Is Debt Really Different in a Partnership?

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I. INTRODUCTION AND OVERVIEW

Although traditional debt-equity principles generally apply to an instrument issued by an entity regardless of the type of entity that issued the instrument, the determination of whether partnership preferred equity is recast as debt or some “other” category is approaching the famed “I'll know it when I see it” test.¹ Back in 1964, the Tax Court in Hambuechen provided a starting point for the analysis with the assumption that the debt-equity test is the same for partnerships as corporations.² 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 a partnership,³ which requires that parties in good faith and acting with a business purpose intended to join together to carry on a business or venture.⁴

¹ See Justice Potter Stewart concurring opinion in Jacobellis v. Ohio, 378 U.S. 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 Hambuechen v. Commissioner, 43 T.C. 90 (1964) (hereinafter “Hambuechen”)
³ Comm'r v. Culbertson, 337 U.S. 733, 733 (1949); Comm'r v. Tower, 327 U.S. 280 (1946). The Tower case involved a purported partnership between a husband and wife in a version of income splitting to 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”. Tower at ____. 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 in the Tower decision in the context of a purported cattle partnership between a father and his sons. In Culbertson the Supreme Court clarified that a partnership could be respected, but it was a detailed factual question of the entire circumstances. Specifically the court noted that “The 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.” Culbertson at ____. 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. IRC § 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”).
A recent line of cases involving tax-motivated transactions have further muddied the water. In these cases, the parties sought partnership equity treatment in order to (i) shift income to a tax-indifferent party,\(^5\) (ii) import built-in tax losses,\(^6\) (iii) sell tax credits,\(^7\) or (iv) obtain significant foreign tax credits based on income earned from funds of a tax-indifferent investor.\(^8\) 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 and debt-equity tests.

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 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”). In these cases, the IRS was generally seeking equity treatment in order to recharacterize deductible interest as non-deductible dividends. In the partnership context, however, classification of an 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, or specific anti-abuse rules?

The following example 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% of its investment as a fixed coupon rate preferred, but it also owns a pure 1% share of “common” residual profits and losses. The pure common owns the 99% remaining common interest. Two key questions to think about throughout this article 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 1% (or some larger share sharing of common residual profits and losses feature of the hybrid preferred

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\(^5\) See *e.g.*, *ASA Investerings Partnership, et. v. Comm’r*, 201 F.3d 505 (DC Cir. 2000) and *TIFD III-E v. U.S.*, 666 F3d 836 (2nd Cir. 2012) (commonly known as “Castle Harbour”).

\(^6\) See *e.g.*, *Superior Trading, LLC v. Comm’r*, 137 T.C. 70 (2011), supplemented by T.C. Memo. 2012-110, aff’d, 728 F.3d 676 (7th Cir. 2013) and *Kenna Trading, LLC, et al. v. Comm’r*, 143 T.C. No. 18 (2014).


\(^8\) See *e.g.*, *Pritired 1, LLC vs. U.S.*, 816 F. Supp. 2d 693 (S.D. Iowa 2011).
(or some other equity attribute) change this result (and if so, whether the same analysis should apply to the identical interests in both structures)?

Unfortunately, these questions do not have clear answers, at least under current case law. That said, as you read on to see how recent cases clearly 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 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.

- **Traditional “Culbertson” partnership equity tests are still reliable.** An instrument will be treated as equity in the partnership context if (i) it is treated as equity under the traditional common law debt-equity test; and (ii) the common law Culbertson “totality-of-the-circumstances test” test is satisfied.

- **The classification of debt-like instruments structured as partnership equity that fail the Culbertson test fall within a partnership gray area.** Indeed, in Debt-Like Equity cases the instrument seems to fall into a no man’s land that is neither debt nor equity. The historical uncertainty regarding this type of Debt-Like Equity has been heightened in the recent Castle

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9 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.

10 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 may be inconsistent with the local law treatment. See TAM 200418008 (December 29, 2003) (non-US 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).

Harbour line of cases,\(^\text{12}\) where the appellate court did not classify the investment as debt, but
denied the benefits of partnership treatment and called it “overwhelmingly in the nature of
debt”.\(^\text{13}\)

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 facts of each taxpayer. Further, even with respect to the same instrument, the issuer
and holder may have difference preferences regarding the tax treatment of the instrument.

