

Spring 2009

# Aggregate-Plus Theory of Partnership Taxation

Bradley T. Borden  
bradley.borden@brooklaw.edu

Follow this and additional works at: <https://brooklynworks.brooklaw.edu/faculty>



Part of the [Other Law Commons](#), and the [Tax Law Commons](#)

---

## Recommended Citation

43 Ga. L. Rev. 717 (2008-2009)

This Article is brought to you for free and open access by BrooklynWorks. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of BrooklynWorks.

AGGREGATE-PLUS THEORY OF  
PARTNERSHIP TAXATION

Bradley T. Borden\*

TABLE OF CONTENTS

I. INTRODUCTION ..... 719

II. LEGAL ATTRIBUTES OF PARTNERSHIPS ..... 723

    A. EARLY PARTNERSHIPS ..... 725

    B. FROM MIDDLE AGES TO MAINSTREAM ..... 734

    C. QUASI-PARTNERSHIPS ..... 737

    D. PARTNERSHIP TAXATION’S SEPARATE EVOLUTION ..... 741

III. ECONOMIC EXPLANATION OF PARTNERSHIPS ..... 743

    A. ECONOMIC REASONS FOR RESOURCE INTEGRATION ..... 744

    B. AGENCY COSTS IN INTEGRATED ARRANGEMENTS ..... 752

    C. ECONOMIC PRINCIPLES AND THE AGGREGATE-PLUS  
        THEORY ..... 761

IV. AGGREGATE-PLUS TAXATION ..... 762

    A. OVERVIEW OF AGGREGATE-PLUS TAXATION ..... 763

    B. AGGREGATE-PLUS THEORY AND EXISTING LAWS ..... 766

    C. AGGREGATE-PLUS THEORY AND FUTURE LAWS ..... 774

---

\* Associate Professor of Law, Washburn University School of Law. LL.M. and J.D., University of Florida, Fredric G. Levin College of Law; M.B.A. and B.B.A., Idaho State University. I thank Steve Bank, Samantha Borden, Kevin Chambers, Heather Field, Christopher Hanna, Tom Henning, Darryll Jones, Ali Khan, Tony Luppino, Walter Schwidetzky, and the participants at the 2007 Annual Meeting of the Midwestern Law and Economics Association for helpful comments and input on earlier drafts of this Article, and Washburn University School of Law for its research support. I thank my wife Sam and daughter Claire for their support and encouragement. All opinions expressed herein and any errors are my own.

V. CONCLUSION .....	780
APPENDIX A .....	781
APPENDIX B .....	784

## I. INTRODUCTION

Partnerships cut across cultures and legal systems;<sup>1</sup> they have existed throughout most of recorded history.<sup>2</sup> The ubiquity of partnerships in time and space suggests that humans have a natural tendency to form partnerships to conduct business. The law recognizes partnerships, but they are not the creation of law.<sup>3</sup> Instead, partnerships appear to be an essential part of human interaction, and the law strives to define that essential relationship. Humans' natural tendency to form partnerships adds to the fascinating nature of partnerships and presents some of the most complicated questions of law, economics, and taxation.

A predominant legal question over the last century has been whether partnerships are entities separate from their members or merely an aggregate of their members.<sup>4</sup> Legislators, courts, scholars, and lawyers have grappled with the question during that time period and continue to consider it today.<sup>5</sup> Certain legal matters call for the application of the entity concept while others appear more suited to the aggregate concept.<sup>6</sup> Applying one concept in lieu of the other can affect the outcome of various legal matters.<sup>7</sup>

---

<sup>1</sup> See, e.g., ABRAHAM L. UDOVITCH, *PARTNERSHIP AND PROFIT IN MEDIEVAL ISLAM* 7–8 (1970) (discussing existence of partnership in medieval Muslim society); Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333, 1399–1401 (2006) (discussing development of partnerships in ancient Rome, medieval Italy, and seventeenth century England).

<sup>2</sup> See, e.g., Henry Fr. Lutz, *Babylonian Partnership*, 4 J. ECON. & BUS. HIST. 552, 558–65 (1932) (describing partnerships in Babylonian society).

<sup>3</sup> As is often the case, business development precedes the development of the law governing business relations. See *id.* at 557 (“[I]n the Hammurabi period (2057 to 1758 B.C.), private business in its various phases is found to have been fully developed, but the legal aspects and regulations governing business had not kept pace with the country’s economic and business developments.”).

<sup>4</sup> See, e.g., Daniel S. Kleinberger, *The Closely Held Business Through the Entity-Aggregate Prism*, 40 WAKE FOREST L. REV. 827, 827 (2005) (raising this question in context of partnerships, close corporations, and limited liability companies).

<sup>5</sup> See generally *id.* (reviewing briefly aspects of debate, recognizing current entity view, and discussing current legal issues that raise entity-aggregate dichotomy in partnership context today).

<sup>6</sup> See *id.* at 876–80 (discussing application of both theories and proposing standard for determining when respective theories should apply to legal matters).

<sup>7</sup> See, e.g., *id.* at 876 n.226 (noting effect of different approaches on certain bankruptcy matters).

Nonetheless, no clear standards dictate when either concept should apply in the legal context.<sup>8</sup> This presents a significant obstacle to lawmaking, even in today's legal environment that favors the entity concept.<sup>9</sup> Issues still arise in partnership law that invoke the entity-aggregate question.<sup>10</sup>

Partnership taxation similarly suffers from a lack of clarity regarding the application of the entity and aggregate concept.<sup>11</sup> The question is perhaps even more pronounced in partnership taxation because partnerships, limited liability companies, limited partnerships, business trusts, and limited liability partnerships (referred to collectively as partnerships in this Article, unless stated otherwise) are all subject to partnership taxation.<sup>12</sup> Partnership tax law contains aspects of both the entity concept and the aggregate concept.<sup>13</sup> No definite pattern of application of either concept emerges from a study of the statutory scheme,<sup>14</sup> and no standard exists to guide lawmakers considering new partnership tax laws.<sup>15</sup>

---

<sup>8</sup> See *id.* at 827 ("With regard to general partnerships, close corporations, and LLCs alike, the 'deep structure' on this question remains somewhat schizoid.").

<sup>9</sup> See *id.* at 835–37 (discussing shift to entity view).

<sup>10</sup> See *id.* at 841–45 (discussing continuing existence of entity-aggregate dichotomy in general partnerships, LLCs, and close corporations).

<sup>11</sup> See *Archibald v. Comm'r*, 27 B.T.A. 837, 844 (1933) ("Since a partnership stands ambiguously before the law in other fields, it is not disturbing that it should be found so under the income tax statute.").

<sup>12</sup> See Treas. Reg. § 301.7701-3(a)–(b)(2) (as amended in 2006) (describing which entities are classified as partnerships).

<sup>13</sup> See 1 WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 1.02 (3d ed. 1997) (discussing entity and aggregate theories generally and recognizing that drafters of statutory partnership tax law "combined the entity and aggregate concepts in developing a comprehensive scheme for the taxation of partnerships"); see also *infra* APPENDIX A (identifying relevant provisions of statutory partnership tax law as adopting either entity concept or aggregate concept).

<sup>14</sup> The pattern is also absent in case law, rulings, and commentary. See Paul Carman et al., *Comments in Response to Notice 2000-29*, 56 TAX LAW. 203, 212 (2002) ("[N]either theory has been determined by the courts, ruled administratively by the Service or overwhelmingly adopted by commentators to be the theory applicable in all situations arising under Subchapter K, . . . to the extent that any trend has developed, the entity theory appears to be dominant, and . . . both theories have been utilized—by the Government, the taxpayers and the commentators—to support whatever was ultimately deemed to be the appropriate policy result.").

<sup>15</sup> See Alfred D. Youngwood & Deborah B. Weiss, *Partners and Partnerships—Aggregate vs. Entity Outside of Subchapter K*, 48 TAX LAW. 39, 39 (1994) ("The blending of [the aggregate concept and entity concept] is a primary source of uncertainty and confusion (1) in the interpretation and application of Subchapter K of the Code; and (2) outside of Subchapter K,

Commentators have recognized a need for standards that would reduce the ad hoc application of the concepts and prevent significantly different outcomes that result from the case-by-case use of the concepts.<sup>16</sup> Because partnership law serves policy goals that differ from tax policy goals, partnership law does not guide partnership taxation.

Finding little guidance in partnership law, this Article turns to economic theory and history. That study reveals that ancient and modern partnerships, in all of their forms, have numerous common characteristics. For example, partners join resources to achieve output that is greater than the sum the separate outputs of the resources would produce independently.<sup>17</sup> Partners also use various techniques to monitor each other and reduce agency costs.<sup>18</sup> One practice that appears to cut across all partnerships, both temporally and spatially, is the partners' apportionment of partnership economic items.<sup>19</sup> Previous work has demonstrated that partnership tax law must account for partners' apportionment of economic

---

in the application of other aspects of the Code to a partnership and its partners.”).

<sup>16</sup> See 1 MCKEE, NELSON & WHITMIRE, *supra* note 13, ¶ 1.02[3] (“A wide variety of situations that are not squarely covered by [statutory partnership tax law] is susceptible to resolution in dramatically different ways, depending on whether effect is given to the entity or aggregate concept. The absence of a unifying entity or aggregate theme in [partnership tax law] means that these situations must be resolved on an ad hoc basis by reference to the way in which the statute applies the entity and aggregate concepts to related or analogous situations—a process that is difficult, tedious, and uncertain. The resultant lack of predictability in the application of [statutory partnership tax law] is exacerbated because the considerations that lead to the predominance of the entity or aggregate concept in one context may be only subtly different from those that give rise to the use of the opposing concept in another.”). McKee, Nelson, and Whitmire provide a general proposition for a guiding standard. They suggest that the aggregate concept should apply with respect to the income from the partnership and contributions to and distributions from the partnership, while the entity concept should govern the transfer of partnership interests. *Id.* This Article builds on that suggestion and demonstrates that the entity-aggregate dichotomy warrants more particular guidance.

<sup>17</sup> See Bradley T. Borden, *Partnership Tax Allocations and the Internalization of Tax-Item Transactions*, 59 S.C. L. REV. 297, 303 (2008) (“[T]he total output of an arrangement may not equal the sum of the separate inputs from individual members of the arrangement. The parties . . . must decide how to apportion any extra output created by combining inputs.” (footnote omitted)).

<sup>18</sup> See, e.g., *id.* at 304 (“By hiring managers to monitor inputs, firms are able to apportion rewards based on inputs and reduce shirking.” (footnote omitted)).

<sup>19</sup> See *id.* at 335 (“The partnership tax allocation rules generally require partnerships to allocate tax items to partners in accordance with their interests in the partnership.”).

items.<sup>20</sup> To avoid discouraging partnership formation and to accurately tax apportioned items, partnership taxation must largely adhere to the aggregate view. This Article suggests that the aggregate concept should be the starting point for any partnership tax rule.<sup>21</sup>

In fact, partnership tax law began as an almost purely aggregate concept in 1913.<sup>22</sup> Congress and courts have incorporated entity components into that law.<sup>23</sup> The early entity components appear to have served tax administration purposes.<sup>24</sup> The purpose of other, later entity provisions is less clear. The search for an underlying theory of partnership taxation recognizes the need for some entity provisions.<sup>25</sup> Nonetheless, it calls for the aggregate concept to be the beginning point for any new partnership tax rule.<sup>26</sup> Lawmakers

---

<sup>20</sup> See generally *id.* (providing examples of how partnership allocation rules may inaccurately assign burden of taxation to partners who do not enjoy economic benefit of thing taxed).

<sup>21</sup> Commentators have made a similar suggestion regarding the application of tax rules outside of Subchapter K. See Youngwood & Weiss, *supra* note 15, at 39, 42–43 (advocating use of aggregate approach).

<sup>22</sup> See Tariff Act of 1913, ch. 16, § II.A, 38 Stat. 114, 166 (imposing first post-Sixteenth Amendment income tax); *id.* § II.G(a), 38 Stat. at 172 (excluding partnership income from “normal tax” imposed on income from corporations, joint-stock companies, and associations); *id.* § II.D., 38 Stat. at 168–69 (requiring partnerships to return certain information to government upon request).

<sup>23</sup> See, e.g., I.R.C. § 703(a) (2006) (requiring partnerships to compute partnership taxable income in same general manner as individual).

<sup>24</sup> See Bradley T. Borden, Sandra Favelukes & Todd E. Molz, *A History and Analysis of the Co-Ownership-Partnership Question*, 21 TAX MGMT. REAL EST. J. 143, 144–45 (2005) (observing that Congress enacted initial entity provisions to facilitate tax accounting). Some commentators believe that partnership taxation is trending toward an entity regime. See Carmen et al., *supra* note 14, at 253 (noting trend in states towards treating tax partnership as entities). Such a trend is questionable, however, since Congress often enacts aggregate provisions to address problems created by entity provisions. See *infra* Part IV.B. Indeed, other commentators recognize Congress is incorporating more aggregate provisions into Subchapter K. See Youngwood & Weiss, *supra* note 15, at 42 n.16 (“In recent years the provisions of Subchapter K appear to be incorporating more of an aggregate approach.”). The aggregate-plus theory would help end such confusion as the law would trend in neither direction. In fact, it appears that since 1954, Congress has enacted nine provisions that have an entity or aggregate tilt. See *infra* APPENDIX B. Of those nine, five have been aggregate provisions and only two have been entity provisions. *Id.* The other two provisions were neither entity nor aggregate but addressed nonrecognition and anti-abuse. *Id.*

<sup>25</sup> See Youngwood & Weiss, *supra* note 15, at 69 (noting that “there clearly should be limited exceptions to application of the aggregate theory”).

<sup>26</sup> See *id.* at 40 (“It is especially important to have a strong presumption in favor of the aggregate concept . . . .” (footnote omitted)).

should add entity components only as needed for tax administration. The aggregate beginning point with additional entity components gives rise to the aggregate-plus theory of partnership taxation.<sup>27</sup>

After exploring the development and current status of partnership law in Part II and considering the economic reasons that compel parties to form partnerships in Part III, the Article introduces the aggregate-plus theory of partnership taxation in Part IV and considers its importance. An examination of several statutory provisions reveals that an entity-minus approach (i.e., beginning with an entity provision and removing entity components) may reach the same end result obtained through the aggregate-plus theory.<sup>28</sup> The difference between the two approaches, however, is the interim between the inception of the rule and the point of equalization. This Article uses an example to demonstrate that the entity-minus approach creates inefficiency and inaccuracy in the interim. The aggregate-plus approach, on the other hand, maintains efficiency and accuracy at the expense of simplicity. Manageable complexity is a small price to pay for efficiency and accuracy. Thus, the aggregate-plus theory of partnership taxation proves to be a sound model for partnership taxation. Finally, this Article illustrates how the aggregate-plus theory can direct current and future rulemaking.

## II. LEGAL ATTRIBUTES OF PARTNERSHIPS

“The central problem of partnership law has been the development of a framework for determining the substantive rights and obligations arising out of the partnership relationship.”<sup>29</sup>

---

<sup>27</sup> This is in stark contrast to corporate flow-through tax law, which imposes a tax on the corporate entity and then removes entity components for certain small businesses—such a tax regime is entity-minus taxation. The concepts of aggregate-plus and entity-minus taxation feature prominently in Bradley T. Borden, *Policy and Theoretical Dimensions of Qualified Tax Partnerships*, 56 KAN. L. REV. 317, 318–20 (2008) (using term “aggregate-plus-plus” taxation to distinguish partnership taxation from taxation of qualified tax partnerships, which distinction is not relevant to this Article).

<sup>28</sup> See *infra* Part IV.B (illustrating how partnership-interest-basis rules evolved from equity-minus approach but could have evolved more efficiently from aggregate-plus approach).

<sup>29</sup> Gary S. Rosin, *The Entity-Aggregate Dispute: Conceptualism and Functionalism in Partnership Law*, 42 ARK. L. REV. 395, 396 (1989).



Central to that problem is knowing whether a partnership is an entity or an aggregate of its owners.<sup>30</sup> The prominent issues in partnership law that raise the aggregate-entity question include (1) the extent to which partners are liable for partnership obligations, (2) the nature and extent of partners' ownership of partnership property, (3) the extent to which partners are able to participate in managing the partnership, (4) the duration of the partnership, (5) the residency of the partnership, (6) the partnership's standing to sue and be sued, and (7) the alienability of interests in the partnership.<sup>31</sup> These issues are at the center of the aggregate-entity debate.

Although the debate regarding whether a partnership is an entity or aggregate began fairly recently in relation to the life of partnerships (it appears to have begun in earnest around the turn of the twentieth century),<sup>32</sup> entity and aggregate elements manifested themselves in the earliest partnership forms. Recall that the essentials of a separate entity are that the entity have (1) its own name; (2) a continuous life separate from that of its owners; (3) the right to contract; (4) the power to acquire, manage, and dispose of both personal and real property; (5) sole liability for torts; and (6) the right to sue and be sued.<sup>33</sup> Examining the early forms of partnership elucidates the historic presence of some of those essentials. The examination of early partnerships creates a context for discussing the aggregate-plus theory and also opens a window into human nature, revealing a human tendency to form relations for business purposes.<sup>34</sup>

---

<sup>30</sup> See *id.* ("Historically, this problem has been addressed on a conceptual basis, determined by whether a partnership is viewed as an 'entity,' a legal person separate from its partners, or an 'aggregate,' a relationship among the partners.").

<sup>31</sup> See 1 ALAN R. BROMBERG & LARRY E. RIBSTEIN, *BROMBERG AND RIBSTEIN ON PARTNERSHIP* § 1.03(c) (1994) (listing factors, including the seven mentioned above, that relate to aggregate-entity distinction in partnerships).

<sup>32</sup> See Kleinberger, *supra* note 4, at 830 (recognizing debate as dating back at least to decade prior to promulgation of UPA in 1914).

<sup>33</sup> A. Ladru Jensen, *Is a Partnership Under the Uniform Partnership Act an Aggregate or an Entity?*, 16 VAND. L. REV. 377, 381 (1963).

