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Towards Equity and Efficiency in Partnership Allocations

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TOWARDS EQUITY AND EFFICIENCY IN PARTNERSHIP ALLOCATIONS

Darryll K. Jones[*]

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I. INTRODUCTION

The primary goal of any tax system is to raise sufficient revenue for government.[1] More precisely, taxation is the means by which government supplies necessary things not available from the private market.[2] Taxation allows society to cure distributional imperfections in the market. It is appropriate, therefore, only to the extent that the market cannot provide goods and services for which there is public demand; if private markets equitably supplied food, shelter, health care, education, and common defense, taxes could be greatly reduced if not completely eliminated. The revenue raising goal is thwarted to the extent the taxing system is either inefficient or inequitable. Inefficiency decreases gross national product[3] and inequity spurs

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[1] "We have lost sight of the fact that the fundamental purpose of our tax system is to raise revenues to fund government." THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S SYSTEM, at xiii (2005) [hereinafter PANEL REPORT], *available at* http://www.taxreformpanel.gov/final-report/. Joseph Sneed listed seven purposes, of which raising revenue was first:

> (1) to supply adequate revenue, (2) to achieve a practical and workable income tax system, (3) to impose equal taxes upon those who enjoy equal incomes, (4) to assist in achieving economic stability, (5) to reduce economic inequality, (6) to avoid impairment of the operation of the market-oriented economy and (7) to accomplish a high degree of harmony between the income tax and the sought-for political order.

Joseph T. Sneed, *The Criteria of Federal Income Tax Policy,* 17 STAN. L. REV. 567, 568 (1965) (emphasis omitted).

[2] This more precise conceptualization allows for the redistribution and behavior modification (i.e., by favoring certain markets over others) goals that animate the tax code. Redistribution and behavior modification are, in fact, public goods that cannot be had via the private market place. Government must therefore raise revenue to purchase those goods. Ultimately, then, taxation is exclusively for the purpose of raising revenue, although merely as a means to other ends. "Taxation has always been both about revenue and equity – about effectively raising government funds and fairly distributing fiscal burdens." Ajay K. Mehrotra, *Envisioning the Modern American Fiscal State: Progressive-Era Economists and the Intellectual Foundations of the U.S. Income Tax*, 52 UCLA L. REV. 1793, 1797 (2005).

[3] The meaning of "efficiency" is discussed in greater detail below. For now, though, it suffices to quote Professors Lazear and Poterba, writing in the *Wall Street Journal*:

> A tax system should generate the government's required revenue with as little economic distortion as possible, while distributing tax burdens fairly.

resentment and avoidance.[4] Both consequences – inefficiency and inequity – interfere with the market's ability to supply goods and services and have the perverse effect of provoking more tax levies. The two secondary concerns – efficiency and equity – need not be mutually exclusive, though it is sometimes argued that the pursuit of equity decreases efficiency and vice versa.[5] Progressive taxation

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> It should not discourage work, saving, or entrepreneurship more than is necessary, and it should not discourage individuals from acquiring skills and education that will increase their productivity. It should not discourage investment, or favor investments in one asset over those in another. In short, an efficient tax system alters economic decision-making as little as possible.

Edward P. Lazear & James M. Poterba, *A Golden Opportunity*, WALL ST. J., Nov. 1, 2005, at A16. The writers are both members of the President's Advisory Panel on Federal Tax Reform. *See supra* note 1.

[4] Equity is actually a component of efficiency. *See* PANEL REPORT *supra* note 1, at 36–37 (including "fairness" in the discussion of an efficient tax system). If taxpayers engage in active resistance or avoidance because they believe a tax system is inequitable, the tax system will be forced to respond by getting and then spending more to combat that resistance or avoidance, and/or increasing the rates of tax on those who are unable to successfully resist or avoid the system, thereby inducing further resistance and avoidance. John Braithwaite, for example, laments the inevitable result of inequity, generated by tax shelter activities that provoke further avoidance amongst those who believe others are getting away with tax avoidance:

> Fiscal termites breed moral termites. Public opinion has not been oblivious to these structural shifts – in an admittedly unsophisticated way, ordinary people have noticed them and resent them deeply. As a result, the problem of top-down tax avoidance . . . is compounded by bottom-up tax evasion – detectable growth in most societies in the size of the underground economy as ordinary people fight back, for example, by using cash transactions and barter to void tax . . .While most people are crudely but acutely aware of the existence of tax shelters that are available to the rich but not to them, their response is not political resistance so much as privatized cheating in smaller ways they can manage to get away with.

JOHN BRAITHWAITE, MARKETS IN VICE, MARKETS IN VIRTUE 31 (2005).

[5] Perhaps Henry Simons made this point best:

> The case for drastic progression in taxation must be rested on the case against inequality – on the ethical or aesthetic judgment that the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly evil or unlovely.
>
> Such a view obviously takes account merely of the distributional effects of progression. Indeed, that is as far as traditional discussions of justice in taxation may properly go. Yet this is obviously but one side of the problem. The degree of progression in a tax system may also affect

seems inequitable because it imposes disparate nominal burdens on taxpayers.[6] One explanation, of course, is that the marginal utility of each dollar is greater to lower earners than to higher earners.[7] The nominally higher extraction from higher earners is equal to the nominally lower extraction from lower earners.[8] Equity is thereby preserved or attained and, assuming progressive rates are set at optimal levels, the tax system should nevertheless achieve its revenue raising goal.[9]

> production and the size of the national income available for distribution. In fact, it is reasonable to expect that every gain, through taxation, in better distribution will be accompanied by some loss in production. The real problem of policy, thus, is that of weighing the one set of effects against the other.

HENRY SIMONS, PERSONAL INCOME TAXATION 18–19 (1938).

[6] The most enduring indictment of progressive taxation is contained in Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952). A more contemporary attack is provided in Jeffrey A. Schoenblum, *Tax Fairness or Unfairness: A Consideration of the Philosophical Bases for Unequal Taxation of Individuals*, 12 AM. J. TAX POL'Y 221 (1995). This paper, of course, is not about progressive taxation, *per se*. This paper assumes that progressive taxation is desirable and then conceptualizes the inefficiency and inequity of partnership allocations as an attack on progressivity.

[7] *See* Sneed, *supra* note 1, at 575–77 (concisely describing the basic rationale for progressive taxation). The scholarly literature regarding progressive taxation is voluminous and exhaustive. *See, e.g.*, Martin J. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 993, 1021 n.109 (2004) (listing numerous books and articles regarding progressive taxation).

[8] The "benefit" and "ability to pay" theories are also used to justify progressive taxation. Very simply stated, those with the most wealth are deemed to benefit most from public goods and therefore should pay more taxes.

[9] That equity and efficiency can co-exist, though not universally accepted, has been previously asserted:

> The absence of a linear relationship between effort, ability, and compensation in winner-take-all markets lends special force to arguments that rest on diminishing marginal utility of money. Even a model that makes conservative assumptions about the rate at which the marginal utility of money declines shows that in winner-take-all markets progressive taxation results in greater total private utility after taxes than proportional taxation. In a society dominated by winner-take-all markets, then, we do not need to trade equity for efficiency. Progressive income taxation can provide both.

Martin J. McMahon, Jr. & Alice G. Abreu, *Winner-Take-All Markets: Easing the Case for Progressive Taxation*, 4 FLA. TAX REV. 1, 10–11 (1998). Legal economists state the rough equilibrium goal as though equity and efficiency are mutually dependent:

> One, laws should be arranged so as to maximize social welfare, that is, to

The equal burden justification is entirely familiar and widely accepted, at least as a political matter.[10] The debate is more often about the degree of progressivity than whether progressive rates are appropriate. Ideally, equity and efficiency exist in rough equilibrium when presumptively correct progressive rates are appropriately enforced.[11] The tax code, broadly defined, contains rules and doctrine

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> serve "efficiency." Two, the tax system should be used to redistribute social resources so as to maximize the sum of individual well-being, that is, to serve "equity." The two-part approach satisfies a paretian constraint: The greater social pie facilitated by the first step can be used in the second step's redistribution to assure that no one is harmed by any reform.

Edward J. McCaffery & Jonathan Baron, *Tax Policy in an Era of Rising Inequality: The Political Psychology of Redistribution,* 52 UCLA L. REV. 1745, 1746–47 (2005); *see also* Tomer Blumkin & Yoram Margalioth, *On The Limits of Redistributive Taxation: Establishing a Case for Equity-Informed Legal Rules,* 25 VA. TAX REV. 1, 18–21 (2005) (making the case that the most efficient legal rule can lead to the most inequity).

[10] That the progressive tax remains politically normative is demonstrated by the continuing failure to adopt a flat tax despite quadrennial calls for the adoption of a truly flat tax. *See generally* Stephen B. Cohen, *The Vanishing Case for Flat Tax Reform: Growth, Inequality, Saving, and Simplification,* 33 VAL. U. L. REV. 819 (1999). Even recent proposals for tax reform retain some degree of progressivity. For example, The President's Advisory Panel on Federal Tax Reform offered two proposals that might generally be described as consumption taxes, both of which retain graduated rates, though at much lower levels than have previously existed. PANEL REPORT, *supra* note 1, at xiv.

> As one of the main proponents of the Flat Tax has commented, the Flat Tax "name is brilliant marketing, but it fails to convey the central feature of the idea relative to a VAT [value added tax] – the Flat Tax is progressive." The Flat Tax is progressive because the individual tax applies only above an exemption amount. Low-income workers, therefore, do not pay tax on their compensation to the extent it falls below the exemption amount. The Flat Tax is most commonly proposed using a single rate tax rate that applies to both businesses and workers above the exemption level. However, the Flat Tax can be made even more progressive by using multiple graduated rates at the individual level.

Id. at 39–40. While it is safe to conclude that scholars and policy makers still generally agree that progressive taxation is appropriate and desirable, there are significant objections put forth. For useful summaries of the growing scholarly objections to progressive taxation beginning during the early 1980s and today, see Marjorie E. Kornhauser, *The Rhetoric of the Anti-Progressive Income Tax Movement: A Typical Male Reaction,* 86 MICH. L. REV. 465 (1987) and Ajay K. Mehrotra, *Envisioning the Modern American Fiscal State: Progressive-Era Economists and the Intellectual Foundations of the U.S. Income Tax,* 52 UCLA L. REV. 1793 (2005).

[11] Zelanak and Moreland note that "optimal income tax analysis provides sophisticated mathematical techniques for finding the tax and transfer system that best balances the utility gains from income redistribution against the efficiency losses

designed to defend presumptively correct progressive rates despite whatever efficiency losses are occasioned thereby.[12] Ironically, the Internal Revenue Code (Code) knowingly tolerates substantial breaches in those defenses because subchapter K, the partnership tax provisions,[13] contains easily exploitable statutes and regulations by which taxpayers may avoid their appropriate tax burden.[14] The

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from the disincentive effect of taxation." Lawrence Zelenak & Kemper Moreland, *Can the Graduated Income Tax Survive Optimal Tax Analysis?*, 53 TAX L. REV. 51, 51–52 (1999); *see also* Martin J. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 993, 1077–79 (2004) (disputing the notion that equity and efficiency are mutually exclusive).

[12] Indeed, one of the arguments against progressive rates is that they "lead to complex tax laws in order to forestall the shifting of income from one taxable year to another, or from one taxable unit to another." Kornhauser, *supra* note 10, at 471. See *infra* notes 56–59 and accompanying text for more detail regarding the tax doctrines designed to protect progressive rates.

[13] Subchapter K consists of I.R.C. §§ 701–777.

[14] The particulars of tax avoidance made possible by subchapter K are discussed in Part III. There is a significant but still manageable body of scholarship regarding the extent to which partnership allocations condone tax avoidance. Representative articles are cited here merely for introductory purposes and to highlight a theme: Curtis J. Berger, *W(h)ither Partnership Taxation*, 47 TAX L. REV. 105, 108 (1991) ("[T]o keep tax planners from wholly abusing the partnership's privileged status, while not denying them all remaining flexibility, Congress and Treasury have had to fashion a statutory and regulatory apparatus which, despite its genius, has become one of the most inaccessible and burdensome features of the entire tax system."); Edward J. Buchholz, *Substantiality Under I.R.C. 704(b) – Some Forgotten Issues and Some Ancient Concepts Revisited*, 19 VA. TAX REV. 165, 235–36 (1999) ("Late in 1994, after surviving protracted attacks by practitioners and others, the Service finalized so-called partnership anti-abuse regulations ostensibly intended to stop a series of transactions taking advantage of specialized basis rules in Subchapter K and the ambivalent treatment of partnerships as either entities or aggregates."); Laura Cunningham, *Use and Abuse of 704(c)*, 3 FLA. TAX REV. 93 (1996) (describing the gain and loss shifting potential under partnership taxation and the regulatory response thereto); Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1 (1990) ("The flexibility of subchapter K, one of its most celebrated features, has given partners license to shift income and loss among themselves and dispose of assets while deferring recognition of gain in ways that are not otherwise possible under the income tax."); Mark P. Gergen, *The End of the Revolution in Partnership Tax*, 56 SMU L. REV. 343, 355 (2003) ("The usual criticism of the system of capital accounts analysis [in partnership taxation] is that it weakly regulates special allocations. The system can be gamed by offsetting allocations."); Jeffrey L. Kwall, *Taxing Private Enterprise in the New Millennium*, 51 TAX LAW. 229, 232 (1998) ("The flexible partnership tax regime was designed to accommodate relatively simple economic undertakings. Over the years, sophisticated taxpayers have entered into a variety of tax-motivated arrangements that exploited this flexibility."); Richard M. Leder, *Tax Driven Partnership Allocations With Economic Effect: The Overall After-*

existence of partnership tax provisions that make progressive rates very nearly optional belies the apparent agreement with regard to progressivity, particularly with respect to taxpayers whose livelihood is funded primarily by stored capital rather than by labor.

