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# ARTICLES

## Profits-Only Partnership Interests

Bradley T. Borden<sup>†</sup>

*Profits-only partnership interests grant service-providing partners an interest in the profits of a partnership but not its capital. Such interests are a proverbial double-edged sword: they create economic arrangements needed in business, but provide opportunities for inequitable tax reductions. Business participants make economic decisions to use profits-only partnership interests to reduce agency costs and appropriable rents. The current law, however, empowers business participants to form partnerships that are equivalent to employment arrangements and use profits-only partnership interests to obtain long-term capital gains. Thus, with no economic consequences, they convert ordinary income (taxed at up to thirty-five percent) to long-term capital gain (taxed at fifteen percent). Commentators and lawmakers generally propose partnership disaggregation to eliminate the inequity. Partnership disaggregation changes the character of income (from capital gain to ordinary income) as it flows from the partnership to service-providing partners. Partnership disaggregation may enhance equity, but it ignores the nature of tax partnerships, threatens the partnership tax regime, and has other negative side effects. This Article suggests that partnership disregard is a better way to address the inequity caused by profits-only partnership interests. Partnership disregard uses economic concepts to identify the policy-relevant differences between tax partnerships and disregarded arrangements, such as employment arrangements, leases, and loans. Partnership disregard distinguishes arrangements that should qualify for partnership tax treatment from those that should not. It eliminates inequity while preserving the integrity of the partnership tax regime and other areas of the law.*

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## I. INTRODUCTION

Consider a situation that plays out innumerable times each year. Two people, Cory and Travis, respectively own property and services. Cory and Travis would like to join Cory's property and Travis's services in a money-making enterprise. Planning for such enterprise, they face myriad legal, economic, and other considerations. Of particular interest are the economic considerations they face.<sup>1</sup> The economic considerations include controlling appropriable quasi rents and agency costs.<sup>2</sup> Cory and Travis have various tools at their disposal to help reduce such costs. For example, they can integrate the property and services to help reduce appropriable quasi rents,<sup>3</sup> and they can use profit-sharing and other arrangements to help reduce agency costs.<sup>4</sup>

After making decisions regarding the economic aspects of the arrangement, Cory and Travis must also consider the tax ramifications of the form they choose for their arrangement. The current law grants Cory and Travis significant latitude in choosing the type and amount of taxes they will pay. For example, if Cory were to hire Travis as an employee to manage the property and pay him a percent of the profits from the property, the compensation to Travis would be income.<sup>5</sup> Travis's tax rate on that income could reach as high as thirty-five percent.<sup>6</sup> If Cory and Travis were to form a corporation and grant stock to Travis in exchange for his services, Travis would recognize compensation income on the

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<sup>1</sup> The economic considerations are of particular interest because they define the arrangement. The legal considerations are important because they help ensure that the parties are able to meet and preserve their economic objectives. Tax considerations are also important, but as this Article discusses, tax law should recognize the economic arrangement and not affect the parties' decision.

<sup>2</sup> See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) (defining agency costs as those costs that arise from an agent not always acting in the best interest of the principal, which costs include the principal's monitoring expenditures of the agent, bonding expenditures by the agent, and residual loss incurred when the agent's actions diverge from the principal's interests); Benjamin Klein, Robert G. Crawford & Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297, 298 (1978) (defining appropriable quasi rents as the portion of the value of an item under contract in excess of its value in its next best use).

<sup>3</sup> See Klein, Crawford & Alchian, *supra* note 2, at 307 ("[I]ntegration by common or joint ownership is more likely, the higher the appropriable specialized quasi rents of the assets involved.").

<sup>4</sup> See Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 786 (1972) (discussing situations in which profit sharing helps reduce shirking, a form of agency cost).

<sup>5</sup> See I.R.C. § 61(a)(1) (2006); Treas. Reg. § 1.61-2(a)(1) (as amended in 2003) (listing "compensation for services on the basis of percentage of profits" as "income to the recipient[]" unless excluded by law"). All code and section references are to the Internal Revenue Code of 1986, as amended, unless stated otherwise.

<sup>6</sup> See I.R.C. § 1(i)(2) (setting the maximum tax rate at thirty-five percent for taxable years beginning in 2003 or thereafter). This is the typical tax treatment of an investment advisor (such as a mutual fund company, a bank, or a broker) hired to manage another person's property. Making payment of fees contingent on performance should not change the tax treatment.

grant of the stock.<sup>7</sup> That income would be subject to the same tax rate, which could be as high as thirty-five percent. If the income from the property will be long-term capital gain, the parties could consider using a limited liability company that tax law treats as a partnership. The limited liability company would help convert Travis's income to long-term capital gain, which would be subject to a fifteen percent tax rate.<sup>8</sup> If the intent is to have an employment arrangement, the corporate form would alter the economics.<sup>9</sup> The limited liability company does not, however, have to materially alter their economic arrangement. Thus, Travis and Cory can maintain their preferred economic arrangement but choose between two very different tax regimes.

Several factors create such a stark difference in tax treatment. First, state law grants members of limited liability companies significant leeway in drafting their governing documents.<sup>10</sup> Cory and Travis could draft an operating agreement that vests each with substantially the same rights and obligations they had under their employment agreement.<sup>11</sup> Second, the definition of tax partnership is ambiguous, but most tax practitioners, commentators, and the Internal Revenue Service (IRS) would agree that a limited liability company comes within the definition of tax partnership.<sup>12</sup> That interpretation of the definition allows Cory and Travis to use a limited liability company to bring their arrangement within the purview of the partnership tax rules.<sup>13</sup> Third, the partnership tax rules determine the character of income at the partnership level and flow that character through to the partners with the income.<sup>14</sup> By forming

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<sup>7</sup> See *id.* § 83(a).

<sup>8</sup> See *id.* § 1(h)(1)(C) (providing the fifteen percent rate for adjusted net capital gain, which would include long-term capital gains, see *id.* § 1222(11)).

<sup>9</sup> Assuming the corporation has just one class of stock, Travis's stock would grant him a residual interest in Cory's property. See MODEL BUS. CORP. ACT § 6.01(b)(2) (1984); 1 MODEL BUS. CORP. ACT ANN. § 6.01 (4th ed. 2008) (providing that corporations must issue at least one class of stock that entitles the holders "to receive the net assets of the corporation upon dissolution").

<sup>10</sup> See UNIF. LTD. LIAB. CO. ACT § 103 (1996), 6B U.L.A. 563 (2008) (providing that a limited liability company operating agreement has primacy over all but a short list of the state law default rules).

<sup>11</sup> For example, Cory and Travis could agree that Cory could expel Travis from the limited liability company at will, and that upon expulsion, Travis would be entitled to no more than his accrued share of company income. The operating agreement could also grant Cory the right to make decisions with respect to the property, including whether Travis would continue providing services with respect to such property.

<sup>12</sup> This assumes that the limited liability company does not elect to be taxed as a corporation. See Treas. Reg. § 301.7701-3(a) (as amended in 2006) (providing that eligible business entities, which would include limited liability companies, may elect to be taxed as corporations).

<sup>13</sup> The federal definition of tax partnership is the gatekeeper for the partnership tax rules. See I.R.C. §§ 701-709 (applying the partnership tax rules to "partnership" as defined in sections 761 and 7701(a)(2), the definition this Article refers to as tax partnership to recognize the modifications tax law has made to the non-tax definition of partnership). The partnership tax rules provide significant opportunity for shifting the incidence of taxation. Thus, the definition of tax partnership, as the gatekeeper, is a very important definition.

<sup>14</sup> See *id.* § 702(b). Partnerships do not pay tax. Instead, they compute partnership taxable income and allocate the income to the partners. *Id.* §§ 702-704 (2000). Partners then pay tax individually on their distributive shares of partnership income. See *id.* § 701.

an entity that comes within the definition of tax partnership, Cory and Travis can create long-term capital gain at the partnership level and flow it through to the partners, including Travis, and reduce Travis's tax rate by as many as twenty basis points, or by about fifty-seven percent.<sup>15</sup> This is a significant difference for a mere change in form.

Different tax treatment of economically similar arrangements causes serious concern. People in similar economic arrangements should pay a similar amount of tax. Also, tax law should not motivate the form a business arrangement takes. The law could address those concerns in a number of different ways. First, the law could ignore the problem and preserve inequitable taxation and encourage tax-motivated business planning. Second, the law could modify the rules of partnership tax law to alter the character of income that flows through to the service provider (i.e., partnership disaggregation). Third, the law could modify the definition of tax partnership to disregard arrangements that tax policy indicates do not warrant the use of the partnership tax rules (i.e., partnership disregard). Most commentary has focused on the second alternative—partnership disaggregation. This Article suggests, however, that partnership disregard finds better support in tax policy.

The taxation of profits-only partnership interests has been the focus of an ongoing debate among academics, practitioners, taxpayers, and lawmakers.<sup>16</sup> Commentators fall into one of two camps. Professor Victor Fleisher's recent work represents the views of one camp (the compensation proponents), which argues that profits-only partnership interests are granted as compensation, at least in part, to a person who provides services to a partnership and should be taxed as such.<sup>17</sup>

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<sup>15</sup> The percent decrease is equal to the twenty basis point decrease divided by thirty-five percent.

<sup>16</sup> Although profits-only partnership interests have emerged recently in the debate of carried interests, various court decisions and rulings that addressed the proper taxation of profit-only partnership interests spurred the debate. *See* *Campbell v. Comm'r*, 943 F.2d 815, 823 (8th Cir. 1991) (holding that a profits-only interest had only speculative, if any, value and, therefore, the grant of such interest is not taxable); *Diamond v. Comm'r*, 492 F.2d 286, 291 (7th Cir. 1974) (holding that the grant of a profits-only partnership interest with a determinable market value for past services is a taxable event); Rev. Proc. 2001-43, 2001-2 C.B. 191 (providing guidance on the tax treatment of nonvested profits-only interests); Rev. Proc. 93-27, 1993-2 C.B. 343 (providing for the tax-free treatment of the grant of most profits-only partnership interests). The House of Representatives passed H.R. 3996, the Temporary Tax Relief Act of 2007, on November 9, 2007, which would have added section 710 to the Internal Revenue Code and would have taxed income allocated to holders of certain profits-only partnership interests as compensation income. Temporary Tax Relief Act of 2007, H.R. 3996, 110th Cong. (as passed by House, Nov. 9, 2007). Treasury and the IRS have also recently proposed rules for taxing profits-only partnership interests, which would have allowed the tax-free grant of profits-only partnership interests and the character of partnership income to flow through from the partnership. *See* Prop. Treas. Reg. § 1.83-3(e), 36 Fed. Reg. 10,787, 10,790-91 (June 3, 1971) (providing that "property includes a partnership interest," which would place the grant of a profits-only partnership interest under the section 83 income recognition timing rules); I.R.S. Notice 2005-43, 2005-1 C.B. 1221 (providing a proposed safe harbor that would allow a service provider to include the liquidation value (which should be zero) of a profits-only interest in income on the date of grant).

<sup>17</sup> *See* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 57-58 (2008) (recommending that at least a portion of the partnership

Compensation proponents tend to be academics, who are concerned with distributive equity.<sup>18</sup> At the core of the argument is the apparent inequity that results when a service-providing partner is able to pay tax on significant amounts of allocated partnership profits at favorable long-term capital gain rates.<sup>19</sup> The other camp (the proponents of partnership-level characterization) argues that any partnership profits allocated to a partner should retain the character determined at the partnership level.<sup>20</sup> They voice concern about the integrity and complexity of partnership tax law, found in subchapter K of the Code.<sup>21</sup> The proponents of partnership-level characterization fear that the current proposals for change would disrupt partnership tax law generally, create arbitrary lines between

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profits allocated to holders of profits-only partnership interests be taxed as ordinary income). Several other law professors have expressed their views as compensation proponents. *See, e.g.*, Gregg D. Polsky, *Private Equity Management Fee Conversion*, 122 TAX NOTES 743 (Feb. 9, 2009) (arguing that the conversion of management fees from compensation income to capital gain income lacks support in the law and violates fundamental principles of equity); *see also Fair and Equitable Tax Policy for America's Working Families: Hearing Before the H. Comm. on Ways & Means*, 110th Cong. 58 (statement of Darryll K. Jones, Professor, Stetson U. College of Law) (recognizing the injustice of a person who makes \$70,000 of compensation a year paying tax at ordinary income rates while fund managers make millions and pay tax at long-term capital gains rates); *Carried Interest, Part II: Hearing Before the S. Comm. on Finance*, 110th Cong. (2007) (statement of Joseph Bankman, Professor, Stanford Law School) (supporting taxing carried interests as compensation to "increase economic welfare and make the tax law more equitable"); *Carried Interest: Hearing Before the S. Comm. on Finance*, 110th Cong. (2007) (statement of Mark P. Gergen, Founder Chair, U. of Texas School of Law) (commenting that the unfairness of the current law is evident and recommending that income allocated to a partner who provides services to a partnership should be ordinary income when the amount allocated is compensation).

<sup>18</sup> *See supra* note 17. Not all academics who concern themselves with this issue are compensation proponents. *See, e.g.*, Adam H. Rosenzweig, *Not All Carried Interests are Created Equal* (Washington Sch. of Law, Paper No. 08-12-02, 2009), available at <http://ssrn.com/abstract=1315004> (arguing that amounts paid to service providers in private equity funds are a combination of labor and investment and the holding period of the property must be considered in determining the character of the income allocated to the service providers); David A. Weisbach, *University of Chicago Professor Says Carried Interest Legislation is Misguided*, 2007 TAX NOTES TODAY 147-32, July 31, 2007 (analogizing an investment partnership to an individual investment and entrepreneurial effort and suggesting the character determined at the partnership level should flow through to the partners); Howard E. Abrams, *Taxation of Carried Interests*, 116 TAX NOTES 1, 6 (2007) ("[T]he current system of taxation, though based on administrative convenience, ultimately reaches what is close to a proper result. And it is hard, both practically and conceptually, to draft a broad rule that reaches a better one.").

<sup>19</sup> *See* Fleischer, *supra* note 17, at 5, 50. The commentary cited above adequately describes the focus of the recent debate. *See supra* notes 17-18; *see infra* notes 20-21. This Article does not rehash those arguments but offers a new perspective and cites that commentary for the convenience of parties unfamiliar with the debate.

<sup>20</sup> *See generally* David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715 (2008) (arguing generally that the nature of partnerships supports partnership-level characterization); *see also* Leo L. Schmolka, *Taxing Partnership Interests Exchanged for Services: Let Diamond/Campbell Quietly Die*, 47 TAX L. REV. 287, 288 (1991) (preferring the law to not tax profits-only partnership interests, but if it does to use a constructive loan method to tax only a portion that is treated as interest on a constructive loan to the service provider).

<sup>21</sup> *See, e.g.*, Michael L. Schler, *Taxing Partnership Profits Interests as Compensation Income*, 119 TAX NOTES 829 (May 26, 2008) (describing significant limitations and potential damage to subchapter K that would result from proposed section 710, which would treat items allocated to certain service-providing partners as compensation income); Am. Bar Ass'n Section of Taxation, Comments on H.R. 2834, Nov. 13, 2007, available at <http://www.abanet.org/tax/pubpolicy/2007/071113commentsshr2834.pdf> [hereinafter "ABA Comments"].

different classes of partners, and send undesirable ripple effects through the Code.<sup>22</sup>

This Article suggests that the differences between the two camps are attributable to the focus of analysis. In particular, focusing on partnership disaggregation creates a stalemate between the two camps. If the analysis changes its focus from partnership disaggregation to partnership disregard,<sup>23</sup> the two camps may find a harmonious solution to the problem profits-only partnership interests pose.

All profits-only partnership interests present a significant conceptual challenge because partnerships are very complex arrangements. The complexity makes properly identifying relationships among partners and partnerships difficult, which in turn makes tax lawmaking difficult. Partnerships are as old as private business and a natural part of our economy, which adds to the importance of partnership tax lawmaking.<sup>24</sup> The prevalence of partnerships and their scope both in terms of absolute size and span of societal cross sections add to their uniqueness among business arrangements. A partnership may be any of the following: a business arrangement between two unsuspecting entrepreneurs, a complicated investment arrangement, or a joint venture between multi-national energy companies. Partnership's unique nature requires tax rules that are often significantly different from tax rules governing other arrangements. Because any partnership could grant one of its members a profits-only partnership interest, tax law governing profits-only partnership interests should produce accurate and consistent tax results regardless of the type or size of partnership in question. The law should also be equitable and efficient. Partnership disaggregation does not accomplish those goals.

Partnerships fall into three general categories: (1) services partnerships, (2) property-services partnerships, and (3) investment partnerships.<sup>25</sup> Understanding these different types of partnerships helps

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<sup>22</sup> See *infra* Part III.C. (discussing the potential problems of proposed rules for taxing profits-only partnership interests).

<sup>23</sup> This suggestion is, in some respects, a reminder of the instruction Congress gave to Treasury in 1984 to promulgate regulations that would "provide, when appropriate, that the purported partner performing services . . . is not a partner at all. Once it is determined that the service performer . . . is actually a partner, the committee believes the factors described below should be considered in determining whether the partner is receiving the putative allocation and distribution in his capacity as a partner." S. COMM. ON FIN., 98TH CONG., 2D SESS., DEFICIT REDUCTION ACT OF 1984, EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 227 (Comm. Print 1984). It also reflects the holding in *Estate of Smith v. Commissioner of Internal Revenue*, 313 F.2d 724, 736 (8th Cir. 1963), in which the court held that a relationship between investors and an investment manager was not a partnership.

