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 PLAINTIFF-APPELLEE

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Corporate Disclosure Statement

Pursuant to Federal Rule of Appellate Procedure 26.1, Appellee TIFD III-E INC. makes the following disclosure:

(1) The indirect parent corporation of TIFD III-E INC. is the General Electric Company ("GE"), a publicly traded corporation.

TABLE OF CONTENTS

CERTIFICATE OF COMPLIANCE i

CORPORATE DISCLOSURE STATEMENT ii

GLOSSARY xvi

STATEMENT OF THE ISSUES 1

STATEMENT OF THE CASE 1

STATEMENT OF FACTS 5

Background. 5

Allocation of Operating Income and Disposition Gain/Loss. 10

The Exhibit E Distributions and their relationship to Capital Accounts. 11

The Class A Guaranteed Payment. 12

Termination of Banks' Investment. 14

Consequences of Castle Harbour Transaction. 15

SUMMARY OF ARGUMENT 17

ARGUMENT 19

I. Section 704(e)(1) Mandates the Recognition of the Banks as Partners 19

Standard of Review 19

A. Section 704(e)(1) Establishes an Alternative Test to *Culbertson*. 19

1. Congress enacted section 704(e)(1) for the express purpose of providing an alternative to the *Culbertson* test. 20

2. Courts have consistently characterized section 704(e)(1) as an alternative to *Culbertson* 24

B. The Government's Arguments are Contrary to the Statute and Its Own Stipulations in this Case. 28

1. Section 704(e)(1) applies regardless of how the interest was "derived." 28

2. Castle Harbour was a preexisting partnership. 30

C. The Banks' Interests Were Capital Interests. 31

1. The definition of "capital interest" does not require participation in residual profits and losses. 33

2. Because the Banks' interests were not debt, they were capital interests. 35

3. The Banks' interests were indistinguishable from commonly recognized preferred equity. 37

4. The Government's assertions that the Banks' interests were not capital interests are legally and factually erroneous. 44

D. Conclusion 50

II. Castle Harbour's Allocation of Operating Income Was Valid 50

Standard of Review 50

A. Sections 704(b) and 704(c) Govern the Allocation of Castle Harbour's Operating Income. 51

B. The Disputed Allocation of Taxable Income to the Banks Flows Directly From the Application of Section 704(c). 55

C. The Allocation of Castle Harbour's Operating Income Had Substantial Economic Effect. 59

1. Section 704(b) governs the allocation of Operating Income. 59

2. The allocation of Operating Income had economic effect 62

3. The economic effect of the Operating Income allocation was "substantial." 65

D. The Partner's Interest in the Partnership standard requires that the Banks be allocated 98% of the Operating Income. 71

E. The Existing Section 704(c) Regulations Refute the Government's Position. 75

F. Conclusion 76

III. THE GOVERNMENT'S PENALTY CLAIMS ARE UNWARRANTED AND UNSUPPORTABLE 77

A. Overview. 77

1. The TEFRA context 78

2. Overview of substantial understatement penalty. 79

B. The Substantial Understatement and Negligence Penalties Do Not Apply. 81

1. Castle Harbour's tax return positions were supported by substantial authority. 81

2. For purposes of section 6662, Castle Harbour was not a "tax shelter." 83

3. There is no basis for imposition of a negligence penalty. 85

C. The Government's reasonable cause argument is irrelevant in this TEFRA proceeding. 88

D. Conclusion 89

CONCLUSION 89

TABLE OF AUTHORITIES

Cases **Page(s)**

Allegheny Energy, Inc. v. Virginia Electric & Power Co., 70 F. Supp. 2d 607 (D. Md. 1999)....85

Ambassador Apartments, Inc. v. Commissioner, 50 T.C. 236 (1968), *aff'd per curiam*, 406 F.2d 288 (2d Cir. 1969) 45-46

Estate of Ballantyne v. Commissioner, 341 F.3d 802 (8th Cir. 2003)....50

Ballou v. United States, 370 F.2d 659 (6th Cir. 1966) 19

Bausch & Lomb, Inc. v. Commissioner, 933 F.2d 1084 (2d Cir. 1991) 50, 51

Bayou Verret Land Co. v. Commissioner, 450 F.2d 850 (5th Cir. 1971) 27

Blair v. Commissioner, 300 U.S. 5 (1937)....22

Bowersock Mills & Power Co. v. Commissioner, 172 F.2d 904 (10th Cir. 1949) 47

Carriage Square, Inc. v. Commissioner, 69 T.C. 119 (1977) 25, 28

Chisholm v. Commissioner, 79 F.2d 14 (2d Cir. 1935) 83, 87

Cirelli v. Commissioner, 82 T.C. 335 (1984) 25

Commissioner v. Meridian & Thirteenth Realty Co., 132 F.2d 182 (7th Cir. 1942) 38

Commissioner v. Culbertson, 337 U.S. 733 (1949).... *passim*

Commissioner v. O.P.P. Holding Corp., 76 F.2d 11 (2d Cir. 1935) 38

Commissioner v. Tower, 327 U.S. 280 (1946)....20, 21, 22, 29

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In re Delta Airlines, Inc., 608 F.3d 139 (2d Cir. 2010) 84-85

Eli Lilly & Co. v. Commissioner, 856 F.2d 855 (7th Cir. 1988) 51

Evans v. Commissioner, 447 F.2d 547 (7th Cir. 1971).....................................25, 26

Evans v. Commissioner, 54 T.C. 40 (1970), *acq.*, 1978-2 C.B. 2 25-26

Frank Lyon Co. v. United States, 435 U.S. 561 (1978).............................4-5, 82-83

Goldman v. Commissioner, 39 F.3d 402 (2d Cir. 1994)..77

Gooding Amusement Co. v. Commissioner, 23 T.C. 408 (1954),
aff'd, 236 F.2d 159 (6th Cir. 1956) 45

Hartman v. Commissioner, 43 T.C. 105 (1964),
acq., 1965-2 C.B. 3 ....25, 29

Hazel Atlas Glass v. Van Dyk & Reeves, Inc.,
8 F.2d 716 (2d Cir. 1925) 47

Helvering v. Clifford, 309 U.S. 331 (1940) 21

Holmes v. United States, 85 F.3d 956 (2d Cir. 1996)...81

Interhotel Co. v. Commissioner, 81 T.C.M. (CCH) 1804 (2001)............................73

Jewel Tea Co. v. United States, 90 F.2d 451 (2d Cir. 1937) 38

John Wanamaker Philadelphia v. Commissioner,
139 F.2d 644 (3d Cir. 1943) 43

Johnston v. Commissioner, 69 T.C.M. (CCH) 2283 (1995)...................................34

Katz v. Commissioner, 335 F.3d 1121 (10th Cir. 2003)...36

Cases (continued) **Page(s)**

Estate of Kluener v. Commissioner, 154 F.3d 630 (6th Cir. 1998) 80

Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2d Cir. 1956) 42, 87

Kuney v. Frank, 308 F.2d 719 (9th Cir. 1962)...19

Lee Telegraph Co. v. Commissioner, 260 F.2d 114 (4th Cir. 1958) 38

Lucas v. Earl, 281 U.S. 111 (1930) 21

Lusthaus v. Commissioner, 327 U.S. 293 (1946) 21, 29

Marshak v. Reed, 229 F. Supp. 2d 179 (E.D.N.Y. 2002) 46

Morris v. Commissioner, 13 T.C. 1020 (1949), *acq.*, 1950-1 C.B. 3 34

N. Refrigerator Line, Inc. v. Commissioner, 1 T.C. 824 (1943).............................47

Nassau Lens Co. v. Commissioner, 308 F.2d 39 (2d Cir. 1962) 42

National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949) 21

Newman v. Commissioner, 902 F.2d 159 (2d Cir. 1990) 4

PAA Management, Ltd. v. United States, 962 F.2d 212 (2d Cir. 1992) 36

PK Ventures, Inc. v. Commissioner, 91 T.C.M. (CCH) 806 (2006), *rev'd on other grounds sub nom. Rose v. Comm'r*, 311 Fed. Appx. 196 (11th Cir. 2008)...37

Payton v. United States, 425 F.2d 1324 (5th Cir. 1970)..27

Pflugradt v. United States, 310 F.2d 412 (7th Cir. 1962).......................................26

Pioneer Parachute Co., Inc. v. Commissioner, 162 F.2d 249 (2d Cir. 1947) 39

Poggetto v. United States, 306 F.2d 76 (9th Cir. 1962)........................ 26, 28, 49-50

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Ragland Investment Co. v. Commissioner, 52 T.C. 867 (1969), *aff'd per curiam*, 435 F.2d 118 (6th Cir. 1970) 42

Singh v. United States Department of Justice, 461 F.3d 290 (2d Cir. 2006) 89

Slifka v. Commissioner, 182 F.2d 345 (2d Cir. 1950) 24

Smith v. Commissioner, 32 T.C. 1261 (1959), *acq*., 1960-2 C.B. 7 ....24, 25, 28

Smith v. Westover, 123 F. Supp. 354 (S.D. Cal. 1954), *aff'd*, 237 F.2d 201 (9th Cir. 1956)..24

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TIFD III-E INC. v. United States, 342 F. Supp. 2d 94 (D. Conn. 2004)... *passim*

TIFD III-E INC. v. United States, 459 F.3d 220 (2d Cir. 2006) 5, 20, 33, 37, 38

TIFD III-E INC. v. United States, 660 F. Supp. 2d 367 (D. Conn. 2009) .... *passim*

TIFD III-E INC. v. United States, 223 F.R.D. 47 (D. Conn. 2004).........................89

Estate of Tobias v. Commissioner, 81 T.C.M. (CCH) 1163 (2001) 72-73

United States v. Adlman, 134 F.3d 1194 (2d Cir. 1998)...84

Vecchio v. Commissioner, 103 T.C. 170 (1994)..72

Estate of Winkler v. Commissioner, 73 T.C.M. (CCH) 1657 (1997) 28

Statutes **Page(s)**

Internal Revenue Code of 1986 (26 U.S.C.) unless otherwise noted

§ 168(c) 62
§ 168(e)(1)....62
§ 168(g)(3)(A)....62
§ 351(g)(3) 39
§ 701....51
§ 702....51
§ 704(b) .... *passim*
§ 704(c) .... *passim*
§ 704(e)(1).... *passim*
§ 704(e)(2)....34
§ 705....59
§ 707(c) 13
§ 721(a) 30
§ 723....53
§ 761....22
§ 1504(a)(4)....39
§ 3797(a)(2) (1939)....22
§ 6221....78
§ 6226(f)....37, 78
§ 6230(a)(2)(A)(i) 78
§ 6231(a)(3)....78
§ 6231(a)(6)....78
§ 6662(a) 79
§ 6662(b)(2) 79
§ 6662(c) 87
§ 6662(d)(1)(A) (1998) 79
§ 6662(d)(1)(B) (1998) 79
§ 6662(d)(2)(B) (1998) 79
§ 6662(d)(2)(C)(i)(II) (1993) 80-81
§ 6664(c)(1) (1997)....88
§ 7701(a)(1)....23
§ 7806(b) 22-23

Treasury Regulations **Page(s)**

§ 1.305-5(b)(3)(i) 13
§ 1.305-5(d), Example 5 39
§ 1.704-1(b)(1)(vii) 58
§ 1.704-1(b)(2) 62
§ 1.704-1(b)(2)(ii) 62-63, 65
§ 1.704-1(b)(2)(ii)(*b*)(*2*) 60
§ 1.704-1(b)(2)(iii) 65-66
§ 1.704-1(b)(2)(iii)(*a*) (1993) 66
§ 1.704-1(b)(2)(iii)(*b*) 66
§ 1.704-1(b)(2)(iii)(*c*) 66, 69
§ 1.704-1(b)(2)(iv)(*b*) 53
§ 1.704-1(b)(2)(iv)(*b*)(*1*) - (*7*) 74
§ 1.704-1(b)(2)(iv)(*b*)(*2*) 54
§ 1.704-1(b)(2)(iv)(*d*)(*1*) 54
§ 1.704-1(b)(2)(iv)(*d*)(*3*) 63
§ 1.704-1(b)(2)(iv)(*f*)(*3*) 63
§ 1.704-1(b)(2)(iv)(*f*)(*5*)(*ii*) 48
§ 1.704-1(b)(2)(iv)(*g*)(*1*) 53, 54
§ 1.704-1(b)(2)(iv)(*g*)(*3*) 62
§ 1.704-1(b)(3)(i) 74-75
§ 1.704-1(b)(3)(ii) 60
§ 1.704-1(b)(3)(ii)(*a*) - (*d*) 74
§ 1.704-1(b)(5), Example (1) 69, 72
§ 1.704-1(b)(5), Example (3) 70-71
§ 1.704-1(b)(5), Example (4) 65
§ 1.704-1(b)(5), Example (5) 67-68, 71-72
§ 1.704-1(b)(5), Example (6) 72
§ 1.704-1(b)(5), Example (7) 72
§ 1.704-1(b)(5), Example (9) 67, 68
§ 1.704-1(b)(5), Example (14) 54, 63, 64
§ 1.704-1(b)(5), Example (18) 63, 64
§ 1.704-1(b)(5), Example (19) 70
§ 1.704-1(c)(2) (1956) 56, 58
§ 1.704-1(c)(2)(i), Example (1) (1956) 53-54, 64
§ 1.704-1(e)(1)(iv) 27
§ 1.704-1(e)(1)(v) 31-32, 34
§ 1.704-1(e)(2)(x) 23

Treasury Regulations (continued) **Page(s)**

§ 1.704-3(b)(2), Example (1)(ii) 54
§ 1.704-3(a)(3)(i) 76
§ 1.704-3(c)(1) 75-76
§ 1.707-1(c), Example (2) 13
§ 1.894-1(d) 14
§ 1.1001-3(e)(2)(ii) 48
§ 1.6662-3(b)(1) 85
§ 1.6662-3(b)(3) 85
§ 1.6662-4(d)(2) 80, 85
§ 1.6662-4(d)(3) 80
§ 1.6662-4(d)(3)(i) 80
§ 1.6662-4(d)(3)(ii) 80
§ 1.6662-4(d)(3)(iv)(C) 80
§ 25.2701-3(d), Example 3 39
§ 301.6221-1T(d) (2000) 88
§ 301.6221-1(f) 88
§ 301.6231(a)(3) 37
§ 301.7701-3(a) 37
§ 301.7701-3(c) 31
§ 301.7701-3(g)(1)(i) 37
§ 301.7701-3(g)(1)(ii) 37
§ 301.7701-3(h)(1) 31
§ 301.7701-3(h)(2) 31
§ 301.7701-4(c)(1) 42
§ 301.7701-4(c)(2), Example (1) 11

Legislative Materials

Revenue Act of 1951, Pub. L. No. 82-183, § 340(a), 65 Stat. 452, 511 (1951) 21

Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 111 Stat. 788 (1982) 3

Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1238(a), 111 Stat. 788, 1026 (1997) 78

H.R. Rep. No. 82-586 (1951) 21-22, 23, 29, 50

Legislative Materials (continued) **Page(s)**

H.R. Rep. No. 83-1337 (1954) 57-58

H.R. Rep. No. 101-247 (1989) 81

H.R. Rep. No. 105-148 (1997) 39

H.R. Rep. No. 105-220 (1997) 39

S. Rep. No. 82-781 (1951) 21-22, 23

S. Rep. No. 83-1622 (1954) 56

S. Rep. No. 98-169 (1984) 75

97 Cong. Rec. 12,146 (1951) 23

135 Cong. Rec. 25,654-55 (1989) 81

I.R.S. Administrative Materials

Notice 2008-55, 2008-2 C.B. 11 40

Notice 2008-80, 2008-2 C.B. 820 41

Notice of Proposed Rulemaking, 57 F.R. 61345 (December 24, 1992) 57

Rev. Proc. 87-56, 1987-2 C.B. 674 62

Rev. Proc. 89-12, 1989-1 C.B. 798 32

Rev. Proc. 93-27, 1993-2 C.B. 343 34

Rev. Proc. 2003-84, 2003-2 C.B. 1159 .... 40, 41-42, 45

Rev. Rul. 78-142, 1978-1 C.B. 111 45

Rev. Rul. 90-27, 1990-1 C.B. 50 .... 39-40, 45

I.R.S. Administrative Materials (continued) **Page(s)**

T.D. 8735, 1997-2 C.B. 72..14

T.D. 8965, 2001-2 C.B. 344..88

T.D. 9398, 2008-24 I.R.B. 1143 67

Tech. Adv. Mem. 200418008 (Dec. 29, 2003).......................................36

Tech. Adv. Mem. 200512020 (Aug. 20, 2004).......................................36

F.S.A. 829, 1992 FSA LEXIS 284 (May 22, 1992) 45

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Miscellaneous

John P. Steines, Jr., *Partnership Allocations of Built-in Gain or Loss,* 45 Tax L. Rev. 615 (1990)..51, 57

Lawrence Lokken, *Partnership Allocations,* 41 Tax L. Rev. 547 (1986)...............51

Daniel L. Simmons, *Built-in Gain and Built-in Loss Property on Formation of a Partnership: An Exploration of the Grand Elegance of Partnership Capital Accounts*, 9 Fla. Tax Rev. 599, 605 (2009) 60-61

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What a Difference Two Years Makes, Tax Notes Today (Jan. 24, 2007) (2007 TNT 16-65)... 35-36

Miscellaneous (continued) **Page(s)**

Revised Uniform Limited Partnership Act § 303(b)(6)
(1976) (1985 Amendments)..33

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(No. 5:04-cv-278) 89

GLOSSARY

B&B	Babcock & Brown
CHLI	Castle Harbour Leasing, Inc.
DRO	Deficit restoration obligation
FPAA	Notice of Final Partnership Administrative Adjustment
GE	General Electric Company
GECC	General Electric Capital Corporation
Gov't Br.	Brief for the Appellant
GPA	Guinness Peat Aviation
ING	ING Bank N.V.
IRS	Internal Revenue Service
Rabo	Rabo Merchant Bank N.V.

