Castle Harbour Revisited: Application of the Code Sec. 704(c) Anti-Abuse Rule to Ceiling Rule Distortions

By Michael P. Spiro

Michael P. Spiro examines the implications of the *Castle Harbour* strategy as it relates to the ceiling rule of Code Sec. 704(c).

On January 24, 2012, the U.S. Court of Appeals for the Second Circuit ("Second Circuit") rendered its final decision in the case of *TIFD III-E, Inc.*[1] (commonly referred to as the "*Castle Harbour*" case), thus ending an eight-year saga spanning two decisions of the U.S. District Court for the District of Connecticut ("District Court") and a prior Second Circuit decision.[2] The *Castle Harbour* case arose from a transaction entered into by General Electric Capital Corporation (GECC) and two Dutch banks. GECC was able to use the so-called ceiling rule of Code Sec. 704(c) to generate significant tax savings by structuring a financing of its aircraft leasing business through a partnership in which the vast majority of the book income was allocated to the Dutch banks.

The *Castle Harbour* strategy will appeal, on a purely technical level, to those of us in the tax community who are aficionados of the many nuances presented in Code Sec. 704(c). The strategy combined a ceiling rule limitation with a self-liquidating partnership interest issued to a tax-neutral party to achieve significant tax deferral benefits on income from leasing fully depreciated aircraft. While the taxpayer was ultimately stymied in its efforts, the question remains as to whether (in the absence of the debt/equity analysis that carried the day) a similar strategy could be pursued—particularly after the promulgation of regulations in 1993 that introduced an anti-abuse rule to Code Sec. 704(c) (hereinafter, the "704(c) anti-abuse rule").

The purpose of this article is to examine the implications of the *Castle Harbour* strategy as it relates to the ceiling rule. In particular, this article will (1) explore the particular justification for the *Castle Harbour* strategy under Code Sec. 704(c) as it existed at the time of the transaction (that is, prior to final Treasury Regulations promulgated in 1993 as modified and amended by additional final Treasury Regulations in 1997,[3] 2004,[4] 2005[5] and 2010[6] ("1993 Regulations")); and (2) examine whether (putting aside the debt/equity analysis applied by the Court) the Code Sec. 704(c) anti-abuse rule would have operated to disallow the *Castle Harbour* strategy (thereby effectively eliminating the possibility of pursuing a strategy similar to the one used in *Castle Harbour*). To this end, Part I of this article recounts the facts of the *Castle Harbour* case (including some simplified illustrative examples of the strategy that was the subject of the case); Part II briefly summarizes the four *Castle Harbour* decisions; Part III discusses in detail the legal basis for the *Castle Harbour* strategy under Code Sec. 704(c) and the potential impact of the 1993 Regulations on the strategy; and Part IV

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concludes. Ultimately, this article will argue that the 704(c) anti-abuse rule is not sufficiently broad to foreclose all planning opportunities arising from ceiling rule distortions.

I. The *Castle Harbour* Transaction

The *Castle Harbour* case stemmed from GECC's commercial aircraft leasing business. As the District Court explained in its initial decision, "Typically, airlines do not own aircraft principally because airlines do not ordinarily produce sufficient income to take advantage of the tax depreciation deductions generated by commercial aircraft. Instead, a company with greater taxable income, such as GECC, will buy the planes and lease them to the airlines, thereby giving the airlines the use of the aircraft and the leasing company the tax deductions."[7]

In 1993, GECC determined to enter into a monetization transaction with respect to its commercial aircraft leasing business. Whether it was primarily intended to hedge economic risk or maximize tax advantages, the basic strategy of the *Castle Habour* transaction was as follows: GECC and two Dutch banks formed a new limited liability company ("Castle Harbour"). GECC contributed to Castle Harbour certain fully depreciated aircraft with a fair market value of approximately $294 million and approximately $246 million in cash, and the two Dutch banks (ING Bank N.V. and Rabo Merchant Bank N.V.) contributed approximately $117.5 million in cash.

The limited liability company operating agreement of Castle Harbour ("Operating Agreement") created a "self-liquidating partnership interest" for the Dutch banks by forecasting the anticipated stream of rental revenues and providing for a series of operating distributions to the Dutch banks (referred to as the "Exhibit E Payments"). If actual revenues matched the forecast, then the Exhibit E Payments would, at the end of an eight-year period, result in the Dutch banks having capital accounts of $0 (thus fully liquidating their partnership interests), and having received an internal rate of return of approximately nine percent. Any deviation from the projection would be preserved in the Dutch banks' capital accounts, thus resulting in either a payment to the Dutch banks upon liquidation (if revenues exceeded projections) or a payment by the Dutch banks to Castle Harbour upon liquidation (if revenues fell short of projections). The self-liquidating partnership interest schematic consisted of (1) allocations of "Operating Income or Loss" (generally gross rental income reduced by book expenses (including book depreciation)); (2) allocations of "Disposition Gain or Loss" (generally book gain or loss from the disposition of any asset of Castle Harbour); (3) the formation of a corporate subsidiary, Castle Harbour Leasing, Inc. (CHILI); and (4) certain downside protections for the Dutch banks.

Operating Income

Operating income was allocated 98 percent to the Dutch banks and two percent to GECC. Key to the strategy was that "operating income" was determined pursuant to the Treasury Regulations promulgated under Code Sec. 704(b), and therefore book depreciation—even though there was no tax depreciation available with respect to the aircraft of Castle Harbour. For purposes of determining its book income, Castle Harbour created a depreciation schedule that resulted in annual depreciation deductions equal to 60 percent to 70 percent of its annual gross rental income for the year.

Operating Losses

Operating losses were allocated 98 percent to the Dutch banks and two percent to GECC until the Dutch banks received cumulative total loss allocations $3,854,493. Thereafter, all operating losses were allocated 99 percent to GE and one percent to the Dutch banks.

Disposition Gains or Losses

Disposition gains were allocated 90 percent to the Dutch banks and 10 percent to GECC until the Dutch banks had received $2,854,493 of disposition gain. Thereafter, disposition gain was allocated 99 percent to GECC and one percent to the Dutch Banks.

Disposition Losses were allocated first to offset prior disposition gains, second 90 percent to the Dutch banks and 10 percent to GECC until the Dutch banks had received $2,854,493 of disposition losses, and thereafter, 99 percent to GECC and one percent to the Dutch banks. All tax gains on a disposition attributable to the built-in gain in the value of the aircraft upon contribution were allocated to GECC.

