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

REPLY BRIEF FOR THE APPELLANT

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REPLY BRIEF FOR THE APPELLANT

This reply brief is directed to those portions of the appellee's brief that we believe warrant a response. With respect to points not addressed, we rely on our opening brief.

In our opening brief, we argued that the District Court erred in ruling that ING Bank, N.V. and Rabo Merchant Bank, N.V. (the "Dutch Banks" or "Banks") qualified as partners of Castle Harbour LLC under I.R.C. § 704(e)(1) (26 U.S.C.), notwithstanding this Court's previous

ruling that the Banks lacked a bona fide equity interest in Castle Harbour under all of the facts and circumstances. *TIFD III-E, Inc. v. United States*, 459 F.3d 220, 240 (2d Cir. 2006) (*Castle Harbour II*). We argued that I.R.C. § 704(e)(1) does not apply in this case, as that section focuses on whether a transferee of a partnership interest is the real owner of such interest. The question here, however, is whether a valid partnership existed between the Banks and U.S. subsidiaries of General Electric Capital Corp. (collectively "GECC").

We further argued that even if I.R.C. § 704(e)(1) applies, the District Court erred in ruling that the Banks qualified as partners under that section. As relevant here, I.R.C. § 704(e)(1) states that a person will be treated as a partner if he owns a "capital interest" in a partnership. A capital interest is synonymous with an equity interest—a point which GECC concedes (Br. 32)— and, therefore, the District Court's ruling is diametrically opposed to this Court's holding. In any event, the District Court's ruling is not supported by the record.

We argued in the alternative that, even if the Dutch Banks are respected as partners, the District Court erred in ruling that the allocation of 98% of Operating Income to them had "substantial

economic effect," as required by I.R.C. § 704(b)(2). We explained that the allocation lacked substantial economic effect because it enhanced the after-tax returns of both GECC and the Banks, without creating a concomitant tax burden for any partner. As a result, Castle Harbour's income must be reallocated according to the partners' interests in the partnership, *i.e.,* no more than 17.8% to the Banks.

Finally, we argued that the District Court erred in ruling that penalties for substantial understatement of tax and negligence did not apply.

A. The District Court erred in ruling that the Dutch Banks were partners under I.R.C. § 704(e)(1)

GECC contends that this Court must review the District Court's I.R.C. § 704(e)(1) ruling for clear error. (Br. 19.) But our argument that I.R.C. § 704(e)(1) does not apply here is a legal question reviewed *de novo*. Likewise, our argument that this Court's previous ruling forecloses the finding of a capital interest is a legal question reviewed *de novo*.

1. I.R.C. § 704(e)(1) has no application in this case

In our opening brief (pp. 49-55), we argued that I.R.C. § 704(e)(1) has no application here because the focus of the section is on whether a putative partner is the true owner of a partnership interest. As GECC acknowledges (Br. 20-23), the section was enacted in response to the confusion that existed in the family-partnership context, where courts constantly faced the question whether there was a bona fide transfer of a partnership interest and whether the recipient was the true owner. I.R.C. § 704(e)(1) clarified the law in this regard, and, as we stated in our brief (p.54), some courts have held that I.R.C. § 704(e)(1) replaced the subjective-intent inquiry of *Commissioner v. Culbertson*, 337 U.S. 733 (1949), in the family-partnership context. As one commentator recently explained, "section 704(e)(1) is best understood as modifying one particular application of the *Tower-Culbertson* intent test by carving out a safe harbor for contributions of donated capital while leaving the test intact for determining the validity of a partnership." Karen C. Burke & Grayson M.P. McCouch, *Snookered Again: Castle Harbour Revisited*, 128 Tax Notes 1143, 1153 (Sept. 13, 2010), *available in* LEXIS, 2010 TNT 177-10; *see also* Alan Gunn & James R. Repetti,

PARTNERSHIP INCOME TAX'N, at 89 & 91 n.4 (4th ed. 2005) (stating that I.R.C. § 704(e) "is of surprisingly little practical importance" because it "requires the same outcomes as the courts had reached before that section was adopted," and that it "says no more than" *Culbertson*). No court has ever applied I.R.C. § 704(e)(1) outside the family-partnership context to determine whether a valid partnership exists.

GECC argues that "courts uniformly recognize that section 704(e)(1) provides an alternative to *Culbertson*" (Br. 25), but all of the cases cited by GECC involved the question whether a transfer of a partnership interest to a closely related person was valid. Those cases involved the very scenario that I.R.C. § 704(e)(1) was intended to address, so it is no wonder that the courts applied I.R.C. § 704(e)(1) (and many applied *Culbertson* as well). GECC's discussion of the case law only highlights the fact that I.R.C. § 704(e)(1) has no application here.