<sup>34</sup> See Charles Sumner Lobingier, *The Natural History of the Private Artificial Person: A Comparative Study in Corporate Origins*, 13 TUL. L. REV. 41, 41 (1938) ("[M]any institutions of today, which we are prone to regard as modern, really have their roots in these first substitutes for the natural relationships."); *id.* at 52 ("In some very early associations an economic purpose clearly appears.").

## A. EARLY PARTNERSHIPS

The origin of partnerships appears to coincide with the origin of private business.<sup>35</sup> Historians speculate that in ancient Babylon, apart from temple property, private property in land did not exist.<sup>36</sup> The almost universal lack of private property gave little opportunity for the development of private business enterprise.<sup>37</sup> Private business and property ownership began as the temple-centric communal society disintegrated. The disintegration of the temple-centric communal society may have begun with the rulers of the community, the *patesis*, who enriched themselves by appropriating temple property to personal benefit.<sup>38</sup> Such appropriations created a wealthy class and led to the gradual rise of private ownership of anything possessable.<sup>39</sup> From this developed the "chief merchant" or *damgar*, who transacted business for his ruler as early as 2750 B.C.<sup>40</sup> The early relationships between the *patesi* and the *damgar* bore some resemblance to modern agency relationships.<sup>41</sup> The Sumerian *damgar* at first transacted business on behalf of the temple organization and later on behalf of wealthy individuals.<sup>42</sup> In such transactions, the *damgar* began to enjoy a certain degree of independence, drew a profit from business carried out on behalf of others, and also bore some risks of the business.<sup>43</sup> The *damgar's*

---

<sup>35</sup> See 1 BROMBERG & RIBSTEIN, *supra* note 31, § 1.02(a) ("Partnership—using the term in a general way—must be as old as cooperative activity.").

<sup>36</sup> See Lutz, *supra* note 2, at 552–53 ("Land for cultivation and grass land for herding cattle seem to have been held solely by the temples, as the trustees of communal property. Private property appears to have been restricted to the individual holdings of small house plots and dwellings within the city area, and to personal belongings. The economic life of the Sumerians was communal both as to production and consumption.").

<sup>37</sup> See *id.* at 553 (positing that underdevelopment of private property rights lead to lack of development of private business enterprises).

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> See *id.* at 554, 556 (discussing history of *damgar*).

<sup>41</sup> Compare RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) ("Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act."), with Lutz, *supra* note 2, at 556 (discussing agency aspects of *damgar-patesi* relationship).

<sup>42</sup> See Lutz, *supra* note 2, at 556 ("In the early period we find the *damgar* transacting business . . . at first for the temple organization . . . and later for rich individuals . . .").

<sup>43</sup> *Id.*

independence and risk bearing represents a deviation from what modern law considers an agency relationship, and the arrangement takes on some attributes of a modern partnership.<sup>44</sup>

Instead of conducting all trading activity individually, the *damgar* (also known as *tamkaru*) began sending out an assistant or agent, a *shamallû*.<sup>45</sup> As the principal, the *damgar* would instruct the *shamallû* to carry on business with the *damgar*'s capital.<sup>46</sup> The *damgar* would not, however, hire the *shamallû*. Instead, *shamallûs* drew income from part of the venture's profit.<sup>47</sup> Such early Babylonian business ventures were known as *commendas*.<sup>48</sup> Babylonian law required the *shamallû* to place the earnings of the venture to the account of the *damgar* and return double the amount of the trading capital invested, if the *shamallû* conducted no business at all.<sup>49</sup> The law required the *shamallû* to make full restitution of the invested capital if the *shamallû* suffered business reverses.<sup>50</sup> On the other hand, if the *shamallû* was attacked and plundered on the road, the *damgar* bore the full loss of invested capital.<sup>51</sup> Thus, the arrangement provided for independent action by the *shamallû*, profit sharing between the *shamallû* and the *damgar*, and liability allocation. These *commendas* are similar to the medieval *commenda* discussed below, both of which bear some similarities to modern partnerships.

Ancient Babylonians also used partnerships in agricultural and trade arrangements. Deeds of partnership from the Amorite

---

<sup>44</sup> See UNIF. P'SHIP ACT § 101(6), 6 U.L.A. 61 (1997) ("Partnership" means an association of two or more persons to carry on as co-owners a business for profit . . .").

<sup>45</sup> Lutz, *supra* note 2, at 558.

<sup>46</sup> *Id.* at 558–59.

<sup>47</sup> *Id.* at 559.

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> *Id.* The law also required the *shamallû* to present an itemized account to his principal after selling the stock of merchandise, required the principal to pay the *shamallû* for the transaction, and imposed penalties for fraudulent assertions related to the accounting and payments. See *id.* ("Fraudulent denial on the part of the *shamallû* of having received the capital from his principal was punished with a heavy fine, which, apart from the return of the original capital, consisted in the payment of thrice the amount of money obtained from his principal. A principal's false denial of receipt of his capital from his assistant was punished with the payment of the capital plus the sixfold amount of that sum.").

<sup>51</sup> See *id.* (providing that *shamallû* would be free of obligation by providing oath attesting to plunder).

Dynasty in Babylon indicate that Babylonians used two types of partnerships: rent partnerships and trade partnerships.<sup>52</sup> A common rent partnership appears to have occurred when two or more people joined together as partners to clear and cultivate land.<sup>53</sup> The landowner would reduce the partners' rent during the first years of the arrangement to reflect the clearing of the field and raise rent to market value after the initial period of reduced rent.<sup>54</sup> The partnership accounted for the expenses of such rent partnerships and the partners shared the profits equally.<sup>55</sup> Landowners could enter into rent partnerships with other persons.<sup>56</sup> In such situations, the service contributors would share the expenses and labors equally.<sup>57</sup> The owner would receive one half of the yield as a partner and receive one-half of the rent as owner of the property but would not pay one-half the rental due as a partner.<sup>58</sup> Although called partnerships, such arrangements are similar to modern sharecropping arrangements.<sup>59</sup>

Trade partnerships, or *tapputum*, required partners to make equal capital investments in some definite business project.<sup>60</sup> Partners would use the contributed capital to purchase merchandise to resell at a profit.<sup>61</sup> Documents show *tapputum* existed as early

---

<sup>52</sup> *Id.* at 560. Early rent partnerships took the form of rental contract because Babylonian scribes did not have previously drafted rent partnerships to copy from. *Id.* at 561.

<sup>53</sup> *See id.* at 560 (describing basic rent partnership).

<sup>54</sup> *See id.* at 560–61 (providing that landowner generally raised rent after second year to correspond to rate paid for adjacent fields).

<sup>55</sup> *Id.* at 561.

<sup>56</sup> *See id.* (describing existing record documenting such arrangement).

<sup>57</sup> *Id.*

<sup>58</sup> *Id.* This is wholly unlike the accounting common in tenancy-in-common arrangements. *See generally* Dudley Weible, *Accountability of Cotenants*, 29 IOWA L. REV. 558 (1944) (reviewing modern cotenant rights). The difference is that in these early partnerships, the landowner and the partner both contributed labor to the endeavor.

<sup>59</sup> *See* JOHN STUART MILL, *PRINCIPLES OF POLITICAL ECONOMY* 296–311 (Prometheus Books 2004) (discussing history and political aspects of tenant farming through nineteenth century); *see also generally* Douglas Allen & Dean Lueck, *Contract Choice in Modern Agriculture: Cash Rent Versus Cropshare*, 35 J.L. & ECON. 397 (1992) (detailing agricultural contracts in United States and exploring choice between sharecropping and cash-rent contracts); Donald L. Winters, *Tenant Farming in Iowa, 1860–1900: A Study of the Terms of Rental Leases*, 48 AGRIC. HIST. 130 (1974) (analyzing modern tenant farming in Iowa).

<sup>60</sup> Lutz, *supra* note 2, at 561–62.

<sup>61</sup> *Id.* at 562.

as 1947 B.C. and could borrow to finance operations.<sup>62</sup> Lending arrangements could provide for joint liability or joint and several liability of the partners.<sup>63</sup> The partners could also mutually guarantee the payment of partnership liabilities and become responsible for partnership liability through a contract entered into by any of the partners.<sup>64</sup>

Babylonian law appears to have been fairly sophisticated regarding partnership formation, operation, and termination. To form a partnership, partners designated their intention before a magistrate—a member of the priesthood of the sun-god, Shamash.<sup>65</sup> Similarly, Shamash temples appear to have been the venue for partnership dissolutions.<sup>66</sup> Partners could form partnerships for a short period of time or for an extended period, to be dissolved only upon the death of a partner.<sup>67</sup> During the course of a partnership that extended over a period of years, partners made periodic settlements (generally at the conclusion of a business journey) and either distributed the profits or reinvested them in the same or a different business.<sup>68</sup> The Babylonian *tapputum* possessed characteristics of both the Medieval *commenda* and *compagnia*.<sup>69</sup>

Although partnerships have been traced to ancient history, many scholars attribute the origins of modern partnership law to medieval

---

<sup>62</sup> *Id.*

<sup>63</sup> *Id.* at 563. Language in loan documents calling for joint liability provided “from a sound and truthful man he [the creditor] will receive.” *Id.* Joint and several liability arose from language such as “they go surety for each other; he who is nearest shall give.” *Id.* Although this latter provision spoke specifically to physical proximity of a partner (i.e., contemplated the possibility of one partner being absent on a business journey), the possibility it created for a creditor to collect the entire balance of an outstanding liability is similar to the modern concept of joint and several liability.

<sup>64</sup> *See id.* (“A loan contracted by one partner for the company made the latter responsible for its payment.”).

<sup>65</sup> *See id.* at 564 (stating that private agreement between individuals was insufficient to form partnership).

<sup>66</sup> *Id.* Lutz bases his conclusion that the temple played a pivotal role in the formation and dissolution of partnerships on documents that state these activities occurred in Shamash Temples. *Id.*

<sup>67</sup> *See id.* at 566 (noting varying lengths of partnerships and citing as example of long-term partnership one that existed for thirty-one years).

<sup>68</sup> *Id.* at 566–67. Often the court could get involved in settling differences between partners and heirs of partners, in the case of the death of a partner. *See id.* at 567–69 (discussing such disputes).

<sup>69</sup> *See infra* notes 71–104 and accompanying text.

partnerships.<sup>70</sup> Two forms of medieval partnerships feature prominently in legal history: the *commenda* and the *compagnia* (also referred to as *societas*).<sup>71</sup> The *commenda* was the most popular form of partnership used for trade in the Middle Ages.<sup>72</sup> This type of partnership separated the roles of the capital investor and manager.<sup>73</sup> Often, the investor would provide all of the money or goods needed for a venture, and the manager would conduct the trade of the venture.<sup>74</sup> The investor and manager did not necessarily share any association prior to the formation of the partnership, and their association might last for only a single venture.<sup>75</sup>

The *commenda* was popular for a number of reasons. First, it allowed the investor (the *commendator*<sup>76</sup>) to invest in a venture without violating the canonical laws against usury.<sup>77</sup> Second, it allowed the small merchant (the *tractator*<sup>78</sup>) to obtain financing without incurring personal economic risk.<sup>79</sup> Third, because the *tractator* traded individually, the *commendator* was only liable for the original amount invested.<sup>80</sup> Fourth, the *commenda* allowed for multiple *commendators*, all of whom were liable only for their initial

---

<sup>70</sup> See William Mitchell, *Early Forms of Partnership*, in 3 SELECT ESSAYS IN ANGLO-AMERICAN LEGAL HISTORY 183, 186 (1909) (identifying *commenda* and *compagnia* as early partnership forms). Lobingier argues that Mitchell overlooked earlier forms of partnership. See Lobingier, *supra* note 34, at 57 ("Mitchell, apparently unaware of its long background, treats *commenda* as a mediaeval contract, citing examples of 1155 (Italy), 1210 (Marseilles), and 1300 (England), as well as instances in Germany and Scandinavia; but in all of these it was an inheritance from the remote past." (footnote omitted)). Nonetheless, Mitchell is often cited for his account of medieval partnerships. See, e.g., FLOYD R. MECHEM, ELEMENTS OF THE LAW OF PARTNERSHIP, at xxiii & n.4 (2d ed. 1920) (citing Mitchell).

<sup>71</sup> See Hansmann, Kraakman & Squire, *supra* note 1, at 1365–74 (discussing economic attributes of medieval partnerships).

<sup>72</sup> See Mitchell, *supra* note 70, at 183–84 ("In the early centuries the most common form of partnership was the 'commenda.'").

<sup>73</sup> See *id.* at 183 (describing division of roles).

<sup>74</sup> *Id.*

<sup>75</sup> See *id.* (noting relationship "was often confined to single ventures").

<sup>76</sup> *Id.* at 184.

<sup>77</sup> *Id.* at 183.

<sup>78</sup> *Id.* at 185.

<sup>79</sup> See *id.* at 183 (noting that small merchant could "secure credit and . . . transfer . . . risk").

<sup>80</sup> See *id.* at 185 (recognizing that *tractator* may have been a mere factor for *commendator* in earlier times, but eventually, *commendator* was only liable for capital advanced, as was established by statute in Florence in 1408).

investments.<sup>81</sup> Fifth, the *commenda* was suited for definite speculations, but partners could form them for an indefinite series of transactions and indefinite time periods.<sup>82</sup>

Because the *commendator* bore the risk of loss, the *commendator* could not recover the amount invested if the *tractator* lost the goods.<sup>83</sup> If the venture was successful, the parties generally divided the profits, with 25% to the *tractator* and 75% to the *commendator*.<sup>84</sup> On the other hand, if the *tractator* invested capital in the venture, the *tractator's* share of profit might rise to 50%.<sup>85</sup> The silent investor's limited liability and the manager's unlimited liability are similar to the arrangement of today's limited partnerships.<sup>86</sup>

The medieval *commenda* largely reflected the aggregate concept. Because the *tractator* acted individually on behalf of the venture, the venture likely did not have its own name.<sup>87</sup> The *commenda* would also end upon the completion of a venture.<sup>88</sup> The *tractator* could undoubtedly enter into contracts on behalf of the venture, but doing so subjected the *tractator* to liability beyond the amount contributed by the *commendator*.<sup>89</sup> The *tractator*, not the entity, was solely liable for torts committed during the venture. These characteristics reveal the aggregate nature of the *commenda*.<sup>90</sup>

Another form of medieval partnership was the *compagnia*.<sup>91</sup> More similar to today's general partnership, the *compagnia* included

---

<sup>81</sup> See *id.* at 185–86 (noting that in Florence by 1408, *commendators* were “freed . . . from all liability beyond the amount of their quota”).

<sup>82</sup> See *id.* at 185 (noting that *commenda* could exist for “as long as 10 years”).

<sup>83</sup> *Id.*

<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

<sup>86</sup> See UNIF. LTD. P'SHIP ACT §§ 303, 404, 6A U.L.A. 46 & 57 (2001) (describing liability of general and limited partners in limited partnership). Mitchell identifies the *commenda* as the ancestor of the *Société en commandite*, which was characterized by its two classes of members: investors with liability limited to the amount contributed to the venture and managers who bore unlimited liability for the obligations of the venture. Mitchell, *supra* note 70, at 186.

<sup>87</sup> See Mitchell, *supra* note 70, at 185 (positing that *tractator* traded in his own name).

<sup>88</sup> See Hansmann, Kraakman & Squire, *supra* note 1, at 1372 (“A *commenda* lasted only a single, round-trip voyage . . .”).

<sup>89</sup> See *id.* (reasoning that limited liability of passive partner protected passive partner from incurring liability due to *tractator's* additional borrowing).

<sup>90</sup> See *supra* note 33 and accompanying text for a list of entity characteristics.

<sup>91</sup> Mitchell, *supra* note 70, at 186.

members who both invested in and managed the business.<sup>92</sup> These arrangements grew out of more permanent associations such as families or “persons who had full confidence in each other.”<sup>93</sup> The name of a *compagnia* usually included the name of one of its members with a phrase like *et socii*.<sup>94</sup> The members of a *compagnia* could be liable for the acts of other members.<sup>95</sup> As the law did not require that all members’ names appear in the name of the *compagnia*, the law had to determine who was legally regarded as a member of the *compagnia*.<sup>96</sup> Medieval Italian law adopted tests similar to those used today to determine intent to form a partnership.<sup>97</sup> For example, early Italian statutes looked to actual common trading of the members of a *compagnia* or general notoriety to prove the partnership.<sup>98</sup> If the investigation into common trading left doubt about the status of a partner or partnership, the partnership books might shed light on the question.<sup>99</sup> Such evidence was not enough, however, to prove the partnership against partners who denied the existence of a partnership or asserted it had been dissolved—an action which required proof by public documentation.<sup>100</sup> Common trading and the partnership books were also insufficient “to protect merchants from a general liability for all

---

<sup>92</sup> See *id.* (“[S]ide by side with the commenda there existed throughout the Middle Ages a closer kind of partnership in which the partners were normally coordinate members of the association with the same privileges and responsibilities.”).

<sup>93</sup> *Id.* at 191.

<sup>94</sup> *Id.* at 186.

<sup>95</sup> *Id.* at 186–87; see also *infra* notes 108–12 and accompanying text (discussing extent to which members of *compagnia* could be liable for contracts entered into by other members of same *compagnia*).

<sup>96</sup> See Mitchell, *supra* note 70, at 187 (“[I]t became important to determine who were to be legally regarded as members of the firm.”).

<sup>97</sup> See 1 BROMBERG & RIBSTEIN, *supra* note 31, § 2.05(b), (c) (identifying written agreements, contributions, use of trade name, keeping partnership books, sharing profits and losses, and interactions with third parties as evidence of intent or lack of intent to form partnership).

<sup>98</sup> Mitchell, *supra* note 70, at 187. This inquiry was comparable to today’s subjective intent test. See 1 BROMBERG & RIBSTEIN, *supra* note 31, § 2.05(b) (discussing similar factors in subjective intent test for presence of partnership).