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 receive deductions for interest expenses on debt but
do not receive a deduction for payments of dividends. 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.\(^\text{14}\) 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), the treatment of guaranteed payments 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.\(^\text{15}\) Non-US holders also generally prefer interest (which typically
qualifies for the portfolio interest exclusion\(^\text{16}\) or reduced withholding under a treaty\(^\text{17}\)), whereas (like the
case with UBTI) the treatment of guaranteed payments is less clear and an allocation of partnership
income may be ECI or US-source FDAP. Note that the holder can benefit from debt treatment even if
the issuer is otherwise a pass-through entity and does not have a similar motivation for debt
treatment.\(^\text{18}\)


\(^\text{13}\) Castle Harbour IV.

\(^\text{14}\) Code § 752 treats partners has having made cash contributions for their share of the debt, thereby boosting their individual outside basis in the partnership. Code § 704(d) requires partners to have outside basis to take their share of partnership deductions. Further, Code § 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.

\(^\text{15}\) Code § 512.

\(^\text{16}\) See Code §§ 871(h) and 881(c).

\(^\text{17}\) 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.

\(^\text{18}\) For example, assume C invested $1,000,000 in the AB partnership and is entitled to a 10% 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% of the net income, but the net income is still reduced by $100,000 paid to C by receiving an interest expense
Benefits of equity

Conversely, treating an investment in a partnership as equity can sometimes achieve significant tax benefits that would not be available with a loan. 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 special benefit of partnership investments; in the corporate context, tax gain on appreciated assets can only be deferred if the contributor is part of an 80% control group. Issuers (and their owners) may prefer an investment to be in the form of equity to avoid the risk that potential non-payment of the obligation would result in ordinary cancellation of debt income. Further, corporate investors may prefer equity treatment to benefit from the dividends received deduction.

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 flexibility to enter, exit, and 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 Section 357(c) in the corporate context. Further, unlike corporations, where appreciated assets distributed to less than 80% shareholders are subject to tax, partnerships generally allow these assets to pass tax-free (subject to various anti-abuse rules). Moreover, the ability to make debt-financed distributions allows many partnerships to borrow against assets and use the money in another deal (or to buy a yacht), all on a tax-deferred basis. Finally, unlike corporations, 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.

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 Section 704(b) substantial economic effect requirements. Thus, if one partner works harder 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 allow a partnership to issue tax-efficient compensatory profits interests to partners, a feature not available to corporations. Beyond special allocations, partnerships also provide 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.

Conversely, sometimes Code § 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.

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

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.\textsuperscript{22} 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 are a free pass, their flexibility is significantly restricted by a number of rules such as built-in loss importation limitations,\textsuperscript{23} special allocation limitations,\textsuperscript{24} rules treating marketable securities as cash,\textsuperscript{25} limitations on shifting ordinary and capital gain income between partners,\textsuperscript{26} and limitations on disguised sale\textsuperscript{27} and mixing bowl\textsuperscript{28} transactions. However, even with these limitations, partnerships still bring much sought-after tax flexibility.

III. GENERAL STATE OF THE LAW – Debt vs. Equity

\textit{The Continuum of Instruments in the Market}

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, 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. The following chart 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 or convert preferred equity into common equity, can also be layered on top of these instruments, which further adds to the potential variations.

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Sample terms</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Basic third party fixed rate loan from bank</td>
<td>6% interest, 70% loan-to-value, unrelated bank lender, security interest in underlying property</td>
</tr>
<tr>
<td>2. Basic third party fixed rate loan from bank plus equity “kicker” warrant with nominal strike price</td>
<td>Loan has same terms as instrument 1. Assume taxpayer treats warrant as separate instrument from the loan.</td>
</tr>
</tbody>
</table>

\textsuperscript{22} Under Code § 732, a partner only receives carry 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 § 754 election in place the basis is reallocated to other similar assets in the partnership under Code § 734(b).

\textsuperscript{23} Code § 704(c)(1)(C).

\textsuperscript{24} Code § 704(b).

\textsuperscript{25} Code § 731(c).

\textsuperscript{26} Code § 751.

\textsuperscript{27} Code § 707(a).

\textsuperscript{28} Code §§ s 704(c)(1)(B) and 737.
3. **Mezzanine loan**,\(^{29}\) fixed or variable index-based interest rate  
   Loan has 10% fixed interest rate, 85% loan-to-value, unrelated non-bank lender, security interest in the property-owning entity

4. **Mezzanine loan with some capped fixed some participating interest**  
   Same terms as instrument 3 except that fixed component of interest is 6% with a 50% share of any property appreciation, capped at total interest of 13%.

