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The Distinction Between Partnership Debt and Partnership Equity

by J. William Dantzler Jr.

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by J. William Dantzler Jr.

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In this report, Dantzler examines the distinction between partnership debt and partnership equity, in part by reference to the distinction between corporate debt and corporate equity, but largely by reference to case law analyzing the distinction in the partnership setting.

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Much ink has been spilled on the distinction between debt and equity, which is a favorite topic of tax lawyers. Most of the discussion has been in the context of corporations. However, with the business world's widespread use of limited liability companies, which usually are treated as partnerships for tax purposes if they have more than one owner, the distinction between debt and equity in the partnership context has become more meaningful. There is much less law in the partnership area, and what is murky in the corporate setting is even more opaque in the partnership setting.

This report examines what law there is in the partnership area.[1] It considers what factors should (and should not) be relevant to a debt-equity determination in the partnership context, with the ultimate goal of envisioning legal arrangements that can be structured with confidence that they will be characterized the desired way.

I. Background

The partnership regulations provide the starting point by stating that "the substance of the

[1] This report is a revision and update of (and supersedes) a prior effort by this author on the same subject. *See* J. William Dantzler Jr., "Debt vs. Equity in the Partnership Context," *Tax Notes*, Jan. 30, 2006, p. 497.

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[arrangement] will govern rather than its form."[2] The Supreme Court in *Culbertson*[3] stated that the test is:

> 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.[4]

There are some nicely turned phrases in the Supreme Court's test, but there is little guidance. As will be discussed below, the soft factors, such as the intent of the parties, are not particularly useful in distinguishing between partnership debt and partnership equity.

Before beginning the analysis, I want to carve out some case law that will not be discussed because it teaches us nothing about the debt-equity distinction. First, there are several sham partnership cases — cases that examine whether a partnership is real.[5] *Culbertson* is usually the beginning point for these cases, but they typically do not reach an analysis of whether an interest in the partnership is debt or equity. I also want to exclude the sham partner cases — cases in which the partnership is real but the court concludes that a particular partner's interest in the partnership (regardless of whether it is debt or equity) is not real.[6] *Culbertson* often begins these cases, too. There are also cases that are highly fact-specific and focus on what actually occurred rather than on what was supposed to occur if the legal arrangements had been honored.[7] Those cases also are not particularly useful in the debt-equity analysis.

The purpose of this report is to consider what types of legal arrangements can be structured, and honored by the parties according to their terms, with some degree of confidence that they will be treated as either debt or equity. To aid in that exercise, let us assume that the taxpayer wants to be characterized as a partner for tax purposes but wants an investment that is commercially very close to debt. How close can one get to the economics and other substantive features of debt without impairing the desired tax characterization as equity?

That issue was presented squarely in General Electric's case in the Connecticut federal district court, which was appealed to the Second Circuit.[8] Two subsidiaries of General Electric Credit Corp. entered into an arrangement, documented as a partnership, with two Dutch banks. The status of

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[2] Reg. section 1.707-1(a) (as amended in 1983). The regulations recognize that a partner can lend money to his partnership and have that loan respected.

[3] *Commissioner v. Culbertson*, 337 U.S. 733 (1949).

[4] *Id.* at 742.

[5] *See, e.g., DJB Holding Corp. v. Commissioner*, 803 F.3d 1014 (9th Cir. 2015); *Superior Trading v. Commissioner*, 728 F.3d 676 (7th Cir. 2013); *Southgate Master Fund v. United States*, 659 F.3d 466 (5th Cir. 2011); *BOCA Investerings Partnership v. United States*, 314 F.3d 625 (D.C. Cir. 2003); *ASA Investerings Partnership v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000); *Principal Life Insurance Co. v. United States*, 120 Fed. Cl. 41 (2015); *Kenna Trading LLC v. Commissioner*, 143 T.C. 322 (2014); *New Millennium Trading LLC v. Commissioner*, T.C. Memo. 2017-9; and *Rovakat LLC v. Commissioner*, T.C. Memo. 2011-225.

[6] *See, e.g., Russian Recovery Fund v. United States*, 122 Fed. Cl. 600 (2015); *Historic Boardwalk Hall LLC v. Commissioner*, 694 F.3d 425 (3d Cir. 2012); *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011); *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122 (D. Conn. 2004), *aff'd*, 150 Fed. Appx. 40 (2d Cir. 2005); and *Santa Monica Pictures LLC v. Commissioner*, T.C. Memo. 2005-104.

[7] *See, e.g., Rouse v. Commissioner*, T.C. Memo. 1964-297 (bad debt deduction of partner denied for notes of his partnership that were not paid, presented, or sought to be enforced according to their terms).

[8] *TIFD III-E Inc. v. United States*, 342 F. Supp.2d 94 (D. Conn. 2004) (banks were holders of an equity interest in a true partnership), *rev'd*, 459 F.3d 220 (2d Cir. 2006) (banks' interest was not equity for tax purposes but was a secured loan), *remanded to* 660 F. Supp.2d 367 (D. Conn. 2009) (banks were partners because they owned a capital interest in the partnership), *rev'd*, 666 F.3d 836 (2d Cir. 2012) (district court failed to provide adequate authority demonstrating that the banks' interest was properly treated as equity for tax purposes), *remanded to* 8 F. Supp.3d 142 (D. Conn. 2014) (denying the government's motion for an imposition of a negligence penalty), *rev'd*, 604 Fed. Appx. 69 (2d Cir. 2015) (district court incorrectly determined that the negligence penalty was inapplicable). The case is often cited as *Castle Harbour* because that was the name of the subject partnership. I will generally refer to it as the General Electric case because General Electric Co. was the ultimate U.S. taxpayer.

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the banks as partners rather than lenders was critical to GE achieving its desired tax result. Most of the district court's analysis in its first opinion[9] went to whether the partnership was a sham, and the court concluded that it was not. The district court then turned to the government's alternative argument that the Dutch banks were lenders to the partnership rather than partners in the partnership. The court (incorrectly) treated this alternative analysis as dictum.[10] The correct analysis would be first to determine whether the partnership is a sham, and if it is not, to then determine whether the interest in the partnership constitutes debt rather than equity. While this particular court may have already made up its mind before beginning its debt-equity analysis,[11] its analysis is interesting in several respects. More importantly, however, the Second Circuit, in reversing the district court, laid out a more coherent analysis, which represents the most authoritative analysis thus far of the distinction between partnership debt and partnership equity.[12]

Another case, which is less authoritative but worthy of discussion, involves Principal Financial.[13] The case concerned a foreign tax credit generator transaction in which Principal Financial and Citibank, through an intervening flow-through entity, paid $300 million for a stapled package issued by a French entity classified as a partnership for U.S. tax purposes. The stapled package consisted of $9 million of common shares (B shares) and $291 million of perpetual certificates (PCs).[14] The PCs earned a floating rate of LIBOR plus 1 percent. The French partnership was set up to acquire securities from two French banks, which were the other common equity owners in the partnership. The partnership had an expected duration of five years. This was because Principal Financial could, after a particular date that was five years out, force liquidation of the partnership, and it was relatively clear from the record that liquidation at that point was required by commercial exigencies and planned by all.

The Principal Financial case is in some ways the mirror image of the GE case. In the latter case, the status of the Dutch banks' interest as equity was critical to the deflection of taxable income to the Dutch entities, which was the desired tax result of the transaction to the benefit of the owner of the undisputed equity interest. In the former case, the status of the stapled package as equity

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[9]The case was contested for more than a decade and was ruled on multiple times by both courts. On the first appeal, the Second Circuit reversed and remanded, finding that the district court had erred in applying a sham partnership test instead of applying *Culbertson*. After analyzing the transaction according to series of debt-equity factors, the Second Circuit held that the Dutch banks did not hold an equity interest in the partnership because their interest was "overwhelmingly in the nature of a secured lender's interest." *TIFD III-E*, 459 F.3d at 231. On remand, the district court again found that the Dutch banks held an equity interest in the partnership, but it did so on alternative grounds: that section 704(e)(1), which granted partnership status to an owner of a capital interest in a partnership in which capital is a material income-producing factor, qualified the Dutch banks as equity holders in the partnership. 660 F. Supp.2d at 395. Again, the Second Circuit reversed. It held that the same reasons that compelled the conclusion that the banks' interest was not bona fide equity also compelled the conclusion that their interest was not a capital interest under section 704(e)(1). 666 F.3d at 847. The government moved to impose a negligence penalty on the partnership, which the district court denied on the grounds that the partnership had a reasonable basis for treating its interest as equity. 8 F. Supp.3d at 163. The Second Circuit again reversed, finding that the partnership failed to carry its burden to establish the absence of negligence. 604 Fed. Appx. at 71.

[10]The court stated that a debt-equity analysis regarding the interests of the Dutch banks was irrelevant. *TIFD III-E*, 342 F. Supp.2d at 114-116. It said that the only consequence of a holding that the banks' interests in the partnership constituted debt would be that the partnership was a sham, and having already concluded that it was not, there could be no such consequence. *Id.* at 115. The court missed the point completely. It failed to comprehend that the banks could be viewed as real — not sham — lenders to a real — not sham — partnership (two GE subsidiaries were partners) or, on a nonrecourse basis, to General Electric Credit Corp. itself.

[11]The court says in a footnote that its debt-equity conclusion is not independent of its economic substance conclusion but rather follows from it. *Id.* at 116 n.40.

[12]*TIFD III-E*, 459 F.3d 220. On remand, the district court characterized the Second Circuit as holding only that the Dutch banks' interest was debt-like and as not holding that the banks' interest was in fact debt. 660 F. Supp.2d at 384. That is not the case. The Second Circuit's conclusion was that the Dutch banks were "for all intents and purposes, secured creditors." 459 F.3d at 240.

[13]*Pritired 1 LLC v. United States*, 816 F. Supp.2d 693 (S.D. Iowa 2011). I generally refer to this as the Principal Financial case because Principal Financial Group was the ultimate U.S. taxpayer.

[14]The court pointed out that the parties gave the instruments various other labels as well, including "undated subordinated securities," "general obligations of the issuers," "subordinated debt," "subordinated debt portion," "the Pritired bond," "hybrid securities," and "preferred stock." *Id.* at 722. The fact that the PCs were stapled to common shares was undoubtedly designed to give the stapled package equity characteristics that the PCs alone did not have.

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was critical to the allocation of FTCs to Principal Financial, which was the desired tax result of the transaction to the benefit of the owner of the disputed equity interest. The cases are similar in other ways, too. In both cases, it was desired that an instrument[15] with debt-like economics be treated as equity for U.S. tax purposes.