GECC further argues that a partnership that would not pass muster under *Culbertson* nevertheless may satisfy I.R.C. § 704(e)(1), claiming that motive does not matter under I.R.C. § 704(e)(1). (Br. 23.) Although Congress intended to quell inquiries into what motivated

intra-family transfers of partnership interests, Congress also made clear that I.R.C. § 704(e)(1) was not intended to sanction tax-avoidance schemes. H. Rep. No. 82-586, at 32-33 (1951) (stating that "[t]ransactions between persons in a close family group, whether or not involving partnership interests, afford much opportunity for deception and should be subject to close scrutiny" and that "[c]ases will arise where the gift or sale is a mere sham"); *see* Treas. Reg. § 1.704-1(e)(1)(iii) (26 C.F.R.) ("donee or purchaser of a capital interest in a partnership is not recognized as a partner under the principles of section 704(e)(1) unless such interest is acquired in a bona fide transaction, not a mere sham for tax avoidance or evasion purposes").

GECC points to *Smith v. Commissioner*, 32 T.C. 1261 (1959), as proof that a partnership can fail to satisfy *Culbertson* and nevertheless be valid under I.R.C. § 704(e)(1). (Br. 24-25.) *Smith* does not stand for such a broad proposition, but instead merely shows the change that I.R.C. § 704(e)(1) effected in the family-partnership context. The court in the first *Smith* case applied *Culbertson* to determine whether valid gifts of family-partnership interests were made and whether the donees were the true owners of the partnership interests. By the time the

second *Smith* case was decided, I.R.C. § 704(e)(1) had clarified that a person could be the real owner of a family-partnership interest even if the interest was derived by gift, and regulations had been issued detailing when a donee would be considered the true owner. The Tax Court also stated that it was presented with "new evidence of facts, not before the Court in the prior case," that were significant to the partnership issue to be decided. 32 T.C. at 1267. In *Smith*, the critical question was whether there was a real transfer of property between closely related parties, and I.R.C. § 704(e)(1) clarified the law in that regard. But the present case does not implicate any questions of transfer or ownership. Rather, it involves the threshold question whether there was a valid partnership between GECC and the Dutch Banks, and—as this Court previously held—based on the totality of the circumstances, there was no valid partnership. I.R.C. § 704(e)(1) cannot redeem it.

GECC challenges as "preposterous" our argument that I.R.C. § 704(e)(1) does not apply in determining whether a valid partnership exists. (Br. 28-31.) However, in its brief to this Court in the first appeal, GECC stated that "[u]nder section 704(e)(1), a person is

recognized as a partner at least in a case where each of the following conditions is satisfied: (i) there is a valid partnership for tax purposes; ... ." (2d. Cir. 05-0064, Appellee Br. 64-65.) GECC claims that the plain language of I.R.C. § 704(e)(1) supports its new position that the statute does not assume the existence of a valid partnership, but the provision is entitled "Recognition of Interest Created by Purchase or Gift" and refers to a "purchase or gift" from another person.[1] Nor does this interpretation conflict with I.R.C. § 721, as GECC contends. A person can acquire a partnership interest via a capital contribution at any time, *i.e.,* at inception or later, and such acquisition is qualitatively different from acquiring a partnership interest by transfer.

GECC cites to two Tax Court cases as evidence that I.R.C. § 704(e)(1) provides a test for determining the validity of a partnership (Br. 29-30), but those cases do not support the application of I.R.C. § 704(e)(1) here. Both cases were quintessential family-partnership cases involving the question whether trusts in favor of the taxpayers' minor children were the true owners of their partnership interests.

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[1] GECC also contends that "section 704(e)(1) makes no reference to family partnerships" (Br. 23), but overlooks the fact that I.R.C. § 704(e) is entitled "Family Partnerships."

Thus, they hardly establish that I.R.C. § 704(e) applies when determining whether a valid partnership exists in the first instance, particularly in a non-family-partnership context. *See* Martin J. McMahon, Jr. et al., *Recent Developments in Federal Income Taxation: The Year 2009*, 10 Fla. Tax Rev. 79, 197-98 (2009) ("Judge Underhill's decision in Castle Harbour III is the very first case ever to discover that § 704(e)(1) applies to determine whether an arrangement between two (or more) otherwise unrelated business entities or unrelated individuals constituted a partnership").

GECC further contends that Castle Harbour was a valid, preexisting partnership prior to the Dutch Banks' involvement (Br. 30-31), but one cannot divorce the Banks from the transaction, pretending that Castle Harbour was formed for some other reason. Rather, the formation of Castle Harbour was but a single step in an interrelated series that culminated in the Banks' involvement. As GECC explains (Br. 8-10), Babcock & Brown's proposal called for the formation of a separate entity (*i.e.,* Castle Harbour) to which GECC subsidiaries would contribute aircraft and cash and foreign investors would contribute cash. Thus, GECC formed Castle Harbour in July 1993 and

began shopping for foreign investors to participate. Less than three months later, the Banks agreed to purchase interests in Castle Harbour. There was no reason for forming Castle Harbour apart from effectuating the transaction at issue.

