

1-4-2016

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Recommended Citation

Karen C. Burke & Grayson M.P. McCouch, *Codifying Castle Harbour*, 150 *Tax Notes* 109 (2016), available at <http://scholarship.law.ufl.edu/facultypub/747>

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Codifying Castle Harbour

By Karen C. Burke and
Grayson M.P. McCouch

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In this article, Burke and McCouch discuss the 2015 statutory amendment, enacted as part of the last-minute budget deal, that revised and renumbered the family partnership provision of section 704(e)(1). They question whether the change will accomplish its stated purposes of clarifying existing law and raising \$1.9 billion in revenue, and they conclude that the 2014 proposals by former House Ways and Means Committee Chair Dave Camp offer a politically expedient source of selective pay-fors for future government spending without actually raising taxes.

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The Bipartisan Budget Act of 2015¹ implements an eleventh-hour budget deal that staves off the prospect of a government shutdown by raising the debt limit and temporarily lifting caps on defense and discretionary non-defense spending. Driven by the need to find revenue offsets without increasing taxes — a limitation imposed by the House majority — Congress cherry-picked proposals from a comprehensive tax reform plan put forward in 2014 by former House Ways and Means Committee Chair Dave Camp.² More than \$11 billion in projected revenue over 10 years comes from provisions for

improved compliance by partnerships, including \$9.3 billion from revised audit procedures.³ Another \$1.9 billion comes from amending the family partnership rules of section 704(e).⁴ These amendments are aimed not at traditional family partnerships but at a handful of high-profile tax shelters, involving billions of dollars in taxes and penalties, that are working their way through the litigation pipeline.

The 2015 act amends the income tax definition of partner in section 761(b) by adding a new sentence: “In the case of a capital interest in a partnership in which capital is a material income-producing factor, whether a person is a partner with respect to such interest shall be determined without regard to whether such interest was derived by gift from any other person.”⁵ The new sentence is substantially identical to existing section 704(e)(1),⁶ which has been stricken from the family partnership provisions of section 704(e). Aside from renumbering, the changes appear to be stylistic rather than substantive, substituting a clumsy but gender-neutral reference to a partner “with respect to such [capital] interest” for the original phrase “if he owns a capital interest.”⁷ The end result appears to be a restoration of the order of the family partnership

³The audit procedures, which replace the 1982 Tax Equity and Fiscal Responsibility Act provisions, are not scheduled to become fully effective until 2018. See 2015 act, *supra* note 1, at section 1101.

⁴See 2015 act, *supra* note 1, at section 1102.

⁵*Id.* at section 1102(a). The new provision is taken verbatim from the 2014 Camp proposals. See Camp proposals, *supra* note 2, at section 3618.

⁶Section 704(e)(1), as codified in 1954, provided 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.”

⁷Thus, the new provision omits any reference to a person who “owns” a capital interest or acquires such an interest by “purchase” and no longer declares that such a person “shall be recognized as a partner” for income tax purposes. The revised statutory language is probably intended to narrow the scope of the provision. Unfortunately, however, because the provision now appears in the general definition of a partner, it might arguably be viewed as broadening the scope of the safe harbor. See 2015 act, *supra* note 1, at section 1102(b)(3) (amending the caption of section 704(e) to read “partnership interests created by gift” instead of “family partnerships”). The import of the revised language remains obscure, and there is no authoritative legislative history to resolve the ambiguity.

¹H.R. 1314, Bipartisan Budget Act of 2015, P.L. 114-74.

²See H.R. 1, Tax Reform Act of 2014, Discussion Draft, 113th Cong. section 3618 (2014) (Camp proposals); and Ways and Means Committee Majority Staff, “Tax Reform Act of 2014, Discussion Draft, Section-by-Section Summary,” at 119 (2014); see also Joint Committee on Taxation, “Technical Explanation of the Tax Reform Act of 2014, a Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title III — Business Tax Reform,” JCX-14-14 (Feb. 16, 2014), at 231-232.