I will also briefly discuss the Dow Chemical case.[16] Somewhat oversimplified, it involved the same facts and the same transaction as the GE case. However, the district court threw the book at the taxpayer. It held that the tax benefit should be disallowed under the economic substance doctrine, that the partnership was a sham, and that five European banks were lenders rather than partners. It is hard to discern a full debt-equity analysis in the district court's opinion, which illustrates the difficulty of looking for a way to distinguish partnership debt from partnership equity in transactions with overlapping issues such as sham partnership. The Fifth Circuit, on appeal, declined to address the district court's debt-equity analysis or its economic substance holding and affirmed the district court's conclusion on the basis of its sham partnership holding.[17]

II. Beginning Partnership Debt-Equity Analysis

Several courts have concluded that the same debt-equity factors that apply in the corporate context should also be applied in the partnership context.[18] As in the corporate analysis, no one factor alone is determinative.[19] Depending on the facts of the particular case, courts will emphasize some factors and ignore others.[20] In *Hambuechen*[21] — which the Tax Court viewed as a case of first impression because it could not find a prior case in which the corporate debt-equity factors had been applied, or held not to apply, in the partnership context — the court was greatly influenced by the subject partnership's lack of creditworthiness. *Hambuechen*, thus, bears similarity to many of the corporate debt-equity cases, which rely heavily on the presence of thin or adequate equity or other facts that indicate the creditworthiness of the obligor.[22]

Other courts will analyze all the factors, perform a balancing test, and come to a

[15] I am treating the stapled package in the Principal Financial case as a single instrument for this purpose, which is what the court mostly did and what is clearly appropriate.

[16] *Chemtech Royalty Associates LP v. United States*, No. 3:05-cv-00944 (M.D. La. 2013), *aff'd*, 766 F.3d 453 (5th Cir. 2014). I generally refer to this as the Dow Chemical case, since Dow Chemical Co. was the ultimate U.S. taxpayer.

[17] *Chemtech*, 766 F.3d at 465. In *Historic Boardwalk*, 694 F.3d 425, a corporation acquired an interest in a partnership in exchange for a "capital contribution" to the partnership. The corporation needed to be characterized as a partner to be allocated rehabilitation tax credits generated from a historic rehabilitation project. The government argued that "the distinction between an equity contribution to a partnership . . . and a transfer of funds to a partnership as payment of the sales price of partnership property . . . is the same as the principal distinction between equity and debt." *Id.* at 453. The court did not overtly reject this comparison and ultimately held in favor of the government but did not perform a debt-equity analysis.

[18] *See, e.g.*, *TIFD III-E*, 459 F.3d at 233; and *Pritired*, 816 F. Supp.2d at 733-734. *See also Hubert Enterprises v. Commissioner*, 125 T.C. 72, 92 (2005), *aff'd in part, vacated in part, and remanded*, 230 Fed. Appx. 526 (6th Cir. 2007); *Hambuechen v. Commissioner*, 43 T.C. 90, 101 (1964); *Herrera v. Commissioner*, T.C. Memo. 2012-308, at *13-*16 n.10; and *Stanchfield v. Commissioner*, 24 T.C.M. (CCH) 1681, 1692 (1965).

[19] *See, e.g.*, *Hubert Enterprises*, 125 T.C. at 92; and *Hambuechen*, 43 T.C. at 99.

[20] *See In re Union Meeting Partners*, 160 B.R. 757, 774 (Bankr. E.D. Pa. 1993) (court emphasized the partners had complete control of debtor, the debtor's financial statements did not reflect a loan from the general partners, and there was no loan agreement and no promissory note); *Hambuechen*, 43 T.C. at 103-105 (court emphasized that an outside creditor would not have made a loan secured only by the future success of the partnership, money was advanced without security in any form, no interest was charged or paid, and the taxpayer's claim was subordinate to that of all other creditors); *Woolley v. Commissioner*, 61 T.C.M. (CCH) 2225, 2231 (1991) (in concluding the advances were debt, court emphasized that the advances were evidenced by interest-bearing notes); *Federal Projects Inc. v. Commissioner*, 53 T.C.M. (CCH) 623, 627 (1987) (court pointed out that advances to limited partnerships were not evidenced in writing or secured, there was no interest rate or maturity date, advances were subordinated to other partnership debts, and no independent lender would have made such advances); and *Stanchfield*, 24 T.C.M. (CCH) at 1692 (court emphasized that funds were advanced without a reasonable expectation of repayment regardless of the success of the venture).

[21] *Hambuechen*, 43 T.C. 90.

[22] The court in *Federal Projects*, after citing *Hambuechen* for the proposition that the same analysis that applies to advances by a shareholder to his corporation applies to advances by a partner to his partnership, went on to set forth the section 385(b) factors as the touchstone for the analysis. *Federal Projects*, 53 T.C.M. (CCH) at 627. This was done even though section 385, by its terms, applies only to interests in corporations.

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conclusion on the debt-versus-equity question.[23] In *Hubert Enterprises*,[24] for example, a few individuals controlled a corporation, Hubert Enterprises Inc. (HEI), and an LLC, Seasons of Sarasota LLC (ALSL), that was treated as a partnership for tax purposes. HEI transferred more than $2 million to ALSL, which was ultimately transferred to a related limited partnership for a construction project. The construction project never began, and almost all the money was never repaid. HEI argued that its transfers to ALSL created debt that became uncollectible and thus entitled HEI to a bad debt deduction. The IRS argued that the transfers did not give rise to debt. The Tax Court sided with the IRS. The court went through an analysis of 11 factors before arriving at its conclusion that it was improbable that an outside lender would have lent without security, with a low rate of interest, and for an unspecified period to an entity in such poor financial condition as ALSL. *Hubert Enterprises*, therefore, like *Hambuechen*, seems to have been driven by the uncreditworthiness of the purported borrower. This report will focus on structural features of the interest in the partnership rather than the creditworthiness of the partnership.

It may seem obvious, but it is worth pointing out that any debt-equity analysis must look at all the pertinent facts and circumstances and view them as they really are, rather than as they are portrayed. That is a lesson of *Culbertson*.[25] The Second Circuit in the GE case criticized the district court for failing to use the all-facts-and-circumstances test of *Culbertson* and for accepting at face value the appearances and labels created by the partnership rather than assessing the underlying economic realities.[26] The Second Circuit went on, however, to apply more traditional debt-equity factors, many drawn from the corporate debt-equity factors.[27] The Principal Financial court began its analysis with the traditional homage to *Culbertson* but quickly went to the corporate debt-equity factors. The court analyzed those factors as enunciated by the IRS and the Eighth Circuit, the relevant circuit court for a district court in Iowa.[28]

III. The Most Important Factors

A. The Existence of Principal

A garden-variety debt instrument provides a stated principal amount.[29] The principal on debt also is typically payable at a fixed time, or at a formulaic time, and most decidedly is not typically payable only upon dissolution of the enterprise. In the corporate context, this tenet is set forth in *John Wanamaker*,[30] in which the taxpayer argued that its preferred shares were

[23]*See, e.g.*, *Pritired*, 816 F. Supp.2d at 722-725 (combining elements of Notice 94-47, 1994-1 C.B. 357, with issues presented in expert testimony as well as factors identified in precedent cases).

[24]*Hubert Enterprises*, 125 T.C. 72.

[25]There was, for a while, an anti-*Culbertson* argument under section 704(e)(1), which provided that a "person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person." Section 704(e)(1) figured prominently in parts of the GE case. *See supra* note 8. This argument was mooted in November 2015 when section 704(e)(1) was struck from the code. Bipartisan Budget Act of 2015, P.L. 114-74, section 1102.

[26]*TIFD III-E*, 459 F.3d at 231. The Second Circuit ignored the parts of *Culbertson* that can be read as a direction to look at the intent of the parties. On remand, the district court succinctly summarized the problem with using *Culbertson* as a guide: "I acknowledge the obvious fact that the Second Circuit reached a different conclusion following its *Culbertson* analysis than I reached following mine." 660 F. Supp.2d at 369 n.1.

[27]*TIFD III-E*, 459 F.3d at 232-240. The court did not, however, state that the corporate debt-equity factors apply equally to a partnership.

[28]Notice 94-47. The Eighth Circuit factors are set forth in *J.S. Biritz Construction Co. v. United States*, 387 F.2d 451 (8th Cir. 1967); and *Matter of Uneco Inc.*, 532 F.2d 1204 (8th Cir. 1976). Both cases involve corporate taxpayers.

[29]The IRS in FSA 199940007 stated: "The presence of a sum certain payable at maturity is a sine qua non of debt treatment under the Code." *See also* Notice 94-47, which sets forth the eight factors the IRS considers worthy of consideration in a debt-equity analysis. Notice 94-47 is not explicitly limited to corporations, although that is the implication. (One of the factors refers to "stockholders.") The first two factors — whether there is an unconditional promise to pay a certain sum on demand or at a fixed maturity date and whether the holder has a right to enforce the payment of principal and interest — go to the existence of principal. Note that the original issue discount regulations assume the existence of debt without unconditional principal. Reg. section 1.1275-4 states, with some exceptions, "This section applies to any debt instrument that provides for one or more contingent payments." *See also* reg. section 1.1275-4(c)(4)(ii)(A) (as amended in 2004). On the other hand, the OID regulations apply only to an instrument that constitutes debt under general principles of tax law, and the existence of the OID regulations cannot influence that determination. *See* reg. section 1.1275-1(d) (as amended in 2016).

[30]*John Wanamaker Philadelphia v. Commissioner*, 139 F.2d 644 (3d Cir. 1943).

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debt for tax purposes. Among the factors that caused the court to reject the taxpayer's claim was the absence of a fixed or determinable maturity date. In contrast, we are all aware of corporate preferred stock that is subject to mandatory redemption and, assuming that the redemption date is far enough out, the mandatory redemption is not thought to convert what would otherwise be equity into debt. In *Crawford Drug Stores*,[31] the preferred stock was "absolutely and unequivocally" payable on a specified date 20 years after its issuance. Without any discussion of this feature, and with the consequential implication that this feature was irrelevant to its analysis, the court concluded that the instrument was stock for tax purposes.[32]

What about the partnership context? Just as in the corporate context, there is some law to the effect that a maturity date is necessary to enable an instrument to be characterized as debt of a partnership for tax purposes.[33] The Principal Financial court, for example, viewed the pertinent instrument as having a five-year maturity.[34] The maturity was derived from the court's conclusion that the partnership would be liquidated at the end of five years. The partnership in the GE case was self-liquidating in the sense that there was a mandatory schedule of cash distributions (corresponding to expected cash receipts from the aircraft leases held by the partnership), and it was implicitly accepted that the mandatory schedule would guarantee a return of an amount equal to the principal by a specific date.[35] Unlike the corporate context, there is no law in the partnership context clearly suggesting that the maturity date can be ignored if it is far enough out.[36] In particular, there is no law suggesting that an analogue to garden-variety corporate preferred stock exists in the partnership context — that is, that an investment in a partnership that bears a fixed return and requires repayment on a specific date, say, 20 years in the future, under circumstances in which that repayment is reasonably likely (albeit subordinate to general creditors) can be characterized as equity.[37] This introduces one apparent distinction between a corporation and a partnership. In the partnership area, it might be risky to put a 20-year mandatory redemption on a partnership interest that is sought to be treated as such, particularly one that has debt-like economics similar to those of corporate preferred stock. That factor may be more ambiguous in a corporate context.[38]

Even if a fixed payment is required to be made at a fixed time, there is also the question whether the payment is unconditionally payable or is payable only out of income. It is fairly easy to dismiss, as unable to constitute principal, a fixed payment that is payable only out of income. For example, in *Hartman*,[39] the taxpayer, an

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[31] *Crawford Drug Stores Inc. v. United States*, 220 F.2d 292 (10th Cir. 1955).