A tax system is perfectly equitable, incidentally, if each person subject to its rules bears an equal share of aggregate societal costs, taking into account relative incomes.[15] Equity losses occur when some taxpayers systematically avoid paying their appropriate share. Unnecessarily high equity losses are intrinsic to subchapter K's substantial economic effect safe harbor[16] while efficiency gains from that harbor are questionable at best. In short, the substantial economic effect safe harbor allows partners to divide the tax benefits and burdens from their joint economic activity in any manner that is not cerebrally motivated, in the first instance, by tax reduction.[17] Any

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Tax Present Value Test for Substantiality and Other Considerations, 54 TAX LAW. 753, 754 (2001) ("There are numerous situations in which U.S. tax benefits among partners may be optimized through special allocations, allocations that would not be made, but for the tax effect . . . ."); Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 FLA. TAX REV. 249, 250 (1999) ("The flexibility of the original conduit model facilitated devices to shift income, deductions, and other tax attributes from partner to partner and from property to property in ways that Congress found unacceptable."); Walter D. Schwidetzky, *The Partnership Allocation Rules of Section 704(b): To Be or Not to Be*, 17 VA. TAX REV. 707, 708 (1998) ("Some members of the legal academic community (the 'academy') have been critical of the substantial economic effect regulations, arguing that they permit the taxpayers to avoid taxation in ways that would not be possible outside the partnership context."); Stephen Utz, *Allocation and Reallocation in Accordance with the Partners' Interests in the Partnership*, 56 TAX LAW. 357 (2003) ("Commentators agree that the [partnership tax allocation] guidelines are vague and puzzling.").

[15] Sneed, *supra* note 1, at 579. I have, of necessity, greatly simplified a concept — equality — that is most likely incapable of consensus. This article assumes, as an equity baseline, that the distribution of tax burdens under the individual income tax represents society's determination of "equity," however defined. A system of taxation that deviates from that determination is therefore presumptively unfair and illegitimate in the absence of efficiency gains that compensate for the unfairness. *See infra* note 30 and accompanying text. For an exploration of the metaphysical, political and historical consideration of equity as it relates to tax law, see Maureen B. Cavanaugh, *Democracy, Equality, and Taxes*, 54 ALA. L. REV. 415 (2003) and Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45 (1990).

[16] Treas. Reg. § 1.704-1(b)(ii) (2005).

[17] The details of the substantial economic effect test are discussed in Part III. The voluminous regulatory language is set out below so the reader may refer to it as needed:

(2) Substantial economic effect

(i) *Two-part analysis.* The determination of whether an allocation of income, gain, loss, or deduction (or item thereof) to a partner has substantial economic effect involves a two-part analysis that is made as of the end of the partnership taxable year to which the allocation relates. First, the allocation must have economic effect (within the meaning of paragraph (b)(2)(ii) of this section). Second, the economic effect of the allocation must be substantial (within the meaning of paragraph (b)(2)(iii) of this section).

(ii) Economic effect

(a) Fundamental principles. In order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.

(b) Three requirements. Based on the principles contained in paragraph (b)(2)(ii)(*a*) of this section, and except as otherwise provided in this paragraph, an allocation of income, gain, loss, or deduction (or item thereof) to a partner will have economic effect if, and only if, throughout the full term of the partnership, the partnership agreement provides —

(1) For the determination and maintenance of the partners' capital accounts in accordance with the rules of paragraph (b)(2)(iv) of this section,

(2) Upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (*2*) and requirement (*3*) of this paragraph (b)(2)(ii)(*b*)), by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), and

(3) If such partner has a deficit balance in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (*3*)), he is unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), which amount shall, upon liquidation of the partnership, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances (in accordance with requirement (*2*) of this paragraph (b)(2)(ii)(*b*)).

Treas. Reg. § 1.704-1(b)(iv)(2) (2005). The substantiality requirement invokes the

division of tax benefits and burdens, even one that is motivated by and in fact results in tax avoidance is permissible so long as the improper tax avoidance intent is undetectable to a nearly blind and deaf observer. Partnership tax could be administered without those high equity losses if it were possible, instead, to articulate a reasonably definitive method by which to assign partners' tax benefits and burdens consistently with the incidence of partners' economic burdens and benefits. Rather than the loose fitting, imprecise substantial economic effect safe harbor, the Code could rely on the reasonably definitive, better fitting test to more accurately measure each partner's appropriate share of a partnerships' tax benefit or burden. The better test would reduce unnecessary equity losses by decreasing partners' ability to transfer or avoid their accurate tax benefit or burden.

This article searches for an administrable and more accurate method to determine each partner's tax benefit and burden. It proposes that allocations, to be respected, must be strictly in accordance with the partner's relative capital in the partnership ("capital account allocations"). Partners should be allowed to deviate from capital account allocations only when they can prove that capital account allocations are inconsistent with the division of economic

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mental processes to which the word "cerebrally" relates:

> (iii) Substantiality
>
> (a) General rules. Except as otherwise provided in this paragraph (b)(2)(iii), the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. Notwithstanding the preceding sentence, the economic effect of an allocation (or allocations) is not substantial if, at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. 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.

Treas. Reg. § 1.704-1(b)(2)(iii)(a) (2005).

benefits and burdens.[18] Frankly, the difference between this proposal and prior proposals is slight.[19] The capital account allocation method replaces the substantial economic effect test as the safe harbor but, unlike prior proposals, is not mandatory in the strictest sense. If partners can show that allocations in accordance with capital accounts would be inconsistent with their relative accessions to wealth, they should be allowed to make special allocations under a more definitively articulated special allocation test. Thus, special allocations are not prohibited but subjected to a very strong negative presumption, and the burden of proof with regard to non-capital

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[18] Present law effectively creates a presumption that allocations disproportionate to contributed capital are consistent with the economic arrangement and then places a nearly impossible burden on the tax collector of proving the taxpayer's illegitimate intent. *See* Kwall, *supra* note 14, at 243 ("When [disproportionate] allocations are sanctioned by a system that taxes all business income to the owners of the enterprise, the burden falls on the tax law to identify the economic relations of the owners. Such a system inevitably is quite complicated and creates potential for abuse."). *Castle Harbour v. Commissioner* contains a stark example of the effect of a positive presumption in favor of disproportionate allocations coupled with a nearly insurmountable government burden to prove the mental state of the taxpayer. Castle Harbour v. Commissioner, 342 F.2d 94 (D. Conn. 2004). In that case, the disproportionate allocation allowed the taxpayer to defer recognition of nearly $64,000,000. *See generally* Karen C. Burke, *Castle Harbour: Economic Substance and The Overall-Tax-Effect Test*, 107 TAX NOTES 1163 (May 30, 2005); Darryll K. Jones, *Castle Harbour and The Hobgoblins of Little Minds*, 106 TAX NOTES 605 (Jan. 31, 2005). The opinion in *Castle Harbour* candidly admits that the taxpayer, as a result of the government's failure to disprove the propriety of disproportionate distributions, received a windfall tax benefit without having incurred a corresponding economic burden. *Castle Harbour*, 342 F.2d at 121 ("In short, the transaction, though it sheltered a great deal of income from taxes, was legally permissible. Under such circumstances, the I.R.S. should address its concerns to those who write the tax laws.").

[19] Most of the scholarly proposals to date would categorically disallow disproportionate allocations. *See* Berger, *supra* note 14 (proposing that all small business — as determined by income — be taxed under a modified version of subchapter S, which does not allow disproportionate allocations); Gergen, *Reforming Subchapter K*, *supra* note 14 (proposing that disproportionate allocations be categorically prohibited); Kwall, *supra* note 14 (proposing that disproportionate allocations be categorically prohibited and imposing a single entity level tax on "complex" private enterprises that would otherwise desire special allocations); Lokken, *supra* note 14 (proposing to foreclose subchapter K to all business except service, firms and allowing all other firms to elect a modified subchapter S taxing regime); George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141 (1999) (proposing an optional subchapter K regime to small business complying with certain ownership limitations and which may not make disproportionate allocations).

account allocations is more explicitly placed on those with the greatest information access.

This article's larger purpose is to address the implicit efficiency and equity assumptions that apparently underlie the continuing reliance on the substantial economic effect safe harbor. Congress's failure to adopt one or the other of the very good and defensible proposals[20] implies that the case against the substantial economic effect test has not been made. Indeed, each of the prior proposals represents an improvement over the present system but their proponents have devoted insufficient attention to proving the extent to which the present system is both inefficient and inequitable. This has allowed some to argue, with apparent success, that the benefits of doing nothing outweigh the costs of change.[21]

This article defines efficiency from a macro standpoint. A tax system is perfectly efficient if it maximizes aggregate social utility — the most good for the most people.[22] If the tax base is defined by

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[20] See *supra* note 19 for descriptions of proposals.

[21] *See* Schwidetzky, *supra* note 14 (arguing that the substantial economic effect test prevents most realistic tax avoidance schemes); Rebecca S. Rudnick, *Enforcing the Fundamental Premises of Partnership Taxation*, 22 HOFSTRA L. REV. 229 (1993) (setting forth the efficiency defenses of subchapter K).

[22] I will make reference to Pareto and Kaldor-Hicks efficiency below. *See infra* note 27 and accompanying text. For now, I adopt the very down-to-earth explanation of efficiency provided by The President's Advisory Panel on Federal Tax Reform:

> *What are efficiency costs?* Finally, the income tax imposes EFFICIENCY COSTS on the economy. These costs arise when high tax rates discourage work, savings, and investment; distort economic decisions of individuals and businesses; and divert resources from productive uses in our economy . . . .
>
> When taxpayers change their behavior to minimize their tax liability, they often make inefficient choices that they would not make in the absence of tax considerations. These tax-motivated behaviors divert resources from their most productive use and reduce the productive capacity of our economy. Economic growth suffers as taxpayers respond to the tax laws rather than to underlying economic fundamentals. These distortions waste economic resources, reduce productivity, and, ultimately lower living standards for all.
>
> It would be difficult, however, to imagine a tax system that has no excess burden. Excess burden arises from people adopting less efficient behavior . . . .
>
> For this reason, it is clear that raising revenue through taxation requires some distortions in the economy. One goal of good tax policy is to

reference to personal consumption, or the potential thereof, the making of economic expenditures and other instances of foregone personal consumption are legitimate efficiency reasons to lessen a taxpayer's relative tax burden.[23] The taxpayer's profit-seeking expenditure (i.e., foregone personal consumption) increases aggregate utility to a greater extent than if the taxpayer engaged in personal consumption and paid a higher tax. The increased satisfaction of societal needs reduces everyone's tax burden to a greater extent than if the taxpayer engaged in personal consumption and paid a higher tax. That is, the private satisfaction of societal needs is better than governmental satisfaction of those needs. Overall, governmental extraction and redistribution should decrease to the extent one person's investment increases economic well-being for many others who would otherwise depend on, and benefit from, higher extractions.[24] Thus, reducing extractions from the maker of economic expenditures is an efficient means of paying for public needs.

The efficiency rationale explains why subchapter K allows partners to determine for themselves the assignment of tax benefits and burdens arising from partnership operations. It is thought most efficient that partners be allowed to assign tax benefits and burdens amongst themselves without government supervision or intervention, provided they do so in a manner consistent with the natural division of economic benefits and burdens arising from their joint activity. Individuals do not have that level of freedom, at least not explicitly, even in instances when it might be more efficient to grant that authority to individuals.[25] In fact, the rules pertaining to partnership taxation have always demonstrated an inordinate solicitude for efficiency, oftentimes at the expense of equity. Partnership tax provisions allow implicit and tax-free economic exchanges for the sake

> minimize these distortions within a "fair" tax structure. The trade-off between fairness and efficiency in raising revenue is one of the central challenges of designing a tax system.

PANEL REPORT, *supra* note 1, at 36–37 (emphasis in the original).

[23] Thuronyi, *supra* note 15, at 56–57 (regarding the deductibility of expenses for which no personal benefit is received).

[24] Governmental extractions of income cannot be entirely eliminated because certain public goods — highways and armies, for example — will never be adequately produced by individual investment nor are they subject to inequitable distribution.

[25] For example, the "kiddie tax" can be viewed as a severe ownership diversification disincentive because it taxes the earnings from capital owned by a child at the parent's marginal rate even in the absence of any tax shifting motivation. I.R.C. § 1(g). A grandparent's entirely altruistic gift of stock to a child, for example, might be delayed because of the negative tax consequences.

of efficiency.[26] The substantial economic effect safe harbor is the sole limitation on partners' ability to engage in these exchanges and that harbor is wide and deep. Individuals separately engaged in economic activity are disadvantaged because they cannot engage in the same activity without a tax cost. Individuals should therefore be compensated for this inequity via lower individual tax burdens.[27] That is, there ought to be measurable efficiency gains if partners are to be granted tax concessions not made available to individuals. The idea implicit in the substantial economic effect safe harbor is that efficiency gains obtained via exchanges occurring within a joint economic activity, the tax benefits and burdens from which are left to the partners' individual judgments, are spread throughout society and ultimately reduce everyone else's tax burden. The substantial economic effect safe harbor, though, does not and cannot ensure that result because it is too loosely defined.

Special allocations are defined broadly to include any division of tax benefits and burdens disproportionate to the partners' relative capital ownership.[28] If two partners have residual claims to equal

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[26] *See infra* notes 90–95 and accompanying text.

[27] If the advantages provided to partners via subchapter K were Pareto efficient, partners would be better off as a result of the tax-free implicit exchanges allowed under subchapter K and individual taxpayers would be no worse off. *See* Christopher T. Wonnell, *Efficiency and Conservatism*, 80 NEB. L. REV. 643, 645 (2001). Individuals are worse off, though, because they suffer a disutility (resentment) from the knowledge that partners do not pay the same amount of taxes on the same income. The advantages provided to partners via subchapter K would be efficient per Kaldor and Hicks if the advantages provided to partners also worked to the advantage of individual taxpayers so that everyone was better off. *Id.* at 646. All of this means that the advantages obtained by partners should lessen the government's need for revenue and therefore everyone's tax liability. I argue below that the substantial economic effect test does not assure this result.

[28] The text definition is consistent with the manner in which the phrase, "special allocations" is variously used in subchapter K. *Compare* Treas. Reg. § 1.704-3(e)(3)(iii)(A) (2005) (referring to non-pro rata allocations made by securities partnerships) *with* Treas. Reg. § 1.706-1(b)(4)(ii)(B) (2002) (referring to the need to account for special allocations in determining a partner's percentage share of profits) *and* Treas. Reg. § 1.731-2(b)(3)(ii) (1996) (referring to the special allocations with regard to a distribution of marketable securities). *See also* Rudnick, *supra* note 21.

> A special allocation is any allocation of an item or temporal preference for income that varies from the partners' interests in the partnership. 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.

amounts of capital but divide the tax benefits and burdens differently, they are making special allocations. The article accepts, for the sake of argument, that allocations in accordance with relative capital are not always optimally efficient and therefore should not be mandated in all cases. Capital account allocations, however, are never inefficient or inequitable and therefore should serve as the safe harbor rather than the always inequitable, and rarely efficient, substantial economic effect safe harbor. Partners who make the assertion, dubious though it may be, that capital account allocations actually create inefficiency (as opposed to being non-optimally efficient) should have the burden of persuasion. In this manner, equity losses arising from any concession granted can be more precisely associated with efficiency gains.