STATEMENT OF THE ISSUES

1. Whether the District Court correctly determined that ING and Rabo (the "Banks")[1] were partners in Castle Harbour under section 704(e)(1).[2]

2. Whether the District Court correctly determined that Castle Harbour's Operating Income was properly allocated under section 704(b).

3. Whether the District Court correctly determined that no accuracy-related penalties are applicable under section 6662.

STATEMENT OF THE CASE

In 2004, this case was tried and decided in favor of the taxpayer. In *Castle Harbour II,* this Court determined that the Banks were not partners under the intent test of *Commissioner v. Culbertson*, 337 U.S. 733 (1949), and remanded to the District Court for its consideration of whether the Banks were partners under the alternative statutory test established by section 704(e)(1). On remand, the District Court made the factual findings necessary to apply section 704(e)(1), including whether the Banks held "capital interests." After a thorough and careful review of the record and the law, the District Court found that the Banks were partners under section 704(e)(1).

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[1] Capitalized terms not defined herein have a meaning consistent with that used in the District Court's and this Court's prior opinions.

[2] Except as otherwise noted, "section" and "I.R.C. §" references are to the Internal Revenue Code of 1986, as amended (26 U.S.C.).

The Government has appealed the District Court's decisions on remand that the Banks were partners in Castle Harbour under section 704(e)(1) and that any underpayments of tax resulting from the Castle Harbour transaction are not subject to penalties. The Government has also appealed the District Court's original decision that the allocations of partnership income satisfied section 704.

On this appeal, the District Court's findings are reviewed only for clear error. The Government tries to frame the issue as whether the IRS has the power to recharacterize the Banks' interests in order to impose a tax liability on GECC. *See* Gov't Br. at 5. As this Court recognized on the first appeal, the IRS has the administrative power to propose adjustments to a taxpayer's return; however, its adjustments are reviewed *de novo* by the trial court.[3] The arguments made by the Government in its brief demonstrate the wisdom of *de novo* review:

(1) The Government argues that this Court's prior decision under *Culbertson* precludes consideration of section 704(e)(1), even though Congress enacted section 704(e)(1) expressly to create an objective alternative to *Culbertson*'s subjective test for determining partner status. Every court that has directly considered the issue has construed the statute accordingly. The

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[3] Both parties agree that, in this proceeding, the trial court reviews the facts and law *de novo*, ignoring the IRS's factual findings and legal analysis. 342 F. Supp. 2d at 108; Gov't Post-Trial Br. at 1. Thus, at trial TIFD III-E had to show, by a preponderance of the evidence, that its position is correct. 342 F. Supp. 2d at 108.

Government's attacks on the remand proceedings are contrary to this Court's remand ruling, the plain language, structure and history of section 704(e)(1), and judicial interpretations of the statute.

(2) Because the value of the aircraft GECC contributed to Castle Harbour exceeded their tax basis, Castle Harbour's taxable income always exceeded its section 704(b) income. As the District Court recognized, section 704(c) and its "ceiling rule" govern the allocation of this excess taxable income. Yet the Government never even mentions section 704(c). Instead, it tries to apply the "substantial economic effect" and "partner's interest in the partnership" standards of section 704(b) to taxable income governed by section 704(c), even though the regulations explicitly provide that section 704(b) standards do not apply to section 704(c) income.

(3) Because this is a partnership-level proceeding under TEFRA,[4] the final decision in this case must make affirmative determinations of what the disputed partnership items were, and not merely negative determinations of what they were not. The Government's brief ignores these affirmative obligations imposed by TEFRA.

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[4] "TEFRA" refers to the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 111 Stat. 788 (1982), which enacted the unified partnership audit procedures (I.R.C. §§ 6221-6234).

(4) Although GECC has twice prevailed in the District Court, the Government continues to seek penalties. In doing so, it criticizes GECC for not introducing "reasonable cause" evidence at trial, even though the TEFRA regulations prohibit introduction of such evidence at trial.

As found by the District Court at trial and on remand, the Castle Harbour transaction resulted from GECC's efforts to address serious business and economic problems in its aircraft leasing business. Responding to those challenges required that GECC obtain equity investments from third parties. As the District Court found, while the structure provided significant tax benefits, tax savings were not the principal purpose of the transaction.

As this Court has stated, "when a taxpayer chooses to conduct his business in a certain form, the tax collector may not deprive him of the incidental tax benefits flowing therefrom, unless it first be found to be but a fiction or a sham." *Newman v. Comm'r*, 902 F.2d 159, 162 (2d Cir. 1990) (citations and internal quotations omitted). This admonition rests upon an established line of Supreme Court precedent, most recently *Frank Lyon Co. v. United States,* 435 U.S. 561, 583-84 (1978) ("[W]here . . . there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government

should honor the allocation of rights and duties effectuated by the parties."). The District Court has now twice found that Castle Harbour was neither a fiction nor a sham, that it was motivated by substantial non-tax business purposes, and that it was a multi-party transaction with economic substance.

STATEMENT OF FACTS

Background. The Government's brief routinely mischaracterizes the facts and largely ignores the District Court's "precise, thorough, and careful findings." 459 F.3d at 224-25. A review is therefore essential to distinguish between what the record establishes and what the Government asserts.

In the early 1990's, leased aircraft were a distressed asset class. 660 F. Supp. 2d at 371. The Persian Gulf War and a recession reduced demand, creating excess capacity. A-78. In 1991, total miles flown on commercial airlines declined for the first time since World War II. A-2127. These economic problems materially increased the risk of default by airline-lessees and virtually destroyed the secondary market for "off-lease" planes. PSA-9;[5] 660 F. Supp. 2d at 371. These problems directly affected GECC. The Eastern Airlines bankruptcy alone resulted in the return of 26 aircraft to GECC, representing over 7% of its total aircraft portfolio. A-79-80; A-83.

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5 Cites to "PSA" are to Plaintiff-Appellee's Supplemental Appendix.

GECC's exposure was acute because approximately 40% of its aircraft portfolio consisted of old "Stage II" aircraft, which were nearing lease-end and were too noisy to satisfy pending noise abatement regulations. 660 F. Supp. 2d at 371; A-2146. The lack of a vibrant residual market exacerbated these problems.[6] Credit rating agencies and stock analysts expressed concern over the valuation of GECC's aircraft portfolio. A-80; A-153-54. Senior management of GE directed GECC management to address GECC's exposure to the domestic airline industry and the apparent illiquidity of its concentrated investment in Stage II aircraft. 660 F. Supp. 2d at 371; A-89-91; A-129; A-2125-32; PSA-21-23.

GECC management responded with a "sell down" strategy to reduce its exposure to Stage II aircraft and to demonstrate liquidity in the aircraft portfolio. The principal business objective was to demonstrate that GECC could attract third-party investment in Stage II aircraft. A-96-97. The goal was not simply to raise money, but to raise money against specific assets. A-95-97; A-1186-89.

GECC faced formidable obstacles. Selling aircraft into the distressed market was not an option, 660 F. Supp. 2d at 371; A-89-90, nor was pledging the aircraft to secure nonrecourse financing, because the aircraft were already subject to substantial purchase-money nonrecourse debt. PSA-11. Moreover, GECC's

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[6] By May 1993, Boeing alone had over 700 aircraft mothballed in the desert, including more than 550 Stage II aircraft that Boeing believed would never fly again. A-2134.

agreements with its unsecured lenders contained a "negative pledge" that prohibited it from using the portfolio to secure additional indebtedness. 660 F. Supp. 2d at 371. Finally, to protect its AAA credit rating, GECC had to maintain a ratio of debt to common equity of no more than 8:1. By the end of 1993, that ratio was 7.96:1, precariously close to that limitation. *Id.*

Given these limitations, GECC sought new ideas from outside advisors. A-139. In May 1992, GECC submitted requests for proposal (the "RFPs") to seven investment banks seeking ways to achieve three primary objectives: (1) accessing liquidity; (2) expanding the pool of investors; and (3) achieving off-balance sheet financing. A-1187; A-2061; A-2079; A-2097. All seven submitted proposals, but none met GECC's requirements. GECC continued discussions with four of the seven, including Babcock & Brown ("B&B"). 660 F. Supp. 2d at 371-72.

Meanwhile, conditions worsened. In June 1992, a major competitor, Guinness Peat Aviation (GPA), suffered a failed IPO, underscoring the seriousness of the challenges confronting GECC. A-108; PSA-3-4; PSA-12-14. In 1992, GECC's return on equity for its aircraft portfolio fell to its lowest point ever. PSA-5-6. In 1993, the nonearning assets in GECC's aircraft portfolio ballooned. A-256-57.[7]

[7] The Government tries to downplay the impact of this crisis on GECC's aircraft division. *See* Gov't Br. at 6 n.2. As the recent financial crisis demonstrates,
(continued…)

Finally, in March 1993, B&B submitted a proposal to raise equity against the portfolio. 660 F. Supp. 2d at 371-72. It contemplated the formation of an entity to which GECC subsidiaries would contribute aircraft and cash and outside investors would contribute cash. The proposal would enable GECC to raise cash against Stage II aircraft scheduled to come "off lease" during the next few years. A-169; PSA-7.

GECC worked with B&B to modify the proposal to meet GECC's unique circumstances. A-160-61. Recognizing that investors were unlikely to accept unlimited exposure to losses from aircraft sales, the revised proposal contemplated a preferred equity investment that would cushion the investors against downside risk while enabling GECC to attract investment without violating its negative pledge obligation or increasing its balance sheet liabilities. A-105-07; A-144; A-1209.

The revised proposal satisfied GECC's critical objectives—demonstrating liquidity and raising capital against the aircraft. A-161-62. Even though the investors insisted that the entity retain liquid assets, GECC could access their contributions by borrowing from the entity. A-200-01. Because the entity would

(…continued)
however, businesses that ignore concerns over the liquidity and value of their assets do so at their peril.

be consolidated with GECC for financial accounting purposes (and therefore eliminated from GECC's consolidated balance sheet), GECC could borrow from the entity without increasing its debt-equity ratio or violating the negative pledge. A-108; A-200-01; A-232-33; A-260-62. Moreover, the partnership could be structured so that most of the interest paid by GECC to the entity could be economically allocated to GECC, thereby focusing the investor's return on income from the aircraft portfolio. A-410-11.

The structure was complex, primarily because GECC needed to attract capital in a way that satisfied the various legal, accounting and financial constraints. Business considerations drove various features of the transaction, including the formation of a separate entity. PSA-15. As the District Court correctly observed, "not only was there a legitimate non-tax reason to create a separate entity . . . but it is actually hard to imagine an alternative to creating a separate entity." 342 F. Supp. 2d at 114.

The revised plan contemplated that the investors would be non-U.S. institutions. This reflected the business reality that, like GECC, most potential domestic investors were already over-exposed to the U.S. commercial aircraft market and were unlikely to take on additional exposure. A-165. Foreign investment would help GECC to achieve another objective—attracting new

sources of capital to the domestic aircraft market. *See, e.g.,* A-1187; A-2061; A-2079; A-2097.

Following management approval, on July 26, 1993, GECC subsidiaries organized Castle Harbour. B&B began approaching potential equity investors. ING and Rabo had some experience in aircraft investments and expressed interest in the proposed transaction. A-416; A-493; A-510. Following weeks of negotiations, on October 6, 1993, the Banks agreed to invest a total of $117.5 million of equity to acquire membership interests in Castle Harbour. A-169-70; A-204-05; A-478.[8]

Allocation of Operating Income and Disposition Gain/Loss. Income from aircraft subject to leveraged leases has two basic components: (i) rent during the lease term, and (ii) gain or loss based on residual value at lease end. The Operating Agreement computed these two components separately, as Operating Income (rent, operating expenses, and book depreciation) and Disposition Gain or Loss (the difference between the market value and book value of aircraft when sold or otherwise transferred). The separate computation permitted the members to

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[8] In October 1993, GECC acquired aircraft assets from GPA, its Irish competitor. The GPA acquisition was consistent with the sell-down strategy, because the GPA planes were Stage III aircraft leased primarily to foreign airlines. The purchase gave GECC a worldwide platform and diversified its airline leasing business. A-108-12; A-156-57. This combination of the sell-down initiative and the GPA transaction enabled GECC to grow its aircraft leasing business while managing the issues it faced in the early 1990s. A-110-12; A-156.

share these two categories of economic income differently. The Banks accepted some limited residual-value risk, but relied more heavily on Operating Income, where the primary risk was lessee default. A-426; A-444; A-508-09. The Banks were allocated 98% of Operating Income and 1% of Disposition Gains. Allocations of Operating Income and Disposition Gains (or Losses) increased (or decreased) the members' capital accounts, thereby ensuring that the allocations would affect, dollar for dollar, the amounts they ultimately received. 660 F. Supp. 2d at 391; A-214.

The Exhibit E Distributions and their relationship to Capital Accounts. The Operating Agreement provided for Exhibit E distributions to the Banks. The scheduled Exhibit E distributions reflected the projected cash flow from the aircraft portfolio assuming no residual gain or loss. Because aircraft are depreciating assets, each rent payment provides both a return on the lessor's investment and the return of a portion of that investment. Thus, like residential mortgages, investments in leased aircraft are self-liquidating. Accordingly, each Exhibit E distribution was partly a distribution of income and partly a return of capital.[9] A portion of each distribution was matched by an allocation of Operating Income,

[9] The IRS recognizes as equity self-liquidating interests in entities that hold self-liquidating assets. *See* Treas. Reg. § 301.7701-4(c)(2), Example (1).

and the balance represented a return of capital that reduced the Banks' capital accounts.

The Exhibit E distributions were based on a target return of 9.03587%. 660 F. Supp. 2d at 373-74. The target return assumed that (1) all scheduled rent would be paid, (2) there would be no variations in assumed expenses, and (3) there would be no net residual gain or loss. In the unlikely event all these assumptions held, the Banks' Operating Income allocations would produce a 9.03587% return on their investment and the cumulative Exhibit E distributions would reduce their capital accounts to zero. Any variance between the assumptions and actual results, however, would leave the Banks with a positive or negative capital account balance.[10] The Banks would receive any positive balance, but would have to repay any capital account deficit. 660 F. Supp. 2d at 391; A-214; A-449; A-517-18.

The Class A Guaranteed Payment. To limit their downside exposure, the Banks negotiated the right to receive a Class A Guaranteed Payment if cumulative allocations of Operating Income and Disposition Gain failed to produce a return on their investment of at least 8.53587%, referred to in the Operating Agreement as the "Applicable Rate." Contrary to the Government's assertions that 9.03587% is the Applicable Rate, Gov't Br. at 11, if Castle Harbour operated as expected and

[10] Such variances occurred. For example, Continental prevailed in a dispute involving two leases, thereby reducing rent (and Operating Income) by $2.3 million. A-219; A-269; A-319; A-1662; A-2594.

the partnership ended on the optional liquidation date of September 3, 2000, the Applicable Rate would be 8.53587%. A-565. If the liquidation of the Banks' interests occurred sooner, the Applicable Rate also would be 8.53587% in most instances in which the liquidation resulted from circumstances beyond GECC's control (such as changes in tax or regulatory laws or a 20% reduction in anticipated lease profits). In certain other instances, the Applicable Rate could increase to 9.03587%. A-565. The 50 basis point increase resembled a premium for early redemption, a common feature of preferred equity. *See, e.g.,* Treas. Reg. § 1.305-5(b)(3)(i).