Finally, GECC characterizes as "bizarre" (Br. 23, n.15) our statement that "there is no precedent for applying I.R.C. § 704(e)(1) to a multi-million dollar transaction involving large, sophisticated corporations acting at arm's length" (Gov. Br. 53), and yet it fails to cite a single such case in which I.R.C. § 704(e)(1) was applied. The only court ever to do so was reversed on appeal. *Boca Investerings P'ship v. United States*, 167 F. Supp. 2d 298, 372 (D.D.C. 2001), *rev'd*, 314 F.3d 625 (D.C. Cir. 2003) (applied *Culbertson* in reversing finding of valid partnership); *see ASA Investerings P'ship v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000) (applied *Culbertson* in ruling there was no valid partnership between AlliedSignal and Dutch bank); *Southgate Master Fund LLC v. United States*, 651 F. Supp. 2d 596, 657 (N.D. Tex. 2009) (applied *Culbertson* in ruling that partnership was a sham); *United States v. G-I Holdings, Inc.*, 2009 U.S. Dist. LEXIS 115850 (D.N.J. 2009) (applied *Culbertson* and *Castle Harbour II* in ruling that there

was not a valid contribution by GAF Corporation in exchange for a partnership interest); Burke & McCouch, 128 Tax Notes at 1151 ("the question of who owns a capital interest—the focus of section 704(e)(1)—almost never arises in an arm's-length transaction between unrelated parties").

2. Even if I.R.C. § 704(e)(1) applies, the Dutch Banks did not have capital interests in Castle Harbour

The bulk of GECC's brief is devoted to rehashing the question whether the Dutch Banks had equity interests in Castle Harbour. (Br. 32-44.) At every turn, GECC compares the Banks' interests to preferred stock to make the case that the interests were equity. But this Court has already rejected these very arguments. In the first appeal, this Court unequivocally held that the Banks did not have bona fide equity interests in Castle Harbour. SPA71[2] ("We conclude that consideration of [the] question under *Culbertson*'s mandate to appraise the totality of the circumstances compels the conclusion that, for tax purposes, the banks were not bona fide equity partners in Castle

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[2] "SPA" refers to the Special Appendix, "A" refers to the Joint Appendix, and "PSA" refers to the Plaintiff-Appellee's Supplemental Appendix.

Harbour.”). GECC simply ignores this Court’s prior ruling, which is law of the case. *See United States v. Quintieri*, 306 F.3d 1217, 1229 (2d Cir. 2002) (law of the case doctrine “forecloses relitigation of issues expressly or impliedly decided by the appellate court”).[3]

In an attempt to make room for its re-argument of the equity characterization, GECC contends that because “section 704(e)(1) is an objective alternative to the *Culbertson* subjective intent test,” “the characterization of the Banks’ interests under *Culbertson* does not determine whether they were capital interests under section 704(e)(1).” (Br. 32; *see* Br. 44.) But *Culbertson* is not just a “subjective intent” test. As this Court stated, *Culbertson* “turns on the fair, objective characterization of the interest in question upon consideration of all the circumstances.” (SPA63.) And, in any event, this Court did not apply a subjective-intent test in its first ruling. Rather, this Court’s ruling was based wholly on objective criteria. The focus of the opinion was on the largely undisputed features of the partnership arrangement and

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[3] GECC states that “[t]he Government never explains why the Banks’ interest were not equity and hence capital interests.” (Br. 32.) There was no need to explain “why” because this Court already did so in *Castle Harbour II*.

whether the Banks' interests had the prevailing character of debt or equity. Inasmuch as I.R.C. § 704(e)(1) also calls for a consideration of all the facts and circumstances, *see* Treas. Reg. § 1.704-1(e)(1)(iii), this Court already considered them and rejected the equity characterization.

GECC attempts to shift its burden in this case to the Government, stating that "the Banks' interests must be characterized as either equity or debt" (Br. 26) and alleging that the Government has failed to establish that the interests were debt. GECC has it wrong. Castle Harbour reported the Banks' interests as equity for tax purposes, and the IRS rejected that characterization in the notices of final partnership administrative adjustment ("FPAA"). It is well-established that an FPAA, like a notice of deficiency, is presumed correct and that the taxpayer bears the burden of proving that the IRS's determination is incorrect. *See Sealy Power v. Commissioner*, 46 F.3d 382, 385-88 (5th Cir. 1995); *Georgetowne Sound v. United States*, 856 F. Supp. 1056 (D. Md. 1993), *aff'd*, 19 F.3d 10 (4th Cir. 1994); *Republic Plaza Properties P'shp v. Commissioner*, 107 T.C. 94, 104 (1996); *RCL Properties, Inc. v. United States*, 2008 U.S. Dist. LEXIS 104422, *8 (D. Colo. 2008). Thus,

GECC bore the burden of proving that the Banks' interests were equity. If GECC does not carry its burden, then the adjustments in the FPAA are sustained. (GECC is thus wrong in stating that "the final decision in this case must make affirmative determinations of what the disputed partnership items were." (Br. 3.) If GECC cannot prove its proffered tax treatment, the IRS's recharacterization set forth in the FPAA stands.) In this case, rejection of the equity characterization results in a reallocation of the Banks' income to GECC. (A2519-20, 2535-36.) The notion that the Government was required to prove the precise nature of the Banks' interests is without merit.[4]

[4] Moreover, though it is enough that the Banks' interests were not equity, GECC is wrong in contending that the choice is solely between debt and equity. As one commentator recently observed, "if equity status is denied, the range of alternative classifications is not necessarily limited to a binary choice between debt and equity." Burke & McCouch, 128 Tax Notes at 1148.