5. **100% preferred equity**  
   10% coupon preferred equity, no entity-level debt, and 70% preferred to common ratio (e.g., for every $7 of preferred there is $3 of junior common).

6. **99% preferred equity, 1% common equity**  
   Same terms on preferred as instrument 5, but investor also owns 1% of the total common equity.

7. **100% common equity**  
   Pure “straight up” common sharing in all net profits and losses.

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**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% 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”)\(^{30}\) 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 may not be intuitive. Whether or not a particular investment is appropriately classified as debt or equity is fundamentally a facts and circumstances test.\(^{31}\) Despite Congress’s and Treasury’s attempt to provide a 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 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.

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\(^{29}\) A “mezzanine” loan is a loan one level up from the unproperty. 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-à-vis unsecured creditors at the property-owner level is usually a neutral factor, since the property owner is usually a bankruptcy remote entity.

\(^{30}\) *Gilbert v. Comm'r*, 248 F2d 399, 402 (2d Cir. 1957).

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.’” Courts have weighed this and numerous other factors in a variety of factual circumstances. 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. 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.

**Bifurcating Debt and Equity Components of an Investment**

As shown in the chart above, 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 fixed interest plus a 50% interest in the net increase in the value of the real property at the time of sale. 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% interest in net profits 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).

The Second Circuit is not alone in this approach, although bifurcation is not commonplace. 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, and the IRS utilized a bifurcation approach to separate a single security into a debt portion and an equity portion in FSA 200148039. Further, Section 163(e)(5) can also operate to bifurcate applicable high yield debt obligations into debt and equity components. 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, and in other IRS authority (for example, the IRS ruled that the right to convert into affiliate stock constituted a separate property right in Revenue Ruling 69-265).

**Section 385 – Pursuing a Uniform Framework**

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32 *Castle Harbour II.*
33 *Georgia-Pacific*, 63 TC 790 at 796 (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.).
34 *Farley Realty Corp. v. Comm’r*, 230 F.2d 909 (2nd Cir. 1960).
36 FSA 200148039.
37 Code § 163(e)(5).
38 Code § 171. Similarly, see *National Can Corp. v. U.S.* 687 F.2d 1107 (7th Cir. 1982) (while the court did not bifurcate the instrument into debt and equity components, it disallowed interest amortization for conversion premium).
39 Revenue Ruling 69-265
In 1969, Congress enacted Section 385 as part of the Tax Reform Act of 1969. Section 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, Section 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. In 1992, Section 385(c) was added to the Code, 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. Note, however, that while the parties may be bound by the issuer’s classification of the instrument, the IRS is not.

Perhaps most ambitiously, Section 385 directed 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).

Section 385 Regulations Falter and Fail

On December 31, 1980, eleven years after Code Section 385 was enacted, the IRS and the Treasury issued final regulations. 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). After these early stumbles, the Section 385 regulations were ultimately repealed as not fully representing the IRS’s and Treasury’s views on the debt/equity analysis, and no regulations have been issued since.

The repealed regulations under Section 385 would have allowed proportionately held debt and equity to be respected separately, but applied a heightened 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,
- Excess debt would be treated as equity (if a financial institution ordinarily making loans would not have made that loan).

42 T.D. 7747.
44 T.D. 7932
45 Reg.$1.385-6(c)

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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% of the total value.\textsuperscript{47}

\textit{Revisiting the Case Law: From Fin Ray Realty (3\textsuperscript{rd} Circuit 1968) to Hardman (9\textsuperscript{th} Cir. 1987)}

In the absence of regulatory guidance, the factors articulated by courts again became paramount in making debt-equity determinations. The court in \textit{Fin Hay Realty}\textsuperscript{48} 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 \textit{Fin Hay Realty} court cited sixteen factors (gleaned from prior case law) relevant to the debt-equity analysis. These factors included: (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 \textit{Fin Ray 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 \textit{Hardman v. U.S.}, an individual sold land to a related corporation in exchange for an earn-out note equal to one-third of net profit on sale of the corporation. The corporation was sold after five years, and the IRS and Tax Court denied the seller capital gain treatment (treating the payout as a dividend on stock of the corporation). The Ninth Circuit reversed, and held that the instrument was properly characterized as debt (despite both lack of formalities and lack of fixed principal).\textsuperscript{49}

The \textit{Hardman} court cited eleven factors relevant to the debt-equity determination (many similar to the factors applied in \textit{Fin Rey 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.