CHILI

The cash held by Castle Harbour was contributed to CHILI. All of the cash was invested in high-grade commercial paper—the vast majority issued by GECC. GECC had the ability to transfer other assets of Castle Harbour to CHILI as well. Any income or loss upon the disposition of the stock CHILI would have been considered "disposition gain or loss" under the Operating Agreement. The purchase by CHILI of GECC commercial paper allowed GECC to retire the debt purchased by CHILI for financial accounting purposes, thus increasing its borrowing capacity.[8]

The interplay (and tax benefit) of this rather complex set of arrangements can be most easily understood through the use of a series of simplified examples. Each of the following examples assumes the following constant set of facts:

1. GECC has an aircraft with value of $1 million.
2. GECC wishes to generate $600,000 in cash against the asset at an eight-percent rate of interest.
3. GECC intends to pay off the $600,000 in cash (plus interest) on an amortized basis over a five-year term.
4. GECC income during the five years of the loan is as follows:

Year 1: +$200,000
Year 2: +$200,000
Year 3: +$200,000
Year 4: +$200,000
Year 5: +$200,000

Table 1.

Interest	Principal
$48,000.00	$102,273.87
$39,818.09	$110,455.78
$30,981.63	$119,292.25
$21,438.25	$128,835.62
$11,131.40	$139,142.47

Table 2.

Income	Interest Deduction	Depreciation Deduction	Taxable Income	Tax	Net Cash
$200,000	$48,000	$150,000	$2,000	$700	$49,026
$200,000	$39,818.09	$150,000	$10,182	$3,564	$46,162
$200,000	$30,981.63	$150,000	$19,018	$6,656	$43,070
$200,000	$21,438.25	$150,000	$28,561	$9,996	$39,730
$200,000	$11,131.40	$150,000	$38,869	$13,604	$36,122
Total					$214,110

Table 3.

Income	Interest Deduction	Depreciation Deduction	Taxable Income	Tax	Net Cash
$200,000	$48,000	$0	$152,000	$53,200	($3,473.87)
$200,000	$39,818.09	$0	$160,182	$56,063	($6,336)
$200,000	$30,981.63	$0	$169,018	$59,156	($9,429.87)
$200,000	$21,438.25	$0	$178,562	$62,497	($12,771)
$200,000	$11,131.40	$0	$188,869	$66,104	($16,378)
Total					($48,388.87)

Example 1. Aircraft has a remaining basis of $750,000, and has five years of depreciation left using the straight-line method. The $600,000 in cash is obtained as a level-amortization loan.

Amortization of the loan will result in the principal and interest depicted in Table 1 with respect to each annual payment of $150,273.87.[9]

The ultimate tax impact on GECC is as illustrated in Table 2 (assuming a 35-percent rate of tax).

Because the depreciation deductions shelter much of the income that is ultimately used to pay down the principal of the loan, GECC's net cash is, in most years, very close to the difference between its pre-tax income and the repayment of principal and interest on its loan.[10]

Example 2. Aircraft has $0 basis. The $600,000 in cash is obtained as a loan. Amortization of the loan will result in the same loan payments as in Example 1. However, without the depreciation deductions to shelter GECC's taxable income, the net result to GECC will differ drastically.

The ultimate tax impact on GECC is as illustrated in Table 3 (assuming a 35-percent rate of tax).

Table 4.

Income	Book Depreciation	Book Income	Book Allocation to Dutch Banks	Book Allocation to GECC	Tax Allocation to Dutch Banks	Tax Allocation to GECC	GECC Tax	Net Cash to GECC
$200,000	$169,108.30	$30,891.70	$30,273.87	$617.93	$196,000	$4,000	$1,400	$48,326
$200,000	$169,108.30	$30,891.70	$30,273.87	$617.93	$196,000	$4,000	$1,400	$48,326
$200,000	$169,108.30	$30,891.70	$30,273.87	$617.93	$196,000	$4,000	$1,400	$48,326
$200,000	$169,108.30	$30,891.70	$30,273.87	$617.93	$196,000	$4,000	$1,400	$48,326
$200,000	$169,108.30	$30,891.70	$30,273.87	$617.93	$196,000	$4,000	$1,400	$48,326
Total								$241,630

Example 3. Aircraft has $0 basis. The $600,000 is obtained as an equity contribution from a tax-neutral party *via* the *Castle Harbour* transaction. Exhibit E Payments are $150,273.87 per year.

In order to cause the Dutch banks' partnership interests to be "self-liquidating," annual income allocations of $30,273.87 should be made to the Dutch banks.[11] If the aircraft is expected to generate $200,000 of gross rental income each year, then a depreciation schedule should be selected for book purposes that will reduce net book income to $30,891.70.[12] Thus, a depreciation schedule will be selected that results in book depreciation deductions of $169,108.30 per year (*see* Table 4).

At the end of five years, the Dutch banks' capital accounts will be reduced to $0 and GECC will be left with the aircraft. Because there was no actual tax depreciation available to allocate to the Dutch banks, the disproportionate allocation of taxable income to the Dutch banks essentially placed GECC in roughly the same position that it would have been in had it obtained a secured loan against a depreciable aircraft with full tax basis. Thus, GECC was able to effectively re-depreciate the aircraft for tax purposes.[13]

II. The *Castle Harbour* Decisions

The IRS challenged the *Castle Harbour* transaction on three alternative grounds: (1) that the transaction was a sham that lacked economic substance; (2) that the allocations to the Dutch banks lacked "substantiality" under Code Sec. 704(b); and (3) that the interest held by the Dutch banks was not partnership equity, but rather a disguised loan to Castle Harbour. Ultimately, over the course of the four *Castle Harbour* decisions, the case was decided against GECC based on the findings by the Second Circuit that (1) the true nature of the Dutch banks' interests in Castle Harbour was that of a creditor;[14] and (2) Code Sec. 704(e) did not render the instruments held by the Dutch banks equity.[15] Neither the Courts nor the IRS attempted to address the sheltering effect of the book depreciation without corresponding tax depreciation that gave rise to the purported tax benefits of the strategy. Indeed, the only attempt by the IRS to challenge the allocations giving rise to the tax benefit was based on a strained reading of the "substantial economic effect" rules of Code Sec. 704(b).[16] As is discussed below, the reason that the legal analysis in the *Castle Harbour* decisions virtually ignored Code Sec. 704(c) was that the "ceiling rule"—particularly as it existed prior to the 1993 Regulations—fairly indisputably mandated the tax allocations utilized in the Castle Harbour transaction.