3. Under the facts of this case, the Banks did not have capital interests in Castle Harbour

Even if the question whether the Banks held capital interests were not foreclosed, the facts establish that the Banks' interests were not capital interests. (*See* Gov. Br. 59-74.) GECC dismisses as irrelevant many of the factors cited by the Government (*e.g.,* no meaningful risk of loss, no realistic possibility of restoring negative capital accounts, no dependence on partnership performance, no need for or use of contributed capital, no participation in management) (Br. 33, 44, 49-50), but these factors were relied on by the District Court in concluding that the Banks had capital interests (SPA108-116). In GECC's view, the only relevant factor is whether the Banks shared in "capital claims at distribution" (Br. 33), though it fails to explain how even that factor is satisfied. As discussed in our opening brief (pp. 60-71) and throughout this Court's first opinion, the interaction of the Investment Accounts, Exhibit E payments, and Class A payments effectively guaranteed the Banks return of their initial investment, plus 8.53587% to 9.03587%, and that is exactly what they received upon Castle Harbour's dissolution. There was never an expectation or realistic possibility that the Banks would receive some greater share of capital

upon dissolution or that they would have to restore negative capital accounts upon dissolution.

GECC cites to the testimony of the Government's financial expert, John Lacey, as conceding that the capital accounts reflected the Banks' ownership interest in Castle Harbour (Br. 47), but GECC has taken the testimony grossly out of context. In explaining the comparative liquidation method for determining the parties' percentage ownership interests in Castle Harbour, which relates to our alternative I.R.C. § 704(b) argument (Gov. Br. 81-82), Lacey stated (during opposing counsel's *voir dire*) that he looked at the capital account balances, as well as the Operating Agreement, to determine how much each party contributed to Castle Harbour and thereby determine their initial ownership percentages. (Doc. 78, Tr. 1031-1035.) He did not suggest that the capital accounts meaningfully reflected the Banks' stake in the transaction.

GECC also claims that Lacey testified that "the Banks' return reflected Castle Harbour's operating results" (Br. 48), but this overstates his testimony. In response to opposing counsel's question whether the Banks' return depended "at least to some extent on the

operating results of Castle Harbour," Lacey replied, "To some extent, yes." And when asked whether "there was some down side potential for the Dutch investors," Lacey replied that there was "some down side potential," but that only in the "unlikely" event of an "extreme catastrophe" was it possible that the Banks would have lost part of their capital. (PSA17-18.) As this Court already recognized, the Banks' interests were "not totally devoid of *indicia* of an equity participation," but "those indicia were either illusory or insignificant in the overall context of the banks' investment."[5] (SPA62.)

On the whole, in refuting our argument that the Banks' interests were not capital interests, GECC blithely ignores this Court's first opinion. It repeatedly challenges our characterization of certain facts as incorrect, even though this Court already ruled on such matters.

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[5] GECC boasts that Castle Harbour's performance "increased the Banks' return by almost 60 basis points over the threshold for a Class A Guaranteed Payment" as evidence that Castle Harbour's performance affected the Banks' return. (Br. 48.) GECC is referring to about $7 million in unrealized Disposition Gain (based on the fair market value of Castle Harbour's assets) that was allocated to the Banks, which had the effect of increasing their rate of return to 9.1%, *i.e.,* roughly 0.6% greater than the 8.53587% return that would have triggered the Class A payment. (A1789-98.) But the target yield was 9.03587%, not 8.53587%, so the actual yield only exceeded the target by about 0.07%, or 7 basis points. (A565.)

For example, GECC disputes that the financial assets held by CHLI, the maintenance of casualty insurance, and the GECC performance guaranty immunized the Banks against losses (Br. 45-46), but this Court cited those very facts in ruling that the Banks had "an ironclad assurance that they would receive repayment." (SPA70-71.) GECC once again argues that the performance guaranty did not secure the Banks' repayment (Br. 46-47), but this Court already rejected the argument (SPA57, 59-60, 68, 71). GECC claims that the Banks' return was tied to Castle Harbour's performance (Br. 48), but this Court plainly stated that the Banks' return "was in no way dependent on partnership performance" (SPA 57). GECC claims that the Banks' cash contributions benefitted the income-producing capacity of Castle Harbour (Br. 49), but this Court already concluded that CHLI's Core Financial Asset requirement "preclud[ed] the partnership from using the banks' investment in the partnership's aircraft-leasing business" (SPA 71). And GECC claims that the Banks treated their interests as equity (Br. 36, n.24), though even the District Court found that they

treated their investments as debt, a fact that this Court believed was relevant (SPA69-70).[6]

In short, GECC's entire case for characterizing the Banks' interests as capital interests rests on its renewed—and previously rejected—argument that the Banks were bona fide equity participants in Castle Harbour.