COMMENTARY / VIEWPOINT

provisions as they were originally enacted in 1951, when the predecessor of section 704(e)(1) was added to the definitions of partnership and partner in the predecessor of section 761.⁸

It seems implausible that merely restating and renumbering an existing provision can increase projected revenue by any amount, let alone \$1.9 billion over 10 years. Presumably, the 2015 amendments are intended to close a gap in existing law. According to the House explanation, the purpose of the amendments is to “clarify that Congress did not intend for the family partnership rules to provide an alternative test for whether a person is a partner in a partnership” and to ensure that the determination of whether the owner of a capital interest in a capital-intensive partnership qualifies as a partner will be made “under the generally applicable rules defining a partnership and a partner.”⁹ This implies that under existing law, section 704(e)(1) might provide an alternative test for partner status, independent of the general definitions of partnership and partner under section 761.

For many years, courts have consistently followed the Supreme Court’s *Culbertson* decision, which held that a partnership is recognized for income tax purposes only if two or more partners join together with good-faith intent and a business purpose to conduct an enterprise.¹⁰ Moreover, in recent tax shelter cases, the courts have applied *Culbertson* to disregard a putative partner whose investment was more in the nature of a secured loan than a participating equity interest.¹¹ Seeking to circumvent the *Culbertson* test, corporate taxpayers such as General Electric Capital Corp. and Dow Chemical Co. have argued that section 704(e)(1) provides an alternative test of partner status under existing law based solely on ownership of a “capital interest,” without regard to good-faith intent or business purpose. This argument relies on a hyper-

literal reading of section 704(e)(1) that flies in the face of the structure, purpose, and legislative history of the family partnership provisions.¹² More importantly, it lacks support in existing case law. The Second Circuit emphatically rejected the section 704(e)(1) argument in its 2012 *Castle Harbour* decision,¹³ and no other reported case — aside from the district court decision reversed by the Second Circuit on appeal — has accepted it. On their face, the 2015 amendments merely codify the Second Circuit’s 2012 *Castle Harbour* decision, but in the absence of contrary authority, such a clarification hardly seems necessary.

The projected revenue of \$1.9 billion over 10 years from the family partnership amendments seems to reflect a concern that the taxpayer’s section 704(e)(1) argument might remain viable under existing law. However plausible that concern might have appeared while the government’s appeal from the district court’s 2009 *Castle Harbour* decision was pending, the Second Circuit’s 2012 decision should have put the concern to rest, and by 2015 it should have been abundantly clear that the section 704(e)(1) argument lacked merit. Although the technical explanation of the 2014 Camp proposals conspicuously omits any reference to the Second Circuit’s 2012 *Castle Harbour* decision,¹⁴ it is difficult to believe that the proponents of the 2014 Camp proposals and the 2015 amendments simply overlooked that decision. Instead, it seems more likely that they were not inclined to question whether

⁸See Revenue Act of 1951, P.L. 82-183, section 340(a) (amending section 3797(a)(2) of the 1939 code); *id.* at section 340(b) (adding section 191, containing the predecessor of section 704(e)(2) and (e)(3), to the 1939 code).

⁹“Bipartisan Budget Act of 2015, Section-by-Section Summary,” at 14, available at <http://docs.house.gov/meetings/RU/RU00/CPRT-114-RU00-D001.pdf>. This explanation is posted on the official House website without any attribution of authorship. It is not reprinted in the *Congressional Record*, nor does it appear in the legislative history on the Library of Congress website. See <https://www.congress.gov/bill/114th-congress/house-bill/1314> (not including explanation quoted in text).

¹⁰See *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949).

¹¹See *ASA Investerings Partnership v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000); *TIFD III-E Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006); and *Chemtech Royalty Associates LP v. United States*, 766 F.3d 453 (5th Cir. 2014); see also *Southgate Master Fund LLC v. United States*, 659 F.3d 466 (5th Cir. 2011); and *Historic Boardwalk Hall LLC v. Commissioner*, 694 F.3d 425 (3d Cir. 2012).

¹²The purpose of section 704(e)(1) was not to provide “a statutory shortcut to partner status without regard to the general definition of a partnership,” but instead to “clarify the test for determining whether the transferee (rather than the transferor) of a donated partnership interest should be recognized as the real owner for income tax purposes.” Karen C. Burke and Grayson M.P. McCouch, “Snooked Again: *Castle Harbour* Revisited,” *Tax Notes*, Sept. 13, 2010, p. 1143, 1153-1154; cf. 4 Boris Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts*, para. 86.3.1, at 86-29 (2003) (“The reference to ‘ownership’ of a capital interest is odd because it is a pervasive principle of tax law, seemingly needing no repetition for a limited class of assets, that income from property transferred by gift is thereafter taxed to the donee.”).

