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ENTITY CLASSIFICATION: THE ONE HUNDRED-YEAR DEBATE

Patrick E. Hobbs*

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I. INTRODUCTION

One hundred years ago, in the Revenue Act of 1894,¹ Congress enacted our Nation's first peacetime income tax.² Although the Supreme Court declared it unconstitutional within a year of its enactment,³ at least

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1. Revenue Act of 1894, ch. 349, 28 Stat. 509 (declared unconstitutional in 1895). For insight into the genesis of the 1894 Act, see *infra* notes 16-30 and accompanying text.

2. See Revenue Act of 1894, ch. 349, 28 Stat. 509 (declared unconstitutional in 1895). Although Congress levied an income tax during the Civil War in an effort to raise revenue, it repealed the tax soon after the end of the war. See Revenue Act of 1862, ch. 119, 12 Stat. 432; Revenue Act of 1864, ch. 173, 13 Stat. 223. The Revenue Act of 1870 provided for the expiration of the income tax at the end of 1871. See Revenue Act of 1870, ch. 255, § 6, 16 Stat. 256, 257.

3. See *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, *modified*, 158 U.S. 601 (1895).

one aspect of the 1894 Act reappeared in subsequent revenue acts and eventually became a permanent part of our federal tax regime—the taxation of a class of taxpayers called “corporations.”⁴ The 1894 Act also marked the first time in this country’s revenue history that the law distinguished corporations from other types of business organizations for tax purposes.⁵ Congress’ decision to create such a distinction raised two issues that still remain unresolved: first, whether the tax law should treat corporations as independent taxpayers, separate and distinct from their owners;⁶ and second, what types of entities fall within this class of taxpayers.⁷ Although this article focuses primarily on the debate surrounding

4. For a discussion of the evolution of the term corporation as a federal tax concept, see *infra* notes 31-179 and accompanying text.

5. Earlier income tax statutes avoided a broad-based classification of taxable entities and instead identified specific industries or trades to be taxed. For example, section 82 of the Revenue Act of 1862 provided for a duty of eight percent on the earnings, whether paid as dividends or surplus, of “all banks, trust companies, and savings institutions, and by all fire, marine, life, inland, stock, and mutual insurance companies.” Revenue Act of 1862 § 82. The Revenue Act of 1864 continued this approach, using almost the identical language as that found in the 1862 Act. See Revenue Act of 1864 § 117. It is interesting to note, however, that during the development of the 1864 Act, the Senate Finance Committee attempted to use a more general classification. See *id.* Section 117 of the Act provided that, in estimating one’s personal income, an individual did not have to include dividends received from industries or companies whose earnings were subject to tax under the Act. See *id.* § 117. Although the original bill identified the specific financial and transportation companies subject to the tax, the Senate Finance Committee removed the specific industry references, inserting instead the language “corporation or joint stock company.” See J.S. SEIDMAN, SEIDMAN’S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1028-29 (1938). The Conference Committee, however, later changed the provision back to its original language, specifically naming any “bank trust company, savings institution, insurance [company], railroad, canal, turnpike, canal navigation, and slack-water company.” See *id.*

6. Those who believe corporate source income should not be subject to an additional layer of tax argue for “integration”—the elimination of one layer of tax on corporate source income. For an in-depth analysis of integration, see generally CHARLES E. MCLURE, JR., MUST CORPORATE INCOME BE TAXED TWICE? (1979); *Colloquium on Corporate Integration*, 47 TAX L. REV. 427 (1992); Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C. L. REV. 613 (1990); Philip F. Postlewaite et al., *A Critique of the ALI’s Federal Income Tax Project—Subchapter K: Proposals on the Taxation of Partners*, 75 GEO. L.J. 423 (1986); Scott A. Taylor, *Corporate Integration in the Federal Income Tax: Lessons from the Past and a Proposal for the Future*, 10 VA. TAX REV. 237 (1990); Anthony P. Polito, Note, *A Proposal for an Integrated Income Tax*, 12 HARV. J.L. & PUB. POL’Y 1009 (1989).

7. For an in-depth analysis of entity classification, see Richard S. Bobrow et al., *Washington Tax Watch: To Be or Not To Be: Partnership Classification Revisited*, 6 J. PARTNERSHIP TAX’N 68 (1989); William B. Brannan, *Lingering Partnership Classification Issues (Just When You Thought it Was Safe to Go Back in The Water)*, 1 FLA. TAX REV. 197 (1993); Francis M. Burdick, *Are Defectively Incorporated Associations Partnerships?*, 6 COLUM. L. REV. 1 (1906); Susan Kalinka, *The Limited Liability Company and Subchapter S: Classification Issues Revisited*, 60 U. CIN. L. REV. 1083 (1992); Colleen J. Doolin, Note, *Determining the Taxable Status of Trusts that Run Businesses*, 70 CORNELL L. REV. 1143 (1985).

the latter question, any conclusions drawn regarding the parameters of the corporate class also must address the questions of why such entities warrant separate tax treatment. For example, if one defines a corporation by the presence of limited liability, then one also suggests that an entity possessing this trait merits separate taxpayer status. On the other hand, if the ultimate conclusion is that one cannot fairly define such a class, then one is also saying that there is not a class of entities called corporations that warrants separate taxation.

In 1894, Congress answered the first question in the affirmative by deciding that entities identified as corporations were subject to separate taxpayer status.⁸ However, having come to this conclusion, Congress abandoned the task of deciding what types of entities would comprise this class, leaving the task to the Treasury Department and the judiciary.⁹ Section 7701(a)(3) of the Internal Revenue Code provides that the term corporation “includes associations, joint-stock companies, and insurance companies.”¹⁰ It is the meaning of the term “associations” that frames the entity classification debate. This term, which first appeared in the 1894 Act,¹¹ currently symbolizes the difference between the state-law notion of the term “corporation” and its meaning for federal income tax purposes. The presence of this term has enabled the definition of corporation to evolve from a layman’s notion of an entity formed under a state enabling statute, into a nebulous concept defined by the Treasury Department and the courts.

The judiciary’s contribution to the development of the definition of association reached its zenith in 1936 when the Supreme Court, in *Morrissey v. Commissioner*,¹² declared that the term association signified entities that “resembled” corporations.¹³ As the *Morrissey* Court ex-

8. See Revenue Act of 1894 § 32.

9. For a discussion of Congress’ abandonment of this critical issue and the subsequent evolution of the scope of the definition of the term “corporation” as it relates to the Internal Revenue Code (the Code), see *infra* notes 177-254 and accompanying text.

10. I.R.C. § 7701(a)(3) (1986).

11. See Revenue Act of 1894 § 32. Section 32 provided:

[T]here shall be assessed, levied, and collected, except as herein otherwise provided, a tax of two per centum annually on the net profits or income above actual operating and business expenses, including expenses for materials purchased for manufacture or bought for resale, losses, and interest on bonded and other indebtedness of all . . . corporations, companies, or *associations* doing business for profit in the United States, no matter how created and organized, but not including partnerships.

Id. (emphasis added).

12. 296 U.S. 344 (1935). For an in-depth discussion of the *Morrissey* case, see *infra* notes 231-61 and accompanying text.

13. See *Morrissey*, 296 U.S. at 357.

plained, an entity passed the resemblance test, and thus qualified for corporate tax treatment, if it possessed certain inherent corporate characteristics; namely, associates, business activity, continuity of life, free transferability of interests, limited liability, and centralization of management.¹⁴ The resemblance test continues to serve as the model for entity classification, and the Treasury Department has provided regulations designed to test the presence or absence of these characteristics.¹⁵ The use of this method of corporate identification for over a half century seems to suggest its success. However, an examination of this period in history reveals just the opposite—that the resemblance test has proven to be completely unsatisfactory. Indeed, what emerges from this historical review is the continued ability of practitioners and state legislators to exploit the Treasury Department's various constructions of the resemblance test by creating new forms of business entities. Three events in particular illustrate this pattern: (1) the emergence of the "professional corporation" in the 1950s and 1960s; (2) the evolution of the limited partnership form of business into tax shelter vehicles and exchange-traded partnerships; and, most recently, (3) the creation of the limited liability company (LLC). Part III of this article will discuss these three events in greater detail.

This article is divided into four parts. Part II traces the development of the federal tax definition of the term "corporation," starting with the Revenue Act of 1894 and ending with the Supreme Court's landmark decision in *Morrissey*. This section reveals that the term "association," at least initially, was not intended to be an independent concept. Instead, the term was part of the general description given to entities known as "joint-stock associations" or "joint-stock companies." This section suggests that the more expansive interpretation was the result of sloppy draftsmanship and an aggressive Treasury Department rather than congressional intent. The remainder of this section examines the role of the Treasury Department and the courts in developing the method, now known as the resemblance test, of determining association status.

Part III examines the application of the resemblance test over the last half century and focuses on the development of the professional corporation, the limited partnership, and the LLC. During this time, the Treasury Department has been the sole author of the meaning of resemblance. This period is marked by the Treasury Department's repeated efforts to rewrite the test to alter the classification of the newly developed organi-

14. *See id.* at 359.

15. *See infra* notes 237-517 and accompanying text (discussing the resemblance test and adopted regulations).

zational forms. It appears that the principal motivation behind these efforts was the desire to curtail potential revenue loss.

Finally, Part IV concludes that history has proven that the resemblance test is fatally flawed and attributes that failure to the mistaken assumption that there are inherent corporate characteristics; an assumption that each successive development in organizational form calls into question. As a result, rather than maintaining the integrity of the corporate tax, the resemblance test has questioned it. This inability to adequately classify entities worthy of corporate taxpayer status becomes yet another reason to eliminate the corporate tax. Nevertheless, even in an integrated world, some form of classification is likely to be necessary. It is here that the resemblance test may have some future utility. Of course, that future goal will depend upon whether Congress is willing to abandon its maintaining of the integrity of the corporate tax base in favor of a more supportable goal—integration.

II. EVOLUTION OF THE TAX DEFINITION OF THE TERM “CORPORATION”

A. *The Revenue Act of 1894*

The entity classification debate began a century ago with the passage of the Revenue Act of 1894, which, in addition to levying a tax on the income of wealthy individuals, imposed an entity level tax on corporate income.¹⁶ The imposition of a tax on corporations raised the issue of Congress' intent in singling out this class of business entities rather than imposing a broad-based tax on all business organizations. As it turns out, Congress based its decision more on an effort to soothe the psyche of the American public than on any theoretical underpinnings.¹⁷

16. Revenue Act of 1894, ch. 349, 28 Stat. 509 (declared unconstitutional in 1895). Although the Supreme Court declared the Act unconstitutional within a year of its passage in *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, *modified*, 158 U.S. 601 (1895), the 1894 Act has proven to be one of the most significant statutes in the history of this country's income tax. Not only was it the first peacetime income tax, but Congress later incorporated much of its language into the Revenue Act of 1913—the first tax act following the passage of the Sixteenth Amendment. Compare Revenue Act of 1913, ch. 16, 38 Stat. 114 with Revenue Act of 1894, ch. 349, 28 Stat. 509 (declared unconstitutional in 1895).

17. See generally ROY G. BLAKEY & GLADYS C. BLAKEY, *THE FEDERAL INCOME TAX 8-17* (1940); JOHN D. BUENKER, *THE INCOME TAX AND THE PROGRESSIVE ERA 1-56* (Robert E. Burke & Frank Freidel eds., 1985); RANDOLPH E. PAUL, *TAXATION IN THE UNITED STATES 30-39* (1954); EDWIN R. A. SELIGMAN, *THE INCOME TAX: A STUDY OF THE HISTORY, THEORY AND PRACTICE OF INCOME TAXATION AT HOME AND ABROAD 493-96* (2d ed. 1914); ALFRED L. THIMM, *BUSINESS IDEOLOGIES IN THE REFORM-PROGRESSIVE ERA, 1880-1914, 7-39* (1976); JOHN F. WITTE, *THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 70-75* (1985).

Prior to the 1894 Act, Congress had levied an income tax only during war-time, when the tax was regarded as an unfortunate but necessary evil brought about by the exigencies of the Civil War.¹⁸ After the war, Congress quickly repealed the income tax, and the federal government returned to the tariff as the principal source of its receipts.¹⁹ In addition to raising revenue, the tariff protected American manufacturers located primarily in the Northeast from having to compete against less expensive foreign imports.²⁰ In the ensuing years, however, the American public became increasingly frustrated by this system of taxation as post-war America began experiencing a remarkable transformation in its economy²¹ and with the country witnessing the emergence of business trusts and conglomerates.²² The tremendous growth of the railroads fueled much of this transformation and created families, like the Vanderbilts and the Goulds, who earned millions of dollars each year, none of which was

18. See, e.g., 26 CONG. REC. 6880 (1894) (statement of Senator Chandler). The Senator argued:

[w]hen the war exigencies required a taxation law that should tax everything, there was a tax put upon individual incomes, and there were all these special taxes put upon corporations, but there never was an attempt before, as I have said, to include in an income tax the income of corporations.

Id.; see also BLAKEY & BLAKEY, *supra* note 17, at 1-8. The authors noted that

In the first months after the outbreak of war neither Congress nor the Secretary of the Treasury had much courage when it came to imposing taxes, but perhaps it is difficult now to appreciate the psychology of a people totally unaccustomed to paying anything for support of the national government except indirectly through the tariff.

Id. at 2-3; see SELIGMAN, *supra* note 17, at 431 ("[The Chairman of the House Ways and Means Committee] conceded that the bill was a most unpleasant one, but contended that Congress must choose 'between these disagreeable duties,' since 'the annihilation of this government is the alternative.'"); Patrick E. Hobbs, *The Scope of the Inventory Exclusion Under I.R.C. § 1221(1): Is it a Broad Exclusion that Should be Narrowly Construed or a Narrow Exclusion that Should be Broadly Construed or is it Just an Illusion?*, 26 LOY. L.A. L. REV. 289, 294 n.26 (1980) (discussing authority for Civil War Acts).

19. BLAKEY & BLAKEY, *supra* note 17, at 2-7; PAUL, *supra* note 17, at 22-32; WITTE, *supra* note 17, at 70. For a comprehensive study of tariff legislation and policy during the nineteenth century, see generally EDWARD STANWOOD, *AMERICAN TARIFF CONTROVERSIES IN THE NINETEENTH CENTURY* (1903).

20. BUENKER, *supra* note 17, at 3-4; PAUL, *supra* note 17, at 7; WITTE, *supra* note 17, at 68.

21. BLAKEY & BLAKEY, *supra* note 17, at 9-10; PAUL, *supra* note 17, at 32; EDWIN R. A. SELIGMAN, *A STUDY OF THE HISTORY, THEORY, AND PRACTICE OF INCOME TAXATION AT HOME AND ABROAD* 494-95 (1921); WITTE, *supra* note 17, at 70.

22. See generally MARTIN J. SKLAR, *THE CORPORATE RECONSTRUCTION OF AMERICAN CAPITALISM, 1890-1916* (1988). For a detailed account of the evolution of the public perception toward big business, see generally LOUIS GALAMBOS, *THE PUBLIC IMAGE OF BIG BUSINESS IN AMERICA, 1880-1940: A QUANTITATIVE STUDY IN SOCIAL CHANGE* (1975).

subject to income tax.²³ The growing national consensus was that wealthy individuals and large corporations were not paying their "fair share."²⁴ This movement²⁵ in American ideals set the stage for the introduction of the 1894 Act.²⁶

Proponents of a federal income tax, primarily western and southern Congressmen, had been maneuvering to introduce income tax legislation for some time.²⁷ Confident that sufficient public support for the new tax existed, this group decided to act in early 1894 when Congress reconvened to mark-up the latest tariff measure.²⁸ On January 29, 1894, an amendment to the tariff bill, proposing an income tax on wealthy individuals and corporations, was introduced.²⁹ The proposed amendment

23. During the debate of the 1894 Revenue Act, Senator William Allen of Nebraska read into the record a list of New York millionaires and their annual untaxed incomes. *See* 26 CONG. REC. 6712 (1894) (statement of Sen. Allen). The list included: J.D. Rockefeller, annual income in excess of \$7.6 million; William W. Astor, annual income of \$8.9 million; George J. Gould, annual income in excess of \$4 million; Cornelius Vanderbilt, annual income in excess of \$4 million; William K. Vanderbilt, annual income of almost \$3.8 million; F.W. Vanderbilt, annual income of \$1.75 million; John J. Astor, annual income of \$2.5 million; Louis C. Tiffany, annual income of \$1.75 million. *Id.* For an interesting account of how the Vanderbilt family amassed their fortune, see generally ARTHUR T. VANDERBILT II, *FORTUNE'S CHILDREN: THE FALL OF THE HOUSE OF VANDERBILT* (1989).

24. BLAKEY & BLAKEY, *supra* note 17, at 10-11.

25. This period was later identified as the "Progressive Era." *Id.*

It was perfectly logical that a demand for an income tax should be part of the program of [the Progressive] movement. It was a tax that would be paid by the rich, not the poor, and the yield would relieve the poor of some of the burdens of supporting the government.

Id.; *see* BUENKER, *supra* note 17, at 4 ("Clearly, the notion of a federal income tax was a familiar one to most Americans by the height of the Progressive Era."); *see also* SELIGMAN, *supra* note 17, at 493 ("The demand for a progressive income tax was indeed found in the planks of the Socialist party and of the farmers' groups which afterwards consolidated into the Populist party."); SKLAR, *supra* note 22, at 1 (describing the Progressive Era as one of reform and corporate reconstruction); Majorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 55 (1990) ("The Progressive Era, roughly from 1890 to 1916, was a unique period of American history in which broad social and political reforms met and combined with a great change in our economic system: the rise of corporate capitalism.").

26. Revenue Act of 1894, ch. 349, 28 Stat. 509 (declared unconstitutional in 1895).

27. BUENKER, *supra* note 17, at 3-4; PAUL, *supra* note 17, at 30; WITTE, *supra* note 17, at 70-71. Fourteen different income tax bills were introduced in Congress between 1873 and 1879. PAUL, *supra* note 17, at 30. In 1894, Congressman Benton McMillen, Democrat from Tennessee and Chairman of the House Ways and Means Subcommittee on Internal Revenue, and Congressman William J. Bryan, Democrat from Nebraska, led proponents of the income tax in the House of Representatives. BLAKEY & BLAKEY, *supra* note 17, at 8-12. The Senate leaders were Daniel Voorhees, Democrat from Indiana and Chairman of the Senate Finance Committee, and George Vest, Democrat from Missouri and Senate Finance Committee member. *Id.* at 12-17.

28. *See* 26 CONG. REC. 537-615 (1894).

29. *See id.* at 1594.

called for a two percent tax on individual incomes exceeding four thousand dollars and the income of "corporations or associations organized for profit by virtue of the laws of the United States or of any State or Territory."³⁰

The debates over the resurrection of the income tax sparked one of the most dramatic battles in the annals of Congress.³¹ Opponents of the new tax argued that it constituted an act of socialism and was simply an attempt by the government to " 'get the rich.' "³² Some of the wealthy even threatened to leave the country.³³ Supporters of the tax, such as the great orator and statesman William Jennings Bryan (who delivered a speech to Congress with an American flag draped across his shoulder), argued that an income tax was appropriate because it was based on one's "ability to pay" and on "fairness to the poor man."³⁴

While a retelling of the entire history of the 1894 Act is beyond the scope of this article, it is vital to revisit that portion of the debate that discussed the birth of entity classification to determine Congress' original intent. The language that imposed a tax on business entities was similar to the Civil War statutes in that it identified specific fields of commerce

30. *Id.* at 1595 (proposed amendment section 59); see Revenue Act of 1894, ch. 349, §§ 27, 32, 28 Stat. 509, 553, 556 (declared unconstitutional in 1895).

31. BLAKEY & BLAKEY, *supra* note 17, at 12-17; PAUL, *supra* note 17, at 32-39; STANWOOD, *supra* note 19, at 296-359.

32. See 26 CONG. REC. 1652, 6703 (1894) (statements of Rep. Thomas L. Johnson of Ohio and Sen. Orville H. Platt of Connecticut). W. Bourke Cockran, Democrat from New York, and Moses T. Stevens, Democrat from Massachusetts, led the opponents of the income tax in the House of Representatives. BLAKEY & BLAKEY, *supra* note 17, at 14. David B. Hill, Democrat from New York; Orville Platt, Republican from Connecticut; George F. Hoar, Republican from Massachusetts; and Nelson W. Aldrich, Republican from Rhode Island led the opponents in the Senate. See *id.* at 16; 26 CONG. REC. 1652, 6703 (1894) (statement of Sen. Orville H. Platt); PAUL, *supra* note 17, at 37.

33. See VANDERBILT, *supra* note 23, at 266 (quoting Ward McAllister).

34. See 26 CONG. REC. 1655 (1894) (statement of Rep. Bryan). Bryan delivered his defense of the income tax in an impassioned speech on January 30, 1894, when he stated:

If "some of our best people" prefer to leave the country rather than pay a tax of 2 per cent, God pity the worst. [Laughter.]

If we have people who value free government so little that they prefer to live under monarchical institutions, even without an income tax, rather than live under the stars and stripes and pay a 2 per cent tax, we can better afford to lose them and their fortunes than risk the contaminating influence of their presence. [Applause.]

I will not attempt to characterize such persons. If Mr. McAllister is a true prophet, if we are to lose some of our "best people" by the imposition of an income tax, let them depart, and as they leave without regret the land of their birth, let them go with the poet's curse ringing in their ears. . . . [Mr. Bryan then recited the poem "My Native Land".]

Id. at 1658.

such as banks and insurance companies.³⁵ The quantum departure between this Act and the Civil War income tax statutes, however, rested in the 1894 Act's blanket application to "all corporations or associations."³⁶ This marked the first time that Congress had imposed an income tax on business entities based solely on their organizational form.³⁷

The majority of the congressional debates pertaining to the proposed income tax on certain business entities occurred in the Senate and focused primarily on two interrelated issues: the rationale behind singling out a group of business entities identified as "corporations or associations," and the meaning of this phrase. With respect to the first issue, Republicans charged that the new tax on corporations was not based on sound principles of taxation. Republicans argued that the new tax was based actually on the efforts of certain representatives to pander to the growing perception of the American public that these entities were to blame for the evils of the world and, therefore, should be eliminated.³⁸ The opponents of the new tax further argued that corporations were no

35. See Revenue Act of 1894 § 32 ("That there shall be assessed, levied, and collected . . . a tax of two per centum annually on . . . all banks, banking institutions, trust companies, saving institutions, fire, marine, life, and other insurance companies, railroad, canal, turnpike, canal navigation, slack water, telephone, telegraph, express, electric light, gas, water, street railway companies. . ."). The 1894 Act also was similar to the Civil War statutes in that the 1894 Act did not impose a double tax on the named entities. Rather, the 1894 Act again allowed taxpayers to exclude income that they received from any entity that was subject to a tax. Compare Revenue Act of 1894 § 28 with Revenue Act of 1864, ch. 173, § 117, 13 Stat. 223, 281-82 (providing that in estimating one's personal income, an individual did not have to include dividends received from industries or companies whose earnings also were subject to tax under the Act).

36. See Revenue Act of 1894 § 32.

37. As originally introduced, the bill identified these entities by limiting its application to organizations whose owners had limited liability. See 26 CONG. REC. 1594-95 (1894) (proposed amendment section 59). This would have been a relatively easy test to apply because taxable entities would have been only those that received a grant of limited liability from the sovereign. The bill, as enacted, abandoned the limited liability requirement, thus negating such a ready interpretation of this taxable class. See Revenue Act of 1894 § 32. The elimination of the limited liability language should not be interpreted as an intentional expansion of the class of entities to which the tax was to apply, however, as it was deleted without comment. See *id.*

38. 26 CONG. REC. 6703-04 (1894) (statement of Sen. Platt). Senator Platt of Connecticut led the Republican charge with this impassioned speech:

There is no reason why this tax should apply to a corporation as a corporation. It is no part of any income scheme that has ever been put in operation or devised in the world. It is no part of the English income scheme, or if so, such an inconsiderable part that it cuts no figure whatever. . . .

. . . [T]his sentiment which has been so widely disseminated among the people, largely by politicians who sought to make them uneasy in order to get their votes[], embraces the idea that all corporations are iniquitous associations and ought to be struck down.

....

different than partnerships and, as such, deserved equal treatment.³⁹ In reply, proponents of the corporate tax argued that a corporation's status as an independent legal entity conferred upon it special privileges that allowed corporations, unlike other entities, to accumulate enormous wealth that completely escaped taxation.⁴⁰ This was the only theoretical argument that the corporate tax advocates expounded.

... I am talking about the sentiment in the country which we hear everywhere, which we hear in the public press, which we hear in speeches of Senators, that in some way corporations are to be denounced because they are corporations, that in some way they are detrimental to the best interests of the Government.

I will not allude to what is said over and over again about their power in legislation. This allegation needs no bill of particulars, no specifications; everybody understands what I mean. Denunciation of corporations forms the stock in trade of nearly half the politicians of the country, and they make no distinction apparently when they denounce corporations.

It is the sentiment that in some way or other the Legislature must get at the corporations, which accounts for the tax upon the incomes of corporations in this bill. It has been a remark made more than once in the Senate, and so publicly that I may refer to it during the consideration of this tariff bill, that the persons trying to pass it desire to "get at the rich men," and that is why this tax is laid on corporations. They wish some way or other to get at corporations.

Id.

39. *See id.* at 6704. Senator Platt argued:

There is no more reason why we should tax the income of a corporation because it is a corporation than why we shall tax the income of a partnership because it is a partnership.

....

... Now, why not tax a partnership? This bill does not tax the income of a partnership; and the corporations of this country, when you step outside of those which are continually in the mind of the people and which are exciting the criticism of people, are nothing more than commercial partnerships.

Id.

40. *See id.* at 6866-67 (statement of Sen. Vest). Leading the proponents of the corporate tax, Senator Vest of Missouri argued:

We treat a corporation as a legal entity, just as we treat the individual. . . .

... We deal with a corporation as a legal being, doing business, artificially created, receiving protection upon its property from the General Government like citizens receive protection upon theirs. . . .

Are we to be told now that these corporations, with their enormous corporate privileges, with their enormous surplus funds, with their control of the capital of this country, are to be entirely exempt from the income tax? . . .

....

Why are corporations created? Why have they increased so marvelously in this country with the increase of wealth? It is because corporate powers and privileges are peculiarly favored by capital. Corporations to-day are thicker almost, I was about to say, than individual investors. The vast body of the wealth of the country is in their hands, and it is because of the peculiar privileges given them by the terms of their creation which are favored as I have said especially by capitalists.

Id.

The Senators actually spent very little time addressing the appropriateness of a corporate tax, focusing instead on the second issue raised—namely, which entities were subject to the new tax. With respect to this issue, Republicans argued that Congress should assess the tax against only certain “large” corporations because they alone “merit[ed] the animosity of [Congress].”⁴¹ Taking this argument to its extreme, one Senator, in a futile attempt to exempt all small corporations, offered to name every large corporation that should be subject to the tax.⁴² It was at this point that the Senators turned to an examination of the term “associations.”

41. *See id.* at 6874 (statement of Sen. Higgins). Being the most vocal Senator, Senator Platt again presented his stance on the issue:

The general idea which one has when he hears about taxing the income of a corporation is that it refers to railroad, telegraph companies, banks, and that class of corporations, and great corporations like the sugar trust or the Standard Oil Company, the great corporations, with great aggregations of wealth, who have concentrated business in their hands, and who are supposed to be more or less monopolistic in their character and in their dealings. That is the idea which seems to be evoked when we talk about taxing the income of corporations.

. . . .

Mr. President, when it comes to my own state it strikes an entirely different class of people and an entirely different class of corporations—corporations engaged in as honest and legitimate business as the merchant who has a retail store or the individual who is printing a country paper, or the mechanic who has been enabled to get a small shop and carry on a small manufacturing business.

Id. Echoing the sentiment that Congress should spare small corporations, Senator Anthony Higgins of Delaware argued:

There are corporations which merit the animosity of the Senators in charge of the bill, and those Senators will have the hearty support of the country if they engage in some sound and legitimate policy as to them. One is the sugar trust. Let them go for it by taking away from it the advantages they have given to it in the bill. Another one is the great octopus, the Standard Oil Company, if it came within their purview.

But because certain overgrown, bloated corporations, which make an unfair and unjust use of the quality of corporate power exist in the country, is that the reason why all the owners in small corporations and all the small owners in large corporations in the country are to be brought under the income tax, contrary to the policy and the reason for which the tax is inaugurated, namely, to get at the rich. This is the combination and accumulation of absurdity which is involved in this proposition.