<sup>24</sup> See generally Bradley T. Borden, *Aggregate-Plus Theory of Partnership Taxation*, 43 GA. L. REV. 717 (2009) (discussing the human tendency to form partnerships for business reasons, the legal and tax issues partnerships raise, and tax law's obligation to minimize interference with the human tendency to form partnerships); Henry Fr. Lutz, *Babylonian Partnership*, 4 J. ECON. BUS. HIST. 552, 557-64 (1932) (describing Babylonian partnerships that emerged 4000 years ago with the arrangement of private property and business).

<sup>25</sup> See *infra* Part II.A (describing the different types of partnerships).

distill three different types of interests in partnerships, namely: (1) profits-only partnership interests, (2) capital-only partnership interests, and (3) capital-profits partnership interests.<sup>26</sup> Understanding and distinguishing the various types of partnerships is critical to develop the proper analytical model for profits-only interests. Also critical to the analysis is a working knowledge of the nature of partnerships.<sup>27</sup> With that background, the weaknesses of partnership disaggregation become apparent,<sup>28</sup> and the appeal of partnership disregard reveals itself.<sup>29</sup>

## II. TAX PARTNERSHIPS AND INTERESTS IN TAX PARTNERSHIPS

The terms “partnership” and “partner” have multiple meanings depending upon the context in which they appear. People may use the terms colloquially to refer to intimate or other non-business relationships.<sup>30</sup> Business professionals may use the terms informally to refer to an arrangement that may have any of various legal forms.<sup>31</sup> The term partnership also has a technical meaning. It is “an association of two or more persons to carry on as co-owners a business for profit.”<sup>32</sup> The definition helps define an arrangement and establish the rights and obligations of its members.<sup>33</sup>

The federal tax definition is much broader than the technical non-tax definition. It may include partnerships, limited partnerships, limited liability companies, and arrangements that fail to satisfy the definition of all of those arrangements, such as a state-law tenancy in common.<sup>34</sup> To avoid confusion, this Article uses the term tax partnership

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<sup>26</sup> See *infra* Part II.B (discussing the different types of partnership interests).

<sup>27</sup> See *infra* Part II.C (discussing the nature of partnerships).

<sup>28</sup> See *infra* Part III (demonstrating the inadequacies of partnership disaggregation).

<sup>29</sup> See *infra* Part IV (illustrating partnership disregard in the profits-only context).

<sup>30</sup> See, e.g., Nicolette Prialux, *Rethinking Progenitive Conflict: Why Reproductive Autonomy Matters*, 16 MED. L. REV. 169, 179 (2008) (referring to the woman and man involved in making child-bearing decisions as partners); Leonard L. Riskin & Nancy A. Welsh, *Is That All There Is? “The Problem” in Court-Oriented Mediation*, 15 GEO. MASON L. REV. 863, 899 (2008) (observing that including aggrieved parties in the mediation process more often would help make them partners in the negotiation).

<sup>31</sup> Business people must, however, use care in making such references because doing so may create a legal partnership with its concomitant consequences. See ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP § 2.05(b) (Supp. 2009) (identifying cases in which parties exposed themselves to joint and several liability by holding themselves out as partners).

<sup>32</sup> See UNIF. P’SHIP ACT § 101(6) (amended 1997), 6 U.L.A. 61 (2001).

<sup>33</sup> See BROMBERG & RIBSTEIN, *supra* note 31, § 2.02(a) (recognizing the existence of a partnership is never the immediate issue, but creditors, for example, often raise the question in searching for a solvent defendant).

<sup>34</sup> See Treas. Reg. § 301.7701-1(a)(1) (as amended in 2006) (“Whether an owner is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.”); Bradley T. Borden, *The Federal Definition of Tax Partnership*, 43 HOUS. L. REV. 925, 982-84 (2006) (suggesting that the state law should not govern tax partnership classification, but some courts appear to still rely upon it).



to refer to any arrangement subject to partnership tax law. The definition of tax partnership is somewhat unclear,<sup>35</sup> but tax law definitely recognizes tax partnerships.<sup>36</sup> The discussion below concludes that much of the debate over the proper tax treatment of profits-only partnership interests results from the current unclear definition of tax partnership. Despite the lack of clarity, three general types of arrangements appear to come within the current definition of tax partnership.

#### A. *Types of Tax Partnerships*

Despite the unclear definition, a tax partnership exists when two or more persons integrate services and share profits from the integrated services or when two or more persons integrate property and services and share the profits from the property-services integration.<sup>37</sup> This Article generally refers to combinations of property and services because such combinations raise compelling theoretical issues. The discussions often could apply equally to service combinations. The tax partnership definition used in this Article adopts the term “integration” to imply the shared control of the property and services.<sup>38</sup> Thus, to come within the definition of tax partnership the parties to an arrangement must share ownership and control of the partnership property and services.<sup>39</sup> This is

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<sup>35</sup> See WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 3.01[1] (3d ed. Supp. IV 2006) (“The most basic, and perhaps the most difficult, problem in the taxation of partnerships and partners is the determination whether a particular financial, business, or otherwise economic arrangement constitutes a partnership for income tax purposes.”).

<sup>36</sup> See *supra* note 13.

<sup>37</sup> For an arrangement to be a tax partnership, the members must share ownership/control of the property and services and must divide the profits of the combined resources. See *generally* Borden, *supra* note 34 (discussing the definition of tax partnership). A tax partnership may also exist if the parties do not combine services, but the Author argues that such arrangements should not be tax partnerships. See *id.* at 1010-11.

<sup>38</sup> The combination of property and services, or just services, gives partnerships their unique nature. See Borden, *supra* note 24, at 752-61. The same concept is contained in the UPA definition of partnership, which uses co-ownership and business to capture the ideas of combining services and/or property for profit. See UNIF. P'SHIP ACT § 101(6) (amended 1997), 6 U.L.A. 61 (2001) (defining partnership as “an association of two or more persons to carry on as co-owners a business for profit”). The UPA definition of partnership does not serve tax law because it uses nontax concepts and terms that do not translate well for tax purposes. See Borden, *supra* note 34, at 1008-11.

<sup>39</sup> See Borden, *supra* note 24, at 744-52 (discussing ownership and control of property and services); *infra* text accompanying notes 83-88. This discussion uses the term control instead of ownership because many of the legal forms used as tax partnerships vest ownership in a separate legal entity. See, e.g., UNIF. P'SHIP ACT § 203 (amended 1997), 6 U.L.A. 96 (2001) (providing that “property acquired by a partnership is [partnership] property”); UNIF. LTD. LIAB. CO. ACT § 112(b)(2) (1996), 6B U.L.A. 572 (2008) (providing that a limited liability company has the powers to own real or personal property). Furthermore, control and integration are economic concepts used to help explain why persons form business arrangements. See Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691, 693-94 (1986) (recognizing that virtual definition of ownership is the power to exercise control); Klein, Crawford & Alchian, *supra* note 2, at 299 (describing vertical integration as joint ownership). The question of why persons form business arrangements is critical to understanding the nature of partnerships.

a spin-off of the substantive law definition of partnership.<sup>40</sup> Although the definition is fraught with shortcomings when used for tax purposes,<sup>41</sup> it remains a significant part of partnership tax law.<sup>42</sup> Under that definition, tax partnerships can be one of three different types: (1) services partnerships, (2) property-services partnerships, or (3) investment partnerships. Each type of partnership can grant profits-only partnership interests. Understanding the various types of tax partnerships and interests in tax partnerships facilitates the analysis of profits-only partnership interests.

### 1. Services Partnerships

A two-person law partnership is an example of a services partnership. Consider such a partnership. Upon completing tax LL.M.s, Sarah and Joline decide to form a law firm. They form Jorah Law Firm, a state-law partnership, and agree to share the expenses of the firm equally and divide profits in such a way that Sarah will receive 60% of the profits from work she originates and Joline will receive 60% of the profits from work she originates. They have no assets to contribute,<sup>43</sup> so their combination of services and profit sharing creates a services partnership. Even though the profit-sharing arrangement favors the rainmaker, each partner takes an interest in the other's services.<sup>44</sup>

Partnership tax law characterizes income at the partnership level.<sup>45</sup> Income of a services partnership is income from services. The income flows to the partners as income from services.<sup>46</sup> The taxation of interests in such arrangements is not heavily disputed.<sup>47</sup> The general lack

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<sup>40</sup> See *supra* text accompanying note 32.

<sup>41</sup> See Borden, *supra* note 34, at 1008-11.

<sup>42</sup> Courts and the IRS have reduced the definition to sets of factors. See, e.g., *Ayrton Metal Co. v. Comm'r*, 299 F.2d 741, 742 (2d Cir. 1962); *Luna v. Comm'r*, 42 T.C. 1067, 1077-78 (1964); *Alhouse v. Comm'r*, 62 T.C.M. (CCH) 1678, 1680 (1991), *aff'd*, 12 F.3d 166 (9th Cir. 1993); Rev. Proc. 2002-22, 2002-1 C.B. 733, 735-37; see also Borden, *supra* note 34, at 975-82 (discussing the use of substantive law to define tax partnership).

<sup>43</sup> The landlord has agreed to waive rent for the first six months they occupy their office space. Joline and Sarah will cover all other expenses using credit or with revenues they earn.

<sup>44</sup> A person cannot control or own another individual. See U.S. CONST., amend. XIII, § 1. Nonetheless, individuals may grant to others an economic interest in the product of their services. Such grant of an economic interest is an important aspect of the virtue of partnerships. See *infra* text accompanying notes 90-97.

<sup>45</sup> See I.R.C. § 702(b) (2006).

<sup>46</sup> See *id.*

<sup>47</sup> To the extent one exists, the point of dispute may be that partnership tax law should allocate tax items according to each partner's capital account balances. Several commentators have made that argument. See, e.g., Darryll K. Jones, *Towards Equity and Efficiency in Partnership Allocations*, 25 VA. TAX REV. 1047, 1093 (2006) (proposing that "capital account allocations should constitute the norm—the accurate safe harbor—but in certain circumstances proven by the partners, the allocations might be made in a different manner to achieve optimal economic efficiency"); William J. Rands, *Passthrough Entities and Their Unprincipled Differences Under Federal Tax Law*, 49 SMU L. REV. 15, 39-40 (1995) (recommending that partnerships be subject to the rigid allocation rules of subchapter S of the Code); George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX. REV. 141, 203 (1999) (proposing that partnerships of individuals be

of controversy regarding the taxation of interests in services partnerships is likely attributable to the character of services partnerships' income. The partnership's services income flows through to the partners. Because the partners recognize income from services, they cannot obtain favorable tax rates. Instead, they pay income on such amounts at ordinary income rates. Such treatment is not controversial.

## 2. Property-Services Partnerships

A simple example illustrates a property-services partnership. Rex recently built an office building, which he has been managing alone. As the building fills up, he realizes he needs help to meet all of the demands of managing a full office building. Lee joins Rex to form Leex Partnership. Rex contributes his building, all of the existing leases, and his services to Leex Partnership; Lee contributes his services to Leex Partnership. Thus, they will share control of the office building and share the management responsibilities of the office building. Rex and Lee agree that they will divide the income from the partnership 60% to Rex and 40% to Lee. They also agree that if they ever sell the office building, they will equally divide any gain realized from the property's appreciating after the partnership formation.<sup>48</sup> The arrangement between Rex and Lee is a tax partnership because they combine property and services and share the profits from their combined resources. As partners, Rex and Lee both take an interest in each others' contributed resources through the combination.<sup>49</sup> Rex and Lee take an interest in the income-producing potential of each others' contributed services, and Lee takes an interest in the property's income-producing potential. Income of this property-services partnership should include rental income and gain, if any, from the potential sale of the office building.<sup>50</sup> Partnership tax law would flow that income through to the members and tax them according

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required to allocate all tax items "in accordance with the percentage interests of the residual interest holders"). Such treatment would ignore the partners' economic arrangement. For instance, in the present example, Jorah Law Firm would have to allocate all tax items equally to Joline and Sarah because they both would have the same zero balance in their capital accounts. That result does not recognize the partners' agreement and therefore would produce a bad tax result. See Bradley T. Borden, *Partnership Tax Allocations and the Internalization of Tax-Item Transactions*, 59 S.C. L. REV. 297, 340-46 (2008). Even though some commentators may question the appropriate allocation of income from services tax partnerships, no one disputes the character of such income.

<sup>48</sup> Having decided to combine resources, Rex and Lee would allocate the income and gain to help reduce agency costs. See generally Larry E. Ribstein, *The Rise of the Uncorporation*, (July 29, 2007) (unpublished manuscript, on file with author), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1003790](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1003790). For example, Lee's share of future gain on the disposition of property will help encourage him to manage the property in such a manner that will help preserve the long-term value of the property.

<sup>49</sup> See generally Borden, *supra* note 24, at 752-61 (discussing how partners integrate property and services and jointly own/control the combined resources including the product of services).

<sup>50</sup> See I.R.C. § 61(a)(3), (5) (providing that gross income includes gains from dealings in property and rents).

to tax rules that apply to rental income and gains from dealings in property.<sup>51</sup>

Other property-services partnerships may generate services income. For example, assume Rachel and Christy decide to form Chrichel LLC, a lawn-mowing service. Rachel agrees to contribute all of the lawn mowing equipment, a customer list, and management and bookkeeping services. Christy agrees to contribute lawn mowing services. Rachel and Christy agree to equally divide the profit from the business. Because they integrate property and services and share the profits, the arrangement appears to be a tax partnership. The income of Chrichel LLC will be income from services.<sup>52</sup> The difference between the character of Leex Partnership's income and Chrichel LLC's income appears to be whether the property or services are the more dominant income-producing factor. The property in Leex Partnership arguably plays a bigger income-producing role than the property in Chrichel LLC. Tenants of an office building seek working space. They expect services only to the extent necessary to keep the working space comfortable and suitable for its designated purpose. Purchasers of lawn mowing services focus on the services and would generally show no interest in equipment used, as long as the end product is a beautifully cared for lawn. Tax law appears to recognize that distinction.

Commentary generally would not express concern about the tax treatment of partners in property-services partnerships. In the case of Chrichel LLC, in particular, the income flowing to the parties is services income. The assets have little or no residual value, so the partners will recognize services income from the partnership. Such tax treatment generally appears to be innocuous. Perhaps commentators could express some concern that Lee has rental income instead of services income. Both types of income are subject to ordinary income rates.<sup>53</sup> The bigger concern would be gain from the property allocated to Rex. That gain could qualify for the favorable long-term capital gains rate.<sup>54</sup> The ordinary income rates paid on the rental income appear to appease commentators generally as the taxation of such interest appears to escape scrutiny, at least in the current debate. The discussion below explains why economics support the treatment.<sup>55</sup>

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<sup>51</sup> See *id.* § 701 (providing that partners shall be liable for tax on partnership income).

<sup>52</sup> See *id.* § 61 (a)(1).

<sup>53</sup> See, e.g., *id.* § 1(h).

<sup>54</sup> See *id.* § 1231 (a) (providing that if section 1231 gains exceed section 1231 losses in a taxable year, the law shall treat such gains and losses as gains and losses from the sale of capital assets). If the property's holding period exceeds one year, the gain could be long-term capital gain. See *id.* § 1222(3).

<sup>55</sup> See *infra* text accompanying notes 132-139.

### 3. Investment Partnerships

A third type of arrangement, the investment partnership, also appears to come within the definition of tax partnership.<sup>56</sup> Assume Warbucks has \$100 million he would like to put to good use (i.e., invest for a significant return). Assume further that Krinkle has a reputation of managing investments well, returns a good profit on invested money, and has access to other resources that help him manage capital. Warbucks and Krinkle agree to form a limited partnership (Kribucks LP) pursuant to which Warbucks will contribute \$100 million and Krinkle will contribute investment services.<sup>57</sup> The partnership agreement provides that the partnership will pay Krinkle \$2 million upon formation as a fee for managing Kribucks LP and divide any profits from the partnership 80% to Warbucks and 20% to Krinkle.<sup>58</sup> Partnership income will primarily derive from the property (i.e., dividends or interest) or gain from the sale of the property (i.e., investment income<sup>59</sup>), and Krinkle will limit his activities to making investment decisions and managing the investments. The arrangement appears to be a partnership because the parties integrate property and services and divide profits. The arrangement is an investment partnership. Although the analysis below suggests that investment partnerships should not come within the definition of tax partnership,<sup>60</sup> the current definition probably includes them.

The extent of Krinkle's services should determine the character of gain that Kribucks LP will recognize on the disposition of the property. If Krinkle improves the property and actively markets the property, the gain will be from the disposition of dealer property and be subject to ordinary income rates.<sup>61</sup> If, however, Krinkle merely selects investments that appreciate over time, gain on the disposition of the property will be capital gain and may qualify for long-term capital gain treatment.<sup>62</sup> The difference between the two results is the primary source of income. If the primary source of income is Krinkle's services (i.e., his efforts to improve and market the property or his actively trading the

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<sup>56</sup> See Rev. Rul. 75-523, 1975-2 C.B. 257 (ruling that an investment club that did not carry on a trade or business for section 162 purposes was a tax partnership).