B. The District Court misapplied the substantial economic effect test of I.R.C. § 704(b)

In our opening brief, we argued that even if the Dutch Banks are respected as partners of Castle Harbour, the book allocation of 98% of Operating Income to them lacked substantial economic effect under I.R.C. § 704(b). In an attempt to distract this Court from that reality, GECC engages in a lengthy discussion of I.R.C. § 704(b) and (c) that is largely smoke and mirrors. The thrust of I.R.C. § 704 is that "the economic sharing as agreed to among the partners must, directly or indirectly, govern the sharing of the tax effects." Arthur B. Willis et al., PARTNERSHIP TAXATION ¶10.01[1] (6th ed. & 2010 Supp.). In other

[6] Contrary to GECC's assertion, the record (A440-42, 535-37) supports the finding that the Banks treated their interests as debt for Dutch accounting and tax purposes.

words, the "tax results follow the economic results, and tax benefits and burdens must coincide with the related economic burden and benefits." *Id*. Viewed as a whole, the transaction here plainly failed that test. GECC enjoyed $288 million of Castle Harbour's actual income (chiefly lease income), but paid tax on only $6 million of it, while the Dutch Banks received only $28 million of Castle Harbour's actual income, but were allocated taxable income of $310 million. And, of course, the Banks paid no U.S. tax. Clearly, the economics did not govern the tax effects.

GECC first claims that I.R.C. § 704(b) is irrelevant because it is I.R.C. § 704(c) that governs the allocation of so-called "excess taxable income" attributable to leasing income that could not be reduced by tax depreciation. (Br. 52.) I.R.C. § 704(c) governs the allocation of specific tax items, such as depreciation, to ensure that built-in gain from contributed property is not shifted to another partner. But the Government is not seeking to reallocate tax depreciation or built-in gain. Rather, the Government seeks to reallocate Castle Harbour's book income (specifically, Operating (leasing) Income). While a reallocation of book income would require a reallocation of taxable

income (as tax generally follows book), the mere fact that taxable income ultimately must be reallocated consistent with book income does not have anything to do with the application of I.R.C. § 704(c). In any case, an allocation must satisfy the substantial economic effect test before I.R.C. § 704(c) even comes into play. *See* Willis ¶10.01[7] ("the partners' shares of the tax items under § 704(c) must be determined with reference to the partners' distributive shares of the corresponding book items as determined under § 704(b)"); Karen C. Burke, *Castle Harbour: Economic Substance and the Overall-Tax-Effect Test,* 107 Tax Notes 1163, 1169 (May 30, 2005). In arguing that I.R.C. § 704(c) required the result here, GECC assumes what it has to prove, *i.e.,* that the 98% allocation of book Operating Income to the Banks had substantial economic effect in the first place.

As discussed in our opening brief (pp. 77-80), an allocation's economic effect is insubstantial if (i) it enhances at least one partner's after-tax economic consequences (as compared with such consequences absent the allocation), and (ii) it does not diminish at least one partner's economic consequences (as compared with such consequences absent the allocation). Treas. Reg. § 1.704-1(b)(2)(iii) (1998). This is

referred to as the "overall-tax-effect" test. The determination of what the economic consequences would be absent an allocation is determined by ascertaining each "partner's interest in the partnership" (PIIP) under Treas. Reg. § 1.704-1(b)(3). If the allocation fails the overall-tax-effect test, the item in question must be reallocated based on PIIP. As established in our opening brief, Castle Harbour's tax-driven allocations do not pass muster under the overall-tax-effect test.[7]

GECC acknowledges that the overall-tax-effect test "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." (Br. 67.) But it goes on to conclude that "[b]ecause of the value-equals-basis rule, the only baseline that is consistent with the parties' economic deal is an allocation of 98% of the Operating Income to the Banks." (Br. 69-70.) GECC claims that any reduction in the Banks' share of Operating Income would have to increase their share of some other category of book income, and, according to GECC, the only

[7] GECC inaccurately contends (Br. 50-51) that the standard of review is clear error. The Government's argument, however, is that the District Court misapplied the substantial economic effect test. In particular, it failed to consider all relevant factors in determining PIIP. The court's legal error requires *de novo* review.

other category was Disposition Gains. Because the value-equals-basis rule requires the fair market value of the aircraft to equal its book value (adjusted by book depreciation), GECC claims that Disposition Gains must be ignored for purposes of establishing the baseline. This is simply not the case. As this Court noted (SPA59, n.6), the partnership agreement defined Disposition Gains broadly to include not only things that typically would be considered be disposition gains, such as gain from the sale of Castle Harbour's airplanes (to which the value-equals-basis rule applies), but also other significant items, such as CHLI's investment and leasing income (to which the value-equals-basis rule does *not* apply). Thus, there clearly is another category of income to reallocate, and the value-equals-basis rule changes nothing.