That special allocations have been allowed almost since partnerships were first recognized as distinct entities suggests that whatever equity loss occurs is, in fact, equaled or exceeded by efficiency gains.[29] Efficiency gains resulting from an apparent inequity ought to compensate for equity loss so that the rough, equity-efficiency equilibrium is undisturbed in the aggregate.[30] The easy and persistent manipulation of the substantial economic effect safe harbor to avoid progressive rates, by character shifts or deferral, and often without efficiency gains, suggests the opposite is true.[31] Efficiency

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[29] For a history of special allocations dating back to 1919, see Rudnick, *supra* note 21, at 373–76.

[30] In such cases, we could conclude that advantages provided to partners are Kaldor-Hicks efficient. *See supra* note 27. Legal economists implicitly recognize that efficiency gains correspond with equity losses but that a rough equilibrium resulting in neither inordinate efficiency nor equity losses can be achieved:

> The fact that an efficient legal rule maximizes the size of the pie means – by the usual argument that margins are zero at a maximum – that there will be no marginal efficiency losses associated with moving off of the perfectly efficient point. There will, however, be nonzero marginal *equity* effects because, of course, the perfectly efficient point does not also maximize equality. Indeed, moving off of the perfectly efficient point in the right direction will positively reduce inequality on the margin.
>
> The presence of marginal equity gains and the absence of marginal efficiency losses means that perfect transfers are possible on the pure efficiency margin.

Chris William Sanchirico, *Deconstructing the New Efficiency Rationale,* 86 CORNELL L. REV. 1003, 1010 (2001).

[31] "Special allocations can provide two different tax advantages. Allocations which shift gain and loss take advantage of tax rate differences between partners by

gains, if any, are greatly exceeded by equity losses particularly when the substantial economic effect test renders economically nonsensical investment nonetheless profitable on an after-tax basis. In the latter instance, partners should be indifferent to efficiency as defined in this article. If this is so, special allocations should be curtailed to the extent necessary to restore the rough equilibrium between equity and efficiency.

The substantial economic effect safe harbor, by which allocations are analyzed for correctness, has never been viewed as the exclusive mechanism to maintain the rough equilibrium between equity and equilibrium.[32] Instead, the test is thought of as simply the best that can be articulated and administered despite its notorious ineffectiveness. In the absence of the substantial economic effect test, or a better alternative, every single partnership and the Service would be obliged to devote such resources to particularized determinations as to render the partnership investment wholly inefficient. Particularized determinations — made through an examination of each partner's investment in, and rights and obligations with respect to the partnership — are therefore mandated under present law only when it is determined that a partnership's special allocations violate the substantial economic effect safe harbor,[33] an unlikely occurrence even if the partners intentionally seek conversion or deferral of income. The looseness of the substantial economic effect safe harbor disrupts the rough equilibrium and suggests the need for a more accurate and equitable approach.

Previous attempts to define the appropriate way to accurately assign tax benefits and burdens to partners have ignored or skipped over the relationship between partnership taxation and individual income taxation in general.[34] Subchapter K, though, is not intended to

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deferring income to the higher rate partner .... Character shifting allocations shift income, gain, or loss on assets so that partners may take advantage of differences in their character." Gergen, *Reforming Subchapter K*, *supra* note 14, at 4; *see also infra* note 122 and accompanying text.

[32] *See* AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: SUBCHAPTER K 248–49 (1984) [hereinafter ALI PROJECT] (stating that the substantial economic effect test should not be changed, but that underlying principles and examples should be included in regulations).

[33] I.R.C. § 704(b).

[34] The comparison, instead, is most often between partnerships and other types of business associations, i.e., the entity versus the aggregate approach. *See, e.g.*, Berger, *supra* note 14; Kwall, *supra* note 14; *Taxation of Private Business Firms*, *supra* note 14; Yin, *supra* note 19. Comparing partnership taxation to the taxation of S or C corporations tends to reduce the equity losses and increase the efficiency gains, at

create a new or free-standing tax but is merely a structural mechanism by which to apply an existing individual income tax to an efficient and frequently occurring context.[35] In Part II, the article therefore reconsiders the circumstances under which individuals are required to bear the burden of a taxable income (positive income) or are granted the benefit of a tax deduction (negative income) outside the partnership concept. Prior efforts have neglected individual income tax concepts such as constructive receipt and the assignment of income doctrine. Those realization concepts are useful in determining the extent to which a partner should be associated with tax benefits and burdens derived through the partnership form. The doctrines essentially confirm the notion that the incidence of income is proportionate, never disproportionate, to the incidence of economic ownership. An obvious but often forgotten point is that Congress intends partners to be taxed exactly like individuals except when significant efficiency concerns — significant enough to outweigh equity losses — justify a departure. We therefore ought to remind ourselves of the explicit circumstances in which individuals bear a tax burden or are granted a tax benefit before articulating how to ensure those benefits and burdens are accurately assigned after passing through the partnership form. Then, we should remember that the assignment of tax benefits and burdens amongst partners should differ from the assignment of tax benefits and burdens amongst individuals only if there is something about the pass-through that justifies or necessitates a difference, and then only to the extent efficiency gains compensate individuals for the inequity they suffer.[36]

Part III proceeds from the established baseline and engages in a critical analysis of the extent to which the substantial economic effect safe harbor is efficient, increases aggregate utility, and maintains the

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least insofar as the comparison is to C corporations.

[35] Indeed, Congress's first decision to enact provisions related to partnership taxation was motivated merely by the need to create uniform reporting amongst individuals who conducted business via unincorporated associations. Bradley T. Borden, Sandra Favelukes & Todd E. Molz, *A History and Analysis of the Co-ownership-Partnership Question,* 106 TAX NOTES 1175 (Mar. 7, 2005). Legal economists also consider the partnership an extension of the sole proprietorship. Rudnick, *supra* note 21, at 259–60 ("The partnership is an extension of the individual savings model through an investment in a firm that deploys resources for production and investment decisions and which is conceptualized as an extended sole proprietorship.").

[36] "Does there remain something special about the partnership that should entitle partners to a degree of flexibility that the tax law allows neither corporate shareholders nor cotenants?" Berger, *supra* note 14, at 131.

equity-efficiency equilibrium. The substantial economic effect safe harbor is entirely procedural. Although it is articulated in substantive tax language, its impact is actually limited to the allocation of compliance and enforcement resources. As such, it serves as a very classic safe harbor akin to an internal policy memorandum regarding the circumstances under which the tax collector will require further explanation from any partner or partnership. That it is manifestly procedural is not, by itself, sufficient to condemn the substantial economic effect safe harbor as a useless tool. We should be cognizant, though, of the familiar tax dichotomy concerning form and substance. An assignment of a tax benefit or burden to a partner may meet the substantial economic effect form perfectly and yet have little or no relationship to the true substantive incidence of tax burdens and benefits.[37] It is inevitable that formal compliance will deviate from substantive compliance with regard to any safe harbor. The objection in this article is that the current amount of deviation is unnecessary.

The question becomes whether the cost associated with whatever irreconcilable deviation exists between safe harbor and substance is justified by the resulting benefit. Are the compliance and enforcement savings outweighed by losses arising from substantive noncompliance? From an efficiency-equity standpoint, a safe harbor is legitimate only to the extent its savings exceed its costs and then only if the savings are significantly greater than the cost. If that assertion is true, the case for the substantial economic effect test is weak, indeed, and we should articulate a better test, even if the result is not one as easily administered as the present safe harbor. If we are to continue to use a safe harbor in partnership taxation, the articulation of that safe harbor should be skewed more towards substantive compliance than enforcement asset allocation.

Part IV returns to the axiom established in Part II — partners' tax benefits and burdens should be the same as if the partners were separately engaged individuals. The axiom underlies the current "partner's interest in the partnership" (PIP) test.[38] Ostensibly, the test

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[37] *See generally* Yin, *supra* note 19, at 154–65 (regarding the inherent ineffectiveness of the substantial economic effect test).

[38] Treas. Reg. § 1.704-1(b)(3) (2005). The exact language is set out for the reader's convenience:

> References in section 704(b) and this paragraph to a partner's interest in the partnership, or to the partners' interests in the partnership, signify 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

seeks to determine the incidence of the economic burden or benefit and then associates the appropriate tax consequence with that incidence.[39] The association of tax and economic benefits and burdens is, in fact, the overriding concern with respect to all partnership allocations, so it would actually make sense that the PIP test would be the exclusive means by which to determine each partner's share of the partnership's aggregate tax benefit and burden.[40] Unfortunately, the test is considered so administratively burdensome that it is applied only when the substantial economic effect safe harbor is breached.[41]

> (or item thereof) that is allocated. Except with respect to partnership items that cannot have economic effect (such as nonrecourse deductions of the partnership), this sharing arrangement may or may not correspond to the overall economic arrangement of the partners. (For example, in the case of an unexpected downward adjustment to the capital account of a partner who does not have a deficit makeup obligation that causes such partner to have a negative capital account, it may be necessary to allocate a disproportionate amount of gross income of the partnership to such partner for such year so as to bring that partner's capital account back up to zero.) Thus, a partner who has a 50 percent overall interest in the partnership may have a 90 percent interest in a particular item of income or deduction. The determination of a partner's interest in a partnership shall be made by taking into account all facts and circumstances relating to the economic arrangement of the partners. All partners' interests in the partnership are presumed to be equal (determined on a per capita basis). However, this presumption may be rebutted by the taxpayer or the Internal Revenue Service by establishing facts and circumstances that show that the partners' interests in the partnership are otherwise.

[39] "References in section 704(b) and this paragraph to a partner's interest in the partnership, or to the partners' interest in the partnership, signify the manner in which the partners have agreed to share the economic burden or benefit (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) (2005). For a comprehensive discussion of the partner's interest in the partnership test, see Stephen Utz, *Allocation and Reallocation in Accordance with the Partners' Interests in the Partnership*, 56 TAX LAW. 357 (2003).

[40] Gregory J. Marich explains that the PIP test is essentially a more accurate variation of the substantial economic effect test:

> The substantial economic effect test and the partner's interest in the partnership standard should generally be viewed as two sides of the same coin. Both are aimed at ensuring that tax consequences are allocated to the partner or partners who will receive the benefit or bear the burden of the related economic consequences.

Gregory J. Marich, *Substantial Economic Effect and The Value Equals Basis Conundrum,* 42 TAX L. REV. 509, 510 (1987).

[41] *See* Leder, *supra* note 14, at 753 (referring to the PIP test as a "black hole");

The burden arises, though, because the PIP test assumes that disproportionate allocations are legitimate in more instances than can actually be proven. The substantial economic effect test is rightly viewed, though, as an extreme opposite of the PIP test. As demonstrated in Part III, the substantial economic effect test condones the disproportionate assignments of tax benefits and burdens that are only vaguely and coincidentally consistent with economic burdens and benefits. The worthy premise of the PIP test is that tax benefits and burdens should precisely correspond to economic burdens and benefits, respectively. Part IV will show that the PIP test is indeed an unduly sophisticated articulation of fundamental realization concepts to a partnership setting and, as a result, achieves no precision at all. The problem, again, is that the PIP test accepts the notion that disproportionate allocations are, in the main, appropriate. This article asserts the exact opposite and thereby simplifies the meaning of a "partner's interest in the partnership." As with individual taxation, the partner who realizes income or loss should be associated with the appropriate tax burden or benefit. The concept is easy enough to apply to the infinite variety of individual taxpayer circumstances without a distorting safe harbor, but it is viewed as prohibitively difficult to apply to the smaller variety of partnership circumstances. The language by which the PIP test is articulated in the regulations is particularly indecipherable.[42] It is hard to know exactly what the drafters intended to convey without very close scrutiny of the thirteen most relevant examples provided elsewhere in the regulations. The drafters' inarticulateness notwithstanding, it should be no more difficult to determine the incidence of economic benefits and burdens incurred via a particular partnership (and thus the appropriate division of tax benefits and burdens) than it is to determine the incidence of economic benefits and burdens incurred by individuals.[43]

Part V proceeds from the conclusion that it is possible to articulate a reasonably definitive and administrable method by which to accurately determine each partner's share of the partnership's aggregate tax benefits and burdens. The substantial economic effect test is often defended on the efficiency rationale that there are an

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Marich, *supra* note 40, at 510 ("The substantial economic effect test thus serves as a safe harbor, providing a degree of certainty that cannot be found in the amorphous determination of a partner's interest in a partnership.").

[42] *See supra* note 38, *infra* notes 138–48 and accompanying text.

[43] *But see* Yin, *supra* note 19, at 163–64 (asserting the impossibility of determining partner's economic burdens and benefits).

infinite variety of legitimate arrangements between partners and a single, mandatory PIP test would interfere with those arrangements.[44] The subsequent assertion is that a single PIP test would be costly to administer and therefore the substantial economic effect test, despite its high equity loss, is most appropriate. The assertion is so well accepted that there has never been an effort to refine the meaning of PIP so as to render it feasible as an administrative matter.[45] The ease with which tax benefits and burdens are assigned to individuals, though, is a function of the notion that economic benefits are related to relative ownership. An individual who owns 50% of Blackacre, for example, is presumptively viewed as suffering 50% of the economic and tax impact from Blackacre. There is no efficiency reason why this easy rationale should not also apply in the partnership setting.

Certainly there may be as many varieties of partnerships as there are individuals. Every partnership, though, prioritizes partners' risk in a few finite ways very similar to the limited ways individuals allocate risk — essentially via borrowing, and employment relationships. Theoretically, then, each partner's annual tax benefit and burden can be determined with little more difficulty than applies to the manner of determining separate an individual's tax benefits and burdens. Recognition of the finite ways by which to determine the incidence of tax benefits and burdens, even benefits and burdens occurring from joint profit-seeking, implies that it is possible to articulate an administrable PIP test — based on distribution preferences, perhaps — and thereby avoid the equity losses inherent to the substantial economic effect test. The question this article ultimately addresses is whether the efficiency gains from disproportionate allocations justify the equity losses that would arise even from an administrable PIP test that continued the present law view that disproportionate allocations are appropriate more often than not. The article answers that question in the negative, primarily because partners do not use special allocations to effectuate the sort of risk *sharing* that is the hallmark of partnership efficiency. Instead, partners use special allocations to effectuate risk *bargaining and trading*, such as already occurs in arms length bargaining between unrelated individuals. Special allocations therefore do not add to aggregate utility; they merely increase

[44] *See, e.g.*, Buchholz, *supra* note 14, at 177–81.

