CASTLE HARBOUR: ECONOMIC SUBSTANCE AND THE OVERALL-TAX-EFFECT TEST

By Karen C. Burke

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The taxpayer victory in Castle Harbour v. Commissioner has been heralded as a watershed in tax shelter litigation. Burke writes that the district court rejected the government’s arguments that the partnership was a sham and that the partnership’s allocations violated the overall-tax-effect test. This article explores the relationship between the economic substance doctrine and limitations on flexible allocations under subchapter K. Although in Burke’s view, the section 704(c) regulations now provide an antiabuse rule that should make it impossible to replicate the Castle Harbour transaction, the government also maintained that the partnership’s allocations lacked substantial economic effect under the section 704(b) regulations. The article argues that the district court’s circular interpretation of the overall test threatens to undermine the ability of the section 704(b) regulations to deter tax-driven allocations. Although Burke thinks that the government’s relative ownership test was defective, she suggests alternative methods for reallocating the partnership’s book items to reflect the partners’ economic interests.

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I. Introduction

The taxpayer victory in Castle Harbour v. Commissioner has been heralded as a watershed in tax shelter litigation. Burke writes that the district court rejected the government’s arguments that the partnership was a sham and that the partnership’s allocations violated the overall-tax-effect test. This article explores the relationship between the economic substance doctrine and limitations on flexible allocations under subchapter K. Although in Burke’s view, the section 704(c) regulations now provide an antiabuse rule that should make it impossible to replicate the Castle Harbour transaction, the government also maintained that the partnership’s allocations lacked substantial economic effect under the section 704(b) regulations. The article argues that the district court’s circular interpretation of the overall test threatens to undermine the ability of the section 704(b) regulations to deter tax-driven allocations. Although Burke thinks that the government’s relative ownership test was defective, she suggests alternative methods for reallocating the partnership’s book items to reflect the partners’ economic interests.


now addresses the particular section 704(c) problem, the application of the substantiality requirement under section 704(b) raises an issue of first impression. Specifically, Castle Harbour presents the novel question of whether the partnership’s tax-driven allocations (that is, allocations that would not have been made but for their tax effect) violated the stringent overall-tax-effect test under the section 704(b) regulations.6 Surprisingly, in applying the partners’ interest standard, the court adopted a circular approach that would make it virtually impossible to violate the overall test, because the “default” allocations and the actual allocations would be identical.7

More broadly, Castle Harbour sheds light on the relationship between the economic substance doctrine and limitations on flexible allocations under subchapter K. In testing partnership allocations, the section 704(b) regulations adopt a potentially more rigorous version of the economic substance doctrine. While there is remarkably little authority specifically applying the partners’ interest standard, the substantiality requirement lies at the core of the section 704(b) regulations.8 The elaborate mechanical tests under the section 704(b) regulations stand in for a more subjective tax-avoidance standard for distinguishing allocations that serve a legitimate business purpose from those that enhance the partners’ after-tax economic consequences solely at the expense of the government. Ironically, the court’s circular interpretation of the partners’ interest standard, while antithetical to the intent of the regulations, followed precisely the analysis suggested by the taxpayer’s preeminent partnership counsel.9

II. Background of Castle Harbour

A. Transaction

Castle Harbour involved a partnership between General Electric Capital Corporation (GECC) and two Dutch banks (ING Bank N.V. and Rabo Merchant Bank N.V.) to engage in the aircraft leasing business.10 GECC contributed $246 million in cash, accounts receivable, and 63 airplanes (worth $530 million, but subject to nonrecourse debt and existing leases with commercial airlines) that were owned by GECC in the ordinary course of its business. The Dutch banks initially had a total combined investment of $117.5 million. The partnership was formed pursuant to a “sell down” effort by GECC intended ostensibly to raise capital, demonstrate liquidity in the aircraft leasing business, and shift some of GECC’s risk from rental income and the residual value of the aircraft.11 The transaction promised significant tax benefits to GECC from shifting most of the partnership’s taxable income to the Dutch banks, which were exempt from U.S. tax.

The partnership’s operating income was allocated 98 percent to the Dutch banks and 2 percent to GECC.12 While the contributed aircraft had a tax basis of zero, their book value in the partnership’s hands was equal to their fair market value. As a result, the partnership had large annual depreciation deductions for book purposes, but no corresponding tax deductions.13 Thus, the partnership’s taxable income generally exceeded its book or economic income by an amount equal to the book depreciation deductions. By allocating 98 percent of the partnership’s operating income to the Dutch banks, GECC greatly reduced its tax liability, while shifting very little economic income.14 Because the so-called ceiling rule under the section 704(c) regulations prevented the

<table>
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<tr>
<th>Dutch Banks</th>
<th>GECC</th>
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<tbody>
<tr>
<td><strong>Tax</strong></td>
<td><strong>Book</strong></td>
</tr>
<tr>
<td>Initial</td>
<td>$118</td>
</tr>
<tr>
<td>Taxable income</td>
<td>310</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(282)</td>
</tr>
<tr>
<td>Bottom line</td>
<td>$428</td>
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In addition, the Dutch banks were allocated cumulative net gain of approximately $4.3 million from disposition of aircraft.