<sup>57</sup> This Article uses the term "investment services" to define those services that a taxpayer can perform without being deemed to carry on a trade or business for purposes of section 162.

<sup>58</sup> This is an example of the traditional two and twenty carried interest structure that has received considerable recent attention. See Fleischer, *supra* note 17, at 8-15 (describing carried interests); *supra* notes 17-21 (citing articles that discuss the tax treatment of carried interests).

<sup>59</sup> See I.R.C. § 163(d)(4)(B) (defining investment income as income from property held for investment).

<sup>60</sup> See *infra* Part IV.C.

<sup>61</sup> Several cases hold that improvements and efforts to market make property dealer property subject to ordinary income rates. See, e.g., *Major Realty Corp. v. Comm'r*, 749 F.2d 1483, 1488-89 (11th Cir. 1985); *United States v. Winthrop*, 417 F.2d 905, 906, 911-12 (5th Cir. 1969).

<sup>62</sup> See, e.g., *Williford v. Comm'r*, 64 T.C.M. (CCH) 422 (1992) (holding that paintings acquired and held for investment were capital assets).

property), then Kribucks LP would have ordinary income.<sup>63</sup> If, however, the primary source of income is the property's appreciation, the income should be capital gain income.<sup>64</sup> By definition, an investment partnership's primary source of income must be property. If services contribute too significantly to the partnership's income, the partnership will be a property-services or services partnership.

The proper tax treatment of Krinkle is the source of the current contention regarding profits-only partnership interests. If Krinkle were to perform the same services as an employee of Warbucks, the income he received would be compensation, potentially taxed at thirty-five percent. If tax law respects the limited partnership, and the arrangement is an investment partnership, Krinkle will pay tax on the income at the favorable capital gain rate, which could be as low as fifteen percent. By changing the form of the arrangement, Warbucks and Krinkle are therefore able to significantly reduce Krinkle's tax liability. That different tax treatment rightfully raises the ire of many commentators.

The four hypothetical partnerships illustrate three general types of tax partnerships and provide a baseline for analyzing profits-only partnership interests. As the analysis proceeds, this Article will refer to the partnerships as follows: Jorah Law Firm, which integrates two parties' services, is a services partnership. Leex Partnership and Chrichel LLC, which integrate one person's property with the contributed services of at least one other person, are property-services partnerships. Kribucks LP, which appears to integrate property with limited investment services, is an investment partnership. Each type of partnership relies upon services and property to a different extent for profit. A pure-services partnership relies almost exclusively on partner services for profit. The property-services partnership relies on both property and services for profit. The investment partnership relies primarily on property for profit.

### B. *Types of Partnership Interests*

As stated above, a tax partnership requires two or more persons to integrate resources and share profits.<sup>65</sup> The persons who integrate the resources and share profits are partners. For a person to be a partner in a tax partnership, the person must contribute property or services and must take a control interest in other property and services.<sup>66</sup> Thus, the following descriptions of the various types of tax partnership interests

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<sup>63</sup> See *supra* note 61.

<sup>64</sup> See *supra* note 62. Property held by a securities trader, however, is a capital asset, the gains and losses from which are capital in nature and may be subject to favorable rates or disallowed, even though the owners may be active in buying or selling securities. See *Marrin v. Comm'r*, 147 F.3d 147, 151-53 (2d Cir. 1998) (holding that individuals were traders rather than dealers because they did not hold property for sale to customers as required in section 1221(1)).

<sup>65</sup> See *supra* note 37 and accompanying text.

<sup>66</sup> The discussion below of the nature of tax partnerships considers these requirements. See *infra* text accompanying notes 84-88.

assume that the parties have made the requisite contributions and taken the requisite control interests to be partners. Generally, the determination of partner status should require significant analysis. As argued below, failure to give due regard to partner status causes many problems. Before considering those issues, consider the various types of partnership interests.

A full understanding of profits-only partnership interests requires understanding the various types of partnership interests. In the examples above, each partnership granted profits-only partnership interests.<sup>67</sup> Leex Partnership also granted a capital-profits partnership interest, and Kribucks LP also granted a capital-only partnership interest. The following discussion describes each type of interest.

### 1. Profits-Only Partnership Interests

A profits-only partnership interest gives a partner a share of future partnership profits but no interest in partnership capital on the date of the grant.<sup>68</sup> That definition has important implications. First, the holder of a profits-only partnership interest is a member of an arrangement that comes within the definition of tax partnership, which means the holder has the rights and powers of a partner. Second, at the time a tax partnership grants a profits-only partnership interest, the grantee does not have a right to any of the partnership capital.<sup>69</sup> Third, the grantee of a profits-only partnership interest contributes only services to the partnership. This definition would include the interests Sarah and Joline take in Jorah Law Firm, the interest Lee takes in Leex Partnership, the interest Christy takes in Chrichel LLC, and the interest Krinkle takes in Kribucks LP. Each of these people contributes only services and has no right to a capital distribution immediately following partnership formation. Each of them is, however, a member of an arrangement that appears to come within the definition of tax partnership. Thus, their interests are profits-only partnership interests.

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<sup>67</sup> Another commentator referred to profits-only partnership interests as “naked profits interest[s].” See Laura E. Cunningham, *Taxing Partnership Interests Exchanged for Services*, 47 *TAX L. REV.* 247, 255 (1991).

<sup>68</sup> Over time, if the partnership does not rule distributions, or if partnership property appreciates, the holder of a profits-only partnership interest may accrue an interest in partnership capital. Thus, the definition focuses on the rights on the day of grant.

<sup>69</sup> This is consistent with the IRS’s definition of profits interest. The IRS defines a profits interest as any interest in a partnership “other than a capital interest.” See Rev. Proc. 93-27, § 2.02, 1993-2 C.B. 343. The IRS defines capital interest in a partnership as “an interest that would give the holder a share of the proceeds if the partnership’s assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership.” *Id.* § 2.01. The IRS generally determines whether a partnership interest is capital or profits at the time the partner receives the partnership interest. *But see* Treas. Reg. § 1.721-1(b)(1) (as amended in 2007) (providing that the timing of recognition of income on the transfer of a capital interest depends upon whether the service provider has provided the services and whether the transfer is conditioned upon rendering services).

The interest Krinkle takes in Kribucks LP is, more particularly, a carried interest.<sup>70</sup> Carried interests have captured the attention of the legal academy,<sup>71</sup> tax bar,<sup>72</sup> and Congress.<sup>73</sup> The typical carried interest is a bit more complicated than the example. Generally, a carried interest will first ensure that the capital contributor receives eighty percent of the first ten percent return (i.e., eight percent) of the return on the capital (“the hurdle rate”).<sup>74</sup> Once the capital contributor receives that eight percent, the service provider receives the next two percent of return and the parties share any other return in an eighty-twenty split. The service provider’s interest is a carried interest. Despite the complexity, a carried interest is an interest in the profits of the arrangement. It is merely a form of profits-only partnership interest. Instead of raising unique tax issues, it brought to the attention of the public the inequity of the tax treatment of profits-only partnership interests. Professor Fleischer is largely responsible for notifying the public of the problem.<sup>75</sup>

## 2. Capital-Only Partnership Interests

A capital-only partnership interest is an interest granted to a person who contributes only property to a tax partnership.<sup>76</sup> The interest Warbucks takes in Kribucks LP is an example of a capital-only partnership interest. Warbucks contributed only property to Kribucks LP. He will share in the partnership profit, but he will not provide services. If the partnership liquidated immediately following formation, as the sole contributor of capital, Warbucks would receive all of the partnership capital.<sup>77</sup> For the same reasons, Rachel also takes a capital-only partnership interest in Chrichel LLC.

## 3. Capital-Profits Partnership Interests

Capital-profits partnership interests are similar to profits-only partnership interests in some respects and similar to capital-only partnership interests in other respects. The interest Rex takes in Leex

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<sup>70</sup> See Fleischer, *supra* note 17, at 8-15 (describing carried interests).

<sup>71</sup> See *supra* note 17.

<sup>72</sup> See *supra* note 21.

<sup>73</sup> See *supra* note 16.

<sup>74</sup> See Weisbach, *supra* note 20, at 722.

<sup>75</sup> See Fleischer, *supra* note 17, at 8-16.

<sup>76</sup> This definition is consistent with the IRS’s definition of capital interest. See Rev. Proc. 93-27 § 2.01, 1993-2 C.B. 343 (“A capital interest is an interest that would give the holder a share of the proceeds if the partnership’s assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership.”). This Article uses the more specific term “capital-only partnership interests” to facilitate the distinction of such interests from capital-profits partnership interests.

<sup>77</sup> This assumes that the partnership liquidates in accordance with positive capital account balances as required by the economic effect safe harbor. See Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2) (as amended in 2008).



Partnership has aspects of a profits-only partnership interest because the profit allocation agreement undoubtedly is based in part on the services Rex will contribute. Rex also contributed property, so he will have a capital interest (i.e., a right to a capital distribution if the partnership liquidated immediately following formation) in Leex Partnership at the time of formation. Thus, Rex's interest in Leex Partnership is a combination of both a capital-only partnership interest and a profits-only partnership interest. Because of the similarity to both types of interests, the interest is a capital-profits partnership interest.

Partnership tax policy generally supports the tax-free formation of partnerships and the tax-free admission of new partners to existing partnerships.<sup>78</sup> The grant of an interest in partnership capital to a service contributor is not, however, a tax-free transaction. The service contributor will generally have compensation income on the date of the grant of the capital interest.<sup>79</sup> With few exceptions, the IRS does not challenge the tax-free grant of a profits-only partnership interest to a service contributor.<sup>80</sup> Instead, holders of profits-only partnership interests recognize income as it flows through from the partnership and take the character of such income as determined at the partnership level.

Even though partnerships can grant different types of partnership interests, most commentary regarding taxation of partners on a partnership formation focuses on the tax consequences of the grantee of profits-only partnership interests. The recent debate more particularly concerns the tax treatment of profits-only partnership interests in investment partnerships.<sup>81</sup> Compensation proponents argue that grantees of profits-only partnership interests have compensation either at the time the partnership grants the interests or over time as the partnership allocates or distributes profits to the grantees.<sup>82</sup> Compensation proponents recommend partnership disaggregation as a way to alter the character of income flowing from an investment partnership to holders of profits-only partnership interests. The nature of partnerships, however, makes partnership disaggregation an unsuitable remedy for the intellectual discomfort the taxation of profits-only partnership interests cause.

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<sup>78</sup> See I.R.C. § 721 (2006).

<sup>79</sup> See MCKEE, NELSON & WHITMIRE, *supra* note 35, ¶ 5.03[1].

<sup>80</sup> See Rev. Proc. 93-27 § 4, 1993-2 C.B. 343.

<sup>81</sup> The taxation of profits-only partnership interests in services partnerships is not as significant a concern because the character of income that flows through to the partners is income from services. See *supra* text accompanying note 47. The same is true for income from property-services partnerships that have services income. The issue with profits-only partnership interests is the timing of income recognition, which is discussed *infra* text accompanying notes 224-228.

<sup>82</sup> See *supra* note 17 and accompanying text.

### C. *Nature of Tax Partnerships*

Tax partnerships are unique arrangements and deserve analysis independent of that applied to other business arrangements. The defining attributes of tax partnerships are integration of services and property (or the services of at least two people) and allocation of economic items.<sup>83</sup> Parties integrate to reduce appropriable quasi rents,<sup>84</sup> and they allocate the economic items of an arrangement to reduce agency costs.<sup>85</sup> Integrating services and property gives the service contributor and property contributor an interest in both the partnership property and partnership services. The property owner commits the property to partnership use. Thus, although the service contributor would not receive a share of the property upon liquidation of the partnership immediately following formation, the service contributor participates in directing the use of the property and shares any increase in the property's value and its product. Participating in the control of property distinguishes a partner from an employee.<sup>86</sup> In particular, an employee does not share in the control of all aspects of property not contracted away (i.e., the property's residual claim).<sup>87</sup> The control of such aspects of property is the property's residual claim.<sup>88</sup> A service provider who shares the residual claim of property becomes a partner to the property owner, if the property owner gains adequate control of the contributed services.

Partners also take an interest in contributed services. The Thirteenth Amendment generally prohibits control of another individual, implying that the product of an individual's labor should belong to the individual.<sup>89</sup> Nonetheless, individuals should be able to transfer the

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<sup>83</sup> See Borden, *supra* note 24, 744-61 (describing the nature of partnerships and the use of allocations to control agency costs); Schmolka, *supra* note 20, at 297-99 (recognizing the unique nature of partnerships as mini-exchanges between the partnership as the partnership conducts business and each mini-exchange is taxed as the partnership allocates tax items to partners under subchapter K).

<sup>84</sup> See Klein, Crawford & Alchian, *supra* note 2, at 298.

<sup>85</sup> See Alchian & Demsetz, *supra* note 4, at 786.

<sup>86</sup> See, e.g., *Fishback v. United States*, 215 F. Supp. 621, 626 (D.S.D. 1963) (finding that parties were joint proprietors and holding that arrangement was a tax partnership); *Copeland v. Ratterree*, 57-2 U.S. Tax Cas. (CCH) ¶ 9895, at 58,195-96 (N.D.N.Y. 1957) (holding no partnership existed even though parties shared profits because they did not share control); *Luna v. Comm'r*, 42 T.C. 1067, 1077-78 (1964) (considering whether the parties shared control and responsibilities of the enterprise in holding that no partnership existed); *Beck Chem. Equip. Co. v. Comm'r*, 27 T.C. 840, 854 (1957) (finding that the parties had mutual proprietary interest in profits and holding that arrangement was a tax partnership).

<sup>87</sup> See Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119, 1121 (1990) ("We suppose that the sole right possessed by the owner of an asset is his ability to exclude others from the use of that asset.").

<sup>88</sup> See Grossman & Hart, *supra* note 39, at 695 (defining residual rights of control (i.e., residual claim) as "the right to control all aspects of the asset that have not been explicitly given away by contract").

<sup>89</sup> U.S. CONST. amend. XIII, § 1. This is consistent with John Locke's understanding of the product of labor as property. See JOHN LOCKE, TWO TREATISES OF GOVERNMENT § 27, at 305-06 (Peter Laslett ed., Cambridge Univ. Press 1988) (1690) ("Though the Earth, and all inferior Creatures be common to all Men, yet every Man has a *Property* in his own *Person*. This no Body

product of their labor to others, and thereby grant to others a share of the residual claim of particular services.<sup>90</sup> By contributing services to a partnership, a service provider grants the other partners a share of the residual claim in the contributed services. Thus, partners become residual claimants, or co-owners, of partnership property and services.

The co-ownership of partnership property and services makes tracing income from either the contributed property or services to the contributor impossible. A tax partnership's income flows from the combined output of partnership property and services, over both of which the partners share control. Sharing control and the residual claims of integrated property and services gives partnerships their distinctive nature. In particular, the parties cannot trace income from its source to a single owner of the source. Consider the nature of the various types of partnerships using these concepts.

Joline and Sarah each contribute services to Jorah Law Firm. If Joline brings in a new client matter and Sarah works on the matter, the partners cannot separate client-origination income from legal-services income when deciding how to divide the profit from the matter.<sup>91</sup> They have agreed, however, to divide the profit from that matter 60% to Joline and 40% to Sarah. Both the origination and legal work are required for the matter to create profit. As partners, Joline and Sarah share control of the origination and legal work and share in the profits from the integrated services. They cannot trace the profits directly or accurately from the exact source, so their agreed allocation determines each partner's share of income for client work Joline originates.<sup>92</sup>

The nature of partnerships also manifests itself in property-services partnerships. The income from Leex Partnership flows from

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has any Right to but himself. The *Labour* of his Body, and the *Work* of his Hands, we may say, are properly his. Whatsoever then he removes out of the State that Nature has provided, and left it in, he hath mixed his *Labour* with, and joyned to it something that is his own, and thereby makes it his *Property*. It being by him removed from the common state Nature placed it in, it hath by this *Labour* something annexed to it, that excludes the common right of other Men. For this *Labour* being the unquestionable Property of the Labourer, no Man but he can have a right to what that is once joyned to, at least where there is enough and as good left in common for others.”)

<sup>90</sup> Although parties may not compel others to act, after contracting to receive services, a party may receive damages from and perhaps impose an injunction on the party who fails to provide the contracted services. See E. ALLAN FARNSWORTH, *CONTRACTS* § 12.5, at 745 (4th ed. 2004). Thus, by entering into a contract, a service provider may transfer the product of labor to another party.

<sup>91</sup> Law firms may routinely allocate a share of profits from a matter to the originating partner to recognize the importance of origination. Such allocation does not necessarily reflect the source of income, but may merely reflect the law firms' perceived importance of rainmaking. The profit allocation to the originator is a form of monitoring that helps discourage shirking. See Borden, *supra* note 24, at 752-61 (describing how partners might allocate partnership profits to reduce shirking and agency costs).