<sup>99</sup> Mitchell, *supra* note 70, at 188.

<sup>100</sup> *Id.* (quoting Florentine guild statute of 1301: “If any one practising in the Calimala craft, . . . or having a share in any “societas” of that craft has renounced or shall renounce it in the future, such renunciation . . . shall show that he withdrew from that firm by means of a public document, and the consuls shall have that document published throughout the whole craft.”).



the debts of a trader with whom they occasionally combined for the purpose of a common speculation."<sup>101</sup> Thus, elements of intent may have been sufficient to prove a partnership, but such proof was not valuable if the partnership had been dissolved or other evidence demonstrated the lack of a partnership.<sup>102</sup> Beginning in the fourteenth century, partners registered with guilds and city authorities.<sup>103</sup> Because such registrations required the direct intervention of all members of the partnership, the registration would have helped prove the existence of a partnership.<sup>104</sup>

The existence of a partnership did not necessarily mean that partners were liable for all contracts entered into by other partners. The extent to which partners were liable depended upon a jurisdiction's law regarding direct representation.<sup>105</sup> Italy, for example, never denied partners the power to bind each other by contract.<sup>106</sup> Roman and Germanic law, on the other hand, developed the concept of direct representation imperfectly, resisting it for some time.<sup>107</sup> Even though medieval Italian law allowed one partner to bind the other partners, such representation required special procuration.<sup>108</sup> Partners could use the partnership agreement to give each other the right to represent and bind the partners.<sup>109</sup> Without such provision in the partnership agreement, creditors who entered into contracts with a single member of a partnership could make good their claim against the partnership as a whole only if the partnership recognized the debt as a partnership debt.<sup>110</sup>

---

<sup>101</sup> *Id.*

<sup>102</sup> Similar difficulties arise today when applying the intent test to determine whether a partnership exists. See 1 BROMBERG & RIBSTEIN, *supra* note 31, § 2.05(a) (noting problems of defining partnership content).

<sup>103</sup> Mitchell, *supra* note 70, at 188.

<sup>104</sup> See *id.* (stating all members of firm needed to be directly involved in registration).

<sup>105</sup> See *id.* at 186-87 (discussing direct representation in different societies).

<sup>106</sup> *Id.*

<sup>107</sup> See *id.* at 187 (quoting Kohler, *Zivilrecht*, in HOLTZENDORFF'S ENCYKLOPÄDIE DER RECHTSWISSENSCHAFT 598 (1904)).

<sup>108</sup> *Id.* at 188.

<sup>109</sup> *Id.*

<sup>110</sup> *Id.* at 188-89 (providing that partnerships could recognize the debt of the firm by entering the debt on the firm's books or employing the borrowed funds "for the common purposes of the firm"); see also *id.* at 189 ("Whoever in the city or district of Florence . . . has sold cloth or other things pertaining to trade to any one of this guild cannot seek nor sue for the money or price of the sale from any of the partners of the buyer, or from any one of his

Eventually, the law evolved to allow partners to bind the partnership without procuration or otherwise demonstrating that the partnership treated the obligation as a partnership obligation.<sup>111</sup> By the seventeenth century, partners had the power to act in the name of the firm, even without procuration.<sup>112</sup>

Unlimited liability of a partner was not uniformly enforced by law in the early centuries of the Middle Ages.<sup>113</sup> Nonetheless, the concept of unlimited liability, like the concept of representation, developed over time, and by the seventeenth century, the law appeared to accept partners' unlimited liability for partnership obligations.<sup>114</sup> The law provided that creditors had recourse first against the capital of the firm and second against the "unlimited liability of the individual partner."<sup>115</sup>

The *compagnia* evinces both aggregate and entity characteristics. For a period of time, under some jurisdictions, the partners were not liable for all of the debts of the partnership.<sup>116</sup> Even after partner liability became an established part of partnership law, partners were liable only if partnership assets were not sufficient to satisfy creditors.<sup>117</sup> Recognizing the partnership in that manner reflects the entity concept. The law did not require the partnership to list all partners in its name.<sup>118</sup> Thus, the partnership took its own name—an essential entity concept. Medieval law also granted partners authority to act on behalf of the partnership,<sup>119</sup> another

---

firm, unless the money shall be found written in the books of the buyer's firm as payable for the price of that sale.' " (quoting Florence gild regulation, St. of Calimala, 1301, Lb. ii. rubric 19)).

<sup>111</sup> See *id.* at 189–90 (attributing evolution of law to frequency with which partners entrusted one member with power to bind partnership and instruction in the Calimala Gild of Florence (1301) to grant any member of partnership who went abroad with special or general procuration).

<sup>112</sup> *Id.* at 190.

<sup>113</sup> *Id.*

<sup>114</sup> See *id.* at 191 (noting recognition of liability of every partner in statutory and judicial decisions).

<sup>115</sup> *Id.*

<sup>116</sup> See, e.g., *id.* at 190 (noting opposition to view recognizing "the responsibility of the other partners for the debts and contracts made by an individual member of the firm").

<sup>117</sup> See *id.* at 191 (discussing order of liability where "in the first place the creditor had recourse to the capital of the firm," and then to individual partner).

<sup>118</sup> See *id.* at 187 (noting that "et socii" commonly appeared instead of all names of partners).

<sup>119</sup> See *supra* notes 106–12 and accompanying text.

essential characteristic of an entity.<sup>120</sup> The partners' power to bind the partnership and the existence of partnership liability gave the *compagnia* aggregate characteristics. That aggregate and entity mix carried over to English and American common law.<sup>121</sup>

## B. FROM MIDDLE AGES TO MAINSTREAM

Early English mercantile courts recognized the *compagnia* and *commenda*.<sup>122</sup> By 1606, mercantile cases were coming into common law courts in increasing numbers, and without established legal principles, courts were forced to decide each case on its facts.<sup>123</sup> In the eighteenth century, Chief Justice Lord Mansfield began creating the common law for commercial matters, relying on the custom of merchants and civil law.<sup>124</sup> As a result of considerable commercial activity during the nineteenth century, England created the Partnership Act of 1890.<sup>125</sup> In the United States, the Commissioners on Uniform State Laws formed a committee to draft the Uniform Partnership Act (the UPA), which the Commissioners completed in 1914.<sup>126</sup> Although common law still contains a significant portion of partnership law in the United States, each state (other than Louisiana) has adopted all or a portion of the UPA.<sup>127</sup> The drafting of the UPA brought the aggregate-entity debate into the foreground of partnership law in the United States.

At the turn of the twentieth century in connection with the drafting of the UPA, scholars and lawyers debated whether a partnership was an aggregate of its owners or an entity separate from its owners.<sup>128</sup> No consensus was reached at that point.<sup>129</sup> The

---

<sup>120</sup> For a list of entity characteristics, see *supra* note 33 and accompanying text.

<sup>121</sup> See Jensen, *supra* note 33, at 378–79 (noting portions of final draft of proposed Uniform Partnership Act contained entity and aggregate characteristics).

<sup>122</sup> See 1 BROMBERG & RIBSTEIN, *supra* note 35, § 1.02(a) (noting that early mercantile courts recognized both *societas* (also called *compagnias*) and *commendas*).

<sup>123</sup> *Id.*

<sup>124</sup> *Id.*

<sup>125</sup> *Id.* § 1.02(b).

<sup>126</sup> See *id.* (discussing creation of Uniform Partnership Act in U.S. and recognizing that some courts and lawyers view UPA as codification of common law, which some use as excuse to ignore UPA).

<sup>127</sup> UNIF. P'SHIP ACT Prefatory Note, 6 U.L.A. 5 (1997).

<sup>128</sup> See 1 BROMBERG & RIBSTEIN, *supra* note 31, § 1.03(b) (discussing debate between entity

UPA approved by the Conference of Commissioners on Uniform State Laws in 1914 contained both entity and aggregate components.<sup>130</sup> Drafters of the UPA originally set out to adopt the entity view.<sup>131</sup> The death of Dean James Barr Ames, the original chairman of the drafting committee and an entity theory supporter, changed the direction of the UPA.<sup>132</sup> Perhaps as a compromise of Conference participants, the UPA includes both the entity and aggregate components.<sup>133</sup> Undoubtedly, however, legal and social issues current at the time of the adoption of the UPA also affected the theory of the UPA.

The common law view of partnership was that a partnership was not a legal person separate from its members.<sup>134</sup> At the turn of the twentieth century, many state constitutions provided that any non-natural person would be a corporation.<sup>135</sup> In such states, a partnership would arguably be a corporation if the law treated it as

---

and aggregate theories during drafting).

<sup>129</sup> An early draft of the UPA treated the partnership as an entity. See UNIF. P'SHIP ACT Prefatory Note, 6 U.L.A. 276 (1914) (noting that early drafts were based on mercantile or "entity" theory). After significant debate, the drafters of the UPA decided to adopt the aggregate view of partnerships with partners treated as owning partnership property as tenants in partnership. *Id.*

<sup>130</sup> The leading contemporary scholars of the UPA present the differing views regarding the UPA's aggregate and entity views. See generally Judson A. Crane, *The Uniform Partnership Act: A Criticism*, 28 HARV. L. REV. 762 (1915) (arguing that several provisions of UPA treat partnerships as entities); William Draper Lewis, *The Uniform Partnership Act—A Reply to Mr. Crane's Criticism*, 29 HARV. L. REV. 158 (1915) (arguing that UPA does not adopt entity concept of partnerships). Crane reiterated his views twenty years after the approval of the final draft of the Act. Judson A. Crane, *Twenty Years Under the Uniform Partnership Act*, 2 U. PITT. L. REV. 129, 132 (1936) ("[T]he [UPA] is a compromise of the entity and of the aggregate views of partnership."). More recent work has recognized the different theories present in the UPA. See, e.g., Jensen, *supra* note 33, at 379 n.11 (listing UPA sections that he deems to have adopted entity concept).

<sup>131</sup> UNIF. P'SHIP ACT Prefatory Note, 6 U.L.A. 276 (1914).

<sup>132</sup> See Jensen, *supra* note 33, at 378 (noting decision to disregard original directive); Kleinberger, *supra* note 4, at 832 (noting that death of Act's first reporter lead to resolution that Conference proceed as if resolution to adopt entity theory had never been adopted).

<sup>133</sup> See Jensen, *supra* note 33, at 378–79 (recognizing that many committee members who had worked with Dean Ames were successful in retaining entity view in several specific substantive provisions, while Lewis's committee successfully adopted aggregate view with respect to certain other specific provisions).

<sup>134</sup> See *id.* at 377 (defining "common law aggregate doctrine" and noting that UPA drafting committee practiced partnership law under that doctrine).

<sup>135</sup> See Lewis, *supra* note 130, at 165 ("[T]he constitutions of some states made a legal but non-natural person a corporation.").

an entity separate from its members. Furthermore, the Sixteenth Amendment and the first income tax laws were enacted shortly before the UPA's adoption.<sup>136</sup> Drafters may have been concerned that treating partnerships as entities under the UPA would subject them to federal income tax.<sup>137</sup> Drafters of the UPA also sought to eliminate confusion regarding the ownership of partnership property.<sup>138</sup> The entity concept proved to be the most effective means of achieving that goal. Whatever the ultimate justification, the UPA did not uniformly adopt the entity or aggregate concept.

Commentators dispute the extent to which the UPA contains entity provisions.<sup>139</sup> The dispute hinges upon whether the term *partnership*, as used in the UPA, has reference to a separate entity or is merely shorthand for the aggregate ownership of property.<sup>140</sup> Sections of the UPA that treat the partnership as owning property and granting it the right to acquire, hold, and transfer property appear to adopt entity characteristics.<sup>141</sup> The definition of partnership in the UPA, however, appears to adopt the aggregate view.<sup>142</sup> Thus, the UPA (1914) contained both aggregate and entity components.

The civil law view of partnerships is that they are entities separate from their owners.<sup>143</sup> This entity concept is the prevailing legal view of partnerships today.<sup>144</sup> As recently revised, the UPA

---

<sup>136</sup> See Jensen, *supra* note 33, at 378 ("Before the final draft was unanimously approved, the sixteenth amendment and a federal income tax thereunder had both become law.").

<sup>137</sup> *Id.*

<sup>138</sup> See Crane, *Twenty Years Under the Uniform Partnership Act*, *supra* note 130, at 135-36 (discussing UPA and partnership property).

<sup>139</sup> Compare Jensen, *supra* note 33, at 379 n.11 (arguing that significant number of provisions of UPA adopt the entity concept based upon UPA's use of "partnership" to represent an entity); with Rosin, *supra* note 29, at 406-07 (arguing that "partnership" as used in UPA refers to aggregate of partners).

<sup>140</sup> See Rosin, *supra* note 29, at 406-15 (arguing primarily for later interpretation).

<sup>141</sup> See *supra* note 33 and accompanying text. Section 8 of the UPA defines partnership property and allows partnerships to acquire property in the partnership name. UNIF. P'SHIP ACT § 8, 6 U.L.A. 532 (1914).

<sup>142</sup> See UNIF. P'SHIP ACT § 6, 6 U.L.A. 393 (1914) ("A partnership is an association of two or more persons to carry on as co-owners a business for profit.").

<sup>143</sup> See 1 BROMBERG & RIBSTEIN, *supra* note 31, § 1.03(b) ("The partnership has been characterized as a legal entity in civil law jurisdictions . . .").

<sup>144</sup> See Kleinberger, *supra* note 4, at 841 ("[I]t does appear that the predominate forms of closely held businesses—general partnerships, close corporations, and LLCs—are indeed all entities now."). Kleinberger recognizes, however, that the various forms of closely held

(RUPA as revised) makes clear that partnerships are entities separate from their members.<sup>145</sup> Nonetheless, aggregate concepts find their way into the RUPA. Perhaps most significantly in the context of partnership taxation, the RUPA grants partners the power to apportion partnership profit and loss to partners.<sup>146</sup> The RUPA also provides that, upon liquidation of a partner's interest in the partnership, the partner is entitled to contributions plus apportioned partnership income.<sup>147</sup> The power to apportion income creates complexity for which entity taxation cannot accurately account. Thus, even though the law may largely view partnerships as entities, tax law must retain an aggregate view of partnerships.

### C. QUASI-PARTNERSHIPS

Business developments and owner preferences have also made quasi-partnerships, such as limited partnerships and limited liability companies, popular today. Quasi-partnerships have significant entity attributes. They can adopt names that do not include the names of the members.<sup>148</sup> They can continue

---

businesses all retain some aggregate aspects. For example, the RUPA retains the "pick your partner principle," allows partners to bring claims directly for injuries suffered by the partnership, and prohibits derivative actions. *Id.* at 841-42. Limited liability company statutes generally follow the "pick your partner" approach and allow members to regulate the affairs of the company with an operating agreement. *Id.* at 842-43. Limited liability company law has also begun to recognize fiduciary duties among the members. *Id.* at 845. Most courts allow shareholders of close corporations to determine their deal by agreement for *inter se* purposes. *Id.* at 844.

<sup>145</sup> See UNIF. P'SHIP ACT § 201, 6 U.L.A. 91 (1997) ("A partnership is an entity distinct from its partners.").

<sup>146</sup> See *id.* § 401(b), 6 U.L.A. 133 (granting partners generally right to receive equal share of partnership profits and be charged equal share of partnership losses); *id.* § 103(a), 6 U.L.A. 73 (granting partners power to define their own relationship through partnership agreement).

<sup>147</sup> See *id.* § 701(a)-(b), 6 U.L.A. 175 (providing that upon dissociation of partner, dissociated partner is entitled to amount that partnership would owe partner if partnership liquidated and its business wound up); *id.* § 807(b), 6 U.L.A. 206 (providing that each partner is entitled to any credits in excess of charges to partner's capital account); *id.* § 401(a), 6 U.L.A. 133 (providing that partner's capital account is credited with contributions and partner's share of partnership profits).

<sup>148</sup> See UNIF. LTD. P'SHIP ACT § 108, 6A U.L.A. 370 (2001) (noting that name of limited partnership may contain name of any partner); UNIF. LTD. LIAB. CO. ACT § 105, 6B U.L.A. 565 (1996) (imposing no requirement related to partner names).

indefinitely, irrespective of the change in membership.<sup>149</sup> They have the right to contract in their own names and to acquire, manage, and dispose of property in their own names.<sup>150</sup> Members of limited liability companies and limited partners of limited partnerships are not liable for debts of the entity or for torts committed by others.<sup>151</sup> Finally, quasi-partnerships can sue and be sued.<sup>152</sup> Thus, they possess the characteristics of an entity and are rightly viewed to be such.<sup>153</sup>

Regardless of the law's general trend toward the entity view of partnerships and quasi-partnerships, such arrangements retain certain aggregate characteristics. For example, like partnerships, quasi-partnerships allow their members to apportion quasi-partnership income.<sup>154</sup> All such entity forms include aggregate "pick-your-partner" rules, which allow members to choose who will be admitted.<sup>155</sup> Moreover, partnerships and quasi-partnerships remain largely creatures of the agreement among members.<sup>156</sup>

---

<sup>149</sup> See UNIF. LTD. P'SHIP ACT § 104(c), 6A U.L.A. 366 ("A limited partnership has a perpetual duration.").

<sup>150</sup> See UNIF. LTD. P'SHIP ACT § 105, 6A U.L.A. 367 (allowing limited partnership any power necessary to carry on business); UNIF. LTD. LIAB. CO. ACT § 112(b), 6B U.L.A. 572 (allowing LLC to make contracts and deal in real estate).

<sup>151</sup> See UNIF. LTD. P'SHIP ACT § 303, 6A U.L.A. 418 (noting that obligation of limited partnership is not obligation of limited partner); UNIF. LTD. LIAB. CO. ACT § 303(a), 6B U.L.A. 587 (noting that obligations of LLC are solely obligations of company).