\textsuperscript{46}Reg. §1.385-6(f)(2).
\textsuperscript{47}Reg. §1.385-5(a)
\textsuperscript{48}Fin Hay Realty Co. v. U.S., 398 F.2d 694 (3d Cir.1968).
\textsuperscript{49}Hardman v. U.S., 827 F.2d 1409 (9th Cir. 1987).
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.50 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 maturity51 or an ability to repay the instrument’s principal with the issuer’s stock,52 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 Section 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) the label placed upon the instruments by the parties; and (8) whether the instruments are intended to be treated as debt or equity for non-tax 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 a instrument’s debt and equity characteristics.

The Beat Goes On – Indmar Products (6th Cir. 2006)

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50 Notice 94-47, 1994-1 CB 357.
51 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”.
52 The IRS indicated that it was aware that taxpayers had recently been relying on Revenue Ruling 85-119, in which the IRS held that company notes that allowed principle 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 Revenue Ruling 85-119 must be limited to its facts, and that an instrument resembling the notes in Revenue Ruling 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”.

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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. v. Commissioner*, the court held that the Tax Court had erroneously focused on *subjective* intent to the exclusion of objective criteria. Key debt-like factors (documented with demand notes; regular interest payments at a fixed and relatively reasonably rate; and repayments through additional debt rather than solely through earnings) outweighed any negative factors.

The court in *Idmar* cited eleven factors (from an earlier Sixth Circuit case, *Roth Steel Tube Co. v. Commissioner*): (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.

**And On – PepsiCo Puerto Rico Inc. (Tax Court 2012)**

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

In its analysis, the Tax Court applied thirteen factors from its 1980 decision in *Dixie Dairies Corporation v. Commissioner*, including (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

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54 *Roth Steel Tube Co. v. Comm’r*, 800 F. 2d 625 (6th Cir. 1986).
56 *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476, 493 (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 designated under Notice 94-47, as well as additional relevant factors considered by other courts).
default or include an unqualified obligation to pay sum certain at 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, *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
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.

IV. THE CONUNDRUM OF THE PREFERRED EQUITY

*Equity-Like Debt vs. Debt-Like Equity*

The gray area of debt vs. equity generally falls on two economic investment models. Equity-Like Debt
and Debt-Like Equity. Equity-Like Debt is the classic fact pattern for which traditional multi-factor debt
vs. equity tests are designed. 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, Section 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 V 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 people seeking equity treatment. Statutorily, other rules are in place to police Debt-Like
Equity. In the corporate context, the treatment of non-qualified preferred stock under Section 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 Section that meets
the requirement of Section 1504(a)(4). In the partnership setting, Section 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 distribution to the contributing partner within a relatively short period of time. Section
707(c) 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.57
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

\[57\] 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 Journal of Taxation, Number 02 (February 2004).
investments 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 kingdom). In all three cases the taxpayer 
ultimately lost its keys and was denied partner status, but the lack of clarity in the rules made these 
cases complex, and in turn these cases made the law on partner classification even more complex and 
convoluted.

Castle Harbour Saga

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

In Castle Harbour, a corporation owned fully depreciated aircraft and sought financing from non-US tax-
indifferent investors in a manner that temporarily shifted material non-cash taxable income to the 
Dutch banks. The Dutch banks, who contributed about 18% of the partnership’s capital and provided no 
services or management, were allocated 98% 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 schedule, the reimbursement of their investment, plus an 
annual return at an agreed rate near 9%, 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% 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 true 9% economics, the partnership agreement specially allocated disposition 
gains away from the Dutch banks, whose residual share was only 1%. Further, 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 9% 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 8 years.

The primary legal issue in the cases was whether the Dutch banks were entitled to partner classification 
or recast as lenders. In Castle Harbour I, the district court held for the taxpayer. The court said there 
can be “little dispute” that the Dutch banks were not partners based on the broad definition of a 
partnership under Section 761 where “the term ‘partnership’ includes a syndicate, group, pool, joint 
ventures, 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.”58 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 test of totality-of-the-circumstances set forth by the Supreme Court in Commissioner v. 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) the requirement that the partnership keep “Core Financial Assets” in an amount equal to 110% 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 court analyzed the traditional multi-factor debt vs. equity test, but while the court concluded that the interest was not “bona fide equity”, it did not conclude 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.”59 Further, the court, citing Hambuechen, 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."

In Castle Harbour III, the district court again held for the taxpayer, but this time using Section 704(e) as its legal support. Section 704(e) provides that a person “shall be recognized as a partner for purposes of

58 Castle Harbour I, at __.
59 Gilbert, 248 F.2d at 406.
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 Section 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 § 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 Culberston’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 Section 704(e).