The Investment Accounts tracked the Banks' potential entitlement to the Class A Guaranteed Payment. They were hypothetical balances of the Banks' investments; their *sole* purpose was to determine whether the Banks were entitled to a Class A Guaranteed Payment. 660 F. Supp. 2d at 378.[11] Contrary to the Government's assertions (Gov't Br. at 16), the distributions the Banks would receive on liquidation were not governed by their Investment Accounts, but by their capital accounts. A-656-57.

[11] Guaranteed payments on a partner's capital are expressly contemplated by the Code and thus entirely consistent with partner status. *See* I.R.C. § 707(c). The regulations under section 707(c) explicitly approve the use of a contingent guaranteed payment in the event the partnership's income allocations are insufficient to provide a partner with a target return. Treas. Reg. § 1.707-1(c), Example (2).

Although the Class A Guaranteed Payment provided the Banks with a minimum return *on* their capital investment, it did not assure them of receiving the return *of* their capital investment. 660 F. Supp. 2d at 380. If, for example, Castle Harbour's cumulative Disposition Losses had exceeded $2.85 million, the Banks' share of any further Disposition Losses (either 1% or 100%) would have reduced their capital accounts without generating (or increasing) a Class A Guaranteed Payment. Operating Agreement, §§ 1.10 at A-570-71 (definition of "Class A Guaranteed Payment"), 3.3(j)(iii) at A-605 (Disposition Losses), 10.8 at A-651-55, 12.7 at A-659-60. The Class A Guaranteed Payment was a contingent obligation of the Partnership. It did not entitle the Banks to look beyond the assets of the Partnership for return of their investments, and it was subordinate to the claims of Castle Harbour's creditors.[12] A-657-59.

Termination of Banks' Investment. In 1997, the IRS issued regulations changing the rules for applying U.S. tax treaties to certain "fiscally transparent" entities. *See* Treas. Reg. § 1.894-1(d); T.D. 8735, 1997-2 C.B. 72. The new rules created uncertainty as to whether the Banks' shares of partnership income would become subject to U.S. tax and, accordingly, whether the GECC entities would be required to indemnify the Banks. As a result, GECC exercised its right to purchase

[12] The Class A Guaranteed Payment provided the Banks with a yield similar to that of preferred stock, whose right to cumulative dividends is fixed and senior to the rights of common stockholders, but subordinate to the rights of creditors.

the Banks' interests. A-239-40. The purchase price for each Bank's interest equaled its positive capital account balance, increased by its allocable share of unrecognized "mark to market" gain in the value of the Partnership's assets. A-240. Thus, each Bank received the amount it would have received had the Partnership liquidated. Because the purchase resulted from a change in law, the Applicable Rate was 8.53587% (*not* 9.03587%). Operating Agreement § 1.10 at A-565 (definition of "Applicable Rate"), A-574-575 (definition of "Excluded Event"); A-240-41. Since the Banks' internal rate of return exceeded 9%, they received no Class A Guaranteed Payment. 660 F. Supp. 2d at 380.

Consequences of Castle Harbour Transaction. As the District Court found, GECC achieved significant non-tax business objectives through the formation and operation of Castle Harbour. 342 F. Supp. 2d at 121; 660 F. Supp. 2d at 400. Castle Harbour enabled GECC to demonstrate to investors, rating agencies, and senior management that it could monetize a portion of its fleet of aging Stage II aircraft without incurring debt. The transaction in fact raised $117.5 million of equity capital. Denis Nayden, then-Executive Vice President and later CEO of GECC, testified that Castle Harbour was "a business deal that dealt with real business issues," and that he approved the Castle Harbour transaction because it "absolutely delivered on a critical financial hurdle, and that is create liquidity for GE and bring in new third party equity." A-280-82. Instead of challenging his

characterization of the business objectives GECC achieved by entering into Castle Harbour, the Government chose not to cross-examine Mr. Nayden. A-2880.

The Banks' contributions were not placed in a lock box. CHLI (Castle Harbour's wholly owned subsidiary) used their contributions to purchase outstanding GECC commercial paper, thereby reducing GECC's balance sheet liabilities, improving GECC's debt-equity ratio and reducing the risk that GECC would exceed the 8:1 ratio negotiated with its rating agencies. A-107-08; A-200-01. Castle Harbour enabled GECC to accomplish these objectives without violating the negative pledge contained in its credit agreements. A-107-08; A-259.

The then-applicable tax law also provided a significant benefit to GECC. Absent any transaction, GECC would have paid tax on the taxable income produced by the aircraft, with no offset for depreciation. The then-applicable partnership tax regulations expressly mandated that Castle Harbour deduct depreciation in computing its section 704(b) book income, even though the aircraft had no remaining tax basis and thus generated no tax depreciation deductions. Under these rules, the allocation of Operating Income to the Banks carried with it a proportionate share of the excess taxable income resulting from the difference between book depreciation and tax depreciation. *See* discussion *infra* Part II.

SUMMARY OF ARGUMENT

1. Congress enacted the predecessor to section 704(e)(1) expressly to provide an objective alternative to *Culbertson*. Because this Court and the District Court previously considered only the *Culbertson* test, the case was remanded for consideration of section 704(e)(1). The District Court's conduct of the remand proceedings was entirely appropriate. Consistent with this Court's admonition, the District Court carefully examined the evidence, including the economic realities of the transaction, and found that the Banks were partners under section 704(e)(1). The Government's attacks on the District Court's holding on remand are predicated on a flawed reading of section 704(e)(1) that is refuted by its plain terms, structure, and history and is inconsistent with relevant case law.

The critical factual question under section 704(e)(1) is whether the Banks owned "capital interests." The Banks' interests were economically and legally equivalent to preferred stock, which is equity for tax purposes even though bearing many characteristics of debt. Structuring the Banks' interests as preferred equity, rather than debt, achieved material non-tax business purposes. While Castle Harbour also provided tax benefits, taxpayers are entitled to adopt business structures that minimize taxes.

2. The Government's arguments for reallocating Castle Harbour's income under section 704(b) completely ignore the controlling law. The specific

tax consequences at issue here flow directly from the mandatory application of the "ceiling rule" prescribed by the section 704(c) regulations. The section 704(c) regulations have since been amended to permit the IRS to override the ceiling rule for certain property contributions after December 20, 1993. To circumvent the explicitly prospective effective date of those amended regulations, the Government concocts an interpretation of section 704(b) that ignores the separate and distinct functions of sections 704(b) and (c) and allocates less section 704(b) book income to the Banks than the economic profit they actually received. The Government's litigating position is irreconcilable with the established rules and regulations under section 704(b).

3. The Government's efforts to extract penalties after having lost at trial and again on remand violate the basic principles that underlie the penalty provisions of the Code. The District Court's two decisions confirm that Castle Harbour was business-motivated, and the reasoning of those decisions demonstrates that substantial authority existed for the reported tax treatment of the transaction. The Government compounds its overreaching by criticizing GECC for failing to offer "reasonable cause" evidence at trial, even though the regulations expressly prohibit the introduction of such evidence in TEFRA proceedings.

ARGUMENT

I. Section 704(e)(1) Mandates the Recognition of the Banks as Partners

Standard of Review

Contrary to the Government's unsupported assertion of *de novo* review by this Court, Gov't Br. at 49, the District Court's findings under section 704(e)(1) are factual determinations reviewable only for clear error. *See Curry v. United States*, 804 F.2d 647, 651 (Fed. Cir. 1986) (whether capital is material income-producing factor); *Ballou v. United States*, 370 F.2d 659, 662 (6th Cir. 1966) (ownership of capital interest); *Kuney v. Frank*, 308 F.2d 719 (9th Cir. 1962) (partner status).

A. Section 704(e)(1) Establishes an Alternative Test to *Culbertson*.

This Court held that the Banks were not partners under *Culbertson*'s intent test, but did not consider whether the Banks were partners under section 704(e)(1), which states: "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."[13]

On remand, the District Court made the factual findings necessary to apply section 704(e)(1) and correctly determined that the Banks were partners. The

[13] The phrase "this subtitle" refers to subtitle A of the Code (I.R.C. §§ 1-1563), which contains the income tax provisions of the Code.

Government's various attacks on the remand decision stem from its erroneous premise that section 704(e)(1) does not provide an alternative to *Culbertson*. As demonstrated below, the statute is indeed an objective alternative to *Culbertson* that focuses on ownership of a capital interest rather than on the parties' subjective intent. Thus, the District Court's inquiry on remand, including its careful examination of the record, was consistent with, and required by, this Court's remand of the section 704(e)(1) issue, including this Court's admonition to examine the objective economic reality of the transaction. 459 F.3d at 233-34.

1. Congress enacted section 704(e)(1) for the express purpose of providing an alternative to the *Culbertson* test.

Culbertson was the culmination of the courts' response to the "family partnership" tax shelter. After years of litigation, the Supreme Court first addressed such partnerships in *Commissioner v. Tower*, 327 U.S. 280 (1946).[14] The Court framed the standard as "whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both." *Id.* at 287. This intent test was not grounded in tax policy; rather, it was derived from the *non-tax* law of partnership, under which a partnership was a mutual agency created by the parties' reciprocal intent. *Tower* also emphasized

[14] At the time, married couples in common-law states could not file joint returns. The Towers sought to shift income from Mr. Tower's high tax bracket to Mrs. Tower's lower bracket.

two objective factors: whether a partner performed vital services or invested "original capital" (as opposed to capital acquired by gift). *Id*. at 290; *see also Lusthaus v. Comm'r*, 327 U.S. 293 (1946) (companion case).

After *Tower*, lower courts struggled to apply its subjective and objective factors. Three years later, in *Culbertson*, the Supreme Court attempted to clarify the test, framing the test as "whether . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." 337 U.S. at 742.

Like *Tower*, *Culbertson* relied on two unrelated lines of analysis. While imposing a subjective intent test derived from the non-tax law of partnerships, the Court also relied on an objective tax principle known as the assignment-of-income doctrine, which requires that income produced by services or capital be taxed to the service provider or capital owner, regardless of intent or subjective considerations. *See id*. at 739-40 (citing *Lucas v. Earl*, 281 U.S. 111 (1930); *Helvering v. Clifford*, 309 U.S. 331 (1940); *Nat'l Carbide Corp. v. Comm'r,* 336 U.S. 422 (1949)). Consequently, *Culbertson*, like *Tower*, produced confusion and inconsistent results.

In 1951, Congress acted to eliminate the confusion by enacting the predecessor to section 704(e)(1). Revenue Act of 1951, Pub. L. No. 82-183, § 340(a), 65 Stat. 452, 511 (1951). The stated intent was "to harmonize the rules

governing interests in the so-called family partnership with those generally applicable to other forms of property or business." H.R. Rep. No. 82-586, at 32 (1951); S. Rep. No. 82-781, at 39 (1951) (identical language). The legislative history characterized the statute as an application of the basic principle that "income from property is attributable to the owner" and criticized the courts for having ignored this principle in favor of an intent test. H.R. Rep. No. 82-586, at 32-33 (1951). *Cf. Blair v. Comm'r*, 300 U.S. 5 (1937) (transfer of ownership of income-producing property subjects transferee to tax on income generated by transferred property).

Section 704(e)(1) responded to *Tower* and *Culbertson*, and like those decisions it applies well beyond the family partnership context. The 1951 statute amended the general definition of "partnership," which contained no reference to family. *See* Internal Revenue Code of 1939 § 3797(a)(2) (now codified as section 761). Consistent with the statute, the legislative history disavowed any intent to create a special rule for family partnerships while characterizing the statute as harmonizing the partnership rules with those applicable to "other forms" of business. In 1954, the provision was recodified, with minor changes, as section 704(e)(1), but this relocation had no substantive effect on the statute. *See* I.R.C. § 7806(b) ("No inference, implication or presumption of legislative construction shall be drawn or made by reason of the location or grouping of any particular

section or provision . . . ."). Like its predecessor, section 704(e)(1) makes no reference to family partnerships.[15]

Congressional opponents objected that the new statute would permit tax-motivated partnerships, because it would "replace the good faith and business purpose tests" the courts had established "with the mere test that the gift of a capital share is a real gift, and that ownership by the recipient is actual ownership." 97 Cong. Rec. 12,146 (1951) (statement of Sen. Humphrey). Despite those complaints, Congress enacted the new standard, emphasizing that, if a partnership interest satisfies the objective criteria, "it does not matter what motivated the transfer . . . or whether the business benefited from the entrance of the new partner." H.R. Rep. No. 82-586 at 32; S. Rep. No. 82-781, at 39. Similarly, the regulations confirm that if the reality of the transaction is established, "the motives for the transaction are generally immaterial." Treas. Reg. § 1.704-1(e)(2)(x).

This does not mean that *Culbertson* is obsolete. *Culbertson* retains vitality as an alternative to section 704(e)(1) and thus governs the treatment of profits interests and service partnerships. In addition, as the District Court determined, it

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[15] The Government makes the bizarre suggestion that section 704(e)(1) does not apply to "large, sophisticated corporations acting at arm's-length." Gov't Br. at 53. Before the District Court, however, the Government correctly conceded that section 704(e)(1) "can be applied to all partners." A-2938-39. Section 704(e)(1) applies to interests owned by a "person," a term that includes corporations (including "large, sophisticated" ones). *See* I.R.C. § 7701(a)(1).

continues to have relevance in cases where the formation of a putative partnership has no economic substance or business purpose. 342 F. Supp. 2d at 111-14. *Cf. Slifka v. Comm'r*, 182 F.2d 345, 345-46 (2d Cir. 1950) (per curiam) (*Culbertson* applicable to partnerships that lack business purpose).

2. Courts have consistently characterized section 704(e)(1) as an alternative to *Culbertson*.

The Government states that "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)." Gov't Br. at 55. This misleading representation ignores a case that the IRS has long accepted. Plaintiff's remand brief discussed this case in detail.

Smith v. Commissioner, 32 T.C. 1261 (1959), *acq.*, 1960-2 C.B. 7, was the second of two cases involving the same partnership. The taxpayers gave interests in a partnership to trusts for their children. After auditing the 1943-48 tax years, the IRS disregarded the trusts as partners and taxed the parents on all of the partnership's income. The taxpayers challenged the IRS adjustments for these years in District Court, but lost based on the District Court's application of *Culbertson*. *Smith v. Westover,* 123 F. Supp. 354 (S.D. Cal. 1954), *aff'd*, 237 F.2d 201 (9th Cir. 1956). Upon auditing the taxpayers' 1952-53 tax years, the IRS again disregarded the trusts as partners. Once again the taxpayers challenged the IRS's adjustments, this time in Tax Court. Invoking collateral estoppel, the IRS

argued that the District Court's decision for 1943-48 foreclosed recognition of the trusts as partners in 1952-53. 32 T.C. at 1265. The Tax Court rejected that argument, because the enactment of the predecessor to section 704(e)(1) in 1951 was not "a mere restatement or codification of existing law," but a substantive change in the governing law. *Id.* at 1267. Applying the statutory standard, the Tax Court held that the trusts were partners, notwithstanding the prior decision under *Culbertson*. Shortly thereafter, the IRS acquiesced in *Smith* (1960-2 C.B. 7) and, aside from the Government's latest brief in this case, has accepted its holding for the last fifty years.

Since *Smith*, the Tax Court has consistently interpreted section 704(e)(1) as applying a different standard than *Culbertson. See, e.g., Cirelli v. Comm'r*, 82 T.C. 335, 348 (1984); *Carriage Square, Inc. v. Comm'r*, 69 T.C. 119, 128 (1977); *cf. Hartman v. Comm'r*, 43 T.C. 105 (1964), *acq.* 1965-2 C.B. 3 (recognizing partnership under section 704(e)(1) without citing *Culbertson*).

Other courts uniformly recognize that section 704(e)(1) provides an alternative to *Culbertson*. In *Evans v. Commissioner*, 447 F.2d 547 (7th Cir. 1971), the taxpayer transferred his entire interest in a two-man partnership to a corporation. Because the taxpayer did not disclose the transfer to the other partner, the IRS argued that the corporation could not be a partner under *Culbertson*'s intent test. The Tax Court held that, even though the partnership was not a "family

partnership," the transferee corporation was a partner under section 704(e)(1).[16] The Seventh Circuit affirmed, reasoning that under section 704(e)(1) "the subjective intent of the parties is not a determinative test." 447 F.2d at 550 (citation omitted). *See also Pflugradt v. United States*, 310 F.2d 412, 415 (7th Cir. 1962) ("The test is no longer whether the parties acted in good faith with a business purpose in joining together to conduct the partnership business. This *was* the test set forth in *Commissioner v. Culbertson* . . . , which was decided before present § 704(e)(1) was a part of the Code." (citations omitted and emphasis added)).

