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Enforcing the Fundamental Premises of Partnership Taxation

Rebecca S. Rudnick

Indiana University School of Law - Bloomington

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ENFORCING THE FUNDAMENTAL PREMISES OF PARTNERSHIP TAXATION

*Rebecca S. Rudnick**

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* Visiting Associate Professor of Law, Boston University School of Law. B.A. 1974, Willamette University; J.D. 1978, University of Texas; LL.M. 1984, New York University. An earlier version of this Article was presented at the George Mason School of Law, Law and Economics Workshop, in November 1991. I thank Robert Anthoine, Evelyn Brody, Jennifer J.S. Brooks, Glenn E. Coven, Susan Pace Hamill, Sherwin Kamin, Kellye Y. Testy, and Stephen G. Utz for comments on an earlier draft. I thank my family in the San Joaquin Valley of California for impressing upon me the utility and benefits of partnerships. I also thank Carl S. Shoup, who suggested to me the importance of thinking about how the income tax system deals with losses. The errors in translation of the general to the particular are, of course, my own. A number of research assistants have helped me with my "partnership tax project" over the years: Mike Schraeder, Lester Law, Van Zimmerman, Tracy Curtner, Valerie Gulick, Connie Lee, and Deborah Friendly. I especially thank John Ferguson. Copyright ©, 1993, Rebecca S. Rudnick.

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I. INTRODUCTION

Federal taxation of partnerships is under intense reexamination. Embodied since 1954 in Subchapter K of the Internal Revenue Code (the "Code"), the flexible partnership taxation rules¹ preserve the tension between aggregate and entity theories of the partnership form.² Since the first income tax law in 1913, partnership rules have allowed great flexibility in allocating tax events among partners.³ The four major premises of Subchapter K state that (1) contributions of property to the partnership are nonrecognition events for gains and losses;⁴ (2) distributions of property are nonrecognition events,⁵ although they are subject to special rules if occurring within five years of contribution of the property and recent proposals may limit nonrecognition for distributions of marketable securities;⁶ (3) human capital

1. The 1954 revision that adopted Subchapter K to provide clarity and certainty to the prior uncertain rules of partnership taxation enacted partnership rules that provide great flexibility in allocating the tax burden of partnership transactions. *See* H.R. REP. NO. 1337, 83d Cong., 2d Sess. 65 (1954) (goal of "simplicity, flexibility, and equity as between the partners"); S. REP. NO. 1622, 83d Cong., 2d Sess. 89 (1954) (same); *see also Forty Topics Pertaining to the General Revision of the Internal Revenue Code: Hearings Before the House Comm. on Ways and Means*, 83d Cong., 1st Sess. 1368, 1369-70 (1953) [hereinafter 1953 *House Hearings*] (statement of Mark H. Johnson).

2. "Aggregate" describes an organization which does not subsume the individual characteristics of the owners; the organization is a conduit through which each owner acts. *See* BLACK'S LAW DICTIONARY 65 (6th ed. 1990). In *Commissioner v. Lehman*, 165 F.2d 383 (2d Cir. 1948), Judge Learned Hand noted that "it was upon this traditional structure that Congress fitted the taxation of partnerships, although it levied the income tax upon the separate distributive shares of the partners, whether they were distributed or not." *Lehman*, 165 F.2d at 385; *see also* *Neuberger v. Commissioner*, 311 U.S. 83, 88 (1940). In contrast, "entity" describes an organization in which the organization's characteristics subsume the owners' individual characteristics. *See Lehman*, 165 F.2d at 385. Various results obtain when applying "aggregate" or "entity" principles and there is no consensus on what "aggregate" means.

3. *See* 1953 *House Hearings*, *supra* note 1, at 1369 (noting that "clarity and certainty" are more important than the end result).

4. *See* I.R.C. §§ 707(a)(2)(B), 721-23 (1988); Treas. Reg. § 1.707-3 (1993). An exception to prevent tax-free diversification of financial assets exists for gain realized on a transfer to certain investment partnerships whose value consists of more than 80 percent in readily marketable stock, securities, and traded investments. *See* I.R.C. § 721(b) (1988). Income, gains, losses and deductions with respect to contributed property is allocated among the partners to take into account the variation between the basis of the property to the partnership and its fair market value at the time of contribution. *See* I.R.C. § 704(c) (Supp. 1992).

5. *See* I.R.C. §§ 731-33 (1988). The exception to nonrecognition and the explicit exchange treatment for disproportionate distributions that shift ordinary income and capital gain between partners operates as an in terrorem provision to shape the form of distributions. *See* I.R.C. § 751(b) (1988).

6. For property contributed after October 3, 1989, the contributing partner must recog-

providers are not taxed on the receipt of interests in profits if they are of merely speculative value, a standard further refined by the Internal Revenue Service (the "Service");⁷ and (4) partners are allowed to make special allocations having substantial economic effect.⁸

Many experts challenge these fundamental premises of current partnership taxation.⁹ Reformers would tax distributions¹⁰ and most contributions,¹¹ abandon special allocations,¹² and fundamentally revise the rules governing taxation of service partners and the partnership on service contributions.¹³ Some reformers argue that special partnership tax rules are an aberration from the norms of the structural tax choices of corporations.¹⁴ Others conceptualize the partnership as an association of individuals operating under a traditional contract.¹⁵ Contributions and distributions become sales, and the respec-

nize gain or loss if the property is distributed to another partner within five years of contribution, I.R.C. § 704(c) (Supp. 1992), or if other property is distributed to the contributor within five years, I.R.C. § 737 (Supp. 1992). See Juliann Avakian-Martin, *Official Outlines IRS Thinking on Forthcoming Partnership Regs.*, 59 TAX NOTES 852, 852 (1993). For proposed legislation on marketable securities' distribution, see *infra* note 568.

7. See *infra* notes 501-16 and accompanying text.

8. Cf. I.R.C. § 704(b) (1988). Regulations prevent allocations that shift tax items without affecting the partners' economics. See *infra* notes 614-28 and accompanying text.

9. See Deborah H. Schenk, *Foreword to Colloquium on Partnership Taxation*, 47 TAX L. REV. 1 (1991).

10. See, e.g., Mark P. Gergen, *Reforming Subchapter K: Contributions and Distributions*, 47 TAX L. REV. 173, 175 (1991); 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, 476 (1986). But see John P. Steines, Jr., *Commentary: Unneeded Reform*, 47 TAX L. REV. 239 (1991).

11. See, e.g., Gergen, *supra* note 10, at 175; David R. Keyser, *A Theory of Nonrecognition Under an Income Tax: The Case of Partnership Formation*, 5 AM. J. TAX POL'Y 269 (1986); Postlewaite et al., *supra* note 10, at 476.

12. See, e.g., Curtis J. Berger, *W(h)ither Partnership Taxation?*, 47 TAX L. REV. 105, 126-46 (1991); Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1 (1990).

13. See, e.g., W. Lesse Castleberry, *Commentary: Campbell—A Simpler Solution*, 47 TAX L. REV. 277 (1991); Laura E. Cunningham, *Taxing Partnership Interests Exchanged for Services*, 47 TAX L. REV. 247 (1991); Mark P. Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 TAX L. REV. 69 (1992) [hereinafter Gergen, *Service Partners*]; Mark P. Gergen, *Pooling or Exchange: The Taxation of Joint Ventures Between Labor and Capital*, 44 TAX L. REV. 519 (1989).

14. See, e.g., Berger, *supra* note 12, at 110-18; William S. McKee, *Partnership Allocations: The Need for an Entity Approach*, 66 VA. L. REV. 1039, 1057-59 & n.85 (1980); David Westfall, *Corporate Analogues in Partnership Taxation*, 80 HARV. L. REV. 765, 796 (1967) (calling for the broader application of corporate tax concepts to partnerships). But see Richard B. Stone, *Back to Fundamentals: Another Version of the Stock Dividend Saga*, 79 COLUM. L. REV. 898, 917-22 (1979) (supporting nonrecognition rules).

15. See Sherwin Kamin, *Partners Dealing with Each Other Through Partnerships*, 46TH

tive merits of aggregate and entity theory are ignored.¹⁶ Other suggested reforms are not as sweeping,¹⁷ while some are consistent with the status quo.¹⁸

The purpose of this Article is to defend the core of the present partnership regime.¹⁹ That core is built on the flexibility principle of a no-tax world.²⁰ Flexibility is important because of the various ex-

ANN. FED. TAX INST. 27-1, 27-1 to 27-3 (1988). Kamin states that "[a] partner's income is really the sum of compensation for his services, a return on his capital, and his share of the entrepreneurial profit." *Id.* at 27-2.

16. See *infra* notes 69-76, 524-35 and accompanying text.

17. See, e.g., William D. Andrews, *Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 TAX L. REV. 3 (1991) (proposing reform by mandating § 734(b) adjustments, amending §§ 732, 751 and 755, and limiting nonrecognition on some distributions); Noel B. Cunningham, *Commentary: Needed Reform: Tending the Sick Rose*, 47 TAX L. REV. 77 (1991).

18. See, e.g., John P. Steines, Jr., *Partnership Allocations of Built-In Gain or Loss*, 45 TAX L. REV. 615, 670-71 (1990) ("modest stop valves" make more sense in Subchapter K than does a "transplant" in order to keep flexibility for nonabusive transactions).

19. I do not deal in this Article with the manner in which partners share basis on recourse and nonrecourse debt, a subject that has been much discussed elsewhere. See, e.g., Howard E. Abrams, *Long-Awaited Regulations Under Section 752 Provide Wrong Answers*, 44 TAX L. REV. 627 (1989); Mark P. Gergen, *Disproportionate Loss Allocations*, 48 TAX NOTES 1051 (1990); Stephen G. Utz, *A Comment on Disproportionate Loss Allocations and Other Matters*, 49 TAX NOTES 1025 (1990); Stephen G. Utz, *Partnership Taxation in Transition: Of Form, Substance, and Economic Risk*, 43 TAX LAW. 693 (1990) [hereinafter Utz, *Partnership Taxation*]. Partnership taxation applies an aggregate theory to the liabilities of the firm. See I.R.C. § 752 (1988). The extreme example of this is a liability not secured by any specific assets which is recourse to the entity's assets but is treated as a nonrecourse liability if no partner assumes recourse liability, guarantees the debt, or is the lender. See Treas. Reg. § 1.752-2(a)-(d) (1991). Allocations of loss attributable to such liabilities, as distinguished from nonrecourse liabilities secured by particular partnership assets, are undergoing further study. See Treas. Reg. § 1.704-2 (1991) (preamble). This is in contrast to the treatment of corporate liabilities. See Calvin H. Johnson, *The Legitimacy of Basis from a Corporation's Own Stock*, 9 AM. J. TAX POL'Y 155, 155 (1991). For another view of corporate basis, see Jasper L. Cummings, Jr., *The Silent Policies of Conservation and Cloning of Tax Basis and Their Corporate Applications*, 48 TAX L. REV. 113 (1992). Many have wrestled with the manner in which partnership liabilities should be shared. See, e.g., *Issues Relating to Passthrough Entities: Hearings Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 99th Cong., 2d Sess. (1986); Philip F. Postlewaite & Tammy Jo Bialosky, *Liabilities in the Partnership Context - Policy Concerns and the Forthcoming Regulations*, 33 UCLA L. REV. 733, 848-49 (1986) (proposing a three-tier system for allocation purposes).

Increased attention to partnership taxation is reflected in treatises and student study guides. See CARTER G. BISHOP & JENNIFER J. S. BROOKS, *FEDERAL PARTNERSHIP TAXATION* (1990); KAREN C. BURKE, *FEDERAL INCOME TAXATION OF PARTNERS AND PARTNERSHIPS IN A NUTSHELL* (1992); ALAN GUNN, *FEDERAL PARTNERSHIP TAXATION* (1990); WILLIAM S. MCKEE ET AL., *FEDERAL INCOME TAXATION OF PARTNERS AND PARTNERSHIPS* (2d ed. 1990); ARTHUR WILLIS ET AL., *PARTNERSHIP TAXATION* (4th ed. 1989).

20. See *infra* notes 201-40 and accompanying text.

pectations that the parties bring to their affairs in less than perfect markets.²¹ Only with the current flexible system will risky marginal investments be made. If we have reason to believe in the net productivity of investment,²² and the correlation between risk and reward, then we should care about retaining the flexibility in Subchapter K. When partnership investment increases wealth which is taxed as income, both the partners and the government benefit. Some commentators doubt that changes to Subchapter K would limit partnership formation.²³ The crucial question is whether limits should be placed on the advantages of flexibility at all. Flexibility in decision making counteracts the effect of uncertainty,²⁴ and allows for the exercise of options.²⁵ Risk arising from the immobility of invested resources highlights the value of flexibility in allowing shared contributions and conditional, enforceable contractual mechanisms to bear risk. In this way, flexibility results in greater systemic efficiency.²⁶

To make a literary analogy, Subchapter K accomplishes a useful "met-him-pike-hoses" within the context of an income taxation system by allowing partners to allocate partnership tax attributes according to their fine-tuned ideas of ideal risk and reward bearing within the group of partners. The term "met-him-pike-hoses" is the Joycean pun on metempsychosis, or the transmigration of the soul, which appears in the pre-1961 edition of *Ulysses* as the pronunciation that Molly Bloom gives to the word metempsychosis. See JAMES JOYCE, *ULYSSES* 67 (1952); see also STUART GILBERT, JAMES JOYCE'S *ULYSSES*: A STUDY BY STUART GILBERT 43-50 (2d ed. 1932); 3 JAMES JOYCE, *ULYSSES*: A CRITICAL AND SYNOPTIC EDITION 1732 (Hans W. Gabler et al. eds., 1984).

21. See *infra* notes 231-40 and accompanying text.

22. See generally ARMEN ALCHIAN & WILLIAM R. ALLEN, *EXCHANGE & PRODUCTION: COMPETITION, COORDINATION AND CONTROL* 147-49 (2d ed. 1977) (the increase in future income created by current investment transforms an invested resource into a form which will be more highly valued than at the time of investment, and increases social welfare and productivity in the long run).

23. See, e.g., Berger, *supra* note 12, at 171 ("[T]he ability to custom design the transaction . . . often makes the partnership the vehicle of first choice. This attraction should readily survive any limits on the tax advantages which partnerships have historically enjoyed."); see also Robert W. Hillman, *Private Ordering Within Partnerships*, 41 U. MIAMI L. REV. 425 (1987) (criticizing the existing nontax rules governing flexible bargaining by partners and discussing concerns to be addressed in revision of the Uniform Partnership Act).

24. See JACK HIRSHLEIFER & JOHN G. RILEY, *THE ANALYTICS OF UNCERTAINTY AND INFORMATION* 7-11 (1992); Ronald E. Shrieves, *Uncertainty, the Theory of Production, and Optimal Operating Leverage*, 47 S. ECON. J. 690, 691 (1981).

25. One individual might value flexibility because adapting choices to the information received permits a more certain pecuniary reward. Another might value flexibility because it enables a more informed, higher risk choice to be made at the last moment. See Robert A. Jones & Joseph M. Ostroy, *Flexibility and Uncertainty*, 51 REV. ECON. STUD. 13, 14 (1984). One example of flexibility is liquidity. See *id.* at 21-23. Liquidity also may lead to a tendency to substitute short-run speculative valuation for an objective analysis of expected long-run revenues. See Michael Carter, *Uncertainty, Liquidity and Speculation: A Keynesian Perspective on Financial Innovation in the Debt Markets*, 14 J. POST KEYNESIAN ECON. 169 (1991-92).

26. See, e.g., Anat R. Admati & Motty Perry, *Joint Projects Without Commitment*, 58

Subchapter K provides nonrecognition treatment for property contributed or received in exchange for a partnership interest. Service partners may agree to contribute services in exchange for distributive shares of partnership income, which are taxed no earlier than the time income is accrued or received.²⁷ While partners must agree specifically to in-kind distributions of partnership property,²⁸ favorable tax rules make in-kind distributions desirable.²⁹ Partners can effect profit-maximizing³⁰ allocations in ways that incur substantial economic risk.³¹ Although Subchapter K needs to be improved, it should not be completely undermined by heavy-handed revision.³²

The tax law should recognize that a partnership is a pooling whereby contributors bring different expectations with respect to sources, security, and time preference for economic and tax-significant items. These closely held businesses need flexibility which administrative and other constraints inhibit. Collaboration may lead to the inability to distinguish the sources of the profits and losses to the firm.³³ Thus, the tax system should accommodate natural business

REV. ECON. STUD. 259, 261, 269-70 (1991) (arguing that if an enforceable conditional commitment to future contributions arising at the time certain levels of production are reached, exists, then efficient funding of socially desirable projects results); Jones & Ostroy, *supra* note 25, at 26-27.

27. See *infra* notes 499-513 and accompanying text.

28. The current Uniform Partnership Act provides that "[a] partner has no right to receive, and may not be required to accept, a distribution in kind." UNIF. PARTNERSHIP ACT § 402 (1993), 6 U.L.A. 252 (Supp. 1994).

29. See I.R.C. §§ 731-733 (1988 & Supp. 1992).

30. This is referred to as a Pareto optimal state. See RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 90-94 (5th ed. 1989). Pareto optimality is defined by the concept of Pareto superiority, which distinguishes one economic state from another on the basis of individual well-being. A given state X is Pareto superior to a given state Y if at least one more individual in X is better off than in Y but in which no individual is less well off. Pareto optimality is defined as a state in which there exists no Pareto superior state. See JOSEPH E. STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR 60-61 (2d ed. 1988). An alternative, game theory, definition regards a given outcome as Pareto optimal if there is no other possible agreement that enables both players to do better simultaneously. ERIC RASMUSEN, GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY 230 (1991).

31. See, e.g., I.R.C. § 704(b) (1988) (governing allocations that merely shift tax items without affecting the partners' economics). See also *infra* notes 66-67, 595-628 and accompanying text.

32. Irregularities in Subchapter K have been well identified in the literature. See *infra* note 675 and accompanying text.

33. The problem of differentiating returns drove Nicholas Kaldor to prefer a consumption tax to an income tax. See NICHOLAS KALDOR, AN EXPENDITURE TAX 54-78 (1955). Classical economics found the rate of interest to be related to the rate of profits. See DAVID RICARDO, THE PRINCIPLES OF POLITICAL ECONOMY AND TAXATION 197-200 (1817, 1911 ed.).

and investment formation³⁴ of partnerships throughout the world,³⁵ and must have a unifying concept of how to tax partnerships.³⁶

The taxation of publicly traded partnerships as associations³⁷ and the debate over the integration of corporate and shareholder taxes reflect this conceptual uncertainty.³⁸ Partnership rules,³⁹ as distinguished from rules for corporations⁴⁰ and proposed rules on widely held partnerships,⁴¹ do not typically deal with the taxation of so-

34. That is, the difficulty of the choices faced by business in general should not be exaggerated for small firms. See *infra* notes 50-53 and accompanying text.

35. See A.H.M. DANIELS, ISSUES IN INTERNATIONAL PARTNERSHIP TAXATION (1991) (comparing systems of partnership taxation in the United States, Germany, and the Netherlands); CAHIERS DE DROIT FISCAL INTERNATIONAL: PARTNERSHIPS AND JOINT VENTURES IN INTERNATIONAL TAX LAW (1974). One model tax system proposed for developing economies may tax all but simple pass-throughs including partnerships as entities. See WARD M. HUSSEY & DONALD C. LUBICK, BASIC WORLD TAX CODE AND COMMENTARY 36-37, 75-76 (1992) (pass-through treatment limited to organizations in which each owner's proportional share of each item of capital, income, and loss is the same as the owner's proportional share of all other such items).

36. Consider the corporate joint venture among three publicly traded corporations. A dividends-received deduction is a mechanism to relieve double taxation of income, and the flow-through of income to a parent corporation with losses is not possible absent the concept of a conduit. Sophisticated classes of stock could mimic temporal and item allocations. The partnership conduit accomplishes all of these goals in an efficient manner, including a single level of tax on the businesses' income and nonrecognition on transfers of assets.

37. See Tax Simplification Act of 1991, H.R. 2777, 102d Cong., 1st Sess. § 201 (1991); H.R. 11, 102d Cong., 2d Sess. §§ 4301-4305 (1992).

38. A theoretically correct view of the taxation of partnerships has ramifications for the taxation of other business entities under a pure pass-through model and in the proposed integration models for the corporate income tax. See DEP'T OF THE TREASURY, REPORT ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE ch. 4 (Jan. 1992) [hereinafter INTEGRATION REPORT]; Anne L. Alstott & James B. Mackie, *Approaches to Corporate Integration: The Treasury Department Report*, 45 NAT'L TAX J. 209 (1992).

39. Publicly traded partnerships are taxed as corporations. See I.R.C. § 7704 (1988). An exception to this rule in firms operating businesses, exists for publicly traded partnerships with "qualifying" income conducting specified investment or real estate activities. See STEPHEN L. NELSON & JOHN A. MARTENS, MASTER LIMITED PARTNERSHIPS: A VIEW FROM THEIR 1986 TAX RETURNS (Department of Treasury Office of Tax Analysis Working Paper No. 63, 1989) (on file with author) (overview of the income in master limited partnerships); Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RES. L. REV. 965, 1148-55 (1989). Consequently, the impact of the partnership rules is not upon the taxation of liquid financial investments of detached owners, as is the case with publicly traded partnerships and corporations.

40. For example, contribution of property to a corporation is a realization and recognition event unless certain control requirements are met. See I.R.C. § 351(a) (Supp 1992). In addition, exit transactions in property are taxable events for the corporation and its shareholders. See I.R.C. §§ 311, 336 (1988). These events are characterized as either a dividend, a return of capital, a gain in excess of the basis in the stock, or an outright sale of stock. See I.R.C. §§ 301, 302 (1988).

41. See H.R. 13, 103d Cong., 1st Sess. § 4301 (1993) (proposal to add § 774, which

called "liquid financial equity investments" held by detached owners, although they do deal with the taxation of liquid financial investments in investment partnerships investing in stocks and bonds for their own accounts.⁴² Partnership rules typically address owners who send start-up capital to entrepreneurial enterprises,⁴³ make capital investment in large partnership firms,⁴⁴ or invest in real estate, finance, or insurance, as data for the 1990 tax filing season indicates.⁴⁵

would mandate the deferred sale approach and the elimination of ceiling rule distortions for large partnerships).

42. See Rudnick, *supra* note 39, at 1097-98.

43. Of course, there are reasons to seek financial support through the public markets. See, e.g., Claudia H. Deutsch, *The Efficiencies of Going Public*, N.Y. TIMES, Sept. 22, 1991, at F25 (discussing management efficiencies and raising cash as reasons to go public).

44. See, e.g., Jon Friedman, *How Playing the Tortoise Paid off for Goldman Sachs*, BUS. WK., May 7, 1990, at 130; Diana Henriques, *Yen to Grow: Goldman Sachs's New Japanese Connection*, BARRON'S, Aug. 11, 1986, at 26 ("With Sumitomo's capital and Goldman's savvy, it is a match made in heaven."); Herbert Swartz, *Goldman Sachs Gets \$225 Million As an Investment From 7 Insurers*, WALL ST. J., Mar. 30, 1989, at C1 (investment structured in the partnership like preferred stock). In societies where interest cannot be charged or paid, capital is provided through profit shares in partnership arrangements. See *Banking Behind the Veil*, ECONOMIST, Apr. 4, 1992, at 49 (Islamic law does not allow interest and partnerships are used to provide the needed capital).

45. In 1990 there were 1.55 million partnerships (of which 286,000 were limited partnerships) with a net income of \$16.6 billion. This was an 18 percent increase over 1989 and continued the trend from the prior year of increasing net income in partnerships. Elaina Shekhter, *Partnerships*, (1990), 12 SOI BULLETIN (Internal Revenue Service, Washington, D.C.), Summer 1992, at 25. The data is in thousands. For all industries there were total assets of \$1,685,223,450 of which \$919,387,895 were in limited partnerships and \$765,835,555 were in general partnerships. *Id.* at 29 (Figure F). The total assets for limited and general partners by selected industries for 1990 (in thousands of dollars) is revealing. In agriculture, forestry and fishing, \$9,165,402 of total assets of \$27,580,013 were in limited partnerships and \$18,414,611 in general partnerships. In mining, \$27,675,587 of \$58,246,016 total assets were in limited partnerships and \$30,570,429 in general partnerships. In construction, \$5,756,040 of total assets of \$17,989,156 were in limited partnerships and \$12,233,116 in general partnerships. In manufacturing, \$22,604,637 of total assets of \$59,789,377 were in limited partnerships and \$37,184,740 in general partnerships. In transportation and public utilities, \$38,988,122 of total assets of \$63,333,737 were in limited partnerships and \$24,345,625 in general partnerships. In wholesale and retail trade, \$10,653,924 of total assets of \$28,422,527 were in limited partnerships and \$17,768,603 in general partnerships. In finance insurance and real estate, \$725,228,199 of total assets of \$1,279,390,201 were in limited partnerships and \$554,162,002 in general partnerships. In real estate, \$490,614,087 of total assets of \$927,458,685 were in limited partnerships and \$436,844,598 in general partnerships. For operators and lessors of buildings, \$399,236,739 of total assets of \$743,140,570 were in limited partnerships and \$343,903,831 in general partnerships. In services, \$79,207,779 of total assets of \$150,062,785 were in limited partnerships and \$70,855,006 in general partnerships. *Id.* Partnerships in services and in finance, insurance and real estate accounted for approximately 75 percent of total partnership net income and 80 percent of the net deficit and almost 69 percent of partnerships in industrial division were operators and lessors of buildings. *Id.* at 25. The number of partnerships in this industry group declined 5 percent from 590,000

Retaining Subchapter K's flexibility is important given the current tax system's biases regarding the choice of the appropriate business entity for activities and assets,⁴⁶ the emergence of limited liability companies premised on partnership tax rules⁴⁷ (which some predict may eclipse partnerships),⁴⁸ and the limitations and distortions in the pass-through taxation regime of Subchapter S corporations.⁴⁹ His-

for 1989 to 564,000 for 1990. *Id.* These partnerships accounted for 36 percent of all partnerships but reported only 19 percent of total net income and 48 percent of total net deficit. *Id.* at 26. Mining partnerships were approximately 3 percent of the total partnership number, and approximately 77 percent of the partners are individuals and 12 percent were corporations. *Id.* at 27-28. In mining, corporate general partners received the largest distribution with the second largest distribution to other partnerships that were also limited partners. *Id.* at 28.

46. The changes in the tax law in 1986 caused a perceptible shift in business organization form strategy, with taxpayers shifting income to pass-through entities and retaining losses, where possible, in corporate, double-taxed entities. See ROGER H. GORDON & JEFFREY MACKIE-MASON, EFFECTS OF THE TAX REFORM ACT OF 1986 ON CORPORATE FINANCIAL POLICY AND ORGANIZATIONAL FORM 28-32 (National Bureau of Economic Research Working Paper No. 3222, 1990). The 1993 rate changes counter this trend to a certain extent. See generally Rosanne Altshuler & Alan J. Auerbach, *The Significance of Tax Law Asymmetries: An Empirical Investigation*, 105 Q.J. ECON. 61 (1990); Michael Bradlee & E. Han Kim, *On the Existence of an Optimal Capital Structure: Theory and Evidence*, 39 J. FIN. 857 (1984).

47. See Susan Pace Hamill, *The Limited Liability Company: A Possible Choice for Doing Business?*, 41 FLA. L. REV. 721 (1989); Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375 (1992); see also Jerome Kurtz, *The Limited Liability Company and the Future of Business Taxation, A Comment on Professor Berger's Plan*, 47 TAX L. REV. 815 (1992). But see Susan Kalinka, *The Limited Liability Company and Subchapter S: Classification Issues Revisited*, 60 U. CIN. L. REV. 1083 (1992) (arguing that limited liability companies resemble S corporations more closely than corporations and should be taxed accordingly).

48. See J. Andrew Hoerner, *ABA Tax Section: Integration Through the Back Door: Expanded Passthroughs Gain Support*, 54 TAX NOTES 930 (1992); Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417 (1992). But see Saul Levmore, *Partnerships, Limited Liability Companies, and Taxes: A Comment on the Survival of Organizational Forms*, 70 WASH. U. L.Q. 489 (1992).

49. See, e.g., Glenn E. Coven, *Subchapter S Distributions and Pseudo Distributions: Proposals for Revising the Defective Blend of Entity and Conduit Concepts*, 42 TAX L. REV. 381 (1987). Although Subchapter S provides a pass-through taxation regime for corporations with a small number of shareholders, it is limited to one class of stock (with only voting right differences allowed) and an allocation of income, gain, deduction, loss, and credit proportionate to stock held. I.R.C. §§ 1361(b)(1), 1366 (1988 & Supp. 1992). All shareholders must be individuals, estates, or testamentary trusts or their surrogates. I.R.C. § 1361(b)(1) (1988). Shareholders in S corporations receive a basis increase in their stock for the corporate income taxed to them pro rata, and then the distributee shareholder applies that basis to the fair market value of the distributed asset. I.R.C. §§ 1367, 1368 (1988). In contrast, in a C corporation, the shareholder reports the distribution, and all distributions of appreciated property generate income at the corporate level, unless the property remains in corporate solution through a spin-off of a business. See I.R.C. § 301 (1988) (shareholder-level rules); I.R.C. § 311(a)-(b) (1988) (current distributions of appreciated property); I.R.C. § 336(a) (1988) (liquidating distributions); I.R.C. § 355 (1988 & Supp. 1992) (divisions).

tory has shown that joint ventures and partnerships are an effective form of risk-sharing and resource deployment,⁵⁰ and the tax law should not penalize those who seek out partnerships and joint ventures⁵¹ for business and investment activities by imposing inflexible rules on pass-through regimes. If we have reason to believe that the classical corporate tax structure disfavors investment,⁵² then there is every reason to have a tax regime for business which allows flexible vehicles for the sharing of financial risks to encourage risky investments which otherwise would not be made.⁵³

50. See STUART BRUCHEY, ENTERPRISE: THE DYNAMIC ECONOMY OF A FREE PEOPLE 15 (1990) (describing the associational practices of Venetian merchants).

51. Joint ventures for specific projects which are taxed as partnerships are an increasingly popular form for a business enterprise. See Note, *Reviewing the Law on Joint Ventures With an Eye Toward the Future*, 63 SO. CAL. L. REV. 487, 487 & n.2 (1990) (value of joint venturing and control); see, e.g., Steven Greenhouse, *Swiss Bank Turns Aggressive*, N.Y. TIMES, Apr. 10, 1989, at D1 (discussing the successful investment banking joint venture between Credit Suisse and First Boston Corp.); *J.C. Penney in Joint Venture to Provide Video in Stores*, N.Y. TIMES, Aug. 20, 1992, at D4 (discussing the creation of a joint venture among J.C. Penney, GTE Spacenet and Capital Cities called Advanced Retail Communications, designed to compete with a rival joint venture between Sears Roebuck & Co. and I.B.M.); Steve Lohr, *Barney's Bets the Store*, N.Y. TIMES, Aug. 29, 1993, Magazine, at 42, 60-62 (retailing joint venture between Barney's and Isetan, Japan's sixth-largest retailer). For tax considerations see Bruce N. Davis & Steven R. Lainoff, *U.S. Taxation of Foreign Joint Ventures*, 46 TAX L. REV. 165 (1991) (detailing resolved and unresolved issues presented by corporate joint ventures and partnerships with foreign partners); David Glickman, *Problems of the Corporation as a Joint Venturer*, 34 FED. TAX'N INST. 581 (1977) (early view of problems and advantages of corporate joint ventures).

52. This is the view expressed in the report of the Treasury on corporate-shareholder income tax integration. See INTEGRATION REPORT, *supra* note 38.

53. Partnerships and joint ventures afford a method for diversifying risk in diffuse business activities. See JOSEPH TAUBMAN, THE JOINT VENTURE AND TAX CLASSIFICATION (1957). There are many examples of the use of partnerships in widely different businesses to pool expertise and diversify risk. See, e.g., Sudipto Bhattacharya et al., *Licensing and the Sharing of Knowledge and Research Joint Ventures*, 56 J. ECON. THEORY 43 (1992); David A. Brown, *British Seek Risk Sharing Partners for High-Agility Aircraft Project*, AVIATION WK. & SPACE TECH., Dec. 14, 1987, at 61; Deirdre Carmody, *A Magazine's Trials, Now on Home Video*, N.Y. TIMES, Feb. 24, 1992, at D8 (discussing the "Court TV" joint venture); Lawrence M. Fisher, *Small Companies Try a Partnership*, N.Y. TIMES, Jan. 9, 1992, at D2 (highlighting a joint venture in which Alkermes, Inc. would provide capital to Cortex Pharmaceuticals, Inc. in order to develop a technology which will enable drugs to enter the brain more easily); *F.T.C. Approves RWE Licensing*, N.Y. TIMES, Jan. 22, 1992, at D3 (mentioning a use of the partnership joint venture form to exploit an existing chemical technology); Constance Mitchell, *Partnerships Are a Way of Life for Corning*, WALL ST. J., July 12, 1988, at 6 (discussing several of the joint ventures of Corning Glass); John R. Stodden, *Strategy Leaves Rohr Poised for Expansion of Sales, Profits*, AVIATION WK. & SPACE TECH., May 2, 1988, at 137 (discussing an aerospace subcontractor's successful strategy of growth through building risk-sharing alliances with other companies); Van Doren, *Partnership Contracts as an Alternative to Failing Agricultural Credit? Sudan's World Credit Experience*,

The role of borrowing and interest in the capital structure of partnerships could reflect further harmonization with the treatment of debt elsewhere in the tax law.⁵⁴ Thus, this Article considers imputation of riskless rate of interest on positive and negative capital account balances before the partners' agreement to share income, losses, deduction, and credit is reflected for tax purposes and characterized as a distributive share which would in certain circumstances recharacterize a portion of the profit shared as interest or salary.⁵⁵

This Article is in eight parts. It steps back from a technical evaluation of the rules in Subchapter K and seeks to find rationales for the key premises underlying the rules. Part II describes capital accounts and the areas of present controversy. Part III discusses current business taxation, explores the nature of the partnership, and discusses the dominance of the aggregate model. Part IV notes the impact of a hybrid income-consumption tax upon the formulation of partnership tax rules in a second-best world. Part V adduces the role of risk-bearing and risk aversion in partnership taxation and introduces a theory of efficient and equitable risk-bearing. Part VI considers the efficiency of partnerships. Part VII discusses efficiency and equity. Part VIII considers the role of interest on capital accounts, applies the analysis in Parts I through VII, and makes recommendations with respect to nonrecognition on contribution and distribution transactions and special allocation allowances.

II. CAPITAL ACCOUNTS AND AREAS OF CONTROVERSY

In order to comprehend the controversy surrounding Subchapter K, one first must understand the partner's interest in the partnership and the role of capital accounts and basis in partnership taxation.

AFRICA INSIGHT, vol. 20, no. 2, 1990, at 87 (risk-sharing with agricultural partnerships to increase credit availability); *Your Money: Theater Investor's High-Risk Role*, N.Y. TIMES, June 4, 1988, at 38 (discussing use of privately placed partnerships). Joint ventures expand products in worldwide markets, although in mature markets the desire for control and a greater profit share often outweigh the sharing advantages. See Maggie Farley, *A New Era in Partnerships*, BUS. TOKYO, Oct. 1991, at 38, 39.

54. See *infra* text accompanying notes 408-58. The original-issue discount rules are classic examples. See I.R.C. §§ 1271-1278 (1988). Not all countries follow this system. See *International Tax Review Survey on Original Issue Discount*, INT'L TAX REV., July-Aug. 1992, at 21.

55. See *infra* notes 446-58 and accompanying text. An analogy to I.R.C. § 7872 was made in the commentary by Leo L. Schmolka, *Taxing Partnership Interests Exchanged for Services: Let Diamond/Campbell Quietly Die*, 47 TAX L. REV. 287, 302-08 (1991), as well as in Kamin, *supra* note 15, at 27-53 to 27-62. See *infra* note 456 and accompanying text.

After considering capital accounts and basis, areas of controversy in Subchapter K's flexibility in pooling and unpooling transactions is explored.

A. Capital Account Maintenance

The partnership interest represents the partner's claim on the partnership and the totality of the economic relationship as partners.⁵⁶ Derived from non-tax law, a partner's interest represents her right to return of contributed capital, her allocation of profits and losses, priorities upon liquidation or interim distributions of earnings and property, and devices to control agency costs.⁵⁷ The partnership interest performs the function of classes of stock that have different rights upon liquidation, different profit and dividend sharing ratios, and rights to manage the underlying assets of the firm. The interests in profits and losses can be nonlinear—they need not be proportionate to the capital contribution to the firm.⁵⁸ Nor does the sharing of profits have to be on the same ratio as the sharing of losses.⁵⁹ A "linear allocation" is an equal sharing of profit-loss relative to capital

56. The substantial economic effect regulations define the partner's interest as "the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated." Treas. Reg. § 1.704-1(b)(3)(i) (as amended 1993). In determining a partner's interest several factors are considered: The partners' relative contributions to the partnership; the interests of the partners in economic profits and losses (if different than that in taxable income or loss); the interests of the partners in cash flow and other non-liquidating distributions; and the rights of the partners to distributions of capital upon liquidation. See Treas. Reg. § 1.704-1(b)(3)(ii) (as amended 1993). The manner in which these factors is weighed is not clear, but rights to any allocated economic profits upon liquidation are key in upholding any allocation.

57. See Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211 (1991). The complexity of the partnership arrangement allows for control of various agency costs—shirking, moral hazard, and imperfect information—in light of the two facets of the principal-agent relationship—risk-sharing and asymmetric information—but at the cost of understanding the complexity of the terms. See Kenneth J. Arrow, *The Economics of Agency*, in PRINCIPALS AND AGENTS 37, 49 (John W. Pratt & Richard L. Zeckhauser eds., 1985). Based on the risk preferences of the agent and the principal, either fixed fee or incentive compensation structures will be chosen to maximize *ex ante* the expected utility and wealth from a given set of events. See Milton Harris & Artur Raviv, *Optimal Incentive Contracts with Imperfect Information*, 20 J. ECON. THEORY 231 (1979); Steven Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 BELL J. ECON. 55 (1979).

58. Thus, the tax law follows the non-tax law which allows profit and loss to be divorced from underlying capital. UNIF. PARTNERSHIP ACT § 18 (1914), 6 U.L.A. 213-14 (1969); REVISED UNIF. PARTNERSHIP ACT § 401(b) (1993), 6 U.L.A. 250 (Supp. 1994).

59. See Stephen B. Land, *Partnership Revaluations*, 43 TAX LAW. 33, 35 (1989) (defining linear and nonlinear allocations).

contributions, in contrast to a nonlinear allocation, which is an unequal sharing and which reflects an arm's length evaluation of the circumstances of loss, gain, and use of capital.⁶⁰

Capital accounts that enforce an economic arrangement are required to validate the tax allocations. The tax rules on capital account maintenance are the core tax enforcement mechanisms of the economic relationship between partners' rights and partnership interests.⁶¹ Property contributions and distributions are recorded at fair market value; items of income and loss allocated to a partner must be charged to the capital account; the partnership must follow capital accounts on liquidation; partners with a deficit capital account must make it up upon or shortly after liquidation, or under certain circumstances be allocated income during the operations of the partnership to make it up;⁶² and capital account consequences affect the basis in the partner's interest.⁶³ Separate rules deal with allocations⁶⁴ attrib-

60. *See id.*

61. *See* Treas. Reg. § 1.704-1(b)(1) (as amended in 1993). The Uniform Partnership Act has rules on capital account crediting for contributions and distributions in liquidation to recover capital. *See* UNIF. PARTNERSHIP ACT § 18 (1914), 6 U.L.A. 213-14 (1992); REVISED UNIF. PARTNERSHIP ACT § 401 (1993), 6 U.L.A. 250 (Supp. 1994); REVISED UNIF. PARTNERSHIP ACT § 807 (1993), 6 U.L.A. 282 (Supp. 1994); UNIF. PARTNERSHIP ACT § 807 (1994) (June 1, 1994 revision). Maintaining partners' individual capital accounts according to certain rules in Treas. Reg. § 1.704-1(b)(2)(iv) (as amended 1993) is central to the integrity of the § 704(b) regulations.

62. Treas. Reg. § 1.704-1(b)(2)(ii)(b)(1) to (ii)(b)(3), -1(b)(2)(ii)(d), -1(b)(2)(iv) (as amended 1993). These rules have other consequences. For example, disclosure of information, such as revaluation of assets, enhances informed decision-making. *See* Jerome G. Baiman, *Agency Research in Managerial Accounting: A Survey*, 1 J. ACCT. LIT. 154, 179-97 (1982).

63. An aggregate system requires keeping track of both the economic consequences in the capital accounts and the tax consequences as recorded by the partners' bases in their partnership interests. For example, if A and B each contribute \$100 cash to the AB Partnership, their capital accounts will be credited with \$100. They will have an adjusted basis in their partnership interests of \$100. If the partnership earns income of \$50 that is split 50-50 between A and B, that income will be taxed to the partners through the partnership as a conduit entity; if it stays in the partnership, each of their capital accounts will be increased by \$25 and their partnership interest bases will increase by \$25. Similarly, if they withdraw a portion of their capital accounts through an operating distribution or a liquidation of their interests, their capital accounts will be reduced by the amount of money or fair market value of the property received. Assuming no distribution, the partners' capital accounts are each \$125 and their respective bases in their partnership interests is \$125. If the partnership had purchased an asset with the partnership capital in the amount of \$75 and that property had appreciated in the hands of the partnership to \$125 and was then distributed to A the following would occur: A's and B's capital accounts each would be increased by \$25, A's capital account would be decreased by \$125, and A's outside basis in her partnership interest would be reduced by \$75. *See infra* note 73. A would have a basis in the asset of \$75 which would have a fair market value of \$125, the gain on which would be recognized when A sold the asset. On a distribution a partner's basis in her partnership interest will first

uted to third-party nonrecourse debt where the partner has no risk of loss or where the partner makes nonrecourse loans to the partnership.⁶⁵

B. Examples to Illustrate Areas of Controversy

The five areas of controversy deal with income allocations, contributions of services and property, and distributions of property.

1. Income Allocations—Sharing Profits and Losses Differently During Different Years

Sharing profits and losses differently over time becomes controversial when one assumes that income can only be shared proportionately to capital accounts. Time-shifting allocations reflect the partners' different expectations as to the timing of income. Each partner thinks she will be have the same present value given the risk that is borne relative to an equal sharing. On the one hand, this is an area of controversy; on the other hand, there is no controversy because time-shifting allocations accomplish the same result as any investment that defers income.

Example 1. Assume in a 50-50 partnership that A and B each contribute assets worth \$100 and A and B will split the profits for the first 5 years on a 60-40 basis and then for the next 5 years on a 40-60 basis.⁶⁶ This is a time-shifting allocation resulting from an interest in profits different from capital accounts. A capital account represents an equity account in the partnership pooled capital. One view of such pooling would not allow a profit-sharing ratio different from a proportionate capital account.

Example 2. One partner agrees to bear current losses in exchange for a greater share of profits in the future. Assume contributions of \$100 each by A and B in a partnership which makes a highly risky investment. They agree that A will bear all of the losses of the partnership until her capital account and basis are fully reduced, then she will be allocated all the income of the partnership until all her losses are restored, and then A and B will share gains and losses 50-50.

be reduced by the cash distributed.

64. No deficit make-up is required if the partner bears the tax effect of loss. See Treas. Reg. § 1.704-1(b)(2)(ii)(d) to 1(b)(3) (as amended 1993).

65. See Treas. Reg. § 1.704-2 (1991).

66. Assume that the allocations in Examples 1 and 2 are valid. See Treas. Reg. § 1.704-1(b)(2)(iii) (as amended 1993).

This is a time-shifting allocation with an income chargeback. Notwithstanding the risk borne by A, an objection to such sharing occurs if one believes that the pooling of capital is a single transaction and that sharing in a partnership requires a proportionate sharing relative to capital account balances.

2. Character-Shifting Allocation

Agreeing to share different characters of income differently presents the same assignment of income problems. Outside of the partnership rules, partners could not divide income from jointly held property in this manner.

Example 3. Assume A and B each contribute \$100 and they agree that A will take 60 percent of the profits from foreign operations and B will take 60 percent of the profits from U.S. operations. This is a character-shifting allocation. If the income is not predictable, the allocation is valid.⁶⁷ There are two possible objections to this allocation. First, the allocation is not proportionate to capital account balances and permits a special sharing of income from different sources. Second, there is no requirement of any special relationship of the partner receiving the disproportionate allocation other than the agreement to share the risks associated with that source of income as represented in the partnership agreement. However, this second objection would not obtain if A were managing the foreign property.

3. Service Contribution

Service contributions for profits interests are controversial because receiving a partnership profits interest for services might be seen as a realization event. This is different from taxation of future compensation rights to service providers outside of partnerships.

Example 4. Assume that A contributes \$100 and that B contributes his services to their joint venture, the "AB Partnership," and they agree to share profits 50-50. Partner A will have a capital account of \$100 and a basis in her partnership interest of \$100. Partner B will not have a capital account nor will she have any basis in a partnership interest. Two issues arise regarding B. First, are profits so certain that A has transferred a portion of her capital account to B such that B ought to recognize compensation income currently? Second, even if future profits are speculative and the right to the 50 percent profits

67. See Treas. Reg. § 1.704-1(b)(2)(iii)(b) (as amended 1993); *infra* note 612.

interest by B is speculative, would it be appropriate to view B as still recognizing income equal to \$50? Under current law and administrative interpretation, a speculative profits interest transfer is not treated as a taxable event for either A or B.⁶⁸

4. Contribution of Property

Outside of a partnership in a transaction diversifying assets, if A sold half of her property to B, A would recognize gain with the appropriate character. If A forms a partnership (or indeed a corporation) with B, A may diversify assets without a current tax. The controversy is whether this policy should override treating similarly situated people the same.

Example 5. A and B have a 50-50 partnership together. Partner A has an asset worth \$100 that has an adjusted basis of \$20. Partner B has an asset with a value of \$100 that has an adjusted basis of \$150. When they contribute the assets to a partnership in exchange for a partnership interest, the gain and loss inherent in the assets is not recognized⁶⁹ and the basis of the assets contributed becomes the partner's basis in the partnership interest.⁷⁰ The partnership takes a basis in the asset equal to the basis that the partner had.⁷¹ Current law does not treat these contributions as taxable sales⁷² even though each partner has diversified her investment.

5. Distribution of Property Non-Pro Rata

Even a simple property distribution non-pro rata is controversial when compared to transactions outside of partnerships.

Example 6. Assume A and B form a 50-50 partnership by each contributing \$100 cash used to buy capital assets. One of the assets purchased for \$20 increases in value to \$100 and the other assets do not change in value. The partnership distributes the appreciated asset to B. The distribution to B will necessarily first increase both A and B's capital accounts by \$40 and then reduce B's capital account by \$100 and B's outside basis in her partnership interest by \$20.⁷³ Un-

68. See *infra* notes 502-04 and accompanying text.

69. See I.R.C. §§ 721, 722 (1988). But see I.R.C. § 707(a)(2)(B) (1988) (property contributions cause recognized income if treated as disguised sales); Treas. Reg. §§ 1.707-1(b)(i) to -1(c) (as amended 1983); Treas. Reg. §§ 1.707-2 to -5(a)(1) (1992).

70. I.R.C. § 722 (1988). This is referred to as "outside" basis.

71. I.R.C. § 723 (1988). This is referred to as "inside" basis.

72. See *supra* note 4 and accompanying text.

73. B will also be taxed on all of the appreciation when she sells the asset, followed

der current law, A is not taxed because it is not treated as a sale by A and B will receive a basis in the asset equal to its adjusted basis in the partnership.⁷⁴ Other rules promote deferral by allowing cash to first absorb all basis rather than have cash receive a proportionate or mixed basis.⁷⁵

An alternative view would see this as a sale transaction.⁷⁶ Under that view, since the profit-sharing ratio stays the same, while the amount of capital contributed by B is smaller, it would be appropriate to view the reduction in capital as a sale transaction by A. However, if B reduces her profit-sharing ratio relative to her capital account, the distribution has the economic effect of a sale by B of a portion of her capital.

C. Pooling and Unpooling

Subchapter K allows the parties to bear risk by treating the pooling and unpooling transaction as nonrecognition events, and to share the risks of the pool in a manner that reflects the actual bearing of risk within the pool by each participant. There are several illustrations of this. First, a transfer of assets to a partnership is sometimes treated as a disguised sale to the partnership.⁷⁷ Under the regulations, the decision whether the risk is borne by the partner so as to treat the transfer as a disguised sale is analyzed with respect to the type of return to the potential pooler.⁷⁸ Second, subject to the disguised sale rules, in the unpooling transaction Subchapter K allows full deferral and nonrecognition, giving the partners full latitude to shift risk-bear-

by an offsetting loss of \$40 when the partnership is liquidated and A has an offsetting gain of \$40 when the partnership is liquidated. See I.R.C. §§ 731, 732, 751 (1988); Treas. Reg. § 1.704-1(b)(2)(iv)(e) (as amended 1993); see *supra* note 63. Recognition of the realized offsetting gain or loss may be deferred depending upon the form of the liquidating distribution. See I.R.C. §§ 731(a), 732(b) (1988).

74. One version of sale treatment would be an exchange transaction between all partners for the interest in the properties distributed. See J. Paul Jackson et al., *The Internal Revenue Code of 1954: Partnerships*, 54 COLUM. L. REV. 1183, 1213 (1954). This is also the result in an S corporation. See I.R.C. §§ 1368, 1371(a)(1) (1988).

75. I.R.C. § 731(a)(1) (1988).

76. See *infra* notes 545-60 and accompanying text.

77. I.R.C. § 707(a)(2)(b) (1988); Treas. Reg. § 1.707-4 (1992) (priority returns and cash flow distributions).

78. Treas. Reg. § 1.707-3 (1992). The risk-bearing in the pool is premised on the appropriate mechanisms for receiving income from a pooled transaction relative to a decision to bear risk within the pool. See *infra* notes 614-28. Taxation of a service partner's interest in profits also proceeds on this model. See *infra* notes 501-16 and accompanying text.

ing among themselves.⁷⁹ Third, partners can decide their amount of risk-bearing with regard to assets, liabilities, incomes, and loss in the pool in a manner that reflects a continuation of a pooled venture.⁸⁰ The risk-sharing on pooled assets requires a mutual dependency on those assets with respect to the partnership.

III. BUSINESS TAXATION AND THE PARTNERSHIP AGGREGATE MODEL

A. *Business Taxation at the Crossroads*

For years, the conduit partnership was thought to provide the purist model for dealing with the taxation of business savings of individuals.⁸¹ This concept is now under assault on various fronts. The need for a contrary response is urgent in light of the recent debate over the integration of corporate shareholder taxation with the corporate tax.⁸² Under all presently proposed models, the flexibility of Subchapter K is not present.⁸³ Equating partnership taxation with

79. Treas. Reg. § 1.707-3 (1992).

80. See I.R.C. §§ 704(b), 752 (1988). The decision is respected so long as the arrangement is a partnership, I.R.C. § 704(b) applies. But, for example, if one partner received all of the income from foreign source activities and the gain or loss on the property used for the foreign source activities, and another received the same from U.S. source activities, there might not be a pooling. See *infra* notes 597 and 617. But in *Wheeler v. Commissioner*, 37 T.C.M. (CCH) 833 (1978), the allocation of losses to the capital partner and a restoration of losses by income before a sharing with the service partner was a valid partnership sharing of profits.

81. See 4 CANADIAN ROYAL COMM'N ON TAXATION, REPORT OF ROYAL COMMISSION ON TAXATION 44-45, 68-70 (1966) [hereinafter CARTER COMMISSION REPORT]; DAVID F. BRADFORD ET AL., BLUEPRINTS FOR BASIC TAX REFORM 122 (2d ed. 1984); CHARLES E. MCLURE, JR., MUST CORPORATE INCOME BE TAXED TWICE? 227-30 (1979); see also George K. Yin, *Achieving Corporate Integration Through Double Taxation*, 56 TAX NOTES 1365 (1992) (beginning with the conduit partnership model as the paradigm). The treatment of pass-through income systems is especially important when the argument is made to conform corporate taxation to the partnership pass-through model and what that conformity should mean. See Paul B. Stephan, *Disaggregation and Subchapter C: Rethinking Corporate Tax Reform*, 76 VA. L. REV. 655, 659, 710 (1990).

82. Compare Jasper L. Cummings, 'Taxing Business Income Once': Where's the Beef? A Review and Critique of the Treasury Integration Study, 54 TAX NOTES 1391, 1397 (1992) (concluding that the report does not "advance[] the ball very far" given the difficulty of finding a replacement tax for the corporate tax and because the economic benefits are difficult to quantify or small compared to the political resistance) with Richard Goode, *Integration of Corporate and Individual Taxes: A Treasury Report*, 54 TAX NOTES 1667 (1992) (finding the dividend exclusion method not clearly superior to the dividend deduction or credit imputation methods and that the comprehensive business income tax should be carefully considered).

83. The Treasury's report on integration of corporate and shareholder taxes swings to the opposite pole: under its long-term comprehensive business income tax (CBIT) prototype,

corporate taxation highlights the question of whether to view these single tax regimes in light of the entity model or the aggregate model.⁸⁴ Although conduit treatment may not offer a feasible approach to the integration of corporate and shareholder taxes for large firms, Subchapter K has demonstrated a capacity to encourage financial and human capital investment and to facilitate resource deployment decisions at the margin. The benefits should not be abandoned to achieve neutrality with a norm that is not more equitable, efficient, or structurally sound.⁸⁵

A move towards considering the partnership as an entity has also occurred for nontax purposes.⁸⁶ While the Uniform Partnership Act

partnerships and sole proprietorships would be treated as entities and subjected to entity taxation, but their owners would not be taxed. See INTEGRATION REPORT, *supra* note 38, at ch. 4. The report has a stated objective of not disturbing the status of corporate earnings and interest payments received by foreigners and tax exempts. *Id.* § 3.I, 3.J, at 36-38. It proposes entity integration leaving the corporate tax in place, exempting all dividends-received by shareholders, and moving to what the study calls a prototype CBIT. *Id.* at ch. 4. The Treasury's approach presumably retains all the entity solutions of the corporate tax, see *id.* § 4.G, at 52, in employing the proposed business entity tax for all firms, corporate, partnership, and sole proprietorship. Partnerships that do not qualify for the small business exception, see *id.* § 4.C (gross receipts less than \$100,000), would be taxed like other CBIT entities. See *id.* § 4.H, at 56. The American Law Institute ("ALI") draft report on integration of corporate shareholder taxes embraces a shareholder credit imputation model. ALVIN C. WARREN, JR., AMERICAN LAW INST., INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES, REPORTER'S STUDY OF CORPORATE AND TAX INTEGRATION 4 (1993) [hereinafter REPORTER'S INTEGRATION STUDY]. An imputation system taxes corporate income at the corporate level at the applicable tax rate and then gives a credit for the corporate tax paid to the shareholders upon distribution of previously taxed earnings. Adjustments are provided for shareholders who sell their shares before the earnings are distributed and an issue is whether the shareholder credit is refundable. Both the Treasury and the ALI give less focus to income timing and allocation.

In one developing country tax model, only simple partnerships where each owner shares capital, income, and loss in the same proportion are taxed on a pass-through model. See HUSSEY & LUBICK, *supra* note 35, § 12(e), (f), at 36-37.

84. See e.g., Berger, *supra* note 12, at 110-12 (harmonizing rules for small firms of pass-through entities generally favoring Subchapter S); James Eustice, *Subchapter S Corporations and Partnerships: A Search for the Pass-through Paradigm (Some Preliminary Proposals)*, 39 TAX L. REV. 353 (1984) (harmonizing rules of pass-through entities generally favoring Subchapter K); Deborah H. Schenk, *Subchapter S and Subchapter C Interface*, (Tax Forum Paper No. 472, Jan. 6, 1992) (on file with author) (interpretations to promote a unitary system of taxation). While one can argue that these are two different tax regimes, i.e., a tax on businesses and a tax on individuals, they are usually viewed as a single income tax regime whether the aggregate model or the entity model is appropriate. See Rudnick, *supra* note 39, at 1030-31, 1099-1103. Others, such as the ABA Task Force on Integration, may provide the practicing bar's view of the proposed solutions. See also Michael Schler, *Taxing Corporate Income Once (Or Hopefully Not At All): A Practitioner's Comparison of the Treasury and ALI Integration Models*, 47 TAX L. REV. 509 (1992).

85. See, e.g., Rudnick, *supra* note 39, at 1066-69.

86. See Uniform Partnership Act Revision Subcomm. of the Comm. on Partnerships and

of 1914⁸⁷ ultimately leaned to the aggregate approach, the Revised Uniform Partnership Acts of 1993 and 1994⁸⁸ signal a controversial move toward an entity approach.⁸⁹ In the 1993 and 1994 Acts, partnership property is vested in the partnership rather than in the partners individually,⁹⁰ thereby changing the tenancy by the partnership rule—although the commentary states that the change is the substantive result under the 1914 Act.⁹¹

Unincorporated Business Orgs., *Should the Uniform Partnership Act Be Revised?*, 43 BUS. LAW. 121 (1987) [hereinafter U.P.A. Revision Subcommittee].

87. 6 U.L.A. 6 (1992).

88. 6 U.L.A. 236 (Supp. 1994); REVISED UNIF. PARTNERSHIP ACT (June 1, 1994 revision); see also 1 ALAN R. BROMBERG & LARRY E. RIBSTEIN, ON PARTNERSHIP § 3.04(b) (1988). In the 1994 Uniform Partnership Act, § 203 again provides that "[p]roperty acquired by a partnership is property of the partnership and not of these partners individually." The comment notes that as follows: "all property acquired by a partnership, by transfer or otherwise, becomes partnership property and belongs to the partnership as an entity, rather than to the individual partners. This expresses a substantive result of UPA §§ 8(1) and 25." REVISED UNIF. PARTNERSHIP ACT § 203, comment at 24 (1994) (June 1, 1994 revision). The summary of the Revised Uniform Partnership Act (1994) states as follows:

RUPA § 203 states simply and affirmatively the principle that since a partnership is a separate entity, its property, however acquired, belongs to it and not to the partners. Because of the entity theory incorporated into RUPA, it is no longer necessary to use artificial concepts like tenancy in partnership (See UPA § 25), which is an outgrowth of the compromise between the aggregate and entity concepts of partnership built into RUPA, to describe the legal status of the partnership.

Summary of the Revised Uniform Partnership Act 3 (July 13, 1994). For discussion of the 1993 Act, see Edward S. Merrill, *Partnership Property and Partnership Authority, Under the Revised Uniform Partnership Act*, 49 BUS. LAW. 83 (1993); Larry E. Ribstein, *The Revised Uniform Partnership Act: Not Ready for Prime Time*, 49 BUS. LAW. 45 (1993); Allan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 B.U. L. REV. 523 (1993); Donald J. Weidner & John W. Larson, *The Revised Uniform Partnership Act: The Reporter's Overview*, 49 BUS. LAW. 1 (1993). For discussion of an earlier draft, see Donald J. Weidner, *The Revised Uniform Partnership Act Midstream: Major Policy Decisions*, 21 U. TOL. L. REV. 825 (1990).

89. See Association of the Bar of the City of New York, Comm. on Uniform State Laws, *The Entity Theory of Partnership and the Proposed Revisions to the Uniform Partnership Act*, 46 RECORD 563 (1991) [hereinafter Ass'n of the Bar].

90. See REVISED UNIF. PARTNERSHIP ACT § 203 (1993), 6 U.L.A. 238 (Supp. 1994) ("Property transferred to or otherwise acquired by a partnership is property of the partnership and not of the partners individually."). In contrast, the Uniform Partnership Act had the concept of partners holding property as "tenants in partnership." See UNIF. PARTNERSHIP ACT § 25(1) (1914), 6 U.L.A. 326 (1969).

91. See REVISED UNIF. PARTNERSHIP ACT § 203 (1993), 6 U.L.A. 239-40 (Supp. 1994) (comment); REVISED UNIF. PARTNERSHIP ACT § 203 and comment (June 1, 1994 revision). The change to an entity approach may make the comparison of the partnership to taxable entities like associations more compelling to some reformers. Under Treas. Reg. § 301.7701-2 (as amended 1993), an association is an organization with associates and an objective to carry on a business for profit, and which has more than two of the following four attributes: limit-

For a long time, policy makers tolerated flexibility within the partnership because of the perceived offsetting positions of the parties to the transactions.⁹² This flexibility was eventually replaced with highly specific tax rules⁹³ and detailed rules outside of Subchapter K to deal with the problem of tax arbitrage.⁹⁴ Many critics implicitly contend that the present tax provisions encapsulate a pro-taxpayer agenda, due to lobbying efforts rather than to sound economic and equity reasons.⁹⁵ Other critics point to practitioner manipulation, which, except for structural defects in and the discretionary nature of the section 754 election,⁹⁶ has been significantly albeit not fully eliminated.⁹⁷ To the extent that present rules and judicial doctrines

ed liability, centralized management, continuity of life, and free transferability of ownership interests. One approach would have the entity theory apply in significant places in Subchapter K since third parties dealing with the partnership regard the partnership as an entity rather than as an aggregate. See Postlewaite et al., *supra* note 10, at 450. The American law is based on the English common law which "knows nothing of the firm as body or artificial person distinct from the members composing it." FRANCIS M. BURDICK, *THE LAW OF PARTNERSHIP* 82 (2d ed. 1906) (quoting FREDERICK POLLOCK, *A DIGEST OF THE LAW OF PARTNERSHIP* 20 (London, Stevens & Sons, 5th ed. 1890)); cf. 1 SCOTT ROWLEY, *MODERN LAW OF PARTNERSHIP* § 121 (1916) ("So it is said that a partnership, though not strictly a legal entity, distinct from the persons composing it, yet is so commonly regarded as such by men of business that it may be so treated in interpreting a commercial contract."). The American Bar Association has recently noted a change in perception. See U.P.A. Revision Subcommittee, *supra* note 86, at 124-27. Federal tax law is presumptively independent of state business entity legislation. See *Commissioner v. Culbertson*, 337 U.S. 733 (1949) (holding that intent is necessary for formation of a partnership); see also Larry E. Ribstein, *A Mid-Term Assessment of the Project to Revise the Uniform Partnership Act*, 46 BUS. LAW. 111, 119 (1990) (commenting on earlier draft and noting that tax status is a tax policy concern); Ass'n of the Bar, *supra* note 89, at 569 (commenting on earlier draft). Nonetheless, state law characterization necessarily informs federal tax policy distinctions. State law defines the rights, and federal tax law and principles determine the tax effect of those rights. *United States v. National Bank of Commerce*, 472 U.S. 713, 723 (1985); *Morgan v. Commissioner*, 309 U.S. 78, 80 (1940); see, e.g., Prop. Treas. Reg. § 1.1001-3, 57 Fed. Reg. 57,036 (1992).

92. See Frederic A. Nicholson, *Disguised Sales Involving Partners and Partnerships*, 47 FED. TAX'N INST. § 27.01 (1989).

93. See, e.g., I.R.C. §§ 704(b), 707(a)(2) (1988). Particularized treatment rather than offsetting positions continues. See, e.g., I.R.C. § 751 (1988).