[45] In 1982, the American Law Institute sought to explicate the principles that should dictate the allocation of partnership items. ALI PROJECT, *supra* note 32, at 221–52. The Institute declined to propose any particular standard, preferring instead to use 21 examples by which to demonstrate fifteen "guiding principles" and "generalizations." *Id.* at 245–48.

inequality. The conclusion, therefore, is that partners should not be allowed to use special allocations, though the article hedges a bit in recognition that it is impossible to definitively rule out the need for special allocations in what must be the very rarest of cases.

II. INDIVIDUALS AND PARTNERS SHOULD BE TAXED ALIKE

The Haig-Simons definition of income as the "algebraic" sum of consumption plus the change in value of stored property[46] implies that individuals have positive or negative income because real numbers can have positive or negative values.[47] One complication inherent in Haig-Simons, particularly as it relates to positive and negative income obtained via a partnership, is that income is measured by reference to increased or decreased consumption *potential* as measured by money or money's worth.[48] It is useful to think of Haig-Simons as articulating a consumption model, with consumption potential serving as a substitute for actual consumption destined to occur. In most cases, consumption potential is not too terribly difficult to observe,[49] but inaccuracies necessarily increase along the farther continuum between potential and actual consumption. Hence, consumption potential is invariably imprecise, even under the best of circumstances.[50] The imprecision increases with the presence of an intermediary agent

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[46] SIMONS, *supra* note 5, at 50.

[47] Thuronyi, *supra* note 15, at 64 ("The unitary nature of income suggests that it is artificial to consider income separately from deductions. The fact that the Code does so may be justified as a matter of mechanics of drafting, but that fact should not be considered as having any further importance.").

[48] The taxation of consumption potential is, of course, the primary objection to the income tax. *See generally* Mitchell L. Engler, *Progressive Consumption Taxes,* 57 HASTINGS L. J. 55 (2005). Thus, all cash flows are subject to tax even if the cash flow is not immediately converted into human consumption. Under the theory of consumption potential, a deduction is appropriate when subsequent events — business investment or casualty loss for example — contradict the previous assumption that all cash flows represent present or future consumption.

[49] The realization requirement of our present system, of course, creates distortions with regard to consumption potential by assuming that increased or decreased consumption potential occurs suddenly and momentarily (at the moment of a market transaction) rather than on a continuous accretion basis. *See* Deborah H. Schenk, *A Positive Account of the Realization Rule,* 57 TAX L. REV. 355 (2004).

[50] To accurately measure consumption potential and thus income under the present system, we would need to know precisely how a taxpayer's cash flow or increased value of stored property will be spent. We would then subtract from cash flow and increased value those future expenses that did not confer a personal benefit to arrive at "income." *See supra* note 47.

(such as a partnership) between potential and actual consumption, particularly when the intermediary has multiple principals to whom it may assign the consumption potential with very little regulatory oversight.[51]

An individual's positive or negative consumption potential may not coincide precisely with actual consumption. For example, if a taxpayer earns $100, the U.S. system reacts as though she has, in fact, consumed $100, even though she has only increased her consumption potential. The taxpayer may incur or already know of a future expense that will prevent her from enjoying the full potential, thereby resulting in negative income. If a negative value in the Haig-Simons equation results from personal consumption, the negative value is perfectly offset by positive value coinciding with actual personal consumption. For example, a decrease by $100 in the taxpayer's monetary capital occasioned by the acquisition of $100 worth of groceries results in neither negative nor positive income because the assumption of inevitable personal consumption justifying a tax on the $100 when received has been confirmed. If negative values do not result from personal consumption, the taxpayer has negative income to the extent of that value and should be granted a deduction.[52] A decrease by $100 in the taxpayer's monetary capital occasioned by a $100 business expense contradicts the earlier assumption that the taxpayer's $100 potential personal consumption would actually be realized. The negative value contradicts an earlier determination concerning consumption potential and represented by positive value in the Haig-Simons formulation at that earlier point. In that instance, the taxpayer has negative income and should be granted a deduction to offset.

An important point in this basic, but fundamental discussion is that negative and positive income is peculiar to each individual.[53] One person's income cannot and should not be ascribed to someone else

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[51] Thus, the inherent inaccuracy of the consumption potential method of measuring income, aggravated by the realization rule, is even worse in the partnership setting to the extent the partnership can decide whose potential consumption has increased.

[52] Actually, Haig-Simons does not anticipate or allow for deductions. It assumes that all expenditures, for whatever purpose, generate personal consumption. As such, deductions are anathema to Haig-Simons. Perhaps this is the reason it is often stated that "an income tax deduction is a matter of legislative grace." *See, e.g.*, Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593 (1943).

[53] Cunningham, *supra* note 14, at 94 ("It is basic to income taxation that each taxpayer should be taxed on his or her own economic income and that only taxpayers who suffer economic losses should derive tax benefits therefrom.").

even in the absence of progressive rates. Equity requires that each person personally pay their share of aggregate societal costs, not just that the government extract an amount equal to aggregate societal cost.[54] This assertion, incidentally, is axiomatic and perhaps even intuitive. If four individuals — Able, Baker, Charlie, and Delta — each have equal incomes, how might Charlie and Delta feel from an equity standpoint if Baker were allowed to shoulder Able's tax cost? Baker may not mind the resulting reduction in his own personal consumption, but it is not hard to imagine that Charlie and Delta might envy Able's higher consumption relative to their own.[55] Nor is it unthinkable that Charlie and Delta's resentment might spur self-help efforts to achieve Able's level of consumption. Hence, an equitable tax code should assign nontransferable burdens and benefits to taxpayers on the basis of their own particular economic benefits (positive income or increased consumption) or burdens (negative income or decreased consumption).

Two doctrines of individual income taxation serve to enforce the notion that tax benefits and burdens correspond, or should correspond, to an individual's particular economic burdens and benefits. The constructive receipt doctrine[56] is most often thought of as a method to ensure the proper timing of income.[57] The doctrine also ensures that tax burdens are assigned to the individual who actually enjoys an accession to wealth. When an employee's monthly wages are deposited in her checking account, the tax burden is

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[54] Ultimately the assertion cannot be proven even if it is intuitively appealing. For a provocative discussion of fairness as it relates to tax policy, though, see Leo P. Martinez, *The Trouble with Taxes: Fairness, Tax Policy, and the Constitution* 31 HASTINGS CONST. L.Q. 413 (2004).

[55] There is an unsettled debate concerning the extent to which envy — "utility interdependence" or "concern for relative position" — impacts tax efficiency. Proponents asset that progressive taxation will not discourage work and innovation because people will always judge the sufficiency of their consumption by comparing their consumption to that of others. In essence, the desire to "keep up with the Joneses" will counteract the disincentive to work harder caused by increased taxation. Zelenak & Moreland, *supra* note 11, at 71–77 (summarizing the empirical research regarding the effect of envy on optimal tax policy). In any event, envy is a product of real or perceived inequity and we should expect that envy will manifest itself in positive or negative self-help. In the text hypothesis, Charlie and Delta can either work harder or find ways to pay fewer taxes.

[56] Treas. Reg. § 1.451-2 (1979).

[57] "The doctrine of constructive receipt was, no doubt, conceived by the Treasury in order to prevent a taxpayer from choosing the year in which to return income merely by choosing the year in which to reduce it to possession." Horning v. Commissioner, 47 T.C. 428, 434 (1967).

imposed on the employee not the banking agent, precisely because it is the employee who receives the economic benefit (consumption potential).[58] The assignment of income doctrine is most often utilized to thwart efforts to mitigate progressively higher rates by individuals who nevertheless obtain or retain the economic benefit to which the higher rates apply.[59] The assignment of income doctrine, though, would have relevance even in a world of single rate taxes. The ability to increase personal consumption by shifting tax burdens to those who are indifferent to decreases in their own personal consumption (resulting from the higher tax burden) would likely engender resentment amongst those without the same opportunity. These two doctrines therefore confirm the notion that tax benefits and burdens are, and should be, personal and nontransferable.

We might conclude from the foregoing that individuals who realize economic benefits and burdens in their capacity as partners should be subject to identical constraints regarding transferability of tax liability. Partners should experience tax benefits or burdens in precisely the same way as individuals unless there is something about the partnership context that should change the matter.[60] The proof that Congress intended that partners be treated like individuals is strong, though not absolute. In fact, even if the ideal is that partner tax liability is no more transferable than individual tax liability we would still be faced with the objective reality that partners have far greater opportunities to successfully transfer tax liabilities than individuals. This point is demonstrated in Part III. The remaining discussion in this Part concerns the extent, if any, to which Congress has intentionally relaxed constraints on tax transferability with respect to partners. Though the conclusion seems obvious, the question is worthy of at least brief discussion, given the amount of tax liability transfer that may actually occur in the partnership setting and the one nagging but significant piece of evidence to the contrary discussed

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[58] Treas. Reg. § 1.451-2 (1979); *cf.* Treas. Reg. § 1.1031(k)-1(g)(4) (2002) (relating to the circumstances under which receipt by an agent will be deemed receipt by the principal, for purposes of like-kind exchanges).

[59] Lucas v. Earl, 281 U.S. 111 (1930). "The true nature of the assignment of income doctrine is simply this: it is a remedial doctrine designed to prevent high income taxpayers from fragmenting their taxable income among related and lower income taxpayers thereby undermining the graduated nature of the income tax system." Ronald H. Jensen, *Schneer v. Commissioner: Continuing Confusion over the Assignment of Income Doctrine and Personal Service Income,* 1 FLA. TAX REV. 623, 627 (1993).

[60] *See* Rudnick, *supra* note 21, at 254–57 (regarding the efficiency gains by granting nonrecognition to partners who pool their resources).

below.

It is not entirely inconceivable that Congress might have intended subchapter K as a wholly different tax system than that applicable to individuals. Subchapters C and J, for example, do not simply create mechanisms by which to trace income through a recognized entity to individuals who receive or shoulder the economic benefits or burdens derived through the entity. Those subchapters were actually intended as different tax systems. That subchapter S establishes an election whereby subchapter C corporation owners are taxed like individuals only when the election is made proves that subchapter C imposes something different on stockholders than that imposed on individuals.[61] Hence, realization concepts applicable to individuals are intentionally and necessarily altered in subchapters C and J so that we need not be concerned with or determine on whose behalf a C corporation, an estate, or trust incurs positive or negative income. Congress could have determined that the taxation of partners should be governed by concerns different from those applicable to individuals when they are not acting as partners.

There might also be a middle ground. That is, Congress might not have intended that positive and negative income in subchapter K be entirely decoupled from the individual who receives the corresponding economic benefit or shoulders the economic burden, but it might have specifically intended to relax the association. Subchapter K could be viewed as an intentionally different tax system than the system applicable to individuals, though the difference might not be as pronounced as the differences between individual and corporate or trust taxation.

Most evidence, if measured by reference to the volume of statutory and regulatory verbiage, contradicts the notion that Congress intended partners to be taxed differently, whether in small or large measure. When, for example, it appeared that partners were gaining wholesale tax advantages relative to individuals, subchapter K was amended in apparent attempt to restore at least a semblance of neutrality as between partners and individuals.[62] In a generic sense, the advantages to which the "anti-abuse" regulations refer have to do with partners obtaining tax advantages vis-à-vis individuals.[63] When

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[61] I.R.C. § 1362 (providing for the subchapter S election).

[62] *See* Treas. Reg. § 1.701-2 (1995) (containing the "partnership anti-abuse regulations").

[63] As Alan Gunn explains:

> The first and probably most important factor [under the partnership anti-

abuse is found under those regulations the explicit remedy is fashioned by reference to the tax outcome that would apply to individuals not acting as partners.[64] The implication is that partners should be taxed just like individuals. There are specific statutes in subchapter K, such as sections 704(c)(2) and 751, that are designed to ensure that partners experience the same tax result as is imposed on individuals.[65] The single suggestion to the contrary, if it be even that, relates to efficiency. The anti-abuse regulations convey an intention to equate partners and individuals while at the same time conceding that partners may sometimes be treated differently for reasons of administrative convenience.[66] Here, the implication is that only when transaction costs greatly overburden the accomplishment of an efficiency goal should the rules of individual taxation be relaxed with

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> abuse regulations] calls for a comparison of the tax results under subchapter K with those that would have obtained had the partners owned the partnership's assets and conducted its activities directly. An American Law Institute study once observed that, subject to the needs of administrative convenience, "the ideal mode for taxing partnership earnings is to tax each partner as though he were directly conducting his proportionate share of partnership business." While there will be cases in which practical considerations make it impossible to achieve this goal, an interpretation of subchapter K that allows parties much more favorable tax results than they could have obtained as individuals should be avoided unless compelled by the language and purposes of the particular Code section in question.

Alan Gunn, *Business Purpose, Economic Substance, and Corporate Tax Shelters: The Use and Misuse of Antiabuse Rules: Lessons from the Partnership Antiabuse Regulations,* 54 SMU L. REV. 159, 166 (2001).

[64] *See, e.g.*, Treas. Reg. § 1.701-2(b)(1) (1995) (allowing the government to treat purported partners as though they were individuals); *id.* § 1.701-2(e) (1995) (same).

[65] Section 704(c)(2) is entitled, "Special rule for distributions where gain or loss would not be recognized outside partnerships" and is designed to preclude "mixing bowl" transactions by which partners previously could engage in explicit nontaxable property exchanges. I.R.C. § 704(c)(2). The statute requires partners to recognize the exact amount of gain individuals would recognize if they engaged in non-like-kind exchanges of property. Laura E. Cunningham & Noël B. Cunningham, *Simplifying Subchapter K: The Deferred Sale Method*, 51 SMU L. REV. 1, 11–13 (1997). Section 751 treats a partner who sells her partnership interest in the same manner as an individual would be treated if she sold her proportionate share of the partnership's assets. I.R.C. § 751.

[66] "Certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income." Treas. Reg. § 1.701-2(a)(3) (1995).

regard to partners. As with the first point — that partners should be taxed like individuals — there are statutory provisions to support the notion that neutrality between individuals and partners is sometimes intentionally relaxed. Sections 704(c), 734, and 743 are primary examples of provisions that tolerate an advantage to partners solely on the basis of efficiency.[67] Even those provisions, though, are calibrated such that the advantage allowed partners is only as much as is necessary to eliminate the efficiency loss. Recent amendments suggest that the tolerance for tax advantages granted to partners for administrative reasons has decreased rather significantly.[68] The conclusion, then, is that Congress intends partners to be taxed as individuals except and only to the extent that taxing partners as such would be greatly inefficient. It might even be safe to say that Congress has grown quite skeptical of the inefficiency rationale as a basis for making distinctions between partners and individuals.

