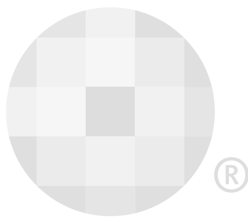
Is Debt vs. Equity Different in a Partnership?

*By Steven R. Schneider**

Partnership debt versus equity classification is approaching the famed "I'll know it when I see it" test. Steven R. Schneider discusses whether the fundamental debt-equity principles have changed in the partnership arena and how recent authorities should be viewed in the context of the overall debt-equity framework.



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I. Introduction and Overview

To classify an instrument as debt, common law confirms traditional debt-equity principles apply to an instrument regardless of the type of entity that issued the instrument. However, the determination of whether debt-like equity rises to the level of being a partnership interest is approaching the famed "I'll know it when I see it" test.[1] The Tax Court in *Hambuechen*[2] provided a starting point for the analysis with the conclusion that the traditional corporate debt-equity test also applies to partnerships. Despite the appealing simplicity and logic of having a single debt-equity test, partnerships clearly add a level of complexity. For example, the *Hambuechen* case did not address the Supreme Court's *Culbertson* "totality of the circumstances" test for determining whether a person rises to the level of a "partner,"[3] which requires that the parties in good faith and acting with a business purpose intended to join together in the present conduct of a business enterprise.[4] Thus the question is whether it is axiomatic that a taxpayer holding an instrument classified as equity in a partnership must be a partner for tax purposes.

Many recent tax-driven cases involved partnership interests with debt-like economic terms ("Debt-Like Equity") where the tax planning was dependent on the interests being treated as partnership equity for tax purposes. Frequently, the investor's right to be repaid was bolstered by assets outside

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of the partnership that provided additional financial support. While the issue in these cases was whether Debt-Like Equity should be respected as equity, much of the law distinguishing debt and equity arose in a different context—that is, where a corporation issues an instrument that was structured as debt for local law purposes, but had equity-like features ("Equity-Like Debt"). The tilt toward treating an instrument as equity in Equity-Like Debt cases creates an easier path taxpayers seeking equity treatment in Debt-Like Equity. This broad definition of partnership equity must be balanced with the *Culbertson* rule when making the determination of whether a taxpayer is classified as a partner. To better understand the current state of affairs, a brief legal history is necessary.

A. *Hambuechen*—Tax Court Directly Addresses Debt vs. Equity in Partnerships

In 1964, the Tax Court in *Hambuechen* was confronted with the exact question of whether the corporate debt-equity principles apply equally in the partnership context. Mr. Hambuechen was a long-term partner in a private banking partnership with significant ties to Germany. Economic and political problems in Germany in the 1930s necessitated the need for cash by the partnership. Mr. Hambuechen "loaned" money to the partnership in 1939 to help the partnership through difficult times, although there was no security and no interest was ever charged or paid. In 1951 the partnership partially repaid the loan and Mr. Hambuechen took a tax loss for the remaining unpaid loan balance. The IRS denied the loss, claiming that the loan was a capital contribution and the repayment was merely a partial return of capital.

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The dispute landed in the Tax Court, where a key issue was whether the general common law debt-equity cases applied equally to partnerships. Specifically, Mr. Hambuechen contended that the thin capitalization cases dealing with corporations are not applicable to a partnership. The Tax Court noted that it is true that the entire area of case law cited by the IRS related only to stockholders and their corporations. The court observed that it did not find any cases applying the corporate authorities to partnerships or denying the application of the authorities to partnerships, and thus found it to be an issue of first impression.

The Tax Court concluded that there was no reason to treat partnerships differently than corporations with respect to determining whether an advance was debt or equity, and applied the historical corporate principles to recast Mr. Hambuechen's advance as partnership equity. The court focused its analysis on the economic reality of what took place and noted that the question of whether the debt is recognized or not is the same for a corporation or a partnership. Specifically the court noted that "whether a corporation is trying to take an interest deduction or whether a stockholder is trying to escape being taxed on the receipt of a constructive dividend or, as in this case, whether a partner can take an ordinary loss deduction, the question remains, did a valid debt exist?"[5] The court did recognize that there may be more careful scrutiny in the corporate context, "but the ultimate determination of the existence or nonexistence of a debt should be made upon the same factors with the possible shifting of the weight given to any one factor."[6]

B. The Statute vs. the Common Law "Totality of the Circumstances Test"

The baseline test for partnership status begins with the broad statutory rule. Code Secs. 761(a) and 7701(a)(2) define a 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 trust or estate."[7] The legislative history to Code Sec. 7701(a)(2) evidences Congress's intent to create a broad statutory definition of "partnership" to avoid taxpayers failing to report certain arrangements. Thus the definition includes as members of a partnership "all joint ventures, syndicates, pools, and similar organizations, which do not constitute associations or trusts, in the category of partners."[8] The regulations further provide that a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom.[9]

The broad statutory definition of a partnership led to taxpayers creating family partnerships as a form of income splitting. The IRS and courts took notice and created common law limitations on partner status, primarily through

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the *F.E. Tower*,[10] *W.O. Culbertson*,[11] and *H.M. Luna*[12] cases described below. These cases set forth a totality of the circumstances test that looked to, among other things, where there was a requisite intent by the parties to join together in a business and share profits and/or losses.

The *Tower* case involved a purported partnership between a husband and wife to shift income to the wife and take advantage of the wife's lower tax rate. The wife was not involved in the business and did not provide independent capital to the business. The Supreme Court held that the wife was not a partner, noting that a partnership is created when people join together with their money, goods, labor, or skill in a business and share profits and losses therefrom and that the real question is 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."[13] The court said the question was not whether the wife actually owned the capital, but whether the husband and wife really intended to carry on business as a partnership and all steps in the process of earning the profits must be taken into consideration.

The *Culbertson* case elaborated on the *Tower* decision in the context of a purported cattle partnership between a father and his sons. In *Culbertson* the Supreme Court clarified that such a partnership could be respected, but it was a detailed factual question of the entire circumstances. Specifically the court noted that "[t]he question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the Tower case, but whether, 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."[14]

Based on *Culbertson*, the determination of whether a partnership exists is a fact-intensive inquiry that considers all the factors without any one factor, or set of factors, controlling. For a partnership to exist, the factors must lead to the conclusion that the parties intend to join together in the present conduct of a business enterprise (although intent to be a "partnership" is not necessary). In addition to intent, other key factors relevant to the determination of whether a partnership exists include the sharing of profits,[15] an agreement to share costs or losses,[16] the ownership of a capital interest or performance of services,[17] and participation in management.[18]

The factors relevant to whether an arrangement constitutes a "partnership" were perhaps best described by the Tax Court in *Luna*:

> The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed Federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.[19]

The *Culbertson* test has been cited in hundreds of cases and continues to be heavily cited in recent case law, often involving tax-advantaged transactions.[20] As discussed below, *Culbertson* is also a consistent theme in recent Debt-Like Equity cases.[21]

C. Recent Cases Create Confusion

A recent line of cases involving tax-motivated transactions have further muddied the water regarding the line between partnership debt and equity. In these cases, the parties sought partnership equity treatment in order to (1) shift income to a tax-indifferent party,[22] (2) import built-in tax losses,[23] (3) sell tax credits,[24] and/or (4) obtain significant foreign tax credits based on income earned from funds of a tax-indifferent investor.[25] While the tax-motivated nature of these transactions may have made them vulnerable to a variety of IRS challenges, the primary challenge brought by the IRS in each case was whether a person holding equity as a local law matter was respected as a "partner" for tax purposes under the *Culbertson* and traditional debt-equity tests.

The traditional debt-equity tests involved Equity-Like Debt which involved different contexts than the current partnership cases. In the traditional cases, the IRS was generally seeking equity treatment in order to recharacterize deductible interest as nondeductible dividends. In the partnership context, however, classification of an

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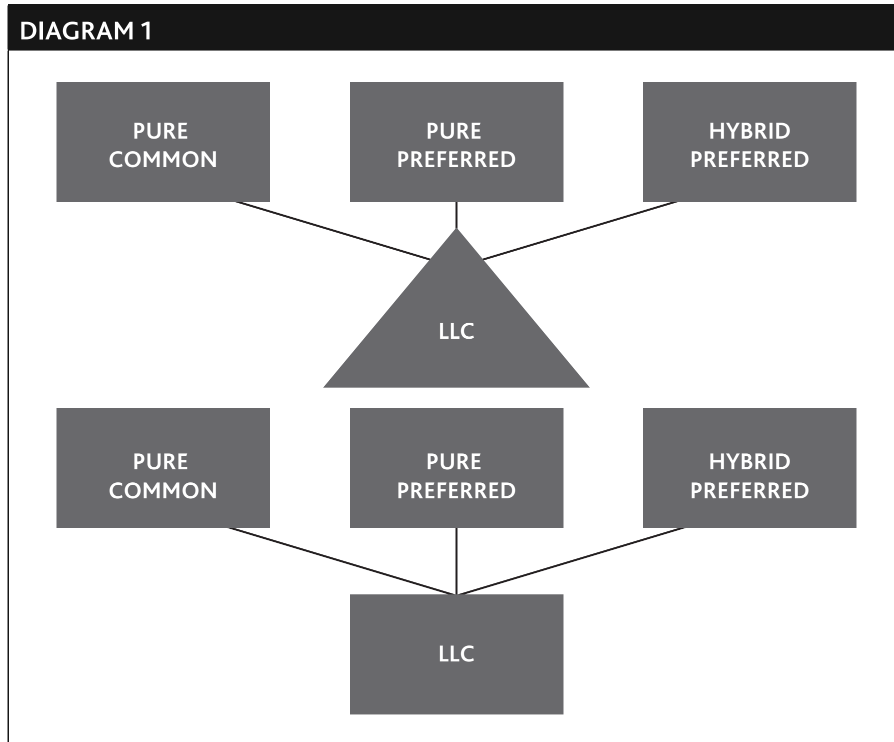
DIAGRAM 1



interest as debt or equity raises a different set of concerns because there is no level of corporate tax and because (regardless of debt or equity treatment) the coupon on the instrument will generally reduce the taxable income of the other partners. As the more recent cases demonstrate, it is easier to use partnership tax rules to shift tax items among persons treated as partners, and equity treatment is often the key into this kingdom of flexibility. Given the additional benefits of equity in a partnership, a natural question is whether Debt-Like Equity in partnerships should be subjected to a tougher (or at least different) test than the test applicable to corporations. Or, alternatively, should uniform debt-equity tests apply to all entities, and perceived abuses in the partnership context be dealt with under existing principles such as sham, economic substance, Code Sec. 704(b), or specific anti-abuse rules?

Diagram 1 shows two identical sets of investors and instruments, with the only difference being that the second LLC has "checked-the-box" to be taxable as a corporation. In both scenarios, the pure preferred investor has a fixed coupon rate of return that is easily satisfied with the assets of the LLC. The hybrid preferred also has 99 percent of its investment as a fixed coupon rate preferred, but it also owns a one-percent share of "common" residual profits and losses. The pure common owns the 99-percent remaining common interest. Two key questions to think about are (1) should an investor that only owns a preferred interest that is easily satisfied by the LLC be subjected to a higher hurdle to equity status when the LLC is taxed as a partnership versus a corporation; and (2) should the one-percent residual (or some larger share of common residual profits and losses) feature of the hybrid preferred (or some other equity attribute) change this result (and if so, whether the same analysis should apply to the identical preferred interests in both structures)?[26]

Unfortunately, these questions do not have clear answers, at least under current case law.[27] That said, as you read on to see how recent cases expose the limitations of historical debt-equity rules as applied to partnerships, you can take comfort in a few "bottom line" observations:

- **Traditional debt-equity principles are still reliable to prove debt.** A debt instrument[28] will be respected as debt in the partnership context if it is treated as debt under the traditional corporate common law debt-equity authorities. Relevant case law provides the baseline test regardless of the type of borrower. When defining whether something structured as debt in fact qualifies as debt for tax purposes, courts have consistently applied the traditional rules regardless of entity type.
- **Traditional "*Culbertson*" partnership equity tests are still reliable.** An instrument will be treated as equity in the partnership context if (1) it is treated as equity under the traditional common law debt-equity test; and (2) the common law *Culbertson* "totality-of-the-circumstances test" test is satisfied.[29]
- **The classification of partnership Debt-Like Equity that fails the *Culbertson* test falls within a partnership gray area.** Indeed, in Debt-Like Equity cases many instruments seem to fall into a no man's land that is neither debt nor partner equity. The historical uncertainty regarding this type of Debt-Like Equity has been heightened in the recent *Castle Harbour* line of cases,[30] where the appellate court did not classify the investment as debt, but denied the benefits of partnership equity treatment and called it "overwhelmingly in the nature of debt."[31] Instead the cases suggest that

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although a uniform debt-equity test should apply regardless of entity type, partner treatment may still be denied to the holder under other principles.