[32] The court held that although the intent of the parties is an important factor, the actions of the corporation favored a finding that the payments represented dividends. Those actions included (1) denominating the certificates as preferred stock; (2) providing that the annual payments be made only out of net earnings; (3) providing that upon dissolution or liquidation, the rights of the holders should be subordinate to the rights of ordinary creditors; (4) setting up the transaction on the books as preferred stock; (5) filing a certificate certifying that the capital stock consisted of common and preferred stock; and (6) filing annual franchise returns reporting that the outstanding capital stock consisted of common shares and first preferred stock. In *Commissioner v. Meridian & Thirteenth Realty Co.*, 132 F.2d 182, 185 (7th Cir. 1942), corporate "preferred stock" had definite but unstated maturity dates. The court held that the instrument was equity, stating that preferred stock normally has a maturity date.

[33] *See Hubert Enterprises*, 125 T.C. at 95 (quoting *Stinnett's Pontiac Service Inc. v. Commissioner*, 730 F.2d 634, 638 (11th Cir. 1984) ("An unsecured note due on demand with no specific maturity date . . . is insufficient to evidence a genuine debt.")); *EPIC Associates*, 81 T.C.M. (CCH) 1311, 1363 (2001) (the absence of a fixed maturity date for repayment of advances indicated that the advances were equity); and *Federal Projects*, 53 T.C.M. (CCH) at 627 (advances to limited partnership had no maturity date, leading to a conclusion that the advances should be classified as equity).

[34] *Pritired*, 816 F. Supp.2d at 724, 734.

[35] *TIFD III-E*, 432 F. Supp.2d at 98-100.

[36] *But see In re Biscayne Investment Group Ltd.*, 264 B.R. 765, 768 (Bankr. S.D. Fla. 2001), in which an advance to a limited partnership undertaking a condominium conversion project had to be repaid on the earlier of two years or the date that all the condominiums were sold. The Bankruptcy Court viewed this fact, under the circumstances, as not establishing a maturity date, although that conclusion is dictum because the court then avoided deciding whether the advances were debt or equity. *Id.* at 771-772.

[37] In the penalty phase of the GE case, one reason the district court denied the government's motion to impose a negligence penalty was because the taxpayer could have reasonably believed that the interest was the "partnership equivalent of corporate preferred stock." *TIFD III-E*, 8 F. Supp.3d at 149-150. The Second Circuit rejected the district court's analogy of the Dutch banks' interest to preferred stock, citing its previous decision that the authorities invoked by the taxpayer provided "*no support* for [its] treatment of the banks' interest as equity." 604 Fed. Appx. at 70.

[38] What about the reverse? If an instrument is styled as debt but has a long maturity, such as the 50-year term of the debt in *Monon Railroad v. Commissioner*, 55 T.C. 345 (1970), *acq.*, 1973-2 C.B. 3, it may be recharacterized as equity. *See* Notice 94-47. The IRS's position appears to apply equally to partnerships and corporations.

[39] *Hartman v. Commissioner*, 17 T.C.M. (CCH) 1020 (1958).

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individual, advanced $5,000 to a corporation under an arrangement whereby all the net profits of a specific venture would be paid to the taxpayer until he had received a return of his $5,000 plus 6 percent "interest"; thereafter, the profits were to be split 50-50. Later, the $5,000 plus 6 percent was paid, but with no further profit splitting. The Tax Court held that the arrangement did not constitute debt of the corporation but rather equity in a joint venture because the principal was payable only out of profits of the venture. The court stated that it is "essential" to debt characterization that absolute payment be called for. In *Beck Chemical*,[40] the taxpayer provided intellectual property and services to a manufacturing venture that otherwise was conducted by another under an agreement under which the taxpayer would receive 50 percent of any profits of the venture. In holding that the taxpayer was a partner in a partnership, the Tax Court stated that the 50 percent profits entitlement is "strongly indicative" of a partnership and is dispositive in the absence of "cogent evidence" to the contrary.

In *Hartman*, the taxpayer would have received nothing on a dissolution of the venture if there had been no profits.[41] What if the taxpayer had been credited with a $5,000 capital account and been entitled to a preferred distribution, ahead of other partners, on dissolution? Could that preferred distribution on dissolution take the place of principal or counteract the fact that the putative principal was otherwise payable only out of profits? It appears not. In *Hambuechen*, the taxpayer advanced money to a partnership in which he was a limited partner. The taxpayer's advance was eventually repaid by the partnership while it was in liquidation. In determining whether the advance was debt or equity, the Tax Court specifically pointed to the fact that repayment was to be made only when the taxpayer terminated his interest in the partnership. While the case is not entirely clear on this point, it appears that the advance, while subordinated to creditors, was senior in liquidation priority to the regular capital accounts of the partners. This priority in liquidation was not discussed by the Tax Court and thus must be viewed as not enough to establish a maturity.

Is there any circumstance in which a distribution upon liquidation can provide the necessary maturity for an instrument to be classified as debt for tax purposes? For a normal operating partnership of indefinite duration, that would seem to be impossible. The timing of any liquidation, and even the existence of that liquidation, would seem too speculative to provide the maturity. The situation is different, however, with special purpose entities that inherently have a limited life.

In the Principal Financial case, the anticipated dissolution of the partnership at the end of five years provided the necessary maturity for the instrument to be held to be debt. The structure of that transaction, while carefully leaving open the remote possibility that the partnership might continue, had so stacked the deck for a liquidation in five years that the court had no trouble reaching its maturity conclusion. Before December 31, 2005, the partnership could be liquidated only by a unanimous vote of the partners. Beginning on that date, the partnership could be liquidated by a majority vote, and the French banks held 98 percent of the vote on that day. Beginning the next day, the voting rights of the French banks decreased to 50.1 percent, and the Principal Financial side gained an unrestricted right to buy 0.2 percent voting control from the French banks, thus giving it the ability to increase its voting right after that date from 49.9 percent to 50.1 percent. Testimony established that the structure was intended to give the French banks an incentive to liquidate the partnership immediately before they lost voting control, and the facts were replete with evidence of the parties' expectation that the transaction would end after five years. The district court viewed the five-year duration as "virtually guaranteed."

What if the facts were not so stark and a particular partnership seems relatively likely, but not certain, to liquidate? Or what if the partnership seems relatively certain to liquidate, but the timing of that liquidation is uncertain? There are no clear answers to those questions. My

[40] *Beck Chemical Equipment Corp. v. Commissioner*, 27 T.C. 840 (1957); *acq.*, 1957-2 C.B. 3.

[41] *Hartman*, 17 T.C.M. (CCH) at 1023 ("The witness . . . testified that the Transit Company assumed no obligation to repay the money advanced.").

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view is that the timing may be less important but that some reasonable certainty of liquidation would be required before the liquidation could furnish the maturity necessary to construe that debt factor to be met.

For a traditional operating partnership, it may even be permissible for the preferred distribution on liquidation to be guaranteed by a third party, even in the absence of profits of the partnership, without that guarantee being said to give rise to principal on a debt for tax purposes. In *Hunt*,[42] a general partner advanced substantial funds to a limited partnership, and the partnership guaranteed repayment of 98 percent of the general partner's capital plus an 18 percent return. In the waterfall on dissolution, 98 percent of the general partner's capital was to be distributed to the general partner ahead of any distributions of capital to the limited partners.[43] Further, the limited partners were required to contribute capital to the partnership to facilitate the mandatory distribution if the partnership income fell below specified levels or at any time that a bank loan by which the general partner funded its capital contribution was due. The government argued that the general partner was a lender for tax purposes because of the guaranteed return of 98 percent of its capital (among other reasons).[44] The Tax Court held that the guaranteed return was not determinative and stressed that the guarantee was triangular in form — that is, that the agreements called for the limited partners to contribute money to the partnership so that the partnership could honor its guarantee, instead of having the limited partners pay the money directly to the general partner. Because of that form, the Tax Court viewed the guarantee as contingent, and the contingent guarantee was not enough to turn the investment into debt. The lesson of *Hunt*[45] is that a top-off guaranteed repayment of investment upon dissolution, at least when the triangular form is preserved, is not inconsistent with a partnership interest.

A similar situation was presented in *Investors Insurance*,[46] in which the taxpayer entered into a joint venture agreement under which it advanced $350,000 and received what in effect was a preferred 6 percent return and a preferred return of its investment. Both preferences applied to any distribution, including distributions on dissolution. The taxpayer argued that it had made an equity investment rather than a loan. From November 1969 through December 1974, the taxpayer benefited from a guarantee of the other partners that it would receive its principal when the joint venture terminated (which was to occur, by contract, no later than December 31, 1973).[47] The taxpayer's interest was held not to constitute debt during that period. The Tax Court then turned to a change that occurred on December 30, 1974, when the guarantors, in exchange for an extension of the termination date, agreed to guarantee repayment of the $350,000 on December 31, 1978, the new scheduled termination date of the venture. With little enunciation of its analysis, the Tax Court concluded that the 1974 change in the agreement created a primary liability of the guarantors rather than the contingent one that existed before that date. This turned the taxpayer's investment into a debt instrument.

The Ninth Circuit agreed, stating that the substance of the 1974 amendment was a conversion of the original investment to a loan.[48] One can fairly question the application of the law to the facts in *Investors Insurance*, but the

[42] *Hunt v. Commissioner*, 59 T.C.M. (CCH) 635 (1990).

[43] The fact that the guarantee was for 98 percent rather than 100 percent has the fingerprints of tax planning and an attempt through that residual 2 percent to defeat a blanket assertion that the general partner was guaranteed a return of every penny of its investment. The Tax Court did not take that bait, and no part of the court's analysis depends on the 98 percent versus 100 percent distinction.