III. Code Sec. 704(c) and the *Castle Harbour* Transaction

As a very broad matter, Code Sec. 704(c) is concerned with allocations of income, gain, loss or deduction with respect to property that is contributed to a partnership. Fundamentally, the purpose of Code Sec. 704(c) is to correct for the shifting of income that can occur as a result of the "entity" approach to partnership taxation. By way of simple illustration:

> A and B form a partnership in which each will receive 50 percent of all items of income, gain, loss or deduction. A contributes property with tax basis $0 and fair market value of $100, and B contributes $100 of cash.

Absent Code Sec. 704(c), upon a sale of the property contributed by A for $100, each of A and B would have taxable income of $50.[17] By contrast, if

a pure aggregate approach were taken, whereby B's $100 contribution was treated as B having purchased from A a 50-percent interest in the property itself for $50 (and A's having thereby acquired a 50-percent interest in the $100 cash), (1) A would recognize $50 in gain at the time of B's purchase; and (2) B would receive $50 of tax basis for its 50-percent interest in the property. Upon a sale of the property for $100, A would recognize $50 in taxable income and B would recognize $0.[18] That is, A would ultimately pay all of the tax on the $100 of gain inherent in the property at the time of contribution. Code Sec. 704(c) is intended to preserve that result in the entity context by requiring that upon the sale of contributed property, the built-in-gain existing upon contribution be allocated solely to the contributing partner.[19]

The regulations under Code Sec. 704(c) further require that depreciation, amortization and similar cost recovery deductions with respect to contributed property be disproportionately allocated to the noncontributing partner so as to place the noncontributing partner in the position of receiving tax deductions to match its share of any book allocations of depreciation.[20] To further refine the example above:

> A contributes property that is depreciable over five years (on the straight-line method) with a tax basis of $50 and a value of $100 to a new partnership, and B contributes $100 in cash to the partnership. The parties agree to share in each partnership item on a 50 percent/50 percent basis.

In the first year, the partnership will recognize $10 in depreciation deductions with respect to the property. In the absence of Code Sec. 704(c), $5 in depreciation deductions would be allocated to A and $5 of depreciation deductions would be allocated to B. By contrast, if B had purchased a 50-percent interest in the property directly for $50, payable in five annual installments, then B would be entitled to depreciate his $50 over five years, resulting in B's recognition of $10 in annual depreciation deductions. A, on the other hand, would have recognized $25 in income over five years, resulting in $5 in income per year, matched by a $5 annual depreciation deduction attributable to A's retained interest, leaving A with a net allocation of $0 in each of the five years. Code Sec. 704(c) provides for the same result as in a deferred sale by allocating the $10 of entity-level depreciation solely to B, thus placing A and B in the same positions they would have been in had a pure aggregate approach been utilized. The technical way that the Regulations achieve this disproportionate tax allocation is by requiring that, for purposes of Code Sec. 704(b) (maintenance of capital accounts), the "book" value of the property (*i.e.*, its fair market value as of the date of its contribution) be depreciated in computing capital accounts.[21] Tax allocations are then made such that the tax allocation to the noncontributing partner is equal to its book allocation of depreciation.[22] Thus, when A contributes property with a fair market value of $100 and a five-year depreciation schedule, the property generates $20 per year of "book" depreciation, of which $10 is allocated to A and $10 is allocated to B in computing capital account balances. Then, the $10 of tax depreciation is allocated solely to B to match B's book allocation.

This basic Code Sec. 704(c) system works quite elegantly so long as there are sufficient items of partnership income, gain loss or deduction to allocate to the parties in order to prevent the shifting of income. However, where the partnership does not have sufficient items, the "ceiling rule" of Code Sec. 704(c) provides that "the total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year."[23] Put another way, a partnership cannot allocate items that it does not recognize at the entity level. Application of the ceiling rule can often lead to distortions that may be exploited by savvy tax planners.

By way of illustration, assume that in the example where A contributes nondepreciable property with a basis of $0 and a fair market value of $100, the property is ultimately sold for $80 instead of being sold for $100. In that case, upon the sale of the property, there would only be $80 of gain. Had B purchased a 50-percent interest in the property for $50, A would have recognized $50 of gain on the sale of the one-half interest to B, and, on the sale of the property for $80, would recognize $40 of gain in connection with the sale of its one-half interest. B would, on the sale of the property for $80 receive $40 and recognize $10 of loss with respect to the sale of its one-half interest. Thus, A would recognize $90 of aggregate gain ($100 of built-in value less 50 percent of the $20 loss of value); and B would recognize $10 of loss. The net effect of the $90 of

gain to A and the $10 of loss to B is $80 of net gain. Ideally, Code Sec. 704(c) would provide a mechanism by which $90 of gain could be allocated to A and $10 of loss could be allocated to B. However, the "ceiling rule," in its purest form, prevents this result, as the partnership does not have $90 of entity-level gain and $10 of entity-level loss to allocate. It only has $80 of entity-level gain to allocate. Thus, the $80 of gain will be allocated to A and no gain will be allocated to B. This distortion is ultimately remedied upon liquidation of the partnership. Upon liquidation for $180, $90 would be distributed to A and $90 would be distributed to B. Because B invested $100, B would recognize a loss of $10. A initially had a basis of $0. A's basis was increased by the $80 allocated to it upon the sale of the property it contributed. Upon receipt of the $90 liquidating distribution, A will recognize $10 in income, resulting in total gain recognition to A of $90.

Code Sec. 704(c) Pre-1993

Ceiling rule distortions also may arise in connection with allocations of depreciation where there is insufficient tax depreciation to match a non-contributing partner's items of book depreciation, and it was this type of distortion that lay at the heart of the *Castle Harbour* strategy. The Castle Harbour partnership had no tax allocations of depreciation to allocate to the Dutch banks to match their book allocations of depreciation. Accordingly, taxable income was simply allocated in the same manner as book income, resulting in the shifting to the Dutch banks of significant taxable operating income. This was possible, and indeed mandated, because prior to the 1993 Regulations, the ceiling rule was absolute.[24]

As a result, at the time of the *Castle Harbour* transaction, a partnership was permitted to make disproportionate allocations of gain, loss, depreciation or depletion with respect to contributed property to remedy a book-tax disparity, but was not entitled to (1) disproportionately allocate other partnership items to remedy the disparity, or (2) make allocations exceeding the allocations otherwise available to the partnership. Because of the absolute nature of the ceiling rule under the pre-1993 Regulations, the fundamental distortion at the heart of the *Castle Harbour* strategy was generally not challenged by the IRS.