II. Do Taxpayers Want Debt or Equity? It Depends

Neither debt nor equity is universally preferred by taxpayers, as the desired treatment depends on the individual context. Further, even with respect to the same instrument, the issuer and holder may have opposing preferences regarding the tax treatment of the instrument.

A. Benefits of Debt

Debt treatment can be quite beneficial to many types of issuers and holders. Debt classification is particularly important to a corporate issuer that receives deductions for interest expenses on debt but does not receive a deduction for payments of dividends. Further, an S corporation would benefit if equity treatment would otherwise create an impermissible second class of stock. In the partnership context, debt treatment can provide needed debt-basis to partners who are otherwise lacking sufficient tax basis to take advantage of deductions or avoid gain.[32] On the holder side, tax-exempt organizations traditionally prefer their profit from a partnership to be in the form of interest income (which is expressly excluded from unrelated business taxable income (UBTI)). If equity, the payment would either be a Code Sec. 707(c) guaranteed payment or a Code Sec. 704(b) income allocation. The treatment of guaranteed payments under UBTI rules is less clear and an allocation of partnership income may be UBTI depending on the type of income recognized by the partnership and allocated to the holder.[33] Non-U.S. holders also generally prefer interest (which frequently qualifies for the portfolio interest exemption[34] or reduced withholding under a treaty[35]), whereas (like the case with UBTI) the treatment of guaranteed payments is less clear and an allocation of partnership income may be ECI or U.S.-source FDAP. Note that the holder can benefit from debt treatment even if the issuer may otherwise be a pass-through entity and does otherwise also benefit from debt treatment.[36]

B. Benefits of Equity—Generally

Conversely, treating an investment in a partnership as equity can sometimes achieve significant tax benefits that would not be available with debt treatment. Perhaps one of the most significant benefits to equity treatment in a partnership is the ability of an investor to use appreciated assets to fund the investment while deferring the tax gain inherent in the contributed assets. This is a more generous benefit of partnership investments; in the corporate context, Code Sec. 351 only defers tax gain on appreciated assets if the contributor is part of an 80-percent control group. Another benefit is that issuers (and their owners) may prefer an investment to be in the form of equity to avoid the risk that potential nonpayment of the loan principal would result in ordinary cancellation of debt income.[37] Further, corporate investors may prefer equity treatment to benefit from the dividends received deduction.[38]

C. Partnership Equity—The Keys to the Kingdom

With partnerships, equity treatment is often the keys to the kingdom of subchapter K. In addition to the primary benefit of no corporate level tax, partnerships provide significant tax flexibility to enter and exit and to transfer interests. Partners can contribute appreciated assets tax-free with limited obstacles. This benefit is multiplied when the property is subject to debt in excess of tax basis, which would trigger gain under Code Sec. 357(c) in the corporate context. Further, unlike corporations, where appreciated assets distributed to less than 80-percent shareholders are subject to tax, partnerships generally allow these assets to be distributed tax-free (subject to various anti-abuse rules). Moreover, the ability to make debt-financed distributions allows many partnerships to borrow against assets and the partners can then receive a distribution of the proceeds and use the money in another deal (or to buy a yacht), all on a tax-deferred basis. Finally, unlike the sale of corporate stock, if a partner sells its partnership interest at a taxable gain, the buyer can push the corresponding tax basis step-up into the underlying partnership assets.[39]

Special allocations and special basis adjustments also make partnerships a powerful and flexible tool. Partnerships can specially allocate income and losses among the partners, assuming such allocations satisfy the complex requirements of Code Sec. 704(b) and 704(c). For example, if one partner is more involved in a certain line of business, the partnership can specially allocate more of the economics associated with that line of business to such partner. This ability to make special allocations is also a key feature in the ability to syndicate tax credits in an economically viable manner. Further, special allocations

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CHART 1. DEBT-TO-EQUITY CONTINUUM

Instrument	Sample terms
1. Basic third-party fixed rate loan from bank	Six-percent interest, 70-percent loan-to-value, unrelated bank lender, security interest in underlying property.
2. Basic third-party fixed rate loan from bank plus equity "kicker" warrant with nominal strike price	Loan has same terms as instrument 1. Warrant is to buy five percent of existing common equity for a nominal strike price.
3. Mezzanine loan,[1] fixed or variable index-based interest at a higher rate than senior loan	Loan has 10-percent fixed interest rate, 85-percent loan-to-value, unrelated non-bank lender, security interest in the property-owning entity.
4. Mezzanine loan with some fixed interest and capped participating interest	Same terms as instrument 3 except that fixed component of interest is six percent with a 50-percent share of any property appreciation, capped at total interest of 13 percent.
5. 100-percent preferred equity	10-percent coupon preferred equity and 70-percent preferred to common ratio (*e.g.,* for every $7 of preferred there is $3 of common).
6. 99-percent preferred equity, one-percent common equity	Same terms on preferred as instrument 5, but investor also owns one percent of the total common equity.
7. 100-percent common equity	Pure "straight up" common sharing in all net profits and losses.

ENDNOTES

1 A "mezzanine" loan is a loan owed by a borrower entity that is located one level up from the underlying property. For example, the owner may form a single-member LLC to hold the property ("property owner"), and such property owner will issue the senior debt. In lieu of the historical "second mortgage" concept, a mezzanine loan achieves similar results by having the "mezzanine" entity that owns the property owner entity issue the mezzanine loan, which instead of being secured by the property is secured by the interest in the property owner. While technically the mezzanine structure can be viewed as putting the second lender as junior to general unsecured creditors at the property-owner level (suggestive of equity treatment), in reality the priority of the second lender vis-a-vis unsecured creditors at the property-owner level is usually a neutral factor, since the property owner is usually a bankruptcy remote entity.

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that create profits-only interests help a partnership to issue tax-efficient compensatory profits interests to partners, a feature not available to corporations.[40] Beyond special allocations, partnerships also provide mechanisms to achieve inside—outside basis parity. These mechanisms, which can be triggered upon the distribution of in-kind assets to a partner, can have the net effect of moving tax basis among assets.[41] Finally, partnerships pass through the character of the underlying income to partners, creating the potential benefit of capital gain income passing to a preferred equity owner (as opposed to ordinary interest income to a lender).

The aforementioned flexibility of partnerships is important to fostering business innovation and joint venturing. However, lest one think partnerships provide limitless flexibility, their planning opportunities are significantly restricted by a number of rules such as built-in loss importation limitations,[42] special allocation limitations,[43] rules treating marketable securities as cash,[44] limitations on shifting ordinary and capital gain income between partners,[45] and limitations on disguised sale[46] and mixing bowl[47] transactions. However, even with these limitations, partnerships still allow much sought-after tax flexibility.

III. General State of the Law—Debt vs. Equity

A. The Continuum of Instruments in the Market

A part of the difficulty in classifying investments as debt or equity stems from the wide range of instruments on the market. As a pure business matter, at the extremes there are some instruments that are clearly thought of as debt or equity, but there are so many variations in between that the tax rules are forced to classify instruments without any clear lines distinguishing debt treatment from equity. The traditional debt-equity test compensates for this lack of clear lines by identifying a multitude of factors to consider with respect to any given investment. Chart 1 identifies a variety of financial instruments in the market and provides sample terms that might accompany each type of investment. Note that additional features, such as the ability to convert debt into equity or preferred equity into common equity, can also be layered on top of these instruments, which further add to the potential variations.

B. The Big Picture: The Traditional Approach to Debt vs. Equity

An investment on either end of the debt-equity continuum might be easy to classify as debt or equity (for example, the basic third-party fixed loan, or the investment in 100-percent common equity), but there is a long road from so-called "straight debt" (which the Second Circuit has defined as "[a]n unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or the lack thereof")[48] to pure investments in common stock. Between the two are investments with myriad combinations of debt and equity features. Classification becomes increasingly thorny as investments become more complex, straying away from the "pure debt" or "pure equity" ends of the continuum.

When faced with more complex investments, classification is less intuitive. Whether or not a particular investment is appropriately classified as debt or equity is fundamentally a facts and circumstances test.[49] Despite Congress's and the Treasury's attempt to provide a statutory or regulatory framework for this analysis, the most useful guidance can only be gleaned from case law, which itself has changed and evolved as the investments at issue have become increasingly complicated. In fact, the case law, far from providing a set of uniform principles, only suggests factors that point towards either equity or debt classification.

Courts have weighed numerous debt-equity factors in a variety of factual circumstances. The Second Circuit, which has not adopted a specific set of factors in debt-equity cases, has stated that "the significant factor" in differentiating debt from equity is "whether 'the funds were advanced with reasonable expectations of repayment regardless of the success of the venture or were placed at the risk of the business.'"[50] While it is essential to look to case law for guideposts in the debt versus equity analysis, the courts have not settled on a uniform set of standards (sometimes even within the same circuit). Given the almost unlimited combination of facts and features that could make up any particular investment, case law provides little in the way of factual precedents.[51] Rather, the cases emphasize the importance of fact-specific inquiry and analysis, and offer the practitioner a variety of factors to consider in light of the specific instruments and underlying facts.

C. Bifurcating Debt and Equity Components of an Investment

As shown in Chart 1, a single investment can combine both debt and equity features. When faced with such instruments, a few courts (and, at times, the IRS) have bifurcated the debt and equity components and considered them separately. In *Farley Realty Corporation*, the Second Circuit evaluated a purported debt instrument that included both a fixed interest rate plus a 50-percent participation in the net increase in the value of the real property payable at the time of sale.[52] The "participating" interest was uncapped, with no maturity date. Despite the parties' intent to treat the entire instrument as debt, the court treated the 50-percent participation right as equity, and concluded that it is possible for an investor to occupy a dual status as both an equity and debt holder (*via* a single instrument).

Although bifurcation is not commonplace, the Second Circuit is not alone in this approach. The Fourth Circuit similarly bifurcated the "equity" portion of a debt instrument (the uncapped participation component of so-called "guaranteed stock") from its debt portion,[53] and the IRS utilized a bifurcation approach to separate a single security into a debt portion and an equity portion in FSA 200148039.[54] Further, Code Sec. 163(e)(5) can also operate to bifurcate applicable high yield debt obligations into debt and equity components.[55] Bifurcation is consistent with concepts articulated elsewhere in the Code, such as the exclusion of the value of conversion premium from the amount of amortizable bond premium,[56] and in other IRS authority (for example, the IRS ruled that the right to convert into affiliate stock constituted a separate property right in Rev. Rul. 69-265).[57]

D. Code Sec. 385—Pursuing a Uniform Framework

In 1969, Congress enacted Code Sec. 385 as part of the Tax Reform Act of 1969. Code Sec. 385 represented Congress's attempt to create a consistent legislative framework that would govern the classification of instruments as debt or equity, at least for corporations. Twenty years later, Code Sec. 385(a) was amended to permit bifurcation of instruments "having significant debt and equity characteristics" into debt and equity components under regulations to be prescribed.[58] In 1992, Code Sec. 385(c) was added, providing that the *issuer's* determination of an instrument as debt or equity is binding on the holders, unless any such holder expressly discloses that they are taking an alternative position.[59] Note, however, that while the parties may be bound by the issuer's classification of the instrument, the IRS is not.