[44] The government also argued that the 18 percent return that the general partner received, which was secured by almost all of the assets of the limited partners, was equivalent to interest.

[45] *Hunt* is only a Tax Court memorandum decision but is unusually well analyzed.

[46] *Investors Insurance Agency Inc. v. Commissioner*, 72 T.C. 1027 (1979), *aff'd*, 677 F.2d 1328 (9th Cir. 1982).

[47] For reasons not clear in the decision, the joint venture agreement was extended to May 31, 1974, and the taxpayer did not exercise its rights through December 30, 1974.

[48] Judge William Norris, the dissenting member of the Ninth Circuit panel, thought that the taxpayer owned a debt instrument and not a partnership interest even before the 1974 amendment. However, the judge admitted that it is unclear whether the joint venture or the guarantor was the obligor on that debt instrument.

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principles of law can be deduced: (1) A priority distribution on dissolution is not principal; (2) a contingent guarantee of that priority return will not convert it to principal; and (3) a direct obligation of the guarantor to pay that priority return may convert the instrument to debt of the guarantor but not to debt of the obligor.

The Second Circuit in the GE case muddied the analysis considerably by suggesting that an agreement comparable to a third-party guarantee may lead a court to characterize an interest as debt *of the partnership* for tax purposes. At trial, the district court noted that a GE subsidiary had guaranteed its entities' compliance with the terms of the partnership's operating agreement. The Second Circuit, on appeal, maintained that the partnership's operating agreement contained protections that virtually guaranteed the Dutch banks the return of their initial investment, and on several instances the court referred to GE's "personal guaranty" as a basis for its decision that the Dutch banks' interest was in the nature of a secured lender's interest.[49] The Second Circuit treated the guarantee as if it were a guarantee of payment. On remand, the district court emphasized that the pertinent guarantee was a "performance guaranty," and it reiterated that GE's guarantee merely ensured that its entities would perform their obligations under the terms of the operating agreement. The district court correctly noted that such a guarantee is not absolute because it would not insulate the Dutch banks from the possibility of losses in excess of their capital investments. The Second Circuit, corrected on the facts but unmoved, later admitted that the "partnership agreement did not expressly guarantee" the expected return, but stated that "there was effectively no practical likelihood that the banks' return would deviate more than trivially" from what was expected.[50] Ultimately, the Second Circuit affirmed its original finding that the banks' interest was not an equity interest.

B. Right to Enforce

It would also seem to be relevant what a holder's remedy is if the putative principal amount is not paid.[51] For a garden-variety debt instrument, the remedy for nonpayment typically is the ability to obtain a judgment and enforce that judgment in the courts.[52] In *Hartman*, the Tax Court stated that for an investment to be characterized as a loan for tax purposes, it is "essential" not only that payment be called for, but that it be "secured in some way."[53] In *Crawford Drug Stores*, which dealt with a corporation rather than a partnership, the nominal preferred stock was due in 20 years, and, if not paid then, the holder had a right to require a dissolution of the corporation, in which case the holder had priority. It would seem that this is a pretty good remedy and one that is analogous in its strength to an ability to enforce a judgment. With no discussion, however, the Tenth Circuit in *Crawford Drug Stores* held that the subject instrument was preferred stock for tax purposes.[54] The mandatory dissolution right of *Crawford Drug Stores*, which is unusual in the corporate context,[55] is more common in the partnership context. Section 15-801(1) of Delaware partnership law[56] states that any partner can force a dissolution of the

[49] *TIFD III-E*, 459 F.3d at 228 ("These protections collectively ensured there was no realistic chance that the Dutch banks would receive less than the reimbursement of their initial investment at the Applicable Rate of return.").

[50] *TIFD III-E*, 666 F.3d at 838.

[51] Whether holders possess the right to enforce payment of both principal and interest is one of the factors in Notice 94-47.

[52] *See* David C. Garlock, *Federal Income Taxation of Debt Instruments*, section 102.03[B] (7th ed. 2017) ("A debt instrument characteristically gives the holder the right to sue the issuer to enforce the payment of principal and all accrued interest in the event of nonpayment of even a single interest payment (typically after a short grace period).").

[53] *Hartman*, 17 T.C.M. (CCH) at 1023.

[54] *Crawford Drug Stores*, 220 F.2d at 296. In *Meridian*, 132 F.2d at 187, which had the same feature, the Seventh Circuit similarly did not view the right to compel liquidation for failure to pay principal at maturity as meaningful. The court also stated that a provision that barred officers' salaries from being paid unless the preferred dividend was paid did not create a right to interest.

[55] For Delaware corporate law governing dissolution generally and procedure, see Del. Code Ann. tit. 8, section 275 (1953).

[56] Based on Uniform Partnership Act, section 801(1) (1997).

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partnership at any time, absent a contrary provision in the partnership agreement.[57]

In the GE case, the Dutch banks could require dissolution.[58] Each year the banks were to have their capital accounts credited or debited, depending on the profitability of the partnership, and each year the banks were to have a significant portion of their ownership interest bought out by the partnership. The annual buyout payment to the banks was set forth in the partnership agreement. The buyout payments technically were discretionary on the part of General Electric Capital Corp., but failure to make an annual buyout payment gave the banks the right to force a liquidation of the partnership. The district court in the GE case, somewhat amazingly, viewed this fact as deserving little weight.[59] The Second Circuit, in contrast, concluded that the right of the Dutch banks to terminate the partnership effectively gave them the right to enforce the payment of what was effectively principal. The Second Circuit emphasized that its conclusion on this point was dependent on its earlier conclusion that the French banks were protected against any diminution in value of their partnership interests and that they were therefore assured that upon liquidation, which they had the right to force, they would receive the deemed principal on the loan. The court explicitly noted that this situation is quite different from that of an ordinary partner in an ordinary partnership, who may be able to force liquidation but has no assurance of what she will receive upon that liquidation.

The Second Circuit's analysis in the GE case seems like the right one. A right to force liquidation should be viewed as a right to enforce payment if there is assurance of moneys with which to return what is thought to be principal. Without that assurance, however, it seems incorrect that a mere right to force liquidation could be viewed as a right to enforce payment of a putative debt.

[57]Del. Code Ann. tit. 6, section 15-801(1) and (3) (2000).

[58]In the Principal Financial case, the U.S. taxpayers could require dissolution after five years.

[59]The court said that while the absence of a right to enforce the payment of principal might convert debt to equity, a right of an equity holder to have its shares bought out is "perfectly normal."

C. Sum Certain

For an instrument to constitute principal, one would normally expect to see a maturity in the temporal sense as well as the right to receive a sum certain at that maturity date. What if there is a bit of variability in the amount that is to be received at maturity? The existence of upside in a particular instrument — the opportunity to receive more than one's investment — logically should be viewed as going to whether there is an interestlike return on the instrument and not to whether there is a sum certain due at maturity. Both the district court and the Second Circuit in the GE case got this wrong. For the district court, it was because it held that what it perceived as significant upside negated any conclusion that there was a sum certain. For the Second Circuit, its perceived lack of significant upside was cited as support for its conclusion that there was a sum certain.[60] In fact, however, it is the downside that should be examined to determine whether there is a sum certain. In the Principal Financial case, it appears that the $291 million face amount of PCs required repayment at that precise amount. It also seems clear that the court viewed the B shares as certain to receive $9 million, although it is not entirely clear why.[61] In any event, the court seemed to find no downside to the transaction and to find a sum certain of $300 million.

D. Interest or Other Debt-Like Economics

Garden-variety debt not only has principal but also typically provides for interest.[62] Not surprisingly, interest or the lack thereof is relevant in the partnership debt-equity cases. Several courts have held that an investment in a

[60]The Second Circuit had separately concluded that the Dutch banks had no downside, so the sum certain conclusion of the Second Circuit was correct, even if its reasoning is a bit loose.

[61]It appears likely that the stapling of the two instruments accounted for this conclusion. The court viewed the Class B shares as effectively elevated in a liquidation waterfall to the level of the PCs because they were stapled to the PCs and they both had to be repaid at the same time.

[62]There is, however, zero coupon debt, and the OID regulations generally impute interest in that case. Perhaps recognizing this fact, Notice 94-47 does not include the existence of interest as a relevant factor in its list of debt-equity factors. If interest exists, however, its enforceability is a factor.

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partnership constitutes equity even though the investment bore a fixed return labeled "interest."[63] This is particularly true when the enterprise was not creditworthy.[64] There is no case or other law holding that an investment in a partnership that does not bear interest is debt. So if one desires debt characterization, it is best to provide for interest, although that will not be dispositive. If one wants equity status, it is best not to provide for interest. But what about a fixed preferred return? In the GE case, the Dutch banks' return came very close to a fixed return, but the district court was influenced heavily by a very thin, but theoretically unlimited, slice of upside economics. That slice of upside was adequate to convince the court that the Dutch banks had an equity-like — not debt-like — return.[65] The Second Circuit belittled this "possibility of a small increase in the event of unforeseen extraordinary partnership profits" as insignificant and viewed the Dutch banks as entitled to an interestlike return.[66] The Principal Financial court reached a similar result on a stapled instrument that mostly bore interest at LIBOR plus 1 percent and had a thin possibility of upside.[67] There remains open the question of how much upside would have been necessary for the GE and Principal Financial courts to see things differently.

What if the instrument has no upside and provides only for an absolutely fixed, straight, preferred return? The fact that a fixed, interestlike return on a partnership interest is permissible is perhaps best illustrated by considering a classic guaranteed payment to a partner for the use of capital by the partnership, the existence of which is blessed by statute.[68] Payments by a partnership to a partner for the use of capital are considered to be made to a nonpartner, but only for purposes of sections 61(a) and 162(a), and then only to the extent that the payment is determined without regard to income of the partnership.[69] The fact that a guaranteed payment is deductible under section 162 rather than treated as a distribution of partnership profits does not convert the instrument that conveys the right to that guaranteed payment to debt of the partnership.

The existence of guaranteed payments in the partnership world is somewhat troubling to a logical debt-equity analysis. The difficulty is similar to that presented in the corporate world by garden-variety preferred stock with a mandatory redemption. A garden-variety guaranteed payment for capital not only has an interestlike return, but because it is not dependent on the profits of the partnership, it is not subject to the entrepreneurial risks of the partnership operations. The garden-variety guaranteed payment for the use of capital does not, however, have a maturity or any other feature that can be analogized to principal, and it is perhaps this fact that enables its equity characterization.[70] However, the law governing guaranteed payments does not seem to mandate that there be no facts that could give rise to a principal analogy.[71]

It seems relatively clear, therefore, that a partnership interest can have a debt-like annual

[63] *See Hubert Enterprises*, 125 T.C. at 72; *EPIC Associates*, 81 T.C.M. (CCH) at 1311; *Stanchfield*, 24 T.C.M. (CCH) at 1681; and *Hartman*, 17 T.C.M. (CCH) at 1020.

