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Is an Explicit Tax Election the Solution to the Debt / Equity Classification Problem for Partnerships?

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*By Heather M. Field**

Heather M. Field analyzes whether a tax election is an appropriate policy response to the debt/equity puzzle, discusses how to design a debt/equity election most effectively, and concludes by comparing the debt/equity election to other suggested solutions.

I. Introduction

Recent cases in the partnership context created confusion about how to determine whether an investment is classified for tax purposes as debt or equity.[1] Although there is a long history of case law and other authorities on the debt/equity determination in the corporate context,[2] the issue is more complicated in the partnership context. This is for several reasons, including because of the fact-intensive inquiry for determining whether a partnership exists at all,[3] because the tax minimization opportunities in partnerships (*e.g.,* shifting income to a tax-indifferent party[4] or selling tax credits[5]) are very different from tax minimization opportunities in corporations (*e.g.,* increasing corporate-level deductions for purported interest), and because much of the case law on the debt/equity determination focused on equity-like purported debt in corporations but the debt/equity query in partnerships generally involves debt-like purported equity.[6]

Even in the corporate context, the debt/equity analysis is not easy. There is a continuum between what we consider "pure debt" and "pure equity." Between these endpoints, classification requires a multi-factored, factually-intensive analysis. And the exact factors relevant to the determination vary from circuit to circuit and case to case.[7]

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Thus, in *Is Debt vs. Equity Different in a Partnership?*, Steven Schneider explains, and makes proposals to solve, the puzzle of distinguishing debt from equity in partnerships. One of his proposed solutions involves the creation of a limited debt/equity classification election.[8] This article explores that proposed solution in greater depth. Specifically, this article analyzes whether a tax election is an appropriate policy response to the debt/equity puzzle, discusses how to design a debt/equity election most effectively, and concludes by comparing the debt/equity election to the other possible solutions suggested by Schneider. Ultimately, this article concludes that, although a debt/equity classification election is worthy of consideration, the case for a debt/equity classification election is, at least at this time, unlikely to be sufficiently compelling to justify the adoption of such a drastic and broadly applicable reform.

II. Considering a Debt/Equity Classification Election

A debt/equity election could facilitate tax classification in the same way that the "check-the-box" election (the "CTB election")[9] facilitated the process of determining whether a business entity is classified as a corporation or flow-through entity for tax purposes.[10] There are parallels between the history of the entity classification election and the evolution of the debt/equity classification analysis. This section explains those parallels. Then, this section draws on those parallels to argue that the adoption of a debt/equity classification election might be appropriate and to analyze potential policy benefits and detriments of such a change.

A. Parallels to the History Behind the CTB Election

Before the adoption of the CTB election, entity classification depended on a multi-factored fact-intensive "corporate resemblance" test articulated in *Morrissey*[11] and later modified by the promulgation of the "Kintner regulations."[12] Under the Kintner regulations, the multi-factored entity classification test protected corporate classification and made it easier for entities to obtain the generally less desirable flow-through treatment.[13] These regulations operated successfully for quite a while, but then the operation of the regulations faced a challenge with the creation of LLCs, which sought to obtain the best of both worlds—pass-through tax treatment (*i.e.,* the easier status to obtain) and corporate-like liability protection to the entity's owners.[14] Moreover, "given the bright line rules set forth in the Kintner regulations and the flexibility afforded under the applicable state business statutes, practitioners were often able to create LLCs and other business entities with a carefully tailored set of rights and responsibilities so as to achieve tax classification as either a corporation or a partnership, as desired by the client, while retaining significant features of the other classification."[15] This meant that, even before the adoption of the CTB election, entity classification was largely elective, albeit implicitly rather than explicitly. These circumstances ultimately led to the replacement of this implicitly elective entity classification regime with the explicitly elective CTB election.[16]

A similar story can be told with respect to the debt/equity classification determination. Generally, the multi-factored debt/equity test, which was developed largely in the context of business entities taxed as corporations, protects debt classification and generally makes it easier to obtain equity classification.[17] However, just as LLCs presented a challenge for the pre-CTB entity classification rules, the increased use of entities taxed as partnerships presents a challenge to the operation of the debt/equity classification rules. This is because, with partnerships, equity classification (*i.e.,* the classification that is generally easier to obtain) is often more taxpayer favorable, and hence, revenue reducing. Indeed, Schneider explains that, although some investors may prefer debt status, equity treatment in subchapter K provides a taxpayer with the "keys to the kingdom."[18] Moreover, although some confusion remains about debt/equity classification in the partnership context (hence, the panel at the University of Chicago Law School's 67th Annual Federal Tax Conference and Steve Schneider's article), lawyers (at least in the corporate context) can increasingly create a set of rights and responsibilities so as to achieve reasonably certain tax classification as either debt or equity, as desired by the client, while retaining significant features of the other classification.[19] These circumstances parallel, to a significant extent, the circumstances that led to the CTB election, which suggests that a debt/equity election might be an appropriate next step.