<sup>92</sup> The allocation of economic items distinguishes tax partnerships from other integrated arrangements. All of the legal forms that can come within the definition of tax partnerships allow their members to allocate economic items by agreement. Corporations do not grant such rights. Thus, the integration of property and services and the legal right to allocate economic items define the nature of tax partnerships.

both the property Rex contributes and the services Rex and Lee contribute. The partners cannot separately trace income from property and services.<sup>93</sup> The income from one source fuses with the income from the other source.<sup>94</sup> The income from the combined sources becomes partnership income and flows to the partners with the character determined at the partnership level. Thus, the income from Rex's and Lee's contributed services and Rex's contributed property becomes rental income. Gain or loss from the sale of the office building should be gain or loss from the sale of a section 1231 asset.<sup>95</sup> The amount of gain recognized after formation will depend on both the contributed property and the contributed services.<sup>96</sup> The inability to trace income from services contributed by the service provider and property contributed by a property owner distinguishes integrated arrangements from nonintegrated arrangements.<sup>97</sup>

A profits-only partnership interest grants the owner of such interest a right to a portion of the income from the combined property and services of the partnership. The income does not merely flow from the service provider's services. The income also flows from the property in which the service provider takes an interest as a partner. Similarly, because a property contributor takes an interest in the service provider's services, income allocated to the property contributor includes income from property and services. Furthermore, the combination of the contributions should create output that exceeds the sum of the output of the contributions working separately.<sup>98</sup> Partners take an interest in that excess which does separately trace from either the property or services. The partners' interests in the product of all contributed resources give tax partnerships their unique nature. Because both parties co-own the resources needed to generate the rental income or gain from sale of a section 1231 asset and cannot trace income directly from the respective contributions, they both recognize the income in the character it takes at the partnership level.

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<sup>93</sup> See Borden, *supra* note 34, at 1024-25 (providing that the inability to trace from arrangements that combine property and services justifies the use of the partnership tax accounting and reporting rules).

<sup>94</sup> The property's location, size of units, and accessibility will affect rental income, as will Rex and Lee's management services. See JOHN MCMAHAN, *THE HANDBOOK OF COMMERCIAL REAL ESTATE INVESTING* 5-21 (2006). There is no way to determine the extent to which income derives from either the property or the services.

<sup>95</sup> See I.R.C. § 1231 (2006).

<sup>96</sup> As with the source of rental income, the parties cannot exactly determine the extent to which property and services independently affect the value of the property. The property's location, market factors, and other development will affect its value, as will Rex's and Lee's efforts to maintain, improve, and lease the property. See MCMAHAN, *supra* note 94, at 5-21. There is simply no way to determine the extent to which the value of the property derives from either source.

<sup>97</sup> See Borden, *supra* note 24, at 752-61 (discussing the nature of partnerships and the inability to trace income from the contributed source).

<sup>98</sup> See Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 779 (1972).

Investment partnerships differ, however, from services partnerships and property-services partnerships in one potentially significant aspect—by definition, the level of services contributed to an investment partnership is nominal.<sup>99</sup> The sale of an investment partnership's assets generates capital gain or loss, which means tax law treats the income as derived almost exclusively from the property, not services.<sup>100</sup> The implication is that the services do not contribute to the profits of the partnership. Because the income derives from the property, the partners should be able to trace the partnership income from its source to the owners of the property.<sup>101</sup> For example, assume two persons contribute equally to a limited liability company that acquires raw land, which the company leases to a cattle rancher. The company provides no services with respect to the land. Because the limited liability company only has income from the land, it should be able to trace that income from the land directly to the members based upon their contributions. The ability to trace the income from the source makes the arrangement look less like a partnership—at a minimum, investment partnerships lack the unique inability-to-trace attribute of both services partnerships and property-services partnerships.<sup>102</sup>

Partnership tax law recognizes the inability to trace partnership income from its source and allows partners to allocate partnership tax items in any reasonable manner. Normally any income from the property should be income to the property owner and income from services should be income to the service provider.<sup>103</sup> Tax law cannot impose that rule in

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<sup>99</sup> See *supra* text accompanying notes 61-64.

<sup>100</sup> Courts look to taxpayers' efforts in determining whether an asset is a capital asset or an asset that generates ordinary income upon sale. See, e.g., *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 423 (5th Cir. 1976) (holding that efforts to develop, frequency of sales, and other taxpayer efforts demonstrated the taxpayer held the property primarily for sale and gain on sale was ordinary income); *Hansche v. Comm'r*, 457 F.2d 429, 434-35 (7th Cir. 1972) (holding that the property's value increased because of taxpayer's efforts and property was not capital asset); see also Marjorie E. Kornhauser, *The Origins of Capital Gains Taxation: What's Law Got to Do with It?*, 39 Sw. L.J. 869, 890 (1985) ("The distinction between investor and businessman is critical here, as it was in Britain, because the former held his capital to produce income in the form of rents, dividends, or interest; the latter used his capital to buy and sell assets such that the act of buying and selling produced income in the form of the gains realized from the increased value.").

<sup>101</sup> See Bradley T. Borden, *Policy and Theoretical Dimensions of Qualified Tax Partnerships*, 56 U. KAN. L. REV. 317, 360 (2008) (arguing that investment qualified tax partnerships should not come within the definition of tax partnerships because they do not need the partnership allocation rules); Borden, *supra* note 34, at 1014 ("Members of [investment partnerships] can trace income from the property directly to the owners based on the owners' respective ownership interests in the property. Thus, the arrangements do not need the partnership accounting and reporting rules or the allocation rules.").

<sup>102</sup> The legislation proposed to change the tax treatment of carried interests recognized the distinction and limited the scope of the proposed rule to investment partnerships. See Temporary Tax Relief Act of 2007, H.R. 3996, 110th Cong. § 710(c) (as passed by House, Nov. 9, 2007) (limiting the scope of the recharacterization of income to services provided with respect to specified assets, which include only securities, real estate, commodities, and options or derivatives in such assets).

<sup>103</sup> See *Helvering v. Horst*, 311 U.S. 112, 114, 119-20 (1940) (holding that a property owner could not assign income from the property); *Lucas v. Earl* 281 U.S. 111, 114-15 (1930) (holding that an employee could not assign compensation to his spouse).

the partnership context because it cannot trace income from property and services. The allocation rules are, therefore, a compromise between the assignment-of-income doctrine and the inability to trace.<sup>104</sup> They should, however, be reserved only for arrangements that create tracing difficulty.<sup>105</sup> Services partnerships and property-services partnerships both present tracing difficulty; investments partnerships, lacking the unique character of partnerships, do not. Thus, investment partnerships do not appear to require the partnership tax allocation rules like other partnerships do. The proper way to address that difference may be to disregard investment partnerships.<sup>106</sup> Nonetheless, many recommendations regarding profits-only interests reform generally have been to disaggregate investment partnerships to cure the ill affects they cause. The byproduct of attempted investment partnership disaggregation has been complexity and a proposed law that would breach the integrity of subchapter K and adversely affect the application of other tax provisions.

### III. PARTNERSHIP DISAGGREGATION

Most commentary regarding profits-only partnership interests assumes the arrangements are tax partnerships and proceeds from that premise.<sup>107</sup> For the sake of analysis, the following discussion of partnership disaggregation accepts the assumption. In Part IV, this Article demonstrates that the assumption may be unfounded in many situations and that many arrangements should not come within the definition of tax partnership. Instead, they should be disregarded.

Assuming that an arrangement is a tax partnership, partnership disaggregation will not properly tax profits-only partnership interests. Partnership tax law provides generally that partnerships compute taxable income and allocate it to their partners who pay tax on the tax partnership income.<sup>108</sup> The character of income at the partnership level flows through to the partners.<sup>109</sup> Thus, if a tax partnership has long-term capital gain on the sale of an asset, it would allocate that gain to its partners, each of whom would individually report the income as long-

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<sup>104</sup> See Borden, *supra* note 47, at 333-46 (explaining the difficulties that inability-to-trace presents); Borden, *supra* note 34, at 951-56 (describing relationship between the assignment-of-income doctrine and the partnership allocation rules).

<sup>105</sup> See Borden, *supra* note 47, at 338-44 (identifying potentially abusive uses of the allocation rules).

<sup>106</sup> See *infra* Part IV.C (suggesting the definition of tax partnership should not include investment partnerships).

<sup>107</sup> See *supra* commentary cited in notes 17-21; see also Weisbach, *supra* note 20, at 719 (“Private equity sponsors, however, are central to the partnership activity. They are the managers of the partnership, making all of the investment decisions. Viewing them as anything other than partners would require reexamining this basic premise of partnership taxation, a premise that has underscored partnership taxation for more than fifty years.”).

<sup>108</sup> See I.R.C. §§ 701-704 (2006).

<sup>109</sup> See *id.* § 702(b).

term capital gain. Similarly, income from tax partnership services would flow through to the partners as income from services. The rules do not consider the separate activities of the partners or what they contribute in applying the character-flow-through rule.

Partnership disaggregation alters the character of partnership income as it flows from the tax partnership to partners. Thus, partnership disaggregation might change income that is long-term capital gain at the partnership level to compensation at the partner level. Compensation proponents recommend partnership disaggregation as the appropriate method for determining the taxation of profits-only partnership interests.<sup>110</sup> They use two primary analytical methods to support disaggregation in the case of income allocated to holders of profits-only partnership interests: (1) a partner-shareholder comparison and (2) a contribution-focused analysis. Each method has serious weaknesses and presents tax policy concerns. Furthermore, partnership disaggregation would cause complexities and difficulties that affect more than partnership taxation and could outweigh possible benefits.

#### A. Partner-Shareholder Comparison

The partner-shareholder comparison is a horizontal equity analysis. The comparison reasons that service-contributing partners are similar to service-providing shareholders and should therefore be taxed similarly.<sup>111</sup> That analysis appears to follow horizontal equity, which requires tax law to treat similarly situated taxpayers similarly.<sup>112</sup> Convincing horizontal equity arguments are difficult to make, however, because all taxpayers are alike in some respects and different in some respects.<sup>113</sup> Whether two persons are alike depends upon the criteria used

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<sup>110</sup> See, e.g., Noël B. Cunningham & Mitchell L. Engler, *The Carried Interest Controversy: Let's Not Get Carried Away*, 61 TAX L. REV. 121, 125-42 (2008) (describing the ordinary-income and imputed-interest approaches to disaggregation).

<sup>111</sup> See Fleischer, *supra* note 17, at 32-33.

<sup>112</sup> See A.C. PIGOU, A STUDY IN PUBLIC FINANCE 5 (3d rev. ed. 1962) (stating that "similar persons should be treated similarly") (emphasis omitted); accord HARVEY S. ROSEN & TED GAYER, PUBLIC FINANCE 367 (8th ed. 2008) ("People in equal positions should be treated equally."); Richard A. Musgrave, *Horizontal Equity, Once More*, 43 NAT'L TAX J. 113, 113 (1990) (describing horizontal equity as "requiring equal treatment of equals").

<sup>113</sup> See J.R. Lucas, *Vive la Difference*, 53 PHIL. 363, 363-64 (1978) ("Men are all alike . . . Men are all different. We are all alike in being featherless bipeds, language-using animals, sentient beings, centres of consciousness, and, granted certain conditions of age and health, rational agents. Each of us is different in spatio-temporal location, and, identical twins apart, in his genetic inheritance and the detailed biochemistry of his body; and, at a more conceptual level, in as much as each has a mind of his own, and can make up his mind for himself, and can make it up differently from anyone else."). Some commentators dismiss horizontal equity as being tautological and therefore of little analytical value. See, e.g., Peter Westen, *The Empty Idea of Equality*, 95 HARV. L. REV. 537, 547-48 (1982) ("Equality is an undeniable and unchangeable moral truth because it is a simple tautology."). Nonetheless, it is a powerful analytical tool, and even critics find themselves relying upon it to support positions. See, e.g., Weisbach, *supra* note 20, at 740-41 (criticizing horizontal equity); *id.* at 752 (using horizontal equity analysis to argue that private equity sponsors should be treated like investors). Because horizontal equity is so tempting to use and so powerful,

for comparison.<sup>114</sup> Thus, the starting point of a horizontal equity analysis is determining the proper criteria to use as a point of comparison.

The criteria used in the partner-shareholder comparison are (1) the provision of services and (2) the receipt of an interest in an entity.<sup>115</sup> The comparison begins by considering the receipt of corporate stock for services. A service-providing shareholder provides services and receives an interest in a corporation. A service-providing shareholder must recognize the grant of compensatory corporate interest as income.<sup>116</sup> The analysis recognizes that a service-providing partner similarly provides services and takes partnership interests. The partner-shareholder comparison therefore suggests that a grantee of a profits-only partnership interest should be taxed like the service-providing shareholder. The analysis then suggests that the grantee of a profits-only partnership interest should recognize compensation income as a result of a grant of a profits-only partnership interest.<sup>117</sup> The criteria used in the partner-shareholder analysis make the analysis attractive but ultimately ineffective because partnerships and corporations are distinctly different.

Comparing members of tax partnerships to shareholders for income tax purposes is often the proverbial comparison of apples to oranges. A very significant attribute distinguishes partnerships from corporations and is relevant to the analysis of the taxation of profits-only partnership interests. In particular, the basic organizational structure of a corporation differs from a partnership's organizational structure. Corporations grant shareholders the right to elect a board of directors.<sup>118</sup> The board of directors appoints officers to manage the corporation.<sup>119</sup> A corporate board of directors may appoint a shareholder to be an officer, and a corporation may grant equity interests to corporate employees.<sup>120</sup> Thus, an individual may be both a shareholder and employee of a corporation. A shareholder generally may not, however, act on behalf of

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the focus should be on the criteria of comparison and establishing standards that will help formulate the best possible criteria.

<sup>114</sup> See Kent Greenwalt, *How Empty is the Idea of Equality?*, 83 COLUM. L. REV. 1167, 1178 (1983) ("In order to decide what persons are relevantly equal or unequal, substantive judgments have to be made about what characteristics count."). Depending upon the criteria used, the outcomes of horizontal analysis may vary significantly. See, e.g., Bradley T. Borden, *The Like-Kind Exchange Equity Conundrum*, 60 FLA. L. REV. 643, 672-82 (2008) (providing examples of different outcomes depending on the criteria used to apply a horizontal equity analysis to section 1031 nonrecognition treatment of like-kind exchanges).

<sup>115</sup> See Fleischer, *supra* note 17, at 25-26.

<sup>116</sup> See I.R.C. § 83(a) (2006).

<sup>117</sup> See Cunningham, *supra* note 67, at 268.

<sup>118</sup> See MODEL BUS. CORP. ACT § 7.28 (1984); 2 MODEL BUS. CORP. ACT ANN. § 7.28 (4th ed. 2008).

<sup>119</sup> See MODEL BUS. CORP. ACT § 8.40 (1984); 2 MODEL BUS. CORP. ACT ANN. § 8.40 (4th ed. 2008).

<sup>120</sup> See generally Sharon Hannes, *Reverse Monitoring: On the Hidden Role of Employee Stock-Based Compensation*, 105 MICH. L. REV. 1421 (2007) (discussing the use of stock to compensate corporate employees).



the corporation in the capacity of a shareholder.<sup>121</sup> Individuals act on behalf of a corporation in the capacity of corporate employee or independent contractor.<sup>122</sup> Consequently, any property that a shareholder receives from a corporation in exchange for services will be compensation from acting as a corporate employee, not as a shareholder. Taxing the grant of corporate stock to a service provider as compensation is therefore appropriate.

Partners, on the other hand, may act on behalf of a partnership in either a partner or nonpartner capacity.<sup>123</sup> The same is true for members of member-managed limited liability companies.<sup>124</sup> That distinction undermines the comparison of partners and shareholders. A partner's ability to act in a partner capacity often makes comparing a partner to a sole proprietor more appropriate than comparing a partner to a corporate employee.<sup>125</sup> A sole proprietor acts in the capacity of a sole proprietor, not in the capacity of an employee of the proprietorship. A sole proprietor who provides services to others generates services income. A sole proprietor may also acquire rental property and perform only tenant services with respect to such property, which would generate rental income for the sole proprietor.<sup>126</sup> A sole proprietor also may acquire and

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<sup>121</sup> In limited situations, a shareholder may bring a derivative suit on behalf of the corporation. *See* MODEL BUS. CORP. ACT §§ 7.40-41 (1984); 2 MODEL BUSINESS CORPORATION ACT. ANNOTATED §§ 7.40-41(4th ed. 2008) (discussing shareholder derivative suits). If, however, the corporation commences an inquiry into the matter, a court may stay a derivative proceeding. MODEL BUS. CORP. ACT § 7.43 (1984); 2 MODEL BUS. CORP. ACT ANN. § 7.43 (4th ed. 2008).

<sup>122</sup> Although the distinction between employee and independent contractor is often important, in this analysis, it is not relevant. Any property an independent contractor receives in exchange for providing services will be compensation to the independent contractor.

<sup>123</sup> *See* UNIF. P'SHIP ACT § 301(1) (amended 1997), 6 U.L.A. 101 (2001) (providing that each partner is an agent of the partnership); UNIF. LTD. P'SHIP ACT § 402(a) (2001), 6A U.L.A. 429 (2008) (providing that a general partner is an agent of a limited partnership). The distinction between a partner as a partner and partner as an employee has recently been the topic of considerable debate. *See generally* Robert W. Hillman, *Law, Culture, and the Lore of Partnership: Of Entrepreneurs, Accountability, and the Evolving Status of Partners*, 40 WAKE FOREST L. REV. 793 (2005) (recognizing the significant changes in business practices and suggesting that such changes should affect the concept of partner and employee); Ann C. McGinley, *Functionality or Formalism? Partners and Shareholders as "Employees" Under the Anti-Discrimination Laws*, 57 SMU L. REV. 3 (2004) (analyzing the distinction between partner and employee in employment discrimination cases, discussing case law that has held that partners can be employees, and suggesting principles that should govern the distinction between partner and employee).