Indeed, the relaxation of individual tax rules for efficiency or "administrative burden" reasons could be viewed as merely

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[67] I.R.C. § 704(c)(1) relates to the allocation of partnership items derived from built-in gain or loss property. Regulations under that provision allow but do not require a partnership to use a tax accounting method that would eliminate tax distortions caused by the "ceiling rule." *See generally* Darryll K. Jones, THE THEORY AND PRACTICE OF PARTNERSHIP TAXATION, 116–21 (West 2005); Cunningham, *supra* note 14. The ceiling rule is discussed below. *See infra* notes 70–74 and accompanying text. I.R.C. §§ 734 and 743 are optional provisions that allow a partnership to adjust the basis of retained or distributed property, respectively, to prevent distortions caused by the partnership basis rules. If the optional methods of each provision are elected partners would incur the exact tax liability that individuals would incur if the individuals owned the partnership's assets outside of the partnership:

> The principal purpose of the basis adjustment provided by § 743(b) when a partnership interest is transferred by sale or exchange or upon death is to put the transferee in the position he would have been in had he acquired a direct interest in the partnership .... The § 734(b) adjustments have the same purpose as the basis adjustments provided by § 743(b).

ALI PROJECT, *supra* note 32, at 188, 191–92. Congress did not mandate the most accurate methods in all cases because it believed doing so would impose an undue administrative burden on some partnerships. *See* H.R. REP. No. 1337, at 70 (1954) (regarding the elective provisions under I.R.C. §§ 734 and 743); ALI PROJECT, *supra* note 32, at 195.

[68] The American Jobs Creation Act of 2004 amended I.R.C. §§ 704 and 743 to, *inter alia*, require basis adjustments under certain circumstances that previously generated an optional basis adjustment. Pub. L. No. 108-357, § 833, 118 Stat. 1418 (2004). In addition, the regulations under I.R.C. § 704(c) express a limitation on the extent to which partners may use optional provisions for purely tax distortion purposes. *See* Treas. Reg. § 1.704-3(a)(10) (2005).

buttressing the notion that subchapter K is not intended as a different system of taxation the way subchapter C or J might be viewed. Fundamental tax principles relating to accessions to wealth are relaxed even with regard to individuals when administrative burdens make a sooner or more accurate collection of tax inefficient.[69] That administrative convenience or efficiency sometimes alters the measure of income in subchapter K perhaps merely proves that the same considerations apply to both partners and individuals, though naturally there may be different results owing to different administrative burdens.

The foregoing conclusion would be indisputable but for one seemingly innocuous sounding sentence in the I.R.C. § 704(b) regulations. The sentence articulates the "ceiling rule" and states: "the total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year."[70] In short, the ceiling rule allows partners to report income later than would an individual in circumstances identical to those pertaining to a partner except for the existence of the partnership.[71] The converse is also true. The ceiling rule sometimes requires a partner to claim a deduction later than would an individual. In certain cases, a partner's accession to wealth, negative or positive, may be equal to an individual's and yet the partner will report more or less income than that individual if the partnership's method of accounting creates a difference between the partner's accession to wealth and the partnership's accession to wealth.[72] The ceiling rule fundamentally alters individual concepts of

[69] The best example of this is the realization doctrine. The realization doctrine recognizes that it would be administratively burdensome to require taxpayers to value their assets each year and then pay a tax on any increase in value from a prior year. As a result, taxpayers do not report the increase in the value of property until a sale or exchange occurs that alleviates the valuation burden and provides the taxpayer with the liquidity by which to pay the resulting tax. *See generally* Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax,* 48 TAX L. REV. 1 (1992); Terrence R. Chorvat, *Perception and Income: The Behavioral Economics of the Realization Doctrine,* 36 CONN. L. REV. 75, 76–77 (2003) ("While it is generally thought that the realization doctrine is both inefficient and inequitable, the realization doctrine is sometimes accepted as an accommodation to practical considerations.") (footnotes omitted).

[70] Treas. Reg. § 1.704-3(b)(1) (2005).

[71] Cunningham, *supra* note 14, at 101–12.

[72] *Id.* In Example 2, Treasury Regulation 1.704-3(d)(7), the application of the ceiling rule results in partner E being $5,500 richer as a result of a partnership

income, particularly to the extent income is infused with notions of timing and the time value of money.

The rule is "seemingly innocuous" because its implications go beyond the oft-cited notion that whatever differences between partner and individual taxation created by the ceiling rule are merely temporary. The differences are temporary only if we ignore the time value of money. The partners whose income or deduction is deferred will invariably report more positive or negative income when the partnership liquidates but liquidation is not likely to occur until some years later.[73] Even if the distortion were only temporary, the ceiling rule would still stand for the proposition that partners' income is derivative rather than personal, as with individuals; that partnerships, like corporations and trusts, really do have income, and that partners can have no more income than their partnership. This is a fundamental statement similar to that pertaining to corporations or trusts.

The ceiling rule therefore suggests a substantive difference between partners and individuals that might justify different tax outcomes. The suggestion is contradicted by the evidence previously recounted but it exists nevertheless. We might conclude that the issue is unresolved except that it seems clear that the ceiling rule owes its existence solely to matters of efficiency — the relief of administrative burden — rather than an attempt to make a substantive distinction between partners and individuals. In fact, the ceiling rule seems mostly to be a relic of the days when partners were inadvertently subject to a wholly different taxing system. When Congress discovered the implications of the ceiling rule — that it created differences between partners and individuals — it enacted provisions to eliminate those differences but made those provisions elective in an effort to relieve any administrative accounting burdens that might result from a requirement that partners be taxed just like individuals.[74]

Here it should be noted that Congress has not given sufficient thought to the issue with respect to the ceiling rule or any other elective provision designed to eliminate differences between partners and individuals. If it ever does so, one hopes it will explicitly conclude that the elective provisions should instead be the norm and the distortions arising from the perceived need to eliminate administrative

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transaction in which the partnership realized only $5,000. Thus, the partner recognized only $5,000 under the ceiling rule, but $5,500 under an optional corrective provision. Treas. Reg. § 1.704-3(d)(7) (2005).

[73] Cunningham, *supra* note 14, at 102–04.

[74] *Id.*

burden should represent the exception. That is, the explicit norm ought to be that partners be taxed just as individuals, with efficiency related distortions being tolerated only in rare instances when an administrative burden is demonstrably rather than presumptively too great.[75] As discussed in Part IV, present law is too often posited in the extreme reverse: partners are normally taxed differently than individuals, owing to the substantial economic effect test and optional provisions within subchapter K, except when there is absolutely no demonstrable efficiency reason.

The ultimate issue, then, is twofold whether with regard to partners or individuals. At what point does the administrative difficulty of accurately measuring income earned via partnerships and then collecting the tax from the proper person create too much inefficiency? This article asserts that the present bar is set way too low. In any event, once that point is passed, how much inaccuracy (i.e. inequity) should be tolerated in order that participants will not abandon the otherwise efficient joint economic activity? In this regard, this article asserts that the present bar is set way too high. What is the best method to eliminate the intolerable administrative burden without creating or encouraging very high inequitable results as between partners and individuals? If, indeed, there is some level of administrative difficulty that is tolerable in the sense that efficiency is not entirely sacrificed, we are left with the task of fashioning the mechanism that precisely imposes only that level of difficulty. The substantial economic effect test eliminates all administrative burdens when perhaps some burdens ought to be maintained so that equity is preserved. Part IV seeks the mechanism that will, admittedly, restore an administrative burden for the sake of equity but not so much that efficiency is entirely sacrificed. The next section, though, identifies the equity losses and efficiency gains under the substantial economic effect test. The earliest attempt at taxing partners simply ignored any potential for inequity and directed partners to assume their accurate

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[75] The enactment of statutory mandates with regard to previously elective provisions is an indication that Congress is moving, however slowly, towards this result. *See supra* note 68 (regarding recent changes requiring basis adjustments that were previously optional where the failure to make an election caused partners' tax liability to be different from what it would be if the partners' were taxed as individuals). Regulatory anti-abuse provisions also suggest that equality of result as between partners and individuals should more often be the norm rather than an optional exception. *See* Treas. Reg. § 1.702-1(d), ex. 8 (2005) (regarding the failure to make an I.R.C. § 754 election resulting in a partner obtaining a loss deduction for which no economic expenditure is made); Treas. Reg. § 1.704-3(a)(10) (2005). The evidence is still too weak to discern a definite trend, however.

share of the partnership's aggregate tax benefits and burdens.[76] Partners were left to their own devices and naturally preferred tax reduction (i.e., individual efficiency) over equity. The disequilibrium between equity and efficiency arising under those circumstances prompted Congress to adopt the substantial economic effect safe harbor.[77] In theory at least, substantial economic effect should ensure that special allocations always result in sufficient efficiency gains to offset equity losses. This is not the case, particularly when the substantial economic effect safe harbor applies in conjunction with other provisions made optional because of an alleged administrative burden. In adopting substantial economic effect, rather than a more precise mechanism, Congress implicitly concluded that accurately measuring each partner's income is too difficult and that the inaccuracies of the substantial economic effect safe harbor are tolerable given the efficiency gains that would be lost under a mandate to be precise. Part III analyzes the second of these determinations and determines it to be false. Part IV proposes a standard that would more accurately measure each partner's income without sacrificing efficiency or equity.

III. EFFICIENCY GAINS AND EQUITY LOSSES OF SUBSTANTIAL ECONOMIC EFFECT

A partnership, of course, cannot have positive or negative income. Income, in the Haig-Simons sense, refers to the satisfaction of human desires and there is nothing human about a partnership.[78] The income, positive or negative, measured at the partnership level is merely the income of one or more human partners. Though not personified, the partnership may itself determine the partner on whose behalf it receives or spends income. Left to its own devices, as it is under current law, the partnership will make a determination that

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[76] Tariff Act of 1913, Section II G(a), ch. 16, 38 Stat. 172 (1913).

[77] The earliest subchapter K version of I.R.C. § 704 did not explicitly reference the substantial economic effect test as a test of allocations. Instead, the provision prohibited allocations "the principal purpose" of which was "the avoidance of any tax." I.R.C. § 704(b)(2) (1954). The phrase "substantial economic effect" was first used in the legislative history of the original version of I.R.C. § 704(b) and subsequently appeared in regulations under old I.R.C. § 704(b). Buchholz, *supra* note 14, at 171–73.

[78] Robert Murray Haig, *The Concept of Income – Economic and Legal Aspects*, *in* THE FEDERAL INCOME TAX 1, 2 (Robert Murray Haig ed., 1921) ("Modern economic analysis recognizes that fundamentally income is a flow of satisfactions, of intangible psychological experiences.").

results in the best tax outcome even if that determination is inconsistent with economic reality. Thus, we should think of the partnership as an unprincipled agent with several principals.[79] The partnership is unprincipled to the extent it can be used to assert that an accession to wealth is being held for the account of one partner, and thus taxed to that partner, when in fact the wealth will ultimately inure to another. Put another way, the partnership may be used to assert that one partner suffers negative income, and is thereafter granted a deduction, from the payment of a partnership expense when in fact the payment will be taken from another partner's account maintained by the partnership. In this situation, economic benefits and burdens are completely disassociated from tax burdens and benefits. The partners' actual positive and negative income will have nothing whatever in common with their separate tax liabilities.

Why is it, then, that partnerships — or more precisely partners — are left to their own devices? The single, universally asserted justification for the latitude given partners is the imperative need for flexibility.[80] According to that mantra, the infinite variety of economic arrangements between joint economic actors is to be encouraged and an inflexible taxing rule would actually discourage beneficial joint business activity apparently by foreclosing certain of those infinite business relationships.[81] That assertion relates to the decreased social

[79] The Supreme Court conceives of the partnership as an agent, stating, "the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners. Once its income is ascertained and reported, its existence may be disregarded since each partner must pay a tax on a portion of the total income as if the partnership were merely an agent or conduit through which the income passed." United States v. Basye, 410 U.S. 441, 448 (1973).

[80] The flexibility notion is asserted so often that one should be surprised not to find mention of it in any discussion of partnership tax. *See infra* note 81. It began, apparently, with the 1954 adoption of subchapter K. Both the House and Senate reports mentioned the need for flexibility prominently. S. REP. NO. 83-1622, at 89 (1954); H.R. REP. NO. 83-1337, at 65 (1954) (both reports stated that the intent of subchapter K was to permit joint profit-making with "simplicity, flexibility, and equity as between the partners."). The Treasury Department repeated the intent when it introduced the anti-abuse regulations in Treas. Reg. § 1.701-2. Subchapter K Anti-Abuse Rule, 59 Fed. Reg. 25,581 (proposed May 17, 1994) ("Subchapter K was enacted to permit businesses organized for joint profit to be conduced with 'simplicity, flexibility, and equity' as between partners.").

[81] Berger, *supra* note 14, at 108; Buchholz, *supra* note 14, at 177 (referring to the "broad latitude" that should be afforded partners); Cunningham, *supra* note 14, at 124; Gergen, *Reforming Subchapter K*, *supra* note 14, at 1; Kwall, *supra* note 14, at 232; Lokken, *Taxation of Private Business Firms*, *supra* note 14, at 250; William J. Rands, *Passthrough Entities and their Unprincipled Differences under Federal Tax*

utility that would result if partners were subjected to greater regulation in their division of tax benefits and burdens. The implication is that some level of beneficial joint business activity would be foregone in the absence of the flexibility.[82] The assertion is normally made as if it is entirely axiomatic, as if the truth of the matter is so apparent that it should be accepted on faith. Yet just the opposite is proven, or at least strongly suggested, by joint business actors' continuing and growing preference for S corporations as the means by which to pursue business profit.[83] S corporations are subjected to a relatively inflexible taxing scheme.[84] Thus, joint economic actors' preference for S corporations is either irrational, or the assertion that flexibility is necessary with regard to when and how

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Law, 49 SMU L. REV. 15, 19 (1997); Christine Rucinski Strong & Susan Pace Hamill, *Allocations Attributable to Partner Nonrecourse Liabilities: Issues Revealed by LLCs and LLPs*, 51 ALA. L. REV. 603, 606 (2000); Yin, *supra* note 19, at 155.

[82] Schwidetzky, *supra* note 14, at 717–18 ("Any effort at significant simplification that simultaneously avoids abuse would likely come at a high price. The rules would have to be made more inflexible, and thus less useful to business conducted through a partnership.").