¹³See *TIFD III-E Inc. v. United States*, 666 F.3d 836, 844 (2d Cir. 2012), *rev’g* 660 F. Supp.2d 367 (D. Conn. 2009) (The “focus [of section 704(e)(1)] is not on the nature of the investment in a partnership, but rather on who should be recognized for tax purposes as the owner of the interest.”).

¹⁴In an earlier *Castle Harbour* decision, the Second Circuit explained in a footnote that it had *not* considered the taxpayer’s section 704(e)(1) argument and remanded the question “for consideration in the first instance by the district court.” *TIFD III-E Inc.*, 459 F.3d, at 241 n.19. Strangely, the technical explanation of the 2014 Camp proposals does not mention the 2012 decision disposing of the taxpayer’s section 704(e)(1) argument but instead cites the 2006 decision to suggest continuing uncertainty about the merits of the argument. See JCX-14-14, *supra* note 2, at 232 n.927.

existing law was actually unsettled or in need of clarification, as long as the proposed amendments provided a sufficiently large increase in projected revenue without any substantive change in existing law.¹⁵

Even if the 2015 amendments merely ratify the Second Circuit's 2012 *Castle Harbour* decision, the belated discovery by the drafters of the 2014 Camp proposals that the scope of section 704(e)(1) was still "not entirely clear" comes at an opportune moment for taxpayers involved in ongoing tax shelter litigation.¹⁶ Having lost on the merits, General Electric and Dow now seek to avoid substantial penalties, and their defense rests in part on the argument that at least until 2012, it was unclear whether the owner of a capital interest was automatically recognized as a partner under section 704(e)(1).¹⁷ Instead of clarifying existing law, the 2015 amendments may be used to lend spurious weight to the taxpayers' discredited section 704(e)(1) argument. In fact, the section 704(e)(1) argument appears to be part of a "concerted litigation strategy for rolling back *Culbertson* and challenging related antiabuse rules."¹⁸

Perhaps unwittingly, the technical explanation of the 2014 Camp proposals may lend support to this litigation strategy. The explanation cites a leading partnership tax treatise for the proposition that in enacting section 704(e)(1) "Congress intended to override the intent test established by the Supreme Court" in *Culbertson*.¹⁹ This sweeping assertion can-

not be accepted without qualification. Although section 704(e)(1) modifies *Culbertson* by allowing the donee or purchaser of a capital interest in a capital-intensive partnership to be treated as a partner regardless of the motive for the transfer, it does not override *Culbertson*'s requirement of good-faith intent and business purpose as part of the general definition of a partnership; nor does it create an alternative test of partner status without regard to the general definition of partnership.²⁰ This is precisely the argument advanced by the taxpayer and expressly rejected by the Second Circuit in its 2012 *Castle Harbour* decision. Ironically, the cited treatise itself is the main source of the taxpayers' section 704(e)(1) argument in ongoing litigation, and two of the treatise's principal authors were actively involved in structuring and defending the tax shelters used by General Electric and Dow.²¹ Although courts have already rejected the taxpayers' argument on the merits, the injection of the discredited section 704(e)(1) argument into the legislative history of the 2015 amendments is likely to create new confusion and uncertainty concerning the *Culbertson* test.

Given the intense pressure to reach a budget deal and stave off a year-end government shutdown, it is not surprising that Congress resorted to "cherry-picking tax compliance provisions" from the 2014 Camp proposals as a politically expedient technique for generating the necessary revenue offsets.²² In the last-minute bipartisan scramble to find an additional \$1.9 billion of revenue, lawmakers apparently had no opportunity or inclination to review the family partnership amendments carefully. It is difficult to take the stated purpose of the amendments at face value, because the Second

¹⁵The projected 10-year revenue increase rose from \$800 million in 2014 to \$1.9 billion in 2015. The difference does not appear to reflect any substantive difference between the 2014 Camp proposals and the 2015 amendments. Oddly, the increase in projected revenue occurred after the Second Circuit summarily imposed a negligence penalty in *Castle Harbour*. See *TIFD III-E Inc. v. United States*, 604 F. App'x 69 (2d Cir. 2015).