<sup>152</sup> See UNIF. LTD. P'SHIP ACT § 105, 6A U.L.A. 367 ("A limited partnership has . . . the power to sue [or] be sued."); UNIF. LTD. LIAB. CO. ACT § 112(b)(1), 6B U.L.A. 576 (providing limited liability company may "sue and be sued").

<sup>153</sup> See *supra* note 33 and accompanying text.

<sup>154</sup> See UNIF. LTD. P'SHIP ACT § 110, 6A U.L.A. 378 (allowing partners to define their relationship through partnership agreement); UNIF. LTD. LIAB. CO. ACT § 103, 6B U.L.A. 563 (allowing members to govern their relationship through operating agreement).

<sup>155</sup> See UNIF. P'SHIP ACT § 401(i), 6 U.L.A. 133 (1997) ("A person may become a partner only with the consent of all of the partners."); UNIF. LTD. P'SHIP ACT § 301, 6A U.L.A. 416 ("A person becomes a limited partner . . . with the consent of all the partners."); UNIF. LTD. LIAB. CO. ACT § 503, 6B U.L.A. 603 ("A transferee . . . may become a member of a limited liability company if . . . all other members consent."); see also Kleinberger, *supra* note 4, at 841-43 (describing aggregate nature of "pick your partner" statutes).

<sup>156</sup> See UNIF. P'SHIP ACT § 103(a), 6 U.L.A. 73 (allowing partners to govern their relationship through partnership agreement); UNIF. LTD. P'SHIP ACT § 110, 6A U.L.A. 378 (stating partnership agreement will govern partnership); UNIF. LTD. LIAB. CO. ACT § 103(a), 6B U.L.A. 563 (allowing members to govern relationship through operating agreement); see also Kleinberger, *supra* note 4, at 841-43 (noting that partners or members may govern their own relationship through agreement).

Thus, even quasi-partnerships, which are widely viewed to be entities, remain aggregate in some very important ways.

Other distinguishing characteristics of today's partnerships are their size, the number of members they have, and their use in "privlic" and other publicly traded companies.<sup>157</sup> Partnerships and quasi-partnerships are popular for many types of businesses because they give owners tools that help reduce agency costs. For example, publicly held limited partnerships commonly require general partners to distribute available cash to limited partners, reducing inadequate risk-taking.<sup>158</sup> The limited partnership agreement also mitigates the separation of ownership and control by granting general partners significant financial incentives that align their interests with the limited partners' interest in receiving distributions.<sup>159</sup>

Private equity firms, which are generally limited partnerships, also reduce some of the agency costs that plagued LBOs (leveraged buyouts) by taking advantage of the innovative incentive structures available to limited partnerships.<sup>160</sup> The general partners of a private equity fund generally receive a fee equal to 2% of the assets managed and 20% of the fund's profits, in excess of a threshold amount.<sup>161</sup> These profit sharing arrangements give the managers a strong incentive to maximize the profits of the fund, aligning their interests with the limited partners' interests.<sup>162</sup> That agency cost reduction is possible because of the apportionment rules available to partnerships and quasi-partnerships.

This discussion of partnerships illustrates that although partnerships and quasi-partnerships are legal entities, they retain some aggregate characteristics. Those aggregate characteristics

---

<sup>157</sup> See Larry E. Ribstein, *The Rise of the Uncorporation* 34 (Ill. L. & Econ. Res. Paper Series, Research Paper No. LE07-026, 2007), available at [http://papers.ssrn.com/pape.tar?abstract\\_id=1003790](http://papers.ssrn.com/pape.tar?abstract_id=1003790) (using term "privlic" to describe public ownership and trading of instruments in private equity firms).

<sup>158</sup> *Id.* at 22.

<sup>159</sup> *Id.*

<sup>160</sup> See *id.* at 27 (discussing incentive structure of private equity association).

<sup>161</sup> *Id.* at 28.

<sup>162</sup> Although private entity arrangements align the investor's and managers' interests, some question whether tax law should treat such arrangements as tax partnerships. See Bradley T. Borden, *Profits-Only Partnership Interests*, 74 BROOK. L. REV. (forthcoming 2009) (discussing debate over such arrangements).



make them desirable business forms in many situations. The increased use of such arrangements will undoubtedly raise legal issues that invoke the aggregate-entity debate. Instead of fighting the aggregate-entity dichotomy, scholars and lawmakers should adopt principles that govern the appropriate application of either concept.<sup>163</sup> One proposed solution is that the aggregate concept should apply to issues that arise *inter se* the members of the organization, and the entity concept should apply to matters that involve third party rights.<sup>164</sup> That proposal reflects an effort to standardize the application of the concepts. Such standardization should provide a measure of predictability for members of partnerships and third parties who deal with partnerships or their members.

The policy that directs the application of entity and aggregate concepts in nontax matters likely will not be appropriate for applying entity and aggregate concepts to tax matters because different areas of law present different policy concerns.<sup>165</sup> As stated above, partnership law is concerned with assessing liability and determining powers with respect to property.<sup>166</sup> Tax law, on the other hand, is concerned with raising revenue in a manner that

---

<sup>163</sup> See Kleinberger, *supra* note 4, at 877–80 (suggesting that aggregate and entity constructs should be servants, not masters, of lawmakers).

<sup>164</sup> *Id.* at 878–79. Professor Kleinberger also offers policy justification for the proposal. He reasons that the aggregate concept is appropriate in most situations for issues that arise *inter se* the members of an organization because the aggregate concept “more closely resembles the real-world views of the participants.” *Id.* at 878. The aggregate concept should, however, give way where any of the following apply: (1) “The entity construct reflects, preserves or implements an aspect of the aggregate arrangement; [(2)] The owners have otherwise agreed (because it is ‘aggregate-like’ to permit the owners to opt into an entity construct); or [(3)] The entity approach is warranted by clearly expressed, overriding policy concerns from other law.” *Id.* at 879. The entity concept is appropriate for matters with third parties “because the ‘shield’ is more than an aggregate’s desideratum; it is by far the most important characteristic of the enterprise as experienced by third parties.” *Id.* at 879 (footnote omitted). Because third parties conceptualize many organizations as an entity, fairness dictates that the law should treat such organizations as an entity for matters involving third parties. *Id.*

<sup>165</sup> See Bradley T. Borden, *The Federal Definition of Tax Partnership*, 43 HOUS. L. REV. 925, 974–75 (2006) (arguing that policy considerations that affect substantive (i.e., nontax) definition of partnership are not appropriate policy considerations when defining partnership for tax purposes).

<sup>166</sup> See *supra* notes 29–31 and accompanying text.

promotes economic growth, stability, and efficiency.<sup>167</sup> Those benefiting from income should bear the burden of the tax on that income.<sup>168</sup> The different policy goals of substantive partnership law and tax law help explain the divergence of the two areas respecting the aggregate and entity concepts. They also suggest that the theory of partnership taxation should not be tethered to the theory of substantive partnership law. The different policy goals of each body of law may justify the adoption of different aspects of the aggregate and entity concepts. A brief review of the history of partnership taxation illustrates that it has evolved independent of partnership law.

#### D. PARTNERSHIP TAXATION'S SEPARATE EVOLUTION

While the law of partnerships has moved toward the entity concept,<sup>169</sup> partnership taxation has moved away from its almost pure aggregate origins. When Congress enacted the first post-Sixteenth Amendment partnership tax law, it almost completely disregarded partnerships, subjecting partners to tax on partnership income.<sup>170</sup> Since then, Congress has added some entity components to partnership tax law. The early entity components focused on tax law administration, addressing the partnership taxable year and the computation of partnership taxable income.<sup>171</sup>

In 1954, Congress codified partnership tax law in subchapter K of the Internal Revenue Code.<sup>172</sup> That body of law retains the

---

<sup>167</sup> See JOSEPH A. PECHMAN, *FEDERAL TAX POLICY* 5 (5th ed. 1987) (describing three goals of taxation).

<sup>168</sup> See *Helvering v. Horst*, 311 U.S. 112, 119–20 (1940) (prohibiting assignment of income from property); *Lucas v. Earl*, 281 U.S. 111, 114–15 (1930) (same).

<sup>169</sup> See *supra* Part II.B–C.

<sup>170</sup> See *Archibald v. Comm'r*, 27 B.T.A. 837, 840 (1933) (“The taxing acts have, since the adoption of the Sixteenth Amendment, recognized the existence of partnerships, expressly providing, however, except in the Revenue Act of 1917, that partnership income should be taxed distributively to the individual partners.”); Borden, *supra* note 165, at 941–42 (suggesting “Congress generally disregard partnerships” but allowed IRS to “administer partner taxation”); see also *supra* note 22 and accompanying text.

<sup>171</sup> See War Revenue Act of 1917, ch. 63, § 1204(1)(e), 40 Stat. 300, 331–32 (1917) (allowing partnerships to compute taxable income and adopt taxable year); Borden, *supra* note 165, at 943–46 (discussing effect of War Revenue Act of 1917 on partnership taxation).

<sup>172</sup> Internal Revenue Code of 1954, Pub. L. No. 591-736, 68A Stat. 239 (codified as amended in 26 I.R.C. § 701-77).

aggregate view but includes several entity components.<sup>173</sup> A general observation is that the entity concept governs partnership tax accounting and property ownership,<sup>174</sup> and the aggregate concept governs all else. Considering the exceptions that exist to that general observation and several reparative uses of the aggregate rules,<sup>175</sup> however, the application of the two concepts may appear random. Undoubtedly, Congress generally understood the results that the respective concepts would generate.<sup>176</sup> Instead of using general principles to apply the respective concepts, perhaps Congress focused on a preferred outcome in adopting the respective concepts for different provisions. Commentators similarly discuss the results that will arise under either concept, but they generally have not sought principles to guide the application of one concept over another.<sup>177</sup> Thus, partnership taxation remains a somewhat inexplicable hodgepodge of aggregate and entity components. Because partnership taxation appears to have developed independent of partnership law, partnership law does not help explain the partnership tax hodgepodge.

On the other hand, the economic nature of partnerships helps explain why partnership tax has not followed the changes in partnership law and why it should not adopt partnership law's entity view. Continuing developments in business and property ownership practices will undoubtedly warrant changes to partnership tax law. The need for change almost invariably will raise the question of whether the entity or aggregate concept should

---

<sup>173</sup> See *infra* APPENDIX A (listing sections of Internal Revenue Code that adopt either aggregate or entity concept).

<sup>174</sup> See, e.g., I.R.C. §§ 703, 705, 706, 722, 723, 731, 741 (2000) (containing sections governing tax accounting and property ownership); see also *infra* APPENDIX B (recognizing that of twenty-four entity provisions in subchapter K, twenty-three address either tax accounting or property/partnership ownership, including partnership-interest-basis rules discussed *infra* Part IV.B.).

<sup>175</sup> See, e.g., I.R.C. § 707 (2000) (applying entity concept to transactions between partners and partnership); *id.* § 704(c) (applying aggregate concept to property ownership and accounting); *id.* §§ 734, 743 (applying aggregate concept to sales of partnership interests and distributions from partnership).

<sup>176</sup> See generally J. Paul Jackson et al., *A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners*—American Law Institute Draft, 9 TAX L. REV. 109 (1954) (discussing different results obtained depending upon concept used).

<sup>177</sup> See Carman et al., *supra* note 14, at 253–67 (discussing different results under either concept, but offering no reason for adopting either concept uniformly).

govern any new tax rule.<sup>178</sup> To avoid confusing and inconsistent rules, lawmakers should rely upon general principles to apply either the aggregate or the entity concept. Because the law of partnerships and quasi-partnerships does not provide such principles, lawmakers must look to partner behavior to determine a workable standard. Economic studies in the theory of the firm provide insight into why parties form partnerships. An understanding of that theory helps create standards for applying the aggregate and entity concepts to partnership tax law.

### III. ECONOMIC EXPLANATION OF PARTNERSHIPS

Economic theory connects the evolution of the law of partnerships to partnership tax law and forms the foundation of the aggregate-plus theory of partnership taxation. Members of ancient business arrangements combined property and services, or simply services, to take advantage of their respective specialized skills. For example, *damgars* developed specialized skills in capital investment and *shamallûs* developed specialized skills in managing trade ventures.<sup>179</sup> Although a *damgar* could have hired a *shamallû's* services, the parties must have realized the economic benefit of integrating property and services, so they formed partnerships. After integrating property and services, the parties allocated economic items to share the bounties of their arrangement. Modern economic theory helps explain why parties integrate resources in this age-old fashion and allocate economic items.<sup>180</sup> Economic theory also helps justify the application of aggregate-plus taxation to tax partnerships.

---

<sup>178</sup> See *id.* at 261–63 (discussing different tax results obtained under entity and aggregate concepts as applied to potential rules addressing recent development in business practices).

<sup>179</sup> See *supra* notes 40–51 and accompanying text.

<sup>180</sup> Recent scholarship has also discovered that modern economic theory nicely explains various aspects of ancient business arrangements and their development. See generally, e.g., Hansmann, Kraakman & Squire, *supra* note 1 (applying economic theory to explain why corporate law developed legal aspects such as entity shielding).

## A. ECONOMIC REASONS FOR RESOURCE INTEGRATION

Property and services (i.e., capital and labor) are the basic resources of business arrangements. The earliest business arrangements demonstrate that business participants developed specialized skills in property ownership and service provision. For example, a *damgar* (an expert in capital allocation), instead of developing merchant skills, could have hired a *shamallû* (an expert in trading) to manage merchant ventures.<sup>181</sup> Conversely, *shamallûs* developed merchant skills and used those skills to generate income, instead of developing capital allocation expertise. Thus, the earliest business arrangements suggest that business participants believed specialization was an effective method for increasing income.

The owners of resources determine the extent to which they will make them available to other parties and the price at which they will make them available. The residual right of control (i.e., the right to control all aspects of property that have not been given away by contract<sup>182</sup>) determines who owns and controls a particular resource. Ancient business arrangements illustrate how both property and services have residual rights of control.<sup>183</sup> Assume

---

<sup>181</sup> See *supra* notes 40–51 and accompanying text.

<sup>182</sup> Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691, 695 (1986). A recent tax case illustrates the scope of this concept of ownership and the types of property to which it may apply. In *Commissioner v. Banks*, the Supreme Court held that the plaintiff, not the attorney working on a contingency-fee basis, controlled the rights to the claim. See 543 U.S. 426, 435–36 (2005) (“[T]he client retains ultimate dominion and control over the underlying claim.”). A contingent fee arrangement entitles the attorney to a portion of any judgment or settlement awarded to the plaintiff. Consequently, both parties share in the product of the attorney’s services and the plaintiff’s claim. Nonetheless, the plaintiff controls decisions such as whether to settle or proceed to trial. See *id.* at 435–37 (“[T]he plaintiff still must determine whether to settle or proceed to judgment and make, as well, other critical decisions.”). Thus, the plaintiff controls significant rights to the claim not given away by contract, and therefore owns the claim. *Id.* at 436–37.

<sup>183</sup> Grossman and Hart use the example of a printer and publisher to illustrate the residual right of control in property. Grossman & Hart, *supra* note 182, at 695. In their example, the printer agrees to print a fixed number of books for the publisher. *Id.* The agreement gives the publisher some rights in the printer’s equipment because, at a minimum, the publisher can receive damages if the printer fails to perform under the contract. In fact, if the printer’s services were unique, the publisher may be able to compel the printer to complete the job run. See Anthony T. Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351, 357–58 (1978) (noting that court may be more likely to compel specific performances if subject of contract is unique). Because courts grant specific performance only if a money

Semiramis owned arable property upon which she wished to grow corn, and Zarek was a reputed farmer. Semiramis could hire Zarek to provide the services necessary to grow the crop instead of developing her own specialized cultivating skills. The parties could agree that Semiramis would pay Zarek a fixed amount for working the property for a fixed period of time. After the terms of the agreement expired, Semiramis would control the disposition or further use of the property. Zarek, after performing his services under the agreement, would control whether he would continue to provide services for Semiramis, if requested, or provide his services some other place, or not at all. Semiramis, having control of the property following the expiration of the terms of the agreement with Zarek, would hold the residual right of control of the property.<sup>184</sup> The same concepts apply to services. Zarek would control all of his services not contracted away to Semiramis, thus holding the residual right of control of his services.

As the holder of the residual right of control of a piece of property, a property owner determines the extent to which a service provider may perform services with respect to the property.<sup>185</sup> Applying that principle to the previous example, Semiramis would control the extent to which Zarek could cultivate the property. If Zarek's most expert skills were in preparing ground and planting, Semiramis could hire Zarek only to prepare the ground and plant the crop and hire another person to cultivate and harvest the crop. Under such an agreement, Zarek would not have authority to harvest the crop. Semiramis may also limit or expand the discretion Zarek may exercise in carrying out the details of the job.<sup>186</sup>

---

damages remedy is inadequate, if other printers are available to complete the print job, money damages would probably be the publisher's sole remedy. *Id.* at 355. After fulfilling its obligation to print the agreed quantity, the printer would control whether to print additional copies. Therefore, the printer would hold the residual right of control over his printing process. Grossman & Hart, *supra* note 182, at 695.

<sup>184</sup> See Grossman & Hart, *supra* note 182, at 695 (describing nature of residual right of control).

<sup>185</sup> See Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119, 1121 (1990) (linking right of residual control to right to exclude).

<sup>186</sup> Under current law, the extent of discretion the service provider has determines whether the service provider is an employee or independent contractor. Treas. Reg. § 31.3401(c)-1(b) (as amended in 1970); see also Internal Revenue Service, Independent Contractor (Self-Employed) or Employee?, <http://www.irs.gov/businesses/small/article/0,,id=99>

Granting some level of discretion does not, however, give the service provider residual right of control over the property. Zarek's rights in the property would depend upon the employment agreement. After agreeing to pay Zarek to prepare the land and plant the crop, Semiramis should not be able to grant another party those same rights,<sup>187</sup> so Semiramis contracts away some control of the property. As long as Semiramis controls all aspects of the property she has not contracted away, however, she will hold the property's residual right of control.