B. Is a Debt/Equity Classification Election Appropriate?

An explicit tax classification election is most appropriate when the need for classification cannot be eliminated[20] and when the substance-based classification test ceases to draw meaningful distinctions between categories.[21]

1. Can the Tax Differences Between Debt and Equity Be Eliminated?

Query whether the tax consequences of debt and the tax consequences of equity should really be so different. If both equity and debt classification provided (or precluded) the tax benefits sought in the recent partnership cases, then taxpayers would not have gone to such great lengths to try to obtain their desired classification. Taxing debt and equity alike would eliminate the importance of the classification determination, thereby solving the debt/equity classification puzzle raised by Schneider. Further, unifying the tax treatment of debt and equity would eliminate the tax bias in favor of one investment structure or the other. Even before the debt/equity classification issue became so prominent in the partnership tax context, numerous commentators argued for unifying the tax treatment of debt and equity.[22] The debt/equity classification problems presented in the partnership context only add to these arguments.

Eliminating the debt/equity distinction, either in its entirety or in the context of subchapter K, would require fundamental change to the tax law. This dramatic change is unlikely to be forthcoming soon, particularly in the current political environment. Thus, the need for classification remains. And if the need to classify a financial instrument as debt or equity remains, there remains a question of whether this determination should continue to be made using a multi-factor test or whether an explicitly elective classification election should be used instead.

2. Is There Still a Meaningful Substantive Difference Between Debt and Equity?

Explicit elections that are used for the purpose of facilitating tax classification are most useful when the relevant factual scenarios have become virtually indistinguishable and the substance-based classification test ceases to be meaningful.[23] This was arguably the case with entity classification when the CTB election was adopted. Indeed, the IRS explained that changes in state law "narrow[ed] considerably the traditional distinctions between corporations and partnerships ... . One consequence of the narrowing of the differences under local law between corporations and partnerships is that taxpayers can achieve partnership tax classification for a nonpublicly traded organization that, in all meaningful respects, is virtually indistinguishable from a corporation."[24] Thus, the classification had become effectively elective, and the purportedly substance-based classification test served primarily to impose transaction and other costs on the choice of entity decision.

Thus, query whether the same is true for debt/equity classification. Have debt and equity investments become virtually indistinguishable? And have the factors that are currently used to distinguish between them ceased to have meaningful tax import? On one hand, "some commentators have argued that the traditional differences between equity and debt have eroded over time with the development of new theories of the firm and that '[t]he recent explosion in financial contract innovation has laid bare the deficiencies of the debt-equity distinction.'"[25]

> *Recent cases in the partnership context created confusion about how to determine whether an investment is classified for tax purposes as debt or equity.*

In the middle of the debt/equity continuum, there are financial instruments with very similar economic terms, some of which are classified as equity and others as debt.[26] On the other hand, perhaps there remain fundamental differences between debt and equity that should have tax consequences,[27] including that the return paid on debt represents a *cost* of doing business, whereas the return paid on equity represents *profits* from doing business.[28] Certainly Congress continues to police the debt/equity line, suggesting that at least Congress continues to believe that there are differences between debt and equity that should continue to have meaning for tax purposes.[29] The IRS seems to agree, at least based on its number of active debt-equity cases; as of January 2014, the "IRS Large Business and International Division [was] believed to have 300 active debt-equity cases in its inventory."[30] Additionally, the attention that continues to be paid to classifying and taxing hybrid instruments suggests that the tax differences between debt and equity still matter.[31]

Adopting an explicitly elective approach to debt/equity classification would be an admission of defeat—an admission that neither Congress nor the IRS can create rules that effectively and appropriately distinguish between financial instruments that should be taxed as debt and those that should be taxed as equity. By adopting a debt/equity election, the government would allow taxpayers to obtain whichever tax classification the taxpayers desire, rather than continuing to fight taxpayers on the debt/equity issue. That means that, among other consequences, the government would lose revenue as a result of tax planning similar to that in *Castle Harbour* and *Historic Boardwalk*, but the government would also avoid the cost of litigating these types of cases.

C. Potential Benefits and Detriments of a Debt/Equity Election

Although the case for adopting a debt/equity classification election, thus far, may not be overwhelming, it is useful to consider the potential benefits and detriments of such a change. Again, parallels between the challenges of entity classification and the challenges of debt/equity classification suggest that adoption of an elective approach for the latter may confer policy benefits and detriments similar to those that have been created as a result of the adoption of an elective approach for the former.[32]

1. Possible Policy Upsides to a Debt/Equity Election

Potential benefits may include simplicity, administrability, efficiency, certainty, and fairness.