(Footnote continued on next page.)
partnership from allocating tax depreciation to the Dutch banks to match their book income (thereby overstating their taxable income), GECC was essentially permitted to "redepreciate" the contributed aircraft.15

B. Risks and Returns

Under the partnership agreement, the Dutch banks' interests were to be bought out over eight years through a self-liquidating mechanism tied to the partnership's income. As the Dutch banks' interests were bought out, GECC's interest would increase correspondingly. The Dutch banks were scheduled to receive annual distributions in the amounts specified in Exhibit E of the partnership's operating agreement (the Exhibit E payments). Although those payments were at the discretion of the partnership's general manager, they were effectively mandatory because nonpayment would give the Dutch banks the right to demand liquidation of the partnership. The Dutch banks' book capital accounts were credited with their initial contributions, increased (or decreased) by their allocable share of the partnership's book income (or loss), and reduced by the amount of the Exhibit E payments. The Exhibit E payments were calculated in a manner that would repay the Dutch banks' initial investment at an internal rate of return of 9.03587 percent over eight years.16 By the end of 1997, the Dutch banks had received Exhibit E payments totaling $118.5 million, or slightly more than their initial investment. No Exhibit E payments were made in 1998 because GECC opted to buy out the Dutch banks' interests.17

One of the unusual features of the partnership agreement was the Dutch banks' investment account balances, which were initially credited with an amount equal to their investment in the partnership. The investment accounts merely kept track of a hypothetical balance; no cash was actually placed in them. On the Dutch banks' exit from the partnership, the balance was to be redetermined as if the investment accounts had been increased each year by an "applicable rate" and reduced by the Exhibit E payments.18 On exit, the Dutch banks were to receive a guaranteed payment (the Class A guaranteed payment) if their investment account balances exceeded the sum of operating income and disposition gain, less operating loss (capped at roughly $4 million) and disposition loss (capped at roughly $3 million), previously allocated to them.19 The Class A guaranteed payment was payable only if the Dutch banks had not previously received net allocations of operating income and gain sufficient to provide the specified minimum yield on their investments.20 In fact, the Dutch banks never received any guaranteed payment; instead, on exit they received the balance in their book capital accounts ($31 million) plus a small call premium for the early buyout.21

The partnership's cash flow was used mainly to fund distributions, service debt, and pay expenses. Under the partnership agreement, GECC was entitled to guaranteed payments (the Class B guaranteed payments) that were treated as operating expenses and did not reduce GECC's capital account.22 Cash in excess of the partnership's needs was transferred to Castle Harbour Leasing Inc. (CHLI), a domestic corporation and wholly owned subsidiary of Castle Harbour. Under the partnership agreement, CHLI was obligated to maintain "core financial assets," consisting of cash and high-grade securities including revaluation gain. The allocation of disposition gain was not at issue in Castle Harbour.23

15See Castle Harbour, 342 F. Supp.2d at 107. The section 704(c) regulations were amended to eliminate the ceiling rule abuse underlying the Castle Harbour transaction for contributions of property after Dec. 21, 1993. See PS-164-84, 1993-1 C.B. 857; T.D. 8500, 1994-1 C.B. 183.

16At the end of eight years, if the partnership allocations had yielded a net return of 9 percent, the Dutch banks' book capital accounts would have been reduced to near zero; the Exhibit E payments would have cancelled the net increases in their book capital accounts and repaid their original investment. If no income had been allocated to the Dutch banks, the Exhibit E payments would have exceeded their investment; in this event, the Dutch banks would have been required to repay the deficit in their book capital accounts. See Plaintiff's Trial Brief 19 (July 8, 2004).

17In 1997 GECC exercised its option to acquire the Dutch banks' interests because of a tax law change that potentially affected U.S. withholding on distributions to the Dutch banks. See Plaintiff's Revised and Annotated Findings of Fact and Conclusions of Law 43 (Aug. 4, 2004).
(including GECC’s commercial paper) equal to 110 percent of the current value of the Dutch banks’ investment accounts. CHLI could use the excess funds to purchase new aircraft or make loans to GECC that did not create additional debt on GECC’s consolidated balance sheet. Once excess funds had been transferred to CHLI, income generated by those funds was accumulated in CHLI and treated as disposition gain (allocable mainly to GECC) on the Dutch banks’ exit.23

C. Economic Substance

The court rejected the government’s argument that, under the economic substance doctrine, the Castle Harbour transaction should be disregarded for tax purposes. The government argued that (1) the Dutch banks never parted with their initial investment because its return was guaranteed by the combined Exhibit E payments and investment accounts and (2) the provision concerning core financial assets “froze” the partnership’s use of the Dutch banks’ investment. While the Exhibit E payments merely provided a self-liquidating mechanism, the court found that the investment accounts practically guaranteed the Dutch banks at least an 8.5 percent return.24 Nevertheless, that diminution in risk was not sufficient to render the transaction economically meaningless.25 The Dutch banks’ investment had upside potential because they would receive a higher return if the partnership’s operating income increased.26 Essentially, the Dutch banks bore the risk that their return would not exceed the balance in their investment accounts. The court also discounted the significance of limitations on use of the Dutch banks’ capital, concluding that CHLI’s actual investments in GECC’s commercial paper enhanced GECC’s ability to borrow.

Based on the reality of the Dutch banks’ contribution of $117.5 million, the court found that the transaction had objective economic effect under the economic substance doctrine. Because “GECC was subjectively motivated... at least in part, by a desire to raise capital and a desire to demonstrate its ability to do so,” the transaction also satisfied the subjective business purpose requirement.27 Even though “it appeared likely that one of GECC’s principal motivations” in entering into the transaction was to substantially reduce its tax burden, the court nevertheless believed that the parties had undertaken an “economically real transaction.”28 The court also considered whether the formation of the partnership might nevertheless be considered economically meaningless. It distinguished a line of recent cases in the D.C. Circuit holding that a partnership will not be recognized for tax purposes if its formation serves no nontax business purpose.29 The court found it “hard to imagine an alternative” to the creation of a separate entity to accomplish the parties’ nontax business objectives.30 While skeptical concerning the self-serving testimony of GECC’s executives, the court nevertheless accepted GECC’s claim that the Castle Harbour transaction served a legitimate nontax business purpose.31

The relative weakness of GECC’s purported business purpose is striking, however, particularly in comparison with the anticipated tax savings. GECC had no need to raise an additional $117.5 million for use in its aircraft leasing business, nor was there any evidence that the Dutch banks’ investment was actually used for that purpose.32 Moreover, the transaction shifted very little economic risk from GECC to the Dutch banks. Not only was the Dutch banks’ risk of loss minimal but GECC retained nearly all of the potential upside in the form of the residual value of the aircraft, the principal source of uncertainty in the partnership arrangement. Although GECC also maintained that the Castle Harbour transaction was intended to generate a pretax profit, the aircraft leases were expected to produce substantial income even without formation of the partnership.33 Perhaps GECC’s

23See id. at 109. The court noted that the standard in the Second Circuit was not “perfectly explicit” concerning whether the two prongs of the economic substance doctrine (objective economic effect and subjective business purpose) should be applied conjunctively or disjunctively. Id. at 109; see Long Term Capital Holdings, 330 F. Supp.2d at 171 n.68 (applying a more flexible standard).

