Rated Note Feeder Funds: Increasingly Common and Not Tax Motivated

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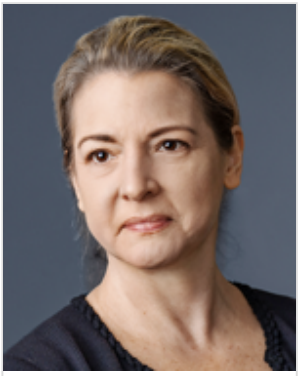

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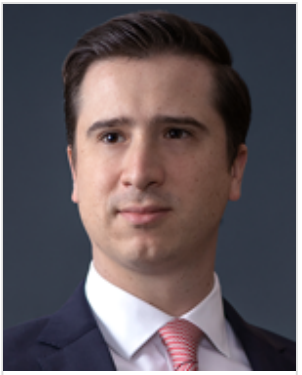

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In this report, the authors examine technical tax issues that can unexpectedly arise for investors in rated note feeders.

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I. Introduction

For many tax practitioners focusing on private investment funds, rated note funds, or feeders, have become a meaningful feature of fund structuring. In its simplest form, a rated note feeder is a feeder fund that invests substantially all its assets in a master fund that, in turn, invests in financial assets (for example, debt instruments). The rated note feeder is capitalized with debt and equity, both of which are usually held by limited partners. The notes issued by the rated note feeder typically receive a risk rating from a credit rating agency such as Moody's or S&P.

Rated note feeders are mostly established to encourage investment by U.S. insurance companies. The investments tend to receive more favorable treatment under the National Association of Insurance Commissioners' risk-based capital rules as a result of investing in the note rather than a direct investment in the underlying master fund or a typical feeder fund. Because of their long-term obligations to policyholders, U.S. insurance companies regularly invest in alternative assets, such as private credit funds, to generate higher yields sufficient to satisfy ultimate policy obligations. However, investments in those funds can result in significant regulatory capital requirements for insurance company investors. To address this concern, fund sponsors have increasingly turned to forming rated note feeder structures when launching or fundraising for existing funds to attract new capital to private credit and other alternative asset funds. There are benefits to both insurance company investors and fund sponsors. Insurance companies achieve favorable regulatory capital treatment while receiving the yield and diversification benefits of private funds. Fund sponsors gain access to an important source of capital in what can be a challenging fundraising environment.

A seasoned tax practitioner might think that the primary tax consideration associated with a rated note feeder structure would be the characterization of the rated notes as debt or equity. One might also think that insurance companies would be indifferent to a debt or equity characterization given that they are ultimately subject to the same tax treatment, whether that be through the inclusion of interest income or original issue discount under a debt instrument directly held or the allocation of income from a partnership investing in financial instruments. However, while both are often true, depending on which characterization is deemed appropriate, there can be meaningfully different tax consequences for investors.

In particular, in light of the interest deductibility limitations under section 163(j) and the applicable high-yield debt obligation rules under section 163(e), debt characterization could be unfavorable to the limited partners. Moreover, as the market evolves and different underlying asset classes in which the underlying master funds invest expand, additional tax complexities are raised, such as the taxable mortgage pool rules for funds investing in mortgages. Further, while these structures are still relatively new and untested, there are potentially meaningful considerations that could be associated with situations in which there are modifications of or defaults under the rated notes.

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This report examines the features of rated note feeder structures, including some of the commercial deviations from a typical feeder fund structure that are required for the notes to be respected as debt for insurance regulatory purposes. After providing background for how those structures work, it explores tax issues that frequently arise or could reasonably be expected to arise in the future. Although not the first examination of the tax considerations associated with investing in rated note feeders,[1] this report seeks to provide a more thorough analysis of some of the technical issues associated with an investment in feeder funds.

Although the focus here is on rated note feeders, insurance companies are investing in a variety of structures designed to receive favorable regulatory capital treatment. For example, stand-alone funds using similar structures without corresponding investment in a master fund but instead investing directly in the underlying investments are becoming more common. Insurance companies also may invest in securitization or other financing vehicles used by funds to borrow through structures that receive favorable regulatory capital treatment. Those structures are not covered in this discussion.

Further, even in a fund with multiple investors, there are situations in which a single investor owns all the equity of, and debt issued by, a rated note feeder. In that case, the debt and equity issued by the rated note feeder are disregarded because of its treatment as a disregarded entity for U.S. federal income tax purposes, and the discussion below is inapplicable. For that reason, this discussion does not address rated note feeders that are treated as disregarded entities.

II. Background on Rated Note Feeders

Insurers are required to hold capital reserves based on the riskiness of their investments as determined by the National Association of Insurance Commissioners. Because investments in limited partnership interests issued by private funds are typically unrated and viewed as relatively high risk, a direct investment in a private fund would require a large capital reserve. In contrast, debt instruments, particularly those in which the risk of default by the borrower is low, are perceived as less risky by the National Association of Insurance Commissioners and receive more favorable treatment. When a debt instrument is able to achieve a high credit rating from a credit rating agency, it is easier to establish that the instrument is relatively low risk.

To provide insurance company investors with the ability to achieve more favorable, risk-based capital treatment, private fund managers have developed a structure in which a feeder fund issues rated notes and limited partnership interests or subordinated notes[2] that are treated as equity to investors. The feeder fund then uses the proceeds from selling these notes to invest in the master fund[3] holding the private assets. The notes are structured to be treated as debt for insurance regulatory purposes and therefore are senior in terms of priority to the limited partnership interests or subordinated notes.

Most rated note feeder funds are targeted to U.S. insurance companies and are formed as Delaware limited partnerships. However, there are some non-U.S. insurance companies that also find this structure beneficial (for example, South Korean insurance companies), and rated note feeders for those insurance companies may be non-U.S. and may elect to be classified as corporations for U.S. federal income tax purposes, depending on whether the underlying fund or funds are expected to generate (or have options to block at the fund level) U.S. tax filing and payment obligations. This report focuses on

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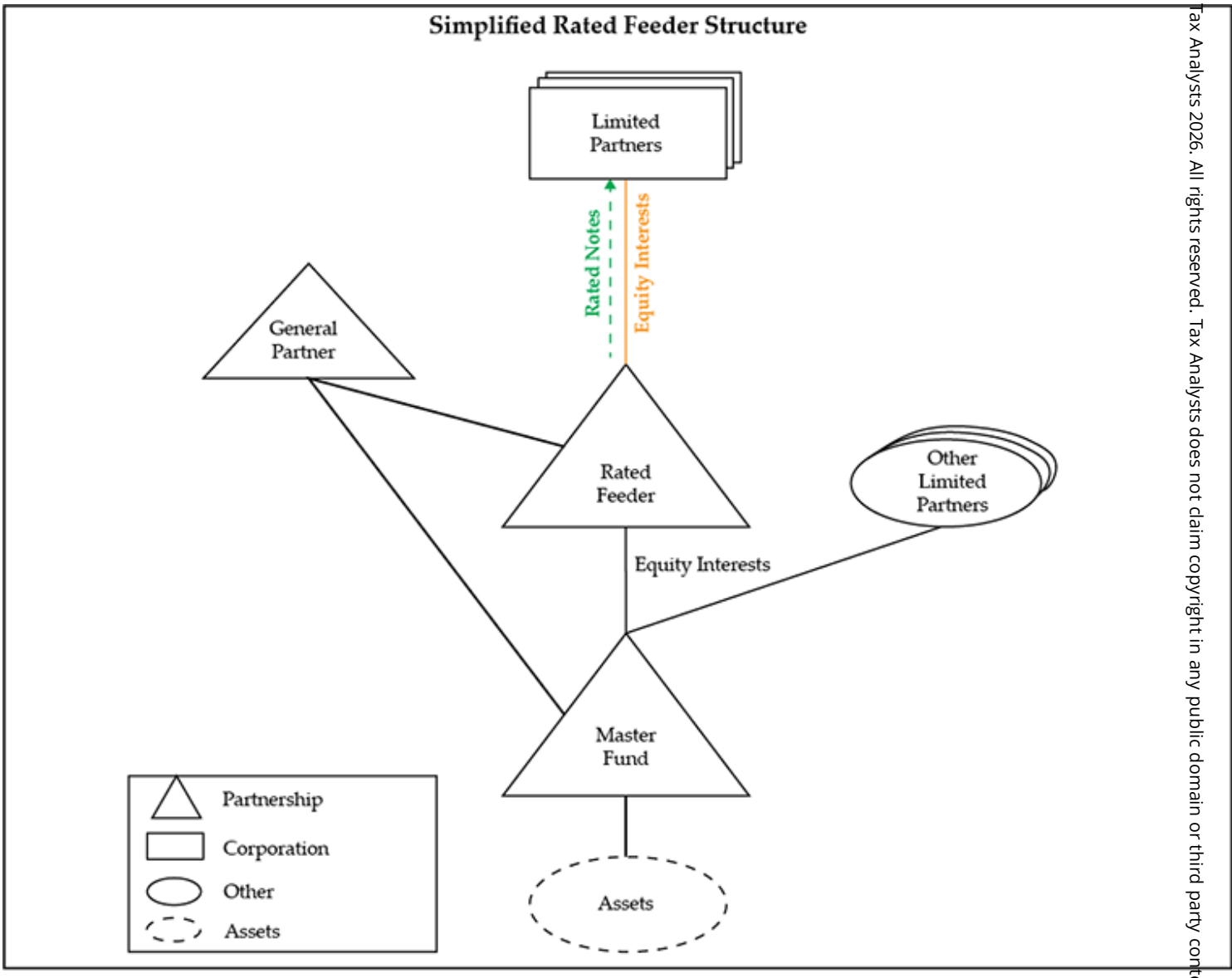
funds that are focused on U.S. insurance company investors, with those funds being treated as a partnership for federal income tax purposes.