GECC further contends that the Government's overall-tax-effect analysis is faulty because it fails to account for the value-equals-basis rule, but this is a red herring. (Br. 68-70.) The value-equals-basis rule is taken into account only in determining the "baseline" PIIP used to test the 98% allocation. *See* Treas. Reg. § 1.704-1(b)(2)(iii)(c)(2). If the test is failed, income is reallocated according to PIIP *without* regard to the value-equals-basis rule. Treas. Reg. § 1.704-1(b)(1)(i) & (b)(3)(i)-(ii).

In this case, the 98% allocation fails to meet the overall-tax-effect test even when the value-equals-basis rule is incorporated.[8] As a result, Operating Income must be reallocated in accordance with PIIP (without regard to the value-equals-basis rule).

PIIP reflects the "overriding principle that the tax effects of partnership operations must conform to the economic effects of those operations." Willis, ¶10.02[1]. The District Court concluded that the Banks' PIIP was, in any event, 98%, but it clearly failed to follow the regulations in determining PIIP. The regulations require "taking into account all facts and circumstances relating to the economic arrangement of the partners," including their relative capital contributions, interests in economic profits and losses, and rights to cash flow and other distributions. Treas. Reg. § 1.704-1(b)(3)(i) & (ii). GECC does not seriously dispute that the District Court failed to consider these factors (Br. 74), nor can it. As discussed in our opening

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[8] The value-equals-basis rule might call for, at most, using a baseline of 26% to the Banks and 74% to GECC. This is a marginal difference from the 18/82 baseline used in our opening brief (pp. 87-88). Thus, the 98% allocation still would fail the overall-tax-effect test.

brief (pp. 80-86), when the *entire* economic deal is considered, it is clear that the Banks' PIIP was no more than 17.8%.

Indeed, many of GECC's arguments depend on its myopic view that book (Operating) income, and not taxable income, reflects the actual, economic income of Castle Harbour. That is not the case. Castle Harbour's book income was reduced 60-70% by depreciation deductions on already depreciated aircraft. The aircraft did not "waste away" again, and, indeed, their fair market value did not decrease. (SPA6, 24.) Castle Harbour's taxable income, which reflected its substantial leasing income unreduced by depreciation, was a truer reflection of economic income. Similarly, GECC claims that the "excess taxable income" allocated to the Banks (*i.e.,* leasing income unreduced by depreciation) did not "affect the partners' economic interest in the partnership" because it was merely a tax item with no book twin. (*See, e.g.,* Br. 52.) But the excess taxable income that was allocated to the Banks clearly improved GECC's economic interest—GECC received the bulk of that income in *real* dollars and paid no tax on it.

GECC disavows the Government's proposed reallocation, contending that it "creates a $22 million discrepancy between the cash

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income the Banks received and the book income allocated to them." (Br. 73.) But the 18/82 reallocation would give the Banks a larger share of Disposition Gains, so they would not be denied the funds. In any event, the reality is that the Banks received money according to Exhibit E and the Investment Accounts. The Investment Accounts ensured that the Banks would receive back their investment, plus about 9%. If the allocations of Operating Income, which were reflected in the capital accounts, plus the Exhibit E payments were insufficient to pay that amount, the Class A payment would make up the difference. The Banks' repayment was not dependent on an ostensible share of Operating Income.

Moreover, the entire notion that GECC and the Banks agreed to "share" the benefits and risks of Operating Income in a particular way is a fiction. Rather, as this Court stated, "[t]he transaction consisted, as a practical matter, of an advance by the Dutch banks of $117.5 million. The partnership undertook to repay the advance at an agreed rate of return, pursuant to a previously agreed payment schedule." (SPA71.) The allocations of Operating Income and Disposition Gain were then designed to effectuate that repayment. To the extent the

allocations failed to achieve the desired result, the Investment Accounts and the Class A payment would make up the difference. As one commentator has explained:

> In effect, the Exhibit E payments and the Dutch banks' investment accounts together completely described the partners' economic agreement apart from taxes. Essentially, the Dutch banks were entitled to a return of their investment plus specified minimum interest. The actual allocations under the partnership agreement were cleverly constructed to produce that result, given the predictability of the partnership's rental income and book depreciation. If the partnership agreement had contained no express allocations, however, there would have been no impediment to determining the partners' pretax economic sharing arrangement based on the Exhibit E payments and the Dutch banks' investment accounts. Because the partnership's book allocations were constructed in such a manner as to have little or no impact on the partners' economic entitlements apart from taxes, they should properly be ignored.