Id. at 6874 (statement of Sen. Higgins).

42. *See id.* at 6833 (statement of Sen. Allison). Senator William B. Allison of Iowa stated:

I desire that this shall be done either by excluding every corporation not named—and I am willing to name the great industrial corporations of the country, in order that there may be no mistake about that—or in any proper way; but I do not want to include the smaller corporations I have described.

Id.

The debate surrounding the meaning of this term shows just how little thought went into drafting the corporate classification provision. In fact, a review of the transcripts of the floor debate reveals that initially, it was unclear to even the Senators whether the term "associations" included partnerships.⁴³ The following exchange reveals the almost comical confusion of the debate:

Mr. ALDRICH. I should be glad to have the Senator from Missouri state whether the interpretation given to this bill by the Senator from Massachusetts in his opinion is a correct one, because if the word "association" here includes partnerships, as the Senator from Massachusetts stated, as I understand—

Mr. HOAR. I did not say that.

Mr. ALDRICH. That is what I understood the Senator to say.

Mr. HOAR. I said "companies."

Mr. ALLISON. I do not understand, and I should be glad to have the Senator from Missouri state, whether he understands that this section and the subsequent sections regulating this subject are intended to deal with anything but associated corporations?

Mr. VEST. That is the meaning of it. I have not had any doubt about it. If I had intended to use the word "partnerships," I should have said "partnerships." For instance, take building and loan associations. That is the way they style themselves. They are not called "companies;" they are not called "corporations" *eo nomine*, but they are called "associations." Two or more individuals associate themselves, and we have a chapter in the Revised Statutes of Missouri which provides for these associations. They are quasi corporations.

Mr. HALE. That is not a private business partnership.

Mr. VEST. No; that is not a partnership.

....

Mr. HOAR. . . . I should like to ask my friend from Missouri, who is a good lawyer and does not want to draw a bill and be responsible for an act that has doubt in its meaning, whether it is not better to make his meaning clear, and whether it is not, to say the least, a doubtful question whether the clause "corporations, companies, or associations doing business for profit in the United States, no matter how created or organized," does not include partnerships?

I say on my responsibility as a lawyer that I think it does. I should give that opinion as at present advised to a client or to an

43. See *id.* at 6833-35.

officer of the Government. I can not conceive a more apt description of a partnership than “companies or associations doing business for profit.” If a partnership is not a company or association of men doing business for profit, what in the world is it, however established or organized?⁴⁴

The final version of the 1894 Act contained language specifically excluding partnerships from the entities subject to the new tax, purportedly ending any confusion with respect to this issue.⁴⁵ Exempting this one type of business entity, however, did little to define the scope of the term “associations.” Did Congress intend this seemingly all-inclusive term to include all business entities other than partnerships? If that was the case, then why did Congress mention corporations? Corporations clearly would have fallen within the broad category of associations. Congress must have intended the term “associations” to have a narrower meaning.

A further review of the Senate debates provides strong evidence that the term “associations” referred to joint-stock companies, a form of business entity that, although unheard of today, seems to have had some measure of popularity at the turn of the century. One of the treatises available during this period described this business form as:

an association of persons for the purpose of business, having a capital stock divided into shares, and governed by articles of association which prescribe its objects, organization, and procedure, and the rights and liabilities of the members, except that the articles cannot release the members from their liability as partners to the creditors of the company.⁴⁶

44. *Id.*

45. See Revenue Act of 1894, ch. 349, § 32, 28 Stat. 509, 556 (declared unconstitutional in 1895). Thus, the final version read:

That there shall be assessed, levied, and collected, except as herein otherwise provided, a tax of two per centum annually on the net profits or income . . . of all banks, banking institutions, trust companies, savings institutions, fire, marine, life, and other insurance companies, railroad, canal, turnpike, canal navigation, slack water, telephone, telegraph, express, electric light, gas, water, street railway companies, and all other corporations, companies, or associations doing business for profit in the United States, no matter how created and organized, *but not including partnerships.*

Id. (emphasis added). A debate later ensued, however, over whether the exemption for partnerships extended to limited partnerships. See *infra* notes 340-480 and accompanying text.

46. 2 WILLIAM W. COOK, A TREATISE ON THE LAW OF CORPORATIONS HAVING A CAPITAL STOCK § 504, at 933-34 (4th ed. 1898); see also 1 VICTOR MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS § 6, at 7 (2d ed. 1886) (“[Joint-stock companies] are associations having some of the features of an ordinary common law copartnership, and some of the features of a private corporation.”).

The joint-stock company fell midway between the corporation and the partnership on the business entity spectrum,⁴⁷ and it existed both at common law and in statutory form.⁴⁸ The Senators regarded the terms “as-

47. See 2 COOK, *supra* note 46, at 934. But see WM. L. CLARK, JR., HANDBOOK OF THE LAW OF PRIVATE CORPORATIONS §§ 6-8, at 23 (I. Maurice Wormser ed., 3d ed. 1916). After suggesting that joint stock companies were not corporations at all, Clark stated:

Joint-stock companies are formed solely by agreement between the associates, and rest upon their common-law right to contract with each other, and do not depend at all, as in the case of a corporation, upon license or authority from the state. They are merely a peculiar kind of partnership.

Id. During the debates Senator Platt argued that joint-stock companies were a unique business form that was neither a corporation nor a partnership:

As my colleague [Mr. HAWLEY] has well said, back in 1851 we introduced into our State the system of encouraging joint stock corporations—I think it was in 1851—and they were, when established, and to-day still are, actual coöperative associations, as much as any reformer ever longed for.

. . . .

The very essential idea of that is a coöperative association, and it has been upon that fortunate idea that the business of Connecticut has been developed. A few skillful men who have been able to acquire by economy and savings from their wages a little capital come together, joining their capital, or perhaps they get some man with money who is willing to help them along, and they start thereby a little manufacturing or a mercantile business or joint stock corporation. That is the way in which the industrial condition of Connecticut has been built up. Why should those institutions be taxed, Mr. President, any more than men who enter into partnership should be taxed as partners?

. . . .

Why should these concerns be taxed directly as corporations? If you are going to have an income tax I do not object to having the money which the individual stockholder may derive from such corporations included within his income; it ought to be; but why tax the corporation as a corporation and not tax a partnership as a partnership? Why tax this business when you do not tax all business?

26 CONG. REC. 6704 (1894) (statement of Sen. Platt) (emphasis added).

48. Professor William L. Clark distinguished the joint-stock association from the corporation by stating that unlike the corporation, the joint-stock association was a creature of agreement that did not depend upon license or authority from the state. See CLARK, *supra* note 47, at 23. Another treatise, however, distinguished the common law joint-stock association from the statutory joint-stock association, and stated that the only difference between statutory joint-stock associations and corporations was the personal liability of the joint-stock association owners. See 2 COOK, *supra* note 46, § 505, at 940-42 (explaining that the statutory joint-stock association was available in England and New York); see also HENRY O. TAYLOR, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS §§ 56-58, at 32-34 (2d ed. 1888) (describing the New York statutory joint-stock association). In light of the variety of definitions of joint-stock association, Victor Morawetz, in his 1888 treatise on corporations, remarked:

[The] constitution [of joint stock associations] varies greatly, and they may be found of every possible variety, from an ordinary copartnership to a corporation in the strictest sense of the word. Their real organization and character must in each case be determined by reference to the laws and articles of agreement under which they are formed: whether they are to be called copartnerships, or joint stock companies, or corporations, is solely a question of definition.

sociations” and “joint-stock companies” as synonymous.⁴⁹ Senator Hoar even regarded these terms as interchangeable.⁵⁰ The most telling example of this perception is his effort to include an amendment to exempt smaller joint-stock associations from the entity-level tax.⁵¹

The proposed amendment was defeated and the term “associations” received no additional clarification. When the 1894 Act became law on August 28, 1894, the final version imposed a federal income tax on “corporations, companies, or associations doing business for profit in the United States, no matter how created and organized, but not including partnerships.”⁵² Although subsequent statutes confirmed the nexus between the term “association” and the business form known as the joint-stock company, this link was eventually severed, rendering entity classification the subject of continuous debate.⁵³ Indeed, Senator William E. Chandler of New Hampshire presciently described the future of entity classification:

1 MORAWETZ, *supra* note 46, at 7.

49. *See supra* note 47.

50. 26 CONG. REC. 6833 (1894).

51. In support for this amendment, Senator Hoar stated:

Mr. Hoar: I move to add at the end of line 22, page 187, the following proviso:

Provided, That there shall be allowed to said corporation, company, or association an exemption equal to the aggregate of the exemptions to which such stockholders would be entitled in estimating their individual tax, not including, however, any exemption which may have been allowed to such stockholders as individuals.

....

The purpose of the amendment is that where a man's whole income, and a small income, comes from a joint stock company he shall have the precise exemption, and no more and no less, out of the income which he gets from the joint stock company that he would get if it came from an ordinary individual business. The largest part of the business of Massachusetts—manufacturing, mechanical, mercantile—is now conducted by joint stock companies. Two young mechanics or five young mechanics do a part of the business of their machine shop—make a particular wheel, a particular lever, a particular small part of the mechanism, and they associate themselves together under our law as a joint stock company.

That saves them, if they comply with the strict requirements of the law, from individual liability for the debt; but that is not the main purpose. The main purpose is to get the benefit of the united action. If one of them dies, or becomes sick, or insane, or is insolvent in his private transactions, that the business has not got to stop by reason of the withdrawal from it of one man, and go into liquidation, and be held up for a year or two. I am stating not an extreme case; I am stating an everyday case, and a case where I am sure every Senator on both sides of the Chamber will agree that this exemption ought to be allowed.

Id. at 6877.

52. *See* Revenue Act of 1894, ch. 349, § 32, 28 Stat. 509, 556 (declared unconstitutional in 1895).

53. *See* 26 CONG. REC. 6880-81 (1894).

The clause is a fearful bungle, and it ought to have, if it passes, a special title to it, and that is "[a] clause to increase the fees of lawyers," because there will be more litigation and more large fees in connection with this wonderful discovery, invention, contrivance, and construction of the Senator from Missouri than ever have been known before in connection with any tax law passed by this Government.

....
 Mr. President, there never was a more loosely drawn, inaccurate, and, I was about to say, impotent taxation clause submitted to a legislative body

The debate over the meaning of this "fearful bungle," however, soon took a fifteen-year hiatus because shortly after enactment, opponents of the income tax were able to void the 1894 Act on constitutional grounds.⁵⁴ In *Pollock v. Farmers' Loan & Trust Co.*,⁵⁵ the Supreme Court held that the taxation of income from property was a direct tax within the meaning of Article I, Section 2 of the Constitution.⁵⁶ As a result, the federal government could not impose a tax on a taxpayer's income if that income included revenue from property unless it was apportioned among the states according to their respective populations.⁵⁷ The *Pollock* Court found that income from property constituted the greatest portion of the tax base under the 1894 Act.⁵⁸ Consequently, it declared the 1894 income tax unconstitutional.⁵⁹ The opponents of the tax, nonetheless, had won only a temporary victory. The Corporate Excise Tax of 1909⁶⁰ permanently revived the income tax as well as the entity classification debate.

B. *The Corporate Excise Tax of 1909*

Despite the Supreme Court's decision in *Pollock*, proponents of the income tax had not surrendered.⁶¹ In the 1908 Presidential election, the

54. *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, *modified*, 158 U.S. 601 (1895). For a detailed discussion of the decision and the constitutionality of the income tax prior to the ratification of the Sixteenth Amendment, see SELIGMAN, *supra* note 17, at 531-90; *see also* PAUL, *supra* note 17, at 16-23.

55. 158 U.S. 601 (1895).

56. *Id.* at 630 (citing U.S. CONST. art. I, § 2).

57. *Id.* at 637.

58. *Id.* at 636.

59. *Id.* at 637.

60. Revenue Act of 1909, ch. 6, § 38, 36 Stat. 11, 112.

61. For a discussion of the economic and political climate during the era prior to the reintroduction of an income tax in 1909, see BUENKER, *supra* note 17, chs. 1 & 2; *see also* BLAKEY & BLAKEY, *supra* note 17, at 22; PAUL, *supra* note 17, at 86-90 (discussing President Theodore Roosevelt's surprising acceptance of the need for an income tax, despite

Democratic candidate, William Jennings Bryan, supported an income tax and called for an amendment to the Constitution to implement the tax.⁶² Although most Republicans were opposed to the income tax⁶³ and the party's platform was silent on the subject, the Republican candidate William Howard Taft, after accepting his party's nomination, indicated that he thought that under certain circumstances, Congress could and should devise an income tax that passed the requirements of the Constitution as interpreted by the Supreme Court.⁶⁴ Yet, after winning the election, President Taft did not mention the income tax again until the issue threatened to split the Republican Party.⁶⁵

In March of 1909, the President called a special session of Congress to revise the tariff, a goal that both parties supported during the 1908 campaign.⁶⁶ During the Senate debates, the intransigence of the northeast Republicans frustrated their midwestern and western counterparts, known as the "Insurgents,"⁶⁷ in achieving this election promise.⁶⁸ This frustration led the Insurgents to defy their Republican colleagues, resulting in two unsuccessful attempts to add an income tax amendment to the tariff measure.⁶⁹ Unbowed, and to the horror of Republican Party leadership, the Insurgents then united with the Democrats in proposing a two-percent tax on the income of individuals and corporations exceeding

heavy Republican criticism); SELIGMAN, *supra* note 17, at 590-94; WITTE, *supra* note 17, at 74 (describing the events leading to the "Insurgent" Republicans' income tax proposals).

62. BLAKEY & BLAKEY, *supra* note 17, at 23; BUENKER, *supra* note 17, at 55; *see also* PAUL, *supra* note 17, at 90 (describing how the Democratic candidate's arguments "collapsed" when Republican challenger William Howard Taft proposed an income tax that would not require a constitutional amendment); SELIGMAN, *supra* note 17, at 591.

63. Despite the general consensus within the Republican Party, an increasing number of Republican representatives from Western and Mid-western states, later known as the "Insurgents," started to consider the income tax as a revenue vehicle that was capable of facilitating tariff relief. BUENKER, *supra* note 17, at 81-91. This group was responsible for the reinstatement of the corporate tax in 1909. *See* BLAKEY & BLAKEY, *supra* note 17, at 28-36; BUENKER, *supra* note 17, ch. 2; WITTE, *supra* note 17, at 74 (discussing the income tax proposals of the Insurgents).

64. BLAKEY & BLAKEY, *supra* note 17, at 23 (explaining that Taft stated: "I believe that an income tax, when the protective system of customs and the internal revenue tax shall not furnish income enough for governmental needs, can and should be devised which, under the decisions of the Supreme Court, will conform to the Constitution"); *see also* SELIGMAN, *supra* note 17, at 592.

65. BLAKEY & BLAKEY, *supra* note 17, at 35; BUENKER, *supra* note 17, at 55-58.

66. BLAKEY & BLAKEY, *supra* note 17, at 23-24; BUENKER, *supra* note 17, at 82.

67. *See supra* note 63 (discussing the emergence of the Insurgents).

68. BUENKER, *supra* note 17, at 98-104.

69. *See* 44 CONG. REC. 1351-54 (1909) (proposed amendment of Sen. Bailey); *id.* at 1420-29 (proposed amendment of Sen. Cummins).

five thousand dollars.⁷⁰ The language of the proposal was almost identical to the 1894 Act.⁷¹

Fearing the demise of the Republican Party, President Taft finally decided to act.⁷² The President realized that the tariff bill had to include some form of income tax, but he did not want to compel the Supreme Court to overturn its earlier decision in *Pollack*.⁷³ Thus, in a letter to the Senate, President Taft instead suggested a two-part compromise.⁷⁴ To protect the integrity of the Court, he called on Congress to propose a Constitutional amendment for state ratification that would give Congress broad power to enact an income tax sometime in the future.⁷⁵ Second, he suggested that Congress enact an excise tax on corporate income.⁷⁶ The letter made it clear, however, that this entity-level tax should apply to only "corporations and joint stock companies."⁷⁷ Apparently, the President's intent in calling this income tax an excise tax was to spare the Court from having to reconsider the income tax issue until after Congress and the states contemplated a Constitutional amendment.⁷⁸ He also believed that the excise tax would provide some measure of victory to those Republicans who opposed the income tax.⁷⁹ After several months of ran-

70. *Id.* at 3137-38 (proposal of Sen. Cummins).

71. *Compare id. with* Revenue Act of 1894, ch. 349, § 32, 28 Stat. 509, 556 (declared unconstitutional in 1895). In fact, the language of the proposal duplicated the entity classification language of the 1894 Act by imposing an income tax on all "corporations, companies, or associations." *See* 44 CONG. REC. at 3137-38 (1909).

72. BLAKEY & BLAKEY, *supra* note 17, at 35-45; BUENKER, *supra* note 17, at 104-16.

73. *See* BUENKER, *supra* note 17, at 70-71 (suggesting that President Taft opposed the income tax because of his concern for protecting the integrity of the Court, a concern resulting from his earlier career as a jurist); 1 HENRY F. PRINGLE, *THE LIFE AND TIMES OF WILLIAM HOWARD TAFT* 433-36 (Holt, Rinehart and Winston, Inc. 1964). President Taft stated:

While I am generally in favor of the principle of the income tax and certainly in favor of the power of the government to levy such a tax . . . the truth is that the Supreme Court has decided that such a tax is unconstitutional, and this bill proposes to resubmit the question to the Supreme Court. I am opposed to this method of securing an income tax or the power to pass one.

1 PRINGLE, *supra* at 433.

74. *See* 44 CONG. REC. 3344-45 (1909) (recording President Taft's letter to the Senate as it was read on June 16, 1909).

75. *Id.*

76. *Id.*

77. *See id.* at 3344. Specifically, the President's letter stated: "I therefore recommend an amendment to the tariff bill imposing upon all *corporations and joint stock companies* for profit, except national banks (otherwise taxed), savings banks, and building and loan associations, an excise tax measured by 2 per cent on the net income of such corporations." *Id.* at 3344 (emphasis added).

78. BUENKER, *supra* note 17, at 106.

79. BLAKEY & BLAKEY, *supra* note 17, at 44-45.

corous debate, Congress acceded to the President's request,⁸⁰ and on August 5, 1909, the Corporate Excise Tax became law.⁸¹

The entity classification language of the Act refers to "every corporation, joint stock company or association, organized for profit and having a capital stock represented by shares, and every insurance company, now or hereafter organized under the laws of the United States."⁸² Once again, Congress' inclusion of the word "association" became the fulcrum of the entity classification debate. While the President had called for a tax on "corporations and joint stock companies,"⁸³ the statute referred to a "joint stock company *or association*."⁸⁴ It should have been clear that Congress added "or association" merely to be precise in its reference to statutory joint-stock companies. Nothing in the record suggests that Congress wanted to expand the President's recommended classification. To the contrary, when the measure was introduced, Senator Frank P. Flint from California indicated that Congress drafted the Act in accordance with the President's recommendation.⁸⁵ Nevertheless, the Treasury Department, in what became a familiar stance, adopted a much broader reading.⁸⁶

On December 3, 1909, the Treasury Department issued regulations to accompany the Corporate Excise Tax of 1909, entitled "Regulations relating to the assessment and collection of the special excise tax imposed by section 38, act of August 5, 1909, on corporations, joint stock companies, associations, and insurance companies."⁸⁷ The Treasury Department sig-

80. *See id.*, *supra* note 17, at 47-52; BUENKER, *supra* note 17, at 106-35; PAUL, *supra* note 17, at 94-96 (explaining the successful efforts of President Taft and the Administration in urging Congress to pass the proposed income tax legislation).

81. Revenue Act of 1909, ch. 6, § 38, 36 Stat. 11, 112. Section 38 of the 1909 Act provided, in pertinent part:

That every corporation, joint stock company or association, organized for profit and having a capital stock represented by shares, and every insurance company, now or hereafter organized under the laws of the United States or of any State or Territory of the United States . . . shall be subject to pay annually a special excise tax with respect to the carrying on or doing business by such corporation, joint stock company or association, or insurance company, equivalent to one per centum upon the entire net income over and above five thousand dollars . . .

Id. at 112 (emphasis added); *see also* PAUL, *supra* note 17, at 96 (describing the events taking place just prior to the excise tax becoming the "law of the land").

82. Revenue Act of 1909 § 38.

83. *See* 44 CONG. REC. 3344 (1909) (letter of President Taft).

84. Revenue Act of 1909 § 38 (emphasis added).

85. *See* 44 CONG. REC. 3936 (1909) (statement of Sen. Flint).

86. *See infra* notes 141-43 and accompanying text (discussing the regulations that the Treasury Department promulgated under the 1913 Act).

87. Treas. Reg. 31, T.D. 1571, 12 Treas. Dec. Int. Rev. 131 (1909). The title alone reveals the expansive reading that the Treasury Department gave to the term "association." These regulations, known as "Regulation 31," provided in part:

nificantly altered the classification language of the 1909 Act by adding a single comma. That comma signified the Treasury Department's specific intent to interpret the term "associations" independently from joint-stock companies.⁸⁸ The Supreme Court, however, quickly put this broad interpretation to rest.

On March 13, 1911, the Supreme Court issued two opinions validating the constitutionality of the 1909 Act and clarifying the fact that the term "associations," as employed within the statutory framework of the Act, was not an independent concept.⁸⁹ In *Flint v. Stone Tracy Co.*,⁹⁰ the first and more infamous of the two cases, the Court upheld the constitutionality of the Act by confirming the illusion that the tax was an excise tax rather than an income tax and, therefore, not a direct tax.⁹¹ Commenting on the issue of classification, the *Stone Tracy* Court reasoned that:

The attention of collectors and others is specially called to the fact that the tax imposed by this section of the law applies to all corporations, joint stock companies, *associations*, or insurance companies described (except those specifically exempted), without reference to the kind of business carried on, and that the tax is to be computed upon the NET INCOME of such corporations, joint stock companies, *associations*, and insurance companies, which shall be calculated by subtracting from the gross income received from all sources during the year certain deductions specifically set forth in the statute.

Every corporation, joint stock company, *association*, or insurance company not specifically enumerated as exempt shall make the return required by law, whether it may have net income liable to tax or not.

In the case of corporations, joint stock companies, *associations*, or insurance companies organized under the authority of the United States or any State or Territory thereof, including Alaska and District of Columbia, such net income relates not only to the business carried on within the confines of the United States, but to income received from business transacted in any foreign country as well. In case of corporations, joint stock companies, and associations organized under the authority of foreign countries the terms "Gross income," "Net income," and "Authorized deductions" relate only to business transacted within the United States or any State or Territory thereof.

Id. at 135-36 (emphasis added).

88. Shortly after the enactment of Regulation 31, and prior to the promulgation of the Uniform Partnership Act (UPA), the Treasury Department acted on this broad interpretation and found that a Pennsylvania partnership association was taxable under the 1909 Act. See T.D. 1742, 14 Treas. Dec. Int. Rev. 123, 126 (1911); 28 Op. Att'y Gen. 189, 192 (1912) (focusing on the provision of the Pennsylvania statute that permitted shares to represent partners' interests). Interestingly, the opinion misquoted the language of the 1909 Act by placing the comma in the same place as it appeared in Regulation 31. See T.D. 1742, 14 Treas. Dec. Int. Rev. at 126.

89. See *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911), *overruled by* *Garcia v. San Antonio Metro. Transit*, 469 U.S. 528 (1985); *Eliot v. Freeman*, 220 U.S. 178 (1911).

90. 220 U.S. 107 (1911). For a discussion of the *Stone Tracy* decision, see BLAKEY & BLAKEY, *supra* note 17, at 54-57.

91. See *Stone Tracy*, 220 U.S. at 147-52.

a reading of this portion of the [Corporate Excise Tax statute] shows the purpose and design of Congress in its enactment and the subject-matter of its operation. It is at once apparent that its terms embrace corporations and joint stock companies or associations which are organized for profit, and have a capital stock represented by shares. *Such joint stock companies, while differing somewhat from corporations, have many of their attributes and enjoy many of their privileges.*⁹²

This passage is readily distinguishable from the broad interpretation that the Treasury Department rendered in Regulation 31,⁹³ and it reveals the Supreme Court's narrow construction of the entity classification language found in the 1909 Act.

The Court's second decision that day was even more direct. *Eliot v. Freeman*⁹⁴ involved the application of the excise tax, now valid, to a form of business entity commonly known as the "Massachusetts Trust,"⁹⁵ which was an organizational form that later would play a major role in the metamorphosis of the term "association."⁹⁶ The trust in *Freeman* is typical of how this organizational form typically was used. The trust was established for the purpose of "purchasing, improving, holding and selling" real estate.⁹⁷ The trustees of the trust had the exclusive right to conduct its affairs, although the shareholders had the power to replace trustees and to amend the trust agreement.⁹⁸ Transferable certificates represented the interests of the beneficiaries of the trust.⁹⁹ The Court did not even consider whether the classification language of the 1909 Act provided for a general class of entities called "associations."¹⁰⁰ It is clear from the Court's classification query that it would have rejected any effort on the part of the government to suggest such a reading.¹⁰¹ For the Court, the question was whether the reach of the statute was limited to joint-stock companies organized under statute or could it be extended to

92. *Id.* at 144 (emphasis added).

93. *See supra* notes 87-88 and accompanying text (discussing the Treasury Department's construction of the statute).

94. 220 U.S. 178 (1911).

95. *See Hecht v. Malley*, 265 U.S. 144, 146-47 (1924) (describing the characteristics of a Massachusetts Trust).

96. *See infra* notes 144-56, 188-215 and accompanying text (discussing the role of the Massachusetts Trust in shaping the definition of "association").

97. *Eliot*, 220 U.S. at 184.

98. *Id.* at 184-85.

99. *Id.* at 184.

100. *See id.* at 185 (narrowing the inquiry to whether the trusts were organized under state law, rather than whether the trust could be classified as an association).

101. *See id.* (noting that the purpose of the Act was to treat "similarly organized" companies, i.e., companies organized under state law, in the same manner).

non-statutory, joint-stock companies.¹⁰² In opting for the narrower interpretation, Justice Day, writing for the majority, explained that Congress did not intend for the corporate tax statute to include the real estate trusts involved in these two cases because these trusts were not organized under a statute.¹⁰³

Stone Tracy and *Freeman* are the last time that the boundaries of corporate taxation were so easily defined. According to the Supreme Court, the Corporate Excise Tax of 1909 provided a well defined class of entities subject to the tax; it applied to corporations and statutory joint-stock companies. Although this classification was susceptible to attack as arbitrary and unfair,¹⁰⁴ its scope was well defined. Within a decade, however,

102. *See id.* at 185-87.

103. *Id.* Justice Day wrote:

It was the purpose of the act to treat corporations and joint stock companies, similarly organized, in the same way, and assess them upon the facility in doing business which is substantially the same in both forms of organization. Joint stock organizations are not infrequently organized under the statute laws of a State, deriving therefrom, in a large measure, the characteristics of a corporation.

The language of the act ". . . now or hereafter organized under the laws of the United States," etc., imports an organization deriving power from statutory enactment. . . . The description of the corporation or joint stock association as one organized under the laws of a State at once suggests that they are such as are the creation of statutory law, from which they derive their powers and are qualified to carry on their operations.

A trust of the character of those here involved can hardly be said to be organized, within the ordinary meaning of that term; it certainly is not organized under statutory laws as corporations are. The difference between joint stock associations at common law and those organized under statutes is well recognized.

. . . .

Entertaining the view that it was the intention of Congress to embrace within the corporation tax statute only such corporations and joint stock associations as are organized under some statute, or derive from that source some quality or benefit not existing at the common law, we are of [the] opinion that the real estate trusts involved in these two cases are not within the terms of the act.

Id. It was Justice Day's reference to the characteristics of a corporation, without enunciation, that later became part of the reasoning behind the steady expansion of the term "association," which ultimately lead to the establishment of the resemblance test. For a detailed discussion of the evolution of the resemblance test, see *infra* notes 180-261 and accompanying text. Such a reading also makes sense in light of the role that George W. Wickersham, President Taft's Attorney General, played in drafting the 1909 corporate income tax. When President Taft decided that he had to act to save the Republican Party, he turned to Wickersham to fashion a compromise, including the drafting of legislation for submission to Congress. BUENKER, *supra* note 17, at 105-06. Wickersham had been a leading corporation counsel in New York, a state that provided for statutory joint-stock companies. See TAYLOR, *supra* note 48, §§ 56-58. It is reasonable to assume that Wickersham considered the types of entities available in New York in drafting this legislation.