The figure depicts a typical rated note feeder structure.



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A credit rating agency will assign a credit rating to the notes issued by the feeder fund. This rating is supported by a payment waterfall in the feeder fund. Senior debt tranches receive a higher rating, while the subordinated limited partnership interests are unrated. The credit quality of the underlying fund investments also affects the ultimate ratings provided. Insurers can then rely on the notes' credit rating to qualify for a lower risk-based capital charge. Rated note feeders in many ways replicate the structures used by securitization vehicles.

The predictability of cash flows on the underlying fund assets is another important feature of rated note feeders. The underlying funds are usually credit funds or funds that invest consistently in cash-yielding ventures, such as equipment leases. Because of their similarity to securitization vehicles, ratings agencies are familiar with evaluating the relative levels of risk associated with the various tranches of

capital of these underlying asset classes. It is uncommon to see rated note feeders used for funds that invest in illiquid assets, such as private equity funds or venture capital funds.

III. Typical Terms of Rated Notes

The terms of the rated notes are typical of debt instruments to be consistent with the expectations of ratings agencies and insurance regulators. The note purchase agreement, which contains the terms of the notes, provides for fairly standard interest payments, a fixed maturity date, creditors' remedies, and priority in payment over the limited partnership interests. That being said, the terms of the notes deviate from what one might expect to see in a syndicated credit agreement following the Loan Syndications and Trading Association form and instead follow more of a shareholder loan model but with more robust covenants and representations.

A. Advances on Notes

The rated notes are usually structured with delayed draw features so that funds are advanced incrementally rather than in a single payment. Advances generally coincide with capital calls for limited partners to contribute funds to the feeder fund, which in turn align with master fund capital calls.

Investors typically advance funds under the notes and make capital contributions simultaneously in proportion to the targeted debt-to-equity ratio of the feeder fund. The general partner of the rated feeder fund may be under an obligation to use commercially reasonable efforts to maintain that debt-to-equity ratio, which usually ranges from 70 to 90 percent. There are rated feeder fund structures, however, in which one group of investors acquires the limited partnership interest in the rated feeder fund and another group of investors (most often insurance companies) acquires the rated notes.

B. Interest Payments

The interest rates are generally fairly simple, being either fixed or secured-overnight-financing-rate-based floating. The rates themselves often approximate the preferred return at the master fund level, particularly if there is only one class of notes issued. Because payments on the notes are fully dependent on underlying distributions from the master fund, interest is ordinarily deferrable at the option of the rated feeder fund, in which case it is "paid in kind" or PIK, although PIK terminology is often not used. If there are multiple classes of notes, the more subordinated classes have higher interest rates.

C. Priority of Payments

There is some variation in the priority of payments of interest and principal under the notes and distributions for the limited partnership interests. However, interest payments under the notes always take priority over distributions.

There is generally the ability to make distributions regarding equity interests early in the life of the fund, so long as the notes have some waterfall priority. In some cases, distributions may take priority over principal payments on the notes until maturity. In other cases, interest and principal must be paid before distributions are made. Another variation is for interest and principal payments to track those of

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the underlying fund investments, with any residual amounts being distributed to the limited partnership interests.

Special distribution rules may apply if there is a default or if certain financial covenants applicable to the notes are breached.

D. Prepayments

The rated notes can often be prepaid without penalty. Sponsors may find it advantageous to prepay the notes particularly in the later stages of a fund's existence. In contrast to leveraged blocker structures, for example, when the continued investment in notes in addition to equity of the partnership provides benefit in the form of ongoing tax benefits, insurance investors at the later stages of a fund's existence may not be as concerned about holding their remaining investment solely in the form of equity.

E. Maturity

The note maturity typically aligns with the fund term, often either matching the term or ending shortly before the scheduled termination date of the fund. Although in some cases fund sponsors actually set a maturity date that is after the scheduled liquidation date of the fund if they expect the fund's investments will take longer than the term to liquidate. There is often flexibility built in.

While it is less common for open-ended funds to use rated note feeders, there are instances in which this occurs. There is additional complexity in structuring the terms of the notes in those structures as it is important for instruments characterized as debt to have a fixed maturity date. There are different structures that can be used, but there are inevitable tensions with the commercial realities of how open-ended funds operate.

F. Stapling

The rated notes are often "stapled" to the limited partnership interests, either formally through requirements that the notes and limited partnership interests cannot be sold or otherwise transferred separately or effectively through informal transfer restrictions and ownership limitations to ensure identity of ownership. This structure is administratively easier for fund sponsors and typically uncontroversial for investors, given that they fully intend to hold both instruments, in the case of the rated notes for regulatory capital purposes and in the case of the limited partnership interest, for enhanced returns. However, as noted elsewhere in this report, there are some rated note feeders that contemplate different owners for each instrument for a variety of reasons, particularly if there are multiple classes of notes.

G. Residency of Investor

To simplify administrative burdens on the general partner and minimize any need to withhold on payments under the notes, rated note feeders often require that investors are U.S. persons within the meaning of section 7701(a)(31). Practically speaking, this would not necessarily affect the potential investor pool because the investors typically interested in investing in rated note feeders are insurance companies subject to the U.S. risk-based capital rules, and thus interested investors are likely to be U.S.

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persons. There can be external factors affecting this decision against allowing non-U.S. investors as well, such as input from the rating agencies that prefer for a stable and predictable investor base to avoid any uncertainty resulting from tax gross-up and withholding issues.

H. Withholding

Withholding provisions are generally minimal and follow other withholding provisions included in a fund's typical operating documents instead of following the Loan Syndications and Trading Association model. For example, a rated note feeder typically ensures that it has the right to withhold and pay taxes on payments attributable to a noteholder, which are usually treated as deemed distributions to that noteholder, and noteholders should provide appropriate tax forms and information for the rated note feeder to comply with any withholding obligations.

I. Limited Events of Default

The note purchase agreement ordinarily includes fairly limited events of default, such as (1) a failure of the feeder fund to pay the principal of or interest on the notes on the maturity date; (2) a default in the performance or observance in any material respect of any covenants contained in the notes that remains unremedied for a specified period; (3) a breach in any material respect of any representation or warranty made by the feeder fund for the notes, which remains unremedied for a specified period; or (4) the bankruptcy or insolvency of the feeder fund.

If an event of default occurs, the holders of the notes have customary creditors' remedies, including the right to accelerate the notes and declare them immediately due and payable. The noteholders also may sue the feeder fund for specific performance of any agreement in the note purchase agreement or in any note or for an injunction against a violation of any of the terms of the note purchase agreement or any note. However, the noteholders also have broad rights to waive any defaults.

The rated notes may be unsecured. Thus, foreclosure is not among the note holders' remedies in those instances.

IV. Typical Features of Limited Partnership Interests

A. Distributions

As is typical for feeder funds, to the extent that the rated note feeder receives distributions, subject to the payment waterfall described above, proceeds received from the master fund, which will be subject to reduction to take into account fund expenses including management fees, will be distributed pro rata to the limited partners on a periodic payment date. The general partner will receive its carried interest at the master fund level. As mentioned above, distributions will be made only to the extent permitted under the payment waterfall.

The limited partnership agreement of the rated note feeder generally does not provide for tax distributions, notwithstanding that there may be phantom income recognized by the limited partners given that they will otherwise receive payments under the notes. When there is no identity of ownership, tax distributions may be desired, but that could affect the ratings on the notes.

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B. Capital Commitments

Limited partners make capital commitments to the fund, which are drawn down over the life of the fund on an investor-by-investor basis to make investments or to pay fund expenses. Typically, there is a simultaneous drawdown under the notes when capital is called. As a result, capital generally needs to be called on a pro rata basis for all existing investors.

C. Costs of Rated Note Feeder

The costs of forming and maintaining the rated note feeder structure are borne solely by the limited partners of the feeder rather than investors in the master fund.

V. Mechanical Challenges of Rated Note Feeders

There are several ways in which fund mechanics do not work particularly well with rated note feeders. For example, to support the characterization of the notes as debt for regulatory purposes, certain obligations that would typically be imposed on limited partners cannot be extended to the holders of the notes. While this is often less problematic in cases in which the lenders are also the limited partners, tensions still exist.

A. Management Fees and Carried Interest

As mentioned above, management fees and carried interest will be paid or borne at the master fund level. The rated note feeder will effectively be charged with the same fees and carried interest as those charged to other limited partners in the master fund (subject to investor-level variations). Limited partners in the rated note feeder will effectively bear a much higher percentage of the fees and carried interest as a percentage of their capital contributed because of the priority of payments compared with other investors because of their subordination to the loans. This is not terribly troubling if there is the same identity of ownership of the notes and limited partnership interests but may be challenging in cases in which there are different holders of each instrument.

B. Rebalancing

The rated note feeder, as well as other feeder funds or the master fund, can admit subsequent closing investors. Subsequent closing investors usually pay their portion of previously drawn-down contributions plus an interest payment. Fund sponsors often take the position that those contributions, particularly when distributed to existing investors, constitute a sale by the existing investors of a portion of their interest to the new partners. To the extent that such a position is taken, presumably the same treatment would apply to a portion of the rated notes held by the existing investors. An additional challenge exists regarding the interest payment made by the new investor. Those proceeds would need to be paid under the notes to the extent that there is accrued but unpaid interest, even though economically all or a portion of that payment should be made to the existing limited partners.

