No. 15-331

In the Supreme Court of the United States

TIFD III-E, LLC, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTIONS PRESENTED

In *Commissioner* v. *Culbertson*, 337 U.S. 733 (1949), this Court announced a totality-of-the-circumstances test for determining whether a purported partnership should be treated as such for federal tax purposes. The Court framed the inquiry as whether "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." *Id.* at 742. The questions presented are as follows:

1. Whether the court of appeals correctly applied the *Culbertson* test to the facts of this case when it held that the financial arrangement at issue should not be treated as a partnership for federal tax purposes.

2. Whether the court of appeals correctly sustained the Internal Revenue Service's assessment of a negligence penalty, based on petitioner's failure adequately to investigate the proper tax treatment of the transaction and on the absence of apposite legal authorities supporting petitioner's tax-return position.

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OPINIONS BELOW

The opinions of the court of appeals are reported at 459 F.3d 220 (Pet. App. 116a-155a), 666 F.3d 836 (Pet App. 23a-49a), and 604 Fed. Appx. 69 (Pet. App. 2a-4a). The opinions of the district court are reported at 342 F. Supp. 2d 94 (Pet. App. 156a-210a), 660 F. Supp. 2d 367 (Pet. App. 50a-115a), and 8 F. Supp. 3d 142 (Pet. App. 5a-22a).

JURISDICTION

The judgment of the court of appeals was entered on May 19, 2015. On August 5, 2015, Justice Ginsburg extended the time within which to file a petition for a writ of certiorari to and including September 16, 2015, and the petition was filed on that date. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

This case involves a purported partnership between two Dutch banks and domestic subsidiaries of G.E. Capital Corporation (GECC) that GECC used in an attempt to shelter $310 million of income from tax. The Internal Revenue Service (IRS) disallowed the claimed tax benefits and assessed a 20% negligence penalty. The court of appeals held that the Dutch banks were not bona fide partners under *Commissioner* v. *Culbertson*, 337 U.S. 733 (1949), and that the penalty was appropriate because there was no reasonable legal basis for GECC's treatment of the Dutch banks as partners. Pet. App. 4a, 120a.

1. a. Under the Internal Revenue Code, a partnership is not treated as a separate taxable entity. Rather, a partnership's income, losses, and other tax items flow through to the individual partners, who report such items on their income-tax returns. 26 U.S.C. 701, 702. The Code defines "partnership" to include "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of [the Code], a corporation or a trust or estate." 26 U.S.C. 761(a).

Congress's intent in enacting the partnership tax provisions was to permit taxpayers to conduct joint business activities through a flexible economic arrangement without incurring an entity-level tax. The absence of entity-level tax, however, has long given rise to tax-avoidance schemes that attempt to manipulate the unique rules applicable to partnerships to gain tax advantages never intended by Congress. For example, some taxpayers used family partnership arrangements to shift taxable income from a person in a high tax-bracket to a family member in a low tax-bracket. The Court's seminal decision in *Culbertson*, which established a framework for determining when a partnership will be respected for income-tax purposes, addressed that tax-avoidance mechanism.

b. With the inception of the modern mass-marketed tax-shelter industry, tax-avoidance schemes have grown in scope and complexity, with taxpayers seeking to manipulate a wide array of partnership tax provisions and using multiple partnerships to execute such schemes. The IRS and the courts have generally sought to block the implementation of those arrangements.[1] In doing so, they have generally relied upon a series of legal doctrines recognized by this Court that allow courts to reject the form of a transaction—even one that complies with the literal terms of the Internal Revenue Code—and to redetermine the attendant tax consequences based on the substance of what actually occurred. See, *e.g.*, *Frank Lyon Co*. v. *United States*, 435 U.S. 561 (1978); *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945); *Gregory* v. *Helvering*, 293 U.S. 465 (1935).

[1] See, *e.g.*, *Chemtech Royalty Assoc. L.P.* v. *United States*, 766 F.3d 453 (5th Cir. 2014) (invalidating a lease strip tax shelter similar to the one employed in this case); *Superior Trading LLC* v. *Commissioner*, 728 F.3d 676 (7th Cir. 2013) (invalidating a "distressed asset/debt" shelter that manipulated partnership basis rules); *Nevada Partners Fund, LLC* v. *United States,* 720 F.3d 594 (5th Cir. 2013) (invalidating a "FOCus" shelter that created artificial tax losses through tiered partnerships); *Stobie Creek Inv. LLC* v. *United States*, 608 F.3d 1366 (Fed. Cir. 2010) (invalidating a "Son of BOSS" shelter that manipulated partnership basis rules).