104. The *Stone Tracy* Court summarily dismissed such an argument:

But, it is insisted, this taxation is so unequal and arbitrary in the fact that it taxes a business when carried on by a corporation and exempts a similar business

the words describing the entities subject to the corporate tax would be rearranged in a manner that would allow the Treasury Department and the judiciary to establish the term "association" as a permanent, independent concept.

C. *After the Sixteenth Amendment: A Case of Floating Commas and Misplaced Modifiers*

The Sixteenth Amendment to the United States Constitution, ratified on February 25, 1913, gave Congress the "power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."¹⁰⁵ On the heels of the Amendment's ratification, Congress enacted the Revenue Act of 1913,¹⁰⁶ which imposed, *inter alia*, a tax of one percent on the net income of "every corporation, joint-stock company or association, and every insurance company, organized in the United States, no matter how created or organized, not including partnerships."¹⁰⁷ This language differed from the 1909 Act in two important respects. First, the 1913 Act eliminated the phrase, "organized for profit and having a capital stock represented by shares."¹⁰⁸ Second, it altered the language modifying "insurance company" from "now or hereafter or-

when carried on by a partnership or private individual as to place it beyond the authority conferred upon Congress. As we have seen, the only limitation upon the authority conferred is uniformity in laying the tax, and uniformity does not require the equal application of the tax to all persons or corporations who may come within its operation, but is limited to geographical uniformity throughout the United States.

Flint v. Stone Tracy Co., 220 U.S. 107, 158 (1911), *overruled by* Garcia v. San Antonio Metro. Transit, 469 U.S. 528 (1985).

105. U.S. CONST. amend. XVI.

106. Revenue Act of 1913, ch. 16, 38 Stat. 114.

107. *Id.* § IIG(a).

108. The Revenue Act of 1909, ch. 6, § 38, 36 Stat. 11, 112 provided:

[E]very corporation, joint stock company or association, *organized for profit and having a capital stock represented by shares*, and every insurance company, *now or hereafter organized under the laws of the United States* or of any State or Territory of the United States or under the Acts of Congress applicable to Alaska or the District of Columbia, or now or hereafter organized under the laws of any foreign country and engaged in business in any State or Territory of the United States or in Alaska or in the District of Columbia, shall be subject to pay annually a special excise tax with respect to the carrying on or doing business by such corporation, joint stock company or association, or insurance company, equivalent to one per centum

Id. (emphasis added). In contrast, section IIG(a) of the Revenue Act of 1913 required that "the normal tax hereinbefore imposed upon individuals [1%] likewise shall be levied, assessed, and paid annually upon the entire net income arising or accruing from all sources during the preceding calendar year to every corporation, joint-stock company or association, and every insurance company, *organized in the United States, no matter how created or*

ganized under the laws of the United States” to “organized in the United States, no matter how created or organized.”¹⁰⁹ In 1924, the Supreme Court cited these alterations as evidence of Congress’ intent to broaden the entity class to include non-statutory entities.¹¹⁰ It is not clear from the legislative history of the 1913 Act, however, whether Congress actually intended such a dramatic expansion.

During the debates in the House of Representatives on this provision of the 1913 Act, Congressman Cordell Hull of Tennessee, one of the principal architects of the 1913 Act,¹¹¹ commented that Congress changed the language to make the tax “more comprehensive so as to embrace all corporations and joint-stock companies or associations, whether or not having capital stock.”¹¹² In support of his statement, the Congressman explained that “[a] large number of corporations that should be subject to tax have escaped under the present corporation-tax law.”¹¹³ Although this comment seems to suggest that Congress intended to expand the scope of the class, Congressman Hull’s subsequent statement raises some doubt about Congress’ intent. His supporting comment implies that he was not concerned with creating a catchall phrase for entities that should be taxed as corporations, but instead that he was addressing a perceived loophole in the 1909 Act; namely, that certain entities formed under state incorporating statutes were manipulating the capital stock requirement to claim exemption from the tax.¹¹⁴ Indeed, it is clear that the Congressman was not accusing joint-stock companies or associations of abusing the capital stock requirement to escape tax, as he specifically identified corporations as the culprits.¹¹⁵

organized, not including partnerships” Revenue Act of 1913 § IIG(a) (emphasis added).

109. See *supra* note 108.

110. See *Hecht v. Malley*, 265 U.S. 144, 151-52 (1924) (discussing the language alterations contained in the Revenue Act of 1916); see also *infra* notes 188-215 and accompanying text (discussing the Court’s decision in *Hecht v. Malley* and its finding that Congress intended to broaden the entity class to include non-statutory entities).

111. See BLAKEY & BLAKEY, *supra* note 17, at 74-77; BUENKER, *supra* note 17, at 45, 361; PAUL, *supra* note 17, at 101; WITTE, *supra* note 17, at 76.

112. 50 CONG. REC. 509 (1913) (statement of Rep. Hull).

113. *Id.*

114. See *id.* It is significant to note that at this point in time, the term corporation had not yet evolved into a term of art for tax purposes. Congressman Hull was referring to the state law concept. The state and federal notion of the term corporation did not diverge until the enactment of the Revenue Act of 1918, ch. 18, § 1, 40 Stat. 1057, 1057. See *infra* notes 172-79 and accompanying text (discussing the emergence of a federal definition of the term corporation).

115. See 50 CONG. REC. 509 (1913) (statement of Rep. Hull).

Even more troublesome is the claim that the modification of the language following insurance companies¹¹⁶ evidenced Congress' intent to include non-statutory as well as statutory joint-stock associations. The most faulty part of this claim is that it assumes that Congress intended to modify the language following "insurance companies" and also to extend the application of this revised modifier to the other described entities—corporations and joint-stock companies. Certainly, the words "however created or organized" would be an odd modifier of the term "corporation" given that state law authorizes the creation of corporations only under an enabling statute. Moreover, if Congress intended such an expansion, one wonders why Congressman Hull only addressed the elimination of the capital stock requirement and not the second alteration. Obviously, the use of the modifier "however created or organized" would have a far more expansive effect on entity classification than would the elimination of the capital stock requirement. Unfortunately, other than Congressman Hull's brief comments, the record is silent as to these changes.¹¹⁷

The 1913 Act did contain, however, other more subtle alterations that actually may bear greater responsibility for the eventual expansion of the taxable entity class. As this article discussed earlier,¹¹⁸ although the 1909 Act referred to "corporation[s], joint stock compan[ies] or association[s]," the Treasury Department drafted regulations using a comma to surgically separate the word "associations" from the words "joint stock company."¹¹⁹ Despite the Treasury Department's literary craftsmanship in adopting Regulation 31,¹²⁰ the Supreme Court confirmed that the word "association" as employed within the statutory framework of the 1909 Act, was not a separate concept.¹²¹ These decisions, contrary to the Treasury Department's overly broad interpretation, were consistent with the language that the statute employed. The provision of the 1913 Act that imposed the entity-level tax retained the narrower reference to "corporation[s], joint-stock compan[ies] or association[s]"¹²² by leaving out the comma setting off associations from joint-stock companies.¹²³

116. See *supra* note 108 and accompanying text (quoting relevant portions of the 1909 Act and the 1913 Act).

117. See generally 50 CONG. REC. (1913).

118. See *supra* notes 82-88 and accompanying text.

119. Treas. Reg. 31, T.D. 1571, 12 Treas. Dec. Int. Rev. 131, 135 (1909).

120. *Id.*

121. See *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911), *overruled by Garcia v. San Antonio Metro. Transit*, 469 U.S. 528 (1985); *Eliot v. Freeman*, 220 U.S. 178, 186-87 (1911); see also *supra* notes 89-104 and accompanying text (discussing the Court's decisions in *Stone Tracy* and *Eliot*).

122. See Revenue Act of 1913, ch. 16, § IIG(a), 38 Stat. 114, 172.

123. See *id.*

Other provisions of the 1913 Act also were consistent with the more circumscribed language of the 1909 Act. For example, section II(G)(b) and (c), which deal with the calculation of an entity's net income and the determination of its taxable year, respectively, also referred to the entity class as "corporation[s], joint-stock compan[ies] or association[s], or insurance compan[ies] . . ." ¹²⁴ In fact, with one exception, all references in the 1913 Act to this class are consistent with the 1909 Act. ¹²⁵

Section II(A) of the 1913 Act, which provided for the assessment of an individual income tax, was divided into two parts: the first imposing a "normal tax," and the second imposing an "additional tax." ¹²⁶ The normal tax was one percent of an individual's net income. ¹²⁷ The additional tax was a graduated tax that did not apply unless an individual's income exceeded twenty thousand dollars. ¹²⁸ This predecessor to the "accumulated earnings tax" ¹²⁹ departed from the other entity references in two ways. First, similar to Regulation 31, a comma separated the words "or associations" from their joint-stock antecedent. ¹³⁰ Second, the words "however created or organized" were, for the first time, attached to the word "association." ¹³¹ In all other instances in the statute, the words "however created or organized" followed the words "insurance companies," ¹³² which, as stated previously, indicated that the modifier only applied to insurance companies and not to corporations or joint-stock companies. When the modifier is attached to the word "associations," which is now separated by a comma, the phrase describes a dramatically different concept. Rather than the relatively concrete reference to "statutory joint-stock companies or associations," one now finds the more universal reference to "associations however created or organized." ¹³³

One question why Congress included a single provision in the 1913 Act that could be read in a radically different manner from every other entity reference in the statute. Further review of the legislative history suggests that the answer is not that Congress chose this particular point to abandon its straightforward, albeit arbitrary, class of statutorily formed corporations and joint-stock companies in favor of a term of art called

124. *See id.* § IIG(b), (c).

125. *See generally id.* § IIG.

126. *See id.* § IIA(1) & (2).

127. *See id.* § IIA(1).

128. *See id.* § IIA(2).

129. I.R.C. §§ 531-37 (1986).

130. *See* Revenue Act of 1913 § IIA(2) ("corporations, joint-stock companies, or associations" (emphasis added)).

131. *See id.*

132. *See generally id.* § II.

133. *See id.* § IIA(2).

“associations.” Congress did not make this change until five years later.¹³⁴ The “additional tax” provision was added to the 1913 Act on the House floor.¹³⁵ When introduced, the bill imposed a tax on entities that it described in such a way that they were capable of very easily avoiding the tax.¹³⁶ Thereafter, the Conference Committee replaced this language with the phrase “all corporations, joint stock companies, *or associations however created or organized.*”¹³⁷ There are two possible reasons for the change. The first, and least likely, is that the Senate wanted the additional tax provision to have a different entity classification than the remainder of the statute. Clearly, this could not have been Congress’ intention as there was no logic or reason for such a distinction. The second and more likely scenario is that the Conference Committee recognized that under the original language, the additional tax only applied to entities that could be used to avoid a tax at the individual level. Since partnerships could not be used for this purpose,¹³⁸ the Conference Committee most likely set out to make sense of the provision by correcting the entity description—a seemingly simple task, but one, the Conference Committee performed miserably.

The phrase “joint-stock company or association,” without the comma, appears consistently in nineteen places in the 1913 Act.¹³⁹ Due to the Conference Committee’s sloppy draftsmanship, however, the final bill contained one reference to “joint-stock companies, *or associations however created or organized.*”¹⁴⁰ Remarkably, the Treasury Department, in drafting its regulations, ignored consistency in favor of the exception. On January 5, 1914, the Treasury Department issued Regulation 33¹⁴¹ entitled “Laws and regulations relative to the tax on income of individuals,

134. See *infra* notes 172-79 and accompanying text (discussing the emergence of the word “associations” as a term of art for entity classification purposes in the Revenue Act of 1918).

135. See 50 CONG. REC. 1245-46 (1913).

136. See *id.* at 3774. When initially introduced, the bill taxed “all companies, whether incorporated or partnership.” *Id.* However, committee members realized that it was very simple for corporations and partnerships to avoid the tax. See *id.* (statements of Sens. Williams and Root).

137. See Revenue Act of 1913 § IIA(2) (emphasis added).

138. See § II(D).

[A]ny persons carrying on business in partnership shall be liable for income tax only in their individual capacity, and the share of the profits of a partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise, shall be returned for taxation and the tax paid, under the provisions of this section

Id.

139. See generally *id.* § II.

140. See *id.* § IIA(2) (emphasis added).

141. Treas. Reg. 33, T.D. 1944, 16 Treas. Dec. Int. Rev. 26a (1914).

corporations, joint stock companies, *associations*, and insurance companies”¹⁴² Once again, the title is illuminating. Significantly, the regulations subsume within the term “corporations” all of the entities described in the statute, marking the first departure from the state law concept of the term. Moreover, the drafters of the regulation ignored any possibility that the modifier “however created or organized” might be limited to describing insurance companies. Instead, they applied it to all of the described entities, including actual corporations, even though such entities cannot be formed under “trust agreements, declarations of trust, or otherwise.”¹⁴³ This illogical result somehow escaped detection by Treasury Department officials.

The Supreme Court, however, was not so easily fooled. In *Crocker v. Malley*,¹⁴⁴ the Court again faced the government’s assertion that the Massachusetts Trust business form¹⁴⁵ should be classified as an association.¹⁴⁶ The case involved a trust whose assets were the entire outstanding stock of a paper manufacturing corporation and the real estate on which the corporation was situated.¹⁴⁷ The beneficiaries were the previous stockholders of the paper company’s parent corporation, and transferable cer-

142. Regulation 33 provided, in pertinent part:

“Corporation” or “corporations,” as used in these regulations, shall be construed to include all corporations, joint-stock companies or associations, and all insurance companies coming within the terms of the law, and such organizations will hereinafter be referred to as “corporations.”

. . . It is immaterial how such corporations are created or organized. The terms “joint-stock companies” or “associations” shall include associates, real estate trusts, or by whatever name known, which carry on or do business in an organized capacity, whether organized under and pursuant to State laws, trust agreements, declarations of trusts, or otherwise, the net income of which, if any, is distributed, or distributable, among the members or share owners on the basis of the capital stock which each holds, or, where there is no capital stock, on the basis of the proportionate share of capital which each has invested in the business or property of the organization, all of which joint-stock companies or associations shall, in their organized capacity, be subject to the tax imposed by this act.

Id. at arts. 78-79. The Treasury Department subsequently made minor changes in these regulations under the Revenue Acts of 1916 and 1917. *See id.* art. 57 (revised 1918) (treating business trusts issuing shares as corporations); *id.* art. 58 (revised 1918) (substituting the term “common law trusts” for “real estate trusts”); *id.* art. 62 (revised 1918) (clarifying the taxation of limited partnerships).

143. *See id.*

144. 249 U.S. 223 (1919). For a discussion of the *Crocker* decision, see Stephen B. Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 605, 629 (1965).

145. For a discussion of the business entity known as the Massachusetts Trust, see *supra* notes 94-103 and accompanying text.

146. *See Crocker*, 249 U.S. at 223.

147. *Id.* at 231.

tificates represented their interests in the trust.¹⁴⁸ Other than the ability to fill trustee vacancies and to amend the trust agreement, the beneficiaries had no rights.¹⁴⁹ The agreement reserved all other powers for the trustees.¹⁵⁰ The government argued that this type of trust arrangement was taxable because Congress intended to tax associations, and “any form of an unincorporated company is an association within the meaning of [the 1913] act.”¹⁵¹ This bold argument demonstrates the government’s disregard for any connection between associations and joint-stock companies in the 1913 Act. The government also specifically contended that the words “however created or organized” applied to all entities, stating that “[t]o be within the income-tax law an association is not required to be one organized under statutory authority.”¹⁵²

The *Crocker* Court rejected the first part of the Treasury Department’s broad reading of the 1913 Act, holding that the Massachusetts trust was not taxable because “[t]he trust that has been described would not fall under any familiar conception of a joint stock association.”¹⁵³ In light of its interpretation of the word “association,” the Court declined to address whether the phrase “no matter how created or organized” modified all of the entities listed in the 1913 Act or just insurance companies.¹⁵⁴ However, the *Crocker* Court noted that even if Congress intended to tax all entities “no matter how created or organized,” and not just insurance companies, it still could not consider the trust in *Crocker* to be a joint stock association because the beneficiaries were not partners who held joint interests or control.¹⁵⁵ By concluding that the Massachusetts Trust was not a joint-stock association, the Court did not have to determine the effect of the modifier, “however created or organized.” However, the

148. *Id.*

149. *Id.*

150. *Id.*

151. *Id.* at 228.

152. *Id.*

153. *Id.* at 233.

154. *Id.* at 233-34.

155. *Id.* The Court noted that

If we assume that the words “no matter how created or organized” apply to “association” and not only to “insurance company,” still it would be a wide departure from normal usage to call the beneficiaries here a joint stock association when they are admitted not to be partners in any sense, and when they have no joint action or interest and no control over the fund.

Id. The Court’s inference that it might have decided differently if the beneficiaries had “control over the fund” played a major role in the Supreme Court’s decisions in *Hecht* and *Morrissey*. See *infra* notes 188-215, 231-61 and accompanying text (discussing the *Hecht* and *Morrissey* decisions). The Treasury Department incorporated this dicta in its next set of entity classification regulations. See *infra* notes 180-87 and accompanying text (discussing Regulations 45 under the Revenue Act of 1918).

Crocker Court implied that if it had addressed the issue, it would have held that the words "no matter how created or organized" only modified the term "insurance companies."¹⁵⁶

Congress' next venture in classification drafting came about with the passage of the Revenue Act of 1916.¹⁵⁷ The 1916 Act contained a significantly greater number of inconsistencies in its classification language. In section 10 of the 1916 Act, which provided for the additional tax,¹⁵⁸ Congress revisited its earlier drafting problems.¹⁵⁹ The first part of the 1916 provision imposed a tax of two percent on the net income of "every corporation, *joint stock company or association*, or insurance company, organized in the United States, no matter how created or organized but not including partnerships."¹⁶⁰ This language reflected the narrower classification¹⁶¹ and makes it clear that the additional tax entity language in the 1913 Act¹⁶² was the result of sloppy draftsmanship, rather than Congressional intent to provide a more expansive class.

Section 2(a) of the 1916 Act, which defined the term "dividend," did contain, however, the more expansive language.¹⁶³ This section provided that

the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, *association*, or insurance company, out of its earnings or profits . . . and payable to its shareholders, whether in cash or in stock of the corporation joint-stock company, *association*, or insurance company, which stock dividend shall be considered income.¹⁶⁴

The original bill referred to corporations only.¹⁶⁵ The Senate Finance Committee added the words "joint-stock company, association, or insurance company."¹⁶⁶ The Committee designated this alteration as a "clerical change," clearly indicating that it did not intend the revision to be an

156. See *Crocker*, 249 U.S. at 233-34.

157. Revenue Act of 1916, ch. 463, 39 Stat. 756.

158. *Id.* § 10, 39 Stat. at 765.

159. See *supra* notes 124-38 and accompanying text (discussing the Conference Committee amendment to the corresponding provision of the 1913 Act).

160. Revenue Act of 1916 § 10 (emphasis added). This language was the original language reported by the House Ways and Means Committee. See SEIDMAN, *supra* note 5, at 953.

161. See Revenue Act of 1916 § 10.

162. Revenue Act of 1913, ch.16, § IIA(2), 38 Stat. 114, 166.

163. See Revenue Act of 1916 § 2(a).

164. *Id.* (emphasis added).

165. See SEIDMAN, *supra* note 5, at 954.

166. See *id.*

expansion of the association concept.¹⁶⁷ Interestingly, during the Conference Committee's mark-up, section 10 of the 1916 Act was amended by adding the definition of "dividend" in section 2(a) verbatim to the end of the paragraph.¹⁶⁸ As a result, section 10 of the 1916 Act contained both the broad and the narrow classification reference.¹⁶⁹ Again, however, this type of language was the exception. Of the thirty times the words "joint stock companies or associations" appeared in the statute, twenty-seven of those references did not use a comma to separate the word "associations."¹⁷⁰ The 1916 Act marked the end of this grammatical odyssey because the classification language of Congress' next income tax act, the Revenue Act of 1918,¹⁷¹ have remained consistent and unchanged to this day. That is the problem.

The Revenue Act of 1918 marked the end of the first entity-classification debate and the beginning of the next. The 1918 Act differed markedly from prior revenue acts in that it was the first statute to contain a "definitions" section that governed the entire statute.¹⁷² Perhaps the most significant definitional change was the creation of a federal concept of the word "corporation."¹⁷³ Prior to the 1918 Act, Congress used the term "corporation" only to denote a business entity formed under a state enabling statute; joint-stock associations and insurance companies were indicated separately.¹⁷⁴ The 1918 Act forever changed this by defining the term "corporation" as including "associations, joint-stock companies, and insurance companies."¹⁷⁵ The word "associations" was permanently divorced from the term joint stock companies, thereby ending the bright line, albeit arbitrary, classification of the 1894 and 1909 Acts.¹⁷⁶ Indeed, that is exactly what the Supreme Court later noted in the seminal case of *Morrissey v. Commissioner*.¹⁷⁷ Thus, the inquiry into the connection be-

167. See H.R. REP. NO. 1200, 64th Cong., 1st Sess., 1939-1 C.B. 32.

168. See Revenue Act of 1916 § 10.

169. See *id.*

170. See *id.*

171. Revenue Act of 1918, ch. 18, 40 Stat. 1057.

172. See *id.* § 1.

173. See *id.*

174. See, e.g., Revenue Act of 1916, ch. 463, 39 Stat. 756; Revenue Act of 1913, ch. 16, 38 Stat. 114; Revenue Act of 1909, ch. 6, 36 Stat. 11; Revenue Act of 1894, ch. 349, 28 Stat. 509. But see Treas. Reg. 33 art. 79, T.D. 1944, 16 Treas. Dec. Int. Rev. 29 (1914) (wherein the Treasury Department defined "corporations" to include joint-stock companies, associations, and insurance companies).

175. Revenue Act of 1918 § 1.

176. See *supra* notes 52-104 and accompanying text (discussing the bright line classification under the 1894 and 1909 Acts).

177. 296 U.S. 344 (1935); see *infra* notes 231-61 and accompanying text (discussing the *Morrissey* decision and the emergence of associations as a separate class of taxable entities).

tween the word "associations" and "joint stock companies" ended, and a second inquiry into the meaning of this new concept called "associations" began.

With respect to this inquiry, however, Congress was not silent. An exchange between Representative William P. Borland of Missouri and Representative John N. Garner of Texas evidenced Congress' intent to create a federal definition of the term "corporation":

Mr. BORLAND. The word "corporation" ordinarily means a legal entity.

Mr. GARNER. I know, but we have changed it. We have undertaken to determine what a corporation is by stating specifically what it includes, and we say that it includes an association. Now, if you want to go to the dictionary and find out the definition of association, well and good. I think it means a number of people, whether organized under law or voluntarily.¹⁷⁸

This exchange also demonstrates Congress' lack of understanding as to the meaning of the term. Indeed, nobody bothered to suggest that perhaps the poorly articulated definition was backwards. Logic dictates that no matter how the terms are defined, the concept of an association is much broader than that of a corporation.

Consequently, Congress left the Treasury Department and the judiciary with only this nonsensical definition and directions "to go to the dictionary," thereby requiring the Treasury and judiciary to flesh out the meaning of the term "corporation"; a term whose definition Congress itself would not revisit for another seventy years. Of course, the Treasury Department had been working since the 1909 Act to develop a definition, and the courts soon followed the advice of Senator Garner and went to the dictionary.¹⁷⁹

D. *Developing Corporate Composite*

After the passage of the Revenue Act of 1918, the task of classifying corporations no longer simply involved identifying business entities formed under a statute. A method had to be developed to determine if a particular entity classified as an association should be taxable as a corporation. Now that Congress had defined corporations to include associations, the term "association" had to be defined. The Treasury Department began this process in 1920, when it issued regulations under

178. 56 CONG. REC. 10418 (1918).

179. See *Hecht v. Malley*, 265 U.S. 144, 157 (1924); see also *infra* note 209 and accompanying text (noting that the Supreme Court in *Hecht* consulted five definitions of "association" from various dictionaries).

the 1918 Act entitled "Regulations No. 45 (1920 ed.), relating to the income tax and war profits and excess profits tax."¹⁸⁰ Article 1502 of this regulation gave the word "association" a definition almost identical to the definition of "association" contained in Regulation 33 under the 1913 Act.¹⁸¹ Under this definition any business entity could be classified as an association, regardless of the label that a particular local law attached to it.

Regulation 45 did represent a significant advance over the earlier regulation, however, because it contained several additional provisions that the Treasury Department designed to distinguish associations from trusts and partnerships.¹⁸² These provisions quickly revealed the methodology

180. Treas. Reg. 45, T.D. 3146, 23 Treas. Dec. Int. Rev. 352 (1921); *see also* Scallen, *supra* note 144, at 655-57 (discussing Regulation 45 as "the first attempt to specify criteria for classifying organizations as associations"). For simplicity, throughout this article, all future references to this regulation will be denoted as "Regulation 45." Article 1502 of this regulation defined "associations" as:

Associations and joint-stock companies include associations, common law trusts, and organizations by whatever name known, which *act* or do business in an organized capacity, whether created under and pursuant to State laws, [trust] agreements, declarations of trust, or otherwise, the net income of which, if any, is distributed or distributable among the members or shareholders on the basis of the capital stock which each holds or, where there is no capital stock, on the basis of the proportionate share or capital which each has or has invested in the business or property of the organization.

Treas. Reg. 45, art. 1502, 23 Treas. Dec. Int. Rev. at 591 (emphasis added).

181. For the text of the definition of the term "association" in Regulation 33 and a discussion of its applicability, *see supra* note 142 and accompanying text.

182. *See* Treas. Reg. 45, arts. 1503-06, 23 Treas. Dec. Int. Rev. at 591-92. In distinguishing an association from a partnership, Article 1503 provided:

An organization the membership interests in which are transferable without the consent of all the members, however the transfer may be otherwise restricted, and the business of which is conducted by trustees or directors and officers without the active participation of all the members as such, is an association and not a partnership. A partnership bank conducted like a corporation and so organized that the interests of its members may be transferred without the consent of the other members is a joint-stock company or association within the meaning of the statute. A partnership bank the interests of whose members can not be so transferred is a partnership.

Id. art. 1503, at 591. Article 1504, distinguishing an association from a trust, provided:

Where trustees hold real estate subject to a lease and collect the rents, doing no business other than distributing the income less taxes and similar expenses to the holders of their receipt certificates, who have no control except the right of filling a vacancy among the trustees and of consenting to a modification of the terms of the trust, no association exists and the cestuis que trust are liable to tax as beneficiaries of a trust the income of which is to be distributed periodically, whether or not at regular intervals. But in such a trust if the trustees pursuant to the terms thereof have the right to hold the income for future distribution, the net income is taxed to the trustees instead of to the beneficiaries. . . . If, however, the cestuis que trust have a voice in the conduct of the business of the trust, whether through

that the Treasury Department thereafter has employed to identify associations; namely, classifying certain characteristics as "corporate," and then examining the entity to determine whether it possessed such characteristics. Thus, under Regulation 45, the Treasury Department would treat an entity purporting to be a trust as an association for tax purposes if it actively engaged in business and its beneficiaries had control over the manner in which the trustees conducted that business.¹⁸³ Likewise, the

the right periodically to elect trustees or otherwise, the trust is an association within the meaning of the statute.

Id. art. 1504. Under article 1505, partnerships included limited partnerships that offered limited liability to limited partners, but not to general partners. *Id.* art. 1505, at 591-92. Such limited partnerships were not corporations for federal tax purposes:

So-called limited partnerships of the type authorized by the statutes of New York and most of the States are partnerships and not corporations within the meaning of the statute. Such limited partnerships, which can not limit the liability of the general partners, although the special partners enjoy limited liability so long as they observe the statutory conditions, which are dissolved by the death or attempted transfer of the interest of a general partner, and which can not take real estate or sue in the partnership name, are so like common law partnerships as to render impracticable any differentiation in their treatment for tax purposes. Michigan and Illinois limited partnerships are partnerships. A California special partnership is a partnership.

Id. art. 1505. Article 1506 classified limited partnerships that offered limited liability to all members—including general partners—as corporations for federal tax purposes. *Id.* art. 1506, at 592. It stated:

On the other hand, limited partnerships of the type of partnerships with limited liability or partnership associations authorized by the statutes of Pennsylvania and of a few other States are only nominally partnerships. Such so-called limited partnerships, offering opportunity for limiting the liability of all the members, providing for the transferability of partnership shares, and capable of holding real estate and bringing suit in the common name, are more truly corporations than partnerships and must make returns of income and pay the tax as corporations. . . . In all doubtful cases limited partnerships will be treated as corporations unless they submit satisfactory proof that they are not in effect so organized. A Michigan partnership association is a corporation. Such a corporation may or may not be a personal service corporation.