Perhaps most ambitiously, Code Sec. 385 directed the Treasury to prescribe regulations enumerating factors to be considered in analyzing whether an instrument in a

corporation is debt or equity. Congress suggested (but did not require) that these factors include (1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest; (2) whether there is subordination to or preference over any indebtedness of the corporation; (3) the ratio of debt to equity of the corporation; (4) whether there is convertibility into the stock of the corporation; and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question (*i.e.,* substantial proportionality).

E. Code Sec. 385 Regulations Falter and Fail

On December 31, 1980, 11 years after Code Sec. 385 was enacted, the IRS and the Treasury issued final regulations.[60] However, after postponing the April 30, 1981, effective date, the IRS and Treasury elected to revise and then reissue the regulations (this time in proposed form).[61] After these early stumbles, the Code Sec. 385 regulations were ultimately revoked as not fully representing the IRS's and Treasury's views on the debt/equity analysis,[62] and no regulations have been issued since.

The revoked regulations under Code Sec. 385 would have allowed proportionately held debt and equity to be respected separately, but applied a heighted standard depending on the facts. If the debt and equity were held in substantial proportion:

- hybrid instruments (convertible into stock or certain contingent payments) would be treated as equity,[63] and
- excess debt would be treated as equity (if a financial institution ordinarily making loans would not have made that loan).[64]

If the debt and equity were *not* held in substantial proportion, the regulations looked at the value of the equity features. The instrument would be treated as debt so long as the equity features represented less than 50 percent of the total value.[65]

F. Revisiting the Case Law: From *Fin Ray Realty* to *Hardman*

In the absence of regulatory guidance, the factors articulated by courts again became paramount in making debt-equity determinations. The Third Circuit opinion in *Fin Hay Realty*[66] evaluated purported advances made to a corporation that required funds in order to continue basic operations. The loans (which were made in proportion to stock ownership) had no set maturity date, and repayment was dependent upon the corporation's profits.

Recasting the advances as equity, the *Fin Hay Realty* court cited 16 factors (gleaned from prior case law) relevant to the debt-equity analysis. These factors were: (1) the intent of the parties; (2) the identity between creditors and shareholders; (3) the extent of participation in management by the holder of the instrument; (4) the ability of the corporation to obtain funds from outside sources; (5) the "thinness" of the capital structure in relation to debt; (6) the risk involved; (7) the formal indicia of the arrangement; (8) the relative position of the obligees as to other creditors regarding the payment of interest and principal; (9) the voting power of the holder of the instrument; (10) the provision of a fixed rate of interest; (11) a contingency on the obligation to repay; (12) the source of the interest payments; (13) the presence or absence of a fixed maturity date; (14) a provision for redemption by the corporation; (15) a provision for redemption at the option of the holder; and (16) the timing of the advance with reference to the organization of the corporation.

The *Fin Hay Realty* court looked to prior case law to compile a list of factors to be used in debt-equity determinations. Almost twenty years later, a uniform set of factors had yet to emerge from case law. In *R.A. Hardman*,[67] an individual had originally acquired land with seller financing. When the individual was not able to keep up with the installment note, the individual sold the land to a related corporation in exchange for an earn-out note equal to one-third of the net profit upon the corporation's later sale of the land. The corporation was sold after five years, and the IRS and Tax Court denied the seller capital gain treatment (treating the sale to the corporation as an equity contribution and treating the payout as a dividend on stock of the corporation as opposed to payment under an installment note). The Ninth Circuit reversed, and held that the instrument was properly characterized as debt (despite both lack of formalities and lack of fixed principal).

The *Hardman* court cited 11 factors relevant to the debt-equity determination (many similar to the factors applied in *Fin Hay Realty*): (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a maturity date; (3) the source of the payments; (4) the right to enforce payment of principal and interest; (5) participation and management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) payment of interest only out of "dividend" money; and (11) the ability of the corporation to obtain loans from outside lending institutions. After analyzing these

factors, the appeals court found that the instrument had more indicia of debt than equity. In its conclusion the court noted that although there was no fixed maturity date, repayment was tied to a fairly certain event-sale of the property, which effectively guarantees payment of an amount relative to the value of the property.

G. The IRS Jumps Back into the Ring—Notice 94-47

By 1994, the IRS had begun to focus on certain complex investments that looked like debt for tax purposes, but otherwise resembled equity. In Notice 94-47 ("Debt/Equity Issues in Recent Financing Transactions"), the IRS noted that instruments had been issued that were designed to constitute debt for federal income tax purposes and equity for regulatory, rating agency, or financial accounting purposes.[68] The Notice stated that on examination, the IRS would scrutinize this type of hybrid instrument to evaluate whether debt classification was appropriate. The IRS flagged as particularly concerning instruments that contained a variety of equity features, including most notably an unreasonably long maturity[69] or an ability to repay the instrument's principal with the issuer's stock,[70] and indicated that its analysis would focus on the cumulative effect of these and other equity features. Interestingly, while other IRS authority (most notably the ill-fated Code Sec. 385 regulations) concerned only corporations, Notice 94-47 was not so limited (although the IRS did not explicitly indicate whether or how the analysis would apply to partnerships).

While the IRS highlighted unreasonably long maturity periods and payment-in-kind features as especially problematic for purported debt instruments, the Notice also set forth other factors relevant to the debt-equity determination (eight in total). These included: (1) whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future; (2) whether holders of the instruments possess the right to enforce the payment of principal and interest; (3) whether the rights of the holders of the instruments are subordinate to rights of general creditors; (4) whether the instruments give the holders the right to participate in the management of the issuer; (5) whether the issuer is thinly capitalized; (6) whether there is identity between holders of the instruments and stockholders of the issuer; (7) whether the label placed upon the instruments by the parties is "debt" or "equity"; and (8) whether the instruments are intended to be treated as debt or equity for nontax purposes, including regulatory, rating agency, or financial accounting purposes. The IRS stressed the importance of evaluating these factors in light of all the facts and circumstances, and of considering the overall effect of an instrument's debt and equity characteristics.

H. The Beat Goes On—*Indmar Products*

In another taxpayer victory at the appellate level, the Sixth Circuit (reversing the Tax Court) held that a shareholder's loans to a corporation should be respected as debt. In *Indmar Products Co. Inc.*, the court held that the Tax Court had erroneously focused on subjective intent to the exclusion of objective criteria.[71] Key debt-like factors (documented with demand notes; regular interest payments at a fixed and relatively reasonable rate; and repayments through additional debt rather than solely through earnings) outweighed any equity-like factors.

The court in *Indmar* cited 11 factors (from an earlier Sixth Circuit case, *Roth Steel Tube Co.*)[72]: (1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, for the advances; (8) the corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments.

I. And On—*PepsiCo Puerto Rico Inc.*

In an even more recent (and much discussed) memorandum opinion, the Tax Court upheld the taxpayer's treatment of certain advance agreements as equity (not debt) for tax purposes, despite the IRS's arguments to the contrary.[73] As part of its complex global tax strategy, the taxpayer in *PepsiCo* structured advances from Dutch subsidiaries to U.S. and Puerto Rican subsidiaries partially as debt for non-U.S. tax purposes, but as equity for U.S. tax purposes.

In its analysis, the Tax Court applied the following 13 factors from its 1980 decision in *Dixie Dairies Corporation*[74]: (1) names or labels given to the instruments, (2) presence or absence of a fixed maturity date, (3) source of payments, (4) right to enforce payments, (5) participation in management as a result of the advances, (6) status of the advances in relation to regular corporate creditors,

(7) intent of the parties, (8) identity of interest between creditor and stockholder, (9) thinness of capital structure in relation to debt, (10) ability of the corporation to obtain credit from outside sources, (11) use to which advances were put, (12) failure of debtor to repay, and (13) risks involved in making advances.

In applying these factors to the instruments in *PepsiCo*, the court observed that despite purported maturity dates, the instruments did not provide for traditional creditor remedies upon default or include an unqualified obligation to a pay sum certain at a reasonable fixed maturity date. The court also focused on high debt-to-equity ratios and that the instruments were not of the type that would be made by an independent lender.

While not binding precedent,[75] *PepsiCo* signals how the Tax Court will approach debt-equity cases and the factors it views as significant. In particular, the Tax Court indicated that the factors listed by the IRS in Notice 94-47 are "subsumed within the more discerning inquiry espoused" by the Tax Court in this case and *Dixie Dairies Corporation*. Still, the Tax Court noted that a "singular defined set of standards" capable of being uniformly applied in debt-versus-equity inquiries remains elusive.

J. PECs and CPECs— More Cross-Border Hybrids

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Issues of debt/equity characterization also arise in the context of structuring cross-border investments. For example, investments are often structured through Luxembourg, in part because of the ability to capitalize the investment structure with preferred equity certificates (PECs) and, increasingly, convertible preferred equity certificates (CPECs). These instruments are highly efficient from a U.S. perspective, as they are generally treated as debt for Luxembourg tax purposes (despite being considered equity for U.S. tax purposes, and having highly equity-like terms), which allows interest to be paid free of withholding tax in Luxembourg[76] (and interest expense can result in Luxembourg tax deductions). While the IRS typically does not issue private letter rulings on debt versus equity characterizations, issuers of CPECs routinely obtain rulings from Luxembourg tax authorities confirming that such instruments will be treated as debt for Luxembourg purposes but equity from a U.S. tax perspective. Typically "equity-like" features of CPECs include a 49-year term, subordination to other debt, convertibility and redemption features, and extraordinarily high debt-equity ratios of the issuers.[77] CPECs and similar types of hybrid instruments often present investors with a "best of both worlds" outcome, because at the investor level returns on equity are often subject to lower taxation than returns on debt, but in Luxembourg (or other applicable structuring jurisdiction) the debt characterization results in a highly-efficient, low-tax investment structure.

IV. The Conundrum of Debt-Like Equity

A. Equity-Like Debt vs. Debt-Like Equity

Two economic investment models fall into a gray area: Equity-Like Debt and Debt-Like Equity. Equity-Like Debt is the classic fact pattern for which traditional multi-factor debt versus equity tests were focused upon. The traditional taxpayer goal in that context is to classify Equity-Like Debt as debt to obtain the benefits of an interest deduction by the payor and/or favorable interest income treatment by the recipient. Although the analysis is complex and fact-intensive, the current rules reasonably hit the target for when Equity-Like Debt should be respected as debt (applying the factors found in Notice 94-47, Code Sec. 385 (and its repealed regulations), and the voluminous case law on the topic, as discussed above). These rules apply well to test whether something rises to the level of debt whether the borrower is a corporation or a partnership. As discussed in Section VI of this article, however, there are potential areas of improvement for these rules, including the creation of safe harbors or limited scope elections to provide investor certainty.

Debt-Like Equity is *not* the prime target of the principles developed in traditional debt-equity analyses. Those rules are targeted at preventing taxpayers from getting the benefits of debt, *not* protecting the fisc from taxpayers seeking equity treatment. Statutorily, other rules are in place to police Debt-Like Equity. In the corporate context, the treatment of nonqualified preferred stock under Code Sec. 351(g) is an example of statutory treatment of a preferred instrument that is not quite debt but is not entitled to the full benefits of equity treatment. Special rules also apply throughout the Code to further limit benefits of equity treatment such as the limitations on stock that that does not meet the requirement of Code Sec. 1504(a)(4). In the partnership setting, Code Sec. 707(a) can (in a fairly limited context) recast equity as debt, such as when a partner contributes an asset to a partnership and there is a pre-planned partnership distribution to the contributing partner within a relatively short period of time. Further, Code Sec. 707(c), dealing in relevant part with guaranteed payments for the use of capital, prescribes a limited set of special rules that can apply to Debt-Like Equity issued by a partnership.