The 1993 Regulations

The 1993 Regulations added Reg. §1.704-3, and provided several limitations on, and modifications to, the ceiling rule.[25] Specifically, the 1993 Regulations introduced the notion of "curative allocations" to cure ceiling rule distortions, and provided an "anti-abuse rule" for allocations under Code Sec. 704(c).

Curative Allocations

A "curative" allocation is:

> ... an allocation of income, gain, loss, or deduction for tax purposes that differs from the partnership's allocation of the corresponding book item. For example, if a noncontributing partner is allocated less tax depreciation than book depreciation with respect to an item of section 704(c) property, the partnership may make a curative allocation to that partner of tax depreciation from *another item of partnership property* to make up the difference, notwithstanding that the corresponding book depreciation is allocated to the contributing partner.[26]

> This can be illustrated through a simple example:

> A contributes two pieces of property to a partnership: a machine (M1) with a tax basis of $0 and fair market value of $100 and a machine (M2) with tax basis of $100 and fair market value of $100. B contributes $200 of cash, and A and B agree to share all partnership items on a 50 percent/50 percent basis. Both M1 and M2 are depreciable over five years on a straight-line method. Each machine will generate $20 in book depreciation per year, of which $10 will be allocated to A and $10 will be allocated to B.

Under the general rule for allocating tax depreciation, depreciation with respect to each property will be allocated *pro rata* according to the partners' sharing of income and loss allocations. M2 will generate $20 in annual depreciation deductions, of which $10 will be allocated to A and $10 will be allocated to B. M1 will generate $0 in depreciation deductions, so neither A nor B will receive any depreciation deduction. This is a ceiling rule distortion, as, had A sold a 50-percent interest in each of M1 and M2 to B for a purchase price of $100 payable over five years, B would have been entitled to annual depreciation deductions of $20; and A would have recognized $10 in annual income (equal to the $50 recognized on the sale of M1), matched by $10 of depreciation deduction (attributable to its retained interest in M2) for a net annual effect of

$0 in gain or loss. The 1993 Regulations permit the partnership to cure this distortion by allocating A's $10 of tax depreciation with respect to M2 to B, in order to cure the ceiling rule limitation on M1. With the curative allocation, A will have received $0 in tax depreciation and B will have received its full $20 in tax depreciation.

In order to be reasonable, a "curative allocation" is subject to several limitations on the amount, timing and type of the curative allocation. The curative allocation cannot exceed the amount of the ceiling rule distortion and curative allocations must be made over a reasonable period of time.[27] Curative allocations are also limited by type:

> If the item limited by the ceiling rule is depreciation or other cost recovery, a curative allocation of income to the contributing partner must be expected to have substantially the same effect as would an allocation to that partner of partnership income with respect to the contributed property. For example, if depreciation deductions with respect to leased equipment contributed by a tax-exempt partner are limited by the ceiling rule, a curative allocation of dividend or interest income to that partner generally is not reasonable, although a curative allocation of depreciation deductions from other leased equipment to the noncontributing partner is reasonable.[28]

Though the Regulation generally requires that curative allocations be of the same character as the item that is limited by the ceiling rule, there is an exception for curative allocations of income from the disposition of contributed property:

> If cost recovery has been limited by the ceiling rule, the general limitation on character does not apply to income from the disposition of contributed property subject to the ceiling rule, but only if properly provided for in the partnership agreement in effect for the year of contribution or revaluation. For example, if allocations of depreciation deductions to a noncontributing partner have been limited by the ceiling rule, a curative allocation to the contributing partner of gain from the sale of that property, if properly provided for in the partnership agreement, is reasonable for purposes of paragraph (c)(3)(iii)(A) of this section even if not of the same character.[29]

Thus, for example, if book allocations of depreciation without corresponding tax allocations result in the noncontributing partner recognizing taxable ordinary income that, but for the ceiling rule limitation, would have been sheltered by tax depreciation, a disproportionate allocation of long-term capital gain income to the contributing partner upon disposition of the property is a "reasonable" method of remedying this distortion, notwithstanding the character mismatch.

The 704(c) Anti-Abuse Rule

The 704(c) anti-abuse rule provides as follows:

> An allocation method (or combination of methods) is not reasonable if the contribution of property ... and the corresponding allocation of tax items with respect to the property 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.[30]

In the event that an allocation method is "unreasonable," the IRS has the right to require a change in the method. The only methods for making allocations that are pre-approved as "reasonable" in the regulations are (1) the traditional method (subject to the ceiling rule); (2) the traditional method with curative allocations; and (3) the "remedial allocation" method, which involves the creation of notional items to remedy ceiling rule distortions. The IRS is specifically prohibited from imposing the use of the "remedial allocation" method to remedy a transaction running afoul of the anti-abuse rule.[31] Accordingly, it would appear that, at least as a practical matter, the IRS's power to reallocate in connection with an abusive transaction arising from use of the traditional method is limited to mandating reasonable "curative allocations" to the extent available under the applicable regulations.[32]

The Regulations give the following example ("Anti-Abuse Example") of (1) a Code Sec. 704(c) methodology that is "unreasonable" under the anti-abuse rule; and (2) the use of the curative allocation method to cure the abuse:

> C and D form partnership CD and agree that each will be allocated a 50 percent share of all partnership items and that CD will make allocations under section 704(c) using the

traditional method. C contributes equipment with an adjusted tax basis of $1,000 and a book value of $10,000, with a view to taking advantage of the fact that the equipment has only one year remaining on its cost recovery schedule although its remaining economic life is significantly longer. At the time of contribution, C has a built-in gain of $9,000 and the equipment is section 704(c) property. D contributes $10,000 of cash, which CD uses to buy securities. D has substantial net operating loss carryforwards that D anticipates will otherwise expire unused. The partnership must allocate the $10,000 of book depreciation to the partners in the first year of the partnership. Thus, there is $10,000 of book depreciation and $1,000 of tax depreciation in the partnership"s first year. CD sells the equipment during the second year for $10,000 and recognizes a $10,000 gain ($10,000, the amount realized, less the adjusted tax basis of $0).[33]

The Anti-Abuse Example explains that the use of the "traditional method" in this context is unreasonable for the following reason: in the first year, there will be $10,000 of book depreciation on the equipment and only $1,000 of tax depreciation. The tax depreciation will be allocated to the noncontributing partner. After allocation of the book depreciation, the property will no longer have a book-tax disparity (as both the tax basis and book value will be $0). Thus, when the property is sold in year 2, the $10,000 of gain will be allocated 50 percent to C and 50 percent to D, effectively shifting $5,000 of the built-in-gain to D. The example thus provides that "under these facts, if the partnership agreement in effect for the year of contribution had provided that tax gain from the sale of the property (if any) would always be allocated first to C to offset the effect of the ceiling rule limitation, the allocation method would not violate the anti-abuse rule."[34] The Anti-Abuse Example is significant in that (1) per the text of the anti-abuse rule, the strategy contemplates "shifting the tax consequences of built-in-gain," and (2) the curative allocation is imposed on disposition of the property.