94. See, e.g., I.R.C. §§ 512, 514(c)(9)(E) (1988).

95. See, e.g., Berger, *supra* note 12; Postlewaite et al., *supra* note 10.

96. On the defects in §§ 754 and 755, see 2 MCKEE ET AL., *supra* note 19, ¶ 22.02[6], at 21-22; see also *infra* notes 533-34, 592, 675 and accompanying text.

97. That is not to say that the partnership tax rules ought not to be reformed to eliminate practitioner planning strategies. See, e.g., Louis S. Freeman & Thomas M. Stephens, *Using a Partnership When a Corporation Won't Do: The Strategic Use and Effects of Partnerships to Conduct Joint Ventures and Other Major Corporate Business Activities*, 68 TAXES 962 (1990). Partnerships are a means of diversifying businesses already in corporate solution without triggering recognition of gain, using so-called mixing bowl and other types of transactions. See MARTIN D. GINSBURG ET AL., *MERGERS, ACQUISITIONS AND LEVERAGED*

such as substance over form are inadequate to police partnership transactions, proposed regulations provide an anti-abuse rule to prevent taxpayers from structuring transactions using partnerships to achieve tax results contrary to the intent of Subchapter K that are inconsistent with the underlying economic arrangement of the parties or the substance of the transactions, or to use partnerships to avoid the purposes of other Code provisions.⁹⁸ While both economic and political foundations support tax structures,⁹⁹ these foundations are distinct concerns. Critics forget that corporations enjoyed favored tax treatment for years,¹⁰⁰ and the argument that partnerships are taxed

BUYOUTS ¶¶ 1403-05 (1993). However, reforms to prevent mixing bowl transactions, see I.R.C. § 737 (Supp. 1992), and changes to the liquidating distribution rules, see I.R.C. §§ 704(c)(2) (Supp. 1992); I.R.C. § 736 (1988), eliminate much tax arbitrage but not all. For example, many inconsistencies in the statute may be exploited using partnerships. For a discussion, see New York State Bar Association, *Report on the Partnership Antiabuse Rule*, 64 TAX NOTES 233, 234-35, 249-52 (1994). Under prior law, net operating losses could be borrowed from one partner and used to park income and then returned in the form of a capital loss without requiring interest. This may now depend on a capital account revaluation that may not pass muster. See Lee A. Sheppard, *Tax Shelter Partnerships for the Big Boys*, 48 TAX NOTES 1087 (1990). Rules on disguised sales prevent tax avoidance by incurring debt to fund a distribution and treat the transaction as a sale rather than a distribution to which more favorable basis rules apply. Gergen, *supra* note 10, at 177 & n.19. There has been much discussion of limiting the effect of § 736 in this context. See AMERICAN LAW INSTITUTE, *FEDERAL INCOME PROJECT - SUBCHAPTER K* 54-67 (1984) [hereinafter 1984 ALI REPORT]; Postlewaite et al., *supra* note 10, at 611-14. Recent amendments of § 736 limit the treatment of a payment as a distributive share to payments for goodwill and unrealized receivables to the case of a partnership in which capital is not a material income-producing factor and the payments are to a general partner. The new section also limits the definition of unrealized receivables for all partners to unbilled amounts and accounts receivable, thus eliminating recapture. See Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13262(a), 107 Stat. 416, 451 (1993) (amending § 736(b)).

98. See Prop. Treas. Reg. § 1.701-2, 59 Fed. Reg. 25,581 (1994). For the argument that regulatory specificity be abandoned, see Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 586-96 (1992).

99. See Walter Hettich & Stanley L. Winer, *Economic and Political Foundations of Tax Structure*, 78 AM. ECON. REV. 701, 707 (1988).

100. See Rudnick, *supra* note 39, at 997-1008. Congress even allowed partnerships to elect the favorable corporate tax regime. See Eustice, *supra* note 84, at 347 & n.14 (discussing § 1361 of the 1954 Internal Revenue Code, which was repealed in 1966 due to disuse). For a detailed description, see BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 2.11 (2d ed. 1966). Only after the 1986 Act inverted the relative tax rates between corporations and shareholders (a pro-corporation rate that reappeared in 1993), did the preference for business organizations free of the classic corporate double tax begin. See G.A. PLESCO, *CHOICE OF CORPORATE ENTITY: THE USE OF S CORPORATIONS BEFORE AND AFTER THE TAX REFORM ACT OF 1986* (Department of the Treasury, Office of Tax Analysis, Working Paper, 1988) (on file with author); NATIONAL TAX ASS'N - TAX INST. OF AM., *PROCEEDINGS OF THE 84TH ANNUAL CONFERENCE* 18-34 (1991). Actual changes between the corporate and noncorporate business sectors remain difficult to

more favorably than other business entities is not straightforward.¹⁰¹ In prior years, partnerships facilitated tax shelters through the interaction of partnership rules with other provisions of the Code.¹⁰² Tan-

measure. See SUSAN NELSON, NONCORPORATE BUSINESS TAXATION: BEFORE AND AFTER THE TAX REFORM ACT OF 1986 (Department of the Treasury, Office of Tax Analysis, Working Paper No. 59, 1988) (on file with author).

101. Until 1958 and the adoption of Subchapter S, there were only three regimes for taxing business: corporations, partnerships, and trusts, with special rules for cooperatives distinguishing between member and nonmember transactions. See I.R.C. §§ 1382(a), 1385(a), 1388(a) (1988). The S corporation regime, commencing in 1958, continued rigid corporate rules and was not as widely used until reforms in 1982 made this regime more attractive. See Eustice, *supra* note 84, at 348; DEBORAH H. SCHENK, FEDERAL TAXATION OF S CORPORATIONS § 2.07 (1985); PLESCO, *supra* note 100, at 7. The corporate regime had its entity biases for distributions and allocations and included a firm-level tax on income, but was in balance with the pass-through partnership regime. See Eric M. Zolt, *Corporate Taxation After the Tax Reform Act of 1986: A State of Disequilibrium*, 66 N.C. L. REV. 839, 841-53 (1988).

The competing pass-through regimes of partnerships and trusts allowed tax-free contributions and distributions of allocations for tax-sensitive items. As to trusts, the question arises whether they are best viewed as an extension of the beneficiary or the grantor. See, e.g., *Patterson v. Commissioner*, 33 B.T.A. 57, 62 (1935) (holding that proper taxation of income from sale must be determined using the statute in effect when the sale was made, but that basis is one factor in that determination). However, trust tax rules are less refined than the partnership tax rules and the lack of precision has induced administrative conservatism in their application. See *Commissioner v. Chase Nat'l Bank*, 122 F.2d 540 (2d Cir. 1941); *Commissioner v. North Am. Bond Trust*, 122 F.2d 545 (2d Cir. 1941).

For example, with respect to investment trusts, the power-to-vary the income test was the sole test for trust income allocations under the regulations issued in 1945 until 1984. See Treas. Reg. § 301.7701-4(c) (as amended in 1986). In 1984, Sears formed an investment trust that issued multiple classes of beneficial interests under a fast pay/slow pay principle which allowed the sponsor to isolate the prepayment risk associated with the pooled mortgage loans. In response to the concern that the grantor trust rules, which were satisfactory in single-class pass-through trusts, were not sufficiently developed to address the complex income allocation issues in multiple class arrangements and the fear that the exiting rules would allow interest income to go untaxed, the Service issued a notice of proposed rulemaking to define a fixed investment trust as a trust with only one class of beneficial interest. See Prop. Treas. Reg. § 301.7701-4(c), 49 Fed. Reg. 18,741, 18,741 (1984). These were later finalized with a carveout for certain senior/subordinated arrangements if the existence of multiple classes of ownership is incidental to the purpose of facilitating the direct ownership reflected by the extent to which the direct ownership could be replicated by a device other than multiple classes. See Treas. Reg. § 301.7701-4(c)(1) (as amended in 1986). This is the standard now employed for fixed investment trusts which have not opted for the Real Estate Mortgage Investment Conduit ("REMIC") election added in 1986 which allows a fast pay/slow pay feature for real estate mortgage pools and enforces the taxation of interest through the creation of a residual interest.

102. See *infra* note 103. Other responses to tax shelters include the proposed and apparently rejected excise tax on partnership roll-ups. See S. 1393, 102d Cong., 1st Sess. (1991); *Taxation of Limited Partnership Rollups: Hearing Before the Subcomm. on Energy and Agricultural Taxation of the Senate Comm. on Finance*, 102d Cong., 1st Sess. (1991); Tim Gray, *Treasury Opposes Taxwriter's Bid for Excise on Partnership Roll-Ups*, 52 TAX NOTES 380 (1991).

gential tax effects should not dictate broad structural principles of the tax law. Whether and why the government bears more risk for or subsidizes particular investments is the issue—not that investment is made through partnerships.¹⁰³

B. Nature of the Partnership and the Aggregate Model

A partnership is a natural form of business organization,¹⁰⁴ and is a "commercial adventure"¹⁰⁵ among parties who join together to operate a business for profit and divide the gains therefrom.¹⁰⁶ The

103. If Congress decides to enact business subsidies in the form of allowing increased loss-sharing on investment and business activities, the investors are acting in response to the increased risk-bearing by the government. The announcement of increased loss-sharing on particular investments without question lead to some highly irrational taxpayer behavior driven solely by an interest in securing tax benefits. See Calvin H. Johnson, *Tax Shelter Gain: The Mismatch of Debt and Supply Side Depreciation*, 61 TEX. L. REV. 1013 (1983). The passive activity loss rules are an excellent example of an attempt to limit this tax driven behavior. See I.R.C. § 469 (1988 & Supp. 1992). This is a policy decision that has a number of critics. See, e.g., Joseph Bankman, *The Case Against Passive Investments: A Critical Appraisal of the Passive Loss Restrictions*, 42 STAN. L. REV. 15 (1989); Robert J. Peroni, *A Policy Critique of the Section 469 Passive Loss Rules*, 62 S. CAL. L. REV. 1 (1988); Lawrence Zelenak, *Do Anti-Tax Shelter Rules Make Sense? A Reply to Professor Johnson*, 68 TEX. L. REV. 491 (1989); Lawrence Zelenak, *When Good Preferences Go Bad: A Critical Analysis of the Anti-Tax Shelter Provisions of the Tax Reform Act of 1986*, 67 TEX. L. REV. 499 (1989). But see Calvin H. Johnson, *Why Have Anti-Tax Shelter Legislation? A Response to Professor Zelenak*, 67 TEX. L. REV. 591 (1989). Regardless of the choice of method, the decision to create or end business subsidies in the tax law should be independent of the appropriateness of a conduit model of business taxation. See, e.g., Prop. Treas. Reg. § 1.701-2(e), ex. 2, 59 Fed. Reg. 25,581, 25,583 (1994) (tax benefit of I.R.C. § 42 that is magnified by investment through partnership is not inconsistent with the intent of Subchapter K).

104. See JOSEPH A. SCHUMPETER, *HISTORY OF ECONOMIC ANALYSIS* 72-142 (1954).

105. A.J. White Hutton, *Some Problems in Partnership Restated*, 34 DICK. L. REV. 1, 1 (1929).

106. See *id.* at 13-17. A partnership is a business or investment arrangement in which adventurers share the risk and rewards of participation in a joint enterprise. See Treas. Reg. § 1.761-1 (as amended 1972); Treas. Reg. § 301.7701-1(c) (as amended in 1977); Commissioner v. Culbertson, 337 U.S. 733, 740 (1949); Allison v. Commissioner, 35 T.C.M. (CCH) 1069, 1076-77 (1976); Podell v. Commissioner, 55 T.C. 429, 431 (1970); Luna v. Commissioner, 42 T.C. 1067, 1077-78 (1964).

Interpretations of the definition of partnership contemplate that the division of gain and profit can be in cash profits from the partnership or a distribution of assets created or held by the partnership which have appreciated in value. See *Madison Gas & Elec. Co. v. Commissioner*, 633 F.2d 512, 515-16 (7th Cir. 1980). Partnerships are distinguished from lending, employer-employee, co-ownership, and expense sharing arrangements. See 1 BROMBERG & RIBSTEIN, *supra* note 91, § 2.09(b), at 2:80-88 (1988); see also HAROLD G. REUSCHLEIN & WILLIAM A. GREGORY, *THE LAW OF AGENCY AND PARTNERSHIP* § 178 (2d ed. 1990); JUDSON A. CRANE, *HANDBOOK ON THE LAW OF PARTNERSHIP AND OTHER UNIN-*

partners are free to allocate risk and tax liabilities among themselves, so long as there is an economic motivation and risk-sharing. The partnership tax rules produce a tax system that makes economic decisions based on the efficiency norms of Pareto optimality,¹⁰⁷ where one party is better off and no party is worse off. To achieve a "Pareto optimal" bargain, the partners negotiate given each of their preferences,¹⁰⁸ albeit in situations of asymmetric or incomplete information.¹⁰⁹ Yet their preferences necessarily reflect after-tax income.¹¹⁰ If so, the after-tax results of a partnership affect the partners' relationship to the partnership and their other investment decisions.¹¹¹

At the same time, the rules should and generally if not always do limit gaming the system.¹¹² Flexible partnership tax rules are required to control market imperfections and to produce efficient risk-bearing and risk-sharing between the partners. The linchpin of the partnership arrangement is risk-sharing among its participants.¹¹³ This reflects the fundamental economic premise that combining resources in a firm provides efficiency gains.¹¹⁴ The nature of the firm is explained by economists¹¹⁵ using either team theory,¹¹⁶ agency

CORPORATED ASSOCIATIONS §§ 15-20 (1938).

107. See *supra* note 30.

108. See *supra* note 30. Many partnerships are in the nature of self-enforcing agreements and are written so that each party believes herself to be better off by continuing the relationship. See Lester G. Telser, *A Theory of Self-Enforcing Agreements*, 53 J. BUS. 27 (1980). Various contractual relationships enforce the bargain. See, e.g., Joseph Farrell & Carl Shapiro, *Optimal Contracts with Lock-In*, 79 AM. ECON. REV. 51 (1989).

109. See RASMUSEN, *supra* note 30, at 133-222, 154 n.6.1, 227-43.

110. And, to some degree, the rules allow some forms of tax arbitrage to enter the calculation of Pareto optimality. These include basis strips, service partner distributive shares, and the rules which do not require a gain chargeback for a depreciation allocation. See *supra* note 97 and *infra* notes 517-28, 533-34, 592, 668-69 and accompanying text.

111. Many believe that tax burdens and tax incentives affect net profitability of a firm and determine the magnitude of future output. See, e.g., Charles R. Hulten, *Tax Policy and the Investment Decision*, 74 AM. ECON. REV. 236, 239 (1984). See *infra* notes 121 and 202.

112. See *supra* notes 97-98.

113. See *infra* notes 274-335 and accompanying text.

114. See, e.g., Jack Carr & Frank Mathewson, *The Economics of Law Firms: A Study in the Legal Organization of the Firm*, 33 J.L. & ECON. 307, 314 (1990) (finding legal partnerships to be more beneficial to clients than sole proprietorships because partners monitor each other's actions, creating lower prices for clients); Jordan E. Cohn, *Starting a Business: Two Heads are Better Than One*, CHANGING TIMES, Feb. 1987, at 78 (discussing advantages of partnerships and corporations as opposed to starting a new business by oneself). Compare Ronald J. Gilson, *Unlimited Liability in Law Firm Organization: Tax Factors and the Direction of Causation*, 99 J. POL. ECON. 420 (1991) with Jack L. Carr & G. Frank Mathewson, *Reply to Professor Gilson*, 99 J. POL. ECON. 426 (1991).

115. See R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

theory,¹¹⁷ or transaction cost economics.¹¹⁸ Reflecting the theory of the firm, joint ventures are used where participants take advantage of risk-sharing, pooling of economic and managerial resources, and synergy.¹¹⁹ Where multiple participants have varying tax rates and tax attributes, taxes obviously will influence the economic relationship.¹²⁰ To the extent the Code permits, the parties will engage in

116. Team theory focuses on cooperation and bargaining among team members. See Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); see also Armen A. Alchian, *Specificity, Specialization, and Coalitions*, 140 J. INST. & THEORETICAL ECON. 34, 34 (1984) (arguing that a firm is "a special set of contracts among owners of resources used in a coalition"). For further discussion, see *infra* text accompanying notes 244 & 293.

117. Under agency cost economics, organizations evolve their structures in response to agency and other costs so that the controls and financial arrangements are best structured to ensure the monitoring of agency problems and the lessening of transaction costs. See Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691, 716 (1986); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 330-43 (1976). For further discussions, see *infra* notes 244-47, 255-94, 298, 366, 390, 514, 598 and accompanying text.

118. Transaction cost economics holds that the organization of economic activity is largely to be understood in transaction cost terms. See, e.g., Michael H. Riordan & Oliver E. Williamson, *Asset Specificity and Economic Organization*, 3 INT'L J. INDUS. ORG. 365, 368 (1985); see also Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233 (1979). Asset mobility is an issue with respect to capital mobility. See Bernard Delbecq, *Exchange-Rate Dynamics in a Model with Imperfect Capital Mobility and Asset Substitutability*, 33 EUR. ECON. REV. 1161 (1989). One of the main insights of transaction cost economics is that where asset specificity is present, internal organization is important to align governance structures with the attributes of transactions. Thus, transaction cost economics explains how and why firms choose organizational structures and why people organize firms with flexibility in the risk-bearing and risk-sharing arrangements among partners. For applications, see *infra* text accompanying notes 332, 352, 485, & 590.

119. Some argue that these joint ventures require different substantive rules than the law of partnership. See Adam B. Weissburg, Note, *Reviewing the Law on Joint Ventures with an Eye Toward the Future*, 63 S. CAL. L. REV. 487, 523-31 (1990). How the dynamics of a bargaining position affect the decision to pool and form subsidiary ventures are tested by experiments in a variety of settings. See, e.g., Thomas L. Barton, *Intuitive Choice of Cooperative Sharing Mechanisms for Joint Cost Savings: Some Empirical Results*, 24 ABACUS 162 (1988) (in an experimental setting, farmers sharing the cost of livestock feed make the most practical choices); Robert E. Martin & Eden S.H. Yu, *Competitive Firm and Resource Allocation under Uncertain Capital Service*, 57 S. ECON. J. 208 (1990) (how capital service uncertainty leads to reduction of the firm's output, input, and capital-labor ratio and how risk aversion affects other items).

120. See, e.g., Mark A. Wolfson, *Tax, Incentive, and Risk Sharing Issues in the Allocation of Property Rights: The Generalized Lease-or-Buy Problem*, 58 J. BUS. 159, 161 (1985) (exploring the risk-sharing and tax-shifting motives of shared ownership arrangements in contracts). For a general discussion, see MYRON S. SCHOLES & MARK A. WOLFSON, *TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH* (1992). See *infra* notes 202, 301-06 and ac-

tax arbitrage.¹²¹ Nonetheless, under Subchapter K and its intent to allow economic relationships that reflect economic substance, the allocation of tax burdens generally only concerns the partners and not the Treasury.¹²²

Risk-bearing and risk-sharing are enforced by the aggregate model. Although some commentators consider the aggregate/entity theory debate a quibble over descriptions,¹²³ the distinction between the models explains and illuminates the current partnership tax rules.¹²⁴ Ever since the Uniform Partnership Act was created in the early part of this century, the aggregate theory of the partnership has dominated both nontax law¹²⁵ and tax law.¹²⁶ The "tenancy by the partner-

companying text.

121. Tax arbitrage will occur and parties will pay one another to get tax advantages. See Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money"*, 95 YALE L.J. 506, 515-19 (1986). For example, because of tax arbitrage, interest payments are generally deducted at a much higher marginal tax rate than applies to the taxation of the corresponding interest receipts. See Eugene Steuerle, *Tax Arbitrage, Inflation, and the Taxation of Interest Payments and Receipts*, 30 WAYNE ST. L. REV. 991, 1002 (1984). Arbitrage also involves investing in assets with tax-preferred cost recovery with no effect on the investors' net worth, apart from tax advantages. See Alvin C. Warren, Jr., *Accelerated Capital Recovery, Debt, and Tax Arbitrage*, 38 TAX LAW. 549 (1985). Econometric studies show that tax rates and net yields vary across income classes, explaining the pattern of ownership of particular assets. See Martin Feldstein, *Personal Taxation and Portfolio Composition: An Econometric Analysis*, 44 ECONOMETRICA 631 (1976). One form of tax arbitrage involves the borrowing and purchasing of a tax preferred asset with generous cost recovery allowances. See ALAN J. AUERBACH & KEVIN HASSETT, RECENT U.S. INVESTMENT BEHAVIOR AND THE TAX REFORM ACT OF 1986 (University of Pennsylvania Institute for Law and Economics Working Paper No. 115, 1992) (on file with author); Joseph E. Stiglitz, *The General Theory of Tax Avoidance*, 38 NAT'L TAX J. 325 (1985) (discussing arbitrage and postponement to avoid taxes).

122. See J. Paul Jackson et al., *A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners—American Law Institute Draft*, 9 TAX L. REV. 109, 112 (1954).

Most of the problems encountered in the partnership area are concerned with the distribution of the burden of taxation among the members of the group. Since the Treasury from the standpoint of tax policy is not greatly concerned about this allocation, the issues are essentially not between Treasury and taxpayer-partner but between partner and partner. Consequently, tax technicians should be able to agree on the formulation of rules to govern the complex partnership relationship, and this formulation should not raise issues that pass beyond technical tax policy.

Id. But see, e.g., I.R.C. § 706(d) (1988) (containing exceptions to the above principle).

123. See Gergen, *supra* note 12, at 8.

124. See 1 MCKEE ET AL., *supra* note 19, ¶ 1.02[3].

125. Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 60 n.21 (1990) ("ultimately, in 1914, an aggregate theory, with certain entity aspects, triumphed").

126. The tax law followed suit with the nontax law. From 1913 until the adoption of the 1954 Internal Revenue Code there were very few provisions pertaining to partnerships. See Jacob Rabkin & Mark H. Johnson, *The Partnership Under the Federal Tax Laws*, 55 HARV.

ship," limiting the rights of partners as to particular property, replaced the joint tenancy of partnership property.¹²⁷ Early partnership law viewed the partnership as indistinguishable from the partner, and this view shaped the aggregate view of the partnership form.¹²⁸ The 1953 and 1984 American Law Institute studies of partnership taxation were based on aggregate principles.¹²⁹ While it may be possible to view Subchapter K as a melange of entity and aggregate principles,¹³⁰ aggregate principles dominate, including a stated intent in the legislative history to apply aggregate principles if more appropri-

L. REV. 909, 915 (1942); see also Valentine Brookes, *The Strange Nature of the Partnership Under the Income Tax Law*, 5 TAX L. REV. 35 (1949) (arguing that the tax law has followed to a great degree the nontax law under which the partnership is treated as an entity). The American Law Institute study commencing in 1949 and culminating in their 1954 model code provided the basis for the congressional enactment of Subchapter K in the 1954 Code, although not all of the ALI recommendations were adopted. See AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT—SUBCHAPTER K (1953) [hereinafter 1953 ALI REPORT]. Proposed revisions to Subchapter K were also provided by an advisory committee in the late 1950s. See Dale E. Anderson & Melvin A. Coffee, *Proposed Revision of Partner and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K (First Installment)*, 15 TAX L. REV. 285 (1960); Dale E. Anderson & Melvin A. Coffee, *Proposed Revision of Partner and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K (Second Installment)*, 15 TAX L. REV. 497 (1960). The most recent American Law Institute study also generally follows the aggregate theory and refines many rules to promote the aggregate nature of the firm and the tax relationships that govern it. See 1984 ALI REPORT, *supra* note 97, at 31-40 (aggregate improvements include the calculation of the gain on the sale of a partnership interest, and allocations of special inside bases to purchasing partners, under a full-fragmentation approach).

127. See Joseph A. Drake, *Partnership Entity and Tenancy in Partnership: The Struggle for Definition*, 15 MICH. L. REV. 609, 616-26 (1917) (discussing the entity theory of partnership); Kornhauser, *supra* note 125, at 60-61 n.21 (noting that one contemporary commentator had wondered "whether 'the radicals had, in the language of the day, 'put one over on' the conservatives' by technically retaining the common law aggregate theory but in reality producing an entity or 'mercantile' view of partnerships" (quoting SYDNEY R. WRIGHTINGTON, THE LAW OF UNINCORPORATED ASSOCIATIONS AND SIMILAR RELATIONS § 36 (1916)). It is unclear whether classical Roman law would have treated the partnership as an entity. See PAUL LITTLE, FEDERAL INCOME TAXATION OF PARTNERSHIPS 5 (1952). The theory of a partnership as an entity carries over into the taxation of partnerships under some civil law. See DANIELS, *supra* note 35, at 3-9.

128. See *infra* notes 461-62, 530.

129. See *supra* note 126 and accompanying text; see also Jackson et al., *supra* note 122, at 112-13 ("Partnership . . . is an aggregate of individuals who are co-owners of property used for a joint purpose.").

130. Entity-like concepts are used to treat a partnership as the appropriate accounting entity and for certain transactions between the partner and the firm. See I.R.C. §§ 702, 707(a)(1) (1988 & Supp. 1992). However, interpretations of the aggregate principle forms the underpinnings of the major tax consequences upon the formation, allocation of income and liabilities, and liquidation of the firm and the distribution of its profits and property to the participants. See I.R.C. §§ 704, 721, 731, 752 (1988 & Supp. 1992).

ate in connection with other Code provisions.¹³¹ The aggregate theory determines tax results in different contexts by using both aggregate and entity rules,¹³² or by employing tax policy criteria to choose between them.¹³³ While some reject the aggregate model for its failure to provide a precise meaning and consistent results,¹³⁴ it remains the paradigm for Subchapter K.

IV. FORMULATING PARTNERSHIP TAX RULES IN THE SECOND BEST WORLD OF A HYBRID INCOME CONSUMPTION TAX

The partnership is an extension of the individual savings model through an investment in a firm that deploys resources for production

131. See H.R. CONF. REP. NO. 2543, 83d Cong., 2d Sess. 59 (1954) (with reference to § 702). For example, mechanically applying an entity approach may lead to anomalous results. See *Brown Group, Inc. v. Commissioner*, 102 T.C. 24 (1994) (determining whether a controlled foreign corporation's distributive share of a foreign partnership's income is subpart F income made at the partnership or partner level).

132. This is a recurrent theme in the literature. See e.g., James W.R. Brown, *The Partnership and Federal Income Taxes*, 31 NEB. L. REV. 531, 531-32 (1952); Note, *Theory of the Tax Treatment of the Sale of a Partnership Interest*, 52 COLUM. L. REV. 257, 258-60 (1952); Donald McDonald, *Income Taxation of Partnerships—A Critique*, 44 VA. L. REV. 903 (1958); Ross T. Warner, *Complications in Taxing Partnerships Caused by Coexistence of Entity & Aggregate Concepts*, 96 J. ACCT. 703, 703 (1953); Michael Pusey, *The Partnership as an "Entity": Implications of Basye*, 54 TAXES 143, 156-57 (1976); Mary Louise Fellows, *Partnership Taxation: Confusion in Section 702(b)*, 32 TAX L. REV. 67, 88-97 (1976); Kurt L. Jones, Note, *Are Partnerships Aggregates or Entities When Determining the Availability of Investment Credit for Used Property?*, 35 WASH. & LEE L. REV. 1013, 1013 n.3 (1978); Thomas E. Settles, Comment, *Proposed Legislative Solutions to Tax Shelter Partnership Abuses—The End of the Aggregate Concept?*, 31 VAND. L. REV. 1475, 1491 (1978); David Shakow, *How Now Brown K?*, 63 TAX NOTES 1761 (1994).

133. For example, Subchapter K clearly chooses an aggregate model including allocation of income upon the sale of a partnership interest. I.R.C. §§ 741, 751(a) (1988). This includes treating a nonresident alien limited partner of a U.S. partnership as engaged in trade or business through a permanent establishment in the United States. See *Donroy, Ltd. v. United States*, 301 F.2d 200, 208 n.3 (9th Cir. 1962); see also *Unger v. Commissioner*, 936 F.2d 1316, 1317 (D.C. Cir. 1991) (using aggregate theory to find that a Canadian had a permanent U.S. establishment through a limited partnership interest). Subchapter K also includes the self-charged interest recharacterization under the passive activity rules. The proposed regulation governing the recharacterization states it is inappropriate to characterize the receipt of interest by a partner as portfolio interest and the deduction at the partnership level is passive if the partnership activity is passive. See Prop. Treas. Reg. § 1.469-7 (preamble), 56 Fed. Reg. 14,034, 14,035 (1991).

134. See Gergen, *supra* note 13, at 520. The conflict between the aggregate and entity models is precisely the debate over the theoretical appropriateness of the full or partial deferred sale model for taxing partnership contributions. The 1984 ALI Report advocated the full deferred sale approach. See 1984 ALI REPORT, *supra* note 97, at 129-38. The partial deferred sale approach, which follows the aggregate model, is discussed in the 1953 ALI Report and the 1957 Advisory Group Report. See 1953 ALI REPORT, *supra* note 126.

and investment decisions and which is conceptualized as an extended sole proprietorship.¹³⁵ In a sole proprietorship, an individual saves and moves assets from a consumption to a savings account without a tax recognition event, and gets the benefits or detriments of leverage on borrowed funds. To analyze these effects, one must review the concepts of realization and nonrecognition.

A. *What is the Best Tax System for Subchapter K's Fundamental Premises in a Second-Best World?*

The Haig-Simons definition of personal income¹³⁶ is essentially an accretionist formula¹³⁷—within a specific time period there is a valuation of all the taxpayer's gains and losses. However, the income tax system that has been adopted in the United States generally proceeds from the principle that until a realization event occurs, income is not taxed.¹³⁸ While the accounting concept of realization

135. See 1 MCKEE ET AL., *supra* note 19, ¶ 3.02. Management rights show partnership intent rather than an employer-employee relationship until losses are recovered. *Id.* ¶ 3.02[5][a] & n.68 (citing *Wheeler v. Commissioner*, 37 T.C.M. (CCH) 883 (1978)).

136. HENRY SIMONS, *PERSONAL INCOME TAXATION* 50 (1938) ("Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question."). The definition also includes the corollary that without any requirement of realization, practicality and administrative problems would limit the taxation of unrealized income because it is simply unworkable for taxpayers to reappraise their assets annually and report unrealized income on them. *See id.* at 207-08. For a normative basis to the Haig-Simons income concept based on fairness, see Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45 (1990).

137. See Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 YALE L.J. 1817, 1860-63 (1990).

138. The realization requirement has been described as the Achilles' heel of the income tax. See William D. Andrews, *The Achilles' Heel of the Comprehensive Income Tax*, in NEW DIRECTIONS IN FEDERAL TAX POLICY FOR THE 1980S 278, 280-85 (Charles E. Walker & Mark A. Bloomfield eds., 1983). But see Calvin H. Johnson, *Soft Money Investing Under the Income Tax*, 1989 U. ILL. L. REV. 1019, 1053-57. Under *Eisner v. Macomber*, 252 U.S. 189, 206 (1920), realization is defined as a derivation of gain from capital, labor or both combined. The doctrine has been refined by later cases. See *Cottage Sav. Ass'n v. Commissioner*, 499 U.S. 554, 559 (1991) (citing *Helvering v. Horst*, 311 U.S. 112 (1940) for proposition that realization doctrine is for administrative convenience); *Commissioner v. Glenshaw Glass Co.*, 309 U.S. 426 (1955); *Helvering v. Bruun*, 309 U.S. 461 (1940). This definition implies an "open-ended" process of defining income. See 1 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 5.2 (2d ed. 1989). Property has an economic definition, usually conceptualized as the discounted present value of the right to income. See J.R. HICKS, *VALUE AND CAPITAL* 181-88 (2d ed. 1946). However, the courts in interpreting the Code at times depart from this economic definition. See, e.g., *Horst*, 311 U.S. at 115-16 (taxation of assignment of income from property); *Irwin v. Gavit*, 268 U.S. 161, 167 (1925) (term holder taxed on all property income).

"embod[ies] the factors of measurability and permanence, and serve[s] as [a guide] to the accountant in determining if [the] change in an asset or liability is sufficiently definite and objective to warrant recognition in the accounts . . . ,"¹³⁹ the income tax concept of realization focuses on a material change of ownership of the particular asset or item and its entitlements.¹⁴⁰ Realization is in large measure an accounting convenience and the consequences of determining that a realization event has occurred should not be overlooked in applying the principle.¹⁴¹

139. Floyd W. Windal, *The Accounting Concept of Realization*, 36 ACCT. REV. 249, 257 (1961); see also HICKS, *supra* note 138, at 172. The accounting literature also contains the notion that any income prediction must also consider the differences between *ex ante* and *ex post* measures in earnings models based on expectations. See Sidney Alexander, *Income Measurement in an Dynamic Economy*, in STUDIES IN ACCOUNTING THEORY 35 (William Baxter & Sidney Davidson eds., 1962) (arguing that inclusion of variable income without mixed economic income which includes an increment or capital gain is a better measure of managerial performance). Both views are based on a "value increment measure." Value is the discounted sum of future net income receipts, following the economic income concept. See IRVING FISHER, *THE NATURE OF CAPITAL AND INCOME* (1906); Erik Lindahl, *The Concept of Income*, in ECONOMIC ESSAYS IN HONOR OF GUSTAV CASSEL 339 (1933); ROBERT STERLING, *THEORY OF THE MEASUREMENT OF ENTERPRISE INCOME* (1970); Harold Bierman, Jr. & Sidney Davidson, *The Income Concept—Value Increment or Earnings Predictor*, 44 ACCT. REV. 239, 241 (1969).

The economic discounted cash flow concept of value measures economic income by the change in the value or wealth aggregate of the firm and assumes away uncertainty associated with future cash flows. See KARL H. BORCH, *THE ECONOMICS OF UNCERTAINTY* 172 (1968). These estimates of future flows are built into models which give little formal regard to the fact that it is made up of stochastic (changing) variables rather than fixed concepts. See John K. Shank, *Income Determination Under Uncertainty: An Application of Markov Chains*, 46 ACCT. REV. 57, 58 (1971). The accounting literature rejects the discounted cash flow concept when considering periodic earnings determination because of the uncertainty of the income flow. See *id.* at 57-59; Richard Goode, *The Economic Definition of Income*, in COMPREHENSIVE INCOME TAXATION 1 (Joseph A. Pechman ed., 1977); see also Rudy Schattke, *Expected Income—A Reporting Challenge*, 37 ACCT. REV. 670 (1962); David Solomons, *Economic and Accounting Concepts of Income*, 36 ACCT. REV. 374 (1961); Reed K. Storey, *Cash Movements and Periodic Income Determination*, 35 ACCT. REV. 449 (1960).

140. See *Cottage Sav. Ass'n v. Commissioner*, 499 U.S. 554 (1991) (detailing the "material change of legal obligation" standard). But see Richard H. Nicholls, *Cottage Savings: More S&L Problems* (Tax Forum Paper No. 470, 1991) (on file with author) (rejecting reading of *Cottage Savings* as a "hair trigger" standard).

141. For example, the shifting of risk is one of the broad parameters of a "sale or exchange" under the income tax. The Supreme Court has decided two cases directly on point as to the meaning of a sale. In 1965, the Court applied a plain meaning approach to the concept of a sale and refused to apply a more functional risk-shifting argument. See *Commissioner v. Brown*, 380 U.S. 563, 573-77 (1965). More recently, the Court found a shifting of risk sufficient to constitute a sale and confer true owner status in the context of a two-party sale-leaseback. *Frank Lyon Co. v. United States*, 435 U.S. 561, 581-83 (1978). Lower courts have tried to distinguish a sale from a lease or loan transaction based on the econom-

The realization principle implements tax policy as a hybrid income consumption tax.¹⁴² On the one hand, the realization doctrine exacts a toll on the conversion of an investment, and converts the income tax on some passive receipts into a consumption tax by deferring taxation of accumulated wealth until "realized," which may approximate the time when the receipts are consumed.¹⁴³ On the other hand, shifts of entitlements among taxpayers linked in certain economic relationships, such as holders and issuers of debt instruments, may be viewed as nonrealization events where the shifting entitlements are viewed as part and parcel of the original relationship.¹⁴⁴ Realization in the partnership context exhibits this same tension.¹⁴⁵ Any deferral can be viewed as creating so-called "Cary Brown" income.¹⁴⁶ The Cary Brown thesis¹⁴⁷ assumes that capital

ic effect of the transaction. Compare *Martin v. Commissioner*, 56 T.C. 1255 (1971), *aff'd*, 72-2 U.S. Tax Cas. (CCH) ¶ 9637 (5th Cir. 1972) (*per curiam*) (finding a loan) with *Stranahan v. Commissioner*, 472 F.2d 867 (6th Cir. 1973) (finding a sale).

Every contract entered into for a future transfer of property could be analyzed as the current transfer of a reversion, thereby imputing an interest in the property. The tax law does not do this since it focuses on if and when there is a sale. See *Bryant v. Commissioner*, 399 F.2d 800 (5th Cir. 1968); *Alstores Realty Corp. v. Commissioner*, 46 T.C. 363 (1966), *acq.*, 1967-2 C.B. 1; see also *Jack Ammann Photogrammetric Eng'rs, Inc. v. Commissioner*, 341 F.2d 466 (5th Cir. 1965) (merger arises in loan transactions); *Smith v. Commissioner*, 78 T.C. 350 (1982), *aff'd*, 820 F.2d 1220 (4th Cir. 1987) (transactional approach to offsetting transactions in butterfly straddles, finding risk of change in value, but no profit motive); *Walker v. Tomlinson*, 63-1 U.S. Tax Cas. (CCH) ¶ 9119 (M.D. Fla. 1962) (involving distribution to a shareholder of a debt obligation owed the corporation in exchange for the cancellation of the obligation because of the merger of debtor and creditor status under state law); Rev. Rul. 93-7, 1993-1 C.B. 125 (distribution of a debt of a partner acquired by the partnership to that partner requires extinguishment of that debt).

142. See generally UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX (Henry J. Aaron et al. eds., 1988); Edward J. McCaffery, *Tax Policy Under a Hybrid Income-Consumption Tax*, 70 TEX. L. REV. 1145, 1152 (1992).

143. See Joseph Isenbergh, *The End of Income Taxation*, 45 TAX L. REV. 283, 315-16 (1990).

144. See Prop. Treas. Reg. § 1.1001-3(c), 57 Fed. Reg. 57,036, 57,036-37 (1992).

145. See *infra* notes 486-91, 569-86 and accompanying text.

146. See E. Cary Brown, *Business-Income Taxation and Investment Incentives*, in INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN 300 (Lloyd A. Meltzer ed., 1948). There is a mathematical equivalence, given a specific rate of return, a specific tax rate and a given period of time, between (1) exempting from taxation principal under a nonrecognition rule or any rule allowing a deduction before the expiration of the usefulness of basis and (2) exempting from taxation the investment income from the asset. The equivalence of expensing and exemption has been given several rationales, including making government a fair partner in the investment and providing relief from the double tax on principal and income which forms the basis of consumption. See Johnson, *supra* note 138, at 1027-31.

147. The Cary Brown thesis is that the exemption of principal from taxation creates,

markets do not react to tax preferences by interest rate fluctuations.¹⁴⁸ The realization requirement may create tax deferral value¹⁴⁹ by deferring until consumption taxation of savings, but when

during the time of that exemption, the equivalent of a tax-free receipt of the investment income on the exempted principal. See *supra* note 146. For example, assume a taxpayer in the 25 percent tax bracket has \$100 of unrealized appreciation in an asset. If she sells the asset today she will have \$75 left after tax to invest. Assuming the reinvested \$75 goes up in value by 50 percent, and she is not taxed on that income when she sells the new asset, at the end of the period she will have \$112.50 total. If she lets her current investment ride and it goes up in value by 50 percent and then she sells, she will have a gain of \$150 and pay a tax of \$37.50, and thus will also have \$112.50. Another application of the Cary Brown thesis involves the value and timing of deductions. To the extent deferral delays a deduction for an otherwise deductible payment, the payor is taxed on the investment income. See Halperin, *supra* note 121, at 532, 544.

148. See Alvin C. Warren, Jr., *Fairness and a Consumption-Type of Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931, 937 (1975).

149. These issues are moot in accrual regimes. See David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986). They are also moot in tax regimes where the value of deferral is compensated for by an interest charge for deferral of the "tax payment between the time the market price increases were deemed to have occurred and the realization event that triggered the tax assessment." Mary Louise Fellows, *A Comprehensive Attack on Tax Deferral*, 88 MICH. L. REV. 722, 810 (1990); see also *id.* at 728-30, 737-38 (proposing the TARET model—time-adjusted-realization-event tax—which would have this effect and eliminate nonrecognition rules); Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does it Matter?*, 47 TAX L. REV. 377 (1992); Theodore S. Sims, *Long-Term Debt, the Term Structure of Interest and the Case for Accrual Taxation*, 47 TAX L. REV. 313 (1992); Strnad, *supra* note 137; Noel B. Cunningham & Deborah H. Schenk, *Taxation Without Realization: A "Revolutionary" Approach to Ownership*, 47 TAX L. REV. 725 (1992); William Vickrey, *Tax Simplification Through Cumulative Averaging*, 34 LAW & CONTEMP. PROBS. 736 (1969) (advocating lifetime cumulative averaging).

The nature of the income tax, with its associated consumption tax aspects, features a number of tax expenditures, yet there is no consensus upon what is the norm for an income tax. Compare STANLEY S. SURREY, *PATHWAYS TO TAX REFORM* 21-23 (1973) and STANLEY S. SURREY & PAUL R. MCDANIEL, *TAX EXPENDITURES* 4-6 (1985) (both citing as the norm the Schanz-Haig-Simons economic definition of income—an increase in economic wealth between two points of time notwithstanding consumption during that period) with Boris I. Bittker, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive out Inequities*, in *THE ECONOMICS OF TAXATION* 19 (Henry J. Aaron & Michael J. Boskin eds., 1980) (advocating single income tax criteria). Nonrecognition rules are a subset of the consumption tax aspect of a hybrid income consumption tax. The Code provides for "nonrecognition" in appropriate circumstances, an approach adopted by Congress in 1924 after unsuccessful attempts at incorporating substantive realization tests into the tax law. See Nicholls, *supra* note 140, at 24-25; see also Edwin Seligman, *Are Stock Dividends Income?*, 9 AM. ECON. REV. 517 (1919). The 1924 addition provided for realization and recognition on all exchanges unless otherwise provided, the rule which exists today. See I.R.C. § 1001(a) (1988); H.R. REP. NO. 179, 68th Cong., 1st Sess. 13 (1924); ROY G. BLAKEY & GLADYS C. BLAKEY, *THE FEDERAL INCOME TAX* 223-50 (1940) (discussing the changes adopted by Congress in 1924). No further changes were made prior to the Treasury adoption of essentially that same standard in the regulations pursuant to the Revenue Act of 1934. See Treas. Reg. 86, art. 111-1 (1934);

the general equilibrium effects of taxation are considered, the requirement does not allow for true tax deferral,¹⁵⁰ and the realization doctrine is demonstrated to promote efficiency in a variety of contexts.¹⁵¹

B. Formulating Partnership Tax Rules in a Second-Best World

The partnership tax rules show the problems in formulating tax policy within a hybrid income consumption tax. The theory of the "second best"¹⁵² states that once the economy moves from the ideal of unregulated perfect competition, it is not certain whether a move toward the more ideal will improve the allocation of resources.¹⁵³ The formulation of tax policy in a second best world in the context of a hybrid income consumption tax requires an "economic" rather than a "tax base" approach to the taxation of human and financial capital.¹⁵⁴ The economic view of income begins with the Haig-

see also S. REP. NO. 398, 68th Cong., 1st Sess. 13 (1924); Gen. Couns. Mem. 39,551 (Aug. 26, 1986); Gen. Couns. Mem. 39,149 (Mar. 1, 1984); Gen. Couns. Mem. 38,838 (Apr. 19, 1982).

Nonrecognition rules explicitly provide deferral value, but do not distinguish between reinvestment and consumption of realized savings. Nonrecognition provisions with respect to partnership and corporate formation, as well as provisions for partnership distributions, are not in the tax expenditure budget. JOINT COMM. ON TAXATION, 102D CONG., 2D SESS., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1993-97 (Comm. Print 1990).

150. See Alvin C. Warren, Jr., *supra* note 148, at 937 (if an income tax raises the gross rate of interest to offset fully "the tax imposed on income producing assets, an accretion-type tax would not discriminate against future consumption, whether equal earners or equal consumers are compared"); see also Johnson, *supra* note 138, at 1053-57. Differences of opinion about the merits of partnership tax deferral rules may reflect this empirical uncertainty; See, e.g., Gergen, *supra* note 13, at 524-25 (using a Cary Brown construct to analyze pooling transactions in partnerships).

151. See Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1 (1992).

152. See R. G. Lipsey & Kelvin Lancaster, *The General Theory of the Second Best*, 24 REV. ECON. STUDIES 11 (1956). See generally RICHARD W. TRESCH, PUBLIC FINANCE: A NORMATIVE THEORY 296-370 (1981).

153. Second best analysis is aimed at defining optimal policies to cope with distortions and inefficiencies (e.g. taxes, budget constraints, monopoly power, externalities) in the marketplace and asserts that the general guidelines for policy provided by welfare economics — e.g. "paretian conditions" where price should equal marginal cost—are not relevant for real-world economics which reflect policy constraints and market distortions. See Peter Bohm, *Second Best*, in 4 THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS 280 (John Eatwell et al. eds., 1987); Jacques H. Dreze, *Second-Best Analysis With Markets In Disequilibrium*, 29 EUR. ECON. REV. 263 (1985).

154. See Deborah M. Weiss, *Can Capital Tax Policy Be Fair? Stimulating Savings Through Differentiated Tax Rates*, 78 CORNELL L. REV. 206, 218 (1993) (contrasting the ability-to-pay approach to income tax policy with the welfare economic approach).

Simons definition of the tax base but then applies the optimal tax theory and the theory of tax incidence.¹⁵⁵ Taxation of different sources of income at different rates can be justified for both efficiency and equity reasons.¹⁵⁶ An efficient tax system will have a higher tax on less elastically supplied factors and a relatively lower tax on the more elastically supplied factors.¹⁵⁷ Other considerations, including tax neutrality and the justification for partnership rules which correspond to the manner in which other transactions are taxed, are important to efficiency as well.¹⁵⁸

The theory of life cycle savings is that each individual fully consumes her lifetime income¹⁵⁹ and raises the question of the proper tax treatment of savings during one's lifetime for future consumption, *i.e.*, the income taxation of capital saved for later discretionary spending.¹⁶⁰ Nonrecognition rules should be resolved with an eye toward the best way to increase life-cycle savings. *Ex ante*, talent and education give individuals different income-producing capacities. *Ex post*, similar earning capacities produce different incomes. The interplay of chance and human autonomy explains our usual preference for *ex post* over *ex ante* tax rules. Income taxation should be based on both *ex post* and *ex ante* determinations and upon a careful consideration of when these principles should apply.¹⁶¹

155. See Martin Feldstein, *On the Theory of Tax Reform*, 6 J. PUB. ECON. 77, 86-102 (1976); see also HERBERT KIESLING, *TAXATION AND PUBLIC GOODS: A WELFARE-ECONOMIC CRITIQUE OF TAX POLICY ANALYSIS* 166-98 (1992) (focusing on the efficiency of taxes and the problem of distortion).

156. See Weiss, *supra* note 154, at 218-24 (proposing tax rates on capital and labor income relative to the level of wage income); STIGLITZ, *supra* note 30, at 534-59.

157. See *infra* notes 348-70 and accompanying text. No true consensus exists as to the equity trade-offs made between the gains of one person and the losses of another. See Weiss, *supra* note 154, at 223 n.40.

158. See *infra* notes 476-79, 486-98, 569-86 and accompanying text. In addition, it is important to incorporate the concept of the time value of money into the Internal Revenue Code, so that the system will tax currently or in a deferred manner interest that is accruing due to the mere passage of time, where that interest is paid on borrowed capital. In order to tax such interest, partner contributions must be treated as loans or the difference between capital accounts and profit-sharing ratios must be treated as a cross-borrowing within the firm. See *infra* notes 442-58 and accompanying text. This Article endorses the latter view.

159. The theory of life cycle savings was proposed by Irving Fisher and later developed by Modigliani and Brumberg. See Franco Modigliani & Richard Brumberg, *Utility Analysis and the Consumption Function: An Interpretation of Cross-Section Data*, in 2 THE COLLECTED PAPERS OF FRANCO MODIGLIANI 388 (Andrew Abel ed., 1980); *Life Cycle Savings and Balanced Growth*, in 2 ESSAYS IN ECONOMICS 128 (James Tobin ed., 1987).

160. See C. EUGENE STEUERLE, *TAXES, LOANS, AND INFLATION: HOW THE NATION'S WEALTH BECOMES MISALLOCATED* 18-24 (1985).

161. See KALDOR, *supra* note 33, at 62-64; Alvin Warren, *Would a Consumption Tax Be*

The policy choice in a second best world supports *ex post* taxation¹⁶²—the taxation of income when it is earned. In part, this is because decision making requires consideration of both uncertainty and risk. In contrast, an *ex ante* system taxes the market value of future income before it materializes. The flexibility of Subchapter K accords well with *ex post* norms for the tax treatment of risk under the tax system for all investors.¹⁶³ An *ex post* system allows deferral of the taxation of human capital contributions and of the assessment of earning potential, and allows deferral of recognition of gain or loss on transfers of property to and from pools. Taxing the unrealized appreciation in contributed property is akin to *ex ante* taxation of the partnership's expected return. Taxing unrealized appreciation on a property distribution is *ex ante* taxation of the new use to which the asset is put.

V. THE ROLE OF RISK-BEARING AND RISK AVERSION IN PARTNERSHIP TAXATION

Those who would reform the premises of partnership tax theory by shifting to an entity model ignore risk and uncertainty.¹⁶⁴ The

Fairer Than an Income Tax?, 89 YALE L.J. 1081, 1098-99 (1980); see also Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575, 1600-02 (1979) (advocating an *ex post* over an *ex ante* basis for income taxation). See generally Reed Shuldiner, *A General Approach to the Taxation of Financial Instruments*, 71 TEX. L. REV. 243, 262-65 (1992).

162. See Richard Goode, *Changing Views of the Personal Income Tax*, in RETROSPECTIVES ON PUBLIC FINANCE 93 (Lorraine Eden ed., 1991). See generally Joshua D. Rosenberg, *Tax Avoidance and Income Measurement*, 87 MICH. L. REV. 365 (1988); Patricia D. White, *Realization, Recognition, Reconciliation, Rationality and the Structure of the Federal Income Tax System*, 88 MICH. L. REV. 2034 (1990).

163. See *infra* notes 459-670 and accompanying text.

164. Risk and uncertainty play an important part in formulating tax rules. See Michael Livingston, *Risky Business: Economics, Culture and Taxation of High-Risk Activities*, 48 TAX L. REV. 163, 167-87 (1993) (exploring economic and noneconomic arguments for taking risk into account in formulating tax rules). Consider the different treatment of contingent obligations for estate and income tax purposes. For estate tax purposes, contingent items are valued for the estate tax return at the time of death. I.R.C. § 2031(a) (1988). For income tax purposes, many contingent items are not valued until they become certain. See, e.g., *Commissioner v. Carter*, 170 F.2d 911, 912 (2d Cir. 1948) (contingent contracts not valued by cash method in corporate liquidation). Uncertainty also may preclude the accrual of income. See *Georgia School-Book Depository, Inc. v. Commissioner*, 1 T.C. 463, 469 (1943) (to shift the accrual of income from one year to another "there must be a definite showing that an unresolved and allegedly intervening legal right makes receipt contingent or that the insolvency of [the] debtor makes it improbable"). In some circumstances it determines the manner in which

contrast between partnership taxation and the taxation of other business entities lies in the different responses to the risks that entrepreneurs and investors bear in these dissimilar types of business organizations when they deploy financial and human capital.¹⁶⁵

A. Risk-Bearing and Risk-Sharing

The main conflict in Subchapter K is over the weight of risk-bearing and risk-sharing in determining who should benefit from or bear the burden of business taxation.¹⁶⁶ Every investment can be viewed as a series of cash flows. This series of cash flows is subject to risks, both economic (such as a change in the interest rate) and noneconomic (such as a natural disaster). Applying finance theory, the deviation of the actual cash flow from the expected cash flow measures these risks.¹⁶⁷

1. Defining Risk and Uncertainty

Risk¹⁶⁸ and uncertainty,¹⁶⁹ while they often co-exist, are

basis will be recovered. *See* *Burnet v. Logan*, 283 U.S. 404, 413 (1931). In yet other circumstances, it determines how basis will be apportioned. *See* *Inaja Land Co. v. Commissioner*, 9 T.C. 727, 735-36 (1947), *acq.*, 1948-1 C.B. 2. On the other hand, where the income tax requires certainty of valuation with respect to certain methods of timing income, contingent obligations are valued. *See, e.g.*, Prop. Treas. Reg. § 1.1274-2(e), 50 Fed. Reg. 6,936 (1985) (valuation of contingent obligations issued for nonpublicly traded property). Nonetheless, as the estate tax example illustrates, where it is imperative to value assets at a certain time uncertainty is turned into a probability and then used to value the asset. Finally, many tax rules turn on whether the taxpayer has undertaken or reduced risk with respect to a transaction. *Compare* Treas. Reg. § 1.707-3 (1992) (definition of disguised sale to partnerships by reference to whether risk is undertaken) *with* Treas. Reg. § 1.1221-2(c)(1) (1994) (definition of risk reduction hedge in a hedging transaction).

165. These relationships are governed by the participants' utility functions including their aversion to or seeking of risk. *See infra* notes 274-335 and accompanying text.

166. For examples of these conflicts, *see infra* notes 463-98, 545-72 and accompanying text.

167. *See* RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 131-39 (4th ed. 1991).

168. Risk literature distinguishes between systematic risk—the risk of the market—and unsystematic risk—the risk of a particular asset. Unsystematic risks can be managed by diversifying into different types of investments, while systematic risk is unavoidable and inherent in the nature of the system. *See infra* note 184. In the insurance context, where the ability exists to diversify the specialized risk of a given policy, under an empirical approach only the policy holder is the gambler. *See* DAVID L. BICKELHAUPT, *GENERAL INSURANCE* 3-29 (10th ed. 1979). The insurer is the "house" and always wins because it has issued policies insuring many different specific risks. HERBERT S. DENENBERG, *RISK AND INSURANCE* 22-27, 510-11 (2d ed. 1974). Thus, much of the literature on risk concerns the three-step process of (1) defining risk, (2) identifying risk, and (3) measuring risk. *See* James Houston, *Risk, Insur-*

distinguishable once it is assumed that there is a boundary that can be placed on the scope of information that can be used to evaluate a series of events.¹⁷⁰ Once it is assumed that the most important aspect is a subjective probability concept—a subjective response to “objective” data—then decision-makers always operate in a world of uncertainty, never one of objectively determined risk.¹⁷¹ Once one assumes boundaries on information and possibly an objective response, risk may be defined “not [only] as the variance in rate of return over some period of time, but rather as a probability of not being able to finance a fixed amount of consumption at some point in the future.”¹⁷² Uncertainty differentiates between predictable and unpredictable changes and outcomes. It is defined by the unpredictability of a firm’s income stream as measured by the *ex post* variance of a firm’s return on investment or equity¹⁷³ from the *ex ante* prediction of a firm’s earnings stream.¹⁷⁴ Uncertainty differs from risk in that uncertainty is unmeasurable, while risk includes a measurable uncertainty.¹⁷⁵ Uncertainty limits the capital supplied to business ventures

ance, and Sampling, 31 J. RISK & INS. 511 (1964).

169. There is a variety of literature on the effects of uncertainty on decision making. See FRANK H. KNIGHT, *RISK, UNCERTAINTY AND PROFIT* (1921); see also JOHN RAWLS, *A THEORY OF JUSTICE* 155-72 (1971) (individuals make decisions under uncertainty for which there is no set model); Susan Moller Okin, *Reason and Feeling in Thinking About Justice*, in *FEMINISM & POLITICAL THEORY* 15, 28-29 (Cass R. Sunstein ed., 1990); Peter F. Drucker, *Planning for Uncertainty*, WALL ST. J., July 22, 1992, at A12. See generally KENNETH J. ARROW, *ESSAYS IN THE THEORY OF RISK-BEARING* (1971) [hereinafter ARROW, *ESSAYS*]; KENNETH J. ARROW, *ASPECTS OF THE THEORY OF RISK-BEARING* (1965); Peter J. Hammond, *Uncertainty*, in *NEW PALGRAVE UTILITY AND PROBABILITY* 280 (John Eatwell et al. eds., 1987); Peter Gardenfors & Nils-Eric Sahlin, *Unreliable Probabilities, Risk Taking and Decision Making*, 53 *SYNTHESE* 361 (1982); John Hirshleifer & John G. Riley, *The Analysis of Uncertainty and Information: An Expository Survey*, 17 J. ECON. LIT. 1375 (1979).

170. Economists debate whether risk can be distinguished from uncertainty. Risk becomes predictable once it is assumed that there is a boundary that can be placed around information to convert uncertainty to risk. See HIRSHLEIFER & RILEY, *supra* note 24, at 9-11. The modern economic view refuses to distinguish between risk and uncertainty.

171. *Id.*

172. STEUERLE, *supra* note 160, at 21.

173. See Edward H. Bowman, *A Risk/Return Paradox for Strategic Management*, 21 SLOAN MGMT. REV. 17 (1980); Avi Fiegenbaum & Howard Thomas, *An Examination of the Structural Stability of Bowman's Risk-Return Paradox*, 28 ACAD. MGMT. PROC. 7 (1985).

174. See, e.g., Philip Bromiley, *Testing a Causal Model of Corporate Risk Taking and Performance*, 34 ACAD. MGMT. J. 37, 44 (1991).

175. KNIGHT, *supra* note 169, at 20-21, 204-06. Classification of risk presupposes that it is linked to properties “sufficiently limited in number and in mode of association for intelligence to grasp.” *Id.* at 206. The differences between risk and uncertainty are a function of probabilities classified in three categories: (1) a priori probability or an absolutely homogeneous classification of instances; (2) statistical probability or the empirical evolution of fre-

as different capital providers are in different positions to view uncertainty as a calculable risk.¹⁷⁶ Nevertheless, in this Article, risk and uncertainty are used interchangeably, but with risk denoting circumstances in which a boundary is placed on information.

Uncertainty still exists, despite increased information and risk measurement devices designed to reduce its presence, since uncertainty involves unquantifiable human knowledge and conduct, in contrast to business events that can be estimated.¹⁷⁷ Frank Knight's famous example is the breakage of bottles in the champagne industry where specialized uncertainty-bearing is a form of self-insurance.¹⁷⁸ While risk is the probability function of a given event, uncertainty is the indeterminacy between the assessments of each of various bargainers and their respective strategies for sharing the risk probabilities within their bounded rationality of behavior. For example, uncertainty causes parties to bargain for "open returns" in contracts, with a resulting gain if the contingencies resolve in the investor's favor.¹⁷⁹

The following examples of partner and partnership decisions involve risk and uncertainty: (1) the decision to contribute property to a partnership and to pool the property with the firm's endeavors; (2) the decision to contribute one's services in exchange for a distributive share of profits; (3) the decision to bear the risk of loss on an asset in an earlier period in exchange for an increased share of the reward from the property in a later period (or to bear a disproportionate allocation of income or loss from particular activities relative to a proportionate contribution to the common pool); and (4) upon exiting

quency of association; and (3) estimation. *Id.* at 224-26. Uncertainty is not susceptible to measurement and hence elimination. See J. FRED WESTON & EUGENE F. BRIGHAM, *MANAGERIAL FINANCE* 223 (4th ed. 1972).

176. See Ansell Egerton, *Acceptable Risk*, in *UNCERTAINTY AND EXPECTATIONS IN ECONOMICS: ESSAYS IN HONOUR OF G.L.S. SHACKLE* 58, 62 (C.F. Carter & J.L. Ford eds., 1972). Borrowing is limited by uncertainty when the supply of capital in respect of a venture with an uncertain outcome is not infinitely elastic. In addition, agency costs such as moral hazard, reduce the optimal allocations under uncertainty. See *infra* note 245.

177. See KNIGHT, *supra* note 169, at 231 ("liability of opinion or estimate to error must be radically distinguished from probability or chance of either type"); G.L.S. SHACKLE, *EXPECTATION IN ECONOMICS* 101-02 (1949) ("[U]ncertainty must enter at some stage into the bargaining process.").

178. See KNIGHT, *supra* note 169, at 51-93. According to Knight, business organizations deal with the problem of uncertainty through specialization, which allows a venturer to understand more closely the uncertainty of a particular business and subject investments to a measured risk, instead of uncertainty, through accumulated experience in similar enterprises. KNIGHT, *supra* note 169, at 255-58.

179. See Mark P. Gergen, *The Use of Open Terms in Contract*, 92 COLUM. L. REV. 997, 1004-05, 1007 (1992) (detailing the role of uncertainty and bounded rationality).

a firm, the decision to take property other than that contributed or with regard to which one had a special allocation.¹⁸⁰

2. Risk-Taking and Risk-Sharing—Entrepreneurism and Economic Development

Risk-bearing is the taking on of risk by an investor or a market participant. A risk premium is the additional return required by investors for bearing risk above the riskless rate of return.¹⁸¹ In financial theory, the market's assessment of risk and return is reflected by the securities market and based on the capital asset pricing model,¹⁸² a model whose explanatory power has been recently challenged.¹⁸³ Market participants are compensated for bearing systemic risk—the risk of the market—but not for bearing unsystemic risk—the risk of a particular investment, which can be eliminated by diversification.¹⁸⁴ An investment's risk is composed of many elements which can be isolated into specific elements of the investment's total risk.¹⁸⁵

180. This final decision may well involve a greater measure of risk than uncertainty because of the specific knowledge the distributee has of the distributee's portfolio outside of the partnership and the effect the distributed property would have on that portfolio.

181. Much research has studied the interrelations of risk premiums among risky assets. Thus, the market price of risk is the "difference between the expected rate of return on the market for risky assets as a whole and on a risk-free asset per unit of risk of the market portfolio." See Irwin Friend & Marshall E. Blume, *The Demand for Risky Assets*, 65 AM. ECON. REV. 900, 918-19 (1975).

182. BREALEY & MYERS, *supra* note 167, at 173-203; STEPHEN A. ROSS ET AL., *FUNDAMENTALS OF CORPORATE FINANCE* 324-92 (2d ed. 1993). The capital asset pricing model values the firm's equity interest. The model assumes: (1) efficient capital markets with well-informed investors, (2) zero transaction costs, (3) negligible restrictions on investment and no taxes, (4) no investor large enough to affect the market price of the stock, and (5) investors that are in general agreement about the likely performance and risk of individual securities and whose expectations are based on a common holding period. JOSEPH VAN HORNE, *FINANCIAL MANAGEMENT AND POLICY* 59 (5th ed. 1980). Other models to predict the market line include the arbitrage pricing theory and the option pricing theory. BREALEY & MYERS, *supra* note 167, at 169-73, 511-30.

183. See Eugene F. Fama & Kenneth R. French, *The Cross-Section of Expected Stock Returns*, 47 J. FIN. 427, 464 (1992) (concluding that the capital asset pricing model does not correctly describe the relationship between market risk and average stock return as compared to the return on riskier stock).