Debt-Like Equity in the partnership context has been the subject of significant litigation in recent years.[78] Three different sets of cases, *Castle Harbour*, *Pritired 1 LLC* and *Historic Boardwalk*, illustrate how Debt-Like Equity has become intertwined with income shifting, foreign tax credit shifting, and the sale of historic rehabilitation credits. Each case is described below. These cases illustrate partnership investment structures that tried to take advantage of the fundamental "doughnut hole": the status of a Debt-Like Equity owner as a partner (with the keys to the subchapter K kingdom). In all three cases, the taxpayer ultimately lost its keys to the kingdom and was denied partner status, but the lack of clarity in the rules made these cases complex, and in turn these cases make the law on partner classification even more complex and convoluted.

B. *Castle Harbour* Saga

Castle Harbour I, II, III and *IV* exemplify how reasonable minds can differ on exactly what it means to be a partner. In both *Castle Harbor I* and *III*, the district court felt strongly that the Debt-Like Equity owners were partners, while in *Castle Harbour II* and *IV*, the appellate court felt just as strongly that the Debt-Like Equity owners were *not* partners.

The underlying facts involved a corporation that owned fully depreciated aircraft and sought financing from Dutch banks in a manner that temporarily shifted material non-cash taxable income to the banks. The Dutch banks, who contributed about 18 percent of the partnership's capital and provided no services or management, were allocated 98 percent of the partnership operating income over an eight year period. The actual distributions to be made to the banks, however, were arranged so that they would receive, according to a previously agreed upon schedule, the reimbursement of their investment, plus an annual return at an agreed rate near nine percent, plus a small share in any unexpectedly large profits. To ensure this economic result, the partnership kept track of the amounts necessary to provide the Dutch banks with this target return and kept funds in high-grade commercial paper or cash (so called "Core Financial Assets") equal to 110 percent of phantom "investment accounts" that represented the amount needed to repay the Dutch banks, including their preferred return. Further, to bring the Dutch banks' capital accounts in line with the target nine-percent economics, the partnership agreement specially allocated disposition gains away from the Dutch banks, whose residual share was only one percent. Also, the partnership created a lower-tier entity that allowed income from any asset (cash or aircraft) to be recognized as disposition gain rather than as operating income, simply by moving that asset to the lower-tier subsidiary. The facts in *Castle Harbour* were complex to say the least, but in essence the structure resulted in the Dutch banks receiving their nine-percent preferred return and allowed the corporate partner to effectively re-depreciate the aircraft for tax purposes by shifting excess income to the Dutch banks over eight years.

The primary legal issue in the cases was whether the Dutch banks were entitled to partner classification or should be recast as something other than partners. In *Castle Harbour I*, the district court held for the taxpayer. The court said there can be "little dispute" that the Dutch banks were partners based on the broad definition of a partnership under Code Sec. 761 where "the term 'partnership' includes 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." The statute further provides that a partner means a member of a partnership and thus the Dutch banks as members of the partnership were partners. The court bolstered its conclusion by analyzing the Notice 94-47 debt-equity factors, but specifically stating that "I do not think the debt/equity test is relevant to classifying a partnership -- the Tax Code's definition of a partnership is extremely broad and easily met in this case."[79] Further, although the court mentioned the *Culbertson* totality of the circumstances test, it appeared to focus its analysis on the economic substance doctrine as opposed to the *Culbertson* test.

In *Castle Harbour II*, the Second Circuit reversed the district court and held that the Dutch banks were not tax partners. The court concluded that this was a structured transaction designed to give the Dutch banks only superficial profit and loss sharing that functioned in the manner of a repayment of a secured loan. The Dutch banks, as a consequence of these arrangements, did not meaningfully share the risks of the partnership business. The appellate court ruled that the district court's legal analysis had multiple errors. First, in rejecting the government's contention that the Dutch banks were not *bona fide* equity partners for tax purposes, the court relied essentially upon the sham-transaction test to the exclusion of the totality-of-the-circumstances test set forth by the Supreme Court in *Culbertson.* Further, the appellate court agreed with the IRS that the facts compelled the conclusion that the banks' interest was not a "bona fide equity participation."

The appellate court pointed to a number of factors to support its conclusion that the Dutch banks did not have *bona fide* equity participation. The factors that were particularly influential in the appellate court's analysis were (1)

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the requirement that the partnership keep "Core Financial Assets" in an amount equal to 110 percent of the current value of the Dutch banks' investment accounts, (2) the partnership's obligation to maintain $300 million worth of casualty-loss insurance to protect the Dutch banks' investment, (3) the common partner (a large and very stable corporation) gave the banks its personal guaranty, which effectively secured the partnership's obligations to the banks, and (4) the ability of the Dutch banks to receive a share of unexpectedly large partnership returns was severely limited.

The appellate court analyzed the traditional multi-factor debt versus equity test, but while the court concluded that the interest was not "bona fide equity," it stopped short of concluding that it was "debt." In its analysis, the court cited *Gilbert* for "the significant factor" in differentiating between debt and equity being whether "the funds were advanced with reasonable expectations of repayment regardless of the success of the venture or were placed at the risk of the business."[80] Further, the court noted that the traditional corporate debt-equity factors should apply equally in this context, observing that:

> In all such cases, a taxpayer has cast a transaction representing an investment as equity or as debt with a view to obtaining tax benefits resulting from that characterization, and the government has challenged the characterization. We see no reason why the standard for distinguishing between debt and equity should not be focused in all such cases on whether "the funds were advanced with reasonable expectations of repayment regardless of the success of the venture or were placed at the risk of the business." *Gilbert*, 248 F.2d at 406; see also *Hambuechen v. Commissioner*, 43 T.C. 90, 99 (1964).[81]

The court then remanded the case for a debt-equity determination consistent with the traditional debt-equity factors.

In *Castle Harbour III*, the district court again held for the taxpayer, but this time using Code Sec. 704(e) as its legal support. Code Sec. 704(e) provides 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" (and the owners of the capital interest are the true owners). The district court, consistent with earlier courts, concluded that Code Sec. 704(e) is not limited to family partnerships (despite the fact that the title of the section is "family partnerships"). The court found that the Dutch banks satisfied all three of the Code Sec. 704(e) requirements. First, capital was a material income-producing factor of the partnership, despite the fact that the Dutch banks' contributions were only held in secured assets (the district court looked to the gross income of the business, rather than whether a particular participating partner's capital contribution was income producing). Second, the court determined that the Dutch banks were the "real owners" of their respective capital interests. Third, the court concluded that the Dutch banks had a true "capital interest" that entitled them to capital upon liquidation of the partnership. Finally, in response to the appellate court decision stating that *Culbertson*'s totality of the circumstances test should be taken into account, the district court concluded that *Culbertson*, although potentially still relevant generally, was not relevant if a taxpayer otherwise qualified as a partner under Code Sec. 704(e).

In *Castle Harbour IV*, the appellate court again reversed the district court, but this time on the grounds that Code Sec. 704(e) was not satisfied because the Dutch banks did not have a "capital interest" within the meaning of Code Sec. 704(e). The court found that for the same reasons it concluded that the Dutch banks' investment were not "bona fide" equity, such investment should not qualify as a "capital interest" for purposes of Code Sec. 704(e). While acknowledging that the term "capital interest" was reasonably subject to multiple interpretations, the appellate court nonetheless stated that any ambiguity should not be interpreted to include an interest that is "overwhelmingly in the nature of debt."[82] The appellate court reasoned that "because the banks' interest was for all practical purposes a fixed obligation, requiring reimbursement of their investment at a set rate of return in all but the most unlikely of scenarios, their interest rather represented a liability of the partnership."[83]

C. *Pritired* and Foreign Tax Credits

Pritired 1, LLC[84] is similar to *Castle Harbor* in that the partnership shifted tax benefits to U.S. investors by relying on treatment of Debt-Like Equity as a partnership interest. This time, instead of shifting U.S. income to a foreign partner, the strategy was to shift foreign tax credits generated from the foreign partner's investment to the lender-like U.S. partners. As in *Castle Harbour*, the Debt-Like Equity partner had limited upside as part of a very complex tax-driven structure. In a nutshell, U.S. companies and French banks contributed $300 million and $900 million, respectively, to invest in low-risk financial instruments that incurred French income taxes. The U.S. companies (which included Pritired) were given the ability to claim foreign tax credits on the taxes paid on the entire

$1.2 billion pool. After sharing the benefits, the French banks were able to essentially borrow $300 million at an attractive rate and the U.S. companies received a high after-tax return on a low-risk investment.

The district court denied foreign tax credits to Pritired on three separate grounds, one of which was that Pritired was not treated as a partner. The court noted that to be a partner, the *Culbertson* totality of the circumstances test must be satisfied, and in this case that meant analyzing the debt and equity characteristics of Pritired's investment. After looking at 16 different traditional debt-equity characteristics, the district court found that the facts weighed in favor of classifying Pritired's investment as debt. The district court was particularly troubled by the fact that the U.S. taxpayer had no possible upside potential because the returns were capped and Pritired intended to recover its original $300 million investment, regardless of the performance of the underlying partnership. The district court also focused on the limited subordination to creditors, including the lack of general creditors. In sum, based on *Culberston* and general debt-equity principles, the court found that the *Pritired* transaction was in the nature of a loan, rather than an equity investment.

D. *Historic Boardwalk Hall*—Rehabilitation Tax Credits—and IRS Safe Harbor

Federal tax credits are typically monetized through syndicated credit-investment partnerships where the investor is required to be treated as a partner for tax purposes in order to receive an allocation of the credit. Reversing the Tax Court,[85] the Third Circuit in *Historic Boardwalk Hall*[86] denied partner status to an investor in an historic rehabilitation credit partnership, thus denying the investor the tax credits. The transaction at issue utilized a typical master-tenant historic tax credit structure. The landlord entity elected to pass the credits to the master-tenant partnership and the investor participated in the transaction as a partner in the master-tenant partnership. The appellate court concluded that the investor did not meet the traditional *Culbertson* totality-of-the-circumstances test for partner classification, and found that the investor lacked the requisite intent to join in the present conduct of a business enterprise. In the appellate court's opinion, the investor lacked meaningful upside potential or downside risk and did not have the intent to be a partner. The Third Circuit court seemed particularly troubled by the existence of various contractual rights that limited the investor's downside risk and upside potential, including a guarantee of tax benefits and a right for the investor to put its interest for a fixed three-percent annualized profit return. Interestingly, there is no mention of Code Sec. 704(e) in the opinion.

In order to encourage investment in rehabilitation properties in light of *Historic Boardwalk Hall*, the IRS published Rev. Proc. 2014-12 to provide a safe harbor for historic credit structures. Rev. Proc. 2014-12 was patterned after the similar wind credit safe harbor set forth in Rev. Proc. 2007-65. The safe harbor is strictly limited to rehabilitation credits, perhaps indicating that the IRS would be less generous in upholding "partner" classification in other, less sympathetic, contexts. In order to qualify for the safe harbor: (1) the investor's partnership interest must constitute a *bona fide* equity investment with a reasonably anticipated value commensurate with the investor's overall percentage interest in the partnership, separate from any federal, state, and local tax deductions, allowances, credits, and other tax attributes to be allocated by the partnership to the investor; (2) the investor's interest cannot be greater than 99 percent, and cannot "flip" to lower than five percent of their largest percentage share (*i.e.,* 4.95 percent, if the investor has 99 percent before the flip); (3) there must be a minimum unconditional investor contribution of 20 percent of its total capital contribution as of the date the property is placed-in-service; and (4) at least 75 percent of the investor's committed amount has to be fixed (though not contributed) before the date the property is placed-in-service.