In the *Castle Harbour* case, both the Second Circuit[35] and the taxpayer itself[36] generally assumed that the *Castle Harbour* transaction would have (1) violated the anti-abuse rule set forth in the 1993 Regulations (had it applied); and (2) could have been remedied by the imposition by the IRS of curative allocations of taxable rental income to GECC. However, it is not at all clear (at least to this author) that (1) the *Castle Harbour* strategy involved any shifting of the tax consequences of built-in-gain, or (2) that the IRS's power under the anti-abuse regulation would necessarily have allowed it to require curative allocations of rental income to GECC. Read in the context of both the legislative history of Code Sec. 704(c) and the 1993 Regulations themselves, there is an argument that even after the 1993 Regulations, the *Castle Harbour* transaction should be permissible under Code Sec. 704(c).[37]

Did Castle Harbour Involve the Shifting of Built-in Gain?

The first prong of the Code Sec. 704(c) anti-abuse rule is that it deals exclusively with allocations "made with a view to shifting the tax consequences of built-in gain or loss." Thus, the salient question is whether the *Castle Harbour* strategy shifted the tax consequences *of the built-in-gain*. When the strategy is examined from a pure aggregate perspective, it would appear that while it certainly resulted in a shift of the tax consequences of the operating income generated by the aircraft, it was actually designed in such a manner as to specifically avoid a shifting of the built-in-gain of the aircraft itself.

Because of its unique nature, it is very difficult to construct a pure aggregate approach by which to test the *Castle Harbour* investment for a shift in gain. However, because the anti-abuse regulation is concerned solely with the taxation of the built-in-gain in the Code Sec. 704(c) property, the corresponding "pure aggregate" transaction could be viewed (using the example of an aircraft with book value of $750,000 and $0 depreciable basis) as a sale to the Dutch banks of an interest in the aircraft for an amount equal to $600,000 plus a deferred payment of $169,108.30 per year (which is the amount of operating income to GECC sheltered under the *Castle Harbour* strategy as described in Example 3 of Part I of this article). Were such a sale to have occurred in a pure aggregate construct, GECC would recognize $600,000 of the built in gain plus the amount of the deferred purchase price (which would be recognized upon payment thereof if installment reporting was used). Upon a subsequent sale of the property for its $750,000 adjusted value on contribution, GECC would recognize $150,000 and the Dutch banks would recognize $0 in gain (as they would have a $600,000 basis in the aircraft). Thus, no gain would be shifted. Likewise, under the far more complex

construct of the actual *Castle Harbour* transaction, all taxable income from the disposition of the aircraft (other than the *de minimis* one percent allocable to the Dutch banks) was allocable to GECC.[38] The true net effect of the transaction was to defer tax on operating income *via* the book depreciation of the aircraft. It did not shift the tax consequences of the built-in value of the aircraft.

While the language of the 704(c) anti-abuse rule certainly encompasses timing benefits as well as absolute reductions in tax (by virtue of testing the "present value of the partners' aggregate tax liability"), the language of the regulation specifically requires that any such timing benefit arise out of a shifting of the tax consequences *of the built-in-gain*. The *Castle Harbour* transaction certainly resulted in certain timing benefits from an exploitation of the ceiling rule. However, those timing benefits arose in connection with the deferral of operating income, and operating income was independent from the value of the built-in-gain of the aircraft. Accordingly, it could certainly be argued that the transaction did not implicate the specific abuse that Code Sec. 704(c) and the 704(c) anti-abuse rule were intended to prevent.

Could the IRS Have Mandated Curative Allocations of Rental Income?

While the reading of the 704(c) anti-abuse rule set forth above may appear overly technical, it actually corresponds to the implicit limitations imposed on the IRS in enforcing the 704(c) anti-abuse rule.

Code Sec. 704(c)(1)(A) provides that:

> Under regulations prescribed by the Secretary—
>
> (A) income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

The language of the statute is very broad, granting discretion to the IRS to determine *how* the variation between basis and fair market value of contributed property should be taken into account. However, the grant of authority to the IRS is limited to devising a methodology for making determinations of income, gain, loss and deduction "with respect to" such property. The use of the words "with respect to" in this context is somewhat ambiguous, and, as a matter of statutory construction, it is appropriate to look to the legislative history to determine the intention of Congress in using those words. The legislative history to Code Sec. 704(c) specifically address this ambiguous point, providing that:

> ... the conferees do not intend for the Treasury to require such variations [between adjusted basis and fair market value on contribution] to be eliminated by allocations of operating income and loss attributable to the contributed property (other than depreciation, depletion and similar items).[39]

Interestingly, the 1993 Regulations virtually ignore this sentence from the Code Sec. 704(c) legislative history in applying the curative method to Code Sec. 704(c) allocations. In Reg. §1.704-3(c)(4), Example 1, the following situation is posited:

> E and F form partnership EF and agree that each will be allocated a 50 percent share of all partnership items and that EF will make allocations under section 704(c) using the traditional method with curative allocations under paragraph (c) of this section . E contributes equipment with an adjusted tax basis of $4,000 and a book value of $10,000. The equipment has 10 years remaining on its cost recovery schedule and is depreciable using the straight-line method. At the time of contribution, E has a built-in gain of $6,000, and therefore, the equipment is section 704(c) property. F contributes $10,000 of cash, which EF uses to buy inventory for resale. In EF's first year, the revenue generated by the equipment equals EF's operating expenses. The equipment generates $1,000 of book depreciation and $400 of tax depreciation for each of 10 years. At the end of the first year EF sells all the inventory for $10,700, recognizing $700 of income. The partners anticipate that the inventory income will have substantially the same effect on their tax liabilities as income from E's contributed equipment.