Likewise, the Ninth Circuit recognizes that section 704(e)(1) establishes an alternative standard to *Culbertson*. In *Poggetto v. United States*, 306 F.2d 76, 79 (9th Cir. 1962), the Ninth Circuit held that an individual could not be ignored as a partner if she satisfied *either* "the objective standards of § 704(e)(1)" *or* *Culbertson*.

Indeed, every case that has considered the relationship between the two standards has concluded that section 704(e)(1) is an alternative to *Culbertson*. This is hardly surprising: treating *Culbertson* as a prerequisite to section 704(e)(1)

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[16] 54 T.C. 40 (1970). The Government's characterization of *Evans* as a "family partnership" case, Gov't Br. at 53, is belied by the IRS's litigating position in that case and the Tax Court's decision. The IRS later acquiesced in the Tax Court decision. *See* 1978-2 C.B. 2.

would recreate the very confusion Congress sought to eliminate by enacting the objective statutory test.

None of the four cases cited by the Government support its assertion that partners must satisfy the *Culbertson* test to come within section 704(e)(1). In *Bayou Verret Land Co. v. Commissioner,* 450 F.2d 850 (5th Cir. 1971), the taxpayer held a partnership interest and transferred a portion of the income he received to his mother, claiming that his partnership interest was owned by an undocumented "sub-partnership" between himself and his mother. The Tax Court rejected that argument, holding that the mother did not own a capital interest for purposes of section 704(e)(1). In remanding the case for additional findings, the Fifth Circuit indicated that the intent to form the alleged subpartnership was relevant, citing *Culbertson. Id.* at 863. The Fifth Circuit did not discuss the legislative history of section 704(e)(1) or the relationship between *Culbertson* and section 704(e)(1).

Payton v. United States, 425 F.2d 1324 (5th Cir. 1970), involved a medical practice, the quintessential services business to which section 704(e)(1) cannot apply because capital is not a material income-producing factor. *See* Treas. Reg. § 1.704-1(e)(1)(iv). In *Spiesman v. Commissioner,* 260 F.2d 940 (9th Cir. 1958), the putative partner was not the real owner of the interest and thus did not satisfy section 704(e)(1). The Ninth Circuit's opinion did not address the relationship

between section 704(e)(1) and *Culbertson*, in contrast to its later opinion in *Poggetto*, which applied them as alternative standards. Finally, in *Estate of Winkler v. Commissioner*, 73 T.C.M. (CCH) 1657 (1997), the Tax Court determined that the arrangement satisfied both section 704(e)(1) and *Culbertson*.[17] None of these cases support the assertion that failure to satisfy *Culbertson* prevents operation of section 704(e)(1).

B. The Government's Arguments are Contrary to the Statute and Its Own Stipulations in this Case.

1. Section 704(e)(1) applies regardless of how the interest was "derived."

The Government's primary technical argument is that section 704(e)(1) is limited to transfers of interests in preexisting partnerships and "does not apply to the formation of a partnership." Gov't Br. at 54. The assertion is not plausible.

First, the plain text of the statute refutes the Government's position. According to the opening clause, a person "shall be recognized as a partner . . . if he owns a capital interest in such a partnership." The operative word, "owns," speaks in the present tense; it does not require that the partnership predate the owner's acquisition of the capital interest. Similarly, the statute's final clause requires recognition of the owner of a capital interest as a partner "whether or not

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[17] The erroneous inference the Government seeks to draw from *Winkler* is contrary to other Tax Court decisions, including *Smith* and *Carriage Square*, which apply section 704(e)(1) independently of *Culbertson*.

such interest was derived by purchase or gift from any other person." It does not limit the statute to acquisitions of interests in preexisting partnerships. *See also* H. R. Rep. No. 82-586, at 32-34 (1951) (statute applies "however the owner of a partnership interest may have acquired such interest").

Second, Congress enacted section 704(e)(1) in response to the Supreme Court's decisions in *Tower*, *Lusthaus*, and *Culbertson*. None of those decisions involved a preexisting partnership. In each, the existence of the putative tax partnership depended on recognition of the transferee as a partner.[18] If taken seriously, the Government's preexisting partnership argument would mean that Congress responded to the Supreme Court decisions by enacting a statute that, by its terms, could never apply to the facts of any of those cases.

No court has limited section 704(e)(1) in this way. For example, in *Hartman v. Commissioner*, 43 T.C. 105 (1964), the Tax Court applied section 704(e)(1) to recognize a partnership in which all three members acquired their interests through capital contributions to a new entity. Similarly, in *Tiberti v. Commissioner*, 21 T.C.M. (CCH) 961 (1962), a sole proprietor transferred undivided one-fifth interests in his business to four trusts. The Tax Court held that all four trusts were

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[18] In *Tower*, the controlling shareholder of a liquidating corporation transferred an interest in the business to his wife; in *Lusthaus*, a sole proprietor transferred interests to a spouse; and in *Culbertson*, the sole owner of a ranch transferred interests to his children.

partners under section 704(e)(1), even though no partnership had existed prior to their acquisitions of interests.

Finally, construing "partnership" to mean "preexisting partnership" would be inconsistent with other provisions of the Code. For example, section 721(a) provides that "[n]o gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." Applying the Government's logic, section 721 could never apply to the formation of a new partnership, because there is no partnership (and no partners) until after the initial contributions have been made. That interpretation of section 721 is no more preposterous than the Government's limitation of section 704(e)(1) to interests in preexisting partnerships.

2. Castle Harbour was a preexisting partnership.

The Government's "preexisting partnership" argument is not only incorrect but irrelevant, because it is based on the false premise that "this case does not involve the transfer of a partnership interest in a valid, existing partnership." Gov't Br. at 53.

The parties' stipulations and the District Court's findings establish that Castle Harbour was an existing partnership when the Banks acquired their interests. The parties agree that Castle Harbour was organized on July 26, 1993, that it initially had three members, and that two of those members sold interests to

the Banks on October 6, 1993. Gov't Br. at 7-9. In the District Court, the Government stipulated that "Castle Harbour was classified as a partnership," Joint Trial Mem. 4, Stipulation No. 14, and consistently framed the issue as whether a partnership existed among multiple GECC entities, on the one hand, and the Banks, on the other, *id.* at 9. The District Court found that Castle Harbour was a partnership. 342 F. Supp. 2d at 111-12, 115.

The Government's brief erroneously states that Castle Harbour "elected" to be a partnership. Gov't Br. at 7 (citing 26 C.F.R. § 301.7701-3(c)). The regulation cited by the Government did not take effect until January 1, 1997, more than three years after the formation of Castle Harbour. Treas. Reg. § 301.7701-3(h)(1). For tax years prior to January 1, 1997, the same regulation requires that Castle Harbour be respected as a partnership as long as a "reasonable basis" existed for such classification. Treas. Reg. § 301.7701-3(h)(2). As the record and the District Court's decisions demonstrate, Castle Harbour easily satisfies that standard.

C. The Banks' Interests Were Capital Interests.

The Government has not challenged the District Court's findings that capital was a material income-producing factor in Castle Harbour and that the Banks were the real owners of their interests. *See* 660 F. Supp. 2d at 390, 392. The only remaining requirement is that the Banks' interests were capital interests. The regulations under section 704(e)(1) define "capital interest" 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). Applying this plain language to the undisputed evidence, the District Court found, as a fact, that the Banks owned capital interests.

The Government argues that the District Court should not have addressed the issue, because this Court had already decided that question. Gov't Br. at 56. As explained above, however, section 704(e)(1) is an objective alternative to the *Culbertson* subjective intent test; thus, the characterization of the Banks' interests under *Culbertson* does not determine whether they were capital interests under section 704(e)(1).

The Government never explains why the Banks' interests were not equity and hence capital interests. It apparently understands that nonparticipating preferred stock is equity even though it carries no voting rights and no participation beyond a fixed dividend. *See* Gov't Br. at 58. The Banks had greater participation in profits, losses and management than conventional preferred shareholders. The Banks' participation in residual profits and losses—a minimum of 1% at all times—exceeded that of conventional preferred stock.[19] The managerial controls held by the Banks, including the right to approve any transfer of aircraft to CHLI

[19] Then-existing IRS partnership guidelines recognized a 1% participation as significant. *See* Rev. Proc. 89-12, 1989-1 C.B. 798, § 4.01.

and modifications of aircraft leases, A-620-24, exceeded those typically possessed by nonvoting preferred shareholders and limited partners.[20] And the Government completely ignores numerous authorities that affirm equity classification for partnership interests and preferred stock while expressly acknowledging their economic equivalence to short-term debt.

1. The definition of "capital interest" does not require participation in residual profits and losses.

This Court determined that the debt-like nature of the Banks' interests negated any inference that the Banks and the GECC members intended to join together as partners under the subjective test of *Culbertson*. *See* 459 F.3d at 241. In reaching that conclusion, the Court focused in particular on the Banks' limited interest in residual profits and losses. *See id.* at 235-38.

Section 704(e)(1), in contrast, imposes no requirement of entrepreneurial participation in profits and losses, and the regulatory definition of "capital interest" properly focuses on capital claims at distribution, rather than participation in residual profits or losses. Indeed, the regulations expressly distinguish between a

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[20] In general, limited partners cannot "participate in the control of the business" without subjecting themselves to unlimited liability. *Compare* Revised Uniform Limited Partnership Act § 303(b)(6) (1976) (1985 amendments) (listing activities limited partners can engage in without subjecting themselves to unlimited liability), *with* A-620-24 (prohibiting Managers from taking certain actions without Banks' approval).

capital interest and "a mere right to participate in the earnings and profits of a partnership." Treas. Reg. § 1.704-1(e)(1)(v).[21]

The history of the statute confirms this interpretation. Congress enacted section 704(e)(1) to harmonize the rules governing partnership interests with the rules that govern other forms of business. *See supra* pp. 22-23. Then as now, a common form of business was the corporation, and it was settled law that nonparticipating preferred stock is equity. *See infra* Part I.C.3. Then-existing case law treated owners of analogous partnership interests as partners under *Culbertson*. *See Morris v. Comm'r*, 13 T.C. 1020 (1949), *acq*., 1950-1 C.B. 3 (individual was partner under *Culbertson* even though she provided no services, did not participate in management, bore no losses, and received a fixed return on her investment plus a small interest in residual profits). Given this background, it is inconceivable that Congress would impose a participation requirement for partnership interests that does not apply to preferred stock or, having decided to impose such a requirement, would say nothing about it in the statute or the legislative history.[22]

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[21] *See also Johnston v. Comm'r,* 69 T.C.M. (CCH) 2283, 2286 n.5 (1995); Rev. Proc. 93-27, 1993-2 C.B. 343.

[22] In contrast, section 704(e)(2) provides that the share of partnership income allocated to a donee of a capital interest may not be proportionately greater than the share of partnership income allocated to the donor in respect of the donor's retained capital. As section 704(e)(2) demonstrates, when Congress wanted to require participation, it did so; it did *not* include a participation requirement in section 704(e)(1).

2. Because the Banks' interests were not debt, they were capital interests.

The District Court rejected the Government's argument that the Banks' interests were debt. 342 F. Supp. 2d at 114-17. The Government did not appeal that finding; instead, it represented that this Court could resolve the *Culbertson* issue without determining whether the Banks were lenders. *See* Brief for Appellant at 53, *TIFD III-E INC. v. United States*, 459 F. 2d 220 (2d Cir. 2006) (No. 05-0064) (owner of nonparticipating interest "may or may not . . . be a lender, but it should not be deemed a valid partner for tax purposes"). On remand, the Government characterized the Banks' interests as "akin to debt" and danced around efforts by the District Court to elicit its position on whether the interests were debt, opting for debt classification only when forced by the Court to choose between debt and equity. A-2931.

The Government's latest brief resumes the dance. The Government does not suggest that the Banks' interests could be anything other than debt or equity. It recognizes that equity and capital interests are synonymous (Gov't Br. at 46), yet it criticizes what it calls "the District Court's misplaced emphasis on whether or not the Dutch Banks' interest was actually debt" (Gov't Br. at 58).[23] The reason for

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[23] The Government has consistently evaded the issue. The then-Chief Counsel of the IRS described this Court's prior opinion as "careful" not to characterize the Banks' interests as debt and emphasized that the decision "does not stand for (continued…)

this obfuscation is understandable: the "holy grail" of financial products is an instrument that is debt for tax purposes and equity for non-tax purposes, enabling the issuer to obtain the tax benefits of debt and the non-tax benefits of equity. Robert Willens, *Are "Maximum Contingent" Instruments Debt?*, 112 Tax Notes (TA) 607 (Aug. 14, 2006). Given the existing authority recognizing preferred equity, the Government would prefer a holding that the Banks were not partners while avoiding a holding that their interests were debt. Under existing law, however, the Banks' interests must be characterized as either equity or debt.[24]

The Government's invitation for this Court to sidestep this issue is irreconcilable with the requirements of TEFRA. This TEFRA proceeding "is the exclusive means" for determining Castle Harbour's partnership items,[25] including

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(…continued)
any position on the debt/equity issue." *What a Difference Two Years Makes*, Tax Notes Today (Jan. 24, 2007) (2007 TNT 16-65).

[24] The Government incorrectly asserts that the Banks treated their interests as debt for Dutch accounting and tax purposes. Gov't Br. at 21. In fact, Hem Mulders of Rabo testified that Rabo treated its interest as equity for Dutch regulatory purposes and placed its interest in the same category as illiquid preferred stock for Dutch accounting purposes. A-474-76. Furthermore, the IRS has consistently ruled that classification of an instrument under foreign law is irrelevant to its U.S. tax status. *See*, *e.g.*, I.R.S. Tech. Adv. Mem. 200512020 (Aug. 20, 2004); I.R.S. Tech. Adv. Mem. 200418008 (Dec. 29, 2003).

[25] *Katz v. Comm'r*, 335 F.3d 1121, 1124 (10th Cir. 2003). *See also PAA Mgmt., Ltd. v. United States*, 962 F.2d 212, 214 (2d Cir. 1992) (partnership items "generally must be determined at the partnership level").

classification of the Banks' investments.[26] TEFRA requires more than a negative determination of what the Banks' interests were *not*; it requires an affirmative determination of what they *were*, so that the partnership-level determination can be applied in partner-level proceedings to calculate the partners' tax liabilities. I.R.C. § 6226(f).

3. The Banks' interests were indistinguishable from commonly recognized preferred equity.

The standards that determine whether an investment in a corporation is debt or equity apply equally to partnership investments. 459 F.3d at 233. The existing entity classification regulations likewise treat the standards as identical. They permit any eligible "business entity" to be classified as either a partnership or corporation. *See* Treas. Reg. § 301.7701-3(a). If a corporation elects to become a tax partnership, the corporation's shareholders automatically become the partners of the new tax partnership. Treas. Reg. § 301.7701-3(g)(1)(ii). Conversely, a partnership's election to become a tax corporation automatically converts its partners into shareholders. Treas. Reg. § 301.7701-3(g)(1)(i). These rules equate

[26] *See* Treas. Reg. §§ 301.6231(a)(3)-1(a)(1)(i), -1(a)(1)(v), -1(a)(4); *see also PK Ventures, Inc. v. Comm'r*, 91 T.C.M. (CCH) 806 (2006) (whether investment is debt or equity is a partnership item determinable only in partnership-level proceeding), *rev'd on other grounds sub nom. Rose v. Comm'r*, 311 Fed. Appx. 196 (11th Cir. 2008).

corporate equity with partnership equity; they are unworkable unless the criteria for partnership and corporate equity are identical.

This Court previously contrasted the Banks' interests with common equity and determined that they were too "akin to debt" to qualify as a "bona fide equity participation" under *Culbertson*. 459 F.3d at 232. But this Court has long recognized that preferred stock is equity even though its holders typically do not participate in profits or management.

In *Jewel Tea Co. v. United States*, 90 F.2d 451, 452 (2d Cir. 1937), this Court observed that while it might have been "entirely logical" to treat preferred stock as debt, the tax law "has always distinguished between creditors and preferred shareholders," even though most preferred shareholders do not share in profits or participate in management. Similarly, in *Commissioner v. O.P.P. Holding Corp.*, 76 F.2d 11, 13 (2d Cir. 1935), this Court noted that while preferred stock and debt instruments are substantially similar, "only in the case of certificates designated as bonds were the holders intended to be creditors." Other circuits have recognized that highly debt-like preferred stock is equity. *See, e.g., Lee Tel. Co. v. Comm'r*, 260 F.2d 114 (4th Cir. 1958) ("sinking fund" preferred stock with cumulative fixed dividend); *Comm'r v. Meridian & Thirteenth Realty Co.*, 132 F.2d 182 (7th Cir. 1942) (preferred stock with definite maturity date and other debt-like features).