[64] *See Hubert Enterprises*, 125 T.C. at 91.

[65] The court stated:

> Thus, although they were guaranteed a minimum return, they were not guaranteed a maximum — or, more to the point, a *certain* — return. The difference is significant. An interest holder guaranteed a fixed return resembles a debtor because he has no interest in anything other than solvency of the entity obligated to pay him. By contrast, even with security against downside risk, an investor with unlimited upside potential has a significant interest in the performance of the entity in question, because performance directly affects the amount of her return.

TIFD III-E, 342 F. Supp.2d at 117.

[66] *TIFD III-E*, 459 F.3d at 226.

[67] *Pritired*, 816 F. Supp.2d at 724 (dismissing a notional upside potential as unable to support an equity characterization when "strict investment guidelines . . . effectively capped the return").

[68] Section 707(c).

[69] *Id.*; reg. section 1.707-1(c) (as amended in 1983).

[70] There is also a textual argument that section 707(c) operates independently of section 707(a)(1), with the implication that Congress intended that a guaranteed payment be subject only to the narrow consequences set forth in section 707(c) and not to the broader nonequity consequences that would ensue if section 707(a)(1) applied. *See Armstrong v. Phinney*, 394 F.2d 661, 663 (5th Cir. 1968) (stating that section 707(a) applies in a situation not covered by section 707(c)).

[71] Section 707(c) and reg. section 1.707-1(c) are silent on this point.

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return and still be a partnership interest. In this sense, a partnership is the same as a corporation, which can replicate debt-like economics through the issuance of preferred stock.[72] It is not so clear, conversely, that the absence of a fixed return (or a return that is something more than a fixed return) compels a characterization of equity rather than debt. A thin but theoretically infinite sliver of upside was very meaningful to the district court in the GE case, albeit not meaningful to the Second Circuit.[73] On the other hand, there is debt with a so-called equity kicker, and that debt in many circumstances is thought to still be debt. At some point, of course, the non-interestlike component of the investor's return could become so significant, as compared with the interestlike component, that it would seem to compel equity characterization. At some point the non-interestlike component of the Dutch banks' return in the GE case could have become so significant, as compared with the interestlike component, that even the Second Circuit would have seen it as indicating equity characterization. If it is interestlike economics that are desired commercially, however, adding enough non-interestlike trappings to be confident of equity characterization for tax purposes could become mighty expensive.

IV. Other Important Factors

A. Participation in Management

The Supreme Court in *Culbertson* reiterated "the importance of participation in the business of the partners,"[74] citing *Tower*,[75] which it had decided three years earlier. The *Culbertson* opinion stated that lack of management and control is "not conclusive" on whether an individual is a partner but that it is a "circumstance of prime importance."[76] *Culbertson* concerned a family ranching partnership among the taxpayer and his four sons and the question whether that partnership was real for tax purposes. The government asserted that the partnership was not real. The facts varied by son. Culbertson's oldest son was 24 years old, married, and lived on the ranch, where he had been the foreman for two years. He received $100 per month plus board and lodging for himself and his wife, before and after the formation of the partnership, until he entered the Army. The second son was 22 years old and went directly into the Army following his college graduation and rendered no services to the partnership. The two younger sons, who were 18 and 16 years old, went to school during the winter and worked on the ranch during the summer. The Supreme Court remanded the decision to the Tax Court for a son-by-son determination of which ones were partners and which were not. In the end, the partnership was upheld, and neither the Tax Court nor the Fifth Circuit on appeal distinguished among the sons.[77] *Culbertson* is thus viewed today primarily as a sham partnership case in which the taxpayer won. Still, it is clear that the Supreme Court remanded the case for a son-by-son determination and intended that each son's degree of participation in the management of the partnership be a factor in deciding whether that particular son was a partner.

In *Stanchfield*,[78] to establish whether A.L. Stanchfield and his son-in-law were joined in a common business venture, the court considered the level of Stanchfield's participation in management. It was particularly difficult to weigh this factor because of "the inconsistency

[72]Corporate preferred stock with interestlike economics and mandatory redemption has the advantage of being envisioned by statute. Section 351(g) envisions that stock that is limited and preferred for dividends and does not participate in corporate growth to any significant extent, and that has a required redemption, can be equity. Section 1504(a)(4) envisions the same. Both sections, however, presuppose that the instrument has emerged from a debt-equity analysis as equity. *See also* reg. section 1.305-5(d), Example 5 (fixed rate preferred stock equity despite mandatory redemption after 10 years).

[73]*Cf. Pritired*, 816 F. Supp.2d at 724 (finding that a "potentially uncapped" return was in reality a debt-like feature because it was effectively capped by other arrangements in the transaction).

[74]*Culbertson*, 337 U.S. at 740.

[75]*Commissioner v. Tower*, 327 U.S. 280 (1946). *See* discussion of *Tower* in *Culbertson*, 337 U.S. at 744 n.13.

[76]*Culbertson*, 337 U.S. at 744, 747 n.17.

[77]On remand, the Tax Court held that there was no intention of any party to form a partnership and found overwhelming evidence to support that conclusion. *Culbertson*, 9 T.C.M. (CCH) 647, 659 (1950). The Fifth Circuit reversed and reiterated an earlier opinion in which it had upheld the entire partnership. *Culbertson*, 194 F.2d 581, 581 (5th Cir. 1952) (citing *Culbertson*, 168 F.2d 979 (5th Cir. 1948)).

[78]*Stanchfield*, 24 T.C.M. (CCH) 1681.

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between [Stanchfield's] initial stated unwillingness to become deeply involved in the enterprise and the actions taken by him subsequent to these statements."[79] The court noted that although Stanchfield's active participation was less than that of his son-in-law, that fact alone did not mean a joint venture did not exist. Among the relevant factors in the court's debt-equity analysis was "the participation of the party making the advances in management."[80] While the decision did not emphasize participation in management in its debt-equity analysis, it was a key factor in determining whether a joint venture existed. In *S&M Plumbing*,[81] the taxpayer entered into a joint venture agreement with another party, invested $50,000 in the venture, and was entitled to 50 percent of the profits subject to a guaranteed minimum profit distribution of $40,000. The Tax Court stated that a partnership for tax purposes requires not only profit sharing but also "joint proprietorship and control."[82] The Tax Court found the second element to be present because two signatures were required on checks of the venture.[83]

It seems clear, therefore, that participation in the business of the partnership is a strong factor indicating status as a partner rather than a lender. The reverse is not true. In *Hartman*, for example, the fact that the taxpayer did not participate in the management of a business venture did not prevent his being characterized as a partner in the joint venture.[84] In particular, a limited partner in a limited partnership, by definition, cannot participate in the management of the partnership but is no less a partner because of that fact.[85] In *Hambuechen*, a limited partner advanced money to the partnership. Before the Tax Court began its analysis of whether this advance should be treated as debt or equity, it listed numerous factors that courts usually consider. In its analysis of the advance, the court emphasized that the advance lacked security, no interest was charged or paid, the advance was subordinate to other partnership creditors, and because of the financial condition of the partnership, it was unlikely that an outside creditor would have made such a loan. The Tax Court ultimately concluded that the advance should be treated as a capital contribution, but it never discussed the issue of participation in management.[86]

Bear in mind that participation in management is an important factor only when there is one interest to be characterized. In other words, if an alleged partner has only one interest in the partnership and that interest carries with it management rights, that participation in management will be strongly suggestive of the interest constituting a partnership interest for tax purposes. In contrast, a partner could clearly be a partner through one interest and also a lender through a separate interest or instrument. When there are multiple interests to be analyzed, any participation in management might logically be tied to what is conceded to be a partnership interest and therefore would not provide support

[79] *Id*. at 1690.

[80] *Id*. at 1692. For example, Stanchfield eventually obtained signature authority over the bank account of the joint venture.

[81] *S&M Plumbing Co. Inc. v. Commissioner*, 55 T.C. 702 (1971), *acq.*, 1971-2 C.B. 3.

[82] *Id.* at 707.

[83] *But see Podell v. Commissioner*, 55 T.C. 429, 432 (1970), in which it was not dispositive that a passive money investor did not control day-to-day activities of a real estate venture operated under an oral understanding. It was enough that the taxpayer controlled his own advances to the venture.

[84] *See Hartman*, 17 T.C.M. (CCH) at 1020.

[85] *Tower*, 327 U.S. 280, involved a limited partnership formed under Michigan law in which the taxpayer was a general partner and his wife was a limited partner. The wife was prohibited from participating in the conduct of the partnership's business. Interestingly, the Supreme Court stated that contribution to management and control of the alleged partnership would have helped the taxpayer sustain his position that his wife was in partnership with him. The Supreme Court then conceded that the taxpayer's wife, despite her lack of participation in management, could have been viewed as a limited partner in the partnership. In the end, the Court held that the wife was not in partnership with her husband, citing the absence of intent to form a partnership. It seems relatively clear that the wife's nonparticipation was a large, if not predominant, factor in the Court's conclusion.

[86] *Hambuechen*, 43 T.C. at 103-105. The district court in the GE case stated that management rights might convert debt to equity. The court then concluded, citing the example of shareholders of public companies, that the absence of management rights does not indicate that equity is really debt. *TIFD III-E*, 342 F. Supp.2d at 116.

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regarding another interest in the partnership that is alleged to be debt. In *EPIC Associates*, "participation in management" was one of the listed factors for determining whether the advances to two partnerships constituted debt or equity.[87] While the decision points out that this was one of the factors that did not clearly indicate whether the advances were debt or equity, that was only because EPIC, the party advancing the funds, did not receive increased management control over either partnership as a result of the advances. Rather, as the general partner, EPIC already exercised full management control of both partnerships. The decision ultimately holds that EPIC's advances to both partnerships were equity, not debt.