184. See ROSS ET AL., *supra* note 182, at 377-91. Evidence suggests that the market compensates for unsystemic risk in areas in which risk is not efficiently diversified. For example, a particular venture in real estate may have a high degree of unsystematic risk associated with it, and thus the argument that the venture could be fully diversified, creating a perfectly balanced portfolio, is inadequate. See Dennis R. Capozza & Gregory M. Schwann, *The Value of Risk in Real Estate Markets*, 3 J. REAL EST. FIN. & ECON. 117 (1990) (the trigger price for developing urban land possesses a higher percentage of total unsystemic risk whereas systematic risk generally has the strongest effect on the price of undeveloped land).

185. One example is zero coupon bonds, in which a bond's cash flow is separated into

Another form of risk-taking is entrepreneurial risk.¹⁸⁶ Entrepreneurial activity is helpful in an economy because it increases social gain as an investment yields positive net benefits.¹⁸⁷ Risk and return have a positive relationship, and while there is some debate whether risk-taking is a desirable end,¹⁸⁸ there is a strong connection between economic growth and risk-taking in the theory of economic development.¹⁸⁹ A normative theory of the value of risk-taking has not yet been fully established.¹⁹⁰ Nonetheless, the value of risk-tak-

the stream of interest payments and the principal repayment at maturity. If the stream of interest payments is sold separately, the investment is denominated a "strip." REMICs are another example of an attempt to eliminate interest rate and reinvestment risk. *See supra* note 101 and accompanying text. In another example, an import/export company faces at least two sources of risk in its business, the risk involved in its choice of products to import and export, and foreign exchange risk. Risk-sharing allows persons with different levels of risk to manage risk by joining a pool of diversified investments.

186. Entrepreneurial profits also refer to profits from innovation and to economic returns that are unrelated to monopoly power, which is the power to be a price setter rather than a price taker. *See* Rudnick, *supra* note 39, at 1175-76 (discussing the profit theory of entrepreneurial behavior). Partnership advocates refer at times to all of the risk-bearing involved in any partnership as "entrepreneurial". The tax rules also do so when only some risk-bearing should be deemed entrepreneurial. *See, e.g.,* Treas. Reg. § 1.707-3 (as amended 1992) (governing disguised sales). In a partnership with risky investments, the risk-bearing should not be characterized as entrepreneurial. Even if a partnership is invested solely in Treasury securities, the return on which defines the riskless interest rate, the partnership rules would treat the partners as risk-sharing even though the investment is riskless—the only risk that they bear could be measured if account is taken of the entire portfolio of assets held by the partners within and without the partnership which may not be diversified. *Cf.* BREALEY & MYERS, *supra* note 167, at 136-39, 143-49 (noting that some risk exists even with diversification). It may be correct to criticize the loose use of the term "entrepreneurial" to describe the risk-bearing in partnerships but this criticism is not substantive.

187. *See* STIGLITZ, *supra* note 30, at 553.

188. *See* Jan Mossin, *Taxation and Risk-Taking: An Expected Utility Approach*, 35 *ECONOMICA* 74, 74 (1968). For example, strategic management is concerned with risk-taking. Poor performance appears to increase risk-taking and risk-taking appears to give poor returns to the firm. *See* Bromiley, *supra* note 174, at 37. Other studies focus on risk and return relative to diversification. *See* Raphael Amit & Joshua Livnat, *Diversification and the Risk-Return Tradeoff*, 31 *ACAD. MGMT. J.* 154 (1988); Richard A. Bettis & Vijay Mahajan, *Risk/Return Performance of Diversified Firms*, 31 *MGMT. SCI.* 785 (1985); Yegmin Chang & Howard Thomas, *The Impact of Diversification Strategy on Risk-Return Performance*, 30 *ACAD. MGMT. PROC.* 2 (1987); *see also* Avi Fiegenbaum & Howard Thomas, *Attitudes Toward Risk and the Risk-Return Paradox: Prospect Theory Explanations*, 31 *ACAD. MGMT. J.* 85 (1988) (surveying the risk-return literature). Management scholars have found that risk and return may be negatively correlated in a business setting. This situation is known as Bowman's paradox. *See* Bowman, *supra* note 173; Edward H. Bowman, *Risk Seeking by Troubled Firms*, 23 *SLOAN MGMT. REV.* 33 (1982). *But see* Benjamin M. Oviatt & Alan D. Bauerschmidt, *Business Risk and Return: A Test of Simultaneous Relationships*, 37 *MGMT. SCI.* 1405, 1405 (1991) (with realistic simultaneous models risk and return are shown to be influenced by various industry conditions and business strategies but not by each other).

189. *See* SCHUMPETER, *supra* note 104, at 894.

190. *See* LOUIS J. KAPLOW, *TAXATION AND RISK TAKING: A GENERAL EQUILIBRIUM*

ing is generally assumed in the literature.¹⁹¹ Intuitively, risk leads to rewards and to an increased social output,¹⁹² just as the effect of uncertainty retards the rate of accumulation of capital.¹⁹³ A risk-taking enterprise thus contributes *ex ante* to social gains rather than social costs.¹⁹⁴ However, excess risk-taking without adequate provision for the adverse effects of risk intuitively leads to reduced social welfare.¹⁹⁵ Applying this insight, some literature finds that risk-taking can cause a loss to society due to a diminution of the productivity of capital which is caused by its uneconomic, risk-driven apportionment.¹⁹⁶ Other factors, such as the presence of limited liability, may increase private risk-taking above the optimal social level.¹⁹⁷ The current level of risk-taking is by definition optimal from the private perspective.¹⁹⁸

Risk may be shared, or transferred to others.¹⁹⁹ The risk premi-

PERSPECTIVE 1 n.2, 2 n.5 (National Bureau of Economic Research Working Paper No. 3709, 1991); cf. Bankman & Griffith, *supra* note 149, at 378.

191. See James Tobin, *Economic Growth as an Objective of Government Policy*, 54 AM. ECON. REV. 1, 13-14 (1964) (analysis of benefits of risk-pooling). For a discussion, see Livingston, *supra* note 166, at 179-80.

192. The popular and practical financial press generally embraces this view. For example, Peter Drucker, who has written for years about the value of risk-taking and entrepreneurship, embraces this view. See PETER F. DRUCKER, *MANAGING FOR THE FUTURE: THE 1990S AND BEYOND* (1992); see also Rudnick, *supra* note 39, at 1175-76 & nn.738-43 (reviewing the academic literature on entrepreneurship in support of this connection).

193. ALLAN H. WILLETT, *THE ECONOMIC THEORY OF RISK AND INSURANCE* 31 (1951).

194. See Rudnick, *supra* note 39, at 1175-76. See generally *THE CULTURE OF ENTREPRENEURSHIP* (Brigitte Berger ed., 1991).

195. The consequences of the failure to provide for risk includes the market response to risk seekers like Donald Trump. See Larry Light & Joseph Weber, *The Donald's Trump Card*, BUS. WK., Mar. 23, 1992, at 74. Risk-seeking coupled with faulty assessment and mismanagement increases social risk and decreases social welfare. See AMARTYA SEN, *ON ETHICS AND ECONOMICS* 10-12 & n.6 (1987). "The world certainly has its share of Hamlets, Macbeths, Lears and Othellos. The coolly rational types may fill our textbooks, but the world is richer." *Id.* at 11.

196. See WILLETT, *supra* note 193, at 26-31 (relating net loss to the "law of diminishing utility on the reluctance to incur risk"); see *supra* note 188.

197. Examples include the bankruptcy of certain insurers. See Richard W. Stevenson, *California Seizes Insurer Burdened with 'Junk Bonds'*, N.Y. TIMES, Apr. 12, 1991, at A1. A recent model suggests that entity-level taxes, or progressive individual taxes on income from partnerships where asset substitution causes risk-shifting and increased social risks, will reduce the level of private risk-taking in limited liability firms to the optimal social level. See KOSE JOHN ET AL., *CORPORATE LIMITED LIABILITY AND THE DESIGN OF CORPORATE TAXATION* 30-34 (Working Paper, Feb. 1991) (on file with author).

198. Since the market will reach an equilibrium, that equilibrium is by definition optimal. Under general equilibrium analysis, a state will be reached that is Pareto optimal or Kaldor-Hicks efficient. See *supra* note 30 and accompanying text and *infra* notes 371-73 and accompanying text.

199. Two motives exist for sharing and transferring risk: "[F]irst, a risk may be trans-

um in the market is proportional to the magnitude of each individual's risk aversion,²⁰⁰ which is discussed in the next section. The variations in return on investment required to compensate an individual for bearing risk are attributable to several causes: (1) differences in risk aversion in general; (2) differences in wealth because risk aversion is likely to decline as wealth increases; and (3) the negative correlation between an individual's income and the particular risk generated by the investment. Where a negative covariance exists, the particular investment will bring about a large return if income from other sources are low, and vice versa. The greater this negative covariance, the more the individual will be willing to pay. The risky prospect will act like an insurance and maximize the return for the investor at any level of her income. To understand this, we must first look at the decision to invest in the real world and the nature of risk aversion.

B. Decision Making in a Tax and No-tax World— Risk-Taking with Risk Aversion

In a "no-tax world," or a "pre-tax world," decisions are not influenced by their tax consequences.²⁰¹ If we introduce an income tax, under either a realization or an accretionist model, decisions are distorted by two income tax consequences as investors invest based on after-tax returns.²⁰² First, the rewards of the business or invest-

ferred from one individual to another more able or willing to bear it; second, by dividing risk among several individuals, not only is the risk faced by each reduced, but the aggregate cost of the risk is, in a sense, reduced." DAVID M.G. NEWBERY & JOSEPH E. STIGLITZ, *THE THEORY OF COMMODITY PRICE STABILIZATION: A STUDY IN THE ECONOMICS OF RISK* 164 (1981).

200. *Id.*

If one individual is less risk averse than another, the cost of his bearing the risk will be less; to put it another way, there is a profitable exchange between the two individuals. The amount which one individual is willing to pay for the risk exceeds the amount which the other individual requires in compensation for giving up the risky prospect.

Id. Thus, when two individuals join in a partnership there may be a greater willingness to take in riskier ventures. See *infra* notes 302-06 and accompanying text.

201. See Louis Kaplow & Alvin C. Warren, Jr., *An Income Tax by Any Other Name—A Reply to Professor Strnad*, 38 STAN. L. REV. 399 (1986); Jeff Strnad, *Taxation of Income from Capital: A Theoretical Reappraisal*, 37 STAN. L. REV. 1023 (1985).

202. The assumption is that the after tax returns affect savings and investment. See Geraldine Gerardi et al., *Corporate Integration Puzzles*, 43 NAT'L TAX J. 307, 309-10 (1990) (discussing evidence to date). There are views on both sides of this issue. Compare Michael J. Boskin, *Taxation, Saving, and the Rate of Interest*, 86 J. POL. ECON. pt. 2, at S3 (1978) (personal savings responds positively to the net return) with George M. von Furstenberg,

ment are shared with the government through the payment of a tax on income. Second, the losses are borne in part by the government at the same rate at which the income would have been taxed. Thus, the income tax discourages the undertaking of risk by taxing the reward, and encourages the undertaking of risk by bearing a portion of the losses. An investor's utility for gain and disutility for loss determines her risk aversion.²⁰³ A risk-averse investor will not take fair gambles: she requires an expected return that is greater than her original investment.²⁰⁴ Her risk aversion can have many attributes, and a different utility for gains and disutility for losses.²⁰⁵

Saving, in *HOW TAXES AFFECT ECONOMIC BEHAVIOR* 327 (Henry Aaron & Joseph Pechman, eds., 1981) (negative response of savers to net return). For a comprehensive discussion of the presumed disutility of saving and deferring consumption, see Mark Kelman, *Time Preference and Tax Equity*, 35 *STAN. L. REV.* 649, 658-60 (1983).

203. For example, assume an investor can make an investment of \$100, which has two possible outcomes: a \$100 gain or a \$100 loss. In a no-tax world this investment has a value of either \$200 or \$0. Each of these outcomes has an equal probability of occurring, and the expected return on the investment is the sum of the value of each outcome given its probability of occurring. If the probabilities of each outcome occurring are equal, the expected return of this investment is \$200 (50 percent) plus \$0 (50 percent), or \$100. As this investment costs \$100 and it is expected to return \$100, it is a fair gamble, and an investor will avoid the bet if she is risk averse. If taxes are introduced at a 25 percent rate with full loss offset, in the investment above the gain will be taxed so that it yields only \$75 while the loss will yield a tax benefit of \$25. With the same probabilities, the expected return, \$175 (50 percent) plus \$25 (50 percent), is the same as in the no-tax world, \$100, and a risk averse investor will still avoid the bet. See Lola L. Lopes, *Re-Modeling Risk Aversion: A Comparison of Bernoullian and Rank Dependent Value Approaches*, in *ACTING UNDER UNCERTAINTY: MULTIDISCIPLINARY CONCEPTIONS* 267 (George M. von Furstenberg ed., 1990).

204. See ROSS ET AL., *supra* note 182, at 256, 296.

205. See Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 *ECONOMETRICA* 263, 278-80 (1979) (attitudes to changes in welfare demonstrate that "losses loom larger than gains" and the value (utility) function for losses is convex and also steeper than for gains); see also *infra* note 208; Paul Shoemaker, *Preferences for Information on Probabilities Versus Prizes: The Role of Risk Taking Attitudes*, 2 *J. RISK & UNCERTAINTY* 37 (1989) (probability information will generally be undervalued on small ranges except when large losses are involved and it is doubtful whether weighted utility models capture how people combine probability and outcome information).

1. Risk Aversion—Absolute and Relative

In the aggregate, individuals presumably avoid risks²⁰⁶ and invest in order to maximize expected utility.²⁰⁷ Individuals exhibit declining marginal utility of wealth which explains their risk aversion. The utility of a gain of \$10 is more than the utility of gaining the next \$10. Risk aversion²⁰⁸ may be categorized as both absolute²⁰⁹

206. See Milton Friedman & L.J. Savage, *The Utility Analysis of Choices Involving Risk*, 56 J. POL. ECON. 279 (1948); Joseph E. Stiglitz, *Taxation, Risk Taking, and the Allocation of Investment in a Competitive Economy*, in STUDIES IN THE THEORY OF CAPITAL MARKETS 294 (Michael C. Jensen ed., 1972). "Both logic and observation suggest that business managers and stockholders are predominantly risk averters." WESTON & BRIGHAM, *supra* note 175, at 189. The concept of risk aversion is directly related to utility theory (satisfaction enjoyed by individuals that result in a set of preferences). Diminishing marginal utility leads directly to risk aversion. See Roger Blair & Richard E. Romano, *The Influence of Attitudes Toward Risk and the Value of Forecasting*, 103 Q.J. ECON. 387 (1989).

207. This is the fundamental economic requirement of the von Neumann-Morgenstern thesis, which is a foundation of game theory. See JOHN VON NEUMANN & OSKAR MORGENTERN, *THEORY OF GAMES AND ECONOMIC BEHAVIOR* 17 (1944). This hypothesis also forms the basis of the Friedman-Savage model of the diminishing marginal utility of money. *Id.* at 26-27, 617-32.

There is little consensus as to the proper index or magnitude of the positive relative risk aversion for United States investors in the aggregate. This index is the measure of the concavity of the utility function (which some economists equate with the elasticity of the marginal utility of wealth) and in the case of risk neutrality, this value is zero. Recent consumption-based estimates range from 0.3 to 1.0. See Lars P. Hansen & Kenneth J. Singleton, *Stochastic Consumption, Risk Aversion and the Temporal Behavior of Asset Returns*, 91 J. POL. ECON. 249 (1983); Gregory Mankiw et al., *Intertemporal Substitution in Macroeconomics*, 100 Q.J. ECON. 225 (1985). In asset demand studies, the index has been determined to be between 2.0 and 6.0, or even greater. See Irwin Friend & Marshall E. Blume, *The Demand for Risky Assets*, 65 AM. ECON. REV. 900 (1975); Irwin Friend & Joel Hasbrock, *Effect of Inflation on Profitability and Valuation of U.S. Corporations*, in SAVINGS, INVESTMENTS, AND CAPITAL MARKETS IN AN INFLATIONARY ECONOMY 37 (Marshall Sarnat & Giorgio P. Szego eds., 1982); Sanford J. Grossman & David J. Schiller, *The Determinants of the Variability of Stock Market Prices*, 71 AM. ECON. REV. 222 (1981). Indices of risk aversion are used in aggregate demand models to determine the effects of government budget deficits or to explain the behavior of interest rates. See ZVI BODIE ET AL., *WHY ARE REAL INTEREST RATES SO HIGH?* (National Bureau of Economic Research Working Paper No. 1141, 1983) (explaining the behavior of long-term interest rates in terms of changing asset return co-variances using a value of risk aversion of two); JEFFREY FRANKEL, *A TEST OF PORTFOLIO CROWDING-OUT AND RELATED ISSUES IN FINANCE* (National Bureau of Economic Research Working Paper No. 1205, 1983) (a crowding out study using a risk aversion factor of two); BENJAMIN FRIEDMAN, *CROWDING OUT OR CROWDING IN? EVIDENCE ON DEBT-EQUITY SUBSTITUTABILITY* (National Bureau of Economic Research Working Paper No. 1565, 1985) (using a value of four for the index of risk aversion in studying crowding out effects).

208. See generally John W. Pratt, *Risk Aversion in the Small and in the Large*, 32 ECONOMETRICA 122 (1964) (measuring risk aversion by derivatives of utility functions of money); ROBERT PINDYCK, *RISK AVERSION AND DETERMINANTS OF STOCK MARKET BEHAVIOR* 5 (National Bureau of Economic Research Working Paper No. 1921, 1986) (applying a constant relative risk aversion theory). The effect of constant relative risk aversion will in-

and relative²¹⁰ to an individual's wealth. In both cases, risk aversion likely declines. In absolute terms, a loss of \$100 to a wealthy person hurts less than the same \$100 loss to a less wealthy person. Under the current view held by economists, as an individual becomes wealthier she is willing to risk more or at least the same proportion, relative to her total wealth, exhibiting decreasing or constant relative risk aversion.²¹¹ That is, declining relative risk aversion means that

crease the index of risk aversion and will show that the return on risky investments is highly elastic and indeed may be relative to the view of risk aversion that is intertwined with the preference for liquidity. *But see* MERVIN KING & JONATHAN LEAPE, *WEALTH AND PORTFOLIO COMPOSITION: THEORY AND EVIDENCE* (National Bureau of Economic Research Working Paper No. 1468, 1984); Roger A. Morin & A. Fernandez Suarez, *Risk Aversion Revisited*, 38 J. FIN. 1201 (1985) (decreasing relative risk aversion when home ownership is excluded from wealth or treated as riskless and increasing with age). Others find data to measure perceived risk with results consistent with the constant relative risk aversion hypothesis. *See* Joel Hasbrouck, *Stock Returns, Inflation and Economic Activity: The Survey Evidence*, 39 J. FIN. 1293 (1984). Increases in risk and risk aversion are closely linked. *See* Peter A. Diamond & Joseph Stiglitz, *Increases in Risk and in Risk Aversion*, 8 J. ECON. THEORY 337 (1974). The increase in risk aversion increases the risk premium for perfect insurance. *Id.* at 346.

There are many models of risk-taking. *See* James G. March & Zur Shapira, *Variable Risk Preferences and the Focus of Attention*, 99 PSYCHOL. REV. 172 (1992). Recent experimental data found a four-fold pattern of risk attitudes: risk aversion for gains and for losses of high probability and risk seeking for gains and for losses of low probability. *See* Amos Teversky & Daniel Kahneman, *Advances in Prospect Theory: Cumulative Representation of Uncertainty*, 5 J. RISK & UNCERTAINTY 297 (1992). Other models try to look at risk preferences as a variable model as opposed to a fixed model. *See* James G. March, *Variable Risk Preferences and Adaptive Aspirations*, 9 J. ECON. BEHAV. & ORG. 5 (1988) (concluding that variable risk preferences require making preferences for risk dependent upon the particular target of the risk but also making the target a function of experience which the participant brings to the transaction with respect to that risk).

209. Absolute risk aversion measures risk when Z , the proposed investment, is a small fixed amount of Y , the total wealth of the investor. An individual that is as likely to purchase a \$1 lottery ticket with a wealth of \$100,000 or a wealth of \$1 million has a constant absolute risk aversion. A more likely hypothesis is that as Y increases, absolute risk aversion decreases. This is intuitive. If Z is a small percentage of Y , the willingness to accept the risk increases as the wealth Y increases. In this hypothesis, an individual with a wealth of \$10,000 is less likely to make a \$10 bet than an individual with a wealth of \$100,000. *See* ARROW, *ESSAYS*, *supra* note 169, at 90-120.

210. Relative risk aversion is a factor when Z , the proposed investment, is a large proportion of Y , the investor's total wealth. Assuming a given probability of success, P , these measures are important when related to different amounts of wealth, Y . If relative risk aversion does not change as Y increases, it is termed constant relative risk aversion. For example, an individual who equates the risk of gambling \$10,000 of a total wealth of \$100,000 with that involved in gambling \$100,000 of a total wealth of \$1 million has a constant relative risk aversion. A more likely hypothesis is that as Y increases, relative risk aversion decreases. For example, a new entrepreneur is less likely to start a company and risk half of her \$10,000 wealth than a wealthy individual is to start a company and risk half of his \$1 million wealth. Therefore, an individual with a wealth of \$10,000 will only risk \$4,000 rather than half of her wealth.

211. *See supra* note 210. While it was previously believed that relative risk aversion was

for a millionaire to lose 40 percent of her wealth by making what turns out to be a losing investment still leaves her with a wealth of \$600,000. However, a loss of 40 percent to a person with a wealth of \$100,000 leaves only \$60,000 and therefore, the less wealthy person is less likely initially to make the investment. Applied to optimal tax theory and efficiency analysis, it is a policy choice as to which form of an investment should bear a higher tax because taxes distort investment.²¹² Risk, as noted above, is defined as the standard deviation (or variance) between the actual and the expected return.²¹³ The introduction of a tax reduces the deviation of the possible outcomes from the expected return. The government, through an income tax system that allows loss offsets, becomes a partner in the investment and bears some of the risk, in an amount proportional to the tax rate,²¹⁴ and given certain assumptions including a proportional in-

increasing based on evidence cited by Kenneth Arrow as to the boundaries of the utility function and the wealth elasticity of demand for cash balances, see Friend & Blume, *supra* note 181, at 901, the general view held by economists is that relative risk aversion is constant or declines with wealth. See *id.*; Lawrence Blume & Daniel L. Rubinfeld, *Compensation for Takings: An Economic Analysis*, 72 CAL. L. REV. 569, 604 & n.99 (1984).

212. See *infra* notes 343-70 and accompanying text.

213. BREALEY & MYERS, *supra* note 167, at 134. Analysis of risk and risk-taking by means of variance or standard deviation of the distribution is the basis of the capital asset pricing model of financial economics. *Id.* at 161-68. Nonetheless, this view of measuring risk was later placed under attack in economic theory, and resulted in the use of different measures other than the mean standard deviation analysis in economic theory. See Mark A. Machina & Michael Rothschild, *Risk*, in 4 THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS, 227-32 (John Eatwell et al. eds., 1987); see also MARK MACHINA, CENTER FOR RESEARCH ON ORGANIZATIONAL EFFICIENCY, THE ECONOMIC THEORY OF INDIVIDUAL BEHAVIOR TOWARD RISK: THEORY, EVIDENCE AND NEW DIRECTIONS (1983); G. Hanoch & H. Levy, *The Efficiency Analysis of Choices Involving Risk*, 36 REV. ECON. STUD. 335 (1969); J.R. Hicks, *Liquidity*, 72 ECON. J. 787 (1962); Menahem E. Yaari, *Some Remarks on Measures of Risk Aversion and on Their Uses*, 1 J. ECON. THEORY 315 (1969). For the purposes of this Article, the mean-standard deviation approach is sufficient.

214. Whether governmental partnership in investment through the tax system increases, decreases, or is neutral to overall risk-taking is unresolved. The effect of governmental risk-sharing is determined by the assumptions of the economic model being used. In a full equilibrium model, an efficient government distributes benefits to investors thereby reducing the required return of their investments. At first blush it would seem that a tax system reduces risk-taking by taxing away gains obtained through risk-taking. In a tax system without full loss offset this is correct, because the government does not share equally in gains and losses, risk-taking does decrease at the margin. See Mossin, *supra* note 188, at 76-79.

Historically, the tax system's effective reduction of the yield of an investment was considered the most important argument against income taxation of business activities. Before the 1944 article by Domar and Musgrave this proposition was universally accepted and received little attention. See Evsey D. Domar & Richard A. Musgrave, *Proportional Income Taxation and Risk-Taking*, 58 Q.J. ECON. 388 (1944). Their article concluded that certain aspects of the tax system could be seen to increase risk-taking. See *id.* at 420; see also

come tax rate and an investor's tendency to be risk averse (and a generally assumed increasing relative risk aversion under which as wealth increases the investor risks a lesser percentage of wealth), an income tax will increase risk-taking.

2. Effect of Incomplete Loss Offsets and Risky Returns on Partnerships

The tax system discourages risky investment in two ways. First, incomplete loss offsets discourage risk-taking. The income tax system's failure to allow full loss offsets may discourage risky investments.²¹⁵ Thus, as partnership tax rules allow taxpayers to use losses

CARL S. SHOUP, PUBLIC FINANCE 341-43 (1969); James Tobin, *Liquidity Preference as Behavior Towards Risk*, 25 REV. ECON. STUD. 65 (1958). In addition, an investment's return is reduced by the introduction of a tax. If an investor has a target after-tax return, she will have to bear more risk in a system with tax than without to achieve the same level of return. See Agnar Sandmo, *The Effects of Taxation on Saving and Risk Taking*, in 1 HANDBOOK OF PUBLIC ECONOMICS 265, 295 (Alan J. Auerbach & Martin Feldstein eds., 1985).

As a formal proposition, the Domar and Musgrave model holds under a variety of utility functions. See SHOUP, *supra*, at 341 n.1; Marcel K. Richter, *Cardinal Utility, Portfolio Selection and Taxation*, 27 REV. ECON. STUD. 152, 154-55 (1960). One model has applied risk-bearing as endogenous (within the model) and finds that given the Domar and Musgrave thesis a flat profits tax is fully neutral. See Abhijit Banerjee & Andrew F. Neuman, *Risk-Bearing and the Theory of Income Distribution* 33-34 (unpublished discussion paper no. 877, on file with the *Hofstra Law Review*). To further complicate matters, it is impossible for a tax to be neutral towards risk-taking, if the government cannot freely dispose of the risk it bears and individuals must ultimately bear this risk, whether through taxes on other income, government expenditures, or budget deficits. See Roger H. Gordon, *Taxation of Corporate Capital Income: Tax Revenues Versus Tax Distortions*, 100 Q.J. ECON. 1 (1985).

Earlier articles had implicitly assumed that the risk in government tax revenues is not borne at all by individuals, resulting in investment stimulation. The assumption in Gordon's article that risk in government tax revenues is as costly to bear as privately traded risks seems much more plausible. Many of the assumptions of Gordon's model are restrictive and by relaxing some of them other economists find that the taxation of capital income can result in an efficiency gain. See Jeremy I. Bulow & Lawrence H. Summers, *Taxation of Risky Investments*, 92 J. POL. ECON. 20 (1984); see also Amin H. Amershi & Jan H.W. Stoeckenius, *The Theory of Syndicates and Linear Sharing Rules*, 51 ECONOMETRICA 1407 (1983); Martin S. Feldstein, *The Effects of Taxation on Risk Taking*, 77 J. POL. ECON. 755 (1978); Jack M. Mintz, *Some Additional Results on Investment, Risk Taking, and Full Loss Offset Corporate Taxation with Interest Deductibility*, 96 Q.J. ECON. 631 (1981).

215. Loss limitations include I.R.C. §§ 172, 469 & 1211 (1988). Full loss offsets include a system of refundability of losses. See *infra* notes 638-66 and accompanying text. But see Robert H. Scarborough, *Risk, Diversification and the Design of Loss Limitations Under a Realization-Based Income Tax*, 48 TAX L. REV. 677 (1993) (demonstrating that the effect on risky investment of loss limitations and loss offsets under various systems depends on other income from risky and nonrisky sources and the extent of risk management through hedging and diversification); Calvin H. Johnson, *Deferring Tax Losses with an Expanded § 1211*, 48 TAX L. REV. 719 (1993) (commentary); Louis Eeckhoudt & Pierre Hansen, *Uncertainty and the Partial Loss Offset Provision*, 9 ECON. LETTERS 31 (1982) (tightening loss write-off op-

through special allocations otherwise not currently available or respond to the lack of loss offsets for human capital contributions, they presumably increase risk-taking, which is desirable.²¹⁶ The argument over the role of risk is an important part of the debate over the economic cost of taxing risky investments. Under one view, a government that allows a full loss offset and taxes away some fraction of the income from a project also taxes away some fraction of the risk.²¹⁷ Under a proportional income tax where investors have increasing relative risk aversion, economic theory assumes that this approach leads to increased risk-taking as investors adjust their portfolios to increase their after-tax return,²¹⁸ but with constant or decreasing relative risk aversion the model does not lead to increased risk-taking because of the income tax.²¹⁹ Under a progressive tax, however, economic theory assumes this approach leads to decreased risk-taking, even under increasing relative risk aversion, although some of the models reach the opposite conclusion.²²⁰ Empirical evidence suggests that the proportional income tax does not increase risk-taking relative to no income tax, but confirms the decrease in risk-taking from a progressive income tax.²²¹ Thus, the ability for provisions within Subchapter K to increase risk-taking by increasing the avail-

portunities does not necessarily lead to less risk-taking); Mossin, *supra* note 188, at 74-78 (theoretical conclusions are still ambiguous).

216. See *infra* notes 510-13, 638-65 and accompanying text.

217. See ANTHONY ATKINSON & JOSEPH STIGLITZ, LECTURES ON PUBLIC ECONOMICS 97-127 (1980); Roger H. Gordon & John D. Wilson, *Measuring the Efficiency Cost of Taxing Risky Capital Income*, 79 AM. ECON. REV. 427 (1989); Domar & Musgrave, *supra* note 214, at 409-15.

218. See Bankman & Griffith, *supra* note 149, at 392; Livingston, *supra* note 164, at 166-71.

219. Under the Domar and Musgrave model, assuming a proportional income tax and increasing relative risk aversion, an income tax with full loss offsets increases risk-taking, although changing the assumption of increasing relative risk aversion may limit the effect of the tax to encourage risk taking as does the introduction of inflation and more than one risky asset. See Livingston, *supra* note 164, at 170 and nn.18-20 (citing inter alia Joseph E. Stiglitz, *The Effects of Income, Wealth, and Capital Gains Taxation on Risk-Taking*, 83 Q.J. ECON. 263, 274 (1969)).

220. See Bankman & Griffith, *supra* note 149, at 406; Livingston, *supra* note 164, at 170 n.22.

221. See Ronald King & David Wallin, *Individual Risk Taking and Income Taxes: An Experimental Examination*, J. AM. TAX'N ASS'N, Fall 1990, at 26 (confirming the effect of the progressive tax but questioning the assertion as to the proportional tax, since the increased risk-taking was found to be temporary and rapidly disappeared with no significant long-term difference between the proportional tax and no-tax regimes); see also F.A. Cowell, *Some Notes on Progression and Risk-Taking*, 42 ECONOMICA 313 (1975); John C. Fellingham & Mark A. Wolfson, *Taxes and Risk Sharing*, 60 ACCT. REV. 10 (1985).

ability of loss offsets or by countering the effects of a lack of loss offsets is also affected by the rate structure.

Second, taxing the risk premium discourages risk-taking. One economic theory states that to achieve tax neutrality between risky and stable-price investments the Code must exempt the premium portion of the return on risky investments to overcome investors' risk aversion.²²² For risk-taking, investors must receive a premium over the return from investment in a riskless asset.²²³ As a result of random fluctuations in income earnings, the efficiency cost of taxing capital income varies proportionately with the risk of earning the income.²²⁴ Therefore, due to the risks inherent in the price of the asset, these projects must earn greater income to compensate investors for risk returns appropriated by the government through income taxes.²²⁵ For example, these tax asymmetries remain an obstacle to undertaking high-risk projects if loss deductions occur earlier than the income generated by the project.²²⁶ Partnership nonrecognition rules counter the effects of taxing risk premia. Although all income taxes,

222. See KALDOR, *supra* note 33, at 102-29; Bulow & Summers, *supra* note 214; Pamela Gann, *Neutral Taxation of Capital Income*, 48 LAW & CONTEMP. PROBS. 77 (1985).

223. See *supra* notes 181-87, 192-94, 200 and accompanying text.

224. One can view the government's tax claim on profits as a contingent claim using option pricing theory. Option pricing theory developed by the Black-Scholes Option Valuation Model points out that corporate securities can be viewed as options or contingent claims on the value of the firm's assets which are contingent on the investment uses of those assets. For example, option pricing theory views a company's creditors as the owners of the firm's assets with the shareholders having a call option to repurchase the assets by paying the debt at maturity. Carl Kester, *An Options Approach to Corporate Finance*, in HANDBOOK OF CORPORATE FINANCE 5-3 (Edward Altman ed., 1986). The Black-Scholes model, the cornerstone of contingent claims analysis, established a theory of option pricing largely based upon a principle of arbitrage and development of a relative valuation for the option in terms of the value of the underlying stock, which is an observable value. See Edward Altman & Marti Subrahmanyam, *Introduction*, in RECENT ADVANCES IN CORPORATE FINANCE 1, 1-4 (Edward Altman & Marti Subrahmanyam eds., 1985); Scott P. Mason & Robert C. Merton, *The Role of Contingent Claims Analysis in Corporate Finance*, in RECENT ADVANCES IN CORPORATE FINANCE 7, 17 (Edward Altman & Marti Subrahmanyam eds., 1985).

225. See Bulow & Summers, *supra* note 214, at 25-29.

226. Under the 1986 tax reform there continues a denial of refund ability of losses, the statutory tax rate decreased, depreciation recovery rates were lowered with tax depreciation more closely approximating economic depreciation, and the investment tax credit is eliminated. Since tax reform adopted these constraints, there is evidence that stand-alone investments are more valuable because there is a reduction of the potential burden of tax asymmetries, but the effective tax rate on marginal investments by firms that always pay taxes will increase. See Saman Majd & Stuart C. Myers, *Tax Asymmetries and Corporate Income Tax Reform*, in TAXES AND CAPITAL FORMATION 93, 94 (Martin Feldstein ed., 1987); see also SAMAN MAJD & STEVEN LEE MYERS, VALUING THE GOVERNMENT'S TAX CLAIM ON RISKY CORPORATE ASSETS 3-8 (National Bureau of Economic Research Working Paper No. 1553, 1985).

even those deferred under a realization based system, reduce pretax investment returns²²⁷ and taxation of interest may be more problematic than taxation of risk,²²⁸ risk premium analysis of nonrecognition for contributions and distributions to and from the partnership is appropriate.²²⁹ The partnership nonrecognition rules may be criticized as not promoting neutrality with respect to taxpayers making investment choices using other organizational forms, but the more important point is that Subchapter K more fully responds to limitations on risk-taking than do other tax provisions for other investments.²³⁰

3. Bargaining in a Firm for Returns from Labor and Capital

When parties join together, they bring their inherent risk aversion and their utility functions, which is each individual's preferred trade-off between labor and leisure, and between consumption and savings. In a tax world, taxation has an effect on risk and utility. As portfolio investors, individuals can try to limit their risks to systemic ones—the risk of the market rather than the risk of particular assets—by diversifying their investments.²³¹ The best bargain that investors can strike in the investment of human and financial capital is based on their evaluation of the after-tax rewards to them.²³² The investors

227. See Johnson, *supra* note 138, at 1041 n.84.

228. See Barbara H. Fried, *Fairness and the Consumption Tax*, 44 STAN. L. REV. 961, 991, 996 (1992) (noting that a consumption tax as a perfected income tax seems far weaker with respect to risk premia than with respect to interest).

229. See Norman Lane, *A Theory of the Tax Base: The Exchange Model*, 3 AM. J. TAX POL'Y 1 (1984). Under the exchange model, the exchange of cash for an equity obligation of a firm does not generate a deduction to the investor or require the inclusion of a positive item in anyone's tax base. Under the identification theory of basis, basis does not change where it represents a continuation of the basis of the exchanged property. See Glen A. Kohl, *The Identification Theory of Basis*, 40 TAX L. REV. 623, 630 (1985).

230. For criticism of nonneutral rules, see Marjorie E. Kornhauser, *Section 1031: We Don't Need Another Hero*, 60 S. CAL. L. REV. 397, 446-51 (1987); Fellows, *supra* note 149, at 804 & nn.181-83.

231. See VICTOR BRUDNEY & WILLIAM W. BRATTON, BRUDNEY AND CHIRELSTEIN'S CORPORATE FINANCE 80-115 (4th ed. 1993). Portfolio theory demonstrates that diversifying the portfolio makes it less risky unless each investment has the same beta—or variance of return relative to the market—in which case the unsystemic risks remain. See BREALEY & MYERS, *supra* note 167, at 131-39, 143-48, 155-59. It can also become more risky if any additions are not diversified relative to the portfolio. They can also eliminate all risk of loss (and profit) through perfect hedging by entering into exactly offsetting positions. See Scarborough, *supra* note 215, at 692-95.

232. These investment decisions may be too complex to be captured by formal models. See Robert Chirinko & Robert Eisner, *Tax Policy and Investment in Major U.S. Macroeconomic Econometric Models*, 20 J. PUB. ECON. 139 (1983); Martin Feldstein, *Inflation, Tax Rules in Investment: Some Econometric Evidence*, 50 ECONOMETRICA 825, 829 (1982).

will bargain to the point that is Pareto optimal, that is, where one party is better off and no party is worse off. These decisions do not produce Pareto optimality throughout the economy, but only in this particular bargaining situation, one of generally asymmetric information and in incomplete markets.²³³

Parties reach the point where they believe that one party is better off and no party is worse off. In a firm, the potential investor faces other investors with the same purposes, but with different concerns: a high or low risk aversion, with high, low, or no preference for consumption over savings or leisure over labor, and more or less interested in deductions or losses which can be applied in a higher or lower tax bracket.²³⁴

There are two basic premises which apply in all situations. First, the totally risk-averse investor will not make an investment if it entails any risk. The financial capital investor will consume her \$100 now if she prefers consumption over savings or, if she prefers savings over consumption, both in a tax or a no-tax world, she will invest in a riskless investment.²³⁵ A human capital investor will seek a riskless payoff for her labor and decide in light of the payoff after tax whether she prefers labor to leisure.²³⁶

233. An asymmetric information situation is one in which each agent does not have the same amount of information about all of the important variables. Consequently, in a world of differentially informed agents, otherwise neutral economic variables may contain potentially valuable information. See Andrew Postlewaite, *Asymmetric Information*, in THE NEW PALGRAVE DICTIONARY OF MONEY AND FINANCE 78 (Peter Newman et al. eds., 1992). Real world markets are incomplete, giving rise to questions concerning the valuation of particular properties. See Kose John, *Market Resolution and Valuation in Incomplete Markets*, 19 J. FIN. & QUANT. ANAL. 29 (1984). Economic theory has begun to study the efficiency of outcomes in incomplete markets—how a second-best Pareto optimality can be determined in the case where an economy has incomplete markets. See Oliver D. Hart, *On the Optimality of Equilibrium When the Market Structure is Incomplete*, 11 J. ECON. THEORY 418 (1975).

234. For an application, see *infra* notes 305-06 and accompanying text. In some cases investors may be risk neutral. See *infra* note 242 and accompanying text.

235. These include Treasury securities or federally insured bank deposits. See CHENG F. LEE & JOHN E. FINNERTY, *CORPORATE FINANCE: THEORY, METHOD AND APPLICATION* 607-09 (1990).

236. For example, she might view a government job with fixed compensation and a historic policy of raising salaries based on the cost of living index as a riskless return for her labor. Her financial wealth, her consumption and savings preferences, and her status concerns will all influence whether she prefers labor or leisure in the face of this particular job. These factors will also influence whether she would be willing to consume her financial capital, or whether her preference for savings over consumption will override her desire for leisure and cause her to labor for a more than riskless payoff at a job where there may be a physical risk of loss (such as illness, accident, or exposure to toxic waste). In addition, job search costs, transaction costs, and government risk-sharing will shape her decision.

Second, human and financial capital investors will only accept or seek risk if the probability of payoff, and the effect it has on their utility functions, is favorable after taxation effects are taken into account. In a tax world, the comparison between risk of loss and the after-tax reward will necessarily take into account the government's share in the rewards of risk. While the government may have contributed greatly to an investor's store of human capital by its past investment in her education and health, it does not now share in the risk of loss of time value when a venture does not pay off. The fact that the government does not absorb some of the risk of loss for the human capital investor is of great significance when we examine the tax rules affecting human capital contributions to partnerships.²³⁷ A human capital investor does not receive a loss deduction, so this opportunity cost of investing human capital is not reduced by the tax rate, as is the case with financial investments.²³⁸ If the market interest rate is 10 percent and the income tax rate is 25 percent, the human capital investor's required rate of return is 10 percent after tax, not 7.5 percent, as it is for the capital investor who shares losses with the government. With risk aversion, decisions on other than fair gambles may be different between a no-tax and tax world.²³⁹ The tax system should be neutral as to the sharing of risks and rewards and should allow investors to take risk positions with economic substance in light of their tax effects.²⁴⁰

C. Risk-Taking and Risk-Pooling

Taxation may influence risk-taking on two levels: portfolio decisions by households or institutions, and the real investment decisions made by businesses and individuals. While a tax may change private decisions to bear risk and cause social risk-taking to be increased, it does not lessen the amount of risk in the economy or answer questions of redistribution.²⁴¹ In a general equilibrium setting the model

237. See *infra* notes 510-13 and accompanying text.

238. In the example in note 203 *supra*, the financial capital investor will lose only \$75, not \$100, if the investment is a total loss. The human capital investor is in a worse position. She has the chance to get \$200 before tax (\$150 after tax) or nothing. She would lose the full after-tax reward for her labor contributed to an otherwise riskless endeavor and must compare the risk of loss to her inherent preference for leisure.

239. See *supra* notes 201-14 and accompanying text; see also Rudnick, *supra* note 39, at 1177 (collecting the literature on this point). Even given risk neutrality, decisions may be different in a tax and no-tax world. See *infra* note 242.

240. See *infra* notes 638-70 and accompanying text.

241. See ATKINSON & STIGLITZ, *supra* note 218, at 120-21. There is some data which

is of risk-neutral capitalists who diversify risk through the market and risk-averse managers. Risk neutrality is the condition where, given the choice of a certain return of \$100, and an investment which has a 50 percent probability of a return of \$200, a risk neutral investor would be indifferent. An entity with large, perfectly diversified wealth can have such a low risk aversion that it is effectively risk neutral. The imposition of a tax without full loss offsets will mean that risk-neutral capitalists may still pick a safe asset rather than a risky asset.²⁴² If risk-averse human capitalists have no loss offset, then taxing gains reduces risk-taking by them. Risk-pooling is efficient and generally desirable since it creates a greater opportunity for diversification. The gains of risk-pooling are easily determined: the total risk on the pool, as measured by the co-efficient of variation, will be smaller than the risk on a single asset.²⁴³ Agency costs also affect these pooling decisions. If there is a belief that there is insufficient pooling of assets due to risks of adverse selection, in that bad projects will be indistinguishable from good projects,²⁴⁴ or as a result of moral hazard (peo-

indicates that the wealth elasticity of demand for risky assets is positive, but less than unity, which means that wealth and income taxation increase social risk-taking. Other data suggests that the elasticity of demand for the risky assets is greater than unity. *Id.* at 124-26. "[T]here are strong reasons to believe that the capability of the market to share and spread risks is limited." *Id.* at 118 (limitations on the market's ability to spread risk include limited liability including the ability to default on loans and imperfections in human capital markets, both of which may provide opportunities for government strategies to promote risk sharing).

242. Robert Scarborough demonstrates that in a tax world with no loss offset a risk neutral investor will pick a risk free asset. He posits a 40 percent tax rate and a \$60 investment after tax. The risk free asset generates a 10 percent return and the risky asset a 130 percent return one-half of the time and a total loss one-half of the time. The risk neutral investor will pick the safe asset, leaving \$63.60 to consume after tax rather than the risky asset, since the risky investment's expected return is only \$53.40 after tax. Scarborough, *supra* note 215, at 692. If, however, the return on the risky asset is 200 percent one-half of the time, the risk neutral investor will pick the risky asset because the expected return after tax is \$66.00. Thus, the rate of return on the risky asset and the odds of its return relative to the safe asset is also relevant in a tax world with no loss offset. *See also infra* notes 243-54 and accompanying text.

243. A stock market spreads risk among a large number of shareholders so that the risk borne by each is small and is treated, in effect, in a risk-neutral manner. *Cf.* LEE & FINNERTY, *supra* note 224, at 169 (discussing the market rate of return). The risk-pooling effect extends to data that the risk-adjusted required rate of return from a larger firm is smaller than for a smaller firm. *Cf.* Raphael Amit & Joseph Livnat, *Diversification and the Risk-Return Trade-Off*, 31 ACAD. MGMT. J. 154 (1988) (viewed as a natural monopoly generated by risk and market imperfections). For the value of pooling in securitization of financial assets, see 1 TAMAR FRANKEL, *SECURITIZATION* 69-93 (1991).

244. *See* Charles Wilson, *Markets With Adverse Selection*, in THE NEW PALGRAVE DICTIONARY OF MONEY AND FINANCE 670 (Peter Newman et al. eds., 1992). Adverse selection theory arises in the context of the demand for insurance. In the non-insurance context, bad

ple will shirk or cheat),²⁴⁵ then the tax system should allow efficient entrance into and exit from pools. Partnership tax exists in the nonpublicly traded world where information may not be as efficiently processed. Insiders ultimately bear all agency costs and under the assumptions of agency cost economics therefore initially choose their firm's capital structure to minimize these costs.²⁴⁶ While income taxes may increase the amount of investment necessary to achieve a certain return, tax deferral through postponement of a tax recognition event lowers the tax cost of diversification by pooling, and lowers the tax cost of de-diversification when the effects of the pool become economically undesirable.²⁴⁷ Subchapter K facilitates risk-pooling by eliminating an additional transaction cost on entry into—and exit from—pools. While risk-pooling is generally desirable, there is some reason to believe that at times pooling may result in increased failure and bankruptcy costs, or increased probability of failure for an intertwined group of firms.²⁴⁸ If pooling becomes undesirable, flexible rules that allow unbundling—and help prevent losses—are efficient.

products will always be sold with the good products. This is a problem of adverse selection which interferes with the effective operation of a market. *See id.*; *see also* William Samuelson, *Bargaining Under Asymmetric Information*, 52 *ECONOMETRICA* 995 (1984); Charles Wilson, *The Nature of Equilibrium in Markets With Adverse Selection*, 11 *BELL J. ECON.* 108 (1980).

245. *See* ARROW, *ESSAYS*, *supra* note 169, at 142-43. Moral hazard is hidden knowledge of an agent seeking a potential reward or outcome. *See* Roger H. Guesnerie, *Hidden Actions, Moral Hazard and Contract Theory*, in 2 *NEW PALGRAVE DICTIONARY OF MONEY AND FINANCE* 304 (Peter Newman et al. eds., 1992); *see also* Bengt Holmstrom, *Moral Hazard in Teams*, 13 *BELL J. ECON.* 324 (1982). Economists show that in the presence of moral hazard, market allocations under uncertainty will not be fully Pareto optimal. *See id.* at 134-43; Mark V. Pauly, *The Economics of Moral Hazard: Comment*, 58 *AM. ECON. REV.* 531 & n.3 (1968).

246. *See* Sanford J. Grossman & Oliver Hart, *An Analysis of the Principal-Agent Problem*, 51 *ECONOMETRICA* 7, 9 (1983); *see also* Eskander Alvi, *Information Revelation and Principal-Agent Contracts*, 6 *J. LAB. ECON.* 132, 135 (1988); Masako N. Darrough & Neal M. Stoughton, *Moral Hazard and Adverse Selection: The Question of Financial Structure*, 41 *J. FIN.* 501 (1986); Milton Harris & Robert M. Townsend, *Resource Allocation Under Asymmetric Information*, 49 *ECONOMETRICA* 33 (1981).

247. *See infra* notes 369-79, 547-48, 562-63 and accompanying text.

248. *See* SHERRILL SHAFFER, *POOLING INTENSIFIES JOINT FAILURE RISK* (Federal Reserve Bank of Philadelphia Research Working Paper No. 89-01, 1989) (noting that small groups of firms require stronger synergies than larger groups to offset the detrimental impact of pooling on the risk of joint failure). An ambiguous impact on bankruptcy costs obtains since one does not know whether it is related to the size or number of failing institutions or if the loss is proportional to the failed firm's size, less than proportional, or more than proportional. *Id.*

D. *The Tax Response to Risk: The Pool of Capital Doctrine*

The tax law first dealt with risky ventures requiring the inputs of service and capital providers under the "pool of capital" doctrine.²⁴⁹ While revisionist thinking now questions this doctrine,²⁵⁰ it still represents a significant alternative to corporate and partnership tax paradigms. The doctrine treats the contribution of development property or services to the "pool of capital" in the establishment of an oil or gas well as a tax-free exchange; later proceeds derived from the interest are taxable receipts.²⁵¹ The essence of the doctrine is a refusal to trace risks associated with the pool of capital in which risks are shared. Capital and service providers negotiate returns based on their *ex ante* evaluations of returns and are taxed on the *ex post* results.²⁵²

To determine the appropriate rules for the taxation of partners and partnerships, one must settle on a theory of risk-sharing and risk aversion comparable to the pool of capital approach. The tax law so reflects risk by differentiating between predictable and unpredictable income streams, and by predicating tax consequences on whether a participant bears risk.²⁵³ This also is related structurally to academic

249. See Walter D. Schwidetzky, *The Pool of Capital Doctrine: A Peace Proposal*, 61 TUL. L. REV. 519 (1987). Pooling concepts come from the pool of capital doctrine under which the contributions of oil in place and drilling and other human capital contributions to the venture in exchange for a payment out of production is not a realization event at the time of contribution. See William M. Linden, *Income Realization in Mineral Sharing Transactions: The Pool of Capital Doctrine*, 33 TAX LAW. 115 (1979). Gen. Couns. Mem. 22,730 (June 21, 1941) when drillers or equipment suppliers and investors contribute materials and services in development of a mineral property for an economic interest in such property, the receipt of the interest does not result in income realization.

250. See Patrick L. O'Daniel, Note, *Muddy Waters in the Pool of Capital: Zuhone and the Abolition of the Doctrine*, 70 TEX. L. REV. 243 (1991).

251. See *Zuhone v. Commissioner*, 883 F.2d 1317, 1319 (7th Cir. 1989).

252. See Juan E. Arrache, Jr., *Is Revenue Ruling 83-46 A "Duster" for Service Contributors Seeking "Tax Free" Pool of Capital Treatment?*, 24 SANTA CLARA L. REV. 857, 868-80 (1984) (pool of capital doctrine enforces and supports national economic policy). Pooling of capital applies in other areas. One theory of law firm growth is that "[i]n a world with transaction costs, attorneys attempting to lend shareable human capital will tend toward internal organization—that is, a firm—in order successfully to govern the transaction." Marc Galanter & Thomas M. Palay, *Why the Big Get Bigger: The Promotion-to-Partner Tournament and the Growth of Large Law Firms*, 76 VA. L. REV. 747, 773 (1990). Transaction costs include opportunistic conduct of the potential sharers. *Id.* at 773 n.66. For an example of differences in negotiated returns, see *infra* note 444.

253. This is the core of I.R.C. § 704(b)(2) (1988) (substantial economic effect), I.R.C. § 707(a)(2) (1988) (disguised sales), and Treas. Reg. § 1.707-3 (1992). See also *supra* note 164.

normative discussions of the taxation of risk under the income tax.²⁵⁴

VI. EFFICIENCY OF PARTNERSHIPS AND RISK-BEARING

A. Agency Costs and Risk-Sharing

This section examines agency costs when they are applied under Subchapter K to partnerships in order to determine whether partner-

254. For example, the government can be viewed as holding a portfolio of assets with a particular risk. Professor Louis Kaplow demonstrates that if the government would engage in offsetting portfolio activity by holding other assets, then *ex post* taxes in which the government absorbs private risk are equivalent to *ex ante* taxes in which the government absorbs no private risk. KAPLOW, *supra* note 190. Thus, an *ex post* tax on investment returns from risky (and riskless) assets in which revenue is uncertain and the government absorbs private risk, is equivalent to an *ex ante* wealth tax in which revenue is certain and no private risk is absorbed, provided the government alters its investment portfolio. In his general equilibrium model, "a wide range of taxes can be decomposed into some combination of a wage tax, an *ex ante* wealth tax, and a modification of the government's investment portfolio." *Id.* at 11. Accordingly, Professor Kaplow's own caveat applies:

Note that, if one does not assume that the government would engage in offsetting portfolio activity, this equivalence would fail. Individual behavior would be affected by different patterns of government revenue. This would change the amount invested in each asset, which in turn would affect returns on investment and thereby feed back upon individual behavior.

Id. at 12. There is no reason to suppose that the government engages in the offsetting portfolio activity required to achieve the demonstrated equivalence. See Cheryl D. Block, *Overt and Covert Bailouts: Developing a Public Bailout Policy*, 67 IND. L.J. 951 (1992). The government portfolio changes very little from the debt obligations it owes to the properties it purchases. The savings and loan crisis changes the risk of the government's assets and liabilities in a manner that is difficult for it to adjust. Under the Kaplow analysis, taxation of risk-taking remains a policy concern.

Professors Joseph Bankman and Thomas Griffith conclude that altruistic concerns might favor increased savings and exclusion of interest from the tax base, but do not justify government policies designed to favor or disfavor risky investments. Bankman & Griffith, *supra* note 149, at 406. An income tax without symmetrical treatment of gains and losses reduces the utility or surplus of risk-takers in much the same way that taxation of interest reduces the utility or surplus of savers. Under these circumstances, taxation of risk raises the same fairness issue as taxation of interest. Adjusting the tax base to affect risk is a difficult task. "[T]he adoption of an income or consumption tax seems an indirect and inefficient means of affecting the quantity of risky investments." *Id.* at 405. Bankman and Griffith acknowledge that a lack of symmetry may occur between gains and losses, and that market imperfections may exist which cause investment portfolios to fail to be adjusted in a manner to accommodate the taxation of risk. Observation of the tax system, under present tax law, and investment behavior bears this out. See Altshuler & Auerbach, *supra* note 46, at 79-80; Bankman & Griffith, *supra* note 149, at 397-402; Weiss, *supra* note 154, at 225-27. For reasons unrelated to rate of return, investors may forego excessively risky portfolios even if diversified, since the taxation of risk affects risk-taking. See generally Tom Petrino, *Investors Find It Harder to Sort Risky from Safe*, L.A. TIMES, Sept. 16, 1991, at D1.

ships are efficient firms.²⁵⁵ The generally nonpublicly traded partnerships considered here are different from public firms²⁵⁶ with freely tradeable residual claims. The agency cost literature notes that non-transferable ownership interests create problems in portfolio diversification and monitoring.²⁵⁷ Agency cost economics suggest that "these organizations survive in the face of such inefficiency when the agency costs that are avoided by restricting residual claims to decision agents exceed the higher costs induced by foregone investments and inefficiency in residual risk-bearing."²⁵⁸ Focusing on the residual claims, partnerships must have specific contracts to specify rights in cash flow. Both theory and procedure for transferring residual claims suggest that these residual claims should be restricted to important decision-making agents in order to avoid agency problems due to the separation of risk-bearing and decision-making functions in public firms.²⁵⁹ Some data indicates a lack of responsiveness to tax changes in the choice of organizational form,²⁶⁰ which other evidence may

255. Firm-structure choice is much studied, as is firm-capital structure, discussed *infra* at notes 268-73 and accompanying text. See Fellingham & Wolfson, *supra* note 221, at 10 (evaluating efficient risk-sharing and incentives in joint ownership of an income-producing project); Harris & Raviv, *supra* note 57, at 231, 233; Jensen & Meckling, *supra* note 117, at 305, 330-43; Terry Shevlin, *Taxes and Off-Balance-Sheet Financing: Research and Development Limited Partnerships*, 62 ACCT. REV. 480, 480-81 (1987) (data supports agency model predictions). Theoretical models suggest that there are identifiable rationales for choosing a general partnership, limited partnership or a corporate form as well as for the financial mutuals and not-for-profit organizations. Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327, 337-45 (1983) [hereinafter Fama & Jensen, *Agency Problems*]. They conjecture that the larger and more complex the decision making hierarchy in a firm, the greater the need to separate the decision management from the risk-bearing claimants. See Eugene F. Fama & Michael C. Jensen, *Organizational Forms and Investment Decisions*, 14 J. FIN. ECON. 101, 102, 106-09, 117-19 (1985) [hereinafter Fama & Jensen, *Organizational Forms*]. For a view of other corporate stakeholders, see Bradford Cornell & Alan C. Shapiro, *Corporate Stakeholder and Corporate Finance*, FIN. MGMT., Spring 1987, at 5 (inclusion of stakeholders other than investors and managers plays an important role in financial policy); see also Henry Hansmann, *Ownership of the Firm*, 4 J.L. ECON. & ORGS. 267, 301 (1988) (surveying for the "dominance of investor-owned firms in market economies").

256. A public corporation has the problem of agency costs that arise from the separation of ownership from control. See ADOLPH A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 119-25 (1968). Publicly traded investment, real estate, and oil and gas partnerships are taxed as partnerships under the Internal Revenue Code. See I.R.C. § 7704 (1988).

257. See Rudnick, *supra* note 39, at 1122.

258. Fama & Jensen, *Organizational Forms*, *supra* note 255, at 119.

259. See Fama & Jensen, *Agency Problems*, *supra* note 255, at 327, 332.

260. See JEFFREY K. MACKIE-MASON & ROGER H. GORDON, *TAXES IN THE CHOICE OF ORGANIZATIONAL FORM* (National Bureau of Economic Research Working Paper No. 3781,

belie.²⁶¹ Other data reveals sizable nontax costs of the noncorporate form, although these costs are variable, and confirms that partnerships self-select in industries where nontax costs are low and that nondiversifiable risk is the largest nontax cost of noncorporate equity.²⁶²

An analysis of principal-agent problems includes risk-sharing within partnerships.²⁶³ Risk-sharing in agency relationships is a requirement for efficiency in monitoring agents, depending on the incentive monitors,²⁶⁴ suggesting that flexibility in partnership tax

1991) (profitable firms should shift out of the corporate sector when the tax distortion to incorporating is larger, and the converse is true for firms with tax losses which are actually small).

261. See Rudnick, *supra* note 39, at 1008-19 (noting increase in pass-through firms after 1986 Tax Act).

262. See ROGER H. GORDON & JEFFREY K. MACKIE-MASON, TAX DISTORTIONS TO THE CHOICE OF ORGANIZATIONAL FORM 22 (National Bureau of Economic Research Working Paper No. 4227, 1992) (nontax costs of the noncorporate form are larger in industries where the firm's investments are riskier and they need to raise more capital from the market, but efficiency gains from removing the differential tax treatment are small because noncorporate firms are concentrated in industries with low nontax costs). Noncorporate firms should be concentrated in industries where nontax costs appear to be low. This is confirmed in this unique study which directly estimates the size of the nontax factors affecting the relative attractiveness of corporate and noncorporate organizations in various industries under the theoretical assumptions of agency cost economics. *Id.* at 13.

263. For a discussion of agency cost economics, see *supra* note 117. Generally the literature has supposed that "the principal chooses the risk-sharing contract, or incentive scheme, to maximize his expected utility subject to the constraints that (a) the agent's expected utility is no lower than some pre-specified level; (b) the agent's utility is at a stationary point, i.e., the agent satisfies his preferences with respect to the choice of action." Grossman & Hart, *Principal-Agent*, *supra* note 246, at 7-8. But see James A. Mirrlees, *The Optimal Structure of Incentives and Authority Within an Organization*, 7 BELL J. ECONOMICS 105 (1976) (showing that the stationary condition or preference is not true except in a unique solution to the agent's maximization).

264. For example, a carried interest may have a greater incentive than a reversionary interest in the oil and gas industry. See Mark A. Wolfson, *Empirical Evidence of Incentive Problems and the Mitigation in Oil and Gas Tax Shelters Programs*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 101 (John W. Pratt & Richard J. Zeckhauser eds., 1984). "Pay-for-performance" may be better for chief executive officer compensation. See Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV., May-June 1990, at 138, 144-48 (demonstrating that the pay-for-performance principle for CEOs is linked to positive stock performance of the underlying company). Possible arrangements are manifold. For example, in service partnerships there is a shirking problem for equal sharing, nonproductivity based compensation arrangements. See, e.g., MARTIN GAYNOR & MARK V. PAULY, ALTERNATIVE COMPENSATION ARRANGEMENTS AND PRODUCTIVE EFFICIENCY IN PARTNERSHIPS: EVIDENCE FOR MEDICAL GROUP PRACTICE 1 (National Bureau of Economic Research Working Paper No. 2170, 1987) (detailing a number of studies); see also Joel S. Demski & David E. M. Sappington, *Resolving Double Moral Hazard Problems With Buy Out Agreements*, 22 RAND J. ECON. 232, 238-40 (1991) (resolved

rules is required to allow the partners to shape arrangements that control agency costs. Few econometric models of incentives in partnership organizations incorporate risk aversion. In one study of compensation agreements chosen by medical partnerships, increased risk aversion caused partnerships to choose productivity-based compensation, which has a positive effect on productivity.²⁶⁵ Of course, these decisions are undertaken under uncertainty generated from various sources.²⁶⁶

Capital structure theory is relevant to this analysis. Recent finance literature sees the firm as a risk-averse individual making decisions based upon perceptions of firm strength.²⁶⁷ While the Modigliani-Miller assumptions which form the core of financial theory's view of the relevance of capital structure in the value of the firm²⁶⁸ indicate that capital structure is irrelevant, the real world di-

by the principal costlessly and completely when she can observe the agent's actions and require the agent to purchase the enterprise at a pre-negotiated price); Martin Gaynor & Mark V. Pauly, *Compensation and Productive Efficiency in Partnerships: Evidence from Medical Group Practice*, 98 J. POL. ECON. 544 (1990); Martin Gaynor, *Competition within the Firm: Theory Plus Some Evidence from Medical Group Practice*, 20 RAND J. ECON. 59 (1989). Other managerial compensation plans which align the interests of the equity holders with managers is in the form of contingent compensation, often structured as stock options and other compensation. See EDWARD LAZEAR, *INCENTIVE CONTRACTS* (National Bureau of Economic Research Working Paper No. 1917, 1986). The percentage of earnings to fixed compensation colors management's attitude about risk-taking. See Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 183 n.42, 200-01.

265. See MARTIN GAYNOR & PAUL J. GERTLER, *MORAL HAZARD IN PARTNERSHIPS* (National Bureau of Economic Research Working Paper No. 3373, 1990) (a classic example of the trade-off between risk spreading and moral hazard). With risk aversion, the more risk averse physicians in this sample sacrificed almost 11 percent of gross income relative to those who were least risk averse. Group size also had a negative effect on productivity. See *id.* at 29-30; see also Gaynor & Pauly, *supra* note 264, at 544; Gaynor, *supra* note 264, at 73-75.