V. Law Addressing Debt-Like Equity

Beyond the traditional debt-equity test, there are certain contexts where special rules apply to Debt-Like Equity. In the corporate area, nonqualified preferred stock receives special treatment.[87] In the partnership area, there are special rules to address Debt-Like Equity in the following contexts: the Code Sec. 707(a) disguised sale rules, the *Culbertson* totality of the circumstances line of cases, and (in the view of some and as raised in the recent cases) potentially the Code Sec. 704(e) rules for capital-intensive partnerships. Each is discussed below.[88]

A. Code Sec. 351(g) Nonqualified Preferred Stock

In 1997, Congress added Code Sec. 351(g) to the Code to treat nonqualified preferred stock (NQPS) as taxable "boot" for certain purposes. NQPS is preferred stock that has a dividend rate that varies with reference to an index, or, in certain circumstances, a put right, a call right, or a mandatory redemption feature. For this purpose preferred

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stock means stock which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent. Stock shall not be treated as participating in corporate growth to any significant extent unless there is a real and meaningful likelihood of the shareholder actually participating in the earnings and growth of the corporation. If there is not a real and meaningful likelihood that dividends beyond any limitation or preference will actually be paid, the possibility of such payments will be disregarded in determining whether stock is limited and preferred as to dividends.

B. Partnership Disguised Sales

In 1984, Congress tightened the Code Sec. 707(a) partnership disguised sale rules. Among the effects of these rules is to recast a purported contribution to a partnership and the related distribution as a taxable sale. The regulations clarify that, to the extent of such deemed sale, the contributor is not treated as a partner.[89] To the extent that there is a delay in time from the initial property transfer and corresponding distribution (or *vice versa*), the purported partner is treated as a lender to the partnership for such duration.[90] The analysis only applies if the interest was not already treated as debt under the traditional debt-equity test, so the disguised sale rules can be viewed as a second layer of debt-equity analysis for partnerships. The disguised sale rules statutorily bring concepts similar to, but more stringent than, the traditional corporate debt-equity factors, to the property (or partnership interest) transfer arena. However, because of the limited scope of the disguised sale rules, they do not sufficiently address the Debt-Like Equity issues that are the subject of recent case law (*e.g.,* income and credit shifting partnerships).

1. Mechanics

The disguised sale rules apply a two-part "but for" test and a two-year presumption. They conclude that there is a disguised sale if (1) the first transfer (*e.g.,* of property to the partnership) would not have been made "but for" the second transfer (*e.g.,* of property from the partnership to the partner), and (2) if the second transfer is not simultaneous, the second transfer is not dependent on the entrepreneurial risks of partnership operations. Combined with this but-for test is a rebuttable presumption that if the second transfer is within two years of the first transfer and does not fall under certain exceptions, that the second transfer is part of a disguised sale unless the facts and circumstances clearly establish that the transfers do not constitute a sale.[91]

2. Facts and Circumstances

Ultimately the determination of whether transfers constitute a disguised sale is a facts and circumstances test with many factors, much like the traditional debt-equity test. The regulations specifically look to the following factors in determining whether two transfers comprise a disguised sale:

- **Certain timing and amount.** That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer
- **Enforceable right by seller.** That the transferor has a legally enforceable right to the subsequent transfer
- **Seller security.** That the partner's right to receive the transfer of money or other consideration is secured in any manner
- **Partner commitment to fund.** That any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration
- **Excess partnership liquidity to fund.** That the partnership has created liquidity to make the subsequent distribution such as through (i) a partner being obligated to make a contribution, (ii) a person has committed to make a loan to the partnership to fund the distribution, (iii) the partnership has other liquidity through borrowing, or (iv) the partnership holds excess liquid assets beyond the needs of partnership operations
- **Special economic sharing and control.** That partnership distributions, allocations or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property
- **Disproportionate distribution.** That the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits
- **No obligation to return the money.** That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner

C. Code Sec. 704(e)—Is a Capital Interest Alone Sufficient?

Code Sec. 704(e) is a provision that has periodically (although not consistently) appeared in Debt-Like Equity partnership litigation. Congress enacted what is now Code

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Sec. 704(e) in 1951 to create a set of rules for respecting (and not respecting) interests in a family partnership and to dictate specific assignment of income concepts.[92] These rules included a specific provision (now Code Sec. 704(e)(1)) that recognizes when a donee is respected as a partner in a family partnership. The provision was included because courts in prior case law repeatedly tried to ignore all family partnership interests, citing (among other reasons) no intent to be a partner under *Culbertson*.[93] The legislative history indicated that there was confusion as to the impact of *Culbertson* on family partnerships and changed the law to be consistent with the following two tax principles: (1) income from property is attributable to the owner of the property; and (2) income from personal services is attributable to the person rendering the services.[94] The legislative history does not evidence any intent to override *Culbertson* generally, but suggests that Congress intended to stop its misapplication in the family partnership context. With this background, Congress created the following provision to specifically respect the donee as a partner as long as it had a capital interest in a capital intensive partnership and income from services was properly tracked to the service provider:

> Section 704(e). Family Partnerships. Recognition of interest created by purchase or gift. -- 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. (*emphasis added*)

This capital-based rule is saying that the income from capital should be taxed to the person who truly owns it, clarifying the application of assignment of income principles in the family partnership context. The rule is limited to partnerships where capital is a material income-producing factor. This capital-intensive requirement is easily met in the typical Equity-Like Debt context. However, Code Sec. 704(e) also requires that the person at issue must have a "capital interest" in such partnership. Although what is meant by a capital interest is not discussed in the legislative history, the regulations define it as the rights the partner has to partnership assets if the partnership liquidates[95] (the same definition used in Rev. Proc. 93-27 and its progeny in distinguishing compensatory profits interests from capital interests). The recent *Castle Harbour* decisions present differing views between the district and appellate courts on whether the definition of a capital interest should or should not include a *Culbertson* or debt-equity type of analysis (with the appeals court saying yes, so Debt-Like Equity may not constitute a "capital interest" for this purpose).

The first $64,000 question[96] is what relevance does Code Sec. 704(e) have outside of the family partner context? Despite the family partnership title and family focus in the legislative history, the plain reading of the statutory language is that the Code Sec. 704(e) test applies for purposes of the entire subtitle (covering subchapter K and beyond). Case law has confirmed this broad application and even the appeals court in *Castle Harbour IV* agreed to this broad scope.[97]

The second $64,000 question is whether Code Sec. 704(e) then writes *Culbertson* out of the law for all purported capital partners in nonservice partnerships? This question is more difficult than the first. The issue is simply not discussed in the numerous cases that continue to apply *Culbertson*, typically with no mention of Code Sec. 704(e). Despite the appeals court position in *Castle Harbour IV*, at least two courts have held that Code Sec. 704(e), when applicable, was meant to override *Culbertson*.[98] Finally, the authors of at least one well-known partnership tax treatise are quite adamant that *Culbertson* does not apply to capital partners in capital-intensive partnerships.[99] All things considered, the conservative view is to continue to apply *Culbertson* to Debt-Like Equity, given the recent appellate cases taking a contrary view[100] and the many other cases that simply apply *Culbertson* without *any* discussion of Code Sec. 704(e). This approach would require a determination that to rely on Code Sec. 704(e) the purported partner must first have a "capital interest," which brings into play *Culbertson* and the debt-equity factors.

VI. Solving the Puzzle

What should be clear now is the bottom line observation that the traditional debt-equity principles to prove *debt* are still alive and well, and are applied consistently to both partnerships and corporations. Several cases specifically conclude that these historically corporate-based principles apply to partnerships,[101] and other IRS and common law authorities appear to simply assume the same principles apply without specifically addressing the question.[102] Thus, if an instrument is treated as debt under these historical principles, it can confidentially be respected as being debt for federal income tax purposes. In contrast, the uncertainty created by the *Culbertson* "totality of the circumstances" test is limited to instruments that are otherwise *equity* under this historical test.

A. What About *Culbertson?* Raising the Bar to Equity in Subchapter K

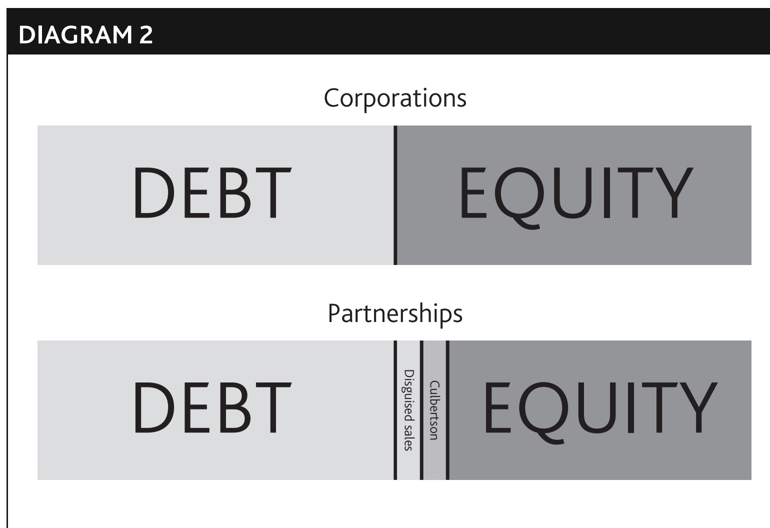
Although most can agree that the debt side of the equation is the same for partnerships and corporations, what about the equity side? The traditional debt-equity rules were developed in the corporate context and essentially created a high bar before the IRS would allow an interest deduction that would permanently and materially reduce tax revenue. Such a high bar is consistent with the principle that deductions are a matter of legislative grace and are to be construed narrowly.[103] Further, since corporate equity carries with it relatively limited tax benefits, the natural and accepted assumption is that if a corporate instrument is not debt, then it is equity. Even when Congress tightened the corporate rules for Code Sec. 351(g) nonqualified preferred stock, it still kept its classification as equity. Thus for corporations, if an instrument is not debt under the traditional principles, it is equity.

Unlike corporations, classification as a partner does not appear to simply be a mirror of the partnership debt test. Thus the definition of partner equity is not simply an instrument that is not a debt under traditional debt-equity principles. As depicted in Diagram 2, two additional concepts must also be incorporated into the analysis, the Code Sec. 707(a) partnership disguised sale rules and the *Culbertson* totality of the circumstances test. The disguised sale rules are at least conceptually fairly straightforward to understand. Because the rules recast a contribution and a distribution as a sale, the investment at issue is never considered equity. Thus, the disguised sale rules are a "part II" to the debt-equity test, and simply move the line between debt and equity incrementally so that debt becomes a larger category. *Culbertson,* on the other hand, leaves us a little bit more in the dark on how to treat an investment that fails this test. To date, case law applying *Culbertson* has focused solely on denying the person the benefit of subchapter K, and once that issue has been decided, the analysis is over. Often the same transactions that fail *Culbertson* are also attacked under other tax principles such as sham and economic substance, and therefore it is not always clear on what category to place the broken pieces of the transaction. For purposes of Diagram 2, *Culbertson* recasts are shaded in a color similar, but not identical, to debt.[104]

The real questions seem to be what to do with *Culbertson* and the Debt-Like Equity problems that seem to continue to reoccur in partnership tax litigation. Is or should *Culbertson* be subsumed by other partnership tax rules? Alternatively, if we need an independent *Culbertson* concept, are there potentially clarifications or changes that could clean up the current state of the law?

The recent Debt-Like Equity cases such as *Castle Harbour* and *Historic Boardwalk Hall* provide evidence that a *Culbertson* type of analysis is important to police subchapter K. Although there are many limiting provisions like disguised sales, mixing bowl rules, and substantial economic effect rules, partnerships continue to be flexible tax vehicles. Disguised sale limitations focus on offsetting contributions and distributions. These were simply not the issues involved in *Castle Harbour* and *Historic Boardwalk Hall.* The issue is, at what point is a long-term preferred capital investor entitled to the full set of keys to the kingdom of subchapter K? The historical barriers to entry included *Culbertson* and the requisite intent to join in a common business enterprise. However, Code Sec. 704(e) raises the question as to whether that rule is simply overridden for the typical capital partner. Even applying *Culbertson*, should a partner with sufficient common capital be allowed a free ride for their preferred capital?