<sup>124</sup> *See* UNIF. LTD. LIAB. CO. ACT § 301(a) (1996), 6B U.L.A. 585 (2008) (providing that members are agents of the limited liability company). Manager-managed limited liability companies may be more similar to corporations for the sake of this analysis. That being the case, a limited liability company interest transferred to a member of a manager-managed limited liability company may be compensation to the recipient. Such a transfer may be indicative of the member acting in a nonpartner capacity, as discussed below, and should be taxed accordingly. These issues deserve greater scrutiny in an effort to better develop the distinction between partners acting in partner and nonpartner capacities.

<sup>125</sup> Others have made this comparison. *See, e.g.,* Cunningham, *supra* note 67, at 256-57 ("An individual conducting business as a partnership should not be taxed less favorably than he would be if he were conducting business as a sole proprietor . . ."); Weisbach, *supra* note 20, at 752 (arguing that tax law should treat a private equity sponsor like an individual investor).

<sup>126</sup> *See* I.R.C. § 61(a)(5) (2006).

hold investment property (i.e., a capital asset).<sup>127</sup> Too much activity on the part of the sole proprietor with respect to investment property will convert it to property that produces ordinary income.<sup>128</sup> Otherwise, income from such property will be investment income. Thus, not all income derived from a sole proprietor's services is compensation. Tax law characterizes income derived from a sole proprietor's services depending upon the comparative levels of involvement of the property and services in creating the income.<sup>129</sup>

Because partners can act in a partner capacity, tax law should treat them more like sole proprietors who act in their individual capacities. Partners acting on behalf of partnerships may generate partnership services income or partnership investment income. The distinction, however, should depend upon the level of activity performed at the partnership level. Partners who act on behalf of an investment partnership perform nominal services.<sup>130</sup> The nominal services do not convert the partnership income to services income. The service provider's services are so limited in nature that the partnership remains an investment partnership. Altering the character of income as it flows from the partnership to the partner would create services income where none may otherwise be present.<sup>131</sup>

The economic nature of tax partnerships and corporations also varies significantly, and partner-shareholder comparisons fail to distinguish between the various types of partnerships. Recall from the discussion above that the allocation of economic items distinguishes tax partnerships from other arrangements.<sup>132</sup> Because a corporation cannot allocate economic items, any payments from a corporation to a shareholder that are not made with respect to stock (i.e., a dividend) must be compensation. If such payments are in the form of stock, a service-providing shareholder could avoid services income. The service provider would take a zero basis in the stock, which would be a capital asset.<sup>133</sup> The stock may have value upon the date of receipt, so not taxing the

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<sup>127</sup> See *id.* § 1221 (defining capital asset).

<sup>128</sup> See *supra* note 100.

<sup>129</sup> Tax law allows a property owner to perform some services that improve the property's value without affecting the property's capital asset status. See, e.g., *Barrios Estate v. Comm'r*, 265 F.2d 517, 519-20 (5th Cir. 1959). If the services become too extensive, the property converts to dealer property and gain from the sale of such property becomes ordinary income. See, e.g., *Sanders v. United States*, 740 F.2d 886, 888-89 (11th Cir. 1984). The line separating services allowed on investment property and services that create dealer property is unclear. This presents another area of the law ripe for consideration using modern analytical methods.

<sup>130</sup> See *supra* text accompanying notes 57-64.

<sup>131</sup> Income from a services partnership will not, however, be treated as services income for self-employment tax purposes if allocated to a limited partner who does not provide services. See I.R.C. § 1402(a)(13). For income tax purposes, it will, however, retain the character derived from the partnership and be service income to the limited partner. See *id.* § 702(b).

<sup>132</sup> See *supra* text accompanying notes 83-85.

<sup>133</sup> See I.R.C. § 1221 (defining corporate stock as a capital asset in the negative by not listing it among the type of property that does not come within the definition of capital asset).

receipt would defer the income and change its character. Any increase in the value of stock following the date of receipt would accrue to the service provider as capital gain, regardless of the character of income at the corporate level. If the corporation were to liquidate, the service provider would recognize capital gain to the extent the liquidating distribution exceeded the basis the shareholder had in the stock.<sup>134</sup> Similarly, the shareholder would recognize capital gain by selling the stock.

That result would obtain regardless of the corporation's enterprise. To illustrate, assume that Rex and Lee decide to form a corporation instead of a tax partnership.<sup>135</sup> Rex contributes the office building to the corporation in exchange for stock, and the corporation distributes stock to Lee in exchange for the services he will provide.<sup>136</sup> Over the life of the corporation, it has rental income, and, if it ever disposes of the office building, it will have section 1231 gain.<sup>137</sup> If the law did not tax Lee on the receipt of the corporate stock, he would have converted an entire stream of rental income (taxed at higher ordinary income rates) to capital gains, which may qualify for favorable tax rates. By taxing Lee on the receipt of the corporate stock, the law recognizes the potential for converting ordinary income into capital gain income and prevents such conversion. Furthermore, as a shareholder, Lee becomes a residual claimant of the corporation.<sup>138</sup> Thus, the value of the stock on the date of issue represents the present value of the future stream of rental income and Lee's residual claim in the building. Any increase in the value of Lee's stock will reflect an increase in the value of the office building. Refuting the validity of that result is difficult.<sup>139</sup>

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<sup>134</sup> See *id.* § 302(a), (b)(3) (providing that payment in complete redemption of stock shall be treated as full payment in exchange for the stock).

<sup>135</sup> See *supra* Part II.A.2. (presenting the facts of the hypothetical Leex Partnership).

<sup>136</sup> Because Rex also agrees to contribute services, see *supra* Part II.A.2., a portion of the stock he receives will be compensation for those services and Rex will have to recognize compensation income upon receipt of the portion of the stock transferred in exchange for his services. See I.R.C. § 83(a).

<sup>137</sup> See *id.* § 1231(a)(A).

<sup>138</sup> See Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J. LAW & ECON. 327, 328 (1983) (introducing the discussion of unrestricted residual claims of open corporation common stock).

<sup>139</sup> The one aspect of the result that is refutable is the double tax on corporations. The corporation will pay tax on the rental income, even though Lee will not. See I.R.C. § 11(a). As stated in the text, the value of the stock upon the date Lee receives it includes the present value of future rental income. Because the law requires Lee to pay tax on that amount and also requires the corporation to pay tax on the rental income, the law taxes the rental income twice. Commentators have criticized the double tax on corporations and have recommended changes that would help eliminate it. See, e.g., Edward D. Kleinbard, *Rehabilitating the Business Income Tax*, 2007 TAX NOTES TODAY 114-42 (Jun. 1, 2007) (proposing elimination of the double tax on corporate shareholders). Those arguments are convincing and deserve greater attention from lawmakers. If corporate tax were integrated, the law would either have to eliminate that tax on Lee at the time he receives the stock, or it would have to eliminate the corporate tax on rental income. That aspect of tax policy does not, however, affect the residual-risk distinction between tax partnerships and tax corporations. See Bradley T. Borden, *Residual-Risk Model for Classifying Tax Entities*, 37 FLA. ST. U. L. REV. (forthcoming 2010).

The flow-through nature of partnerships distinguishes them from corporations. Whereas Lee would not recognize any of the corporate income, if he were a shareholder, Lee would recognize his share of partnership income as the partnership allocates the income to him.<sup>140</sup> Thus, as the partnership has rental income, Lee will recognize rental income. He cannot convert that rental income into capital gain as a member of a partnership. Because Lee's interest in the partnership is a profits-only interest, he does not take any interest in the value of the office building at the time of formation. Instead, his interest in the office building is limited to the office building's future increase in value. Any portion of the gain allocated to him upon sale of the office building will be section 1231 gain, eligible for favorable capital gain rates.<sup>141</sup> That amount of gain is similar to the capital gain reflected in the increase of stock that a service provider recognizes as corporate assets increase in value. Because Lee would recognize ordinary income as the partnership allocates rental income to him, a partnership is fundamentally different from a corporation. That difference warrants treating the grant of a profits-only interest differently from the grant of corporate stock in exchange for services.

The analysis withstands scrutiny even in the case of an investment partnership. Whereas a service provider would pay tax on compensation for services if performed for a property owner,<sup>142</sup> a partner who provides those same services could convert compensation income to capital gain. Thus, Krinkle and Warbucks can convert what would otherwise be compensation income into capital gain by creating Kribucks LP instead of entering into an employment arrangement.

The partnership form thus allows Krinkle to defer recognition, as he would be able to do as an employee, but it also allows him to change the character of the income. Policy justifies the deferral because as a profits-only partner, Krinkle's interest in the property accrues as the property's value increases. Krinkle does not take an interest in the present value of the property. If Warbucks and Krinkle had instead formed a corporation, Krinkle would recognize compensation income upon receipt of his share of the stock. The value of the stock would represent Krinkle's share of the residual value of the property that Warbucks would contribute to the corporation. Having received the stock in exchange for services, Krinkle would recognize the value of such stock as compensation income.<sup>143</sup> The corporate form is different from the employment arrangement and tax partnership because as a shareholder, Krinkle takes an interest in the property at the time of corporate formation. As an employee or profits-only partner, Krinkle's

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<sup>140</sup> See I.R.C. §§ 701, 704.

<sup>141</sup> See *id.* § 1231(a).

<sup>142</sup> See *id.* § 61(a)(1).

<sup>143</sup> See *id.* § 83(a).

interest is limited to a share of the property's future appreciation. That distinction indicates that a profits-only partner of an investment partnership should not be taxed like a shareholder. The profits-only partner of an investment partnership should instead be taxed like an individual.

In the case of services partnerships or property-services partnerships, the grantee of a profits-only partnership interest will recognize ordinary income as the partnership allocates income to the partners. Thus, tax policy justifies deferring gain recognition until that time and allowing the character to flow from the partnership to the partners. The situation changes, however, in the case of an investment partnership that does not have ordinary income. The comparison of profits-only partners to individuals suggests that the services partner should have compensation income for the services provided. Compensation proponents suggest partnership disaggregation is the correct way to ensure that a profits-only partner of an investment partnership recognizes compensation. As demonstrated below, however, partnership disregard accomplishes these policy objectives without adverse consequences.<sup>144</sup>

The allocation of economic items and the inability to trace them from their sources suggests that tax law should treat allocations to partners differently than it treats payments to shareholders. Even though a tax partnership integrates property and services, and thus is significantly different than an individual, the allocation of economic items from a partnership makes the comparison to an individual superior. Therefore, a horizontal equity analysis should not compare service-contributing partners to service-providing shareholders. A horizontal equity analysis more appropriately compares service-contributing partners to sole proprietors and employees.

#### *B. Contribution-Focused Analysis*

Compensation proponents also rely upon a contribution-focused analysis to argue for partnership disaggregation. A contribution-focused analysis considers what a partner contributes to a partnership to determine the character of income allocated to a partner.<sup>145</sup> Under a contribution-focused analysis, partnership income allocated to a service contributor would be income from services; partnership income allocated to a property contributor would be income from property. Most applications of contribution-focused analysis focus on service contributions. If applied at all, a contribution-focused analysis should

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<sup>144</sup> See *infra* Part IV.

<sup>145</sup> The commentators who suggest that service partners should recognize ordinary income from partnerships focus on the partners' contributions. See *generally* sources cited *supra* note 17.

apply to all contributions, so any analysis that focuses solely on contributed services is incomplete. Changing the character of income to reflect contributed resources will, however, produce results that are difficult to justify.

Leex Partnership helps illustrate how a fully functioning contribution-focused analysis should work. Recall that the Leex Partnership agreement provided that Rex would contribute both property and services.<sup>146</sup> Under a contribution-focused analysis, a portion of all income allocated to Rex would be consideration for services provided and a portion would be a return on his contributed capital.<sup>147</sup> That varies from the tax treatment Rex would obtain as sole owner. As sole owner of the office building, Rex would recognize income from the office building as rental income, and income from the sale of the office building would be gain from the sale of section 1231 property. Under a contribution-focused analysis, Rex's contribution of the property to a tax partnership would, in part, change the character of income he recognizes. Instead of only rental and section 1231 income he recognized as an individual, he would also recognize some services income as a service-contributing partner. That result is unjustified because the building continues to generate rental income after the partnership formation.

The change of tax treatment would also cause inefficient results because parties would avoid partnership formation if the results were unfavorable, and they form partnerships to obtain favorable tax results when possible. For example, if services income increased Rex's tax liability more than the benefit he would obtain by contributing the office building to a partnership, he would not join the partnership.<sup>148</sup> Such inefficiency makes a contribution-focused analysis unattractive.

Another unexpected result of a contribution-focused analysis is that partnership income allocated to a property contributor would be income from property. Thus, if Piers contributed dry cleaning assets and no services to Piergan LLC, a dry cleaning partnership formed with Morgan, all partnership income allocated to Piers should be rental income from the property or gain from the sale of the property. Thus, even though the partnership may have only income from services, when allocated to Piers, that income would transform to rental or other investment income. If Piers had contributed cash instead of property, income allocated to him should be interest income under a contribution-focused analysis.

A contribution-focused analysis ignores the operations at the partnership level and only considers the partners' contributions. Thus,

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<sup>146</sup> See *supra* text accompanying note 48.

<sup>147</sup> Professor Weisbach also considered this analysis. See Weisbach, *supra* note 20, at 736.

<sup>148</sup> See ROSEN & GAYER, *supra* note 103, at 331-48 (discussing the effects of tax on behavior).

the contribution-focused analysis should also require income from property to reflect the character of the property in the hands of the contributor. As a result, gain allocated to an investor from a dealer partnership should be capital gain income if the investor had contributed a capital asset. Such treatment would be a deviation from current law, except in cases where current law prohibits property owners from changing the character of income to obtain favorable tax results.<sup>149</sup> A contribution-focused analysis should require the law to apply consistently to all situations. This potential result reveals how a contribution-focused analysis produces a result that is incongruous with established partnership tax rules. Changing tax rules is not necessarily a bad thing, but with respect to contribution focused-analysis, such a change would alter taxpayer behavior without generating taxable income.

The ultimate effect of a consistent application of a contribution-focused analysis would be uncertain. Some partnership income that is currently investment income would become services income when allocated to holders of profits-only partnership interests. Services income allocated to holders of capital-only partnership interests would become investment income. The result may be a wash from a revenue standpoint (the increased tax revenue from investment income converted to compensation income may be offset by services income converted to investment income). Nonetheless, if a contribution-focused analysis were to apply to profits-only partnership interests, it should apply to all other types of interests. Merely altering the tax treatment of holders of profits-only partnership interests is inappropriate because it applies different standards to members of the same partnership.<sup>150</sup> Thus, a contribution-focused analysis is an unattractive tool for analyzing profits-only partnership interests.

### C. *Ripple Effects of Partnership Disaggregation*

Using partnership disaggregation to tax profits-only partnership interests raises the policy concerns discussed above. It also would cause technical complexity. Recent proposed legislation illustrates the complexity that could result from partnership disaggregation. In apparent response to urgings from compensation proponents, proposed legislation would tax as compensation amounts allocated to a service provider with respect to profits-only interests in investment partnerships.<sup>151</sup> The proposed legislation would thus disaggregate investment tax partnerships. The proposed legislation indicates that the proponents of

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<sup>149</sup> See I.R.C. § 724 (2006) (denying the conversion of ordinary income to capital gain and the conversion of capital loss to ordinary loss on contribution of property to a tax partnership).

<sup>150</sup> Such different treatment appears to be an unjustified breach of horizontal equity. See *supra* text accompanying notes 112-114.

<sup>151</sup> See Temporary Tax Relief Act of 2007, H.R. 3996, 110th Cong. (as passed by House, Nov. 9, 2007).

partnership disaggregation recognize that investment partnerships are different from other types of partnerships. Therefore, they attempt to limit partnership disaggregation to investment partnerships.<sup>152</sup> Although it may be a noble attempt, the proposed legislation misses the mark by using partnership disaggregation.

Partnership tax practitioners and members of the Partnerships & LLCs Committee of the American Bar Association Section of Taxation have uncovered many problems that the proposed legislation would create.<sup>153</sup> Simply altering the character of partnership profits allocated to a service-providing partner mis-taxes the allocated amount. First, it does not provide an offsetting deduction for the amount characterized as compensation income.<sup>154</sup> The payment of compensation generally results in a deduction for the party who pays the compensation.<sup>155</sup> Failing to provide such a deduction creates an anomalous asymmetrical treatment of compensation. Second, it does not take into account other tax law provisions.<sup>156</sup> For example, if the receipt of the interest were also a taxable event under section 83, the holder of the interest would be taxed a second time on allocations of partnership income.<sup>157</sup> Third, the law must consider the tax treatment of non-U.S. partners in U.S. partnerships and U.S. partners in non-U.S. partnerships.<sup>158</sup> Fourth, the law may mischaracterize gain or loss on the sale of a profits-only partnership interest and not properly account for the basis the purchaser would take in such interest.<sup>159</sup> These and many other potential issues demonstrate that disaggregation will cause significant technical complexities.<sup>160</sup>

The nature of partnerships makes partnership disaggregation an unattractive method for reducing the inequities caused by the current tax treatment of profits-only partnership interests. Partnership disaggregation also raises technical complexities that make the proposed rules

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<sup>152</sup> H.R. 3996, § 710(c) (limiting the scope of the section's application to services provided with respect to securities, real estate, commodities, and options or derivatives in such property); see generally Fleischer, *supra* note 17 (focusing on private equity funds).