266. For example, tax rate changes add uncertainty to individual agents' decisions in determining compensation. See Michael Dotsey, *The Economic Effects of Production Taxes in a Stochastic Growth Model*, 80 AM. ECON. REV. 1168 (1990).

267. See BRUCE GREENWALD & JOSEPH E. STIGLITZ, *ASYMMETRIC INFORMATION AND THE NEW THEORY OF THE FIRM: FINANCIAL CONSTRAINTS AND RISK BEHAVIOR* 11-12 (National Bureau of Economic Research Working Paper No. 3359, 1990) (extending the Modigliani-Miller view).

268. Under the first proposition, the financial leverage of the firm—the mix between its debt and equity claims—has no effect on the value of the firm. See Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958) [hereinafter Modigliani & Miller I]; Franco Modigliani & Merton Miller, *Corporate Income Taxes and the Cost of Capital: A Correction*, 53 AM. ECON. REV. 433 (1963) [hereinafter Modigliani & Miller II] (correcting the error in valuing "tax shields" to the firm). Under the second proposition, the rate of return to equity increases

verges from a theoretical world of perfect information and no-taxes in a number of ways that serve to rebut that indication.²⁶⁹ First, agency cost²⁷⁰ economics demonstrate that bonding and monitoring in the firm affect firm value.²⁷¹ Second, in a world with taxes, different participants have different tax rates such that the value of the project is increased by the tax position of each participant and the effect of the investment with respect to tax. Third, the assumptions of the capital structure irrelevance theorem are not fully realized in the real world of investors, borrowing costs, and transaction and information costs.²⁷² Thus, the capital structure is relevant to the efficiency of a particular firm.²⁷³

as the firm's debt-equity ratio increases due to the risk that the debt claims will be paid before the equity claims. Modigliani & Miller II, *supra* at 441.

269. Nonetheless, the Modigliani-Miller propositions are important for several reasons. First, capital structure theory posits that capital can always earn at the riskless rate of return which enforces the agreement that all firm participants will make absent tax considerations. Second, ability to have special allocations of profit and loss remains warranted since it does not increase or change the value of the firm or overall efficiency. However, one must consult two other propositions of capital structure analysis to evaluate that proposition. First, a firm undertakes to maximize overall value for the owners by taking into account personal taxes. See Merton H. Miller, *Debt and Taxes*, 32 J. FIN. 261, 268-72 (1977). Second, debt may be preferred to equity. See Modigliani & Miller II, *supra* note 268, at 433, 435-39 (value enhancement is discounted present value of tax savings), but that approach is not universally followed; see, e.g., ROSS ET AL., *supra* note 182, at 373-75; Harry DeAngelo & Ronald W. Masulis, *Optimal Capital Structure Under Corporate and Personal Taxation*, 8 J. FIN. ECON. 3, 19-20 (1980) (estimated costs of bankruptcy and financial distress need to be considered); Robert H. Litzenberger, *Some Observations on Capital Structure and the Impact of Recent Recapitalizations on Share Prices*, 21 J. FIN. & QUANT. ANAL. 59, 66 (1986) (same). Third, risk aversion and participants' utility functions provide an optimal capital structure for a particular firm. See Joseph E. Stiglitz, *Why Financial Structure Matters*, 2 J. ECON. PERSP., Fall 1988, at 121, 122-24; Stiglitz & Weiss, *infra* note 296, at 393.

270. These agency costs include the costs of writing, monitoring, and enforcing the contracts within the firm, the bonding costs which are expenditures of resources by the promisor (the agent) to give the promisee (the principal) a degree of assurance that the promisor will not deviate from the promised performance, and the residual loss to the promisee resulting from the remaining deviation in the behavior of the promisor from what it would be if the assumption of costs it was contracting were correct—the risk of bankruptcy.

271. See Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 310 (1983); Jensen & Meckling, *supra* note 117, at 337-39; see also Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

272. See WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE* 315-17 (5th ed. 1993).

273. For example, in a world with bankruptcy costs and asymmetric information, debt and equity differ in the amount of monitoring required. The concentration of debt holders and the dispersion of equity holders have effects on the firm, and provide different incentives for managerial risk-taking. Because of bankruptcy costs and asymmetric information, finance theory does search for the optimal capital structure for the firm. See, e.g., Jongmoo Jay Choi et

B. Optimal Risk-Bearing and Agency Problems

Consideration of whether partnerships are efficient forms of organization requires examination of risk-bearing in nonpublic general and limited partnerships, including corporate joint ventures, and the effect of agency costs. There is emerging literature on whether a partnership allows optimal risk-bearing and whether agency costs limit efficiency. The theory of optimal risk-bearing states that residual claims that allow unrestricted risk-sharing have advantages in organizations.²⁷⁴ Small, noncomplex organizations control agency problems through a combination of decision and risk-bearing functions that is efficient because the benefits of unrestricted risk-sharing and specialization of decision functions are less than the costs of controlling the resulting agency problems that more restricted residual claims allow. Far from all investments are made through publicly traded corporations. Pooling resources in a nonpublic context should be encouraged since each organization finds its niche in production.²⁷⁵

The residual claimants in an organization suffer the most direct consequences of failure or the agency costs that occur because of separation between ownership and control.²⁷⁶ In a publicly traded corporation, low transaction costs on transferability of ownership rights help hedge against the results of failure. The analysis changes

al., *Optimum Corporate Leverage with Risky Debt: A Demand Approach*, 12 J. FIN. RES. 129 (1989) (investigating the Modigliani-Miller theorem and finding that bankruptcy risk has an ambiguous effect on the value of the firm and its optimal leverage); Sheridan Titman & Roberto Wessels, *The Determinants of Capital Structure Choice*, 43 J. FIN. 1 (1988) (testing theory of capital structure choice based on collateral value of assets, non-debt tax shields, growth, uniqueness, industry classification, size, volatility and profitability and finding a positive correlation for uniqueness explained under the view that firms that can impose costs on suppliers and customers in bankruptcy have a lower debt ratio and confirming the importance of transaction costs).

274. Fama & Jensen, *supra* note 271, at 301, 305 & n.8 (citing Kenneth J. Arrow, *The Role of Securities and the Optimal Allocation of Risk Bearing*, 31 REV. ECON. STUD. 91 (1964)). If partnerships require that residual claims are restricted to decision makers controlling agency problems, this sacrifices both unrestricted risk-sharing and specialization of decision functions to the extent that risk-sharing cannot be specified in an unrestricted way. *Id.* at 306. Moreover, capital structure analysis suggests that risk-bearing can be best accomplished with a variety of securities. See Iraj Fooladi et al., *Preferred Stock and Taxes*, 18 J. BUS. FIN. & ACCT., Jan. 1991, at 99; Robert Heinkel & Josef Zechner, *The Role of Debt and Preferred Stock as a Solution to Adverse Investment Incentives*, 25 J. FIN. & QUANT. ANAL. Mar. 1990, at 1, 19 (debt solves the over investment problem present in all-equity firms).

275. See Fama & Jensen, *supra* note 271, at 307. "Organizational survival involves a balance of the costs of alternative decision systems and systems for allocating residual risk against the benefits." *Id.*

276. See *supra* text accompanying note 256.

when the risk bearers are risk-averse and the switching of managers among firms is not a matter of indifference to the residual claimants.²⁷⁷ Managers try to avoid having their wages discounted by agency costs and to maintain complete freedom to switch among firms by undertaking risk within the firm.²⁷⁸

Corporate joint ventures provide for risk-neutral participation by residual claimants. The managers of a corporate joint venture invest resources that ultimately derive from the public capital markets. Corporate managers decide the issues of the corporate joint venture under conditions of risk aversion, with the public as the ultimate residual claimants.²⁷⁹

Partnerships also offer residual claims in the form of limited partnership interests. The *sine qua non* of a limited partnership interest is the inability to control management decisions.²⁸⁰ Thus, limited partnership interests are often structured to provide for financing in a specialized manner to control agency problems through outside debt financing.²⁸¹ This limited partnership interest concerns the efficiency of partnerships, especially since limited partner equity cannot generally be publicly traded in order to diversify risk.²⁸² Management en-

277. See Fama, *supra* note 271, at 288, 291, 303 ("[E]fficient allocation of risk bearing seems to imply a large degree of separation of security ownership from control of the firm.").

278. Theory suggests that the manager may possibly hedge against these problems in the capital market and will always choose to share part of the uncertainty in the evaluation of her performance with the firms' risk bearers. The manager will agree to some amount of *ex post* settling up, but always less than 100 percent of the deviation of her measured marginal product from its *ex ante* expected value. *Id.* at 305 (citing, *inter alia*, Bengt Holmstrom, *Moral Hazard and Observability*, 10 BELL J. ECON. 74, 89 (1979)). The manager both contracts to control agency problems faced by risk averse residual claimants and avoids a discount in wages due to the market discount for agency costs precisely because the firm is not publicly traded and the residual claimants are not risk neutral.

279. Efficiency in partnerships is a two stage process. First, the ultimate beneficiaries are efficiently risk-bearing, while the corporate managers may not be so. Second, the moral hazard and adverse selection problems are still present, but involve decisions undertaken by managers who have a separation of ownership from control. These decisions may be undertaken in conjunction with an entrepreneur, who may be risk averse, in trying to get residual financing for an idea through corporate sponsorship.

280. On the limited partnership and limited control, see Rudnick, *supra* note 39, at 1013 n.140, 1059 n.291.

281. For example, if an owner of a project cannot raise capital, there will be an opportunity loss represented by the increment of value by selling additional investment opportunities. See Jensen & Meckling, *supra* note 117, at 343.

282. See I.R.C. § 7704(a) (1988). The value of limited liability may also help overpooling through the risks associated with limited liability. Nonetheless, limited partnership interests should be compared with nonvoting preferred stock. The only distinction is the lack

trenchment is a corollary of the organizational form, and according to some commentators may even be a desirable attribute of that form.²⁸³ A limited partnership agreement also controls the agency costs and the additional risk-bearing by finely tailoring the bonding mechanism of the particular managers.²⁸⁴ Once it is realized that, outside the public market, risk-bearing is not fully efficient, and that even the public market imposes agency costs on separation of ownership from control, efficiency analysis indicates that pooling and unpooling should be as free of transaction cost, including taxes, as possible.²⁸⁵ The economic literature views risk-sharing between labor and capital as essential for economic efficiency, and recognizes that specialization of risk fulfills Pareto optimal deployment of finite resources.²⁸⁶ Some literature suggests, however, that risk aversion can induce formation of too many firms; there should be an incentive for risk-averse individuals not to shift risk to others.²⁸⁷ If one believes that too many partnerships are being formed, then the tax code should adopt rules to discourage firm formation by taxing financial and human capital contributions; that is, the method to combat perceived excessive risk-shifting is to tax risk-shifting.²⁸⁸

of a public market to fully diversify risk so that there is too much risk-bearing by the limited partners. Partnership interests can also function as preferred stock in that the return is contingent upon the profitability of the firm.

283. See Larry E. Ribstein, *An Applied Theory of Limited Partnership*, 37 EMORY L.J. 835, 842-43, 849-50, 854, 857, 894 (1988) (limited partnerships offer the limiteds a guarantee by the general partner's entrenchment to insulate the firm from takeover, lower the cost of credit, and provide limited liability which reduces monitoring and increases marketability).

284. For example, with respect to monitoring by limited partners, a heavy distribution of earnings requirement averts excessive retention of earnings and forces the partners to finance new activities with new equity. See Ribstein, *supra* note 283, at 886-88. On agency theory, see AMIR BARNEA ET AL., AGENCY PROBLEMS AND FINANCIAL CONTRACTING 27-30 (Ezra Solomon ed., 1985).

285. A toll charge on allocation of risk has other deadweight costs. It inefficiently disadvantages taxpayers who are relatively risk averse and it may reduce net investment by both discouraging risk averse investors and by impeding the use of certain transactions to preserve credit worthiness for subsequent transactions. Daniel N. Shaviro, *Risk and Accrual: The Tax Treatment of Nonrecourse Debt*, 44 TAX L. REV. 401, 437 (1989); see also Shaviro, *supra* note 151.

286. See generally ATKINSON & STIGLITZ, *supra* note 218, at 97-127; see *infra* text accompanying notes 307-35.

287. See Harry Watson, *An Analysis of the Formation and Behavior of Partnerships*, 17 PUB. FIN. Q. 281 (1989) [hereinafter "Watson I"] (positing that human service partnership formation will be too high since there is an incentive for risk averse participants to form too many firms). Here, the Watson analysis is unrewarding since it is based on the debatable assumption that the partnership cannot monitor the skills of the participants as the labor market can.

288. For instance, contributions to partnerships cannot currently be subjected to a tax,

C. Partnerships Are Efficient

Early literature argued that partnerships are inefficient forms of organizations because the partners cannot solve their "moral hazard" problem.²⁸⁹ More recent literature disagrees with this argument.²⁹⁰ Nonetheless, economic models posit that limited liability, such as does exist in limited partnerships and limited liability companies, changes the efficient outcome because it involves two factors: (1) the relative liability levels; and (2) the first best opportunity costs of the partners, that is, what the partners gave up to get into the partnership.²⁹¹ In models with risk-neutral partners and an uncertain output, an efficient relationship can exist because uncertainty makes any budget constraint (limits on the wealth of the participants) irrelevant, but the results point to a less than efficient outcome when risk aversion is introduced.²⁹² Nonetheless, even given risk aversion, the first best result can occur, if contracts that are provided for within the partnership control the moral hazard risk.²⁹³ The theoretical literature supports the proposition that the real world rules governing the payments and contracts that partners demand for their participation may be efficient. There also exists real world evidence of efficiency.²⁹⁴

either measured on the value or in the income tax model on the gain or loss. See *supra* text accompanying notes 69-72. Another response is to limit private risk-taking through asset diversification, which limits the private risk-taking.

289. The moral hazard problem lies primarily in shirking and cheating. Alchian & Demsetz, *supra* note 116, at 777-785; Holmstrom, *supra* note 244, at 324; Radner et al., *An Example of a Repeated Gain With Discounting and With Uniformly Inefficient Equilibria*, 53 REV. ECON. STUD. 59, 60 (1986).

290. See Patrick Legros & Hitoshi Matsushima, *Efficiency in Partnerships*, 55 J. ECON. THEORY 296 (1991) (finding such efficiency where there is joint production with uncertain output and after the realization of the output). One of the conditions of the model is that side payments are allowed. *Id.* at 297. There are also other controls. See Eugene Kandel & Edward P. Lazear, *Peer Pressure in Partnerships*, 100 J. POL. ECON. 801 (1992) (discussing the affect of peer pressure).

291. See Legros & Matsushima, *supra* note 290, at 298.

292. See STEVEN R. WILLIAMS & ROY RADNER, *EFFICIENCY IN PARTNERSHIP WHEN THE JOINT OUTPUT IS UNCERTAIN* 8 (Northwestern Univ., The Ctr. for Mathematical Studies in Economics and Management Science Discussion Paper No. 760, 1988) (due to moral hazard, partners have an incentive to change their organization by bringing in a principal, either to monitor input or administer budget breaking compensation schemes, and therefore evolve into a more hierarchical form).

293. *Id.*; see, e.g., Eric Rasmusen, *Moral Hazard in Risk-Adverse Teams*, 18 RAND J. ECON. 428 (1987) (a "massacre" contract which punishes all but one agent when the outcome is low generally attains the first best result under risk aversion).

294. Partnership networks are important as an effective governance arrangement for entrepreneurial companies. See Andrea Larson, *Partner Networks: Leveraging External Ties to Improve Entrepreneurial Performance*, 6 J. BUS. VENTURING 173 (1991) (finding positive

The economic literature focuses on the effect of attitudes toward risk on pooling. Under one model, if market participants are risk-neutral, projects with negative expected returns are financed in a pooling equilibrium because of adverse selection in which the presence of good projects lowers the interest rate charged to poor projects.²⁹⁵ In the same model, when risk aversion is substantial and different participants react in different ways to the investment, an equilibrium may emerge, characterized by an appropriate level of investment on the one hand, and insufficient risk-sharing on the other.²⁹⁶ Evidence also suggests that greater risks are taken with new resources than with long-held resources.²⁹⁷ These insights suggest that the partnership rules for pooling permit nonrecognition to increase risk-sharing, although some models predict over-investment²⁹⁸ that can be

results from vertical alliances). Partnerships offer unique advantages in co-operative business modes for women entrepreneurs. See Kathryn Campbell, *Women and Their Business Partners: Some Research Issues*, J. SMALL BUS. & ENTREPRENEURSHIP, Jan.-Mar. 1991, at 39. Partnerships provide efficient distribution and marketing networks. See Stephanie Strom, *More Suppliers Helping Stores Push the Goods*, N.Y. TIMES, Jan. 20, 1992, at D1, D8. Partnerships provide opportunities for smaller firms. See, e.g., Fisher, *supra* note 53, at D2. Partnerships and joint ventures are argued to foster a competitive cooperative business alliance. See generally ROBERT PORTER LYNCH, *THE PRACTICAL GUIDE TO JOINT VENTURES AND CORPORATE ALLIANCES* (1990); JOHN P. KARALIS, *INTERNATIONAL JOINT VENTURES* (1992), and support competitiveness in world markets by affecting savings and productivity. See JOINT COMM. ON TAXATION, 1ST CONG., 102D SESS., *FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES* Joint Comm. Print 1991). For other examples, see *supra* text accompanying notes 51, 53.

295. David De Meza & David Webb, *Risk, Adverse Selection and Capital Market Failure*, 100 ECON. J. 206 (1990) [hereinafter De Meza & Webb, *Failure*]. De Meza and Webb assume that entrepreneurs differ in ability, which is contrasted to another model, see Joseph Stiglitz & David Weiss, *Credit Rationing in Markets With Imperfect Information*, 71 AM. ECON. REV. 393 (1981), characterizing entrepreneurs by differential risk. In another model, the De Meza and Webb capital structure implies equity rather than debt finance, although if equity contracts are costly to write or enforce, the debt will be the dominant form of financing, and even under risk neutrality investment will be socially too low. See David De Meza & David Webb, *Too Much Investment: A Problem With Asymmetric Information*, 102 Q.J. ECON. 281, 292 (1987) [hereinafter De Meza & Webb, *Information*] (analyzing of risk-neutral and risk-adverse investors). The argument is that capital market failure involves adverse selection: banks are less able to judge success potential than the entrepreneur seeking capital, which means that there is greater debt finance rather than the sale of equity; and for the entrepreneur who gets debt finance, the loan is an exploitable signal of project quality. *Id.*

296. See De Meza & Webb, *Failure*, *supra* note 295, at 214.

297. See William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. RISK & UNCERTAINTY 7 (1988).

298. Risk-neutral entrepreneur models predict overinvestment due to the presence of moral hazard and adverse selection. See *supra* notes 244-45. Other market mechanisms exist to eliminate the bias of risk neutral entrepreneurs to overinvest, such as the role of debt as a monitor. KLEIN & COFFEE, JR., *supra* note 272, at 11. Debt has both bankruptcy and agency

countered by various strategies,²⁹⁹ such as including within the partnership wealthy individuals who can and do hold large liabilities.³⁰⁰

One partnership risk aversion model suggests that partner utility be combined in such a way that the partnership can be viewed simply as an individual.³⁰¹ Assuming the partnership form is chosen to promote

costs, which can be applied to contingent claims analysis of the value of debt and to determine the optimum debt level for a particular firm. See Antonio S. Mello & John E. Parsons, *Measuring the Agency Cost of Debt*, 48 J. FIN. 1887 (1992). Other studies focus on the inefficient "deterministic" partnerships in which risk-neutral partners share and jointly produce an output according to a certain technology. By contracts allocating risk and its rewards and detriments, approximate efficiency is attainable in a wide range of these partnerships. Patrick Legros & Steven A. Matthews, *Efficient and Nearly-Efficient Partnerships*, 60 REV. ECON. STUD. 599 (1993). The partner may choose her minimal action with small probability or her maximum with small probability, which suggests an intuitive game of incomplete information in which the other partners put small probability on the first named partner being a "slacker" (large marginal disutility) type or a "workaholic" (small marginal disutility) type. *Id.* at 607; see also PATRICK LEGROS & ANDREW S. NEWMAN, *WEALTH EFFECTS, DISTRIBUTION, AND THE THEORY OF ORGANIZATION* (Northwestern Univ. Ctr. for Mathematical Studies in Economics and Management Science Discussion Paper No. 1024, 1993) (general equilibrium to test wealth effects and the way in which different organizational forms, including partnerships, can divide the proceeds of production).

299. Other papers have shown that efficiency or near efficiency can be obtained in partnerships in which the partners need not share the output, see Holmstrom, *supra* note 278, or the output is achieved by a random technology, see WILLIAMS & RADNER, *supra* note 292; Legros & Matushima, *supra* note 290, or the partners are risk averse and sharing rules can be random, see Rasmusen, *supra* note 293, or the partnership game is played repeatedly, see Radner et al., *supra* note 289, at 61-63. The Legros and Matthews article, see *supra* note 298, is the first to consider the efficiency and near efficiency of a single partnership with risk-neutral partners.

300. See Legros & Matthews, *supra* note 298, at 600.

301. The model found that:

[T]he measure of partnership risk aversion is not a weighted average of partner risk aversion [and] it is entirely independent of the weights that might be assigned partner utility . . . [and that] partnership risk aversion is always less than that of any partner . . . [.] [which] should not be surprising since the sharing of risk made possible by the partnership should make the risk premium required for any joint venture less than that required for any individual venture.

Harry Watson, *The Effects of Taxation on Partnership Investment*, 36 J. PUB. ECON. 111, 116 (1988) [hereinafter "Watson II"] (extending the measure to taxation and Pareto-optimal risk-sharing rules which depend on a measure of risk aversion for pre-tax partner income that is identical to that used above). Risk aversion also relates to the partners' tax attributes under a proportional or a progressive income tax. Watson concludes that if partnership income is increased, investment by the partnership will rise if its absolute risk aversion is decreasing, remain the same if the aversion is constant, and fall if there is increasing absolute risk aversion. A distribution of the partnership's income among the partners leaves total partnership capital unaffected and will have no effect on partnership investment. More retained partnership income does not necessarily mitigate the risks of larger investment, so that partnerships with the most resources as measured by retained income will not make the largest investments; therefore the

efficiency in the partner relationship, and if partnerships have a lower level of risk aversion than individuals, the formation of a partnership will increase the riskiness of ventures undertaken.³⁰² If risk-bearing advances economic goals, it will also increase the production of goods and services.

Knowledge of the behavior of relative risk aversion for the partnership is sufficient to predict the effect of a rate increase on investment. In an existing partnership, it is presumed that risks are already optimally distributed among the partners so that a government role in sharing risk through allowing loss offsets yields no benefits; higher tax rates will only produce an income effect (increasing work to make up for income lost to taxation) or a substitution effect (substituting leisure for labor) by the individual who shares her return with the government.³⁰³ If partners are risk-neutral, then increasing the progressivity of taxation reduces partnership investment and income because it is akin to raising risk aversion in pre-tax income for the partners.³⁰⁴ If partners are subject to linear (flat) income taxation at different rates, and exhibit constant absolute risk aversion in after-tax income, the partnership investment will rise as the variation in the absolute risk aversion measures of the partners increase.³⁰⁵ Because a partnership comprised of individuals with negatively related tax rates and risk aversion will result in a broader range of values for after-tax absolute risk aversion and therefore greater variation in the partners' absolute risk aversion, it will invest more than one made up of partners who have similar tastes and tax rates. For example, partners A and B have tax rates and risk aversion measures of 10 percent and 5 and 40 percent and 1 respectively. If they form a partnership, the variation in the after-tax risk aversion measure will be $(1-10\%)(5) - (1-40\%)(1)$ or 4.1. If partner B has the same tax rate and risk aversion measure as A, the variation will be $(1-10\%)(5) - (1-10\%)(5)$, or 0. If partner B has the same tax rate as A but a risk aversion measure of 3, the variation will

reduction of taxes on outside income which increases the resources available to the partnership does not necessarily stimulate partnership investment. *Id.* at 117.

302. See *infra* text accompanying notes 306, 320-25.

303. That is, her income is reduced. See Watson II, *supra* note 301, at 118-20.

304. The partners keep less of the return to the investment the more successful it is and therefore are willing to risk less. This is even true when the government allows full loss offsets. See *supra* note 214.

305. Watson II, *supra* note 301, at 120. Other factors, such as one partner's influence over another, may change the mix. See RICHARD ARNOTT & JOSEPH STIGLITZ, DYSFUNCTIONAL NON-MARKET INSTITUTIONS AND THE MARKET (National Bureau of Economic Research Working Paper No. 2666, 1988).

be $(1-10\%)(5) - (1-10\%)(3)$ or 1.8. If partner B has a different tax rate than A, 40 percent, but the same risk aversion measure, the variation will be $(1-10\%)(5) - (1-40\%)(5)$ or 1.5. Under the model, an increased variation in absolute risk aversion of the partners increases partnership investment, and therefore the variation in both tax rates and risk aversion matters. The general intuition behind this is that each partner is able to receive her first best choice within the partnership for risk bearing given her risk aversion and her after-tax return. Investments produce levels of risk and tax benefits at various stages. The partnership investment is able to be carved up into segments that allocate the first best choice to the partners. Thus, the sum of the parts is greater than the whole and each partner can invest to an optimal level. Moreover, the greater variation in risk aversion and tax rates increases the value to each partner of an allocation of partnership investment that matches her risk aversion and tax rate attributes.³⁰⁶

Thus, attitudes on adverse selection, moral hazard and decision making limit efficient pooling.

*D. Risk-Bearing and Its Effect on Financial and Human
Contributions, and Risk-Sharing Through
Special Allocations*

Much of the criticism of the lenient rules in Subchapter K, special allocations, and contribution transactions is based on assumptions of certainty or accurately predicted gambles.³⁰⁷ Because business formation and investment is risky and takes place in less than perfect markets,³⁰⁸ business and investment levels depend in part on the timing and sharing of taxes relative to the risks borne by the partners.³⁰⁹

Risk-sharing is economically efficient; the tax system ought to

306. For an example of the continuum of this sharing, see *infra* note 444; see also *supra* notes 121 and 200.

307. See, e.g., Gergen, *supra* note 12, at 5-9.

308. Some economists contend that the interaction between uncertainty and risk leads to negative elasticity of business formation. See SHACKLE, *supra* note 177, at 108.

309. See, e.g., Richard M. Peck, *Taxation, Risk, and Returns to Scale*, 40 J. PUB. ECON. 319 (1989). Peck points out that with free mobility between the labor and entrepreneurial sectors, in the absence of uncertainty, equilibrium requires equality of labor income and profits; a profits tax will be borne equally by workers and entrepreneurs. However, with uncertainty, it is possible for the burden of a profits tax to be borne by entrepreneurs by more than 100 percent. This happens when profits taxation encourages business formation, driving up the demand for labor and wage rates. Hence, net profits decline not only because of taxation but also because of higher wage rates. *Id.* at 323.

allow risk-sharing consistent with tax policy equity goals to the fullest extent possible.³¹⁰ As discussed earlier, persons with diverse attributes are likely to join together for risk- and reward-bearing,³¹¹ and the contribution and special allocation rules in Subchapter K accommodate this difference.

Partnership formation and continuation is an exercise in risk-sharing among persons, economically classified as "syndicates," with various risk aversions.³¹² Early group risk-sharing models posited homogenous attitudes towards risk and found that pro rata sharing

310. A firm is a risk-sharing arrangement since capital suppliers share residual risks and rewards. Under limited liability situations, capital suppliers merely risk their investment, be it equity or human capital. Under situations of unlimited liability, equity suppliers and owners supplying human capital place all their personal assets at risk. Debt capital suppliers are at risk of nonrepayment of principal and delayed payment of interest. Other participants under this "nexus of contracts" approach to firm organization include product suppliers, employees, and the community. See KLEIN & COFFEE, *supra* note 272, at 54. Since general economic analysis presumes individuals to be generally risk averse, prospective partners shall be presumed here also to be risk averse. See *supra* text accompanying notes 203-07. For modeling of partnership arrangements, see Watson II, *supra* note 301, at 111. One can view the partnership as a series of options, valued using contingent claims analysis, exercised by each partner. See *supra* note 224 and accompanying text. Contingent claims analysis bifurcates instruments into debt and option components. See *supra* note 224. Or, one may view the partnership as a different portfolio composition of the partners with a risk separate from the systematic risk of the individual contributions, which may be more or less risky depending upon the composition of the partners' previous portfolios. See *supra* note 301-06 and accompanying text. The tax effects of a firm's formation alter choices with respect to the preferred forms of risk-sharing regarding highly transferable assets or firm specific assets. A firm-specific capital investment can be determined from the existence of a quasi-rent, which is defined as when an asset is specialized to a particular user or when there are other costs of removal; high transaction costs prevent the owner from transferring the asset to others. See Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297, 299, 308-10 (1978). Some argue that these firm specific capital investments are also the firm-specific human capital investments of managers, workers, customers, and suppliers to particular firms. See John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 17 n.42, 24 (1986). These investments should be viewed as a bargain within the particular firm to which the investments attach. See Macey, *supra* note 264, at 188-97.

311. See *supra* text accompanying notes 301-06 and *infra* note 317.

312. A "syndicate" is "a group of individual decision makers who must make a common decision under an uncertainty, and who, as a result, will receive jointly a payoff to be shared among them." Robert Wilson, *The Theory of Syndicates*, 36 ECONOMETRICA 119, 119 (1968) [hereinafter Wilson, *Theory*]. The decision making process of a syndicate is analyzed when "the members have diverse risk tolerances and/or diverse probability assessments of the uncertain events affecting the payoff . . . [this involves] the possibility of constructing a surrogate 'group utility function' and a surrogate 'group probability assessment.'" *Id.* Wilson found that consistent results were uniquely associated with linear Pareto-optimal sharing rules in the absence of agreement on the probability assessment. *Id.* at 131. This analysis is unrewarding in the partnership context because the bargains struck are uniquely individual and require separate evaluation and sharing of the common risk should the partners so choose.

agreements were optimal.³¹³ Complex sharing arrangements reflecting heterogenous beliefs about risk produce more efficient outcomes,³¹⁴ although one study treats equal sharing as the only way to exercise control over bargaining in a joint venture under asymmetric information even when participants contribute unequal amounts.³¹⁵ Other models of individual bargaining³¹⁶ find that equal sharing is inefficient because people can only exploit economies by sharing with less able people and cannot achieve size without heterogeneity.³¹⁷ Thus, the partnership entity value is greater than that of a sole proprietorship in many contexts.³¹⁸ If individuals know and have various views of their risk aversion,³¹⁹ they should receive greater latitude in selecting capital

313. See Wilson, *Theory*, *supra* note 312, at 131.

314. See John Windsor Pratt & Richard Jay Zeckhauser, *The Impact of Risk Sharing on Efficient Decision*, 2 J. RISK & UNCERTAINTY 219, 220 (1989).

315. See Masko N. Darrough & Neal Stoughton, *A Bargaining Approach to Profit-sharing in Joint Ventures*, 62 J. BUS. 237 (1989) (model of asymmetric bargaining leading to equal allocation of realized net profit).

316. STEVEN C. HACKETT, HETEROGENEITY AND SHARE CONTRACTING IN MEDICAL GROUP PRACTICES (Indiana University Working Paper, July 7, 1993) (forthcoming J. BUS. ECON.) (finding support that productivity heterogeneity among physicians limits equal income sharing).

317. See Joseph Farrell & Suzanne Scotchmer, *Partnerships*, 103 Q.J. ECON. 279 (1988) (efficiency may require heterogenous groups and the homogeneity caused by equal sharing is inefficient apart from any effect on group size).

318. This has long been recognized. See *State v. Frear*, 134 N.W. 673 (1912), *error dismissed*, 231 U.S. 616 (Wis. 1914), *cited in* H. BLACK, A TREATISE ON THE LAW OF INCOME TAXATION UNDER FEDERAL AND STATE LAWS 29 (1913) (partnership advantages in transaction of business over the individual).

319. Rawls doubts that an individual can "know" her risk aversion. See RAWLS, *supra* note 169, at 155-72. But see *supra* text accompanying notes 208-11. Nonetheless, economic literature also supports the view that a person considers a venture or asset as a set of numerical probabilities, assigning a probability of occurrence to each gain or loss hypothesis about the venture or asset. Early views of this occurred in ALBERT GAYLORD HART, *ANTICIPATIONS, UNCERTAINTY AND DYNAMIC PLANNING* (1940) and Jacob Marschak, *Lack of Confidence*, 8 SOC. RES. 52 (1941). These are discussed in SHACKLE, *supra* note 177, at 117-19. Thus, an individual develops a weighted average of probabilities, a concept that has different foci. See Marschak, *supra* at 53 (bases the relationship on a distribution of both gains and losses with their respective probabilities). Departing from the traditional economic definition of risk, Professors Domar, Musgrave, and Shackle split the distribution into its positive and negative parts and took the average weighted probabilities of each of these parts separately, thus obtaining the positive component, termed the yield, and the negative component, called the risk. Domar & Musgrave, *supra* note 214, at 388. There is also an uncertainty of response with respect to "calculable risks"—risks that can be estimated. Thus, it is both the presence of risk and the presence of uncertainty that is the setting for the human response to risk that gives rise to a fundamental assumption about economic action. See JOHN MAYNARD KEYNES, A TREATISE ON PROBABILITY 3-4 (1921); GEORGE L.S. SHACKLE, *IMAGINATION AND THE NATURE OF CHOICE* 134-52 (1979). Frank Knight says probabilities of outcomes may exaggerate the importance of pure uncertainty. Shackle says that individuals look at the probabilities of particular outcomes, good and bad, but only actually view the most likely, and not the least

structure and profit and loss sharing.

In a partnership of both property and human capital service contributions, there is risk-sharing of both. For example, individuals choose between being entrepreneurs, workers, and managers based on both risk-sharing and risk aversion,³²⁰ and many models explain the difference between workers and entrepreneurs in terms of risk.³²¹ Occupational choice is a major vehicle for risk-taking,³²² and is an extension of the effect of taxation on risk-taking.³²³ Economists also posit that it is also rare for decisions on the purchase of risky assets to

likely. SCHACKLE, *supra*. Game theory causes the participant's to weigh the risks of the possible choices; the goal is to outwit the other gamers. See Rasmusen, *supra* note 30. In all cases, these risks are weighed intuitively to establish probabilities. See *supra* text accompanying notes 171-79.

320. See JANE GRAVELLE & LAURENCE J. KOTLIKOFF, CORPORATE TAXATION AND THE EFFICIENCY GAINS OF THE 1986 TAX REFORM ACT 31-34 (National Bureau of Economic Research Working Paper No. 3142, 1989). The issue with respect to risk aversion in choosing employment versus a partnership entrepreneurial position has been dealt with in many ways. See MARTIN WEITZMAN, THE SHARE ECONOMY: CONQUERING STAGFLATION 138-40 (1984).

321. See Richard Kihlstrom & Jacques Laffont, *A General Equilibrium Entrepreneurial Theory of Firm Formation Based on Risk Aversion*, 87 J. POL. ECON. 719, 746 (1979). Kihlstrom and Laffont construct a general equilibrium model of firm formation in which production requires entrepreneurial as well as normal labor inputs. *Id.* at 745. The equilibrium wage to the level of entrepreneurial risk aversion mirrors that of Knight which concludes that "entrepreneur income, being residual, is determined by the demand for these other [productive] services which demand is a matter of self confidence of entrepreneurs as a class" *Id.* at 747. S.M. Ravi Kanbur sets forth a theory of risk-taking based on nonmarginal choices between alternative activities with different risk characteristics and entrepreneurial risk. See S.M. Ravi Kanbur, *Risk Taking and Taxation*, 15 J. PUB. ECON. 163 (1981). The model is a continuous control variable in combination with a discrete choice between safety and risk which is referred to as "occupational choice framework." For a newer model, see Robin Boadway et al., *Optimal Linear Income Taxation in Models With Occupational Choice* 46 J. PUB. ECON. 133, 148, 154-55, 160 (1991) (demonstrating that risk-pooling is necessary to be more optimal). Other papers consider the affect of taxation on occupational choice. See Peck, *supra* note 309, at 319. Another shows that a flat tax on the allocation of a work force means that there will be a trade off between occupations based on ability. See Vidar Christiansen, *Choice of Occupation, Tax Incidence and Piece Meal Tax Revision*, 90 SCANDINAVIAN J. ECON. 141 (1988). In another model, households choose between being workers or corporate managers or entrepreneurs in unincorporated firms, they are all equally efficient as workers or managers but different in efficiency as entrepreneurs. See Jane Gravelle & Lawrence Kotlikoff, *The Incidence in Efficiency Costs of Corporate Taxation When Corporate and Noncorporate Firms Produce the Same Good*, 97 J. POL. ECON. 749 (1989). Other agency views focus on the asset owned by an agent and the optimal assignment of assets to firms. See Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119 (1990).

322. See ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 129 (1776) (Book 1, Ch. X) (originating the concept).

323. See Kanbur, *supra* note 321, at 179 (noting effects of tax rates on occupational distribution). For the effect of tax on occupational choice, see Sandmo, *supra* note 214, at 303-04.

be taken in the absence of wage income risk as individuals consider their financial and human capital income and wealth.³²⁴ And, risk aversion causes service (as well as other) partners to elect less risky income and returns.³²⁵

Taxing service partners *ex ante* on the value of their human capital contributions would cause efficiency and equity concerns.³²⁶ One model demonstrates that an income tax on wages as they are earned will reduce the riskiness of wage income under conditions of uncertainty and will increase the labor supply because taxes are proportionate to income earned.³²⁷ Applying the view of distributive justice to wage income taxation, systems are developed for limiting taxation of human capital to actual earnings.³²⁸ Others note the relationship to the form of taxation, social insurance, and the limited market opportunities for reducing human capital risk.³²⁹ This observation indicates the need for increasing tax deference to human capital diversification and deployment decisions.

Economic theory has paid little attention to the difficult subject of the impact of risk-sharing on group decisions,³³⁰ or to nonlinear

324. See GUNTER FRANKE ET AL., COMMENTS ON IDIOSYNCRATIC RISK, SHARING RULES AND THE THEORY OF RISK BEARING (INSEAD Working Paper No. 92/34/FIN, Apr. 1992).

325. See *supra* text accompanying notes 263-66. Moreover, some view intellectual property and human capital as commanding the greatest value for the future. See Walter B. Wriston, *The State of American Management*, HARV. BUS. REV. 78, 81-83 (Jan.-Feb. 1990) (arguing that the accounting profession and generally accepted accounting standards have not followed this view).

326. See Weiss, *supra* note 154, at 221 (noting this with respect to the differential taxation of wage and capital income); Shaviro, *supra* note 151, at 9-10 (comparing effect of realization rules on labor and asset transactions).

327. See Jonathan Eaton & Harvey S. Rosen, *Labor Supply, Uncertainty, and Efficient Taxation*, 14 J. PUB. ECON. 365 (1980) (contending that income tax mitigates risk exceeding incentive costs given under assumptions that private insurance cannot be obtained). But see LOUIS J. KAPLOW, A NOTE ON TAXATION AS SOCIAL INSURANCE FOR UNCERTAIN LABOR INCOME (National Bureau of Economic Research Working Paper No. 3708, 1991) (problems of private insurance).

328. Limiting taxation of human capital under a theory of distributive justice would also exclude lump sum taxation of wealth based on a forecasted view of value of human capital. See Edmund Phelps, *Taxation of Wage Income For Economic Justice*, 87 Q.J. ECON. 331, 332 (1973).

329. See Laurence J. Kotlikoff, *Taxation and Savings: A Neoclassical Perspective*, 22 J. ECON. LIT. 1576, 1621 (1984) ("In assessing the savings impact of these potential forms of government insurance provisions, the key question appears to be the extent to which the private market would otherwise provide each particular form of insurance.").

330. See, e.g., Carmen F. Menezes & Debra L. Hanson, *On the Theory of Risk Aversion*, 11 INT'L ECON. REV. 481 (1970); Stephen A. Ross, *On the Economic Theory of Agency and the Principle of Similarity*, in ESSAYS IN ECONOMIC BEHAVIOR UNDER UNCERTAINTY (M. Balch et al. eds., 1974); Wilson, *Theory*, *supra* note 312; Wolfson, *supra* note 263.

allocations that will result in an optimal risk-sharing.³³¹ Various tax incentives and the ability of the partners to use them produce more favorable sharing than sole proprietorships.³³² Various claims against the firm allow the competitive allocation of risk-bearing to promote or enhance efficiency if the participants have different risk aversion.³³³ In a property-only partnership, there is risk-sharing with respect to the ownership of that property.³³⁴ The issue is how to deal with a partnership situation where one partner, taxpayer A, is more risk-averse as to growing apples and the other partner, taxpayer B, is more risk-averse as to growing oranges. Is not the better risk-sharing allocation one that takes into account the risk-sharing preferences of the partners? Why not uphold the allocation of 60 percent of the profits and losses on oranges to A and 40 percent to B, and 60 percent of the profits and losses on apples to B and 40 percent to A? Is not the only concern the relative risk preferences of A and B about both ventures?³³⁵ Any deviation from the *ex ante* outcome *ex post* changes the economic risk and rewards between the partners.

Analysis of risk and the need to encourage investment at the margin leads to a consideration of the principles to be applied in achieving this goal within the tax law. Thus, this Article now considers efficiency and equity in tax policy.

VII. EFFICIENCY AND EQUITY

Under the efficiency concerns most notably applied in optimal tax models, a tax applied to activities (or commodities) for which demand is elastic will result in a social welfare loss.³³⁶ Distorting one's choice

331. Linear sharing arrangements rarely produce Pareto optimal results under very specific and unrealistic assumptions. See Wilson, *Theory*, *supra* note 312. Once non-homogenous groups and differing expectations are introduced into the model, non-linear sharing produces Pareto optimal results. Pratt & Zeckhauser, *supra* note 314, at 219, 220; see also Amershi & Stoeckenius, *supra* note 214, at 1407 (demonstrating this result by "creating a class of groups with heterogeneous beliefs and nonlinear sharing rules, but which do act as Savage rational individuals").

332. See John C. Fellingham & Richard A. Young, *Special Allocations, Investment Decisions, and Transaction Costs in Partnerships*, 27 J. ACCT. RES. 179 (1985) (nonetheless transaction costs are incurred because an unobservable moral hazard arises even for risk neutral partners and decreases the ability to use special allocations rather than proportional sharing).

333. See ARROW, *ESSAYS*, *supra* note 169, at 91.

334. The importance of owner equity has been noted in other contexts. See, e.g., Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 190-95 (1991) (owners raising additional personal capital—"new value"—is an index of good faith).

335. See *infra* text accompanying notes 593-670.

336. See Agnar Sandmo, *Optimal Taxation: An Introduction to the Literature*, 6 J. PUB.

of business form through taxation may result in distortion in the economy, deadweight losses, and other inefficiencies. Finally, whether the partnership rules promote horizontal equity may depend upon whether horizontal equity is understood in terms of utility or ability-to-pay. Current Subchapter K rules with respect to contributions, distributions, and special allocations are more consistent with efficiency concerns of taxation than the reforms suggest, since the flexible rules of Subchapter K discussed in Part VIII increase social welfare.

A. *Optimal Taxes and Efficiency*

1. In General

Economic theory generally begins with the proposition that most taxes on profits excessively burden economic production and thereby lead to inefficiency.³³⁷ The excess burden of a tax—the deadweight loss—is the amount lost to the economy in excess of the taxes the government collects to redistribute to others.³³⁸ Efficiency is a necessary and desirable condition of a tax system only if it is relative to a criterion of social welfare or distributive justice.³³⁹ This redistribution may be through a particular tax provision,³⁴⁰ rather than through a

ECON. 37 (1976).

337. It is difficult to measure excess burden for an aggregation of individuals when one attempts to consider individual tastes and preferences. Because individuals are different, the tax system needs to be something other than a lump sum tax. Anthony A. Atkinson & Joseph E. Stiglitz, *The Design of Tax Structure: Direct Versus Indirect Taxation*, 6 J. PUB. ECON. 74, 79, 86 (1976) [hereinafter Atkinson & Stiglitz, *Design*]. Furthermore, lump sum taxation has been seen as being inefficient when studied in a model of uncertainty. Richard Arnott & Joseph E. Stiglitz, *Moral Hazard and Optimal Commodity Taxation*, 29 J. PUB. ECON. 366 (1986).

338. See MUSGRAVE & MUSGRAVE, *supra* note 30, at 277-97.

339. Utilitarianism and Rawlsianism offer different concepts of social welfare. See RAWLS, *supra* note 169; JOSEPH E. STIGLITZ, PARETO EFFICIENT AND OPTIMAL TAXATION AND THE NEW WELFARE ECONOMICS 60 (National Bureau of Economic Research Working Paper No. 2189, 1987). Most individuals studying and writing on optimal tax theory use a utilitarian social welfare function. Different weighing procedures are often applied to deal with vertical equity considerations. Hettich & Winer, *supra* note 99, at 427. Thus, a policy maker must choose, according to her values, a set of feasible allocations. See Dagobert L. Brito et al., *Pareto Efficient Tax Structures*, 42 OXFORD ECON. PAPERS 61 (1990). The government cannot do this, it only observes differences in earned income. Joseph E. Stiglitz, *Pareto Efficient Taxation*, 17 J. PUB. ECON. 213, 214 (1981). For competing views on equality, see AMARTYA SEN, CHOICE, WELFARE AND MEASUREMENT 353-69 (1982) (examining utilitarian, Rawlsian, and total utility equality and offering a combined equity equation—basic capability equality, a person's ability to do certain things).

340. See George M. von Furstenberg & Dennis G. Mueller, *The Pareto Optimal Approach to Income Redistribution: A Fiscal Application*, 61 AM. ECON. REV. 628 (1971); Peter A. Diamond & James A. Mirrlees, *Optimal Taxation and Public Production I: Production Efficiency*, 61 AM. ECON. REV. 8 (1971); Peter A. Diamond & James A. Mirrlees, *Optimal Taxation*

government transfer payment.³⁴¹ If efficiency requires non-neutral tax policy rules to produce the socially optimal mix, that can be done by privately directed initiatives.³⁴²

Optimal tax theory is concerned with social welfare primarily from the standpoint of efficiency;³⁴³ horizontal equity considerations are introduced later to limit permissible forms of taxation.³⁴⁴ An optimal tax system³⁴⁵ seeks to eliminate inefficient behavior of taxpayers, distortions in the economy, and deadweight losses.³⁴⁶ Thus, the literature on optimal taxation widely states the view that taxes should not distort individual labor decisions.³⁴⁷ Optimal taxation ("OT") suggests that no social welfare loss will accompany a tax that is applied to activities or commodities for which demand is inelastic. This social welfare loss can

and *Public Production II: Tax Rules*, 61 AM. ECON. REV. 261 (1971); David E. Wildasin, *Distributional Neutrality and Optimal Commodity Taxation*, 67 AM. ECON. REV. 889 (1977).

341. See A. Mitchell Polinsky, *Shortsightedness and Nonmarginal Pareto Optimal Redistribution*, 61 AM. ECON. REV. 972 (1971).

342. See, e.g., EDMUND S. PHELPS, *FISCAL NEUTRALITY TOWARD ECONOMIC GROWTH* 85 (1965) (noting investment subsidies to investments with a high variation in rates of return).

343. "The optimal tax structure is the one that maximizes social welfare, in which the choice between equity and efficiency best reflects society's attitudes toward these competing goals." STIGLITZ, *supra* note 30, at 480. Under this view, the tax system is a series of excise taxes aimed at increasing social welfare. See STEPHEN G. UTZ, *TAX POLICY* 237-45 (1993). Such a system of taxation has been studied and criticized in terms of equity and efficiency. Anthony A. Atkinson & Joseph E. Stiglitz, *The Structure of Indirect Taxation and Economic Efficiency*, 1 J. PUB. ECON. 117 (1972) [hereinafter Atkinson & Stiglitz, *Structure*]. The optimal tax view of progressive taxation leaves society to decide who are the beneficiaries of progressive tax rates. See Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905, 1945 (1987).

344. For discussion of optimal taxes, see Rudnick, *supra* note 39, at 1179-87. An optimal commodity tax is viewed under the Ramsey Rule, see Frank P. Ramsey, *A Contribution to the Theory of Taxation*, 37 ECON. J. 47, 54 (1927), as an inverse elasticity rule where the tax rate is inversely proportional to a goods' own compensated elasticity of demand. An optimal tax is one that produces the fewest distortions in relative prices.

345. See JOEL SLEMROD, *OPTIMAL TAXATION AND OPTIMAL TAX SYSTEMS* 2-3 (National Bureau of Economic Research Working Paper No. 3038, 1989); Joseph E. Stiglitz, *Self-Selection and Pareto Efficient Taxation*, 17 J. PUB. ECON. 213, 214 (1982) (arguing that the optimal tax theory is incomplete). Optimal tax also neglects considerations of the resource costs of administration. See *infra* note 352.

346. See Alan J. Auerbach, *The Theory of Excess Burden and Optimal Taxation*, in 1 HANDBOOK OF PUBLIC ECONOMICS 67 (Alan J. Auerbach & Martin Feldstein eds., 1985) [hereinafter Auerbach, *Optimal Tax*]. Deadweight losses are associated with any tax but the lump sum tax. See STIGLITZ, *supra* note 30, at 478.

347. See MARTIN FELDSTEIN, *ON THE THEORY OF OPTIMAL TAXATION IN A GROWING ECONOMY* (National Bureau of Economic Research Working Paper No. 1435, 1984); see also ARTHUR C. PIGOU, *A STUDY IN PUBLIC FINANCE* 29 (3d ed. 1949) (noting that distortionary taxes should be added to the cost of production to obtain the true opportunity cost of the public good).

be measured by the welfare loss to taxpayers who change their transactions because of the tax minus the revenue gain from taxing the transaction or activity.³⁴⁸ The theory relies on many assumptions that reduce its applicability to the real world.³⁴⁹

Optimal tax theory can be applied to savings decisions.³⁵⁰ For taxation of investment-financed business activities, optimal tax theory offers some guidance. The potential contributor to a partnership has a range of alternatives and the demand for partnership is highly elastic because alternative transactions are available with different transaction costs. The application of optimal tax principles suggests that tax policy should not be applied in a manner that would limit business formation at the margin.³⁵¹ In addition, efficiency is impaired where tax policy increases transaction costs.³⁵²

348. See Shaviro, *supra* note 151, at 31. For an application, see *infra* notes 351, 369 and accompanying text.

349. See SLEMROD, *supra* note 345, at 17; Rudnick, *supra* note 39, at 1180-81. In addition, the notion of relative income or consumption as determinants of individual welfare has not been analyzed in optimal tax theory. See Michael J. Boskin & Eytan Sheshinski, *Optimal Redistributive Taxation When Individual Welfare Depends Upon Relative Income*, 92 J. ECON. 489, 490 (1978). Slemrod develops a theory called optimal tax systems which is: "the normative theory of taxation that considers not only the structure of preferences but also takes seriously the technology of collecting taxes." SLEMROD, *supra* note 345, at 18. There have been attempts to assess the interdependency of optimal taxation and optimal enforcement. See LOUIS J. KAPLOW, OPTIMAL TAXATION WITH COSTLY ENFORCEMENT AND EVASION 16 (National Bureau of Economic Research Working Paper No. 2996, 1989) (finding that while optimal enforcement policy is indeterminate, the optimal choice should consider the compliance costs of tax systems).

350. See Sandmo, *supra* note 214, at 265, 288.

351. The basis for this proposition is that business formation is done based on perceived needs to collaborate but there are alternative forms to collaboration. While partnerships and joint ventures are used by core enterprises, the partnership is the only choice at the margin. The potential pooler is presumed to anticipate the result of the pooling and, to the extent decisions are different in a tax rather than a no-tax world, the pooler will not engage in some pooling. This is true of both pooling by individuals and pooling by firms, *i.e.*, corporate joint ventures. Professor Shaviro notes that the decision to contribute assets or human capital to firms is a voluntary rather than involuntary act, and for such voluntary acts there are alternative transactions. Shaviro, *supra* note 151, at 33. A sale of an asset in which the owner severs all interest in the asset is also voluntary. The tax elasticity depends, according to Professor Shaviro, on the change from the taxpayer's original position to the new position. *Id.* at 33-34. The transaction is less tax elastic the greater the change in the taxpayer's position. Thus, a sale in which the taxpayer severs all interest is more inelastic compared to a contribution of the asset to a firm in which the taxpayer retains an interest in the asset through ownership of the firm. Similarly, the decision to sell is less tax elastic than the decision to borrow on the asset. *Id.* at 34-35.

352. See Shaviro, *supra* note 151, at 35-36 (noting tax planning, compliance, and administration costs). Other forms of transaction costs also impact efficiency. See, *e.g.*, BRUCE C. GREENWALD & JOSEPH E. STIGLITZ, PARETO INEFFICIENCIES OF MARKET ECONOMIES: SEARCH AND EFFICIENCY WAGE MODELS (National Bureau of Economic Research Working

The focus of optimal tax theory is on "the tradeoff between equity goals and the deadweight costs of taxation facing the social planner, given available tax instruments and the influence of these instruments on private behavior."³⁵³ The application of the theory may then preclude the differential taxation of inputs of firms: economic theory suggests that there is a welfare loss of taxing capital differently in different uses.³⁵⁴ That is, if borrowing and leasing—transactions which diversify the risk of an asset while the owner retains an ownership interest—are taxed differently than a transaction contributing the asset to a firm, a welfare loss occurs. Moreover, the flexible rules of Subchapter K can increase social welfare by promoting socially desirable risk-sharing that reflects individual preferences.³⁵⁵

2. Optimal Tax Response to Risk and Partnerships

Another aspect of optimal tax efficiency analysis focuses on the relationship between risk aversion and the choices taxpayers have with respect to investments. The optimal tax theory model determines that taxes should be equal when relative risk aversion is constant.³⁵⁶ A

Paper No. 2651, 1988) (finding that search costs lead to biases in product and labor markets, and where firms are wage setters rather than wage takers, they may set a wage at a level causing market imperfections and a lessened efficiency).

353. Hettich & Winer, *supra* note 99, at 710.

354. In an early work, Professor Auerbach notes that it is not optimal to tax all types of capital equally if some other condition of optimal fiscal policy is not satisfied, such as when the government does not have the instruments needed to bring the economy to the golden rule of capital intensity and when the tax rate on labor income is not set optimally. See Alan J. Auerbach, *The Optimal Taxation of Heterogeneous Capital*, 93 Q.J. ECON. 589 (1979); Weiss, *supra* note 154, at 224 (Pareto-efficiency is a precondition to all economically-oriented ideas of fairness, and may require differential taxes.).

355. See *supra* text accompanying notes 231-335. A related point is the use of legal rules and flexibility to relieve problems of over and under monitoring and excessive free-riding. See Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 76-83 (1982). A second-best analysis shows that constraining the tax rate on one type of capital to zero implies in general that other tax rates should no longer be equal. See MARTIN FELDSTEIN, *THE SECOND BEST THEORY OF DIFFERENTIAL CAPITAL TAXATION* (National Bureau of Economic Research Working Paper No. 1781, 1985) [hereinafter FELDSTEIN, SECOND BEST]. Other models consider the role of government and profit taxation. See Robert Innes, *Adverse Selection, Investment, and Profit Taxation*, 36 EUROPEAN ECON. REV. 1427 (1992) (noting that some optimal allocations can be supported by a tax regime that includes both a proportional profit tax and a fixed transfer by the government).

356. Auerbach, *Optimal Tax*, *supra* note 346, at 116; see also Alan J. Auerbach, *Corporate Taxation in the United States*, in 2 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 451 (1983) (analyzing the welfare cost of the differential taxation of different types of business capital including the excess burden of the corporate tax and the differential taxation of certain equipment).

risky asset should face a higher or lower tax than a safe asset according to whether relative risk aversion is increasing or decreasing.³⁵⁷ As an individual becomes more risk-averse, the individual behavior becomes less responsive to differences in rates of return; under optimal tax principles the tax is less distortionary.³⁵⁸ Moreover, taxation can cause a change in the original decision that may decrease efficiency by increasing transaction costs.³⁵⁹ With respect to two risky assets, the riskier asset should be taxed more highly or less highly depending upon whether relative risk aversion is increasing or decreasing.³⁶⁰ A further complication comes from the endowment theory—individuals are reluctant to part with assets in their endowment and would rather take greater risks with newer resources.³⁶¹

Optimal tax principles apply both to income taxes or production taxes, that is, the taxation of the investment itself.³⁶² As to nonrecognition rules, even though they apply to a tax on income, they have the effect of a tax on production. As with the income tax, the issue is whether to tax more heavily the gain from risky or less risky assets. First, as set forth above, it is likely that partnership investment will be more risky than the investment that a partner would make independent-

357. Stiglitz, *supra* note 206, at 294.

358. See Pratt, *supra* note 208, at 142. A distortionary tax under optimal tax principles will produce substitution effects as the parties will alter their first choice for a second best solution. In economic literature, the assumption of a complete set of asset markets can lead to conflicting results. See Auerbach, *Optimal Tax*, *supra* note 346, at 86 (demonstrating that differential taxation of asset returns is in general desirable and that restrictions on preferences implies a heavier taxation of the more risky asset); Stiglitz, *supra* note 206, at 317 (demonstrating that if the government is risk-neutral and individuals are not, there is a case for taxing the safe asset or industry at a higher rate than a risky one); see also Michael G. Allingham, *Risk-Taking and Taxation*, 32 ZEITSCHRIFT FÜR NATIONALÖKONOMIE 203 (1972).

359. Those individuals with riskier incomes also have consumption and savings patterns that are different from those with less risky income. See JONATHAN SKINNER, RISKY INCOME, LIFE CYCLE CONSUMPTION, AND PRECAUTIONARY SAVINGS 23-25 (National Bureau of Economic Research Working Paper No. 2336, 1987).

360. See Stiglitz, *supra* note 206, at 329; Auerbach, *Optimal Tax*, *supra* note 346, at 115-18. The source for the relativity of risk aversion stems from Michael Rothschild & Joseph E. Stiglitz, *Increasing Risk: I. A Definition*, 2 J. ECON. THEORY 225 (1970); see also ARROW, *ESSAYS*, *supra* note 169, at 90-96. Increasing the number of risky assets does not change the model. See Agnar Sandmo, *Portfolio Theory, Asset Demand and Taxation: Comparative Statistics with Many Assets*, 44 REV. ECON. STUD. 369 (1977).

361. See Richard H. Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39, 43-47 (1980); see also Samuelson & Zeckhauser, *supra* note 297 (greater risks are taken with new resources than with resources that have been held for a long time); *supra* note 297 and accompanying text.

362. See Stiglitz, *supra* note 206, at 295, 302-22.

ly.³⁶³ Therefore, it is presumed that the partnership investment, which involves the contribution of assets to the partnership or the distribution of assets from the partnership, is more risky than the investment held by the individual before or after the contribution or distribution. On the individual level before contributing the asset to a partnership or after receiving a property distribution from a partnership, the individual's position may be more risky because the individual is less diversified. The issue, however, to be considered is the increased risk of the partnership investment that the partner adds to her portfolio, which is presumed to be riskier and the effect of the tax to the contributor on the contribution or to the distributee or nondistributee partners on the distribution of property. Second, wealth is a variable in determining relative risk aversion. That is, relative risk aversion (like absolute risk aversion) is measured in terms of wealth. Where a partner contributes an asset to the partnership, the wealth level does not change, the wealth of the individual is exactly the same—presumably the individual gives up exactly what she receives. This is akin to a state of both constant absolute and relative risk aversion. If the change in the position is taxed in the case of the partnership contribution and not in the case of holding the asset by itself, a tax on the contribution will discourage contributions (as would a tax on distributions of property where the total wealth of the distributee and nondistributees does not change).³⁶⁴

As noted earlier, most economists now assume that relative risk aversion is constant or at best decreasing,³⁶⁵ and with constant or decreasing relative risk aversion, an income tax will not increase risk-taking. With decreasing relative risk aversion, a production tax on investment will cause more investment in safer assets because with declining relative risk aversion, the demand for the riskier asset is more elastic than the demand for the safer asset.³⁶⁶ Therefore, optimal tax principles would suggest that the asset to be taxed is the safer asset, not the riskier asset if the tax system wants to encourage risky investment, which also suggest that deferral of taxation of contributions

363. See *supra* notes 301-06 and accompanying text.

364. Another way to analogize the transfer is to see the contribution as one that decreases the liquidity of the partner. In that case, the partnership interest would be worth less than before, which is the result of decreasing wealth and therefore increasing relative risk aversion. If the partnership contribution is taxed, then arguably it will lead to greater risk-taking but that is a condition that arises after the contribution.

365. See *supra* note 211 and accompanying text.

366. See Stiglitz, *supra* note 206, at 305-07 (proportional production tax on safe and risky industry). The same result obtains for a proportional income tax on a safe and a risky asset. See also *supra* note 219 and accompanying text.

and distributions is good tax policy.³⁶⁷

Efficient allocation of resources, *ex post* as well as that involving individual rationality during the time period in which assets are being held, exists in a partnership when more than one individual owns a particular set of assets. In the case where specific capital needs or other transaction costs make it inefficient and less desirable to continue to hold the assets in the partnership or to sell the assets on the market and split the proceeds, the partners are able to bargain to allocate the assets to be traded to the partner who values the assets the most.³⁶⁸ The nonrecognition rules on property distributions promote efficiency.

Consider a partnership that manufactures suntan lotion and umbrellas, a classic diversified business because one business has increased demand for its products when it is sunny and the other when it rains. Because of global warming, rainy days decrease dramatically and the demand for umbrellas declines. The partnership could convert its umbrella manufacturing facilities to the production of ice cream, but it chooses not to do so. Assume one partner desires a distribution of some of the umbrella production facilities in order to start producing ice cream. A tax distorts the distribution and redeployability of assets outside but not within the partnership—or in a subpartnership—by imposing additional transaction and agency costs.³⁶⁹ A nonrecognition rule allows the partnership to shift less productive resources outside the pool to a more productive use. Unpooling transactions allow a redeployability of assets at the margin.

Another context in which a partner may desire the distribution of an asset is when the other partners are cheating him or her. Taxation interferes with partnership monitoring costs, and with the flexibility of

367. Given market imperfections and given a desire to have parties efficiently bear risk, deferral of taxation may also be welfare enhancing throughout the economy. This latter insight applies an economic view of the use of “induced risk as a policy tool.” Auerbach, *Optimal Tax*, *supra* note 346, at 117 (once Pareto optimality is violated, violating other conditions will not worsen matters).

368. See Peter Crampton et al., *Dissolving a Partnership Efficiently*, 55 *ECONOMETRICA* 615, 626 (1987) (demonstrating that multiple, not single, ownership will efficiently allocate assets).