In Castle Harbour IV, the appellate court again reversed the district court, but this time on the grounds that Section 704(e) was not satisfied because the Dutch banks did not have a “capital interest” within the meaning of Section 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 Section 704(e). While acknowledging that the term “capital interest” was reasonably subject to multiple interpretations, the appellate court nonetheless stated that any ambiguity should be not be interpreted to include an interest that is “overwhelmingly in the nature of debt”. 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.”

Pritired and Foreign Tax Credits

Pritired 1, LLC v. U.S.60 is similar to Castle Harbor in that Debt-Like Equity was used to give partnership tax shifting benefits to an investor with debt-like interests. 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 American 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 American companies received a high after-tax return on a low-risk investment.

The U.S. 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 sixteen 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.

*Historic Boardwalk - 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, the Third Circuit in *Historic Boardwalk Hall* denied partner status to an investor in a 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 or downside potential 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 and upside risk, including a guarantee of tax benefits and a right for the investor to put its interest for a fixed 3% annualized profit return. Interestingly, Section 704(e) was not mentioned in the opinion at all.

In response to *Historic Boardwalk*, the IRS published Revenue Procedure 2014-12 to provide a safe harbor for historic credit structures. Revenue Procedure 2014-12 was patterned after the similar wind credit safe harbor set forth in Revenue Procedure 2007-65. The safe harbor is strictly limited to rehabilitation credits, perhaps indicated 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%, and cannot “flip” to lower than 5% of their largest percentage share (i.e., 4.95% if Investor has 99% before the flip); (3) there must be a minimum unconditional investor contribution of 20% of its total capital contribution as of the property placed-in-service date; and (4) at least 75% of the investor’s committed amount has to be fixed (though not contributed) before the property placed-in-service date.

V. LAW ADDRESSING DEBT-LIKE PREFERRED EQUITY

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62 694 F.3d 425 (3d Cir. 2012).
Beyond the traditional debt-equity test, the law recognizes that Debt-Like Equity sometimes requires special rules to set for parameters for equity status. As discussed below, corporations have one such provision (addressing somewhat controversial nonqualified preferred stock). Partnerships have three concepts based on the Code and case law: the Section 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 Section 704(e) rules for capital-intensive partnerships. Each is discussed below.

**Section 351(g) nonqualified preferred stock**

In 1997, Congress added Section 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 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.

**Partnership disguised sales**

In 1984 Congress tightened the Section 707(a) partnership disguised sale rules. Among the effects of these rules is to recast a purported contribution to a partnership and related distribution as a taxable sale. The regulations clarify that to the extent of such deemed sale, the property contributor is not treated as a partner. To the extent that there is a delay in time from the initial property transfer and corresponding distribution, the purported partner is treated as a lender to the partnership. 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 *Culbertson* 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).

**Mechanics**

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63 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. v. Comm’r* (143 T.C. No. 18 (2014)).

64 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).

65 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.”).
The disguised sale rules apply a two-part “but for” test and a two-year presumption. They conclude that there is a disguised sale applies 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.66

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 determine 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) 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 liquidate assets beyond the needs of partnership operations;
- **Special P&L allocations.** 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; and

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66 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).
- **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.

**Culbertson and Intent to be a Partner**

To understand *Culbertson*, it is important first to understand the broad baseline definition of a partnership. Sections 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.”67 The legislative history to section 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 “all joint ventures, syndicates, pools, and similar organizations, which do not constitute associations or trusts, in the category of partners.”68 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.69

In *Culbertson*, the Supreme Court added a facts and circumstances intent-based limitation to what qualifies as a partnership (and hence who qualifies as a partner). The Supreme Court established that a partnership exists for federal income tax purposes when the facts of the arrangement show that “the parties in good faith and acting with a business purpose” intended to join together to carry on a business or venture.70 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,71 an agreement to share costs or losses,72 the ownership of a capital interest or performance of services,73 and participation in management.74

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67 Sections 761(a) and 7701(a)(2).
68 H. Rept. No. 708, 72d Cong., 1st Sess. 53 (1932), 1939-1 C.B. (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. Rept. No. 665, 72d Cong., 1st Sess. 59 (1932), 1939-1 C.B. (Part 2) 538.
69 Reg. § 301.7701-1(a)(2).
71 See *Madison Gas & Elec. Co. v. Comm’r*, 72 T.C. 521 (1979), aff’d 633 F.2d 512 (7th Cir. 1980).
73 See *Comm’r v. Tower*, 327 U.S. 280 (1946); *vans v. Comm’r*, 447 F.2d 547 (7th Cir. 1971), aff’g 54 T.C. 40 (acq. 1978-2 C.B. 2).
The factors relevant to whether an arrangement constitutes a “partnership” were perhaps best described by the Tax Court in *Luna v. Commissioner*75:

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.76

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. As discussed earlier, the test was raised in *Castle Harbour, Pritired 1*, and *Historic Boardwalk*. Courts also relied on to deny tax benefits in the recent built-in loss importation transactions of *Kenna Trading*77 and *Superior Trading*.78 The test has also been cited as authority in so-called “Son of BOSS” transactions such as in the recent *AD Global*79 case.

**Section 704(e) – is a capital interest alone sufficient?**

Section 704(e) is a provision that has periodically (although not consistently) appeared in Debt-Like Equity partnership litigation. Congress enacted what is now § 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.80 These rules included a specific provision (now § 704(e)(1)) that specifically recognizes when a donee is respected as a partner in a family partnership. i The provision was included because taxpayers in prior case law repeatedly tried to ignore their partnership interests, citing (among other reasons) no intent to be a partner under *Culbertson*.81 The legislative history indicated that there

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75 42 T.C. 1067, 1077-78 (1964).
76 Id.
80 The 1939 language for § 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. . . .”
81 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 U. S. 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. [add cite – at page 39]
was confusion as to the impact of Culbertson on such 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; (2) income from personal services is attributable to the person rendering the services.82 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 they 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.

This capital-based rule is saying that the income from capital should be taxed to the person who truly owns it, effectively codifying assignment of income principles in the family partnership context. The rule is limited to partnerships where capital is a material income producing factor. That requirement is easily met in the typical Equity-Like Debt context and really relates to preventing assignment of service income between family members. The rule also requires that the person at issue must have a “capital interest”. Although what is meant by a capital interest is not discussed in the legislative history, the regulations provide a rudimentary definition of the rights the partner has to partnership assets if the partnership liquidates83 (the same definition used in Revenue Procedure 93-27 and its progeny regarding compensatory profits interest). The recent Castle Harbour decisions had differing views on whether capital interest should or should not inherently build in a Culbertson or debt-equity type of analysis (with the appeals court saying yes, so debt-like preferred equity would not constitute a “capital interest” for this purpose).

The $64,000 questions84 are what relevance does Section 704(e) have outside of the family partnership context and does the Section 704(e) formulaic share-of-capital approach simply write Culbertson out of the law for all non-service partnerships? In answer to the first question, despite the family partnership title and focus in the legislative history, the plain reading of the statutory language is that the Section 704(e) test applies for purposes of the entire subtitle (covering subchapter K and beyond). Case law has confirmed this broad application.85 Answering the second question is more difficult. The issue is simply not discussed in the numerous cases that continue to apply Culbertson with no apparent limitation to non-capital intensive partnerships. However, other than Castle Harbour IV, courts that have addressed the issue have clearly held that Section 704(e) was meant to override Culbertson entirely for all capital-

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82 82nd CONGRESS 1st Session Revenue Act of 1951, H.R Rept. No. 586 (accompanying H.R. 4473). At page 32
83 Reg.§1.704-1(e)(1)(iv).
84 According to Wikipedia, in today’s dollars the $64,000 question would be worth about $560,000. http://en.wikipedia.org/wiki/The_$64,000_Question
intensive partnerships. 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. All things considered, despite the merits of the arguments that Section 704(e) overrides Culbertson, given the recent appellate cases taking a contrary view and the many other cases that simply apply Culbertson without any discussion of Section 704(e), the conservative view is to continue to apply Culbertson to Debt-Like Equity.

VI. SOLVING THE PUZZLE

We know what the rules for determining debt are, but does it always need to be this complicated?

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. In addition to cases that specifically conclude that these historically corporate-based principles apply to partnerships, the relevance of traditional debt-equity principles is an underlying assumption as other IRS and common law authorities apply these principals to analyze partnership debt. Thus, if an instrument is treated as debt under these historical principles, it can confidentially be respected debt. 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.

86 See Evans v. Commissioner, 447 F2d 547 (7th Cir. 1971). 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 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 § 704(e)(1) states: "... The emphasis has shifted from "business purposes" to ownership of a capital interest"); Atlas v. U.S., 51 AFTR 2d 83-692 (555 F.Supp. 110) ("Despite the passage of 33 years, Culbertson is still good law. [citations omitted]. This is so although the Code's present section 740(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.")