<sup>153</sup> See Carol Kulish Harvey & Eric Lee, *A Technical Walk Through the Carried Interest Provisions Contained in Chairman Rangel's Tax Reform Proposal*, TAXES, Feb. 2008, at 77; Schler, *supra* note 21; see also ABA Comments, *supra* note 21. This Part of the Article draws examples of technical complexity from those articles.

<sup>154</sup> See Schler, *supra* note 21, at 847.

<sup>155</sup> See I.R.C. § 162(a)(1) (2006).

<sup>156</sup> See Schler, *supra* note 21, at 849.

<sup>157</sup> In limited circumstances, the IRS appears prepared to use section 83 to tax the grant of profits-only partnership interests. See Rev. Proc. 93-27, 1993-27 C.B. 343 (providing a safe harbor from taxation for grants of profits-only partnership interests). The proposed legislation does not eliminate that possibility. Therefore, the grant of the interest may be taxed, and income allocated with respect to the interest may be taxed. Because any value of the interest at the date of grant would include the estimated present value of future allocations, taxing the grant and allocations would create a double tax.

<sup>158</sup> See Schler, *supra* note 21, at 854-57 (identifying the proposed legislation's inadequacies regarding cross-border arrangements).

<sup>159</sup> See *id.* at 865-67.

<sup>160</sup> Because commentators have thoroughly discussed those issues, this Article does not revisit them here in greater detail.



untenable. Therefore, partnership disaggregation appears to be an untenable solution to the problem profits-only interests raise. Part IV recommends partnership disregard as a better method for addressing concerns raised by profits-only partnership interests.

#### IV. PARTNERSHIP DISREGARD

“[T]hat which we call a rose [b]y any other name would smell as sweet[,]”<sup>161</sup> and that which is a nonpartnership by any other name, including “partnership,” should remain a nonpartnership for tax purposes. Interestingly, the recent discussions about carried interests all appear to assume that the subject arrangements are tax partnerships, without scrutinizing the underlying agreements and economic arrangements.<sup>162</sup> Although tax law specifically provides that state law classification of an arrangement does not determine its tax classification,<sup>163</sup> commentary on profits-only partnership interests appears to disregard that aspect of federal tax entity classification.<sup>164</sup> Blind acceptance of state law classification would provide taxpayers the opportunity to disguise any number of arrangements as tax partnerships and take advantage of the partnership tax law accounting and reporting rules (in particular, the allocation rules), even though tax policy does not support such classification.<sup>165</sup> Furthermore, even if the current definition of tax partnership includes all of the various types of partnerships described above,<sup>166</sup> the definition may be too broad and may need to be modified to address current business practices and modern partnership tax theory.

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<sup>161</sup> See WILLIAM SHAKESPEARE, *ROMEO AND JULIET* act 2, sc. 2.

<sup>162</sup> Some commentators have suggested that profits-only partnership interests should be treated as implicit or constructive loans to the service provider. See Cunningham & Engler, *supra* note 110, at 122, 128-32 (advocating treating the carried interest as an implicit loan); Schmolka, *supra* note 20, at 302 (“Economically, that temporary shift is the equivalent of an interest-free, compensatory demand loan. Though the relationship among partners obviously is not that of debtor and creditor, the essential fact is that S’s services are in part compensated by S’s use of A’s and B’s money.”). Professor Schmolka did, however, raise partnership disregard as an appropriate way to analyze the proper tax treatment of a profits-only partnership interest. See *id.* at 299-301. The latter recognition that a purported partnership may not be a tax partnership is the essence of partnership disregard. Constructive recharacterization misses the mark because it fails to recognize the true nature of tax partnerships and because there is “no real loan.” See Schler, *supra* note 21, at 861-64.

<sup>163</sup> See Treas. Reg. § 301.7701-1(a)(1) (as amended in 2006) (“Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.”).

<sup>164</sup> See *supra* notes 16-17 (listing articles that discuss profits-only interests but fail to consider whether the arrangement satisfies the definition of tax partnership).

<sup>165</sup> See Borden, *supra* note 34, at 1010-11 (presenting policy reasons for not relying upon state-law classification to define tax partnerships). For an example of disguising an arrangement, see *supra* text accompanying notes 8-15 (describing the use of a limited liability company to disguise an employment arrangement).

<sup>166</sup> See *supra* Part II.A. (describing services partnerships, property-services partnerships, and investment partnerships).

Tax law can avoid the policy problems and tax complexities that partnership disaggregation would cause by focusing on whether an arrangement labeled a partnership comes within the definition of tax partnership and whether an interest labeled a partnership interest should be recognized for tax purposes. Tax law should disregard any arrangements that do not come within the definition of tax partnership. If an arrangement is a tax partnership, the analysis should consider whether any partners act in a nonpartner capacity. Such a focus will require clearer definitions of what a tax partnership is and when a partner acts in a nonpartner capacity. The recommendation to disaggregate partnerships may result from an inability to clearly identify and express the source of discomfort profits-only partnership interests cause. The misdiagnosis has led to a prescription that will not alleviate the discomfort, and which will have serious negative side effects.<sup>167</sup> Partnership disregard is a better prescription for the perceived ills that profits-only partnership interests create. It requires examining whether an arrangement is a hired-services or hired-property arrangement or is a tax partnership. It also requires examining the capacity in which members of tax partnerships act. This analysis suggests that tax law should narrow the definition of tax partnership. A narrower definition of tax partnership will deprive service arrangements of the partnership allocation rules and will help ensure that compensation is taxed at ordinary rates. It will also help preserve the integrity of the partnership tax rules.

A. *Hired Services Versus Hired Property*

Partnership disregard examines an arrangement purporting to be a tax partnership. If the examination reveals the arrangement is not a tax partnership, it disregards the arrangement. Partnership disregard means tax law should treat any agreements between the parties as something other than a tax partnership. Disregarded arrangements should be either hired-services arrangements or hired-property arrangements. As described above, a partnership is an integration of at least two persons' property and services or an integration of services of at least two persons.<sup>168</sup> Hired-services and hired-property arrangements are not integrated arrangements. The service provider and property owner retain the residual claims of their respective resources.<sup>169</sup> In the case of hired

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<sup>167</sup> See JEROME GROOPMAN, HOW DOCTORS THINK 24 (2008) (reporting that inadequate medical knowledge is rarely the cause of medical error, whereas up to fifteen percent of medical diagnoses are inaccurate); Kaveh G. Shojania, Elizabeth C. Burton, Kathryn M. McDonald & Lee Goldman, *Changes in Rates of Autopsy-Detected Diagnostic Errors Over Time*, 289 JAMA 2849, 2850-52 (2003) (discussing the results of a study of diagnostic error rates detected in autopsies). The medical analogy may not be too far afield as lawyers and legal scholars are also surely open to the possibility of misdiagnosing legal problems.

<sup>168</sup> See *supra* text accompanying note 83.

<sup>169</sup> The parties may be able to share the residual claim of one resource (e.g., property) without becoming a tax partnership, if they do not share the residual claim of the other resource. See

services, income the service provider receives is compensation. In the case of hired property, income the property owner receives is interest or rent, depending upon the type of property and use.<sup>170</sup> Payment as a share of profits should not change the classification of an arrangement as either hired services or hired property.<sup>171</sup> In either such situation, the proprietor may determine the amount to pay for the hired item as a percentage of profits without converting the arrangement to a tax partnership.<sup>172</sup>

Discussions regarding the taxation of profits-only partnership interests have focused mainly on the tax treatment of the service provider. If an analysis disregards a purported partnership, however, it should not automatically assume that the default arrangement is a hired-services arrangement.<sup>173</sup> Instead, after disregarding a partnership, the analysis must consider whether the arrangement is a hired-services arrangement or a hired-property arrangement.

Unfortunately, the law is largely unhelpful with each of those determinations. The law does not clearly define the distinction between tax partnerships and disregarded arrangements.<sup>174</sup> It also fails to delineate between hired-services and hired-property arrangements. This Article suggests that lawmakers and commentators should focus more effort on defining the distinctions necessary to properly disregard purported tax partnerships. Because the law has generally failed in this area, legal precedent provides very limited direction. Instead, the analysis should look to economic concepts to help draw the distinctions. Economic concepts help ensure that the law correctly places the incidence of taxation, regardless of precedent.

Beginning with Professor R.H. Coase's seminal work, *The Nature of the Firm*,<sup>175</sup> economists have struggled to discover why parties join together to form business arrangements, identify the boundaries of

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*supra* text accompanying note 83 (describing partnerships as an integration of property and services).

<sup>170</sup> For example, a property manager could hire an office building by leasing it from the owner and subleasing it to tenants. A borrower hires money and pays for it with interest.

<sup>171</sup> See Grossman & Hart, *supra* note 39, at 694.

<sup>172</sup> See, e.g., Arthur Venneri Co. v. United States, 340 F.2d 337, 342-43 (Ct. Cl. 1965) (holding that advance did not create a tax partnership, even though the creditor would share in the profits of the borrower), *abrogation recognized by* Consol. Flooring Servs. v. United States, 42 Fed. Cl. 878 (1999); Luna v. Comm'r, 42 T.C. 1067, 1078-79 (1964) (holding that an arrangement was an employment arrangement, not a tax partnership, even though parties shared profits); Place v. Comm'r, 17 T.C. 199, 206 (1951), *aff'd*, 199 F.2d 373 (6th Cir. 1952) (holding that sharing of profits was not sufficient to show arrangement was tax partnership and not a lease).

<sup>173</sup> One commentator analogized the holder of a carried interest to an entrepreneur borrowing money from the capital investors. See Weisbach, *supra* note 18. The focus of that commentary was on the taxation of the service provider, who would probably be able to report the gain from sale of assets acquired with the borrowed funds as capital gain. The commentary did not focus on the tax consequences to the lender. Taxing the share of gain allocated to the lender as interest would create significantly different tax consequences to the lender than those obtained if the arrangement is a partnership that allocates long-term capital gain to the property contributor.

<sup>174</sup> See Borden, *supra* note 34, at 1008-31 (identifying inadequacies of the current definition of tax partnership).

<sup>175</sup> R.H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937).

business arrangements, and explain why arrangements engage in particular activities.<sup>176</sup> The economists' exploration of the reasons for forming business arrangements helps tax law identify the distinction between tax partnerships and disregarded arrangements. The discussion above suggested that the difference between disregarded arrangements and tax partnerships is the integration of property and services.<sup>177</sup> Economists theorize that parties integrate property and services to reduce transaction costs and to reduce appropriable quasi rent seeking activities.<sup>178</sup> Because integration is the solution for certain economic concerns, it distinguishes firms from other types of arrangements. Integration also creates tax accounting complexity.<sup>179</sup> That is why it should also distinguish tax partnerships from disregarded arrangements. To apply that test, the law must be able to identify integrated arrangements.

A two-person arrangement is not integrated if one party retains the residual claim of either the property or services. The residual claim is "the right to control all aspects" of property or services not contracted away.<sup>180</sup> To determine whether an arrangement is integrated, the analysis must ask whether one party retains the residual claim of either the property or services. The agreement among parties to an arrangement should reveal who holds the residual claim, regardless of the form used to memorialize the agreement. Thus, whether the agreement takes the form of a loan, employment agreement, a lease, a partnership agreement, or an operating agreement of a limited liability company is irrelevant. The analysis must examine any such agreement to determine whether the parties have integrated property and services.

The examples presented above help illustrate how integration can distinguish disregarded arrangements from tax partnerships. Recall that Rex and Lee formed Leex Partnership by Rex contributing property and services and Lee contributing services.<sup>181</sup> Assume they memorialize their agreement with a written partnership agreement that includes their allocation formulae and provides that the arrangement is perpetual. The agreement says nothing about how the partnership will distribute assets upon liquidation, so the state default rule applies.<sup>182</sup> Thus, the partners'

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<sup>176</sup> See Jensen & Meckling, *supra* note 2, at 306.

<sup>177</sup> See discussion *supra* Part II.C. Because the relevant analysis only concerns the difference between tax partnerships and disregarded arrangements, it assumes all integrated arrangements allocate economic items to their members. Thus, the arrangements would not be corporations.

<sup>178</sup> See Coase, *supra* note 175, at 390-91 (claiming that internalizing transactions eliminates the need to negotiate each transaction); Klein, Crawford & Alchian, *supra* note 2, at 307 (concluding that parties integrate if appropriable quasi rents are high).

<sup>179</sup> See *supra* text accompanying notes 90-92 (demonstrating that integration makes tracing impossible).

<sup>180</sup> See Grossman & Hart, *supra* note 39, at 695.

<sup>181</sup> See *supra* Part II.A.2.

<sup>182</sup> See UNIF. P'SHIP ACT § 103(a) (1997), 6 (pt. 2) U.L.A. 73 (2001).

liquidating distributions will equal the sum of their contributions plus allocations, minus any distributions received from the partnership.<sup>183</sup> By contributing the property to Leex Partnership, Rex forfeits the right to control all aspects of the property not contracted away. Rex no longer unilaterally controls the disposition of the property, the use of the property, or the power to exclude Lee from participating in managing the property.<sup>184</sup>

By contributing services, Lee forfeits the economic benefit of performing such services for others.<sup>185</sup> That forfeiture vests Rex with a portion of the residual claim of Lee's services. If Lee were to perform office management services for the owner of another office building, Rex should be able to recover the economic damages such other services cause Rex.<sup>186</sup> By sharing control of the property with Rex, Lee can also help prevent Rex from terminating her services. As sole owner of the property, Rex controlled who could provide services with respect to the property.<sup>187</sup> He forfeits that control when the property and services merge. Rex's and Lee's mutual forfeiture of rights create a partnership.

Contrast Leex Partnership with Chrichel LLC, with modified facts. Recall that Chrichel LLC was a lawn mowing service.<sup>188</sup> Rachel contributed lawn mowing equipment and Christy agreed to use the equipment to mow lawns. Rachel and Christy agreed to divide the profits from the lawn mowing.<sup>189</sup> Assume further that the parties agreed that at the end of the lawn mowing season Chrichel LLC would dissolve and distribute any cash to the parties according to their profit-sharing agreement and distribute the lawn mowing equipment and other assets to Rachel. Although the arrangement takes the form of a limited liability company, Rachel appears to retain the property's residual claim. During the lawn mowing season Christy uses the equipment and other assets to mow lawns, but she has no interest in the property following the lawn mowing season. If the arrangement is profitable to Rachel, she may enter into a similar arrangement with Christy in a subsequent year, but she has no obligation to do so. Rachel appears to have contracted away the use and disposition rights during the lawn mowing season. Following the lawn mowing season, however, Rachel will possess the rights to control all aspects of the property. Therefore, Rachel retains the property's residual claim and the parties did not integrate their resources. They merely used a limited liability operating agreement as the medium for a

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<sup>183</sup> See UNIF. P'SHIP ACT §§ 401, 807, 6 (pt. 2) U.L.A. 133, 206.

<sup>184</sup> This assumes the partnership agreement does not vest all such powers with Lee. If it had, then Lee would retain the residual claim of the property and the arrangement would not be a tax partnership.

<sup>185</sup> See *supra* note 90.

<sup>186</sup> See *id.*

<sup>187</sup> See Hart & Moore, *supra* note 87, at 1121.

<sup>188</sup> See *supra* text accompanying notes 52-55.

<sup>189</sup> See *supra* text accompanying note 52.

hired-services or hired-property arrangement. As a result, the arrangement should not be a tax partnership under the integration test.

An analysis that disregards a purported tax partnership must turn its focus to whether the disregarded arrangement is a hired-services or hired-property arrangement. That analysis would likely focus on who controls the property and services.<sup>190</sup> If the service provider has control, the arrangement would be a hired-property arrangement. Alternatively, if the property owner has control, the arrangement would probably be a hired-services arrangement. Often, making such a distinction is difficult, especially if the parties have control, as partners do. For instance, in the Chrichel LLC example, if the law disregards the arrangement, it is either an employment arrangement or a lease. Either Rachel has hired Christy to mow the lawns, or Christy has leased the equipment from Rachel.

Whereas residual claims determine whether an arrangement is a tax partnership or disregarded arrangement, control of current claims determines whether an arrangement is a hired-services or hired-property arrangement. For this purpose, the current claims of the property include its current use, and current claims of services include the power to control the economic product of the services. Therefore, if Rachel controls the use of the property and can direct Christy's services for the duration of the agreement, the arrangement would be a hired-services arrangement. On the other hand, if Christy controls the use of the property for the duration of the agreement, the arrangement would be a hired-services arrangement.

The tax classification of disregarded arrangements may significantly affect the tax liability of the parties. If the law disregards Chrichel LLC, and treats the arrangement as a hired-services arrangement, Rachel and Christy will both have services income. If the law treats the arrangement as a hired-property arrangement, Rachel will have rental income and Christy will have services income. Tax law treats each of those classes of income as ordinary income,<sup>191</sup> so that classification does not alter the type of income.