369. A subpartnership could be formed and the partnership would contribute the excess umbrella machinery to that partnership. The individual partner who wanted the umbrella equipment for making ice cream could become a partner directly in the subpartnership or, if ice cream making were to be treated as being formed with another in a partnership, the other investor would be a partner and make another contribution. See *infra* notes 549-50, 599-600. If the partner receiving the subpartnership interest in the ice cream equipment has fewer assets specifically contributed to the suntan lotion business, the partner's risk does not change. If the partner continues the same profit-sharing attributable to suntan lotion, then the partner has taken on more risk for which she will have to diversify outside of the partnership.

the partners to enter into contracts that will police partnership efficiency, such as by requiring distributions when a partner so desires in order to protect an investment.³⁷⁰ Furthermore, the utility of all partners is tied up with the firm and its assets; the disutility of having to take a distribution of an asset purely to avoid further losses is offset by the utility of foregoing current taxation. Because all partners are presumably rational, any benefit for shifting tax attributes through distributions would be compensated by the other partners. Nonrecognition rules for losses require that the partner correctly evaluate the after-tax cost of holding the asset outside of the partnership and may force sales of assets that are more productive if put to other uses. The excess burden of a tax on contributions to and distributions from partnerships can be determined by comparing the elasticity of alternative transactions, the revenue generated by the tax, and the loss in taxpayer utility.³⁷¹ Thus, the assumption is that partnership contributions are

370. See *supra* text accompanying notes 275-335.

371. Consider two transactions derived from the analysis provided by Professor Shaviro. See Shaviro, *supra* note 151, at 31-32. Transaction 1 is more inelastic and also is one that taxpayers strongly prefer to the next best alternative. Transaction 2 is more elastic, unrelated to Transaction 1 and not an alternative to it and taxpayers prefer it only slightly before tax. Assume that thirty taxpayers regard Transaction 1 as \$100 better before tax than the next best alternative and regard Transaction 2 as \$40 better before tax than the next alternative. Assume if the transactions were made taxable the tax cost of engaging in either one would be \$15 for each of taxpayers 1 through 10, \$25 for each of taxpayers 11 through 20, and \$55 for each of taxpayers 21 through 30. Under these assumptions if the relatively inelastic Transaction 1 is an activity in which they receive high returns ("high-rent event"), were made taxable taxpayers 1 through 20 would each engage in the transaction yielding the taxes of \$400 and the welfare loss from taxpayers 21 through 30 would be \$1000. If the relatively elastic Transaction 2 generating lower returns ("low-rent event"), were made taxable only taxpayers 1 through 20 would still engage in it yielding taxes of \$400 and a welfare loss of from taxpayers 21 through 30 of \$400. Therefore, despite Transaction 1 being less elastic, taxing it yields a greater welfare loss than taxing Transaction 2. Professor Shaviro notes that taxing Transaction 1 still may be preferable to taxing Transaction 2 since it yields more revenue. (In Professor Shaviro's example, there is a revenue gain in excess of the welfare loss in taxing Transaction 2 but it is less than taxing Transaction 1). Taxing Transaction 2 under the above assumptions is preferable to taxing Transaction 1 since the welfare loss exactly offsets the revenue gain. Professor Shaviro finds correct, and I agree, that it is usually best to tax relatively high rent and hence inelastic events. See Shaviro, *supra* note 151, at 32.

[T]axpayers will consent to pay more tax before ceasing to engage in high-rent events, taxing such events instead of low-rent events permits tax revenues to increase substantially . . . while the amount of resulting welfare loss may either increase or decrease (since fewer taxpayers are being deterred, but at a greater percentage cost). It therefore is quite likely that taxing high-rent events will yield better overall results, assuming that the overall amount of revenue that needs to be raised by the tax system remains constant.

Id.

relatively more elastic than are sales and partnership distributions are relatively more elastic than partnership sales because of the alternative forms in which the parties can contract for sharing contributions and in which partnerships can be structured to avoid a tax on distributions. In addition, with constant or decreasing relative risk aversion of the partners, taxing contributions and distributions will decrease risk-taking.

Special allocations also present an issue with respect to tax elasticity. There is a welfare loss if participants who do not wish to bear risk are required to do so, such as through proportionate sharing, when one party would wish to bear a certain amount of risk for a particular return and another a certain amount of risk for a particular return. The resulting welfare loss is increased. Thus, the question as to whether to allow special allocations in partnerships turns not on merely the resulting welfare loss from the decision not to allow special allocations but the ability to use other transactions to circumvent the partnership rule. As set forth in the next section, partnership special allocations are superior to other forms of transactions such as leasing and the partnership form is more flexible than any other type of venture where special allocations of profit over time are desired. To be sure, an agreement could be structured for an ownership of underlying property and a ratio equal to the profits value which is to be secured. However, the ability to allocate a loss in one time to one party, made up by a gain in another time to another party, from the same asset cannot be replicated. The issue of special allocations is not the elasticity or inelasticity of the proposed transaction since the choice of the partnership form is more inelastic because its flexibility produces a higher value to the parties because their relative risk and reward preferences upon contracting are maximized.³⁷² The issue is whether it is appropriate to eliminate or to impose a tax cost on the value that flexible allocations produce when limiting flexibility reduces the overall welfare of the parties by reducing the ability to allocate risk and reward optimally. Thus, the efficiency argument for allowing special allocations is based not on the inelasticity or elasticity of a special allocation compared to another transaction but on the social welfare loss of eliminating and reducing efficient risk-bearing.

Two of the more common standards for judging efficiency invoked

372. Consider partners A and B. In forming a partnership, they agree to a special allocation that A values at \$50 and B values at \$40. If the special allocation were not allowed, the next best form of the transaction would be valued by A at \$35 and by B at \$40. There is a resulting total welfare loss. On the value of optimal risk-sharing, see *supra* note 274.

in welfare economics are Pareto optimality and Kaldor-Hicks optimality.³⁷³ A tax rule that produces overall efficiency gains in the allocation of capital and labor pooling to productive enterprises is likely to deliver a Pareto improvement if it does not selectively visit harm on some individuals while not visiting such harm on others.³⁷⁴ Therefore, if Subchapter K achieves efficiency gains, measured without regard to Pareto or Kaldor-Hicks standards of optimality or improvement, it probably achieves gains under these standards as well.³⁷⁵ Here, it seems reasonable to assume that any refinement that produces efficiency gains with the prevailing business tax regime satisfies standards at least as exacting as Pareto or Kaldor-Hicks optimality.

Subchapter K appears to satisfy requirements of tax neutrality as among competing business opportunities.³⁷⁶ This would be the one respect in which we would expect a deviation from Pareto or Kaldor-Hicks optimality to show up in so second-best a context as that of real-world business taxation. Neutrality as a tax policy goal is not undermined if the partnership safety valve is limited to appropriate self-selecting enterprises. The question is whether detailed equity considerations justify a different result.

373. See *supra* note 30; see also J.R. Hicks, *The Foundations of Welfare Economics*, 49 *ECON. J.* 696 (1939); Nicholas Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, 49 *ECON. J.* 549 (1939) (requires that the winners could in theory compensate the losers so that no one would be worse off). The two standards just mentioned have seemed relatively uncontroversial to many welfare economists. Pareto optimality embodies a minimal requirement concerning the effect of an acceptable change of policy on the existing individual welfare distribution. So does Kaldor-Hicks optimality, though the requirement does not prevent a worsening of anyone's plight; it merely requires conditions that may prevent such a worsening. Legal writers often invoke Pareto optimality because of its prominence in the New Welfare Economics. See STIGLITZ, *supra* note 30, at 405-08. A Pareto optimal change in the law is one that harms no one and produces a greater social gain overall than any other possible change in the law that will harm no one. By contrast, a policy or measure is optimal under the Kaldor-Hicks criterion if it produces the greatest increase in social welfare. In the real world, the optimality that is reached may more closely resemble Kaldor-Hicks efficiency.

374. In other words, most tax rules that have any chance of becoming law are probably satisfactory because they have no obvious victims.

375. Optimal tax theory illustrates this principle as follows. For reasons of mathematical complexity alone, the designers of some optimal tax models choose not to require their ideal tax systems to satisfy Pareto optimality; instead, they impose a requirement of Kaldor-Hicks optimality, which, though weaker than Pareto optimality, is a realistic substitute given the political judgments that pose problems about income taxation in the first place. Optimal tax theory belongs to the theory of the second-best anyway; it would always be preferable to impose one-time lump-sum taxes than to impose periodic commodity or income taxes.

376. See *infra* notes 398-407, 472-79, 570 and accompanying text.

B. Equitable Concerns in Taxation

Tax policy analysis is typically concerned centrally with horizontal equity—the equal treatment of equals—which is a necessary condition for all tax provisions, although it is a condition without precise definition.³⁷⁷ Under the discussion of the Haig-Simons income tax base, equal ability-to-pay has traditionally been thought sufficient for the fair imposition of equal tax liability.³⁷⁸ Horizontal equity may be inconsistent with both utilitarianism and Pareto optimality.³⁷⁹ Equality of utility derived from consumption and leisure bundles is an increasingly influential³⁸⁰ and useful view of horizontal equity. If two individuals are equally well off in the absence of taxation, they should also be equally well off if there is a tax.³⁸¹ Under this view, horizontal equity is not adequately defined in terms of income “because individuals with identical opportunity sets but different tastes will have different incomes . . . individuals are the ‘same’ only if they derive identical

377. See Phelps, *supra* note 328, at 331. According to many, horizontal equity is a principle subject to manipulation. See, e.g., Louis J. Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT'L TAX J. 139, 139-40 (1989). The debate over the proper interpretation of horizontal equity continues. See ATKINSON & STIGLITZ, *supra* note 218, at 354-56 (discussing a variety of interpretations of horizontal equity in considering its relationship to vertical equity). Compare Richard A. Musgrave, *Horizontal Equity, Once More*, 43 NAT'L TAX J. 113 (1990) with Louis J. Kaplow, *A Note on Horizontal Equity*, 1 FLA. TAX REV. 191 (1992). “[T]he requirement of equity becomes empty if the vector x [range of possible comparisons] is so lengthy or personal as to allow tailoring the tax to each person within wide limits.” Phelps, *supra* note 328, at 331. This suggests that “equity depends upon some deeper notion of impartiality or fairness.” *Id.* A random tax allocation produces horizontal equity *ex ante* but not *ex post*. See DAGOBERT L. BRITO ET AL., INFORMATION AND MULTI-PERIOD OPTIMAL INCOME TAXATION WITH GOVERNMENT COMMITMENT (National Bureau of Economic Research Working Paper No. 2458, 1987).

378. See Weiss, *supra* note 154, at 210-14. These issues may be held to form the realm of equitable taxation (“ET”) theory. Richard A. Musgrave, *ET, OT, and SBT*, 6 J. PUB. ECON. 13 (1976) (ET considers horizontal equity at cost of efficiency, while OT considers the reverse).

379. See Joseph E. Stiglitz, *Utilitarianism and Horizontal Equity: The Case for Random Taxation*, 18 J. PUB. ECON. 2, 28-29 (1982) (finds cases where randomization of taxes is optimal).

380. See, e.g., TIBOR SCITOVSKY, THE JOYLESS ECONOMY: THE PSYCHOLOGY OF HUMAN SATISFACTION 98, 100, 102-04 (rev. ed. 1992).

381. See Feldstein, *supra* note 155, at 77, 83. Feldstein distinguishes between the meaning of “utility” when considering tax *design* versus tax *reform*. Feldstein posits that “a pre-existing tax structure is not a source of horizontal inequity. All horizontal inequities arise from *changes* in tax laws. The principle of horizontal equity in reform thus requires that *if two individuals would have the same utility level if the tax remained unchanged, they should also have the same utility level if the tax is changed*. *Id.* at 95; see also Dagobert L. Brito et al., *Pareto Efficient Tax Structures*, 42 OXFORD ECON. PAPERS 61, 61-70 (1990) (more able individuals might have an “elasticity of substitution” between leisure and consumption different from that of less able individuals).

amounts of utility from their consumption and leisure bundles."³⁸²

Different tastes need different views of fairness.³⁸³ The relationship of the utility view to horizontal equity rather than ability to pay, the premise of which is criticized,³⁸⁴ is key.³⁸⁵ While there are attempts to derive household utility levels from labor supply behavior,³⁸⁶ Professor William Vickrey posits that the "attempt to derive a utility function [for individuals] is a wild-goose chase after a function that would have a doubtful meaning even if it could be determined," and suggests that the more meaningful focus is on "individual reactions to choices involving risks."³⁸⁷ While the determination of what constitutes an individual's reaction to risk and its relationship to subjective utility may be difficult to address,³⁸⁸ a utility focus that incorporates risk-bearing is a useful general approach to guide the partnership rules. The choice between an ability-to-pay view and a utility view of horizontal equity is of no small consequence, as the former is essentially the one adopted by the critics of Subchapter K.³⁸⁹ The latter notes that the market has adjusted to the current regime and that hori-

382. David F. Bradford & Harvey S. Rosen, *The Optimal Taxation of Commodities and Income*, 66 AM. ECON. REV. 94, 99 (1976). Bernoulli, an early scholar, recognized the relativity inherent in the concept of utility. DANIEL C. BERNOULLI, EXPOSITION OF A NEW THEORY ON THE MEASUREMENT OF RISK (1738), translated in UTILITY THEORY: A BOOK OF READINGS 199, 201 (Alfred N. Page ed., 1968).

383. Bradford & Rosen, *supra* note 382, at 99 (the criterion for horizontal equity is important: between individuals, different criterion may lead to different conclusions as to the fairness of a given tax).

384. See MUSGRAVE & MUSGRAVE, *supra* note 30, at 223-32; Weiss, *supra* note 154, at 209-29. This is reflected by the reasonableness of a rollover regime for savings. See Cynthia Blum, *Rollover: An Alternative Treatment of Capital Gains*, 41 TAX L. REV. 383 (1986).

385. See Eugene Steuerle, *Wealth, Realized Income and the Measure of Well-Being*, in HORIZONTAL EQUITY, UNCERTAINTY, AND ECONOMIC WELL-BEING 91, 109-12 (Martin David & Timothy Smeeding eds., 1985).

386. See Jane J. Leuthold & Ralph D. Husby, *Horizontal Equity and Taxpayer Characteristics: Who is Advantaged and Disadvantaged by the Federal Income Tax?*, 15 E. ECON. J. 35, 35 (1989).

387. William Vickrey, *Measuring Marginal Utility by Reactions to Risk*, 13 J. PUB. ECON. 319 (1945). Others have the same doubts. See, e.g., Gary Lawson, *Efficiency and Individualism*, 42 DUKE L.J. 53, 60-83 (1992). Indeed, the impossibility of making interpersonal comparisons of utility is roundly noted in the economic literature and challenged by others, since there are many measures of utility. *Id.* at 61 n.26 (but noting that Amartya Sen, Richard Epstein and Robin West do not subscribe to this belief); see also Robert Plotnick, *A Comparison of Measures of Horizontal Inequity*, in HORIZONTAL EQUITY, UNCERTAINTY, AND ECONOMIC WELL-BEING 239 (Martin David & Timothy Smeeding eds., 1985).

388. See Fried, *supra* note 228, at 990-94; Bankman & Griffith, *supra* note 166, at 40-51.

389. For instance, Professor Mark Gergen views horizontal equity as ability to pay. See *infra* notes 518-19 and accompanying text.

zontal inequities develop from changes in the tax laws.³⁹⁰ The flexibility of partnership rules allows partners to be treated differently precisely because these other relationships (lenders, lessors, etc.) are different with respect to bonding, monitoring and other agency costs. Organizational economists see these attributes as reasons that particular contracts are used for certain activities that have other costs reflected in the market for investments.³⁹¹ Partnership tax rules promote horizontal equity as utility to the extent that the tax rules comport with the taxation of other transactions such as contingent compensation agreements, leasing, and borrowing.³⁹²

Viewing horizontal equity as utility fits well with the nonrecognition provisions in the partnership regime: the partners are able to distribute those assets on a nonrecognition basis, and hence, unpool their investments. If tax-free contributions and distributions are necessary in order to overcome the effects of risk aversion, the market adjusts the required rates of return with respect to partnerships to take into account the flexibility of the no-tax world that partnerships allow.³⁹³ The risk-adjusted view of horizontal equity suggests that risk is the most relevant criterion in making a tax policy decision with respect to the like treatment of like events. If risk aversion is real and risk-taking is beneficial to society, nonrecognition rules that promote risk-taking and pooling are valuable. A nonrecognition provision with respect to contributions to firms does not distort the choice between contribution of assets to a corporation or to a partnership. Thus, contribution-based nonrecognition rules satisfy the criteria of a neutral tax. On the other hand, the nonrecognition rules for partnership distributions or partnership service contributions appear to violate the idea of a neutral tax because there are no similar rules for corporations. However, the issue is not the divergence between corporate and partnership rules, but the reason for that divergence. Thus, any concern the partnership tax rules cause on horizontal equity as ability-to-pay is rebutted by their positive effect on horizontal equity as utility.

The partnership rules are not responsible for horizontal inequity

390. See HARVEY S. ROSEN, PUBLIC FINANCE 316-19 (1985).

391. See, e.g., RASMUSEN, *supra* note 30, at 154 n.6.1.

392. Within the context of a realization-based tax system, any deferral or nonrecognition rule raises a horizontal equity issue with respect to a taxpayer in a like situation for which no deferral is allowed. As set forth in Section VIII.A. *infra*, the partnership tax rules generally comport with the taxation of similar transactions and policy reasons exist for deviations. See *infra* text accompanying notes 459-591.

393. See ROSEN, *supra* note 389, at 317-19.

between partnership investors and consumers, even on an ability-to-pay approach. Special rules for savers must also be appraised by their effect on consumers and consumption.³⁹⁴ The relevant pool is savers rather than consumers. The nonrecognition rules for contributions and distributions reflect this symmetry with respect to savers;³⁹⁵ so too, do rules on special allocations. Nonrecognition on contributions is premised de facto on continued savings of the asset. Consumption of unrealized income through a distribution of assets is limited, and if it were not, an investment motive should be required.³⁹⁶ Special allocation rules apportion the risks and rewards of savings between partners. Horizontal equity as utility between savers indicates that partnership rules on nonrecognition and special allocations reflect equity.

VIII. APPLICATION AND RECOMMENDATIONS

This section considers the specific components of the tax system for partnerships as they affect risk-bearing and risk-sharing, including (1) interest on capital accounts; (2) contributions of property and services; (3) distributions; and (4) special allocations. It refers back to the first-best considerations of optimal tax theory and the taxation of risk that were considered in Parts VI and VII and to second-best considerations in taxation of other economic transactions.

394. See Calvin H. Johnson, *The Consumption of Capital Gains*, 55 TAX NOTES 957 (1992) (demonstrating that the capital gains preference benefits consumers rather than savers because there is no requirement of reinvestment). In another example, for consumers, the denial of an interest deduction for "personal interest," see I.R.C. § 163(h) (1988), taxes the principal of loans undertaken for consumption and realizes loan proceeds in the year received for consumption. See William A. Klein, *Borrowing to Finance Tax-Favored Investments*, 1962 WIS. L. REV. 608, 609-10 (taxpayers have the same result if they borrow to buy tax-free investments where interest is deductible or sell taxable investments to purchase tax-free investments). Denial of the deduction equates the cost of current consumption with the cost of future consumption; if an interest deduction is allowed, accelerating consumption is cheaper than forgoing consumption. See JOSEPH M. DODGE, *THE LOGIC OF TAX* 222-23 (1989); Isenbergh, *supra* note 143, at 309. The interest deduction is allowed unless the interest is not producing current income or is otherwise a passive activity for which there is no offsetting passive income. I.R.C. §§ 163(d), (h)(2)(C) (1988). Other limitations include where the interest is properly capitalized into the basis of property, I.R.C. § 263A (1988 & Supp. 1992), or is undertaken to purchase or carry a tax exempt obligation, I.R.C. § 265(a)(2) (Supp. 1992).

395. If formation of businesses is desirable, any arbitrage opportunities of deferral presented by nonrecognition transactions are outweighed by the efficiency consideration of bringing together various capital providers. See Alan J. Auerbach, *Should Interest Deductions be Limited?*, in UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX 195, 208-10 (Henry Aaron et al. eds., 1988).

396. This is like a reorganization business purpose analysis in the corporate context.

A. *Economic Analogies—Salary, Leasing, and Borrowing*

Analogies to different forms of economic production and participation are relevant for two reasons. First, analogies to the current tax system demonstrate that the current rules of Subchapter K comport well with the tax policy choices for other transactions in the current hybrid income-consumption tax. Second, analogies to other forms of transactions illustrate that diversity in organizational form and business arrangements is desirable because other economic arrangements cannot replicate the risk-bearing and partnership risk-sharing opportunities.

Salary payments to an employee or independent contractor may be either fixed or contingent. Nonetheless, the present value of the contract is not taxed.³⁹⁷ The taxation of wage income reflects a deferral of tax consequences until payment, which may be offset by the denial of a deduction to the payor until income is realized by the payee.³⁹⁸

Leasing is analogous to the special ability to allocate income in the partnership. Consider the owner of an asset who decides to lease the asset for its entire life. The owner will enter into an arm's-length agreement for payments over time to equal the present value of the property but will reserve a value attributable to a reversionary interest, and through depreciation matches the recovery and loss to the lease payments.³⁹⁹ The risk of the term decline value of the lease is shifted to the lessee and the reversionary or remainder decline in value remains with the lessor.⁴⁰⁰ Receipt of the property subject to a reversion is not

397. The receipt by an employee or independent contractor of an unfunded promise to pay compensation in the future in either a fixed or a contingent amount is not presently income. See Treas. Reg. § 1.83-3(e) (as amended in 1985).

398. See I.R.C. §§ 267(a)(2), 404(a) (1988 & Supp. 1992).

399. Some criticize the present system's treatment of business rents. See George Mundstock, *Taxation of Business Rent*, 11 VA. TAX REV. 683, 695, 714 (1992) (arguing that the tax law improperly presumes that level rent is economic rent). Other provisions with respect to leasing allow for unrealized appreciation to go untaxed. Nonetheless, the foregoing describes current law. See DODGE, *supra* note 394, at 252-57.

400. See Shaviro, *supra* note 285, at 435. The ability to shift the risk of the term decline in property to the lessee and keep the remainder interest or reversionary interest in property by the lessor is a nonrecognition event since shifting could also be viewed as an installment sale of the term interest in the property, just as the diversification of risk within a pool could be viewed as a sale. The tax law correctly allows a current deduction for the rental payment, because a requirement of capitalization and then decreasing the term interest's value produces the same result. See DODGE, *supra* note 394, at 259-60. The substantial economic effect test in Subchapter K does not allow the form of risk-sharing as a lease which may be insufficient risk-sharing vis-a-vis the current participants. The lessor has a deduction for depreciation that is offset currently by income and the lessee has a return that is at any rate above the cost of the lease. Under the transitory test of § 704(b) of the Code, the return to the lessor would be invalidated as an income chargeback based both on the five year transitory rule, the certainty of

a realization event. In the partnership, the asset can be purchased and all the depreciation allocated to one participant. If the income stream is risky enough or over a sufficient time period, it can be charged back to that participant, and the residual value can be shared. Even if under the substantial economic effect rules an income chargeback is not allowed, one partner may bear a tax loss, share the income equally with the other partner,⁴⁰¹ be allocated the gain on the sale of the asset to restore any unrestored losses and then, for bearing the earlier risk, be allocated 75 percent of any additional gain. In addition, because current law does not tax the receipt of a long-term lease to the lessor⁴⁰² or the value of the reversion upon the receipt of property subject to the reversion, nonrecognition on partnership contributions comports with the tax rules that apply in leasing.

Borrowing keeps the risky portion of the asset with the owner and shifts the less risky portion to the lender, which, *ex ante*, is fully shifted to the lender in nonrecourse borrowing on the full present value of the asset.⁴⁰³ For example, in a partnership, a nonrecourse loan is replicated where one partner takes the loss with respect to property but is not required to have gain from the sale of the property charged back to make up the prior losses. In recourse borrowing with respect to assets, that is precisely what the partnership rules allow regarding guaranteed payments on contributions, deficit capital accounts, and the allocation of a loss with respect to assets of one partner who agrees to bear the risk of loss.⁴⁰⁴ Nonetheless, partners must intend to share profits from the asset or activity to validate it as a partnership under the rules.⁴⁰⁵ The current income tax does not treat borrowing, recourse

the return and if there is a tax advantage to the parties. I.R.C. § 704(b) (1988). In effect, the transitory rule indicates that the transaction is an insufficient pooling of risk.

401. For this transitory rule, *see infra* note 622.

402. *See* WILLIAM KLEIN ET AL., *FEDERAL INCOME TAXATION* 299 (9th ed. 1993). The shifting of the term interest and not treating the receipt of a long-term contract as a realization event is not distortionary. *See* DODGE, *supra* note 394, at 256-60.

403. The interest rate for a nonrecourse debt should be higher than a rate for recourse borrowing because of the additional risk borne by the lender. *See* Shaviro, *supra* note 285, at 430-31. A residual claim partially occurs in nonrecourse borrowing, and *ex ante* is shared by both the lender and the borrower and through which the lender believes that the borrower is compensating the lender for the residual risk.

404. *See* Treas. Reg. § 1.704-1(b)(2) (as amended in 1993).

405. Under the Service's guidelines, this can be as small as a 1 percent interest. *See* Rev. Proc. 91-13, 1991-1 C.B. 477; Rev. Proc. 89-12, 1989-1 C.B. 298, § 4.01. The case law on sharing as indicative of a partnership is less strict. *See, e.g.,* Wheeler v. Commissioner, 37 T.C.M. (CCH) 883 (1928) (allocating of all losses and then all income to restore losses to capital partner before sharing with service partner is a partnership).

or nonrecourse,⁴⁰⁶ on appreciation in assets as a realization event. Nor is receipt of property after the loan has been repaid a realization event. To be sure, the lender receives money or its equivalent equal to the amount loaned and has a basis in the debt equal to its face amount.⁴⁰⁷ The partnership nonrecognition rules on contribution and distribution are generally consistent with borrowing as to timing of income realization.

B. Interest on Capital Accounts

Under the view developed in this section, a partnership is a cross-borrowing of capital by human and financial equity capital suppliers to the firm.⁴⁰⁸ Thus, certain income from the partnership should be characterized as a borrowing transaction.⁴⁰⁹ Resolution of the cross-borrowing could be done explicitly by the partners⁴¹⁰ or if not so resolved,⁴¹¹ by recharacterization of distributive shares of income under amended partnership tax provisions.⁴¹² The partnership income allocation standards require following capital account rules under the basic or alternative test for substantial economic effect so that economically the transaction follows the partners' interest in the partnership.⁴¹³ These rules generally require recognition of a deficit capital account not attributable to losses supportable by nonrecourse debt as a recourse debt to the partnership.⁴¹⁴ Thus, at a minimum, interest must be required on a deficit capital account balance when it reflects

406. See *Woodsam Assocs., Inc. v. Commissioner*, 198 F.2d 357, 359 (2d Cir. 1952). With respect to the *Woodsam* issue, see Shaviro, *supra* note 285, at 447-48 (noting little sense in the reversal of *Woodsam* because little gain to taxpayers and possible increase in tax overhead and risk); see also Alvin Lurie, *Mortgagor's Gain on Mortgaging Property for More than Cost Without Personal Liability (Contentions of Taxpayer's Counsel in a Pending Case)*, 6 TAX L. REV. 319 (1951).

407. This observation suggests that nonrecognition rules for return of partner contributed property could be viewed differently than distributions of property (1) acquired by the partnership and distributed non pro rata or (2) contributed by one partner and distributed either non pro rata or to a partner other than the contributing partner. See *infra* note 558.

408. The approach is like a partial deferred sale. In the partial deferred sale, the partner is treated as engaging in a partial sale of contributed assets with the partnership, retaining the portion by which she has a proportionate profits interest, and on the sale portion gain or loss is deferred until the partnership disposes of the asset or depreciates it. See *infra* text accompanying note 465.

409. See *infra* notes 447-56 and accompanying text.

410. This is much like the safe harbor approaches in Treas. Reg. § 1.707-3 (1992).

411. Difficulties arise, such as the use of guaranteed payments to change the sourcing of income. See MCKEE ET AL., *supra* note 19, ¶ 13.03[1][a], at 13-5.

412. See *infra* text accompanying notes 447-56.

413. See Treas. Reg. §§ 1.704-1(b)(2)(ii)(a),(b),(d), -1(b)(3) (as amended in 1993).

414. See Treas. Reg. §§ 1.704-1(b)(2)(ii)(b)(3), (c), -2(b) (as amended in 1993).

borrowing from partners.

1. Role of Interest on Capital Accounts

Capital accounts record the partners' rights to receive the value of contributed property and accumulated earnings in the firm. Neither the 1914 nor the 1993 or 1994 Uniform Partnership Acts require interest on partner capital accounts.⁴¹⁵ The current tax rules do not require interest on either positive or negative capital accounts.⁴¹⁶ Thus, there

415. UNIF. PARTNERSHIP ACT § 18(a)-(d) (1914), 6 U.L.A. 213 (1969); REVISED UNIF. PARTNERSHIP ACT § 401(a)-(e) (1993), 6 U.L.A. 250 (Supp. 1994); REVISED UNIF. PARTNERSHIP ACT § 401(a)-(e) (1994) (June 21, 1994 revision). A partner has a right to receive back contributions and to share equally in the profits and surplus remaining after all liabilities, but that provision in the Uniform Act can be modified by agreement. See UNIF. PARTNERSHIP ACT § 18(a) (1914) (prefatory language), 6 U.L.A. 213 (1969). The only requirement for interest is where a partner has a right to receive back the capital contributed: interest will accrue "only from the date when repayment should be made." UNIF. PARTNERSHIP ACT § 18(d) (1914), 6 U.L.A. 213 (1969); see also BURDICK, *supra* note 91 (citing *McGibbon v. Tarbox*, 98 N.E. 390 (N.Y. 1912); *Rodgers v. Clement*, 56 N.E. 901 (N.Y. 1900)). Payment of interest is not required even where one partner furnishes all the capital because "the courts will infer that the parties considered the skill and labor of the other as a contribution of equal value to the earning power of the firm." BURDICK, *supra* note 91, at 364 n.1.

416. Failure to treat capital accounts as interest-bearing savings accounts is a flaw in the capital account version of the substantial economic effect test. See Alan Gunn, *The Character of a Partner's Distributive Share Under the "Substantial Economic Effect" Regulations*, 40 TAX LAW. 121, 124 & n.20 (1986) [hereinafter Gunn, *Character*]. Gunn notes that while the regulations under the substantial after-tax economic effect do "ask for a comparison 'in present value terms[.]" Treas. Reg. § 1.704-1(b)(2)(iii)(a)[.]" [t]his falls far short, however, of taking time-value considerations fully into account in allocating income." *Id.* at 124 n.20. Others have briefly reflected on the lack of interest on deficit capital accounts, see McKee, *supra* note 14, at 1058-59 & n.85, and considered the suggestion to impute interest, see Mark P. Gergen, *Disproportionate Loss Allocations*, 48 TAX NOTES 1051, 1053 n.9 (1990) (suggesting that allocations of income be required to reflect an interest rate equal to the firm's return on its capital); see also Kamin, *supra* note 15, at 27-54 (service partner receiving income from investment of capital partners contribution in tax exempt securities should be recharacterized as an interest free loan to the service partner). In the 1985 regulations on substantial economic effect, the failure to require interest on capital account deficits implied allocations were not substantial. A deficit partner did not have to make the other partners whole with respect to the time value of that borrowing. The initial recognition that time value of money issues were important with respect to tax shelters also highlighted the concerns with respect to partnerships and the failure to take time value of money considerations into effect. See Robert G. Woodward, *Treasury Presents Views on 'Abusive' Tax Shelters*, 20 TAX NOTES 83, 86 (1983). When the final substantial economic effect regulations were promulgated in December 1985, the Treasury indicated it would consider further the time value of money issues even though under the regulations capital account deficits were not required to bear interest and the regulations did include some time value of money concepts in testing substantiality in tax allocations. See T.D. 8065, 50 Fed. Reg. 53,420 (1985). The Treasury cited abuses of the substantial economic effect regulations through allocations of a large portion of income to partners with net operating losses ("NOLs") creating an excess capital account based on that income allocation, a Golddome transaction now dealt with in Treas. Reg. § 1.704-1(b)(8), ex. 9 (as amended in 1993). The partnership was used as

are two roles for interest: (1) interest on deficit capital accounts to compensate for original issue discount⁴¹⁷ and assignment of in-

a vehicle to purchase a business largely with borrowed funds and after the acquisition indebtedness was retired, the partnership's income was allocated largely to the acquisition group and the NOL partner received prearranged distributions to reduce the excess capital account; however, the NOL partner was not paid a market rate of interest on the excess capital account. H.R. REP. NO. 426, 99th Cong., 1st Sess., at 259 (1985) (noting that the Treasury has authority to deal with such transactions through regulations). For additional discussion on time value of money, see Lee A. Sheppard, *The Gauntlet: Joint Committee's Corporate Base Broadeners*, 36 TAX NOTES 9 (1987) (present § 704(b) regulations ignore the time value of money). See John Lee, *Choice of Entity Passthrough Entities*, 33d William & Mary Tax Conference 2-1, 2-13-14 (1987) (noting that flip-flops in the 1986 Passthrough Entity Hearing could be eliminated by requiring the § 704(b) regulations to reflect time-value-of-money principles and would not be permitted to the extent that deductions created a negative capital account). The regulations under Code § 752, which address the allocation of debt in a partner's outside basis in the partnership interest, recognize interest in only two situations. The first is where a partner fails to restore a deficit capital account on liquidation or to make a contribution to a partnership at the time of liquidation in order to pay a debt within 90 days of the liquidation or by the end of the year, whichever is later, and the obligation does not otherwise bear interest. See Treas. Reg. § 1.752-2(g) (1991). Second, with respect to nonrecourse debt where a partner has assumed the obligation to pay interest, the present value of interest with respect to a partnership liability is determined. See Treas. Reg. § 1.752-2(e)(2) (1991). The at risk rules also fail to consider time value of money.

417. See *infra* note 444 and accompanying text; see also I.R.C. §§ 1272, 1273(a)(1) (1988). The failure to charge interest on deficit capital accounts creates original issue discount. Consider the following scenario: A and B form a partnership in which A contributes \$100 and B contributes property with a fair market value of \$75 and an adjusted basis of \$100. They agree to share profits and losses equally. The equal profit and loss sharing may indicate that B is performing services for the partnership which reflects her increased allocation of profits over the proportionate share of capital of 42.86 percent and that A will require B to agree to an equal sharing currently of any losses allocable to that increased percentage of profits. If in the first year the partnership loses \$160, it is allocated \$80 to both A and B. For tax purposes both A and B are able to deduct \$80 in year 1 which will reduce A's capital account to \$20 and basis to \$20 and which will reduce B's capital account to - \$5 and basis to \$20. Economically, B has utilized A's capital of \$5 and for the allocation to be given tax effect under current tax rules, B must be required to return this internal borrowing to A. This borrowing is represented by the deficit in B's capital account which is now negative by \$5. Under present partnership rules, economic sharing to validate the tax allocation will be accomplished by B's promise to restore her deficit capital account at liquidation of the partnership. That promise to restore the deficit does not have to bear interest nor does there have to be a specific allocation of interest on any positive capital account balances of any partners before profits and losses can be shared. If the partnership operates for five years breaking even and then liquidates in year 6, B will be required to restore a deficit capital account of \$5 in year 6. Assuming five years of deferral, the present value of B's promise in year one using a ten percent before tax discount rate is \$3.10. By not requiring interest on a deficit capital account, B has borrowed \$5 from A through the partnership agreement, and is required to pay back only \$3.10 and has received a before tax economic transfer from A of \$1.90. On the other hand, if B were required to pay interest compounded annually on the deficit capital account, B would owe A \$8.05 in year 6. Viewing the transaction as to its component parts, B's borrowing from A to fund an increased capital contribution and an allocation of economic losses, preserves the transaction's economic reality.

come;⁴¹⁸ and (2) interest on capital account balances generally or in certain circumstances⁴¹⁹ to validate income allocations and nonrecognition transactions. Capital accounts in firms taxed as partnerships can be conceptualized either as an equity account, a debt account, or a combination of the two, and there is no need to distinguish between general and limited partnerships and limited liability companies.

a. Equity Account

Viewing a capital account as an equity account reflects an economic arrangement which does not require that the partners' capital be repaid to the partners if the firm suffers losses. Only a deficit capital account with an explicit or implicit restoration agreement creates a loan between the partners.⁴²⁰ Prior to Subchapter K, "interest" on partner capital contributions was treated as part of the proportionate share of partnership income, not under an "entity" theory as being paid from the partnership to the partner in a third-party capacity.⁴²¹ The 1954 enactment of Subchapter K created the concept of a guaranteed payment.⁴²² The guaranteed payment absolves the partner from some of the risk of the partnership venture and foists a liability on the

418. See I.R.C. § 7872 (1988). For the view of interest-free loans as an assignment of income pre-§ 7872, see Kenneth F. Joyce & Louis A. Del Cotto, *Interest-Free Loans: The Odyssey of a Misnomer*, 35 TAX L. REV. 459 (1980).

419. See *infra* text accompanying notes 445-48.

420. Under a discontinuity in the treatment of loans between partners, deficit capital accounts with a deficit restoration agreement do not create additional basis for the partner. See I.R.C. § 704(d) (1988).

421. See *Blake v. Commissioner*, 9 B.T.A. 651, 654-55 (1927), *acq.*, VII-1 C.B. 3. The partnership rules were aligned with the premise of the pool of capital doctrine. Furthermore, the Board of Tax Appeals refused to distinguish between the risks of business capital contributed to a partnership and the risks of business capital loaned to a partnership where the interest paid on the capital contribution was clearly at a rate that embraced a portion of partnership profits. *Id.* at 654-55. The 1939 Code viewed the partner's capital account as a pure equity claim: only if the partner loaned money to the partnership, interest on the loan was ordinary income to the partner in a creditor capacity. See LITTLE, *supra* note 127, at 60 (noting that there was no case on point but that the implication of *Burns v. Commissioner*, 13 B.T.A. 579 (1928), *acq.*, VII-2 C.B. 6, would support that reasoning). Treating the partner's capital account as an equity account supports the view that there ought not to be any special allocations of income of the partnership different from proportionate capital accounts.

422. See I.R.C. § 707(c) (1988). A guaranteed payment is a form of payment that is treated as a distributive share of income for timing purposes but for character purposes the partner receiving the guaranteed payment is treated as receiving it outside of his or her capacity as partner at the time when the payment is deducted by the partnership under its method of accounting. See Treas. Reg. § 1.707-1(c) (as amended in 1983). For guaranteed payments on capital, see Sheldon I. Banoff, *Guaranteed Payments for the Use of Capital: Schizophrenia in Subchapter K*, 70 TAXES 820 (1992).

partnership for its use of capital. Nonetheless, the capital account is still an equity account in terms of its right to repayment on liquidation and the allocation of bargained-for returns.

b. Debt Account

The case for viewing a capital account as a debt account is that the partners loan their capital to the partnership for its activities.⁴²³ Debt capital is normally defined as an unconditional promise to pay a sum certain on a future date in money or its equivalent.⁴²⁴ Thus, another way to view capital contributions is as nonrecourse loans to the partnership by the contributing partners.⁴²⁵ If that view of the transaction is upheld, then it would be appropriate to require that the entire interest component of the partnership be taken into account before the partners split an equity return.⁴²⁶ This recharacterizes a portion of the partners' financial return as interest before the income of the partnership is split in the manner that the partners desire (*i.e.*, mandatory guaranteed payments).⁴²⁷ A partner's contribution of money or

423. See McKee, *supra* note 14, at 1047 (noting that I.R.S. Technical Advice Mem. 7707260880A (July 26, 1977) took this position).

424. See *Deputy v. Dupont*, 308 U.S. 488, 498 (1940); *Old Colony R.R. Co. v. Commissioner*, 284 U.S. 552, 560 (1932). As a corollary, debt should include interest for the use of that money. See Glenn E. Coven, *Redefining Debt: Of Indianapolis Power and Fictitious Interest*, 10 V.A. TAX. REV. 587, 660 (1991).

425. See *infra* text accompanying notes 445 & 447. The Service has sought to recharacterize partners' contributions to the partnership as nonrecourse loans to other partners which must bear interest where the allocation of losses was different from the allocation of profits relative to the capital contributions. See *Hamilton v. United States*, 687 F.2d 408 (Ct. Cl. 1982). A similar issue arose in *Gibson Prods. Co. v. United States*, 637 F.2d 1041, 1047 (5th Cir. 1981) (nonrecourse note payable out of speculative production is not a loan for purposes of I.R.C. § 636). The Service has rulings on this point. See Rev. Rul. 72-135, 1972-1 C.B. 200; 72-350, 1972-2 C.B. 394 (criticized in MCKEE ET AL., *supra* note 19, ¶ 7.02[2], 7-12 to 7-13); see also McKee, *supra* note 14, at 1047-49 (criticizing Technical Advice Mem. 7707260880A (July 26, 1977) that sought to treat such allocations as a nonrecourse loan from the limited to the generals at the beginning of the partnership). This is consistent with judicial approaches in "carried interest" cases which respect differing prepay and postpay income and expense sharing ratios outside of the partnership contexts. See, e.g., *United States v. Cocke*, 399 F.2d 433 (5th Cir. 1968), *cert. denied*, 394 U.S. 922 (1969).

426. See *infra* note 445.

427. Financial accounting theory might support the debt view of capital accounts—a firm must account for the returns to all capital in determining profit or loss. See STEPHEN GILMAN, ACCOUNTING CONCEPTS OF PROFIT 92-95, 322-24 (1939). For a history of accounting, see Mark E. Richardson, *Accounting Theory and Taxation*, in THE HISTORY AND PHILOSOPHY OF TAXATION 71 (1955) (conference on April 15, 1955 at William and Mary). Other views of the concept of profit include the appropriate accounting for cash flow in a business which means that pure profit is earned when there is a return in excess of what is anticipated by the market;

property to a partnership is like a nonrecourse loan only to the extent that the losses are allocable to the contributor because losses allocable to another partner and supported by another partner's capital contribution are allowed if the partner taking the loss has a deficit make-up agreement, express or implied, that converts the capital contribution into a recourse loan to the partner who was allocated the loss.⁴²⁸

I reject the debt account theory for two reasons: (1) there is no explicit agreement among the partners that a partner has a right to be paid a specific amount; and (2) pooling in a partnership does not create a separate entity but creates an aggregate of participants in a pool. Under this view, the partnership is a borrowing transaction undertaken by all of the suppliers with the ultimate reward incurring to the equity participants.⁴²⁹

c. Debt-Equity Account

The best characterization of a partnership capital account is to view it as a combination debt-equity account. A partner who contributes property or cash to a partnership takes on an economic equity risk with respect to the contribution.⁴³⁰ Nonetheless, there is an implicit loan between partners with respect to that amount⁴³¹ which at times should

this differs from a definition of business profit as pure profit plus the normal return on an investment which is the Haig-Simons' definition of income based on the difference between end-of-period wealth and initial investment. See PAUL HANSEN, *THE ACCOUNTING CONCEPT OF PROFIT: AN ANALYSIS AND EVALUATION IN THE LIGHT OF THE ECONOMIC THEORY OF INCOME* (2d ed. 1972); Howard Bodenhorn, *A Cash-Flow of Profit*, 19 J. FIN. 16, 21-23 (1964). It also fails to recognize the nature of investment returns on capital. Allowing an interest deduction on capital in the corporate tax base is an issue for which there are various proposals. See INTEGRATION REPORT, *supra* note 38; Rudnick, *supra* note 39, at 1037-38, 1242-44.

428. Strange results may occur if losses are first attributed to debt from third parties rather than attributed to the cash or property capital accounts. See, e.g., *infra* note 620.

429. This is consistent with the tax treatment of mutual funds in which there is a pooling of financial assets that produces an equity return. Because of Subchapter K's nonrecognition rule on contributions, and the manner in which the partners are allowed to allocate income, gain, loss, deduction and credit, there might be a requirement for interest to be imputed as a guaranteed payment. This, however, would impede partnership formation and changes the economics of the transaction agreed to by the partners. See *infra* text accompanying note 445.

430. This is because of the provisions of the Uniform Partnership Act on dissolution and the general notion in the tax law that distinguishes between debt and equity. See I.R.C. § 385 (1988 & Supp. 1992).

431. The extreme example is a service partner who has no capital account and a property partner who has a capital account. A disparity between profit-sharing and capital also occurs when one partner agrees to bear all losses, to have income or gain charged back to the extent of such losses, and income be split at a ratio different from the capital account. The partner taking the losses bears risk with respect to the partnership and ought to receive the full return without any recharacterization. The other partner foregoes a current interest return for presum-

bear interest to prevent the assignment of earning capability and reflect the participant's minimum return if the proceeds had been kept outside of the firm for his or her own account, leading to the conclusion that the appropriate rate of interest on the "debt" portion is the "applicable federal rate."⁴³²

2. Applicable Interest Rate

Serious attention to interest began in 1984 with the adoption of many provisions requiring current accrual of interest.⁴³³ When Congress first considered the imputation of interest, it sought to produce a system that would both yield an approximation of the rate at what a good credit risk with adequate security could borrow⁴³⁴ and account more properly for the time value of money. Congress ultimately arrived at the applicable federal rate.⁴³⁵ This theory is consistent with section

ably a future equity return supporting imputation of interest on a portion of that amount that represents the foregone interest.

432. The applicable federal rate ("AFR") is the risk-free interest rate on Treasury securities which is compounded semi-annually. See I.R.C. §§ 1274(d), 7872(f)(2) (1988). The AFR is different for short-term debt (not over three years), mid-term debt (over three years but not over nine years), and long term debt (over nine years) and is determined based on the rates for the average market yield on such Treasury obligations over one calendar month. See I.R.C. § 1274(d)(1) (1988); see also *infra* text accompanying notes 433-41.

433. See Lawrence Lokken, *The Time Value of Money Rules*, 42 TAX L. REV. 9 (1986). For recognition prior to 1984, see Peter C. Canellos & Edward D. Kleinbard, *The Miracle of Compound Interest: Interest Deferral and Discount After 1982*, 38 TAX L. REV. 565 (1983). A deduction has been allowed for original issue discount from the early years of the income tax. See *Helvering v. Union Pac. R.R.*, 293 U.S. 282, 284-85 (1934), and the Treasury regulations and rulings cited therein. Initially, there was some doubt as to whether original issue discount was deductible as a loss or as interest. It is now well settled, however, that original issue discount is a form of interest. See *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 145 (1974); Treas. Reg. § 1.61-7(c) (as amended in 1966).

434. See JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 115 n.24 (1984); see also H.R. REP. NO. 749, 88th Cong., 1st Sess. 72 (1963) (imputation rate assumed to be a normative rate). One such provision in the 1984 Act dealt with imputed interest on seller-financed sales of property. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 41(a), 98 Stat. 538-39 (1984) (adding I.R.C. § 1274 and applying a penalty rate of 110 percent of the applicable Federal rate as a safe harbor rate and a penalty rate of 120 percent). The rationale for the rate higher than the AFR to be required as a safe harbor rate was that "the use of a safe harbor rate equal to 110 percent of the applicable Federal rate will roughly correspond to the rate at which a good credit risk can borrow." See H.R. REP. NO. 432, 98th Cong., 2d Sess. 1247 n.13 (1984).

435. For a definition of the AFR, see *supra* note 432. In the 1984 Act, Congress added I.R.C. § 7872 and then referred to a foregone interest computed solely on the basis of the AFR. See I.R.C. § 7872(f) (1988); see also JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 528-29 (1984) ("arm's length" treatment defined as AFR rather than the *Dickman* decision which looked to the fair rate of interest for the borrower related to the borrower's risk). In 1985, Congress

7872 (dealing with interest-free and below-market loans), which imputes only a riskless rate of return on borrowed capital as the "arm's length" rate and allows the transference of entrepreneurial risk and return to the actual investment of the capital to the borrower.⁴³⁶

There are other possible positions,⁴³⁷ but I advance a view of profit that separates the theory of profit from interest, viewing profit as a return to risk-taking and management;⁴³⁸ it concerns the line between reward for risk-taking and the mere passage of time.⁴³⁹ A

changed the rate of interest on seller-financed sales, *see supra* note 434, to the AFR. *See* JOINT COMM. ON TAXATION, DESCRIPTION OF THE TAX TREATMENT OF IMPUTED INTEREST ON DEFERRED PAYMENT SALES OF PROPERTY (and H.R. 242 and H.R. 2069), JT. COMM. RPT. JCS-16-85, at 19-20 (1985) [hereinafter JT. COMM., 1985 INTEREST]. A higher imputed rate may be required in (1) sale-leaseback transactions, *see* Amendments to Imputed Interest Rules, Pub. L. No. 99-121, § 101(c), 99 Stat. 506 (1985) (amending I.R.C. § 1274A), and (2) transactions engineered for the purpose of avoiding an actual arm's length interest rate, *see* H.R. CONF. REP. NO. 250, 99th Cong., 1st Sess. 17 (1985). The House Ways and Means Committee stated that it believed that an imputed interest rate of 100 percent of the AFR is a fair minimum rate and one which will not impose hardships on taxpayers. H.R. 87, 99th Cong., 1st Sess. 11 (1985). Congress decided this even though there was evidence that the 110 percent rate in the 1984 Act was not too high relative to prevailing market interest rates. JT. COMM., 1985 INTEREST, *supra* at 23.

436. *See supra* note 435. In other contexts, higher rates reflect the permissible interest return: for example, disguised sales and debt financed investments of tax exempt entities in connection with taxable entities. Treas. Reg. §§ 1.707-0 to 1.707-9 (1992); I.R.S. Notice 90-41, 1990-1 C.B. 350 (to I.R.C. § 514(c)(9) (1988)). Both deal with the concept of fixed returns on capital based on percentages of the applicable interest rate, 150 percent and 120 percent, respectively. Treas. Reg. § 1.707-4(a)(3)(ii) (1992); I.R.S. Notice 90-41, 1990-1 C.B. 350, 352.

437. The appropriate interest rate to charge on this "borrowed capital" has at least four possible positions: (1) a risk-free rate; (2) the firm's best estimate of its "cost of capital" that could include the cost of equity capital, which emphasizes the cost of funds supplied rather than the opportunity value of the funds to be released; (3) the "internal rate of return" on a firm's assets; and (4) a rate incorporating uncertainty into future flows resulting in an average cost of capital that focuses on the cost of funds supplied rather than the opportunity value.

438. The interest rate is viewed as the risk premium for the capitalist's cost of money. *See* IRVING FISHER, THE THEORY OF INTEREST (1930). While this seems self-evident now, it is often still expressed. *See* GEORGE L.S. SHACKLE, THE NATURE OF ECONOMIC THOUGHT 164 (1966) [hereinafter SHACKLE, ECONOMIC THOUGHT]; *see also* Naoki Kishimoto, *Pricing Contingent Claims Under Interest Rate and Asset Price Risk*, 44 J. FIN. 571 (1989) (arguing contingent claims analysis in risk premiums); David C. Shimko, *The Equilibrium Valuation of Risky Discrete Cash Flows in Continuous Time*, 44 J. FIN. 1373 (1989) (determining cash flow as related to interest rate assumption). Capital budgeting is based on attempts to determine an appropriate discount rate for risky cash flows. *See, e.g.*, Michael J. Brennan, *An Approach to the Valuation of Uncertain Income Streams*, 28 J. FIN. 661, 665 (1973); George M. Constantinides, *Market Risk Adjustment in Project Valuation*, 33 J. FIN. 603 (1978) (applying the theory of Jacob Merton, *An Intertemporal Capital Asset Pricing Model*, 41 ECONOMETRICA 867 (1973)); William Samuelson, *Rational Theory of Warrant Pricing*, 6 INDUS. MGMT. REV. 41 (1965). A risk adjusted view, however, may limit capital formation and risk. Hence, a risk-adjusted view may produce a return different from the best estimate of current present value.

439. This view of profit is set forth in the early literature on the subject. *See* Roger H.

risk-free rate of return compensates the partners for the time-value cost of their money, but does not compensate the tax system for assignments of income through a borrowing rate that does not reflect underlying risk.⁴⁴⁰ To suggest the rate of return on the firm's assets as the appropriate rate,⁴⁴¹ begs the question as to the character and timing problem in the allocation of profits from human and financial capital.

3. Timing of Taxation of Interest on Positive and Negative Capital Accounts

In considering the role of interest in partnership taxation, the income tax system need not fully equate savers in partnerships with savers receiving interest. For example, in constructing any imputed interest system in partnership taxation one issue is whether to use the current rule for contingent interest (defer the deduction and the inclusion until payment) or the rule for noncontingent interest (accrue interest income and deduction currently while the loan is outstanding).⁴⁴² Simplicity suggests deferral as does the contingent nature of

Gordon, *Criticism of Ricardian Views on Value and Distribution in the British Periodicals, 1820-1850*, in 1 HIST. OF POL. ECON. 370, 383 (1869) (quoting William Ellis), reprinted in C.C. Lamberton, *Information and Profit*, in EXPECTATION IN ECONOMICS 191, 194 (G.L.S. Shackle ed., 1949); see also GEORGE L.S. SHACKLE, DECISION, ORDER AND TIME IN HUMAN AFFAIRS 252-53 (2d ed. 1969) (presenting questions designed to elucidate the content of the concept of profit).

440. The choice of a market interest rate is the same as arms' length pricing for loans between related parties. Treas. Reg. § 1.482-2(A)(2) (as amended in 1993).

441. See Gergen, *supra* note 12, at 13-14, 40.

442. In 1991, proposed regulations on original issue discount treated all contingent payments as interest. See Prop. Treas. Reg. § 1.1275-4, 56 Fed. Reg. 8308 (1991); see also DAVID GARLOCK, FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS 145-99 (2d ed. 1991). These regulations were viewed as defective and review of alternatives is occurring. See A.B.A. Tax Sec., *Report on Amendments to Proposed Regulation Section 1.1275-4: Proposed Regulations Regarding Certain Contingent Debt Instruments Under the Original Issue Discount Rules*, 53 TAX NOTES 1187 (1991). In 1992, the Treasury issued a substantially revised version of the proposed regulations that govern the treatment of debt instruments issued at a discount including reversal of a bifurcation approach to convertible debt. See 57 Fed. Reg. 60,750 (1992); see also David C. Garlock, *A Primer on the New Proposed (Almost) Regulations for Contingent Debt Instruments*, 58 TAX NOTES 1225, 1226-27 (1993); David P. Hariton, *Contingent Debt: Putting the Pieces Together*, 58 TAX NOTES 1231 (1993); David P. Hariton, *Significant Changes in the Original Issue Discount Rules*, 58 TAX NOTES 347, 349 (1993).

The final original issue discount regulations were published in 1994 without contingent payment debt rules. See T.D. 8517, 59 Fed. Reg. 4799 (1994) (noting earlier proposed and withdrawn regulations that contained five methods, including ones that relied on estimates of the value of contingent payments, for accrual). For a review of the history, see Lee A. Sheppard, *Contingent Payment Debt or the Trifecta*, 63 TAX NOTES 1671 (1994). For the view imputing a return to the whole instrument including the contingency, see Alvin C. Warren, Jr., *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460 (1993).

partnership profits and capital repayment.⁴⁴³ At a minimum, partnerships should be required to charge interest on deficit capital accounts, that represents borrowing of another partner's capital contribution. The interest on deficit capital accounts is demonstrated easily,⁴⁴⁴ as is in-

443. See *supra* text accompanying notes 420-32 and *infra* notes 453 & 456.

444. In order for deficit capital accounts to be created, there must be a requirement to restore the deficit (or a minimum gain chargeback for nonrecourse deductions). The partner must also have sufficient outside basis to utilize the losses, see I.R.C. § 704(d), which can be obtained by contributions of property (but not solely for the purpose of getting outside basis) or by having a share of debt. The deficit may be created both when the partner is allocated losses supported by partnership debt or by the capital contributions of other partners. Where the deficit is supported by partnership debt, the deficit does not cause a shift between the partners where the interest paid to the lender from the partnership income is allocated to the partner using the debt capital. Where the interest is deducted from bottom line income and profits are shared in a different ratio than losses, then in effect the other partners bear a portion of the cost of the debt and their profit ratios are effectively reduced. That shift might more correctly be viewed in light of profit sharing and capital account differentials. See *infra* note 447. Where, however, the deficit arises from using another partner's equity contribution (which effectively occurs after all losses supported by debt and the partner's own capital contribution have been taken), there is no explicit interest charge to benefit the partner whose capital is borrowed unless deficit capital accounts bear interest.

Consider the following example. X and Y contribute \$850 and \$150, respectively, to a partnership that invests \$1000 at the beginning of the year in a risky venture the cost of which is expensed at the end of the year and has an expected cash flow of \$250 a year for ten years. Y is in the 40 percent tax bracket and X is in the 20 percent tax bracket. The market interest rate is 10 percent. Thus, X and Y have after-tax required rates of return of 8 percent and 6 percent, respectively. See *infra* note 644. As set forth in Table 1 at p. 391, the net present value of the investment before tax is \$536.14 and it has an internal rate of return of 21.41 percent. (The internal rate of return is the rate at which a series of cash flows has a present value of zero). X and Y have net present values after tax of \$448.12 and \$72.21, respectively. X and Y have internal rates of return of 20.17 percent and 18.49 percent, respectively.

Now assume as in Table 2 at p. 392 that all losses from the investment and income is allocated to Y. All cash is distributed to X until Y's capital account is restored to zero, at which point income is allocated and cash distributed 20 percent to X and 80 percent to Y. Y pays no interest on negative capital account balances. Table 2 illustrates the relative net present values after-tax to X and Y, \$21.34 and \$452.80, respectively. X's internal rate of return is now 8.90 percent which is greater than her required rate of return of 8 percent. (The internal rate of return cannot be calculated for Y because there is a change in sign (minus, plus, minus)). If they agreed to share and distribute profits 50/50 after Y's capital account is restored to zero, X's and Y's net present values after tax would be \$251.67 and \$256.14, respectively. X's internal rate of return would be 16.14 percent.

In Table 3 at p. 393, Y is required to pay interest on negative capital account balances at an assumed risk-free rate of 7 percent which is paid by first allocating to X the amount of interest that accrued on Y's negative capital account. The remaining income is allocated to Y and all cash is distributed to X until Y's capital account is restored to zero. Thereafter they share profits and distribute all cash 20 percent to X and 80 percent to Y. X and Y's net present value after tax would be \$90.03 and \$400.25, respectively. X's internal rate of return would be 11.62 percent. If they had agreed to share and distribute profits 50/50 after Y's capital account is restored to zero, X's and Y's net present values after tax would be \$293.18 and \$225.58,

terest on positive capital accounts.⁴⁴⁵

respectively. X's internal rate of return would be 17.24 percent.

Applying the accrual method where Y pays no interest on negative capital account balances, but interest accrues in a deferred payment account taxed on the accrual method and which upon liquidation is paid to X, gives a positive net present value after-tax for both X and Y of \$93.46 and \$398.28, respectively, as Table 4 at p. 394 illustrates where X and Y share profits and cash distributions in a 20/80 ratio after Y's capital account is restored to zero. X's internal rate of return is 11.13 percent. If they had shared 50/50, X's and Y's net present values would be \$323.80 and \$201.62, respectively. X's internal rate of return would be 17.00 percent.

Where X and Y share profits and cash distributions in a 20/80 ratio after Y's capital account is restored to zero, if Y pays no interest on negative capital account balances, but interest accrues in a deferred payment account taxed on the cash method and which upon liquidation must be restored to X, the net present value after-tax to X and Y is \$107.08 and \$375.27, respectively, because on liquidation Y will owe X \$231.40 and the interest income and the interest liability is taxed on the cash method. X's internal rate of return is 11.74 percent. If they had shared 50/50, X's and Y's net present values after-tax would be \$337.42 and \$178.61 respectively. The cash method reduces Y's net present value after-tax to a negative return and increases X's net present value after-tax. For interest on a deficit capital account in the context of another special allocation, see *infra* note 667 and Table 14 at p. 404.

The above example illustrates risk sharing under uncertainty. X can receive her highest reward if she shares proportionately with Y. Nonetheless, if X is risk-adverse, she will prefer the greater certainty of shifting the initial loss to Y in exchange for Y's promise to repay X out of the income from the partnership, and if no income materializes from X's personal assets. Y agrees to bear greater risk in exchange for a leveraged after-tax return. The actual partnership between X and Y and their levels of contribution will depend upon the relative variance between X's and Y's risk aversion and tax rates. See *supra* note 306 and accompanying text. Importantly, the partnership arrangement allows X and Y to agree to an optimal sharing based on their relative risk aversion and tax rates, and leads to increased partnership investment.

445. The effect of interest on capital accounts may be illustrated by an extreme example. Q and R form "Partnership QR," whereby Q contributes \$400 to the enterprise and R contributes \$100. The partnership invests in a fully depreciable asset that produces a cash flow of \$150 annually for a period of five years. Tax rates for Q and R are 40 percent and the market interest rate is 10 percent. Depreciation is on a straight-line basis. The agreement provides that all cash flow will be distributed based on the distributive shares of partnership taxable income. The excess is distributed based on their 80/20 capital account ratios. As set forth in Table 5 at p. 395, the partnership's internal rate of return before tax is 15.24 percent. If the partners agree to share profits based on their capital account ratios, they will each receive an 9.43 percent internal rate of return after tax. The net present values after tax for Q and R are \$38.09 and \$9.52, respectively. If the partners decide to share income first by providing a 10 percent return on capital and then allocate income based on their relative capital account ratios at the beginning of each year, the result will be the same. Now assume as in Table 6 at p. 496 that the partners agree to share profits 50/50, and the partnership distributes the net income in the ratio in which it was taxed but retains the remainder of the cash flow and invests it at the market interest rate of 10 percent and in later years allocates the interest on the cash not distributed to Q and R in accordance with their capital account ratios. The partnership is then liquidated in Year 5 according to capital account ratios. This sharing without first allocating a risk-free payment to capital accounts shifts income to the lower contributing partner R, and away from Q. As set forth in Table 6, Q could still make the investment because she has a net present value after tax of \$0.17 and an internal rate of return of 6.01 percent which is greater than her required return of 6 percent. R's net present value after tax increases to \$47.43 and her internal rate of return is 17.03 percent. By providing a return at the assumed 7 percent

Requiring interest on full capital account balances produces a different economic arrangement, not different tax treatment. If the partners provided for an interest payment on capital accounts, there would be no need for an imputed return because even more interest accrues than would otherwise be required.⁴⁴⁶ Under an aggregate theory, the tax law could recharacterize the actual cross-borrowing between the partners for their financial and human capital on a basis of capital account differentials relative to profit-sharing ratios as illustrated in the footnote.⁴⁴⁷ The differential view of interest on

risk-free rate on their capital accounts as in Table 7 at p. 397, this shift of income is alleviated in part. In Table 7 the partners are taxed on their distributive shares of partnership net income based on their 50/50 sharing ratio and on their guaranteed payments of interest. The partnership distributes partnership net income and the guaranteed payments. It retains all remaining cash flow and allocates income from the retained cash flow in accordance with capital accounts ratios. The partnership then liquidates in Year 5 according to capital account ratios. Now *Q* has a net present value after tax of \$26.71 and an internal rate of return of 7.55 percent. *R* has a net present value after tax of \$20.89 and an internal rate of return of 10.85 percent. Providing for interest on full capital account balances should be contrasted with interest on the differential between capital accounts and profit sharing ratios as set forth in note 447 *infra*. The transaction is treated as a borrowing transaction between *Q* and *R*. *R* increases her return on investment relative to an allocation of income based on pure capital account sharing at the price of paying *Q* interest on that partner's capital contribution.