The Dutch banks in the GE case had no right to participate in the management of the partnership. The Second Circuit found it odd that partners that had contributed nearly 20 percent of the assets of the partnership had no right to participate in management, although the Second Circuit admitted that that absence was "certainly not conclusive."[88] The court viewed this fact as "slightly" favoring a debt conclusion. The European banks in the Dow Chemical case were granted limited voting rights on specifically reserved matters but were otherwise not involved in the management of the partnership. The court concluded that "the banks clearly had rights in theory but not as clearly in practice" and viewed this factor as "inconclusive."[89]

In the Principal Financial case, in the first five years, the Class B shares held by the U.S. taxpayers had a 2 percent vote in the partnership.[90] Moreover, all decisions of the partnership during that time required a unanimous vote, so the voting rights of the B shares would appear to be meaningful. Relying in part on the opinion of an expert, the district court concluded that the voting rights were more akin to negative covenants in a loan agreement. It is difficult to understand this thinking. The court perhaps was influenced by the limited purpose of the partnership and its short, five-year life and perhaps concluded that having a blocking right on board-level decisions during that period was not particularly meaningful. Aside from the Principal Financial case, it would seem that although the absence of a voting right is not a dispositive indication that the instrument is debt, the existence of a meaningful voting right would be a powerful fact indicating equity.

In *Culbertson*, of course, the form was a traditional partnership. Many, if not most, partnerships these days are LLCs, and many of those companies are set up with corporate-type governance structures with a governing board with appointed members. A minority partner often can appoint members to the governing board. It is relatively easy for a controlling partner to give a "vote" to a minority partner that in effect entitles the minority partner to a seat at the table when decisions are being made but no right to block or alter those decisions. Would such a vote be meaningful in a debt-equity analysis?

B. Subordination to General Creditors

In *John Wanamaker*, a corporate debt-equity case, the Third Circuit stated that subordination to general creditors is the "most significant characteristic."[91] The partnership cases reach the same conclusion.[92] In *Hambuechen*, the limited partner's advance was agreed to be subordinate to the claims of all the creditors of the partnership. In determining that the advance was a capital contribution and not a valid debt, the Tax Court stated, "the subordinating of [Hambuechen's]

[87] *EPIC Associates*, 81 T.C.M. (CCH) at 1363.

[88] *TIFD III-E*, 459 F.3d at 239.

[89] *Chemtech*, 2013-1 U.S.T.C. para. 50,204 at 46, *aff'd*, 766 F.3d 453.

[90] The fact that the B shares were stapled to the PCs tied the vote to the entire package that was being analyzed by the court for debt versus equity.

[91] *John Wanamaker*, 139 F.2d at 647. *See also Meridian*, 132 F.2d at 188 (subordination to general creditors, "while not decisive, bears real weight").

[92] Several decisions list subordination as a factor in the debt-equity analysis. *See Pritired*, 816 F. Supp.2d at 734; *TIFD III-E*, 342 F. Supp.2d at 116, *rev'd*, 459 F.3d 220; *Hubert Enterprises*, 125 T.C. at 99; and *EPIC Associates*, 81 T.C.M. (CCH) at 1363. There is also a curious IRS authority, Rev. Proc. 2003-84, 2003-2 C.B. 1159, proposed to be modified by Notice 2008-80, 2008-2 C.B. 820, which appears to bless a partnership that splits the ownership of a single tax-exempt obligation between one equity class, entitled to a preferred variable return, and another equity class, entitled to the remaining return on the tax-exempt bond. It is difficult to see a rationale for this conclusion, which is perhaps more appropriately viewed as specific to its facts.

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claim to that of all other creditors of the partnership is a strong indication that the advance was really a capital contribution."[93] In *Stanchfield*, the Tax Court divided its analysis into two steps — first, whether a partnership existed at all; and second, if a partnership existed, whether the taxpayer was a lender to that partnership. Subordination to general creditors was considered by the court to be relevant to both steps of the analysis and helped the court reach its conclusion that the taxpayer was a partner in, and not a creditor of, a partnership. In the GE case, after listing eight factors to be considered in the debt-equity analysis,[94] the district court excluded three factors that deserve "little weight"[95] and analyzed the remaining five. Whether the Dutch banks' interest was subordinate to that of general creditors — it was, in form — was one of the five factors considered by the court. This factor, among others, led the court to conclude that the Dutch banks were partners.[96]

If subordination to general creditors is a factor that supports an interest being characterized as equity rather than debt, subordination to both general creditors and specific other partners should even more strongly suggest (or even require) that conclusion. In *Federal Projects*,[97] a corporation and one of its subsidiaries made advances to limited partnerships.[98] In analyzing whether the advances were debt or equity, the Tax Court emphasized that "all of the advances were subordinated to other partnership debts including the right of the investor/limited partners to receive their investment plus a specified rate of return thereon."[99] The placement of the advances at the very end of the liquidation waterfall was one of the primary reasons cited by the Tax Court for why the corporation in question did not intend the advances to be definite obligations but rather intended that they be capital contributions.

One issue that has not been analyzed by the courts is whether, if one desires partnership characterization and therefore has constructed an interest that is subordinated to general creditors, the practical or expected meaning of that subordination provision matters. For a special purpose entity, for example, it may be unrealistic that there would be general creditors of any significance. That was likely true in the GE case and the Principal Financial case.[100] If the entity is organized to be bankruptcy remote, it would seem that subordination to general creditors may carry little weight.

V. Factors That May or May Not Be Important

A. Form

In *Hubert Enterprises*, funds were advanced under a demand note. The funds were never repaid, and the court had to decide whether a bad debt loss claimed by the nominal lender was allowable. Judge David Laro stated that the form of the advance is relevant but not in itself; rather, the form is relevant as evidence of the intent of the parties.[101] In *Hambuechen*, which is primarily a case of thin capitalization of a partnership, the Tax Court also appeared to be influenced by the form of the investment, which was that of equity.[102] Form has also been relevant in other cases, and it

[93] *Hambuechen*, 43 T.C. at 105.

[94] The court used the eight factors from Notice 94-47 but noted that the factors are intended to be used to recharacterize debt as equity and are not as useful in recharacterizing equity as debt.

[95] *TIFD III-E*, 342 F. Supp.2d at 116.

[96] The Second Circuit also viewed subordination as an important factor but, continuing its misinterpretation of the significance of the performance guarantee of General Electric Credit Corp., stated that "the apparent subordination found by the district court was a fiction overridden by GECC's guaranty." *TIFD III-E*, 459 F.3d at 237.

[97] *Federal Projects*, 53 T.C.M. (CCH) 623.

[98] The advances were usually not actual transfers of money because the advances were for costs owed by the partnership to the corporation or its subsidiary.

[99] *Federal Projects*, 53 T.C.M. (CCH) at 627.

[100] *TIFD III-E*, 459 F.3d at 237 (noting that the banks' interest "was even more securely protected than by priority over the general creditors"). *See also Pritired*, 816 F. Supp.2d at 734-735 (noting that the limitations on the subordination of the interest (it was subordinated only to specified debt), and the absence of any other general creditors, strongly suggested that equity characterization was improper).

[101] *Hubert Enterprises*, 125 T.C. at 91-92.

[102] However, the Tax Court noted that other courts have "stated numerous times that [a taxpayer's] self-serving statements that the advances were intended to be loans bear little weight in the face of the other facts of record." *Hambuechen*, 43 T.C. at 104.

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is frequently listed as one of the relevant factors.[103] Form has been irrelevant in other cases.[104] In *S&M Plumbing*, the taxpayer issued its own nonvoting preferred stock, with a 10 percent cumulative dividend and a liquidation preference equal to the investor's investment in a joint venture plus the guaranteed return from that venture. The Tax Court, relying heavily on the perceived intent of all parties to create a joint venture for a specified project rather than an investment in the taxpayer itself, dismissed the form of the investment.[105] In the GE case, the district court briefly discussed form as a way to determine the intent of the parties. The court stated that "although there was some evidence that the Dutch Banks at times referred to their investments as debt, in general it appears that all the parties primarily considered the banks' interest to be that of partners."[106] In the end, the fact that the form was that of a partnership interest was one of the factors the district court relied on in its conclusion that the banks were partners and not lenders. The Second Circuit took a more realistic view, stating that "the fact that the taxpayer, in accordance with its strong self-interest, consistently described the banks' interest as equity would seem to be of only slight probative value."[107]

It seems clear that the form of an interest in a partnership does not, and should not, carry much weight in the determination of whether that interest is debt or equity.[108] The best and most logical view remains that of Laro, which is that form may, depending on the circumstances, be indicative of the parties' intent but is otherwise irrelevant.

B. Intent

Not surprisingly, given the Supreme Court's direction in *Culbertson*, in determining whether an advance to a partnership is debt or equity, the subjective intent of the parties is commonly considered.[109] Yet courts place different amounts of emphasis on the intent of the parties in reaching a conclusion on the debt-equity question.[110] In *EPIC Associates*, the decision outlined 13 factors to be considered when determining whether the advances were debt or equity, including the intent of the parties. The decision noted that while some of the factors supported a classification of equity, other factors supported classification as debt, and other factors did not clearly indicate that the advances were either equity or debt. In making its determination, the court stated that the factors on the whole favored an equity classification "when we consider the intent of the parties."[111] It seems that the decision in *EPIC Associates* used the subjective intent of the parties as a tiebreaker in the debt-equity analysis. However, other decisions do not give intent as much weight.

In *Hambuechen*, before the Tax Court began its analysis, it plainly stated that "the taxpayer's motive, though a factor to be considered, is not the crucial factor."[112] In its analysis, the court said that "the characterization urged by [Hambuechen] does not accord with substantial economic reality. . . . Accordingly, the absence of any tax motive consideration on the part of the taxpayer is not determinative of the issue."[113] The court also was "mindful of [Hambuechen's] testimony that he made the advance with the understanding that he would be able to establish a creditor's claim. However, [Hambuechen's] self-serving statements that the advances were intended to be loans bear little weight."[114] It seems that in *Hambuechen*, although the Tax Court considered the taxpayer's

[103] *Pritired*, 816 F. Supp.2d at 722; *TIFD III-E*, 342 F. Supp.2d at 116, *rev'd*, 459 F.3d 220; *In re Biscayne*, 264 B.R. at 770; *EPIC Associates*, 81 T.C.M. (CCH) at 1363; *Federal Projects*, 53 T.C.M. (CCH) at 627; *A.L. Stanchfield*, 24 T.C.M. (CCH) at 1692.

[104] *See, e.g., Hartman*, 17 T.C.M. (CCH) at 1023 (label of "loan" was not controlling).

[105] *S&M Plumbing*, 55 T.C. at 708-709.

[106] *TIFD III-E*, 342 F. Supp.2d at 117.

[107] *TIFD III-E*, 459 F.3d at 239.

[108] *Cf. John Wanamaker*, 139 F.2d at 646 (label of corporate "preferred shares" is not conclusive but not to be ignored).

[109] *See TIFD III-E*, 342 F. Supp.2d at 117; *In re Biscayne*, 264 B.R. at 770; *Hubert Enterprises*, 125 T.C. at 91-92; *Hambuechen*, 43 T.C. at 104; *EPIC Associates*, 81 T.C.M. (CCH) at 1363; *Federal Projects*, 53 T.C.M. (CCH) at 627; *A.L. Stanchfield*, 24 T.C.M. (CCH) at 1692.