[83] As Lawrence Lokken explains:

> Subchapter S is very popular. For 1999, the most recent year reported, approximately 2.7 million corporations filed returns as S corporations. For that year, the number of S corporation returns was more than 135 percent of the number of partnership returns. These statistics may surprise some observers, who see subchapter S as a relic of an earlier era. Limited liability company laws protect members against personal liability for entity debt much like corporation laws and are much more flexible than corporation laws; moreover, an LLC and its members can enjoy the permissiveness of subchapter K and not be burdened by the rigidities of subchapter S. However, the 1999 statistics lend little support to the common assumption that LLCs are well on the way to supplanting S corporations. The number of S corporation returns in 1999 was 5.3 percent larger than the number of 1998 returns, while the number of partnership returns increased by 4.4 percent. Approximately 302,000 corporations first elected S status for 1999, of which approximately 217,000 were newly organized corporations. Newly organized S corporations thus exceeded ten percent of the number of all partnerships, new and old. Vanishing relic, indeed! Anecdotal evidence indicates that organizing a new venture as an LLC, checking the box corporate, and electing subchapter S is a not uncommon (if treacherous) practice.

Lawrence Lokken, *As the World of Partnership Taxation Turns*, 56 SMU L. REV. 365, 367–68 (2003).

[84] There are no eligibility requirements under subchapter K. *See* I.R.C. § 761(a). By contrast, there are specific and detailed eligibility requirements under subchapter S. *See* I.R.C. § 1361(b).

partners ought to be taxed cannot withstand close scrutiny. In any case, the assertion never references specific activities that could not be undertaken efficiently if the partners were required to assume the tax benefits and burdens strictly in accordance with their relative capital. The failure to provide concrete reference makes the assertion difficult to disprove other than by equally vague denials. Setting aside the demonstrated preference for S corporations, one can therefore only accept or reject on faith the assertion that denying partners flexibility with respect to their tax liability is an inefficient thing to do.

The growing preference for S corporations is not conclusive, though, if one assumes that joint economic actors who require flexibility would simply not join together in the absence of subchapter K as it is presently configured. Joint actors who utilize the S corporation form might simply be remnants of the entire population of would-be joint economic actors, the others having forsaken the activity because of a lack of flexibility. As a policy matter, we are therefore obliged to anticipate and imagine those joint activities that contribute to social utility but which would not be undertaken in the absence of flexibility. This seems an impossible task and perhaps forces the acceptance of the substantial economic effect test as a matter of caution.

Other scholars, fortunately, have attempted to define a representative body of transactions that might be foregone in the absence of flexibility.[85] There is a consensus that special allocations are useful because they allow partners to order their relationships in a manner that replicates sale-leasebacks, asset exchanges, borrowing, or profit-sharing salary plans.[86] The first transaction is illegitimate from a tax standpoint.[87] It should not be accommodated whether undertaken within or without a partnership because sale-leasebacks merely distort economic decisions by allowing one party to sell tax benefits to another.[88] The other three can be accommodated without the equity losses occasioned by special allocations. This article does not attempt to belabor the point by imagining even more sophisticated transactions, or even relating with any great detail the examples already provided. The article relates the general parameters,

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[85] Gergen, *Reforming Subchapter K*, *supra* note 14, at 1, 4, 19–28 (regarding safe harbor leases and asset exchanges); Lokken, *supra* note 14, at 257–71 (regarding loans); Schwidetzky, *supra* note 14, at 716–26 (regarding profit-sharing plans).

[86] *See infra* note 84.

[87] Gergen, *Reforming Subchapter K*, *supra* note 14, at 21.

[88] *Id.*

primarily in footnotes,[89] solely to prove that the real utility of joint economic activity, properly conceived, would not be affected if partners enjoyed less flexibility and were required to accurately report their income.

Professor Gergen's early work posits "spatial" and "temporal" transactions.[90] Spatial allocations involve allocating all tax items from one partnership asset to one partner and all items from another asset to another partner.[91] In effect, the partners have merely divided up the partnership's assets and their associated economic benefits and

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[89] I prefer to describe the examples in footnotes so as not to unduly interrupt or belabor the text discussion. For example, Gergen asserts that the following allocations duplicate a sale-leaseback:

> *ABC* is considering an investment of $1,000 to develop a mine which will produce $160 income per year for nine years. *ABC* has sufficient net operating losses carried over from prior years so that it will not pay taxes for many years. *ABC* enters into a partnership with *DEF*, which has a 40% marginal rate, to develop the mine. *ABC* contributes $850 and *DEF* contributes $150. Under the partnership agreement, 100% of the mine development expense is allocated to DEF and 100% of the income is allocated to *DEF* until its capital account is restored to zero. Thereafter, 80% of the income is allocated to *ABC* and 20% is allocated to *DEF*. So long as *DEF* has a negative capital account balance, available cash is distributed to *ABC*.
>
> Assuming the prevailing interest rate is 10%, *ABC* would choose not to invest $1,000 in developing the mine since the rate of return is only 8%. In [this example], *ABC* sells the tax benefits of the expenditure, which are of no value to it, to *DEF*. The resulting investment should be attractive to both *ABC* and *DEF*. Assuming the projections are accurate, this investment has a positive net present value for *ABC* at a 10% interest rate and for *DEF* at a 6% interest rate. That is, each does better than it would investing its capital at the normal pretax 10% rate of return.
>
> [This example] is similar to a safe-harbor lease. *DEF*'s capital contribution takes the place of the down payment. *DEF*'s 20% residual interest takes the place of the option price at the end of the lease. *DEF* has the benefit of the losses, and the income allocated to *DEF* under the income chargeback to return its capital account to zero is similar to the income the lessor would have under a safe-harbor lease from rents used to service the debt that are not offset by the interest deduction on the note. Just like rents used to pay principal, the income on the chargeback merely offsets the earlier depreciation deductions and provides *DEF* no economic benefit.

Gergen, *Reforming Subchapter K*, *supra* note 14, at 21–22 (citations omitted).

[90] *Id.* at 34–40.

[91] *Id.* at 34–35.

burdens amongst themselves.[92] If the properties were contributed by partners other than those to whom items from the properties are allocated, the partners will have effectuated an implicit, untaxed exchange because in an economic sense, the one who owns the yield owns the property.[93] The allocation would be respected, more often than not, under the substantial economic effect test. Gergen's second generic classification involves "temporal" allocations.[94] These involve allocations from one asset to one partner for a period of time followed by allocations from that same asset to another partner. Here the partners have implicitly bought and sold divisible interests in a single asset.[95] They will have achieved something that could not be achieved tax free outside of the partnership context.

In a later article, Professor Lokken describes property exchanges as well as transactions that should most accurately be described as loans.[96] One of Lokken's examples proves that a special allocation designed to effectuate a preferred return to one partner is economically identical to a loan between two individuals acting outside of the partnership context.[97] Gergen and Lokken therefore make the point that the transactions, about which they imagine the need for flexibility is asserted, can be achieved in other ways and indeed with as much or more efficiency than through special allocations. To deny partners the flexibility they presently enjoy should therefore not artificially prevent beneficial transactions since those transactions can be accomplished in other efficient ways and with greater assurance that the same tax imposed on individuals will be imposed on partners.

The examples probably disprove the need for flexibility to a greater extent than even Gergen and Lokken might have anticipated.

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[92] *Id.*

[93] I do not mean to suggest that the concept of "property" or "ownership" can be so easily summarized for all purposes. In fact, the opposite is true. *See* Adam Mossoff, *What is Property? Putting the Pieces Back Together,* 45 ARIZ. L. REV. 371 (2003) (describing the philosophical theories that attempt to explain and exemplify the legal concept of "property"). For tax purposes, though, property ownership can be described as simply as stated in the text. Rights to yield from property connotes ownership which, in turn, determines the proper taxpayer. *See* Helvering v. Horst, 311 U.S. 112 (1940). *See generally* David S. Miller, *Taxpayers' Ability to Avoid Tax Ownership: Current Law and Future Prospects,* 51 TAX LAW. 279, 281–90 (1998) (regarding the tax benefits and burdens triggered by property ownership).

[94] Gergen, *Reforming Subchapter K, supra* note 14, at 34, 36.

[95] *See id.*

[96] Lokken, *supra* note 14, at 256–58.

[97] *Id.*

Flexibility, it should be remembered, is justified by anticipated utility gains derived from joint economic activity. Cooperative strivings can add to total utility because cooperative efforts allow investors with differing risk tolerances to share risks they would otherwise avoid if they had to shoulder those risks individually.[98] This is the law and economics rationale underlying state laws regarding partnerships and other non-corporate forms of joint economic activity.[99] Those laws are

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[98] Professor Rudnick provides a nice summary of the economic literature regarding the efficiency gains from risk sharing:

> Risk-sharing is economically efficient; the tax system ought to allow risk-sharing consistent with tax policy equity goals to the fullest extent possible. As discussed earlier, persons with diverse attributes are likely to join together for risk- and reward-bearing, 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. Early group risk-sharing models posited homogenous attitudes towards risk and found that pro rata sharing agreements were optimal. Complex sharing arrangements reflecting heterogeneous beliefs about risk produce more efficient outcomes, 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. Other models of individual bargaining find that equal sharing is inefficient because people can only exploit economies by sharing with less able people and cannot achieve size without heterogeneity. Thus, the partnership entity value is greater than that of a sole proprietorship in many contexts. If individuals know and have various views of their risk aversion, they should receive greater latitude in selecting capital structure and profit and loss sharing.

Rudnick, *supra* note 21, at 299–302 (citations omitted).

[99] *Id.* at 254–57. Professor Ribstein elegantly describes the role that laws should have in the regulation of partnerships:

> Partnership law itself is now nonuniform across U.S. jurisdictions. More importantly, the partnership form itself has split into subforms, including the limited liability company (LLC) and the limited liability partnership (LLP), that provide a continuous spectrum of forms.
>
> This recent history in the United States holds important lessons for Europe as it embarks on partnership law reform. A single set of business association rules issued by a central planner cannot meet the needs of various types of firms or respond to firms' changing business needs. Central planning is hostage both to inherent limits on human knowledge and foresight and to interest group politics. Rather, firms should be able to pick suitable rules by making both "horizontal" choices among the various

derived from the notion that enforcement of the flexible, fiduciary relationship between partners increases utility. It is better that laws encourage rather than discourage the mutual risk sharing that characterizes partnerships. Thus, it is axiomatic that tax laws should not inhibit this process. Flexibility should be condoned provided it does not sacrifice other goals. Gergen and Lokken's examples, though, are different from the partnership process that is to be encouraged. Their examples, presumed representative of the universe of transactions with regard to which the flexibility mantra is asserted, do not involve the mutual striving — "the all for one and one for all" — ideal from which increased utility is derived. The transactions described by Gergen and Lokken are mere variations of the opposite-end bargaining that occurs between buyers and sellers. Those transactions do not involve the classic, mutual striving or risk sharing characteristic of classic partnerships and from which particular social utility is derived. Increased utility may well result, but it is the same sort that results when individuals with adverse interest bargain at arms length outside the partnership context. Nothing is added to aggregate social utility that could not be achieved outside the partnership context. The transactions are beneficial, no doubt, but the partnership is merely background scenery. Hence, the tax laws pertaining to those transactions need not be any more flexible than those applicable to individuals outside of the partnership context. There is no reason to provide greater flexibility with regard to tax burdens and benefits merely because opposite-end bargaining occurs within the partnership context.

Even if it could be shown that the flexibility granted to partners was efficient and resulted in utility gains, we would still be obliged to juxtapose those gains with whatever equity losses result from the flexibility. Equity losses are, of course, implicit in any decision to tax persons with identical income differently unless efficiency gains

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> jurisdictions and "vertical" choices among business forms available within jurisdictions. Moreover, more efficient rules can emerge from jurisdictional competition for business formations, and from an evolutionary process in which more efficient forms become more prevalent and less efficient forms fall into disuse. The primary engine of efficiency is the parties' ability to contract for the applicable law, including selection of a firm's internal governance rules through choice of the state of organization. There is significant evidence that permitting horizontal and vertical choice of business forms produces efficient outcomes.

Larry Ribstein, *The Evolving Partnership,* 26 J. CORP. L. 819, 820–21 (2001) (citations omitted).

compensate the disadvantaged taxpayer.[100] The matter could be left at that because this article has shown that there are no utility gains from partnerships that could not be obtained in the absence of flexibility. There is at least one scholarly assertion, though, that the equity losses occasioned by the flexibility given to partners is both efficient and results in no equity losses. In his 1998 article, Professor Walter Schwidetzky gives two examples of transactions that are benefited by flexibility in the regulation of partners' tax liabilities. His first example is that of a partnership in which partners differ in how active a role they desire in the business. Schwidetzky notes that under a flexible system, the partners "can amend the voting rights and allocations of income can be adjusted to take this change into account, all without generating a taxable transaction."[101]

Schwidetzky further argues that in the absence of flexibility, partners might have to engage in taxable transactions to achieve their governance objectives.[102] This appears to be a rather classic non sequitur. It is not apparent why partners must be granted broad flexibility with respect to their tax liabilities as a means to effectuate their level of involvement in the partnership. State law flexibility that partnerships already enjoy allows partners to reallocate voting and governance rights as they see fit. That state law flexibility is complemented by an established and concise body of tax law, wholly unrelated to the division of tax benefits and burdens, holding that changes in partnership participation rights can be made quite easily without incurring a tax liability.[103] The division of tax benefits and burdens has nothing to do with levels of participation so any tax advantages provided to partners vis-à-vis individuals on that logic is, by definition, inequitable.

Schwidetzky's second example makes better sense and, as he notes, is conceded even by others who object to the substantial economic effect test. In the stereotypical "money and brains" partnership one partner contributes all or most of the capital, while

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[100] *See supra* note 9.

[101] Schwidetzky, *supra* note 14, at 724.

[102] *See id.*

[103] *See* Rev. Rul. 84-52, 1984-1 C.B. 157 (regarding the tax-free conversion of a general partnership interest to a limited partnership interest); Rev. Rul. 95-37, 1995-1 C.B. 130 (regarding the tax-free conversion of a partnership to a limited liability company); Rev. Rul. 99-5, 1999-1 C.B. 434 (regarding taxable and tax-free conversion of a single member LLC to a partnership); Treas. Reg. § 1.708-1(c)-(d) (2005) (regarding the taxable and tax-free methods of achieving partnership mergers and divisions).

another contributes all or most of the labor and expertise.[104] Schwidetzky notes, quite correctly, that requiring partners to allocate partnership items strictly in accordance with contributed capital would deprive the brains partner of the ability to share in the partnership's profits. In effect, such a rule would relegate the brains partner to the status of employee. Hence, inflexibility would discourage money and brains partnerships. Schwidetzky acknowledges the obvious point, that there are myriad ways by which employees can be compensated by a profit share and even by methods that lead to the conversion of the employee to an owner.[105] He dismisses those alternative methods too easily with the claim that they would be "complex."[106] That profit and employee ownership plans have become ubiquitous is sufficient to belie the complexity claim at least in comparison to the complexity provoked by special allocations designed to achieve the same result.