The differential between *Q*'s and *R*'s capital accounts is the difference between their profit sharing ratios, 50/50, and their capital account ratios, which is 80/20. Under this view *R* is borrowing \$150 of *Q*'s contribution. This view obtains whether or not *R* contributes any services to the partnership or assumes any risk different from that of *Q*. Thus, a differential view of capital account and profit allocations should first impute to *Q* a return on her capital account differential based on a risk-free return and then treat that amount as transferred to *R*. Where *R* contributes services, a similar amount should be viewed as transferred to *Q*. The characterization of the transfer would be based on the relationship that exists between *Q* and *R* including the risks assumed by each partner or the services provided by each partner and would extend the categories of relationships in I.R.C. § 7872. For example, where a greater profit ratio is received for a disproportionate sharing of loss, there is no need to recharacterize the differential. For further consideration, see *infra* notes 447 & 456.

446. The implicit exchange model with the cross-borrowing of a portion of partnership capital by the service partner and human and financial capital by the capital partner does not change the economic deal of the partners and just converts the problem into a characterization problem. Differential sharing rules and viewing amounts cross-transferred as ordinary income respond to the assignment of income issue by recharacterization of the character of receipts, while the payment mechanism does so by reconstituting the risk-bearing of the parties. The tables showing the required payment illustrate assignment of income issues, see *supra* note 445, but not the characterization issue.

447. The implicit exchange between the partners is the profit-sharing ratios relative to capital contributions. This can be illustrated as follows. Consider a two person partnership in which *A* contributes \$100,000 and *B* contributes services; *A* will bear all losses up to her capital account and then be charged with all income to recover losses up to the amount of the capital account, and thereafter *A* and *B* will share profits equally. Assume that the partnership buys an asset for \$100,000 and three years later sells it for \$200,000; there is a \$100,000 gain.

If the asset were a capital asset in the hands of the partnership, the gain would be capital gain. On the other hand, since *B*'s share is disproportionate to *B*'s capital account, there is an implicit borrowing of 50 percent of *A*'s capital by *B*. Therefore a portion of the return received by *B* must be returned to *A* in the form of interest. Similarly, since *A*'s capital account and profit-sharing ratio is disproportionate to the capital account, and the ratio for *A* is 100 percent, *B*'s implicit capital contribution for services is deemed to be equal to the capital contribution by *A*. If so, then there is a deemed payment of salary from the profit-sharing that *A* has from the partnership assets to *B* as ordinary salary income. Assuming a risk-free interest of 10 percent compounded annually, the explicit transfers between *A* and *B* are \$16,550, and the remainder of the gain would be characterized as capital gain. This is illustrated in Table 8 at p. 398. In the tables, interest is imputed on the capital account balances at the beginning of the year. If the balances were to change during the year such as by a distribution, the differential would change as would the amount of the imputed interest and salary.

Because the amount of *A*'s capital contribution is known, therefore the discrepancy between the actual capital contribution of *A* and the profit-sharing ratio determines the valuation that the parties placed on *B*'s contribution. The theory follows *Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184, 189 (Cl. Ct. 1954), in that the amount given up is deemed equal to the amount received. The intuition behind the sharing is easy to see in a 50/50 sharing where *B* contributes only services. *A* thinks *B*'s services are worth \$100,000, the same that *A* puts up for her 50 percent share, and *A* lends *B* one half of her capital and *B* gives *A* one half of her services for a total financial and human capital in the partnership of \$200,000. When the profit ratio changes, such as to 60 percent for *A* and 40 percent for *B*, the differential is 40 percent and the amount of borrowed capital for both *A* and *B* is \$40,000 upon which interest is imputed. The total capital in the partnership (financial and human) would be determined under the following reasoning: *B* contributes \$40,000 of services to share 40/60 with \$60,000 of *A*'s capital. *B* also contributes \$40,000 of services to share equally with the remaining \$40,000 of *A*'s capital. In other words, *A* forbears from collecting the return for \$40,000 directly in exchange for the contribution of \$40,000 of services by *B*. Thus, the total financial and human capital in the partnership is \$180,000.

It is important to note that the recharacterization does not reflect actual economic reality but merely recharacterizes *ex post* the arrangement that the partners agreed to *ex ante*. In Table 8, assuming *B*'s services are fully consumed and the partners liquidate the partnership after the asset is sold, the sharing of profits between the partners may not reflect actual reality. Assume the asset acquired with *A*'s capital had a change in value due solely to a change in the market and none of *B*'s services with respect to the asset affected the value. If *A* had not shared with *B*, *A* would have been entitled to the full \$100,000 capital gain. Sharing with *B*, whose services actually added no value, means that *A* should receive a \$50,000 loss deduction (assuming that she is entitled to all of the market gain) and *B* should have \$50,000 of ordinary income because her return is not linked to the capital asset, merely the agreement with *A*. Similarly, if *B*'s services added all the value, *B* should have all of the gain (presumably capital) and *B* should have a loss deduction for the interest component for the use of all of *A*'s capital to acquire the asset and a deduction for the remaining amount of the total \$50,000 transferred to *A*. *A* should have \$50,000 of ordinary income. This illustrates the problem with sorting out the returns to a firm in which capital and labor are mixed. See *supra* note 33 and accompanying text. Any tax rule that does not look to the source of the economic gain or loss is distortionary. Assume that in Year 2, the partners decide that *B*'s services do not add much value to the partnership but that both *A* and *B* want the partnership to continue. They change *A*'s and *B*'s profit sharing ratios to 90 percent and 10 percent, respectively. This would not require a revaluation of capital accounts and under Subchapter K would involve no immediate tax consequences. When the partnership realizes the income from the sale of the asset, it would be shared 90/10. The change of profit sharing ratios changes the result that would obtain

outside of Subchapter K. Assume the property had a value of \$200,000 when the change was made and then was later sold for that same amount. The tax consequences from following the economics of the transfer would first tax *A* and *B* on the \$100,000 of gain (\$50,000 each) and then *A* would have an additional \$40,000 of ordinary income from *B*'s transfer and *B* would have a \$40,000 ordinary deduction. Cf. Kamin, *supra* note 15, at 27-58 to 27-59. With respect to interest on the capital-profit sharing ratio differential, the change of the ratio would adjust the amount of the imputed interest and salary as Table 9 discussed below illustrates.

In Table 9 at p. 399, assume as before that the partners agree that *A* will bear all losses and then be allocated all income to restore the losses and then the partners will share profits 60 percent for *A* and 40 percent for *B*. The \$100,000 investment is made in Year zero and carries \$4,000 of an imputed amount for each partner each year. Assume as reflected in Table 9 that in Year 2 the tax law allows a depreciation deduction in that year of 40 percent of the investment that is not subject to recapture as ordinary income. The profit and capital account ratio that exists at the beginning of Year 3 changes (*B* was assumed to contribute \$80,000 of services) but the ratio is unchanged on the partnership books. One view could be that *B*, who presumably continues the same level of human capital contribution, should have an imputed return on that contribution. Another view would be to assume that *B* has implicitly realized a loss of \$40,000, which is the amount of her services that attach to 40 percent of the property, and that loss occurs simultaneously with the financial capital loss. Under the latter approach, the interest for Year 3 is calculated using a total capital base of \$60,000, as is done in Table 9, which changes the imputed interest for Year 3 to \$2,400 for each. On the sale of the asset for \$200,000, *A* is allocated the first \$40,000 of capital gain and *A* and *B* then share 60/40 in the remaining gain of \$100,000, with \$11,640 recharacterized for each as reflected in Table 9.

Interestingly, the same net result would obtain if the partners in all events shared profits and losses 60/40. The \$40,000 loss in Year 2 would be allocated \$24,000 to *A* and \$16,000 to *B*. The capital accounts are \$76,000 for *A* and -\$16,000 for *B*. To validate the loss allocation, *B* must agree to a deficit make-up obligation. Thus the \$16,000 deficit should be deemed to be restored and (an interest should be imputed on that amount in *A*'s favor) and with that deemed restoration, *A*'s capital account should be deemed to be \$60,000 in Year 3, not \$76,000.

Table 10 at p. 400 illustrates that the profit and capital differential recharacterization approach may be used even when the service partner contributes capital. For example, assume that *A* contributes \$66,667 and *B* contributes \$33,333, and they agree to share profits 50/50. Based on capital contributions, *B*'s profit-sharing ratio would only be 33 1/3 percent. When the partnership buys an asset for \$100,000 and sells it for \$200,000, there needs to be a recharacterization of the \$100,000 gain. The discrepancy between their capital accounts based on profit-sharing ratios and their capital accounts based on actual values is 16 2/3 percent. The cross borrowing is \$16,667 of the total capital contributed to the partnership. Assuming the same profit-sharing ratio and Year zero contributions and that the asset is held for three years before it is sold, the deemed income is recharacterized using a 10 percent risk-free interest rate in Year 3, as illustrated in Table 10 at p. 400.

If *A* had contributed \$100,000 and *B* \$50,000, the differential would be the same but the borrowed amount would be \$25,000 which should be conceptualized as the equal sharing for \$100,000 of the financial capital contributed by both and a contribution of \$50,000 of services for *B* to share 50/50 with the contribution of *A*'s additional \$50,000 under the cross borrowing mechanism discussed with respect to Table 8. The amount of the differential is 50 percent for a sharing of \$25,000. Here the total financial and human capital contributed would be \$200,000 as in Table 8 but the mix would be different—\$150,000 of financial and \$50,000 of human capital.

Assuming the contribution in Table 10 but that the profit sharing ratios were 50/50 for

capital accounts comports well with contributions of hard-to-value financial and human capital. The use of human capital should have a return imputed and recharacterized for its use by another partner in the partnership.⁴⁴⁸ Both suppliers of human and financial capital are risk-takers within the firm. Outside of the family partnership context, which treats salary as an expense and allocates entrepreneurial returns solely

the first \$100,000 of profits, 60/40 for the next \$100,000 of profits, and then 66.67/33.33 for the remainder, the difficulty with the profit-capital account differential approach becomes apparent. The best result would be to use a weighted average of the profit ratios based on the probabilities of occurrence with that average changing as income is earned. Moreover, if the income is not distributed, the capital account ratios change each year.

Table 10 implies that the additional return to *B* reflects services contributed to the partnership. This is why recharacterization using a 10 percent discount rate for the differential was appropriate to reflect *A*'s and *B*'s relationship. If the additional return to *B* were not for services to the partnership, such as where *B* assumes greater risks with respect to partnership losses, see *supra* note 445, then recharacterization would not be appropriate. While the agreement to bear a greater share of losses in exchange for more income could be viewed as "insurance" for *B*, that insurance feature of risk-bearing in the partnership by capital providers need not be explicitly recharacterized as service income to *B* and imputed income to *A* followed by a potential deduction for an insurance premium. Many other relationships with respect to risk-sharing by capital contributing partners can cause profit and loss ratios not to match capital account balances. Because other complex financial instruments do not recharacterize these forms of risk-sharing, it seems less compelling to do so when done through a partnership. In addition where the differential is not based on additional risk undertaken by a partner in the partnership, the partnership income should be reallocated to reflect the true nature of the transaction as interest to the partner who foregoes a return and as a transfer to the partner who receives an increased return relative to the risk the partner undertakes in the partnership. Characterization of the receipt and the transfer would be made based on the relationship of the partners under an expanded version of § 7872. See *supra* note 445 and *infra* text accompanying note 458.

448. For example, early family partnership cases sought to ascertain the appropriate allocation of income to services and capital. See William F. Robinson, *The Allocation Theory in Family Partnership Cases*, 25 TAXES 963 (1947) (fair return on capital must be made with regard to risk-bearing functions of partners); see also Vernon J. Veron, *Taxation of the Income of Family Partnerships*, 59 HARV. L. REV. 209 (1945). In 1951, I.R.C. § 704(e) (1988) rejected the view expressed in Gen. Couns. Mem. 9825, X-II C.B. 146 (1931) that a proportional distribution of income of the partnership based on the proportion of services and invested capital reflected the source of profits. See Robinson, *supra* at 970. The approach of Gen. Couns. Mem. 9825 had been followed in later cases which gave equal weight to the value of service contributions and capital contributions. See Gen. Couns. Mem. 25,642, 1948-1 C.B. 60. This is based on a theory that the courts will not take into account a different valuation than the earning capacity of the respective contributions of the individual partners. See *Estate of Tilton v. Commissioner*, 8 B.T.A. 914, 917 (1927). However, the proportionate theory is much criticized. See Robinson, *supra* at 970; Note, *Family Partnerships and the Revenue Act of 1951*, 61 YALE L.J. 541, 553-54 (1952) [hereinafter *Family Partnerships*]. The argument was made that in a family partnership it is the donee who ought to be limited to a fair return on invested capital, which return might be measured by the income generally received on capital invested in similar industries, and the remaining partnership income ought to be credited to the donor where the donor continues to work in the business. This approach reallocates the entrepreneurial return to the human capital investment. See *Family Partnerships*, *supra* at 555.

to investment capital,⁴⁴⁹ there is no reason to impute and recharacterize a return based on reasonable compensation, and in other contexts the rules of Code § 482 apply.⁴⁵⁰ The human capital investor does not engage in the risk of loss-shifting with the government and faces the same after-tax rate of return when she invests her human capital in the partnership firm for a share of partnership income contingent upon either gross or net profit, or accepts contingent compensation from an employer as an employee.⁴⁵¹

Several difficult issues emerge in imputing interest on capital accounts using the differentials between profit ratios and capital accounts.⁴⁵² Fine-tuning is required to reflect changing capital ac-

449. See ALAN J.B. ARONSOHN, PARTNERSHIP INCOME TAXES 249-57 (1978). It remains unclear in the legislative history to I.R.C. § 704(e) (1988) whether the standard for allocation to services was merely a "reasonable compensation" or was a proportional allocation to the service contribution, see *Family Partnerships*, *supra* note 448, at 552 n.41, but the position in the regulations is to treat services as fully compensated by an allocation of the percentage of partnership interest fairly attributable to the contribution and to divide the remainder of the profits to the capital contributions. See Treas. Reg. § 1.704-1(e)(3)(i)(a) (as amended in 1993); see also Floyd K. Haskell, *Capital Contributions and "Business Purpose" in Family Partnerships*, 33 MINN. L. REV. 714, 730 (1949).

450. It could be argued that without interest imputation, the transaction is not economic for the contributing partner and therefore ought to be taxed under a gift or other model. See MCKEE ET AL., *supra* note 19, ¶ 14.05[2]. For reallocation of partnership income under section 482 involving related parties, see *Rodebaugh v. Commissioner*, 33 T.C.M. 169 (1974), *aff'd per curiam*, 518 F.2d 73 (6th Cir. 1975).

451. See *supra* text accompanying notes 237-40.

452. First, capital values and the capital balance must be adequately defined and adjusted for the length of such period and the period of compounding and reflect the appropriate treatment for taxable and tax exempt partners and tax exempt interest. Partnerships may contain special provisions with respect to time, measurement, and allocation of income for accounting purposes. See R. Glenn Berryman, *Partnership Accounting*, in HANDBOOK OF MODERN ACCOUNTING 30-25 to 30-26 (Sidney Davidson et al. eds., 3d ed. 1983). Moreover, distributions adjust capital accounts as they occur while income and deduction is determined annually. Imputing interest on capital accounts also requires a determination of the amount that is either to be changing over time, such as the applicable federal rate compounded semi-annually on a fixed or demand basis, or is to be at a specific rate which is first established in a binding written agreement among the partners, ending at the end of this period and reflecting the term of the partnership. To the extent that there are tax exempt obligations in the partnership, then the applicable interest rate for the relevant value of the partnership capital accounts attributable to such obligations could be the tax-exempt original issue discount as adjusted under I.R.C. § 1288(b)(1). If the agreement contains a preferred return or guaranteed payment, the accrued preferred return or guaranteed payment of a partner must include any amount characterized as interest that accrues thereon. Examples include those with respect to accounting for deficit capital accounts (Tables 3 and 4), and those imputing interest generally (Table 7). In either case, capital account maintenance would be required. Treas. Reg. § 1.704-1(b)(2)(iv) (as amended in 1993). This could be modified with the requirement that generally any distribution to a partner that the partnership agreement designates as reducing the base on which that partner's preferred return or guaranteed payment is computed constitutes a return of the partner's

contributed capital and the value would be monitored. Special rules would be required for a tax exempt partner's capital account and any preferred return payment for capital. Preferred returns need special rules which might include the manner in which partnership items of income and gain will be allocated to support a preferred return, or if none or an amount insufficient to cover the preferred return, a pro rata portion of the partnership's income and gain including tax exempt income, which would be allocated to the partner entitled to a preferred return pro rata. For example, the preferred return or guaranteed payment that accrues for a tax exempt partner for any taxable year in which a partner has an accrued but unpaid preferred return or guaranteed payment might not be allowed to be less than the amount determined by multiplying the unpaid partner's average preferred return or guaranteed payment for the year by at a minimum the lowest applicable federal rate for purposes of I.R.C. § 1274(d) (1988) or I.R.C. § 1288(b) (1988). Extreme time sensitivity would reflect monthly compounding of the return. Moreover, interest imputation on missed payments could be provided. *See* I.R.C. § 514(c)(9)(E) (Supp. 1992); Prop. Treas. Reg. § 1.514(c)-2, 57 Fed. Reg. 62,266 (1992) (with respect to debt financed real estate and guaranteed or preferred returns to tax exempt entities, there is a requirement of payment so that the returns do not generate original issue discount). As to guaranteed returns in the context of contributions generally, there is an addition to capital for missed payments. *See* Treas. Reg. § 1.707-4(a)(3)(ii) (1992). Since the partner drawing accounts against partnership income are treated as loans from the partnership to the partners, *see* Treas. Reg. § 1.731-1(a)(1)(ii) (1960) (draws against distributive shares of income treated as distributions on the last day of the partnership taxable year), there must be a decision whether draws should be included in the imputed interest rules and require an interest component. Revaluations also raise issues as to the correct interest imputation. If interest compensates for nonrecognition, much like the interest on the tax difference under the installment sale rules, then the historical difference and basis is what is appropriate. A revaluation adjusts historical value and entitlements among partners and is the appropriate capital measure for interest imputation. A realization based system has obvious limitations in the correct accounting for the value of the partnership.

Second, the payment for capital could be recharacterized as in note 447 *supra* unless a specific provision for payment of interest on financial capital account balances is set forth in a written partnership agreement.

Third, another question arises to whether the imputed interest under a recharacterization model always should be ordinary income because it is not under a guaranteed payment model. Where the transaction is viewed as a borrowing transaction, this recharacterization is correct. It might be argued that it should be capital gain where the only partnership assets are capital. The recharacterized amount should be treated like a guaranteed payment on capital which is always treated as ordinary income and not as a pro rata portion of the mix of income in the partnership at the time it is paid or accrued. *See* Rev. Rul. 69-180, 1969-1 C.B. 183 (the guaranteed payment formula first sources to the guaranteed payment the partnership's ordinary income). This view is reinforced by both the view that income from pooled ventures are invariably a mix of income derived from all assets, and the pre-1954 view of the partner/income relationship. This insight reflects that the "interest" first allocated as a distributive share usually should be proportionate to the partnership's income. Nonetheless this is inconsistent with the view of cross-borrowing under a recharacterization model and should be rejected.

Fourth, once it is recognized that the contribution of capital is a loan, an issue remains if further capitalization rules are necessary under the proposed system. *See infra* note 453.

Fifth, the problem where the capital accounts do not fairly represent an obligation to the partners and partnership on dissolution must be considered. The I.R.C. § 704(b) (1988) regulations do not classify a removal of a guarantee on recourse debt as a deficit restoration agreement. While the liquidation of the partnerships with a deficit account and the removal of

counts,⁴⁵³ profit-loss flips and loss ventures,⁴⁵⁴ and special allocations in multiple asset partnerships.⁴⁵⁵ The recharacterization model differs from Internal Revenue Code § 7872 but principles in § 7872 might then be applied to require that the partners receive special inside bases for cost attributable to the production of assets in the partnership that would otherwise be capitalizable interest or salary.⁴⁵⁶

the guarantee may cause a deemed distribution for gain purposes and I.R.C. § 752 (1988), it does not create any deficit restoration requirement. *See* Treas. Reg. § 1.704-2 (1991). Thus, a deficit that does not have to be restored should not count. This, however, raises a more significant issue as to substantiality under the regulations and should be corrected there as proposed by commentators. *See* A.B.A. Tax Sect., *Proposed Simplification of Treasury Regulations Under Section 704(b) Concerning Partnership Tax Allocations* §§ 1.704-0(e)(2)(ii), 1.704-0(e)(3)(ii), A.B.A. TAX, at 35-37 (1990) (defining recourse minimum gain and providing for recourse minimum gain chargebacks and a deemed deficit restoration agreement).

Sixth, an issue arises as to the treatment of sales of a partnership interest. To enforce the regime, an allocation in addition to that in I.R.C. § 751(a) (1988) would recharacterize a portion of the gain as ordinary income where attributable to imputed interest or salary.

453. As the capital account ratio changes over time, the amount of imputed interest or salary would change each particular year. *See* Table 9 at p. 399.

454. Where there are earlier losses allocated to the capital partner and then recompensed by income, arguably the interest imputation on the service partner's amount is not needed. *See* Table 9 at p. 399. The asset presumably had lost its value under the value equals basis rule and was a nonrecourse loan born solely by the contributing capital partner. Nonetheless, the contributing capital partner had borrowed the service partner's services (and the service partner the capital partner's capital) and a portion of the profits in excess of the losses should be recharacterized as in Table 9. Where the venture results in a total loss, there is in effect a cancellation of the loan obligation of the service partner to the capital partner and the salary obligation of the capital partner to the service partner. Each could be viewed as having cancellation of indebtedness income. However, the risks that both engage in with respect to the loan and promise of salary is contingent upon profits and that contingency suggests that there ought not be cancellation of indebtedness income.

455. Where the sharing ratio for profits differs for particular assets and items, then arguably the capital accounts ought to be allocated to the particular assets of the partnership.

456. Consider the following example introduced in note 417 *supra*, A and B form a partnership in which A contributes \$100 and B contributes property with a fair market value of \$75 and an adjusted basis of \$100. They agree to share profits and losses equally. The equal profit and loss sharing may indicate that B is performing services for the partnership which reflects her increased allocation of profits over the proportionate share of capital of 42.86 percent. If A outside of the partnership context wished to loan B \$12.50, which is the amount of capital representing the difference between 50 percent of profits and losses and 42.86 percent of the profits and losses, without B paying any interest, current tax law on below market rate loans would require an imputation of interest income to A and a recharacterization of the transfer of value to B to reflect the reality of the situation as either a gift, compensation for services to be provided to A by B, rental in the form of the property provided from B to A, or if A were a corporation and B a shareholder, a distribution of corporate profits. *See* I.R.C. § 7872(a),(c) (1988). By taking the simple situation of a demand loan and an applicable federal rate of interest of ten percent, profits of \$1.25 would have to be taxed to A, and then transferred to B with a characterization based on the relationship between A and B. *See* I.R.C. § 7872(a)-(c) (1988). If the agreement provided that the partnership would continue for a period

Finally, in a partnership, shifting profit and loss ratios or profit ratios not relative to capital accounts could represent risk borne through time by purely capital providers. Unlike stock in corporations, the partnership specifically allows the parties to divorce profit and loss values from capital values.⁴⁵⁷ Where the differential between profit ratios and capital accounts does not reflect a service contribution by one partner, the "borrowing" of financial capital by one partner should not cause income of the partnership to be recharacterized absent some

of ten years, the transfer would be treated as a transfer of present value of \$4.81 from A to B and B would be required to pay back the additional \$7.69 to A over the ten year time period with the payments taxable to A on an amortization schedule and deductible for or capitalized by B. The recharacterization proposal differs from § 7872 in two respects. First, the proposal does not impute income when the partnership does not have income, but recharacterizes income when earned. If the partnership has no profits, then there is no interest imputed to either partner. Section 7872 creates income from the imputed transfers generally except for the very limited circumstance for certain gift loans where the borrower does not have any investment income. See I.R.C. § 7872(d)(1) (1988). Second, § 7872 treats the amount transferred as from the lender to the borrower and then retransferred from the lender to the borrower as interest. The transfer and the retransfer creates income for each party and potential deductions which has the effect of capitalizing payments. Applying either the demand loan analogy of the term loan analogy to the partnership profit allocation between A and B, the imputation of the recharacterized amount would be accomplished on the tax returns of the partners to whom the income of the partnership was allocated, much like I.R.C. § 7872 (1988). See Schmolka, *supra* note 55, at 306-07 (analyzing the transfer as a demand loan). I.R.C. § 7872 by its explicit terms does not apply to a disproportionate allocation of profits relative to capital accounts. Nonetheless, applying the methodology of I.R.C. § 7872, this imputed amount would be in addition to the amount of profits actually divided between A and B. On the retransfer of the imputed amount, each respective partner would receive a deduction for interest or salary if the payment would be deductible and no deduction if it were capitalizable or otherwise nondeductible. See Schmolka, *supra* note 55, at 312 n.105; see also Kamin, *supra* note 15, at 27-53 to 27-62. The proposal could be refined to add capitalization which would be accomplished by increasing the amount of income realized by the partner whose transfer to the other is capitalized and then creating a basis in the partnership for that amount.

While recharacterization under the I.R.C. § 7872 model could be used, it creates greater complexity than the simple recharacterization model described in *supra* note 447 which is applied without reaching the issue of capitalization of the recharacterized payments, but could be adapted to a system that would consider that further step. Since there is no requirement that B be required to pay back the loan out of B's capital but only through the provision of partnership profits, if there are no profits then the repayment and allocation of income would not be made, and A would bear the risk of loss like any other nonrecourse lender. If B were not performing services for the partnership (that is, if the additional 7.14 percent of profits in the above example did not represent additional value provided by B), such allocation would be an assignment of income from A to B. However, where B provides services, B loses the time value of her human capital if there are no profits. These results to A and B in the partnership suggest treating the transaction as a demand loan and also not imputing any interest or salary until profits are realized. See *supra* note 447.

457. Even if stock, such as preferred stock, has a dividend on the common shares, the value of the preferred shares should represent the proportionate value of the interest relative to the other equity interests based on the present value of the cash flow and rights on liquidation.

form of disguised gift or other transfer.⁴⁵⁸ The differentials there should be presumed to represent arm's length sharing of risk. Thus, while the profit and capital account sharing differential for recharacterization of the borrowing conforms with norms for borrowing and salary, it still reflects the problem in all but the simplest cases of disaggregating the returns from labor and capital in a pooled venture. A rule is required to implement the differential view of income recharacterization to look at all the facts and circumstances as to whether the differential reflects payment for services and borrowed capital.

C. Contributions

1. General Principles

When participants contribute assets and human capital to a firm, there is both a sharing of risk and a diversification of the existing asset risk.⁴⁵⁹ Viewed as risk-shifting, the transaction creates a tax able event under a realization-based system; viewed as a continuation of an existing risk and the taking on of an additional risk through the lack of liquidity of the interest received, a realization based system would not impose a tax.⁴⁶⁰ Early views of the partnership reflected a risk-sharing view.⁴⁶¹ Risk-sharing under uncertainty and risk aversion show that both contributions of human and financial capital to firms ought to be nonrecognition events.

2. Property Contributions

Early interpretations found no realization on partnership contributions based on the formal relationship between partners under state law.⁴⁶² The current tax system treats generally property contributions

458. For a discussion, see *supra* notes 445 & 447 and Table 10 at p. 400.

459. For example, a corn farmer who forms a partnership with a cattle rancher now shares the risk of the corn and cattle markets and diversifies the risk of the corn market.

460. See *infra* text accompanying notes 484-85; cf. Lane, *supra* note 229.

461. This is implicit in I.R.C. § 721 (1988), but has its roots in early interpretations. See *Archbald v. Commissioner*, 27 B.T.A. 837, 844 (1933) (no realization in shifting title of contributed property from the individual to the partnership).

462. The Service's early application of the aggregate principle did not treat the diversification by contributions of property as sale events. See, e.g., Gen. Couns. Mem. 11,557, reprinted in XII-1 C.B. 128 (1933); Gen. Couns. Mem. 10,092, reprinted in XI-1 C.B. 114 (1932) (revoked for other reasons by Gen. Couns. Mem. 26,379, reprinted in 1950-1 C.B. 58). They were deemed analogous to a transfer of property to oneself. *Mim.* 4311, XIV-1 C.B. 208 (1935); *ROSWELL MACGILL, TAXABLE INCOME* 119 (1936). They were also viewed as not a realization event or a closed transaction. See Gen. Couns. Mem. 10,092, reprinted in XI-1 C.B.

as nonrecognition events,⁴⁶³ while specific Code provisions prevent disguised sales.⁴⁶⁴ Other provisions tax the contributor upon pre-contribution appreciation or depreciation upon partnership realization events.⁴⁶⁵ The section 704(b) regulations provide a mechanism to allocate unrealized appreciation or depreciation to the existing partners on admission of new members to the firm in so-called "reverse-section 704(c)" allocations. These allocations are mandatory if capital accounts are revalued because the partners are contributing property to a new partnership upon admission of a new partner or upon a change in profit-sharing agreements.⁴⁶⁶ The mandated reverse-section 704(c) allocations throughout the partnership do not apply when profit-sharing

114 (1932). Such non-taxation was also based on the theory that the partnership interest lacked a fair market value. See *Helvering v. Walbridge*, 70 F.2d 683, 684 (2d Cir. 1934), *cert. denied*, 293 U.S. 594 (pre-I.R.C. § 704(c) bifurcation of contributed property). Some early commentators argued for taxing contributions. See Note, *Taxation of Contributions of Appreciated Property to Partnership Capital in Kind*, 86 U. PA. L. REV. 413, 416 (1938) (arguing that the partnership interest is an "assignable right" to be repaid the capital contribution out of partnership assets before profits and surplus are shared); Note, *Sale of Property Contributed to Partnership-Gain Accruing Prior to Contribution*, 34 COLUM. L. REV. 1562, 1563 (1934). On nonrecognition for partnership contributions, see Rabkin & Johnson, *supra* note 126, at 912 (difficulty in attributing fair market value to the unmarketable entity interest of the partner). Other factors were noted to weigh against taxing contributions: (1) administrative aversion to a rule that necessitates multiple computations of profit and loss and (2) the theory that an event "which fixes tax liability be an incident of substantial economic consequence." *Id.* at 918.

463. See I.R.C. §§ 721-23 (1988); *supra* notes 69-72 and accompanying text. But see I.R.C. § 721(b) (1988) (recognition of gain for transfers to certain investment partnerships whose value consists more than 80 percent in readily marketable stock, securities, and traded investments).

464. I.R.C. § 707(a)(2) (1988). The regulations define several facts and circumstances aimed at finding a "sale", see Treas. Reg. § 1.707-3(b)(2) (1992), and generally "entrepreneurial risks," see Treas. Reg. § 1.707-3(b)(1)(ii) (1992). The premise of entrepreneurial risk is only mentioned once in Treas. Reg. §§ 1.707-0 to 1.707-9, even though it is part of the operative test. See Treas. Reg. § 1.707-3(b)(1)(ii) (1992).

465. See I.R.C. § 704(c) (Supp. 1992); I.R.C. § 737 (Supp. 1992). The methods include deferred sale or partial deferred sale, deficit offset, and curative allocations. See Treas. Reg. § 1.704-3 (1993). These prevent the distortions caused by the ceiling rule in the regulations, which treats the maximum basis for the partnership as the basis in the hands of the contributor and causes distortions in allocations to the other partners. See Boyd K. Dyer, *Tax Conflicts in Partnership Contributions*, 1974 UTAH L. REV. 491, 495 (theoretical calculation of discounts for ceiling rule distortions); Gergen, *supra* note 12, at 20 (revaluation and admission); Gregory J. Marich & William S. McKee, *Sections 704(c) and 743(b): The Shortcomings of Existing Regulations and the Problems of Publicly Traded Partnerships*, 41 TAX. L. REV. 627 (1986) (distortions from the ceiling rule).

466. See Treas. Reg. § 1.704-1(b)(2)(iv)(f) (as amended in 1993). Contrary to Gergen's assertion, while the rules do not directly apply if there is no revaluation of assets, the lack of a revaluation is tested under other tax principles and if its effect is to produce tax consequences of a gift or a deductible payment of an otherwise capitalizable expense, then the capital change would be taxed under other rules and accelerate the otherwise deferred transaction. See Treas. Reg. § 1.704-1(b)(1)(iii)-(iv) (as amended in 1993).

ratios change without an additional contribution or distribution.⁴⁶⁷ The motivations for such a failure to apply section 704(c) are tested under a number of generalized tax principles.⁴⁶⁸ The tax treatment of reverse-section 704(c) transactions is correct, since a partnership that does not revalue its assets does not create an absolute positive capital account adjustment to the other partners: the risks or fluctuations in value are borne by all partners. Arm's-length bargaining causes partners to require a revaluation of assets when they bet on the assets to increase, and when the remaining partners have an increased profit-sharing ratio. Partnership taxation's hallmark is the ability to choose to make that bet and to adjust in a multi-period setting for effects of taxation and the economic results required by the partners.

3. Efficiency Arguments for Nonrecognition

The general policy for nonrecognition on contributions is that legal shifts of proprietorships to partnerships or to corporations should not entail adverse tax consequences.⁴⁶⁹ Nonrecognition is viewed as an incentive to risk-bearing for normally risk-averse taxpayers who commit existing assets to an uncertain venture; taxpayers invest on an after-tax basis and counters a decrease in the rate of return for a risky capital transaction if contributions generate a tax cost.⁴⁷⁰ Tax-free formation of the firm promotes efficient risk-sharing. It increases society's income

467. Treas. Reg. § 1.704-1(b)(2)(iv) (as amended in 1993). The regulations allow revaluations not accompanied by a non-de minimis contribution or distribution only in securities partnerships. Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)(iii) (as amended in 1993).

468. Treas. Reg. § 1.704-1(b)(1)(iii)-(iv), (b)(2)(iv)(f) (as amended in 1993).

469. See *Bazley v. Commissioner*, 331 U.S. 737, 740 (1947) (examining the predecessor of § 351 in the 1939 Code). In both instances, Congress views this as a continuity of investment in the property, and hence an inappropriate time to require recognition of gain. *Id.*; BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 12.21, at 12-24 to 12-25 & n.22 (6th ed. 1994). The theory of continuity of investment has been expressed throughout the tax law as the rationale for nonrecognition. The legislative history pertaining to the predecessors of §§ 1031, 351, and 368 demonstrates the deferral nature of the three provisions. See H.R. REP. NO. 704, 73d Cong., 2d Sess. 13 (1934), reprinted in 1939-1 C.B. 554, 564. Despite the fact that the nonrecognition provisions for like-kind exchanges were questioned early in the legislative process and justified under what has been termed a "res" theory of income, see Kornhauser, *supra* note 230, at 427 & nn.68-69, the arguments for nonrecognition for the like-kind exchange and the exchange of securities in reorganizations reaffirm the allowance of tax-free incorporation. *Id.* at 406 & n.16. For the corporation, contributions were not taxable to the corporation and the shareholders under several theories. See Patricia L. Bryan, *Cancellation of Indebtedness by Issuing Stock in Exchange: Challenging the Congressional Solution to Debt-Equity Swaps*, 63 TEX. L. REV. 89, 107-20 (1984).

470. See *supra* notes 110-11, 202 and accompanying text.

by lowering costs, supporting a dynamic view of entrepreneurial and other risk-taking activity filling production and investment gaps.⁴⁷¹

If contributions to firms are taxed upon formation, there will be a lower level of formation of partnerships because the supply of human and other capital to partnerships is elastic.⁴⁷² For example, because of the difficulty in obtaining nonrecourse loans generally, risk-prone lenders of capital may be able to generate efficiency and risk-bearing gains by teaming with suppliers of labor. The partnership form is a substitute for a nonrecourse loan and a contribution of cash to the partnership.⁴⁷³ Taxing one transaction and not another distorts investment and efficient risk-bearing.⁴⁷⁴

This argument is a variant on the lock-in argument for a capital gains preference: the investor either will stay locked-in to an asset or will be able to borrow against an asset without making a sale, resulting in a lower rate of tax on the transfer.⁴⁷⁵ If alternative transactions are available, a tax on contributions causes excess burden.⁴⁷⁶ If the risk-

471. Cf. LAWRENCE LINDSEY, *THE GROWTH EXPERIMENT* 183-87 (1990) (arguing for investment neutrality in the decision to take risk and a pro-investment tax policy). See also Ronald J. Gilson & Robert H. Mnookin, *Sharing Among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profits*, 37 STAN. L. REV. 313, 334-35 (1985) (discussing how diversified firms outbid undiversified individuals, thus lowering costs generally and increasing income). In essence, the argument for nonrecognition may be an argument for a cash flow tax on business investment. There is an implicit tax on the value of the contribution and appreciation in the asset and an immediate offsetting deduction for the reinvestment of that asset in the business activity. The government becomes a full partner in the investment decision and the question is whether this is a desirable mechanism for increasing investment. LINDSEY, *supra* at 183-87. But cf. Gerardi et al., *supra* note 202, at 309.

472. See *supra* text accompanying notes 320-25. On the inelasticity of the aggregate labor supply, see ATKINSON & STIGLITZ, *supra* note 218, at 48-59; JOSEPH A. PECHMAN, *WHO PAID THE TAXES, 1966-85?* 27-31 (1985).

473. Viewing contributions as nonrecourse loans, nonrecognition also helps to correct the imbalance between the lesser ability of new enterprises to obtain loan funds and investment borrowing. See STEUERLE, *supra* note 160, at 108-11, 132 (noting that new businesses are unable to take advantage of tax incentives since most lenders give new loans to those with cash flow in excess of the amount needed to cover interest due on outstanding debts; accordingly, at the margin many businesses are able to negotiate loans for new investments based on the cash flow from all activities, not just new investments).

474. See *supra* text accompanying notes 403-07.

475. See Richard L. Schmalbeck, *The Uneasy Case for a Lower Capital Gains Tax: Why Not the Second Best?*, 48 TAX NOTES 195, 200-01 (1990) (suggesting that the lock-in problem is the strongest rationale for a lower capital gains tax). But see Daniel I. Halperin, *Why Not The Best? Retain Equal Treatment of Capital and Ordinary Income*, 48 TAX NOTES 368 (1990).

476. An investor in a business entity can retain the asset, sell it, borrow against it, lease it, lend it, or contribute it to the venture. If a choice is between selling and borrowing or leasing, the elasticity of preference for the amount of income or gain after-tax relative to the before-tax value of the contribution is the taxpayer's relevant consideration.

sharing possibilities are different from the taxation of the borrowing or other transaction and there is a real or perceived increase in value to the taxpayer from the venture, there will be less excess burden.⁴⁷⁷ The reluctance to engage in the transaction if it produces a tax cost relative to the value of borrowing or leasing⁴⁷⁸ precludes the asset owner from joining the venture. Comparing the leasing transaction and sale transaction demonstrates that taxes are avoidable in one situation and not the other. Assuming that taxpayers will avoid taxes, taxation of appreciated property capital is discretionary. Partnership contributions are more tax elastic than sales of property to third parties; the nonrecognition on contributions to a partnership is rationalized on an economic efficiency ground.⁴⁷⁹

Nonrecognition is justified by symmetry with human capital investments. Unlike financial capital, only the investment return or income stream from human capital is taxed rather than its net asset value.⁴⁸⁰ Nonrecognition for financial capital may be justified as a form of parity with the treatment of human capital.⁴⁸¹ Distinguishing

477. For example, a taxpayer possesses an asset that produces an income stream of \$100 per year and has a present value of \$500 and an adjusted basis of \$200. Given a 25 percent tax on gains, the taxpayer will have to value the interest to be received in the business venture at more than \$425 which is her after-tax investment. If the ownership of the other assets within the business creates a positive utility by shifting the risk of loss favorably to another person with the asset at a nominal value of \$500, then the required rate of return will be less than \$425 because of a perceived increase in value by the contributor. On the other hand, the market does not reward investors for diversifiable risk-bearing and that the only risk of an asset is the systematic risk of the market. See generally, Linda A. Schwartzstein, *Austrian Economics and the Current Debate Between Critical Legal Studies and Law and Economics*, 20 HOFSTRA L. REV. 1105 (1992). A diversified portfolio of assets is less risky than the single asset alone, but an investor's value placed on the investment should be the same as the asset contributed. See *supra* notes 181-85. The gain is a change in the taxpayer's investment, not in the absolute value to be received.

478. See *supra* text accompanying notes 399-407.

479. Professor Daniel Shavero reasons that a "better rationale for not taxing the quantum of real change upon a contribution of property to a partnership is the easy avoidability through alternative arrangement such as leasing the property to the partnership." Shavero, *supra* note 151, at 50. Professor Shavero distinguishes the sale of property outright to a third party based on the reasoning that, if two or more persons are willing to form a partnership, they are willing to contemplate an ongoing contractual relationship such as a lease alternative. A third-party sale would be preferred only where the ongoing contractual relationship is too costly. Thus, the sale is likely to be more inelastic than the contribution of property to a partnership. *Id.*

480. See DODGE, *supra* note 394, at 107-09; see also Michael J. Boskin, *Notes on the Tax Treatment of Human Capital*, in OFFICE OF TAX ANALYSIS, DEPARTMENT OF THE TREASURY, CONFERENCE ON TAX RESEARCH 185 (1975).

481. The present value of human capital is not taxed currently; only the income stream from capital is so taxed. There is a tax symmetry by treating capital transactions as not generating a tax and only taxing the investment returns in a contribution transaction. For

between nonrecognition for human and other capital contributions distorts capital taxation as compared to wage income.⁴⁸² To the extent that assets contributed to a firm are deployed in production or in a balanced portfolio investment, they may become illiquid.⁴⁸³ To the extent a contributor sacrifices liquidity for a contribution to the partnership and asset deployment-business or investment activities, "liquidity preference"⁴⁸⁴ also supports nonrecognition on contribution transactions. An asset in a business enterprise may be less valuable than the asset in isolation because of the illiquidity of the ownership interest in the enterprise and the uncertainty of the outside market's assessment of the enterprise.⁴⁸⁵ These efficiency concerns point to parity for nonrecognition for contributions when compared to alternative transactions and the wealth restraints in the form of illiquidity that contributions to firms may pose.

The general observations on nonrecognition must be compared with other rules, such as the taxation of options, leases, and nonrecourse borrowing. Nonrecognition for contributions (and distributions) can be justified by viewing the firm and the participants as holding options on all of the assets, thus acting as a response to uncertainty.⁴⁸⁶ Option taxation reflects a deferral view of the income tax and is akin to the treatment of property contributions.⁴⁸⁷ A premium received for

analysis, see JAMES DAVIES & JOHN WHALLEY, TAXES AND CAPITAL FORMATION: HOW IMPORTANT IS HUMAN CAPITAL? (National Bureau of Economic Research Working Paper No. 2899, 1989).

482. STEUERLE, *supra* note 160, at 149. It exacerbates the difference in the tax arbitrage between the two forms of income even though tax arbitrage can and does affect both. *Id.* Capital owners may be more likely to incur risks than wage earners. *Id.*; see also *supra* text accompanying notes 327-29.

483. See *supra* note 485 and accompanying text.

484. See Rudnick, *supra* note 39, at 1108 & n.482, 1109-10.

485. In such a situation, the value of the asset although diversified is at a potential loss or discounted for illiquidity. See generally JOAN ROBINSON, THE RATE OF INTEREST AND OTHER ESSAYS (1952) (analysis of types of illiquidity). Alternatively, borrowing can be viewed as double illiquidity: a lender substituting a liquid asset, cash, for an illiquid asset, an I.O.U., and the deprivation of the borrower of one possible source of liquid funds to which she could otherwise resort in an emergency or in the face of unforeseen profit opportunity. See N.J. Cunningham, *Business Investment and the Marginal Cost of Funds*, 10 METROECONOMICS 60 (1958).

486. See Stephen A. Ross, *Options and Efficiency*, 90 Q.J. ECON. 75 (1976). A warrant or option is a presently exercisable right to purchase property for a fixed consideration. It is generally a right to buy or sell property rights at a predetermined price within a specified period of time. In exchange for a payment, the owner of the option has the right, but not the obligation, to acquire (a call option), or sell (a put option) the underlying property rights. Lack of obligation distinguishes options from a futures contract for the purchase or sale of an asset.

487. See Yishai Beer, *Nonrecourse Loans: Do Not Forget to Tax the Option*, 53 TAX

granting an option is not income to the issuer. Instead, the option holder becomes the surrogate taxpayer because no deduction is allowed.⁴⁸⁸ Neither is the exercise of an option to acquire property a realization event for the holder.⁴⁸⁹ Under, current time value of money taxation,⁴⁹⁰ interest on the increasing value of an option is not imput-

NOTES 837, 841-42 (1991) [hereinafter Beer, *Nonrecourse Loans*]. Option theory and the current taxation of options set forth the nature of the relationship between partners and partnership assets. The cross-option theory means that the partners are both writing call options on the particular assets contributed and are receiving call options on the assets contributed by the other partners or later received by the firm. See *id.* at 837; see also Yishai Beer, *The Taxation of The Risk Component in a Loan: An Option Analysis*, 57 TAX NOTES 525 (1992); cf. Yishai Beer, *Toward Extension of the Option Tax Legislation: From Option "In Personam" to Option "In Rem,"* 58 TAX NOTES 1097, 1100-05 (1993) (extending the analysis to human capital).

488. See I.R.C. § 1234 (1988 & Supp. 1992). The complex tax rules governing options can be viewed as a response to the problem of when to tax the grantor of an option contract. When a taxpayer grants an option she generally receives cash. In turn, the taxpayer incurs legal obligations. This situation can be viewed in the following ways: (1) suspended open transaction; (2) sale or exchange; (3) open transaction with adjustment of basis; (4) gift/loan; (5) installment sale; (6) account payable; and (7) borrowing transaction. For the history of the taxation of options and the argument that a grantor ought to have income on the receipt of an option due to the similarity to the option receipt with the taxation of other contingent receipts, see Bruce Kayle, *Realization Without Taxation? The Not-So-Clear Reflection of Income From an Option to Acquire Property*, 48 TAX L. REV. 233 (1993).

489. See *Palmer v. Commissioner*, 302 U.S. 63, 70-73 (1937); *Knop v. United States*, 234 F.2d 760, 765 (8th Cir. 1956).

490. This is not to suggest that the rules could not be changed. See Shuldiner, *supra* note 161, at 269-72. Interest could be accrued on option elements when they are attached to a debt instrument. This is not to say that a naked option, unattached to a debt instrument, would have interest imputed under current law. See Kenneth H. Heitner & Jonathan M. Kushner, *To Bifurcate or Not to Bifurcate: The Answer Becomes Less Clear*, 46 TAX LAW. 43, 62-81 (1992). In a realization-based tax system, the sole concern is for the appropriate compensation of the time value of money with respect to the option element imbedded in property. See Beer, *Nonrecourse Loans*, *supra* note 487, at 838.

Options can be viewed as loans when the option grantor receives the use of the money of the option holder, but the option's increasing value and the use of the money inures to the holder's benefit. The analogy is to the option that each partner has on specific partnership property. The exercise of an option, although increasing in value over time, should have a portion of its value taxed as interest, and is expressed as having both intrinsic and time value. The increasing value of an option reflects a passage of time increase since part of the value is determined by the payment of funds in the past for future rights. This payment is reflected in the pricing of options. *Id.* See generally Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973); Fischer Black, *Fact and Fantasy in the Use of Options*, 1975 FIN. ANALYSTS J. 36, 41. Interest on the option component is increasingly viewed as an issue of taxing the time value of money. See Beer, *Nonrecourse Loans*, *supra* note 487, at 838. For example, I.R.C. § 483 applied to deferred payments of stock made pursuant to a sale or exchange of property, including a reorganization qualifying under I.R.C. § 368(a)(1) that had a contingent stock payout. See *Katkin v. Commissioner*, 570 F.2d 139, 143 (6th Cir. 1978); *Solomon v. Commissioner*, 570 F.2d 28, 30 (2d Cir. 1977); *Jeffers v. United States*, 556 F.2d 986, 993-94 (Ct. Cl. 1977). A portion of the stock was treated as unstated interest, which was deductible by the payor and includable in income

ed.⁴⁹¹

Contributions can also be characterized as leases and loans. Assets are always available for leasing. As set forth above, shifting the risk of ownership in exchange for a rental payment under a lease may be even greater than for a contribution.⁴⁹² Even if the rationale for treating mortgaging-out for nonrecourse debt as a realization is not persuasive,⁴⁹³ the analogy does not hold where the nonrecourse borrowing receipt is in an illiquid ownership interest in property subject to the tenancy-in-partnership or other state law rules under which no individual has a right to specific property. Nonrecourse borrowing shifts risk, although not to the extent of a partnership contribution where there is also a diversification of risk.⁴⁹⁴ Diversification is at the heart of the firm: it diversifies the risk of specific capital, but it has its own risks based on redeployability of the assets, the business of the firm, and the risks of the firm.⁴⁹⁵ Diversification of risk can also be accomplished outside the firm with a *Woodsam* borrowing,⁴⁹⁶ where the borrowed proceeds are reinvested in other assets.⁴⁹⁷ The ability to

by the payee. See *Katkin*, 570 F.2d at 143; *Solomon*, 570 F.2d at 32; *Jeffers*, 556 F.2d at 993-94.

491. See David P. Hariton, *The Taxation of Complex Financial Instruments*, 43 TAX L. REV. 731, 759-60 (1988).

492. See *supra* notes 399-402. The analogy to leasing is straightforward. A lessor who leases property for its entire useful life but retains a slight reversionary interest has shifted the risk of decline in the value of the property to the lessee less the reversion. If the reversion is valued at 5 percent of the present value of the property, the risk of decline borne by the lessor is quite small. If the same property is contributed to a partnership in which the contributor has a 25 percent profit and loss interest, there is a greater retention of a risk of loss with respect to the asset in the contribution transaction. This is the case even if a deferred sale approach is applied with respect to the asset, since the decline in value as of the date of contribution is still retained 25 percent by the contributor, rather than merely 5 percent as in the lease.

493. Some commentators argue for a rule that provides for recognition of gain on borrowing against unrealized appreciation. See Cheryl D. Block, *The Trouble with Interest: Reflections on Interest Deductions After the Tax Reform Act of 1986*, 40 U. FLA. L. REV. 689, 709 (1988).

494. The distinction between risk-shifting and risk diversification may be important, since asset diversification alone was the rationale for the 1967 amendments to § 351 and the 1976 amendment adding § 721(b). See William S. McKee et al., *The Tax Reform Act of 1976: Changes Affecting the Taxation of Partnerships and Partners*, 33 TAX L. REV. 485, 542-43 (1978). In the partnership context, transference of nonidentical securities could still be a non-recognition event if the partnership agreement allocated the partner the income from those assets and returned them to her upon liquidation. See S. REP. NO. 938, 94th Cong., 2d Sess. 99-100 (1976), reprinted in 1976 U.S.C.A.N. 4030, 4069-70.

495. See Stuart M. Gerson, *When Lawyers Must Disclose*, N.Y. TIMES, Apr. 9, 1992, at A25 (discussing risks of human capital diversification, which include law suits, asset injunctions, and settlements against large law firm partnerships).

496. See *supra* text accompanying note 406.

497. If nonrecourse borrowing is risk-shifting, reason exists to distinguish recourse from

diversify risk within a firm means lower transaction costs, which produce efficiency gains.⁴⁹⁸

4. Service Contributions

Service partners epitomize the clash between the pass-through of partnership income and the decision to tax individuals on realized gains.⁴⁹⁹ Neutrality toward the taxation of service transactions outside of Subchapter K indicates the appropriateness of the equity and efficiency arguments for a pooling approach to receipts of rights to future profits.⁵⁰⁰

a. Receipt of Profits and Capital Interests

Current law taxes a service provider contributing human capital when she receives either a vested capital account with value⁵⁰¹ or a share of future profits with a determinable or more than "speculative" value.⁵⁰² The Service has issued safe harbor guidelines defining capital

nonrecourse borrowing or the value change by pooling capital. There may be problems in encouraging nonrecourse borrowing. The partners may not advance social and economic well being if they accelerate consumption through nonrecourse borrowing. Taxing borrowing to finance consumption is a basis to treat a *Woodsam* borrowing as a realization event. Therefore, the only general, favorable policy approach for *Woodsam* nonrealization borrowing is borrowing to finance savings. If borrowed amounts are transferred to other forms of savings, the transfer of the asset's risk is defensible.

498. Homemade leveraging is more expensive than firm level borrowing.

499. Whether the statutory scheme in I.R.C. §§ 707 and 721 is inapplicable to profit's interest based on a theory that the nonrealization is incorporated into current law is not the issue. See generally MCKEE ET AL., *supra* note 19, at ¶ 5.02[1][b], at 5-13 to 5-14 and ¶ 5.02[1][c], at 55-2 to 55-9 (Cumulative Supp. No. 2 1991). This same position was advocated in an amicus brief filed by a client represented by McKee in *Campbell*, Brief for American Film Marketing Ass'n et al. at 5-14, *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991). Alan Gunn argues that taxation of profit's interests is not a fair reading of the legislative and regulatory record. See Alan Gunn, *Partnership Interest for Services: Partnership Gain and Loss?*, 47 TAX NOTES 699 (1990). But see Mark P. Gergen, *Why a Partnership Should Recognize Gain On an Exchange of a Partnership Interest for Services*, 47 TAX NOTES 1487 (1990). The issue is whether a service partner ought to receive income for the value of her contribution in exchange for her rights in the partnership's cash flow.

500. Proposals without such a tax policy basis have been made. See *Proposal to Amend the Regulations Under Sections 83 and 721 to Define a Partnership Capital Interest and a Partnership Profits Interest, and to Clarify the Tax Treatment of Compensatory Transfers of Both Forms of Partnership Interests*, A.B.A. TAX SEC. (1987).

501. Treas. Reg. § 1.721-1(a) (as amended in 1972). A partner receiving an interest in partnership capital in exchange for services is taxed upon receipt under the rules of I.R.C. §§ 83, 721. See Treas. Reg. § 1.721-1(b) (as amended in 1972).

502. Compare *St. John v. United States*, 84 T.C. 9158 (1983) (liquidation value approach) with *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991), *rev'g* 59 T.C.M. (CCH) 236 (1990) (speculative value approach). In *Campbell*, the court held for nontaxation of a profits

and profits interests which limit invocation of taxation and review by the Service.⁵⁰³ However, failing to meet the safe harbor does not preclude a showing that the receipt is at the risk of the partnership venture.⁵⁰⁴

In a recent symposium, commentators discussed the problem of taxing the service partner on a profits interest,⁵⁰⁵ with various conclusions.⁵⁰⁶ The current system correctly provides for deferral of gain for pooling of human capital resources.⁵⁰⁷ When a service partner joins

interest based on valuation which was not viewed as evidence of fair market value. An independent appraisal was viewed as the relevant valuation standard. *Campbell*, 943 F.2d at 823. While profits interest is a reciprocal of the remainder interest left in the capital account, the court apparently reasoned that there was an economical distinction between a profits interest and a capital interest. *See id.* at 820. The court did not view a profits interest as subsumed in a capital interest, and that a carve-out of a profits interest is a transfer of capital as is a term interest in property placed in trust. *See id.* Unlike insurance, future profits interests are not subject to the law of large numbers and therefore are often not predictable or subject to valuation. *See supra* note 168. Other courts have viewed the transfer as a valuation based on the value of the services rendered. *See Hensel Phelps Constr. Co. v. Commissioner*, 74 T.C. 939 (1980), *aff'd*, 703 F.2d 485 (10th Cir. 1983).

503. *See* Rev. Proc. 93-27, 1993-1 I.R.B. 63. A capital interest is defined as an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value with the proceeds distributed in a complete liquidation of the partnership. The determination generally is made at the time of receipt of the partnership interest. A profits interest is a partnership interest other than a capital interest. Under Rev. Proc. 93-27, the Service will not treat as taxable the receipt of a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner. The safe harbor does not apply if (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease, (2) within two years of receipt, the partner disposes of the profits interest, or (3) the profits interest is a limited partnership interest in a "publicly-traded partnership" as defined in I.R.C. § 704(b). The Rev. Proc. focuses on the risk of the partner with respect to the partnership.

504. *See* Charles H. Egerton, *Rev. Proc. 93-27 Provides Limited Relief on Receipt of Profits Interest for Services*, 79 J. TAX'N 132, 133-36 (1993).

505. *See* Castleberry, *supra* note 13; Cunningham, *supra* note 13; Schmolka, *supra* note 55. The controversy with respect to the correct taxation of service partners continues in other fora. *See, e.g.,* Henry Ordower, *Taxing Service Partners to Achieve Horizontal Equity*, 46 TAX LAW. 19, 31 (1992) (suggesting a simple pricing formula to assess the value of a service partner's interest to avoid a tax advantage).

506. One seeks to try to value all partnership profits interests on a discounted basis. *See* Cunningham, *supra* note 13, at 256-61. Another applies the liquidation value approach. *See* Castleberry, *supra* note 13, at 277-78 (based on administrability). Still another concludes that taxing the value of profits interests with ascertainable value should be the norm and in all events tax the amount as reasonable compensation. *See* Gergen, *supra* note 13, at 527-29, 555. This analysis is changed in a later article. *See* Gergen, *Service Partners*, *supra* note 13; *see also infra* text accompanying note 519. The most promising conclusion views it as a loan between the two partners and would apply § 7872, and comports with my view of interest on capital accounts and the comparison of human capital suppliers with untaxed contingent compensation employees. *See* Schmolka, *supra* note 55, at 312.

507. Other structural provisions of the Code enforce the pooling versus sale ideal. Under

a partnership, the deferral of gain allows her to be compensated with a distributive share of profits.⁵⁰⁸ Both a liquidation value approach—liquidate the partnership when the partner joins and tax the partner on any constructive receipt—and the mere “speculative” value approach to taxing profits interests view the partnership capital as both a term and a remainder interest. The more natural analog might be the manner in which contingent income is not taxed in an employment contract entitling the holder to compensation contingent upon the profits of the business.⁵⁰⁹ Human capital is not generally taxed on its expectancy value.⁵¹⁰ This is justified by the elasticity of demand for service provision and the distortions of taxation in human capital deployment decisions.⁵¹¹ The effect of wage versus lump-sum taxes for partnership taxation implies that a wage tax based on uncertain income as it is earned is more efficient than a lump-sum tax based on a present value of expected income.⁵¹² It also suggests that the risk of earlier labor taxation is a disincentive rather than a stabilizing factor. Such suggestion is further confirmed by the lack of loss-sharing by the government in human capital deployment decisions.⁵¹³

I.R.C. § 83, the value of taxable profits is subject to deferral if there are restrictions on transferability or receipt.

508. The receipt of a capital or profits interest in exchange for services will affect the claim to income of the partnership when it is earned as a distributive share. There are many accounting mechanisms to deal with this issue. See Ass’n of the Bar of the City of New York, Comm. on the Taxation of Partnerships and Other Pass-Through Entities, *The Receipt of a Partnership Interest for Services*, reprinted in 46 THE REC. 423 (1991).

509. Even if the income is a fixed right, the contract is not taxed currently. See Treas. Reg. § 1.83-3(e) (as amended in 1985). Are the psychic benefits of partnership ownership status enough to prefer the property model over the contingent compensation model? Nonetheless, the analogy to an unfunded, unsecured promise to pay of a third-party employer is not entirely accurate. A partner with a right to profits in the partnership still has a claim for state law purposes to ownership of the partnership assets under a tenancy-by-the-partnership. Likewise, in a going concern where a partnership has goodwill or going concern value, a partner receiving a profits interest for services is sharing in a capital interest where these amounts exist. Goodwill allows a greater return on assets; going concern value reflects the absence of start-up costs. See VGS Corp. v. Commissioner, 68 T.C. 563, 592 (1977); see also Newark Morning Ledger Co. v. United States, 113 S. Ct. 1670, 1681-82 (1993) (holding acquired subscription base with determinable useful life separate from goodwill). There is no transfer of value to the service provider if capital is compensated at a market rate. The only profit is derived by the increasing value of the services contributed from the past or in the future by the service provider. If there is an adequate return to existing capital, the profits interest is valueless. Thus, there is no realization needing a nonrecognition rule.

510. Gergen, *supra*, note 13, at 550. Nor is taxation on expectancy value desirable. *Id.* at 549-50.

511. See *supra* text accompanying notes 320-29.

512. See *supra* text accompanying notes 320-29, 397.

513. See *supra* text accompanying notes 337-39.

Applying this principle, a bright-line approach to viewing transfers within the firm as current compensatory capital shifts becomes less compelling. That the capital providers also receive deferral is consistent with the rule as to employees. Nonrecognition also equalizes the equity of taxation of wage income received from other business entities. Where the profits interest is valued on a highly speculative approach to impose a current tax, the agency contract that service providers make to accept an *ex post* settling up rather than an *ex ante* evaluation is rewritten. A decision to value such profits interest is at odds with the need to control agency costs through incentive compensation, and the current administrative position is correct.⁵¹⁴ For service providers, the economic analysis of human capital providers who do not receive vested rights in the firm is two-fold: she is expected to sweat for equity, and she receives an implicit loan from the capital provider which reflects the capital provider's risk in a project that benefits the service provider. The fact that the service provider receives a distributive share of firm profits is supported by the indices of ownership she possesses.⁵¹⁵ Furthermore, priority under state law or in bankruptcy is lower for a service provider than for an employee.⁵¹⁶ While there is a viable line between a contingent compensation employee and an equity provider, and differing tax treatment does not *a priori* violate horizontal equity, harmonizing the treatment for service partners and contingent compensation employees is the correct treatment of the receipt of wage income. It is also correctly based on the status that a service partner has as a human capital *equity* contributor who does not share losses with the government and the bargaining between the human capital and the financial capital suppliers for the service provider's contingent compensation.

b. Capitalization and Characterization of Profits Received by Service Providers

The status of a service partner determines entitlement to distributive shares of income for tax purposes. The difference arises only if the service partner is performing services, the payment for which would be

514. See, e.g., *supra* note 57.

515. UNIF. PARTNERSHIP ACT § 18 (1914), 6 U.L.A. 213 (1969).

516. See, e.g., UNIF. PARTNERSHIP ACT § 38 (1914), 6 U.L.A. 456-57 (1969); 11 U.S.C. §§ 101(5) (claim), 502(b)(7) (terminated employment contracts), 507(a)(3) (wage priority for wages within the earlier of 90 days before filing or the date of the cessation of the debtors' business) (1988 & Supp. 1992).

capitalized if done by an employee, and a taxpayer favorable interaction between economics and tax attributes is accomplished because the rules on capitalization are avoided.⁵¹⁷ Thus, taxing service providers and capital providers raises three questions. First, should there be a recognition of gain by the capital providers when they carve out a profits interest in a partnership for the service provider?⁵¹⁸ Second, should avoidance of capitalization through the transfer of a distributive share of profits that is not otherwise taxed be remedied in the tax system? Third, should service providers be required to treat all distributive shares of profits as salary? One commentator, in changing the analysis from that in an earlier article, suggests that any compensatory allocation to a service partner should be treated as salary paid by the partnership and income to the recipient and the partnership would deduct or capitalize this expense.⁵¹⁹ The economic value to capital providers depends on the service partner's evaluation of the risk of payment for the service equity contribution. By viewing profits as highly risky, the service partner negates the tax benefit to the capital providers by demanding more in the future than a fixed payment today. The service provider may place a higher discount rate on the future profits than do the capital partners. The value of a distributive share of income is determined based on the actual presence of risk in the transaction rather than on the proposition that the capital partners, B and C, avoid capitalization through the payment of distributive share income to the service partner, A.⁵²⁰ The difference between capitaliza-

517. See McKee, *supra* note 14, at 1058-61 & n.85. The capitalization of distributions to service partners was also recommended by the A.L.I. See 1984 A.L.I. REPORT, *supra* note 97, at 221-26.