Burke, 107 Tax Notes at 1172. Contrary to GECC's repeated claims (Br. 58) that I.R.C. § 704(c) dictated the allocations here, it was GECC that determined that 98% of Operating Income would be allocated to the Banks. Only after GECC chose that allocation for Operating Income did it follow that 98% of taxable income also would be allocated to the Banks.

Finally, GECC's suggestion (Br. 58-59, 75-76) that the arrangement, even if apparently abusive, was permissible before the 1993 amendment of the I.R.C. § 704(c) regulations is flatly wrong. Even before that regulation's adoption, *to wit*, Treas. Reg. § 1.704-3(a)(10), the courts consistently have interpreted the tax laws to prohibit U.S. taxpayers from transferring income otherwise taxable to them to foreign entities in order to shelter the income from U.S. taxation.[9] Here, the Dutch Banks were allocated the lion's share of the income for tax purposes, while GECC retained the lion's share of the economic benefit of that income. That simply is not consistent with the tax law. GECC's argument, at bottom, is that it found what it believed to be a loophole in the tax law, and because it darted through the

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[9] The enactment of a provision to deter abuses does not signify that the abuses passed muster under prior law. *See Knetsch v. United States*, 364 U.S. 361, 367-68 (1960). Because virtually any taxpayer with fully depreciated, but still income-producing, property could have entered into a "partnership" arrangement with foreign entities similar to the one at issue, the abusive potential of such schemes is obvious. In fact, proposed Treas. Reg. § 1.704-3(a)(10) was issued in 1992, well before the Castle Harbour transaction was undertaken. *See* 57 Fed. Reg. 61345 (Dec. 24, 1992). Thus, the writing was on the wall. The final regulations were issued in December 1993, two months after the deal was closed. *See* T.D. 8500, 58 Fed. Reg. 67676 (Dec. 22, 1993).

purported loophole before it was closed by the Treasury, it is entitled to the benefits. That argument plainly is wrong and should be rejected.

C. The District Court erred in rejecting the Government's penalty claims

In our opening brief, we argued that the District Court erred in ruling that penalties for substantial understatement of tax and negligence do not apply here. GECC makes the bold assertion that the Government has overreached in appealing the penalties ruling. (Br. 81.) GECC cites to a case in which this Court criticized the Government for pursuing a negligence penalty against a *pro se* taxpayer in a case where the law was "at best, unclear," *Holmes v. United States*, 85 F.3d 956, 963 n.7 (2d Cir. 1996), to suggest that this Court frowns on "a Government effort to impose penalties after having lost at trial" (Br. 81). GECC also contends that the Government is advocating a strict liability approach to penalties. (Br. 81.) These assertions are unfounded and lack merit. As this Court stated in *Castle Harbour II*, the District Court ruled in favor of GECC only because it "accept[ed] at face value the appearances and labels created by the partnership, rather than assess[ ] the underlying economic realities." (SPA62.) It is a basic maxim of tax law, however, that "[t]he incidence

of taxation depends upon the substance of a transaction," not its form. *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945). That the District Court twice elevated the "the artificial constructs of the partnership agreement" (SPA63) over its substance does not require the Government to forgo its penalties claim.

GECC contends that the substantial authority for Castle Harbour's return position was "the plain language of the statute and regulations," as well as "established case law" stating that it is permissible to shelter income from tax in the pursuit of a business objective. (Br. 82.) As for the claim that the Code and Treasury regulations technically allowed the return position, the following illustration aptly describes how the Castle Harbour transaction exploited these provisions:

> Say you have a dog, but you need to create a duck on the [tax returns]. Fortunately, there are specific [tax] rules for what constitutes a duck: yellow feet, white covering, orange beak. So you take the dog and paint its feet yellow and its fur white and you paste an orange plastic beak on its nose, and then you say to your accountants, "This is a duck! Don't you agree that it's a duck?" And the accountants say, "Yes, according to the rules, this is a duck." Everybody knows that it's a dog, not a duck, but that doesn't matter, because you've met the rules for calling it a duck.

Bethany McLean & Peter Elkind, THE SMARTEST GUYS IN THE ROOM, at 142-43 (Portfolio 2004 ed.); *see BB&T Corp. v. United States*, 523 F.3d 461, 477 (4th Cir. 2008) ("we are reminded of Abe Lincoln's riddle 'How many legs does a dog have if you call a tail a leg?' 'The answer is four,' because 'calling a tail a leg does not make it one.'") (internal citations & quotations omitted). As this Court stated, GECC's "$60 million tax objective depended on successfully characterizing the interest of the Dutch banks as an equity partnership participation. There could be no conceivable doubt that the taxpayer had a vital interest in the acceptance by the IRS and the courts of the banks' participation as equity, and had taken pains in the design of the partnership to promote that characterization." (SPA70.)