As the holder of the residual right of control of his services, Zarek should be able to contract away the economic product of those services.<sup>188</sup> For example, by agreeing to provide services with

---

921,00.html (last visited Mar. 21, 2009) (discussing use of control and independence in determining whether person is employee). Such distinction is important for tax purposes because it determines whether the service recipient must withhold taxes on employee wages. *id.*; see also I.R.C. § 3402(a)(1) (2006) (mandating tax withholding by employer). Tax law treats a service provider as an employee if the service provider's relationship with a property owner is that of employer and employee. Treas. Reg. § 31.3401(c)-1(a) (as amended in 1970). As the property owner grants more discretion to a service provider, the service provider appears to be an independent contractor. See *id.* § 31.3401(c)-1(b) (listing factors—such as furnishing of tools and a place to work—relevant in determining whether a service provider is an employee or independent contractor); Grossman & Hart, *supra* note 182, at 717 (“An employer-employee relationship is typically characterized by the fact that many details of the job to be carried out are left to the employer’s discretion; that is, the employer has many of the residual rights of control. In a contractor-contractee relationship, the job is specified in much greater detail, and the contractee typically has many of the residual rights of control over nonspecified actions.”). The question of whether a service provider is an employee or independent contractor is not significant for purposes of determining whether an arrangement should be subject to aggregate-plus taxation. In particular, the distinction does not affect the parties’ ability to trace income from the source of the income to the party who holds the residual right of control of such resource. See *infra* notes 189–90 and accompanying text (discussing significance of tracing income from its source to party who holds residual right of control of income-producing resource).

<sup>187</sup> If Semiramis were to grant someone else the right to perform the services, Zarek should nonetheless be able to receive the consideration provided for in his agreement with Semiramis as money damages. See *supra* note 183 and accompanying text.

<sup>188</sup> The U.S. Constitution prohibits involuntary servitude. U.S. CONST. amend. XIII, § 1. Nonetheless, a party should be able to contract away the economic product of those services.

Though the Earth, and all inferior Creatures be common to all Men, yet every Man has a *Property* in his own *Person*. This no Body has any Right to but himself. The *Labour* of his Body, and the *Work* of his Hands, we may say, are properly his. Whatsoever then he removes out of the State that Nature hath provided, and left it in, he hath mixed his *Labour* with, and joyned to it something that is his own, and thereby makes it his *Property*. It being by him removed from the common state Nature placed it in, it hath by this *labour* something annexed to it, that excludes the

respect to Semiramis's property, Zarek contracts away his rights with respect to those services. Under today's law, Semiramis could not legally compel Zarek to provide services, but she could sue for breach of contract if Zarek failed to provide services as agreed. If Semiramis is successful in her cause of action, she may receive damages and a possible injunction, which would prohibit Zarek from performing the services elsewhere.<sup>189</sup> Thus, by contracting to receive Zarek's services, Semiramis acquires the economic equivalent of the services Zarek agrees to provide. In that regard, Zarek can sell the economic value of his services. After performing the contracted services or paying the damages (including observing an injunction), Zarek would control the full economic value of his services not contracted away. This example illustrates how service providers, such as Zarek, contract away a portion of the economic value of their services but nonetheless retain the residual right of control of those services.

Arrangements in which property owners and service providers retain the residual right of control of their respective resources do not pose significant economic or tax challenges. By determining who holds the residual right of control of a specific resource, the parties may identify the source of any economic item paid to the holder of that resource. The parties know the source of income from an arrangement by observing who holds the residual right of control of the respective resources. If a property owner retains the residual right of control of property, any economic item the property owner receives will be from the property. Conversely, any amount that the

---

common right of other Men. For this *Labour* being the unquestionable Property of the Labourer, no Man but he can have a right to what that is once joyned to, at least where there is enough, and as good left in common for others.

JOHN LOCKE, *TWO TREATISES OF GOVERNMENT* § 27, at 305–06 (Peter Laslett ed., Cambridge Univ. Press 1967) (1690).

<sup>189</sup> Courts are not likely to grant an injunction, however, if money damages are adequate. E. ALLAN FARNSWORTH, *CONTRACTS* § 12.5 (3d ed. 2003). A court would be more likely to grant an injunction "if the employee's services are unique or extraordinary, either because of special skill that the employee possesses . . . or because of special knowledge that the employee has acquired of the employer's business." *Id.* As discussed below, the employee's unique or extraordinary services give rise to appropriable specialized quasi rents. *See infra* notes 194–96 and accompanying text. Nonetheless, the cost of obtaining the services through legal action may be cost prohibitive for the party who had contracted to receive the services.



property owner pays to a person, who holds the residual right of control of services performed with respect to the property, will be compensation.<sup>190</sup>

A property owner may grant a service provider use of property and charge the service provider a fee for using the property. Such arrangements are the inverse of employment arrangements and generally create leases and loans. Leases and loans grant service providers the right to use property. The service provider uses the property in the provision of services and pays the property owner for the use of the property. Although leases and loans grant service providers the right to use property, the property owner retains all of the rights in the property not contracted away and takes no interest in the service provider's services. Consequently, any payment the property owner receives from the service provider with respect to the property should be considered rent or interest, regardless of the method used to determine the payment amount.<sup>191</sup>

Arrangements that keep the residual right to control property and services separate facilitate convenient accounting of income from the property and services. The parties are able to trace the product of the property and services to the owner of the respective resources and characterize the product accordingly.<sup>192</sup> Economic

---

<sup>190</sup> The method used to compute the amount paid to the service provider will not affect the nature of the relationship between the property owner and service provider or the character of the payments to the service provider. Some employment arrangements may appear at first blush to be a tax partnership. See, e.g., *Luna v. Comm'r*, 42 T.C. 1067, 1076-78 (1964) (finding arrangement was not tax partnership). The *Luna* court listed factors to distinguish between partnerships and employment arrangements that do not include a mode of payment for services: (1) agreement and conduct in executing agreement, (2) contributions made to the venture, (3) control over income and the right to make withdrawals, (4) whether parties were coproprietors or had a principal-agent relationship, (5) whether parties filed a partnership tax return, (6) whether the venture maintained separate books, and (7) whether the parties exercised mutual control and responsibilities for the enterprise. *Id.* at 1077-79. See also Grossman & Hart, *supra* note 182, at 694 ("A firm may pay another firm or person by the piece or a fixed amount (salary), irrespective of the ownership of the machines.").

<sup>191</sup> See, e.g., *Harlan E. Moore Charitable Trust v. United States*, 9 F.3d 623, 625-27 (7th Cir. 1993) (considering whether cost and output sharing create tax partnership, holding that lessor's payment of some costs of farming rental property and receiving rent as percentage of crop produced did not result in tax partnership); *Place v. Comm'r*, 17 T.C. 199, 206 (1951) (holding sharing of profits not sufficient to show that arrangement is tax partnership); see also Borden, *supra* note 17, at 313 (discussing residual right of control of property in leasing context).

<sup>192</sup> In such arrangements, income a property owner receives is income from property in

theory suggests, however, that the separation of property ownership and services ownership may give rise to costly opportunistic behavior and suggests why parties formed partnerships in ancient times.<sup>193</sup> For example, assume Semiramis and Zarek agree that Zarek will plant, cultivate, and harvest the corn crop in B.C. 1019 for 10% of the harvested crop. Demand for farmers in a distant land draws away many Babylonian farmers. As the growing season progresses, the demand in Babylon for good farm managers like Zarek increases. Property owners who have not entered into contracts agree to hire qualified managers and pay them as much as 15% of their crop. The change in market conditions creates a specialized quasi rent that Zarek may seek to appropriate.<sup>194</sup> The appropriable portion of the quasi rent is roughly the difference between the 15% other property owners have to pay to hire a manager and the 10% Semiramis agreed to pay Zarek.<sup>195</sup> To justify the change in contract terms, Zarek may claim that his family refuses to remain in Babylon when other areas provide greater opportunities. Because Semiramis would have to pay significantly more to replace Zarek, she may agree to increase his share of crops to retain his services.

---

the form of rent, interest, or the product of the property. I.R.C. § 61(a)(2), (3), (4), (5) (2000). Income a service provider receives is compensation. *Id.* § 61(a)(1).

<sup>193</sup> See Benjamin Klein, Robert G. Crawford & Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297, 298–302 (1978) (illustrating how parties may appropriate quasi rents if parties keep asset ownership separate).

<sup>194</sup> Entering into a contract for a fixed period of time is a form of investment that exposes each party to the other party's potential opportunistic behavior. See *id.* at 298 ("After a specific investment is made and such quasi rents are created, the possibility of opportunistic behavior is very real.").

<sup>195</sup> See D. Bruce Johnsen, *The Quasi-Rent Structure of Corporate Enterprise: A Transaction Cost Theory*, 44 EMORY L.J. 1277, 1281 (1995) (defining quasi rents as "the payment to an asset above that which is necessary to keep it in its present use"). Zarek would have the quasi rent because he is paying more in his labor than is necessary under the current market conditions to receive the compensation he will receive. Quasi rents often refer to value that accrues to one party as property changes value. See Klein, Crawford & Alchian, *supra* note 193, at 298 (defining quasi-rent value of property as "the excess of its value over its salvage value, that is, its value in its next best use to another renter" and defining potentially appropriable specialized portion of the quasi rent as "that portion, if any, in excess of its value to the second highest-valuing user"). The same principles should apply to services. See *id.* at 313–19 (illustrating quasi rent in service context by crop-picking example in which service providers may have appropriable specialized quasi rent if they can prohibit farmer from hiring other pickers).

Alternatively, after Semiramis and Zarek enter into the contract, the market may shift, creating appropriable quasi rents for Semiramis. For example, following the execution of the contract, a flood might destroy a significant amount of crops on property other than Semiramis's. The destruction could put numerous other farm managers out of work, increasing the supply of managers. The destruction of many crops could also increase the value of any crops that ultimately make it to the market. Such factors present Semiramis an appropriable quasi rent. She could obtain the same services Zarek has agreed to provide for a fraction of the price, and because crop prices have increased, Zarek could receive the same expected value of crops even though he receives less than 10%. To appropriate that specialized quasi rent, Semiramis could assert that she would not pay him 10% of the yield. Because Zarek knows he could receive his same original expected value with a lower percent of the yield and realizes the market is not favorable for managers, he would likely accept a lower percentage to retain his position.

Semiramis and Zarek could attempt to reduce the appropriation of specialized quasi rents by anticipating future contingencies and providing for them in a contract. Identifying and enforcing all future contingencies is difficult, if not impossible, and thus very costly.<sup>196</sup> Consequently, Semiramis and Zarek may alternatively attempt to rely upon market forces to help enforce their contract.<sup>197</sup> For example, one of the parties may offer a future premium that will exceed the appropriable specialized quasi rents to be obtained

---

<sup>196</sup> Even if parties are able to identify all future contingencies that may give rise to opportunistic behavior, they may not be able to calculate the costs that litigation or the threat of litigation may impose. See Klein, Crawford & Alchian, *supra* note 193, at 301 ("[F]or those assets used in situations where all relevant quality dimensions can be unambiguously specified in a contract, the threat of production delay during litigation may be an effective bargaining device. A contract therefore may be clearly enforceable but still subject to postcontractual opportunistic behavior.").

<sup>197</sup> The respective goodwill of each party is a market force the parties may rely upon to help reduce opportunistic behavior. See *id.* at 303-04 (recognizing that potential loss of business due to diminished goodwill will encourages parties to honor contracts). Under that theory, Semiramis would hope that Zarek would continue working for the agreed compensation because such loyalty could redound to his benefit if he later seeks employment from another land owner. Of course, Semiramis's goodwill would also be at stake. If she hesitated to adjust Zarek's compensation to reflect market forces, other managers would be less inclined to enter into an employment contract with her in the future.

through opportunistic behavior.<sup>198</sup> Economists predict, however, that the cost to draft a contract that anticipates all future contingencies and premiums is positively related to the level of appropriable specialized quasi rents.<sup>199</sup> Thus, Semiramis and Zarek would use contractual and market mechanisms to control appropriable specialized quasi rents only when such rents are relatively low.<sup>200</sup> Otherwise, they would consider alternatives for reducing such rents.

If Semiramis and Zarek realized that appropriable specialized quasi rents were high, they could consider alternatives to integrate their property and services to help reduce opportunistic behavior.<sup>201</sup> For example, if appropriable specialized quasi rents in the agriculture industry were high, Zarek could consider acquiring Semiramis's property, or Semiramis could consider developing farming skills equal to Zarek's. One party's acquisition of another party's resource is one way in which the parties could integrate the resources, but that type of integration defeats the benefits of specialization. Consequently, parties with specialized skills may prefer to integrate their resources through reciprocal transfers of the residual rights of control in the resources.<sup>202</sup> Such a co-

---

<sup>198</sup> *Id.* at 304.

<sup>199</sup> *Id.* at 307.

<sup>200</sup> *See id.* (positing that "lower . . . appropriable specialized quasi rents" will lead to reliance "on a contractual relationship rather than common ownership").

<sup>201</sup> *See id.* at 308–10 (illustrating ineffectiveness of long-term contracts in controlling opportunistic behavior, often leading to vertical integration, as was case with General Motors and Fisher Body).

<sup>202</sup> Although current U.S. law prohibits one individual from owning another individual, the right to transfer economic aspects of services effectively gives another party an ownership interest in the services. For example, entertainers can assign to another party all of the benefits of their specialized skills. The assignee of those rights may not compel the entertainer to perform, but may prohibit the person from performing anywhere else during the contract period. *See generally* Dallas Cowboys Football Club, Inc. v. Harris, 348 S.W.2d 37 (Tex. Civ. App. 1961) (granting temporary injunction preventing football player from playing for any team besides one in his contract); Lumley v. Wagner, (1852) 42 Eng. Rep. 687 (Ch.) (granting injunction preventing singer from performing for third party in violation of contract). A contract assigning all of an individual's services to another party would be against public policy, just as requiring specific performance would be. Nonetheless, an individual can assign all of the rights to a certain type of service, subject to some restrictions. For example, an individual may enter into a covenant not to compete, but to be valid, the restrictions must protect a legitimate interest of the promisee and be reasonable in scope. FARNSWORTH, *supra* note 189, § 5.3.

ownership arrangement would help prevent both parties from engaging in opportunistic behavior and would form a partnership under the current definition.<sup>203</sup> It would also allow the parties to retain their respective specializations to a significant extent. Thus, integration through partnership formation would have been as attractive in ancient times as it is today, because it helps reduce appropriable specialized quasi rents and allows the parties to retain their specialties.<sup>204</sup>

## B. AGENCY COSTS IN INTEGRATED ARRANGEMENTS

Integration has definite economic benefits, but it also may give rise to agency costs. As a consequence, parties who integrate resources must consider how they will minimize agency costs. Agency costs are those costs incurred when parties with different personal preferences form an arrangement.<sup>205</sup> Agency costs may arise between Semiramis and Zarek if they integrate their resources.

<sup>203</sup> See UNIF. P'SHIP ACT § 101(6), 6 U.L.A. 61 (1997) (defining partnership as two or more persons "carry[ing] on as co-owners a business for profit"). The idea that co-ownership of property and services creates a partnership rejects the claim that integration is no different from a long-term contract. See generally Friedrich Kessler & Richard H. Stern, *Competition, Contract, and Vertical Integration*, 69 YALE L.J. 1 (1959) (discussing long-term contracts as form of integration). Economists assume that opportunistic behavior can only occur with a long-term contract and without integration. Klein, Crawford & Alchian, *supra* note 193, at 302. Under that theory, to the extent a long-term contract eliminates opportunistic behavior, the contract would integrate resources. Thus, economic theory would disregard the form of the arrangement and consider the parties' rights under the governing documents.

<sup>204</sup> Understanding the economic aspects of a partnership is simple compared to understanding what constitutes a partnership. See 1 BROMBERG & RIBSTEIN, *supra* note 31, § 2.01(a) (describing factors and situations that make it difficult to define partnership). Such determination is equally difficult for tax purposes. See 1 MCKEE, NELSON & WHITMIRE, *supra* note 13, ¶ 3.01[1] ("The most basic, and perhaps the most difficult, problem in the taxation of partnerships and partners is [determining] whether . . . [an] arrangement constitutes a partnership . . ."); Borden, *supra* note 165, at 970-1001 (describing various tests lawmakers use to define tax partnership). This Article assumes for the sake of analysis that any resource integration that includes integrated services is a partnership.

<sup>205</sup> See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) ("We define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. . . . We define *agency costs* as the sum of: (1) the monitoring expenditures by the principal, (2) the bonding expenditures by the agent, (3) the residual loss." (footnote omitted)).

Assume that Semiramis and Zarek decide to integrate their property and services to reduce appropriable specialized quasi-rents. After transferring a portion of the residual right to the property to Zarek, Semiramis shares any decline in the property's value with Zarek. As a consequence, she may become more interested in short-term production and less interested in the long-term arability of the property.<sup>206</sup> A decrease in the long-term arability would adversely affect Zarek's interest in the property, so Semiramis's short-term perspective is an agency cost. Zarek, on the other hand, may work with less vigor upon realizing that he will not only share in the short-term production, but also in any increase in the value of the property. In partnerships and quasi-partnerships, the parties allocate the economic items of the arrangement to help reduce agency costs.<sup>207</sup> Such allocations help determine parties' economic rights to partnership assets and should inform the construction of a theory of partnership taxation.<sup>208</sup>

Integration gives each partner an interest in property contributed to the arrangement.<sup>209</sup> As a result, economic items allocated to any member of the arrangement will derive from every source that member co-owns. Thus, the law cannot merely look to the contributed resource to determine the source of a partner's allocated items. Furthermore, the output of integrated resources should be greater than the sum of the output of the resources operating individually.<sup>210</sup> Thus, parties to an integrated arrangement must

---

<sup>206</sup> See *id.* at 312–13 (describing how sharing ownership may cause previous owner-manager to engage in activities that are costly to new arrangement).