Those judicially-recognized doctrines include the economic-substance doctrine (also referred to as the sham-transaction doctrine), under which a transaction will be disregarded *in its entirety* for tax purposes if it lacks economic substance (*e.g.*, a realistic profit potential ignoring tax benefits) or a non-tax business purpose. See *Reddam* v. *Commissioner,* 755 F.3d 1051, 1059-1062 (9th Cir. 2014); *Sala* v. *United States*, 613 F.3d 1249, 1252 (10th Cir. 2010); *Coltec Indus., Inc.* v. *United States*, 454 F.3d 1340, 1355-1357 (Fed. Cir. 2006); 26 U.S.C. 7701(*o*) (codifying economic-substance doctrine). They also include the substance-over-form doctrine, under which courts may recharacterize a transaction based on its objective economic realities and determine the tax consequences based on that recharacterization. See generally, *Frank Lyon*, 435 U.S. at 572-573. Although courts recognize the economic-substance and substance-over-form doctrines as distinct grounds for disallowing tax benefits not intended by Congress, both doctrines reflect the guiding principle that, "[i]n the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." *Id.* at 573 (citations omitted); see, *e.g.*, *Feldman* v. *Commissioner*, 779 F.3d 448, 454-455 (7th Cir. 2015) (discussing the various doctrines).

c. This case involves a particular application of the substance-over-form doctrine under which the IRS and the courts may disregard a purported partnership—even one that falls within the definition of "partnership" in 26 U.S.C. 761—where use of the partnership form is a sham. See *Moline Props. Inc.* v. *Commissioner*, 319 U.S. 436, 439 (1943) ("In general, in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal.").

This Court first recognized the IRS's authority to challenge the partnership form in *Commissioner* v. *Tower*, 327 U.S. 280 (1946). The Court stated that, "[w]hen the existence of an alleged partnership arrangement is challenged by outsiders, the question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both." *Id.* at 286-287. The Court recognized that, if the partners did not so intend, the partnership may be disregarded for purposes of determining federal tax liability. *Id.* at 287.

Three years later, the Court in *Culbertson* elaborated on that ruling. The Court established a multifactor, totality-of-the-circumstances test (sometimes referred to as the "sham-partnership test") for determining whether the parties truly intended to "join together for the purpose of carrying on the business and sharing in the profits or losses or both." *Culbertson*, 337 U.S. at 741 (quoting *Tower*, 327 U.S. at 287). The Court explained that whether or not an ostensible partnership will be respected for tax purposes turns on

> [w]hether, considering all the facts—the agreement, the conduct of the parties in 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.

Id. at 742.

2. This case arises from GECC's implementation from 1993 to 1998 of a so-called "lease-stripping" transaction, through which GECC sought to take advantage of the partnership form to shelter from tax approximately $310 million in lease income. The underlying mechanics of the transaction are extremely complex and are set forth in detail in the district court's first opinion. Pet. App. 156a-182a. The transaction is summarized below.

a. GECC is a subsidiary of General Electric Company. Part of GECC's business is leasing aircraft to airlines. Pet. App. 158a. In the early 1990s, a number of GECC's aircraft were fully depreciated for tax purposes but still retained rental value and were producing large amounts of taxable income. 7/21/04 Trial Tr. (Tr.) 317. To shelter that income from tax, GECC created a separate entity, Castle Harbour-I LLC (Castle Harbour), to which it contributed fully depreciated aircraft then being leased to airlines on a long-term basis. PX 383. Castle Harbour elected to be treated as a partnership for federal income-tax purposes. See 26 C.F.R. 301.7701-3(c). That election was critical to obtaining the tax benefits of the transaction, which depended on a manipulation of the Internal Revenue Code's partnership provisions.

After forming Castle Harbour, GECC solicited two Dutch banks, not subject to United States taxes, to invest in Castle Harbour as ostensible partners. Tr. 223-225. The Dutch banks (ING Bank N.V. and Rabo Merchant Bank N.V.) invested a total of $117.5 million in Castle Harbour in exchange for limited partnership interests with no management rights. JX 1, §§ 2.2, 2.3, 6.1, 6.2.

Through a series of highly complex agreements, the Dutch banks were allocated the majority of Castle Harbour's taxable income from the aircraft leases—a total of $310 million. Pet. App. 166a-172a, 181a-182a. In reality, however, only $28 million was actually paid to the banks. *Id.* at 181a. This was because, under applicable accounting rules, Castle Harbour was permitted to reduce the *book* income allocated to the Dutch banks by *book* depreciation with respect to the aircraft, notwithstanding that the aircraft were fully depreciated for tax purposes. *Id.* at 179a-180a. Through its arrangement with the Dutch banks, GECC thus effectively re-depreciated the aircraft. *Id.* at 180a.

The parties designed the arrangement to provide the Dutch banks with a rate of return of approximately nine percent on their investment. Pet. App. 164a. A number of other agreements effectively assured that the Dutch banks would receive back their investment, plus the agreed rate of return, regardless of Castle Harbour's financial performance. *Id.* at 125a-129a, 151a. The banks' return could be enhanced or reduced by a change in value in Castle Harbour's assets, although this variable was capped at one percent of any such gain or loss. *Id.* at 168a-171a. Castle Harbour was originally intended to last for a predetermined number of years (although it was terminated three years early due to changes in U.S. tax law), with the Dutch banks gradually being bought out according to a pre-set schedule. JX 1, Ex. E; Tr. 364-365.

b. The purpose of the Castle Harbour arrangement with the Dutch banks was to reduce GECC's federal tax liability. Because the Dutch banks were not subject to United States taxes, the $310 million of taxable income allocated to them on Castle Harbour's books escaped federal taxation, although the bulk of that income was funneled to GECC by virtue of Castle Harbour's purchase (through a subsidiary) of GECC commercial paper. Tr. 322-325; Pet. App. 173a, 179a-180a. GECC did not report the $310 million as income on its tax returns for the 1993 through 1998 tax years.