¹⁶JCX-14-14, *supra* note 2, at 232.

¹⁷See *TIFD III-E Inc.*, 604 F. App'x 69, petition for cert. filed, No. 15-331 (U.S. Sept. 17, 2015) (arguing that a return position has reasonable basis if the case raises an issue of "first impression" or the issue is "unsettled" and taxpayer's position is "reasonably debatable"); *Chemtech Royalty Associates LP v. United States*, 2015-1 U.S.T.C. para. 50,301 (M.D. La. 2015), *appeal docketed*, No. 15-30577 (5th Cir. Jul. 6, 2015) (Oct. 8, 2015) (appealing penalties and arguing that "at the time Chemtech filed its applicable tax returns, every court to consider the issue had held that section 704(e)(1) provided an alternative to the *Culbertson* standard for partner status"). For a more measured assessment of prior law, see 1 William S. McKee et al., *Federal Taxation of Partnerships and Partners*, para. 3.02[5][b], at 3-19 (1990); and Burke and McCouch, "Illusory Partnership Interests and the Anti-Antiabuse Rule," *Tax Notes*, Aug. 22, 2011, p. 813, 816 n.19. The taxpayers have reserved a partner-level penalty defense of good-faith reasonable reliance, which may raise issues concerning the tax opinions rendered.

¹⁸Burke and McCouch, *supra* note 17, at 813.

¹⁹JCX-14-14, *supra* note 2, at 232 (citing McKee et al., *Federal Taxation of Partnerships and Partners*, para. 3.02[3], at 3-21 to 3-25 (2007)). The explanation also notes that section 704(e) was

(Footnote continued in next column.)

enacted "to prevent the IRS from denying partner status to a taxpayer who shared actual ownership of the partnership's income-producing capital on the basis that the interest was acquired from a family member." JCX-14-14, *supra* note 2, at 231. Cf. 1 Arthur B. Willis and Philip F. Postlewaite, *Partnership Taxation*, para. 2.01[1], at 2-6 (2011 and 2015 supp.) (explaining that the principal purpose of section 704(e)(1) was to clarify that "a partner in a partnership in which capital is a material income-producing factor will be recognized as a partner for tax purposes if the partner owns a capital interest, regardless of whether that interest was acquired by purchase or by gift" without regard to "the actual motives for the transfer").

²⁰See Burke and McCouch, *supra* note 12, at 1153 ("Section 704(e)(1) is best understood as modifying one particular application of the *Tower-Culbertson* test by carving out a safe harbor for contributions of donated capital while leaving the test intact for determining the validity of a partnership under section 761.").

²¹See Jesse Drucker, "Bermuda Triangle: How Merck Saved \$1.5 Billion Paying Itself for Drug Patents," *The Wall Street Journal*, Sept. 28, 2006, at A1.

²²Marc Heller, "Camp Tax Plan Lives On as Farm for Budget Offsets," *DTR* G-6 (Nov. 4, 2015).

Circuit had dispelled any lingering uncertainty about the scope of section 704(e)(1) three years earlier in its 2012 *Castle Harbour* decision. There is no reason to believe that the amendments will actually clarify the law or raise revenue; indeed, they may well have the opposite effect. In the absence of contrary judicial authority, there is no need to codify the *Castle Harbour* holding, and doing so in such a clumsy fashion may lose more revenue than leaving section 704(e)(1) unchanged²³ or repealing it altogether.²⁴ This is a far cry from the comprehensive tax reform promised by the 2014 Camp proposals, but it suggests that those proposals may be destined to lurch forward, zombie-like, as a fertile source of dubious revenue offsets.

²³The 2015 amendment may lose revenue if a court were to interpret the revised statutory language as broadening, rather than narrowing, the scope of the section 704(e)(1) safe harbor. *See supra* note 7.

²⁴Although section 704(e)(1) has arguably been essentially redundant since its original enactment, the provision may have been retained to preserve a safe harbor for donative transfers of partnership interests. *See supra* note 12.

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