C. Giveback and Recycling Obligations

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Investors often are subject to "give back" previously distributed amounts in the event of a loss or indemnification event of the fund. The foregoing giveback obligations are generally subject to a cap. Similarly, investors may be subject to recycling obligations under which their capital commitments increase to the extent they receive a distribution. These mechanics do not work particularly well with rated note feeders because this type of obligation is inconsistent with the typical features of a debt instrument. Fund sponsors must decide whether to build these features into the loans and risk potential reductions in credit ratings for the notes or whether to impose increased obligations for the limited partnership interests, to the extent possible.

VI. Tax Classification of Rated Notes as Debt or Equity

The gating issue when analyzing the U.S. tax considerations applicable to rated note feeder funds is the classification of the rated notes as debt or equity for federal income tax purposes. At its core, the distinction between debt and equity is straightforward: An instrument is generally treated as equity if it provides the holder with the right to share in the profits of the enterprise, subject to the associated risks of loss,[4] while debt represents a fixed obligation to repay a sum certain, not tied to any upside or equity-type return.[5] In practice, however, the analysis is rarely simple and most frequently requires a careful assessment of all the facts and circumstances involving each instrument.[6]

In this regard, both the IRS and the courts have developed a multifactor framework to evaluate whether an instrument more closely resembles equity or debt.[7] Although the precise formulation of these factors varies depending on each structure, the core inquiry isolates and weighs the debt-like and equity-like features of an instrument to determine which characterization predominates.

Among the most commonly cited considerations are the presence of an unconditional promise to pay a sum certain on a fixed date, a holder's enforcement rights, whether the instrument grants the holder the right to vote or participate in management of the issuer, the identity of the holder as creditor or as an equity holder, the issuer's capitalization and debt-to-equity ratio, subordination to other creditors, the intent of the parties, and the label of the instrument and its treatment for nontax purposes, such as regulatory, rating agency, or accounting classifications.[8]

Courts have emphasized that not all factors are relevant in every case[9] and that the factors are merely aids to answering the ultimate question: whether the instrument, in economic reality, constitutes risk capital entirely subject to the fortunes of the venture or a strict debtor-creditor relationship.[10] It is also worth noting that, while the leading cases applying this analysis arose in the corporate context, several courts have concluded that the same debt and equity framework applies in the partnership context.[11] This extension is particularly relevant to rated note feeders, as examined below.

A. Unconditional Promise to Pay a Sum Certain on a Fixed Maturity Date

The existence of a fixed principal obligation, coupled with an unconditional right to interest, is at the core of what defines a debtor-creditor relationship and is perhaps the single most important factor in distinguishing debt from equity.[12] In applying this principle, courts have held that unsecured notes payable on demand with no fixed maturity date are insufficient to evidence bona fide indebtedness.[13] Similarly, advances to a limited partnership without a fixed maturity date have been recharacterized as

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equity, as the absence of a clear repayment schedule indicates that the funds are, in substance, risk capital rather than a fixed obligation.[14] Even if a fixed payment is required, courts have found that payments out of the profits of the borrower support equity treatment if they are not unconditionally payable.[15]

Still, courts have acknowledged that some variation from this formula does not automatically preclude debt treatment. For example, a distribution upon liquidation of a partnership does not ordinarily provide the necessary maturity for an instrument, because liquidation dates are usually uncertain and not fixed in the sense required for debt classification. However, courts have recognized that when a partnership is formed with a predetermined or reasonably fixed liquidation date, an instrument payable at that time may satisfy the maturity requirement.[16] In those cases, the existence of a defined termination point for the partnership can lend sufficient certainty to the obligation, allowing the instrument to be treated as debt rather than equity.

The rationale for disregarding a fixed maturity date that is set unreasonably far into the future is that repayment under that circumstance becomes increasingly dependent on the issuer's continued profitability (one of the classic hallmarks of equity). There is, however, no bright-line rule for when a maturity date is considered too remote from the date of issuance to weigh in favor of debt classification. Instead, courts have taken a fact-specific approach, considering factors such as the nature of the issuer's business, its financial condition, the length of its operating history, and the likelihood that the issuer will remain in existence when the instrument comes due.[17]

Rated notes are generally issued with an unconditional right of repayment as to both principal and interest, a fundamental hallmark of debt. The maturity of these instruments is often set to align with the term of the fund itself, matching or concluding shortly before the scheduled termination date of the fund. Because those funds are generally expected to liquidate within 10-12 years, this term appears reasonable for purposes of debt characterization. The question, however, is how far into the future that maturity can extend before it raises recharacterization concerns. In the case of an open-ended fund, the challenge is determining an appropriate maturity date for its notes; if the date is set too far in the future, there is a risk that it could be disregarded as illusory, undermining the debt classification of the instrument.[18] In that case, the notes may be structured as revolving debt.

B. Right to Enforce Payment of Principal and Interest

The enforcement rights of the holder are another key factor in distinguishing debt from equity. When an instrument grants the holder the rights of a creditor upon default, courts have generally viewed that as supportive of debt treatment.[19] Those rights may include the right to assume control of the issuer upon default, the right to sue to enforce payment of principal and accrued interest, the right to file a claim as a creditor if the issuer enters receivership, the right to institute bankruptcy proceedings, the right to share in the issuer's assets ahead of stockholders in the event of liquidation or dissolution, and the right to recover payments of principal and interest from a sinking fund or through a security interest.[20]

The presence of these rights reflects the economic reality of a debtor or creditor relationship. As a result, if an event of default occurs and noteholders have the customary remedies available to creditors,

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including the right to accelerate the notes and declare them immediately due and payable, this factor should weigh in favor of debt treatment.

Conversely, when those rights are absent, or when the definition of default and the associated remedies diverge from those typically found in debt instruments, the holder's position is more closely aligned with that of a residual owner than a creditor.[21] For example, if the issuer or its equity holders have broad discretion to unilaterally defer payment of principal and interest or to waive defaults altogether, the flexibility of those rights underscores the equity-like character of the instrument.

Rated notes typically have customary events of default including failure to make scheduled payments when due, breaches of material representations and covenants, and insolvency of the rated note feeder. There are also customary creditor remedies. However, the only real recourse is to the cash flow of the rated note feeder.

C. Payments, Seniority, and Subordination to General Creditors

In a typical debt instrument, noteholders are generally entitled to receive or accrue interest without any action by the issuer's management and are not limited by a local law requirement that there be legally available funds. Interest should also be paid ahead of any distributions to equity holders. As such, if payments on an instrument are dependent on a discretionary determination by management, or are subordinated to distributions on equity, the instrument ordinarily will not be treated as debt.[22] Payments on rated notes are generally dependent on underlying distributions from the master fund and can be deferred at the option of the issuer; however, the interest entitlement itself should not be affected by those actions, and holders of rated notes will generally be entitled to any unpaid interest when there are sufficient available funds or at maturity.

Further, an advance of funds is more likely to be treated as equity if the issuer does not have liquid assets or reasonably anticipated cash flow from which to repay the obligation.[23] Thus, when an issuer's projected cash flow is adequate to retire the obligation, there exists little risk that the amount will not be timely repaid, and thus the instrument is more likely to be treated as debt.[24] The rated notes are typically structured with delayed draw features so that funds are advanced incrementally rather than in a single payment. Advances usually coincide with capital calls for limited partners to contribute funds to the rated note feeder, which in turn align with master fund capital calls. Those mechanics generally ensure that the funds remain adequately capitalized and that payments on the rated notes are supported by sufficient assets at the feeder and fund level.

Another important factor to consider is whether the holder of a debt instrument has the right to share with the issuer's general creditors in the event of the issuer's liquidation. Courts have agreed that some subordination is acceptable, but generally the subordination of a security holder's rights upon liquidation to those of general creditors is a factor indicative of an equity interest.[25] How a rated note feeder structures its liquidation rights could affect the determination of the tax treatment of the rated notes. Usually, there is no subordination and the feeder fund's liquidation provisions simply provide for obligations to creditors to be satisfied before any distributions can be made to the partners.

D. Capitalization of the Issuer

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Funds advanced to a thinly capitalized entity generally are treated as evidence of an equity investment.[26] A high debt-to-equity ratio suggests that the funds advanced are at greater risk from the entity's operations, or even beyond the entity's realistic capacity to repay, thereby indicating an equity-like investment.[27]

In the case of rated note structures, investors often provide funding under the notes while making simultaneous capital contributions, with the proportions determined by a targeted debt-to-equity ratio for the rated note feeder that can range between 70 and 90 percent. The general partner may be required to use commercially reasonable efforts to maintain this ratio. That said, some rated note feeders employ a bifurcated structure, in which one class of investors subscribes for the limited partnership interests while others, often institutional investors such as insurance companies, acquire the rated notes. While this alternative structure can help support treating the rated notes as debt, especially when the identity of the holders becomes a decisive factor in making this determination, it can also affect the capitalization of the issuer because funds may not be able to call capital and advances in the same proportion when different holders are involved.

One thing that bears mentioning regarding the debt-to-equity ratio of the rated note feeder is that the underlying investments made by the master fund are often leveraged through securitizations, repurchase agreements, or other borrowing structures. As a result, the effective leverage is much higher than 70 to 90 percent. Still, ratings agencies are comfortable issuing relatively high ratings, despite the significant leverage, which supports the notion that the rated note feeder is not too thinly capitalized.

E. Identity of Holders and Voting Rights

When equity and debt are held proportionately, courts have been more inclined to recharacterize a purported debt instrument as equity.[28] The rationale is that when all holders share in gains and losses on the same basis, they are less likely to enforce creditor remedies, such as demanding repayment or declaring a default, when doing so would harm the venture as a whole.