The different tax results could, however, be profound if the property were money. With money as the property, a hired-property arrangement would be a loan. Income paid to the property owner would be interest income.<sup>192</sup> Income earned by the service provider would vary depending upon the use to which the service provider puts the money. If the service provider acquires a capital asset and the only income is from

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<sup>190</sup> Undoubtedly such an analysis will be difficult. No set standard exists for determining when joining property and services creates a tax partnership. *See* Borden, *supra* note 34, at 970-1001 (describing the various tests Congress, courts, and the IRS use to define tax partnership). Furthermore, no set standards exist that delineate between hired property and hired services. A complete analysis requires, however, a justification for reaching a particular conclusion. An arbitrary selection will create inconsistent and perhaps unfair tax treatment of parties.

<sup>191</sup> *See* I.R.C. § 1(h)(1)(A) (2006) (taxing at ordinary income rates any income that does not qualify for preferential rates).

<sup>192</sup> *See id.* § 61(a)(5).

gain on the sale of the asset more than one year after the acquisition, the income will be long-term capital gain to the service provider.<sup>193</sup> If the service provider uses the money to start a dry cleaning business, income to the service provider will be services income.<sup>194</sup> If the arrangement is a hired-services arrangement, income to the service provider will be compensation. Thus, the use to which a service provider puts its money can significantly affect the service provider's tax liability.

A service provider may use money to acquire a capital asset on the property owner's behalf. If the only income from the property is from sale of the property more than one year following the acquisition, the income will be long-term capital gain to the property owner.<sup>195</sup> If the property owner uses the money to fund a dry cleaning business, and hires the service provider to manage it, income to the property owner will be services income.<sup>196</sup> Thus, if the property is money the different uses to which it is put can significantly affect the tax liability of both parties. Payments to the parties as a percent of profits should not affect the analysis or the outcome.<sup>197</sup>

Suggesting that the law should treat a disregarded tax partnership as a hired-property arrangement may raise a hue and cry from the tax bar. An initial response may be that the arrangement cannot be a loan or a lease, and such consideration raises the debt-equity question (in the case of lending arrangements), which most of the bar would prefer to avoid. The debt-equity question is no more difficult, however, than the partner-employee question.<sup>198</sup> An analysis that assumes away a partnership must consider all possible outcomes and justify the selection of any particular one. If nothing justifies the fixation on a hired-services arrangement, an analysis that merely adopts that approach is unsound. A better analysis would examine the economics of an arrangement and allow the economic aspects to determine the classification.

Once an analysis disregards a purported tax partnership and properly identifies the arrangement, the correct tax result falls into

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<sup>193</sup> See *id.* §§ 1(h), 1222(3).

<sup>194</sup> See *id.* § 61(a)(1).

<sup>195</sup> See *id.* § 1222(3).

<sup>196</sup> See *id.* § 61(a)(1).

<sup>197</sup> See, e.g., *Arthur Venneri Co. v. United States*, 340 F.2d 337, 342-43 (Ct. Cl. 1965) (holding that advance did not create a tax partnership, even though the creditor would share in the profits of the borrower); *Place v. Comm'r*, 17 T.C. 199, 206 (1951), *aff'd*, 199 F.2d 373 (6th Cir. 1952) (holding that sharing of profits was not sufficient to show arrangement was tax partnership and not a lease).

<sup>198</sup> The cases considering each question do not definitively draw the line between a partnership and either an employment arrangement or a loan. See, e.g., *Halen v. Comm'r*, 203 F.2d 815, 820 (5th Cir. 1953) (finding arrangement a tax partnership, not a loan); *Joe Balestrieri & Co. v. Comm'r*, 177 F.2d 867, 870-73 (9th Cir. 1949) (finding a loan, not a tax partnership); *Tate v. Knox*, 131 F. Supp. 514, 517 (D. Minn. 1955) (finding arrangement an employment arrangement, not a tax partnership); *Beck Chem. Equip. Corp. v. Comm'r*, 27 T.C. 840, 853 (1957), *acq.* I.R.S. Announcement 1957-2 C.B. 3 (1957) (finding arrangement was a tax partnership, not an employment arrangement).

place.<sup>199</sup> The analysis turns, however, on the definition of tax partnership. The definition of tax partnership leaves much to be desired. As the line separating disregarded arrangements from tax partnerships, the definition is very important.<sup>200</sup> The definition of tax partnership needs further attention and refinement. Further study should also consider how to distinguish between hired-property and hired-services arrangements when an analysis disregards a purported partnership.<sup>201</sup> The discussion above provides suggestions for such analyses. With further scrutiny, the integration test could improve and become viable quickly.

### B. Partner/Nonpartner Capacity

An analysis may conclude that an arrangement is a partnership and that the holder of a profits-only partnership interest is a partner but leave compensation proponents with a bitter distaste for the tax treatment of the profits-only partners. The distaste may result from a subconscious inkling that the holder of the interest is acting on behalf of the partnership in a nonpartner capacity. In such a situation, recommending partnership disaggregation flows from a misdiagnosis, and the subconscious inkling does not properly manifest itself in the recommendation to disaggregate the partnership.<sup>202</sup> The discussion above demonstrates that parties may enter into agreements that look like partnership agreements primarily to obtain the tax benefits that only the partnership tax and accounting rules offer.<sup>203</sup> Some tax-avoidance arrangements may come within the definition of tax partnership. The substance of such arrangements may, however, prove that a so-called partner is not a partner or is acting in a nonpartner capacity.<sup>204</sup> An interest labeled “profits-only partnership interest” may be a combination of a profits-only partnership interest and an interest in the future profits of a

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<sup>199</sup> See *supra* text accompanying notes 191-197.

<sup>200</sup> See Borden, *supra* note 34, at 974-75 (suggesting that the definition should derive from tax concepts); *id.* at 1028 (recommending the following as a definition of tax partnership: “a tax partnership is two or more persons, at least one of whom provides significant services, who have (or will have) common gross income”).

<sup>201</sup> In *TIFD III-E Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006), the court held that the arrangement was not a tax partnership, and while characterizing it as “in the nature of a secured lender’s interest” or “secured loan,” it failed to identify what the arrangement was and how it should be taxed. See *id.* at 231, 241. Thus, the case showed how partnership disregard can help reduce abusive use of partnership tax rules, but it did not describe what the disregarded arrangement was.

<sup>202</sup> See *supra* note 167 and accompanying text.

<sup>203</sup> See S. COMM. ON FIN., 98TH CONG., 2D SESS., DEFICIT REDUCTION ACT OF 1984, EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 228 (Comm. Print 1984) (“The fourth factor is whether, under all facts and circumstances, it appears the recipient became a partner primarily to obtain tax benefits for himself or the partnership which would not have been available if he had rendered the services to the partnership in a third party capacity.”).

<sup>204</sup> *Id.* (“Treasury and courts should be careful not to be misled by possibly self-serving assertions in the partnership agreement as to the duties of a partner in his partner capacity but should instead seek the substance of the transaction.”). The compensation proponents’ distaste may be subconsciously sensing that service providers either are not partners in substance or they act in nonpartner capacities in substance.



partnership granted to the partner for services to be performed in a nonpartner capacity.<sup>205</sup> Tax law should recognize such interest as part partnership interest and part compensatory arrangement.

If a service provider holds a profits-only partnership interest and acts on behalf of the partnership in a nonpartner capacity, the analysis must determine the extent to which the service provider acts in a nonpartner capacity.<sup>206</sup> Thus, the analysis performs three tasks: (1) it determines whether a partner acts in a nonpartner capacity, (2) it determines whether the partner acts in a partner capacity, and (3) it determines the extent to which the partner acts in each capacity. The current law does not provide clear guidance on any of those points. As Professor Weisbach states, “distinguishing ‘true’ from ‘disguised’ partners can be futile” under current law.<sup>207</sup> Nonetheless, the distinction is important, and the law must develop to provide guidance regarding the difference between partner and nonpartner capacity.

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<sup>205</sup> The Eighth Circuit in *Campbell v. Commissioner*, recognized that so-called profits-only partnership interests may actually be payments to a nonpartner, and the court stated:

In *Diamond*, where the service provider became a partner solely to avoid receiving ordinary income, we have no doubt that the receipt of the profits interest was for services provided other than in a partner capacity. That is, Diamond was likely to (and in fact did) receive money equal to the value of his services and apparently did not intend to function as or remain a partner. Thus, the receipt of his partnership profits interest was properly taxable as easily calculable compensation for services performed.

*Campbell v. Comm’r*, 943 F.2d 815, 822 (8th Cir. 1991).

<sup>206</sup> The law on this issue is far from fully developed. See I.R.C. § 707(a)(2)(A) (2006) (providing that if a partner performs services, the partnership makes a related allocation and distribution to such partner, and the services and allocation and distribution viewed together are properly characterized as a transaction between a partnership and a partner acting in a nonpartner capacity, such allocation shall be treated as occurring between a partnership and a person who is not a partner). The legislative history of section 707(a)(2)(A) lists several factors that the Senate Committee on Finance suggests may indicate whether allocations and distributions are payments to a nonpartner and providing two examples of the application of the factors. See S. COMM. ON FIN., 98TH CONG., 2D SESS., DEFICIT REDUCTION ACT OF 1984, EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 227-30 (Comm. Print 1984). The list has not proven entirely helpful. See MCKEE, NELSON & WHITMIRE, *supra* note 35, ¶ 13.02[4][a] (“Distinguishing ‘true’ from ‘disguised’ partners is difficult. Congress identified the need to make this distinction when it enacted § 707(a)(2)(A) as part of the Deficit Restoration Act of 1984. Unfortunately, § 707(a)(2)(A) does not come to grips with the difficult task of actually making the distinction.”). Furthermore, the case law and rulings that address the distinction between a partner acting in a partner capacity and a partner acting in a nonpartner capacity are generally difficult to distinguish and do not present clear general rules for drawing the distinction. See *Pratt v. Comm’r*, 550 F.2d 1023, 1026 (5th Cir. 1977) (holding that partners who managed a partnership were not acting in nonpartner capacities because the services they provided were duties for which the partnership was created); Rev. Rul. 81-301, 1981-2 C.B. 144 (ruling that an advisor partner who managed the investment and reinvestment of a partnership’s assets acted in a nonpartner capacity because the “advisor general partner” provided similar services to others as part of its regular trade or business, director partners supervised advisor partner’s work, director partners could fire advisor partner, and advisor partner could resign).

<sup>207</sup> See Weisbach, *supra* note 20, at 731. After making that observation, Weisbach proceeded to apply the multi-factor test recommended by the Senate Committee on Finance and cursorily concluded that private equity sponsors act in a partner capacity. See *id.* at 731-32 (“[T]here is simply no question under current law that a typical private equity sponsor would be treated as a partner with respect to the carried interest and would not be subject to recharacterization under Section 707(a)(2)(A).”).

Twenty-four years ago, Congress decreed by legislation that a partner acting in a nonpartner capacity should be taxed as an employee of the partnership.<sup>208</sup> At that time, the Senate Committee on Finance instructed Treasury to promulgate regulations to define the distinction between partner and nonpartner capacities.<sup>209</sup> Since that time, no legal guidance has emerged regarding the distinction. The lack of guidance does not indicate the issue is unimportant. Instead, it implies the issue is difficult and new analytical methods are required to create the needed guidance. The recent incorporation of economic theory into the analysis of partnership tax may help draw the distinction between partner and nonpartner capacities.

A partnership, as an integration of property and services, grants the service provider an interest in the residual claim of the property and the property owner an interest in the residual claim of the services.<sup>210</sup> The Senate Committee on Finance listed several factors that indicate whether a partner acts in a nonpartner capacity.<sup>211</sup> The factors fail to account for integration.<sup>212</sup> This Article demonstrates that integration provides a model for determining whether a partner acts in a nonpartner capacity. For property and services to be fully integrated, the service provider must share in the residual claim of the property. Recall that the holders of property's residual claim retain the rights to control all aspects of the property not specifically contracted away.<sup>213</sup> The holder of the residual claim thus controls who may provide services with respect to the property.<sup>214</sup> The holder of property's residual claim may provide services with respect to the property at the holder's discretion. An employee has the right to provide services with respect to the property only as agreed to by the holder of the property's residual claim. Thus, holders of a property's residual claim may hire service providers to provide certain services with respect to the property and may fire them. Consequently, a service provider who does not control hiring with respect to the property does not share the residual claim of the property and is an employee, not a partner, at least with respect to a particular type of services. That distinction helps identify when a service provider acts in a nonpartner capacity.

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<sup>208</sup> See I.R.C. § 707(a)(2)(A) (2006).

<sup>209</sup> See S. COMM. ON FIN., 98TH CONG., 2D SESS., DEFICIT REDUCTION ACT OF 1984, EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 226 (Comm. Print 1984).

<sup>210</sup> See *supra* text accompanying notes 86-90.

<sup>211</sup> See S. COMM. ON FIN., 98TH CONG., 2D SESS., DEFICIT REDUCTION ACT OF 1984, EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 227-28 (Comm. Print 1984).

<sup>212</sup> The factors focus instead on financial concepts such as risk, proximity of services and distributions, permanency of relationship, and tax motivation. *Id.* That is not surprising as the Committee listed the factors vaguely as suggestions. See *id.* at 227. Surely the Committee believed Treasury would carefully examine the factors and work out any deficiencies.

<sup>213</sup> See Grossman & Hart, *supra* note 39, at 695.

<sup>214</sup> See *supra* text accompanying notes 86-90.

To be a partner, a service provider must share the residual claim of any partnership property.<sup>215</sup> That means that the service provider must share control of who can provide services with respect to the property.<sup>216</sup> That control will not be unilateral in a partnership because the other members of the partnership share the control. As a body, the partners may decide who will provide certain services with respect to the property. For example, in the case of Piergan LLC, described above,<sup>217</sup> Piers and Morgan could agree that together they will determine who will maintain the dry cleaning equipment. Under such an agreement, Morgan would share in control of the maintenance as a partner. He could not unilaterally decide who would perform the maintenance services. Thus, if Morgan performed the services, it would be at the discretion of the partners, and he would not act in his partner capacity.

Contrast that to Morgan acting in a partner capacity. Because the arrangement is a limited liability company, the company could be member-managed.<sup>218</sup> The operating agreement might specify those services Morgan has a right and obligation to perform as a member of the company.<sup>219</sup> Those services may include, or specifically exclude, maintaining the dry cleaning equipment. If that were the case, Morgan would be able to provide such services pursuant to the operating agreement, not at the discretion of the partners. In other words, if the operating agreement made maintenance of the equipment part of Morgan's contributed services, the partners could not fire Morgan for performing such services without amending the arrangement's governing documents. That distinction (requiring an amendment to the governing document versus the partners making a management decision) should distinguish partner capacity from nonpartner capacity. If the partner can act pursuant to the governing documents, the partner acts in a partner capacity. If the partner acts at the discretion of the partners, the partner acts in a nonpartner capacity.

If the law determines that a portion of partnership income allocated to a partner is for services performed in a nonpartner capacity, it should bifurcate the service provider's share of profits into two categories.<sup>220</sup> One category would be profits allocated to the service

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<sup>215</sup> See *supra* text accompanying notes 86-90. The substantive law definition of partnership requires the sharing of residual claims by providing that a partnership is a co-ownership of property. See UNIF. P'SHIP ACT § 101(6) (1997), 6 U.L.A. 61 (2001).

<sup>216</sup> See *supra* text accompanying notes 86-90.

<sup>217</sup> See *supra* text accompanying notes 148-149.

<sup>218</sup> See UNIF. LTD. LIAB. CO. ACT § 301(a)(1) (1996), 6B U.L.A. 585 (2008).

<sup>219</sup> *Id.* § 103, 6B U.L.A. at 563.

<sup>220</sup> This reflects the intent of Congress at the time it enacted section 707(a)(2)(A). See S. COMM. ON FIN., 98TH CONG., 2D SESS., DEFICIT REDUCTION ACT OF 1984, EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 228 (Comm. Print 1984) ("In the case of allocations which are only partly determined to be related to the performance of services for . . . the partnership, the provision will apply to that portion of the allocation which is reasonably determined to be related to the . . . services provided to the partnership.").

provider as a partner. That share of profits should bear the character determined at the partnership level for all of the reasons described above.<sup>221</sup> The other category would be profits allocated to the service provider as a nonpartner. That share of profits should be compensation income.<sup>222</sup> Thus, the law taxes a partner acting in a nonpartner capacity like it taxes a nonpartner who provides services to a partnership, to the extent the partner is compensated for nonpartner services. The law already provides for such treatment, once the capacity is known.<sup>223</sup>

The timing of income from the right to future profits granted to a nonpartner (or partner acting as nonpartner) depends upon the nature of the rights granted.<sup>224</sup> The right to future partnership profits granted to a nonpartner (or partner acting as a nonpartner) should trigger compensation income to the service provider either at the time of the grant, as the profits accrue, or when the partnership pays the service provider.<sup>225</sup> For example, if the grant gives the grantee the unconditional and transferable right to an interest in future partnership profits, the grantee should have income upon receipt of the right, which would be similar to the taxation of compensatory stock.<sup>226</sup> The grant of an interest in a partnership's future profits may, however, be more similar to an employment arrangement pursuant to which the employer agrees to pay the employee out of future profits.<sup>227</sup> Under such an arrangement, the grantee of the profits interest would recognize income as the partnership profits accrue or as the partnership pays the service provider a share of the profits.<sup>228</sup> The partnership should take an offsetting deduction or capitalize the expense under existing laws.