24Castle Harbour, 342 F. Supp.2d at 121.

25See id. at 112 (characterizing ASA Investerings as representing a specific application of the economic substance or sham doctrine rather than “enunciating a new standard of review”). See ASA Investerings Partnership, 201 F.3d at 512; Boca Investerings Partnership v. United States, 314 F.3d 625, 632, Doc 2003-1175, 2003 TNT 8-7 (D.C. Cir. 2003). See also Andantech v. Comm’r, 331 F.3d 972, 980 (D.C. Cir. 2003). Unlike the foreign banks in ASA Investerings, the Dutch banks were not “guaranteed an exact amount of return regardless of the business’s performance.” Castle Harbour, 342 F. Supp.2d at 113-14.

26Castle Harbour, 342 F. Supp.2d at 114.

27See id. at 111 (“Were the executives’ testimony the only evidence before me, I am not sure how persuaded I would be of GECC’s motives.”).

28See id. at 109 n.33 (noting that it was impossible to determine which part of the Dutch banks’ investment was used to purchase aircraft or retire GECC debt because “money is fungible”).

29See id. at 113 n.37 (indicating that pretax profit would be relevant only if compared to GECC’s cost of capital).
most plausible nontax business purpose was its desire to “monetize” its aging aircraft and to signal that ability to the market. Even that goal was inherently self-limiting, however, because the proposed section 704(c) antiabuse rule prevented GECC from duplicating the shelter for property contributed after the effective date of the final regulations. Thus, Castle Harbour implicitly raises the issue of whether the business purpose requirement is satisfied if the taxpayer’s purported nontax business objectives can be realized only by signaling the ability to replicate a shelter transaction that has already been identified as abusive.

III. Section 704(c) Abuse and Business Purpose

A. Ceiling Rule Distortion

The Castle Harbour transaction was carefully structured to reduce GECC’s tax liability, while literally complying with the traditional method of section 704(c) allocations.35 The traditional method mandates that “tax follow book,” that is, the noncontributing partner must be allocated tax items equal to that partner’s share of book items to the extent available.36 If the partnership lacks sufficient tax items to match book items allocable to the noncontributing partners, the ceiling rule comes into play. The ceiling rule, which dates from the 1954 code, limits the amount of income, gain, or loss that can be taken into account to the partnership’s actual tax items.37

In effect, the ceiling rule countenances temporary shifting of built-in gain inherent in section 704(c) property from the contributing partner to the noncontributing partners. Although ceiling rule distortions are routine, manipulation of the ceiling rule may be abusive, particularly when coupled with contributions of low-basis, high-value depreciable property with a short recovery period and a longer economic life.

To understand the section 704(c) abuse, it is useful to consider the Castle Harbour partnership’s first full year of operations. Assume that, in 1994, the partnership realized gross income of $100 from lease of the aircraft and incurred cash operating expenses of $25, leaving taxable income of $75. In addition, assume that the partnership took book depreciation of $65 and tax depreciation of zero with respect to the aircraft. Thus, the partnership’s book income would be $10 ($100 gross income less $25 cash expenses less $65 book depreciation), or $65 less than its taxable income. According to the partnership agreement, operating income (both book and tax) would be allocated 98 percent to the Dutch banks and 2 percent to GECC. The impact of those allocations on the partners’ tax and book capital accounts can be summarized as follows:

<table>
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<tr>
<th>Allocation</th>
<th>Dutch Banks</th>
<th>GECC</th>
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<tbody>
<tr>
<td>Rent</td>
<td>$98</td>
<td>$2</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(63.7)</td>
<td>(1.3)</td>
</tr>
<tr>
<td>Expenses</td>
<td>(24.5)</td>
<td>(0.5)</td>
</tr>
<tr>
<td>Bottom line</td>
<td>$73.5</td>
<td>$0.2</td>
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Nearly all of the partnership’s taxable income would be allocated to the Dutch banks ($73.50), even though their book capital accounts increased by a much smaller figure ($9.80). The difference, of course, represents the amount of book depreciation allocated to the Dutch banks ($63.70) that is not matched by any tax depreciation, since the aircraft were fully depreciated for tax purposes.38

B. Antiabuse Rule

Before 1984, partners were permitted to shift built-in gain attributable to contributed property freely among themselves, on the theory that such shifting represented mere “deferral.” To the extent that all partners are taxed at identical rates, shifting of built-in gain affects only the timing of each partner’s tax liability, not the partners’ aggregate tax liability. Although the 1954 code permitted partners to mitigate the tax consequences of shifting built-in gain on an elective basis, the ceiling rule might nevertheless prevent complete elimination of that shifting. When Congress revised section 704(c) in 1984 to mandate that partners take into account book-tax disparities with respect to contributed property, the ceiling rule survived. Treasury apparently considered that it lacked authority to simply repeal the rule.39

Under the current section 704(c) regulations, the traditional method — one of three permissible allocation methods — is essentially identical to the elective method under the 1954 code, which embodied the ceiling rule. The other two permissible allocation methods — the traditional method with curative allocations and the

34As the court recognized, this goal implicated more “appearance or marketing” interests than “purely economic interests.” Closing Arguments, Doc 2004-21979, 2004 TNT 221-18 (Nov. 15, 2004) (Underhill, J.); see id. (noting “fairly high cost of achieving nonmonetary goals when the ultimate economic return, not considering taxes, was certainly below what the evidence suggested GECC sought in the ordinary course of business”) (Underhill, J.).