A distinctive feature of many rated note feeder structures is the requirement that investors subscribe for both notes and equity in the fund in the same proportion. In these cases, the notes are effectively stapled to the limited partnership interests either formally, through restrictions that prevent separate transfer of the instruments, or informally, through ownership and transfer limitations designed to ensure identity of ownership. If a rated note is formally stapled to a limited partnership interest, it is likely to be treated as equity for tax purposes. Even absent stapling, a one-to-one overlap between noteholders and equity holders remains a factor that weighs in favor of equity classification given that there is no clear separation between debtor and creditor interests in connection with the rated notes and the limited partnership interests.

Similarly, a right to participate in management and the right to vote are generally indicative of equity.[29] Although the rated notes themselves may not grant holders direct management or voting rights in the issuer, the fact that the noteholders are also limited partners of the fund may render this distinction effectively meaningless, because their equity position already provides them with those rights, at least to the narrow extent that a limited partner in a fund has consent rights.

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F. Label and Treatment of Instrument for Nontax Purposes

Finally, courts have noted that the label chosen by the parties can be an important indicator of intent. When the parties consistently and unambiguously refer to an instrument as either "debt" or "equity" across all relevant documents (such as governing agreements, offering materials, and accounting records), courts have considered that labeling as a factor in the overall analysis. However, while consistency can strengthen a taxpayer's position, it is rarely determinative if the underlying economic reality of the instrument conflicts with its label.[30]

Similarly, in Notice 94-47, 1994-1 C.B. 357, the IRS said that among the factors that may be considered in determining the characterization of instruments for U.S. federal income tax purposes is "whether the instruments are intended to be treated as debt or equity for non-tax purposes."

Rated notes will be both labeled as debt and treated as debt for nontax purposes. These factors, on their own, should not determine the tax treatment of the rated notes as debt instruments for tax purposes; however, some of the factors taken into consideration by rating agencies engaged to provide rating classifications on the rated notes may (for example, if a ratings agency runs loss severity scenarios that mathematically show the rated notes being repaid in several stress scenarios) strengthen the argument that the rated notes should be treated as debt for tax purposes.

Given that some of these factors weigh in favor of debt and some in favor of equity, it is not surprising that market practice is evolving, although it clearly has not yet settled. Initially, it was more common for parties to take the position that rated notes should be characterized as equity. However, as structures have become more sophisticated and regulators have been scrutinizing the structures, there is increasing pressure to characterize the notes as debt to support the regulatory treatment. Still, for the reasons we discuss below, tax advisers may prefer for the notes to be treated as equity for tax purposes. The totality of these factors should be carefully considered by tax advisers involved in structuring rated note funds and feeder vehicles.

VII. Tax Treatment of the Rated Notes if Classified as Debt

A. Original Issue Discount

If rated notes are treated as debt for federal income tax purposes, they may be subject to OID, equal to the amount of the excess, if any, of their stated redemption price at maturity over their issue price.[31] A debt instrument's stated redemption price at maturity is the sum of all payments provided by the debt instrument other than qualified stated interest payments.[32] The stated redemption price at maturity will typically be a debt instrument's principal amount. However, this will not be the case when there is interest other than qualified stated interest.

The holders of notes that are subject to OID should include the OID in income over the term of the notes in accordance with the rules of reg. section 1.1272-1(b).[33] Simultaneously, the issuer (that is, a rated note feeder) that issues the notes may generally deduct OID for the corresponding amount as interest expense.

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Under normal circumstances, this premature recognition of interest income (before the actual payment of the income) can become unwelcome for taxable investors. This requires an investor to pay the amount of tax due with cash from other sources and can make instruments subject to OID less attractive because of the time value of money and opportunity cost. However, investors in a rated note feeder are uniquely positioned to overcome the phantom income associated with OID because the interest expense deductions are passed through to the partners of the rated note feeder, who typically also hold the notes issued by the rated note feeder.

Because of the PIK feature that is almost always present in rated notes, the notes typically have OID because interest is not unconditionally payable, at least annually. Instead, interest is only payable to the extent the rated feeder fund has sufficient cash flow.

Importantly, as discussed below, interest expense deductions are often limited and have been limited even more so with the enactment of section 163(j) in 2017. Further, interest expense deductions may be limited if the note is an applicable high-yield discount obligation (AHYDO), defined and examined below. As a result of these various limitations, investors (in the case of a rated note feeder treated as a partnership) and the rated note feeder itself (in the case of a rated note feeder treated as a corporation) may not be entitled to the full OID interest expense deduction depending on individual circumstances.

B. Applicable High-Yield Discount Obligation

A note will be considered an AHYDO instrument if it has significant OID as defined under section 163(i)(2),[34] the maturity of the note is more than five years from the issue date, and the yield to maturity of the note equals or exceeds the applicable federal rate plus 5 percent. The AHYDO rules, if applicable, can meaningfully limit the deductibility of OID on the note.

If a note is classified as an AHYDO, the deductibility of OID on the note is subject to two different limitations. If the yield on an AHYDO does not exceed the applicable federal rate by more than 6 percent, the AHYDO rules deny a deduction by the issuer for OID on the AHYDO until paid. If the yield on the debt instrument exceeds the applicable federal rate by more than 6 percent, a portion of the total return on the debt instrument (the disqualified portion) is not deductible at all by the issuer. Simply stated, if the note is classified as an AHYDO, a portion of the OID interest expense will never be deductible and the remainder of the expense will be deductible only upon the actual payment of the associated amount. And while the deferred OID remains nondeductible, the investors will continue to recognize the phantom income associated with OID.

Interest rates on the rated notes are often not high enough to implicate the AHYDO rules. However, particularly when there are multiple tranches of notes, the potential income inclusion without a corresponding interest expense deduction can be a significant concern. It is therefore important for advisers of rated note feeders and investors to be aware of the AHYDO rules.

It should also be mentioned that while section 165(e)(5)(A) expressly limits the application of the AHYDO rules to corporate issuers of debt, section 165(i)(5)(B) grants the secretary authority to prescribe regulations to prevent the avoidance of the AHYDO rules by issuers of debt other than corporations. This has been primarily accomplished through the use of the partnership antiabuse regulations under reg.

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section 1.701-2(e). Under that regulation, the AHYDO rules are applied to partnership issuers of debt, provided the partnership has corporate partners.

C. Feasibility of Catch-Up Payments

One method often used by lenders to avoid classification of their debt as an AHYDO instrument is to implement catch-up payments starting on the first interest payment date following the fifth anniversary of the issue date. Those catch-up payments are explicitly required in the associated loan documents and designed to ensure that the instrument does not have "significant OID" and thus cannot be classified as an AHYDO instrument. More particularly, these provisions alter the terms of the debt so that when the accrued but unpaid OID could exceed one-year yield at the end of any accrual period occurring more than five years after the date of the debt's issuance, the issuer will make a cash payment to the holder (before the end of that post-five-year accrual period) in an amount sufficient to decrease the accrued but unpaid OID to less than the one-year yield as of that date.

In the context of rated note feeders, those catch-up payments may be difficult to implement successfully. Because rated note feeders often invest the proceeds of their notes in a master fund that invests in debt instruments, the primary source of income for rated note feeders is often interest on the underlying debt instruments. That interest may not be sufficient to cover a necessary catch-up payment. There is often uncertainty about whether a catch-up payment can be made. This makes careful planning during the structuring of notes more important if AHYDO classification is to be avoided.

D. Section 163(j)

When the notes are classified as debt for federal income tax purposes, the rated note feeder will generally be entitled to a deduction for the related interest expense. However, the deductibility of the interest expense may be subject to limitation under section 163(j). Section 163(j) generally limits a taxpayer's deduction for net business interest expense to 30 percent of its adjusted taxable income. "Net business interest expense" means the excess of business interest expense over business interest income.[35]

In practice, when a rated note feeder primarily invests in interest-bearing debt instruments, the section 163(j) limitation is unlikely to apply because the rated note feeder typically generates sufficient business interest income to offset its interest expense. By contrast, when the rated note feeder invests in non-interest-generating assets, such as leases or other structured asset strategies, the rated note feeder may have insufficient business interest income and its interest deductions may be limited under section 163(j).

E. Application of Taxable Mortgage Pool Rules to Rated Note Feeders

Another important aspect that rated note funds should consider is whether issuing rated notes to their investors could result in the fund being taxable as a corporation under the taxable mortgage pool (TMP) rules.[36] If a fund (or a portion thereof) is a TMP, it will be subject to U.S. corporate tax with regard to any income received by the fund, and a corporate owner of the fund will not be able to consolidate its ownership in the TMP as part of an affiliated group. The TMP rules apply, however, only to the extent

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that the rated note fund is issuing two or more classes of debt and the fund invests in real estate mortgages, as further explained below.

Generally, an entity will be classified as a TMP if (1) substantially all (80 percent) of its assets consist of debt obligations and more than half of those obligations are secured by real estate mortgages (the asset test), (2) the entity issues debt with two or more maturities (the maturities test), and (3) payments on those issued obligations bear a direct relationship to the payments received on the mortgage assets (the relationship test).[37] Whether an entity is a TMP is determined on each testing day. A testing day is any day on which an entity issues a related debt obligation that is significant in amount.[38]

If a rated note fund's investment strategy results in the fund meeting the asset test, the fund's advisers should carefully consider whether the fund could qualify as a TMP as a result of issuing rated notes to its investors. If the fund issues a single class of notes with matching maturity dates, the risk of the fund being a TMP should be minimal; however, if the notes have different payment schedules (for example, if some notes can be accelerated or pay sequentially under normal payment conditions) or the fund is an open-ended fund (so that investors can be issued rated notes at different dates), the fund may run the risk of qualifying as a TMP unless payments on the rated notes can be structured in a way that does not bear a relationship with the underlying mortgage loans.