A debt/equity election would make it simpler for investors and business entities to determine with certainty the classification of an investment. No longer would lawyers be required to undertake complex, fact-intensive multi-factored analyses to determine whether a particular investment would be classified as debt or equity for federal income tax purposes. An elective approach to debt/equity classification would arguably enhance simplicity more than the CTB election did in the entity classification context. This is because the current debt/equity analysis is arguably more complex than the pre-CTB entity classification election analysis was, meaning that the benefits of simplification may be more significant in the debt/equity context.

Admittedly, the debt/equity analysis for investments in corporations is complicated and fact-intensive, but it is stable and reasonably well-understood by lawyers who can help their clients plan.

The difference in complexity comes from at least three aspects of the classification analysis. First, the debt/equity analysis factors vary by circuit, with each circuit having its own, slightly different, articulation of the debt/equity test; this means that the fact-intensive debt/equity analysis requires a determination of which debt/equity test is applicable.[33] In comparison, the pre-CTB entity classification analysis was uniform across circuits because the Kintner regulations articulated a set of factors that applied to all business entities.[34] Second, the number of factors relevant to the current debt/equity analysis (up to 16, depending on the circuit)[35] exceeds the four (possibly six) factors relevant to the pre-CTB entity classification analysis.[36] Third, under the pre-CTB entity classification analysis, the analysis was numerical; if the entity had more corporate than noncorporate features, the entity was treated as a corporation, and otherwise, the entity was treated as a flow-through.[37] In comparison, the debt/equity classification cannot be determined merely by counting up the debt features and comparing the number of debt-like features to the number of equity-like features; rather, the factors are evaluated holistically, which requires the exercise of careful, considered professional judgment.[38] Thus, because of the complexity of the debt/equity analysis, the potential simplification benefits of an elective approach may be large, possibly more significant than the simplification benefits that were achieved by the adoption of the CTB election.

In addition, the move to a debt/equity classification election may be efficiency enhancing in that taxpayers would not need to accept possibly suboptimal terms in order to obtain the preferred tax classification. The CTB election has had this benefit for entity classification,[39] and a debt/equity election could similarly reduce the distortion of the business terms of an investment that taxpayers would have to accept in order to obtain their desired tax treatment. That is, a debt/equity classification election could remove the tax bias in favor of one business term or another and would provide taxpayers with more latitude to structure financial instruments in the way that is optimal for business purposes.

By removing the tax bias in favor of particular business terms and by reducing the complexity of the debt/equity classification analysis, a debt/equity classification election could reduce transaction costs. This is because the election would reduce the amount of work and number of hours lawyers would need to invest in the debt/equity classification analysis and would reduce the costs imposed by the need to restructure the business deal to obtain the preferred treatment. Again, this parallels the cost reductions associated with the replacement of the Kintner regulations with the CTB election.[40] Of course, as is still the case post-CTB election, taxpayers and their lawyers would still be required to spend time analyzing which classification is preferable, even if a debt/equity election is adopted. However, once that analysis is completed, an elective approach makes it much simpler to ensure that the desired classification is achieved. The desired classification could be obtained by filing an election form; no alterations to the terms of the instrument would be needed in order to obtain the desired classification.

The adoption of an elective debt/equity classification could confer additional benefits, including an administrability benefit for the IRS (they are no longer required to engage in complex facts and circumstances analysis in order to do a debt/equity classification audit), a certainty benefit (taxpayers need not rely on difficult judgment calls in close cases), and possibly a fairness benefit ("reduc[ing] the premium that facts and circumstances tests place on taxpayer knowledge, sophistication, and ability to obtain expensive advice.").[41]

2. Possible Policy Downsides to a Debt/Equity Election

Notwithstanding the potential benefits of the use of a classification election, the CTB election has not been an unmitigated success. There are many criticisms of the CTB election and of elections in general that could weaken the case for moving to an elective approach to debt/equity classification.

Some of the simplicity and administrability gains described above would be reduced because of the need for taxpayers to file election forms and the need for the IRS to process the elections. That requires time and energy, and all of the filings provide significant opportunities for errors. Further, a debt/equity election would be revenue reducing; taxpayers will almost certainly make the election that best reduces their tax costs, and given that an explicit election removes the frictions of nontax constraints on the tax treatment, this tax minimization opportunity would become widely available and the revenue loss could be significant. And, of course, giving taxpayers the opportunity to make choices about their tax treatment opens the door for possible abuse. In the CTB context, the major abuse concern involved foreign entities.[42] With a debt/equity election, there may be similar opportunities for tax minimization that are considered abusive.[43]

The magnitude of the benefits and detriments of a debt/equity election would vary depending on the design of the particular election.

III. Designing a Debt/Equity Classification Election

Any debt/equity classification election would need to be carefully designed so as to maximize the benefits of the election while minimizing the risk of abuse and the costs. Key design features include eligibility (*i.e.,* for which financial instruments may the debt/equity election be made?), default rule (*i.e.,* what is the classification in the absence of an election?) and technical requirements (*i.e.,* what is the process for making the election?).[44] Each will be considered in turn.