c. In 2001, the IRS issued notices of final partnership administrative adjustment to Castle Harbour, reallocating its taxable income from the Dutch banks to GECC for the 1993 through 1998 tax years. Pet. App. 118a. The IRS determined, *inter alia*, that GECC's transactions with the Dutch banks lacked economic substance; that the partnership should not be respected under *Culbertson*; and that the Dutch banks were, in substance, secured lenders to Castle Harbour rather than partners. *Ibid.*; see PXs 377 & 378. The IRS concluded that GECC had underpaid its federal taxes by approximately $62.2 million. Pet. App. 118a. In its notice covering the 1997 and 1998 tax years, the IRS also determined that GECC should be assessed a 20% accuracy-related penalty, pursuant to 26 U.S.C. 6662, based either on GECC's substantial understatement of tax or on negligence. PX 378.[2]

3. Petitioner is a wholly-owned subsidiary of GECC, and it operated as the tax matters partner of

[2] Penalties were not asserted in the IRS's notice covering the 1993 through 1996 tax years only because the law at that time did not allow penalties to be determined at the partnership level. See 26 U.S.C. 6221, 6226 (1996); Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1238(a) and (b)(1), 111 Stat. 788. Penalties for those years nevertheless may be imposed at the partner level.

Castle Harbour. In 2001, petitioner filed suit in the district court contesting the IRS's adjustments to Castle Harbour's tax reporting. As a prerequisite to filing suit, GECC deposited the disputed $62.2 million with the IRS. Pet. App. 118a; see 26 U.S.C. 6226(e).

a. After a trial in July 2004, the district court ruled in favor of petitioner. Pet. App. 156a-210a. As relevant here, the court found that Castle Harbour had satisfied the requirements of the economic-substance doctrine. Although the court found that the Dutch banks "were almost entirely certain of at least an 8.5% internal rate of return on their investment," it stated that "a lack of risk is not enough to make a transaction economically meaningless." *Id.* at 186a. The court acknowledged that "it appears likely that one of GECC's principal motivations in entering into this transaction—though certainly not its only motivation—was to avoid [a] substantial tax burden." *Id.* at 210a. "Nevertheless," the court found that "the Castle Harbour transaction was an economically real transaction, undertaken, at least in part, for a non-tax business purpose." *Id.* at 209a-210a.

The district court also held that Castle Harbour was a valid partnership under the *Culbertson* test. Pet. App. 190a-195a. The court treated that inquiry as essentially the same as the economic-substance analysis it had just undertaken, except with a more narrow focus on Castle Harbour's choice of the partnership form. *Id.* at 190a-193a.

b. The government appealed, primarily arguing that Castle Harbour was not a valid partnership under the *Culbertson* test. The court of appeals agreed with the government and reversed. Pet. App. 116a-155a.

The court of appeals observed that "[t]he material facts of this case consist essentially of the rights and obligations created as between the taxpayer and the Dutch banks by the partnership agreement." Pet. App. 120a. It concluded that "[t]he partnership interests of the Dutch banks were designed to have a superficial appearance of equity participation, but in the end (in all but a negligible part) to function in the manner of a repayment of a secured loan." *Id.* at 125a. The court stated that "[t]his was achieved either by reason of the requirements of the partnership agreement that trumped the provisions that appeared to create an equity interest, or by reason of the powers given to the taxpayer and to the Dutch banks to protect their respective interests." *Ibid.* Thus, the court held, "[t]he banks had no meaningful stake in the success or failure of Castle Harbour," and their "interest was overwhelmingly in the nature of a secured lender's interest." *Id.* at 133a. The court stated that, "[w]hile their interest was not totally devoid of *indicia* of an equity participation in a partnership, those indicia were either illusory or insignificant in the overall context of the banks' investment." *Ibid.*

The court of appeals further held that the district court had erred by relying exclusively on the "sham-transactions test [*i.e.*, the economic-substance doctrine]," while failing to conduct the distinct "*Culbertson* analysis of whether the banks' interest was a bona fide equity partnership participation." Pet. App. 132a, 135a. The court explained that, even when a taxpayer's interest in a transaction or arrangement has "economic substance," the IRS may re-examine the taxpayer's characterization of that interest by conducting "a realistic appraisal of the totality of the circumstances." *Id.* at 134a. The court noted that the test for a valid partnership under *Culbertson* is whether, "considering all the facts * * * the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." *Id.* at 133a-134a (quoting *Culbertson*, 337 U.S. at 742). It explained that the *Culbertson* inquiry is "not foreclosed merely because the taxpayer can point to the existence of some business purpose or objective reality in addition to its tax-avoidance objective." *Id.* at 135a.

The court of appeals then applied the *Culbertson* test and rejected petitioner's contention that its arrangement with the Dutch banks was a partnership. The court explained that the determination "whether an interest has the prevailing character of debt or equity can be helpful in analyzing whether, for tax purposes, the interest should be deemed a bona fide equity participation in a partnership." Pet. App. 135a. The court rejected the district court's conclusion that the Dutch banks' interest was more akin to equity than to debt, concluding that the district court had erred by "accepting at face value artificial constructs of the partnership agreement without examining all the circumstances to determine whether powers granted to the taxpayer effectively negated the apparent interests of the banks." *Id.* at 136a.