Likewise, numerous provisions of the Code and Regulations recognize that debt-like investments providing little or no participation in profits or losses may qualify as equity. For example, section 1504(a)(4) provides that nonvoting, nonparticipating preferred stock is disregarded in determining whether corporations may file a consolidated tax return. The provision presumes that such stock is equity for tax purposes, even though, as this Court has recognized, the provision is limited to stock that does not share in the success of the business. *See Pioneer Parachute Co., Inc. v. Comm'r*, 162 F.2d 249 (2d Cir. 1947). Section 351(g)(3) applies special rules for stock that "is limited and preferred as to dividends and does not participate in corporate growth to any significant extent."[27] The Treasury Regulations contain numerous examples describing debt-like preferred stock. *See, e.g.,* Treas. Reg. §§ 1.305-5(d), Example 5, 25.2701-3(d), Example 3. These statutory and regulatory provisions presuppose that highly debt-like preferred stock is equity.

In Revenue Ruling 90-27, 1990-1 C.B. 50, the IRS describes auction rate preferred stock as "an investment alternative to commercial paper or other short-term debt," but nevertheless classifies it as equity. The preferred stock in Revenue

[27] The legislative history to section 351(g) observes that issuers of preferred stock are often required to maintain large pools of liquid assets, but confirms that this debt-like, non-participating preferred stock is equity. H.R. Rep. No. 105-148, at 471, 473-474 (1997); H.R. Rep. No. 105-220, at 543-44 (1997) (Conf. Rep.).

Ruling 90-27 is at least as "debt-like" as the Banks' interests in Castle Harbour, providing for (1) a cumulative preferred dividend; (2) an adjustable dividend rate reset periodically to ensure that the stock will always trade at its initial purchase price plus accrued dividends; (3) no participation in residual profits; (4) no participation in losses until elimination of all of the issuer's common equity; (5) no management or voting rights absent dividend arrearages; (6) a liquidation preference equal to original investment plus accrued dividends; and (7) the right to remarket the shares at initial purchase price plus accrued dividends. Additionally, holders typically have the right to put the shares to a third party for the initial purchase price plus accrued dividends. Notice 2008-55, 2008-2 C.B. 11. As a practical matter, these attributes virtually ensure that the investor will receive the return of its investment plus an interest-like return, subject only to the issuer's credit worthiness. Nevertheless, Revenue Ruling 90-27 and Notice 2008-55 recognize auction rate preferred stock as equity for tax purposes.

The Government's brief also ignores IRS pronouncements recognizing holders of nonparticipating preferred interests as partners for tax purposes, even while characterizing the interests as economically equivalent to variable rate bonds. In Revenue Procedure 2003-84, 2003-2 C.B. 1159, the IRS characterized, as partners, holders of preferred partnership interests that provided: (1) cumulative preferential distributions based on prevailing interest rates; (2) the right to a regular

adjustment in the distribution rate designed to assure the value of the interests are equal to the holder's capital investment; (3) zero participation in residual profits; (4) zero participation in losses until complete extinguishment of the common interests; (5) reduction in the practical risk of loss through bond insurance or other credit enhancement of the partnership's assets; (6) mandatory redemption as the partnership receives principal payments on the underlying bonds; (7) liquidation preference equal to unrecovered capital plus accrued but undistributed preferred return; and (8) the right to sell the interests to a third party for a price equal to the unrecovered investment plus accrued distributions. These features ensure that, except in a highly remote circumstance, the holder will receive its original investment and its full interest-like return. *See* Notice 2008-80, 2008-2 C.B. 820. In contrast, the Banks had greater participation in residual profits[28] and greater exposure to loss.

Not only does Revenue Procedure 2003-84 *permit* holders of these interests to qualify as partners—it *mandates* that result, expressly rejecting requests by

[28] In Notice 2008-80, the IRS announced that it *may* amend Rev. Proc. 2003-84 to require that the variable rate interests be allocated 5% of gains recognized from sales of bonds. Even this 5% participation would be less material, in relation to capital invested, than the Banks' 1% interest in Disposition Gains. The Banks initially owned 17% of the capital, and their 1% interest remained intact even as their share of capital declined. Notice 2008-80 contemplates a 5% gain allocation to variable-rate interests representing 99% of the initial capital. The Banks' 1% minimum interest in Disposition Gains is higher, relative to their share of capital, than a 5% share for a 99% owner.

sponsors to be excluded from partnership treatment. *See* Rev. Proc. 2003-84, § 2. Indeed, the IRS requires that virtually all unincorporated business or investment arrangements that have multiple classes of ownership be taxed as partnerships. *See* Treas. Reg. § 301.7701-4(c)(1). These authorities do not mention *Culbertson* or its intent standard, and their treatment of nonparticipating investments as partnership interests is inconsistent with this Court's prior *Culbertson* analysis. These authorities are, however, completely consistent with the objective standard of section 704(e)(1).

The Government objects to the tax consequences of equity classification in this case, but this Court consistently has rejected tax motive as a factor in debt-equity classification. In *Kraft Foods Co. v. Commissioner*, 232 F.2d 118, 128 (2d Cir. 1956), this Court acknowledged that a corporation's recapitalization of a portion of its equity into debt was *solely* tax motivated, but nevertheless upheld the transaction. In *Nassau Lens Co. v. Commissioner*, 308 F.2d 39, 44-45 (2d Cir. 1962), this Court again rejected an IRS effort to reclassify a corporate instrument, affirming the taxpayer's "freedom to choose between legal forms similar in a broad economic sense but having disparate tax consequences." *See also Ragland Inv. Co. v. Comm'r*, 52 T.C. 867 (1969), *aff'd per curiam*, 435 F.2d 118 (6th Cir. 1970) (rejecting IRS effort to recharacterize preferred stock as debt, even though taxpayer insisted on receiving preferred stock to minimize its taxes). In contrast to these

cases, the facts here demonstrate substantial non-tax business purposes for structuring the Banks' investments as equity, including the need to comply with the negative pledge and to maintain GECC's debt-equity ratio at less than 8:1.

To the extent any debt-equity issue remains, it must be resolved by comparing the Banks' interests to the numerous debt-like preferred interests that the tax law routinely recognizes as equity. The Banks' interests were much more equity-like than garden-variety nonvoting fixed-rate preferred stock. The principal difference between preferred equity and debt is the absence of creditors' rights. *See, e.g., John Wanamaker Philadelphia v. Comm'r*, 139 F.2d 644, 647 (3d Cir. 1943) (preferred stock with cumulative, fixed dividend and no participation in residual earnings or management was equity because it lacked the "most significant characteristic of a creditor-debtor relationship—the right to share with general creditors in the assets in the event of dissolution or liquidation."). Like preferred shareholders, the Banks did not have creditors' rights; Castle Harbour's failure to make Exhibit E distributions would not result in a default. A-664-65. The Banks' exclusive remedy from a failure to receive scheduled Exhibit E distributions was the equity right to cause a liquidation of the partnership, in which case they were entitled to receive their capital account balances, which could vary materially from their Exhibit E distributions and could even be negative. *See* Operating Agreement § 12.2 at A-656-57. And unlike preferred shareholders, the

Banks were at risk of having to repay some Exhibit E distributions if future results fell short of assumptions.

Accepting this Court's decision that the Banks' interests were too debt-like to qualify them as "bona fide equity participant[s]" under *Culbertson*'s subjective intent standard, those interests in Castle Harbour nonetheless were partnership equity under the objective standard of section 704(e)(1) and the numerous authorities that respect highly debt-like preferred interests as equity for tax purposes.

4. The Government's assertions that the Banks' interests were not capital interests are legally and factually erroneous.

In challenging the District Court's finding that the Banks owned capital interests, the Government asserts that (1) the Banks' risk of loss was not "meaningful," (2) their capital accounts were "meaningless," and (3) their return was not tied to the performance of Castle Harbour. *See* Gov't Br. at 59-71. The Government distorts the definition of capital interest and plays fast and loose with the facts as found by the District Court and amply supported by the record.

The claim that the Banks did not have a "realistic" risk of loss is simply irrelevant. Likelihood of loss does not distinguish preferred equity from debt. A corporation may have substantial common equity to absorb losses, but that does not convert its preferred stock into debt. A corporation's debt may be riskier than

its preferred stock.[29] The interests described in Revenue Ruling 90-27 and Revenue Procedure 2003-84 are bona fide equity, even though structured to insulate their holders from any downside risk.

The Government cites the financial assets held by CHLI (Castle Harbour's corporate subsidiary), the maintenance of casualty insurance, and the performance guaranty as evidence the Banks were "immunized" against loss. Gov't Br. at 63. CHLI's financial assets provided liquidity for the Banks' interests, PSA-8-9, but they did not compensate the Banks for losses allocated to them under the Operating Agreement. Moreover, numerous authorities respect as equity preferred stock supported by similar financial asset requirements. *See, e.g.,* Rev. Rul. 78-142, 1978-1 C.B. 111; *cf.* F.S.A. 829, 1992 FSA LEXIS 284 (May 22, 1992) (noting the issuance of "tens of billions of dollars of preferred stock" with similar terms).

Businesses routinely purchase casualty insurance. Ironically, elsewhere the IRS has successfully argued that casualty insurance supports *equity* classification—the exact opposite of the Government's litigating position in this case. *Gooding Amusement Co. v. Comm'r*, 23 T.C. 408, 420 (1954), *aff'd*, 236 F.2d 159 (6th Cir. 1956); *see also Ambassador Apartments, Inc. v. Comm'r*, 50

[29] For example, nonrecourse debt collateralized by a specific pool of consumer receivables or by a specific piece of real estate may be riskier than preferred stock supported by the issuer's remaining, unencumbered assets.

T.C. 236, 246 (1968) (IRS made similar argument; court sustained equity classification on other grounds), *aff'd per curiam*, 406 F.2d 288 (2d Cir. 1969).

The Government's assertion that GECC's performance guaranty protected the Banks against loss of their capital investment is wrong and goes beyond what it argued at trial. GECC guaranteed only that its subsidiaries would perform their obligations under the Operating Agreement.[30] Because these obligations included making certain payments (such as the payment of insurance and management fees), the guaranty refers to "payment." The Government's assertion (Gov't Br. at 65-66) that this reference assured the Banks of the repayment of their capital investment is superficial and patently wrong.[31] The performance guaranty did not reduce the Banks' economic stake in the partnership, which depended on their positive capital account balances (and Class A Guaranteed Payments, if any). *See* § 3(a) at A-1068-69 (limiting guaranty to Banks' rights under the Operating Agreement and related agreements). The District Court correctly found, as fact, that the performance guaranty did not assure the Banks of the return of their entire

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[30] *See* A-1062-93, §2 at A-1068 (guaranteeing "the due and punctual performance and payment by the GECC Subsidiaries (in their respective individual corporate capacities) and the Managers of all covenants, obligations and indemnities . . . to be performed or observed or paid by them" under the transaction documents).

[31] The Government (Gov't Br. at 37 n.16) cites as support this Court's denial of Plaintiff's Petition for Rehearing, but denials of petitions for rehearing have no precedential value and imply no judgment on the merits. *See, e.g., Marshak v. Reed*, 229 F. Supp. 2d 179, 184 (E.D.N.Y. 2002).

capital investment. 660 F. Supp. 2d at 391. The record confirms this finding: Hem Mulders, who led the negotiations on behalf of Rabo, testified that the performance guaranty did not assure the Banks that they would recover their entire investment. *See* A-445 ("It's not a payment guarantee."); A-447 ("Of course, we would have preferred the payment guarantee, but that was inconceivable under this transaction structure.").[32]

While the Government characterizes the Banks' capital accounts as "essentially meaningless" (Gov't Br. at 67-70), its own financial expert testified that the members' capital accounts reflected their ownership interests in Castle Harbour. PSA-16. The Government makes the additional unfounded claim that GECC controlled the Banks' capital accounts and implies that GECC manipulated the mark-to-market adjustments used to determine the purchase price to ensure the Banks would receive their Investment Account balances. *See* Gov't Br. at 69-70. These insinuations are unsupported by the record or common sense: because the purchase of their interests resulted from a change in tax law, the Banks were not

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[32] Even if the guaranty had been a payment guaranty, the Banks' interests would still be equity. *See Bowersock Mills & Power Co. v. Comm'r*, 172 F.2d 904 (10th Cir. 1949) (preferred stock was equity even though fixed dividends guaranteed by separate contract); *N. Refrigerator Line, Inc. v. Comm'r*, 1 T.C. 824 (1943) (preferred stock backed by payment guaranty of parent corporation was equity). This treatment is consistent with longstanding commercial law. *See Hazel Atlas Glass v. Van Dyk & Reeves, Inc.*, 8 F.2d 716 (2d Cir. 1925) (common shareholders' guarantee of preferred dividends and redemption obligation did not convert preferred stockholder into creditor of issuer).

entitled to any Class A Guaranteed Payment unless their return fell below 8.53%. A-240-41. The mark-to-market adjustments increased the Banks' return to 9.1%, almost 60 basis points more than the Banks were entitled to receive, and they were made only after the Banks challenged the third-party appraisal submitted by GECC. A-1710-13.[33]

The contention that the Banks' return was not tied to Castle Harbour's performance is both incorrect and irrelevant. The Government's economic expert testified that the Banks' return reflected Castle Harbour's operating results. PSA-17-18. As noted above, Castle Harbour's performance (including the mark-to-market adjustments to the value of its asses) increased the Banks' return by almost 60 basis points over the threshold for a Class A Guaranteed Payment.[34] Moreover, the Government's contention is irrelevant: the definition of "capital interest" does not require that the holder's return vary with the partnership's performance, and nothing in that definition supports the exclusion of partnership interests that are economically indistinguishable from preferred stock.

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[33] The section 704(b) regulations explicitly approve "mark to market" adjustments to partners' capital accounts prior to redemption of a partnership interest. Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)(*5*)(*ii*).

[34] This increase was material. Existing regulations recognize that a change in yield that exceeds the greater of 25 basis points or 5% of the pre-change yield is sufficiently significant to trigger a taxable exchange. *See* Treas. Reg. § 1.1001-3(e)(2)(ii). The difference between 8.53587% and 9.1% exceeds both thresholds.

Other factors identified by the Government are also irrelevant. The Government refers to the Banks' level of participation in management (Gov't Br. at 20, 72-73), but that factor is irrelevant to the definition of "capital interest."[35]

The Government alleges that the Banks' contributions did not benefit Castle Harbour's income-producing capacity (Gov't. Br. at 73) because Castle Harbour transferred the Banks' contributions to its wholly owned subsidiary, CHLI. The allegation is incorrect, because CHLI invested the contributions in income-producing assets (GECC commercial paper and additional leased aircraft).[36] Thus, the Government's assertion relies on an irrelevant distinction between income-producing assets held directly by a partnership and those held indirectly through wholly owned subsidiaries. The Government's reliance on *Poggetto* is similarly misplaced. *Poggetto* involved a partnership that derived its revenue from sales commissions. The court determined that section 704(e)(1) did not apply because capital was not a material income-producing factor in the business, 306 F.2d at 79;

[35] Nevertheless, the Banks exercised some management rights, including participating in annual and quarterly partnership meetings. 660 F. Supp. 2d at 389. The Banks' consent was also required for the general manager to take certain actions, such as transferring original aircraft (e.g., to CHLI) and extending existing leases. *Id.* at 379; A-617; A-645-47; A-620-24.

[36] The allegation is also inconsistent with other portions of the Government's brief, which characterize CHLI's income as generating Disposition Gains for Castle Harbour. *See* Gov't Br. at 14-15.

it provides no support for disregarding interests in partnerships, like Castle Harbour, in which capital is a material income-producing factor.

And finally, there is simply no support—legislative, judicial, or administrative—for disregarding a capital interest in a capital-intensive partnership merely because the IRS believes the partnership could have gotten by without the additional capital. The legislative history flatly refutes any such limitation on section 704(e)(1): "it does not matter . . . whether the business benefitted from the entrance of the new partner." H.R. Rep. No. 82-586, at 32 (1951).

D. Conclusion

The District Court correctly determined that the Banks were partners under section 704(e)(1). The Government's legal arguments cannot be squared with the plain meaning of the statute, and its factual assertions are unsupported by the record.