Under the traditional method for making allocations under Code Sec. 704(c), each of E and F would receive book allocations of depreciation of $500 for the first year. However, there is only $400 of tax depreciation that can be allocated to F (the

noncontributing partner). In order to place F in the position it would have been in absent this ceiling rule limitation, the example provides that "EF may properly allocate to E under paragraph (c) of this section an additional $100 of income from the sale of inventory for tax purposes." Thus, operating income from the sale of inventory may, under this example, be used to remedy the book-tax disparity arising upon contribution of the equipment.

This example would generally suggest that if the *Castle Harbour* transaction was violative of the anti-abuse rule (by reason of selecting the "traditional method" as a means of reducing the present value of the aggregate tax liabilities of the parties), the IRS could have imposed allocations of taxable rental income to GECC that differed from the book allocation of such items. However, query whether the regulations, when read this way, exceed the Department of the Treasury's rulemaking authority afforded by the statute (which only permitted rules governing the allocation of items "with respect to" the contributed property). Indeed, one might reasonably argue that to be read consistently with the statute (as intended by Congress in its legislative history), the regulations should be read more narrowly as consisting of two types of curative allocations: those which will be accepted by the IRS as reasonable (*i.e.*, those that are *permissible*) and those which may be mandated by the IRS, with the latter type of method being narrower than the former. Thus, it may very well be argued that the IRS may *permit* certain special curative allocations of operating income to remedy book-tax disparities, but *requiring* them, would exceed its authority under the statute.[40] This reading of the regulations bolsters a narrow reading of the 704(c) anti-abuse rule as it suggests that when a curative allocation would correct for a timing difference with respect to operating income from contributed property, but would not be necessary to prevent an actual shift in the taxation of the built-in gain of the Code Sec. 704(c) property, curative allocations of operating income cannot be mandated because there has been no violation of the anti-abuse rule.

IV. Conclusion

Ultimately, the arguments set forth in this article have no impact on the analysis of the Court in *Castle Harbour.* By accident of timing, the IRS was forced to argue its position on the basis of Code Sec. 704(b) (which was an uphill battle at best) and on the grounds of a debt-equity analysis (which ultimately proved successful). However, because the litigation did not, ultimately, turn on the fundamental tax strategy of exploiting ceiling rule limitations to defer tax, the question remains as to whether the 704(c) anti-abuse rule has effectively eliminated the possibility of utilizing such strategies. In the view of this author, the 704(c) anti-abuse rule is a precise instrument, whose purpose and utilization is limited to preventing the shifting of the taxation on the built-in-gain of contributed property from one taxpayer to another. It should not be read to disallow all deferral of *operating income* generated by contributed property where there is no shift in the *gain* in the contributed property (whether upon disposition or in cost recovery deductions). While the regulations do provide taxpayers with several means of remedying such timing distortions, Code Sec. 704(c) does not give the IRS license to eliminate all distortions by virtue of the 704(c) anti-abuse rule. Of course, the broader Subchapter K anti-abuse rule of Reg. §1.701-2 (as well as the codified economic substance doctrine) may apply to provide the IRS with broader administrative authority to challenge abusive transactions that lack economic substance or business purpose. However, the precise bounds of when it is abusive or inappropriate to derive tax deferral *via* a proper application of regulations to contributed property has yet to be determined.

Endnotes

1. *TIFD III-E, Inc.*, CA-2, 2012-1 USTC ¶50,167, 666 F3d 836 (2012).
2. Throughout this article, the initial District Court decision (DC-CT, 2004-2 USTC ¶50,401, 342 FSupp2d 94 (2004)) is referred to as "*Castle I*," the first decision of the Court of Appeals for the Second Circuit (CA-2, 2006-2 ¶50,442, 459 F3d 220 (2006)) is referred to as "*Castle II*," the District Court's decision on remand (DC-CT, 660 FSupp2d 367 (2009)) is referred as "*Castle III*," and the final decision of the Court of Appeals for the Second Circuit (*supra* note 1) is referred to as "*Castle IV*."
3. T.D. 8717, 1997-1 CB 125, May 9, 1997, *as amended by* T.D. 8730, 1997-2 CB 94, Aug. 20, 1997.
4. T.D. 9137, IRB 2004-34, 308, July 16, 2004.
5. T.D. 9193, IRB 2005-15, 862, Mar. 22, 2005; as amended by T.D. 9207, IRB 2005-36, 1344, May 26, 2005, *as corrected by* 70 FR 45530–45531, Aug. 8, 2005.
6. T.D. 9485, IRB 2010-26, 771, June 9, 2010.
7. *Castle I*, *supra* note 2.
8. In addition to the limitation on disposition losses that could be allocated to the Dutch banks, the Dutch banks received additional downside protections in the form of an "investment account" and a limited

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[10] *Stinnett's Pontiac Service, Inc.*, CA-11, 84-1 USTC ¶9406, 730 F2d 634 (1984).
[11] *Laidlaw Transportation, Inc. and Subsidiaries*, 75 TCM 2598, Dec. 52,766(M), TC Memo. 1998-232.
[12] TAM 9024001 (Feb. 20, 1990).
[13] *Malone & Hyde, Inc.*, 49 TC 575, Dec. 28,866 (1968).
[14] *Cascade Designs, Inc.*, 79 TCM 1542, Dec. 53,762(M), TC Memo. 2000-58.
[15] *NA General Partnership, et. al.*, 103 TCM 1916, Dec. 59,094(M), TC Memo. 2012-172.

Tackling Taxes

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better income matching under the recurring item exception if the liability is prorated over tax years for financial statement purposes. While the regulation for the three-and-a-half-month rule exception may be ambiguous, the Tax Court supported the IRS's position that this exception only applies when all the services or products are reasonably expected to be provided within the three-and-a-half-month period. The challenge now is to draft a severable contract that can allow a deduction for identifiable and separate services or products provided within the three-and-a-half-month period.