Id. art. 1506; *see also* Scallen, *supra* note 144, at 655-56 & nn.270 & 273 and accompanying text (citing and discussing articles 1503 through 1506 of Regulation 45).

183. *See* Treas. Reg. 45, art. 1504, 23 Treas. Dec. Int. Rev. at 591. Professor Scallen asserts that the Treasury Department drafted this regulation to reflect the Supreme Court's decision in *Crocker v. Malley*, 249 U.S. 223 (1919). Scallen, *supra* note 144, at 656. Although Professor Scallen's assertion is correct, it is equally as clear that the Treasury Department misread the Court's opinion. The *Crocker* Court held that the 1913 Act did not apply to the Massachusetts Trust because it was not a joint-stock association. *See Crocker*, 249 U.S. at 233. Although the Court pointed out that "it would be a wide departure from normal usage to call the beneficiaries here a joint-stock association when they are admitted not to be partners in any sense, and when they have no joint action or interest and no control over the fund," *id.* at 233-34, it did not say that if such control were present the trust would be a joint-stock association, much less an association. *See id.* The Supreme Court later confirmed this statement in *Hecht v. Malley*, 265 U.S. 144 (1924), wherein the Court stated that "merely because such a slight measure of control may be vested in the

Treasury Department treated a partnership as an association if the partnership's membership interests were freely transferable and some of its members were "passive investors,"¹⁸⁴ yet the regulation provided no explanation on how to measure this passivity.¹⁸⁵ Also, under this regulation, the Treasury Department deemed a limited partnership to be a corporation for tax purposes if the partnership provided for limited liability, free transferability of interest, and the right to bring suit in a common name.¹⁸⁶ Regulation 45 further provided that the burden of proving non-corporate status was on the taxpayer, with all doubts being resolved in favor of corporate treatment.¹⁸⁷ The historical significance of Regulation 45 cannot be overstated. Although future regulations radically altered the meaning and weight of the identified characteristics, this method of corporate classification has remained unchanged.

Within four years, the Supreme Court eliminated the issue of beneficiary control over trustees as a factor in classifying trusts.¹⁸⁸ In *Hecht v. Malley*,¹⁸⁹ the Court returned to the issue it had considered twice before: the classification of the Massachusetts Trust business form.¹⁹⁰ Specifically, the Court considered whether the involved trusts were subject to excise taxes under both the Revenue Act of 1916 and 1918.¹⁹¹ The 1916 Act imposed an excise tax on the fair market value of the capital stock of "[e]very corporation, joint stock company or association, now or hereafter organized in the United States for profit and having a capital stock represented by shares, and every insurance company, now or hereafter organized under the laws of the United States."¹⁹² In an attempt to de-

beneficiaries" did not mean that the trusts were not associations under the 1918 Act. *See id.* at 160-61. *See infra* notes 188-215 and accompanying text (discussing the *Hecht* decision and the subsequent elimination of the control test in determining a trust's taxable status).

184. *See* Treas. Reg. 45, art. 1503, 23 Treas. Dec. Int. Rev. at 591.

185. *See generally id.*

186. *Id.*, art. 1506, at 592.

187. *Id.*

188. *Hecht v. Malley*, 265 U.S. 144 (1924).

189. *Id.*

190. *Id.* at 145-46. For a discussion of the Supreme Court's previous treatment of the Massachusetts Trust, see *supra* notes 94-103, 144-56 and accompanying text. Interestingly, one of the cases consolidated in *Hecht* involved the Crocker, Burbank & Co. association, the successor to the Wachusett Realty Trust, which was the Massachusetts Trust that the Court examined in *Crocker v. Malley*, 249 U.S. 223 (1919). The case was before the Court a second time because the beneficiaries had specifically amended the original trust agreement to change the form of organization to that of an association. *See Hecht*, 265 U.S. at 149. In addition, the trustees had begun to operate the paper manufacturing corporation actively rather than just holding its stock. *See id.* at 144.

191. *Hecht*, 265 U.S. at 145-46.

192. *Id.* at 151 (quoting Revenue Act of 1916, ch. 463, § 407, 39 Stat. 756, 789).

termine the applicability of this excise tax to the Massachusetts Trust, the *Hecht* Court contrasted the above-quoted language with another section of the 1916 Act that imposed a two percent entity-level income tax on net income.¹⁹³ The income tax applied to “‘every corporation, joint-stock company or association, or insurance company, organized in the United States, no matter how created or organized.’”¹⁹⁴ This income tax language was consistent with the 1913 Act language,¹⁹⁵ which the *Crocker* Court held to be inapplicable to the Massachusetts Trust because it was not a joint-stock company.¹⁹⁶

In contrast, the language of the section in the 1916 Act that imposed the excise tax reflected the classification language of the 1909 Act.¹⁹⁷ The *Hecht* Court concluded that the differences in the language of the excise tax provision and the income tax provision in the 1916 Act was intentional, despite the fact that the Conference Committee inserted those differences.¹⁹⁸ The Court ignored the fact that the record was silent as to Congress’ intent to provide two distinct entity classifications.¹⁹⁹ Writing for the majority, Justice Sanford surmised that it appeared that Congress intended the income tax provision to apply to all domestic corporations, joint-stock companies or associations, no matter how created, and the excise tax provision to apply to only those entities that were created by statute.²⁰⁰ In effect, he suggested that the 1913 Act’s income tax language also expanded the class of taxable entities because it was consistent with the income tax language of the 1916 Act,²⁰¹ which the Court interpreted as expanding the taxable entity classification to include non-statutory entities.²⁰² Thus, the *Hecht* decision implied an interpretation of the 1913 Act that the *Crocker* Court felt incapable of rendering.²⁰³ Nevertheless, the *Hecht* Court read the excise tax in the 1916 Act to apply only to statutory entities.²⁰⁴ Therefore, the Court found that the excise tax was not applicable to the Massachusetts Trust.²⁰⁵

193. *Id.* at 151.

194. *Id.* (quoting Revenue Act of 1916 § 10).

195. Compare Revenue Act of 1913, ch. 16, § IIG(a), 38 Stat. 114, 172 with Revenue Act of 1916 § 10. See *supra* notes 106-40 and accompanying text (discussing the 1913 Act).

196. See *supra* notes 144-56 and accompanying text (discussing the *Crocker* decision).

197. Compare Revenue Act of 1909, ch. 6, § 38, 36 Stat. 11, 112 with Revenue Act of 1916 § 407. See *supra* notes 61-86 and accompanying text (discussing the 1909 Act).

198. *Hecht*, 265 U.S. at 152.

199. See *id.*

200. *Id.*

201. See *supra* note 195.

202. See *supra* note 200 and accompanying text.

203. See *supra* notes 144-56 and accompanying text (discussing the *Crocker* decision).

204. *Hecht*, 265 U.S. at 153-54.

205. *Id.*

The *Hecht* Court, however, reached the opposite conclusion regarding the applicability of the excise tax under the 1918 Act.²⁰⁶ The Court first noted the dramatic change that this Act made to the definition of "corporation." In particular, the Court noted that the 1918 Act specifically taxed associations.²⁰⁷ The *Hecht* Court considered the meaning of the term association by following Congress' advice to read the dictionary.²⁰⁸ After consulting five dictionaries, the Court concluded that the Massachusetts Trust was, in fact, an association.²⁰⁹ The trustees protested this association status by arguing that under *Crocker*, the beneficiaries did not have the requisite degree of control over the trustees to engender the status of an association under Massachusetts law.²¹⁰ The trustees contended that beneficiary control was the linchpin of corporate status.²¹¹ The *Hecht* Court rejected this interpretation of *Crocker*, stating that the trust in *Crocker* was not an association because the trustees simply were holding the property for collection and distribution of income to the beneficiaries and were not conducting any business.²¹² This is an interesting reading of the *Crocker* decision by the Court since no mention of shephardship of assets can be found. It states only that the trust was not taxable because it was not a joint-stock company.²¹³ Nevertheless, the *Hecht* Court refused to consider the degree of beneficiary control as relevant to the resolution of the issue, and instead made an inquiry into whether the trust was conducting any business activity.²¹⁴ The Court found that all three of the trusts under examination were engaged in business activity.²¹⁵

206. *See id.* at 156 (deciding that the three trusts were associations under the Act).

207. *Id.* at 155.

208. *See supra* note 178 and accompanying text (discussing Representative Garner's advice to read the dictionary).

209. *Hecht*, 265 U.S. at 157.

210. *Id.* at 158.

211. *See id.* Interestingly, the taxpayers did not cite Regulation 45 for this proposition. *See id.* Although the Treasury Department did not publish Regulation 45 until 1920, one year after the tax year involved in *Hecht*, the regulation reflected the Treasury Department's understanding of the association concept, an understanding the Court gave broad deference to in future years. *See infra* notes 231-61 and accompanying text (discussing the *Morrissey* decision and the Court's deference to the Treasury Department's concept of an association); *see also infra* notes 406-14 and accompanying text (discussing the *Larson* decision).

212. *See Hecht*, 265 U.S. at 160-61.

213. *See supra* notes 144-156 and accompanying text (discussing the *Crocker* decision).

214. *Hecht*, 265 U.S. at 161.

215. *Id.* This conclusion was rather remarkable because one of the trusts under consideration, the *Hecht Realty Trust*, was conducting the same type of real estate activity as the trust in the original *Crocker* decision; yet the Court had just finished stating that the *Crocker* trust was not taxable because it was "merely holding property" and not engaged in

The Treasury Department quickly amended the regulations to reflect this remarkable decision.²¹⁶ Article 1504 of Regulation 65 stated that operating trusts are associations under the 1918 Act when the trustees do more than collect funds and make payments to the beneficiaries regardless of the degree of the beneficiaries' control.²¹⁷ Moreover, the amendment to the regulation stated that when the trustees are associated in a manner similar to the directors of a business corporation, the trust is an association, regardless of the beneficiaries' control over the trustees.²¹⁸

Shortly after Congress enacted the Revenue Act of 1934,²¹⁹ the Treasury Department adopted regulations, entitled "Regulations 86 Relating to the income tax under the Revenue Act of 1934," that effectively amended Regulation 45.²²⁰ In Regulation 86, the Treasury Department stated that local labels were not important in determining an entity's classification for tax purposes, and that it would not use the term "association" in any narrow or technical sense.²²¹ This was clearly an

business activity. *See id.* at 160-61; *see also supra* notes 144-56 and accompanying text (discussing the *Crocker* decision).

216. *See* Treas. Reg. 65, art. 1504, T.D. 3640, 26 Treas. Dec. Int. Rev. 745, 1003 (1924).

217. *Id.*

218. *Id.* The Treasury Department further amended this section in August, 1925 to read as follows:

If, however, the beneficiaries have positive control over the trust, whether through the right periodically to elect trustees or otherwise, an association exists within the meaning of section 2. Even in the absence of any control by the beneficiaries, where the trustees are not restricted to the mere collection of funds and their payment to the beneficiaries, but are associated together with similar or greater powers than the directors in a corporation for the purpose of carrying on some business enterprise, the trust is an association within the meaning of the statute.

T.D. 3748, 27 Treas. Dec. Int. Rev. 462 (1925) (amending T.D. 3640). It was obvious that if the Treasury Department could find "control," they wanted to be able to use it to their benefit.

219. Revenue Act of 1934, ch. 277, 48 Stat. 680.

220. *See* Treas. Reg. 86 (1935). In contrast, those regulations that the Treasury Department issued during the time between Regulation 45 and Regulation 86 were almost identical to Regulation 45. *See, e.g.,* Treas. Reg. 65, T.D. 3640, 26 Treas. Dec. Int. Rev. 745 (1924); Treas. Reg. 74 (1931); Treas. Reg. 77 (1933); *see also* Scallen, *supra* note 144, at 658-59.

221. Treas. Reg. 86, art. 801-2. Article 801-1 of Regulation 86 provided, in pertinent part:

For the purpose of taxation the Act makes its own classifications and prescribes its own standards of classification. *Local law is of no importance in this connection.* Thus a trust may be classed as a trust or as an association (and, therefore, as a corporation), depending upon its nature or its activities. . . . The term "partnership" is not limited to the common law meaning of partnership, but is broader in its scope and includes groups not commonly called partnerships. . . . The term "corporation" is not limited to the artificial entity usually known as a corporation, but includes also an association, a trust classed as an association because of its

overstatement because the Treasury Department made no attempt to classify a corporation that was formed under state law as anything other than a corporation.

The most significant revision found in Regulation 86 was the article that distinguished trusts from associations.²²² This detailed provision made it clear that association status would attach in every instance, ex-

nature or its activities, a joint-stock company, an insurance company, and certain kinds of partnerships.

Id. art. 801-1 (internal citations omitted) (emphasis added). Article 801-2 of Regulation 86 provided, in pertinent part:

The term "association" is not used in the Act in any narrow or technical sense. It includes any organization, created for the transaction of designated affairs, or the attainment of some object, which, like a corporation, continues notwithstanding that its members or participants change, and the affairs of which, like corporate affairs, are conducted by a single individual, a committee, a board, or some other group, acting in a representative capacity. It is immaterial whether such organization is created by an agreement, a declaration of trust, a statute, or otherwise. It includes a voluntary association, a joint-stock association or company, a "business" trust, a "Massachusetts" trust, a "common law" trust, an "investment" trust (whether of the fixed or the management type), an interinsurance exchange operating through an attorney in fact, a partnership association, and any other type of organization (by whatever name known) which is not, within the meaning of the Act, a trust or an estate, or a partnership. If the conduct of the affairs of a corporation continues after the expiration of its charter, or the termination of its existence, it becomes an association.

Id. art. 801-2.

222. *Id.* art. 801-3. Article 801-3 of Regulation 86 provided, in pertinent part:

The term "trust," as used in the Act, refers to an ordinary trust, namely, one created by will or by declaration of the trustees or the grantor, the trustees of which take title to the property for the purpose of protecting or conserving it as customarily required under the ordinary rules applied in chancery and probate courts. . . . Even though the beneficiaries do create such a trust, it is ordinarily done to conserve the trust property without undertaking any activity not strictly necessary to the attainment of that object.

As distinguished from the ordinary trust described in the preceding paragraph is an arrangement whereby the legal title to the property is conveyed to trustees (or a trustee) who, under a declaration or agreement of trust, hold and manage the property with a view to income or profit for the benefit of beneficiaries. Such an arrangement is designed (whether expressly or otherwise) to afford a medium whereby an income or profit-seeking activity may be carried on through a substitute for an organization such as a voluntary association or a joint-stock company or a corporation, thus obtaining the advantages of those forms of organization without their disadvantages.

If a trust is an undertaking or arrangement conducted for income or profit, the capital or property of the trust being supplied by the beneficiaries, and if the trustees or other designated persons are, in effect, the managers of the undertaking or arrangement, whether the beneficiaries do or do not appoint or control them, the beneficiaries are to be treated as voluntarily joining or cooperating with each other in the trust, just as do members of an association, and the undertaking or arrangement is deemed to be an association classified by the Act as a corporation.

cept where the trustee simply performed the traditional role of protecting and conserving trust property.²²³ The provision also clarified those characteristics that the Treasury Department regarded as corporate: profit-seeking activity, continuity of existence, centralization of management, ability to hold property, ability to sue and be sued, and limited liability.²²⁴

With respect to partnerships, Regulation 86 was less explicit. The Treasury Department still would classify ordinary partnerships that did not limit the liability of their partners as associations if they had both continuity of life and centralized management.²²⁵ The relative unimpor-

... [The] advantages which the trust form provides are frequently referred to as resemblance to the general form, mode of procedure, or effectiveness in action, of an association or a corporation, or as "quasi-corporate form." The effectiveness in action in the case of a trust or of a corporation does not depend upon technical arrangements or devices such as the appointment or election of a president, secretary, treasurer, or other "officer," the use of a "seal," the issuance of certificates to the beneficiaries, the holding of meetings by managers or beneficiaries, the use of a "charter" or "by-laws," the existence of "control" by the beneficiaries over the affairs of the organization, or upon other minor elements. They serve to emphasize the fact that an organization possessing them should be treated as a corporation, but they are not essential to such classification, for the fundamental benefits enjoyed by a corporation, as outlined above, are attained, in the case of a trust, by the use of the trust form *itself*. The Act disregards the technical distinction between a trust agreement (or declaration) and ordinary articles of association or a corporate charter, and all other differences of detail. It treats such a trust according to its essential nature, namely, as an association. This is true whether the beneficiaries form the trust or, by purchase or otherwise, acquire an interest in an existing trust.

The mere size or amount of capital invested in the trust is of no importance. . . . The distinction is that between the activity or purpose for which an ordinary strict trust of the traditional type would be created, and the activity or purpose for which a corporation for profit might have been formed.

Id. art. 801-3.

223. *See id.*

224. *See id.*

225. Treas. Reg. 86, art. 801-4. Article 801-4 of Regulation 86 provided for the classification of partnerships:

The Act provides its own concept of a partnership. Under the term "partnership" it includes not only a partnership as known at common law but, as well, a syndicate, group, pool, joint venture, or other unincorporated organization which carries on any business, financial operation, or venture, and which is not, within the meaning of the Act, a trust, estate, or a corporation. On the other hand the Act classifies under the term "corporation" an association or joint-stock company, the members of which may be subject to the personal liability of partners. If an organization is not interrupted by the death of a member or by a change in ownership of a participating interest during the agreed period of its existence, and its management is centralized in one or more persons in their representative capacities, such an organization is an association, taxable as a corporation.

Id. In addition, Art. 801-4 provided illustrations of its definition of partnership:

(1) If A and B buy some acreage for the purpose of subdivision, they are joint adventurers, and the joint venture is classified by the Act as a partnership.

tance that this regulation placed on limited liability with respect to ordinary partnerships is ironic given that limited liability is of primary importance in classifying a limited partnership as a "limited partnership."²²⁶ Thus, under Regulation 86, if the partners organized a limited partnership under a statute that allowed for limited liability to all partners, including the general partner, then the Treasury Department would classify it as an association.²²⁷ If the state statute did not permit the partners to limit the liability of the general partner, then the Treasury Department would not classify the partnership as an association, particularly if the partnership dissolved on the death or attempted transfer of the general partner's interest.²²⁸

Regulation 86 confirmed the Treasury Department's desire to interpret the association concept as broadly as possible.²²⁹ The Treasury Department's methodology for determining an entity's classification did not,

(2) A, B and C each contributes \$10,000 for the purpose of buying and selling real estate. If A, B, C, or D, an outside party (or any combination of them as long as the approval of each participant is not required for syndicate action), takes control of the money, property and business of the enterprise, and the syndicate is not terminated on the death of any of the participants, the syndicate is classified as an association.

Id.

226. *See id.* art. 801-5. Article 801-5 of Regulation 86, which classified some limited partnerships as corporations, provided:

Limited partnerships of the type of partnerships with limited liability or partnership associations authorized by the statutes of Pennsylvania and a few other States are only nominally partnerships. Such so-called limited partnerships, offering opportunity for limiting the liability of all the members, providing for the transferability of partnership shares, or having other material characteristics of corporate form, must make returns of income and pay the tax as corporations. In all doubtful cases limited partnerships will be treated as corporations unless they submit satisfactory proof that they are not in effect so organized. A Michigan partnership association is taxable as a corporation.

Id. Article 801-6 of Regulation 86, which classified other limited partnerships as partnerships, provided:

Limited partnerships of the type authorized by the statutes of New York and many other States are ordinarily partnerships and not corporations within the meaning of the Act. Such limited partnerships, which can not limit the liability of the general partners, although the special partners enjoy limited liability so long as they observe the statutory conditions, which are dissolved by the death or attempted transfer of the interest of a general partner, and which can not take real estate or sue in the partnership name, are so like common law partnerships as to render impracticable any differentiation in their treatment for tax purposes.

Id. art. 801-6. For a complete discussion of the classification history of limited partnerships, see *infra* notes 339-481 and accompanying text.

227. *See* Treas. Reg. 86, art. 801-5.

228. *See id.* art. 801-6.

229. *See generally id.* The Treasury Department continued to make minor changes to the regulations, but the tenor of the language that the Department employed in interpreting the term "association" remained consistently broad. *See, e.g.,* Treas. Reg. 111,

however, have a name. But, shortly after the Treasury Department issued Regulation 86, the Supreme Court provided its lasting moniker.²³⁰

Although most commentators and courts consider *Morrissey v. Commissioner*²³¹ to be the seminal case on entity classification,²³² the decision did little to clarify the Treasury Department's muddled definition of an "association" when it is considered with the backdrop of the regulations that already existed at that time. The Court actually failed to clarify the definition because it simply adopted the methodology and classification characteristics already found in the regulations.²³³ Nonetheless, the decision did provide two significant contributions to the entity classification debate.²³⁴ First, after *Morrissey* the entity-classification methodology forever would be known as the "resemblance test."²³⁵ Second, and perhaps more significantly, the *Morrissey* Court noticed that Congress delegated to the Treasury Department the role of determining the nature of a corporation for federal tax purposes.²³⁶

At issue in *Morrissey* was the tax status of a trust that had been formed to develop golf courses on a piece of California real estate.²³⁷ The interests of the beneficiaries included transferable certificates, referred to as "shares,"²³⁸ and the shareholders/beneficiaries had the right to make recommendations to the trustees regarding business ventures, but they could not force the trustees to take action.²³⁹ Another feature of the trust was

§ 29.3797-1 to -6 (1943); Treas. Reg. 101, art. 901-1 to -6 (1939); Treas. Reg. 94, art. 1001-1 to -6 (1936).

230. See *Morrissey v. Commissioner*, 296 U.S. 344 (1935) (applying Regulation 86); see also *Helvering v. Coleman-Gilbert Assocs.*, 296 U.S. 369 (1935) (companion case of *Morrissey*); *Helvering v. Combs*, 296 U.S. 365 (1935) (same); *Swanson v. Commissioner*, 296 U.S. 362 (1935).

231. 296 U.S. 344 (1935).

232. See DOUGLAS A. KAHN & PAMELA B. GANN, CORPORATE TAXATION 100 (3d ed. 1989) (calling *Morrissey* "the only significant Supreme Court decision to address the classification issue"); 1 WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 3.06[1] (2d ed. 1990) (calling *Morrissey* the lead case in this area); SAMUEL C. THOMPSON, JR., TAXATION OF BUSINESS ENTITIES: C CORPORATIONS, PARTNERSHIPS AND S CORPORATIONS 237 (1994) (commenting that the *Morrissey* decision "is the foundation on which characterization regulations are built").

233. See *Morrissey*, 296 U.S. at 357, 359-60 (stating the approach is to identify features distinguishing associations from partnerships at will and ordinary trusts).

234. See *id.* at 354.

235. Eaton, *infra* note 262, at 4; Scallen, *supra* note 144, at 631.

236. *Morrissey*, 296 U.S. at 354-55 (noting that Congress authorized the Treasury Department to supply rules for the enforcement of the Act).

237. *Id.* at 347.

238. *Id.* The trust document provided for "share ledgers" to keep track of investors. *Id.*

239. *Id.*

that it did not terminate upon the death of a trustee or beneficiary.²⁴⁰ The fact that the case involved tax years 1924 through 1926²⁴¹ is significant because, in 1924, the Treasury Department issued Regulation 65, which incorporated the Supreme Court's decision in *Hecht* that beneficiary control over trustees was not relevant in determining association status.²⁴²

The taxpayers first argued that the trust at issue was not an association because the beneficiaries could not exert any form of control over the trustees.²⁴³ Second, they contended that the Treasury Department exceeded its regulatory authority when it revised its classification regulations to reflect the Court's decision in *Hecht*.²⁴⁴ After summarily rejecting the taxpayers' arguments, Chief Justice Hughes stated that Congress permitted the Treasury Department to establish rules, within certain limits, to enforce the Act because the statute, without further definition, merely stated that the term "corporation" includes associations.²⁴⁵ He noted that the Treasury Department could later change these rules to meet administrative requirements or to adapt to a judicial decision.²⁴⁶ Moreover, the Court rejected the notion that tax acts enacted after *Crocker*, albeit silent on classification, restrict the Treasury Department's ability to reflect subsequent decisions such as *Hecht*.²⁴⁷

Having affirmed the broad regulatory mandate of the Treasury Department, the *Morrissey* Court examined the association concept.²⁴⁸ Refer-

240. *Id.*

241. *Id.* at 346.

242. *See supra* notes 189-219 and accompanying text (discussing the *Hecht* decision and Regulation 65).

243. *Morrissey*, 296 U.S. at 348-49; *see supra* notes 189-219 and accompanying text (discussing the Court's disposition of *Hecht*).

244. *See Morrissey*, 296 U.S. at 355.

245. *Id.* at 354-55.

246. *Id.* One troubling aspect of this decision is that although the Treasury Department's regulatory mandate already is quite broad, the Court's opinion seems to suggest that Congress, through its silence, gave a government agency the power to decide who is and who is not a taxpayer. *See id.* The next section of this article examines the Treasury Department's repeated attempts to capitalize on the *Morrissey* decision and its progeny in abusing this authority. *See infra* part III and accompanying text (discussing the Treasury Department's abuse of authority in defining and redefining what constitutes an association taxable as a corporation).

247. *Morrissey*, 296 U.S. at 354-55.

248. *See id.* at 356-60. In retrospect, it is clear that the Court understated its description of this inquiry:

While it is impossible in the nature of things to translate the statutory concept of "association" into a particularity of detail that would fix the status of every sort of enterprise or organization which ingenuity may create, the recurring disputes emphasize the need of a further examination of the congressional intent.

Id. at 356.

ring to the regulations generally, the Chief Justice declared that an association implied associates joining together for the transaction of business.²⁴⁹ In a statement destined to provide a lasting title to entity-classification methodology, the Court posited that “[t]he inclusion of associations with corporations implies *resemblance*; but it is *resemblance* and not identity.”²⁵⁰ Moreover, the Court noted the fact that the concept of association was no longer confined to the joint-stock company, which courts historically had perceived as closely resembling a corporation.²⁵¹ The Court verified that the definition of “association” had changed, stating that “in the revenue acts, associations are mentioned separately and are not to be treated as limited to ‘joint-stock companies,’ although belonging to the same group.”²⁵² Regrettably, the Court did not inquire as to why Congress deviated from the former entity-classification language that had identified recognized business forms, thereafter to adopt an amorphous concept. Nor did it ask why Congress’ only guidance was a suggestion to find the term’s meaning in the dictionary.²⁵³ Instead, the Court articulated the “salient” features that made a trust analogous to a corporation.²⁵⁴

Like a corporation, trustees were able to hold title to property and to provide centralized management.²⁵⁵ Moreover, the trust provided the enterprise with a continuity of life akin to a corporation because a trust also can continue despite the death of a beneficiary or the transfer of his beneficial interest.²⁵⁶ Lastly, the trust provides limitation of liability to the assets of the trust, similar to a corporate enterprise.²⁵⁷ The Court rejected the assertion that “these advantages flow from the very nature of trusts,” and therefore should not be considered.²⁵⁸ According to the *Morrissey* Court, such an argument missed the point because these features were relevant only if the trust was created to carry on a business.²⁵⁹ Applying this theory to the trust in question, the Court found that the trust, which was created to develop real estate and operate a golf course, constituted an association.²⁶⁰

249. *Id.*

250. *Id.* at 357 (emphasis added).

251. *Id.* at 358.

252. *Id.*; see *supra* notes 171-77 and accompanying text (discussing the 1918 Act).

253. See *supra* note 178 and accompanying text (discussing the commentary of Rep. Garner).

254. *Morrissey*, 296 U.S. at 359.

255. *Id.*

256. *Id.*

257. *Id.*

258. *Id.*

259. *Id.* at 360.

260. *Id.*

Buoyed by the Supreme Court's decision in *Morrissey*, the Treasury Department continued its effort to confer association status to as many entities as possible.²⁶¹ However, the Treasury Department soon discovered the need to reverse course.

III. THE FAILURE OF THE RESEMBLANCE TEST

A. *The Professional Corporation*

Beginning in the early 1930s, professionals, especially doctors, began to abandon their solo practices in favor of large unincorporated groups organized under a trust or partnership agreement.²⁶² Not surprisingly, the Treasury Department sought to have these organizations taxed as associations.²⁶³ The government experienced immediate success in this effort when the United States Court of Appeals for the Seventh Circuit held in *Pelton v. Commissioner*,²⁶⁴ that a medical clinic, organized under a trust agreement that provided for free transferability of interests and limited liability, was taxable as an association.²⁶⁵ The *Pelton* decision, consisting of only two paragraphs of legal analysis, involved no more than a glorified cite to *Morrissey*, which the Supreme Court decided while the appeal in *Pelton* was pending.²⁶⁶ Having won this initial battle, the government was about to lose the war.