II. Castle Harbour's Allocation of Operating Income Was Valid

Standard of Review

The allocation of income under section 704(b) is a factual determination reviewable for clear error. *See Estate of Ballantyne v. Comm'r*, 341 F.3d 802, 807-09 (8th Cir. 2003) (applying clear error standard to affirm decision under section 704(b) in favor of IRS). In an effort to obtain *de novo* review of the District Court's findings under section 704(b), the Government invokes *Bausch & Lomb, Inc. v. Commissioner*, 933 F.2d 1084, 1088 (2d Cir. 1991). Gov't Br. at 75.

Bausch & Lomb actually refutes the Government's position: "Mixed questions of law and fact, entailing the application of a legal standard to a given factual pattern, are reviewed under the clearly erroneous standard." 933 F.2d at 1088 (quoting *Eli Lilly & Co. v. Comm'r*, 856 F.2d 855, 860-61 (7th Cir. 1988)) (internal citations and quotations omitted).

As explained below, not only are the District Court's determinations logical and well-supported, but they are the only possible outcome that satisfies the requirements of section 704.

A. Sections 704(b) and 704(c) Govern the Allocation of Castle Harbour's Operating Income.

Partnerships are not subject to federal income tax; instead, each partner is taxed on its share of the partnership's income, gains, deductions and losses. I.R.C. §§ 701, 702. The allocation of partnership taxable income in this case is governed by two Code provisions: section 704(b) and section 704(c).[37]

[37] The discussion that follows is consistent with these sources, which explain the interaction between section 704(b) and the section 704(c) rules in effect at the time of the transaction: John P. Steines, Jr., *Partnership Allocations of Built-in Gain or Loss*, 45 Tax L. Rev. 615 (1990); Lawrence Lokken, *Partnership Allocations*, 41 Tax. L. Rev. 547 (1986); William S. McKee, William F. Nelson & Robert L. Whitmire, *Federal Taxation of Partnerships and Partners* § 10.02[2][c][iii] (2d ed. 1990).

Section 704(b) governs the allocation of "items" of economic or "book" income. Allocations of book income under section 704(b) adjust the partners' capital accounts, thereby affecting their economic interests in the partnership.

Section 704(c) governs the allocation of tax items attributable to unrealized tax gain or loss that is "built in" to the value of contributed property at the time of contribution. These tax items have no book corollary, do not affect the partners' capital accounts, and do not affect the partners' economic interests in the partnership.

The taxable income that the Government seeks to reallocate was attributable *entirely* to built-in gain in the contributed aircraft. Section 704(c)—not section 704(b)—governs allocations of this taxable income. Inexplicably, the Government never mentions section 704(c), even though an understanding of the provision is essential to determining the appropriate allocation of Castle Harbour's taxable income.

Section 704(c) is best understood by comparing the consequences of a purchase of property by a partnership to a contribution of property. When a partnership buys property, it enters the property on its books at cost and uses this "book value" to compute its future section 704(b) gain or loss from the property. If the property is depreciable, the partnership determines its section 704(b) book income by computing depreciation based on the book value of the property.

Because the property's tax basis equals its cost, the partnership's book and tax depreciation deductions are identical.

In contrast, a contribution of property by a partner almost invariably creates book/tax differences. The property's fair market value becomes the partnership's initial book value, which is thereafter used to compute the partnership's book income, including its book depreciation.[38] For tax purposes, however, the contributing partner's tax basis in the property carries over to the partnership. I.R.C. § 723. Any difference between initial book value and tax basis represents built-in gain or loss in the contributed property, which inevitably creates disparities between the partnership's book income (which ignores the built-in gain or loss) and its taxable income (which reflects the built-in gain or loss). Section 704(b) governs the allocation of book income, but not the allocation of the gap between book and taxable income.

Minding the gap between book and taxable income is the exclusive province of section 704(c). The following example illustrates the relationship between sections 704(b) and (c).[39]

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[38] Treas. Reg. §§ 1.704-1(b)(2)(iv)(*b*) (requiring partners' capital accounts be credited with the fair market value of property contributed by them), -1(b)(2)(iv)(*g*)(*1*) (requiring maintenance of partners' capital accounts based on allocations of depreciation "as computed for book purposes").

[39] This example is derived from an example in the section 704(c) regulations issued in 1956, which apply to the Castle Harbour transaction. *See* Treas. Reg.

(continued…)

A and B form an equal partnership. A contributes depreciable property with a tax basis of $400 and a value of $1,000. B contributes cash of $1,000. Pursuant to the section 704(b) regulations (Treas. Reg. §§ 1.704-1(b)(2)(iv)(*b*)(*2*), (*d*)(*1*)), the partnership's initial books show $2,000 of assets and $2,000 of capital, but the partnership's tax basis in its assets is only $1,400, creating a book/tax disparity of $600. Because the contributed property is depreciable on a straight-line basis over 10 years, the section 704(b) regulations require the partnership to take a $100 book depreciation deduction each year in computing its book income,[40] but its tax depreciation is only $40. Assuming no other differences between book and taxable income, the initial $600 book/tax disparity will cause the partnership's taxable income to exceed its book income by $60 per year over the 10-year life of the asset. This excess taxable income is not attributable to the partnership's economic results and has no impact on any partner's economic interest in the partnership. It is attributable entirely to the built-in gain in the property at the time of its contribution by A.

(…continued)
§ 1.704-1(c)(2)(i), Example (1) (1956). The example survives, in modified form, as Example (1)(ii) of § 1.704-3(b)(2).

[40] Treas. Reg. §§ 1.704-1(b)(2)(iv)(*g*)(*1*) (requiring maintenance of partners' capital accounts based on allocations of depreciation "as computed for book purposes"), -1(b)(5), Example (14) ("An allocation of [built-in] taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts.").

Section 704(b) governs the allocation of the partnership's $100 annual book depreciation deduction. Section 704(c) provides the rules to allocate the $40 of available tax depreciation to account for the $60 difference between book and tax depreciation. The distinction between these two provisions is critical to determining the proper allocation of Castle Harbour's income. The District Court understood this distinction and applied it; the Government ignores the distinction and erroneously seeks to apply section 704(b) to taxable income governed by section 704(c).

B. The Disputed Allocation of Taxable Income to the Banks Flows Directly From the Application of Section 704(c).

When the existing partnership tax rules were first codified in 1954, Congress provided a special rule to address the allocation of tax items attributable to built-in gain or loss in contributed property. Section 704(c)(2) permitted, but did not require, partnerships to allocate built-in gain or loss items to the contributing partner.[41] But the legislative history limited the partners' ability to allocate built-in gain to the contributing partner:

[41] Under section 704(c)(1) of the 1954 Code, the general rule required that all tax items attributable to built-in gain or loss items be allocated in the same manner as the associated book items, even though the result was to shift the tax burden attributable to the built-in gain (or tax benefit, in the case of a built-in loss) to noncontributing partners.

> In any case, however, the total gain, loss, or depreciation allocated to the partners may not differ from the amount of gain or loss realized by the partnership, or the depreciation or depletion allowable to it.

S. Rep. No. 83-1622, at 381 (1954). The Regulations promulgated in 1956 incorporated this limitation. Treas. Reg. § 1.704-1(c)(2) (1956). This limitation is generally referred to as the "ceiling rule," because the taxable item reported on the partnership's tax return caps the amount the partnership can specially allocate under section 704(c). As the District Court correctly understood, the ceiling rule is at the core of this case. *See* 342 F. Supp. 2d at 121 n.45.

The Senate Committee Report for the 1954 Code includes an example illustrating the application of the ceiling rule to depreciable property. In the example, A and B form an equal partnership. A contributes property with a value of $1,000 and a tax basis of $400; B contributes $1,000 cash. The property contributed by A depreciates at an annual rate of 10%. The Committee Report states:

> Since B, who contributed $1,000 in cash, has, in effect, purchased an undivided half interest in the property for $500, and since the property depreciates at an annual rate of 10 percent, B should be entitled to a deduction of $50 per year. But since the partnership is allowed only $40 per year (10 percent of $400), no more than this amount may be allocated to B.

S. Rep. No. 83-1622, at 381 (1954). Thus, the ceiling rule prohibits the partnership from allocating to B more tax depreciation than the $40 of total tax depreciation

available to the partnership. The partnership cannot create additional tax depreciation to bridge the gap, nor can it reallocate other items of taxable income or deduction to compensate B for the shortfall. *See* Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 87.3.2 (3d ed. 2003) ("The ceiling rule, however, bars this approach.").[42]

As this example makes clear, when a contribution of built-in gain property triggers the ceiling rule, it is inevitable that the taxable income of the *non*contributing partner (B in the example) will exceed its share of the partnership's book income.[43] Congress understood that the ceiling rule could result in the overstatement (or understatement) of the taxable income of noncontributing partners, but imposed the rule in the interest of simplicity. H.R. Rep. No. 83-1337, at A223-24 (1954). In part, this decision was based on the view that, when

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[42] The IRS recognized this. *See* Notice of Proposed Rulemaking, 57 F.R. 61345 (December 24, 1992) ("[T]he ceiling rule may prevent elimination of the entire effect of the disparity between the fair market value and adjusted basis in the partnership for the contributing partner and may create a disparity for the noncontributing partners."). As discussed *infra* Part II.E, later regulations that do not apply here now permit the use of certain methods to reallocate taxable income to bridge the gap.

[43] As one commentator has explained, "the ceiling rule is a pervasive obstacle to satisfying the objectives of §704(c), often causing it to fall far short of its mark." Steines, *supra* note 37, at 647. The same commentator observed: "One can only speculate about this, but it is not extreme to think that the ceiling is hit in over half of the contributions to and purchases of interests in partnerships." *Id.*

noncontributing partners disposed of their interests, the effects of the ceiling rule would be reversed through a corresponding benefit. *Id.*[44]

The same phenomenon occurred in Castle Harbour. TIFD III-E contributed aircraft with a fair market value of $530 million and a tax basis of zero. Under the section 704(b) regulations, Castle Harbour's initial book value in the aircraft was $530 million, and this amount was used to compute book depreciation. The allocation of 98% of Operating Income to the Banks carried 98% of each item included in the computation of Operating Income (including rent, expenses, and book depreciation), resulting in allocation to them of 98% of the corresponding taxable items (rent and tax-deductible expenses). Treas. Reg. § 1.704-1(b)(1)(vii). Section 704(c) required that any available tax depreciation be allocated first to the Banks to the extent of their share of book depreciation, but there was no tax depreciation to allocate. The ceiling rule prohibited Castle Harbour from creating additional tax depreciation to allocate to the Banks or from reallocating other taxable income (such as rent) from the Banks to GECC in order to make up for the shortfall in tax depreciation. *See* Treas. Reg. § 1.704-1(c)(2) (1956) (last sentence).

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[44] In the example, after one year B's tax basis in its partnership interest will reflect the $10 of taxable income shifted to it by the ceiling rule. When B sells its interest, the additional tax basis will generate a taxable loss (or reduced taxable gain, depending on the circumstances).

The same allocation of taxable income would have resulted had the Banks been U.S. taxpayers. While a U.S. taxpayer would have paid tax on the income allocated to it by reason of the ceiling rule, under section 705, the additional taxable income would have increased its tax basis in its partnership interest. Upon a sale or liquidation of its interest, it would have recognized a taxable loss exactly offsetting the excess taxable income previously allocated to it under the ceiling rule.

The Government repeatedly complains that the Banks' shares of taxable income exceeded their shares of economic income. As the legislative history and applicable regulations demonstrate, however, that was the inevitable—and intended—consequence of the ceiling rule.[45]

C. The Allocation of Castle Harbour's Operating Income Had Substantial Economic Effect.

1. Section 704(b) governs the allocation of Operating Income.

Because of the section 704(c) ceiling rule, it is impossible to reallocate the excess of Castle Harbour's taxable income over its Operating Income to the GECC partners, as the Government's litigating position seeks. To alter the allocation of taxable income to the Banks, the Government must convince this Court to

[45] On any sale or disposition of an aircraft, section 704(c) allocated all of the excess taxable income to TIFD III-E as contributing partner.

reallocate Operating Income under section 704(b) from the Banks to the GECC partners. To the extent the Banks were allocated less than 98% of the Operating Income, the ceiling rule consequences under section 704(c) would reduce (but not eliminate) the excess taxable income allocated to them proportionately.

In general, allocations of book items contained in the partnership agreement must be respected under section 704(b) if they have "substantial economic effect." If an allocation lacks substantial economic effect, the book item is allocated according to the "partner's interest in the partnership" or "PIIP" standard. While the section 704(b) regulations are intricate, they reflect a fundamental principle. A partnership's items of book income must be allocated so that, if the partnership sold its assets for cash equal to their current book value and liquidated, each partner would receive an amount equal to the sum of its contributions to the partnership and the cumulative allocations of book income it has received, reduced by prior distributions and cumulative allocations of book loss. In other words, partners must be allocated book income equal to their economic profit (or loss) as reflected in their capital accounts. *See* Treas. Reg. §§ 1.704-1(b)(2)(ii)(*b*)(*2*), -1(b)(3)(ii); *see also* Daniel L. Simmons, *Built-in Gain and Built-in Loss Property on Formation of a Partnership: An Exploration of the Grand Elegance of Partnership Capital Accounts*, 9 Fla. Tax Rev. 599, 605 (2009) ("Properly

maintained capital accounts designate the interest of each partner in the assets of a partnership at any point in time.").

To overturn the District Court's findings under section 704(b), the Government would have to show either (i) that Castle Harbour incorrectly computed its Operating Income, or (ii) that the District Court's determinations of section 704(b) allocations are clearly erroneous. On the facts of this case, it cannot do either.

It is beyond dispute that the computation of Operating Income was correct. The Government asserts that "Operating Income did not reflect the economic performance of Castle Harbour," Gov't Br. at 91, and it refers to the District Court's characterization of Operating Income as "non-obvious," *id.* But at trial the Government accepted the computation of Operating Income, and it acknowledged that Castle Harbour "us[ed] '704(b) book accounting,' *which is required by § 704(b) of the Internal Revenue Code and the regulations thereunder.*" Defendant's Proposed Findings of Uncontroverted Fact and Conclusions of Law ¶ 46 (emphasis added). Notwithstanding the Government's complaints about "redepreciation," the regulations unambiguously required Castle Harbour to deduct book depreciation in computing section 704(b) income. And despite repeatedly implying that the book depreciation deductions were excessive (Gov't Br. at 13,

83, 91), the Government has never challenged their computation.[46] Little wonder that the District Court *never* questioned the fact that Castle Harbour had correctly computed its section 704(b) income.

Similarly, the Government cannot show that the District Court committed clear error in determining the allocation of Castle Harbour's reported Operating Income under the standards of section 704(b). As explained below, the District Court's decision is the only possible result that comports with section 704(b).

2. The allocation of Operating Income had economic effect.

To have substantial economic effect, an allocation (1) must have "economic effect" and (2) that economic effect must be "substantial." Treas. Reg. § 1.704-1(b)(2). The regulations precisely define both terms, adopting a three-part capital account analysis to determine whether an allocation has economic effect: (i) the partnership must properly maintain capital accounts, (ii) liquidating distributions must be made in accordance with capital accounts, and (iii) each partner must be

[46] The regulations permitted Castle Harbour to use "any reasonable method" to compute book depreciation. Treas. Reg. § 1.704-1(b)(2)(iv)(*g*)(*3*) (last sentence). Castle Harbour computed book depreciation on a straight-line basis over the greater of seven years or 125% of the remaining lease term. 660 F. Supp. 2d at 375. It used the same method for its Stage II aircraft, most of which were more than 15 years old, that would have applied to newly purchased aircraft. *See* I.R.C. §§ 168(c), (e)(1) (seven-year recovery period for property with class life of 10-15 years), (g)(3)(A) (minimum period for leased tax-exempt use property equal to 125% of lease term); Rev. Proc. 87-56, 1987-2 C.B. 674 (prescribing class life of 12 years for commercial aircraft).

required to restore any deficit in its capital account upon liquidation of its interest in the partnership (commonly referred to as a deficit restoration obligation or "DRO"). Treas. Reg. § 1.704-1(b)(2)(ii).[47]

The capital account maintenance rules require that partners' capital accounts be adjusted by their shares of items of book income or loss, including book depreciation. Treas. Reg. §§ 1.704-1(b)(2)(iv)(*d*)(*3*), (*f*)(*3*). Differences between book and tax depreciation are ignored in computing capital accounts, because "only allocations of book depreciation have economic effect. The difference between tax and book depreciation is a tax item that has no economic significance apart from taxes." Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 87.3.2 (3d ed. 2003); *see also* Treas. Reg. § 1.704-1(b)(5), Example (14). Because section 704(b) income is determined by reference to the book value of contributed property, the ceiling rule—which applies to the book/tax disparity—does not affect the allocation of section 704(b) income and section 704(b) income cannot be reallocated to offset the effects of the ceiling rule.[48]

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[47] A significant factor in the complexity of the Operating Agreement is the need to comply with the section 704(b) regulations. Most of section 3 of the Operating Agreement falls within this category.