518. The carve-out, Professor Mark Gergen first argued, should be taxed to the capital providers except in the situation where basis equals fair market value. See Gergen, *supra* note 13, at 533. This is based on the failure of current law adequately to apportion basis between carve outs of term interests if such apportionment occurs.

519. Gergen, *Service Partners*, *supra* note 13, at 69. He would apply this to an allocation of current earnings and to an assignment of interest in partnership capital for services including compensatory increases in capital accounts of existing partners. Thus, on the one hand Professor Gergen would treat all profits allocations to service partners as salary, meaning ordinary income, and all salary payments by the partnership as a payment that is potentially capitalized into the basis of an asset created by those services. With respect to the issue of salary characterization, it is demonstrated that interest on capital accounts based on the profit ratio differentials between the service partner and the capital partner ought to be the true measure of a borrowing amount between the service provider and the capital provider such that only a portion of the income stream allocated to the service partner should be treated as salary and potentially the payment capitalized by the capital providers. Similarly, the allocation to the capital providers ought to be allocated as interest and presumably capitalized by the service partner. See *supra* text accompanying notes 447, 456.

520. This example is drawn from William S. McKee considering a real estate partnership

tion and amortization and a distributive share increases as the time period over which the amount must be capitalized increases.⁵²¹ The current rules on disguised sales to partnerships and related contributions accurately focus on this issue.⁵²² Lowering the tax rate lessens the difference between a distributive share and capitalization and amortization.⁵²³ Thus, the distortion between capitalization and the distributive share increases as the capital partners' tax rates and the depreciation life term increase, and decreases if the capital partners' tax rates are

admitted an architect as a service partner. He would apply I.R.C. § 263 to the acquisition of the interest and treat all distributions to service partners as guaranteed payments subject to capitalization. See McKee, *supra* note 14, at 1053. However, McKee notes that the tax benefit to the capital providers of making the service provider a partner "should generally be sufficient to enable them to make the transaction attractive to [the service provider] (e.g., by setting his expected 'fee' somewhat higher than his usual fee)." *Id.* at 1055 n.80.

521. If one assumes a 10 percent amortization of the normal \$20,000 architectural fee for the service partner, A, a 10 percent after-tax discount rate for A, which is the same as her before tax discount rate, and a 31 percent tax bracket, the annual tax deduction for B and C is \$2,000, assuming the partnership makes a payment to a third party at the end of year 1 and produces an annual tax savings of \$620, which has a present value to B and C of \$3,810 using a 10 percent discount rate. Since the present value of the payment to A is \$18,182, and the value of the tax benefits is \$3,810, the net value present cost to B and C is \$14,372. A's risk aversion would be required to be increased in order to equalize the cost of a payment to a third party that needs to be capitalized with a cost of a payment to a partner out of distributive share. Instead of \$20,000, it should be increased to \$22,912 or a risk premium amount of \$2,912 or a total risk premium of 16.016 percent on a present value of \$18,182. Thus, a tax deduction allocated to B and C of \$7,103 for the payment of a distributive share to A of \$22,912 has a present value of \$6,457 and the present value of the payment is \$20,829 for a net present value cost to B and C of \$14,372. The amount required to be paid by A to equalize the cost of capitalization, assuming a 27.5 year depreciation schedule, is \$25,652. This produces a present tax savings of \$7,952 which has a present value of \$7,229. When taken into account with the present value of the payment to A of \$23,320, the net present value cost to B and C is \$16,091. This is the same as if B and C had paid A \$20,000 at the end of year 1 and had taken a depreciation deduction for 27.5 years of \$727. This would produce an annual tax savings of \$225, or a total present value tax savings of \$2,091, which when offset against the present value of the payment to A of \$18,182 has a net present value cost of \$16,091. A's risk aversion would require a risk premium of 31.086 percent (\$5,652 divided by \$18,182).

522. As the time for payment increases relative to the time the service is rendered, it is more likely to be less risky and classified as a payment to a third party than when a payment is far-off and the service is rendered much earlier. See H.R. CONF. REP. NO. 861, 98th Cong., 2d Sess. 859-65 (1984).

523. Assuming that the amount in note 521 *supra* would be depreciated in 27.5 years, and that B and C have a 15 percent tax rate, the net present value cost of the payment to A is still \$18,182. However, the annual tax savings from depreciation to B and C is only \$109, for a present value tax savings of \$1,012 and a net present value cost of \$17,170. The equalizing payment required by A to compensate for risk would be \$22,220 rather than \$25,652. That is, the value of a deduction of \$22,220 to B and C has a value of \$3,333, which has a present value of \$3,030, which subtracted from the present value of payment to A of \$20,200 is a net present value cost to B and C of \$17,170. Thus, the risk premium required by A is only 12.21 percent (\$2,220 divided by \$18,182).

lower and the time period difference between expensing and capitalization decreases.⁵²⁴ To the extent that the service partner has a bargaining position, she will negotiate for an increased profits participation relative to the expense to the capital partners.⁵²⁵ The service provider also may take on some liability as a general partner.⁵²⁶ This general liability and pooling suggests that capital providers do not fully take advantage of the lack of capitalization of the service provider's profits payment.⁵²⁷ An approach to service partner taxation—requiring all profits to be taxed as salary—severely limits the choice that a service partner has with being a sole proprietor borrowing outside of the partnership to produce a particular asset and being a partner within the partnership. Thus, it would distort the choice between being a partner versus a sole proprietor engaging in a borrowing transaction. In essence, this approach can be circumvented by structuring the transaction as a loan with a contingent payoff to the capital providers which produces

524. That is, the distinction between a distributive share and a payment to a third party is based on the level of risk aversion of the recipient partners, the time period over which the asset is created, and the tax brackets of the other partners. As tax rates increase, there is an incentive to pay more as a distributive share. While arbitrage is possible between the relative risk aversion of the service partner and the capital partners' tax rates and the time over which the expense would be capitalized, a distortionary rule ignores the risk element borne by the service provider who accepts a risky stream of income. A service partner who bears the risk of loss in exchange for a percentage interest in the partnership avoids the capitalization requirement. This has value to the capital partners who will negotiate with the service provider for the appropriate fee based on the tax benefit of the saving to them and the perceived risk of loss by the service provider.

525. That is, she will appropriate the difference between the choice the capital partners have between employing an employee and "employing" a partner. If the demands are too onerous, then the capital partners will employ an employee and suffer the tax consequences relative to capitalization. If the demands are reasonable, then the value of the increased payment to the service partner will be taxed at her tax rate. There is no loss if the service partner and the capital partners are in the same tax bracket. If the service partner is in a lower bracket, there is a revenue loss, but the distortion is less with flatter rate schedules.

526. It would be difficult for the service provider to become a limited partner. Indeed, the partnership law may require a capital contribution in order to have limited partner's status. The determination of what constitutes taking a role in management to convert a limited partner to a general partner is questionable enough that a service provider would believe that she could continue limited partner status. Nonetheless, she could be a member of a limited liability company taxed as a partnership. The service provider may have little to risk in terms of liability because her initial wealth is low.

527. This benefit in contracting to avoid capitalization offsets the disutility from the moral hazard with respect to admitting the service partner as a partner. Moreover, the equity-loan theory of the capital account suggests that the issue is not capitalization of the entire return but merely the differential return. The choice is between picking an inflexible rule over a flexible rule which has some avoidance possibilities but is generally allocatively efficient, given the parameters of a realization-based income tax.

an efficiency loss. Because a service provider would not be able to receive capital gain on service contributions, the choice between a sole proprietor borrowing from the capital partners and a partner would be further exacerbated. To be sure, there are many projects that cannot be funded by debt capital and which require equity risks. In that case, the tax law has generally allowed service providers to share equity returns with others and to receive capital gain returns.⁵²⁸ Reforming the rule in partnerships along these lines departs radically from the tax and economic result that is generally obtainable through the use of restricted stock (or indeed a restricted partnership interest) and electing to recognize current ordinary income. The policy of allowing a service provider to capitalize service contributions through receipt of restricted stock does not differentiate the sharing by a human capital contributor with capital providers on whether those capital providers contribute debt or equity to the project. A position that so distinguishes between human and financial capital contributors to a taxation would limit the efficient bearing of risk and the allocation of human and financial capital.

The case for capitalization of the payment to a service partner is somewhat stronger. As the model with respect to interest on capital accounts demonstrates, the differential payment profits percentage from both the capital and the service partner relative to capital accounts could be viewed as a salary payment and a loan which would normally require capitalization outside of the partnership context. Can a case be made for current law treatment that does not require such capitalization? Perhaps the partner's approach to risk as outlined above suggests that the problem and the benefit to the capital partners is less substantial than previously viewed.

D. Distributions

Economic theory and efficiency suggests that where the benefits of pooling are exhausted, the partners should be given the freedom to reallocate their property ownership without a current tax cost,⁵²⁹ and to redeploy assets to their best use. The following discussion considers rationales for the current system of fungibility of basis and nonrecognition to all partners in distribution transactions.

528. The receipt of restricted stock in a C or S corporation by a service providing shareholder, or a restricted partnership interest by a service provider that would otherwise be taxed, and the election available under I.R.C. § 83 is the classic example.

529. *See supra* text accompanying notes 365-69.

1. In General

Subchapter K generally treats distributions as nonrecognition events, with special rules for contributed property.⁵³⁰ This benefits both the distributee and nondistributee partners. Any distribution is applied against the outside basis in the partner's partnership interest; the partner carries out the inside basis the partnership had in the property distributed⁵³¹ plus any special basis resulting from a section 754 election made by the partnership which increases the basis to be carried out.⁵³² While a distribution of money or property normally does not

530. See I.R.C. §§ 704(c), 731-733, 737 (1988 & Supp. 1992). Some contributions followed by distributions are taxed as disguised sales. See Treas. Reg. § 1.707-3 (1992). There are some exceptions for distribution of contributed property to others within 5 years of contribution. See I.R.C. § 704(c) (Supp. 1992). Explicit aggregate exchange is taxed under § 751(b) for disproportionate distributions of assets with different characters, but is not otherwise generally taxed under an exchange model. For a review of the partnership distribution rules in Subchapter K, see Paul Little, *Partnership Distributions Under the Internal Revenue Code of 1954 (First Installment)*, 10 TAX L. REV. 161 (1954); Paul Little, *Partnership Distributions Under the Internal Revenue Code of 1954 (Second Installment)*, 10 TAX L. REV. 335 (1955). Contributed assets do not include assets with built-in gain or loss from a reverse § 704(c) allocation caused by a revaluation of partnership property where a partner is admitted to the partnership. There, the disguised sale rules could trigger gain if any partnership assets were distributed within 2 years of the partner's admission. I.R.C. § 707(a)(2)(B) (1988); Treas. Reg. § 1.707-1 (as amended in 1983). Thus, pooled assets in the partnership are treated more favorably than assets not previously pooled. The rules before 1954 were based on the theory of co-ownership of partnership property. See Mark H. Johnson, *Property Distributions by Partnerships*, 4 TAX L. REV. 118, 121-22 n.7 (1948) (citing *Flood v. United States*, 133 F.2d 173 (1st Cir. 1943); *Commissioner v. Whitney*, 169 F.2d 562 (2d Cir. 1948)). The different treatment of distributions in the early years of the income tax was based on the theory that a partner would realize no gain or loss. See T.B.R. 34, 1 C.B. 46 (1919); LITTLE, *supra* note 127, at 206, 340 (the allocation of basis to the partnership interest and to cash and property in "mixed" distributions was an issue). Nonrecognition was not applied by the Tax Court to limited partners under the theory that nonrecognition of gain or loss upon distributions in kind was to be strictly construed. See *Woodruff v. Commissioner*, 38 B.T.A. 739 (1938), *nonacq.*, 1939-1 C.B. 69. Cf. *Boettcher*, 1939 BTA Mem. Decs. (P-H) ¶ 39,353 (T.C. July 15, 1939).

531. See *supra* text accompanying notes 73-76.

532. I.R.C. § 743 (1988). A § 754 election allows the partnership to reflect the cost of a partnership interest to a purchaser as if the purchaser had bought an undivided interest in an asset or set of assets outside of the partnership. For example, assume the AB partnership has assets with a basis of \$200 and a fair market value of \$400. If C buys B's interest for \$200, there will be a disparity between outside and inside basis. Normally C's purchase does not change the inside basis in the partnership's assets. If the partnership has the optional basis adjustments, in effect, the election under Code § 754 allows C to have a special inside basis in the amount of \$100 to be used upon sale or distribution of the assets of the partnership. This reflects the difference between the adjusted basis inside the partnership with respect to C's interest and the cost that C had for her partnership interest. See I.R.C. § 743 (1988). However, if the inside basis is \$600, the election lowers the proportionate inside basis from \$300 to \$200. The allocation under a § 754 election can cause several distortions. First, to the extent that a new inside basis is attributable to depreciable property, it can grandfather faster deprecia-

affect the basis of property remaining in the partnership or trigger gain or loss to the nondistributed partners, the section 754 election also provides upward and downward basis adjustments inside the partnership. The election reallocates any lost basis where the distributee has insufficient outside basis to the property remaining in the partnership and when in liquidation of her interest a partner applies more of her outside basis to property distributed than the partnership had in the property, the remaining inside basis in partnership property will be reduced by that amount.⁵³³ Absent the election, the partners may negotiate compensation for basis discontinuities. The elective treatment for inside basis adjustments causes selectivity in application since partnerships will elect it if it is favorable and not elect it when it will produce less favorable results.⁵³⁴ Gain is recognized when cash distributed exceeds basis, and a recent proposal may extend gain recognition in certain circumstances where marketable securities are distributed.⁵³⁵ On liquidation, all remaining basis applies to non-section 751 property, and losses are allowed only in limited situations.⁵³⁶

tion than if the property had been purchased from a third party and was not held within a partnership for which one bought a partnership interest. That is, Treas. Reg. § 1.743-1(b) (1960) provides that the basis will be used for depreciation, and only the Prop. Treas. Reg. § 1.168-2(n) (1992) provides that new inside basis will be treated as an improvement to property creating its own useful life rather than an addition to the existing depreciation schedule. Second, § 755 can cause an over-allocation of basis to depreciable property if the capital assets within the capital asset group have depreciated but there is a total appreciation in the group. I.R.C. § 755 (1988).

533. The election steps down the basis to other partners if assets receive a greater basis when distributed than they had inside the partnership or increases the partnership basis in its remaining property if the partnership loses basis in a distribution where the distributee has insufficient outside basis to absorb the partnership basis or if the distributee recognizes gain upon the distribution. I.R.C. § 734(b) (1988).

534. For example, consider the ABC partnership with three capital assets each with a fair market value of \$200. The inside bases of assets one, two and three are \$50, \$125 and \$125, respectively. A, B and C are equal partners and each have a \$100 outside basis. The partnership makes a liquidating distribution of asset one to C. Under I.R.C. § 732(b), C applies all of her outside basis to asset one and now holds asset one with a \$100 basis and \$200 value. The inside bases of assets two and three do not change under § 734(a). If the partnership sells the assets for \$200 each, A and B will each recognize \$75 of gain and their outside bases will increase to \$175 each. It is only when the partnership is liquidated that A and B will each realize, and in this example where cash is distributed, recognize the additional \$25 of gain. The liquidating distribution to C caused a favorable basis strip for A and B and was not detrimental to C. If a § 754 election was in place, the inside basis of assets one and two would each be reduced by \$25 under § 734(b). Here, the partnership would not make the election, which is difficult to revoke when made. See Treas. Reg. § 1.754-1(c) (1960).

535. See *infra* note 568.

536. I.R.C. § 731(a) (1988).

A partner would often prefer a distribution of partnership property to be made in kind, rather than as a sale of the property, in order to postpone tax liability created by a sale or to retain the property for use in another business.⁵³⁷ Distribution of property with no-tax consequences produces the most efficient taxation for both business and economic reasons.⁵³⁸ It allows flexibility in the decision to pool and unpool assets without creating tax barriers on the efficient unit from a pool. Nonrecognition on distributions is also a corollary to special allocations. Distributing a specific asset to a partner who takes the partnership's inside basis specially allocates the income to that partner; a special allocation of profits and losses relative to the property to the partner in lieu of a distribution accomplishes the same result as a distribution.⁵³⁹ Retaining the property in the partnership does entail other costs including continuing to place the property at the risk of liability for partnership debts. Exchange treatment can be accomplished under an aggregate system for non-pro rata distributions.⁵⁴⁰ For

537. See Martin Worthy, *The Tax Incidents of Readjusting Partnership Interests*, 10 GA. B.J. 413 (1948).

538. By contrast, in the classical corporate tax regime, the recognition rules on distributions of assets from corporations are necessary to fix the value of the unrealized, undistributed profits which are key to the correct timing of income for the second tax. And, where a transfer of stock is made to the firm, unlike a partnership, gain or loss will apply to the shareholder if the transaction is a redemption. See I.R.C. §§ 302, 336 (1988). This choice, based on other tax policy considerations, is not the benchmark from which distributions from partnerships should be judged. This timing consideration is a major premise of A.L.I., FEDERAL INCOME TAX PROJECT: 538.12 SUBCHAPTER C (supplemental study), Reporter's Study Draft (1989) and A.L.I., FEDERAL INCOME TAX PROJECT: SUBCHAPTER C, PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS AND REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS 1982 A.L.I. 327-33.

539. If the property remains in the partnership, the special allocation would be respected, assuming requisite pooling of other assets would mean the activity is a partnership. The § 704(c) rules prevent the special allocation from being undone. That is, when the asset is recontributed, it is required that income be allocated first to the contributing partner to the extent of the book-tax disparity. An example of the relationship of the nonrecognition on distribution rules and special allocations is the circumvention of the current rules triggering income to a contributing partner if property contributed is distributed within five years. It can be avoided by having the partnership specially allocate all items of income gain and loss attributable to that asset to the noncontributing partner, and by then having the partnership borrow an amount secured by the asset held by the partnership with the noncontributing partner bearing full responsibility for the loan under the recourse rules or establishing a profit-sharing ratio under the nonrecourse rules allocating the full amount to that partner as well as allocating all interest. The other partners then share in the income from the assets purchased by the loaned amount and the noncontributing partner bears the economic responsibility for principal and interest payments on the loan.

540. Assume in a non-pro rata distribution that partner A receives \$5,000 cash and partner B receives securities with a value of \$5,000 and a basis to the partnership of \$2,000. Assume further that the total value of the securities is \$10,000. Under an aggregate view, the

example, reduction of a profit ratio accompanied by a distribution may be analogized to a partial liquidation and require basis apportionment, although not necessarily gain recognition.⁵⁴¹ Exchange treatment is counter to Subchapter K's flexibility and fungibility.⁵⁴²

An alternative would be to apply the partial liquidation theory and require recognition of gain or loss every time a distribution reduced a partner's interest. Early commentators viewed this approach as unneces-

distribution is non-pro rata and partner *B* would be required to recognize a gain of \$1,500 (\$2,500 interest in cash received less \$1,000 basis for her interest in securities distributed to *A*). The counter-intuitiveness of the examples requires that the partner receiving a distribution of property does not recognize gain but the partner receiving cash does. See Jackson et al., *supra* note 74, at 1213. A full exchange approach would change this. This view of the aggregate characteristics on distributions would require the partner receiving the property to be first treated as if he received cash and then purchased the non-pro rata portion of the interest. Thus, *B* would recognize \$1,500 of gain and have a basis in the securities of \$3,500. Either approach would treat non-pro rata current distributions of property as exchanges between the partners of their interest in the properties distributed. Gain is recognized only to the extent that an interest in cash received exceeds the basis for an interest in property transferred, and loss is recognized only if cash received is less than the basis in the transferred interest.

541. Cf. Andrews, *supra* note 17, at 71-73. The aggregate theory can justify, in my view, a recognition of gain only by the partner receiving cash or liquid assets, not property, in a distribution, or via a § 751 approach. All partners recognize gain or loss under a constructive exchange of the property relinquished to one partner where character differences in the property justify departure from nonrecognition and exchange treatment. The argument for a carryover basis in distribution transactions is the same as for an elective basis in corporate acquisitions. See Glenn E. Coven, *Taxing Corporate Acquisitions: A Proposal for Mandatory Uniform Rules*, 44 TAX L. REV. 145, 159-73 (1989); Stephan, *supra* note 81, at 655, 659, 710.

542. The premise of Subchapter K is that once assets are contributed to a pool, their bases are fungible with respect to the partnership interest. Characteristics of assets contributed to or purchased by the pool are subsumed in the activities of the pooled venture. Allocating particular basis to properties distributed and then effecting an exchange creates unjustified complexity and distortion based on the partners' expectations entering the pool. This is not to say that the distribution rules are without fault as applied within the totality of Subchapter K. For example, the special allocation rules do not apply to property distributions and the partners can assign income by basis shifting and gain timing through nontaxable distributions which may contravene the substantial economic effect limitations. One possible refinement on the special allocation rules would be to include a tax avoidance provision as to property distributions which are entitled to nonrecognition treatment. For example, assume in the *AB* partnership that *A* is in a low bracket, and *B* in a high bracket. The partnership plans to make \$10,000 cash available to *A* and *B*. *A* is willing to take an asset with a value of \$11,000 in exchange for varying the tax on sale of that asset of \$1,000 using *A*'s tax bracket, and *B* is distributed \$10,000 in cash. Obviously, arbitrage with respect to the tax rates and timing are available between *A* and *B* that avoids the application of the special allocation rules with respect to allocation of income items, since the gain recognized by *A* is not an item of partnership gain, loss, or income. On the other hand, an open ended tax avoidance rule might raise undue complexity in decisions to distribute property in partnerships when they are unrelated to potential tax avoidance. A holding period could be required to validate nonrecognition on the distribution, for example requiring that the distributee partner in a non-pro rata distribution hold the property for two or more years in order to validate the nontax avoidance purpose.

sarily burdensome, since the carryover of basis technique in Subchapter K for distributions was argued to have the "advantage of certainty and simplicity."⁵⁴³ A non-pro rata distribution could be viewed as an exchange between the partners of their interests in the properties distributed. They rejected this approach as "unnecessarily complex and impractical," noting that partners will negotiate "any inequities resulting from this possible shifting of gains and losses by arm's length negotiations."⁵⁴⁴

2. The Challenge to Nonrecognition

The nonrecognition rules on distributions proceed from the premise of a no-tax world, and apply with respect to the partnership, the distributee partner, and the other partners. One proposed reform for distributions generally supports nonrecognition by sensibly using basis adjustments inside and outside the partnership (including a mandatory adjustment under section 734(b) with further refinements as currently occurs if a section 754 election is in place) to deal with distortions in the distribution of tax burdens among partners that may result when a property distribution results in shifts among partners in partnership unrealized appreciation, eliminating exchange treatment for non-pro-rata distributions between section 751 assets (unrealized receivables broadly defined and inventory) and non-section 751 assets (capital assets and section 1231 assets) by requiring partners to recognize ordinary income in the amount of any reduction in shares of appreciation in section 751 assets resulting from a distribution and by enlarging the class of section 751 assets to include gain attributable to depreciation regardless of

543. Jackson et al., *supra* note 74, at 1214. The 1953 A.L.I. draft adopted the current carryover rule to prevent manipulation of basis. It first considered a substituted basis approach in which the partner would take a basis equal to the basis that the partner would have had if the property would have been sold by the partnership and then taxed on the proceeds. They were not oblivious to the issue of the difference between a partial liquidation and a current distribution and the need for the partners to recognize basis effects, but they viewed the issue of pro rata and non-pro rata distributions differently.

544. *Id.* at 1213-14. They did note that "a disproportionate allocation of the burdens might be advantageous in that the low basis property could be currently distributed to a low bracket taxpayer or to one with compensating losses." *Id.* at 1214. This carryover approach differed from the 1939 Code view that first referenced the basis of the property to the partner's interest. Section 113(a)(13) of the Revenue Act of 1934 applied a basis for distributed property related to the partner's basis for all partnership property reflected in her partnership interest. *See* H.R. REP. NO. 704, 73d Cong., 2d Sess. 18 (1934). The Service allowed a mixing of basis by interpreting the valuation issue to be the proportionate interest to the basis in all partnership assets and the proportionate value of the asset to all partnership assets. *See* Gen. Couns. Mem. 20,251, 1938-2 C.B. 169.

characterization as ordinary income, and taxing a distributee partner who receives a non-pro-rata distribution of cash as if part of her interest is redeemed by allocating only part of her outside basis proportionate to the value of the interest redeemed.⁵⁴⁵ In addition, to avoid problems with section 704(c), the proposal taxes nondistributee partners on their proportionate share of gain or loss if a current distribution of property is made to a distributee partner who does not reduce her relative profits interest.⁵⁴⁶

If unpooling transactions generate a tax, the inefficient pooling of assets will continue.⁵⁴⁷ Thus, requiring that nondistributee partners recognize their respective shares of gain or loss on the properties leads to inefficiency. For example, if the partner receiving the asset wants the asset, and the nondistributees see that it is less valuable in the pooled venture than to the prospective distributee, imposing a tax cost on the nondistributees in the unpooling transaction is a disincentive to pooling. Because partners can agree to bear as little as one percent of the income, gain, or loss from an asset,⁵⁴⁸ the partners could agree to allocate the income specially from the asset in the pool to the partner desiring the asset, and then lease the asset to the partner for an arm's-length rental. As set forth previously,⁵⁴⁹ this ability to use special allocations alone or special allocations in combination with leasing negates the effect of a recognition rule on distributions.

Rules that tax distributions of property from partnerships can also be avoided by subpartnerships which accomplish substantially the same effect of a nonrecognition transaction upon distribution.⁵⁵⁰ A rule

545. See Andrews, *supra* note 17, at 70-71, 75 & n.240 (stating "[t]he proposals throughout this article are constructed on the unexamined assumption that the basis will continue to be allocated between cash and other distributed property in a manner that minimizes current gain recognition" and noting other ways of allocating basis to the distributed property); Cunningham, *supra* note 17, at 77-102.

546. See Andrews, *supra* note 17, at 71-73; Cunningham, *supra* note 17, at 102-04.

547. Professor Andrews' proposed rules do not refer to or provide the flexibility of the corporate unpooling rules with respect to divisive transactions (spin offs, split ups, and split offs) that defer gain recognition for the distributee shareholders and for the corporation. See, e.g., I.R.C. § 355 (1988 & Supp. 1992).

548. A 1 percent interest is sufficient under the Service's guidelines. See Rev. Proc. 89-12, 1989-1 C.B. 798. Under the case law, a partnership exists if there is a sharing within the partnership, but not necessarily with respect to all assets at all times. See *supra* note 405.

549. See *supra* note 538, 542.

550. See *infra* text accompanying note 600. Without prohibiting the formation of subpartnerships in a manner that would prevent the shifting of risk, the rules requiring a taxable transaction on distribution are wholly ineffective. Under the rubric of preventing tax avoidance, the result is different from that allowed if the partnership continued.

would be required to tax the contribution to a subpartnership, with a special allocation of subpartnership income in a manner different from that in which income from the asset was generally shared while previously held in the partnership.⁵⁵¹ Such a rule would be difficult to draft, and would limit the existing rule that an admission of a new partner does not cause gain recognition by the existing partners.⁵⁵² Transaction costs also are avoided by the flexible rules on unpooling. Furthermore, because the regulations do not allow revaluation of capital accounts merely upon changing profit-loss ratios unaccompanied by a contribution or distribution,⁵⁵³ the partners incur added risk by keeping the asset in the firm.⁵⁵⁴ Treating non-pro-rata distributions as recognition events where profit ratios do not change adds complexity to what

551. This would be extremely complicated if the asset was a multi-use asset and income generated from it was allocated in different ways. It would be easier if the income from the asset were shared say 1/3, 1/3, 1/3 and one partner received 98 percent of the income from the subpartnership.

552. Reverse § 704(c) allocations and revaluations could be mandatory and would lock in the tax and economic consequences to all partners on an admission of a new partner or the contribution of a partnership asset to a subpartnership in exchange for a partnership interest in the subpartnership allocated income from that asset in a different manner than in the upper tier partnership. While this might be desirable, there is no need to eliminate the benefit of deferral.

553. In other than securities partnerships, a more than a de minimis contribution or distribution is required. Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)(i) (as amended in 1993).

554. Failing to treat changing profit-loss ratios as revaluation events means that the partners will negotiate other agreements to preserve economic entitlements such as specifying rights to profits and losses based on sale prices of partnership assets. With respect to distributions, economic bargaining will generally prevent partners from allowing one partner the full benefit of deferral on distributions. The capital account rules require that unrealized gain and loss be charged to the appropriate partners upon a distribution of property. For example, assume that *A* and *B* form a partnership and each contributes \$500 to buy one asset, *Z*, for \$100 which increases in value to \$1000 and a second asset, *Y*, for \$900 which value does not change. Assume that the partners agree to share profits and losses 50/50 and the partnership distributes asset *Z* to *A* and retains asset *Y* in the partnership. Upon the distribution, *A* and *B*'s capital accounts are increased by \$450 each and *A*'s is reduced by \$1000. *A* has a negative capital account of \$50 and *B* has a positive capital account of \$950. A deficit make up obligation will have to be in place to validate the distribution. *Arm's length* dealing will induce *B* to negotiate for more returns from the firm than 50/50, because while they made equal contributions, *A* has received a distribution reducing her capital account below zero and *B* has a positive account of \$950. *Cary Brown* income is created where a party retains the interest derived from investment of deferred gains. If *B* is acting economically, *B* will require *A* to compensate *B* for the time value of the use of \$50 of *B*'s after-tax capital (reflecting *A*'s negative capital account of \$50) and \$450 of *B*'s before-tax capital. Interest on a deficit capital account will only account for the use of *B*'s after-tax capital, but interest on all capital account balances will compensate *B* for the use of \$450 of before-tax capital, that is, the return to *B* had the property been retained in the firm and generated current income reflecting its then present value. *A* will not be able to siphon off the advantage and to the extent interest is required, no *Cary Brown* income is created for *A* and *B* are in the same position as if *B* had lent *A* *B*'s share of the partnership assets.

the partners will handle by arm's-length bargaining.

In another proposal for partnership contributions and distributions, assets are revalued to current value on every non-pro rata distribution.⁵⁵⁵ The resulting built-in gain or loss would be allocated provisionally among the partners according to section 704(c) principles,⁵⁵⁶ recognized by the partnership on distribution, and like the section 311(b) rule for corporations distributing property, allocated according to the rules governing built-in gain or loss.⁵⁵⁷ Distributions of cash

555. See Gergen, *supra* note 10. Professor Gergen alleges a number of defects in the current rules on distributions especially with § 704(a)-(d) and the regulations on disguised sales under § 707(a)(2)(B). *Id.* at 181-98. Professor John Steines correctly finds Professor Gergen's proposals to be a "thicket of rules and a multitude of accounts that could be justified only as a response to a grave problem not susceptible to simpler correction." Steines, *supra* note 10, at 245; Gergen, *supra* note 10, at 198. For example, Professor Gergen points out that reverse § 704(c) allocations may not be caught by § 704(b), and the assignment of income rule in the regulations is problematic and ought to be explored. *Id.* at 184-86; Steines, *supra* note 10, at 243 & n.29. He overreacts to the sale problem; for him it is not possible to determine the variation in risk from the norm in a partnership "before preferences or other arrangements that reduce a partner's risk turn a contribution into a sale." Gergen, *supra* note 10, at 196. In support, he shows how partnership contribution, income allocation, and distribution can be used possibly to avoid disguised sale characterization and to give a more favorable result than an installment sale. His example is as follows:

A contributes *Blackacre* (basis \$50, worth \$100) to AB Partnership. B contributes \$100 cash, which is used to improve *Blackacre*. The partners' shares of gain, profits and losses are determined by the relative size of their capital accounts. A is allocated 100 [percent] of all cash distributions until his capital account is reduced to \$20.

Id. at 191 (example 10). He questions the feasibility of determining how much "entrepreneurial" risk is enough to not warrant treating a contribution and related distribution as not a sale. In his example, the disguised sale rules potentially would tax the distributions in the first two years as a sale; others may not work under the existing rules. *Id.* at 196. See also Treas. Reg. §§ 1.707-4(a)(2), (b)(2)(ii) (1992). The other allocations are unclear although the timing and amount of the distributions may be determined with reasonable certainty at the time of the contribution and the other regulation factors suggest there might be a difference where A can look only to the income from the property contributed rather than from other property held by the partnership. There is a risk to A even under Professor Gergen's example by a drop in value of *Blackacre* which will be borne by A and although B receives most of the gain from an increased value of *Blackacre*, A still profits from the increase in value in *Blackacre*. See Sheppard, *supra* note 97. In my view, the disguised sale rules correctly operate in a manner that includes risk and determines what is an appropriate amount of risk to be borne to keep the transaction from being treated as a sale.

556. Gergen, *supra* note 10, at 217-20. For Professor Gergen, the corollary that A and B recognize a gain upon a distribution of an asset to C is that C ought to recognize gain based on the difference between the basis and the fair market value of the 1/3 interest that she gives up in the other partnership assets. *Id.* at 219. This would fully tax the unpooling in the same manner that the transaction in an S corporation does—the distribution creates gain for all parties. *Id.*

557. There are exceptions in the proposal for property distributed to the partner to whom the previously untaxed gain would be allocated. *Id.* at 225-29.

attributable to earnings of the partnership are recorded in an accumulated earnings account and can be distributed to reduce basis without a tax.⁵⁵⁸ On a distribution of property, the distributee partner would recognize the value of property as income to the extent of the remaining unrealized gain in her partnership interest.⁵⁵⁹ The distortion of the S corporation regime, where the corporation holds assets in the firm until all shareholders are willing to incur the tax cost of a distribution, would be transported to Subchapter K.⁵⁶⁰

The flaw in the approaches⁵⁶¹ to a greater and very limited extent is the lack of flexibility for partner exit options for assets from pools in non-abusive situations where they impose mandatory recognition for partners who are content to bear risk in exchange for deferral.⁵⁶² While these proposals would accelerate losses as well as gains, loss acceleration is already available.⁵⁶³ While a case for recognition may

558. Professor Gergen's proposal allows a tax-free distribution of the cash a partner contributes and permits a partner to withdraw assets she contributes and a share of income on other assets tax free. *Id.* at 223. However, the ability to withdraw assets that one has contributed overlooks the aggregation of other capital. There is no basis for the idea that a partner who receives back property she once owned outside of the partnership should have preferred treatment. That view would suggest that the partnership is a borrower and ought to have a rule that requires that interest be calculated and recharacterized on the entire partnership return up to the riskless rate of return on a partner's capital account and that only the risky rate of return is income other than interest.

559. This rule is subject to exception for distributions out of the distributee's previously taxed partnership income, contributed cash (and basis of contributed property that the partnership has sold prior to the distribution), and the share of partnership debt (comprising two or possibly three accounts). *Id.* at 225-29 (noting that this is designed to prevent double taxation of income).

560. The argument is that assets distributed in a nonrecognition event may end up escaping taxation altogether if held at death by the partner. See I.R.C. § 1014 (1988). See Gergen, *supra* note 10, at 180. That death is not a realization event is not a persuasive reason to impose a tax on partnership distributions.

561. This is true also of Professor Curtis Berger for liquidating distributions. See Berger, *supra* note 12, at 154.

562. Under a § 754 election the capital accounts do not change where there has been a transfer of a partner's interest. I.R.C. § 754 (1988). This reflects the fact that the other non-transferor partners are not guaranteeing the value of the partnership at the time that the transferor partner sells her interest, in contrast to the revaluation that may occur, but is not mandatory, where a new partner acquires a capital interest in the partnership for a contribution. See Treas. Reg. § 1.704-1(b)(i), (iii), (iv), (5) example 13 (as amended in 1993). In that situation the other partners are selling a portion of the partnership and are guaranteed that amount at the same time, in contrast to what would occur only if the § 704(c) consequences were determined by a special allocation of gain or loss on the sale of pre-contribution property. See *id.* However, even if capital accounts are left unchanged, the economics of the transaction are changed since the firm has additional capital and the profit-sharing of the partners is also readjusted. Where that readjustment reflects increased earning prospects, it is favorable to the original partners. Where that does not materialize, they have been disadvantaged.

563. That is, the realization-based tax system allows selectively in the recognition of losses.

be made for cash distributions, treating partnership distributions as exchange transactions was rejected earlier in favor of flexibility, a principle that still remains valid.

Present rules prevent manipulation. For example, in order to buy out a partner who has received a distributive share of income with a limited right to distributions of that income, the partner would either be cashed out directly through a purchase of the partnership interest at its then fair market value, or be liquidated through a distribution which would revalue the capital account so that the distribution was less than the nominal capital value amount. Revaluation to a lower amount presents problems since a capital account can be revalued only if there is a "substantial non-tax business purpose."⁵⁶⁴

Subchapter K can prevent obvious diversification of financial assets on a contribution to an investment partnership with a high percentage of liquid financial instruments as assets as a realization-recognition event.⁵⁶⁵ If one were concerned that the distribution rules allowed for nonrecognition on the distribution in redemption of a partner's interest, an amendment that distributions could be sales could use the same standard as section 721(b) does for contributions.⁵⁶⁶ There, it would be similar to a redemption which might trigger tax for all firm

Requiring a recognition event upon distribution of property for non-distributee partners can accelerate loss. Nondistributee partners with expiring net operating loss carryovers would find such a trigger disadvantageous and, on balance, would not wish the distribution to take place. Consider the *ABC Partnership* (one-third each) in which the asset to be distributed would produce a loss for the nondistributee partners, *A* and *B*, if the partnership sold the asset, or if the partnership tax rule required recognition on distributions, and such losses would at that time cause an undesired tax effect. It is unlikely that the nondistributee partners would agree to the distribution of the asset to the distributee partner, *C*, absent a payment by the distributee partner either through the partnership or outside the partnership to compensate for the adverse tax effect. Under current law, the distributee partner may claim the use of the asset is more valuable outside of the partnership and there is no-tax impediment for the remaining partners as to the value of the asset within or without the pool. Current law also correctly allows the partnership to account for the tax functions of the partners. Consider the sale of the same asset. Assume that *A* and *B*, the remaining partners, decide that it would be appropriate to recognize the loss on the asset. The partnership is able to sell the asset to partner *C* who would like the asset. This would trigger a loss at the partnership level to the partners. Section 707(b)(1) would disallow the loss with respect to *C* only if *C* had more than a 50 percent interest in capital or profits; the other partners, *A* and *B*, regardless of the treatment of *C*'s proportionate loss, would be allowed to recognize such a loss. See I.R.C. § 707(b)(1) (1988). This would require a transfer of cash by the partnership to the partner buying the asset and would require her to transfer the cash back to the partnership. All this produces a transaction cost but it is one that is better than an inflexible rule.

564. Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5) (as amended in 1993).

565. See I.R.C. § 721(b) (1988); see also *supra* note 4.

566. For investment partnerships, see Shekhter, *supra* note 45, at 25, 41 (Table 1 col. 59).

members, and would affect investment partnerships.⁵⁶⁷ Similarly, "cash" could be defined as including cash equivalents, such as Treasury securities and other marketable securities as in proposed legislation.⁵⁶⁸

Why should one care about preserving flexibility through nonrecognition rules on exit rights? First, under second best analysis, such nonrecognition reflects a view that such property-dividing transactions may not be realizations, and for the partner holding in effect a cross option on partnership assets, the distribution of partnership assets reflects the exercise of the option and the abandonment of another option. Second, flexibility facilitates the entrance into and exit from pools, and stimulates marginal investments. Third, market failures support the retention of flexibility in distributions and facilitate the

567. Because this course is not followed in the corporate context with respect to redemption transactions, such an approach is somewhat less compelling. See Marvin A. Chirelstein, *Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares*, 78 YALE L.J. 739, 739, 754-56 (1969).

568. Under a proposal in the Uruguay Round GATT implementing legislation, certain partnership distributions of marketable securities would be recognition events. See JOINT COMM. ON TAXATION STAFF DESCRIPTION (JCX-13-94) AND REVENUE ESTIMATES (JCX-14-94) ON FINANCING PACKAGE FOR URUGUAY ROUND AGREEMENT OF GENERAL AGREEMENT ON TARIFFS AND TRADE, AS APPROVED BY SENATE FINANCE COMMITTEE July 29, 1994, at 27-28 (Aug. 5, 1994). Under the proposal, a partner would recognize gain on the distribution by a partnership of marketable securities to the extent the fair market value of the marketable securities exceeds the partner's adjusted basis in its partnership interest immediately before the distribution. The partner's basis in the distributed securities would be increased by the amount of the gain recognized. The proposal excepts partnership distributions (1) of marketable securities that the distributee partner contributed; (2) that does not exceed the distributee partner's proportionate share of the securities (taking into account all the facts and circumstances, including the terms of the partnership agreement); or (3) by an investment partnership to a partner who contributed no property other than cash or securities. Investment partnerships are defined as any partnership (1) that has never been engaged in the active conduct of a trade or business other than as an investor, trader or dealer in securities and (2) in which substantially all of the assets have always consisted of money and securities and other financial instruments such as debt instruments, notional principal contracts and derivative financial instruments. A marketable security means any security for which there is a market on an established securities market or otherwise. Rules would be provided to treat as a marketable security a distributed interest in an entity, if, e.g., at the time of the distribution substantially all the assets of the entity directly or indirectly consist of marketable securities and money. Regulatory authority would be provided to prevent avoidance of the rules, to deal with tiered partnerships and to apply the rules to other distribution of readily tradeable property such as commodities and foreign currency. The effective date is for partnership distributions after December 31, 1994 of marketable securities held by the partnership on or before July 27, 1994. A transition rule provides that it does not apply to a partnership distribution of marketable securities in liquidation of a partner's interest pursuant to a binding written contract as of July 15, 1994 and at all times thereafter to purchase the partner's interest in the partnership by a date certain for a fixed dollar amount of marketable securities specified in the contract or for other property but the rule does not apply if the partner has the right to choose to receive payment in money or other property in lieu of marketable securities. *Id.*

redeployment of assets directly rather than through transactions such as leasing with higher transaction costs.

One justification for the nonrecognition on partnership distributions is the avoidability of tax through alternative arrangements because taxpayers can respond to a rule imposing a tax on partnership distributions (assuming they agreed to contribute property to a partnership in which the distribution in the future could be taxed) by keeping the property in the partnership's hands even after a distribution has become desirable and using leases and capital account and income allocation adjustments and the like to accomplish the objective at a lower tax cost.⁵⁶⁹

A realization-based tax system is defined in terms of income. Thus, it is entirely appropriate to view the change in rights with respect to property as not being a realization event.⁵⁷⁰ The exercise of an option to purchase property is not a realization event, and no gain occurs if the option's cost plus the exercise price is less than the fair market value of the property purchased.⁵⁷¹

Few property-dividing transactions in a realization-based tax system are treated as realization events. All of the following are not realization events: divorce case law in community property states prior to the enactment of section 1041 with respect to the release of particular property by community property owners in exchange for other community property;⁵⁷² co-tenant divisions of property;⁵⁷³ the receipt of a

569. Professor Shaviro provides the example of a partner who desires a particular asset. The partnership could lease it to her at a market rental, make a special allocation to her of depreciation on the asset and any gain on the sale, and provide that the partner could withdraw the asset from the partnership upon demand. He also notes that large C corporations and their shareholders can not so easily as partnerships achieve the end results that follow from distributing property without formally distributing it. See Shaviro, *supra* note 151, at 50.

570. Recent proposed regulations contain the best example. See Prop. Treas. Reg. § 1.1001-3, 57 Fed. Reg. 57,035 (1992).

571. See *supra* text accompanying notes 486-91. The only issue is whether there has been an appropriate charge for the time value use of the implicit option.

572. Prior to I.R.C. § 1041, a division of community property effected through an exchange of one portion of community property for an undivided 100 percent ownership interest in another portion of community property did not constitute a taxable division. See *Carrieres v. Commissioner*, 64 T.C. 959, 963 (1975), *aff'd per curiam*, 552 F.2d 1350 (9th Cir. 1977), *acq. in result*, 1976-2 C.B. 1. The courts treated such a transfer as "[i]n effect, a nonstatutory nonrecognition rule." *Id.* On the other hand, the early courts treated such a conversion as a transfer that was not a realization. *Id.* at 964; see also *Walz v. Commissioner*, 32 B.T.A. 718 (1935) (holding that where the whole of certain assets of the community, including cash, are set aside to one spouse and others to another spouse but where each has an aggregate of equal value of 1/2 of the entire community, the division is a nontaxable partition, and the basis in the property received by each spouse is its basis to the community prior to the division); Wren

remainder interest in a trust;⁵⁷⁴ the distribution by a trustee of trust property to a particular beneficiary, even where the beneficiary has only a proportionate share in trust assets, is not a realization event for the beneficiary who receives the adjusted basis of the trust;⁵⁷⁵ the increase in an interest of a surviving joint tenant as the other tenants die;⁵⁷⁶

v. Commissioner, 24 T.C.M. (CCH) 290, 294 (1965); *Davenport v. Commissioner*, 12 T.C.M. (CCH) 856 (1953); *Oliver v. Commissioner*, 8 T.C.M. (CCH) 403, 430 (1949). On the other hand, where the spouse takes an unequal portion, then there is a realization, recognition event. *See Long v. Commissioner*, 173 F.2d 471 (5th Cir.), *cert. denied*, 338 U.S. 818 (1949); *Johnson v. United States*, 135 F.2d 125 (9th Cir. 1943); *Rouse v. Commissioner*, 6 T.C. 908 (1946), *aff'd*, 159 F.2d 706 (5th Cir. 1947). The Service viewed the transfer as a nonrecognition event where there was an approximately equal division of the fair market value of community property, but the rationale was that "the transaction does not involve a sale or exchange of community property between the husband and wife but merely an approximately equal division of such property." Rev. Rul. 76-83, 1976-1 C.B. 213, 214.

573. Where six tenants-in-common owned individual interests in real property including a building and one desired to purchase the undivided interest of another, a partition action which resulted in a sale of the property and a repurchase by the taxpayer tenants-in-common with four of the other tenants-in-common did not constitute a taxable transaction and the taxpayer "neither realized a taxable gain nor sustained a deductible loss on the sale." Rev. Rul. 55-77, 1955-1 C.B. 339; *cf. Hunnicutt v. Commissioner*, 10 B.T.A. 1004 (1928), *acq.*, VII-2 C.B. 19 (1928). The conversion, for the purpose of eliminating a survivorship feature of a joint tenancy into a tenancy-in-common, is a nontaxable transaction. The same result is reached on the severance of a joint tenancy under a partition action and the issuance of separate ownership interests to each joint tenant. *See* Rev. Rul. 56-437, 1956-2 C.B. 507; Rev. Rul. 55-179, 1955-1 C.B. 340.

574. *See Hunter v. Commissioner*, 44 T.C. 109 (1965) (recognizing no income to the term holder on terminating the term interest or on the remainder upon receipt of distributed property). The Service has held that the receipt of a life estate in exchange for a remainder interest in separate property is a realization. *See* Rev. Rul. 72-601, 1972-2 C.B. 467; Rev. Rul. 78-4, 1978-1 C.B. 256. For tax planning using this principle, see Rolf Auster, *Amortizing Term Interests in Partnership Property and Partnership Interests*, 69 TAXES 244 (1991).

575. *See* I.R.C. § 643(e)(1) (1988); *see also* David P. Webb, *Application of the Equitable Adjustment Doctrine to The Section 643(e) Election*, 38 U. FLA. L. REV. 811, 812 (1986) (deeming beneficiary of trust to carry out distributable net income to extent of property's fair market value at time of distribution with no gain or loss realized unless in satisfaction of a right to receive a specific property other than that distributed); Treas. Reg. § 1.661(a)-2(f)(2) (as amended in 1973). It is also not a realization event for the trust, unless it elects to be taxed on the gain or loss from all distributions during the year. I.R.C. § 643(e)(3) (1988). The transfer of securities to a trust will result in income to the transferor to the extent of the amount of any appreciation if the trust is to extinguish a pre-existing obligation to the taxpayer. *See Kenan v. Commissioner*, 114 F.2d 217, 220 (2d Cir. 1940). Where the trust is merely a conduit to make the payments, the appreciation in value is not taxed. *See* Rev. Rul. 59-47, 1959-1 C.B. 198.

576. For a review of ambiguous transactions, see BORIS I. BITTKER, *FUNDAMENTALS OF FEDERAL INCOME TAXATION* ¶ 22.5 (1983). Likewise, a tontine, a fund or venture in which the interest of a participant increases as the number of participants decreases, does not create realizations over the term of the relationship. There is no case law on this, but Professors William Klein and Joseph Bankman suggest that the cotenancy principles indicate this result. Justification exists by comparison to other nonrealization events such as the conversion of business property to personal use or the imputed income from the use of one's own property.

the receipt of property purchased by a private annuity, even though the purchaser may not have paid the full value for the property due to the annuitant's early death;⁵⁷⁷ and the convertibility of a bond into another bond,⁵⁷⁸ as in conversion of a debenture into the issuer's stock.⁵⁷⁹

The case law on when a renegotiation of an existing contract right terminates the contract and effects a sale or exchange⁵⁸⁰ supports current law on partnership distributions. This raises the issue of the scope of the Supreme Court's *Cottage Savings*⁵⁸¹ "material change"

See Helvering v. Independent Life Ins. Co., 292 U.S. 371, 379 (1934).

577. Most, if not all, private annuities are sales in exchange for *property* rather than transfers of *money* for an annuity. Rev. Rul. 55-119, 1955-1 C.B. 352 (emphasis added). The question then arises as to the tax treatment of the obligor in the event the annuitant dies before the property is sold by the obligor and where payments made have not yet exceeded the obligor's basis in the property. There is meager authority that in the case of a private annuity acquired for *money*, the excess of the amount received by the obligor over the payments made to the annuitant will, at the annuitant's death, be recognized as income to the obligor. I.T. 1242, I-1 C.B. 61 (1922). This makes sense in that no other events need to occur before income has been clearly and positively realized should premature death occur. But in the case of a private annuity acquired for *property*, similar authority for immediate taxation does not seem to exist. In the case of a private annuity acquired for *property*, no part of the obligor's payments to the annuitant is deductible as interest. *See Bell v. Commissioner*, 76 T.C. 232, 237 (1981), *aff'd per curiam*, 668 F.2d 448 (8th Cir. 1982); Rev. Rul. 55-119, 1955-1 C.B. 352. The theory is that there is no fixed obligation but rather a contingent obligation. In effect, each annuity payment constitutes part of the purchase price of the property and is treated as a capital expenditure as to the obligor. *See, e.g., Garvey, Inc. v. United States*, 726 F.2d 1569, 1574 (Fed. Cir.), *cert. denied*, 469 U.S. 823 (1984); *Dix v. Commissioner*, 392 F.2d 313, 317 (4th Cir. 1968). The actual purchase price is not, then, the property's fair market value, or "projected value" of the annuity payments, but rather the total amount of payments actually made under the annuity contract. *See also* Gen. Couns. Mem. 39,503 (May 7, 1986); Rev. Rul. 86-72, 1986-1 C.B. 253; Rev. Rul. 69-74, 1969-1 C.B. 43.

578. Rev. Rul. 57-535, 1957-2 C.B. 513; *see, e.g., Bethlehem Steel Corp. v. United States*, 434 F.2d 1357, 1361 (Ct. Cl. 1970); Arthur Fleischer, Jr. & William L. Cary, *The Taxation of Convertible Bonds and Stock*, 74 HARV. L. REV. 473, 477-78, 482 (1961).

579. Rev. Rul. 79-262, 1979-2 C.B. 33. Here conversion features exist in the instruments from the outset; the issuer's absence of discretion is implied and old case law suggests that if the issuer retains any discretion, the exchange is a realization event. *See Mutual Loan and Sav. Co. v. Commissioner*, 184 F.2d 161 (5th Cir. 1950); Philip S. Winterer, "Reissuance" and *Deemed Exchanges Generally*, 37 TAX LAW. 509 (1984); *see also* Harold L. Adrion & Ronald W. Blasi, *Renegotiated Debt: The Search for Standards*, 44 TAX LAW. 967 (1991); Margaret C. Henry, *Reissuance Revisited*, 42 TAX NOTES 91 (1989).

580. For example, *Wener v. Commissioner*, 24 T.C. 529, 532 (1955), *aff'd*, 242 F.2d 938 (9th Cir. 1957).

581. *Cottage Sav. Ass'n v. Commissioner*, 499 U.S. 554 (1991). This test finds that a realization has occurred when the changed view of the transaction has materially altered existing legal rights but not when there is no change in the existing rights. *Id.* at 562-67. The cases relied on by the Court in *Cottage Savings* specifically did not apply to partnerships because the Court in the 1920s had accepted the preeminence of state law in characterizing partnership transactions. *Id.*

standard for realizations.⁵⁸² The tenancy by the partnership under the 1914 Uniform Partnership Act and its rewrite in 1992-1994 effecting no substantive changes is the right to possess all property.⁵⁸³ The tenancy in partnership supports the aggregate theory and the theory of cross-borrowing in such arrangements.⁵⁸⁴ The partnership is a carve-out or a lease of the property in exchange for the sharing in partnership profits; the return of the property is like the termination of a lease which under the realization based system is not a realization event.⁵⁸⁵

Economic analysis supports the current rules on distributions. Non-pro rata distributions of partnership assets are the converse of the risks of assumption and diversification by the partners in entering into a partnership. The concepts of risk-sharing and capital pooling are at the heart of a business venture. Distribution rules ought to permit asset redeployment,⁵⁸⁶ which is a core issue in the proper taxation of distri-

582. State law rights and interest should affect tax results; state law defines rights and the tax law decides how to tax. *See Morgan v. Commissioner*, 309 U.S. 78, 80 (1940).

583. *See supra* notes 86-91 and accompanying text. Ownership is a bundle of rights in property. *See WILLIAM E. HEARN, THE THEORY OF LEGAL DUTIES AND RIGHTS* 186 (Fred B. Rothman & Co. 1990) (1883).

584. The extension to limited liability companies is based on the classification standards. If a partner holds a tenancy, the distribution of partnership property to a particular partner involves the simultaneous release of a proportionate claim to undistributed assets and an increase in a proportionate claim as to the specific asset distributed. Absent an agreement, the partners on dissolution have a right under § 38(1) of the Uniform Partnership Act to have the property sold and applied to the payment of the partnership liabilities and then any remaining cash paid to the partners. *See BROMBERG & RIBSTEIN, supra* note 91, at §§ 7:11(b), 7:99. It is based on a view that outside of an actual sale it is difficult to value the property, *see id.* at § 7:99 n.3 (citing *Schoenborn v. Schoenborn*, 402 N.W.2d 212 (Minn. App. 1987)), and that

undivided interests force partners who probably wish to go their separate ways to maintain a joint ownership relationship. Partners who are forced to accept a distribution in kind may get property they do not want, and distribution in kind may permit the recipient partner to delay recognition of gain for tax purposes, thus giving them an advantage over partners who sell out for cash and must recognize the appreciation in taxable income.

Id. at §§ 7:99-7:100 & n.4 (noting similar rule in Unif. Ltd. Partnership Act § 501).

585. The issue with treating contributed property differently from noncontributed property is ultimately based on a theory of efficiency. Namely, that in the bargaining between agents for tax attributes existing during an agency relationship, the efficiency gains in allowing the costless winding up of the adventure at the price of a deferral and at the price of allowing within the venture a 100 percent shifting of the risk of particular assets at a particular time is paramount.

586. This contrasts with Professor Marjorie Kornhauser's view of § 1031, and the caveat that where similar risks are not exchanged, such a principle violates a norm of horizontal equity. *See Kornhauser, supra* note 125. Because partnership pooling is open to all market participants, there is not the same "insider" problem as is noted with like-kind exchanges. The same question arises as to lock-in effect and capital gains transactions. As the tax consequence of selling an asset becomes more unfavorable, individuals exhibit a greater lock-in effect by

bution transactions. If distributions of property in kind are taxed in either operating or liquidating settings, there will be an incentive to keep the assets in the firm at an efficiency loss to the participant wishing to bear that risk outside of the firm. Moreover, the imposition of taxation on the winding up of the firm will cause a lock-in effect and cause the firm to last longer than necessary and lead to a less efficient redeployment of assets.⁵⁸⁷ In a rational world, the choice between continuing the entity and making a taxable liquidating distribution would be based on the decreased after-tax return of the investment continued in the partnership form versus the increased after-tax return from the asset when distributed in liquidation.⁵⁸⁸ Where asset specificity is required, there is a demand for firms and hence issues arise with respect to redeployability of these assets where demand shifts and governance costs change.⁵⁸⁹ In those events, there is a need to change the assets within the firm, and the existence of those assets becomes a transaction cost disadvantage. Thus, Subchapter K's flexibility in redeployment of firm assets economizes on transaction costs.

Partners are able to choose the risks to be assumed. If the issue is de-diversification, then the increased amount of risk assumed by the partner is a justification for not imposing a tax at the time of distribu-

allocating a decreasing portion of their capital to a new risky asset. For example, in an experimental setting, subjects realized significantly fewer capital gains and allocated a significantly smaller portion of their portfolios to a new risky asset when they were charged with the equivalent of a capital gains tax at the time of an asset's sale than when their gains were taxed under regimes based on appreciation in asset value or reinvestment of sales proceeds, which deferred any tax until actual non-reinvestment. See Janet A. Meade, *The Impact of Different Capital Gains Tax Regimes on the Lock-In Effect and New Risky Investment Decisions*, 65 ACCT. REV. 406, 413-14 (1990) (seeking to establish the link between the lock-in effect and investment in new risky ventures).

587. The argument for the treatment of the winding up of the venture as a taxable event is that the risk diversification has ended, the venture is over or partially liquidated with respect to a particular partner and termination is the appropriate time to determine the tax. A corollary requirement would impose some form of like kind use of the assets, which may generally be met to avoid recognition, but efficiency concerns would argue against this as a requirement of efficient deployment.

588. Thus, the tax on distribution would be viewed as a transaction cost. The efficiency of the asset as to its deployment in the economy would be distorted and the tax would produce a wedge between the after tax value within and outside of the firm.

589. See *supra* text accompanying notes 255-73. There are four kinds of asset specificity: site, physical, human, and dedicated assets. See Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519, 522-26 (1983). Transaction costs economic views, asset redeployability and asset specificity are main components in choosing firms. Once the form of the firm is chosen, governance cost and demand changes create their own transaction costs because they make the choice of the firm more expensive.

tion. Second-best analysis and avoidance of transaction costs supports nonrecognition on distribution transactions.⁵⁹⁰ Existing provisions police the ability to shift ordinary income and capital gain (and arguably should be applied on a full fragmentation approach or amended as in one proposal).⁵⁹¹ In addition, compensating inside basis adjustments as when a section 754 election is in place, should be mandated to eliminate distortions in basis allocation caused by the current default rule under section 734(a) that partnership inside basis does not adjust as a result of a distribution of property to a partner.⁵⁹²

E. Special Allocations

It is unquestionable that optimal risk-sharing is efficient between partners.⁵⁹³ This section considers the current law and concerns on special allocations, in particular loss allocations. Loss shifting is efficient and promotes optimal risk-taking under an income tax; loss offsets are required for taxation to increase risk-taking, which is an economic benefit.⁵⁹⁴

1. In General

A special allocation is any allocation of an item or temporal preference for income that varies from the partners' interests in the partnership.⁵⁹⁵ This includes bottom-line income allocations and other forms, such as a division of profits and losses that is different from the underlying capital in the firm, or a special ratio for sharing profits and losses with respect to particular partnership property or source of income.⁵⁹⁶ Both the property and the income source allocation are

590. For example, where the effects of nonrecognition can be simulated by leasing, the risk on the decline in value is shifted to the partner and away from the firm. On a *risk*, rather than an *ownership* analysis, leasing can and does affect the risk-shifting of a sale. See Shaviro, *supra* note 285, at 418-20 (making precisely this point with respect to nonrecourse debt).

591. See I.R.C. § 751 (1988); Andrews, *supra* note 17, at 52-55. Full fragmentation is the position of the A.L.I. See 1984 A.L.I. REPORT, *supra* note 97, at 47-55.

592. See Andrews, *supra* note 17, at 70-71. If the § 734(b) adjustment is mandatory for distributions, then the basis adjustment under § 743(b) on purchase of a partnership interest should also be mandated.

593. See *supra* text accompanying notes 224-335.

594. See *supra* text accompanying notes 215-40.

595. Treas. Reg. § 1.704-1(b) (as amended in 1993) (discussing a partner's distributive share).

596. For examples, see *supra* text accompanying notes 66-67. For an overview, see MCKEE ET AL., *supra* note 19, at ¶ 4.04; GUNN, *supra* note 19, at 545; Lawrence Lokken, *Partnership Allocations*, 41 TAX L. REV. 545, 548-49 (1986); Arthur Kalish & Jeffrey J. Rosen, *The Risky Basis for Partnership Allocations*, 38 TAX LAW. 119, 120-28 (1984).

source-based allocations. A special allocation that gives a partner a greater share of a particular source of income is often accompanied by a priority distribution of economic profit.⁵⁹⁷ Special allocations have a variety of sound rationales. Special allocations allow many ways to control agency costs, reflecting in the real world theoretical models that show where a partner fails in the partnership, a “massacre” arrangement best controls agency costs by requiring that partner to bear the full burden of the losses caused by her action.⁵⁹⁸ These allocations reflect the choices that partners can make by contract and have the tax law reflect. By distributions, the partners can mimic the arrangement sought by any allocation of income.⁵⁹⁹ The partners may also use subpartnerships to the same result.⁶⁰⁰ Thus, special allocations in Subchapter K facilitate the optimal sharing arrangements and efficiency of partnerships.

The recognition of special allocations has had a convoluted

597. A special allocation of a source of income requires that the partners share non-pro rata in items from various sources. That item also may have a more valuable tax effect for one partner than the other. This is a pure shifting and takes into account the tax attributes of the various parties. It may not appropriately reflect tax policy with respect to tax attributes because it is difficult to draw the line between an appropriate tax attribute and an inappropriate tax attribute. Thus, one might criticize the ability to shift foreign source income to taxpayers who pay no-taxes on the foreign source income and have no attribute other than the ability and the willingness to take that particular risk in that particular pool. This is not unlike any portfolio investment that the same taxpayers could have done with respect to income that would have a similar character for tax purposes. Other rules may police this potential abuse. *See supra* note 98 and accompanying text.

598. *See de Meza & Webb, supra* notes 285 & 286; *see also supra* note 293. The rules allow partners to determine their profit and loss sharing ratios for the year after the year arises and before the filing of a tax return. *See* I.R.C. § 761(c) (1988) (a partnership agreement is defined as the agreement of the partners at the time they file their tax return). This result is confirmed by the legislative history to 706 that refers to *Richardson v. Commissioner*, 76 T.C. 512 (1981), *aff'd on other grounds*, 693 F.2d 1189 (5th Cir. 1982), where failure to make an additional capital contribution allowed profit-sharing ratios to change. However, *Williams v. United States*, 680 F.2d 382 (5th Cir. 1982), which rejected a retroactive allocation, in the accrual method partnership was not cited. “Retroactive allocations” are not viewed as part of the substantial economic effect and special allocation question, but they are examples of flexibility’s efficiency.