Shortly after the *Pelton* decision, taxpayers realized that they would be entitled to the benefits as well as the burdens of corporate status if such organizations were classified as associations.²⁶⁷ Corporations could adopt tax-favored pension plans and subject their income to lower margi-

261. See XV-32-8230, Mim. 4483, 2 C.B. 175, 178 (1936) (mimeograph from the Office of the Commissioner of the Internal Revenue Service directing its revenue agents to give full effect to *Morrissey* and its companion decisions in deciding the tax status of trusts); see also Kurzner v. United States, 413 F.2d 97, 101 (5th Cir. 1969) (excluding numerous corporate-like associations from receiving tax benefits such as profit-sharing and pension plans under corporate status).

262. See *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954); *Pelton v. Commissioner*, 82 F.2d 473 (7th Cir. 1936); Berrien C. Eaton, Jr., *Professional Corporations and Associations in Perspective*, 23 TAX L. REV. 1, 6 (1967).

263. See *Pelton*, 82 F.2d at 474.

264. 82 F.2d 473 (7th Cir. 1936). For a discussion of the *Pelton* decision, see Scallen, *supra* note 144, at 637-38.

265. *Pelton*, 82 F.2d at 476. But see *Mobile Bar Pilots Ass'n v. Commissioner*, 97 F.2d 695 (5th Cir. 1938) (The government sought association status for a non-profit pilots organization, and the United States Court of Appeals for the Fifth Circuit determined that the pilots organization was not a business entity and therefore, not taxable as a corporation.). For an analysis of the contradictory holdings in *Pelton* and *Mobile Bar*, see Eaton, *supra* note 262, at 5-6.

266. See *Pelton*, 82 F.2d at 476.

267. See *Kurzner v. United States*, 413 F.2d 97, 101 (5th Cir. 1969).

nal rates than those applicable to individual taxpayers.²⁶⁸ Consequently,

268. *Id.*; see Eaton, *supra* note 262, at 6; William J. Rands, *Organizations Classified as Corporations for Federal Tax Purposes*, 59 ST. JOHN'S L. REV. 657, 665 (1985); Scallen, *supra* note 144, at 604 n.3 (discussing the tax advantages associated with the corporate form of business organization). It is significant to note that the maximum corporate tax rate did not exceed the maximum individual tax rate until 1986:

Years	Maximum Corporate Tax Rate	Maximum Individual Tax Rate
1936-		
1937	15.00%	79.0%
1938-		
1939	19.00%	79.0%
1940	22.10%	79.0%
1941	31.00%	81.0%
1942-		
1943	40.00%	88.0%
1944-		
1945	40.00%	94.0%
1946-		
1947	38.00%	86.4%
1948-		
1949	38.00%	82.1%
1950	42.00%	84.4%
1951	50.75%	91.0%
1952-		
1953	52.00%	92.0%
1954-		
1963	52.00%	91.0%
1964	50.00%	77.0%
1965-		
1978	48.00%	70.0%
1979-		
1980	46.00%	70.0%
1981-		
1985	46.00%	50.0%
[1986]	[34.00%]	[28.0%]

Kwall, *supra* note 6, at 621 n.39 (citing Revenue Act of 1934, ch. 277, §§ 11-13, 48 Stat. 680, 684-86; Revenue Act of 1935, ch. 829, §§ 101-02, 49 Stat. 1014, 1014-15; Revenue Act of 1938, ch. 289, §§ 11-13, 52 Stat. 447, 452-55; Second Revenue Act of 1940, ch. 757, § 101(a), 54 Stat. 974 (amending I.R.C. § 13(b) (1939)); Revenue Act of 1941, ch. 412, §§ 101, 103(a), 104(a), 55 Stat. 687, 688-89, 692-93 (amending I.R.C. §§ 12(g), 13(b), 15 (1939)); Revenue Act of 1942, ch. 619, §§ 102, 103, 105(b), 56 Stat. 798, 802-03, 805-06 (amending I.R.C. §§ 11, 12(b), 13(b), 15 (1939)); Individual Income Tax Act of 1944, ch. 210, §§ 3, 4(a), 58 Stat. 231, 231-32 (amending I.R.C. §§ 11, 12(g) (1939)); Revenue Act of 1945, ch. 453, §§ 101(c), 121(a), 59 Stat. 556, 558, 568 (amending I.R.C. §§ 12(g), 15(b) (1939)); Revenue Act of 1948, ch. 168, § 101, 62 Stat. 110, 111 (amending I.R.C. § 12(c) (1939)); Revenue Act of 1950, ch. 994, §§ 101, 121(a), 64 Stat. 906, 910-11, 914-15 (amending I.R.C. §§ 12(c), 13, 15 (1939)); Revenue Act of 1951, ch. 521, §§ 101(b), 121(a), 121(f), 65 Stat. 452, 459-61, 465-66, 468 (amending I.R.C. §§ 12(f), 13, 15 (1939)); Revenue Act of 1964, Pub. L. No. 88-272, §§ 111, 121, 78 Stat. 19, 19-23, 25; Revenue Act of 1978, Pub. L. No. 95-600, § 301, 92 Stat. 2763, 2820; Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101, 95 Stat. 172, 176-82); see Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 101(a), 601, 100 Stat. 2085, 2096, 2249 (providing data for 1986).

practitioners began forming business organizations under articles of association designed to provide the corporate resemblance that was necessary to achieve association status.²⁶⁹ Of course, once taxpayers began exploiting the classification rules to deprive the public fisc, the Service reversed its course.²⁷⁰ In its attempt to deny association status to pension seeking entities, the Service soon discovered that it was swimming upstream against both judicial precedent and its own regulations.²⁷¹

One taxpayer who saw the advantages incumbent in association status is the now famous Doctor Arthur Kintner.²⁷² In 1948, Dr. Kintner and several of his colleagues executed Articles of Association to create an unincorporated association to practice medicine.²⁷³ The agreement provided that the entity "was to be endowed with the 'attributes of a corporation' and [was] to be 'treated as a corporation for the purposes of taxation.'"²⁷⁴ Needless to say, the agreement provided for the establishment of a tax-favored pension plan.²⁷⁵ The Service immediately intervened, denied corporate status, and levied a deficiency assessment against Dr. Kintner for the amount that the association contributed to the pension fund.²⁷⁶ Dr. Kintner paid the assessment and then filed a claim for refund in the United States District Court for the District of Montana.²⁷⁷ The district court, citing *Morrissey*, found in favor of the taxpayer, and the government appealed.²⁷⁸

Arguing before the United States Court of Appeals for the Ninth Circuit, the government asserted that the business organization at issue could not be classified as a corporation for federal tax purposes.²⁷⁹ The Service contended that under state law, physicians could not form a cor-

269. Eaton, *supra* note 262, at 6; Rands, *supra* note 268, at 665; see, e.g., *Kurzner*, 413 F.2d at 101; *United States v. Kintner*, 216 F.2d 418, 419-20 (9th Cir. 1954).

270. Eaton, *supra* note 262, at 6 (suggesting that Congress altered its position to prevent the possible spread of the corporate tax benefit of qualified pension plans).

271. See *id.* at 6-8.

272. *Kintner*, 216 F.2d at 419-20.

273. *Id.*

274. *Id.* at 420. The agreement further provided that the association would not terminate until the death of the last surviving original member and that the death or retirement of a member would not result in dissolution. *Id.* In addition, an executive committee, with the taxpayer serving as the president, was to manage the association. *Id.*

275. *Id.*

276. *Id.* at 421. The assessment also included Dr. Kintner's portion of a reserve set up by the association to meet operating expenses. *Id.*

277. *Kintner v. United States*, 107 F. Supp. 976, 980 (D. Mont. 1952), *aff'd*, 216 F.2d 418 (9th Cir. 1954) (holding that the medical association met all of the Commissioner's requirements of a corporation, and that the taxpayer, a member of the association, was not liable to pay taxes on the established pension plan until distribution).

278. *Kintner*, 216 F.2d at 421.

279. *Id.*

poration because the practice of medicine was personal.²⁸⁰ The government's reliance on local law was ironic because, as Judge Yankwich writing for the three-judge panel noted, the Service always refuses to be "bound by State law."²⁸¹ The court also declined to follow the government's reliance on state grounds because the government's regulations themselves undermined the government's argument.²⁸² The *Kintner* court cited with approval the Seventh Circuit's decision in *Pelton*, which involved a medical association formed under Illinois law that, like Montana, did not allow medical practices to incorporate.²⁸³ The *Kintner* court noted that in *Pelton*, the government had taken the opposite position with respect to local law.²⁸⁴ As a result, the *Kintner* court affirmed the lower court's finding of association status,²⁸⁵ and set in motion a dramatic re-statement of the resemblance test.

Despite the setback it experienced in *Kintner*, the government refused to accept defeat. In 1956, the Service issued Revenue Ruling 56-23,²⁸⁶ wherein it explicitly rejected the *Kintner* decision, stating that for statutory purposes, a group of doctors who form an association to derive the pension benefits of corporate status under the Internal Revenue Code of 1954 (section 401(a)) essentially create a partnership.²⁸⁷ This ruling indicated that the Service based its position solely on the government's desire to preclude medical practices such as the one found in *Kintner* from establishing tax-favored pension plans.²⁸⁸ In effect, the Service said that doctors could form an association and thus be taxed as a corporation as long as they did not try to adopt a qualified pension plan.²⁸⁹ Consequently, the Service based the resemblance test that it established for physicians' organizations on one factor: an association's attempt to adopt a pension plan. Perhaps recognizing the outrageousness of this position,

280. *Id.*

281. *Id.* at 423 (incorporating the applicable language from the regulation).

282. *Id.*

283. *Id.* at 422 (citing *Pelton v. Commissioner*, 82 F.2d 473 (7th Cir. 1936)).

284. *Id.*

285. *Id.* at 428.

286. Rev. Rul. 56-23, 1956-1 C.B. 598 (*modified* in Rev. Rul. 57-546, 1957-2 C.B. 886).

287. *Id.* (stating that the *Kintner* decision "will not be accepted by the Internal Revenue Service as a precedent"). This ruling dealt with two issues: whether a group of doctors may operate as an association and whether they may implement a tax-favored pension-plan. *Id.*

288. *Id.*

289. *See id.* (holding that the Service would treat an association formed to gain the benefits of such a pension plan as a partnership); *see also* Rev. Rul. 57-546, 1957-2 C.B. 886-87 (modifying its former position so that "the fact that an association establishes a pension plan . . . is not determinative of whether such organization will be classified as a partnership or an association taxable as a corporation").

the Service effectively rescinded Revenue Ruling 56-23 the following year when it issued Revenue Ruling 57-546.²⁹⁰ That ruling stated that an association may not be classified as a partnership or as a corporation for tax purposes solely because the association creates a pension plan; instead, it directed the Service to employ the usual tests to determine whether a group of doctors or other professionals are more similar to a corporation than a partnership.²⁹¹ In the ruling, however, the Service indicated that it had not conceded the issue; rather, it implied that it was simply reexamining its position and intended to issue a revised test for medical organizations in the future.²⁹²

In 1959, the Treasury Department issued its revised test in a set of proposed regulations that redrew the battle lines and revealed the enormous power that it had in establishing the criteria for entity classification under the Code.²⁹³ The new regulations, now known as the "Kintner Regulations," became final in 1960²⁹⁴ and revealed the Treasury Department's latest strategy to combat professional associations. These regulations made it clear that if the judiciary was going to hold the government to its regulations, then the government simply would rewrite them.

Still in effect today, the Kintner Regulations represented a complete restatement of the resemblance test. First, they stated that although federal law established the standards for corporate status, local law had to be examined to determine whether these standards were met.²⁹⁵ In prior regulations, local law was of no importance.²⁹⁶ By eliminating its former practice, the government apparently was hoping to avoid the problems it

290. Rev. Rul. 57-546, 1957-2 C.B. 886 (modifying Rev. Rul. 56-23, 1956-1 C.B. 598).

291. *Id.* at 887.

292. *Id.* at 886 (stating that it was "modifying" Rev. Rul. 56-23). Before the Service issued any new rules, however, it suffered another setback in *Galt v. United States*, 175 F. Supp. 360 (N.D. Tex. 1959), wherein the United States District Court for the Northern District of Texas held that a medical practice similar to that in *Kintner* qualified for corporate tax treatment. See *Galt*, 175 F. Supp. at 362.

293. See Prop. Treas. Reg. §§ 301.7701-1, .7701-3, 24 Fed. Reg. 10,451 (1959).

294. See Treas. Reg. §§ 301.7701-1 to -11 (1960), T.D. 6503, 1960-2 C.B. 409. For a detailed discussion of these regulations and their subsequent effect, see Scallen, *supra* note 144, at 671-94.

295. The Kintner Regulations dictated that the Internal Revenue Code (the Code) would determine the tests for classifying an organization for tax purposes. Treas. Reg. § 301.7701-1(b) (1960). Local law still had some relevance in the classification of an organization, however, *id.* § 301.7701-1(c), as it still determined whether some significant relationships existed. *Id.* The Service would consider the existence or absence of these relationships as one relevant factor when applying the standards set forth under the Code. *Id.*

296. See *supra* notes 87-88, 140-43, 180-87, 216-30 and accompanying text (discussing the requirements under prior regulations).

had encountered in *Kintner*.²⁹⁷ The regulations set forth a seemingly straightforward test that delineated six characteristics distinguishing a "pure" corporation from other associations: (1) associates; (2) an objective to carry on business and to distribute the resulting profits; (3) continuity of life; (4) centralized management; (5) limited liability; and (6) free transferability of interest.²⁹⁸ Although the characteristics that the Treasury Department used in entity classification had not changed, the Kintner Regulations made it far more difficult for certain business organizations to "resemble" a corporation. Moreover, under these regulations the Service ignored those characteristics that were generally common to both corporations and the entity being examined.²⁹⁹ Thus, in determining whether a trust is taxable as a corporation, one would look only for the presence of associates and an intent to carry on business and to distribute profits, because these are characteristics that are not common to both.³⁰⁰ On the other hand, because associates and the intent to carry on business and to distribute profits are generally common to both partnerships and corporations, the classification of a partnership as a corporation depended upon a finding of other characteristics, such as centralization of management, continuity of life, free transferability of interest, and limited liability.³⁰¹ The regulations further provided that each factor weighed equally in assessing the presence or absence of corporate status and that the Treasury Department would not classify the entity being examined as an association unless it had more corporate characteristics than non-corporate characteristics.³⁰² Consequently, a trust must possess both associates and a business objective to be classified as an association,³⁰³ whereas a partnership must possess at least three of the four non-common characteristics.³⁰⁴

297. See *supra* notes 272-85 and accompanying text (discussing the *Kintner* decision).

298. Treas. Reg. § 301.7701-2(a)(1).

299. See *id.* § 301.7701-2(a)(2).

300. See *id.*

301. See *id.*

302. See *id.*

303. See *id.* The regulations define neither the term "associates" nor the phrase "an objective to carry on business and divide the profits." See *id.* For a detailed discussion of the examination of these two characteristics in the classification of trusts, see generally Doolin, *supra* note 7. The remainder of this article focuses on the area where the resemblance test is inadequate, the partnership versus association context.

304. See Treas. Reg. § 301.7701-2(a)(2-3) (1960). For a discussion of the Kintner Regulations in the limited partnership context, see *infra* notes 394-403 and accompanying text.

The first characteristic that the Kintner Regulations defined is “continuity of life.”³⁰⁵ A corporation possesses this characteristic because it is unaffected by events that take place at the shareholder level.³⁰⁶ Therefore, the regulations provided that the Treasury Department would not find continuity of life if, under local law, the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member causes a dissolution.³⁰⁷ Even if the remaining members agree to continue the organization, continuity of life does not exist if, under local law, a technical dissolution would occur.³⁰⁸ The next characteristic, “centralized management,” existed if one or more persons had exclusive authority to conduct an organization’s business in a manner that resembled the function of a corporate board of directors.³⁰⁹ To be centralized, the managers had to have *exclusive* authority to make *independent* business decisions without ratification by members of the organization.³¹⁰ Thus, if under local law each member had the authority to bind the organization legally, then exclusive authority was lacking and centralized management did not exist.³¹¹ The regulations provided that the corporate characteristic of “limited liability” existed if, under local law, the liability of every member was limited to their respective investment in the organization.³¹² In other words, if local law permitted a creditor to reach the personal assets of

305. The regulations define “continuity of life” as a situation where “the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization.” Treas. Reg. § 301.7701-2(b)(1).

306. See *id.* § 301.7701-2(b)(2).

307. *Id.*

308. *Id.* Such an agreement remained valid, but it did not determine the association’s tax status. *Id.*

309. *Id.* § 301.7701-2(c)(1). Section 301.7701-2(c)(1), defining the characteristic of centralized management, provided:

(1) An organization has centralized management if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed.

....

(3) Centralized management means a concentration of continuing exclusive authority to make independent business decisions on behalf of the organization which do not require ratification by members of such organization. Thus, there is not centralized management when the centralized authority is merely to perform ministerial acts as an agent at the direction of a principal.

Id. §§ 301.7701-2(c)(1), (3).

310. See *id.* § 301.7701-2(c)(3). This provision guaranteed that the substantive business decision-making process was centralized. *Id.*

311. See *id.* § 301.7701-2(c)(4) (discussing the difficulties of partnerships in achieving centralized management).

312. See *id.* § 301.7701-2(d)(1). This provision stipulated that “(1) [a]n organization has the corporate characteristics of limited liability if there is no member who is personally liable for the debts of or the claims against the organization.” *Id.*

even one member of the organization, then limited liability did not exist.³¹³ "Free transferability of interests" existed under the regulations if members owning substantially all of the interests in the organization had the power to transfer their entire interest to a non-member without consent.³¹⁴ If, however, members were only free to transfer their rights to the profits of the enterprise and not their rights to participate in the management of the enterprise, then the corporate characteristic of free transferability did not exist.³¹⁵

Under these revised regulations, the Service also explicitly indicated that a general partnership organized under the Uniform Partnership Act (UPA)³¹⁶ never could be classified as an association.³¹⁷ This is where the regulation specifically attacked professional associations. State laws treated most medical associations as general partnerships, so under the Kintner Regulations they could not be classified as corporations for tax

313. *Id.*

314. *See id.* § 301.7701-2(e). Section 301.7701-2(e)(1) defined free transferability as:

(1) An organization has the corporate characteristic of transferability of interests if each of its members or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the organization a person who is not a member of the organization.

Id. Furthermore, the regulations make clear that the transfer of interest must be complete, stating that the member must be free to confer "all the attributes of his position in the organization." *Id.*

315. *See id.* The regulations recognized that an organization could have had a form of transferability that was not quite a pure form of free transferability, but which resembled free transferability enough so that the Service should give it some consideration. *Id.* § 301.7701-2(e)(2).

(2) If each member of an organization can transfer his interest to a person who is not a member of the organization only after having offered such interest to the other members at its fair market value, it will be recognized that a modified form of free transferability of interests exists. In determining the classification of an organization, the presence of this modified corporate characteristic will be accorded less significance than if such characteristic were present in an unmodified form.

Id.

316. UNIF. PARTNERSHIP ACT (1993).

317. *See* Treas. Reg. § 301.7701-2(b)(3) (stating that partnerships corresponding to the UPA may lack continuity of life); *id.* § 301.7701-2(c)(4) (stating that because of the "mutual agency relationship between [its] members . . . a general partnership cannot achieve effective concentration of management powers and, therefore, centralized management"); *id.* § 301.7701-2(d)(1) (limited liability cannot exist because under the UPA, liability exists with respect to each partner). A general partnership was only capable of possessing free transferability, thus it could never be classified as an association because it could never possess a preponderance of the corporate characteristics as the regulations required. *Id.* § 301.7701-2(a)(1) (implying that the Service will not classify an unincorporated organization as an association unless such organization has more corporate characteristics than noncorporate characteristics).

purposes.³¹⁸ The good doctors, however, did not concede defeat. Rather than challenge the Treasury Department's regulatory authority to rewrite the resemblance test, they chose an alternative route. Professionals, recognizing the Kintner Regulations' reliance upon local law,³¹⁹ soon began petitioning state legislatures to allow incorporation of professional groups.³²⁰ The state legislatures listened, and by 1963, more than thirty states had enacted such legislation.³²¹

In 1965, in response to these statutes, the Treasury Department practically abandoned its newly crafted resemblance test and implemented rather startling amendments to the Kintner Regulations.³²² The 1965 amendments clearly revealed that the Treasury Department's sole purpose in enacting these changes was to prevent those entities formed under the newly enacted state professional corporation statutes from being classified as corporations under the Internal Revenue Code.³²³ The de-emphasis on the importance of local law in the 1965 amendments evidenced such intent.³²⁴ Although local law was still relevant in establishing the existence of corporate characteristics, the Code, rather than the labels that local law applied, determined an organization's classification for tax purposes.³²⁵ The regulation specifically stated that local laws did not qualify "so-called professional service corporations" for corporate

318. See Eaton, *supra* note 262, at 7-8 (stating that under the *Kintner* Regulations, a partnership or association in a state that had the UPA was not treated as a corporation for federal tax purposes).

319. See generally Treas. Reg. § 301.7701 (1960).

320. See Eaton, *supra* note 262, at 8-9 & n.52; Scallen, *supra* note 144, at 694-95.

321. See, e.g., ALA. CODE §§ 10-4-380 to -406 (1975) (legislation approved in 1961); COLO. REV. STAT. § 12-36-134 (1990) (permitting incorporation effective July 1, 1969); FLA. STAT. ANN. §§ 621.01 to .15 (West 1992) (allowing such groups per amendment, effective July 1, 1969); IDAHO CODE §§ 30-1301 to -1315 (1989) (allowing incorporation effective 1963); MASS. GEN. LAWS ANN. ch. 156A, §§ 1-17 (West 1992) (legislation amended to allow incorporation effective in 1965); MINN. STAT. ANN. §§ 319.01 to .961 (West 1969) (incorporation permitted in 1963); MO. ANN. STAT. §§ 356.010 to .261 (Vernon 1947) (effective 1963); N.D. CENT. CODE ANN. §§ 10-31-01 to -14 (Supp. 1993) (enacting legislation in 1963); OKLA. STAT. ANN. tit. 18, §§ 801 to 819 (West 1986) (amended legislation that was effective in 1963); UTAH CODE ANN. §§ 16-11-1 to -15 (1991) (effective May 14, 1963). It is significant to note that many new associations were formed under agreements that were drafted to conform to the first example in the *Kintner* Regulations. See Eaton, *supra* note 262, at 11 n.63 (citing Treas. Reg. § 301.7701-2(g), Ex. (1) (1960)); Scallen, *supra* note 144, at 689 n.411 (citing Treas. Reg. § 301.7701-2(g), Ex. (1) (1960)).

322. See Prop. Treas. Reg. §§ 301.7701-1(d), 301.7701-2(g), (h), 28 Fed. Reg. 13,750, 13,751 (1963) (approved by T.D. 6797, 1965-1 C.B. 553). For a detailed discussion of the 1965 regulations, see Eaton, *supra* note 262, at 13-18; Scallen, *supra* note 144, at 698-708.

323. See *Kurzner v. United States*, 413 F.2d 97, 106 (5th Cir. 1969).

324. See Treas. Reg. § 301.7701-1(c) (1965) (as amended by T.D. 6797, 1965-1 C.B. 553).

325. See *id.*

status under the Code.³²⁶ Furthermore, the 1965 amendments defined each corporate characteristic in a manner that made it nearly impossible for a professional corporation to satisfy this resemblance test.³²⁷ According to the new regulations, a professional corporation did not possess continuity of life because of the unique employment relationship that existed between the professional and the organization.³²⁸ Additionally, a professional corporation did not have centralized management if the members retained "traditional professional responsibility" by determining matters such as the acceptance of a client or patient, or what policies and procedures the corporation would follow in handling a given matter.³²⁹ To establish limited liability, the organization had to demonstrate that "the personal liability of its members, in their capacity as members of the organization, was no greater in any aspect than that of shareholder-employees of an ordinary business corporation."³³⁰ Finally, free transferability did not exist in the corporate context unless the members could transfer, "without the consent of the other members, . . . both the right to share in the profits of the organization and the right to an employment relationship with the organization."³³¹

This represents a rather remarkable exercise of regulatory authority. In effect, the Treasury Department said that while the Kintner Regulations remained the general standard of review for association status, it would maintain an independent, insurmountable test for professional corporations. Congress remained silent despite this disturbing exercise of administrative authority. Taxpayers, however, did not; they turned to the judiciary where they won a resounding victory. Court after court invalidated the 1965 amendments as "arbitrary and discriminatory."³³² In *Kurzner v. United States*,³³³ the United States Court of Appeals for the Fifth Circuit strongly criticized the Treasury Department's action, stating that "the only apparent expediency served by the amendments has been the collection of more taxes; in this regard, we need only observe that the

326. *Id.* (citations omitted).

327. Eaton, *supra* note 262, at 14; cf. Scallen, *supra* note 144, at 694 (stating that the amended regulations overemphasized distinctions between corporations and professional groups, thus compelling classification as partnerships rather than as corporations).

328. Treas. Reg. § 301.7701-2(h)(2) (1965).

329. *Id.* § 301.7701-2(h)(3).

330. *Id.* § 301.7701-2(h)(4).

331. *Id.* § 301.7701-2(h)(5)(i).

332. See, e.g., *Kurzner v. United States*, 413 F.2d 97, 106 n.43 (5th Cir. 1969). For a complete listing of court decisions invalidating the 1965 amendments, see Rev. Rul. 70-101, 1970-1 C.B. 278.

333. 413 F.2d 97 (5th Cir. 1969).

courts have not yet become so cynical as to subscribe to the tax-dollar school of statutory construction."³³⁴

At this point the government finally relented. In 1970, the Service issued Revenue Ruling 70-101,³³⁵ stating that it would treat an organization formed under a professional corporation statute as an association.³³⁶ This Revenue Ruling ended the debate surrounding the classification of professional associations.

This first post-*Morrissey* episode in entity classification proved that the resemblance test was anything but a static concept.³³⁷ Immediately following *Morrissey*, the Treasury Department applied the resemblance test in as broad a manner as possible.³³⁸ When a new organizational form developed and threatened a large loss of tax revenue, the Treasury Department revealed just how easily it could rewrite the test. Taxpayers, however, were quick to adapt to the test's various manifestations. Finally, the government learned that although the courts would give it wide latitude in determining which entities were corporations for tax purposes, there was a limit. In the next episode of the entity classification debate one cannot help feeling a little *deja vu*.

B. The Limited Partnership

When Congress exempted partnerships from the entity level tax in the 1894 Act,³³⁹ it did not distinguish between general partnerships and limited partnerships. Instead it provided that the entity level tax applied to corporations and associations, "but not including partnerships."³⁴⁰ Congress finally added a definition of partnership to the Code in 1932,³⁴¹ but it did not specifically mention limited partnerships, although its broad

334. *Id.* at 112.

335. Rev. Rul. 70-101, 1970-1 C.B. 278 (confirmed by Rev. Rul. 77-31, 1977-1 C.B. 409).

336. *Id.* This, however, did not end the Service's attempt to deny the availability of tax-favored pension plans to professional corporations. See *Rands*, *supra* note 268, at 667-68 & nn.76-83 (discussing the Service's approach to denying benefits to professional corporations).

337. See *supra* notes 230-60 and accompanying text (discussing the *Morrissey* decision).

338. See *Pelton v. Commissioner*, 82 F.2d 473 (7th Cir. 1936) (demonstrating the Treasury Department's efforts to apply the resemblance test to physician associations).

339. Revenue Act of 1894, ch. 349, 28 Stat. 509; see 26 CONG. REC. 6833 (1894) (statements of Sen. Hale and Sen. Hoar, discussing partnerships); see *supra* note 45 and accompanying text (discussing the exemption of partnerships from the entity-level of tax under the 1894 Act).