The court of appeals conducted its own fact-intensive analysis of the Dutch banks' interest in Castle Harbour. Pet. App. 138a-154a. It ultimately held that "the totality of the circumstances compels the conclusion that, for tax purposes [under *Culbertson*], the banks were not bona fide equity partners in Castle Harbour." *Id.* at 152a. The court explained that the transaction at issue "consisted, as a practical matter, of an advance by the Dutch banks of $117.5 million." *Ibid.* The court observed that (1) the partnership "undertook to repay the advance at an agreed rate of return, pursuant to a previously agreed payment schedule"; (2) "the payments were to be made regardless of the fortunes of the partnership"; and (3) the payments "were guaranteed by GECC," such that "the banks were secured in the receipt of the payments, regardless of whether the partnership profited or lost money." *Id.* at 152a-153a. The court acknowledged that the banks' interest "took on some aspect of equity participation" insofar as the banks "ran a small risk of a shortfall in event of catastrophic loss" and could obtain a small "participation in extraordinary unforeseen profits of the partnership." *Id.* at 153a. The court of appeals concluded, however, that the potential for such minimal gains or losses "was not a significant participation in the profits of the partnership." *Ibid.*

The court of appeals ultimately held that "[t]he Dutch banks' interest was in the nature of a secured loan, with an insignificant equity kicker." Pet. App. 154a. The court explained:

> Only in a negligible fashion was [the Dutch banks'] well-secured interest intertwined with the fortunes of the business. The facts and circumstances presented, considered in their totality [under *Culbertson*], compel the conclusion that the Dutch banks' interest was, for tax purposes, not a bona fide equity participation.

Ibid.

c. The court of appeals remanded the case for consideration of petitioner's alternative argument that

Castle Harbour qualified as a "family partnership" under 26 U.S.C. 704(e). Pet. App. 155a n.19. As relevant here, that provision states that "[a] person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person." 26 U.S.C. 704(e)(1).

On remand, the government argued that the court of appeals' *Culbertson* analysis compelled the conclusion that the banks were not partners under 26 U.S.C. 704(e). The government also renewed its argument that petitioner was liable, under 26 U.S.C. 6662, for an accuracy-related penalty in the amount of 20% of the underpaid tax. Section 6662 provides for the imposition of such a penalty on any underpayment of tax that is attributable to, *inter alia*, substantial understatement of tax or negligence. See 26 C.F.R. 1.6662-2(c).

The district court again ruled in favor of petitioner. Pet. App. 50a-115a. The court concluded that the Dutch banks had "incurred real risk that their capital accounts would run negative," in which case "the Banks would have owed money to the partnership." *Id.* at 95a-96a. The court therefore held that the Dutch banks owned "capital interests" in Castle Harbour, within the meaning of 26 U.S.C. 704(e), and hence that the asserted partnership was valid. Pet. App. 103a.

The district court further held that, even if the court of appeals disagreed with its Section 704(e) analysis, no penalties should be imposed under Section 6662. The court explained that petitioner had advanced "substantial authority" for the position asserted on its tax return, and that the existence of such authority rendered inapplicable both the substantial-understatement penalty and the negligence penalty. Pet. App. 106a-114a.

d. The court of appeals again reversed. Pet. App. 23a-49a. The court held that "the same evidence which, on our last review, compelled the conclusion that the banks' interest was so markedly in the nature of debt that it does not qualify as bona fide equity participation also compels the conclusion that the banks' interest was not a capital interest under [Section] 704(e)(1)." *Id.* at 33a.

The court of appeals also held that Section 6662's substantial-understatement penalty applied because there was no substantial legal authority supporting petitioner's tax position. Pet. App. 47a-49a. The court stated that the district court had "mistakenly concluded that several of our decisions supported treatment of the banks as partners in Castle Harbour." *Id.* at 47a. The court reviewed the decisions cited by the district court and held that "[t]he banks' interest is * * * readily distinguishable from the preferred shares at issue in *Jewel Tea* [*Co.* v. *United* States, 90 F.2d 451 (2d Cir. 1937)], and is properly treated as debt under the test of [*Commissioner* v.] *O.P.P.* [*Holding Corp.,* 76 F.2d 11 (2d Cir. 1935)]." *Id.* at 48a. The court held that the IRS had "properly assessed" the substantial-understatement penalty, and it accordingly did not address the negligence penalty. *Id.* at 49a & n.10.

e. In the district court, the parties moved to alter the judgment pursuant to Federal Rule of Civil Procedure 59(e). While that motion was pending, the government determined that, as a result of unrelated changes in the total tax liability of General Electric's consolidated group, the tax underpayment from the Castle Harbour transaction no longer qualified as "substantial" for purposes of the substantial-understatement penalty authorized by Section 6662. Pet. App. 6a; see 26 U.S.C. 6662(d)(1)(A). The government therefore filed a motion renewing its alternative claim for the negligence penalty. Pet. App. 6a.