A. Eligibility for the Debt/Equity Election

Eligibility for the debt/equity election is a critical question because elections impose revenue costs. Thus, eligibility limitations impose an important constraint on the magnitude of that revenue loss. Eligibility limitations can also help to advance the rationale for the election by limiting the availability of the election to those situations in which the rationale for the election is most persuasive.[45]

Several eligibility questions arise in connection with a possible debt/equity classification election. These include whether the election should be available for investments in both corporations and partnerships, which financial instruments should be eligible to make the election (*i.e.,* are there any instruments that are excluded and treated as per se debt or per se equity), and directionality (*i.e.,* which classification status is electable—debt, equity or both). Each of these eligibility considerations will be addressed in turn.

1. Corporations, Partnerships or Both?

Although it was a series of subchapter K cases that led to the University of Chicago's recent panel on the debt/equity distinction, the adoption of a debt/equity classification election arguably should not be limited to investments in partnerships only. Indeed, a key conclusion of Steve Schneider's article, with which I agree, is that debt is not and should not be different in a partnership.[46] Accordingly, allowing a debt/equity election for investments in partnerships but not for investments in corporations would be contrary to the fundamental notion that an investment that is treated as debt in a partnership should still be treated as debt even if the entity were to make CTB election to be treated as a corporation for tax purposes.

2. Eligible Financial Instruments?

The debt/equity election could be limited to what Schneider calls "Debt-Like Equity" and "Equity-Like Debt"—*i.e.,* the financial instruments that are nominally classified as one thing but that have significant features of the other.[47] This would limit the election to those factual situations that are virtually indistinguishable and that are toward the center of the continuous array of financial instruments between classic debt and classic equity. That is, by limiting the debt/equity election to the "Debt-Like Equity" and "Equity-Like Debt" (*i.e.,* the "hard" cases), the election would be limited to those instruments where the analysis is most likely to be difficult both for the taxpayer and the IRS, where taxpayers are most likely to alter the business deal to achieve a particular classification, and where there is most likely to be uncertainty. That is, the election would be limited to those instruments where the simplicity, administrability, efficiency and certainty benefits would likely be greatest.

As illustrated in this article, there are no easy answers to these (and other) election design questions.

Further, this eligibility limitation preserves the use of the substance-based classification test for those factual situations closer to the endpoints of the continuum where the substance-based differences between debt and equity remain more meaningful. This could be done either by applying the current law's multi-factor test to financial instruments that are ineligible for the election or by using a "per se" approach, similar to the one that is used in the CTB election,[48] where instruments that are ineligible for the election would be treated as "per se" debt or "per se" equity. The per se approach could provide more certainty and simplicity for the financial instruments that are closer to classic debt or classic equity. Providing for per se classification and avoiding actual election filings for "easy" cases reduce transaction costs and minimize errors.

An alternative approach for classification of the instruments closer to the endpoints would be to create a safe harbor or a classification presumption for those instruments with features that locate them closer to the endpoints of the continuum.

The problem with limiting which financial instruments are eligible for the election is the difficulty inherent in identifying any particular feature(s) of financial instruments that distinguish instruments whose classifications are clear (and thus should be treated as "per se" debt or "per se" equity, or even "safe harbor" or "presumptive" debt or equity) from instruments whose classifications are unclear. This is a challenge with any classification question, but it is arguably harder in the debt/equity context than in the entity classification context. With entity classification, the regulations use state law choice of entity to determine which domestic entities are per se corporations and which are eligible to elect; domestic entities that are incorporated under state law are per se corporations, and other domestic business entities are eligible to elect.[49] Incorporation is a clear, easily determinable feature that cannot be changed without a state filing.

Financial instruments lack an analogous feature that could be used to separate per se debt/equity from instruments eligible to elect. Features such as a fixed maturity date or determinable interest rate could be used for this purpose, but those features remain a product of private contract rather than an agreement with the state, and hence they are more easily changed. Further, these features are more easily manipulated or obscured with the additional of other contract terms, including options and side agreements. There may be other features that could be used to identify per se debt or per se equity or to identify financial instruments eligible to elect. For example, an analogy to the Code Sec. 305 definition of "preferred stock" or the Code Sec. 707(c) definition of guaranteed payment could be used to define Debt-Like Equity that is eligible to elect, and debt that would qualify for the Code Sec. 1361(b)(5) subchapter S straight debt safe harbor would be treated as per se debt. However, drawing many of these lines would likely prove to be very challenging.