35The traditional method is now found in reg. section 1.704-3(b)(1).

36Although allocations of tax items with respect to contributed or revalued property cannot have economic effect, the partnership’s allocation of book items will be respected under the section 704(b) regulations if the corresponding tax items are allocated under the rules of section 704(c). Reg. section 1.704-1(b)(1)(vi), -1(b)(4)(i).

37See Cunningham, “Use and Abuse of Section 704(c),” 3 Fla. Tax Rev. 93, 101-103 (1996) (discussing origin of the ceiling rule); Marich and McKee, “Sections 704(c) and 743(b): The Shortcomings of Existing Regulations and the Problems of Publicly-Traded Partnerships,” 41 Tax L. Rev. 627, 635 (1986) (describing ceiling rule as “a product of the entity-aggregate conflict that is deeply embedded within Subchapter K”).

38During 1994, the Dutch banks’ book capital accounts actually increased by about $10 million (the allocation of book operating income) and decreased by about $40 million (the distribution of Exhibit E payments).

39See Cunningham, supra note 37 at 116.
remedial method — both provide taxpayers an opportunity to mitigate or entirely eliminate ceiling rule distortions. The choice of an allocation method is respected provided that the particular method chosen is reasonable. An allocation method is considered unreasonable when the contribution of property and corresponding allocation of tax items “are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners’ aggregate tax liability.” When an allocation method is deemed unreasonable, the section 704(c) antiabuse rule overrides the traditional method by requiring curative allocations to remedy ceiling rule distortions.

The section 704(c) antiabuse rule, proposed in 1992 and finalized in 1993, represents a specific application of the general principle that the partnership form may not be used to accomplish results inconsistent with the purpose of subchapter K. Some commentators have argued that the section 704(c) antiabuse rule should be interpreted narrowly to avoid a “back door repeal” of the ceiling rule. Otherwise, taxpayers would arguably be penalized for failing to adopt the curative (or remedial) allocation method that Treasury lacked authority to impose directly. Clearly, the section 704(c) antiabuse rule cannot be construed so broadly as to prohibit shifting of taxable income whenever the ceiling rule comes into play. Rather, the prohibited abuse occurs only to the extent the parties structure a transaction with the requisite view to shift taxable income in a manner that reduces the partners’ aggregate tax liability.

The section 704(c) antiabuse rule should make it impossible to replicate the result in Castle Harbour. Under current law, the antiabuse rule would presumably require the partnership to make curative allocations to remedy the shortfall in tax depreciation allocable to the Dutch banks. As illustrated below, curative allocations would shift taxable income away from the Dutch banks to GECC, thereby fully eliminating the ceiling rule distortion:

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<th>Dutch Banks</th>
<th>GECC</th>
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<tbody>
<tr>
<td></td>
<td>Tax</td>
<td>Book</td>
</tr>
<tr>
<td>Rent</td>
<td>$98</td>
<td>$98</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(63.7)</td>
<td>(1.3)</td>
</tr>
<tr>
<td>Expenses</td>
<td>(24.5)</td>
<td>(24.5)</td>
</tr>
<tr>
<td>Bottom line</td>
<td>73.5</td>
<td>9.8</td>
</tr>
<tr>
<td>Curative allocation</td>
<td>(63.7)</td>
<td>63.7</td>
</tr>
<tr>
<td>Revisted bottom line</td>
<td>$9.8</td>
<td>$9.8</td>
</tr>
</tbody>
</table>

Because curative allocations affect only tax items, the partners would end up with identical book results over the life of the partnership. The Dutch banks would be allocated taxable income equal to their share of the partnership’s book income, while the remaining taxable income would be allocated entirely to GECC. Thus, taxable income equal to approximately 98 percent of the partnership’s book depreciation would be reallocated to GECC, eliminating the tax benefit to GECC from redeprecating the aircraft.

By capitalizing the partnership in July 1993 — after issuance of the proposed section 704(c) regulations but before the Dutch banks were identified as partners — GECC successfully forestalled application of the antiabuse rule. GECC’s contribution of fully depreciated aircraft with a fair market value greatly in excess of their tax basis, coupled with an allocation of book income to the Dutch banks disproportionate to their percentage interests in the partnership, was clearly driven by the favorable tax consequences that resulted from the interaction of the ceiling rule and the tax-exempt status of the Dutch banks. But for the tax savings resulting from the ceiling rule abuse, the transaction would not have been sufficiently profitable for GECC to undertake, since it needed to compensate the Dutch banks for their participation. Despite the court’s findings, it is not clear that GECC had an “adequate business purpose to neutralize any tax-avoidance motive.”

C. Lack of Business Purpose

The section 704(c) antiabuse rule focuses narrowly on the interaction between particular contributed property and the partnership’s allocations of tax and book income. In Castle Harbour, the court did not consider whether the contribution of zero-basis, high-value aircraft combined with the partnership’s book allocations were rationally related to GECC’s business objectives, apart from taxes. Because the government conceded that the book allocations had economic effect (albeit not necessarily substantial economic effect), the court may have thought that this line of inquiry was foreclosed. Nevertheless, allocation of a large percentage of book income to the Dutch banks

40See reg. section 1.704-3(c), (d).
41See reg. section 1.704-3(a)(10).
42See reg. section 1.704-3(b)(2) Ex. 2, -3(c)(4) Ex. 3. Like Castle Harbour, the two antiabuse examples both involve contribution of low-basis, high-value depreciable property with a short recovery period and a longer economic life.
43See reg. section 1.701-2(a), (b). The relationship between the section 701 antiabuse rules and tax-driven allocations is outside the scope of this article. See, e.g., Leder, supra note 6 at 783-85.
44Cunningham, supra note 37 at 118.

