¶ 3.02[2A] The Questionable Requirement of Participation under *Culbertson* [New]

Since 2006, at least two circuit courts have adduced the view that implicit in the *Culbertson* standard is a requirement that a person must "participate" to some material extent in the partnership's profits and losses to be recognized as a partner. Both circuit court cases denied partner status to investors who made investments determined to have economic substance (to a partnership whose activities were determined to have economic substance) because the investors did not participate sufficiently in profits and losses to satisfy a "participation" requirement the courts inferred from *Culbertson*. Neither circuit court resolved the question of whether an equity investor who does not participate sufficiently to be a partner under *Culbertson* can nevertheless be a partner under § 704(e)(1).[68.1]

The source of this participation requirement is the Second Circuit's first opinion in *TIFD III-E v. United States* (commonly referred to as *Castle Harbour*, the name of the partnership involved). The case actually involves four different opinions—two by the district court and two by the Second Circuit. For convenience, these cases are referred to as *Castle Harbour I*,[68.2] *Castle Harbour II*,[68.3] *Castle Harbour III*,[68.4] and *Castle Harbour IV*.[68.5]

Castle Harbour series involved a partnership that owned and operated a large fleet of leased commercial aircraft and also indirectly owned a large portfolio of liquid investment assets. Two Dutch banks invested about $117 million in the partnership. The investors were entitled to a

return of their investment plus a preferred return, computed like a variable cumulative preferred stock dividend. In addition, the investors had an upside participation right, which the district court thought was real but the Second Circuit dismissed as de minimis. Further, the banks were generally protected against loss because the vast majority of their investment would not bear losses until the other partners' very substantial capital had been lost. If the banks were partners, the operation of § 704(c) would have allocated a substantial amount of partnership taxable income in excess of their § 704(b) income to the banks, which, being foreign, would not have been liable for any U.S. income tax on such taxable income.

Structurally, the banks' interests resembled debt in the same sense that modern preferred stock can resemble debt, though such stock is generally respected as equity. In *Castle Harbour I*, the district court held that, despite the similarity of the banks' interests to debt, such interests were equity. The district court also held that the partnership and the banks' interests had economic effect and that the overall arrangement was motivated by a substantial non-tax business purpose. In its analysis, the district court applied the *Culbertson* intent test, which included an analysis of the banks' limited rights to variable partnership profits and limited exposure to downside risk. It held that the banks' interests were partnership interests under *Culbertson*, but did not address the taxpayer's separate argument that, regardless of *Culbertson*, the banks were partners under the alternative test of § 704(e)(1).

Though it appealed, the government did not challenge either the district court's determinations relating to business purpose or economic substance, nor did it not directly challenge the district court's holding that the banks' interests were not debt. Instead, the government argued that even if the banks' interests had economic substance and were not debt, the banks did not participate sufficiently in the entrepreneurial results of partnership operations to be considered partners under *Culbertson*. In *Castle Harbour II*, the Second Circuit appeared to adopt the government's interpretation of *Culbertson*, namely, that the banks' interests were so overwhelmingly debt-like that they failed to qualify as "bona fide partnership equity participations" under *Culbertson*.

In *Castle Harbour II*, the Second Circuit did not address the taxpayer's alternative theory that, regardless of their lack of participation and similarity to debt, the banks' interests were equity, and as equity, were "capital interests" under § 704(e)(1). As explained in ¶ 3.02[3], § 704(e)(1) requires that the owner of capital interest in a partnership be treated as a partner if capital is a

material factor in the partnership's business. Instead, *Castle Harbour II* remanded the § 704(e)(1) issue to the district court. In *Castle Harbour III*, the district court determined that the banks' interests were indeed partnership capital interests under § 704(e)(1) because (despite their similarity to debt) they were equity. The district court did not think participation was a criterion of a § 704(e)(1) capital interest.

On appeal, in *Castle Harbour IV*, the Second Circuit did not resolve the § 704(e)(1) issue and, perhaps unwittingly, relegated its disquisition in *Castle Harbour II* on the necessity of participation under *Culbertson* to the status of dictum. In *Castle Habour IV*, the Second Circuit adopted a revisionist interpretation of its prior opinion. According to *Castle Harbour IV*, *Castle Harbour II* had determined that the banks' interests were in fact debt, not merely an interest "in the nature of" debt. Partnership debt (including "participating" partnership debt) cannot qualify as a partnership interest for the simple reason that debt *of* a partnership cannot be an interest *in* the partnership, any more than the debt of a corporation can be stock.