3. Electable Classifications and Directionality

Assuming that eligible instruments could be defined, query whether a debt/equity election should allow the taxpayer to elect only debt status, only equity status, or either. For investments in partnerships, equity status likely presents the greater opportunity for abuse, as is demonstrated by the partnership tax cases Schneider discusses.[50] This suggests that, to minimize the risk of abuse, the election should only enable taxpayers to elect debt status, but not equity status, when the investment is in a partnership. However, for investments in corporations, debt status is often the more taxpayer-favorable status, suggesting that the election might only enable taxpayers to elect equity status. Thus, one possibility would be to allow different electable debt/equity classifications for investments in different types of entities—debt status could be elected for investments in partnerships, and equity status could be elected for investments in corporations. However, this approach would violate the principle that the test for debt should not be different in a partnership than it is in a corporation.

A second possibility would be to allow taxpayers to elect debt status *only*, regardless of whether the underlying entity is a corporation or a partnership. This would create the same test for debt in both partnerships and corporations. Further, at least with corporate entities, this approach could reduce tax-created business distortions by making it easier to obtain the often more favorable debt treatment without potentially suboptimal changes to the nontax business economics. However, because corporate debt is often used to minimize the corporate level tax, allowing taxpayers to elect into debt status regardless of the classification of the underlying entity might open up more opportunities corporate tax minimization. This could be revenue reducing and could increase opportunities for abuse.

Moreover, neither of the foregoing options solves the problem identified in Schneider's article. The problem raised by the partnership debt/equity classification cases is really about *equity*—when should an investment in a partnership be treated as *equity*? An election *into debt* only provides certainty with respect to the treatment of instruments for which the election is *made*, but the debt/equity conundrum would remain with respect to the investments in partnerships for which the election is *not made*. If there is a partnership instrument for which the election is not made, how does *Culbertson* apply? What about Code Sec. 704(e)? Should an investment in a partnership for which a debt election is not made be treated as partnership equity and be "entitled to the full set of keys" to the subchapter K kingdom? If so, wouldn't that be tantamount to a bi-directional election (election into either debt or equity), rather than uni-directional election (election only into debt)? If not, how is the investment classified for tax purposes?

A third possibility would be to provide an explicit bi-directional election, allowing taxpayers to elect to treat eligible instruments as either debt or equity. This would open up even more opportunities for tax minimization, and in particular, it would explicitly enable the tax minimization strategies at issue in the *Castle Harbour, Historic Boardwalk*, and other recent partnership tax cases. Or said differently, this approach would "solve" the debt/equity conundrum in partnerships by giving up any effort to police the debt/equity line in close cases. Moreover, this approach would arguably override the *Culbertson* test for partnerships, meaning that taxpayers might be able to elect into partnership status when their substantive relationship is as co-owners or lender/borrower. Ultimately, an election into debt only fails to solve the problem in hard cases, but adding an election into equity would, as Schneider noted, "fraught with potential abuse."[51]

B. Default Rule If a Taxpayer Does Not Make a Debt/Equity Election

When designing an election, it is also important to specify the tax treatment in the absence of an election.[52] Alternatives for default rules include a penalty default rule (*i.e.,* where the default treatment is set so as to be unfavorable to at least one party, thereby encouraging parties to contract around the default), a preference-meeting default rule (*i.e.,* default treatment that generally meets parties' expectations), a bifurcated approach (*i.e.,* a penalty default in certain situations, and a preference-meeting default in others), and no default rule.[53]

A penalty default rule is most useful when there are informational asymmetries between the parties and there is a desire to create an incentive for the party with the information to contract around the default.[54] Accordingly, a penalty default rule, either in whole or in part, would not appropriate for a debt/equity classification election because there is little, if any, information-forcing benefit to be gained. Moreover, penalty defaults increase transaction costs because they generally result in bargaining and the filing of elections. Part of the benefit of a possible debt/equity election is to reduce transaction costs. Thus, using a penalty default rule for the debt/equity election would be counterproductive.

In contrast, a preference-meeting default would give the parties, as their default treatment, the tax treatment that they would most likely have selected. One challenge with this approach is determining what the preference-meeting default would be. How do we know which tax treatment the parties would most likely have selected?

It would be an oversimplification to assume that investors in corporations prefer debt and investors in partnerships prefer equity. Although there are tax minimization opportunities associated with these classifications, different taxpayers have different preferences. Even if those assumptions provided the baselines for strong preference-meeting default rules, they would again result in the creation of different rules for corporations and partnerships, which is contrary to the conclusion that the test for debt should be the same regardless of the type of entity.

Another possibility would be to assume that the current law provides the preference-meeting baseline. That is, a debt/equity election could provide that, in the absence of an explicit election, the current law determines the classification of the instrument. On one hand, this could be conceived of as an expectation-meeting default rule for those whose expectations are set based on the law with which they are already familiar. On the other hand, a "current law" default rule would be tantamount to providing no default rule; that is, the "default rule" would provide no greater clarity or certainty than does the current law.

The benefit of this approach is that nothing changes for taxpayers who are comfortable with the debt/equity analysis of their instruments under current law. These taxpayers can continue to apply current law despite the adoption of a debt/

equity election. The only taxpayers who would be affected are those who choose to opt out of the multi-factored debt/equity analysis required by the current law. These taxpayers would have the option to gain certainty and simplicity by making an affirmative and explicit choice.