<sup>207</sup> See Ribstein, *supra* note 157, at 21–24 (describing how partnership and quasi-partnership allocation rules allow investors and other partners to align interests of managers with their own, especially in large or publicly-traded integrated business arrangements).

<sup>208</sup> Economic theory suggests further that the allocation formula the parties adopt should affect whether the integrated arrangement is a tax partnership or tax corporation. See generally Bradley T. Borden, *Residual-Risk Model for Classifying Business Arrangements* (Oct. 4, 2008) (unpublished manuscript, on file with author) (assuming all arrangements adopt only allocation-dependent residual risk).

<sup>209</sup> See, e.g., UNIF. P'SHIP ACT § 101(6) (amended 1997), 6 U.L.A. 61 (2001) (defining "partnership" as "association of two or more persons to carry on as co-owners [of] a business for profit").

<sup>210</sup> Armen Alchian and Harold Demsetz express the production function of an integrated arrangement mathematically to demonstrate that it is the output of a team, which exceeds the sum of the separate outputs of its members. See Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 779

allocate that excess among themselves. These aspects of integration give partnership taxation its uniqueness. Tax law must recognize the parties' economic arrangement and the inability to trace economic items from a source to the contributor of a specific resource. To recognize the economic arrangement, tax law must understand why parties use allocations and why they are important in defining the tax attributes of a partnership.

Simple examples illustrate the use of allocations in integrated arrangements. Assume Semiramis hires Zarek to clear her land, which requires Zarek to haul large rocks and felled trees off the property. The agreement between Semiramis and Zarek provides that Semiramis will pay Zarek on a per load basis for rocks and trees hauled off the land.<sup>211</sup> Working alone, Zarek would have to haul each load individually, and he should receive the full amount of compensation that Semiramis pays. After hauling the smaller rocks and trees, however, Zarek may recruit Cyrus to help him remove the remaining larger items. If each of the larger items were too heavy or too awkward for one person to handle, Zarek and Cyrus would have to work together to lift each large item into the cart and haul them away. Such activities may not, however, require the full strength of both parties. In this simple example, Zarek and Cyrus integrate their lifting and hauling resources. Semiramis may decide not to monitor the parties and to divide the compensation equally between them. Under such conditions, each party may look for opportunities to do less work than the other.<sup>212</sup> If one of the parties shirks more than the other, equal sharing of the compensation

---

(1972) ("Team production of  $Z$  involves at least two inputs,  $X_i$  and  $X_j$ , with  $\partial^2 Z / \partial X_i \partial X_j \neq 0$ ."). The two economists recognize that "[t]he production function is *not* separable into two functions each involving only inputs  $X_i$  or only inputs  $X_j$ . Consequently there is no *sum* of  $Z$  of two separable functions to treat as the  $Z$  of the team production function. (An example of a *separable* case is  $Z = aX_i^2 + bX_j^2$  which is separable into  $Z_i = aX_i^2$  and  $Z_j = bX_j^2$ , and  $Z = Z_i + Z_j$ . This is not team production.)." *Id.*

<sup>211</sup> Because Semiramis pays Zarek by the load, the arrangement will not be like the ancient rent partnerships that provided reduced rent. See *supra* notes 53-59 and accompanying text.

<sup>212</sup> In fact, economists predict that if the parties know that they are not being monitored, they will tend to shirk. See Alchian & Demsetz, *supra* note 210, at 780 ("[E]ach input owner will have more incentive to shirk when he works as part of a team, than if his performances could be monitored easily . . .").

would not accurately match contributed resources with the arrangement's output.

As this example demonstrates, failure to monitor and pay the parties based on contributed resources will likely lead to shirking and create agency costs. To help reduce shirking, Semiramis may appoint a manager to monitor Zarek and Cyrus and apportion rewards based on perceivable contributions.<sup>213</sup> Such monitoring and award apportionment may help reduce shirking, but it cannot perfectly measure the parties' relative contributions, and the manager's compensation could exceed any reduction in agency costs.<sup>214</sup> Without sophisticated equipment, the manager could not accurately assess the amount of force Zarek and Cyrus separately exert each time they jointly lift an item and pull the cart. Thus, the manager could not accurately pay each party based upon contributed resources. Consequently, managers may reduce shirking, but often cannot completely eliminate it or apportion rewards based upon relative contributions.

Zarek and Cyrus may be able to control agency costs better by forming a partnership that contracts with Semiramis to clear the field of the larger items.<sup>215</sup> Monitoring requirements change significantly in a partnership. Instead of having an independent party to monitor their behavior, members of a partnership must

---

<sup>213</sup> To effectively reduce shirking, the manager would have to determine the extent to which either party's efforts contributed to the arrangement's output. *See id.* at 782 (observing that by examining inputs, managers may be able to measure marginal productivity that individual's input has on arrangement's output). Other commentators agree that in some situations, separating ownership, control, and management may reduce agency costs. *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 307–11 (1983) (describing instances dictating separation of ownership, decision control, and decision management).

<sup>214</sup> *See* Alchian & Demsetz, *supra* note 210, at 781–83 (arguing that centralized management helps reduce shirking better than management by multiple owners, provided managers have tools needed to manage parties). If either Zarek or Cyrus disagreed with the payment allocation, they could cease providing services to Semiramis. *See id.* at 783 (observing that service providers (i.e., employees) can terminate employment arrangement as readily as property owner (i.e., employer)). That places additional burdens on the manager and on the parties in this situation. Because the work requires the efforts of two people, if one person leaves the other will not be able to continue working and will lose income.

<sup>215</sup> Such an arrangement would be similar in some respects to the ancient rent partnerships. *See supra* notes 53–59 and accompanying text. Payment in cash would be economically equivalent to reduced rent, if Zarek and Cyrus also rented and farmed the property.



cross-monitor each other to reduce shirking. Because shirking by either party will reduce total output, both parties will be motivated to monitor the other party.<sup>216</sup> The parties may use various tools to help reduce shirking, but the apportionment of economic items will often be the key tool used.<sup>217</sup> Zarek and Cyrus would therefore divide the payments from Semiramis in such a manner as to help minimize each other's shirking. Dividing the compensation to reduce shirking may not accurately reflect each party's contribution. Instead, the focus of the division of compensation may be on maximizing the overall performance of the arrangement. For example, Zarek may realize that a small increase in Cyrus's efforts may create a disproportionately larger increase in the arrangement's total output.<sup>218</sup> Thus, Zarek may agree to share the compensation with Cyrus in a manner that disproportionately compensates Cyrus based on his relative contributions. The compensation-sharing arrangement would accurately reflect the parties' understanding of the need to cross monitor, and each party would receive the economic benefit of his share of the compensation. Those results indicate that the allocation formula accurately reflects the economic qualities of the arrangement, even though they may not accurately reflect each party's contributions. Tax law should therefore focus on the arrangement's economic qualities.

---

<sup>216</sup> For example, if Cyrus shirks, the number of loads the parties will be able to complete in a given day will likely decrease, reducing Zarek's income as well as Cyrus's.

<sup>217</sup> See Alchian & Demsetz, *supra* note 210, at 786 (observing that members of smaller teams may use profit-sharing to self-police and help reduce shirking). Parties may also use fiduciary duties and the threat of dissociation to help reduce shirking. See Jason Scott Johnston, *Opting In and Opting Out: Bargaining for Fiduciary Duties in Cooperative Ventures*, 70 WASH. U. L.Q. 291, 329-33 (1992) (illustrating how partners may use fiduciary duties to minimize their partners' shirking); Larry E. Ribstein, *A Statutory Approach to Partner Dissociation*, 65 WASH. U. L.Q. 357, 364-68 (1987) (defining partner dissociation and identifying conditions under which partners may dissociate).

<sup>218</sup> For example, because no item requires the total effort of both parties, Zarek could routinely bear the brunt of the work required to lift items. If Cyrus does not help at all, however, Zarek will not be able to remove any of the large items. If Zarek were able to motivate Cyrus to lift items regularly but only bear 30% of the weight, Zarek could bear the remaining burden and productivity would increase. Thus, Cyrus's minimal effort helps increase Zarek's income, even though Zarek may exert more effort. To move from no income to some income, Zarek may agree to allocate more than 30% of the compensation to Cyrus, even though Cyrus contributes only 30% of the effort.

The same economic concerns arise in modern-day integrated arrangements. A simple accounting firm demonstrates the economic aspects of a modern-day services partnership.<sup>219</sup> A successful accounting firm requires business development and technical expertise. Assume Denise is a successful accountant with significant business development skills. Unfortunately, her business development activity limits the time she is able to devote to work on client matters. Her annual income is therefore limited to \$150,000. Ed, on the other hand, is an outstanding technical accountant, but he develops business poorly and has significant downtime. Consequently, Ed makes only \$95,000 per year.

If Denise and Ed were to combine their specialized skills, they could each enjoy larger annual revenue. They could consider combining their services without integrating them. To do so, one of the parties would have to hire the other and that, of course, would create appropriable specialized quasi-rents.<sup>220</sup> They could therefore integrate their services by forming a partnership and use allocations to discourage shirking. After integrating their resources, the parties may be able to generate \$300,000 of annual income if both accountants work full time. Their combined efforts would therefore generate \$55,000 more than the sum of their individual efforts.<sup>221</sup>

---

<sup>219</sup> Accounting firms, like law firms, are quintessential services partnerships that nicely illustrate the economic aspects of such arrangements. See Borden, *supra* note 17, at 305–06 (discussing reciprocal monitoring in context of two-attorney law firm). Other commentators have also subjected services partnerships—including large law firms—to economic analysis. See Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. ECON. 327, 334–37 (1983) (suggesting partners use residual claims and flexible profit-sharing to help reduce agency costs and that members of large professional services partnerships be modeled as fluid association of small partnerships); Fama & Jensen, *supra* note 213, at 315–17 (analyzing residual claims and decision making in large partnerships). See generally Robert W. Hillman, *Law, Culture, and the Lore of Partnership: Of Entrepreneurs, Accountability, and the Evolving Status of Partners*, 40 WAKE FOREST L. REV. 793 (2005) (using economic theory to consider recent evolution of certain aspects of partnership law and resulting implications for professional services firms such as accounting and law firms). The Author has also used economic analysis to illustrate economic aspects of partnerships that are important in formulating nonabusive partnership tax allocation rules. Borden, *supra* note 17, at 334–46.

<sup>220</sup> For example, if Denise were to hire Ed and bring in a significant amount of repeat clients, Ed could threaten to terminate his relationship with Denise to expropriate more compensation. If the clients followed Ed, Denise would have to meet Ed's demands or risk losing a share of the future income from those clients.

<sup>221</sup> Individually, Denise could generate \$150,000 and Ed \$95,000 of annual income for a

The parties could not, however, determine the extent to which either party's efforts generate that additional income. After forming the partnership, Ed would have enough work to stay busy, and clients pleased with his work would bring the firm return business. Denise would be able to attract more clients because they know that they will be able to obtain Ed's expert services, if needed. Thus, the additional income would not derive from a single source, but from a combination of the sources. The parties could not, therefore, accurately allocate income based upon the parties' relative contributions.

Denise and Ed will likely decide to allocate the income to reduce agency costs. For example, they may decide to give Denise a larger share of income from first-time work she generates and give Ed a larger share of income from repeat clients. This allocation formula should help motivate Denise to continue to aggressively develop new business. It should also motivate Ed to care for existing clients and provide them service that will encourage repeat business. Allocating income in this manner should help increase overall firm performance. Such allocation formulae may not, however, reflect the partners' estimate of the relative contribution of the separate services.<sup>222</sup> Nonetheless, because each partner would receive the allocated income on liquidation,<sup>223</sup> the allocations would accurately represent a portion of the partners' interests in the partnership. Tax law must recognize this aspect of partnerships.

Partnerships that combine property and services raise similar matching and monitoring difficulties. The ancient *commenda* illustrates this timeless difficulty.<sup>224</sup> Assume Damgar, a wealthy

---

total of \$245,000. That amount is \$55,000 less than the \$300,000 they could generate together.

<sup>222</sup> Observing the behavior and activity of certain service providers, such as artists or professionals, often will not provide insight into the actual productivity of the person being observed. Alchian & Demsetz, *supra* note 210, at 786. To help reduce shirking by these types of service providers, Alchian and Demsetz suggest the parties use profit-sharing arrangements. *Id.*; cf. Fama & Jensen, *supra* note 213, at 315-16 (suggesting that mutual monitoring is attractive for professional services arrangements when professionals with similar specialized skills agree to share liability for each other's actions).

<sup>223</sup> See UNIF. P'SHIP ACT §§ 401, 807(b) (amended 1997), 6 U.L.A. 133, 206 (2001) (providing that upon liquidation of partnership, partners receive their individual contributions plus any allocations after all liabilities of partnership have been settled).

<sup>224</sup> See *supra* notes 45-49 and accompanying text.

citizen of Babylon, and Shamallu, a successful merchant, entered into a business venture together. The two agreed that Damgar would purchase twenty chariots and that Shamallu would take possession of them, transport them to Egypt, and sell them. As was typical of *commenda* of the day, the agreement between Damgar and Shamallu provided that if Shamallu, due to his own neglect, did not sell the chariots, he would return to Damgar his full investment plus a 100% return on the investment.<sup>225</sup> If, however, the chariots were lost or damaged through no fault of Shamallu, Damgar would bear the full loss of the venture.<sup>226</sup> The parties also agreed that they would divide the profits from the venture equally.<sup>227</sup> Because the parties joined together to co-own property in association for profit, they would be partners under the RUPA,<sup>228</sup> so the example, although of an ancient arrangement, has modern day implications.

Consider why the parties might have agreed to their particular apportionment formula. Damgar wanted a reasonable return on his investment, and Shamallu sought reasonable profit for his services. Neither party could obtain his goal alone, so they combined resources. If Damgar had sought a fixed return, he would not have benefited from any unexpected gains of the venture. Also, if Shamallu were to participate in gains only to the extent they exceeded Damgar's fixed return, Shamallu may have shirked if he believed the gains would not have exceeded the threshold. Furthermore, Shamallu would not have participated in the venture unless he believed the venture's profit would significantly exceed the threshold.

A profit-sharing arrangement, as opposed to a fixed-return arrangement, also would have motivated Damgar to study the venture and add his expertise to the decision-making process. A fixed-return arrangement should not have peaked Damgar's interest. Similarly, a profit-sharing arrangement would have

---

<sup>225</sup> See *supra* note 49 and accompanying text.

<sup>226</sup> See *supra* note 51 and accompanying text.

<sup>227</sup> The parties defined profits as all amounts in excess of the amount Damgar paid for the chariots and the costs Shamallu incurred to travel to Egypt, sell the chariots, and to return to Babylon.

<sup>228</sup> See UNIF. P'SHIP ACT § 101(6) (amended 1997), 6 U.L.A. 61 (2001) (defining "partnership").

encouraged Shamallu to exert maximum effort throughout the venture. If he were to receive a fixed fee, he may have been less inclined to work to obtain additional profit for Damgar. Regardless of the exact profit-sharing motivation, each party received income from the combination of property and services.

Modern business people also use profit apportionment to affect behavior and thus face tracing problems. Private equity funds, for example, often grant the managing partners a profit interest in the fund.<sup>229</sup> The performance of the managers attracts or repels potential investors. Seeing managers' success, investors will contribute to the fund because investors wish to receive the highest possible return on their investment. To help ensure a high return, the investors grant a significant profits interest to the managers. Thus, the managers' and investors' interests align. Both groups increase their returns when the managers' services and the investors' capital produce at maximum capacity. Each group benefits from the other group's contributions, but tracing difficulties prevent the parties from knowing the exact source of profits received from the venture. All profits will include income from capital and income from services. Tax law must recognize the economic aspects of allocations and the inability to precisely identify the source of allocated economic items, regardless of business form.

Modern law provides resource owners several alternative business forms to use to integrate resources. Parties may choose from various partnership and quasi-partnership forms in structuring arrangements.<sup>230</sup> Quasi-partnerships evolved to provide business participants with certain legal attributes to help facilitate economic activity.<sup>231</sup> Nonetheless, quasi-partnerships provide their members the same opportunities that partnerships provide for reducing agency costs by allocating economic items. Therefore, from an economic perspective, partnerships and quasi-partnerships are

---

<sup>229</sup> See Ulf Axelson, Per Stromberg & Michael S. Weisbach, *Why Are Buyouts Levered: The Financial Structure of Private Equity Funds* 26 (Nat'l Bureau of Econ. Research, Working Paper No. 12826, 2007), available at <http://ssrn.com/abstract=676546> (discussing private equity funds and exploring how profit-sharing arrangements help reduce agency costs).

<sup>230</sup> See *supra* Part II.C.

<sup>231</sup> See Hansmann, Kraakman & Squire, *supra* note 1, at 1388–99 (describing development of limited partnerships and limited liability companies to provide entity shielding and limited liability to arrangements wishing to avoid entity taxation).

similar in a way that is important to tax law. Legal theory's focus on whether a business arrangement is an entity separate from its members or an aggregate of its members becomes irrelevant. Therefore, this Article recommends that any arrangement that allocates economic items to reduce agency costs in a manner similar to partnerships should be subject to aggregate-plus taxation.

Examining arrangements that integrate resources reveals that the members of such arrangements cannot trace the arrangement's output directly to a specific contributed resource.<sup>232</sup> Thus, partners cannot allocate rewards exclusively on the proportionate contributions of each partner and a particular contribution's effect on output. Partners may, however, apportion items to discourage partner shirking, align their respective interests, and increase the partnership's productivity.<sup>233</sup> Allocated items reflect the partners' respective economic rights to partnership assets. Partnership law is less concerned with the allocation of economic items and can therefore generally treat partnerships as entities separate from their owners. The analysis of partnership tax allocations presented below, however, suggests that tax allocation rules should account for the economic factors of a partnership and should require tax items to follow the economic items that partners apportion to each other. After establishing the primacy of allocating tax items according to the allocation of economic items, the following discussion demonstrates how such a mandate should also affect other provisions of partnership tax law. In short, this Article suggests that tax law should not necessarily follow the substantive law of partnerships.