The district court denied that motion, ruling that GECC had a "reasonable basis" for its tax-return position. Pet. App. 6a; see 26 C.F.R. 1.6662-3(b)(1) (stating that a return position that has a "reasonable basis" is not attributable to negligence). The district court stated that the Castle Harbour transaction had "resulted in a partnership arrangement that in some ways resembled preferred stock, but in other ways resembled the relationship between a debtor and a creditor." Pet. App. 8a. The court acknowledged that, "[i]n the Second Circuit's estimation, the Dutch Banks simply accepted too little risk in the venture to be treated as equity holders." *Id.* at 15a. The district court nonetheless concluded that "GECC reasonably could have believed that, to borrow the Second Circuit's term, the Dutch Bank's 'narrowly circumscribed risk' would not transform equity into debt." *Ibid.*

The district court added that GECC's view "looks especially reasonable in light of this litigation." Pet. App. 17a. It stated that, "[h]aving presided at the trial of this matter, I twice found not merely that [GECC] was reasonable in its tax position, but that it was correct." *Ibid.* The court noted that, "[a]lthough the Second Circuit ultimately disagreed with my interpretation of the law, it did not indicate that my conclusions were 'unreasonable.'" *Id.* at 17a-18a. The court concluded that the reasonableness of a tax position is "virtually unassailable" when the taxpayer "actually prevails at trial before a district judge who was not compromised by conflict, substance abuse, or senility." *Id.* at 18a.

f. The court of appeals again reversed. Pet. App. 1a-4a. In a summary order, it rejected the district court's holding that GECC had a reasonable basis for treating the Dutch banks as partners. The court stated that "the District Court relied on various inapposite authorities treating preferred stock as equity for tax purposes. We previously rejected such an analogy to preferred stock as inapt, finding that the Dutch banks' interests here were 'overwhelmingly in the nature of a secured lender's interest.'" *Id.* at 3a (citations omitted). The court stated that petitioner had "pointed to no authorities treating an interest such as the Dutch banks' interest—which we previously found had only 'illusory or insignificant' indicia of equity—as equity." *Ibid.*

The court of appeals also held that petitioner had failed to satisfy its burden of proving the absence of negligence. Pet. App. 4a. The court concluded that "[a]n attempt to create the appearance of a legitimate tax position is not an attempt in fact to comply with the Internal Revenue Code, and neither [petitioner] nor the District Court cites any evidence in the record that [petitioner] made a proper investigation of the correctness of its tax position." *Ibid.*

ARGUMENT

Petitioner challenges (1) the court of appeals' application of the *Culbertson* test to the partnership at issue here, and (2) that court's imposition of a 20% penalty based on petitioner's negligent underpayment of tax. Neither issue warrants this Court's review.

The court of appeals correctly applied the fact-intensive *Culbertson* analysis to the complex transactions at issue in this case, and it correctly determined that petitioner's underpayment was unreasonable and thus negligent. The court's analysis of those issues does not conflict with any decision of this Court or another court of appeals. The petition should be denied.

1. The court of appeals conducted a lengthy, fact-intensive analysis of the relationship between Castle Harbour, GECC, and the Dutch banks. Based on that inquiry, the court correctly held that the purported partnership should not be treated as such for federal tax purposes. Petitioner's contrary arguments are unavailing.

a. In *Tower* and *Culbertson*, this Court recognized that the IRS need not accept a taxpayer's characterization of a business relationship as a "partnership" for federal tax purposes unless "the partners really and truly intended to join together for the purpose of carrying on the business and sharing in the profits or losses or both." *Commissioner* v. *Culbertson*, 337 U.S. 733, 741 (1949) (quoting *Commissioner* v. *Tower*, 327 U.S. 280, 287 (1946)); see *id.* at 740 (quoting *Tower*, 327 U.S. at 286, for the proposition that a partnership requires "community of interest in the profits and losses"). The Court explained that, when analyzing the relationship between the purported partners, the IRS and courts should consider the totality of the relevant circumstances, including the legal agreements between the parties, their statements and conduct, the "actual control" of the business's income, and "any other facts throwing light on their true intent." *Id.* at 742.

The court of appeals properly applied the *Culbertson* test to the facts at issue here. The court correctly explained that *Culbertson* requires a "totality-of-the-circumstances" inquiry into whether the parties truly intended "to join together in the present conduct of the enterprise." Pet. App. 132a-135a. Based on a detailed analysis of the relevant facts, the court of appeals concluded that the Dutch banks were, "for all intents and purposes, secured creditors" rather than "bona fide equity partners" in Castle Harbour. *Id.* at 152a-153a; see *id.* at 154a (concluding that the banks' interest "was in the nature of a secured loan, with an insignificant equity kicker"); see generally *id.* at 135a-153a (analyzing the relevant transactions and agreements). The court explained that, because the Dutch banks were virtually guaranteed to receive a specified rate of return regardless of Castle Harbour's actual profits and losses, "[o]nly in a negligible fashion was their well-secured interest intertwined with the fortunes of the business." *Id.* at 154a.

b. Petitioner argues (Pet. 18-21) that the court of appeals' decision is inconsistent with *Tower* and *Culbertson*. In petitioner's view, the court below held that,

> even when a partnership satisfies the *Tower/Culbertson* "sham partnership" test, and even when no partner is in fact a lender to the partnership, the interests of certain partners can nevertheless be dismissed as not "bona fide" if a court finds, based on the "totality of the circumstances," that those interests are "more akin to debt than to equity.'"