DIAGRAM 2



The competing theories of *Culbertson*, Code Sec. 704(e), and the concept of a single partnership interest leave subchapter K with a number of oddities. Could it be that as long as there is a partnership with at least two partners that satisfy *Culbertson*, then new partners can be added without having to worry about *Culbertson*? Does Code Sec. 704(e) go so far as to eliminate the *Culbertson* requirement altogether for partners that are capital partners where capital is a material income producing activity of the partnership? If so, isn't this a rather large backdoor into subchapter K? Even applying *Culbertson*, the rules should address how adding a small amount of common equity affects whether a Debt-Like Equity owner is a partner with respect to their

preferred interest as well. Presumably this situation is what Code Sec. 707(c) is designed to address in terms of allowing the preferred equity partner status but treating the recipient's guaranteed return as more akin to interest.[105]

Outside of *Culbertson*, the current rules leave a hole for Debt-Like Equity to take advantage of subchapter K. The debt-equity rules' apparent bias toward protecting debt treatment makes it easier for debt-like preferred equity. Tax motivated transactions such as in *Castle Harbour* and *Historic Boardwalk Hall* can on their face avoid many of the more traditional debt factors, although often contain behind the scenes credit support. Fixed interest is readily replaced with a near economic equivalent preferred return. The disguised sale rules are often inapplicable because of the lack of a need for a pre-planned offsetting distribution from the partnership.

B. Dealing with Debt-Like Equity Around the Edges

Perhaps the Debt-Like Equity phenomenon can be addressed through clarification of the Code Sec. 707(a) rules. Although the primary focus of the regulations under Code Sec. 707(a) relates to sales of property to or from the partnership, the statutory text leaves room for more. Note that the statute speaks in terms of recasting "a transaction" with the partnership as occurring between the partnership and a nonpartner. Although a Debt-Like Equity investment may not be a traditional "transaction" where someone is selling property or services to the partnership, the investment is still a "transaction" in the sense that the investor is transferring assets to the partnership in exchange for purported equity. However, there could be some resistance to addressing this in Code Sec. 707(a) regulations because it would be essentially writing a different debt-equity test for partnerships in contradiction of case law stating that the same historical corporate debt-equity test applies. Moreover, the IRS might be better off including the analysis under the definition of partner under Code Sec. 761 rather than Code Sec. 707(a) since it is an entity/partner classification question.

Another possible avenue to address Debt-Like Equity is under the Code Sec. 707(c) guaranteed payment rules. These rules would continue to respect Debt-Like Equity as equity but would prevent the shifting of income and loss to the Debt-Like Equity partner by treating their sharing as an amount determined without regard to the income of the partnership. Indeed perhaps this is a fruitful avenue to address Debt-Like Equity, but it would likely require a significant regulatory expansion and clarification of just what a guaranteed payment is and how it should be treated. The current statute is quite limited in scope and only treats a guaranteed payment as a nonallocation for purposes of two code sections, with the regulations treating it as an allocation for other purposes of the Code.[106] Currently guaranteed payments arguably create more confusion than benefit and the solution proposed is often repealing the rule rather than trying to figure out what it means.[107] The concept of a special rule to treat the income from Debt-Like Equity like interest for all purposes may be a good alternative, but to include that under Code Sec. 707(c) would likely require a statutory expansion.

What should be clear now is the bottom line observation that the traditional debt-equity principles to prove debt are still alive and well, and are applied consistently to both partnerships and corporations.

Code Sec. 704(b) is another potential avenue to limit abuse. Many of the Debt-Like Equity tax shelter cases involved special allocations that took advantage of the flexibility in Code Sec. 704(b) allocations. Although this flexibility is important, the regulations could create anti-abuse rules or other limitations that would, for example, require income and loss allocations to be proportionate to relative capital interest for Debt-Like Equity partners. This solution would still involve the formidable task of defining Debt-Like Equity, and would likely take the approach of listing a series of facts and circumstances as opposed to creating a hard and fast rule. This would be comparable to the facts-and-circumstances test in the partnership disguised sale rules discussed earlier. Although the regulations could also include a rebuttable presumption for what constitutes Debt-Like Equity subject to *pro rata* allocations, the IRS may be hesitant in light of their experience with the Code Sec. 385 regulations.

Another incremental way to address the Debt-Like Equity abuse in *Castle Harbour* may be to mandate the application of the Code Sec. 704(c) remedial method to Debt-Like Equity. This could be applied in tandem with the Code Sec. 704(b) idea above. One of the effects of subchapter K is that as assets are depreciated, if there is insufficient tax basis, the noncontributing partner may not receive its full share of depreciation deductions (the so-called "ceiling rule").[108] If a Debt-Like Equity partner as in *Castle Harbour* is indifferent to receiving this income, the ceiling rule can actually be used as a

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tool to shift income to the Debt-Like Equity partner. The inverse can also be true if the Debt-Like Equity partner contributes appreciated property and wants to shift built-in gain to the other partner. The Code Sec. 704(c) regulations already anticipate how the ceiling rule can result in inappropriate shifting and have a general anti-abuse rule in place.[109] However, as currently written the regulations do not allow the IRS to mandate the Code Sec. 704(c) remedial method to ensure that there is no such shifting.[110] Therefore, any expansion to the remedial method to apply to Debt-Like Equity would require a regulatory change.

Expansion of the existing Code Sec. 704(e) regulations could also provide a partial clarity on the Debt-Like Equity front. The issue of whether Code Sec. 704(e) allows Debt-Like Equity to be treated as a partnership interest in spite of *Culbertson* has arisen in many Debt-Like Equity cases.[111] This confusion is ripe for regulatory clarification. One likely solution is for the IRS to expand on what is meant by a "capital interest."[112] The current definition simply refers to a right to receive a distribution on liquidation of the partnership, which would include Debt-Like Equity absent a *Culbertson* or disguised sale override. The legislative history indicates the Code Sec. 704(e) was created because *Culbertson* was being misapplied in the family context, but the regulations currently do not clarify the correct treatment of *Culbertson* in the Code Sec. 704(e) context. For example, future regulations could state that Code Sec. 704(e) was intended to simply clarify that no more harsh application of *Culbertson* should be applied in the family limited partnership context than in a non-family context, but that there was no intent for Code Sec. 704(e) to override the fundamental concept of *Culbertson* generally. Essentially, you don't need a business purpose to transfer a partnership interest to a family member if that family member truly owns the partnership interest, but what you transfer must indeed be a partnership interest that would have otherwise passed muster under *Culbertson* outside of the family context.

C. Expanding the Code—Nonqualified Preferred Partnership Interest

Code Sec. 351(g) nonqualified preferred stock provides guideposts for a similar quasi-equity concept that may make sense in partnerships. The Code Sec. 351(g) compromise was to respect the preferred interest as equity, but provide limitations to the benefits of equity treatment. Nonqualified preferred is denied tax-free treatment under Code Sec. 351. If both nonqualified preferred and other stock is received, the nonqualified preferred is treated as boot (*i.e.,* gain is recognized by not losses).

The concept is to introduce a parallel to Code Sec. 351(g) for partnerships, except with modifications needed to work in subchapter K.[113] Nonqualified partnership interest (NPI) would continue to be treated as equity, but with limitations. These limitations could be the same limitations discussed above regarding Code Secs. 704(b), 704(c) and/or 707(c). For example a preferred return for NPI could either be treated as interest that would not carry with it a share of underlying tax character or credits, or alternatively it could be treated as simply carrying with it a *pro rata* share of underlying items based on relative capital share. If treated as interest, the provision could state that it is not treated as a profits interest for purposes of subchapter K generally.[114] NPI would be defined based on debt-like principles to encompass Debt-Like Equity and would specifically include equity interests that fail *Culbertson*. To avoid casting too wide a net, consider a safe harbor of non-NPI status if the value of the taxpayer's common interest is worth at least five percent of its NPI.

The practical considerations of NPI are many and daunting. Defining NPI may be more of an anti-abuse concept than something that can be neatly set forth in regulations. It is not always easy to separate the fixed component of NPI from the true profit sharing component or to determine if the profit sharing component is small enough to be subsumed by the fixed component. NPI would need to be tested based on the totality of the agreements among the parties, in turn based on the same broad definition of partnership agreement currently in the Code.[115] NPI would also need exceptions for credit syndication structures the IRS is comfortable with, such as in Rev. Proc. 2014-12 (historic credits) and Rev. Proc. 2007-65 (wind credit). Ultimately the NPI guidance would need to answer the question of how to treat a purported partnership interest that is equity under traditional debt-equity principles but fails the *Culbertson* test.

D. Adding Some Certainty on Applying Traditional Debt-Equity Principles?

While cleaning up the Code to fight abuse, taxpayers would also welcome some helpful debt-equity certainty for ordinary investment structures caught in the cross-fire. In many ways this is reminiscent of the pre-"check-the-box" world where taxpayers were frequently uncertain as to whether their business entity would be taxable as a partnership or a corporation. Although the check-the-box regulations have led to many unanticipated planning

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structures,[116] the business and tax world would never go back to the old days of uncertainty and constant evaluation and scrutiny to achieve partnership or corporate status under the old *Kintner* regulations.[117]

A limited debt election may be a helpful corollary to the check-the-box entity classification regulations.[118] The traditional debt-equity test brings to bear so many unweighted factors that it becomes a very subjective process for determining the tax classification of legitimate hybrid instruments. These inherent complications often set taxpayers and the IRS on a course for future controversy that benefits neither side. The traditional debt-equity test unnecessarily complicates and raises the costs for business transactions. Congress and the IRS have long recognized the benefits of tax elections, which are specifically sanctioned as long as taxpayers file consistently and have sufficient restrictions on their ability to change the election. At present, there are over 300 explicit tax elections in the Code, which include: check-the-box entity classification, consolidated returns, accounting methods, bonus depreciation, Code Sec. 754 elections, and Code Sec. 83(b) elections.[119] With such precedent, it is worth considering whether taxpayers and the IRS could—at a minimum—streamline the traditional debt-equity rules. After all, it has been a third of a century since the ill-fated Code Sec. 385 regulations were promulgated in 1980, and financial instruments have only grown geometrically in variety and complication since then.

It is difficult to define the parameters on what should qualify as debt without first understanding why the Tax Code treats debt so differently than equity. Recognizing that this issue is also implicated in the various tax reform policy discussions, this article focuses on one simple explanation for the distinction: namely, that interest is simply an expense of doing business whereas dividends are the profits from doing business. Thus when characterized as debt, the interest payable is just like any other operational expense (as opposed to a profit taking). The justification of interest expense as an operational cost becomes more gray once the purported loan starts morphing into a more equity-like instrument, with the "cost" of capital now looking more like a nondeductible share of business profits. For a corporation subject to an independent "double" tax, allowing equity to morph into debt (with deductible interest) cuts directly into the double tax revenue the IRS counts on from the corporation. Hence the critical question is, how close or far is the investor from the status of an "entrepreneurial owner" of the underlying business or investment?

Codifying a limited debt election would involve many component considerations. First, the drafters may draw some "per se" lines around instruments that are simply off limits to being eligible for election. Certain features or lack of features may be viewed as simply fundamental to debt or equity.[120] Second, the possibility of bifurcation should be considered, as in *Farley Realty* when there was a loan and a separate profit participation. One could argue that bifurcation makes more sense if the different debt and equity features could ever transfer independently, although that type of analysis implies a form over substance approach. In reality, the bifurcation question depends on how intrinsically tied the debt and equity features are as part of a single instrument. A third consideration is whether an election or perhaps a safe harbor would be the best approach. Elections are prone to user-error, as can be seen by the numerous late elections the IRS has granted under Code Sec. 9100. Fear of even more Code Sec. 9100 rulings would means it is likely a better plan to implement the concept without a formal election but instead through the form of a rebuttable presumption, much like the partnership disguised sale regulations use. Finally, if an election is used, there should be consistent treatment on both sides of the instrument, similar to the requirement under Form 8594 for the buyer and seller to both file a form consistently allocating purchase price among the component assets of a business.