599. *See supra* text accompanying notes 538, 542, 549-50. For example, a special allocation of the income from a particular asset or the gain on its sale may be set forth in the partnership agreement as a special allocation as income or gain is received by the partnership. Alternatively, the asset may be distributed to the partner in a nonrecognition transaction under I.R.C. §§ 731, 732, with the partner exchanging her outside basis in the partnership interest and a claim in her capital account for the asset and retain the income from the asset or receive the gain on sale.

600. That is, partners could form separate partnerships at additional transaction costs to have different sharing ratios with respect to separate assets and then by contract between the partnerships commit the assets to an interlocked business of all partnerships.

history.⁶⁰¹ There have been two historic objections to honoring allocation agreements among partners. First, the rules allocating partnership income under the aggregate theory presuppose that the partner will pay a tax on an aggregate share of partnership income. This income is considered to be earned by the partners themselves and no aggregate agreement can be based on a sourcing provision.⁶⁰² Second, the allocation agreement could allow manipulation of ordinary income and capital gain between partners.⁶⁰³ Special allocation in partnerships with respect to particular *items* has an historically weaker basis than allocations of particular *amounts*. An item allocation that creates a tax benefit might have to be accomplished under a standard

601. For the history, see Gunn, *supra* note 416, at 121-25. The early Treasury decisions on special allocations prohibited the partner's ability to allocate classes of partnership profits as distinguished from amounts of total partnership profits.

[T]he partners are best qualified to judge the worth to the enterprise of their respective contributions . . . [t]herefore, the partners may agree among themselves as to the relative value of the contribution of each to the partnership, and the proportional distribution of profits to each member based upon that relative value.

LITTLE, *supra* note 127, at 39-40. The Bureau of Internal Revenue first prohibited class-based allocation, then allowed it for a partnership with foreign and domestic source income for a non-resident alien member of the partnership who was receiving income from the branch of the firm located in the non-resident alien's home country. Compare O.D. 140, 1 C.B. 174 (1919) (prohibiting class-based allocation) with Gen. Couns. Mem. 13,771 (1934), reprinted in XIII-2 C.B. 229 (1934) (allowing a non-resident alien member of a partnership to treat her distributive share of income as first coming from foreign source income and thereafter from U.S. source income). The Treasury later reconsidered the General Counsel Memorandum in Gen. Couns. Mem. 17,255 (1936), reprinted in XV-2 C.B. 243 (1936). It reaffirmed the original holding, but in view of a specific provision of the partnership agreement that it should be charged against profits of the foreign branch, the agreement was upheld. Thus, the later General Counsel Memorandum allowed the partnership agreement to separate partner income into two classes based on source of income and allocation. The income from one source was allocated to a particular partner based on the particular facts and the physical location of both the partner and the partnership income. This may be accurate because it was based on the particular relationship of the parties. An economic reason for the allocation is appropriate for the allocation given the underlying economics of the arrangement.

602. The following example is given by William S. McKee:

This example poses the issue of the legitimacy of the taxpayer interest in item allocations in its starkest form: should the contributor of money to a partnership be allowed to retain for himself one hundred percent of the tax attributes associated with what the partnership does with the contributed funds? . . . The argument in favor of permitting such an allocation is that it increases the incentive effect of the deduction by allowing all of it to inure to the benefit of the partner who takes the associated risk by contributing the capital that funded the expenditure. This possibility is available only under the blended entity-aggregate approach, which creates the additional incentive by allowing a partner to retain for himself the attributes of his contribution to the joint enterprise.

McKee, *supra* note 14, at 1070-71.

603. See LITTLE, *supra* note 127, at 41-42.

not only affecting the economics of the arrangement, but also of appropriateness of the allocation to the partner based on the partner's activities within the partnership.⁶⁰⁴ An early provision sought to prevent tax rather than economically motivated allocations.⁶⁰⁵ The Service had ruled prior to 1955 that partners could share losses in a ratio different from their profit-sharing.⁶⁰⁶ In 1954, the legislative history to section 704(b) was relatively incomplete,⁶⁰⁷ and special allocations were not dealt with in the 1953 American Law Institute draft.⁶⁰⁸ The Senate Report added a "substantial economic effect" test.⁶⁰⁹ The regulations set forth the sole operative test of tax avoidance or evasion, although viewed with other factors,⁶¹⁰ which provoked extensive analysis.⁶¹¹ In 1976 "substantial economic effect"

604. Under this theory, disembodied allocations, even with substantial economic effect would not be respected, e.g., foreign source real estate income could not be allocated to foreign partners who provide no management services. The Service does not follow an appropriateness approach and allows even a special allocation of cancellation of indebtedness income to any partner. See Rev. Rul. 92-97, 1992-2 C.B. 124. There are others who would impose an appropriateness or "business purpose" standard to validate an allocation that has substantial economic effect but insufficient business motivation. See Berger, *supra* note 12, at 134-36.

605. The limitation on allocations of bottom line profits and losses prior to Subchapter K appeared in a test in § 129 of the 1939 Code related to the acquisition to avoid income tax. This provision was relatively unsuccessful in disallowing losses on the ground that the purpose of the acquisition was to secure a reduction in taxes. Cf. Commissioner v. Chelsea Products, Inc., 197 F.2d 620 (3d Cir. 1952); Alpha Tank & Sheet Metal Mfg. Co. v. United States, 116 F. Supp. 721 (Ct. Cl. 1953).

606. See Rev. Rul. 54-84, 1954-1 C.B. 284. One commentator indicated that the rationale for the position was "a recognition of rule that there is no limitation on the division of the general profit or loss of a partnership among unrelated partners." Donald McDonald, *Distributive Shares of Partnership Income and Loss*, 15 FED. TAX. INST. 41, 49 (1957).

607. See Donald J. Weidner, *Passing Depreciation to Investor-Partners*, 25 S.C. L. REV. 215, 215-18 (1973); see also Donald J. Weidner, *Partnership Allocations and Tax Reform*, 5 FLA. ST. U. L. REV. 1, 15-17 (1977).

608. This omission is unexplained. I thank Stephen Utz for pointing out that the rationale for this unexplained change would be worthwhile to explore.

609. See H.R. REP. NO. 1337, 83d Cong., 2d Sess. 223 (1954) (setting forth examples); S. REP. NO. 1622, 83d Cong., 2d Sess. 379 (1954) (setting forth the "substantial economic effect" test). For discussion of the House and Senate reports, see John S. Pennell, *Allocating Deductions in Oil and Gas Partnerships*, 24 INST. ON OIL & GAS L. & TAX'N 485, 490-511 (1973); Joseph P. Driscoll, *Tax Problems of Partnerships - Special Allocation of Specific Items*, 10 U.S.C. TAX INST. 421, 423-24 (1958) (noting that Rev. Rul. 56-134, 1956-1 C.B. 649 provided a rationale for special allocations in terms of multiple partnerships); Comment, *Allocation of Income, Gain and Loss in Partnership Taxation*, 38 TUL. L. REV. 104 (1963).

610. See Treas. Reg. § 1.704-1(b)(2) (as amended in 1993). The regulations recognized both the economic effect test and the business purpose of the partners for the allocation, and noted that it would be related to other items of the partnership and that a partner with a special allocation would assume a business risk.

611. See AMERICAN LAW INSTITUTE, FEDERAL INCOME, ESTATE AND GIFT TAX STATUTE

became the operative test,⁶¹² and is reflected in the highly detailed regulations.⁶¹³

2. Substantial Economic Effect

Special allocations allow the broadest scope in working out joint business arrangements and recognizing risks actually borne by only certain partners.⁶¹⁴ Reformers would eliminate or restrict item allocations, thus restricting partnership allocations to bottom-line income or loss.⁶¹⁵ This restriction (with a provision for compensating partners for preference or minimum payments due to disproportionate contribution of services or capital through an expanded version of a guaranteed payment)⁶¹⁶ improperly negates the partners' ability to engage in arm's-length bargaining for risk-bearing and risk-sharing positions with substantial economic effect, without imposing additional requirements to validate risk-bearing and risk-sharing for tax purposes.⁶¹⁷

179-92 (Tentative Draft No. 11, 1956).

612. See S. REP. NO. 938, 94th Cong., 2d Sess. 99-100 (1976). For analysis of the changes, see Martin Cowan, *Treasury Proposes New Rules for Partnership Allocations*, 42 FED. TAX'N INST. Ch. 19, at 19-1 (1984); Sherwin Kamin, *Partnership Income and Loss Allocations Before and After the Tax Reform Act of 1976*, 30 TAX LAW. 667 (1976). The Service has recently ruled that the substantial economic effect test is overridden by tax treaty. See Priv. Ltr. Rul. 93-31-012, 1993 PLR LEXIS 1149 (May 5, 1993) (allocation of U.S.-source profits to German partner resident in the U.S. and non-U.S.-source profits to German non-resident partners upheld under U.S.-Germany income tax treaty).

613. See Treas. Reg. §§ 1.704-1, -2 (as amended in 1993). In 1984, the A.L.I. proposed a tax avoidance standard which stated that "[i]f an allocation may have a substantial economic effect, it will be recognized for tax purposes. In determining whether an allocation may have a substantial economic effect, the likelihood and magnitude of the economic effect must be weighed against the shifting of tax consequences" 1984 A.L.I. REPORT, *supra* note 97, at 251.

614. See Davis & Lainoff, *supra* note 51, at 257-59 (discussing how limitations on tax arbitrage and economic dealing may successfully prevent gaming the system).

615. See Gergen, *supra* note 12, at 40-43; Berger, *supra* note 12, at 134-36. Some would also require that service partners be allocated a fixed or contingent return taxed to them like employees. See Gergen, *supra* note 13, at 542-43. But see Gergen, *Service Partners*, *supra* note 13.

616. For a discussion of guaranteed payments on capital, see Banoff, *supra* note 422, at 825-27.

617. It would also enforce the loan theory of the capital account and allow item allocations only after creation of a return to capital of other income in an *amount* to compensate for that borrowing. Even commentators criticizing allocations of special items recognize the difficulty it poses with respect to legitimate economic transactions such as allocation of foreign source income to the foreign resident partners who help earn such income. See McKee, *supra* note 14, at 1068-69. For a discussion of the problem, see Gunn, *supra* note 416, at 139-43. Similarly, the objection that allocation of tax exempt income from municipal bonds to one taxpayer and dividends on corporate stock to another, with respect to all risk and reward within the partnership, presumably is not a special allocation even though it is invalidated under the

Economic effect is required for all allocations,⁶¹⁸ or a surrogate for economic effect in the case of nonrecourse allocations.⁶¹⁹ These requirements impose real dollar costs to allocations of losses in terms of risk-bearing and capital account entitlements of the partners.⁶²⁰ *Substantiality*, under the general rule of *after-tax* economic effect, requires that the allocation not be merely for a tax benefit such that no partner is worse off because of the allocation.⁶²¹ Substantiality rules are predicated on risky income streams⁶²² and the *value-equals-basis-*

special allocation rules. The better analysis is to treat the transaction outside of the partnership since it is not a partnership with respect to those assets and the partners are appropriately treated as the true owners of such assets. *Cf.* Rev. Rul. 55-39, 1955-1 C.B. 403 (general partner's investment of capital contribution in securities of her selection with the interest on the securities to go to the partner's capital account and the purchase price deducted from the capital account, held not to be partnership property despite the partnership agreement's contrary provision, but is treated for tax purposes as the general partner's personal property at the time that the partnership purchases securities for the general partner).

618. Treas. Reg. § 1.704-1(b)(2) (as amended in 1993) (economic effect provided for in the main test, an alternate test and an economic equivalence test). *See* Gunn, *supra* note 416, at 123.

619. Treas. Reg. § 1.704-2 (1991) (minimum gain chargeback).

620. The bearing of loss and the sharing of gain are not illusory under the capital account rules in the regulations. There may be some distortions due to the interaction of the recourse and nonrecourse debt rules that could be corrected by regulations. Two problems arise. First, a deficit restoration obligation may be illusory. Consider the following example. *A* contributes \$100 cash and *B* makes no capital contribution. The partnership borrows \$100 to buy an asset, with the borrowing fully recourse and *B* issuing a guarantee that makes *B* ultimately liable. *B* will receive basis under I.R.C. § 752. *See* Treas. Reg. § 1.752-2(b)(1),(6) (1991). Assume that the partnership allocates all losses to *B* and the asset is expensed and becomes worthless. If *B* is allocated the loss, treating the guarantee as a deficit restoration obligation, the obligation is illusory since upon foreclosure the creditor will take *A*'s \$100 cash and *B* will not be required to pay \$100 to *A* because the obligation runs to the creditor not to *A*. In this case the expense should be allocated to *A* to prevent *B*'s deficit restoration obligation from becoming illusory. *See* Treas. Reg. § 1.704-1(b)(2)(ii)(c) (as amended in 1993). Second, nonrecourse debt when converted to recourse debt by guarantees allows the partners to freely allocate any gain that would have been a minimum gain subject to the nonrecourse debt regulations. *See supra* notes 19, 283, 404, 411, 422, 426, 429, 452, 520, 562, 616 and accompanying text.

621. *See* James R. Hamill & Richard I. Alitzer, *Alternate Methods for Measuring a Property Interest*, 51 TAX'N ACCT. 10, 11 (1993); Treas. Reg. § 1.704-1(b)(2)(iii)(a) (as amended in 1993).

622. *See* Treas. Reg. § 1.704-1(b)(2)(iii)(a) (as amended in 1993). Professor Shavero criticizes the focus on "long-term risk as a proxy for accrual, despite the fact that risk and accrual are not equivalent." Shavero, *supra* note 285, at 455 (noting the justification for the rules must "rest on a combination of (1) the unfeasibility of locating economic depreciation more accurately, and (2) the rules' capacity to impede the location of preferential depreciation in high tax brackets due to risk aversion"). In addition to the general rule, allocations can also be invalidated as insubstantial if they are *shifting* the capital accounts of the partners do not change despite the allocation, and there is a strong likelihood at the beginning of the partnership that the allocation will have a tax effect only but not change the relative dollar amounts of the capital accounts. *See* Treas. Reg. § 1.704-1(b)(2)(iii)(b) (as amended in 1993). An

rule.⁶²³ The *value-equals-basis rule* presumes that depreciation deductions reflect true economic loss on the property and that in the future there will be gain from the sale.⁶²⁴ Section 704(b) allocation problems sometimes may be avoided by the distribution rules.⁶²⁵ Only risky income can be used to meet the substantiality of the economic risk that a partner agrees to bear in testing an allocation that varies from the partner's interest in the partnership.⁶²⁶ The *value-equals-basis rule* applies generally,⁶²⁷ and allows gain chargebacks by testing income chargebacks under the substantiality standard. The system appropriately is not tied to "real values"—a nightmare of administrability—and is

allocation also can be viewed as insubstantial if it is *transitory*. The charges to capital accounts such as losses will be made up through gains and the total dollar amount will be unchanged. See Treas. Reg. § 1.704-1(b)(2)(iii)(c) (as amended in 1993). Time-shifting allocations seem appropriate under a risk-bearing standard and are more restrictive under the substantial economic effect regulations than they would be under a pure risk-bearing standard. The transitory rule limits allocations that will be made up within five years. Income chargebacks are not generally allowed. See *supra* text accompanying note 626. There remains some room for the substantiality rule to be refined. The substantiality test could be strengthened. For example, what if a partnership produces a loss that is made up by the sale of property which produces ordinary income, *i.e.*, inventory. Should that be subject to the *value-equals-basis* presumption and exempt from the transitory rule? Arguably not since ordinary income in this context represents periodic income rather than "gain" subject to market risk, the concern of the *value-equals-basis* presumption. The insubstantiality rule for transitory allocations is tempered by the fact that the allocation of a loss must be made up by a gain allocation within five years. See Treas. Reg. § 1.704-1(b)(2)(iii)(c)(2) (as amended in 1993).

623. See Treas. Reg. § 1.704-1(b)(2)(iii)(c)(2) (as amended in 1993). One of the effects of the *value-equals-basis rule* is that all gain allocations are presumably risky because it cannot be implied that the value of the property will at anytime be greater than its basis.

624. Hamill & Alitzer, *supra* note 621, at 15.

625. See *supra* notes 548-49, 588. Distribution rules are not flawless. Consider the *ABC Partnership* in note 569. If *C* is a loss taxpayer with net operating losses and *A* and *B* are in the highest marginal tax bracket, the distribution of an asset with a \$90 gain and a \$100 fair market value by the partnership to *C* and *C*'s immediate sale circumvents the substantial economic effect test—the allocation produces a net present value of \$100 to *C* and defers the gain inherent in the partnership assets of \$60 to *A* and *B*, who will have that taxed at capital gain rates. To validate distributions there ought to be a tax avoidance two year rule, like disguised sale rules, that would validate risk-bearing. This does not answer the objection based on the substantial economic effect regulations because *A* and *B* are receiving the present use value of \$60 which if they had received it directly would have produced a tax. If *C* is required to hold the asset distributed for a minimum time period of two to five years for nonrecognition, then a "no-tax avoidance standard" with respect to the partnership would be met. Alternatively, a general anti-abuse partnership tax regulation might well prohibit this transaction as not being within the intent of Subchapter K.

626. Treas. Reg. §§ 1.704-1(b)(2)(iii)(a)-(c) (as amended in 1993) (all predicated finding income, deduction, loss and gain events for which a "strong likelihood" of occurrence is not present at the time into which the allocation is entered).

627. Treas. Reg. § 1.704-1(b)(2)(iii)(c)(2) (as amended in 1993) (stating that the *value-equals-basis rule* is applicable to the entire substantiality test).

predicated on the presumption that basis equals value.⁶²⁸

In addition to item allocations, critics object the most to time-shifting allocations, claiming that up to 99 percent of the risk and gain from a particular asset cannot be allocated to one partner for a time even though the future gain may be allocated 99 percent to another partner, and that all allocations must be relative to capital accounts—which can cause bizarre consequences. Consider the two-person “AB Partnership.” Partner A contributes \$1000 and partner B contributes services to the partnership and therefore does not receive a capital account. All losses would be allocated to A until A’s capital account was zero, but all income would be allocated fifty-fifty.⁶²⁹ Even critics note that the allocation of the losses to the capital partner and a chargeback of income equal to losses, as in a research and development partnership, “is an arrangement that business people might agree to without regard to its tax advantages [and] the tax system should respect it.”⁶³⁰

Ultimately, the prohibition of special allocations holds that property cannot be held in trust in the current manner of taxation of trust term interests and remainders. The current tax rules on term interests tax the entire income to the term holder; if the term holder has a basis in the interest by purchase, she is able to use that basis.⁶³¹ Within the partnership, a special allocation allows the creation of term and deferred remainder interests, which could be enjoyed outside the partnership if the partnership property were held in trust, the term holder given a depreciation deduction, and the underlying basis of property reduced.⁶³²

It is also argued incorrectly that side payments by partners can vitiate the otherwise sound economic effect of allocations, and that mere timing difference can occur with respect to allocations of loss in earlier years that are made up with ascertainable *income* in future years.⁶³³ With respect to the first, the provisions in the regulations that define the partnership agreement as including agreements outside of the

628. Without doubt, there are more sophisticated ways to view income. See Mundstock, *supra* note 399, at 695.

629. See Gergen, *supra* note 12, at 40-41.

630. Berger, *supra* note 12, at 132. The regulations permit this allocation. See Treas. Reg. § 1.704-1(b)(5), example 5 (as amended in 1993).

631. See DODGE, *supra* note 394, at 236-38; KLEIN ET AL., *supra* note 402.

632. A specific tax provision prevents ownership of property in trust from producing deferral when related parties are involved. See I.R.C. § 167(e) (Supp. 1992).

633. Gergen, *supra* note 12, at 11-33.

partnership⁶³⁴ already address these problems.⁶³⁵ There is substantial precedent under the doctrine of substance-over-form to prevent taxpayers from creating economic effect within the partnership and then eliminating it outside the partnership.⁶³⁶ Second, with respect to *income* allocations, only *gain* chargebacks are subject to the value-equals-basis presumption and income chargebacks will be substantial only if the income was not reasonably anticipated.⁶³⁷

3. Utilization of Losses in Special Allocations

The most pointed attack on the efficiency and equity of special allocations (exclusive of allocations supported by nonrecourse debt)⁶³⁸ is the ability to shift losses between partners, which may allow partners to mimic the effect of the now extinct safe harbor leases.⁶³⁹ Three relationships can exist between partners in their tax functions. First, one partner can have losses that cannot be used to reduce income, and the other partner can be taxable. Second, the partners can face different tax brackets, especially if one is tax exempt.⁶⁴⁰ Third, the partners can be in the same tax bracket. Arbitrage concerns arise in the first and second relationships between the partners. The last leaves open whether the income tax system should allow the shifting of the timing of income

634. See Treas. Reg. § 1.704-1(b)(2)(ii)(h) (as amended in 1993).

635. See Treas. Reg. § 1.704-1(b)(2)(iii)(a) (as amended in 1993) ("In determining the after-tax economic benefit or detriment to a partner, tax consequences that result from the interaction of the allocation with such partner's tax attributes that are unrelated to the partnership will be taken into account"). Side payments—guaranteed amounts—within the partnership can accomplish the same thing, but the substance-over-form and step-transaction cases broadly apply here.

636. Broad substance over form analysis is applicable. See *Gregory v. Helvering*, 293 U.S. 465 (1935); *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74, *aff'd*, 187 F.2d 718 (5th Cir. 1950), *cert. denied*, 342 U.S. 827 (1951). This is not recreating steps, but merely interpreting what the partners in Gergen's hypotheticals do. See *Esmark, Inc. v. Commissioner*, 90 T.C. 171 (1988), *aff'd without opinion*, 886 F.2d 1318 (7th Cir. 1989); *Grove v. Commissioner*, 490 F.2d 241 (2d Cir. 1973).

637. See Treas. Reg. § 1.704-1(b)(2)(iii)(c) (as amended in 1993). On the acceptance of this view, see Gregory J. Marich, *Substantial Economic Effect and the Value Equals Basis Conundrum*, 42 TAX. L. REV. 509 (1987).

638. There is a parallel regime for allocations that are supported by nonrecourse debt and which by definition cannot have economic effect because neither the partners nor the partnership have assumed liability, and the economic risk of loss is borne by the lender. Professor Gergen's criticism of the general regime would also apply to the regime for nonrecourse allocations.

639. Gergen, *supra* note 12, at 19. A safe harbor lease was one of various statutory arrangements for shifting the tax benefit of losses among qualifying corporations. See I.R.C. § 168(f) (1988 & Supp. 1992).

640. Tax exempt investors raise other issues such as the availability of guaranteed payments and preferred return raise problems with income parking. See I.R.C. § 514(c)(9)(E) (Supp. 1992); Prop. Treas. Reg. § 1.514-2(c) pmb., 57 Fed. Reg. 62,266 (1992).

from a pooled venture—the partners may have different risk aversions, expectations, and preferences.

Special allocations in partnerships were used by practitioners prior to safe harbor leasing,⁶⁴¹ and its repeal had nothing to do with deciding whether *partnership* loss allocations were desirable or valid. There were many reasons, including the efficiency of the form of loss utilization provided by safe harbor leasing, that made that system undesirable.⁶⁴² The special allocation rules provide an effective mechanism for refunding prior losses in a tax system that otherwise creates inequities by not refunding losses, and facilitate social welfare gains under several economic standards.

To understand the refundability of losses to loss partners through special allocations, one must first consider safe harbor leasing in the context of investment and loss taxpayers. When a taxpayer incurs a loss, the tax effects can significantly differ depending on the taxpayer's characteristics. A loss can be used to offset other income and reduce a taxpayer's tax liability.⁶⁴³ To a taxpayer with other income, the actual loss is reduced to the amount determined by multiplying the loss

641. While admittedly practitioners prior to the § 704(b) regulations and the amendment regarding substantial economic effect may have played fast and loose with special allocations and allocations without economic effect, *see* Kamin, *supra* note 612, at 682, legitimate special allocations did predate safe harbor leasing.

642. The goal of safe harbor leasing was to allow loss and startup companies to benefit from investment tax credit and the accelerated cost recovery system by mirroring a direct selling of the credit and deduction benefits of an investment to taxable taxpayers for a fee. It sought to relieve competitive neutrality through a system of transferability of tax attributes between taxpayers. "[L]imitations . . . that were thought to inhibit transfers were eliminated, presumably on the theory that leasing would accomplish whatever would be accomplished by a program of explicit transferability." Alvin C. Warren, Jr. & Alan J. Auerbach, *Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing*, 95 HARV. L. REV. 1752, 1772 (1982). This system proved to be inadequate. *Id.* at 1753. The system of transferability is objected to on the basis of transaction costs and other inadequacies. That is, "the statutory fiction of leasing inhibits reaching the correct results under any version of competitive neutrality." *Id.* at 1773. If they were subsidies, then they should have been freely transferable; if they are reductions of capital income tax, because loss taxpayers pay no-tax, loss taxpayers should not have been able to reap the rewards of transferring tax benefits. *Id.* at 1773-78; *cf.* Donald Lubick & Harvey Galper, *The Defects of Safe Harbor Leasing and What To Do About Them*, 14 TAX NOTES 643 (1982) (safe harbor leasing ought to be uniform for other forms of losses, bringing fair payment of wages, interest or expenses incurred in purchasing other assets).

643. Startup companies have characteristics similar to loss companies in that they have no current income with which to offset their current expenses. *See* Warren & Auerbach, *supra* note 642, at 1758-60. While expectations *ex ante* about inflation inform the riskless rate of interest and represent a large component of the interest rate, if the market assessment *ex post* shows that the prior estimate was incorrect, the distortion created by greater than anticipated inflation decreases the value of the deferred deductible losses.

by one minus the tax rate $(1-t)$. Otherwise the taxpayer must absorb the entire loss until such time as the taxpayer has income. The discount rate used to calculate net present value will change once she has net income,⁶⁴⁴ and the after-tax discount rate will be used to value the remaining returns from the investment.⁶⁴⁵

Deferral of government risk-sharing, and reduction of the present value of losses to a taxpayer, has a significant impact on the expected after-tax net present value, which will be greater to a partner with whom the government shares risk than to a loss partner.⁶⁴⁶ Investors make investment decisions based on the after-tax returns of an investment.⁶⁴⁷ An investment must return at a rate at least equal to the investor's after-tax discount rate, the market rate of return times $(1-t)$ or the required rate of return. The loss taxpayer's after-tax required rate of return will be higher than a taxable investor. This impairs a loss taxpayer's ability to compete in the market.⁶⁴⁸

644. An investor's required rate of return is the return demanded for bearing a level of risk as determined by the market. The after-tax required rate of return is reduced by a factor of $(1-t)$. An investment's after-tax return is also reduced, but by how much depends on the timing of expenses and income. Usually, the reduction in the rate of return is less than required, making investments more appealing after tax. The time value of money and a greater than anticipated inflation rate decrease the value of loss deductions over time. The value of the deduction and its relationship to income must be discounted back to present value using an after-tax discount rate for a market investment of that particular taxpayer. As a loss taxpayer will have an effective tax rate of zero, the after-tax rate of return of a loss taxpayer will remain the pre-tax rate of return, rate of return multiplied by $(1-t)$, $t=0$. This will necessarily be higher than a nonloss taxpayer whose after-tax rate of return is equal to the rate of return multiplied by $(1-t)$, $t>0$.

645. The net present value of an investment is determined by the discount rate of the investor. Assume the market discount rate (r) to be 10 percent. This is the time value of money. This rate is the same for all investors similarly situated. However, after taxes, different investors have different discount rates, depending on the amount of the government's risk-sharing. The after-tax discount rate will be the discount rate times one minus the tax rate (t), or $r(1-t)$. Assume a non-loss taxpayer has a tax rate of 40 percent. Her after-tax discount rate is $10\%(1-.4)$, or six percent. A loss taxpayer's tax rate is zero. His after-tax discount rate remains 10 percent. These discount rates are the required after-tax rates of return for these investors.

646. See *supra* notes 644-45 and *infra* notes 655-66 and accompanying text.

647. See *supra* notes 644-45 and text accompanying notes 110-11.

648. An understanding of the equivalence of risk-taking ability is critical to the concept of competitive neutrality. For an excellent analysis of why this is so, see Mark Campisano & Roberta Romano, *Recouping Losses: The Case for Full Loss Offsets*, 76 NW. U. L. REV. 709, 722-30 (1981). For other discussions, see Scarborough, *supra* note 215, at 684 n.22. The unequal treatment of losses distorts investment decisions. The government assumes a portion of the risk a partner undertakes, receives a portion of the profits a partner earns, and, by allowing a partner to offset a portion of her losses against other income, bears a portion of the losses incurred. The greatest worth of the government as a risk-sharing partner is the ability to deduct losses and expenses in the early years of an investment, when, due to the time value of money

Disruption of the equivalence of risk-taking ability among partners distorts investment decisions. If loss partners cannot accept some of the risky projects in the market solely because they have losses and there is no system for direct refundability of losses, overall economic welfare will decrease, and the principle of competitive neutrality in the tax system will be violated.⁶⁴⁹ Competitive neutrality should be expressed as the equivalence of risk-taking ability, that is, the ability of loss taxpayers to accept projects with the after-tax market rate of return. Each investment has an expected return and expectation as to the riskiness of its cash flows and will be on, above or below the market line familiar to financial analysis. An efficient investment is on or above the line if, given the expectation of an investment's risk, its return exceeds the required rate as depicted by the market's requirement for additional return for bearing additional risk.⁶⁵⁰ Arbitrage brings an above-the-line investment down to the line; only the below-the-line investment is of concern because the market has deemed it sub-optimal.

Partnership allocations have as their goal competitive neutrality in risk-taking and a tangential effect on competitive neutrality with respect to subsidized and unsubsidized investments that are undertaken. Special allocations allow the partners to bargain for risk and the reward from risk-bearing.⁶⁵¹ Access to subsidies by all taxpayers supports competitive neutrality, the same goal as a system of refundability.⁶⁵²

and actual inflation, they are most valuable. *See infra* Appendix, Tables 11-14 at pp. 401-04, which demonstrate the effect of deferred risk-sharing on the net present value of the same investment to loss and non-loss taxpayers. This is also not to say that the nonneutrality of the treatment of losses under a realization based tax system could not be improved to "eliminate unnecessary bias for or against risk." *See* Scarborough, *supra* note 215, at 717 (proposing a system generally to bifurcate the realized return on certain liquid and financial investments into ordinary gain defined as not in excess of the risk-free rate of return and allowing losses only to the extent of realized return in excess of the risk-free return).

649. *See* Warren & Auerbach, *supra* note 642, at 1758-61. A tax that is not competitively neutral may decrease economic welfare if the companies in whose favor the tax works are not those best able to make the most socially desirable investments. *Id.* at 1761. Rules should not be written that have bias in favor or against taxpayers who may be in competition with each other in the economy. *See* Campisano & Romano, *supra* note 648, at 709, 721-22.

650. *See supra* notes 181-85.

651. The A.L.I. implicitly recognized it when, in 1984, it reviewed special allocations and discussed a "tax motivation" standard. 1984 A.L.I. REPORT, *supra* note 97, at 245.

652. A refundability system is one in which a loss taxpayer receives an immediate refund from the government in the amount of the loss the government had agreed to share through the tax system. Attempts to remedy the failure of the government to share in the risk of loss companies have been proposed. Programs of transferability, such as safe harbor leasing, and refundability of losses, such as that proposed by Mark Campisano and Roberta Romano, *see supra* note 648, at 711-15, have been proposed as corrective measures for the unequal treatment of losses. Under a program of transferability (although Warren and Auerbach do not make the

Using special allocations to achieve competitive neutrality in equivalence of risk-taking ability is a worthy tax policy objective despite transaction costs.⁶⁵³ First, in the existing tax structure, special allocations facilitate investment for all partners, albeit with transaction costs, and at a current tax cost to the government. The government has no entitlement to suspended losses or the returns from differential marginal tax rates as an *a priori* matter.⁶⁵⁴ Second, special allocations accomplish refundability by transfer payments between parties outside the tax system to encourage marginal investment.

Special allocations that allow loss shifting have been criticized as facilitating undesirable sub-optimal investment.⁶⁵⁵ The benchmark is an investment no person would make because it would yield a negative net present value before tax.⁶⁵⁶ This is true for a wide range of investments.⁶⁵⁷ While one should be concerned that sub-optimal invest-

remedy of the failure of the joint share in the risk of loss companies an explicit goal of transferability, it can and should be inferred), "tax instruments" would be created, which could then be sold for the value of the deductions. Warren & Auerbach, *supra* note 642, at 1772-73.

653. There is some ambiguity as to the efficiency of a system of transferability or refundability. The most efficient method would achieve equivalence of risk-taking ability by transferring or refunding just the amount necessary to equalize risk-taking ability.

654. It may have where the taxpayer has unrealized gains that it may realize selectively or has otherwise eliminated economic risk through hedging or diversification. See Scarborough, *supra* note 215, at 699.

655. Professor Mark Gergen argues that special allocation rules permit results like those of safe harbor leasing in the transfer of losses. He does not distinguish between the different goals of special allocations and safe harbor leasing. Gergen, *supra* note 12, at 19. He dismisses safe harbor leasing by noting its shortcomings and pointing out that it has been rejected by Congress, neither of which has any impact whatsoever on the utility of special allocations. *Id.* at 19 & n.81.

656. Professor Gergen posits an investment to which one taxable party in the 40 percent tax bracket, DEF, contributes \$150 and ABC, the other party with a net operating loss, contributes \$850. *Id.* at 21. The investment has a net present value before tax of \$78.56. The taxable party (who borrows outside the partnership and contributes this to the partnership for basis to avoid the problem in I.R.C. § 704(d)) is allocated the losses on a mining expense of \$1,000 that is immediately deducted, is allocated income to restore losses and her negative capital account with the income distributed to the loss partner, and in the future gets 20 percent of the income and losses and the loss partner gets 80 percent. A table modeled on Professor Gergen's table with his assumptions is reproduced in the Appendix as Table 11 at p. 401. The investment has a 7.99 percent before-tax internal rate of return. The internal rate of return is the rate at which a series of cash flows have a net present value of zero. It is equivalent to depreciating the initial value using economic depreciation. Absent the tax system and depreciation at a rate greater than economic depreciation, the 7.99 percent investment would not be made in an economy with a 10 percent market interest rate.

657. In Table 12 at p. 402, the investment is made at Time zero and starts earning income at the end of Year 1, at which time the tax benefit of the writeoff is realized. Income and losses are allocated and cash is distributed as in Professor Gergen's example.

This is a more realistic investment, as the investment is made at Time zero. The present

ment will be facilitated, rational market participants will not invest sub-optimally. While the market determines which investments are efficient,⁶⁵⁸ the government encourages investing in risky projects both by prescribing the manner in which capital is recovered under the income tax and by bearing some of the risk of investment which decreases the required return of the particular investor.⁶⁵⁹ Due to the unequal treatment of losses, a non-loss partner could make this investment, after-tax, while a loss partner could not, because the loss taxpayer has a negative net present value and the taxable taxpayer has a positive net present value.⁶⁶⁰ Absent special allocations, underinvestment in marginal activities occurs because the supply of capital available to these ventures is limited.⁶⁶¹ With special allocations, loss

values are calculated back to Time zero. This accounts for the lag between the initial expenditure and the write-off available to *DEF*. Changing the timing of the \$1,000 deduction for *DEF* from Year 1 as in Table 11 at p. 401, to Year 1 using Time zero—that is, an investment of \$1,000 at the beginning of the year that is not deducted until the end of the year, reduces *DEF*'s net present value from \$11.79 (Table 11) to -\$10.85 (Table 12) and she would not make the investment. If *DEF* were to make the investment alone without the special allocation, *i.e.*, investing only \$150 and assuming less risk, her net present value assuming a Year 1 deduction using Time zero is \$4.55. If the investment generated a cash flow of \$160 for ten years rather than nine years, giving it a 9.61 percent internal rate of return before-tax, even with the special allocation and computing the return in the manner provided in Table 12, *ABC* would have a net present value after-tax of \$63.45 and an internal rate of return of 11.81 percent, but *DEF* would have a net present value after-tax of -\$0.13 and would not make the investment.

658. Each investment will have a required rate of return, dependent upon the riskiness of its cash flows. The risk-free rate is that which a riskless investment will return and will be determined by the market. See BREALEY & MYERS, *supra* note 167, at 161-165. The market rate of interest, which is the before-tax required return, is the rate at which the partner can borrow or lend.

659. Professor Gergen's example demonstrates is that through special allocations, an investment that before-tax was below the market security line is now on the line for both *ABC* and *DEF*. See *infra* Appendix, Table 11 at p. 401 (Gergen's table).

660. This is demonstrated in Table 13 at p. 403, where both the loss and taxpaying partners share profits and losses based on their capital account ratios.

661. Professor Gergen fails to note in his example that even without special allocations, *DEF* could make the investment. See Gergen, *supra* note 12, at 19-27. In Table 11 at p. 401, *DEF*'s net present value after-tax is \$11.79. It is \$7.94 in Table 13 at p. 403. However, given *DEF*'s wealth constraints, if *DEF* only has \$150 to invest, only \$150 will be invested. The special allocation allows *DEF* to borrow *ABC*'s capital of \$850 and invest it in the project. With the special allocation in Table 12, *DEF* incurs additional risk by borrowing \$850 of *ABC*'s capital but if the venture is successful, *DEF* received an increased reward. That is to support the allocation, *DEF* must have agreed to make up any deficit capital account to *ABC*, and with risky income, this risk of loss would be real if there was no income from the partnership. Professor Gergen criticizes this as a sale of tax benefits that disregards Congress's repeal of safe harbor leasing. See *supra* note 642. The criticism of this special allocation is generally misplaced. First, to keep the allocation and chargeback from failing the after-tax

or startup taxpayers come to the market and lend their capital to these activities which after-tax are desirable investments.⁶⁶² While there is

economic effect test, the future income must be risky and thus the taxable partner takes on a real risk since any deficit capital account would have to be restored if she had borrowed through the partnership, and any lender repaid if she borrowed outside. The after-tax economic effect test, as well as the transitory test are predicated on risky income streams. Second, the same transaction could be accomplished outside the formation of an initial partnership. The loss partner could loan the taxable partner \$850 on a recourse basis secured by the mine with interest and principal paid from the cash flow. If this is respected as a loan, the same result as the partnership with the special allocation is accomplished but with lesser participation by the loss partner but no greater risk by the taxable partner if the partners adjust the allocation of the contingent cash flows while the loan is amortized to readjust the net present value to the net present value under the special allocation. For further consideration of the implicit loan in Table 11 at p. 401, see *infra* note 662. Thus, this problem reverts to the same question—should the tax system allow investors to take a return greater or less than the amount invested relative to fair market value? For the loss partner who is risk averse, the return is greater than the market return or the partner would not agree to it. For the taxable partner, the greater return is compensation for previous risk-bearing. The rewards to earlier venture capital investors bear this out. See Gregory F. Chiampou & Joel J. Kallet, *Risk/Return Profile of Venture Capital*, 4 J. BUS. VENTURING 1, 2 (1989). Allocating income first based on an interest factor on capital accounts would ensure that only risky income is split differently. Again, tax rates always determine who makes particular investments—"arbitrage" is systemic, see *supra* note 121—in a world with differential income tax rates and no loss refundability. The government should be neutral among potential investors to avoid economic distortions.

662. Given a market interest rate of 10 percent, is it ever efficient to invest in a risky asset that generates a return of 9.61 percent or 7.99 percent? See *supra* note 657 and *infra* Appendix, Tables 11-14 at pp. 401-04. This is a problem endemic to the imposition of an income taxes and stems from two sources. First, the income tax provides tax subsidies in the manner in which capital is recovered more rapidly than economic depreciation allows. Second, the government's loss sharing lowers a particular investor's required rate of return, such that the same investment that before-tax would not be made will be made after-tax, enabling marginal investments to be made. The question then becomes: is it efficient to prevent one investor from making investments another could make, simply by virtue of its status as a loss partner? Clearly not, as this distorts investment decisions. If so, special allocations are a *better* form of income tax provision. Whether it is efficient to lower ABC's required rate of return is determined by how it is accomplished. The after-tax rate of return of an asset is raised without increasing the before-tax cash flows by reducing the total tax liability of the investment. The government has decided that this is efficient by the policy of risk-sharing in enacting an income tax and by prescribing the manner in which capital is recovered. Had the government not allowed immediate expensing of the investment made in Tables 11-14 at pp. 401-04, no person would make a 7.99 percent investment where the market interest rate is 10 percent, or indeed where the risk-free rate is 9 percent. However, it is equitable when viewed as part of a system of refundability, as the overpayment of taxes is being reversed. There are three situations in which raising the after-tax return of specific investors by enabling them to mirror systems of refundability or transferability would be efficient. The first situation is investor specific; when the government has stopped participating in risk-sharing with an investor, that investor will have a higher required rate of return than otherwise similarly placed investors and will be precluded from making investments that, after taxes, the market has determined should be made. Allowing the investor to specially allocate income and expenses will enable it to accept investments that it would have been able to accept had the government continued sharing risk with this investor; diminishing its tax liability is analogous to a refund for prior over-

some indication that poor performance in firms leads to risk-taking,⁶⁶³ there is no indication that investors with prior losses may have behaved more irrationally than investors with wealth.⁶⁶⁴ With special allocations, loss taxpayers who reduce their required after-tax rate of return, are able to participate in riskier projects,⁶⁶⁵ to generate income, and to facilitate investment at the margin.⁶⁶⁶ Here, the marginal investment is presumed to yield a welfare gain greater than the revenue lost to the government through allowing deductions during the term of the investment. Nonetheless, the special allocation rules could be improved by requiring interest on deficit capital accounts.⁶⁶⁷

payment of taxes. The second situation occurs where the partners have different tax rates such that certain tax aspects of the investment, such as deductible losses or credits, are preferred by one partner because of differential tax rates. The third is where one partner has different expectations about the likelihood of a particular payoff of a particular part of the income from the investment. See *supra* text accompanying note 335. If the investors considering a risky investment with an uncertain probability of payout and the market rate of return reflects this, there are two cases in which it would be efficient to lower an investor's required rate of return to be able to accept a risky project. One is where the market's assessment is incorrect. This can occur because it overvalues the government's effective use of resources. If one views the government as an ineffective user of resources, then society gains by giving the money to a more effective user of resources. It can also occur if the market fails to recognize the long-term benefit of the investment and if this occurs, the government will step in with direct subsidies or indirect subsidies. That is, there exists a class of investments which generate benefits that cannot be quantified and do not appear in the return of the investment. Society benefits from these investments in ways other than simple profits. Because special allocations facilitate the optimal sharing of risk, return, and tax attributes when there is economic substance, partnership investment facilitates risk-bearing in cases of market failure. The classic example is low income housing and the partnership investment in it. It is also obvious that the economy has not fully factored in an income tax on the returns it offers (that is capitalized the tax into prices generally, as opposed to specific assets such as municipal bonds), or when it has, it creates investments that must be subsidized by the government. There may be circumstances in which certain investors should be precluded from investments or have the types of the investments they can make dictated to them. ABC cannot make this investment only because the government has stopped sharing the risk of ABC's investments and increased ABC's required rate of return.

663. See *supra* notes 173-74, 188.

664. See Warren & Auerbach, *supra* note 642, at 1760-61; Campisano & Romano, *supra* note 648, at 733-34. With respect to partnerships, Stephen Utz demonstrates that it would be highly unlikely that inefficient investments would be made. See Utz, *Partnership Taxation*, *supra* note 19, at 717 (if both parties have the same information about the risk, they would not undertake a below the line investment).

665. See Campisano & Romano, *supra* note 648, at 722-30.

666. This is not the same problem with respect to investment by tax exempt entities which is covered by provisions requiring a rate of return and treating them as lenders to the project.

667. For discussion of interest on deficit capital accounts, see *supra* note 444 and accompanying text. As demonstrated in Table 14 at p. 404, if interest at an assumed 7 percent risk-free rate is required on DEF's deficit capital account under the assumptions in Table 11 at p. 401, which is reflected in a net income allocation to ABC of 7 percent of the deficit capital account balance at the beginning of the year, with the remaining income allocated to

4. In Sum

A special allocation performs the function of shifting time and event risk with respect to particular assets.⁶⁶⁸ Thus, the only issue, after requiring a payment of interest on capital accounts to validate the risk-sharing within the partnership, is determining what additional rules must be in place to ensure that the optimal allocation is not solely for tax reasons.⁶⁶⁹ The partnership mechanism allows a special allocation of operating income that is different from an allocation of residual loss. Furthermore, one partner may have agreed to bear depreciation; she is not required to bear gain chargeback,⁶⁷⁰ which reflects a flaw in the current rules.⁶⁷¹ This permits shifting both income and the value of

DEF and all cash flow distributed to *ABC* until the deficit is restored to zero with the partners thereafter sharing income 80 percent to *ABC* and 20 percent to *DEF*. *DEF* implicitly gets the benefit of the tax deduction for the interest but is required to distribute more of the cash flow to *ABC* (\$522.05 rather than \$472.00). The net present value after-tax to *ABC* is \$40.92 and *ABC* now has an internal rate of return of 11.24 percent, rather than the net present value of \$14.10 and internal rate of return of 10.44 percent in Table 11. The net present value to *DEF* is now \$7.13 rather than \$11.79. An adjustment in the profit sharing ratio after the deficit is restored could change the net present value to each into the manner they were allocated in Table 11. If interest were imputed even at the market rate of interest of 10 percent, *ABC*'s net present value would be \$57.16, with an internal rate of return of 11.70 percent. *DEF*'s net present value after-tax would be \$5.19.

Importantly, even if interest were imputed on deficit capital accounts, taxable partners could make the investment. If in Table 14 at p. 404, *ABC* were in the 20 percent tax bracket with an 8 percent required rate of return after-tax, the net present value of the investment would be \$45.53, with a 9.33 percent internal rate of return after-tax, and if *ABC* were in the 40 percent tax bracket with a 6 percent required rate of return, the net present value of the investment would be \$45.83 with a 7.31 percent internal rate of return after-tax. *DEF*'s net present value after-tax would not change. This is also consistent with the proposition that variations in partners' tax rates and risk aversion increase partnership investment. See *supra* notes 303-06 and accompanying text.

668. Cf. Jeffrey L. Kwall, *The Income Tax Consequences of Sales of Present Interests and Future Interests: Distinguishing Time From Space*, 49 OHIO ST. L.J. 1 (1988) (interest shifting between term and remainder holders).

669. Where, however, the choice is based on a value that is obtained on an after-tax utility function that is unrelated to a change in the utility of the economic allocation, the rules prohibit the special allocation and require an allocation in accordance with the partner's total interest in the partnership.

670. Treas. Reg. § 1.704-1(b)(2)(ii) (as amended in 1993).

671. See Gunn, *supra* note 416, at 135 (stating no legitimate reason for attempting to allocate cost recovery deductions without appropriate chargebacks). To be sure, the failure to require an income chargeback and the limitations on allowable income chargebacks can also result in a shift of capital, see *National Oil Co. v. Commissioner*, 52 T.C.M. (CCH) 1223 (1986) (no-taxable capital shift where drilling deductions allocated to one partner and income split between all partners without an income chargeback). The recently issued temporary regulations under § 482 require that an allocation of risk between controlled parties reflect the true assumption of a risk. See Treas. Reg. § 1.482-1T(c)(3)(ii) (1993). Risks must be allocated consistently from year to year so that a risk that causes a taxpayer to earn a below average

the partnership capital and liabilities (where recourse)⁶⁷² and an economic effect both partners would not otherwise agree to in an arm's-length bargain.

IX. CONCLUSION

The provisions that govern the taxation of partners in partnerships may be likened to a rose bush:⁶⁷³ one navigates through the thorns to reach an object of symmetrical beauty, a flower whose color, fragrance, and other attributes are totally unlike any other's. For some reformers of Subchapter K, its flexibility constitutes a dangerous fungus, a fungus that must be controlled. Yet this fungus has some of the most useful and economically sound provisions. The fine-tuning required to eliminate several unintended results must be made in a manner consistent with nature's favorable balance within Subchapter K.

The present aggregate system should be retained—and flexible rules, such as the regulation sanctioning overrides of the “ceiling” rule, are steps in the right direction.⁶⁷⁴ Amendments should be considered to correct unexpected results following from the interaction of several tax rules to the extent an anti-abuse regulation does not preclude these transactions.⁶⁷⁵ Ultimately, the debate over the proper role of Subchap-

return in the early years of an activity will tend to cause above average returns in subsequent years for the same taxpayer. See Treas. Reg. § 1.482-1T(c)(3)(ii)(D) (1993). Provision is made for market share strategies if it can be demonstrated that the same pricing would have been accomplished between uncontrolled entities. See Treas. Reg. § 1.482-1T(c)(4) (1993).

672. Under the rules for deductions attributable to nonrecourse debt, any deductions premised on nonrecourse debt create minimum gain and when the property is sold, or there is otherwise a reduction in minimum gain, a minimum gain chargeback is triggered which requires the gain to be allocated to the partner who took the nonrecourse deduction. See Treas. Reg. §§ 1.704-2(b)(1)-(2) (1991). This requirement is avoided if prior to the event triggering a minimum gain chargeback the obligation is converted from nonrecourse to recourse which allows the partners to allocate any future gain in accordance with the substantial economic effect principles.

673. And they have. See Andrews, *supra* note 17, at 42 n.138; Cunningham, *supra* note 17, at 77.

674. See Treas. Reg. § 1.704-1(c) (as amended in 1993).

675. See generally Richard G. Cohen & Lori S. Hoberman, *Partnership Taxation: Changes for the 90's*, 71 TAXES 882 (1993). These include (1) the ability to manipulate tax results and affect basis with the election or failure to elect section 754, see Andrews, *supra* note 17, at 7-40; (2) the creation of artificial losses through a combination of the partnership tax rules and the installment sale provisions on basis recovery on contingent-price installment sales, see Gergen, *supra* note 10, at 180-81, 191-94; (3) the potential to circumvent the explicit provisions of section 707(a)(2)(B) with the contribution of property to a partnership and an allocation of the income from that property to another partner in a manner that uses up fully the entire amount of its asset value in exchange for an allocation of income from another asset within

ter K has to do with the proper taxation of business and investment: Should one view a partnership as an extension of a sole proprietor or as a combination of detached financial and human capital investors? The shape of partnership taxation must be determined by the economic realities of risk-averse parties contracting with each other in a realization-based tax system that increasingly incorporates the time value of money in its self-definition. The current rules are consistent with a hybrid income-consumption tax system and serve a purpose in encouraging investment at the margin. Complexity in the execution—or administration—is not an objection to the system. Those who want accuracy can adopt it; those who do not can adopt a more simplified form of business taxation for their ventures.

the partnership except to the extent that the new regulations under the disguised sale provisions apply, *id.* at 185-87; and (4) the possible failure of some interactions of the section 704(b) and 704(c) regulations. *Id.* at 184-85; Andrews, *supra* note 17, at 63, 71.

TABLE 5

Capital Account Contributions		Effective Tax Rates		Profit and Loss Allocation Ratios		Straight Line Depreciation	
Q	R	Q	R	Q	R	Q	R
400.00	100.00	40%	40%	80%	20%	100.00	
Partnership Income/ (Expense)		Depreciation Expense		Net Income		Net Present Value Before-Tax at 10%	
Year		Q	R	Q	R	Q	R
0	-500.00					400.00	100.00
1	150.00	80.00	20.00	40.00	10.00	36.36	9.09
2	150.00	80.00	20.00	40.00	10.00	33.06	8.26
3	150.00	80.00	20.00	40.00	10.00	30.05	7.51
4	150.00	80.00	20.00	40.00	10.00	27.32	6.83
5	150.00	80.00	20.00	40.00	10.00	24.84	6.21
Total	250.00	400.00	100.00	200.00	50.00	151.63	37.91
Internal Rates of Return							
						9.43%	9.43%
						15.24%	
Cash Distributed		Capital Account		After-Tax Return		Net Present Value After-Tax at 6%	
Q	R	Q	R	Q	R	Q	R
-400.00	-100.00					-400.00	-100.00
120.00	30.00					98.11	24.53
120.00	30.00					92.56	23.14
120.00	30.00					87.32	21.83
120.00	30.00					82.38	20.59
120.00	30.00					77.71	19.43
600.00	150.00					38.09	9.52

TABLE 6

Capital Account		Effective Tax Rates		Profit and Loss		Straight Line	
Contributions		Q		Allocation Ratios		Depreciation	
Q		R		50%		100.00	
400.00		100.00		50%		50%	
Partnership		Depreciation		Net		Balance of	
Income/		Expense		Income**		Cash Not	
Income/		Q		Q		Distributed	
Q		R		R		at 10%	
Year		Q		R		Q	
0		50.00		25.00		25.00	
1		150.00		33.00		33.00	
2		150.00		33.00		33.00	
3		150.00		33.00		33.00	
4		150.00		33.00		33.00	
5		150.00		33.00		33.00	
Total		250.00		205.00		145.00	
Internal		Rates of		Return		15.24%	
Return		15.24%		6.01%		17.03%	

* Does not include interest on cash not distributed.

** Includes interest on cash not distributed.

TABLE 7

Capital Account Contributions			Effective Tax Rates			Profit and Loss Allocation Ratios			Straight Line Depreciation		
Q	R		Q	R		Q	R		Q	R	
400.00	100.00		40%		40%	50%		50%	100.00		
Partnership Income/			Depreciation Expense			Net Income**			Net Present Value Before-Tax at 10%		
Year	Q	R	Q	R		Q	R		Q	R	
0	-500.00										
1	150.00	50.00	50.00	50.00	7.50	7.50	6.82	400.00	100.00	100.00	100.00
2	150.00	50.00	50.00	50.00	15.50	9.50	12.81	400.00	100.00	28.00	7.00
3	150.00	50.00	50.00	50.00	23.50	11.50	17.66	400.00	100.00	28.00	7.00
4	150.00	50.00	50.00	50.00	31.50	13.50	21.51	400.00	100.00	28.00	7.00
5	150.00	50.00	50.00	50.00	39.50	15.50	24.53	400.00	100.00	28.00	7.00
Total	250.00	250.00	250.00	250.00	117.50	57.50	83.33	42.15	140.00	35.00	517.50

Internal Rates of Return 15.24%

7.55% 10.85%

* Does not include interest on cash not distributed.
** Includes interest on cash not distributed.

TABLE 8

Capital Account Ratio				Partner A							
A	B			Capital Account	Partnership Income	Interest Imputed on B's Cross-Borrowing	Imputed Income From Cross-Borrowing				
100.00%	0.00%										
Profit Sharing Ratio				Year	Distributive Share	Capital Gain	Ordinary Income	a Portion of A's Capital Contribution	(Taxed on a Realization Basis)		
A	B			0	100,000.00						
50.00 %	50.00%			1	100,000.00	0.00	5,000.00 *	5,000.00	5,000.00		
Differential Between Capital Account and Profit Sharing Ratios				2	100,000.00	0.00	10,500.00 *	5,000.00	10,500.00		
A	B			3	100,000.00	50,000.00	16,550.00	5,000.00	16,550.00		
50.00%	50.00%			Beg 4	150,000.00						
				Total	50,000.00	33,450.00	16,550.00	15,000.00	16,550.00		
Interest Rate 10%				Partner B							
				Year	Distributive Share	Partnership Income	Ordinary Income	A's Use of a Portion of B's Service Contribution	Imputed Income From Cross-Borrowing		
Basis in Property 100,000				0	0.00						
				1	0.00	0.00	5,000.00 *	5,000.00	5,000.00		
				2	0.00	0.00	10,500.00 *	5,000.00	10,500.00		
				3	0.00	50,000.00	16,550.00	5,000.00	16,550.00		
				Beg 4	50,000.00						
				Total	50,000.00	33,450.00	16,550.00	15,000.00	16,550.00		
*Cumulative Income Accrued but not Realized				Partnership							
				Capital Account	Partnership Income						
				Year							
				0	100,000.00						
				1	100,000.00						
				2	100,000.00						
				3	100,000.00	100,000.00					
				Beg 4	200,000.00						

TABLE 9

<u>Capital Account Ratio</u>		<u>Partner A</u>		<u>Partner B</u>	
A	B	Capital Account	Partnership Income	Capital Account	Partnership Income
100.00% 0.00%	0.00%				
<u>Profit Sharing Ratio**</u>					
A	B	Distributive Share	Capital Gain	Distributive Share	Capital Gain
60.00% 40.00%	40.00%				
<u>Loss Sharing Ratio</u>					
A	B				
100.00% 0.00%	0.00%				
<u>Differential Between Capital Account and Profit Sharing Ratios</u>					
A	B				
40.00% 40.00%	40.00%				
<u>Interest Rate</u>					
10%					
<u>Basis in Property</u>					
100,000					
<u>Year 2 Depreciation Deduction Not Subject to Recapture</u>					
40,000					
<u>Sale Price</u>					
200,000					
*Cumulative Income Accrued but not Realized					
** After Losses Restored					

Year	Capital Account	Partnership Income	Imputed Income From Cross-Borrowing (Taxed on a Realization Basis)
0	100,000.00		
1	100,000.00		
2	60,000.00		
3	60,000.00		
Beg 4	160,000.00		
Total			

Year	Capital Account	Partnership Income	Imputed Income From Cross-Borrowing (Taxed on a Realization Basis)
0	0.00		
1	0.00		
2	0.00		
3	0.00		
Beg 4	40,000.00		
Total			

Year	Capital Account	Partnership Income	Imputed Income From Cross-Borrowing (Taxed on a Realization Basis)
0	0.00		
1	0.00		
2	0.00		
3	0.00		
Beg 4	40,000.00		
Total			

TABLE 10

Capital Account Ratio		Partner A		Partner B	
A	B	Capital Account	Distributive Share	Capital Account	Distributive Share
66.67% 33.33%					
Profit Sharing Ratio					
A	B				
50.00 % 50.00%					
Differential Between Capital Account and Profit Sharing Ratios					
A	B				
16.67% 16.67%					
Interest Rate					
10%					
Basis in Property					
100,000					
Sale Price					
200,000					
*Cumulative Income Accrued but not Realized					

Partner A		Partnership Income		Interest Imputed on B's Cross-Borrowing a Portion of A's Capital Contribution		Imputed Income From Cross-Borrowing (Taxed on a Realization Basis)	
Year	Capital Account	Distributive Share	Capital Gain	Ordinary Income	Capital Contribution	From Cross-Borrowing (Taxed on a Realization Basis)	
0	66,667.00						
1	66,667.00	0.00		1,666.67 *	1,666.67	1,666.67	
2	66,667.00	0.00		3,500.00 *	1,666.67	3,500.00	
3	66,667.00	50,000.00	44,483.33	5,516.67	1,666.67	5,516.67	
Beg 4	116,667.00						
Total		50,000.00	44,483.33	5,516.67	5,000.00		5,516.67

Partner B		Partnership Income		Interest Imputed on A's Use of a Portion of B's Service Contribution		Imputed Income From Cross-Borrowing (Taxed on a Realization Basis)	
Year	Capital Account	Distributive Share	Capital Gain	Ordinary Income	Service Contribution	From Cross-Borrowing (Taxed on a Realization Basis)	
0	33,333.00						
1	33,333.00	0.00		1,666.67 *	1,666.67	1,666.67	
2	33,333.00	0.00		3,500.00 *	1,666.67	3,500.00	
3	33,333.00	50,000.00	44,483.33	5,516.67	1,666.67	5,516.67	
Beg 4	83,333.00						
Total		50,000.00	44,483.00	5,516.67	5,000.00		5,516.67

Partnership		Partnership Income	
Year	Capital Account	Partnership Income	
0	100,000.00		
1	100,000.00		
2	100,000.00		
3	100,000.00	100,000.00	
Beg 4	200,000.00		

TABLE 12

Capital Account Contributions			Effective Tax Rates			Profit Allocation			Net Present		
ABC	DEF		ABC	DEF		ABC	DEF		Value	After-Tax	Value
850.00	150.00		0%	40%		80%	20%		at 10%	at 6%	
Partnership Income			Income (Loss)			Cash (Invested)			After-Tax		
Year	Income	Expense	ABC	DEF	Allocation	ABC	DEF	Distributed	ABC	DEF	Return
0	0.00	1000.00	-1000.00	-1000.00	0.00	0.00	0.00	-850.00	-150.00	-150.00	-850.00
1	160.00	0.00	160.00	145.45	0.00	-840.00	0.00	160.00	336.00	145.45	316.98
2	160.00	0.00	160.00	132.23	0.00	160.00	0.00	160.00	160.00	132.23	-56.96
3	160.00	0.00	160.00	120.21	0.00	160.00	0.00	160.00	160.00	120.21	-53.74
4	160.00	0.00	160.00	109.28	0.00	160.00	0.00	160.00	160.00	109.28	-50.69
5	160.00	0.00	160.00	99.35	0.00	160.00	0.00	160.00	160.00	99.35	-47.82
6	160.00	0.00	160.00	90.32	0.00	88.00	72.00	138.00	138.00	77.90	-4.79
7	160.00	0.00	160.00	82.11	0.00	128.00	32.00	128.00	128.00	65.68	12.77
8	160.00	0.00	160.00	74.64	0.00	128.00	32.00	128.00	128.00	59.71	12.05
9	160.00	0.00	160.00	67.86	0.00	128.00	32.00	128.00	128.00	54.28	11.36
Total	1440.00	1000.00	440.00	-78.56	472.00	-32.00	-32.00	472.00	472.00	14.10	-10.85
Internal Rates of Return			7.99%			10.44%					

TABLE 13

Capital Account Contributions			Effective Tax Rates			Profit/Loss Allocation		
ABC	DEF		ABC	DEF		ABC	DEF	
850.00	150.00		0%	40%		80%	20%	
Partnership Income			Capital Account			Cash (Invested)		
Year	Income	Expense	Net	ABC	DEF	ABC	DEF	ABC
1	0.00	1000.00	-1000.00	0.00	0.00	-850.00	-150.00	-850.00
2	160.00	0.00	160.00	0.00	0.00	136.00	24.00	136.00
3	160.00	0.00	160.00	0.00	0.00	136.00	24.00	136.00
4	160.00	0.00	160.00	0.00	0.00	136.00	24.00	136.00
5	160.00	0.00	160.00	0.00	0.00	136.00	24.00	136.00
6	160.00	0.00	160.00	0.00	0.00	136.00	24.00	136.00
7	160.00	0.00	160.00	0.00	0.00	136.00	24.00	136.00
8	160.00	0.00	160.00	0.00	0.00	136.00	24.00	136.00
9	160.00	0.00	160.00	0.00	0.00	136.00	24.00	136.00
10	160.00	0.00	160.00	0.00	0.00	136.00	24.00	136.00
Total	1440.00	1000.00	440.00			374.00	66.00	374.00
Internal Rates of Return			7.99%	After-Tax Return			7.99%	7.99%
				Net Present Value Before-Tax at 10%			Net Present Value After-Tax at 6%	
				ABC	DEF	ABC	DEF	ABC
				-1000.00	145.45	-850.00	-90.00	-850.00
				160.00	132.23	136.00	14.40	123.64
				160.00	120.21	136.00	14.40	112.40
				160.00	109.28	136.00	14.40	102.18
				160.00	99.35	136.00	14.40	92.89
				160.00	90.32	136.00	14.40	84.45
				160.00	82.11	136.00	14.40	76.77
				160.00	74.64	136.00	14.40	69.79
				160.00	67.86	136.00	14.40	63.45
				-78.56		374.00	39.60	57.68
								-66.77
								7.94