This is becoming an increasingly prevalent tax consideration for rated note feeders because players in the mortgage arena are increasingly forming funds using rated note feeder structures and, given securitization structures, are increasingly structuring the debt to involve multiple classes of notes. The easiest fix is to take positions treating all or some of the classes of notes as equity for tax purposes, but this is not without risk, particularly given the inherent ambiguity of the classification of the rated notes for tax purposes. This is because the TMP rules are accompanied by broad antiavoidance provisions designed to prevent taxpayers from structuring around the statute. In particular, the IRS has authority to disregard or adjust any transaction, or series of transactions, undertaken with the intent of replicating the economic effect of a TMP arrangement while avoiding its classification.[39]

This broad authority includes recharacterizing instruments to reflect their true substance by, for example, combining separate transactions for purposes of testing for TMP, looking through certain instruments for purposes of determining whether the relationship test is met, and treating equity interests issued by a fund as debt obligations "if the entity issues equity interests that correspond to maturity classes of debt."[40]

The TMP regulations provide several examples that indicate how the antiavoidance rules may be used by the IRS to disregard or make adjustments to a transaction if the transaction (or series of transactions) is entered into with a view to achieving the same economic effect as that of a TMP when in form no TMP should have been found.[41] While none of the examples directly address rated note feeders, they provide useful insight into how the IRS may approach reclassifying a structure if it deems it to be economically similar to a TMP. For instance, in Example 1, the IRS applies the antiavoidance rule by disregarding the existence of a two-tier trust structure that was artificially separated to avoid TMP status.[42] In Example 4, the IRS applies the antiavoidance rules to the acquisition of loans secured by a partnership interest rather than directly by real estate to find a TMP when there otherwise wouldn't

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have been a TMP based on the form of the transaction.[43] There are no examples illustrating the rule recharacterizing equity in an issuer as debt.

Taking all this into consideration, the IRS could potentially treat rated notes issued by a feeder that are secured by partnership interests in a master fund as secured by mortgage loans held by the master fund if the agency determines that this structure was put in place to avoid TMP. Or the IRS could potentially disregard the existence of the feeder fund if it deems that the structure was put in place to avoid TMP status. If the master fund issues other debt instruments with different maturities, then a TMP concern could arise.

Finally, while there are no examples addressing this fact pattern, the IRS could potentially determine either (1) that rated notes with different maturities that are classified as equity under the debt for tax rules are actually debt instruments for TMP or (2) that equity or preferred equity in a rated feeder fund that has also issued rated notes is better classified as debt for purposes of testing for TMP (however, the regulations allow the IRS to treat interests in the form of equity as debt only if the recharacterized equity interests correspond to maturity classes of debt).

Advisers may want to consider imposing certain restrictions on a fund that meets the asset test to mitigate this risk, as well as disclosing this alternative characterization in the fund offering documents.

VIII. Debt Restructurings Involving Rated Note Funds

We have not yet seen meaningful restructuring activity in the context of rated note funds for a variety of reasons. One of the primary reasons is that rated note funds are still a relatively new product and the maturity dates for most funds with rated note feeders have not yet been reached. The predictability of the underlying cash flows, as indicated by the ratings, suggests a low likelihood of the need to engage in future restructurings. Further, when there is identity of ownership between the rated notes and partnership interests, it is likely that the parties would simply live with a default and forbear. Still, potential complications associated with debt restructurings should be considered.

The following is an examination of certain potential tax considerations arising from debt modifications, equitization, and foreclosure transactions when the rated notes are treated as debt for federal income tax purposes. It does not address the tax treatment of restructurings when the rated notes are treated as equity because there should be no consequences when there is identity of ownership between the holders of the debt and equity (which is typically the case when the rated notes are treated as equity for tax purposes), and even if there is no identity of ownership, there should be consequences only if there is a taxable capital shift.

A. Significant Modification of Rated Notes

When a debt instrument is amended, there is the potential to trigger material federal income tax consequences for both lenders and borrowers, primarily depending on whether (1) there is a significant modification that results in a deemed exchange of the old debt instrument for a new debt instrument (that is, the modified instrument) and (2) if there is a deemed exchange, regardless of whether the debt is considered publicly traded. Many fairly routine modifications to economic terms, such as increasing

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interest rates or paying fees, typically result in a significant modification and, therefore, a deemed exchange.

1. Significant modification.

Under reg. section 1.1001-3, a significant modification of a debt instrument can result in a deemed exchange of the old debt for a new debt instrument. "Modification" is broadly defined in the regulations as any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is indicated by an express agreement (oral or written), conduct of the parties, or otherwise.[44] A modification can occur from amending the terms of a debt instrument or exchanging one debt instrument for another.

Under reg. section 1.1001-3(c)(4)(ii), a lender's agreement to stay collection does not result in a modification (and therefore not a significant modification) unless and until the forbearance period exceeds two years plus any additional period in which the parties are conducting good-faith negotiations. Because this provision is so generous, the mere forbearance by a lender to pursue foreclosure or collection rarely triggers a significant modification. Any forbearance, however, may also involve either an express or implied deferral of any interest or principal payments that are due. It is that deferral that has the potential for triggering a significant modification.

A modification is significant if, based on all facts and circumstances, the legal rights or obligations are materially altered. The tax treatment of a modification as significant looks to the substance of the changes rather than the form of those changes. Significant modifications, and therefore deemed exchanges, may result from many fairly routine modifications to economic terms, such as increasing interest rates, adding a payment-in-kind feature, or paying fees, as well as changes to features such as the security for or guarantee of the instrument in a way that changes payment expectations. While a full discussion of reg. section 1.1001-3 is beyond the scope of this report, a few examples of when a significant modification could occur follow.

One common type of modification is a change in the yield of a debt instrument. An increase or decrease in the interest rate results in a significant modification if the change in yield of the modified debt exceeds the greater of (1) 25 basis points per year and (2) 5 percent of the annual yield on the unmodified debt instrument. The yield of the modified debt is determined by comparing the adjusted issue price of the unmodified debt with the payments that are scheduled to be made on the modified debt from the date of modification.[45]

A significant modification also occurs if there is a material deferral of interest payments. The materiality of a deferral is generally determined based on the overall facts and circumstances. However, a safe harbor provides that deferrals of payments within a period that begins on the due date of the first payment deferred and ends five years later (or, if a lesser period, 50 percent of the original term of the debt instrument) will not be a significant modification.[46]

2. Lender consequences.

A significant modification results in a deemed exchange of the existing debt instrument for a new debt instrument, which may be taxable to the lender to the extent the issue price of the new instrument

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exceeds the lender's adjusted tax basis in the instrument. The federal income tax consequences depend on whether the old debt instrument or the new debt instrument is treated as "publicly traded" as defined in the regulations.

If neither the original debt instrument nor the deemed reissued debt instrument were publicly traded, then the old debt instrument is treated as exchanged for the outstanding principal amount of the new instrument. However, if the debt instrument is treated as publicly traded, the issue price of the modified debt instrument will ordinarily be the market price.

A debt instrument is treated as publicly traded if (1) the outstanding principal amount of the issue that includes the debt instrument exceeds $100 million and (2) at any time during the 31-day period ending 15 days after the issue date (or in the case of a workout that is treated as a significant modification, the deemed reissue date), a sales price, a firm quote, or an indicative quote is available for the instrument. These rules are viewed to cast a wide net in terms of what can cause an instrument to be treated as publicly traded.

Given the typical identity of interest between the lenders and limited partners, in many cases, the rated notes will not be publicly traded and will be held by the same owners until the liquidation of the fund. However, there may be secondary trading of fund interests. While the feeder fund limited partnership agreement will typically contain meaningful transfer restrictions, it may be that there are transfers of fund interests that are permitted under the feeder fund limited partnership agreement, and the transfer will likely be of both the rated notes and the limited partnership interests. If the rated notes and limited partnership interest are stapled, the transfer necessarily would be of both instruments. It is possible that these secondary market transfers of fund interest and rated notes could cause the rated notes to be treated as publicly traded. Although this is largely a theoretical risk, given the breadth of what is treated as publicly traded under the applicable regulations, the rated notes could be treated as publicly traded.

The character of the lender's loss in connection with the deemed exchange as a result of the significant modification of the debt instrument is fact specific and dependent in part on the other activities of the lender (for example, whether it is a bank or otherwise in the business of making loans or is a dealer). The loss may be a worthless security loss under section 165 or a bad debt deduction under section 166, depending on the particular facts and circumstances of the lender.[47]

If there is a difference between the issue price of the modified debt instrument and the stated redemption price of a maturity, that will constitute OID and, as discussed above, must be accrued over the life of the loan on a yield-to-maturity basis. As a result, it may not be particularly advantageous for a lender to claim a loss (particularly if capital) if it is required to accrue OID over the life of the modified loan.

It is also possible that the lender may recognize a gain if the loan was issued at a discount and, as a result, the lender's tax basis in the loan is less than the issue price of the modified debt instrument. Thus, the significant modification and deemed reissuance would have the unexpected consequence of accelerating income recognition when there is no actual cash received by the lender.

3. Limited partner consequences.

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As a general matter, cancellation of indebtedness (COD) income arises if a borrower repurchases its debt for an amount less than the "adjusted issue price" of the outstanding debt. If neither the new nor old debt is considered "publicly traded" and there is no change in principal amount, COD income generally should not be generated. However, if the debt is considered publicly traded, the old debt instrument is treated as being repaid for an amount equal to the fair market value (ordinarily the sales price or quoted price) of the debt, and the resulting COD income is the difference between that value and the adjusted issue price of the old debt instrument.