Thus, while the Second Circuit's opinions in *Castle Harbour* make much of participation, the participation analysis ultimately informed the court's determination that the banks' interests were debt for tax purposes, and not whether the banks' interests would have been denied partner status if they were highly secure, non-participating preferred equity for tax purposes. Further, because the relevance of *Culbertson* to a debt-equity analysis is tertiary at best, the Second Circuit's reliance on *Culbertson* seems entirely misplaced in view of its ultimate determination that the banks' interests were debt.

Nevertheless, in *Historic Boardwalk Hall, LLC v. Commissioner*, [68.6] the Third Circuit picked up the participation theme from *Castle Harbour II*, and applied it in a case in which the government conceded that the interest at issue was not debt. *Historic Boardwalk* involved a partnership formed between a tax exempt governmental entity and a taxable investor to rehabilitate historic property, with the expectation of earning historic rehabilitation tax credits under § 47 and then to own and operate the property. The investor contributed funds and, under the partnership agreement, was allocated the tax credits. The Service determined that the investor was not a partner and that the transaction was merely an attempted sale of tax credits by a governmental entity that could not use them to a taxable entity that could. The investor negotiated for and received various protections against loss and also entered into collateral agreements which, in

the Third Circuit's view, virtually eliminated profit over and above a 3 percent preferred return. While the investor's interest had some similarity to debt, the government conceded that the interest was not debt.

The Tax Court, in *Historic Boardwalk*, had determined that the arrangement had economic substance and that the investor was a partner entitled to the credits. The Third Circuit did not overturn those determinations. Instead, the Third Circuit reversed, relying heavily on the Second Circuit's participation analysis in *Castle Harbour II* (which, as explained above, was effectively mooted when *Castle Harbour IV* held that the interests in question could not be partnership interests because they were debt).

Several aspects of a participation requirement are noteworthy. First, if participation is the issue, the question must be participation in what? If a partnership is formed by equal partners to invest in short-term Treasury bills, there may be little upside or downside in the partnership's activity. Nevertheless, the partners participate fully in the benefits and burdens (however limited) that are inherent in the underlying enterprise, and so must be recognized as partners under any participation standard. Similarly, some tax-recognized partnerships are not formed to earn a profit at all. For example, *Madison Gas & Electric Co.*[68.7] involved a venture among electric power companies to own and operate a generating facility that would not sell its output, but would permit its owners to access and sell their shares of electricity produced by the facility. The owners participated fully in the joint enterprise and were deemed partners.

Second, the participation requirement simply does not square with modern tax law that accords equity status to very debt-like instruments issued by partnerships and corporations.[68.8]

Third, the absence of participation in entrepreneurial profit and loss fairly informs the question of whether an investment is debt or equity. But if, despite the absence of participation, an investment is equity, and not debt, for tax purposes, then the investment should be recognized as a valid partnership interest. Otherwise, the investment falls into a category to which no established tax regime applies. The tax law makes elaborate provision to determine the tax consequences of debt, on the one hand, and equity, on the other. No existing rules, however, apply to an investment in a partnership that is not recognized as a bona fide partnership interest.

[68.1] See infra ¶ 3.02[3].

[68.2] TIFD III-E v. United States, 342 F. Supp. 2d 94 (D. Conn. 2004) .

[68.3] TIFD III-E v. United States, 459 F3d 220 (2d Cir. 2006) .

[68.4] TIFD III-E v. United States, 660 F. Supp. 2d 367 (D. Conn. 2009) .

[68.5] TIFD III-E v. United States, 666 F3d 836 (2d Cir. 2012) .

[68.6] Historic Boardwalk Hall, LLC v. Commissioner, 694 F3d 425 (3d Cir. 2012) , rev'g and remanding 136 TC 1 (2011) .

[68.7] Madison Gas & Electric Co. 72 TC 521 (1979) , aff'd, 633 F2d 512 (7th Cir. 1980) .

[68.8] See, e.g., Rev. Rul. 90-27, 1990-1 CB 50; Rev. Proc. 2003-84, 2003-2 CB 1159.