The money and brains partnership, though, is useful to show the equity loss caused by the substantial economic effect test. It is understandable that the money partner would agree to share the profits equally or on some other basis disproportionate to her relative capital contribution. Doing so would not be problematic in a tax system that made no distinctions between types of income because some of the profit will be attributable to the brain partner's expertise and that partner must necessarily pay taxes on her share of the profit. In a system that distinguishes between income from capital and income from labor, with the former being taxed at lower rates, allocations to the service partner create opportunities for inequity as between service partners and individual laborers. The individual laborer will, of course, report her compensation as ordinary income and be subjected to the highest tax rates. A brains partner, though, could be allocated a share of the partnership's capital gain as compensation and thereafter be taxed at lower rates than the individual in identical circumstances except for the existence of a partnership.[107] This is an unnecessary inequity, given the available alternative for sharing profits and ownership between the two

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[104] Schwidetzky, *supra* note 14, at 724–25. Schwidetzky does not mention options by which an employee would be given the right to purchase ownership shares but that too would solve the problem he identifies.

[105] *Id.*

[106] *Id.*

[107] *See* Rev. Proc. 2001-43, 2001-2 C.B. 191 (regarding the treatment of a service provider as a partner to whom allocations of income characterized at the partnership level may be made).

participants.[108]

Schwidetzky argues, in opposition to the equity loss notion, that the substantial economic effect safe harbor thwarts most tax avoidance schemes.[109] His analysis, though, defines equity losses solely by reference to whether subsequent tax reductions result from special allocations and is therefore too narrow. This definition ignores the economic reality that special allocations effectuate tax-free property exchanges.[110] The inequity occurs at the moment partners are allowed to engage in tax-free exchanges — exchanges that individuals could not engage in tax free — regardless of subsequent tax outcomes resulting from allocations of items from the exchanged properties. An overview of the substantial economic effect test helps clarify this rejoinder.

Under present law, all allocations — capital account or special — must comply with the substantial economic effect safe harbor or be consistent with the partners' interest in the partnership. The substantial economic effect safe harbor has the advantage of certainty. The PIP test is extremely uncertain. Economic actors value certainty of results and therefore prefer the substantial economic effect safe harbor. The safe harbor is met if allocations have "economic effect" which is "substantial."[111] Achieving economic effect requires only that the partnership follow certain accounting rules. First, the partnership must maintain separate "capital accounts" for each partner using rules similar to those applied to simple checking or savings accounts — capital accounts must be credited with deposits and debited with withdrawals.[112] Second, upon liquidation of the partnership or a partner's interest in the partnership, the partnership must distribute to each partner her capital account balance.[113] Third, each partner must repay to the partnership any overdraft in her capital account.[114] These requirements, which must be imposed by provisions in the partnership agreement, are quite easily complied with.

The second part of the substantial economic effect test requires that allocations be "substantial."[115] The substantiality requirement is

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[108] *See generally* I.R.C. §§ 412–423.

[109] Schwidetzky, *supra* note 14, at 718 (asserting that the vast majority of abusive transactions do not survive scrutiny under the substantial economic effect test).

[110] *See* Gergen, *Reforming Subchapter K*, *supra* note 14, at 34–38.

[111] Treas. Reg. § 1.704-1(b)(2)(i) (2005).

[112] *Id.* § 1.704-1(b)(2)(ii), (iv).

[113] *Id.* § 1.704-1(b)(2)(ii)(b)(2).

[114] *Id.* § 1.704-1(b)(2)(ii)(b)(3).

[115] *Id.* § 1.704-1(b)(2)(iii).

designed to prevent purely tax driven allocations while not impeding allocations dictated by economic circumstances. Implicit in this goal is the necessity to determine human motivations. The substantiality test uses undefined probabilities to ascertain motivations. The overall rule is that allocations will be substantial if there is a "reasonable possibility" that allocations will affect dollar amounts that each partner will receive from the partnership independent of tax consequences.[116] The meaning of this rule is obscured by the fact that it is stated without explicit reference to any particular starting point. Without knowing a partner's baseline economic take, it is impossible to know whether an allocation will have the required effect. The most likely starting point, though, is one based on capital account allocations because that is the explicit, presumptive baseline when allocations violate the substantial economic effect test.[117] Thus, the tax and economic effect of special allocations should be compared to the tax and economic effect of capital account allocations.

Note that the substantiality test requires a showing of "reasonable possibility," though that phrase is not defined. The general rule, such as it is, is implemented via two relatively more specific benchmarks. If (1) an allocation may reduce at least one partner's taxes and (2) there is a strong likelihood that the allocation will not substantially diminish any partner's economic yield or take from the partnership, the allocation will not be substantial.[118] The probabilities — "may" and "strong likelihood" — must exist at the time the allocations are agreed upon but can be proven on a prospective or a five year retrospective basis.[119] That is, if there are facts known prior to the allocations that allow the partners to think that one partner's taxes may be reduced and there is a strong likelihood that no other partners will sacrifice anything, the allocation will not be substantial. In addition, if it just turns out that way within five years — one partner is benefited but no partner is substantially worse off — the probability is presumed to have existed on the day the allocations were adopted.[120] That presumption, though, can be overcome by looking at what could have been known on the day the allocations were adopted.[121] Thus, an

[116] *See supra* note 17 (quoting Treas. Reg. § 1.704-1(b)(iv)(2)(iii) (2005)).

[117] Treas. Reg. § 1.704-1(b)(3)(i) (2005) ("All partners' interests in the partnership are presumed to be equal (determined on a per capita basis).").

[118] *Id.* § 1.704-1(b)(2)(iii)(a).

[119] *Id.* § 1.704-1(b)(2)(iii)(c).

[120] *Id.* § 1.704-1(b)(2)(iii)(b)-(c) (containing "look-back" rules for "shifting" and "transitory" allocations).

[121] Thus, the five year look-back rule shifts the burden of explanation to partners.

allocation will be insubstantial only when there are sufficient facts from which to foretell with any reasonable certainty that the only impact of the allocation is a reduction in taxes. If the foretold reduction in taxes is accompanied by a strong likelihood that no partner's economic circumstances will change, the allocation will be insubstantial.

Gergen and Schwidetzky disagree as to the level of tax avoidance spawned by the substantiality test's focus on the ability to foretell the future. Gergen's two most relevant examples are these:

> Example 1: A and B each invests $50 in AB partnership. The partnership expends and deducts $100 in year one. It expects to earn $106 in year two. The entire $100 of loss in year one and the first $100 of income in year two are allocated to A. The remaining $6 income in year two is split evenly between A and B.[122]

> Example 4: A and B are equal partners in AB partnership, which owns taxable and tax-exempt bonds earning equal amounts of total interest. A has a 40% marginal rate and B is tax exempt. The interest on the tax-exempt bonds is allocated to A and the interest on the taxable bonds is allocated to B.[123]

In Example 1, A defers $50 income by virtue of the special allocation. If B had non-partnership losses in year 1 sufficient to offset whatever gains he realized, we could expect him to accommodate A's desire for more first year losses. The capital accounts, and thus each partner's economic take from the partnerships, would not differ under these allocations from what they would be if items were allocated in accordance with each partner's capital contribution. The only difference is that the partners would have a lower aggregate tax liability.[124] In Example 4, the partners' tax liability would decrease while the capital accounts would remain identical to what they would be in the absence of the allocation. B would be indifferent to the

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Even so, this burden cannot be terribly difficult because the partners have the greatest access to information.

[122] Gergen, *Reforming Subchapter K*, *supra* note 14, at 5, 8.

[123] *Id.* at 8.

[124] Assuming the facts exist to prove the requisite probabilities, these allocations would be labeled "transitory" and would fail the substantiality requirement. Treas. Reg. § 1.704-1(b)(2)(iii)(c) (2005).

allocation and the allocation of tax-exempt interest to A would result in one party having a lower tax burden.[125]

Schwidetzky notes, quite correctly, that Gergen's income and gain shifting allocations would very likely be prohibited under the substantial economic effect test.[126] The stipulated facts allow us to conclude that one partner — A — will have a better after-tax result because of the allocation and there is a strong likelihood that no partner's economic circumstance will change for the worse. The problem of course is that both examples stipulate the essential facts by which to achieve the level of probability necessary to preclude the allocations. The substantiality test is based on patently vague and amorphous concepts such as "may," "strong likelihood," and "substantial" differences.[127] It seems illogical to assume that partners seeking illegitimate tax advantages could not build some minimal amount of uncertainty, whatever that may be, into their transaction and thereby achieve substantiality. In any event, Gergen's two examples and Schwidetzky's response ignore the moral hazard inherent to the substantiality test. It is not that partners must explicitly lie regarding their expectations to achieve substantiality, they need only create plausible uncertainty. This seems an easy task. As a result, the potential equity losses pertaining to the substantial economic effect test are high even under Schwidetzky's narrow definition.

Even if that were not the case, it would be incomplete to consider the substantial economic effect safe harbor in a vacuum. Most of the recent and notorious tax avoidance wrought via subchapter K would not be possible under the substantial economic effect safe harbor alone, but the safe harbor is indispensable to those efforts. When used in conjunction with the ceiling rule, for example, the substantial economic effect test can result in significant deferral, as demonstrated in the following hypothetical based on a recent case:[128] Heavy debt laden Domestic partner contributes airplanes worth $540 million to a partnership. The airplanes are fully depreciated and thus have an inside basis of zero. They generate $100 million in annual rental income and approximately $65 million in annual book depreciation. The partnership also has approximately $25 million in other

[125] If the requisite probabilities are shown in this instance, the allocations would be labeled "shifting" and thus fail the substantiality requirement. *Id.* § 1.704-1(b)(2)(iii)(b).

[126] Schwidetzky, *supra* note 14, at 720–21.

[127] There are no cases defining these terms.

[128] Castle Harbour v. Commissioner, 342 F. Supp. 2d 94 (D. Conn. 2004).

deductible expenses. Two Foreign partners contribute $112 million. The partnership agreement allocates 98% of the income and expenses to the Foreign partners and 2% to Domestic partner. Provisions are also made to liquidate the Foreign partners' capital accounts by eight annual distributions such that the Foreign partners will receive an above market return on their capital investment. The partnership elects to use the traditional method to make allocations with respect to the airplanes.

The effect of the disproportionate allocation (relative to capital investment) on book accounts is that the Foreign partners will be allocated only about $9.8 million book income — the allocated book income will be reduced by allocated book depreciation, leaving a net of only $9.8 million. For tax purposes, however, the Foreign partners will be allocated about $74 million because the ceiling rule will deny an allocation of tax depreciation to correspond to the book depreciation.[129] If the partnership also makes annual distributions, it can effectively buy out the Foreign partners' interests, leaving the majority of the income originally assigned to the Foreign partners for distribution to the Domestic partner. That this outcome — i.e., the bulk of the income being stored for distribution to the Domestic Partner — was always intended means that the income should have been taxed to the Domestic partner at a much earlier point in time. The partners could rectify the timing distortion by electing an optional approach that would require the Domestic partner to recognize earlier an amount equal to book depreciation and provide the Foreign partners with offsetting tax depreciation equal to book depreciation.[130] In the absence of that election, and in conjunction with the liquidating distributions, the book income allocated to the Foreign partners will actually inure to the Domestic partner's benefit, though not taxed to the Domestic partner until the partnership liquidates. In short, the special allocation coupled with the ceiling rule, allows the Domestic partner to defer tax on large amounts of taxable income. This outcome would not have been possible if income were allocated in accordance with relative capital — 98% to the Domestic partner and 2% to the Foreign partners.

Some might argue that the just described transaction does not represent an abuse or equity loss at all because the Domestic partner

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[129] Treas. Reg. § 1.704-1 (b)(1)(2005).

[130] *See id.* § 1.704-1(c)-(d) (describing the curative and remedial allocation methods which, if elected, would require Domestic partner to recognize income currently).

could have achieved the same result by borrowing money from the Foreign partners outside of the partnership context. The assertion proves too much. If the transaction could have been achieved outside the partnership, there is certainly no need to condone distortions under subchapter K to facilitate the transaction within the partnership context. That the Domestic partner used the partnership to create a debtor-creditor relationship proves that it could not do so outside the partnership. The transaction is a classic off-balance sheet financing deal designed to thwart the market's decision not to provide the Domestic partner with further debt financing. Indeed, the market signals when debtors have too much debt or are otherwise not creditworthy by denying further debt financing, usually by way of debt-equity covenants or downgraded credit ratings.[131] This is an efficient and useful process. Allowing debt laden borrowers to bypass rational market limitations via the flexibility of subchapter K is therefore inefficient on a macro level and, assuming the market was correct with regard to the debtor's credit rating, should result in decreased utility. In any event, the subchapter K flexibility in this fact pattern provides an advantage to un-creditworthy partners that would not be extended to individuals. This is a significant efficiency as well as equity loss.

This section demonstrates two things. First, there is no efficiency-based reason to grant partners greater flexibility with respect to their tax benefits and burdens than that granted to individuals. Doing so

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[131] Schwarcz explains the benefits and shortcomings of structured-finance transactions as follows:

> Structured-finance transactions that are used to raise money off-balance-sheet are not inherently bad, and indeed can have important benefits, such as better allocating risk with assets. However, they also can mask liabilities that only first become evident when a company goes bankrupt. Say, for example, a company is able to characterize a transaction as a sale with contingent recourse, which otherwise (but less appropriately) would be viewed as balance-sheet debt. In a sale transaction, the contingent recourse only needs to be shown on the company's balance sheet if the contingency is "probable." Although diligent investors would learn of contingent liabilities by reading the footnotes to the balance sheet – such liabilities must be disclosed in those footnotes if the contingency is merely a "reasonable possibility" – investors often focus exclusively on the balance sheet itself without regard to risks disclosed in the footnotes. They therefore often fail to anticipate that, in a bankruptcy, contingent recourse may be asserted as a claim against the company.

Steven L. Schwarcz, *The Limits of Lawyering: Legal Opinions in Structured Finance*, 84 TEX. L. REV. 1, 4–5 (2005).

might be conducive to partners' private utility but there is no improvement to social utility since the transactions to which the flexibility is applied are nothing more than the opposite end bargaining that already occurs efficiently between unrelated parties. To allow partners to accomplish what the market otherwise prohibits decreases social utility assuming the market prohibits the result for good and efficient reasons. Second, the flexibility of subchapter K creates significant equity losses. In the first two examples above, the substantial economic effect test allows a partner to obtain timing advantages through untaxed exchanges of property. In the last example, the substantial economic effect test helps a partner gain a timing advantage by manipulating the constructive receipt and assignment of income rules that would otherwise cause that partner, as an individual, to recognize income sooner. The unprincipled partnership holds the income on behalf of one partner for economic purposes but the allocation rules allow the partnership to attribute the income to another partner for tax purposes (which partner is exempt from U.S. taxation, coincidentally). The next section presents the proposed solution: partnerships must allocate tax items in accordance with relative capital accounts unless the partners can shoulder a heavy burden of showing that capital account allocations are inefficient in light of their particular circumstance. If partners can meet their burden, they should be allowed to allocate partnership items under a more understandable PIP test.