87 McKee, Nelson & Whitmire: Federal Taxation of Partnerships & Partners ¶3.02 (WG&L) (online version October 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.")

88 See Boca Investerings Partnership v. U.S., 91 AFTR 2d 2003-444 (314 F.3d 625) (reversing lower court because lower court had not properly applied Culbertson test (lower court had instead applied capital-interest test in § 704(e)); Castle Harbour IV (reversing lower court which had held for taxpayer based on § 704(e), instead requiring the in determining whether a partner had the requisite “capital interest” even for § 704(e), the same general facts and circumstances Culbertson-type analysis must be applied).

89 Hambuechen v. Commissioner, 43 T.C. 90, 99 (1964) and Castle Harbour II.

One problem with the traditional debt-equity test is that its multi-faceted nature creates uncertainty for many ordinary investment structures. 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 structures,\textsuperscript{91} the 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.\textsuperscript{92}

A limited debt election may be a helpful corollary to the check-the-box entity classification regulations.\textsuperscript{93} As the chart above shows, the traditional debt-equity test brings to bear so many unweighted factors that it becomes a very subjective process for determining whether hybrid instruments are debt. These inherent complications often set taxpayers and the IRS on a course for future controversy that benefits neither side. The traditional debt-equity test further unnecessarily complicates a business transaction by requiring a detailed analytical tax review, which may lead to economic changes to the documents. Congress and the IRS have long recognized the benefits of tax elections, which are specifically sanctioned as long as taxpayers file consistently with such elections or ask the IRS for permission 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,

\textsuperscript{91} See Potter, Revisiting Check-and-Sell Transactions, 115 Tax Notes 1277 (June 25, 2007).
\textsuperscript{92} See e.g., PLR 9643023 (German GmbH ruled as partnership for US tax purposes under old tax regulations).
\textsuperscript{93} The author recommends that any potential election be limited to debt classification. A corresponding “equity” election would be fraught with potential abuse.
section 754 elections, and section 83(b) elections. 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 long time since the ill-fated Section 385 regulations in 1980, and financial instruments have only grown 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). One would not treat payments to the person that cuts the grass as nondeductible dividends, so why would a deduction for the interest paid to the bank be at risk? However, 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 guiding principle is how close or far the investor is 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. 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 Section 9100. At a minimum, the default treatment of an instrument should be based on the current facts and circumstances test instead of a particular default classification as debt or equity. Otherwise, the failure to make an election could put someone in a worse position than under current law. Finally, to avoid IRS whipsaw and give certainty to all parties, 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.

What about Culberston? Raising the bar to equity in subchapter K

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94 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. on Legis. 21 (2010)
95 Current tax law already provides many markers for what Congress considers more debt-like features. For example, the Section 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.
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 exemptions from tax are to be construed narrowly.⁹⁶ 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 Section 351(g) nonqualified preferred stock, they still kept its classification as equity. Thus for corporations, if an instrument is not debt under the traditional principles, it is equity.

Unlike corporations, the equity test for partnerships does not appear to simply be a mirror of the debt test. Thus the definition of equity for partnerships is not simply as all instruments that are not debt. As depicted in the diagram below and discussed above, two additional concepts must also be incorporated into the analysis, the 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 the diagram below, *Culbertson* recasts are shaded in a color similar to, but not identical to debt.⁹⁷

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⁹⁷ For an in depth discussion of the “other”, see Carman and Bender, *Debt, Equity, or Other: Applying a Binary Analysis in Multidimensional World*, 107 J. of Tax’n No 1 (July 2007).
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 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. The issue is, at what point is a long-term preferred capital investor entitled to the full set of keys to subchapter K? The historical barriers to entry included Culbertson and the requisite intent to join in a common business enterprise. However, Section 704(e) raises the question as to whether that rule is simply ignored for preferred capital partners. Even applying Culbertson, should a partner with sufficient common capital be allowed a free ride for their preferred capital?

The competing theories of Culbertson, Section 704(e), and 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 §704(e) go so far as to eliminate the Culbertson requirement altogether as long as both partners are capital partners and capital is a material income producing activity? If so, isn’t this a rather large backdoor into subchapter K? Even applying Culbertson, it is a bit of an oddity that adding a small amount of common sharing allow an otherwise non-qualifying Debt-Like Equity into subchapter K.
Presumably this situation is what § 707(c) is designed to address in terms of treating the preferred return as more akin to interest, but that Code section is not a model of clarity.  