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<sup>221</sup> See *supra* Part II.C.

<sup>222</sup> See I.R.C. § 707(a)(2)(A) (2006) (providing that tax law may treat amounts paid to a service-providing partner acting in a nonpartner capacity as amounts paid to a nonpartner). *But see supra* text accompanying notes 118-131 (describing why income allocated to a partner acting on behalf of the partnership in a nonpartner capacity should not be compensation income).

<sup>223</sup> See I.R.C. § 707(a) (providing that a partner who acts in a nonpartner capacity shall be treated as a nonpartner for tax purposes); see also MCKEE, NELSON & WHITMIRE, *supra* note 35, ¶ 13.02[4][a] (discussing the tax treatment of a partner acting in a nonpartner capacity and a partnership allocating partnership items to a partner acting in a nonpartner capacity).

<sup>224</sup> See Mark P. Gergen, *Pooling or Exchange: The Taxation of Joint Ventures Between Labor and Capital*, 44 TAX. L. REV. 519, 523-25 (1989) (discussing the different tax consequences under pooling and exchange regimes).

<sup>225</sup> See Weisbach, *supra* note 20, at 728-33.

<sup>226</sup> See I.R.C. § 83(a) (requiring taxpayers to include in gross income the value of property received in exchange for services at the time “the beneficial interest[s] in such property are transferable” and “not subject to a substantial risk of forfeiture”); Treas. Reg. § 1.83-3(e) (as amended in 2005) (defining property to include “real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future”).

<sup>227</sup> Every employment arrangement grants the employee some right to the employee's future income. The law does not, however, require the employee to recognize services income at the time of the contract. See Treas. Reg. § 1.83-3(e) (providing that a mere “promise to pay” is not property).

<sup>228</sup> The right to future profits would not satisfy the Treas. Reg. § 1.83-3(e) definition of property because it would be “unfunded and unsecured.” *Id.*

The law taxes income allocated to a service provider properly if the service provider is a nonpartner or acts in a nonpartner capacity. The difficulty, however, is in correctly describing and identifying arrangements that are not tax partnerships and partners who act in nonpartner capacities.<sup>229</sup> The discussion above presents some possibilities for drawing the distinction between partner and nonpartner capacities. The intellectual power of the partnership tax bar, tax academics, and law makers should focus on developing tools that will help properly diagnose such arrangements.<sup>230</sup> Principles of division of labor suggest that academics should carefully study and articulate partnership tax theory as it relates to the difference between tax partnerships, and disregarded arrangements and partners acting in nonpartner capacities.<sup>231</sup> They may consider many of the developments in the theory of the firm and other economic thought in their studies. Members of the bar can apply their technical skills and familiarity with current business practices to help create the needed tools. Surely the combined resources of both camps can work toward suitable conclusions of these most difficult concepts. Attention should also focus on whether the definition of tax partnership should include investment partnerships.

### C. *Investment Partnership Misconception*

The analysis of profits-only partnership interests will not be complete until it revisits the definition of tax partnership. The ongoing debate over the proper tax treatment of profits-only partnership interests

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<sup>229</sup> One commentator cursorily concluded that holders of carried interests satisfy the factors listed in the Senate Committee on Finance's 1984 committee print and therefore act as partners. See Weisbach, *supra* note 18. An analysis of this issue requires more than a cursory conclusion that the factors apply. Rather, the analysis must include a careful examination of the factors to determine whether they adequately distinguish between partners acting in partner and nonpartner capacities.

<sup>230</sup> In 1984, the Senate Committee on Finance directed Treasury to draft regulations that would help define the line between partners acting in partner and nonpartner capacities. See S. COMM. ON FIN., 98TH CONG., 2D SESS., DEFICIT REDUCTION ACT OF 1984, EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 226-27 (Comm. Print 1984). As of the date of this Article, twenty-four years after the direction from the Senate Committee on Finance, no regulations exist providing such guidance. The recent focus on carried interests suggests the time is ripe to revisit the issue and begin working to define when a partner acts in a nonpartner capacity.

<sup>231</sup> The division of labor is a well-documented principle of economics. See ADAM SMITH, WEALTH OF NATIONS 7-21 (Edwin Cannan ed., University of Chicago Press, 1976) (1776). Division of labor becomes more important as an economy develops and is advantageous to all persons employed. See *id.* at 351-71. The concept should apply equally to intellectual pursuits in the law. Scholars will have more and more difficulty maintaining the technical proficiency that practitioners must maintain to competently serve clients. As practitioners develop expertise, their proficiency will increase. Practitioners' time demands will, however, prohibit them from performing theoretical research. That task must fall to scholars, who will sacrifice technical proficiency to some extent to study the theory of the law. Without a theoretical foundation, the law may produce undesirable results. In fact, without thought concerning the theory of partnership taxation, it may fall prey to taxpayers who use it to gain favorable tax treatment for transactions that otherwise would not qualify for such treatment. See, e.g., Borden, *supra* note 47, at 338-46 (describing how taxpayers use the partnership tax allocation rules to exchange tax items in a manner that the law otherwise prohibits).

concerns the proper tax treatment of holders of such interests in investment partnerships.<sup>232</sup> Earlier theoretical work suggested that investment partnerships should not qualify for partnership tax treatment.<sup>233</sup> The reasoning deems the nominal level of activity performed by members of an investment partnership too insignificant to warrant access to the partnership tax accounting and reporting rules.<sup>234</sup> Recall that the nature of tax partnerships makes tracing income from its source difficult.<sup>235</sup> Because tracing is difficult, tax law allows partners to allocate tax items by agreement.<sup>236</sup> If parties can trace income from its source, however, they do not need the partnership tax rules, and such arrangements should not be tax partnerships.

By definition, investment partnerships should be able to trace income from its source and should not be tax partnerships. Property held by investment partnerships should come within the definition of capital asset.<sup>237</sup> To come within the definition of capital asset, the income from the property must be almost exclusively from appreciation in the value of the property.<sup>238</sup> Thus, the income from investment partnerships derives from the increase in the value of the property and services become an insignificant income-producing factor. In other words, investment partnerships do not integrate property and services; they rely solely on the property for income. The absence of property-service integration in an investment partnership makes tracing income from the property simple. Because the income in an investment partnership is traceable, the

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<sup>232</sup> See *supra* text accompanying note 64.

<sup>233</sup> See Borden, *supra* note 34, at 992-93; Borden, *supra* note 101, at 360.

<sup>234</sup> See Borden, *supra* note 34, at 1014-15.

<sup>235</sup> See *supra* text accompanying notes 90-97.

<sup>236</sup> See I.R.C. § 704(a) (2006). Tax law will recognize agreed-upon allocations as long as they have substantial economic effect, *see id.* § 704(b), a test that is more difficult to understand than satisfy. See Jones, *supra* note 47, at 1077-93 (describing the test and potential abuses).

<sup>237</sup> Investment partnerships may have business-use assets such as rental property, which is section 1231 property, not a capital asset. The typical investment partnership, however, is one that holds property to realize its appreciation in value. The most significant income of such partnerships is income from the sale of the capital assets.

<sup>238</sup> In some cases with very narrow facts, courts have held that the activities of owners to improve the value of property did not cause the property to lose its capital asset status. *See, e.g., Estate of Barrios v. Comm'r*, 265 F.2d 517, 519-20 (5th Cir. 1959) (holding that value-improving services do not taint the classification of the property where the owners acquired the property with a clear investment intent). *But see Sanders v. United States*, 740 F.2d 886, 888-89 (11th Cir. 1984) (holding that value-improving services are a factor that helped the court decide that property was dealer property where the intent at the time of acquisition was clearly to improve and dispose of the property). Also, property held by a securities trader will be a capital asset, even if the trader engages in a significant amount of activity. *See Marrin v. Comm'r*, 147 F.3d 147, 151-53 (2d Cir. 1998) (holding that individuals were traders because they did not hold property for sale to customers as required in section 1221(1)). The rule regarding the tax treatment of trader property is an anachronism and finds no support in current tax policy. *See* BORIS I. BITTKER ET AL., *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶ 31.04[2] (3d ed. 2002); Shu-Yi Oei, *A Structural Critique of Trader Taxation*, FLA. TAX REV. (forthcoming 2009). Thus, although gains recognized by some partnerships with significant activity may qualify for capital gains treatment, this Article agrees with the position that such tax treatment disregards sound tax policy and reaches the incorrect theoretical result.

arrangement does not need the partnership tax accounting and reporting rules. All income can be traced from the property to the property contributors, and the property contributors should recognize income from the property.<sup>239</sup> To the extent another party provides investment services, income paid to that party out of profits should be compensation. If income is paid in the form of an interest in the property, the service provider should have compensation income upon receipt of the interest.<sup>240</sup>

The current federal definition of tax partnership appears to include investment partnerships,<sup>241</sup> but grants them the option to elect out of all or part of subchapter K under section 761 of the Code.<sup>242</sup> Partnerships that elect out of subchapter K under section 761 are qualified tax partnerships.<sup>243</sup> With virtually no explanation of the reason for qualified tax investment partnerships, speculation directs the analysis.<sup>244</sup> The breadth of the definition of tax partnership subjects investment partnerships to the partnership tax accounting and reporting rules. The simplicity of investment partnerships (a single source of income traceable from the property) does not justify the application of the complex partnership tax accounting and reporting rules. The members of an investment partnership should merely allocate partnership income to the members based upon their ownership interests in the property. In apparent recognition of such simplicity, Congress provided an option for such arrangements to elect out of subchapter K.<sup>245</sup> Thus, subchapter K is elective for investment partnerships, and many investment partnerships elect to remain within subchapter K because the allocation rules provide such wonderful planning opportunities. The election for investment partnerships further indicates, however, that they do not require the partnership tax accounting and reporting rules.

One way to address the concern raised by profits-only partnership interests in investment partnerships (which is the source of the carried interest debate and the primary concern about profits-only partnership interests) is to narrow the definition of tax partnership to

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<sup>239</sup> In the case of an exchange of assets that does not have a significant services component, the parties would recognize gain upon exchange because the transaction is treated as transfer of property for services, *see* Gergen, *supra* note 224, at 521-22, unless some other nonrecognition provision, such as section 1031 applied to the exchange.

<sup>240</sup> *See* I.R.C. § 83(a); Gergen, *supra* note 224, at 522.

<sup>241</sup> *See* Borden, *supra* note 101, at 331-33.

<sup>242</sup> *See* I.R.C. § 761(a)(1).

<sup>243</sup> The IRS coined the phrase “qualified partnership” in 1948. *See* I.T. 3930, 1948-2 C.B. 126, 129 (“The Bureau, under [I.T. 2749 and I.T. 2785] has consistently treated all such operating agreements as creating *qualified partnerships* . . .” (emphasis added)); *see also* Borden, *supra* note 101, at 325 (explaining briefly the history of the development of the qualified tax partnership concept). This Article uses “qualified tax partnership” instead of “qualified partnership,” as used originally by the IRS, and the term “tax partnership” to refer to arrangements tax law recognizes as partnerships.

<sup>244</sup> *See* Borden, *supra* note 101, at 332.

<sup>245</sup> *See* I.R.C. § 761(a).

exclude investment partnerships. The option such arrangements have to elect out of subchapter K<sup>246</sup> is evidence that they do not need to be subject to partnership taxation. The members of such arrangements can determine their respective shares of income and loss without using the partnership tax accounting and reporting rules. The broad definition of tax partnership currently provides members of investment partnerships the opportunity to take advantage of the partnership tax accounting and reporting rules, even though policy does not justify such use.<sup>247</sup> Changing the focus of analysis from the proper tax treatment of a partner with a profits-only interest to whether the definition of tax partnership should include investment partnerships would help resolve the concern raised by profits-only partnership interests in investment partnerships. Because that is the main focus of compensation proponents' concern, such a change would resolve many of the iniquities of profits-only partnership interests.

If the definition of tax partnership excluded investment partnerships, the analysis of carried interests would become simple. All profits from the property would belong to the property owners. Any profits allocated to the service provider would be compensation income to the service provider in the case of a hired-services arrangement.<sup>248</sup> A service provider, who becomes a co-owner of the property upon formation of the arrangement, would have income upon receipt of the interest in property.<sup>249</sup> Income allocated to the property owner would be interest or rent if the arrangement were a hired-property arrangement.<sup>250</sup> Existing tax laws could easily handle either type of arrangement.

Changing the definition of tax partnership would create a catch twenty-two for property owners and service providers and would help stop tax abuse. To argue that the arrangement sufficiently integrated property and services to warrant the use of partnership tax and accounting rules, the parties would have to argue that services were integrated to the arrangement's success. If the services were that significant, the property would not come within the definition of capital asset.<sup>251</sup> If the parties were to argue that the property came within the definition of capital asset, they would have to concede that the arrangement did not have sufficient services to warrant tax partnership classification. A definition of tax partnership that excludes investment partnerships thus alleviates the stress the current system now bears.<sup>252</sup> It would also help discourage tax game-playing.

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<sup>246</sup> *Id.*

<sup>247</sup> See Borden, *supra* note 34, at 951-56 (explaining that partnership tax should apply to arrangements that are unable to trace income from its source to the owner of the income's source).

<sup>248</sup> See *supra* text accompanying notes 191.

<sup>249</sup> See Treas. Reg. § 1.61-2(d)(1) (as amended in 2003).

<sup>250</sup> See *supra* text accompanying notes 192-197.

<sup>251</sup> See *supra* text accompanying notes 61-64.

<sup>252</sup> Such a change in definition would not, however, preclude tax partnerships from holding investment property. It is very possible, for example, that Piergan LLC might retain some of



In contrast, a definition of tax partnership that excludes investment partnerships would not affect the tax treatment of profits-only partnership interests in services partnerships and property-services partnerships. The income of such partnerships derives from the combination of at least two persons' services or services and property.<sup>253</sup> Tracing income from the source of such arrangements is impossible,<sup>254</sup> so the members need the partnership tax accounting and reporting rules. The main issue with such arrangements would be the extent to which the service provider received a share of partnership profits for services performed in a non-partner capacity.<sup>255</sup> Partnership disregard helps distinguish between the different types of arrangements by focusing on the capacity in which a service provider provides services.

## V. CONCLUSION

Profits-only partnership interests present an inviting intellectual challenge for scholars and law makers but also create opportunities for tax game playing and abuse. This Article has demonstrated that proposed solutions requiring partnership disaggregation do not adequately solve the problem. First, partnership disaggregation ignores the nature of partnerships. Second, it threatens the integrity of partnership tax law and the application of other provisions of tax law. Third, it encourages tax game-playing. Thus, partnership disaggregation is not an attractive means for remedying the tax treatment of profits-only partnership interests.

Partnership disregard, on the other hand, presents a viable method for addressing profits-only partnership interests. Partnership disregard eliminates the inequity of the current rules, recognizes the nature of tax partnerships, and preserves the integrity of subchapter K without frustrating other areas of tax law. Intellectual attention should focus on establishing analytical tools for determining when a purported tax partnership should be disregarded and when a partner acts in a nonpartner capacity. An interest labeled "profits-only partnership interest" may be an employment arrangement loan, or lease, at least in

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its earnings to acquire a capital asset, such as corporate stock. *See supra* text accompanying notes 148-149 (presenting the Piergan LLC facts). If the partnership did not actively trade the stock, it should qualify as a capital asset, and if the partnership were to later sell the stock, any gain from the stock should be capital gain. That gain should retain its character as it flows through from the partnership. One reason for distinguishing this situation from an investment partnership is that the economics of the arrangement between Piers and Morgan is so economically complicated that they would not form the arrangement merely to obtain capital gain preferences on some of the residual earnings of the endeavor.

<sup>253</sup> *See supra* Part II.A.1. (describing a services partnership as a combination of the services of two or more persons); *supra* Part II.A.2. (describing a property-services partnership as a combination of property and services of two or more persons).

<sup>254</sup> *See* discussion *supra* Part II.C. (discussing the consequences of integrating services or property and services).

<sup>255</sup> *See supra* Part IV.B. (discussing partner/nonpartner capacity).

part. If tools existed to help identify such arrangements, the taxation of disregarded partnerships would become obvious.

Simply identifying arrangements that do not come within the current definition of tax partnership may not be sufficient. Attention must also focus on the definition of tax partnership to ensure that it is not too broad. This Article has suggested that the current definition of tax partnership, which includes investment partnerships, is too broad. Investment partnerships have no business using the partnership tax accounting and reporting rules and should be excluded from doing so. Narrowing the definition of tax partnership would properly exclude them from subchapter K. Such exclusion would eliminate the angst created by the current tax treatment of carried interests and would help preserve the integrity of subchapter K and recognize the nature of tax partnerships and their unique needs.

The current interpretation of the definition of tax partnership encourages parties to choose one business form over another. As demonstrated above, Cory and Travis could transform an employment arrangement into a tax partnership by using a limited liability company instead of an employment contract.<sup>256</sup> That change in form may not change the substance of the arrangement. Partnership disregard's focus on the economic aspects of arrangements elevates substance over form. Partnership disregard thus helps tax the parties' true economic arrangement, reduces tax game-playing, preserves the integrity of the partnership taxation, and promotes equity.

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<sup>256</sup> See *supra* text accompanying notes 8-15.