[110] *Cf. Meridian*, 132 F.2d at 186 (in a corporate debt-equity case, intent of the partners is "of extreme importance").

[111] *EPIC Associates*, 81 T.C.M. (CCH) at 1363.

[112] *Hambuechen*, 43 T.C. at 98-99 (citing *Gilbert v. Commissioner*, 248 F.2d 399, 404 (2d Cir. 1957)).

[113] *Id.*

[114] *Id.*

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subjective intent, it gave that intent little weight in its analysis of the debt-equity question. This may be because the court in *Hambuechen* did not start its analysis with *Culbertson* and the intent language therein, as is customary.

Even when a court does consider intent, the outcome can be difficult to determine. Intent was the focus of the Supreme Court's decision in *Culbertson*.[115] As noted earlier, the Court remanded the case to the Tax Court for a decision on which, if any, of Culbertson's sons were partners. The question was, in other words, whether there was a bona fide intent that any of the sons be partners in the conduct of the partnership. After a lengthy discussion of the facts, the Tax Court found that it was not the intent of Culbertson and his sons, "or any of them, in good faith to become partners in the cattle business during the taxable years."[116] The facts cited by the Tax Court were overwhelmingly on the side of this conclusion. The decision was appealed to the Fifth Circuit, which reversed it. In a very brief opinion, the Fifth Circuit did little more than uphold its prior opinion in the case.[117] In that prior opinion, the Fifth Circuit held that "the purpose and intent of all the parties [was] to form an actual, real, and bona fide partnership between Culbertson and his four sons."[118] The entire record in *Culbertson* shows, at a minimum, that when it comes to intent, reasonable judges can disagree. *Culbertson* may also be an example of a more result-oriented approach in which a conclusion is reached and intent is then viewed in a manner that supports that conclusion.[119]

In a 2012 opinion, on a subsequent appeal involving the GE case, the Second Circuit addressed the taxpayer's argument that *Culbertson* requires that intent be the ultimate test. The court of appeals reiterated its embrace of *Culbertson* as the applicable test but then stated that in applying *Culbertson*, it found that the taxpayer's "claimed subjective intent was insufficient to defeat the claimed objective facts."[120] The inability to use intent as a meaningful factor in distinguishing between partnership debt and partnership equity is illustrated in the Principal Financial case. There was ample evidence in that case that the parties intended that the stapled package of B shares and PCs be treated as equity for tax purposes. But, of course, an intent to be labeled a partner is not the same thing as an intent to be a partner. The court summed it up: "The parties acted with the intent to structure a transaction that appeared to be equity but was debt in substance."[121]

C. Funds at Risk

The Second Circuit in the GE case piously cited its prior decision in *Gilbert* to the effect that "the significant factor" in distinguishing between debt and 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."[122] That is a nicely phrased standard, like the "intent" standard of the Supreme Court in *Culbertson*, but it is slippery to apply. In most commercial ventures, both lenders and equity holders expect at least to get their money back, but both probably also realize that if the venture is unsuccessful, they may not. Thus, the *Gilbert* test is not really a viable test for distinguishing between debt and equity. Rather, what truth there is in the *Gilbert* test is embedded in the other factors discussed in this report. Subordination

[115] *Culbertson* is primarily a sham partnership case; however, it purports to shed light on the importance of intent in a partnership analysis. *See* discussion, *supra* note 9.

[116] *Culbertson*, 9 T.C.M. (CCH) at 659.

[117] *Culbertson*, 194 F.2d at 581. The prior opinion is *Culbertson*, 168 F.2d at 979, which the Supreme Court reviewed before remanding the case to the Tax Court.

[118] *Culbertson*, 168 F.2d at 982.

[119] In *Investors Insurance*, 72 T.C. 1027, intent was the subject of one paragraph of the Tax Court's discussion supporting its conclusion that the taxpayer was not a lender before December 1974. The court concluded that the taxpayer's intent was to be an investor, not a lender. It found that the taxpayer was a lender after December 1974 and that the intent of the December 1974 changes to the relationship was to create a primary obligation of the guarantor to the taxpayer.

[120] *TIFD III-E*, 666 F.3d at 847 n.8.

[121] *Pritired*, 816 F. Supp.2d at 735.

[122] *Gilbert v. Commissioner*, 248 F.2d 399, 406 (2d Cir. 1957).

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goes to the likelihood that a participant will get its funds back regardless of the success of the venture, as does a sum certain and a right to enforce.[123] Creditworthiness, discussed below, similarly is a part of the *Gilbert* test that has merit.

D. Creditworthiness

Some of the partnership debt-equity cases focus on the creditworthiness of the partnership.[124] This is also a classic factor in the corporate debt-equity cases.[125] For an LLC classified as a partnership for tax purposes, the corporate analysis would also seem to apply. What about a general or limited partnership in which the general partners are liable under state law for the obligations of the partnership? One could argue that a person who has an enforceable claim against a thinly capitalized partnership should be able to ignore that thin capital if there is recourse to the general partners and those general partners are creditworthy.

The taxpayer in *Hambuechen* tried to make this argument. The case involved a limited partnership with three general partners. The taxpayer, a limited partner in the partnership, "advanced" 1.6 million reichsmarks to the partnership, which was thinly capitalized and in a difficult financial condition. He argued that the corporate thin capitalization cases did not apply to a partnership. His rationale was that an advance to a general partnership has the credit of the general partners behind it and that that is what makes the thin capitalization cases irrelevant. The court did not appear to understand the argument, and in any event dismissed it. Interestingly, the taxpayer made the argument only in the abstract; he did not point to any facts illustrating that the general partners were themselves creditworthy, and there was an implication that they may not have been.[126]

But what about the opposite situation, in which equity treatment is being sought for tax purposes but the partnership has sufficient wherewithal to support the underlying obligations? What if the equity has a senior claim on dissolution of the partnership and the partnership is so creditworthy that it is virtually inconceivable that there would be insufficient assets to pay the equity claim upon dissolution. Just like preferred stock of a blue-chip corporation, it would seem that the creditworthiness of the partnership is irrelevant and could not prevent equity characterization of the interest. The district court in the Dow Chemical case did not see it that way. The court stated that risk and return is the primary factor when distinguishing between debt and equity, and it focused on the fact that the European banks were almost certain to receive a fixed priority return of 6.947 percent per annum on their $200 million contribution. The court characterized the European banks' interests as debt because the risk

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[123] The legislative history of section 707(a)(2)(A) lists six factors for determining whether a transaction is between a partnership and a partner not acting in a partner capacity. The one relevant factor is "whether the payment is subject to an appreciable risk as to amount. Partners extract the profits of the partnership with reference to the business success of the venture while third parties generally receive payments which are not subject to this risk." Sen. Rep. No. 98-169, Vol. I, at 277 (1984). This factor ties the entrepreneurial risk to the amount of the payment — *i.e.*, whether there is a sum certain. The proposed regulations that implement section 707(a)(2)(A) elevate the entrepreneurial risk factor to the most important factor but do not tie it to amounts. Rather, the most important factor under the proposed regulations is whether "the arrangement lacks significant entrepreneurial risk," a determination that is based on the service provider's entrepreneurial risk relative to the overall entrepreneurial risk of the partnership. Prop. reg. section 1.707-2(c)(1). The factor as it emerged in the proposed regulations is more akin to subordination.

[124] *See, e.g.*, *Hubert Enterprises*, 125 T.C. at 96-97. The role of creditworthiness may be illustrated by a pair of 1972 revenue rulings. In Rev. Rul. 72-135, 1972-1 C.B. 200, and Rev. Rul. 72-350, 1972-2 C.B. 394, nonrecourse "loans" to partnerships were determined to be equity, apparently on the basis of the partnerships' lack of creditworthiness (although neither ruling contains enough facts to support that conclusion). *See also Pritired*, 816 F. Supp.2d at 733 (citing as a factor whether third parties would have made the loan under the same conditions).

[125] *See also Plantation Patterns Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972) (lack of creditworthiness of nominal borrower helps establish that guarantor was true borrower and that the nominal borrower is deemed to have received an equity contribution from its parent, the guarantor); *PepsiCo Puerto Rico Inc. v. Commissioner*, T.C. Memo. 2012-269 (finding that the terms of some agreements, which "could not have been replicated, in any reasonable manner, by independent debt financing," highlighted the equity characteristics of the instruments).

[126] Although the court did not explicitly discuss the financial position of the general partners, one can assume the general partners were not in a strong financial position. Not only did the court point out that "it is obvious that the partnership was in difficulty," but the taxpayer, Joseph Hambuechen, lent money to the two new general partners to enable them to buy into the partnership. *Hambuechen*, 43 T.C. at 95, 103.

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to the European banks of not receiving that return was "equal to or less than that borne by a Dow debtholder."[127]

Creditworthiness does not seem to be a useful factor for planning purposes. It would be difficult to derive much confidence, from a planning standpoint, that an interest in a creditworthy entity is debt on that basis or that an interest in a more risky credit is equity on that basis.[128] Rather, the use of creditworthiness is more of a defensive factor. If one has planned an interest that needs to be sustained as debt or equity, as the case may be, one would be well advised to try to ensure that the credit profile of that interest is consistent with the desired tax characterization of it.

E. Use of Proceeds

Hambuechen cited "the use to which the funds were put" as a factor to be used in determining whether the investment of the funds constituted debt or equity.[129] While not entirely clear, it appeared that the funds in *Hambuechen* were used as working capital. The Tax Court held that the investment constituted equity rather than debt, but it is unclear how, or indeed whether, the use of proceeds was particularly relevant in reaching that conclusion. In the GE case, the funds invested by the Dutch banks were not used, and could not be used, in the aircraft leasing business of the partnership. Rather, the funds were invested in financial assets, and those financial assets effectively secured the repayment of the Dutch banks. While this fact clearly influenced the holding of the Second Circuit that the investment of the Dutch banks was debt rather than equity, it seems that the Second Circuit viewed this factor as more of a creditworthiness factor than an independent factor. In the Principal Financial case, the funds invested by the French banks were used to buy securities under repurchase arrangements with the French banks and thus in effect were lent back to the French banks. Without really enunciating how this fact fit into its analysis, the district court held that the investment of the French banks was debt.