IV. A PROPOSED SOLUTION: CAPITAL ACCOUNT ALLOCATIONS AND A REVISED PIP TEST

The proposed solution to the efficiency and equity losses occasioned under present law is based on one basic assumption. Allocating partnership items strictly in accordance with relative capital account balances may not be optimally efficient in certain rare circumstances, but doing so is never *inefficient*. Thus, capital account allocations should constitute the norm — the accurate safe harbor — but in certain circumstances proven by the partners, the allocations might be made in a different manner to achieve optimal economic efficiency. One such circumstance involves a limited partnership containing at least one general partner. In those situations, once a limited partner's capital account is reduced to zero, even if the general partner's capital account is also zero, no further allocations of loss or deduction should be made to the limited partner except to the extent

of that partner's obligation to contribute additional capital to the partnership.[132] Allocations beyond that point will necessarily be disproportionate to capital account balances because a limited partner's capital account should not have a negative balance greater than her restoration obligation. A second example involves "waterfall" distributions designed to implement preferred returns of capital.[133] The partners may agree that one partner is entitled to the return of her residual capital before any other partners. In those circumstances, it is not inappropriate to allocate partnership loss in the same order as distributions upon liquidation are to be made.[134] There may be other circumstances justifying non-capital account allocations, though I agree with current law to the extent it implicitly doubts the possibility.[135]

Only brief argument need be made regarding the notion that capital account allocations can never be inefficient. Current law implicitly agrees as demonstrated by the regulatory presumption that allocations should be shared on a "per capita" basis.[136] The discussion of efficiency has centered on the notion that it is inefficient to discourage or prevent the most productive use of property. Advocates for flexibility make the same assertion – that in the absence of a flexible taxing scheme applied to partnerships, partners would not pool their capital and make the most productive use of it. Thus, taxing owners on the yield from their capital is inefficient only if the tax discourages or prevents productive use of the capital. Earlier examples show that flexibility is not at all correlated to the utility

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[132] *Cf.* Treas. Reg. § 1.704-1(b)(2)(d) (2005) (regarding the impropriety of allocating deductions to limited partners who are not obligated to contribute additional capital).

[133] *See, e.g., id.* § 1.704-1(b)(5), ex. 16(i).

[134] *Id.* Example 16(i), unlike other examples in the regulations, does not specify that allocations must be made in accordance with relative capital. *Cf. id.* § 1.704-1(b)(5), ex. 1(i)-(ii), 4(i), and 8(i). This seems to leave open the possibility that allocations might be made in a manner consistent with the preferred liquidating distributions.

[135] The examples in Treas. Reg. § 1.704-1(b) with respect to the PIP test demonstrate only capital account allocations or allocations as described in the text with regard to limited partners and preferred distributions. *See id.* § 1.704-1(b)(5), ex. 16(i) (exemplifying waterfall allocations under the PIP standard); *id.* § 1.704-1(b)(5), ex. 1(iv) and 15(ii) (exemplifying limited partner allocations under the PIP standard); *id.* § 1.704-1(b)(5), ex. 1(i)-(ii), 4(i), and 8(i) (exemplifying capital account allocations under the PIP standard). One might expect that the drafters anticipated as many circumstances as possible.

[136] *Id.* § 1.704-1(b)(3)(i).

gains occurring when joint actors share risks and mutually strive for profit. Flexibility in the representative partnership transactions is, instead, correlated with opposite-end bargaining that coincidentally occurs within a partnership. Partners use special allocations to create bargains with respect to their capital or labor in the same manner and taking into account the same risks as individuals. Hence, there is no efficiency gain by taxing partners other than on a capital account allocation system. That conclusion nearly proves the opposite point. There is nothing inefficient in taxing the yield from capital strictly to the owners in accordance with their relative ownership of the capital. Doing so would be inefficient — by discouraging the productive use of the property — only if the tax rate were so high as to be confiscatory. This relates to the rate of tax, though, not to the identity of the taxpayer. A confiscatory tax would discourage productive use of capital no matter the identity of the taxpayer. Capital account allocations, too, would discourage mutual striving for profit only if the tax rate was confiscatory. In all other instances, capital account allocations can be no more inefficient than taxation in general and in any context.

As noted earlier, other scholars have suggested that capital account allocations should be the only permissible system.[137] The present analysis is basically consistent with that approach but because it is impossible to anticipate the entire universe of true partnership economic arrangements — as opposed to opposite end bargaining occurring within a partnership — I am not willing to completely foreclose the possibility that non-capital account allocations may be used. Indeed, we have identified two such circumstances. When a limited partner's capital account is reduced to zero as a result of prior pro rata allocations, no further allocations of loss can be allocated to that partner because she is not obligated to pay the economic cost corresponding to the loss. She cannot be expected to ever suffer the economic burden corresponding to earlier allocation of loss deduction. Thus future allocations of loss must be made to the general partner in amounts disproportionate to their respective capital accounts. Capital account allocations of loss in this instance would be inefficient because it is the general partner who would bear the entire economic burden. A rule mandating strict capital account allocations would thus discourage the presence of a general partner. The second circumstance involves preferred returns of capital. Mandating capital account allocations in that instance would likewise discourage a

[137] *See supra* note 19.

common risk ordering device.

When, as in the limited partner or preferred return examples, capital account allocations would prove inefficient, subchapter K should allow partners to allocate tax items in accordance with their economic interest in the partnership. This is essentially the rule under current law. If the partners' economic arrangement cannot be structured to meet the substantial economic effect test, allocations are tested under the partners' interest in the partnership test. This proposal differs from current law and prior proposals in that it eliminates the substantial economic effect test and replaces it with capital account allocations as the safe harbor. A more precisely defined PIP test would apply as well, but only when partners carried the burden of proving the inefficiency of capital account allocations.

The current partners' interest in the partnership test has been variously described as a "black hole,"[138] "nebulous and uncertain,"[139] and a standard about which "meaningful generalization . . . is not possible."[140] Those descriptions misconstrue the PIP test as an proactive statement of how tax burdens should be allocated. As explained below, the PIP test is entirely reactive. It accepts the notion that disproportionate allocations are appropriate in the main and merely reacts to those disproportionate outside the main. As such, the PIP test does not proactively define anything.

The general PIP test is described as a function of four factors designed to determine the true incidence of economic benefits and burdens derived from the partnership: (1) the partners' relative contributions to the partnership, (2) the interests of the partners in economic profits and losses, (3) the interests of the partners in cash flow and other non-liquidating distributions, and (4) the rights of the partners to distributions of capital upon liquidation.[141] These factors are to be applied in light of an initial, refutable presumption that allocations are to be made in accordance with capital account balances.[142] The regulations are conspicuously devoid of any statement regarding priority of consideration other than the initial presumption.[143] They are explained in thirteen examples that seem

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[138] Leder, *supra* note 14, at 753.

[139] Schwidetzky, *supra* note 14, at 711.

[140] Lawrence Lokken, *Partnership Allocations,* 41 TAX L. REV. 547, 614 (1986).

[141] Treas. Reg. § 1.704-1(b)(3)(ii) (2005).

[142] *Id.* § 1.704-1(b)(3)(i).

[143] There are surprisingly few cases interpreting the PIP test. In one case, the Tax Court merely went through the factors seriatim, without stating whether any particular factor should be given more weight than any other. *See* Estate of James R.

haphazard at first, but which actually demonstrate three separate approaches. Nevertheless, the syntactical structure of the PIP regulation certainly does not help convey the intended meaning.

A second, more important reason why the PIP test seems indecipherable is because the standard is reactive rather than proactive. Like the substantial economic effect test, the PIP test intends only to say that partners may do whatever they please insofar as the division of tax benefits and burdens is concerned, but they may not engage in illegitimate tax avoidance. Illegitimate tax avoidance is defined and limited to any allocation that lacks economic effect or predictably results in tax reduction without a corresponding economic reduction.[144] The regulatory articulation does not actually define any partner's interest in a partnership. Instead, the PIP test merely defines those allocations outside the substantial economic effect safe harbor that are also *not* within a partner's interest in a partnership. It is intended only as a reaction when illegitimate tax avoidance is identified and then only to the extent necessary to prevent the identified harm.[145] Taxpayers will necessarily come away with a vague and uncertain feeling if they mistakenly believe that the PIP test is intended to proactively identify the economics of any partnership structure.

A general standard, of course, ought to be articulated with the greatest simplicity possible. The present PIP articulation violates this rule of thumb but there are, nevertheless, three discernable, reactive rules:

> 1. If allocations do not have economic effect because (a) the partners do not maintain capital accounts in accordance with the checking account rules, or (b) liquidations will not be made in accordance with capital account balances, allocations must be made on a pro rata basis unless the partners have indicated a liquidation preference. In the latter instance, allocations may be made in accordance with relative capital

Tobias v. Commissioner, 81 T.C.M. (CCH) 1163 (2001).

[144] *See supra* note 18 and accompanying text.

[145] The substantiality requirement does not require capital account allocations even when illegitimate tax avoidance arising from disproportionate allocations is objectively predictable. Instead, the requirement merely dictates that the allocations in such circumstances be changed enough to eliminate the tax avoidance, though not to the extent that the allocations are proportional. *See* Treas. Reg. § 1.704-1(b)(5), ex. 5, 6, 7, and 10(ii) (2005).

or in the same order as the liquidation preference.[146]

> 2. If an allocation does not have economic effect because (a) the allocation will cause a capital account deficit greater than a partner's deficit restoration obligation or (b) the partnership agreement does not contain a qualified offset provision, the item must be reallocated to the partners who can be called upon to contribute more capital on a pro rata basis. A corollary to this rule is that an unexpected deficit greater than a partner's deficit restoration obligation will trigger a priority disproportionate allocation of income or gain to that partner sufficient to eliminate the deficit.[147]
>
> 3. If an allocation has economic effect but shifts income or character in a manner that reduces aggregate tax liability without a corresponding economic reduction, the allocation must be strictly in accordance with the partnership agreement as it would appear without the provision that creates the shift.[148]

Earlier, it was noted that capital account allocations serve as the implicit baseline against which allocations are tested for substantial economic effect.[149] Designating capital account allocations as the proper baseline is both efficient and equitable because nobody has identified any real partnership transaction or relationship that would be rendered inefficient by such a rule, and the rule would ensure equal treatment between partners and individuals. The first and second PIP restatements can coexist with the capital account allocation approach advocated in this article because they require allocations consistent with residual ownership, even though preferred liquidating distributions allow for preferred allocations to the extent of a preferred partner's residual capital. The third, however, is not consistent with the capital account allocation approach. The third restatement necessarily implies that some non-capital account allocations are legitimate as long as tax avoidance cannot be objectively predicted. In effect, the third restatement would reinstate the very same special allocation scheme condoned under present law

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[146] *Id.* § 1.704-1(b)(5), ex. 1(i)-(ii), 4(i), 8(i), and 16(i).

[147] *Id.* § 1.704-1(b)(5), ex. 1(iv) and 15(ii).

[148] *Id.* § 1.704-1(b)(5), ex. 5, 6, 7, and 10(ii).

[149] *See supra* note 117 and accompanying text.

but without the explicit imprimatur inherent to the substantial economic effect safe harbor.

The foregoing analysis therefore leads to the following allocation restatement. First, partners should allocate partnership items in the same ratio as their relative ownership of capital. In limited partnerships and partnership with preferred liquidating distributions, the PIP standard would allow disproportionate allocations without further proof of inefficiency. In the unlikely event the partners can prove that capital account allocations are inconsistent with another special relationship that can be efficiently achieved only in the partnership form, they should be allowed to make disproportionate allocations.[150] This is an explicitly particularized determination about which the regulations should not attempt to articulate standards. It is simply impossible to anticipate the universe of transactions via articulated standards. It is enough that the standard recognizes the possibility of inefficiency, however much skepticism is warranted, and thereby allows for case by case exceptions.

V. CONCLUSION

A system that mandated capital account allocations as the presumptive method, but then allowed for non-capital allocations so long as the timing advantages were not objectively predictable would essentially be the same as the present model. Partners could simply rely on PIP restatements to obtain the illegitimate advantages available under the present law substantial economic effect safe harbor. On the other hand, a system should absolutely prohibit non-capital account allowances only if the arguments in favor of flexibility can be categorically and universally dismissed. Some scholars implicitly or explicitly adopt this view. This article has argued only that advocates for flexibility have not put forth any transaction or particular partnership relationship that could not be achieved in the

[150] A skeptical approach that holds open the possibility of other circumstances is consistent with other instances where the Internal Revenue Code expresses skepticism with respect to a particular assertion but does not entirely foreclose the possibility. *See, e.g.*, I.R.C. § 706(b)(1)(C) (allowing partnerships to elect an unspecified taxable year only if the partnership can convince the Secretary that a business purpose exists for the selected taxable year); Treas. Reg. § 15A.453-1(d)(2)(iii) (2005) ("Only in those rare and extraordinary cases involving sales for a contingent payment obligation in which the fair market value of the obligation (determinable under the preceding sentences) cannot reasonably be ascertained will the taxpayer be entitled to assert that the transaction is "open." Any such transaction will be carefully scrutinized to determine whether a sale in fact has taken place.").

absence of flexibility while admitting that the entire universe of transaction may yet be defined. It seems very doubtful that such transactions exist, but it would not be imprudent to allow for the slim possibility. While there has been no convincing efficiency argument in favor of non-capital account allocations, there are significant equity arguments against non-capital account allocations. Hence, the present proposal would make capital account allocations mandatory except in two occasions. First, non-capital account allocations would be mandated with respect to limited or preferred partners. Second, non-capital account allocations would be permissible upon application to the Secretary demonstrating the legitimate business need for the deviation and why the business need cannot be accomplished without the non-capital account allocation. If partners can meet this intentionally heavy burden, they should not be denied relief because the non-capital allocation will result in a tax advantage relative to individuals. This is consistent with the notion that efficiency gains justify and compensate for equity losses. The theoretical baseline, of course, is that efficiency and equity should exist in rough equilibrium. The proposal with regard to non-capital account allocations would adhere to that theoretical baseline.