If the debtor is not bankrupt or insolvent when the debt is cancelled, then the COD income is taxable ordinary income to the debtor. If, however, the debtor is a corporation and is insolvent or in bankruptcy when the COD income is recognized, then some of or all the COD can be excluded from income. However, it is important to note that, in the case of partnerships, the bankruptcy and insolvency exceptions are applied at the partner, rather than the partnership, level. Thus, COD income arising from a partnership in bankruptcy will be excluded only if the partner also is in bankruptcy. Thus, each limited partner would include its distributive share and COD income in its taxable income, assuming that no partner-level exclusions from COD income are applicable.

4. Potential mismatches if lenders and limited partners are the same.

In the context of rated note feeders, there is the potential for mismatches of character in the case of a significant modification of the rated notes when the holders of the rated notes are the same as the limited partners of the feeder fund that is the borrower. As discussed above, if the lender recognizes a loss in connection with the deemed exchange of the existing debt instrument for the modified debt instrument, the character of the loss could be capital. The magnitude of the loss could be significant if the rated notes are viewed as publicly traded.

In contrast, if the feeder fund recognizes COD income, the character of that income will be ordinary. An investor that holds both rated notes and limited partnership interests could be in the unenviable position of having a capital loss (with subsequent OID inclusions) and ordinary income.

B. Equitization of Rated Notes

If a debt instrument issued by a partnership is exchanged for an interest in that partnership, the tax treatment of the lender and borrower differ from a debt-for-debt exchange. Generally, this transaction is treated as a contribution of the debt to a partnership, and the consequences are governed by sections 108 and 721.

1. Lender consequences.

The regulations also provide that section 721 will apply to a creditor's contribution of a partnership's indebtedness to the partnership in exchange for an interest in the partnership.[48] Thus, neither gain nor loss is generally recognized by the creditor. The creditor will have a tax basis in its partnership interest equal to its tax basis in the extinguished debt instrument. However, section 721 does not apply to a debt-for-equity exchange to the extent the transfer of the partnership interest to the creditor is in exchange for the partnership's indebtedness of interest that accrued on or after the beginning of the creditor's holding period for the indebtedness.

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2. Limited partner consequences.

When a creditor agrees to an extinguishment of a debt instrument in exchange for an interest in the partnership, section 108(e)(8) provides that a debtor partnership has COD income equal to the difference between the adjusted issue price of the debt and the FMV of the partnership interest.[49]

The regulations provide guidance on how to value partnership interests for this purpose. The regulations provide a safe harbor if the partnership and the creditor may value the partnership interest transferred to the creditor based on the liquidation value of the transferred partnership interest.[50] For this purpose, liquidation value equals the amount of cash the creditor would receive for the debt-for-equity interest if, immediately after the transfer, the partnership sold all its assets (including intangibles) for cash equal to their FMV and then liquidated.

For this approach to be eligible for the safe harbor, certain conditions must be satisfied: (1) the creditor, debtor partnership, and the partners treat the FMV of the debt as equal to the liquidation value for purposes of determining the tax consequences of the debt-for-equity exchange; (2) if, as part of the same overall transaction, the debtor partnership transfers more than one debt-for-equity interest to one or more creditors, then each creditor, debtor partnership, and its partners treat the FMV of each debt-for-equity interest transferred by the debtor partnership to the creditors as equal to its liquidation value; (3) the debt-for-equity interest exchange is a transaction with terms that are comparable to terms that would be agreed to by unrelated parties negotiating with adverse interests; and (4) after the exchange, neither the partnership redeems nor any related person purchases the debt-for-equity interest as part of a plan to avoid COD income.[51]

To the extent that the partnership recognizes COD income, it will be allocated to the partners that are partners immediately before the discharge in accordance with their interest in the partnership.[52] Any income allocated to those partners will increase their tax basis in their partnership interests.

Moreover, when the partnership's debt is decreased, each partner's share of the partnership liabilities decreases. Under section 752(b), a decrease in a partner's share of partnership liabilities is treated as if the partner received a cash distribution from the partnership. This deemed distribution of cash decreases the partner's basis in their partnership interest.[53] To the extent the deemed distribution (the decrease in liabilities allocated to the partner) exceeds the adjusted basis of the partner's interest in the partnership, the partner must recognize gain.[54] In situations in which a partnership has COD income, the increase in basis resulting from the allocation of COD income may offset in part the decrease in basis resulting from the deemed distribution from debt cancellation.

3. Potential mismatches if lenders and limited partners are the same.

In connection with a transaction in which a lender that is also a partner in the borrower partnership exchanges the debt instrument for an additional interest in the partnership, it is possible that a partner could recognize COD income from the discharge of partnership liabilities. Because the deemed contribution of the debt to the partnership would be tax free under section 721, any such partner would recognize taxable income without being able to claim a corresponding loss.

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C. Foreclosure of Assets of the Rated Note Feeder

If the notes are treated as nonrecourse for tax purposes,[55] in connection with a foreclosure on the assets of the rated note feeder, the feeder would be treated as selling its assets to the holders of the rated notes in exchange for the extinguishment of its debt.[56]

1. Lender consequences.

Under a foreclosure in which the holders of the rated notes take title to the assets of the rated note feeder in extinguishment of rated notes, the foreclosure would be treated as an exchange to which section 1001 applies. Thus, the note holders should recognize gain or loss on the exchange equal to the excess of the FMV of the assets of the rated note feeder over their tax basis in the rated notes.

As discussed above, the character of the lender's loss in connection with the deemed exchange as a result of the significant modification of the debt instrument is fact-specific and dependent in part on the other activities of the lender (for example, whether it is a bank or otherwise in the business of making loans or is a dealer).

Further, it is possible that certain loss limitation rules, such as section 267, could apply to deny any loss.

2. Limited partner consequences.

If the rated note feeder is treated as selling its assets to the holders of the rated notes in exchange for the extinguishment of its debt, the rated note feeder would recognize gain or loss equal to the difference between its tax basis in the asset transfers and the amount realized. The amount realized would be the outstanding principal amount of the debt, including interest that has been "paid in kind." Any gain or loss recognized by the rated note feeder would flow through to the limited partners.

Although the character of any income recognized in connection with the deemed sale of assets of the rated note fund (that is, partnership interests in the master fund) should generally be capital gain, there are rules that recharacterize that gain as ordinary income if the master fund holds certain assets that generate ordinary income (so-called hot assets).[57] This could occur, for example, if the fund were engaged in dealer activity and the underlying debt obligations owned by the master fund were treated as inventory.

3. Potential mismatches if lenders and limited partners are the same.

In connection with a transaction in which a lender that is also a limited partner in the rated note feeder forecloses on its assets, there could be differences in the amount and character of gain or loss recognized in connection with the deemed exchange. This may come as a surprise to investors in these structures that would have thought that the tax consequences would be offsetting.

IX. Tax Treatment of the Rated Notes if Classified as Equity

If the rated notes are properly characterized as equity from a tax perspective, the same considerations applicable to any investment in a fund generally apply. Issues such as section 163(j) (absent the

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application of antiabuse rules as discussed below), AHYDO, and the TMP rules generally should be inapplicable. However, the primary area of uncertainty concerns issues that tax practitioners wrestle with in the context of preferred partnership interests. Those issues relate to whether payments under the rated notes should be treated as guaranteed payments or simply reflected as a priority payment of the partners' distributive share of partnership income and, if the payments are treated as guaranteed payments, what the tax considerations are.

If the rated notes are properly characterized as equity, another tax issue to consider is that it is theoretically possible that the issuance of the rated notes could result in a taxable capital shift in circumstances when there is no identity of ownership between the holders of the notes and the holders of a limited partnership interest. However, this does not seem terribly compelling because, as of the date of issuance, the holders of the rated notes would not be entitled to share in the capital of the limited partners on a hypothetical liquidation. We do not discuss this potential characterization in light of the foregoing. Still, there are interesting arguments that the preferred return accruals on a preferred partnership interest can result in a taxable capital shift.[58]

A. Guaranteed Payments vs. Distributive Share

When the rated notes are treated as equity and the rated note feeder is treated as a partnership for tax purposes, the economic rights of the noteholders may be characterized as guaranteed payments. Under section 707(c), guaranteed payments are amounts paid by a partnership to a partner for services rendered or for the use of capital, to the extent those payments are determined without regard to the income of the partnership.[59]

In a typical rated note feeder structure, the interest payable on the rated notes represents compensation for the use of capital contributed by the noteholders. The feeder is obligated to make the interest and principal payments regardless of whether it has income or profits in a given period. These features generally support treating the payments on the notes as guaranteed payments, rather than as allocations of partnership income under section 704(b).

However, there are also factors supporting the characterization that the interest payments should instead be treated as a priority distribution of partnership profits. The only source of funding for interest payments is the underlying cash flow received by the feeder fund from the master fund. Given that the interest payments on the rated notes are typically PIK, they could be viewed as dependent on the profits of the fund, subject to the ultimate payment obligations at maturity or upon default. In structures in which there is identity of ownership between the holder of the rated notes and the limited partnership interests (and the general partner has no economic interest, which is typical), there is arguably no economic significance to the interest payments if the notes are treated as equity. All investors share in the economics pro rata.

But there is no clear authority addressing whether a guaranteed payment for the use of capital should be treated as a separate interest-like item of income or instead as part of the recipient partner's distributive share of the partnership's underlying income.