Pet. 17-18 (quoting Pet. App. 134a-136a). That argument reflects a misunderstanding of the decision below. Far from concluding that the purported partnership here "satisfie[d]" the *Culbertson* test (Pet. 17), the court of appeals held that the partnership *failed* that test. See Pet. App. 132a-135a (identifying *Culbertson* test as the operative legal standard and concluding that the district court had erroneously failed to apply that test); *id.* at 152a (applying *Culbertson* and concluding that the Dutch banks "were not bona fide equity partners in Castle Harbour").

Petitioner contends (Pet. 17) that the *Culbertson* test is satisfied whenever the transactions at issue have some "real business purpose or economic substance." Neither *Culbertson* or *Tower* supports that proposition. Those decisions instead make clear that, to qualify as a partnership for tax purposes, the relevant entities must have "intended to join together in the present conduct of the enterprise," including by "sharing in the profits or losses or both." *Culbertson*, 337 U.S. at 741-742; see *Tower*, 327 U.S. at 286. When the entities lack a "community of interest in the profits and losses" of the business—as the court of appeals found was the case here—they may not be treated as partners for tax purposes. *Culbertson*, 337 U.S. at 740; Pet. App. 138a-154a. Neither decision suggests that an arrangement like the one at issue, which in economic substance was a secured loan, must be treated as a partnership for tax purposes simply because the participants characterize it as such.

Petitioner conflates (Pet. 3, 17, 21) the *Culbertson* test and economic-substance doctrine, treating them as one and the same. Although the two doctrines share overlapping factors, they are distinct tests that present alternative bases for disallowing the tax benefits of a transaction. The economic-substance doctrine allows the IRS to disregard a transaction in its entirety when the transaction lacks *any* non-tax business purpose or a realistic profit potential ignoring tax benefits. See pp. 3-4, *supra* (citing cases). The *Culbertson* test, by contrast, focuses on the parties' use of the partnership form and on whether that form reflects an actual intent to join together in a business endeavor and share profits and losses. *Culbertson*, 337 U.S. at 741-742. Although a secured loan with a fixed rate of return is a real and legitimate business arrangement having economic substance, it is economically distinct from a partnership because it does not provide for the sharing of profits and losses between lender and borrower and therefore does not give the lender an economic stake in the success of the borrower's operations. *Culbertson* allows the IRS to disregard the partnership form in circumstances like these, where the parties' arrangement has an economic substance *different from* that of a partnership.

The courts of appeals have consistently recognized that the *Culbertson* test and economic-substance doctrine are distinct. In *Southgate Master Fund, L.L.C.* v. *United States*, 659 F.3d 466, 484 (2011), for example, the Fifth Circuit invalidated a partnership under *Culbertson* notwithstanding its agreement with the district court that the overall transaction had economic substance. The court stated that "[t]he fact that a partnership's underlying business activities had economic substance does not, standing alone, immunize the partnership from judicial scrutiny." *Ibid.* The court further explained that, "[i]f there was not a legitimate, profit-motivated reason to operate as a partnership, then the partnership will be disregarded for tax purposes even if it engaged in transactions that had economic substance." *Ibid.*[3] As a corollary to that proposition, courts have also consistently held that a transaction with economic substance may be recharacterized for tax purposes under the substance-over-form doctrine, of which the *Culbertson* test is a subset.[4]

The decision below is fully consistent with those principles. As discussed above, the district court found that the transactions at issue had some economic reality and non-tax business purpose. Pet. App. 184a-188a. The court of appeals correctly recognized

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[3] See, *e.g.*, *ASA Investerings P'ship* v. *Commissioner*, 201 F.3d 505, 511-512 (D.C. Cir. 2000) (recognizing distinction between *Culbertson* test and economic-substance doctrine); *Historic Boardwalk Hall, LLC* v. *Commissioner*, 694 F.3d 425, 448 n.50 (3d Cir. 2012) (disregarding partnership under *Culbertson* while assuming, without deciding, that the transactions had economic substance).

[4] See, *e.g.*, *Feldman* v. *Commissioner*, 779 F.3d 448, 457 (7th Cir. 2015) ("[E]ven when a transaction has *some* degree of nontax economic substance, the substance-over-form principle may provide an independent justification for recharacterizing it."); *Rogers* v. *United States*, 281 F.3d 1108, 1118 (10th Cir. 2002) ("Since the transaction clearly had real-world economic consequences, application of the economic substance doctrine is not appropriate. Rather, this is a case in which the taxpayers seek to characterize a substantive transaction as one thing rather than another and force the Commissioner—and this court—to accept the automatic consequences of the characterization. * * * [H]owever, it is not up to the taxpayers to have the final say on how it is characterized."); see also *Consolidated Edison Co. of N.Y, Inc.* v. *United States*, 703 F.3d 1367, 1375 (Fed. Cir. 2013) (recharacterizing a lease as a sale without disturbing trial court's finding that transaction had economic substance); *BB&T Corp.* v. *United States*, 523 F.3d 461, 477 (4th Cir. 2008) (recharacterizing a lease as a sale while assuming, for purposes of reviewing grant of summary judgment, that transaction had economic substance).

that these findings did not resolve the question whether the Dutch banks were bona fide partners under *Culbertson*, *i.e.*, whether Castle Harbour itself was a valid partnership for federal tax purposes. *Id.* at 134a-135a. As the court explained, "[t]he IRS's challenge to [petitioner's] characterization [of the purported partnership] is not foreclosed merely because the taxpayer can point to the existence of some business purpose or objective reality in addition to its tax-avoidance motive." *Id.* at 135a.