ENDNOTES

[1] Paul C. Lau, Cara Hoffman and Kim Haumann, Tackling Taxes, *The Ageless All-Events Hurdle—Part I*, TAXES, Aug. 2012.
[2] Code Sec. 461(h)(2)(A) and Reg. §1.461-4(d)(6).
[3] Code Sec. 461(h)(2)(B) and Reg. §1.461-4(d)(4)
[4] Code Sec. 461(h)(2)(A)(iii) and Reg. §1.461-4(d)(3).
[5] Reg. §1.461-4(d)(3)(i).
[6] Reg. §1.461-4(d)(3)(ii).
[7] Reg. §1.461-4(d)(3)(ii)(B).
[8] Reg. §1.461-4(g)(1)(ii)(A).
[9] Code Sec. 461(h)(2)(C) and Reg. §1.461-4(g)(2).
[10] Reg. §1.461-4(g)(3).
[11] Reg. §1.461-4(g)(4).
[12] Reg. §1.461-4(g)(5).
[13] Reg. §1.461-4(g)(6)(i), (iii).
[14] Reg. §1.461-4(g)(6)(ii).
[15] Reg. §1.461-4(g)(7).
[16] Rev. Rul. 2012-1, IRB 2012-2, 255.
[17] CCA 201121001 (May 27, 2011).
[18] *Centel Communications Co.*, CA-7, 90-2 USTC ¶50,603 (1990).
[19] While beyond the scope of this column, can the facility fee be treated as a guarantee payment under Code Sec. 707(c)?
[20] TAM 200846021 (Nov. 14, 2008).
[21] In our August tax column, *supra* note 1, we cited *General Dynamics Corp.*, SCt, 87-1 USTC ¶9280, 481 US 239, which held that the "all-events" test was not met for a medical expense reimbursement until a properly documented claim form was filed by the employee. *General Dynamics* is not applicable here because it was the medical service provider, not the employee, filing the claim for payment. An eligible employee was not required to pay the service provider for covered expenses and submit a claim for reimbursement.
[22] Reg. §1.461-5(b)(5)(i).
[23] Rev. Rul. 2012-1, *supra* note 16.
[24] Rev. Proc. 2008-25, IRB 2008-13, 686.
[25] Reg. §1.461-5(b)(5)(ii).
[26] *See* Rev. Rul. 74-70, 1974-1 CB 116, *revoked by* Rev. Rul. 96-51, 1996-2 CB 36.
[27] Rev. Rul. 2007-12, 2007-1 CB 685, *revoking* Rev. Rul. 69-587.
[28] *Eastman Kodak*, CtCls, 76-1 USTC ¶9363 (1976).
[29] *See, e.g.*, TAM 200619022 (Feb. 1, 2006).
[30] *Caltex Oil Venture*, 138 TC No. 2, Dec. 58,915 (2012).
[31] T.D. 8404, 1992-1 CB 296.

Tangible Property

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[41] Adapted from Temporary Reg. §1.263(a)-3T(j), Example 3.
[42] Adapted from Temporary Reg. §1.263(a)-3T(j), Example 4.
[43] Temporary Reg. §1.263(a)-3T(k)(1).
[44] Temporary Reg. §1.263(a)-3T(k)(2).
[45] Temporary Reg. §1.263(a)-3T(k)(3).
[46] Adapted from Temporary Reg. §1.263(a)-3T(k)(4), Example 1.
[47] Adapted from Temporary Reg. §1.263(a)-3T(k)(4), Example 4.
[48] Temporary Reg. §1.263(a)-3T(d).
[49] Temporary Reg. §1.263(a)-3T(g)(1).
[50] *Id.*
[51] Temporary Reg. §1.263(a)-3T(g)(3).
[52] Adapted from Temporary Reg. §1.162-3(T)(g), Example 4.
[53] Adapted from Temporary Reg. §1.162-3(T)(g), Example 5.
[54] Adapted from Temporary Reg. §1.162-3(T)(g), Example 6.

Ceiling Rule Distortions

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guaranty from GECC. The investment account was a notional account on the books of Castle Harbour. The opening balance of the investment account of each Dutch bank was equal to its initial investment. This balance was increased annually by an annual fixed yield of 9.03587 percent or 8.25 percent (depending on exit event) and reduced by Exhibit E Payments. If, upon liquidation of Castle Harbour, a Dutch bank's investment account exceeded the algebraic sum of the Dutch banks' total allocation of (1) operating gains, (2) operating losses allocated at the rate of 98 percent (which was limited to $3,854,493), (3) disposition gains, and (4) disposition losses allocated at the 90-percent rate (which was limited to $2,854,493), then an amount equal to such excess would be paid to the Dutch banks upon their exit from Castle Harbour as a "guaranteed payment" described in Code Sec. 707(c). This possible payment (which served as a means of limiting the downward exposure of the Dutch banks) was referred to as a "Class A Guaranteed Payment." The Class A Guaranteed Payment did not hedge against the risk of any losses allocated to the Dutch banks at the one-percent rate. GECC also entered into a limited guaranty, guaranteeing the payment by Castle Harbour of certain insurance premiums and management fees. The full scope of the guaranty was hotly contested. The *Castle II* Court held that the GECC guaranty essentially provided security for all amounts due to the Dutch banks from Castle Harbour. *See Castle II, supra* note 2. The taxpayer argued in its briefs, however, that "the performance guaranty did not assure the banks of the return of their entire capital investment." Brief for Plaintiff-Appellee, Sept. 14, 2010, at 46.
[9] Derived using the PMT function in Microsoft Excel.
[10] Of course, the benefit of depreciation is, as a general matter, a timing benefit, as upon any subsequent disposal of the property, the basis in the property will have been reduced by the depreciation deductions. Thus, if the aircraft were ultimately sold for the $750,000 depreciated value upon contribution, the resulting $750,000 of gain will effectively reverse the tax benefit of the prior $750,000 in depreciation deductions.
[11] Exhibit E Payments of $150,273.87 will result in the Dutch banks receiving an eight-percent yield. $150,273.87 – ($600,000 / 5) = $30,273.87.
[12] $30,273.87 / 0.98.
[13] The timing benefit to GECC was only possible because the Dutch banks did not have a corresponding income inclusion as a result of the allocation to them of the excess taxable income. As in the case of Example 1, upon liquidation of the partnership, the tax benefits of the disproportionate tax allocation to the Dutch banks will be recaptured as tax will be paid on the cash distributed to GECC on which it had not previously paid tax by reason of the disproportionate tax allocation to the Dutch banks. *See* Code Sec. 731(a)(1).

[14] *Castle II, supra* note 2. For an in-depth discussion of the partnership debt/equity concerns raised by the decision in *Castle II, see* Jerry Williford and David M. Kaplon, *The* Castle Harbour *Case: Is There Reason to Reconsider Debt-Equity Issues Under Subchapter K?* 48 TAX MGMT MEMO. 75 (Mar. 5, 2007).

[15] *Castle IV, supra* note 2.