45GECC apparently did not contest that the transaction would have run afoul of the antiabuse rule if the property had been contributed after December 21, 1993, the effective date of the final regulations. See Plaintiff’s Posttrial Brief 34 (Aug. 4, 2004). As the court noted, the prior regulations did not permit the partnership to remedy ceiling rule distortions by allocating “non-existent depreciation deductions to the banks.” Castle Harbour, 342 F. Supp.2d at 121.
46Because the noneconomic income would have been taxable to a U.S. entity, an equity investment would have been substantially more expensive. See Plaintiff’s Trial Brief, supra note 16 at 30.
48See Castle Harbour, 342 F. Supp.2d at 118 (“It is not disputed that Castle Harbour’s allocations had “economic effect.””); cf. FSA 200108003, Doc 2001-5443, 2001 TNT 38-13 (Feb. 23, 2001) (involving facts similar to Castle Harbour; economic effect may be lacking because foreign banks never received an economic benefit corresponding to the allocation of taxable income).
made sense precisely to “attract” a correspondingly large percentage of taxable income that would not be offset by any tax depreciation. The Dutch banks did not receive an economic benefit equal to the $310 million of taxable income allocated to them; rather, they received the economic benefit of a much smaller amount of book income equal to the net increase in their capital accounts.49

Admittedly, once the book allocations were agreed on, the allocation of tax items automatically followed the allocation of book items under the section 704(c) regulations.50 The parties agreed that, under the section 704(b) regulations, the allocation of book items drove the allocation of section 704(c) items. In fact, however, the partnership’s book allocations were undertaken only once their tax consequences were fully predictable. GECC’s assertions that ceiling rule distortions are ubiquitous or that the section 704(b) regulations somehow failed to respect the partnership’s section 704(c) allocations only if the underlying section 704(b) allocations were valid.

The court believed that the “large allocation [of book income] provided a rational method of liquidating the Dutch banks’ partnership interests over a relatively short period of time.”52 In fact, the transaction could have been structured much more straightforwardly as a section 707(c) guaranteed payment (rather than a section 704(b) allocative share) equal to the specified minimum return.53 The disadvantage of a section 707(c) guaranteed payment was that GECC (not the Dutch banks) would have been forced to bear the consequences of the shortfall in tax depreciation.54 If the goal were simply to buy out the Dutch banks and provide a specified minimum return, it would not have been necessary to allocate 98 percent of the partnership’s book income to the Dutch banks. Because the book income allocated to the Dutch banks exceeded their anticipated economic return by the amount of the nonexistent tax depreciation deductions, however, the book allocations were essential to achieve the partners’ desired after-tax economic consequences. Of course, the court might have found that the lack of a business purpose for the partnership’s book allocations was better addressed by the section 704(b) regulations than by the economic substance doctrine.

Because the Castle Harbour transaction was only tangentially related to GECC’s business, it should not fit within any exception to the economic substance doctrine for transactions tied to the taxpayer’s ordinary business.55 The showing of “any” business purpose, no matter how minimal, should not suffice to outweigh an abusive tax motivation. At most, the Castle Harbour transaction represented a one-shot opportunity to reap tax benefits from the section 704(c) abuse. As shown by the early formation of the partnership, GECC’s advisers understood perfectly well the self-limiting nature of this strategy. Because the section 704(c) abuse was soon to be shut down, the transaction’s future value in terms of “signaling” GECC’s ability to monetize its aging aircraft was nil. Under those circumstances, the formation of the partnership was no less a sham merely because the Dutch banks were guaranteed a minimum return rather than an exact amount.56 The application of the sham transaction doctrine should not be affected by mere window dressing.

IV. Partners’ Interest Standard: Circular Approach

A. Overall-Tax-Effect Test

The government’s alternative argument in Castle Harbour was that the partnership’s book allocations lacked substantial economic effect. Under the section 704(b) regulations, an allocation that has “economic effect” may nevertheless be invalid if it fails to satisfy the “substantiality” requirement.57 The strongest version of the substantiality requirement — the overall-tax-effect test — looks to whether an allocation will enhance the after-tax economic consequences of at least one partner without

49Cf. Castle Harbour, 342 F. Supp.2d at 118 (“It is therefore crystal clear that the Dutch Banks agreed to receive — and actually did receive — the economic benefit of 98 percent of all the Operating Income . . . .”) The court’s statement is accurate only under the bottom-line definition of “operating income” set forth in the partnership agreement. See supra notes 12 and 22.
50See Lipton and Austen, supra note 2 at 41 (”Put simply, the IRS was hoist on its own petard . . . .”).
51See Plaintiff’s Posttrial Brief, supra note 45 at 32 (noting that “[t]he ceiling rule was not obscure or esoteric”).
52Castle Harbour, 342 F. Supp.2d at 121 n. 44.
53Indeed, the court found that the Dutch banks were entitled to a “guaranteed . . . minimum return,” though not a maximum (or certain) return. Id. at 117; cf. Hunt v. Comm’r, 59 T.C.M (CCH) 635 (1990) (right to 18 percent return and repayment of 98 percent of investment guaranteed by other partners; partnership interest respected as equity).
54Under section 707(c), GECC would presumably have been entitled to interest deductions for any guaranteed payments. Cf. Steinberg, “Fun and Games with Guaranteed Payments,” 57 Tax Law 533, 546-554 (2004) (arguing that guaranteed payments on a partner’s capital should generally not be treated as interest because they do not constitute indebtedness). Because guaranteed payments can produce the same economic results as allocations of income, gain or loss, those payments should logically be taken into account for purposes of the overall-tax-effect test under the section 704(b) regulations. See Leder, supra note 6 at 768-69; Buchholz, supra note 8 at 243-44.
55Castle Harbour illustrates the slippery slope nature of any “ordinary course of business exception” for tax shelters. See Bankman, supra note 4 at 17-20; id., “The Tax Shelter Problem,” 57 Nat’l Tax J. 925, 929 (2004) (noting that the “continued utility [of the economic substance doctrine] depends on taxpayers not being able to tie shelter transactions into existing businesses”).
56In fact, the actual return to the Dutch banks differed by only approximately $80,000 from the 9 percent target rate. See U.S. Trial Brief 31-32 (July 8, 2004). GECC maintained that the actual return would have diverged more significantly from the target return but for unexpected gain on disposition of aircraft. See Closing Arguments, Doc 2004-21979, 2004 TNT 221-18 (Nov. 15, 2004) (Nelson). The partnership’s aggressive book depreciation schedule meant, however, that the fair market value of the aircraft could be expected to substantially exceed its depreciated book value, generating significant book gain on actual disposition or revaluation of the aircraft. See supra note 13.
57See reg. section 1.704-1(b)(2)(i).
substantially diminishing the after-tax economic consequences of any other partner (in present value terms). The purpose of the overall test is to ferret out tax-driven allocations that reduce the partners’ aggregate tax liability at the sole expense of the government. When an allocation is invalid under the overall test, the tax consequences must be reallocated to reflect the partners’ economic sharing arrangement, that is, the partners’ interests in the partnership (PIP).