VII. Conclusion

This article started out asking the question whether debt was different in a partnership. The short answer is clearly "no," if you have something that is debt for a corporation it is also debt in a partnership. The longer answer is that the question of debt is integrally tied into the question of what is equity, as most believe you must be either debt or equity (since there are not tax rules governing an "other" category). Partnerships, unlike corporations, have additional limitations on the question of what is equity. The partnership disguised sale rules clearly go beyond traditional corporate debt-equity rules and can move some interests from the equity to the debt column (thus defeating my earlier answer as to whether debt is different). More troublesome is the uncertain impact of Code Sec. 704(e). Legislative or regulatory clarification is needed as to whether a capital interest in a capital intensive partnership simply bypasses a *Culbertson* totality of the circumstances analysis. Ideally the broader issue of Debt-Like Equity should be addressed through the legislative or regulatory guidance process. This article has suggested various alternatives for addressing Debt-Like Equity, some of which are relatively simple and others of which are not. Even a little guidance would go a long way on this topic.

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ENDNOTES

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1 *See* Justice Potter Stewart concurring opinion in *Jacobellis v. Ohio*, 378 US 184, 197 (1964) ("I shall not today attempt to further define the kinds of material I understand to [be hard-core pornography] and perhaps I could never succeed in intelligibly doing so. But I know it when I see it, and the motion picture involved in this case is not that.")

2 *J.W. Hambuechen*, 43 TC 90, Dec. 27,018 (1964) (hereinafter "*Hambuechen*").

3 *W.O. Culbertson*, SCt, 49-1 USTC ¶9323, 337 US 733 (1949); *F.E. Tower,* SCt, 46-1 USTC ¶9189, 327 US 280 (1946).

4 In *Hambuechen,* the Tax Court did not cite the "Culbertson test," an analysis traditionally used to determine whether a person rises to the level of being classified as a partner. However, the taxpayer in *Hambuechen* was already a partner at the time he made the purported loan to his partnership, so that the Tax Court did not need to apply the *Culbertson* test to determine whether the taxpayer was also a partner. Partnerships also have special "disguised sale" rules. An investment that avoids debt classification under the traditional debt-equity test can still be recast as debt as part of a disguised sale. Reg. §1.707-3(a)(2) (treating a transaction recast as a disguised sale as a sale for all purposes of the Code, with the economic rights by the purported partner treated as "an obligation to transfer to the partner money or other consideration").

5 *Hambuechen*, 1964 USTC LEXIS 27, at 30 (TC 1964).

6 *Id.,* at 31.

7 Code Secs. 761(a) and 7701(a)(2).

8 H.R. Rep. No. 72-708, at 53 (1932), 1939-1 CB (Part 2) 495 ("The bill does away with the uncertainty by placing all joint ventures, syndicates, pools, and similar organizations, which do not constitute associations or trusts, in the category of partners."). *See also* S. Rep. No. 72-665, at 59 (1932), 1939-1 CB (Part 2) 538.

9 Reg. §301.7701-1(a)(2).

10 *F.E. Tower*, *supra* note 3.

11 *W.O. Culbertson*, *supra* note 3.

12 *H.M. Luna*, 42 TC 1067, Dec. 26,967 (1964).

13 *F.E. Tower,* 34 AFTR 799 (1946), at 803.

14 *W.O. Culbertson*, 37 AFTR 1391 (1949), at 1395.

15 *See Madison Gas & Elec. Co.*, 72 TC 521, Dec. 36,142 (1979), *aff'd,* CA-7, 80-2 USTC ¶9754, 633 F2d 512.

16 *See, e.g.*, *H.M. Luna, supra* note 12.

17 *See F.E. Tower*, *supra* note 10; *D.L. Evans*, CA-7, 71-2 USTC ¶9597, 447 F2d 547, *aff'g,* 54 TC 40, 51, Dec. 29,915 (1970), *acq.,* 1978-2 CB 2.

18 *See, e.g.*, *Arthur Venneri Co.*, CtCls, 65-1 USTC ¶9190, 340 F2d 337, 169 CtCls 74.

19 *H.M. Luna, supra* note 12.

20 Courts have relied on *Culbertson* to deny tax benefits in recent built-in loss importation transactions. *Kenna Trading, LLC, et al.,* 143 TC No. 18, Dec. 60,059 (2014); *Superior Trading, LLC*, 137 TC 70, Dec. 58,751 (2011). The test has also been cited as authority in so-called "Son of BOSS" loss-generation transactions. *AD Global FX Fund, LLC*, DC-NY, 113 AFTR 2d 2014-1582 (2014).

21 Note that partners in investment partnerships can still be partners even with minimal management, services or other *Culbertson*-type features. Reg. §301.7701-4(c) focuses simply on whether the investment entity has a power to vary investments, which sends the entity out of trust treatment and into business entity treatment.

22 *See, e.g., ASA Investerings Partnership, et al.*, CA-DC, 2000-1 USTC ¶50,185, 201 F3d 505 and *TIFD III-E Inc.,* CA-2, 2012-1 USTC ¶50,167, 666 F3d 836 (commonly known as "*Castle Harbour*").

23 *See, e.g., Superior Trading, LLC*, *supra* note 20, supplemented by TC Memo. 2012-110, *aff'd,* CA-7, 2013-2 USTC ¶50,499, 728 F3d 676 and *Kenna Trading, LLC, et al., supra* note 20.

24 *See, e.g., Historic Boardwalk Hall, LLC.*, CA-3, 2012-2 USTC ¶50,538, 694 F3d 425, *cert. denied,* US, No. 12-901, May 28, 2013.

25 *See, e.g., Pritired 1, LLC*, DC-IA, 816 FSupp2d 693 (2011).

26 Perhaps a third question is whether a partner with a sufficient "common" interest to be regarded as a partner should be treated differently with respect to its Debt-Like Equity as compared to a person who may have only Debt-Like Equity and otherwise may not be respected as a partner.

27 For clarity, most practitioners would feel quite comfortable with equity treatment for hybrid preferred in a partnership or a corporation. However, there is less of a consensus on the treatment of pure preferred in a partnership, even if such pure preferred would clearly be equity if the entity were a corporation.

28 It is possible that something not defined as debt under local law can still be treated as debt for tax purposes, which touches on the broader topic of the "strong proof" taxpayers must show to disavow their form under the so-called *Danielson* rule. Taxpayers can mitigate the potential higher *Danielson* standard by ensuring that all parties treat the instrument consistently for tax purposes, even if that tax treatment may be inconsistent with the local law treatment. *See* TAM 200418008 (Dec. 29, 2003) (non-U.S. instrument treated as debt under local law, but taxpayer not subject to *Danielson* rule when treating as equity for tax purposes because taxpayer consistently treated it as equity for tax purposes). For a recent article on the *Danielson* rule, *see* R. Jacobus, *Dodging the Danielson Rule: Hartman v. United States*, 138 TAX NOTES 715 (Feb. 11, 2013).

29 *See TIFD III-E Inc., supra* note 22 (describing the *Culbertson* test as the "totality of the circumstances test").

30 *TIFD III-E Inc.,* DC-CT, 2004-2 USTC ¶50,401, 342 FSupp2d 94 (hereinafter "*Castle Harbour I*"); *TIFD III-E Inc.,* CA-6, 2006-2 USTC ¶50,442, 459 F3d 220 (hereinafter "*Castle Harbour II*"); *TIFD III-E Inc.,* DC-CT, 2009-2 USTC ¶50,676, 660 FSupp2d 367 (2009) (hereinafter "*Castle Harbour III*"); and *TIFD III-E Inc.,* CA-2, 2012-1 USTC ¶50,167, 666 F3d 836 (hereinafter "*Castle Harbour IV*").

31 *Castle Harbour IV*, *supra* note 30.

32 Code Sec. 752 treats partners as having made cash contributions for their share of the debt, thereby boosting their individual outside basis in the partnership. Code Sec. 704(d) requires partners to have outside basis to take their share of partnership deductions. Further, Code Sec. 731(a) provides that a partner recognizes gain to the extent the partnership makes cash distributions in excess of a partner's individual outside basis.

33 Code Sec. 512.

34 *See* Code Secs. 871(h) and 881(c).

35 *See* S. Schneider, J. Grumbacher, and E. Norman, *Structuring Asian Investment Into US Real Estate*, AFIRE News (Summer 2014) (including a chart showing treaty withholding rates in Asia). Note that the participating component of interest can still qualify for lower treaty rates on interest, even though such variable interest does not qualify for the portfolio interest exemption.

36 For example, assume C invested $1,000,000 in the AB partnership and is entitled to a 10-percent annual return (*i.e.,* $100,000). If C joined as an equity partner, A and B would simply allocate $100,000 of annual income to C, thereby reducing the remaining net income allocable to A and B. However, if C joined as a lender, A and B would report 100 percent of the net income, but the net income is still reduced by the $100,000 interest expense deduction. There could be some tension between A, B, and C, if, for example, the interest expense was required to be capitalized in a long-term asset such that A and B suffered a timing detriment by treating C as a lender and not a partner.

37 Conversely, sometimes Code Sec. 108 cancellation of debt income may be preferred if the borrow can otherwise exclude the income, such as a corporate borrower who is bankrupt or insolvent.

38 Code Sec. 243 excludes varied percentages of dividend income depending on the percentage of ownership of the underlying corporation.

39 In the corporate context a Code Sec. 338 election is sometimes available to achieve an inside tax basis step up, but often at a cost of higher taxes to the seller.

40 *See generally* Rev. Proc. 93-27 and Rev. Proc. 2001-43 and Schneider and O'Connor, *Proposed Rules Substantially Change the Treatment of Compensatory Partnership Interest: Are You Ready?*, 8 J. PASSTHROUGH ENTITIES 35 (Sept.-Oct. 2005); Banoff, *Conversions of Services into Property Interests: Choice of Form of Business,* 60 TAXES 844 (Dec. 1983) and Carman, *Taxation of Carried Interests,* TAXES, Mar. 2009, at 111.

41 Under Code Sec. 732, a partner only receives carry

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over basis in a distributed asset to the extent of such partner's outside basis in the partnership. If a partnership distributes an asset with a high "inside" basis to a partner with a lower outside basis, the partner loses that excess basis and if the partnership has a Code Sec. 754 election in place the basis is reallocated to other similar assets in the partnership under Code Sec. 734(b).

[42] Code Sec. 704(c)(1)(C).

[43] Code Sec. 704(b).

[44] Code Sec. 731(c).

[45] Code Sec. 751.

[46] Code Sec. 707(a).

[47] Code Secs. 704(c)(1)(B) and 737.

[48] *B.D. Gilbert*, CA-2, 57-2 USTC ¶9929, 248 F2d 399, 402.

[49] *John Kelley Co.*, SCt, 46-1 USTC ¶9133, 326 US 521, 66 SCt 299.

[50] *Castle Harbour II, supra* note 30.

[51] *Georgia-Pacific*, 63 TC 790 at 796, Dec. 33,118 (1975) (stating that each case must be decided on its own facts and there are so many combinations of factual circumstances that precedents in factual cases are usually of little value).

[52] *Farley Realty Corp.*, CA-2, 56-1 USTC ¶9337, 230 F2d 909.

[53] *Richmond, Fredericksburg & Potomac Railroad Co.*, CA-4, 76-1 USTC ¶9101, 528 F2d 917.

[54] FSA 200148039 (Aug. 30, 2001).

[55] Code Sec. 163(e)(5).

[56] Code Sec. 171. Similarly, see *National Can Corp.*, CA-7, 82-2 USTC ¶9572, 687 F2d 1107 (while the court did not bifurcate the instrument into debt and equity components, it disallowed interest amortization for a conversion premium).

[57] Rev. Rul. 69-265, 1969-1 CB 109.

[58] Revenue Reconciliation Act of 1989, P.L. No. 239, 101st Cong., 1st Sess. §7208(a)(1); H.R. Rep. No. 247, 101st Cong., 1st Sess. 1235 (1989).

[59] Energy Policy Act of 1992, P.L. No. 102-486, §1936(a), 106 Stat. 2776 (1992).