### C. ECONOMIC PRINCIPLES AND THE AGGREGATE-PLUS THEORY

Economic theory contributes to the aggregate-plus theory of partnership taxation. Economic theory suggests that individuals form partnerships to increase productivity and reduce rent-seeking behavior.<sup>234</sup> The integration of resources can produce output that is

---

<sup>232</sup> See *supra* notes 209–10 and accompanying text.

<sup>233</sup> See *supra* notes 215–18 and accompanying text.

<sup>234</sup> See *supra* notes 202–04 and accompanying text.

greater than the sum of the separate outputs of the respective resources, but integration also creates agency costs.<sup>235</sup> Partners therefore allocate economic items, including the increased output, to help reduce agency costs. Additionally, allocation is important because partners cannot accurately determine whether partnership profit derives from contributed profit or contributed services.<sup>236</sup> Thus, all amounts of allocated partnership profit likely include profits from each source. If partnership tax law does not recognize such use of allocations, it will stymie economic behavior. A person will be less inclined to allocate income to a partner, if that person will be liable for tax on such income. Without the benefit of the allocation tool to reduce agency costs, people will be less inclined to form partnerships. Furthermore, partnership tax law must recognize partnerships as an integration of resources. That recognition requires that partnership profit retain its character as it flows through to the partners pursuant to the apportionment agreement. Only aggregate taxation can serve all of the economic demands of partnerships. Nonetheless, other demands suggest that partnership tax law must incorporate some entity provisions.

#### IV. AGGREGATE-PLUS TAXATION

The study of the law of partnerships and the economic nature of partnerships lays the groundwork for considering the aggregate-plus theory of partnership taxation. The following discussion proposes that partnership tax law should first apply the aggregate concept and resist entity components, largely for efficiency and accuracy purposes.<sup>237</sup> Partnership tax law should adopt entity components only when needed to simplify tax administration. Entity

---

<sup>235</sup> See *supra* notes 205–07 and accompanying text.

<sup>236</sup> See *supra* notes 209–10 and accompanying text.

<sup>237</sup> Tax laws create economic inefficiencies when they affect behavior in a way that results in “a loss of welfare above and beyond the tax revenues collected.” HARVEY S. ROSEN & TED GAYER, *PUBLIC FINANCE* 331 (8th ed. 2008). Equity is often cited as a desirable characteristic of tax law, and the Author has previously argued that partnership taxation should incorporate equitable provisions. See Borden, *supra* note 165, at 1002–06 (arguing that equity justifies unequal tax treatment when differences between taxpayers justify that treatment). This Article demonstrates that efficiency also supports the general inclination to avoid partnerships for tax purposes.

components should not, however, interfere with the efficiency and accuracy obtained through aggregate taxation. If legislators begin with the entity concept when enacting partnership tax laws, the result will often be inefficient rules that inaccurately assign tax liability and provide opportunity for abuse. In such situations, legislators will be forced to create reparative aggregate provisions to address the deficiencies created by the entity concept. The discussion below illustrates how past entity-oriented partnership tax lawmaking has required such measures. It also illustrates how the aggregate-plus theory can guide future lawmaking.

#### A. OVERVIEW OF AGGREGATE-PLUS TAXATION

The historical perspective of partnerships indicates that humans have a tendency to combine resources in the pursuit of profit.<sup>238</sup> To avoid causing economic inefficiency, partnership tax rules, to the extent administrably possible, should not discourage or interfere with the human tendency to combine resources for business purposes.<sup>239</sup> Rational business people would not combine resources unless they expected the combination to produce more output than the sum of the output of the separate resources.<sup>240</sup> If tax law discouraged the combination of businesses, the potential business partners would lose the benefit of joining together and the government would gain no revenue.<sup>241</sup> In formulating standards for applying either the aggregate concept or entity concept to partnership taxation, the law should recognize the human tendency to combine resources for the purpose of conducting business, and

---

<sup>238</sup> See *supra* Part II.A.

<sup>239</sup> Commentators have cited this proposition as the basis for allowing tax-free formation of business entities. See, e.g., J. Paul Jackson et al., *The Internal Revenue Code of 1954: Partnerships*, 54 COLUM. L. REV. 1183, 1204 (1954) ("This policy of non-recognition of gain (and, of course, loss) is based primarily on a desire not to discourage the formation of partnerships and is continued by Section 721 of the new law.").

<sup>240</sup> See *supra* notes 209–10 and accompanying text.

<sup>241</sup> For example, if tax law were to adopt an entity tax for partnerships—which discourages partnership formation—the additional welfare to be obtained through combining resources would be lost, and the government would lose the tax revenue that it could have collected on the partnership's additional income.



should not interfere with that tendency. The aggregate concept provides the means of doing this.

Tax law avoids interfering with the combination of business resources by allowing tax-free partnership formations.<sup>242</sup> Under either the aggregate or entity concept, the formation of a partnership could be tax free.<sup>243</sup> Thus, neither concept guides lawmaking at this point. Formation, however, is only one part of the life of a partnership. The tax treatment of the partnership following formation could affect the parties' decision to combine resources in a partnership. The economic study of partnerships reveals that partners apportion partnership income and loss to achieve economic goals, such as reducing agency costs.<sup>244</sup> Entity taxation could not effectively address the apportionment of economic items.<sup>245</sup> Entity taxation treats the entity as controlling its income—any distributions to the members of the entity would be transfers between two different persons (the entity and the member), and the tax law must recognize those transfers. Thus, under the entity theory, capital gain could become compensation to the apportionee for tax purposes.<sup>246</sup> And this may discourage people from joining together. Aggregate taxation, on the other hand, treats the members as controlling the arrangement's income. Because the members control the arrangement's income, aggregate taxation does not recognize distributions from the arrangement to its members. Thus, aggregate taxation can recognize the apportionment of economic items as the members' respective shares of those items.

---

<sup>242</sup> I.R.C. § 721(a) (2000).

<sup>243</sup> See Jackson et al., *supra* note 176, at 120 ("Under the present law no gain or loss is recognized on the formation of a partnership. It was decided to adhere to this rule, whether the exchange be regarded as an exchange of interests in property or as an exchange of properties for a 'partnership interest.' It was felt that to tax the transaction would tend to discourage the formation of partnerships and operate as a deterrent to new business enterprises." (footnote omitted)). Under the entity concept, the law could provide that transfers to the partnership are tax free. Under the aggregate concept, the law could provide that transfers of interests in property among partners is tax free.

<sup>244</sup> See *supra* Part III.B.

<sup>245</sup> Borden, *supra* note 162, at 41–45.

<sup>246</sup> This is the result that would obtain under Subchapter S of the Internal Revenue Code (Subchapter S hereinafter) because Subchapter S requires allocations to be in accordance with shareholders' interest in the corporation. I.R.C. § 1366(a). As discussed above, however, partners apportion items for various economic reasons, and the recharacterization may not reflect the partners' arrangement. See *supra* Part III.A–B.

Therefore, the character of capital gain flows through to an apportionee under aggregate taxation. Because aggregate taxation reflects the economic arrangement of the partners, aggregate taxation is efficient; it will not discourage partnership formation.

The entity concept's inability to recognize the apportionment of economic items makes the allocation of tax items the center of the aggregate-plus theory of partnership taxation. Other aspects of partnership taxation could be addressed with the entity concept,<sup>247</sup> but the economic nature of partnerships requires the aggregate concept to appropriately treat apportioned economic items. All aggregate provisions help ensure that apportioned items are taxed correctly to the partners. Aggregate taxation also helps reduce tax-liability burden shifting.<sup>248</sup> For example, aggregate taxation prevents the allocation of pre-contribution gain or loss to partners other than the contributing partner.<sup>249</sup> Having accepted the need for the aggregate concept as the fundamental theory of partnership taxation, the entity concept serves the sole function of easing administrative complexity. More expansive use of the entity concept requires lawmakers to create reparative aggregate rules to remove inefficiencies and inaccuracies the entity concept creates. In fact, a significant percentage of the aggregate provisions in Subchapter K are reparative provisions.<sup>250</sup> The following discussion reveals problems that entity provisions create and how Congress addresses such problems with reparative aggregate provisions.

---

<sup>247</sup> For example, rules governing computation of partnership income and the partnership's taxable year should follow the entity concept.

<sup>248</sup> See Borden, *supra* note 17, at 340–46 (arguing that allocations which are inherently aggregate and that do not follow partners' economic arrangement create tax-item transactions that tax law otherwise prohibits). At the time Subchapter K became law, commentators recommended the aggregate approach in many situations, with an optional election to apply the entity approach. See Jackson et al., *supra* note 176, at 129, 144 (recommending aggregate approach for both formation of partnership and disposition of partnership interest and discussing elective rule permitting partnership to apply entity concepts).

<sup>249</sup> See *infra* notes 282–96 and accompanying text.

<sup>250</sup> See *infra* APPENDIX B (revealing that seven of seventeen aggregate provisions are reparative provisions enacted to address problems that entity concept created).

## B. AGGREGATE-PLUS THEORY AND EXISTING LAWS

Congress has added several entity provisions to partnership taxation.<sup>251</sup> Provisions like these that do more than serve tax administration often cause problems, especially if they affect the allocation of partnership items. The partnership-interest-basis rules illustrate problems that entity provisions can cause. These rules treat partners as holding interests in the partnership and the partnership as holding partnership property.<sup>252</sup> The partnership-interest-basis rules recognize partners' transfers of interests in partnerships, as opposed to recognizing their transfers of interests in partnership property.<sup>253</sup> Upon partnership formation, the rules treat partners as transferring property to the partnership in exchange for partnership interests.<sup>254</sup> The partners take a basis in the partnership interest equal to the basis of the contributed property plus the amount of money contributed.<sup>255</sup> The partnership takes a basis in the contributed property equal to the basis the contributing partner had in the property.<sup>256</sup> The partnership-interest-basis rules also adopt the entity concept for dispositions of partnership interests.<sup>257</sup> Thus, the rules treat partners as disposing of interests in the partnership, not interest in partnership property. Therefore, the rationale for partnership-interest-basis rules appears to be administrative convenience.<sup>258</sup>

If Congress had based the partnership formation rules on the aggregate concept, then the law would treat the formation of a partnership as transfers of undivided property interests among

---

<sup>251</sup> See, e.g., Jackson et al., *supra* note 239, at 1199–1210 (describing entity concept as adopted in Internal Revenue Code of 1954).

<sup>252</sup> See I.R.C. § 722 (2000) (providing that partner's basis in partnership shall equal partner's basis in contributed property); see also *id.* § 705(a) (providing that adjustments to basis of partner's interest in partnership be calculated under section 722).

<sup>253</sup> See *id.* § 741 (recognizing partnership interest for purposes of determining gain or loss and character on disposition of such interest).

<sup>254</sup> *Id.* § 722.

<sup>255</sup> *Id.*

<sup>256</sup> *Id.* § 723.

<sup>257</sup> See *id.* § 741 ("In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner.").

<sup>258</sup> See Jackson et al., *supra* note 176, at 125 ("The entity approach, at least up to the point of liquidation or other disposition of the partnership interest, has the advantage of simplicity.").

partners and the subsequent contributions of those interests to the partnership.<sup>259</sup> Under the aggregate concept, a disposition of a partner's interest would be a disposition of the partner's interest in all of the assets of the partnership.<sup>260</sup> The entity approach therefore appears simpler because it does not require the deemed *inter se* transfer of undivided interests at the time of formation or look-through accounting on the disposition of a partnership interest. The entity concept, however, creates other more troubling concerns.

In the case of partnership formation and the disposition of partnership interests, the hidden cost of simplicity manifests itself in the opportunities the partnership-interest-basis rules provide for abuse and the potential they create for misallocation of tax items.<sup>261</sup> The combination of the policy supporting tax-free partnership formation and the entity concept requires that partners take a basis in their partnership interests equal to the sum of contributed cash and the basis of contributed property.<sup>262</sup> They also require the partnership to take a basis in contributed property equal to the basis the contributor had in the property.<sup>263</sup> Taxpayers learned quickly that they could use these rules to change the character of income and loss. They also learned they could use the rules to shift the incidence of taxation.

To illustrate the potential for abuse, consider a dealer in real property. A dealer in real property holds property as inventory, and any gain recognized on the disposition of inventory is taxed at such rates.<sup>264</sup> To avoid being taxed at ordinary income rates on the sale

---

<sup>259</sup> See *id.* at 119 (describing aggregate approach as one where each co-owner "possess[es] an undivided interest in all of the partnership properties").

<sup>260</sup> *Id.* at 141.

<sup>261</sup> See Borden, *supra* note 17, at 340–45 (discussing how current partnership allocation rules create opportunities for tax-item transactions and how failure to allocate tax items in accordance with partnership's economic arrangement may create inadvertent tax-item transactions); Jackson et al., *supra* note 176, at 121 (observing that contributing partner should bear tax incurred on entire pre-contribution gain when partnership sells contributed property); *id.* at 125 ("This simple entity approach, however, means that a partner who contributes cash or high basis properties is, to a degree, penalized on account of the low-basis of properties contributed by another.").

<sup>262</sup> I.R.C. §§ 721–722 (2000); see also Jackson et al., *supra* note 239, at 1204 ("Since no gain or loss is recognized on [the contribution of property], the partnership's basis for the property would be the same as its basis in the hands of the contributor. . .").

<sup>263</sup> I.R.C. § 723; Jackson et al., *supra* note 239, at 1204.

<sup>264</sup> See *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 423 (5th Cir. 1976) (holding

of inventory, a dealer may consider contributing the property to a partnership. The partnership would take the dealer's basis in the property and could hold it as a capital asset and obtain favorable long-term capital gains on the disposition of the property.<sup>265</sup> Thus, the entity concept combined with the partnership-interest-basis rules provided the opportunity for taxpayers to change the character of income or loss by contributing property to a partnership.

Congress used aggregate concepts to repair the problems the entity-oriented rules created. For example, Congress recognized that taxpayers could convert the character of gain or loss by contributing property to a partnership. To reduce the potential for abuse, Congress enacted reparative aggregate provisions that prohibited converting the character of built-in gain or loss to the contributing partner for a number of years following the contribution.<sup>266</sup> This reparative aggregate provision was enacted in 1984.<sup>267</sup>

The partnership-interest-basis rules also create the potential for inappropriate allocations of partnership items that shift the incidence of taxation. Property contributed to a partnership by a partner will likely have built-in gain or built-in loss, representing the difference between the property's basis and its fair market value on the date of contribution.<sup>268</sup> Built-in gain and built-in loss reflect economic changes that occur with respect to property before it is contributed to the partnership. For example, if a contributing partner purchased raw land for \$50,000 and contributed it to a

---

that improvements, frequency of sales, and other factors demonstrated that taxpayer held property for resale and that gain on sale was ordinary income); *see also id.* at 414 ("[T]he real estate capital gains-ordinary income issue [is] 'old, familiar, recurring, vexing, and oftentimes elusive.' " (quoting *Thompson v. Comm'r*, 322 F.2d 122, 123 (5th Cir. 1963))).

<sup>265</sup> *See* I.R.C. § 702(b) (providing that character of partnership tax items flows through to partners); *see also id.* § 1(h)(1) (granting favorable tax rates to certain capital gains).

<sup>266</sup> *Id.* § 724 (providing special rules for characterizing gain and loss recognized on partnership's sale of contributed unrealized receivables, inventory items, and capital-loss property).

<sup>267</sup> Deficit Reduction Act of 1984, Pub. L. No. 98-369, 74(a), § 724, 98 Stat. 494, 592-93 (1984) (codified as amended at I.R.C. § 724 (2000)).

<sup>268</sup> *See* Treas. Reg. § 1.704-3(a)(3)(ii) (as amended in 2005) (defining built-in gain and built-in loss). Contributed property will generally have built-in gain or built-in loss because property tends to fluctuate in value, whereas basis remains constant with respect to property that does not qualify for cost recovery, and cost recovery may not reflect fluctuations in the property's value.

partnership when it was worth \$100,000, the property would have a \$50,000 built-in gain.<sup>269</sup> That built-in gain represents the amount the property appreciates while the contributing partner holds it. That amount also represents \$50,000 of income to the contributing partner,<sup>270</sup> an amount the partner would have recognized upon contribution but for the tax-free-formation rules.<sup>271</sup> Because such income accrues while the contributing partner holds the property, the contributing partner should pay tax on that income.<sup>272</sup>

Under the partnership-interest-basis rules, the partnership takes the contributing partner's basis in the property and the built-in gain carries over to the partnership. To ensure the contributing partner pays tax on the built-in gain, the partnership should allocate the built-in gain to the contributing partner when the partnership recognizes the gain. The 1954 Code allowed partnerships to disregard built-in gain or loss or elect to allocate tax items to account for the built-in gain or loss.<sup>273</sup> The first option reflects the entity concept. The entity concept would suggest that the partnership should allocate the gain based upon ownership in the entity.<sup>274</sup> Such allocations produce an undesirable tax result

---

<sup>269</sup> The built-in gain would equal the difference between the \$100,000 fair market value and the \$50,000 basis, representing a gain that the contributing partner would recognize upon the sale of such property for cash. I.R.C. § 1001(a)–(c).

<sup>270</sup> See HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938) ("Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.").

<sup>271</sup> See I.R.C. § 1001(c) (providing that taxpayers must recognize entire amount of gain or loss on sale or exchange of property unless provided otherwise). Section 721 provides otherwise in the case of contributions to partnerships. *Id.* § 721.

<sup>272</sup> See *Helvering v. Horst*, 311 U.S. 112, 119–20 (1940) (holding that holder of property must pay tax on income from property); Jackson et al., *supra* note 176, at 121 (arguing that contributor should bear tax incurred on gain upon sale of property).

<sup>273</sup> INT. REV. CODE OF 1954, § 704(c).

