authority, let alone substantial authority, for the proposition that the partnership provisions can be so manipulated. To the contrary, such manipulation is not what the statute intended. *Cf. Gregory v. Helvering,* 55 S. Ct. 266, 267 (1935) ("the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended"); *Gilbert v. Commissioner*, 248 F.2d 399 (2d Cir. 1957) ("[t]he

inquiry is not what the purpose of the taxpayer is, but whether what is claimed to be, is in fact"); *Gilman v. Commissioner*, 933 F.2d 143, 146 & 148 (2d Cir. 1991) (endorsing the Tax Court's analysis that elevated objective substance over business purpose); *Estate of Kahn v. Commissioner*, 499 F.2d 1186, 1189 (2d Cir. 1974) (holding that the Tax Court correctly concluded that a partnership existed in form only without discussing good faith).

The District Court's suggestion that this Court established new law by holding that even if a transaction creating a partnership is not a sham, it may nonetheless not result in a bona fide partnership, is incorrect. *Slifka* and *Dyer* stand for the proposition that a business may be organized, and transactions structured, with tax consequences in mind. But neither stand for the proposition that a transaction and a partnership that are designed to manipulate the provisions of the Internal Revenue Code so as to shelter income from tax will withstand scrutiny. Similarly, that *Jewel Tea* and *O.P.P. Holding* hold that equity can have some of the hallmarks of debt does not support the scheme constructed here.

Finally, GECC did not establish that it reasonably believed that its tax treatment was more likely than not correct. GECC did not

establish that it relied on any of the cases cited by the District Court, nor did it establish that it conducted any analysis that led it to conclude that its tax position was proper.

2. The negligence penalty

For the same reasons, the District Court erred in rejected application of the negligence penalty. GECC had no reasonable basis for its position. Again, taxpayers are not permitted to manipulate the provisions of the Internal Revenue Code to shelter otherwise taxable income. GECC's sheltering of approximately $310 million of income clearly was "too good to be true." Treas. Reg. § 1.6662-3(b)(1)(ii). And there is no evidence in the record that GECC made any real attempt to comply with the tax laws. Its witnesses either lacked familiarity with the details of the transaction or disclaimed any specific knowledge or tax expertise with respect to the tax effects of the transaction. (A2870-73, 2875-79 (testimony of Robert O' Reilly and Robert Lewis, senior executives of GECC's Transportation and Industrial Financing Division, who oversaw aircraft leasing and approved the Castle Harbour transaction).) Moreover, GECC successfully objected to including any of the tax advice it received into the record, including a tax opinion prepared by King & Spalding. (Docs. 37, 40, 47.)

C. GECC made no effort to show reasonable cause or good faith under I.R.C. § 6664(c)

Under I.R.C. § 6664(c)(1), neither of the penalties discussed above applies "with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion." At issue here is the reasonable cause of the partnership and not of the individual partners. Treas. Reg. § 301.6221-1(c). The determination of whether a taxpayer acted with reasonable cause and good faith is made on a "case-by-case basis, taking into account all pertinent facts and circumstances." Treas. Reg. § 1.6664-4(b)(1). The most important factor in determining good faith and reasonable cause is the extent of the taxpayer's effort to assess his liability. *Id.* Reasonable cause and good faith can be established by reasonable reliance on the opinion or advice of a competent and independent tax advisor. Treas. Reg. § 1.6664-4(c)(1). If a tax shelter is involved, the taxpayer must establish that there was substantial authority for its position and that it concluded, based upon either its own analysis or that of a professional tax advisor, that there was a greater than 50% likelihood that the tax treatment would be upheld if challenged by the IRS.

Treas. Reg. § 1.6664-4(f).

Again, it is clear from the structure and actual workings of the deal, when viewed in its entirety, that GECC did not reasonably believe that it was more likely than not that its tax treatment was correct. Despite having the burden of proof, GECC made no real attempt to establish that it was entitled to rely on the reasonable cause exception, and, as noted above, GECC successfully prevented the admission into the record of the tax advice it received. It also failed to establish that it conducted any analysis on its own. Finally, as discussed above, GECC could not establish substantial authority for its position.

CONCLUSION

Based on the foregoing, the District Court's judgment should be reversed.

Respectfully submitted,

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UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

CAPTION:

TIFD III-E, Inc.

v.

United States of America

CERTIFICATE OF SERVICE

Docket Number: 10-70

I, Francesca U. Tamami (name), hereby certify under penalty of perjury that on May 14, 2010 (date), I served a copy of Appellant's Opening Brief

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May 14, 2010
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/s/ Francesca U. Tamami
Signature

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