In Castle Harbour, the central issue concerned how to identify, for purposes of the overall test, the proper baseline allocation(s) against which to test the actual allocation(s) contained in the partnership agreement. The government argued that the allocations contained in the partnership agreement should be tested against hypothetical allocations based on the partners’ relative book capital account balances. Compared with those baseline allocations, the actual allocations in the partnership agreement violated the overall test because they enhanced the after-tax economic consequences to GECC by approximately $26 million ($56 million tax savings less $30 million payment to the Dutch banks), while leaving the Dutch banks better off by $30 million. Applying the comparative liquidation method, the government proposed to reallocate approximately $25 million of book income ($284 million of taxable income) from the Dutch banks to GECC. See table above. By contrast, GECC claimed that the allocations under the partnership agreement satisfied the overall test and, alternatively, PIP should be determined based on the partnership agreement, not the partners’ relative ownership interests.

GECC also criticized the government for improperly resorting to section 704(b) to address the section 704(c) ceiling rule problem.

B. Circular Analysis

The court gave short shrift to the government’s argument that the partnership’s book allocations violated the substantiality requirement. It dismissed the government’s notion that PIP corresponded to relative ownership interests as apparently “made out of whole cloth,” noting that the partners’ relative capital contributions were only one factor to be considered in determining the partners’ economic sharing arrangement. While the partnership agreement contains express allocations that have economic effect, the court concluded that (1) PIP “is determined by reference to the agreement, not by reference to ownership interest[s],” and (2) “this determination is not circular.” In Castle Harbour, “there was simply no ground” for arguing that the partners’ sharing arrangement was anything other than a ratio of 98:2. Thus, the overall test was not applicable because there was no difference between the baseline allocations and the actual allocations. Even if the overall test were applicable, reassigning the partnership’s book income in accordance with PIP would not alter the actual results.

The government expressed concern that determining PIP based on actual allocations would render the overall test meaningless: If PIP and the partnership’s actual allocations were always identical, it would be “logically impossible to violate” the overall test. The court rejected the government’s objection that determining PIP based on actual allocations would render the overall test meaningless: If PIP and the partnership’s actual allocations were always identical, it would be “logically impossible to violate” the overall test.
by reference to the partnership agreement was circular. Based on Example 5 of the section 704(b) regulations, the court concluded that any circularity was more apparent than real.68 The example involves an invalid special allocation of taxable and tax-exempt interest income in a two-person partnership in which all other items are shared in the ratio 50:50.69 Taking into account the partners’ differing tax brackets, the source-based special allocation violates the overall test. Nevertheless, the regulations give full effect to the relative changes in the partners’ book capital accounts resulting from the allocation.70

Although pure character allocations cannot have substantial economic effect, the section 704(b) regulations recognize that the amount of those allocations can have economic effect. Accordingly, the character rules require a pro rata reallocation, based on capital-account analysis, under which each partner is deemed to have the identical fraction of each item that makes up the total gain or loss.71 The pro rata reallocation method respects the economic effect produced by the character allocation but rectifies the improper character assignment. The court mistakenly believed that Example 5 supported a general principle that PIP should always be determined by reference to the partnership agreement when an allocation has economic effect but lacks substantiality.72 In fact, Example 5 deals only with a subset of insubstantial allocations that assign income items based solely on their tax characteristics. Although pure character allocations are likely to be abusive, the section 704(b) regulations also prohibit other types of tax-driven allocations that seek to minimize the partners’ overall taxes.

The circularity of the court’s approach is apparent if one considers the underlying purpose of the substantial-economic-effect test — namely, to discourage tax-motivated allocations that lack a business purpose (or principal business purpose).73 Specifically, the overall test focuses on the partners’ “economic motivation apart from tax consequences as the touchstone of validity.”74 Because tax-driven allocations reflect the partners’ anticipated tax savings, those allocations cannot serve as a reliable guide to the partners’ pretax economic arrangement. Otherwise, PIP would be determined based on after-tax economic consequences rather than the partners’ pretax sharing arrangement. If an allocation is determined to be defective under the overall test, it is necessary to consider a range of factors in determining how particular items should be reallocated.75 Given the wide variety of circumstances in which tax-driven allocations may arise, it is perhaps not surprising that the section 704(b) regulations provide few precise guidelines for remedying violations of the overall test. While the PIP standard seems to be intentionally vague or ambiguous, the dearth of case law or other guidance may encourage taxpayers to take overly aggressive positions as in Castle Harbour.76

C. Reallocation Method

The overall test requires a comparison of the tax consequences of an actual allocation under the partnership agreement with the tax consequences that would have obtained if the partnership agreement had lacked that allocation. Under prior law, an allocation would not be respected if its principal purpose was “avoidance or evasion.” In amending section 704(b) in 1976, Congress eliminated the principal purpose test and made explicit the requirement that an allocation must have “substantial economic effect.” Despite those changes, the elaborate mechanical tests under the substantial-economic-effect regulations serve a similar purpose as the more subjective tax-avoidance-or-evasion standard.77 Under the