340. See Revenue Act of 1894 § 32.

341. The Revenue Act of 1932 added section 1111(a)(3), which provided: "The term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this Act, a trust or estate or a corporation" Revenue Act of 1932, ch. 209, § 1111(a)(3), 47 Stat. 169, 289.

language seemingly included them within its scope.³⁴² In fact, to date, Congress has not enacted a single provision in the Code that differentiates limited partnerships from general partnerships. Yet, beginning with regulations enacted after the passage of the Revenue Act of 1913,³⁴³ the Treasury Department would feel uninhibited in treating limited partnerships as a distinct organizational form.³⁴⁴ When the Service issued Regulation 33, the Treasury Department made it clear that the exemption of partnerships from entity-level taxation did not apply to *all* partnerships.³⁴⁵ According to the Treasury Department, “[o]rdinary copartnerships” were not subject to tax,³⁴⁶ but limited partnerships were “corporations within the meaning of this Act.”³⁴⁷ This was an interesting construction of the 1913 Act, considering that Congress made no mention of limited partnerships in either the statute or its legislative history.³⁴⁸ Indeed, it is difficult to reconcile this regulatory interpretation with the plain language of the statute. Perhaps the Treasury Department felt that the statutory nature of limited partnerships warranted their classification as corporations, although the regulations make no mention of this as a controlling factor.³⁴⁹ This reading also was inconsistent with the Treasury Department’s efforts to attach corporate status to non-statutorily created entities under the 1913 Act.³⁵⁰ Furthermore, subsequent revisions to Regulation 33 did not make formation under a statute part of the test for corporate status.³⁵¹

The Treasury Department’s blanket treatment of all limited partnerships as corporations ended with the promulgation of Regulation 45,³⁵² under the Revenue Act of 1918. The 1918 Act had established the word

342. *See id.*

343. Revenue Act of 1913, ch. 16, 38 Stat. 114.

344. *See* Treas. Reg. 33, art. 86 (1914), T.D. 1944, 16 Treas. Dec. Int. Rev. 26a (amended 1918). For some insight into Regulation 33, see *supra* notes 141-43 and accompanying text.

345. Treas. Reg. 33, art. 86.

346. *Id.* art. 94.

347. *Id.* art. 86.

348. *See* Revenue Act of 1913, ch. 16, 38 Stat. 114; 50 CONG. REC. (1913); 49 CONG. REC. (1913).

349. *See* Treas. Reg. 33, art. 86.

350. *See, e.g.,* Crocker v. Malley, 249 U.S. 223 (1919) (discussing an unsuccessful attempt to classify a non-statutory trust as an association).

351. *See, e.g.,* Treas. Reg. 33, art. 62 (as revised in 1918 by T.D. 2690, 20 Treas. Dec. Int. Rev. 126) (focusing instead on the corporate characteristic of limited liability).

352. *Compare* Treas. Reg. 45, art. 1505, T.D. 3146, 23 Treas. Dec. Int. Rev. 352 (1920 ed. 1921) *with* Treas. Reg. 45, art. 1506 (1920 ed. 1921). For some insight into Regulation 45, see *supra* notes 180-87 and accompanying text.

“associations” as a separate concept in classification.³⁵³ Under Regulation 45, it was possible for the Treasury Department to classify a limited partnership as either a partnership or a corporation, with the determining factor being the enabling statute of the state where the limited partnership was organized.³⁵⁴ If the statute provided limited liability to all partners and free transferability of partnership shares, then the limited partnership was taxed as a corporation.³⁵⁵ On the other hand, if the statute did not limit the personal liability of the general partners and provided for dissolution on the death or transfer of the general partner’s interest, then the limited partnership was taxed as a partnership.³⁵⁶ This approach to limited partnership classification remained essentially unchanged until after the Supreme Court’s decision in *Morrissey*.³⁵⁷

Following the passage of the Revenue Act of 1939,³⁵⁸ the Treasury Department issued Regulation 103,³⁵⁹ which provided that a limited partnership would be classified as a corporation if it possessed centralized management and continuity of life.³⁶⁰ Regulation 103 noted that despite

353. Revenue Act of 1918, ch. 18, 40 Stat. 1057. For a discussion of the emergence of the term “association” as a separate classifiable entity under the regulations accompanying 1918 Act, see *supra* notes 180-87 and accompanying text.

354. See Treas. Reg. 45, arts. 1505, 1506. The Uniform Limited Partnership Act (ULPA) was enacted in 1916, yet only 10 states adopted it by the time the Treasury Department issued these regulations: Alaska, effective May 2, 1917; Idaho, effective January 1, 1920; Illinois, effective July 1, 1917; Maryland, effective April 10, 1918; Minnesota, effective April 25, 1919; New Jersey, effective April 15, 1919; Pennsylvania, effective April 12, 1917; Tennessee, effective January 1, 1920; Virginia, effective March 14, 1918; Wisconsin, effective June 28, 1919. See UNIF. LTD. PARTNERSHIP ACT (1976).

355. See Treas. Reg. 45, art. 1506 (identifying the pre-ULPA Pennsylvania statute as an example).

356. See Treas. Reg. 45, art. 1505 (identifying the pre-ULPA limited partnership statutes of New York, Michigan, and Illinois as examples).

357. *Morrissey v. Commissioner*, 296 U.S. 344 (1935); see *supra* notes 231-60 and accompanying text (discussing the *Morrissey* decision). For pre-*Morrissey* regulations pertaining to limited partnerships, see Treas. Reg. 65, arts. 1505, 1506 (1924); Treas. Reg. 74, arts. 1315, 1316 (1929); Treas. Reg. 77, arts. 1315, 1316 (1933); Treas. Reg. 86, arts. 801-5, 801-6 (1935).

358. Revenue Act of 1939, ch. 247, 53 Stat. 862.

359. Treas. Reg. 103 (1940).

360. *Id.* § 19.3797-5. This section provided for the classification of limited partnerships as follows:

A limited partnership is classified for the purpose of the Internal Revenue Code as an ordinary partnership, or, on the other hand, as an association taxable as a corporation, depending upon its character in certain material respects. If the organization is not interrupted by the death of a general partner or by a change in the ownership of his participating interest, and if the management of its affairs is centralized in one or more persons acting in a representative capacity, it is taxable as a corporation. For want of these essential characteristics, a limited partnership is to be considered as an ordinary partnership notwithstanding other characteristics conferred upon it by local law.

the fact that several states had adopted the ULPA, the Treasury Department would continue to determine taxable status by examining the "essential characteristics of an association."³⁶¹ Although the Treasury Department's earlier regulations had focused on limited liability and free transferability of interests in assessing corporate status,³⁶² Regulation 103 focused on continuity of life and centralized management.³⁶³ The Treasury Department did not explain this change in emphasis, but it was becoming increasingly clear that a test of corporate resemblance for limited partnerships was elusive.

A more lasting test emerged as a result of a 1942 Board of Tax Appeals' opinion, *Glensder Textile Co. v. Commissioner*.³⁶⁴ *Glensder Textile Co.* involved the classification of a limited partnership formed in New York under the ULPA.³⁶⁵ The predecessor to this New York limited partnership was a general partnership formed by four individuals engaged in the business of marketing ladies' scarves and handkerchiefs.³⁶⁶ In 1936, the original founders decided to convert the enterprise into a limited partnership.³⁶⁷ The Service denied the enterprise partnership status, contending that it possessed all of the "corporate" characteristics enunciated in *Morrissey*³⁶⁸ and, therefore, was an association taxable as a corporation.³⁶⁹

In *Glensder*, the Board first established the distinction between a partnership and a limited partnership by examining the historical exemption of partnerships from entity-level tax.³⁷⁰ The Board cited the earlier Supreme Court decision in *Burk-Waggoner Oil Ass'n v. Hopkins*³⁷¹ as authority for the proposition that the exemption of partnerships " 'obvi-

The Uniform Limited Partnership Act has been adopted in several states. A limited partnership organized under the provisions of that Act may be either an association or a partnership depending upon whether or not in the particular case the essential characteristics of an association exist.

Id. (footnote omitted).

361. *Id.*

362. *See supra* notes 87-88, 140-43, 180-87, 216-30 and accompanying text (discussing how earlier regulations assessed corporate status).

363. *See* Treas. Reg. 103, § 19.3797-5.

364. 46 B.T.A. 176 (1942), *acq.* 1942-1 C.B. 8. The Board of Tax Appeals (B.T.A.) was the predecessor to the Tax Court.

365. *Id.* at 177.

366. *Id.* at 178.

367. *Id.* at 179.

368. *See supra* notes 231-60 and accompanying text (discussing the impact of the Supreme Court's decision in *Morrissey*).

369. *Glensder Textile Co.*, 46 B.T.A. at 182.

370. *Id.*

371. 269 U.S. 110 (1925).

ously refers only to ordinary partnerships.’³⁷² The Board’s use of *Burk-Waggoner* as authority for this proposition was misplaced, as *Burk-Waggoner* involved the classification of a joint-stock association, not a limited partnership.³⁷³ The taxpayer in *Burk-Waggoner* asserted that a joint-stock association was exempted from the income tax because the association was a partnership.³⁷⁴ It was in the context of joint-stock associations that the *Burk-Waggoner* Court held that the partnership exemption applied to only “ordinary partnerships”; it was not examining the limited partnership form of organization.³⁷⁵ The Board in *Glensder* noted this distinction, but still found the *Burk-Waggoner* Court’s statement to be authority for the proposition that “[t]he limited partnership appears to hold a middle ground between the [taxable] joint stock association and the [exempt] general partnership . . . [and therefore,] the local statute must first be examined before a line can be drawn” between the two.³⁷⁶

Having placed the limited partnership on middle ground, the Board then analyzed the *Morrissey* characteristics to determine if a limited partnership resembled a corporation.³⁷⁷ The Board first noted that although the corporate characteristic of limited liability was important, it “can not [sic] be taken as the sole touchstone of classification.”³⁷⁸ The Board first suggested that under certain circumstances, limited liability could be present in a limited partnership despite the presence of a personally liable general partner, such as if the general partners were “mere dummies without real means acting as the agents of the limited partners.”³⁷⁹ The Board then recognized that under this hypothetical scenario, the limited partners would risk losing their statutory protection against liability because they would be exercising too much control over the entity.³⁸⁰ The Board indicated that as a result of exercising this control, local law would treat the limited partners as general partners, thereby extinguishing limited liability.³⁸¹ Unable to find a scenario that provided for full protection from liability for the partners who also had control, the Board determined that limited liability could not exist in the instant case be-

372. *Glensder Textile Co.*, 46 B.T.A. at 182 (quoting *Burk-Waggoner Oil Ass’n*, 269 U.S. at 113).

373. See *Burk-Waggoner*, 269 U.S. at 110.

374. *Id.* at 111.

375. *Id.* at 113.

376. *Glensder Textile Co.*, 46 B.T.A. at 182-83.

377. *Id.* at 185-87.

378. *Id.* at 183; see also *id.* at 186.

379. *Id.* at 183.

380. *Id.*

381. *Id.*

cause the New York statute did not permit the organization to limit the liability of the general partners.³⁸²

The Board's test of free transferability was whether an assignee automatically became a substitute limited partner with all of the rights of ownership.³⁸³ The New York statute did not allow this automatic transfer of rights, although it did allow the partners to reserve such a right in the partnership agreement.³⁸⁴ Interestingly, the limited partnership agreement in *Glensder* did reserve such power.³⁸⁵ Nevertheless, the Board remained unconvinced that free transferability existed because "[i]t [did] not appear . . . that such transfers were contemplated, for no mechanics were provided for the ready transfer of interests through certificates representing shares in the partnership."³⁸⁶ The import of this statement is clear: free transferability did not exist unless transferable certificates represented the partnership interests—simply reserving the power to transfer was not enough to meet this test.³⁸⁷

The Board also found continuity of life and centralized management lacking in the limited partnership context.³⁸⁸ According to the Board, continuity of life could not exist because, under the statute, the death, retirement, or insanity of a general partner caused a dissolution of the partnership.³⁸⁹ The Board determined that the remaining partners' power to continue the business was not analogous to the chartered life of the corporation.³⁹⁰ The Board further found that centralized management did not exist because the general partners in *Glensder* were acting in their own interests, "not merely in a representative capacity for a body of persons having a limited investment and a limited liability," and thus did not have control analogous to corporate directors.³⁹¹ As a result, the Board found that the *Glensder* limited partnership was not an association.³⁹² It is difficult to conceive of any limited partnership that would have satisfied this interpretation of the resemblance test. *Glensder* thus became valuable precedent for associations that wanted to avoid the clas-

382. *Id.* at 186.

383. *Id.*

384. *See id.*

385. *Id.*

386. *Id.*

387. *Id.*

388. *Id.* at 185.

389. *Id.*

390. *Id.* ("We do not think this [reservation of power is] analogous to the chartered life of a corporation which continues regardless of the death or resignation of its directors or stockholders.").

391. *Id.*

392. *Id.* at 187.

sification of their limited partnerships as corporations. Eighteen years later, when it drafted regulations to restrict the availability of association status to taxpayers like Dr. Kintner, the Treasury Department made excellent use of this precedent.³⁹³

In drafting the portion of the Kintner Regulations relating to the classification of limited partnerships, the Treasury Department borrowed heavily from the Board's opinion in *Glensder*.³⁹⁴ The regulations stated that a limited partnership did not possess continuity of life if death, insanity, bankruptcy, retirement, resignation, expulsion, or another event of withdrawal of the general partner could cause the dissolution of the partnership.³⁹⁵ The regulations further provided that centralized management was not present unless the limited partners owned substantially all of the interests in the partnership;³⁹⁶ the Board in *Glensder* had determined that because the general partners of the limited partnership had a substantial stake in the limited partnership, centralized management did not

393. See *supra* notes 287-310 and accompanying text (discussing the adoption of the Kintner Regulations by the Treasury Department).

394. See Treas. Reg. § 301.7701-2(b), (c)(4), (d), (e) (1960), T.D. 6503, 1960-2 C.B. 409; see also *supra* notes 286-321 and accompanying text (discussing the Kintner Regulations and their treatment of limited partnerships).

395. Treas. Reg. § 301.7701-2(b) (1960). The Treasury Department amended this regulation in 1993 to "clarify the rule" regarding a limited partnership:

continuity of life does not exist notwithstanding the fact that a dissolution of the limited partnership may be avoided, upon such an event of withdrawal of a general partner, by the remaining general partners agreeing to continue the partnership or by at least a majority in interest of the remaining partners agreeing to continue the partnership. See *Glensder Textile Co. v. Commissioner*, 46 B.T.A. 176 (1942), *acq.*, 1942-1 C.B. 8.

Treas. Reg. § 301.7701-2(b)(1) (as amended by T.D. 8475 (1993), 1993-1 C.B. 236, 237).

Under Revenue Procedure 89-12, however, "the Internal Revenue Service will not rule that [a limited partnership] lacks continuity of life" if the limited partnership agreement permits less than a majority of the limited partner interests to elect a new general partner when a general partner is removed. Rev. Proc. 89-12, § 4.05, 1989-1 C.B. 798, 801. Revenue Procedure 92-35 provides that

[i]f under local law and the partnership agreement the bankruptcy or removal of a general partner of a limited partnership causes a dissolution of the partnership unless the remaining general partners or at least a majority in interest of all remaining partners agree to continue the partnership, the Service will not take the position that the limited partnership has the corporate characteristic of continuity of life.

Rev. Proc. 92-35, 1992-1 C.B. 790, 791.

In turn, Revenue Procedure 94-46 provides a safe harbor for determining "majority in interest." Rev. Proc. 94-46, 1994-28 I.R.B. 129.

396. Treas. Reg. § 301.7701-2(c). Under Revenue Procedure 89-12, the Service will not rule that a limited partnership lacks centralized management if the limited partners' interests exceed 80% of the total interest in the entity. Rev. Proc. 89-12, § 4.06, 1989-1 C.B. 798, 801.

exist.³⁹⁷ According to the Kintner Regulations, free transferability existed only if the partners had the ability to assign all of the attributes of their interest without the consent of the other partners.³⁹⁸ This is actually a somewhat different standard than that considered by the Board in *Glensder* which examined the likelihood that such transfers would actually occur.³⁹⁹ In regard to the test for limited liability, however, the drafters of the Kintner Regulations seem to have misread the Board's opinion. The regulations incorporated the *Glensder* "dummy" hypothetical,⁴⁰⁰ surprising since the Board had determined that the dummy scenario did not result in limited liability.⁴⁰¹ The Board simply found that limited liability could not exist at all under the ULPA.⁴⁰² In contrast, the regulations hold that a limited partnership will not have limited liability if the general partner has substantial assets or if the general partner is not "merely a 'dummy' acting as the agent of the limited partners."⁴⁰³

The *Glensder* opinion was suited perfectly to the Treasury Department's desire to draft the Kintner Regulations in a manner that made the presence of a particular corporate characteristic unlikely. These descriptions, combined with the requirement that three of the four factors had to be present in order to be classified as an association, enabled the Treasury Department to deny corporate status to professional associations. As will be seen below the Treasury Department would soon regret this drafting.

Beginning in the late 1960s, practitioners began using the limited partnership as a vehicle for providing investors with certain tax benefits. These limited partnerships are now commonly referred to as "tax shelters."⁴⁰⁴ The use of tax shelters accelerated during the 1970s, enabling an increasing number of taxpayers to avoid paying any income tax. It was not long before the Treasury Department decided that something had to be done. Once again, however, the government found that its chief ob-

397. *Glensder Textile Co.*, 46 B.T.A. at 185; see *supra* note 391 and accompanying text (discussing the characteristic of centralized management in the *Glensder* opinion).

398. Treas. Reg. § 301.7701-2(e); see Rev. Proc. 92-33, 1992-1 C.B. 782 (providing additional guidance with respect to free transferability of interest by defining the phrase "substantially all").

399. *Glensder Textile Co.*, 46 B.T.A. at 186.

400. See *id.* at 183; Treas. Reg. § 301.7701-2(d).

401. See *Glensder Textile Co.*, 46 B.T.A. at 183.

402. *Id.* at 186-87.

403. Treas. Reg. § 301.7701-2(d)(2). Under Revenue Procedure 89-12, the Service further indicated that a partnership lacked limited liability if it had a limited partner and a corporate general partner and if the net worth of the corporate general partner, independent of its interests in the limited partnership, was equal to or greater than 10% of the total contributions to the partnership. Rev. Proc. 89-12 § 4.07, 1989-1 C.B. 798, 801.

404. See generally WILLIAM A. KLEIN & JOSEPH BANKMAN, FEDERAL INCOME TAX 632-735 (1994).

stacle in combating this latest revenue-reducing vehicle was its own regulations.⁴⁰⁵

In its effort to curtail the growth of tax shelters, the government first attempted to classify limited partnerships as associations despite existing regulations. In the Tax Court's widely recognized opinion in *Larson v. Commissioner*, the government quickly discovered just how impenetrable the Kintner Regulations would be.⁴⁰⁶ *Larson* involved a typical tax shelter limited partnership.⁴⁰⁷ Using a corporate general partner and non-recourse financing, the promoters offered limited partners significant tax benefits generated through a real estate investment.⁴⁰⁸ The Service attempted to deny these benefits to the taxpayer by contending that the limited partnership was an association and therefore, was taxable as a corporation.⁴⁰⁹

The Tax Court, in an opinion reminiscent of the Fifth Circuit's decision in *Kintner*, ruled that although this type of limited partnership seemed to warrant corporate treatment, the government was bound by its own regulations.⁴¹⁰ With the regulations so heavily skewed against corporate status, the *Larson* court somewhat grudgingly found for the taxpayer.⁴¹¹ The opinion did, however, provide the government with some insight on one possible avenue of success.⁴¹² By recognizing the Treasury Department's broad regulatory authority⁴¹³ and implying that the result may have been different if the regulations were reformulated, the court essentially suggested that it might be in the government's best interest simply to rewrite the regulations.⁴¹⁴

Taking the Tax Court's advice, the Treasury Department embarked on its second, albeit short-lived, line of attack. Within a year of the Tax Court's decision in *Larson*, the Treasury Department proposed compre-

405. See, e.g., *Larson v. Commissioner*, 66 T.C. 159 (1976), acq. 1979-2 C.B. 1, 2d acq. 1979-2 C.B. 2; *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1975).

406. 66 T.C. 159 (1976).

407. See *id.* at 159. For a description of tax-shelter limited partnership formation, see generally ROBERT J. HAFT & PETER M. FASS, 1985 TAX SHELTERED INVESTMENTS HANDBOOK chs. 1 & 2 (1985).

408. *Larson*, 66 T.C. at 161-62; see also HAFT & FASS, *supra* note 407, chs. 1 & 2.

409. *Larson*, 66 T.C. at 171-72.

410. *Id.* at 185-86.

411. See *id.* ("Were not the regulations' thumbs upon the scales, it appears to us that the practical continuity and limited liability of both entities would decisively tip . . . in [the Government's] favor."). The tax court split seven to six in favor of the taxpayer in a decision that contained eight separate opinions. See *id.* at 186-213.

412. See *id.* at 172.

413. *Id.* at 172 n.8 (citing *Morrissey v. Commissioner*, 296 U.S. 344, 354-55 (1935)).

414. *Id.* at 185-86 ("Our task herein is to apply the provisions of [the Treasury Department's] regulations as we find them and not as we think they might or ought to have been written." (footnote omitted)).

hensive amendments to the Kintner Regulations that classified most tax-shelter limited partnerships as corporations.⁴¹⁵ The Treasury Department withdrew the proposed regulations without explanation two days after publication.⁴¹⁶ The reason most often cited for the quick recision is that the newly published regulations would have adversely affected the Department of Housing and Urban Development's low-income housing projects.⁴¹⁷ Even if the Department had not withdrawn these regulations, it was likely that the judiciary would have reacted to this blatant attack on tax shelter limited partnerships in the same manner that it reacted to the 1965 amendments directly attack professional corporations.⁴¹⁸

The 1977 proposed regulations were aimed solely at limited partnerships, with special emphasis on tax shelter limited partnerships.⁴¹⁹ The prefatory remarks stated that the Kintner Regulations were "not well suited to the classification of organizations, such as limited partnerships, whose members have widely differing rights and responsibilities."⁴²⁰ Even though the proposed regulations retained the process of identifying and examining the four, standard, corporate characteristics, the description of these factors made it clear that the amendments were designed specifically for tax-shelter limited partnerships.⁴²¹ For example, under the 1977 proposed regulations, continuity of life would have existed if the general partner was a corporation in which the limited partners had a controlling interest, or if partners with a majority interest could continue the partnership's business despite a technical dissolution under local law.⁴²² Undoubtedly, most tax shelter limited partnerships would have possessed this characteristic under the proposed test. Similarly, limited liability existed if the limited partners' percentage interests greatly exceeded the general partners' interests in the partnership, or if non-recourse debt financed the activity of the partnership and the partnership

415. See Prop. Treas. Regs. §§ 301.7701-1 to 301.7701-3, 42 Fed. Reg. 1038-44 (1977).

416. *Id.* at 1489.

417. See Note, *Tax Classification of Limited Partnerships: The IRS Bombards the Tax Shelters*, 52 N.Y.U. L. REV. 408, 410-11 & nn.23-25 (1977) (citing *Battle is Joined on I.R.S. Partnership-Corporation Ruling*, N.Y. TIMES, Jan. 7, 1977, at A-11).

418. See *supra* note 332 and accompanying text (discussing the judiciary's invalidation of the 1965 amendments to the Kintner Regulations after concluding that they were "arbitrary and discriminating").

419. See 42 Fed. Reg. 1038 (1977). The newly proffered regulations were not an attempt to provide an all-encompassing redefinition of the resemblance test. See *id.* (stating that classification rules for those organizations that are "neither profit-seeking organizations nor ordinary trusts will be published at a later time").

420. *Id.*

421. See *id.* § 301.7701-2, 42 Fed. Reg. 1039-44.

422. See *id.* § 301.7701-2(d)(2)(ii), 42 Fed. Reg. 1041.

was insured against ordinary risks⁴²³—a fact of life for most tax-shelter limited partnerships. Whereas under the Kintner Regulations a limited partnership could avoid free transferability by imposing consent restrictions on a member's ability to transfer management rights,⁴²⁴ free transferability existed under the proposed regulations if the members could unilaterally convey the "primary attributes of the interest, such as the rights to share in the profits and to a return of a contribution of capital."⁴²⁵ Because the profits interest, and not the management interest, was the primary attribute of the limited partners' interest in a tax shelter, free transferability would exist provided that the profits interest was transferable. Only the definition of centralized management comported with the previous definition,⁴²⁶ and because most tax shelter limited partnerships conceded the presence of this attribute,⁴²⁷ it was irrelevant that the wording of this definition was left relatively unchanged.

Perhaps the most significant change contained in the 1977 proposed regulations was the elimination of the preponderance test.⁴²⁸ It was no longer necessary that the business entity at issue possess three out of the four corporate characteristics for the Service to find association status.⁴²⁹ Under the proposed regulations, the pressure of two characteristics would be sufficient if the surrounding facts and circumstances suggested corporate resemblance.⁴³⁰ The diminution in the number of required characteristics, coupled with the new definitions for limited liability, continuity of life, and free transferability, effectively guaranteed association status for most tax shelter limited partnerships. The Treasury Department's attack on tax shelters was even more apparent in the examples provided within the regulations themselves.⁴³¹ Of the fourteen examples provided, twelve involved typical tax shelter investments—real estate, livestock, mineral resources, equipment leasing, and film production.⁴³² Whether the Court would have invalidated these regulations never will be

423. See *id.* § 301.7701-2(f)(2), 42 Fed. Reg. 1041-42.

424. See *supra* notes 377-81, 391-92 (discussing limited partnerships and free transferability).

425. See Prop. Treas. Regs. §§ 301.7701-2(g)(2), (h) ex.5, 42 Fed. Reg. 1042.

426. Compare Treas. Reg. § 301.7701-2(c) (1960) with § 301.7701-2(e), 42 Fed. Reg. 1041 (1977).

427. See generally HAFT & FASS, *supra* note 407, chs. 1 & 2.

428. See Prop. Treas. Regs. §§ 301.7701-2(a)(1) to -2(a)(3), 42 Fed. Reg. 1039-40; see also *supra* notes 286-321 and accompanying text (discussing the resemblance test).

429. *Id.* § 301.7701-2(a)(1), 42 Fed. Reg. 1040.

430. See *id.*

431. See *id.* §§ 301.7701-2(a)(4), 301.7701-2(a)(5), 301.7701-2(h), 42 Fed. Reg. 1040, 1042.

432. *Id.*

known because of their brief lifespan.⁴³³ Yet, even with the withdrawal of these regulations, the Treasury Department was not ready to concede.⁴³⁴ The Treasury Department could not replace the resemblance test, so it attempted to circumvent the test by bringing to Congress its appeal to reclassify limited partnerships. With the next evolutionary phase of the limited partnership on the horizon—the Master Limited Partnership (MLP)—the Treasury Department found a receptive ear.

An MLP is a large limited partnership, sometimes having thousands of investors whose interests are traded on an established securities exchange such as the New York Stock Exchange, a secondary market, or in a manner that indicates a ready market for such interests.⁴³⁵ First appearing in

433. See *id.* at 1489.

434. The Service, however, did issue Revenue Ruling 79-106, which indicated that it would apply the Kintner Regulations to limited partnerships in accordance with the Tax Court's decision in *Larson*. See Rev. Rul. 79-106, 1979-1 C.B. 147.

435. See I.R.C. § 7704(b) (1994). Section 7704(b), which addresses MLPs, defines a "publicly traded partnership" as "any partnership if—(1) interests in such partnership are traded on an established securities market, or (2) interests in such partnership are readily tradeable on a secondary market (or the substantial equivalent thereof)." *Id.* One of the many forms that an MLP can take is a "Rollout (drop-down) transaction:"

A rollout is a transaction whereby a corporation rolls out (or drops down, depending on one's preference for terminology) corporate assets to a limited partnership in exchange for an interest in the partnership. The corporation (often referred to as the corporate sponsor) is typically the general partner of the partnership, and may also receive an interest as a limited partner (i.e., limited partnership units) . . .

When the property is contributed to the partnership, limited partnership units are distributed to the public. Three principal alternative means of distributing units to the public are available: (1) a primary offering (sale of limited partnership units directly by the partnership to investors, normally using an underwriter); (2) a secondary offering (sale by the corporation of its limited partnership units to the public); and (3) a distribution by the corporation to its shareholders of limited partnership units.

JOINT COMMITTEE ON TAXATION, TAX TREATMENT OF MASTER LIMITED PARTNERSHIPS 21 (1987) [hereinafter MLP PAMPHLET].

Another form of the MLP is an "Acquisition (equity buyout) transaction":

This type of MLP formation transaction frequently involves a corporate sponsor (like the rollout). The primary difference between a rollout-type transaction and an acquisition-type transaction is that in the former, the corporation contributes assets to the partnership, whereas in the latter, the partnership buys the assets from the sponsoring corporation or from unrelated parties. An acquisition-type transaction may be arranged to buy particular assets, or to buy unidentified assets generically (e.g., rental real estate).