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Both the House and Senate reports from the legislative history to section 707(c) provide that guaranteed payments should not be considered a distributive share. The House report indicated the intent of section 707(c) was "that payment of a fixed or guaranteed amount for services . . . be treated as salary income to the recipient and allowed as a business deduction to the partnership."[60] It went on to say that "the amount of such salary shall be included in the partner's gross income, and shall not be considered a distributive share of partnership income or gain."[61] The Senate version of section 707(c), which was ultimately adopted into law, purported to extend the treatment to guaranteed interest payments on capital.[62] The Senate report reiterated the House view that salary payments would be included in the recipient's gross income and would not constitute a distributive share of partnership income.[63] Further, it said that it intended to provide "the same treatment as that provided in the case of guaranteed salaries to payments for the use of capital, to the extent the payments are determined without regard to partnership income."[64] That being said, there is no indication whether the House and the Senate considered that guaranteed payments should constitute interest (and not a distributive share of partnership income) for all purposes of the code, such as the rules for income that is effectively connected with the conduct of a U.S. trade or business. In fact, reg. section 1.707-1(c) provides the following:

> Guaranteed payments do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b), and 708(b). For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income.

However, other regulations appear to support the treatment of guaranteed payments as interest. Under reg. section 1.704-1(b)(2)(iv)(o), guaranteed payments only result in adjustments to the capital account of the recipient partner to the extent of the deduction or loss of the partnership resulting from the payment. This supports the view that guaranteed payments are not a distributive share of income because that income generally would increase the recipient's capital account when recognized under section 704 and decrease its capital account when paid under section 731, neither of which appears to be permitted by reg. section 1.704-1(b)(2)(iv)(o).

The issue is also unsettled in case law. In *Miller*,[65] the Tax Court held that certain guaranteed payments that the taxpayer received in exchange for services provided to the firm constituted salary and therefore earned income for purposes of section 911 and not a distributive share of partnership income. However, in *Kampel*,[66] the court took the opposite approach and held that guaranteed payments are properly viewed as a distributive share for purposes of former section 1348, which imposed a maximum tax rate on earned income, as defined in section 911.[67] In *Mallary*,[68] the Tax Court also adopted the distributive share approach, holding that a guaranteed payment for services does not decrease the amount of net income from property held by a partnership for purposes of calculating the depletion allowance under section 613.

In GCM 36702,[69] the IRS commented on a proposed revenue ruling about whether an advance to a partnership was properly viewed as equity rather than debt. The IRS concluded that the advance should be treated as equity, saying that section 707(c) "permits a partner to earn interest on capital

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contributions." The agency found no issue with interest characterization despite the fact that section 707(c) allows a deduction to the partnership under section 162 rather than section 163, saying:

> Although Code section 707(c) contains no reference to Code section 163, we believe that guaranteed payments for the use of capital constitute interest income under Code section 61(a)(4). . . . The fact that the deduction of guaranteed interest payments is limited by Code section 162 does not affect the characterization of those payments as interest income under Code section 61(a)(4).

In the real estate investment trust context, the IRS has taken the opposite approach. For example, in LTR 8728033 it characterized a guaranteed payment received by a REIT as a distributive share of the income of the payer partnership in determining whether that payment constituted qualifying rental income under section 856(c).[70] It is worth noting that these REIT rulings are geared toward a specific situation: determining whether the REIT would satisfy the income tests of section 856(c). It is possible that the IRS was motivated to help taxpayers in those rulings, given the severe consequences that could result from the taxpayer losing its REIT status.

In light of the above, we are of the view that either position is supportable and the ultimate position taken should depend on the ownership of the notes and feeder fund interests. When there is complete identity of ownership, the more intuitive approach is to treat the interest payments for the notes as a distributive share of partnership income. In contrast, when there is disparate ownership, guaranteed payment characterization may be more appropriate. In a similar manner to the characterization of the rated notes as debt or equity, there is similar ambiguity here.

B. Tax Consequences of Guaranteed Payments

The payment of interest on the notes would generally be treated as an ordinary and necessary expense of the rated note feeder under section 162, giving rise to a corresponding deduction at the fund level. That deduction would then be allocated among the partners of the feeder in accordance with their respective interests under section 704. The noteholder would include the payment as ordinary income in its tax year that includes (or ends with) the feeder's tax year in which the interest payment is deducted or accrued, depending on the feeder's method of accounting.[71]

C. Section 163(j)

When the interest payments are treated as guaranteed payments, section 163(j) does not generally apply to guaranteed payments unless certain conditions apply. Final regulations promulgated under section 163(j) exclude guaranteed payments for the use of capital from the definition of interest for purposes of these rules, unless the antiavoidance rule in the regulations applies. The antiavoidance rule includes an example of a situation in which a guaranteed payment for the use of capital is treated as interest expense and interest income for purposes of section 163(j).[72] In this example, a partner in the partnership, which has significant debt and interest expense, agrees to make an additional contribution to the partnership for use in its business operations in exchange for a guaranteed payment for the use of capital under section 707(c). A principal purpose of the partner's making a contribution in exchange for a guaranteed payment for the use of capital was to reduce the amount incurred by the partnership

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that otherwise would be interest expense. As a result, the example concludes that, for purposes of section 163(j), the guaranteed payment is treated as interest expense of the partnership. Moreover, if the partner knows that the guaranteed payment is treated as interest expense of the partnership, the guaranteed payment is treated as interest income of the partner. It is uncertain whether the IRS may assert that the antiavoidance rule applies to guaranteed payments, but it's likely that guaranteed payments are not considered interest for purposes of section 163(j) if the rated note feeder has a clear business purpose for raising the funds and no material discussion of any tax benefits to investors occurs as part of the negotiations.

X. Conclusion

Although even seasoned tax practitioners might be lulled into thinking that the tax considerations associated with rated note feeder structures are pedestrian, as these fund structures become more prevalent and continue to evolve, our awareness of the potential issues grows. Of particular concern is that when there is identity of interest of holders of rated notes and limited partnership interests, in certain circumstances, the tax consequences are not reciprocal and offsetting. As discussed in this report, there are several situations when asymmetries are present. We thus encourage practitioners to be more thoughtful in considering issues concerning the intended tax treatment of rated notes and the resulting consequences of a particular characterization.

FOOTNOTES

[1] *See, e.g.*, Robert M. Kane Jr., "Tax Considerations for Rated Note Funds," *Tax Notes Federal*, Apr. 7, 2025, p. 47.

[2] We refer to instruments that are treated as equity for regulatory purposes as limited partnership interests for ease of reference, even though the terminology in the fund documents may differ.

[3] The term "master fund" refers to the main fund vehicle in which other investors invest directly or indirectly through other nonrated feeder funds.

[4] *See Commissioner v. Meridian & Thirteenth Realty Co.*, 132 F.2d 182, 186 (7th Cir. 1942).

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

[6] *See Berkowitz v. United States*, 411 F.2d 818, 820 (5th Cir. 1969).

[7] *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972). There is no definitive list of factors. For example, the Tax Court cited a set of 11 "nonexclusive factors" that courts use when analyzing debt-equity questions. *Javorski v. Commissioner*, T.C. Summ. Op. 2010-136. *See also Ramig v. Commissioner*, T.C. Memo. 2011-147 (11 factors), and *Knutsen-Rowell Inc. v. Commissioner*, T.C. Memo. 2011-65 (seven factors). Notice 94-47, 1994-1 C.B. 357, provides that the characterization of an instrument for federal income tax purposes depends on the terms of the instrument and all related facts and circumstances. The notice identifies the following factors as being among those that may be considered in making that determination: (1) whether there is an unconditional promise on the part of the issuer to pay a sum

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certain on demand or at a fixed maturity date that is in the reasonably foreseeable future; (2) whether holders possess the right to enforce the payment of principal and interest; (3) whether the rights of the holders of the instrument are subordinate to rights of general creditors; (4) whether the instruments give the holders the right to participate in the management of the issuer; (5) whether the issuer is thinly capitalized; (6) whether there is identity between holders of the instruments and stockholders of the issuer; (7) the label placed on the instrument by the parties; and (8) whether the instrument is intended to be treated as debt or equity for nontax purposes, including regulatory, rating agency, or financial accounting purposes.

[8] *See Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968); *Development Corp. of America v. Commissioner*, T.C. Memo. 1988-127; Rev. Rul. 85-119, 1985-2 C.B. 60; Rev. Rul. 83-98, 1983-2 C.B. 40; Notice 94-47. *See also* section 385.

[9] *See Tyler v. Tomlinson*, 414 F.2d 844, 848 (5th Cir. 1969) (observing "the object of the inquiry is not to count factors, but to evaluate them").

[10] *Fin Hay Realty Co.*, 398 F.2d 694. *See also Javorski*, T.C. Summ. Op. 2010-136 (citing *Fin Hay Realty Co.*).

[11] *See TIFD III-E Inc. v. United States*, 459 F.3d 220, 233 (2d Cir. 2006); *Hambuechen v. Commissioner*, 43 T.C. 90, 101 (1964).

[12] *Gilbert*, 248 F.2d 399.

[13] *Hubert Enterprises Inc. v. Commissioner*, 125 T.C. 72, 95 (2005).

[14] *Federal Projects Inc. v. Commissioner*, T.C. Memo. 1987-202.

[15] *Hartman v. Commissioner*, T.C. Memo. 1958-206.

[16] *Pritired 1 LLC v. United States*, 816 F. Supp. 2d 693 (S.D. Iowa 2011).

[17] *See Monon Railroad v. Commissioner*, 55 T.C. 345, 359 (1970).

