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All in the Family: *Castle Harbour* Gives New Meaning to Extended Family

By David Libman • Wood & Porter • San Francisco

It is hardly noticeable these days when individuals and business entities formulate sophisticated and creative transactions to raise capital. Almost invariably, at least one piece of the financial puzzle involves forming one or more partnerships. In a recent case on remand from the Second Circuit Court of Appeals, the U.S. District Court for the District of Connecticut issued an opinion that serves as a reminder that Internal Revenue Code Section ("Code Sec.") 704(e)'s "Family partnerships" provision does not just apply to family members. [*See TIFD III-E Inc.*, DC-CT, 2009-2 (Oct. 23, 2009) ("*Castle III*").]

The court applied Code Sec. 704(e)(1) to uphold the validity of the partnership interests of corporate entities that were decidedly *not* family members. That makes this latest in the *Castle Harbour* saga worth a read.

Family History

Like all family squabbles and many disagreements of a more sanguine variety, this dispute involves a bit of history. In 1993, Castle Harbour (a Nevada limited liability company) was formed as a self-liquidating partnership. Its partners consisted of two Dutch banks and some subsidiaries of General Electric Capital Corporation ("GECC"). TIFD III-E (a Delaware corporation) was one of those GECC subsidiaries.

The partners formed Castle Harbour as part of a complex transaction designed to raise capital for GECC's aircraft leasing business. Pursuant to the transaction, GECC contributed approximately $294 million worth of leased aircraft. The Dutch banks contributed approximately

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$117.5 million in cash. TIFD III-E was Castle Harbour's tax matters partner.

Castle Harbour's operating agreement allocated partnership income according to two defined categories: (1) operating income, and (2) disposition gains/losses. Operating income came from items such as rent and interest. Disposition gains and losses came from items such as the sales of aircraft.

The operating agreement entitled the Dutch banks to almost all of the operating income upside, plus a small portion of the disposition upside. The Dutch banks bore some, but only minimal risk, from operating or disposition losses. Furthermore, the operating agreement provided for an annual buyout of the Dutch banks' partnership ownership interests. Over time, it would essentially reduce the Dutch banks' capital interests to zero.

Castle Harbour filed partnership income tax returns from 1993 to 1998. In 1998, GECC bought out the Dutch banks, and the partnership liquidated. The Dutch banks were foreign entities not subject to U.S. income tax. Under the operating agreement's allocation method, these foreign entities were allocated much more of the partnership's taxable income than its book income. This allocation gave the Dutch banks $310 million in taxable income. If that income had been allocated to GECC, it would have been required to pay approximately $62 million in taxes.

Castle I

In 2001, the IRS issued two notices of Final Partnership Administrative Adjustment (FPAAs) concerning Castle Harbour. The FPAAs attributed approximately $310 million of additional income to TIFD III-E (Castle Harbour's tax matters partner), causing an additional tax liability of approximately $62 million. TIFD III-E deposited the $62 million with the IRS. TIFD III-E then sued for a refund in the U.S. District Court for the District of Connecticut. The results of that eight-day trial are reported at *TIFD III-E Inc.*, DC-CT, 2004-2, ¶50,401, 342 FSupp2d 94 (2004) ("*Castle I*").

The district court held against the IRS. The FPAAs were in error said the court, and the IRS must refund the $62 million plus interest. The district court determined that (1) Castle Harbour was not formed pursuant to a sham transaction; (2) the Dutch banks were partners rather than lenders both in economic reality and for tax purposes; and (3) the partner entities' allocation of Castle Harbour's income did not violate the "overall tax effect" rule of Code Sec. 704(b).

How does one determine the latter? Not surprisingly, that devolves to a facts-and-circumstances test. Code Sec. 704(b) will govern a partner's distributive share of income, gains, losses, deductions or credits if the partnership agreement fails to so provide, or does so in a manner lacking substantial economic effect.

Castle II

On appeal, the Second Circuit held that the district court erred as a matter of law in rejecting the government's argument that the Dutch banks were not *bona fide* equity partners for tax purposes. *TIFD III-E, Inc.*, CA-2, 2006-2 USTC ¶50,442, 459 F3d 220, 231 (2006) ("*Castle*

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II"). The Second Circuit found the error to be due to the district court's failure to fully consider the test set forth in the Supreme Court's decision in *W.O. Culbertson, Sr.*, CA-5, 52-1 USTC ¶9233, 337 US 733, 742 (1949).