[48] The section 704(b) regulations contain two examples illustrating the principle that the ceiling rule does not affect the allocation of section 704(b) book income. *See* Treas. Reg. § 1.704-1(b)(5), Example (14)(iii), Example (18)(iv).
(continued…)

The Operating Agreement satisfied all three requirements of the economic-effect test, and the allocations to the partners yielded capital account balances that determined the amounts they would have received had Castle Harbour sold its assets for their book value and liquidated. Thus, the District Court correctly found that Castle Harbour's allocations had economic effect. 342 F. Supp. 2d at 120-21.

The Government now questions that finding. It concedes that, when before the District Court, it never questioned whether the allocations had economic effect, attributing its failure to having "focused its attention below on the 'substantiality' factor." Gov't Br. at 77 n.22. That explanation is disingenuous. The Government conceded that the allocations of book income "result[ed] in actual cash payments." Gov't Tr. Br. at 9. And its latest brief acknowledges that the Banks actually received the $28 million of Operating Income allocated to them. Gov't Br. at 88, 90. These statements confirm that the allocations had economic effect, and they explain the Government's failure to "make a separate argument" below.

In raising the issue on appeal, the Government suggests that the allocations did not satisfy the third prong of the economic effect test (the deficit restoration

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(…continued)
In both examples, the noncontributing partner bears an economic loss but is denied the tax benefit of a taxable loss that matches that economic loss. The failure to receive the corresponding taxable loss "is attributable entirely to the 'ceiling rule.'" *Id.* These examples are completely consistent with Example (1) of Treas. Reg. § 1.704-1(c)(2)(i) (1956).

obligation or DRO requirement) because there was not a "realistic possibility" the Banks would have deficit capital accounts at liquidation. *Id*. at 77 n.22. But the section 704(b) regulations neither explicitly nor implicitly condition the economic-effect test on whether a capital account deficit is likely to occur. The economic effect test requires that a partner bear the economic burden of its share of book losses, first out of its positive capital and then, to the extent of any capital account deficit, out of its own pocket. The DRO comes into play only if and when loss allocations exceed the capital of one or more partners. Even if an agreement does not contain a DRO, the allocations are deemed to have economic effect for any year if all partners have positive capital accounts that reflect the amounts they would receive on liquidation. Treas. Reg. §§ 1.704-1(b)(2)(ii), -1(b)(5), Example (4). That was the case throughout the term of the Banks' investment. Once again, the Government's litigating position ignores the facts and the clear dictates of the regulations.

3. The economic effect of the Operating Income allocation was "substantial."

An allocation that has "economic effect" may be disregarded if the economic effect of the allocation is not "substantial." Treas. Reg. § 1.704-1(b)(2)(iii). Substantiality is an *objective* standard—it does not permit the IRS to disregard an allocation merely because it dislikes the tax result. The economic effect of an allocation is substantial "if there is a reasonable *possibility* that the allocation . . .

will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences." *Id.* (emphasis added).

Conversely, the economic effect of an allocation is not substantial if it reduces the partners' aggregate tax liabilities without materially altering their expected pre-tax economic results. The section 704(b) regulations contain three specific rules that govern such cases. Two of these rules are irrelevant here: allocations with "shifting tax consequences" (Treas. Reg. § 1.704-1(b)(2)(iii)(*b*)) and "transitory allocations" (Treas. Reg. § 1.704-1(b)(2)(iii)(*c*)). The Government bases its challenge to the allocation of Operating Income on the third rule, the "overall-tax-effect test":

> [T]he economic effect of an allocation (or allocations) 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.

Treas. Reg. § 1.704-1(b)(2)(iii)(*a*) (1993).

The overall-tax-effect test requires a comparison between the likely after-tax consequences of the tested allocation and the likely after-tax consequences of a baseline allocation, specifically, how the item would have been shared if the tested allocation "were not contained in the partnership agreement." Section 704(b)

provides that if the partnership agreement does not allocate an item, it must be allocated according to the "partner's interest in the partnership," or PIIP.[49] Thus, the overall-tax-effect baseline is a projection, based on the PIIP factors.

As the District Court observed, the baseline must be consistent with the partners' underlying economic agreement. 342 F. Supp. 2d at 120-21. The two regulatory examples that illustrate the application of the overall-tax-effect test make this clear. Each example infers a baseline that reflects how, in light of their economic deal, the partners would likely have agreed to share items of book income in a world without tax. The projected after-tax results of the allocations contained in the agreement are then compared to the projected after-tax results of the baseline. Treas. Reg. § 1.704-1(b)(5), Examples (5), (9). In each example, the disputed allocations take advantage of differences in the character or timing of the allocated book income to enable at least one partner to improve its after-tax results, while providing a "substantial likelihood" that no other partner will incur an after-tax detriment.

Example (5) involves a two-member partnership. One partner, I, is in a high tax bracket and J is in a low tax bracket. They contribute equal amounts and generally share profits and losses equally. At formation, a "strong likelihood"

[49] Subsequent to the trial in this case, the regulations were amended to revise the determination of PIIP for purposes of this baseline, but those amendments do not apply to this case. *See* T.D. 9398, 2008 I.R.B. 1143.

exists that the partnership will receive between $450 and $550 annually in taxable investment income and a comparable amount in tax-exempt investment income. I and J allocate 80% of the tax-exempt income to I, while J receives 20% of the tax-exempt income and 100% of the taxable income.

Example (5) applies the overall-tax-effect test by comparing the expected effect of these allocations to a baseline. The facts suggest that, absent tax considerations, I and J would likely be indifferent as to the source of the income and would likely share the taxable and tax-exempt income equally. Thus, the example infers a 50/50 baseline. When compared to this baseline, the special allocations are expected to enhance I's after-tax position, and there is a substantial likelihood that J's after-tax return will not be substantially diminished. Therefore, the economic effect of the special allocations is not substantial and the items are reallocated according to PIIP.[50]

The regulations require that the overall-tax-effect test be applied by presuming that the value of partnership property will always equal its book value

[50] The only other example illustrating the overall-tax-effect test is Example (9) of Treas. Reg. § 1.704-1(b)(5), which applies the test to strike down disproportionate allocations of income to a partner with a net operating loss (NOL). Distributions of the income allocated to the partner are delayed for many years. The overall allocation scheme is expected to produce time-value adjusted results that comport with the partners' relative contributions. The quid pro quo for the disproportionately high allocation of income to the NOL partner is the delay in the distribution, which substantially reduces the present value of the tested allocation. There is no present value issue in this case.

(the "value-equals-basis rule").[51] Under this presumption, the overall-tax-effect test baseline is determined by disregarding the possibility that the partnership will realize future book gains or losses from asset dispositions.

Because of the value-equals-basis rule, there is only one possible baseline: the 98/2 allocation contained in the Operating Agreement. To be consistent with the economic deal, any baseline that reduced the Banks' share of Operating Income would have to increase their share of some other category of book income. But the only other category of book income was Disposition Gains, and the value-equals-basis rule establishes a conclusive presumption that the fair market value of the aircraft would always equal their book value (as adjusted by book depreciation). Thus, even if future aircraft sales were expected, as a practical matter, to generate substantial Disposition Gains, the value-equals-basis rule requires that the possibility of future Disposition Gains be ignored in applying the overall-tax-effect test.[52] Accordingly, the only baseline that is consistent with the parties' economic

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[51] As relevant here, the value-equals-basis rule presumes that the fair market value of the aircraft will always equal their book value and that any adjustments to the book value of the aircraft (i.e., book depreciation) will be matched by corresponding changes to their fair market value. Treas. Reg. § 1.704-1(b)(2)(iii)(*c*).

[52] Treas. Reg. § 1.704-1(b)(5), Example (1)(xi); Bittker & Lokken, *supra* p. 57, ¶ 87.2.6 ("The presumption applies even if presumed facts contrast starkly with actual facts.").

deal is an allocation of 98% of the Operating Income to the Banks, and that allocation satisfies the overall-tax-effect test.

Even if the value-equals-basis rule did not exist, the allocation of Castle Harbour's book income would not violate the overall-tax-effect test. Under clause (2) of the test, the allocations would not fail the test unless a "strong likelihood" existed that the Banks' economic return would not be substantially diminished compared to their return under the baseline. For example, a hypothetical baseline that gave the Banks a share of Operating Income and Disposition Gains proportionate to their capital contributions would provide them with less Operating Income but more Disposition Gains than the Operating Agreement. Disposition Gains were unpredictable and varied with the spot market for off-lease aircraft. Given that uncertainty and the lack of any predictable correlation between Disposition Gains and Operating Income, it would be impossible to conclude that there was a "strong likelihood" that the allocations in the Operating Agreement would not leave the Banks worse off when compared to that baseline. Therefore, the allocations would not violate the overall-tax-effect test, even in the absence of the value-equals-basis rule.[53]

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[53] Other examples show that allocations do not violate the overall-tax-effect rule unless there is a strong likelihood that a tax-sensitive allocation will be offset by another allocation. *See* Treas. Reg. §1.704-1(b)(5), Examples (3), (19). In Example (3), all of the deductions for research and experimental expenses are (continued…)

D. The Partner's Interest in the Partnership standard requires that the Banks be allocated 98% of the Operating Income.

If the allocation of Castle Harbour's Operating Income lacked substantial economic effect, it must be reallocated according to the partner's interest in the partnership ("PIIP"). I.R.C. § 704(b). Applying the PIIP standard, the District Court found as fact that the Banks had a 98% interest in the Operating Income. 342 F. Supp. 2d at 119-21. Not only was this finding correct—under the section 704(b) regulations it is the *only* possible result.

Example (5) of Treasury Regulation § 1.704-1(b)(5) demonstrates why. In Year 1, the partnership receives $450 of tax-exempt income and $550 of taxable income. The agreement allocates $360 (80% of the tax-exempt income) to I and $640 (20% of the tax-exempt and 100% of the taxable income) to J. These allocations lack substantiality, but they have economic effect, because they are credited to the partners' capital accounts and thus affect, dollar-for-dollar, the amounts I and J would receive if the partnership liquidated at the end of Year 1. Although Example (5) uses a 50/50 baseline to apply the overall-tax-effect test,

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(…continued)
allocated to one partner, who also receives a disproportionate allocation of partnership income to offset the deduction allocation. Because of the nature of the partnership's activities, there is not a strong likelihood that the disproportionate allocation of income will offset the allocation of research and experimental expenditures. Accordingly, the example concludes that the economic effect of the deduction allocations is substantial, without even applying the overall-tax-effect test.

when it applies PIIP to the actual results in Year 1 it does not reallocate the items 50/50. Instead, it respects the actual credits to the partners' capital accounts (36% to I, 64% to J); however, it changes the composition of the book items allocated to each partner to include a proportionate share of the taxable and tax-exempt income. Thus, I's $360 share of book income is adjusted to include 36% of both taxable and tax-exempt income, and J's $640 allocation is adjusted to include 64% of each category. In other words, regardless of the projected sharing implied by the overall-tax-effect test baseline, the reallocation of actual book income must reflect how the partners actually share that income, as reflected in their capital accounts.

Example (5) is not unique. Other examples in the section 704(b) regulations also demonstrate that the reallocation of an item under PIIP must be made in a manner that, had it been contained in the original agreement, would have had economic effect. *See* Treas. Reg. §§ 1.704-1(b)(5) Examples (1)(iv), (6) (last two sentences), (7)(i) (last two sentences), (7)(ii) (last two sentences). Where, as in this case, the tested allocation has economic effect, any reallocation under PIIP cannot alter the partners' capital account balances.

The Tax Court applies PIIP consistently with this approach. *See Vecchio v. Comm'r*, 103 T.C. 170, 194-95 (1994) (allocating entire gain to one partner to eliminate that partner's negative capital account and satisfy that partner's liquidation preference); *Estate of Tobias v. Comm'r*, 81 T.C.M. (CCH) 1163, 1170

(2001) (allocating 100% of the partnership's income for the year to the partner who received "economic benefit" of the income); *Interhotel Co. v. Comm'r*, 81 T.C.M. (CCH) 1804 (2001) (PIIP requires analysis of actual economic impact of allocations).

Here, the Government's proposed reallocation creates a $22 million discrepancy between the cash income the Banks received and the book income allocated to them. Its own expert witness readily confirmed that the Government's allocation would not match the parties' economic deal. PSA-19-20 ("Less income is allocated to the Dutch banks than cash they received, if that's your point.")

By contrast, Castle Harbour's allocation of Operating Income clearly satisfied the PIIP standard. For example, in 1994 the Banks' opening capital accounts totaled $112,032,000 and they received distributions during the year of $39,128,000. These distributions would otherwise reduce their capital accounts to $72,904,000, but the Banks' closing capital accounts totaled $85,432,000. Therefore, PIIP requires that they be allocated $12,528,000 of book income in 1994. It is undisputed that the Banks were validly allocated $2,868,000 of Disposition Gains, and that "[t]he gains were reported appropriately." PSA-1-2 (Government Opening Statement). The only allocation of Operating Income that complies with PIIP is the allocation the Banks received: $9,660,000.

The Government also accuses the District Court of failing to evaluate the four factors identified in the regulations as relevant to the PIIP determination. The accusation is yet another instance of the Government blithely ignoring its own regulations. The four factors identified in the PIIP regulations—contributions, income allocations, nonliquidating distributions, and liquidating distributions—correspond to the adjustments that the economic effect test requires be made to maintain partners' capital accounts. *Compare* Treas. Reg. § 1.704-1(b)(3)(ii)(*a*) - (*d*) (PIIP factors), *with* Treas. Reg. § 1.704-1(b)(2)(iv)(*b*)(*1*) - (*7*) (capital account adjustments). The PIIP factors apply to determine, in hindsight, how the partners actually shared the economic benefit or burden of the particular item or items at issue. Therefore, any reallocation under PIIP must reflect the partners' economic entitlements.

Because it disconnects PIIP from economic reality, the Government's litigating position fails this standard. The Government posits no PIIP allocation that corresponds to the manner in which the partners actually shared Operating Income. In part, this failure results from the fact that the Government purports to determine a single PIIP percentage that applies to all partnership items; thus, under the Government's litigating position, it would be impossible for a partner to have a 50% interest in some items and a 90% interest in others. But the regulations make clear that PIIP is an item-by-item determination that "may or may not correspond

to the overall economic arrangement of the partners," and that "a partner who has a 50 percent overall interest in the partnership may have a 90 percent interest in a particular item of income or deduction." Treas. Reg. § 1.704-1(b)(3)(i).

At bottom, the Government bungles the PIIP standard because it ignores the fundamental distinction between book income, which is subject to the PIIP standard, and taxable income items attributable to built-in gain in contributed property, which are governed by the very different rule of section 704(c). This basic error is fatal to the Government's PIIP analysis.

E. The Existing Section 704(c) Regulations Refute the Government's Position.

In 1984, Congress amended section 704(c). A related committee report suggested that "it *may* be appropriate" for the Treasury to revise the regulations to modify the ceiling rule, but made clear that any regulatory changes should be prospective. S. Rep. No. 98-169, vol. 1, at 215 n.2 (1984) (emphasis added). More than nine years later, on December 21, 1993, the Treasury amended the section 704(c) regulations, making the changes prospective. It is undisputed that these amended regulations do not apply to Castle Harbour.

The 1993 amendments retain the ceiling rule, but permit taxpayers and the IRS to mitigate its effects in certain cases. Had the amended regulations applied to Castle Harbour, they would have permitted the IRS to mandate "curative" allocations of other items of taxable income to the GECC partners, thereby

reducing the Banks' taxable income by an amount equal to the shortfall in tax depreciation. *See* Treas. Reg. § 1.704-3(c)(1). The Government's proposed reallocation here would achieve the same effect as curative allocations created under the 1993 amendments—even though the regulations in effect at the time of the transaction, which govern this case, flatly prohibit any such reallocation.

Notably, the 1993 amendments changed the section 704(c) regulations, but did *not* change the section 704(b) regulations. The section 704(b) regulations continue to require that partnerships use the book value of contributed property in applying section 704(b). *See* Treas. Reg. § 1.704-3(a)(3)(i). Thus, even today, the section 704(b) regulations prohibit the IRS from doing what the Government seeks here, which is to impose noneconomic reallocations of section 704(b) income in order to mitigate the effects of the section 704(c) ceiling rule.