68 See reg. section 1.704-1(b)(5) Ex. 5. Another example addresses the present value component of the overall test. See reg. section 1.704-1(b)(5) Ex. 9.
69 In Ex. 5, the partners agree to specially allocate tax-exempt interest 80 percent to the high-bracket partner and 20 percent to the low-bracket partner, while specially allocating the partnership’s taxable interest and dividends entirely to the high-bracket partner; the partnership anticipates earning roughly equal amounts of each type of income.
70 In Ex. 5, the baseline allocation (in the ratio 64:36) differs from both allocations specified in the partnership agreement, that is, the partners’ overall 50:50 sharing ratio and the invalid special allocation. See reg. section 1.704-1(b)(5) Ex. 5(ii).
71 See Gunn, “The Character of a Partner’s Distributive Share Under the ‘Substantial Economic Effect’ Regulations,” 40 Tax L. Rev. 121, 127 (1986); id. at 132 (“Every reallocation under an agreement held to have an economic effect that is not ‘substantial’ is accomplished by allocating the items pro rata.”).
72 See Castle Harbour, 342 F. Supp.2d at 120 (concluding that analysis is not circular because the pro rata reallocation method “can lead to different allocations, particularly in cases where items are allocated based on their taxable characteristics”).
73 See Buchholz, supra note 8 at 177 (noting that the section 704(b) regulations “implicitly establish a tax-avoidance standard by using a mechanical test which leaves many issues unresolved”).
74 Utz, supra note 8 at 380.
75 The regulations provide that PIP is determined by “taking into account all facts and circumstances relating to the economic arrangement of the partners.” Reg. section 1.704-1(b)(3)(i), -1(b)(3)(ii) (factors).
76 See Lokken, “Partnership Allocations,” 41 Tax L. Rev. 545, 614 (1986) (“Meaningful generalization about the application of these factors is not possible.”).
78 See Buchholz, supra note 8 at 183 (noting that the “mathematical tests should probably be viewed as a surrogate for a subjective tax avoidance test”).
virtual-economic-agreement standard applicable if a partnership’s express allocations have economic effect but lack substantiality, the section 704(b) regulations require a determination of what the parties would have agreed to in a no-tax world.78

The overall test requires that partners have advance knowledge concerning the likely after-tax economic consequences when the partnership’s allocations are agreed on. Unless the after-tax economic consequences can be predicted with relative certainty, it is impossible at the outset to determine whether tax-driven allocations actually improve at least one partner’s after-tax results without harming any other partner. Thus, that predictability is an integral component of the overall test, justifying heightened scrutiny of allocations that are made after significant facts concerning the composition of the partnership’s income and deductions become known. In Castle Harbour, the predictability of the lease income combined with the cost recovery rules made it possible to fine tune the partnership’s allocations to minimize the partners’ aggregate tax liability, without sacrificing too much of GECC’s economic upside. Because they were essentially retrospective in nature, the partnership’s allocations of predictable book income offset by book depreciation revealed little concerning the partners’ risk-sharing arrangement.79

While the court’s analysis is circular, the government’s relative ownership test for determining PIP also appears defective. In relationship to the PIP standard, the partners’ capital contributions may often be a “meaningless factor” and easily susceptible to manipulation.80 Moreover, subchapter K does not require that all partnership items be allocated in an identical manner. In Castle Harbour, the court was apparently concerned that, under the government’s approach, the overall test would potentially invalidate any allocation of income to a tax-exempt entity that deviated from the partners’ relative ownership interests.81 But the function of the overall test is more limited: It prohibits tax-driven allocations only when the after-tax economic consequences can be predicted with a high degree of certainty. While the overall test is potentially sufficiently broad to reach virtually all tax-driven allocations,82 most such allocations will nevertheless pass muster because the actual economic results are uncertain or dependent on the risks of the partnership’s business.

The government’s relative ownership test departed significantly from the comparative liquidation method used to cure defective allocations under the special partners’ interest test.83 The comparative liquidation method requires a year-by-year comparison of the partnership’s allocations and the amounts to which the partners would be entitled on a hypothetical liquidation of the partnership. By reducing the book income allocable to the Dutch banks, the government increased the taxable income allocated to GECC, but simultaneously distorted the partners’ actual economic results. Thus, the partners’ hypothetical book capital accounts, based on relative ownership interests, bore no relationship to their actual book capital accounts as determined under the agreement. Accordingly, GECC could argue plausibly that the government’s approach violated the fundamental principles of the section 704(b) regulations.84

By focusing exclusively on relative ownership interests, the government ignored the most significant element of the Castle Harbour transaction: the Dutch banks’ guaranteed minimum return. Under the PIP standard, the partners’ interests are to be determined by taking into account all of the facts and circumstances relating to the partners’ economic arrangement. The factors to be considered under the PIP standard include the partners’ interests in “economic profits and losses (if different from that in taxable income or loss)” and the partners’ interests in “cash flow and other non-liquidating distributions.”85 In effect, the Exhibit E payments and the Dutch banks’ investment accounts together completely described the partners’ economic arrangement 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. Thus, the government should have argued that the baseline comparison was the amount of gross operating income that, if allocated annually to the Dutch banks (and adjusted to reflect Exhibit E payments), would

78 See Utz, supra note 8 at 357 n. 3 (suggesting that the virtual-economic-agreement standard resembles the pre-1985 standard of reallocation that simply disregarded a defective express allocation).
79 See Rev. Rul. 99-43, 1999-2 C.B. 506, Doc 1999-33519, 1999 TNT 200-7 (disregarding special allocations of book income from debt discharge and offsetting revaluation loss; allocations were effectively retroactive because made after the encumbered property declined in value).
80 See Leder, supra note 6 at 794.
82 As one commentator concluded, “the substantiality rules are so sweeping that they can be used as authority for striking down practically any allocation that a court dislikes.” Gunn, supra note 71 at 136.
83 See reg. section 1.704-1(b)(3)(iii).
84 See Plaintiff’s Posttrial Brief, supra note 45 at 29 (“Allocating book income to one partner’s capital account when another partner is the real economic beneficiary of that book income is antithetical to section 704(b), yet that is precisely what the government is advocating in this case.”); id. at 26 (“The approach used by the government would be unrecognizable to the drafters of the section 704(b) regulations.”).
generate the guaranteed 8.5 percent return. For example, assume that in 1994 the Dutch banks were allocated 9.8 percent of the partnership’s gross operating income (and no other items) based on the actual net increase in their book capital accounts:

<table>
<thead>
<tr>
<th>Income</th>
<th>Dutch Banks</th>
<th>GECC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent</td>
<td>$9.8</td>
<td>$90.2</td>
</tr>
<tr>
<td>Depreciation</td>
<td>$90.2</td>
<td>$90.2</td>
</tr>
<tr>
<td>Expenses</td>
<td>(65.0)</td>
<td>(25.0)</td>
</tr>
<tr>
<td>Bottom line</td>
<td>$9.8</td>
<td>$65.2</td>
</tr>
</tbody>
</table>

Although the reallocation respects the economic effect created by the partnership’s actual allocations, the Dutch banks would no longer be allocated taxable income in excess of their anticipated economic income. Reallocation under PIP would simply ignore the defective 98:2 allocation of noneconomic income, which was driven by tax rather than economic considerations.

Over the life of the partnership, the Dutch banks received total payments of approximately $150 million, while GECC received approximately $728 million. Thus, the Dutch banks received roughly 17 percent of the partnership’s total liquidating and nonliquidating distributions. Overall, the partnership had total book income of approximately $165.6 million, consisting of $28.6 million book operating income (allocated $28 million to the Dutch banks and $0.6 million to GECC) and $137 million of cumulative disposition gain (allocated $4 million to the Dutch banks and $133 million to GECC). Accordingly, the Dutch banks were allocated approximately 19 percent of the partnership’s total book income. Thus, based on the factors relevant to determining PIP, the court might have found that the Dutch banks had roughly an 18 percent overall interest in the partnership commensurate with their initial capital contributions. If the Dutch banks were allocated book items equal to their 18 percent ratable share of the partnership’s operating income and cumulative disposition gain (rather than 98 percent of operating income and a minuscule share of cumulative disposition gain), their share of taxable income would be greatly reduced. Of the partnership’s taxable operating income of $316 million, the Dutch banks would be allocated only $57 million (18 percent) rather than $310 million (98 percent). GECC’s share of taxable operating income would be correspondingly increased, resulting in $51 million of additional tax liability.

On appeal, the Second Circuit must determine how to apply the partners’ interest standard. While the regulations do not provide precise guidance for determining PIP, the district court’s circular analysis is flawed. As the section 704(b) regulations recognize, different allocation formulas may produce identical economic results. Despite the paucity of authority aimed at uncovering the partners’ pretax economic arrangement when an express allocation violates the overall test, the PIP standard is quite flexible. It requires a case-by-case analysis to determine whether allocations under the partnership agreement reflect the partners’ economic interests apart from taxes.

V. Conclusion

In *Castle Harbour*, the court was confronted by a well-crafted but abusive transaction that sought to exploit the outer limits of the section 704(b) regulations. The court evidently viewed the government’s section 704(b) argument as a backdoor attempt to remedy the section 704(c) abuse or to reargue the sham transaction doctrine. Noting that the government was “understandably concerned that the Castle Harbour transaction deprived the public fisc of some $62 million in tax revenue,” the court believed that any remedy should be left “to those who write the tax laws.” Indeed, commentators have suggested that the lesson of *Castle Harbour* is that Congress should simply repeal “attractive nuisances” such as the ceiling rule under section 704(c). Taken seriously, such a view might warrant repealing outright most of the elective features of subchapter K that have been vociferously defended on grounds of administrative convenience or the desire not to impede legitimate business transactions.
To date, most shelters that have failed to withstand scrutiny under the economic substance doctrine have lacked any nontax business purpose. At first glance, Castle Harbour may appear to present a closer call, because the sought-after tax benefits were arguably related to GECC’s ordinary business. As a result, GECC could plausibly claim that the transaction had been entered into for a bona fide business purpose, notwithstanding the presence of significant tax benefits. Nevertheless, the manner in which the partnership’s allocations were structured was clearly not necessary to accomplish GECC’s business objectives independent of taxes. The contribution of the particular property and the partnership’s book allocations were driven entirely by the interaction between the ceiling rule abuse and the Dutch banks’ tax-exempt status. Even without the specific anti-abuse rule now contained in the section 704(b) regulations, GECC’s tax-avoidance motive should have been fatal to recognition of the partnership form.

If the Castle Harbour transaction is disregarded as a sham, the section 704(b) issue would be moot. It seems puzzling that the overall test for invalidating tax-driven allocations has thus far received scant judicial attention. Given the unanswered questions concerning the application of the partners’ interest standard, the lack of guidance might seem to invite aggressive tax planning designed to exploit opportunities presented by the relatively mechanical tests under the economic-effect safe harbor. The court’s circular interpretation of the overall test should clearly be rejected as incompatible with the underlying purpose of the section 704(b) regulations. When a partnership’s express allocations fail to satisfy the overall test, the partners’ interest standard is intended to have an in terrorem effect and to give the IRS and courts the flexibility needed to reallocate partnership items on a case-by-case basis. If upheld on appeal, Castle Harbour threatens to undermine the administrability of such a flexible standard as a means of deterring sophisticated tax shelter abuses.

Appendix

Trial Briefs:
- Plaintiff’s Trial Brief (July 8, 2004)
- Plaintiff’s Posttrial Brief (Aug. 4, 2004)
- U.S. Trial Brief (July 8, 2004)
- Brief for the Appellant (May 2005)

Miscellaneous:
- Joint Trial Memorandum (July 8, 2004)
- Defendant’s Proposed Findings of Uncontroverted Fact and Conclusions of Law (July 8, 2004)

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96 See Buchholz, supra note 8 at 275.