There are, however, downsides to using the current law as the default rule. For example, taxpayers would have to undertake the entire multi-factored analysis under the current law to know whether they want to make an election out of this default treatment, in which case complexity is not reduced as compared to current law. Alternatively, a taxpayer might skip the default rule analysis and just make an election, whether or not it is needed. This would provide more certainty and would reduce the transaction costs imposed by current multi-factored analysis, but this has the potential to result in a huge number of unnecessary election filings. This would impose different, but potentially sizable, transaction costs.

Another approach to devising a preference-meeting default rule would be to use, as a default rule, the treatment of the instrument as determined for some nontax purpose. For example, the debt/equity classification election default rule could provide that the instrument is classified for tax purposes in the same way that it is classified for financial statement purposes. This bears some similarity to the entity classification rules, which also refer to determinable nontax metrics (*e.g.,* the presence or absence of unlimited liability for foreign entities)[55] to help ascertain the default tax treatment for eligible entities.

Relying on a non-tax metric, such as the debt/equity classification of the instrument for financial statement purposes, is likely to be expectation-meeting at least to some degree. Despite the continued interest in hybrid securities, it is generally more common for taxpayers to treat a single instrument consistently for multiple purposes than it is for taxpayers to intentionally create hybrid instruments that have different treatments for different purposes. Moreover, this approach would require taxpayers to make explicit elections with respect to hybrid securities, thereby easily identifying those securities for the IRS, in case the IRS wanted to focus extra attention on hybrid securities. This approach also likely reduces transaction costs as compared to the "current law" default rule approach. This is because most taxpayers, and certainly larger and more sophisticated taxpayers with more complicated financial instruments, will already make the financial statement determination. Thus, this approach eliminates the need to do a separate analysis in order to determine the default tax classification. Further, the certainty conferred with this approach would likely also result in many fewer "protective elections" than would a "current law" default rule.

C. Technical Requirements for a Debt/Equity Election

As with any election, it would be important to specify the basic technical requirements for making the election.[56] As Schneider notes, the most important technical requirement for a debt/equity classification election is likely to be ensuring consistent reporting.[57] This is because the debt/equity classification of a financial instrument affects multiple taxpayers (*i.e.,* both the entity and the investor), which puts the government at risk of whipsaw. Consistent reporting could be achieved by requiring both the entity and the investor to make the election jointly, as with a Code Sec. 338(h)(10) election. That would be practicable with small private investments, but requiring joint elections could be very challenging with broader offerings. As an alternative, the entity could make the election, and the regulations on the debt/equity election could provide that investors are bound by the election made by the entity unless the investors disclose otherwise to the IRS. Given that the entity has information reporting obligations and will generally send the investor (and the IRS) 1099-INTs or 1099-DIVs, it is highly likely that the entity's debt/equity classification election will be followed by the investor.

IV. Conclusion

Schneider suggests a wide variety of possible solutions to the debt/equity conundrum that is highlighted by *Castle Harbour, Historic Boardwalk*, and other similar recent partnership tax cases. Most of the solutions he suggests are specific to subchapter K: clarifying the Code Sec. 707(a) rules, redefining the term "partner" under Code Sec. 761, expanding the scope of Code Sec. 707(c), using the Code Sec. 704(b) rules to curtail the special allocations that led to the abuses identified in the partnership debt/equity cases, clarifying the applicability of Code Sec. 704(e), and expanding the Code to introduce a "nonqualified preferred partnership interest" parallel to Code Sec. 351(g). Each of these approaches has pros and cons, but all of them narrowly target the hardest part of the problem identified—when is debt-like purported equity treated as real equity for purposes of subchapter K?

The debt/equity puzzle in subchapter K led us to think more broadly about the debt/equity analysis throughout the Code and spurred us to consider tackling the larger debt/equity analysis with a broadly applicable solution. Often, fundamental reform that responds coherently to multiple related problems is better than tiny *ad hoc* reforms that respond to specific, narrowly defined problems. But in this case, the tailored solution is likely better. A subchapter K-based solution can respond to the narrow problem of identifying equity in subchapter K.

Admittedly, the debt/equity analysis for investments in corporations is complicated and fact-intensive, but it is stable and reasonably well-understood by lawyers who can help their clients plan. Of the many things in the Code in need of reform, the debt/equity test for corporate investments is relatively low on the list. That said, broader debt/equity reform could be a positive development, especially if the reform reduced or eliminated the tax differences between the two classifications. But even in a second-best world, query whether an elective approach would be the right reform. Despite the continuum of financial products between debt and equity, there still seems to be something meaningfully different between debt and equity. Or at least it is not clear that there has ceased to be a meaningful distinction. This makes the case for an elective classification approach relatively weak.