[60] T.D. 7747, 1981-1 CB 141.

[61] Proposed Reg. §§1.385-0–1.385-8, 47 FR. 147, 164 (1982), withdrawn, 48 FR. 31,053-31,054 (1983).

[62] T.D. 7932, 1984-1 CB 236.

[63] Reg. §1.385-6(c).

[64] Reg. §1.385-6(f)(2).

[65] Reg. §1.385-5(a).

[66] *Fin Hay Realty Co.*, CA-3, 68-2 USTC ¶9438, 398 F2d 694.

[67] *R.A. Hardman*, CA-9, 87-2 USTC ¶9523, 827 F2d 1409.

[68] Notice 94-47, 1994-1 CB 357.

[69] The IRS highlighted recent instruments that had come to its attention that combined long maturities with other equity features (for example, senior debentures issued for a 100-year period), and that were being treated as debt by taxpayers. The IRS cautioned that instruments with significantly shorter terms could be treated as equity depending on its other features, stating that the reasonableness of an instrument's terms must be based on all the facts and circumstances (including what other equity features are present). Notice 94-47, "Unreasonably Long Maturities."

[70] The IRS indicated that it was aware that taxpayers had recently been relying on Rev. Rul. 85-119, 1985-2 CB 60, in which the IRS held that company notes that allowed principal to be repaid with company stock on maturity were properly classified as debt based on all the facts and circumstances (including that a holder had the right to be repaid either in cash or stock). In Notice 94-47, the IRS stated that the holding in Rev. Rul. 85-119 must be limited to its facts, and that an instrument resembling the notes in Rev. Rul. 85-119 would be unlikely to qualify as debt if it was, on balance, any more equity-like (for example, if the instrument was nominally payable in cash but did not substantively give the holder a right to receive cash, or otherwise was structured such that despite having the right to elect cash, the holder would choose the stock). *See* FSA 200145005 (characterizing as equity a promissory note that required the holder to accept all principal payments in the issuer's stock). Notice 94-47, "Payable in Stock."

[71] *Indmar Products Co. Inc.*, CA-6, 2006-1 USTC ¶50,270, 444 F3d 771.

[72] *Roth Steel Tube Co.*, CA-6, 86-2 USTC ¶9676, 800 F2d 625.

[73] *PepsiCo Puerto Rico, Inc. and PepsiCo, Inc. and Affiliates* (PepsiCo), 104 TCM 322, Dec. 59,199(M), TC Memo. 2012-269.

[74] *Dixie Dairies Corp.*, 74 TC 476, 493, Dec. 36,987 (1980). The Tax Court applied factors developed in prior Tax Court cases, since the Second Circuit (the applicable appellate court for the cases at issue) had not explicitly adopted a specific factor test (but would instead look to factors later identified in Notice 94-47, as well as additional relevant factors considered by other courts).

[75] *See, e.g.,* Banoff Letter to the Editor, The True Value of Tax Court Memorandum Opinions, TAX NOTES, Mar. 15, 1993, at 1551.

[76] Le Gouvernment Du Grand-Duche De Luxembourg, "Taxation of interest paid to lenders—Withholding tax," at *www.guichet.public.lu/entreprises/en/fiscalite/impots-benefices/imposition-benefices-distribues/interets-preteurs/index.html* (last visited Dec. 15, 2014).

[77] *See* Joosen, Christophe, *Luxembourg Tax Environment*, ABA Tax Section 2011 Midyear Meeting, at *www.americanbar.org/content/dam/aba/events/taxation/taxiq-11mid-103.authcheckdam.pdf* (last visited Dec. 15, 2014); Alexandre, Luc, *Luxembourg Tax Opportunities for US Investors*, 2010 Luxembourg Symposium, at *www.texastaxsection.org/LinkClick.aspx?fileticket=L84O4gY41Nw=* (last visited Dec. 15, 2014).

[78] For a discussion of partner classification in case law prior to 2004 *see* Lipton & Dixon, *When Is a Partner Not a Partner? When Does a Partnership Exist?*, 100 J. TAX'N, 73 (Feb. 2004).

[79] *Castle Harbour I*, *supra* note 30, at 2004-6650.

[80] *Gilbert*, 248 F2d, at 406.

[81] *Castle Harbour II, supra* note 30, at 2006-5625.

[82] *Castle Harbour IV, supra* note 30, at 2012-633.

[83] *Castle Harbour IV, supra* note 30, at 2012-640.

[84] *Pritired 1, LLC*, *supra* note 25.

[85] 136 TC No. 1 (Jan. 3, 2011).

[86] *Historic Boardwalk Hall*, CA-3, 2012-2 USTC ¶50,538, 694 F3d 425.

[87] Code Sec. 351(g). Conversely, corporate debt with overly high interest rates is subject to interest deduction limitations. Code Sec. 163(i) limits corporation interest deductions for an applicable high-yield discount obligation (*i.e.,* AHYDO).

[88] Another concept that may be considered is whether the Reg. §301.7701-2 "check-the-box" regulations intend to override the *Culbertson* totality-of-the-circumstances test. This notion was specifically rejected in *Kenna Trading LLC et al.*, *supra* note 20.

[89] The regulations specifically state, however, that even if a person is no longer treated as a partner, if they had originally purported to transfer the property in as a partnership, the partnership disguised sale regulations will still apply. Reg. §1.707-3(a)(3).

[90] Reg. §1.707-3(a)(2). ("If the transfer of money or other consideration from the partnership to the partner occurs after the transfer of property to the partnership, the partner and the partnership are treated as if, on the date of the sale, the partnership transferred to the partner an obligation to transfer to the partner money or other consideration.").

[91] Reg. §1.707-3(c). The regulations have an inverse rebuttable presumption against sale treatment if the second transfer is after two years. Reg. §1.707-3(d).

[92] The original language for Code Sec. 704(e) (then numbered §191) provided the following assignment of income rule:

In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. ...

[93] This concept was specifically stated in the following passage from the 1951 legislative history:

> Many court decisions since the decision of the Supreme Court in *Commissioner v. Culbertson* (337 US 733) have held invalid for tax purposes family partnerships which arose by virtue of a gift of a partnership interest from one member of a family to another, where the donee performed no vital services for the partnership.

S. Rep. No. 82-781 (accompanying H.R. 4473), at 39 (1951).

[94] H.R. Rep. No. 82-586 (accompanying H.R. 4473), at 32 (1951).

[95] Reg. §1.704-1(e)(1)(iv).

[96] According to Wikipedia, in today's dollars "The $64,000 Question" (the name of a popular 1950's TV show) would be worth about $560,000. *en.wikipedia.org/wiki/The_$64,000_Question*.

[97] *D.L. Evans, supra* note 17; *Castle Harbour III*, *supra* note 30; *Carriage Square, Inc.*, 69 TC 119, Dec. 34,710 (1977); *Castle Harbour IV, supra* note 30.

[98] *See D.L. Evans, supra* note 17 ("If the corporation's ownership is real then the subjective intent of the parties is not a determinative test. The test is no longer whether the parties acted in good faith with

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a business purpose in joining together to conduct a partnership business. This was the test set forth in *Commissioner v. Culbertson* ..., which was decided before present §704(e)(1) was part of the Code.

The committee report accompanying H.R. 4473 which became Code Sec. 704(e)(1) states: '... The emphasis has shifted from "business purposes" to ownership of a capital interest'."); *R. Atlas*, DC-IL, 83-1 USTC ¶9162, 555 FSupp 110 ("Despite the passage of 33 years, *Culbertson* is still good law. [citations omitted]. This is so although the Code's present section 704(e)(1) replaced the "good-faith/business purpose" test in force in 1949 with the 'ownership of a capital interest' test"); and *Castle Harbour III* ("the case law indicates that section 704(e)(1) provides an alternative test that parties to a partnership in which capital is a material income-producing factor may use to determine treatment of their partnership interests for tax purposes.")

[99] McKee, Nelson & Whitmire, *Federal Taxation of Partnerships & Partners* ¶3.02 (WG&L) (online version Oct. 19, 2014) ("It could hardly be clearer from the language added to the Code and the accompanying legislative history that, at least where capital is a material income-producing factor, Congress rejected the intent test established by *Tower* and *Culbertson*, as well as any limits (*e.g.,* the original capital requirement) on the type of capital that qualifies for partnership treatment").

[100] *See Boca Investerings Partnership*, CA-DC, 2003-1 USTC ¶50,181, 314 F3d 625 (reversing lower court because lower court had not properly applied Culbertson test (lower court had instead applied capital-interest test in Code Sec. 704(e)); *Castle Harbour IV, supra* note 30 (reversing lower court which had held for taxpayer based on Code Sec. 704(e), instead requiring that in determining whether a partner had the requisite "capital interest" even for Code Sec. 704(e), the same general facts and circumstances *Culbertson*-type analysis must be applied).

[101] *J.W. Hambuechen*, *supra* note 2, at 99 and *Castle Harbour II, supra* note 30.

[102] Notice 94-47 (no distinction made between types of entities in listing debt-equity factors); *PepsiCo Puerto Rico, Inc. and PepsiCo, Inc. and Affiliates* (PepsiCo), *supra* note 73 (applying *Fin Hay Realty Co.* factors and Notice 94-47 to partnership); and *Pritired 1, LLC*, *supra* note 25 (applying Notice 94-47 factors to partnership).

[103] *Bingler v. R.E. Johnson*, SCt, 69-1 USTC ¶9348, 394 US 721, 89 SCt 1439.

[104] For an in-depth discussion of the "other," *see* Carman and Bender, *Debt, Equity, or Other: Applying a Binary Analysis in a Multidimensional World*, 107 J. TAX'N. 17 (2007).

[105] Unfortunately Code Sec. 707(c) is not a model of clarity. *See* Banoff, *Guaranteed Payments for the Use of Capital: Schizophrenia in Subchapter K,* 70 TAXES 820 (Dec. 1992).

[106] Reg. §1.707-1(c) provides the following: "Guaranteed payments are considered as made to one who is not a member of the partnership only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses). … For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income."

[107] *See* Joint Committee on Taxation, Review of Selected Entity Classification and Partnership Tax Issues, JCS-6-97 (Apr. 8, 1997).

[108] Reg. §1.704-3(b)(1) (defining the "ceiling rule").

[109] Reg. §1.704-3(a)(10).

[110] Reg. §1.704-3(d)(5)(ii) (the IRS will not mandate remedial method).

[111] *See* earlier discussion under the Section V heading "Section 704(e) – is a capital interest alone sufficient."

[112] Reg. §1.704-1(e)(1)(v).

[113] Although the FY 2015 Obama Administration's Greenbook already wants to repeal non-qualified preferred stock, it is for reasons unrelated to how the parallel would be applied with partnerships. Proposed repeal is based on taxpayers using it to create a recognition transaction (boot), which already is covered for partnerships under the disguised sale rules and would not occur under the proposed partnership parallel discussed in this article.

[114] *See* Banoff, *Identifying Partners' Interests in Profits and Capital: Uncertainties, Opportunities, and Traps,* TAXES, Mar. 2007, at 197.

[115] *See, e.g.,* Reg. §1.704-1(b)(2)(ii)(h) (defining partnership agreement broadly for Code Sec. 704(b) allocation purposes).

[116] *See* Potter, *Revisiting Check-and-Sell Transactions*, 115 TAX NOTES 1277 (June 25, 2007).

[117] *See, e.g.,* LTR 9643023 (July 24, 1996) (German GmbH ruled as partnership for U.S. tax purposes under old tax regulations).

[118] The author recommends that any potential election be limited to debt classification. A corresponding "equity" election would be fraught with potential abuse.

[119] For an excellent article about the policy behind tax elections see Field, *Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System*, 47 HARV. J. LEGIS. 21 (2010).

[120] Current tax law already provides many markers for what Congress considers more debt-like features. For example, the Code Sec. 163(j) interest stripping rules create a concept of "disqualified interest," which applies to instruments that are respected as debt but have certain equity-like features or are otherwise more prone to abuse.

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