[18] *See* Notice 94-47 (warning taxpayers that *Monon Railroad*, 55 T.C. 345, which classified an instrument with a 50-year term as debt, generally does not provide support for treating an instrument as debt for federal income tax purposes if that instrument combines a long maturity with substantial equity characteristics); *Swoby Corp. v. Commissioner*, 9 T.C. 887, 894 (1947), *aff'd*, 10 T.C. 129 (1948) (holding that a term of 99 years was unreasonable when that term far exceeded the life of the corporation's principal asset and that the instrument was equity, not debt); *Reef Corp. v. Commissioner*, T.C. Memo. 1965-72 (finding a 15-year term excessive in the case of an extractive industry with limited reserves and holding that the debt instrument actually represented a proprietary interest), *aff'd*, 368 F.2d 125 (5th Cir. 1966).

[19] *See In re Lane*, 742 F.2d 1311, 1317 (11th Cir. 1984); *Estate of Mixon*, 464 F.2d at 405-406.

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[20] *See In re Lane*, 742 F.2d at 1317 (concluding that an instrument that did not provide for a sinking fund from which interest and principal payments could be made and did not provide for a security interest was properly classified as equity); *Bowersock Mills & Power Co. v. Commissioner*, 172 F.2d 904, 907 (10th Cir. 1949) (holding an instrument to be debt when the holders of that instrument would become owners of the corporation upon default); *Bolinger-Franklin Lumber Co. v. Commissioner*, 7 B.T.A. 402, 407-408 (1927) (concluding that an instrument permitting holders to assume control of the corporation upon default was properly classified as debt), *acq.*, 1928-1 C.B. 4.

[21] *See Miele v. Commissioner*, 56 T.C. 556, 565 (1971), *acq.*, 1972-2 C.B. 2, *aff'd*, 474 F.2d 1338 (3d Cir. 1973) (holding an instrument to be stock when holders could not file claims as creditors if the corporation went into receivership).

[22] *See Berkowitz*, 411 F.2d at 821; *Lee Telephone Co. v. Commissioner*, 260 F.2d 114, 116 (4th Cir. 1958); *Wetterau Grocer Co. v. Commissioner*, 179 F.2d 158, 160 (8th Cir. 1950); *Green Bay & W.R. Co. v. Commissioner*, 147 F.2d 585, 586 (7th Cir. 1945); *Gokey Properties Inc. v. Commissioner*, 34 T.C. 829, 835 (1960), *aff'd*, 290 F.2d 870 (2d Cir. 1961); *Wilbur Security Co. v. Commissioner*, 31 T.C. 938, 952 (1959), *acq.*, 1959-2 C.B. 7, *aff'd*, 279 F.2d 657 (9th Cir. 1960).

[23] *See Estate of Mixon*, 464 F.2d at 405; *Segel v. Commissioner*, 89 T.C. 816, 830-831 (1987).

[24] *See Santa Anita Consolidated Inc. v. Commissioner*, 50 T.C. 536, 553 (1968).

[25] *See Milwaukee & Suburban Transport Corp. v. Commissioner*, 283 F.2d 279, 283 (7th Cir. 1960); *Crawford Drug Stores Inc. v. United States*, 220 F.2d 292, 296 (10th Cir. 1955); *John Wanamaker Philadelphia v. Commissioner*, 139 F.2d 644, 647 (3d Cir. 1943); *Meridian & Thirteenth Realty Co.*, 132 F.2d at 188; *Miele*, 56 T.C. at 565; *Ragland Investment Co. v. Commissioner*, 52 T.C. 867, 877 (1969) (subordination to general creditors upon the dissolution of the corporation is an important characteristic of a stockholder relationship).

[26] *See Hardman v. United States*, 827 F.2d 1409, 1414 (9th Cir. 1987).

[27] *See Gyro Engineering Corp. v. United States*, 417 F.2d 437 (9th Cir. 1969).

[28] *See Tomlinson v. 1661 Corp.*, 377 F.2d 291, 297 (5th Cir. 1967); *Gilbert*, 248 F.2d at 399.

[29] *See Estate of Mixon*, 464 F.2d at 406.

[30] *See Milwaukee & Suburban Transport Corp.*, 283 F.2d at 283.

[31] Section 1273(a)(1).

[32] Section 1273(a)(2).

[33] Section 1272(a)(1).

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[34] A debt obligation has significant OID if the aggregate amount that would be includible in gross income for the debt obligation for periods before the close of any accrual period (as defined in section 1275(a)(5)) ending after the date five years after the date of issue exceeds the sum of the aggregate amount of interest to be paid under the debt obligation, before the close of the accrual period, and the product of the issue price of the debt obligation and its yield to maturity.

[35] Section 163(j)(1); reg. section 1.163(j)-2(b)(1).

[36] *See* section 7701(i).

[37] Reg. section 301.7701(i)-1(b).

[38] Reg. section 301.7701(i)-3(c)(2).

[39] Reg. section 301.7701(i)-1(g).

[40] Reg. section 301.7701(i)-1(g)(1).

[41] *Id.*

[42] In Example 1, a partnership, in addition to its other investments, owns $10 million of mortgage passthrough certificates. On May 15, 1997, the partnership transfers the passthrough certificates to Trust 1 in exchange for 100 Class A bonds and Certificate 1. The Class A bonds, under which Trust 1 is the obligor, have a stated principal amount of $5 million and bear a relationship to the passthrough certificates. Certificate 1 represents the residual beneficial ownership of the passthrough certificates. On July 5, 1997, with a view to avoiding the application of the TMP rules, the partnership transfers Certificate 1 to Trust 2 in exchange for 100 Class B bonds and Certificate 2. The Class B bonds, under which Trust 2 is the obligor, have a stated principal amount of $5 million, bear a relationship to the passthrough certificates, and have a different maturity than the Class A bonds. Certificate 2 represents the residual beneficial ownership of Certificate 1. For purposes of determining whether Trust 1 is classified as a taxable mortgage pool, the example in the regulations provides that the IRS can disregard the separate existence of Trust 2 and treat Trust 1 and Trust 2 as a single trust, which would result in the single trust being a TMP. Reg. section 301.7701(i)-1(g)(2), Example 1.

[43] In Example 4, corporation Y, in addition to its other assets, owns $1.9 million in obligations secured by personal property. On November 1, 1995, Y begins negotiating a $2 million loan to individual A. As security for the loan, A offers a first deed of trust on land worth $1.7 million. With a view to avoiding the application of section 7701(i), Y induces A to place the land in a partnership in which A will have a 95 percent interest and agrees to accept the partnership interest as security for the $2 million loan. The loan to A, together with the $1.9 million in obligations secured by personal property, is then transferred to Trust 5 and used to issue bonds that have different maturities (within the meaning of reg. section 301.7701(i)-1(e)) and that bear a relationship (within the meaning of reg. section 301.7701(i)-1(f)) to the $1.9 million in obligations secured by personal property and the loan to A. For purposes of determining whether Trust 5 is a taxable mortgage pool, the commissioner can treat the loan to A as an obligation

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secured by an interest in real property rather than as an obligation secured by an interest in a partnership. Reg. section 301.7701(i)-1(g)(2), Example 4.

[44] Reg. section 1.1001-3(c)(1)(i).

[45] Reg. section 1.1001-3(e)(2).

[46] Reg. section 1.1001-3(e)(3).

[47] The character of a worthless security deduction under section 165 is capital, and a bad debt deduction under section 166 is ordinary. The scope of these provisions is beyond the reach of this discussion.

[48] Reg. section 1.721-1(d)(1).

[49] Section 108(e)(8)(B).

[50] Reg. section 1.108-8(b)(1).

[51] *Id.*

[52] For a detailed discussion of the tax considerations associated with allocating COD income to partners in a partnership, *see* Linda Z. Swartz, "Partnership Bankruptcy Tax Issues," Cadwalader LLP (2015). Note also that a partnership's ability to allocate COD income attributable to a reduction of nonrecourse debt is limited if the debt cancellation causes a minimum gain chargeback. In that instance, the COD must be allocated under the minimum gain chargeback rules to the partners whose shares of nonrecourse debt were reduced in the same ratio as the debt was reduced. Reg. section 1.704-2(i)(4).

[53] Section 733.

[54] Section 731(b).

[55] A discussion about what constitutes nonrecourse for purposes of these rules is outside the scope of this report.

[56] *See Tufts v. Commissioner*, 461 U.S. 300 (1983).

[57] *See* sections 741 and 751.

[58] *See, e.g.*, Deborah L. Paul, "What's Unrealized About the Tax Treatment of Partnership Capital Shifts," *Tax Notes Federal*, Sept. 19, 2022, p. 1835.

[59] Section 707 and reg. section 1.707-1(c).

[60] H.R. Rep. No. 1337, at 68 (1954), as reprinted in 1954 U.S.C.C.A.N. 4017, 4094.

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[61] *Id.* at 4367.

[62] S. Rep. No. 1622, at 386 (1954).

[63] *Id.* at 387.

[64] *Id.*

[65] *Miller v. Commissioner*, 52 T.C. 752 (1969), *acq*. 1972-2 C. B. 2.

[66] *Kampel v. Commissioner*, 72 T.C. 827 (1979), *aff'd*, 634 F.2d 708 (2d Cir. 1980).

[67] *See also Mallary v. United States*, 238 F. Supp. 87 (1965) (holding that a guaranteed payment for services does not decrease the amount of net income from property held by a partnership for purposes of calculating the depletion allowance under section 613; the court held that, at least for purposes of that section, the guaranteed payment for services should be viewed as one way of providing the recipient with its distributive share).

[68] *Mallary*, 238 F. Supp. 87.

[69] GCM 36702 (1976).

[70] *See also* LTR 8639035.

[71] Reg. section 1.707-1(c).

[72] Reg. section 1.163(j)-1(b)(22)(v)(E), Example 5.

END FOOTNOTES

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