Generally, in an acquisition transaction, a limited partnership is formed (with the corporate sponsor, if any, typically serving as general partner), and limited partnership units are sold to the public in a primary offering. The cash raised through the offering of units (plus any additional amounts borrowed by the partnership) are used to acquire assets by the partnership.

Id. at 22.

1981,⁴³⁶ the MLP provided investors with the liquidity of publicly traded corporate stock without subjecting them to an entity-level tax on the return on their investment.⁴³⁷ This new generation of limited partnerships achieved this result because it did not meet the resemblance test as set out in the Kintner Regulations.⁴³⁸ Although it possessed the corporate characteristic of centralized management, it avoided at least two of the other three corporate factors.⁴³⁹ The MLPs' size and method of ownership transfer gave them the same appearance as publicly traded corporations, and thus it was not long before these limited partnerships became an issue in entity classification.

Congress, rather than the Treasury Department, first raised government concern over MLPs.⁴⁴⁰ In 1983, the Senate Finance Committee released a preliminary report that proposed taxing MLPs as corporations.⁴⁴¹ Somewhat surprisingly, the Treasury Department spoke

A third form of MLP is the "Rollup transaction":

In a rollup transaction, existing limited partnerships are "rolled up" and consolidated into one larger partnership. In a rollup, the existing partnerships are treated as contributing their assets to the master limited partnership, in exchange for units of the master limited partnership, and then distributing the units to their partners in liquidation. The master limited partnership thereby owns the assets of the pre-existing partnership, and has as its unit holders the partners of the pre-existing partnerships.

Id. at 23.

Finally, an MLP may take the form of a "Liquidation transaction":

A liquidation transaction for forming an MLP involves the complete liquidation of the corporation whose assets the MLP acquires. In the transaction, the corporation contributes all of its assets to the MLP in exchange for units of the MLP. The corporation then distributes the units to its shareholders in complete liquidation.

Id.; see also R. Donald Turlington & Reba A. Beeson, *Master Limited Partnerships: Current Issues, Techniques and Strategies*, in *PARTNERSHIP TAXATION 1988: AN ADVANCED PROGRAM*, 211, 232-48 (Tax Law and Estate Planning Series, Tax Law and Practice Course Handbook Series No. 269, 1988).

436. See Robert Metz, *Market Place: The Apache Partnership*, N.Y. TIMES, Mar. 5, 1981, at D8.

437. See W. John Moore, *Publicly Traded Partnerships Gaining Converts*, 6 LEGAL TIMES, Feb. 13, 1984, at 2.

438. See *supra* notes 286-321 and accompanying text (discussing the resemblance test as set forth in the Kintner Regulations).

439. All MLPs lack the corporate characteristics of limited liability and continuity of life and, depending on the form, some even avoid free transferability of interests. See MLP PAMPHLET, *supra* note 435, at 27; Turlington & Beeson, *supra* note 435, at 227-32.

440. See STAFF OF SEN. FIN. COMM., 98TH CONG., 1ST SESS., REPORT ON THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS 80 (Comm. Print 1983) [hereinafter 1983 SENATE REPORT].

441. *Id.* The proposal was based on an earlier ALI study. See THE AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: SUBCHAPTER K-TENTATIVE DRAFT NO. 7, 95-97, 109 (1981).

out against this proposal, possibly because the Treasury did not want to base its classification of an organization solely on the degree of marketability of interests.⁴⁴² Subsequent events, however, suggested that the more likely reason for the Treasury Department's opposition to the measure was that it had not yet conceded on reclassifying *all* large limited partnerships. This became evident the following year when the Treasury Department published its 1984 Treasury Report, which contained a proposal to impose corporate tax status on all limited partnerships with more than thirty-five partners.⁴⁴³ The theoretical justification for the proposal was that the economic relationship of the limited partners to these partnerships resembled that of shareholders to a corporation, notwithstanding the Kintner Regulations.⁴⁴⁴ Interestingly, the 1984 Treasury Report also expressed continued support for integration⁴⁴⁵ and included a proposal to allow corporations a fifty percent, dividend-paid deduction.⁴⁴⁶ Apparently, the Treasury Department was attempting to achieve inconsistent goals—reclassifying limited partnerships to preserve the integrity of the corporate tax system, while at the same time offering to reduce the corporate tax burden because of its doubt about the integrity of the corporate tax. The opportunity to debate this seemingly inconsistent position never emerged, however, as neither proposal garnered any support and quickly faded away.⁴⁴⁷ With its 1984 effort spurned, it became clear that the Treasury Department would be unable to defeat tax shelter limited partnerships through classification.⁴⁴⁸

In 1986 the Treasury Department decided to return to the limited partnership classification arena because it viewed the MLP as a present reve-

442. Lee A. Sheppard, *Treasury's Plan to Intercept Passthrough Shelter Arrangements*, 26 TAX NOTES 307 (1985).

443. See 2 U.S. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH 147 (1984) [hereinafter 1984 TREASURY PROPOSAL]. As a result of this proposal, the Senate Finance Committee did not include its proposal to tax MLPs in its final report on Subchapter C in 1985. See STAFF OF SEN. FIN. COMM., 99TH CONG., 1ST SESS., REPORT ON THE SUBCHAPTER C REVISION ACT OF 1985 72 (Comm. Print 1985).

444. 1984 TREASURY PROPOSAL, *supra* note 443, at 148.

445. For a discussion of the concept of integration, see *infra* part IV.

446. See 1984 TREASURY PROPOSAL, *supra* note 443, at 133. The Treasury Department had released a comprehensive analysis of the entity tax system that resulted in a call for complete integration as early as 1977. See DAVID F. BRADFORD, U.S. DEPT. OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 64-67 (2d ed. rev. 1984). Ironically, the Treasury Department was preparing this proposal at the time it was drafting its 1977 regulations which, if not withdrawn, would have removed many entities from full integration.

447. See Lee A. Sheppard, *Rethinking Limited Partnership Taxation*, 30 TAX NOTES 877, 879 (1986).

448. Of course, other changes in the Code eventually reduced the attraction, or abuse, depending on one's point of view, of these entities. See, e.g., I.R.C. § 465 (1990) (limiting deductions to amount at risk); *id.* § 469 (1993) (limiting passive activity losses and credits).

nue threat. Taxpayers were forming MLPs at an accelerating rate.⁴⁴⁹ Also, while initial MLP formations had involved only oil, gas, and real estate investments, taxpayers began to use MLPs in other industries, such as sports franchises, cable television businesses, motion picture businesses, hotel and motel chains, health-care businesses, and home building companies.⁴⁵⁰ The Treasury Department launched its assault on MLPs during 1986 congressional hearings that examined pass-through entities.⁴⁵¹ Significantly, J. Roger Mentz, Assistant Treasury Secretary for Tax Policy, opened the hearings by discussing the interrelationship between integration and classification.⁴⁵² With respect to integration, Secretary Mentz stated that the agency shared the view of most economists that “[a]s a matter of ideal tax policy, income from different business activities should be taxed at equivalent rates, irrespective of the form of business entity.”⁴⁵³ Due to the failure of the Treasury Department’s 1984 integration proposal, however, Secretary Mentz stated that he did not believe that there was any significant prospect for integration in the near future.⁴⁵⁴ The inference that he apparently wanted Congress to draw from these statements was that until integration could be achieved, classification would have to be accepted as a necessary evil.⁴⁵⁵ Secretary Mentz then switched the discussion to this necessary evil and began to attack MLPs.⁴⁵⁶ He explained that one of the chief problems with classifying entities by business form was that two enterprises could be engaged in the same income generating activity—such as computers—and yet be

449. Between the years 1981 and 1986, 86 MLPs were formed. See *Master Limited Partnerships, 1987: Hearings Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 100th Cong., 1st Sess. 20 (1987) [hereinafter *1987 Hearings*] (statement of J. Roger Mentz, Assistant Treasury Secretary for Tax Policy). The specific breakdown was as follows: 3 in 1981, 5 in 1982, 6 in 1983, 6 in 1984, 28 in 1985, and 38 in 1986. See *id.*

450. See *id.* at 21.

451. See *Issues Relating to Passthrough Entities, 1986: Hearings Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 99th Cong., 2d Sess. (1986) [hereinafter *1986 Hearings*]. The 1986 hearings resulted in legislation that effected both Real Estate Investment Trusts (REITs) and Regulated Investment Companies (RICs) and provided for a new tax vehicle—the Real Estate Mortgage Investment Conduit (REMIC). See Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 661-68, 100 Stat. 2085, 2299-2308 (effecting REITs); *id.* §§ 651-57 (effecting REITs); *id.* §§ 671-74 (allowing for the creation of REMICs).

452. See *1986 Hearings*, *supra* note 451, at 10-11.

453. *Id.* at 10.

454. *Id.* at 11 (stating that “[t]he treatment of entities not as corporations that function in a manner similar to corporations, and compete with corporations results in inequity”).

455. See *id.*

456. *Id.*

taxed at significantly different tax rates if one was organized as a partnership and the other as a corporation.⁴⁵⁷

The Treasury Department wanted to tax MLPs as corporations, but this suggestion had a major shortcoming: it did not solve the problem that Secretary Mentz had described. A limited partnership and a corporation still could engage in similar income generating activities, such as computers, and the Treasury Department's proposal would limit only the ability of the limited partnership to raise capital. If the Treasury Department was truly serious about taxing all income generated in the computer business equally, the solution would have been to subject that income to the same rate of tax regardless of the organizational form through which it was generated, rather than to reclassify the organizational form. Of course, the logical end to this argument is to tax all business income at the same rate, thereby achieving full integration. The Treasury Department, however, had just finished telling Congress that such a result was unattainable.

In 1987, Congress again held hearings, this time focusing solely on MLPs.⁴⁵⁸ During these debates, the Treasury Department expressed an even greater urgency to reclassify MLPs.⁴⁵⁹ It argued that the Tax Reform Act of 1986⁴⁶⁰ made partnership treatment more desirable by (1) reducing tax rates so that the maximum corporate rate exceeded the maximum individual rate⁴⁶¹ and (2) repealing the *General Utilities* doc-

457. *Id.* Although the Treasury Department was leery of making significant changes to the current classification standards because any distinctions would have been concededly arbitrary and unfair, it voiced its belief that one modest change was appropriate given the nature of the problem identified, stating:

We believe that access to passthrough treatment by noncorporate entities should be limited in certain circumstances. In our view, this limit should apply to require corporate classification in the case of an entity that, one, has a large number of owners, substantially all of whom are not involved in the management or operation of the entity; two, has ownership interests that change hands frequently; three, *has access to capital markets in a manner comparable to large corporate entities*; and, four, is carrying on significant business activity and dividing the gains therefrom.

Id. at 10 (emphasis added).

458. See generally 1987 Hearings, *supra* note 449.

459. See *id.*

460. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in 26 U.S.C. §§ 1 to 9602).

461. Under the Tax Reform Act of 1986, the maximum corporate rate was 34% and the maximum individual rate was 28%. *Id.* § 1(g)(2)(B). Also under the 1986 Tax Reform Act, Congress removed the historical preference for capital gains by putting the top capital gains rates for individuals and corporations at 28% and 34%, respectively. See *id.* §§ 302, 601. Of course, this is no longer the case because subsequent tax acts have increased the top marginal rate for individuals to 36% and for corporations to 35%, thus creating a gap between top capital gains rates and ordinary rates.

trine,⁴⁶² which had made it possible to avoid the corporate level of tax on gains from the sale or distribution of appreciated corporate assets.⁴⁶³ In this climate, the Treasury Department announced three reasons why MLPs should be taxed as corporations.⁴⁶⁴ The first was a concern over ad hoc integration.⁴⁶⁵ The Treasury Department's argument was that although start-up businesses had access to MLPs as well as to their concomitant integration, existing corporations were unable to transform themselves into MLPs due to the repeal of the *General Utilities* doctrine.⁴⁶⁶ The Treasury Department also mentioned non-tax costs, although it did not elaborate on that issue.⁴⁶⁷ Apparently, the Treasury Department felt that if this form of integration could not be made available to *all* businesses, it should not be available to MLPs.⁴⁶⁸ Once again, the Treasury Department's argument had no logical end. Small start-up businesses have access to the partnership form even though existing small corporations are unable to transform themselves into partnerships. Consistency, therefore, would call for a denial of pass-through treatment to all newly formed entities.

The Treasury Department's next reason was the administrative complexity involved in applying the rules of Subchapter K⁴⁶⁹ to large, publicly traded partnerships, including: (1) the allocation of pre-contribution gain or loss to the contributing partner under section 704(c); (2) determining basis adjustment under sections 743(b) and 754; and (3) whether there had been a constructive termination under section 708(b) due to a turnover of fifty percent of partnership interests.⁴⁷⁰ It is interesting to note that with respect to this issue, the Treasury Department had insisted that there were no difficulties in applying Subchapter K to large partnerships only four years earlier.⁴⁷¹ Moreover, many leading partnership experts

462. See *General Util. & Operating Co. v. Helvering*, 296 U.S. 200 (1935). For an elaborate discussion of the evolution of the *General Utilities* doctrine and its subsequent application, see generally DOUGLAS A. KAHN & PAMELA B. GANN, *CORPORATE TAXATION* 178-81 (3d ed. 1989).

463. See *1987 Hearings*, *supra* note 449, at 17.

464. See *id.* at 23-26.

465. *Id.* at 24.

466. *Id.*

467. *Id.*

468. See *id.*

469. See I.R.C. §§ 701-61 (1986).

470. *1987 Hearings*, *supra* note 449, at 24-25.

471. See *1986 Hearings*, *supra* note 451, at 46-54. During the hearings, the House Committee on Ways and Means heard the statement of Ronald Pearlman, Deputy Assistant Secretary (Tax Policy), Department of Treasury:

"Its [the ALI's] suggestion to exclude publicly traded partnerships from this recommendation was based primarily on the perceived problems that the IRS would encounter in auditing these partnerships. We believe that many of these

contested this supposed complexity by citing advances in computer software, efforts to keep MLPs "clean," and the partnership-level audit procedures enacted in 1982.⁴⁷²

The Treasury Department's third reason, and historical motivator for challenging an organization's classification, was revenue.⁴⁷³ Indeed, the fact that Secretary Mentz opened his testimony before Congress with the words "[w]e are going to lose a lot of money," is evidence that revenue loss probably took precedence over concerns for ad hoc integration and administrative complexity.⁴⁷⁴ The Treasury Department feared that a revenue loss would occur in two ways: (1) through the conversion of existing entities to the MLP form and (2) through the use of the MLP form by newly formed entities that would have otherwise formed as corporations.⁴⁷⁵ Although the threat of newly formed entities choosing the MLP form over the corporate form was real, the disincorporation of America was an unlikely event given the repeal of the *General Utilities* doctrine.⁴⁷⁶

Although many leading tax experts opposed the reclassification of MLPs, Congress ultimately sided with the Treasury Department and enacted section 7704 of the Code in the Omnibus Budget Reconciliation Act of 1987.⁴⁷⁷ Section 7704, however, does not reclassify all MLPs as

problems have been eliminated or substantially reduced as a result of the partnership level audit provisions contained in TEFRA. The administrative problem most often associated with publicly traded limited partnerships is the perceived difficulty in allocating various tax items among partners when there are multiple transfers of partnership interests during the taxable year or where partnership interests are held in street name. These allocation problems are faced with greater or lesser degree by every partnership and we are not convinced that the mechanics of making these calculations are insuperable; nor are we aware of any significant abuses that have been linked to publicly traded limited partnerships. Indeed, we suspect that the reporting requirements imposed upon publicly traded and registered partnerships and the public scrutiny that these organizations receive make them less likely to engage in abusive activities than partnerships with fewer partners."

Id. at 49-50.

472. See 1987 Hearings, *supra* note 449, at 117-18 (statement of William S. McKee and Mark A. Kuller); *id.* at 149-51 (statement of R. Donald Turlington).

473. *Id.* at 25-26.

474. *Id.* at 7 (testimony of Mentz).

475. *Id.* at 25-26.

476. See *supra* notes 462-63 and accompanying text.

477. I.R.C. § 7704 (1988). Section 7704 provides, in pertinent part:

(a) General Rule.—For purposes of this title, except as provided in subsection (c), a publicly traded partnership shall be treated as a corporation.

(b) Publicly traded partnership.—For purposes of this section, the term "publicly traded partnership" means any partnership if—

(1) interests in such partnership are traded on an established securities market, or

corporations.⁴⁷⁸ An MLP is still taxed as a partnership if it derives ninety percent of its gross income from natural resources or real estate.⁴⁷⁹ The 1987 Act also contained a transition rule that provided that the Treasury Department would not reclassify existing MLPs, formed prior to December 17, 1987, until the year 1997.⁴⁸⁰ This exception, combined with the ten-year transition rule, suggests that concerns over administrative feasibility may have been overstated. Moreover, the exception for MLPs involved in real estate and natural resources and the continued pass-through treatment of non-publicly traded partnerships indicate that Congress was willing to allow a great deal of ad hoc integration.

Section 7704 marked the end, at least for a while, of the Treasury Department's efforts to reclassify limited partnerships. The resemblance test

(2) interests in such partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

(c) Exception for partnerships with passive-type income.—

(1) In general.—Subsection (a) shall not apply to any publicly traded partnership for any taxable year if such partnership met the gross income requirements of paragraph (2) for such taxable year and each preceding taxable year beginning after December 31, 1987, during which the partnership (or any predecessor) was in existence.

(2) Gross income requirements.—A partnership meets the gross income requirements of this paragraph for any taxable year if 90 percent or more of the gross income of such partnership for such taxable year consists of qualifying income.

....

(d) Qualifying income.—For purposes of this section—

(1) In general.—Except as otherwise provided in this subsection, the term “qualifying income” means—

(A) interest,

(B) dividends,

(C) real property rents,

(D) gain from the sale or other disposition of real property

(including property described in section 1221(1)),

(E) income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber),

(F) any gain from the sale or disposition of a capital asset (or property described in section 1231(b)) held for the production of income described in any of the foregoing subparagraphs of this paragraph, and

(G) in the case of a partnership described in the second sentence of subsection (c)(3), income and gains from commodities (not described in section 1221(1)) or futures, forwards, and options with respect to commodities.

Id.; see also Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10211, 101 Stat. 1330, 1330-1403.

478. I.R.C. § 7704(c) (1988).

479. See *id.* § 7704(c)(2).

480. See Omnibus Budget Reconciliation Act § 10211(c)(2).

had proved once again to be incapable of producing satisfactory results for the Treasury Department. However, section 7704 opened a new avenue of reclassification. Finding that it was unable to rewrite the resemblance test in an effective manner, the Treasury Department turned to Congress for resemblance test relief. Admittedly, Congress was unwilling to follow the advice of the Treasury Department and tax all large limited partnerships, but the Treasury Department's efforts resulted in Congress' first amendment to the definition of "corporations" since 1918. In the end, section 7704 proved only that Congress has the power to do what the Treasury Department cannot—reclassify a newly developed form of business entity despite its classification under the resemblance test. By doing this, Congress avoided addressing the reasons for the inadequacy of the resemblance test. It remains to be seen how long Congress can wait before taking a more global approach to the problem of entity classification.

The Treasury Department was correct when it stated that the 1986 Tax Reform Act would produce greater interest in pass-through treatment and its attendant elective integration.⁴⁸¹ The MLP was the first testament to the ingenuity of tax lawyers reacting to the post-1986 Act tax scheme. The next challenger to the resemblance test, and the prohibitive favorite to force Congress to reexamine entity classification seriously, is a new entity that promised small entities the full integration of partnership treatment. This new form is called the Limited Liability Company (LLC).

C. *The Limited Liability Company*

LLCs are a hybrid form of business entity that combine the limited liability of corporations with the tax aspects of partnerships.⁴⁸² In truth,

481. See *supra* notes 458-68 and accompanying text (discussing the effect of the 1986 Tax Reform Act on the taxation of MLPs).

482. For a discussion of this emerging organizational form, see generally Thomas Earl Geu, *Understanding the Limited Liability Company: A Basic Comparative Primer (Part One)*, 37 S.D. L. REV. 44 (1992). For other articles on LLCs, see Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*, 41 CASE W. RES. L. REV. 387 (1991); Susan Pace Hamill, *The Limited Liability Company: A Possible Choice for Doing Business?*, 41 FLA. L. REV. 721 (1989); Richard M. Horwood & Jeffrey A. Hechtman, *The Limited Liability Company: The New Kid in Town*, 20 J. CORP. TAX'N 334 (1994); James W. Lovely, *Agency Costs, Liquidity, and the Limited Liability Company as an Alternative to the Close Corporation*, 21 STETSON L. REV. 377 (1992); Marybeth Bosko, Note, *The Best of Both Worlds: The Limited Liability Company*, 54 OHIO ST. L.J. 175 (1993); Curtis J. Braukmann, Comment, *Limited Liability Companies*, 39 KAN. L. REV. 967 (1991); see also Kenneth L. Harris & Francis J. Wirtz, *Corporate Governance, Limited Liability Companies and the IRS's View of Centralized Management*, 71 TAXES 225 (1993); Michael Lux & Don Herskovitz, *Recent Developments in LLCs*, 25 TAX ADVISER 144 (1994); Lee A. Sheppard,

however, LLCs are purely the offspring of the resemblance test that the Kintner Regulations set forth.⁴⁸³ Although LLCs are formed via state enabling statutes, such statutes allow these entities to avoid at least two of the Kintner corporate characteristics and thereby avoid, association status.⁴⁸⁴ In 1977, Wyoming enacted the first LLC statute.⁴⁸⁵ The Wyoming statute served as the test statute for LLC classification purposes.⁴⁸⁶ Entities formed under the Wyoming statute lack the corporate characteristics

The Dark Side of Limited Liability Companies, 55 TAX NOTES 1441 (1992); Alan E. Weiner, *Considerations When Asking: To Be Or Not To Be An LLC?*, 24 TAX ADVISER 645 (1993); Bernard Wolfman, *Self-Help Integration (LLCs) or Otherwise*, 62 TAX NOTES 769 (1994).

483. For a complete discussion of the Kintner Regulations, see *supra* notes 286-315 and accompanying text.

484. See, e.g., ALA. CODE §§ 10-12-1 to -61 (Supp. 1994); ALASKA STAT. § 10.50.010 (1994); ARIZ. REV. STAT. ANN. §§ 29-601 to -857 (Supp. 1994); ARK. CODE ANN. §§ 4-32-101 to -1316 (Michie Supp. 1993); COLO. REV. STAT. ANN. §§ 7-80-101 to -1101 (West Supp. 1994); CONN. GEN. STAT. §§ 34-100 to -242; DEL. CODE ANN. tit. 6, §§ 18-101 to -1107 (Cum. Supp. 1992); FLA. STAT. ANN. §§ 608.401 to .514 (West 1994); GA. CODE ANN. §§ 14-11-100 to -1109 (1994); IDAHO CODE §§ 53-601 to -672 (1994); ILL. ANN. STAT. ch. 805, para. 180/1-1 to 180/60-1 (Smith-Hurd Supp. 1994); IND. CODE §§ 23-18-1-1 to -13-1 (1994); 1992 Iowa Acts No. 152 (to be codified at IOWA CODE ANN. § 490A.100 to .1519 (West 1993); KAN. STAT. ANN. §§ 17-7601 to -7651 (Cum. Supp. 1993); KY. REV. STAT. ANN. § 275.001 to .455 (Baldwin 1994); LA. REV. STAT. ANN. §§ 12:1301 to :1369 (West Supp. 1994); ME. REV. STAT. ANN. tit. 31, § 601 (West 1995); MD. CODE ANN., CORPS. & ASS'NS §§ 4A-101 to -1103 (Supp. 1994); MICH. COMP. LAWS ANN. §§ 450.4101 to .5200 (West 1994); MINN. STAT. §§ 322B.01 to .960 (Cum. Supp. 1994); MISS. CODE ANN. § 29-101 to -1204 (Cum. Supp. 1994); MO. ANN. STAT. §§ 347.010 to .187 (Vernon Supp. 1994); MONT. CODE ANN. §§ 35-8-101 to -1307 (1993); NEB. REV. STAT. §§ 21-2601 to -2645 (1993) (amended 1994); NEV. REV. STAT. ANN. §§ 86.010 to .571 (Michie 1994); N.H. REV. STAT. ANN. §§ 304-C:1 to :85 (1993); N.J. STAT. ANN. §§ 42:2B-1 to -70 (West 1994); N.M. STAT. ANN. §§ 53-19-1 to -74 (Michie 1993); N.Y. BUS. CORP. LAW. ch. 34 (McKinney 1994); N.C. GEN. STAT. §§ 57C-1-01 to -10-07 (1993); N.D. CENT. CODE §§ 10-32-01 to -155 (1993); OKLA. STAT. ANN. tit. 18, §§ 2000-2060 (West Cum. Supp. 1993); OR. REV. STAT. §§ 63.001 to .990 (1993); R.I. GEN. LAWS §§ 7-16-1 to -75 (1992); S.D. CODIFIED LAWS ANN. §§ 47-34-1 to -59 (1994); TENN. CODE ANN. §§ 48-201 to -248 (1994); TEX. REV. CIV. STAT. ANN. art. 1528n, §§ 1.10 to 11.07 (West Supp. 1995); UTAH CODE ANN. §§ 48-2b-102 to -158 (Cum. Supp. 1994); VA. CODE ANN. §§ 13.1-1000 to -1073 (Michie 1993); W. VA. CODE §§ 31-1A-1 to -69 (Cum. Supp. 1994); WIS. STAT. ANN. ch. 83 (West 1995); WYO. STAT. §§ 17-15-101 to -136 (1977). A recent search in the bill-tracking service on Westlaw indicated that state legislatures had enacted LLC legislation during 1994 in the following jurisdictions: Massachusetts, 1994 Mass. S.B. 72; Ohio, 1994 Ohio S.B. 74 (codified as amended in scattered sections of OHIO REV. CODE ANN. §§ 111, 1329, 1701-85, 3734, 4701-33, 5701-53 (Baldwin 1994)); South Carolina, 1993 S.C. H.B. 4283; and Washington, 1993 Wash. H.B. 1235. In Hawaii, the LLC bill passed the House and is being considered by the Senate.

Legislation also has been introduced in Alaska, California, Pennsylvania, and Vermont.

485. Wyoming Limited Liability Company Act, WYO. STAT. §§ 17-15-101 to -136 (1977). For a discussion of the Wyoming statute, see generally Hamill, *supra* note 482.

486. See *infra* note 520 and accompanying text.

of continuity of life and free transferability of interest.⁴⁸⁷ Continuity of life does not exist in a Wyoming LLC because the enabling statute includes language similar to the dissolution language of the UPA.⁴⁸⁸ Specifically, the statute provides that an LLC dissolves upon the earliest of: (1) the expiration of the period, up to thirty years, by which the LLC is required to dissolve; (2) the unanimous consent of the members to terminate; or (3) the death, retirement, resignation, insanity, bankruptcy, or expulsion of a member, unless all remaining members consent to continue the business of the LLC.⁴⁸⁹ As a result, the framers of the Wyoming statute had complete confidence that entities formed thereunder lacked continuity of life. The drafters took a similar approach with respect to free transferability of interests. Under the Kintner Regulations, a general partnership lacks this corporate characteristic because the UPA provides that no person can become a member of a general partnership without the consent of the other partners.⁴⁹⁰ Similarly, the Wyoming statute prohibits the assignee of a member's interest from becoming a full member with the right to participate in the governance of the LLC without the unanimous consent of its members.⁴⁹¹

A Wyoming LLC lacks both of these corporate characteristics, so it cannot be a corporation under the resemblance test, regardless of the existence of the other two characteristics.⁴⁹² Nevertheless, the framers of the Wyoming statute also provided the requisite flexibility to avoid centralization of management.⁴⁹³ The statute allows the members to appoint managers to run the business⁴⁹⁴ and therefore, depending on the substantiality of the manager's interest in the LLC, centralization of management may or may not exist.⁴⁹⁵ If, on the other hand, the members of the LLC

487. See WYO. STAT. §§ 17-15-122, -123 (1977).

488. Compare *id.* § 17-15-123 with UNIF. PARTNERSHIP ACT § 29 (1914).

489. WYO. STAT. § 17-15-107(a)(ii).

490. Compare Treas. Reg. § 301.7701-2(e) (1983) with UNIF. PARTNERSHIP ACT § 18(g) (1914). Any transfer without consent entitles the transferee to only the transferor's share of profits and losses. UNIF. PARTNERSHIP ACT § 27(1).