In the normal case, it should not matter to what use the proceeds are put. In the normal case, funds provided by equity investors are commingled with funds provided by lenders, and those commingled funds are devoted to the business use of the partnership. Thus, the particular use to which the funds are put does not provide a way of distinguishing debt from equity. That is not true in the more unusual case in which the invested funds are locked up in some fashion and kept away from the risks inherent in the business of the partnership. That was the situation in the GE case and was arguably the situation in the Principal Financial case. Logically, such a lockup of the funds should be a very strong stand-alone factor indicating the existence of a secured loan rather than an equity investment. The absence of such a lockup, however, would seem to have no particular significance, and in that case the use of proceeds would not seem to be particularly relevant.

F. Accounting Treatment

In addition to the debt-equity factors already presented, some decisions look to the parties' accounting treatment of the transaction.[130] Other decisions, while noting the accounting of the parties, do not emphasize it as a factor in the debt-equity analysis.[131] In *Union Meeting*,[132] the bankruptcy court classified the claims of the debtor's partners as contributions to equity, not as loans. The court listed many factors to be considered, notably "how the debt was treated in the business records."[133] In addition to focusing on the fact that the partners had complete control of the debtor and that other loans were available when the partners made their contributions, the court emphasized that the debtor's financial statements did not reflect a loan from the general partners. Further, the debtor's original bankruptcy schedules and corresponding

[127] *Chemtech*, 2013-1 U.S.T.C. para. 50, 204 at 43.

[128] Interestingly, a debt-like instrument issued by an uncreditworthy partnership, if it failed to constitute debt for tax purposes on that basis, would likely give rise to guaranteed payments under section 707(c).

[129] *Hambuechen*, 43 T.C. at 99.

[130] *See Union Meeting*, 160 B.R. at 774; *Hubert Enterprises*, 125 T.C. at 92-94.

[131] *See Pritired*, 816 F. Supp.2d at 722; *EPIC Associates*, 81 T.C.M. (CCH) at 1340-1342; and *Stanchfield*, 24 T.C.M. (CCH) at 1688.

[132] *Union Meeting*, 160 B.R. 757.

[133] *Id.* at 774.

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financial statements were signed by the apparent managing general partner, and they did not list any claims due and owing to the general partners. In short, the accounting treatment was considered by the bankruptcy court in *Union Meeting* to support its conclusion that the general partners' claims arose from contributions to the debtor's equity, not from loans.

The parties' accounting treatment was also discussed in *Hubert Enterprises*, in which HEI, a corporation, made advances to ALSL, an LLC that was treated as a partnership for tax purposes. Even though HEI and ALSL "posted in their records that the transfers were loans, those postings provide[d] little if any support for a finding of bona fide debt."[134] On the other hand, in GE's case, the district court rested its conclusion that the banks were partners, in part, on the fact that their interest was recorded as "minority equity" on the financial statements of General Electric Credit Corp.[135] It seems, as with some of the debt-equity factors, that the importance of the parties' accountant treatment is dealt with case by case. It seems logical that not recording an advance to a partnership as debt may sway a court to conclude that the advance is in fact equity.[136] However, recording an advance to a partnership as debt does not guarantee that the court will honor that classification.

VI. Effect of Section 385 Regulations

Section 385 by its terms does not apply to interests issued by partnerships and thus on the surface the new section 385 regulations would not seem to have any applicability to the determination of whether an interest in a partnership is debt or equity. The section 385 regulations, however, do represent the latest thinking of Treasury on the distinction between debt and equity and cannot be wholly ignored in the partnership context.[137]

Reg. section 1.385-2 imposes documentation requirements for some corporate debt issued beginning in 2018.[138] Under the new regulations, to be treated as debt rather than stock, a debt instrument must generally be documented in the form of debt and must include a binding obligation to pay a sum certain on a maturity date, and the holder must have the rights of a creditor to enforce the obligation. There must also be a reasonable expectation that the issuer can meet its obligations — that is, that the issuer is creditworthy.[139] If one wants an instrument issued by a partnership to be treated as debt, one would be well-advised to meet these requirements, although in truth that would have been the advice before the new regulations, too.[140] Although the new section 385 regulations establish minimum requirements to constitute debt, it does not follow that satisfaction of those minimum requirements means that the interest is in fact debt for tax purposes. Rather, the regulations are clear that meeting the documentation requirements merely entitles a taxpayer then to a determination of whether the interest is properly treated as debt for tax purposes under general tax principles.[141] So, apart from the minimum requirements to be debt, the new documentation regulations make no change to the factors used to distinguish between debt and equity. What if, like the banks in the GE case and the taxpayers in the Principal Financial

[134] *Hubert Enterprises*, 125 T.C. at 93.

[135] *TIFD III-E*, 342 F. Supp.2d at 117. The court also noted that the interest was not considered debt for purposes of GECC's negative pledge covenants.

[136] The PCs in the Principal Financial case were treated as debt for U.S. accounting purposes. The court did not view this fact as particularly meaningful itself but viewed it rather as one of several facts that illustrated the "malleability and flexibility of the characterization" of the PCs. *Pritired*, 816 F. Supp.2d at 735.

[137] Note that an IRS auditor must coordinate with the IRS Associate Chief Counsel's office if a section 385 issue is raised. CC-2016-009. That does not appear to be required if a partnership debt-equity issue is raised.

[138] The regulation applies to debt issued by a covered corporate member or by a disregarded entity that has a regarded owner that is a covered corporate member. Reg. section 1.385-2(a)(3)(i). Thus, the documentation requirements imposed by reg. section 1.385-2 do not apply to an interest in a partnership. The antiabuse rule in reg. section 1.382-2(f) could, however, apply to an interest issued by a partnership if it is issued with a principal purpose of avoiding the application of the regulations to corporate debt.

[139] Reg. section 1.382-2(c)(2).

[140] Meeting these requirements would also clearly show an intent that the instrument be treated as debt.

[141] Reg. section 1.385-2(b)(1).

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and Dow Chemical cases, one wants the interest to be treated as a partnership interest rather than debt? In that case, the section 385 regulations may provide some reassurance that the absence of a sum certain, a clear maturity, or a right to enforce might lead to that result.[142]

It is unclear whether there is anything to be learned in the partnership context from the new rules set forth in reg. section 1.385-3, which deem some corporate debt to be equity if the debt is issued in a distribution, in exchange for affiliate stock, or in an affiliated asset reorganization. Those new regulations do not directly apply to debt of a partnership.[143] Apart from the goal of eliminating some of the "juice" that fuels corporate inversions, the regulations are based on a clear policy conclusion by Treasury that an instrument that does not result in new investment in the operations of the issuer is at least suspect if it is desired that the instrument be characterized as debt. The Treasury decision announcing the regulations cites two cases[144] for the proposition that new money is a factor in the corporate debt-equity determination.[145] The stated importance of new money in the corporate context is a bit strained,[146] and there is no authority whatsoever in the partnership context for imposing new money as a requirement for an interest in a partnership to be treated as debt rather than equity. It remains to be seen whether the elevation of the new money factor in the section 385 regulations will spill over to the partnership area.

VII. Summary and Comments

This report began by asking the reader to assume that a taxpayer wants to be characterized as a partner for tax purposes but wants an investment that economically is very close to debt. The first thing such an investor would want would be a date or dates on which its principal will be repaid. It would seem risky, given the paucity of favorable law in the partnership area on this subject, to incorporate a precise date on which principal must be repaid. It seems possible, as a general matter, to replicate that result with an amount, analogous to the principal of debt, that is a preferred payment on dissolution, coupled with the ability to force dissolution on a particular date. The payment on dissolution can even be guaranteed by a third party if it is a top-off guarantee that is triangular in form — that is, the third party guarantees only what cannot be covered from the partnership's assets.

The acceptability of using a preferred payment on dissolution to simulate a maturity is strongest for a partnership with indefinite duration. For a special purpose partnership with a finite and predictable duration, however, like the GE and Principal Financial partnerships, that position may be weaker. Similarly, if an instrument that is economically close to debt is sought to be characterized as equity for tax purposes, the place in the liquidation waterfall is relevant. It is clearly best to avoid being on a parity with any creditors, even general creditors. It may be possible for general creditors to be made remote through the structure of the venture, although the position would be stronger if the general creditors are not too remote.

It should also be relatively safe to have a straight interestlike return. A thin sliver of upside, as in the GE case, is a positive fact and may even be dispositive if the upside is so material that one can be confident of it being viewed as meaningful by a court. Taking reassurance in this approach could get expensive, however. It may be better to rely on what is, under the case law (or at least the case law other than the Principal Financial district

[142] The regulations reserve on whether they can be affirmatively used by a taxpayer. Reg. section 1.385-2(g).

[143] For debt issued by a partnership that is 80 percent owned by corporate members of a defined group, however, the regulations will deem the debt to be issued ratably by the corporate partners and then potentially recharacterized as equity in the corporate partners. Reg. section 1.385-3T(f)(3) and (4). Technically, the partnership debt is deemed to be owned by the corporate partners, and the nominal owner of the partnership debt is deemed instead to hold new equity issued by the corporate partners.

[144] *Talbot Mills v. Commissioner*, 146 F.2d 809, 811 (1st Cir. 1944); *aff'd sub nom, John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946); *Kraft Foods Co. v. Commissioner*, 232 F.2d 118, 126-127 (2d Cir. 1956).

[145] T.D. 9790, at 548. The preamble to the proposed regulations also cited *Sayles Finishing Plants Inc. v. United States*, 399 F.2d 214 (Ct. Cl. 1968), for this proposition. "Treatment of Certain Interests in Corporations as Stock or Indebtedness," 81 F.R. 20911, 20917 (Apr. 8, 2016). In that case, the court rejected no new money as a dispositive factor but viewed it to be a significant factor in the factual context of that case, which was debt issued in exchange for equity — *i.e.*, a "continuation without [substantive] change" of an equity interest. *Sayles*, 399 F.2d at 214.

[146] The First Circuit case, which involved debt issued in exchange for equity, lists no new money as the first item in a list of overwhelmingly equity-pointing factors and concludes on the basis of all the factors that the instrument was equity. The Supreme Court affirmed but on non-substantive grounds. The Second Circuit case, which involved debt issued as a dividend, rejected the IRS argument that no new money was a factor indicating equity.

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court case), the killer factor: participation in management. The use of an LLC could facilitate reliance on this fact. Under Delaware's and most other states' laws, an LLC can be governed just like a regular corporation, with a board of directors, elected by the members, operating under bylaws. An investor with a board seat or board seats and, accordingly, with a voice in management, would seem to possess very strong indicia of being a partner rather than a lender. This is true even when the investor has a minority position on the board and therefore may not have a controlling or even blocking position.

Finally, attention should be paid to the softer factors, although it is unlikely that they will be dispositive. In other words, ideally, the form should carefully coincide with the desired characterization for tax purposes. It would also be helpful for the intention of the parties to be contemporaneously memorialized. ■

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