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 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 of a preferred return. The disguised sale rules are readily avoided because of the lack of a need for a pre-planned offsetting distribution from the partnership. This is particularly true for credit partnerships where the economic return is the tax credits and not future distributions.

Dealing with Debt-Like Equity around the edges

Perhaps the Debt-Like Equity phenomenon can be addresses through clarification of the § 707(a) rules. Although the primary focus of the regulations under Section 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 non-partner. 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 Section 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, at a minimum the IRS would be better off including the analysis under the definition of partner under § 761 rather than § 707(a).

Another possible avenue to address Debt-Like Equity is under the § 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 original statute is quite limited in scope and only treats a guaranteed payment as a non-allocation for purposes of three code sections, with the regulations treating it as an allocation for other purposes of the Code. 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. The concept of a special rule to treat the income

99 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.”
100 See Joint Committee on Taxation, Review of Selected Entity Classification and Partnership Tax Issues, JCS-6-97 (April 8, 1997).
from Debt-Like Equity like interest for all purposes may be a good alternative, but to include under § 707(c) would likely require a statutory expansion.

Expansion of the existing § 704(e) regulations could provide a partial clarity on the Debt-Like Equity issue. The issue of whether § 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.101 This confusion is ripe for regulatory clarification. One likely solution is for the IRS to expand on what is meant by a “capital interest”.102 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 § 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 § 704(e) context. Assuming Culbertson is still alive in the § 704(e) context, future regulations could expand on this point. For example, the regulations could state that § 704(e) was simply to 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 § 704(c) 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.

Another tangential way to address Debt-Like Equity would be to mandate the application of the § 704(c) remedial method to Debt-Like Equity to minimize the risk of income shifting. The primary concern with Debt-Like Equity is that it may be too debt-like to be entitled to the full benefits of subchapter K. One of the effects of subchapter K is that as assets are depreciated, if there is insufficient tax basis, the non-contributing partner may not receive its full share of depreciation deductions (the so-called “ceiling rule”).103 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 tool to shift income to the Debt-Like Equity. The inverse can also be true if the Debt-Like Equity contributes appreciated property and wants to shift built-in gain to the other partner. The § 704(c) regulations already anticipate how the ceiling rule can result in inappropriate shifting and have a general anti-abuse rule in place.104 However, as currently written the regulations do not allow the IRS to mandate the § 704(c) remedial method to ensure that there is no such shifting.105 Therefore, any expansion to the remedial method to apply to Debt-Like Equity would require a regulatory change.

Expanding the Code – Nonqualified preferred partnership interest

Section 351(g) nonqualified preferred provides guideposts for a similar quasi-equity concept that may make sense in partnerships. The § 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

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101 See earlier discussion under the heading “Section 704(e) – is a capital interest alone sufficient”.
102 Reg. § 1.704-1(e)(1)(v).
103 Reg. § 1.704-3(b)(1) (defining the “ceiling rule”).
104 Reg. § 1.704-3(a)(10).
105 Reg. § 1.704-3(d)(5)(ii) (IRS will not mandate remedial method).
treatment under §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 §351(g) for partnerships, except with modifications needed to work in subchapter K. Nonqualified partnership interest (“NPI”) would continue to be treated as equity, but with limitations. An expanded §707(c) concept would apply, treating all preferred return as interest for all purposes. The statute would need a broader definition than the current § 707(c) definition to encompass the overall substance of whether a return is a preferred return. Section 704(c) remedial allocations would be required with respect to the NPI. 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 c common interest is worth at least 5% 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, based on the same broad definition of partnership agreement currently in the Code. 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). Ultimately NPI would need to provide the answer to the currently missing question of just when does Culbertson cause a partnership interest to fail and just how is that interest treated under the tax law if it does fail Culbertson.

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 impact of Culbertson and § 704(e). This law simply needs some cleaning up. In the process, the broader issue of Debt-Like Equity should be addressed. This article has suggested various alternatives for addressing Debt-Like Equity, some of

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106 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 create a recognition transaction (boot), which already covered in partnerships under the disguised sale rules and would not occur under the proposed partnership parallel discussed in this article.

107 The preferred return would not carry with it credits or underlying section 704(b) character or bottom line allocations. It would also not be a profits for any purpose, such as § 752 liability sharing.
which are relatively simple and others of which are not. Regardless of the course taken a little more clarity in this area of law would be welcome.