491. WYO. STAT. § 17-15-122.

492. Under the resemblance test, to qualify for association status, an entity must possess three out of the four corporate characteristics. For a detailed discussion of the resemblance test under the Kintner Regulations, see *supra* notes 276-309 and accompanying text.

493. WYO. STAT. § 17-15-116.

494. See *id.*

495. See *id.*; see also Treas. Reg. § 301.7701-2(c) (1983) (defining centralization of management). Revenue Procedure 89-12 provides that where the general partner in a limited partnership has an ownership interest of 20% or more, centralization of management will not exist. Rev. Proc. 89-12, 1989-1 C.B. 798. The IRS currently is analyzing whether a similar rule should apply in the LLC context. See *IRS Working to Resolve Conflicts Between Rules on LLCs, Partnerships, Official Says*, DAILY TAX REP. (BNA) at G-1 (Nov. 9, 1993).

decide not to appoint managers, the statute vests in the members the power to manage the LLC in proportion to their capital contributions, thus avoiding centralization of management.⁴⁹⁶ Therefore, the only characteristic that an LLC formed under the Wyoming statute always will possess is limited liability, which is the primary reason why this new innovation emerged.

The framers of the Wyoming statute provided the business world with an organizational form that is much easier to use than either the limited partnership or the S corporation for achieving the combination of pass-through treatment and limited liability.⁴⁹⁷ Although the S corporation provides the same level of limited liability as an LLC, the Code places severe restrictions on an S corporation's financial structure,⁴⁹⁸ as well as on the number and type of shareholders it may have.⁴⁹⁹ Moreover, because the LLC is taxed under Subchapter K, it provides members with more generous basis rules than those found in the Subchapter S corporation provisions.⁵⁰⁰ A limited partnership protects against liability only if a corporation serves as the general partner.⁵⁰¹ To achieve complete pass-through treatment, the corporate general partner must make an S election, which, as stated above, entails shareholder and capital structure lim-

496. See WYO. STAT. § 17-15-116.

497. For a discussion of choice of business form as a result of the emergence of the LLC, see S. Brian Farmer & Louis A. Mezzullo, *Limited Liability Company Act*, 25 U RICH. L. REV. 789, 821-28 (1991); Geu, *supra* note 482, at 472-89; Kalinka, *supra* note 7, at 1103-29; Edward J. Roche, Jr. et. al., *Limited Liability Companies Offer Pass-Through Benefits Without S Corp. Restrictions*, 74 J. TAX'N 248 (1991); Joseph C. Vitek, *Tax Aspects of Limited Liability Companies*, 27 CREIGHTON L. REV. 191, 206-13 (1993). See generally Alan S. Lederman, *Miami Device: The Florida Limited Liability Company*, 67 TAXES 339, 347-48 (1989); Larry E. Ribstein, *The Deregulation of Limited Liability and The Death of Partnership*, 70 WASH. U. L.Q. 417 (1992); Louis A. Mezzullo, *Limited Liability Companies: A New Business Form?*, TAX'N FOR LAWYERS, Mar./Apr. 1993, at 296, 298-302; Ronald P. Platner, *Limited Liability Companies Are Increasingly Popular*, TAX'N FOR LAWYERS, Jan./Feb. 1992, at 225, 230.

498. See I.R.C. § 1361(b)(1)(D) (1986) (limiting an S Corporation to one class of stock).

499. See *id.* § 1361(b)(1) (limiting the number of shareholders in an S corporation to 35 and not allowing corporations, partnerships, nonresident aliens, most trusts, pension plans or charitable organizations to serve as shareholders).

500. Under the Code, a partner's basis includes the partner's proportionate share of partnership liabilities, whereas a shareholder in an S corporation is not entitled to any basis increase for the liabilities of the corporation. Compare I.R.C. § 752 (1986) with *id.* §§ 358, 1367. As a result, LLC members have a greater ability to deduct losses than shareholders of an S corporation. In addition, section 754 allows LLCs to step up the basis of their assets upon sale of membership interests. *Id.* § 754.

501. See I.R.C. §§ 1361(b)(1)(B) & (C) (describing a corporation with a shareholder who is not an individual, such as a corporation or a nonresident alien, as ineligible to elect S corporation status).

itations.⁵⁰² Moreover, the corporate general partners must be capitalized sufficiently if the partners want to avoid limited liability under the Kintner Regulations.⁵⁰³ Finally, the limited partners must monitor their level of participation closely or they risk being relabeled as general partners.⁵⁰⁴

LLCs achieve these benefits without any apparent cost for avoiding the corporate form.⁵⁰⁵ For the closely-held business, continuity of life depends more upon the continued health of the employee-owners than on any statutory perpetual existence. Few small enterprises desire the supposed free transferability of corporate stock; indeed, the closely-held business owner uses buy-sell agreements and transfer restrictions as sound business planning, regardless of the organizational form chosen. Thus, the framers of the Wyoming enabling statute provided a remarkable new entity. They took the bold step of allowing the creation of business entities that would resemble non-publicly traded corporations in all ways, but which the IRS was seemingly powerless to treat as an association under the current test of corporate resemblance. Nevertheless, it was six years before any other state followed Wyoming's lead.⁵⁰⁶ Other states apparently were waiting to see how the Treasury Department would respond to Wyoming LLCs.

At first, the government responded in traditional fashion and attempted to amend the regulations to achieve its desired result. Repeating its mistakes of 1965 and 1977,⁵⁰⁷ the Treasury Department proposed an amendment designed specifically for LLCs.⁵⁰⁸ The proposed amendment, entitled "Classification of Limited Liability Companies," provided that the Service would classify any organization as an association "if

502. *Id.*

503. See Treas. Reg. § 301.7701-2(d)(2) (1983). In the case of a limited partnership, the Service will not provide a ruling unless the corporate partner has a net worth of at least 10% of the total contributions to the limited partnership. Rev. Proc. 89-12, 1989-1 C.B. 798.

504. See UNIF. LTD. PARTNERSHIP ACT § 303 (1985); see, e.g., Broffman v. Newman, 213 Cal. App. 3d. 252 (Cal. Ct. App. 1989); Mount Vernon Sav. & Loan Ass'n v. Partridge Assoc., 679 F. Supp. 522 (D. Md. 1987).

505. See generally Lovely, *supra* note 482 (discussing limited liability companies as alternatives to closely held corporations).

506. Florida was the next state to enact an LLC statute. See FLA. STAT. ANN. §§ 608.401 to .514 (West 1994).

507. See *supra* notes 322-31, 415-34 and accompanying text (discussing the Treasury Department's 1965 and 1977 amendments to the Kintner Regulations).

508. See Prop. Treas. Reg. § 301.7701-2, 45 Fed. Reg. 75,710 (1980) (proposed Nov. 17, 1980, later withdrawn). Prior to the release of this amendment, the Service issued a Private Letter Ruling that concluded that it would tax a particular Wyoming LLC as a partnership. See Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980). After the amendment's release, the Service issued another Private Letter Ruling that determined that a Wyoming LLC was a corporation. Priv. Ltr. Rul. 83-04-138 (Oct. 29, 1982).

under local law no member of the organization is personally liable for debts of the organization."⁵⁰⁹ Therefore, under the proposed amendment, as long as limited liability existed, the absence of other corporate characteristics was irrelevant.⁵¹⁰ The Service made it clear, however, that this approach applied only to LLCs, and that it would continue to examine all other business entities under the resemblance test.⁵¹¹ Of course, because only Wyoming had enacted an LLC enabling statute and very few entities had been formed,⁵¹² the release of the amendment had little effect. Then, in early 1983, the Treasury Department withdrew the proposed regulation, stating that it would conduct an extensive study of the role of limited liability in entity classification.⁵¹³ During that same year, the Treasury Department told Congress that MLPs should not be taxed as corporations because it did not believe that only one characteristic should determine an entity's classification.⁵¹⁴

The government was silent until 1988, when it published Revenue Ruling 88-76, which classified a Wyoming LLC as a partnership for federal

509. Prop. Treas. Reg. § 301.7701-2, 45 Fed. Reg. 75710 (1980) (proposed Nov. 17, 1980, later withdrawn). Sections 301.7701-2(a)(2),(3), & (g) described the characteristics of a corporation:

[2] *** However, such an organization will be classified as an association if under local law no member of the organization is personally liable for debts of the organization. For purposes of the preceding sentence, only liability arising solely from membership in the organization shall be taken into account; liability of a member as a guarantor on an obligation of the organization shall be disregarded.

[3] Except in the case of an organization none of whose members is personally liable under local law for the debts of the organization, an unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics. ***

....
[g] Examples. ***

Example [1]. Three individuals form an unincorporated business organization known under local law as a limited liability company. The organization has associates and an objective to carry on business and divide the resulting gains. The local law provides that no member of the organization shall be personally liable for any debt of the organization. The organization will be classified as an association for all purposes of the Internal Revenue Code.

Id.

510. See *id.* § 301.7701-2.

511. See *id.* § 301.7701-2(a)(3).

512. As of February 22, 1988, there were only 26 Wyoming LLCs. Joseph P. Fonfara & Corey R. McCool, Comment, *The Wyoming Limited Liability Company: A Viable Alternative to the S Corporation and the Limited Partnership?*, 23 LAND & WATER L. REV. 523, 531 (1988). The Wyoming statute had been in existence for more than a decade at that time, which indicates that the popularity of LLCs was quite limited until the IRS determined that they could be classified as partnerships. *Id.*

513. See Announcement 83-4, 1983-2 I.R.B. 31 (Jan. 10, 1983).

514. See *supra* notes 440-42 and accompanying text (discussing the Treasury Department's initial opposition to reclassifying MLPs).

income tax purposes.⁵¹⁵ One possible explanation for the dramatic turn-around is that the Service had decided that it did not want to risk judicial rebukes similar to *Kintner* and *Kurzner*.⁵¹⁶ The most likely reason is that the Treasury Department decided that the resolution of such issues was better left to Congress. Indeed, Congress only recently provided an indication of its willingness to deal with classification issues with its enactment of section 7704 in the prior year.⁵¹⁷ In any event, Revenue Ruling 88-76 was the blessing for which the states were waiting. Since then, states have rushed to provide their citizenry with this latest, tax-favored entity.⁵¹⁸ To date, forty-four states have passed LLC legislation and six others have similar bills pending.⁵¹⁹ Although these state statutes vary considerably from the original Wyoming statute, the central component of each is to allow for tax classification as a partnership.⁵²⁰ It also is significant to note that the Service has issued favorable rulings for LLCs

515. Rev. Rul. 88-76, 1988-2 C.B. 360. The ruling considered the classification of an LLC that owned and operated improved real property. *Id.* at 360. It had 25 members, three of whom were designated as the managers. *Id.* The ruling found that the organization possessed limited liability and centralized management, but lacked continuity of life and free transferability. *Id.* at 361.

516. See *supra* notes 332-34 and accompanying text (discussing the judiciary's rejection of the 1965 *Kintner* Regulations as arbitrary and discriminatory).

517. I.R.C. § 7704 (1986). For the text of Section 7704, see *supra* note 477.

518. Prior to Rev. Rul. 88-76, only one other state, Florida, enacted a LLC statute. See FLA. STAT. ANN. §§ 608.401 to .471 (West 1993).

519. For a complete listing of the state enabling statutes, see *supra* note 484.

520. These statutes can be divided into two types: (1) statutes that automatically qualify the LLC as a partnership for federal tax purposes such as those that state legislatures enacted in Colorado, Michigan, Nevada, South Dakota, Virginia, West Virginia, and Wyoming; and (2) the remainder of the states which provide the flexibility to form the LLC which qualifies as either a corporation or a partnership. For a complete listing of these statutes, see *supra* note 484.

created under the statutes of fifteen states⁵²¹ and is in the process of drafting guidance for achieving partnership status.⁵²²

The LLC, perhaps more than the professional corporation or the limited partnership, highlights the failure of the resemblance test. Practically speaking, there is no difference between a closely-held entity that is organized as an LLC and one that is organized as a corporation. As previously stated, the closely-held business owner is not enticed by the theoretical perpetual life of the corporation and is resistant to providing free transferability of interests in the enterprise. Although closely-held corporations do have the option of electing pass-through treatment under Subchapter S, it is not the optimum pass-through scheme. The only cur-

521. See Rev. Rul. 88-76, 1988-2 C.B. 360 (ruling that a Wyoming LLC is classified as a partnership for federal tax purposes because it has associates and an objective to carry on business and divide the gains therefrom but lacks a preponderance of the four remaining corporate characteristics); Rev. Rul. 93-5, 1993-1 C.B. 227 (ruling that the Virginia LLC is classified as a partnership for federal tax purposes because it has associates and an objective to carry on business and divide the gains therefrom but lacks a preponderance of the four remaining corporate characteristics); Rev. Rul. 93-6, 1993-1 C.B. 229 (ruling that a Colorado LLC is classified as a partnership for federal tax purposes since it has associates and an objective to carry on business and divide the gains therefrom but lacks a preponderance of the four remaining corporate characteristics); Rev. Rul. 93-30, 1993-1 C.B. 231 (ruling that a Nevada LLC may be taxed as partnership because it lacked a preponderance of corporate characteristics); Rev. Rul. 93-38, 1993-1 C.B. 233 (holding that, due to the flexibility of the statute, a Delaware LLC may be taxed as a partnership or a corporation depending on the provisions adopted); Rev. Rul. 93-49, 1993-2 C.B. 308 (holding that, due to the flexibility of the statute, an Illinois LLC may be taxed as a partnership or a corporation depending on provisions adopted); Rev. Rul. 93-50, 1993-2 C.B. 310 (ruling that a West Virginia LLC may be taxed as a partnership because it lacked a preponderance of corporate characteristics); Rev. Rul. 93-53, 1993-2 C.B. 312 (ruling that a Florida LLC may be taxed as partnership or corporation depending on the provisions adopted; this LLC was classified as a partnership for federal tax purposes); Rev. Rul. 93-81, 1993-2 C.B. 314 (holding that a Rhode Island LLC may be taxed as a partnership or a corporation depending on the provisions adopted); Rev. Rul. 93-91, 1993-2 C.B. 316 (ruling that a Utah LLC may be taxed as a partnership depending on the provisions adopted); Rev. Rul. 93-92, 1993-2 C.B. 318 (holding that an Oklahoma LLC may be taxed as a partnership or a corporation depending on the provisions adopted); Rev. Rul. 93-93, 1993-2 C.B. 321 (holding that an Arizona LLC may be taxed as a partnership or a corporation depending on the provisions adopted); Rev. Rul. 94-5, 1994-1 C.B. 312 (holding that a Louisiana LLC may be taxed as a partnership or a corporation depending on the provisions adopted); Rev. Rul. 94-6, 1994-1 C.B. 314 (holding that because of the flexibility in the Alabama LLC Act, an Alabama LLC may be classified as a partnership or as an association taxable as a corporation depending on the provisions adopted in the limited liability company's articles of organization or operating agreement); Rev. Rul. 94-30, 1994-1 C.B. 316 (ruling that because of the flexibility that the Kansas Limited Liability Company Act accords, a Kansas limited liability company may be classified as a partnership or as an association taxable as a corporation depending upon the provisions adopted in the limited liability company's articles of organization or operating agreement).

522. See Susan Pace Hamill, *IRS Counsel Offers Insight on LLC Issues*, LLC ADVISOR, June 1994, at 4 (comment of former attorney with the IRS Office of Chief Counsel regarding forthcoming Revenue Procedure addressing LLC classification).

rent drawbacks to the LLC are the unanswered questions as to whether other states will respect the limited liability of foreign LLCs and the resulting confusion from trying to apply traditional state law corporate and partnership doctrines to this unique form.

If the MLP caused the Treasury Department to fear ad hoc integration and posed a threat to the integrity of the corporate tax base, then what will become of the LLC? But for the repeal of the *General Utilities* doctrine,⁵²³ there no doubt would be a tremendous migration of entities from the corporate form to the LLC. Thus, the LLC magnifies the problem that the Treasury Department identified in the 1987 MLP hearings—unfairness to existing entities. Newly formed entities are free to elect pass-through treatment by adopting the LLC form, whereas a hefty toll tax prohibits existing entities from making a similar election. Consequently, although reincorporation does not threaten the corporate tax base, the threat of elections to not incorporate does exist. This unfairness is heightened by the fact that unlike MLPs, selecting the LLC form does not involve a cost to economic efficiency.⁵²⁴ Left unchanged, two very different tax regimes will govern entities with almost identical management and perhaps even similar financial structures. It is incumbent upon Congress, therefore, to return once again to the entity classification debate.⁵²⁵

IV. CONCLUSION

The Revenue Act of 1894 resulted in the first entity-level income tax to be applied on the basis of the form of the organization. This entity-level tax became a permanent part of the American tax landscape in the Revenue Act of 1909 as a result of political necessity, not of any theoretical calling. The 1909 Act and subsequent statutes imposed the tax on entities

523. See *supra* notes 462-63 and accompanying text (discussing the repeal of the *General Utilities* doctrine).

524. One can make an argument, however, that the dollar amount involved may not be as significant as one might expect due to the ability of the closely held business either to elect S Corporation treatment or to avoid a layer of tax by deducting payments to owners through the retention of earnings at the corporate level.

525. Congressman Charles Rangel, Chairman of the House Ways and Means Subcommittee on Select Revenue Measures, plans to hold hearings on LLCs and their role in reshaping entity classification. See *Use of Limited Liability Companies Seen Not Jeopardizing Corporate Tax Base*, 59 DAILY TAX REP. (BNA), at J1 (Mar. 30, 1993). As of this writing those hearings have not yet been scheduled. *Id.*; see also *Congress May Examine IRS' Position on LLCs in Future; Subchapter S Bill Gains Speed*, 72 DAILY TAX REP. (BNA), at G7 (Apr. 15, 1994) (statement of Steve Glaze, tax legislative aide to Sen. David H. Pryor (D. Ark.), to District of Columbia Bar, Section of Taxation: "It seems like [the] IRS has taken great liberty to do something that has [sic] very profound effect . . . [s]hould there be a significant revenue loss because of the IRS' decision, then Congress has to come in later.").

that state law identified as corporations and joint-stock companies. Although this classification was arbitrary and undoubtedly unfair, popular opinion made any justification unnecessary. In 1918, this simple method of classification ended, when Congress decided that the term “corporation” should have a distinct definition for federal tax purposes. The term no longer applied to just corporations organized under an enabling statute, it also applied to business entities called “associations”—a concept previously confined to the dictionary. Congress’ abandonment of the arbitrary, bright-line classification of the early statutes for a more refined concept, however, came with a price. A theoretical model for identifying these associations needed to be developed, and Congress left the task to the Treasury Department and the judiciary.

The model chosen was the resemblance test, and the underlying theory is that an entity can be identified as an association if it possesses certain characteristics that are inherent in the corporate form. Supported in 1935 by the Supreme Court in *Morrissey*, the resemblance test remains the methodology for entity classification today. However, it has not become cemented into the foundation of accepted tax doctrine. Indeed, given its history of inadequacy, it is remarkable that the resemblance test has survived. Even its principal author, the Treasury Department, never has grown comfortable with any of the resemblance test’s promulgated manifestations. The resemblance test has proven inadequate because its underlying assumption is that all corporations resemble each other and that other organizations resemble corporations. It identifies certain characteristics that, in theory, all corporations formed under state law possess: continuity of life, centralization of management, limited liability, and free transferability of interest. But while all corporations may resemble one another in a theoretical construct that limits itself to four narrowly defined characteristics, the test is relatively worthless when comparing organizations in the marketplace. A large corporation bears no more of a resemblance to a small corporation than a large partnership bears to a small partnership. Indeed, the small corporation has far more in common with an LLC or even a general partnership than with its publicly-traded counterpart. In fact, the only safe generalization to be made concerning entities in the marketplace is that they are all engaged in business for the purpose of making a profit.

The resemblance test asserts that one can distinguish a partnership from a corporation by examining the four “corporate characteristics.” Although these factors may be very useful pedagogically in explaining the concept of the pure corporation, they become objectionable in determining taxable status. Each time the resemblance test is applied in an effort

to attach corporate taxpayer status to the latest innovation in organizational forms, it invites corporations that do not resemble these innovations to question their position as separate taxpayers. Granted, because of their enabling statutes, all corporations possess the four characteristics that the Kintner Regulations define. However, when the theoretical definition is so divorced from the practical operation of the enterprise, one must question the efficacy of the inquiry. A small corporation is as likely to terminate upon the death, bankruptcy, or insanity of a shareholder as an LLC or partnership if such an event should befall a member or partner. Moreover, the owners of a small corporation are as determined to prevent outsiders from gaining a voice in their enterprise as any other owner of a closely-held business.⁵²⁶ Furthermore, centralized management is more relevant as a matter of entity size than of the organizational form chosen. Even the relevance of limited liability is questionable given the development of the LLC and the advancement of the limited partnership form.

These factors raise the question of whether the resemblance test should be abandoned in favor of an alternative classification scheme. There are many choices. The entity-level tax could be imposed based on a single characteristic, such as limited liability. Here again, however, one encounters the difficulty identified with the resemblance test. One would have to determine whether the test would be based on statutory limited liability or whether all of the facts and circumstances would have to be examined, such as personal guarantees, insurance, and perhaps even the nature of the business being conducted. Another alternative would be to tax only those entities whose shares were publicly traded. Section 7704 already provides a statutory construction to support this alternative.⁵²⁷ Taxation based upon liquidity of investment, however, would seem to contradict the goal of economic neutrality. A third possibility would be to divide entities into two groups: large and small. The difficulty with this approach is finding the appropriate yardstick—i.e., gross receipts, number of shareholders, number of employees, asset values, or some combination of these choices. One can only imagine the ingenuity with which lobbyists and tax practitioners would attack this whole cloth. Perhaps the first demand would be an exception for large entities involved in natural resource or real estate development. This argument was success-

526. Indeed, it is recommended practice for closely held corporations to limit the transferability of ownership interests through shareholder agreements.

527. See I.R.C. § 7704 (1986).

ful when Congress enacted section 7704.⁵²⁸ It is no wonder the resemblance test has survived.

One must marvel as to why a more satisfactory classification scheme has not emerged in one-hundred years of entity-level taxation. Perhaps the difficulty lies in the goal of entity classification. The current purpose of entity classification is to preserve the integrity of the entity-level tax. A century of classification history, however, reveals that each successive effort to amend the classification standards seemed to question rather than to preserve the integrity of the corporate tax. The resemblance test has failed not only because it is based on a theoretical construct that describes very few enterprises in the marketplace but also because it attempts to achieve an unattainable goal. Each successive attempt to refine the concept of the appropriate taxable entity questions the appropriateness of taxing any entity. Nevertheless, because Congress has been unable or unwilling to address this underlying issue of classification, the resemblance test has survived.

Recently, both the Treasury Department and the American Law Institute circulated proposals for achieving corporate integration.⁵²⁹ Both cited three reasons for eliminating the disparity between the taxation of income from corporate equity investments and income from other types of investments.⁵³⁰ They determined that integration was necessary because it would eliminate: (1) the tax disincentive to incorporate; (2) the tax-motivated preference for debt rather than equity; and (3) the incentive either to retain earnings or to distribute such earnings only in non-dividend transactions.⁵³¹ The continued inability of Congress and the Treasury Department to classify entities for tax purposes satisfactorily should be added to these reasons for change. The case for integration certainly is championed by over one hundred years of failed attempts to define a class of entities that deserve an additional layer of tax. Yet, even if the goal of achieving integration replaces the goal of preserving the integrity of the corporate tax, the need for classification will not necessarily end. Only two forms of integration would eliminate the need for en-

528. *See id.*

529. *See* TREASURY DEPARTMENT, A RECOMMENDATION FOR INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS (1992) [hereinafter TREASURY PROPOSAL]; ALVIN C. WARREN, JR., REP., AMER. LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES, REPORTER'S STUDY OF CORPORATE TAX INTEGRATION (1993) [hereinafter ALI PROPOSAL].

530. *See* TREASURY PROPOSAL, *supra* note 529, at 3-12; ALI PROPOSAL, *supra* note 529, at 21-40 (discussing the various defects in the current laws).

531. *See* TREASURY PROPOSAL, *supra* note 529, at 3-12; ALI PROPOSAL, *supra* note 529, at 21.

tity classification—the partnership model⁵³² and the Comprehensive Business Income Tax (CBIT).⁵³³ All other integration proposals would involve a plurality of tax regimes,⁵³⁴ making some form of classification necessary. Both the Treasury Department proposal and the ALI proposal, although achieving integration in radically different ways,⁵³⁵ would impose their methodology on all entities that the resemblance test currently identifies as corporations.⁵³⁶ The retention of the current resemblance test without any adjustment, however, will prevent many entities currently classified as corporations from using the partnership model. This will occur even though the partnership model is the ideal model from a tax policy standpoint and these entities are administratively capable of using it. If one could devise a method to give these corporations access to the partnership model, then the resemblance test could be left undisturbed. One possibility that recent classification history supports would be to allow greater use of pass-through MLPs or LLCs. If the partnership model is the preferred method, then corporations should be allowed to migrate to organizational forms that already provide such treatment. If existing corporations are allowed to reorganize as pass-through MLPs and LLCs, depending on which form is more suitable from a non-tax standpoint, the greatest number of entities possible will be ad-

532. The partnership model, also known as “full integration,” would treat the corporation as a conduit and allocate income to shareholders as earned. It is regarded as the ideal integration method from a tax equity standpoint, although it is identified as the most difficult method administratively. See RICHARD GOODE, *THE CORPORATION INCOME TAX* 182-86 (1951); JOSEPH A. PECHMAN, *FEDERAL TAX POLICY* 186 (5th ed. 1987); CHARLES E. MCLURE, JR., *MUST CORPORATE INCOME BE TAXED TWICE?* 154-60 (1979); STEPHEN G. UTZ, *TAX POLICY* 186-87 (1993); George K. Yin, *Corporate Tax Integration and the Search for the Pragmatic Ideal*, 47 *TAX L. REV.* 431, 433-34 (1992).

533. The CBIT would impose a layer of tax at the entity level, whether conducted in corporate or partnership form, but would eliminate any tax at the owner level; it is regarded as one of the easiest methods of integration to administer, but is unlikely to have any political support for some time. See *TREASURY PROPOSAL*, *supra* note 529, at 39-60; UTZ, *supra* note 532, at 193-94; Richard Goode, *Integration of Corporate and Individual Taxes: A Treasury Report*, 56 *TAX NOTES* 1667 (1992).

534. For a thorough discussion of integration and the variety of available methods, see generally *Colloquium on Corporate Integration*, *supra* note 6, at 427.

535. The Treasury Department has formally recommended the dividend exclusion model for implementing integration. See *TREASURY PROPOSAL*, *supra* note 529, at 15-27. Under this model, corporate income is taxed on the entity level, but shareholders generally would be allowed to exclude such dividends from their income. *Id.* For a discussion of the dividend exclusion model, see Yin, *supra* note 531, at 449-68, 505-08. The ALI Proposal recommends a Corporate Withholding/Shareholder Credit Model. ALI PROPOSAL, *supra* note 529, at 92-113. Under this model, a form of withholding tax would be imposed at the corporate level and when the shareholders included dividend distributions in income, they would receive a credit for tax withheld at the corporate level. *Id.*

536. See *TREASURY PROPOSAL*, *supra* note 529, at 3-12; ALI PROPOSAL, *supra* note 529, at 21-40.

ministered under the partnership model, with the remaining entities subject to whatever less satisfactory model they selected. This approach would allow Congress to avoid the dual search for integration methods and alternative classification schemes.

Any discussion of classification in an integrated world, however, will continue to be postponed until Congress decides to confront the underlying reason for the failure of classification in a non-integrated world. The growth in LLCs presents Congress with another opportunity to address this issue. Congress can ignore the situation and continue to treat LLCs as partnerships, thus penalizing small entities for coming into existence before a fully-integrated organizational form that met all of their needs was available. It can adopt a section 7704-type remedy and classify LLCs as corporations, despite their classification as partnerships under the resemblance test, which likely will result in the immediate extinction of the LLC, much like its joint-stock association predecessor. Or Congress can decide that the time has come to abandon the idea that the corporate tax base has any integrity and instead adopt integration as an attainable goal for entity classification. The classification train has reached the policy junction once again. This time its passenger is the LLC. Congress can go down the track of protecting revenue and an insupportable tax base which, as usual, will provide a round trip back to the policy junction. Or it can go down the track toward integration, no return trip necessary. It is time for Congress to pull the switch.