F. Conclusion

The Government's real, but unarticulated, complaint is that a straightforward application of the ceiling rule shifted taxable income from the GECC partners to the Banks. Because of the ceiling rule, there was no legal means by which either Castle Harbour or the IRS could have achieved the reallocation that the Government now seeks. The IRS remedied this problem seventeen years ago by amending the section 704(c) regulations, but those amendments do not apply to Castle Harbour. In an effort to circumvent the effective date of the 1993

regulations, the Government has concocted an untenable interpretation of section 704(b) that would disrupt the carefully crafted rules governing partnership allocations.

III. THE GOVERNMENT'S PENALTY CLAIMS ARE UNWARRANTED AND UNSUPPORTABLE

Standard of Review

The District Court's determination that penalties do not apply for 1997 and 1998 is reviewable for clear error. *Goldman v. Comm'r*, 39 F.3d 402, 406 (2d Cir. 1994).

A. Overview

Even though the District Court held for GECC after a full trial on the merits, on remand the Government insisted that the District Court consider the application of the substantial understatement and negligence penalties. The Government essentially argued that this Court's prior reversal of the District Court's first decision entitled it to penalties. In essence, the Government argued for strict liability, an approach that the relevant statutory, regulatory and judicial authority reject. After carefully considering the facts and the parties' arguments, the District Court held that even if the Banks are later held not to have been partners, "penalties against the taxpayer are unwarranted." 660 F. Supp. 2d at 97.

The Government has dressed up its penalty position before this Court, but essentially makes the same strict liability demand that it presented, albeit more

candidly, in the District Court. The Government's penalty arguments rely on legal and factual assertions that are inconsistent with the record, the findings of the District Court, and relevant legal authority, including the Government's own regulations.

1. The TEFRA context

The TEFRA provisions of the Code provide for partnership-level determinations of the proper treatment of "partnership items," which are limited to items "required to be taken into account for the partnership's taxable year under any provision of subtitle A." I.R.C. § 6231(a)(3). Penalties are governed by subtitle F and thus are not partnership items;[54] instead, penalties are "affected items" the tax treatment of which is determined at the partner level. I.R.C. §§ 6230(a)(2)(A)(i), 6231(a)(6).

In 1997, Congress amended the TEFRA provisions to provide for partnership-level determination of certain penalty-related issues. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1238(a), (b)(1), 111 Stat. 788, 1026 (1997) (codified at I.R.C. §§ 6221, 6226(f)). Even after 1997, however, the Regulations require adjudication of partner-level defenses in separate, partner-level proceedings and prohibit adjudication of those defenses in the partnership-level

[54] Subtitle A covers income taxes and includes sections 1 through 1563. The penalty provisions are found in subtitle F (procedure and administration).

proceeding. Therefore, the only penalty-related issues before this Court are those determinations relating to 1997 and 1998 that do not involve partner-specific defenses. There are three such issues:

> (1) whether "substantial authority" existed for the treatment of the Banks as partners and allocation of taxable income to them;
>
> (2) whether the Partnership was a "tax shelter" for purposes of the substantial understatement penalty; and
>
> (3) whether a "reasonable basis" existed for classifying the Banks as partners.

Issues (1) and (2) relate to the substantial understatement penalty, while issue (3) relates to the negligence penalty.

2. Overview of substantial understatement penalty

Section 6662 imposes a 20% penalty on the amount of any "substantial understatement" of tax. I.R.C. § 6662(a), (b)(2). For 1997 and 1998, the threshold understatement for imposition of the penalty against a corporation was the greater of $10,000 or 10% of the tax that should have been shown on its return. I.R.C. § 6662(d)(1)(A), (B) (1998).[55]

An understatement is reduced by the portion attributable to any item for which "substantial authority" existed. I.R.C. § 6662(d)(2)(B) (1998). Thus, if there was substantial authority for the taxpayer's treatment of the item on its tax

[55] Whether an understatement exceeds this threshold is a partner-level determination and thus is beyond the scope of this TEFRA proceeding.

return, the amount of the item is excluded from the numerator of the fraction used to determine whether the taxpayer's understatement exceeds 10% of the amount it should have reported.

Substantial authority is an objective standard that "involv[es] an analysis of the law and application of the law to the relevant facts." Treas. Reg. § 1.6662-4(d)(2). Substantial authority exists for the tax treatment of an item if "the weight of authorities supporting the treatment is substantial in relation to the weight of the authorities supporting contrary treatment." Treas. Reg. § 1.6662-4(d)(3); *see Estate of Kluener v. Comm'r*, 154 F.3d 630, 639 n.2 (6th Cir. 1998) (comparing substantial authority standard to the "substantial evidence" standard used to determine whether the evidence could satisfy a reasonable factfinder). The regulations recognize that "[t]here may be substantial authority for more than one position with respect to the same item," Treas. Reg. § 1.6662-4(d)(3)(i), and that substantial authority may exist even if the position is supported by nothing more than "a well-reasoned construction of the applicable statutory provision," Treas. Reg. § 1.6662-4(d)(3)(ii). Substantial authority is analyzed as of the date on which the return containing the item is filed or the last day of the taxable year to which the return relates. Treas. Reg. § 1.6662-4(d)(3)(iv)(C).

As applicable in this case, section 6662 provides that, if an understatement is attributable to a "tax shelter," the taxpayer must also show that it "reasonably

believed" that its tax return treatment was "more likely than not" correct. I.R.C. § 6662(d)(2)(C)(i)(II) (1993).

B. The Substantial Understatement and Negligence Penalties Do Not Apply.

1. Castle Harbour's tax return positions were supported by substantial authority.

This Court has previously characterized as "mind boggling" a Government effort to impose penalties after having lost at trial. *Holmes v. United States*, 85 F.3d 956, 963 n.7 (2d Cir. 1996). Similarly, despite having its arguments on the merits here rejected twice by the District Court, the Government continues to insist that the tax return treatment of the Castle Harbour transaction was not supported by substantial authority. The Government's obsessive pursuit of penalties is inconsistent with the purpose of the penalty provisions. Congress did not enact a strict liability standard for penalties, and it intended that courts would carefully review the IRS's assertions to prevent inappropriate and overreaching applications of penalties. H.R. Rep. No. 101-247, at 1393 (1989); 135 Cong. Rec. 25,654-55 (1989) (statement of Sen. Pryor).

Since the Government did not appeal the District Court's holdings that the transaction had economic substance and that the Banks were not lenders,[56] the only

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[56] The Government's criticism of the District Court for observing that its initial economic substance finding remains intact, Gov't Br. at 99, is misplaced. The (continued…)

disputed issues remaining in the case that could give rise to a tax deficiency are whether the Banks were partners and whether Castle Harbour's income was correctly allocated. As evidenced by the District Court's analysis of the relevant authorities under both *Culbertson* and section 704(e)(1), when Castle Harbour filed its 1997 and 1998 tax returns, substantial authority existed for treating the Banks as partners. Likewise, the District Court's analysis of section 704(b) and the analysis set forth above demonstrate that substantial authority existed for the allocation of Castle Harbour's income under sections 704(b) and (c). Indeed, if there is any interpretation of sections 704(b) and (c) for which no authority exists, it is the Government's litigating position in this case.

According to the Government, Castle Harbour was not entitled to rely on the plain language of the statute and regulations and established case law because the transaction was designed to "shelter income from tax." Gov't Br. at 100. It is well established, however, that taxpayers are entitled to adopt business structures (including partnerships) that minimize taxes. *See, e.g., Frank Lyon Co. v. United States*, 435 U.S. 561, 580 (1978) ("The fact that favorable tax consequences were taken into account . . . on entering into [a] transaction is no reason for disallowing

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(…continued)
Government did not even appeal that finding, *see* Brief for Appellant at 32 n.14, *TIFD-E INC. v. United States*, 459 F.2d 220 (2d Cir. 2006) (No. 05-0064), nor did the Government appeal the finding that the Banks were not lenders, *id.* at 53.

those consequences" where the transaction has a legitimate business purpose); *Chisholm v. Comm'r*, 79 F.2d 14 (2d Cir. 1935) (respecting partnership formed to enable taxpayers to avoid tax on pending sale of highly appreciated stock).

2. For purposes of section 6662, Castle Harbour was not a "tax shelter."

For purposes of section 6662, the "tax shelter" determination depends on a factual finding that "the principal purpose" of the transaction was the avoidance of tax. At trial, GECC introduced testimony from five current and former executives involved in initiating, reviewing, and approving the transaction. The senior GECC executive who approved the Castle Harbour transaction testified that he did so because it was "a business deal that dealt with business issues." A-280-81. After thoroughly examining the transaction documents and other objective aspects of the transaction, the District Court found, as a fact, that "the objective economic reality of the Castle Harbour transaction supports a conclusion that the partnership was not principally tax-motivated" and held that Castle Harbour "was not a tax shelter." 660 F. Supp. 2d at 400. These determinations are amply supported by the record.[57]

In disputing these findings, the Government once again makes misleading and irrelevant allegations, claiming that the Banks "were assured a set pay-out,"

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[57] Having found that Castle Harbour was not a tax shelter, the District Court did not address whether the reasonable-belief defense applied. 660 F. Supp. 2d at 400.

that "no debt was retired," and that "the entire venture was terminated" once it became possible that the Banks might be subjected to U.S. tax. Gov't Br. at 97-98. The allegation that the Banks were "assured a set pay-out" is irrelevant and, in any event, is refuted by the District Court's findings. Moreover, as the District Court determined, because Castle Harbour and GECC were consolidated for GAAP purposes, CHLI's acquisition of GECC commercial paper effectively retired the acquired debt and reduced GECC's debt-equity ratio, thereby creating capacity for additional debt. 660 F. Supp. 2d at 378-79, 388, 400.

That GECC agreed to indemnify the Banks for certain U.S. taxes and acquired the Banks' interests in response to an unexpected change in the tax law is irrelevant to whether the transaction was primarily tax motivated. As this Court has previously held, the "desire to achieve a favorable tax result . . . is in no way incompatible with the existence of a 'legitimate non-tax business reason'" for choosing a particular business structure. *United States v. Adlman*, 134 F.3d 1194, 1204 (2d Cir. 1998) (citations omitted). Businesses routinely base commercial and investment decisions on their understanding of the applicable tax rules, and it is commonplace for commercial transactions to include tax indemnification agreements allocating the risk of changes in the tax laws. *See, e.g., In re Delta*

Airlines, Inc., 608 F.3d 139 (2d Cir. 2010); *Allegheny Energy, Inc. v. Va. Elec. & Power Co.*, 70 F. Supp. 2d 607 (D. Md. 1999).[58]

The District Court's finding that Castle Harbour was not principally tax-motivated is amply supported by the record. The Government's contrary arguments are incorrect and irrelevant.

3. There is no basis for imposition of a negligence penalty.

Negligence includes "any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return." Treas. Reg. § 1.6662-3(b)(1). The regulations explicitly provide that a "return position that has a reasonable basis . . . is not attributable to negligence." *Id.* The "reasonable basis" standard generally is less demanding than the "substantial authority" standard. *See* Treas. Reg. §§ 1.6662-3(b)(3), -4(d)(2). Thus, because the tax return treatment of the

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[58] The Government mistakenly asserts that the Operating Agreement prohibited transfers of the Banks' interests to U.S. residents in order "[t]o prevent Castle Harbour's lease income from being taxed in the United States." Gov't Br. at 22 (citing A-647-49). The Operating Agreement only prohibited transfers occurring within one year of the closing to U.S. persons as defined for purposes of Regulation S under the Securities Act of 1933. A-647. This ensured compliance with U.S. securities laws; had taxes been the motivation, the restriction would have been permanent. GECC took no responsibility for U.S. taxes owed by U.S. persons, and thus had no tax reason to prevent U.S. persons from purchasing interests in Castle Harbour.

Castle Harbour transaction was supported by substantial authority, it was not negligent.

The Government's claims of negligence are curious when contrasted with its opening brief, which

(1) mistakenly represents that no court has ever applied section 704(e)(1) to an arrangement that did not satisfy *Culbertson*, Gov't Br. at 55;

(2) imposes a "preexisting partnership" limitation on section 704(e)(1) that is irreconcilable with the text and history of the statute, Gov't Br. at 52-54;

(3) ignores section 704(c) and the ceiling rule, even though they determine the tax consequences at issue here;

(4) states that Castle Harbour "elected" to be classified as a partnership, citing a regulation promulgated more than three years after Castle Harbour was formed, Gov't Br. at 7; and

(5) seeks to reallocate Castle Harbour's book income in a manner that creates an enormous discrepancy between the income received by the Banks and the income allocated to them, in clear violation of the section 704(b) regulations, Gov't Br. at 87-89.

Had a U.S. taxpayer in the Banks' position tried to reduce its taxable income by filing tax returns based on the Government's litigating positions in this case, the

IRS would have, at a minimum, imposed negligence penalties for failing "to make a reasonable attempt to comply" with the tax laws. I.R.C. § 6662(c).

Numerous cases refute the Government's categorical assertion that taxpayers are not permitted to "shelter income from tax." Gov't Br. at 100-01. For example, *Chisholm* and *Kraft Foods* upheld transactions undertaken for the *sole* purpose of sheltering otherwise taxable income. In contrast to those cases, the Castle Harbour transaction was implemented to achieve significant non-tax business purposes and in fact enabled GECC to achieve its stated non-tax business objectives. A-280-82.

The claim that GECC's witnesses "either lacked familiarity with the details of the transaction or disclaimed any specific knowledge or tax expertise" is unjustifiably misleading and unsupported by the record. Gov't Br. at 101. GECC introduced highly detailed, credible testimony from the business executive who negotiated the transaction and from four other current and former executives, including the senior executive responsible for final approval of the transaction. All five were experts in the business, and all five testified that the transaction met the business's non-tax objectives. While the executives are not tax experts, they testified that, as with other business transactions, they reviewed the potential tax consequences of the Castle Harbour with the appropriate personnel. Their testimony refutes any suggestion of negligence. A-283; A-259-60.

C. The Government's reasonable cause argument is irrelevant in this TEFRA proceeding.

Section 6664(c) provides that no penalty shall be imposed on an understatement of tax if there was "reasonable cause" for the understatement and the taxpayer acted in good faith. I.R.C. § 6664(c)(1) (1997). Thus, reasonable cause is a defense against penalties in cases where the taxpayer does not satisfy the objective "substantial authority" or "reasonable basis" standards. The applicable TEFRA regulations explicitly state that reasonable cause is a partner-level defense that "*may not be asserted* in the partnership-level proceeding." Temp. Treas. Reg. § 301.6221-1T(d) (2000) (emphasis added); *see* Treas. Reg. § 301.6221-1(f). The Treasury Department promulgated this temporary regulation more than two years before the filing of the complaints in this case; the final regulation retains this prohibition. *See* T.D. 8965, 2001-2 C.B. 344.

Notwithstanding the regulatory prohibition, the Government criticizes GECC for not putting on a reasonable cause defense at trial: "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." Gov't Br. at 103. This criticism is misleading and hypocritical.

In other cases, the Government has not hesitated to invoke the regulations to oppose the introduction of reasonable-cause evidence in TEFRA partnership

proceedings. Long after completion of the trial in this case, the Government was filing briefs in other courts to prevent taxpayers from introducing reasonable-cause evidence in TEFRA partnership cases. *See, e.g.,* United States' First Motion in Limine at 5, *Klamath Strategic Inv. Fund, LLC v. United States*, 472 F. Supp. 2d 885 (E.D. Tex. 2007) (No. 5:04-cv-278). Yet here, the Government has the audacity to criticize GECC for not trying to introduce such evidence.

Once again, the Government has ignored the explicit requirements of the applicable regulations because they happen to be inconvenient to its litigating posture in this particular case.[59] It does not have that right. *See*, *e.g.*, *Singh v. United States Dep't of Justice*, 461 F.3d 290, 296 (2d Cir. 2006).

D. Conclusion

The District Court correctly found that penalties would not apply to any understatements of tax in 1997 or 1998 resulting from the Castle Harbour partnership.

CONCLUSION

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

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[59] Since the Government's regulations prohibit partners from introducing reasonable-cause evidence in a TEFRA proceeding, the Government's criticism of GECC for asserting attorney-client privilege over a legal opinion addressed to it (and not to the partnership) is unfounded and misleading. After reviewing the opinion *in camera*, the District Court sustained GECC's privilege claims. *TIFD III-E INC. v. United States*, 223 F.R.D. 47 (D. Conn. 2004).

Respectfully submitted,

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Dated: September 14, 2010

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

CAPTION:

____________________________ v.

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