Moreover, even if debt and equity are, at least within some parameters, sufficiently interchangeable to support a move to an elective approach, there would be many design challenges in devising a debt/equity classification election that would confer more policy net policy benefits than our current classification regime. How would we draw the line between instruments that are eligible to make the debt/equity classification election and those that are not? What classification status is electable and in what circumstances? What is the default treatment if no election is made? As illustrated in this article, there are no easy answers to these (and other) election design questions. But by working through the analysis on these issues, this article helps to illustrate some of the key challenges that would be faced were Congress or the Treasury to consider broader reform that would adopt an explicitly elective approach to debt/equity classification.

ENDNOTES

* I appreciated the opportunity to participate in the University of Chicago Law School's 67th Annual Federal Tax Conference, and I thank Steven Schneider, Bahar Schippel and David Schnabel for their insights and assistance as we discussed debt/equity classification in partnerships. This article reflects my commentary in response to the presentation made by Steven Schneider during the panel and to the article he wrote in connection therewith.

1 *See, e.g., TIFD III-E, Inc.,* CA-2, 2012-1 USTC ¶50,167, 666 F3d 836 [hereinafter "*Castle Harbour*"]; *Historic Boardwalk Hall, LLC.,* CA-3, 2012-2 USTC ¶50,538, 694 F3d 425, *cert. denied*, No. 12-901 (May 28, 2013); *Pritired 1, LLC,* DC-IA, 816 FSupp2d 693 (2011); *Superior Trading, LLC,* 137 TC 70, Dec. 58,751 (2011), *supplemented by* 103 TCM 1604, Dec. 59,026(M), TC Memo. 2012-110, *aff'd,* CA-7, 2013-2 USTC ¶50,499, 728 F3d 676; and *Kenna Trading, LLC, et al.,* 143 TC No. 18, Dec. 60,059 (2014).

2 *See, e.g.,* Code Sec. 385; *O.P.P. Holding Corp.,* CA-2, 35-1 USTC ¶9179, 76 F2d 11; *Fin Hay Realty Co.,* CA-3, 68-2 USTC ¶9438, 398 F2d 694; *R. Hardman*, CA-9, 87-2 USTC ¶9523, 827 F2d 1409; *Indmar Products Co., Inc.,* CA-6, 2006-1 USTC ¶50,270, 444 F3d 771; *see generally* William T. Plumb, *The Federal Income Tax Significance or Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971) (providing a comprehensive discussion of the factors that distinguish debt from equity).

3 *See F. Tower,* SCt, 46-1 USTC ¶9189, 327 US 280, 66 SCt 532; *W. Culbertson,* SCt, 49-1 USTC ¶9323, 337 US 733, 69 SCt 1210.

4 *See, e.g., Castle Harbour, supra* note 1.

5 *See, e.g., Historic Boardwalk, supra* note 1.

6 *See* Steven R. Schneider, *Is Debt vs. Equity Different in a Partnership?* TAXES, Mar. 2015.

7 *See, e.g.,* Fin Hay Realty Co., *supra* note 2 (16-factor test); *T. Mixon Est.*, CA-5, 72-2 USTC ¶9537, 464 F2d 394 (13-factor test); *Roth Steel Tube Co.,* CA-6, 86-2 USTC ¶9676, 800 F2d 625 (11-factor test).

8 *See* Schneider, *supra* note 6.

9 Reg. §§301.7701-2, -3.

10 Heather M. Field, *Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System*, 47 HARV. J. LEGIS. 21, 46–53 (2010) (discussing how explicit elections can be used to facilitate tax classification).

11 *T.A. Morrissey,* SCt, 36-1 USTC ¶9020, 296 US 344, 56 SCt 289.

12 26 CFR §301.7701-2(a) (1960) (promulgated in response to the application of the *Morrissey* corporate resemblance test in *A. Kintner,* DC-MT, 52-2 USTC ¶9563, 107 FSupp 976, *aff'd,* CA-9, 54-2 USTC ¶9626, 216 F2d 418; *see generally* Patrick E. Hobbs, *Entity Classification: The One Hundred-Year Debate*, 44 CATH. U. L. REV. 437 (1995) (providing a history of the pre-CTB election entity classification rules).

13 *See* Heather M. Field, *Checking In on Check-the-Box*, 42 LOY. L.A. L. REV. 451, 460 (2009).

14 Susan Pace Hammill, *The Story of LLCs: Combining the Best Features of a Flawed Business Tax Structure*, *in* BUSINESS TAX STORIES 295, 295–98 (Steven A. Bank & Kirk J. Stark eds., 2005).

15 Field, *Check-the-Box, supra* note 13, at 463.

16 *See id.,* at 463–70.

17 Schneider, *supra* note 6.

18 *Id.*

19 *See* J. Dean Heller, *What's in a Name: Mezzanine Debt Versus Preferred Equity*, 18 STAN. J. L. BUS. & FIN. 40 (2012).