Like a classic big Hollywood picture of the old days, none of us should forget *Culbertson.* There, the Supreme Court established the test for whether a true partnership exists for income tax purposes. One must consider *all* the facts and circumstances.

That means that when considering the agreement, the conduct of the parties in the execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent, the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise. [*Culbertson*, 337 US, at 742.]

In *Castle II,* The Second Circuit noted its view that the district court did not err by applying the sham transaction test to the partnership. Rather, the Second Circuit believed that the district court erred by failing to apply the *Culbertson* test to the Dutch banks' partnership interests (after it had determined that that the taxpayer's characterization survived the sham test).

The Second Circuit remanded the matter for the district court to consider yet another possibility to uphold the partnership's validity: TIFP III-E's argument that Castle Harbour constituted a partnership under Code Sec. 704(e)—a family partnership provision.

Castle III

On remand, the district court disagreed with the Second Court's conclusion that it had failed to apply the *Culbertson* analysis to address the question of whether the Dutch banks' interest constituted *bona fide* equity partnership participation. The district court noted that *Castle I* included a comprehensive discussion of the totality of the circumstances and of court decisions applying *Culbertson.* The district court emphasized that prior decisions considering *Culbertson* did not require a focus on whether the partnership interest constituted *bona fide* equity participation.

Nevertheless, Judge Stefan R. Underhill conceded that the Second Circuit "reached a different conclusion following its *Culbertson* analysis than I reached following mine." [*Castle III,* at *4, note 1.] The district court then explained that the question remained open as to whether the Dutch banks constituted partners under Code Sec. 704(e)(1). Code Sec. 704(e) is titled "Family partnerships."

Who Is a Partner?

Code Sec. 704(e)(1) states that a person is recognized as a partner for tax purposes "if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person." Such persons can include individuals or business organizations. [*See Castle III,* at *57–58.] Despite Code Sec. 704(e)'s "Family partnership" moniker, Code Sec. 704(e)(1) may apply to situations where the partners have no familial relationship. [*Castle III*, at *55–56.]

Indeed, Code Sec. 704(e)(1) sets forth an objective test for determining a partner's status. If the person owns a capital interest in a partnership in which capital is a material income-producing factor, that person is a partner. That means the person is taxed as one for federal income tax purposes.

Three-Part Test

The district court analyzed each prong of this three-prong test. First, the district court determined that the Dutch banks were the "real owners" of their partnership interests. It noted that the Dutch banks had no guaranteed return on their investment in Castle Harbour.

Moreover, even though other partners had primary control and management over the partnership, the Dutch banks had a right to force its liquidation. The Dutch banks also had real participation (although not a substantial participation) in the partnership's management. The Dutch banks were also consistently treated as partners with ownership interests.

Second, the district court assessed whether the Dutch banks had a capital interest in Castle Harbour. It noted that for purposes of Code Sec. 704(e), a capital interest exists when the assets of the partnership are distributable to the owner upon his withdrawal from the partnership or on the partnership's liquidation. A mere right to participate in partnership profits and earnings would not constitute a capital interest. The district court found that both a hypothetical liquidation test, and the results of the actual liquidation, demonstrated that the Dutch banks possessed capital interests in the partnership.

Then there was the third prong of the Code Sec. 704(e)(1) test. Here, the district court explained that the issue is whether capital is a material income producing factor of the *partnership*. This determination takes place at the *partnership* level. It does not depend on whether a particular participating partner's contribution is income-producing.

In fact, the court determined that capital was the *only* material income-producing factor. After all, Castle Harbour generated its income—not through fees or commissions—but through leasing commercial aircraft that it owned.

Having determined that the three-prong test of Code Sec. 704(e)(1) was satisfied, the district court identified case law suggesting that Code Sec. 704(e)(1) should now *replace* the *Culbertson* test. The district court did not emphatically say that *Culbertson* no longer applied. Yet it did conclude that Code Sec. 704(e)(1) provides an alternative test to determine the treatment of partnership interests for tax purposes.

New Alternative?

This means that it may be possible for an entity that is not a partner under *Culbertson's* analysis to still eek by. It might still be a partner under Code Sec. 704(e)(1)'s three-prong test. In light of the district court's determination that the Dutch banks held valid capital interests in the Castle Harbour partnership, it ordered the IRS to refund TIFD III-E's jurisdictional deposit plus interest.

It will be interesting to see just how far the not-so-family partnership will be taken. Stay tuned.