And GECC's claim that *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978) (Br. 82), provides substantial authority for Castle Harbour's return position depends upon a highly selective reading of the case. In *Frank Lyon*, what the Supreme Court actually held was that where "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." 435 U.S. at 583. Even accepting the District Court's finding that there was some business purpose for the Castle Harbour transaction, the transaction cannot be described as one "imbued with tax-independent considerations" and "not shaped solely by tax-avoidance features that have meaningless labels attached." Indeed, as this Court stated, the Banks' "apparent 98% share of partnership income . . . was more in the nature of window dressing designed to give ostensible support to the characterization of equity participation, which was essential to the dominant tax objective, than a meaningful stake in the profits of the venture." (SPA67.)

GECC disavows as irrelevant the factors cited by the Government in arguing that the principal purpose of the Castle Harbour transaction was tax avoidance. (Br. 83-85.) But it is plain that those factors are relevant, *to wit*, GECC sought only foreign investors to participate in the transaction; Castle Harbour did not spread the risk of the aircraft leasing business to the Dutch Banks as they effectively were guaranteed the return of their investment; the transaction did not

increase the leasing business's liquidity because the Banks' investment had to be kept in Core Financial Assets; and Castle Harbour was terminated once the tax laws were changed such that, as a result of the tax indemnification obligation, GECC might have to bear the tax burden of the very income it sought to shelter.[10] The District Court clearly erred in ruling that Castle Harbour was not a "tax shelter."

Finally, GECC states that it did not introduce evidence to support a reasonable-cause defense because it claims (incorrectly) that Treasury regulations governing partnership-level proceedings prohibit it from doing so. (Br. 88-89.) As stated in our brief (p.102), at issue here is the reasonable cause of the partnership and not of the individual partners. Treas. Reg. § 301.6221-1(c). Although Treas. Reg. § 301.6221-1(c) and (d) do not allow a partner to raise its *own* defense of reasonable cause in the partnership proceeding, they do not bar the *partnership* from raising a reasonable-cause defense on its own behalf. *See American*

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[10] In an attempt to add to its stock of ostensible business purposes, GECC contends that the transaction enabled it to retire debt and thereby "creat[e] capacity for additional debt." (Br. 84.) But in the proceedings below, improving the debt-equity ratio was not advanced as a reason *for* the transaction. It was discussed solely to explain why GECC could not borrow funds to increase its liquidity. Doc. 52 at 7-8 (Plaintiff's Trial Brief).

Boat Co., LLC v. United States, 583 F.3d 471, 479 (7th Cir. 2009) ("Despite the inclusion of reasonable cause in Treasury Regulation § 301.6221-1(d), the vast majority of courts have held or indicated that a partnership may also raise such a defense on its own behalf, based on the conduct of its general or managing partner."); *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537, 548 (5th Cir. 2009) (TEFRA "does not permit a partner to raise an individual defense during a partnership-level proceeding, but when considering the determination of penalties at the partnership level the court may consider the defenses of the partnership").

Nor did the Government's litigating position in *Klamath* bar such a defense, as GECC claims (Br. 89). In *Klamath*, the Government objected on the grounds that the partners were raising their own reasonable-cause defenses and not a partnership-level defense. Moreover, at the same time the instant case was being tried, the question whether a partnership had established a reasonable-cause defense to penalties for substantial understatement of tax was decided on the merits in *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 205-12 (D. Conn. 2004), *aff'd,* 150 Fed. Appx. 40 (2d Cir.

2005) (in which counsel for GECC here represented the partnership). Thus, GECC cannot blame the Government for its failure to make a partnership-level reasonable-cause defense.

CONCLUSION

Based on the foregoing and the Government's opening brief, the District Court's judgment should be reversed.

Respectfully submitted,

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(s) Francesca U. Tamami
Attorney for the Appellant
Dated: October 15, 2010

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

CAPTION:

TIFD III-E, Inc.
v.
United States of America

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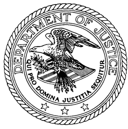

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New York, NY 10007

Re: *TIFD III-E, Inc. v. United States*
(2d. Cir. - No. 10-70)

Dear Ms. Wolfe:

Enclosed for filing with the Court are six copies of the reply brief for the appellant in the above-entitled case. The brief also is being filed and served today via CM/ECF.

Please note that in a previous appeal of this case, the panel that heard the case (Judges Cardamone, Leval, and Sack) stated in its opinion that "[i]n the event of a subsequent appeal, the matter will be assigned to this panel." *See TIFD III-E, Inc. v. United States*, 459 F.3d 220, 241 (2d Cir. 2006); 2d. Cir. No. 05-0064-cv (argued Dec. 1, 2005; decided Aug. 3, 2006).

If you have any questions, I can be reached at (202) 514-1882.

Sincerely,

/s/ Francesca U. Tamami
FRANCESCA U. TAMAMI
Attorney

Enclosures

cc: David J. Curtin, Esq.
(via CM/ECF)