20 Field, *Choosing Tax, supra* note 10, at 52–53 ("absent an argument explaining the distinction between the relevant tax regimes, a fairer, simpler, and more neutral solution would be to make classification irrelevant by imposing the same tax treatment regardless of classification").

21 *Id.,* at 50–52.

22 *See, e.g.,* Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055 (2000); Anthony Polito, *Useful Fictions: Debt and Equity Classification in Corporate Tax Law*, 30 ARIZ ST. L. J. 761 (1998).

23 Field, *Choosing Tax*, *supra* note 10, at 50–52.

24 Notice 95-14, IRB 1995-14, 7.

25 Field, *Choosing Tax*, *supra* note 10, at 52 (quoting Pratt, *supra* note 22).

26 *See* Heller, *supra* note 20.

27 *See* Robert Flannigan, *The Debt-Equity Distinction*, 26 B.F.L.R. 451 (2011).

28 *See generally* Hideki Kanda, *Debtholders and Equityholders*, 21 J. LEGAL STUD. 431 (1992).

29 *See* Code Secs. 163(e), (j), (l), 385; *see generally* Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* 20-56 (JCX-41-11), July 11, 2011 (explaining various efforts to police the debt/equity line and the consequences of one characterization or the other).

30 Lee A. Sheppard, *Defending Cross-Border Debt-Equity Cases*, 2014 TAX NOTES TODAY 15-1 (Jan. 23, 2014).

31 *See, e.g.,* JCT *supra* note 37, at 80–85; Herwig J. Schlunk, *Little Boxes*: *Can Optimal Commodity Tax Methodology Save the Debt-Equity Distinction?* 80 TEX. L. REV. 859 (2002).

32 *See generally* Field, *Check-the-Box, supra* note 13, at 470–96 (examining the policy implications of the CTB election).

33 *See supra* note 7.

34 26 CFR §301.7701-2(a) (1960).

35 *Fin Hay Realty Co., supra* note 2 (16 factors).

36 26 CFR §301.7701-2(a) (1960).

[37] *Id.* Reg. §301.7701-2(a)(2) to (3).
[38] *See John Kelley Co.,* SCt, 326 US 489 (1943).
[39] *See* Field, *Check-the-Box, supra* note 13, at 482–87.
[40] *See id.,* at 471–73, 480–81.
[41] Field, *Choosing Tax*, *supra* note 10, at 50.
[42] *See* Field, *Check-the-Box, supra* note 13, at 487–91.
[43] For example, a debt-equity election could help taxpayers' further interest stripping in inversions. *See* Stephen E. Shay, *Mr. Secretary, Take the Tax Juice Out of Corporate Expatriations*, 144 Tax Notes 473 (July 28, 2014); Andrew Velarde, *Debt Reclassification or Interest Limits Possible for Inversions*, 2014 Tax Notes Today 210-1 (Oct. 30, 2014).
[44] Field, *Choosing Tax*, *supra* note 10, at 66–71.
[45] *See generally id.,* at 69–70 (discussing eligibility limitations generally).
[46] Schneider, *supra* note 6; *see also J. Hambuechen,* 43 TC 90, Dec. 27,018.
[47] For purposes of this discussion, I assume that the debt and equity like features of the instrument are not severable or separately tradable. Thus, bifurcation is unlikely to be appropriate. If, however, the instrument could be bifurcated, then each piece should be classified separately.
[48] Reg. §301.7701-3.
[49] *Id.,* at Reg. §§301.7703-2, -3.
[50] Schneider, *supra* note 6. These preferences are not absolute, and they do vary situation to situation. There are some tax reasons why an investor in a partnership would want debt, rather than equity, status; for example, a foreign investor would prefer to invest in debt because interest is portfolio income. And there are some tax reasons why an investor in a corporation would want equity, rather than debt, status; for example, an investor wanting to benefit from the dividends received deduction would want to invest in equity. However, these general understandings about taxpayer preferences could help determine what classifications should be electable.
[51] Schneider, *supra* note 6.
[52] *See* Field, *Choosing Tax*, *supra* note 10, at 66–69.
[53] *See* Heather M. Field, *Tax Elections & Private Bargaining*, 31 Va. Tax. Rev. 1, 49–60 (2011).
[54] *See* Ian Ayres & Robert Gertner, *Filling the Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L. J. 87, 91 (1989).
[55] Reg. §301.7701-3(b).
[56] *See* Field, *Choosing Tax*, *supra* note 10, at 70–71.
[57] Schneider, *supra* note 6. The technical requirements should, for example, also specify the time within which the debt/equity election should be made. This could, for example, provide that the debt/equity election must be made within two and one half months after initial issuance of the instrument. This would be the same timeframe for making an S corporation election. Code Sec. 1362(b)(1). Other time periods would be acceptable too, as long as the time period is short enough so that the entity would be able to comply with any information reporting obligations it has with respect to the instrument.