[16] The IRS argued that the allocations to the Dutch banks in the *Castle Harbour* transaction lacked "substantial economic effect" under the "overall tax effect" test of Reg. §1.704-1(b)(2)(iii)(A), which provides that:

> The economic effect of an allocation (or allocations) is not substantial if, at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement.

The IRS essentially argued that because the disproportionate allocation of taxable income to tax-neutral parties substantially reduced the aggregate tax burden of the partners on a present value basis, the allocations lacked substantiality and should instead be tested under the "partners' interest in the partnership" test of Reg. §1.704-1(b)(3) (PIP). The IRS argued that because the PIP test looks to, among other facts and circumstances, "the partners' relative contributions to the partnership," a "baseline" allocation should be determined for the Dutch banks (1) assuming that all income is allocated based on the partners' relative share of capital, and that there is no distinction between the two different streams of income (Operating Income and Disposition Gain), and (2) ignoring the book depreciation deductions (as those deductions "clearly did not reflect any loss in economic value to the taxpayer" and thus had no "economic effect"). (*See Castle II* Appellant Reply Brief, 2005 WL 5713618, at 23.)

GECC argued that this interpretation of the overall economic effect rule and the PIP standard was antithetical the very purpose of PIP, which is to give effect to the business deal of the parties, not to alter it. Moreover, GECC pointed out that the regulations under Code Sec. 704(b) require that in applying the "overall tax effect" for substantiality (and consequently, the PIP test), the parties assume that the value of partnership property is equal to its book value. Ultimately, the District Court agreed with GECC, finding that "[t]he problem with the government's argument is that its premise, that the partners' interests in the partnership are their respective percentages of ownership, appears to be made out of whole cloth." (*Castle I, supra* note 1.) While both the government and the taxpayer continued to argue the issues of substantiality and PIP in the three subsequent appeals and remands, the Second Circuit did not address this argument, and it did not play into the final disposition of the case. (*See Castle II, supra* note 2.) For a far more in-depth analysis of the competing arguments surrounding the substantiality and PIP standards in the *Castle I* decision, *see* Karen C. Burke, Castle Harbour: *Economic Substance and the Overall Economic Effect Test,* TAX NOTES, May 30, 2005.

[17] Under Code Sec. 723, the entity will have a $0 basis in the property, and the sale will thus generate $100 of gain under Code Sec. 1001.

[18] *See* Code Sec. 1001. Because the sale would constitute a sale of two tenant-in-common interests in the same property, it would be bifurcated and each of A and B would be treated as having sold its one-half interest in the property.

[19] Though Reg. §1.704-3(a)(1) provides quite simply that "[t]he purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss," such shifting is only possible as a result of the treatment of the partnership as an entity for purposes of calculating the taxable income of the partners. *See* H.R. REP. 83-1337, at 66 (1954) (acknowledging the income shifting that occurs by virtue of "recognize[ing] the partnership as an entity for purposes of income reporting"). As is discussed in the text above, treating the partnership as a pure aggregate would, by application of general sale or exchange principles of Code Sec. 1001, prevent any shifting of income as between the contributing partner and the noncontributing partners. Accordingly, it is appropriate, in testing to determine whether a particular transaction has resulted in a "shift" of income among partners, to compare the result under the partnership rules with the result that would have occurred in the absence of a partnership entity. This approach is generally endorsed by the IRS in the general partnership anti-abuse rule of Reg. §1.701-2, which, in determining whether a transaction is abusive looks to whether the tax result differed from the result which would have been derived "had the partners owned the partnership's assets and conducted the partnership's activities directly." Reg. §1.701-2(c)(1).

[20] *See* Reg. §1.704-3(b), -3(c) and -3(d).

[21] Reg. §1.704-1(b)(2)(iv)(g)(3).

[22] Reg. §1.704-3(b)(1).

[23] *Id.*

[24] *See* Reg. §1.704-1(c)(2) as in effect prior to the 1993 Regulations.

[25] The *Castle II* Court stated that "the so-called Ceiling Rule derived from I.R.C. 704(c), which has since been repealed was the statutory provision upon which the partnership relied to justify its allocations." *Castle II, supra* note 2. This is an incorrect characterization of the 1993 Regulations. In fact, subject to certain specific limitations placed on ceiling rule distortions (which are discussed in the text above), the 1993 Regulations retained the ceiling rule, and it can continue to play an important role in partnership tax planning.

[26] Reg. §1.704-3(c)(1).

[27] Reg. §1.704-3(c)(3)(i)–(ii).

[28] Reg. §1.704-3(c)(3)(iii)(A).

[29] Reg. §1.704-3(c)(iii)(B).

[30] Reg. §1.704-3(a)(10).

[31] Reg. §1.704-3(d)(5)(ii).

[32] Arguably, the IRS could attempt to devise a "reasonable method" not set forth in the Regulations (which does not require the creation of notional tax items like the remedial allocation method), that it could impose on taxpayers running afoul of the ceiling rule. In practicality, it is difficult to imagine that IRS devising a method that differs significantly from the methods published in the Regulations (as, presumably, if such a method existed, it would have been included as "reasonable method" in the final Regulations).

[33] Reg. §1.704-3(b)(2), Example 2.

[34] *Id.*

[35] *See* note 14, *supra*.

[36] In its *Castle IV* briefing, the taxpayer argues that "[h]ad the amended regulations applied to Castle Harbour, they would have permitted the IRS to mandate 'curative' allocations of other items of taxable income to the GECC partners, thereby reducing the Banks' taxable income by an amount equal to the shortfall in tax depreciation." Brief for Plaintiff-Appellee, Sept. 14, 2010, at 93. Of course, in this context, the taxpayer was arguing that because the 1993 Regulations did not apply at the time of the *Castle Harbour* transaction, the IRS was powerless to adjust the tax result of the transaction.

[37] This conclusion would require that the transaction be respected as a *bona fide* equity investment (which it was not).

[38] Likewise, the cash receipts that were sheltered by the disproportionate tax allocation to the Dutch banks would ultimately be taxed to GECC upon the unwinding of the Castle Harbour partnership.

[39] COMREP ¶7041.005, *Partnership Allocations as to Contributed Property* ('84 TRA, P.L. 98-369, July 18, 1984).

[40] *See* McKee, Nelson and Whitmire, FEDERAL TAXATION OF PARTNERS AND PARTNERSHIPS (4th ed 2007), at ¶11.04[3][d], note 522. As of this writing there are no cases construing this particular element of the anti-abuse rule.