c. Petitioner argues (Pet. 22-24) that the court of appeals' treatment of the *Culbertson* test as a distinct and independent basis for deeming a partnership invalid for tax purposes conflicts with the D.C. Circuit's decision in *ASA Investerings Partnership* v. *Commissioner*, 201 F.3d 505 (2000). In that case, the D.C. Circuit affirmed the Tax Court's ruling that a purported partnership between Allied Signal, a domestic corporation, and a foreign bank failed to pass muster under *Culbertson*. The Tax Court did not reach the economic-substance argument. On appeal, Allied Signal argued that the D.C. Circuit could not "consider whether the partnership was a 'sham' because the Tax Court (a) explicitly refused to consider that, and (b) never used the word 'sham.'" *Id.* at 511. In rejecting that contention, the D.C. Circuit stated that, "[a]lthough the Tax Court said that it would not consider whether the *transactions* at issue lacked 'economic substance,' * * * its decision rejecting the bona fides of the *partnership* was the equivalent of a finding that it was, for tax purposes, a 'sham.'" *Id.* at 512 (citation omitted).

Petitioner appears to construe that statement as indicating that the D.C. Circuit views the economic-substance doctrine and *Culbertson* test as identical. See Pet. 22-24. Particularly when that statement is read in context, it is clear that the D.C. Circuit appreciated the distinction between those legal standards. Several paragraphs earlier in its opinion, that court noted that the Tax Court had "agreed with the [IRS] that [the purported partnership] was not a valid partnership for tax purposes [under *Culbertson*], and thus did not reach the economic substance argument." *ASA*, 201 F.3d at 511. The sentence on which petitioner relies, moreover, reflects the D.C. Circuit's recognition that a *partnership* may be a sham even though the *transactions* in which the purported partners engage have real economic substance. Far from equating the economic-substance doctrine and the *Culbertson* test, the *ASA* court appreciated the difference between the two.

Petitioner also points to the *ASA* court's statement that the "basic inquiry" in assessing the validity of a partnership is "whether, all facts considered, the parties intended to join together as partners to conduct business activity for a purpose other than tax avoidance." Pet. 22 (quoting 201 F.3d at 513). Petitioner appears to interpret that statement to mean that a partnership is valid so long as it pursues some "legitimate, non-tax purpose." *Ibid.* That is mistaken.

Although a non-tax purpose is *necessary* to satisfy the *Culbertson* test, it is not *sufficient*. The D.C. Circuit framed the relevant question as whether the parties "intended to join together *as partners*." *ASA*, 201 F.3d at 513 (emphasis added). Under *Culbertson*, persons collaborate as partners only if they intend to "shar[e] in the profits or losses" of the enterprise. 337 U.S. at 741. And, contrary to petitioner's assertion, the court below did not "expressly disagree[]" with the D.C. Circuit's analysis in *ASA*. Pet. 12 (citing Pet. App 135a n.13). In the footnote cited by petitioner, the court of appeals *declined* to read *ASA* in the manner that petitioner advocates, *i.e.*, as equating the economic-substance doctrine with the *Culbertson* test. See Pet. App. 135a n.13 ("We do not believe that this language [in *ASA*] should be interpreted as suggesting that the two underlying inquiries are identical."). The court observed that, "[w]hile a classification that fails the sham test [*i.e.*, the economic-substance doctrine] may be certain also to fail the *Culbertson* analysis, a classification that passes the sham test would not necessarily survive *Culbertson*." *Ibid.* That statement is both correct and consistent with the *ASA* court's analysis.

In any event, subsequent decisions confirm that the D.C. Circuit, like the court of appeals in this case, recognizes the distinction between the *Culbertson* test and the economic-substance doctrine. In *Andantech* v. *Commissioner*, 331 F.3d 972 (D.C. Cir. 2003), for example, the court acknowledged that "the computer leasing business could have been profitable and beneficial to any one of the parties involved," but it disregarded the partnership under *Culbertson* because "there was no evidence of a non-tax need to form the partnership in order to take advantage of the potential profits of the business." *Id.* at 980; see *Boca Investering P'ship* v. *United States*, 314 F.3d 625 (D.C. Cir. 2003) (reversing district court's judgment that partnership was bona fide under *Culbertson* without disturbing the district court's finding that the transactions had economic substance).[5]

Petitioner's claim of a circuit conflict thus lacks merit. Petitioner does not identify any court of appeals decision that has equated the *Culbertson* test with the economic-substance inquiry, or that has allowed a purported partnership to be treated as such for federal tax purposes absent a bona fide intent to "shar[e] in the profits or losses" of the business. *Culbertson*, 337 U.S. at 741. Indeed, most of the courts of appeals that have applied the *Culbertson* test since the Second Circuit issued its opinion in this case have either expressly endorsed that court's analysis or cited its decision with approval.[6]

d. Petitioner argues (Pet. 20) that, by considering whether the Dutch banks' interests had the prevailing character of debt or equity, the court of appeals "fundamentally—and improperly—changed the relevant inquiry" under *Culbertson*. But as petitioner elsewhere acknowledges (Pet. i), the Court in *Culbertson* announced a totality-of-the-circumstances test, under which "any * * * facts throwing light on [the part-

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[5] As petitioner points out, the D.C. Circuit has reaffirmed *ASA*'s conclusion that "the absence of a nontax business purpose is fatal" to the argument that the IRS must recognize a partnership for federal tax purposes. Pet. 23 (citing cases and quoting *ASA*, 201 F.3d at 512). As explained above, however, the court's recognition that a nontax business purpose is necessary for partnership status does not logically imply that it is sufficient.

[6] See, *e.g.*, *Southgate*, 659 F.3d at 484 nn.57-58, 60, 488 nn.69-70; *Historic Boardwalk*, 694 F.3d at 449-463; *Superior Trading, LLC* v. *Commissioner*, 728 F.3d 676, 680 (7th Cir. 2013); *Chemtech Royalty Assocs. L.P.* v. *United States*, 766 F.3d 453, 461-464 (5th Cir. 2014).

ners'] true intent" with respect to the business relationship may be considered. 337 U.S. at 742. As petitioner rightly concedes (Pet. 17), "the act of lending money to a partnership does not make the lender a member of that partnership." That is because a lender who is entitled to a fixed rate of return lacks any economic stake in the success or failure of the borrower's enterprise. See Pet. App. 133a; pp. 10-12, 18-22, *supra*. The debt-like nature of a purported partner's interest therefore bears directly on whether the business arrangement is properly considered a partnership for tax purposes. *Culbertson*, 337 U.S. at 742; see *Historic Boardwalk Hall, LLC* v. *Commissioner*, 694 F.3d 425, 454 (3d Cir. 2012) (agreeing with court of appeals' view in this case that whether the partner's interest is closer to debt or equity is "highly relevant" to the question whether a true partnership exists).

e. Petitioner argues (Pet. 24-29) that the court of appeals' legal analysis (1) conflicts with the broad definitions of "partner" and "partnership" in 26 U.S.C. 761, and (2) creates confusion over the proper tax treatment of certain partnerships. Neither criticism has merit.

Although the *Culbertson* test is not specifically mandated by the Code's definitions of "partner" and "partnership," it is an important (and firmly established) constraint on when a business entity may be treated for federal tax purposes as a partnership. The test reflects the overarching principle that, "[i]n the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." *Frank Lyon Co.* v. *United States*, 435 U.S. 561, 573 (1978); see also, *e.g.*, *Gregory* v. *Helvering*, 293

U.S. 465, 469-470 (1935) (refusing to treat a transaction as a corporate "reorganization," despite compliance with the Code's definition of that term, when the transaction "was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization"). *Culbertson* accordingly requires a totality-of-the-circumstances inquiry into the parties' "true intent" with respect to their business relationship. 337 U.S. at 742. As the court below correctly held, the "true facts and circumstances" here established that the Dutch banks' interest was "in the nature of a secured loan" and was "intertwined with the fortunes of [Castle Harbour's] business" "[o]nly in a negligible fashion." Pet. App. 154a.

2. Petitioner also challenges (Pet. 29-32) the Second Circuit's unpublished summary order sustaining the IRS's imposition of the negligence penalty under 26 U.S.C. 6662. Further review of that order is not warranted.

Section 6662 provides for the imposition of a penalty equal to 20% of the portion of a taxpayer's underpayment of tax that is attributable to negligence. 26 U.S.C. 6662(a) and (b). It defines "negligence" to include "any failure to make a reasonable attempt to comply with the provisions of [the Code]." 26 U.S.C. 6662(c). IRS regulations explain that a tax return position is not attributable to negligence if it has a "reasonable basis." 26 C.F.R. 1.6662-3(b)(1). That standard is "significantly higher than not frivolous or not patently improper," and it is "not satisfied by a return position that is merely arguable or that is merely a colorable claim." 26 C.F.R. 1.6662-3(b)(3).

The court of appeals correctly summarized the legal standard for imposing the negligence penalty and correctly applied that standard to the facts of this case. Pet. App. 3a-4a. The court explained that there was no authority for treating the Dutch banks' interest as equity for tax purposes. *Id.* at 3a. It further noted that petitioner's "attempt to create the appearance of a legitimate tax position is not an attempt in fact to comply with the [Code]," and that petitioner had not identified "any evidence in the record that [it] made a proper investigation of the correctness of its tax position." *Id.* at 4a. The court of appeals' straightforward and factbound analysis does not warrant review by this Court.

Petitioner asserts that the decision below conflicts with Ninth Circuit decisions indicating that a negligence penalty is not appropriate when the relevant legal issues are "unsettled" or "reasonably debatable." Pet. 30-31 (citing cases). But the Second Circuit agrees that the penalty does not apply in such circumstances. See*, e.g., Holmes* v. *United States*, 85 F.3d 956, 963 & n.7 (1996) (refusing to impose a negligence penalty where the disputed merits issue was "a close one" and "anything but clear").

The court of appeals did not view this case as involving a close question or an unsettled legal issue. Although the court acknowledged that "[o]n different facts a difficult question [c]ould arise whether an investor's right to a share of profits was sufficient to make its interest a bona fide equity participation for tax purposes notwithstanding the secured guaranty of the return of its principal plus interest," it concluded that "[t]his is not such a case." Pet. App. 154a. The Second Circuit's straightforward application of law to fact was correct and raises no issue of broad importance warranting this Court's review.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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