<sup>274</sup> Students of corporate tax will recognize that Subchapter S requires shareholders of S corporations to take into account their pro rata share of corporate income. I.R.C. § 1366(a). This simple allocation rule makes sense in the Subchapter S context because the one-class-of-stock rule prohibits the allocation of economic items in a manner that varies from the shareholder's pro rata interest in the corporation. See *id.* § 1361(b)(1)(D) (limiting S corporations to one class of stock). The Subchapter S allocation rules fail, however, to account for built-in gain or loss on property contributed to the corporation in a tax-free contribution. Thus, the rigid yet simple Subchapter S allocation rules do not accurately tax the person who realized income or loss on contributed property. A recent corporate amendment sought to remove that entity flaw from corporate tax with respect to certain built-in losses. I.R.C.

because they would likely allocate a portion of built-in gain or loss to noncontributing partners. For example, if an equal partnership of two partners receives contributed property from one partner that has a \$50,000 built-in gain, equal allocations would result in a split of that gain between the partners when the partnership recognizes it. With such an allocation, the noncontributing partner would pay tax on half of the built-in gain. That represents a shift of the tax burden from the contributing partner to the noncontributing partner.<sup>275</sup> Such an allocation not only shifts the incidence of taxation, but may also discourage partnership formation because the noncontributing partner may be hesitant to join a partnership that will require the assumption of the tax burden of the contributing partner's precontribution gain.<sup>276</sup>

The potential misallocation of built-in gain or loss further illustrates the primacy of the allocation rules in partnership taxation. To avoid discouraging partnership formation, tax law must allow tax-free partnership formation.<sup>277</sup> In the case of contributed property, the law could discourage partnership formation if the allocation rules did not properly account for built-in gain or loss. The entity concept does not recognize these important nuances of partnerships. Starting from an entity concept, the law must adjust for its shortcomings with reparative aggregate provisions. To reduce the potential of allocating built-in gain or loss to a noncontributing partner, Congress required partnerships to make allocations in a manner that took into consideration any built-in gain or loss.<sup>278</sup> The application of that rule is somewhat

---

§ 362(e) (West Supp. 2006). The flaw remains with respect to built-in gains.

<sup>275</sup> See Borden, *supra* note 17, at 343–44 (describing how allocations based on capital accounts may shift tax burden).

<sup>276</sup> The partners may be able to address the tax burden shift in their negotiations by, for example, ensuring that the noncontributing partner receives sufficiently disproportionate distributions from the partnership to offset the tax burden arising from the allocation of built-in gain. Such disproportionate distributions may create taxable income to the noncontributing partner because the amount of the distribution could exceed the partner's basis in the partnership. The law taxing distributions in excess of basis has been a part of statutory partnership tax law since 1954. I.R.C. § 731(a)(1); see also Christopher H. Hanna, *Partnership Distributions: Whatever Happened to Nonrecognition?*, 82 KY. L.J. 465, 523 (1993–1994) (noting that section 731(a)(1) has not changed since its enactment in 1954).

<sup>277</sup> See *supra* notes 242–43 and accompanying text.

<sup>278</sup> I.R.C. § 704(c)(1)(B). Congress enacted the original version in 1984. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 71(a), 98 Stat. 494, 589 (1984) (codified as amended at I.R.C.

complicated, and the rule has generated a complicated set of regulations,<sup>279</sup> which undoubtedly requires sophisticated accounting software for implementation in the case of large multi-asset partnerships. Nonetheless, the rule is efficient and accurate, and modern technology helps alleviate the effects of the complicated accounting.

Finally, the entity-oriented partnership-basis-rules could provide favorable tax results to the transferor of a partnership interest. For example, assume a partnership holds inventory, which would generate ordinary income if the partnership were to sell it. The gain from the sale of inventory would flow through to the partners as ordinary income.<sup>280</sup> The entity concept provides partners the opportunity to convert the gain from the sale of partnership inventory to capital gain. The entity concept treats the partner as owning a partnership interest, not an interest in partnership property. The interest in a partnership is arguably a capital asset,<sup>281</sup> so the sale of the partnership interest should generate capital gain, but the value of the partnership interest should include unrealized gain in the partnership's inventory. Thus, by selling an interest in the partnership, the partner could convert the benefit of the unrealized gain in the inventory into capital gain.<sup>282</sup> Recognizing that partners could convert ordinary income to capital gain income by selling partnership interests instead of partnership assets, Congress enacted aggregate rules that attributed the ordinary income to the sale of the partnership interest.<sup>283</sup> These rules were part of the original Subchapter K, indicating that

---

§ 704(c) (2000)).

<sup>279</sup> See, e.g., Treas. Reg. § 1.704-3 (as amended in 2005) (discussing purposes of section 704(c)). For an in-depth discussion of the rules, see generally Laura E. Cunningham, *Use and Abuse of Section 704(c)*, 3 FLA. TAX REV. 93 (1996).

<sup>280</sup> I.R.C. § 702(b).

<sup>281</sup> The 1954 law adopted this view. See INT. REV. CODE OF 1954, § 741 (1954) (treating gain or loss from interest in partnership as gain or loss in capital asset). The current law retains it. See I.R.C. § 741 (2000) (same).

<sup>282</sup> See Jackson et al., *supra* note 176, at 144–45 (recognizing that gain realized on sale of partnership interest is “on account of the appreciation or depreciation in value of the partnership’s assets” and could be treated as capital asset).

<sup>283</sup> INT. REV. CODE OF 1954, § 751(a) (1954). The same law survives in the current Subchapter K. I.R.C. § 751(a) (2000).



Congress foresaw the potential for abuse.<sup>284</sup> Thus, upon enactment of the entity rules, Congress already recognized the need to address problems the entity concept would raise in the partnership tax context.

In addition to these reparative aggregate rules, Congress has enacted several other reparative aggregate rules to address problems arising from treating partnerships as entities for property ownership purposes.<sup>285</sup> The reparative aggregate provisions carve so many holes in the original entity rules that the entity framework has become a veritable slice of Swiss cheese. In fact, it is difficult to tell whether the framework is more entity cheese or more aggregate hole at this time. The simplicity the entity rules promised is thus largely replaced by the more accurate and efficient aggregate rules. Instead of simplifying things, the entity rules may have complicated matters.

After the enactment of the reparative aggregate provisions, the partnership-interest-basis rules retain the entity concept with respect to capital assets and nondepreciable assets acquired by the partnership.<sup>286</sup> The aggregate concept applies to all property contributed by a partner to the partnership and to all property that would produce ordinary income if sold by the partnership. The classes of assets to which the aggregate provisions apply—namely depreciable property and contributed property—generate the most complex accounting issues. Thus, the entity concept, which is supposed to simplify tax administration, is left largely to govern

---

<sup>284</sup> See Jackson et al., *supra* note 176, at 145 (discussing alternative results obtained by using entity or aggregate concepts prior to enactment of Subchapter K).

<sup>285</sup> See, e.g., I.R.C. § 731(c) (1994) (addressing abusive distribution of marketable securities); I.R.C. § 737 (1988 & Supp. V 1994) (prohibiting antimixing-bowl transaction); I.R.C. § 734 (1952 & Supp. V 1958) (providing elective rules for adjusting basis of partnership property to reflect gain recognized by partner upon distribution from partnership); *id.* § 743 (providing elective rules for adjusting basis of partnership property upon disposition of partnership interest to reflect proportional basis of acquiring partner); *id.* § 751(b) (providing rules for determining character of gain recognized by partner on distribution of partnership assets).

<sup>286</sup> The aggregate concept of section 751 applies to all inventory and unrealized receivables. I.R.C. § 751(a) (2000). The definition of unrealized receivables captures a broad class of property, including contractual rights to receive payments for goods and services, gains from certain properties under sections 617(f)(2), 992(a), 1248, 1252(a), and 1253(a), and recapture of cost recovery deductions under sections 1245, 1250(a), and 1254(a). I.R.C. § 751(c). Income from such property is ordinary income. *Id.*

only the assets which create the least complex administrative demands. In the end, the entity concept has limited utility and may be the source of unneeded complexity.

If Congress had relied upon the aggregate-plus theory in enacting the partnership-interest-basis rules, its starting point would have been aggregate taxation. It would have added to the entity rules only as warranted by tax administration. The end result might have been similar to that obtained under the current entity-minus rules, which began with the entity concept and added reparative aggregate rules as needed to ensure an economically efficient and appropriately allocative set of rules. The difference between an entity-minus approach and an aggregate-plus approach, each of which obtain the same end result, is the tax treatment between the inception of the original rule and the addition of the final reparative provisions that equalize the two rules.<sup>287</sup> Thus, in comparing an entity-minus end result to a similar aggregate-plus end result, the focus becomes the interim between the inception of the rule and the point of equalization.

Under entity-minus taxation, simplicity reigns during the interim, at the expense of efficiency and accuracy.<sup>288</sup> Under aggregate-plus taxation, simplicity is lost to some extent during the interim, but the rules are efficient and they accurately allocate partnership income and loss. The simplicity sacrificed under aggregate-plus taxation is a small price to pay during the interim because the aggregate concept promotes economic efficiency and allocates partnership tax items accurately.<sup>289</sup> Furthermore, end results may vary. An aggregate starting point may allow lawmakers to create aggregate rules that are simpler than reparative aggregate rules. Thus, the end result of aggregate-plus rules may be simpler than the end result of entity-minus rules. This analysis of existing law provides an example of the strength of the aggregate-plus theory of partnership taxation.

---

<sup>287</sup> Professor Ali Khan would refer to the interim as  $\Delta t$ , beginning upon the enactment of the original rule and ending when the rules equalize. See Liaquat Ali Khan, *Temporality of Law*, 40 MCGEORGE L. REV. 55, 57–58 (2009) (referring to  $\Delta t$  as “a span of time” in explaining principles of law’s temporality).

<sup>288</sup> See *supra* notes 267–73 and accompanying text.

<sup>289</sup> See *supra* notes 274–305 and accompanying text.

## C. AGGREGATE-PLUS THEORY AND FUTURE LAWS

The strength of the aggregate-plus theory also depends upon the extent to which it provides direction regarding rules that will govern future developments in partnership law and advances in business practices. The following discussion illustrates that the aggregate-plus theory applies nicely to partnerships even if the law largely treats them as entities. Partners commonly grant profit interests to managers.<sup>290</sup> This is a natural outgrowth of partnerships as members seek to reduce management agency costs by aligning management's economic interests with the members' economic interests.<sup>291</sup> The granting of such interests raises many tax law questions.<sup>292</sup> One question is whether rules governing the grant of a profits interest in a partnership should follow the aggregate concept or the entity concept.<sup>293</sup> With no standard to guide such a decision, end-result analysis comes into play and the government and commentators will propose rules that provide the best end result from each party's particular perspective. On the other hand, the aggregate-plus theory would require new partnership tax rules to adopt the aggregate concept and add entity provisions only as needed to simplify tax administration. The end result should not direct the rule making. Such a standard provides greater predictability (parties can anticipate the rule before it becomes effective) and less opportunity for self-serving rules. Thus, rules governing the grant of profits interests should follow the aggregate-plus theory.

A profits interest in a partnership provides the recipient with a right to a share of future partnership profit, but does not grant the recipient a current interest in the capital of the partnership.<sup>294</sup> The

---

<sup>290</sup> See Ribstein, *supra* note 157, at 36 ("These managers will own equity shares in the operating partnerships and will continue to directly receive a share of the company.").

<sup>291</sup> See Axelson et al., *supra* note 229, at 3 (positing that optimum management compensation includes factors which align management's compensation with other members' financial interests).

<sup>292</sup> See Carman et al., *supra* note 14, at 230-38 (discussing tax issues raised by grant of compensatory partnership options).

<sup>293</sup> See *id.* at 212-13 (recommending adoption of entity concept).

<sup>294</sup> See Rev. Proc. 93-27, 1993-2 C.B. 343 (defining "profits interest" as "any partnership interest other than a capital interest" and defining "capital interest" as interest entitling

holder of a partnership profits interest (a profits-interest partner) should have the same rights as other partners, such as voting and management rights.<sup>295</sup> As a partnership earns profits and apportions the profits to the profits-interest partner, the profits-interest partner may build capital in the partnership. For example, the profits-interest partner's capital account should increase if the partner has a right to partnership profits, but the partnership does not make distributions. The partner should be entitled to that amount upon liquidation of the partner's interest.<sup>296</sup> To illustrate, if a partnership with no liabilities makes \$100,000 over a two-year period and makes no distributions, a profits-interest partner with a 20% profits interest would be entitled to a \$20,000 distribution upon liquidation.<sup>297</sup> Prior to that distribution, the profits-interest partner would have a \$20,000 capital interest in the partnership.

Partnerships often grant profits interests to service providers.<sup>298</sup> As stated above, partners grant such interests to align the service provider's interests with that of other partners, reducing agency costs.<sup>299</sup> The granting of profits interests to service providers raises several tax questions, all of which the aggregate-plus theory can address. For example, a grant of a profits interest raises the question of how to treat the grant of the interest. The entity concept, which courts and the IRS have adopted, recognizes that a profits interest is a property interest in an entity.<sup>300</sup> If the interest has a readily ascertainable market value, the recipient must recognize income upon receipt of such interest.<sup>301</sup> The recognition

---

holder to share of partnership's assets).

<sup>295</sup> See UNIF. P'SHIP ACT § 401(f) (amended 1997), 6 U.L.A. 133 (2001) (providing that each partner shall have equal rights in management of partnership).

<sup>296</sup> See Rosin, *supra* note 29, at 443–46 (discussing partner's interest in partnership and effect of partners' claims to partnership profits on their rights in liquidation).

<sup>297</sup> See UNIF. P'SHIP ACT § 401(a), 6 U.L.A. 133 (providing partner account maintenance rules); *id.* § 807(a)–(b), 6 U.L.A. 206 (providing distribution rules that apply upon liquidation of partnership).

<sup>298</sup> See Carman et al., *supra* note 14, at 204 (noting rise in popularity of service options).

<sup>299</sup> See *supra* Part III.A–B.

<sup>300</sup> See *Diamond v. Comm'r*, 492 F.2d 286, 290–91 (7th Cir. 1974) (holding that recipient of profits interest in partnership received in exchange for past services has gross income upon receipt of interest); Prop. Treas. Reg. § 1.83-3(e), 70 Fed. Reg. 29680, 29680 (May 24, 2005) (“[P]roperty includes a partnership interest.”).

<sup>301</sup> See *Campbell v. Comm'r*, 943 F.2d 815, 823 (8th Cir. 1991) (holding that receipt of profits interest is taxable event but recipient did not recognize gross income because interest

of income upon receipt of the interest requires an adjustment to the partner's capital account.<sup>302</sup> Although capital accounts usually reflect the partners' interests in the capital of a partnership, a partner with a profits-only interest would have no right to the capital of the partnership upon grant of the profits interest.<sup>303</sup> Thus, a positive capital account balance of a profits-interests partner at the time of grant would misstate the partners' interests in partnership capital. To repair such a misstatement, the entity approach must include reparative aggregate provisions to ensure that the profits-interest partner does not receive another partner's share of partnership capital in the event of a liquidation.<sup>304</sup> This type of entity-minus lawmaking in partnership taxation is similar to that used for the partner-interest-basis rules.<sup>305</sup> It creates inaccurate and inefficient rules and requires reparative aggregate provisions. It also fails to simplify the law. The aggregate-plus theory would eliminate these problems.

The aggregate-plus theory first treats the partnership as an aggregate of its owners. As such, the service provider becomes a member of the partnership upon the grant of the profits interest. A partnership with the service provider is an integration of partnership property, the services contributed by the profits-interest partner, and any other services contributed by other partners.<sup>306</sup> The existing partners grant the service provider a profits interest to align the service provider's interests with the interests of the other partners.<sup>307</sup> To effectively align interests, the profits interest would have to be subject to risks of forfeiture. In other words, for the

---

had only speculative value); Rev. Proc. 93-27, 1993-2 C.B. 343-44 (providing that IRS will not treat recipient of profits interest as having gross income upon receipt of interest unless one of three factors are satisfied, including showing interest had an ascertainable value).

<sup>302</sup> Prop. Treas. Reg. § 1.704-1(b)(2)(iv)(b)(1), 70 Fed. Reg. at 29681.

<sup>303</sup> See *supra* note 294 and accompanying text.

<sup>304</sup> For example, if a profits-interest partner included \$50,000 in income upon grant of a profits interest, the partner's capital account would increase by \$50,000, but the profits-interest partner would have no right to partnership capital upon liquidation. Thus, if the partnership were to liquidate, it would have to adjust the capital account to the initial balance.

<sup>305</sup> See *supra* Part IV.B.

<sup>306</sup> See *supra* Part III.B.

<sup>307</sup> See *supra* Part III.A-B.

profits interest to serve its economic objectives, the service provider could only receive its benefit after providing services.

If the interest is not subject to a risk of forfeiture, arguably it is not a partnership interest. Instead, it imposes a present obligation on the partnership or partners to pay the recipient of the interest some amount in the future, and the interest grants the recipient the unconditional right to receive such amount. Under an economic analysis, such right would not be a partnership interest because the profits-interest recipient's services would not become integrated with partnership property (or the services of other partners). Instead, the recipient would trade the services, to the extent provided, for the vested rights to profits. Thus, the arrangement would not be a partnership, at least not between the profits-interest recipient and the other partners.<sup>308</sup> The aggregate concept correctly recognizes that subtlety and should govern the grant of such profits interests. The result under the aggregate concept is that the service provider receives the profits interest in exchange for services and does not integrate them with partnership resources. Consequently, the service provider should be taxed upon grant of the profits interest. This treatment recognizes that the service provider is providing services in exchange for an interest in profits.

If the interest is subject to forfeiture (i.e., the service provider loses the right to profits if it discontinues the services), the arrangement is integrated. The potential forfeiture of profits indicates that the other partners have an economic interest in the services. In such integrated arrangements, the service provider should recognize income from the profits interest as the partnership earns and apportions profits to the partners. Such treatment better reflects the service provider's interest in all resources of the integrated arrangement.

---

<sup>308</sup> See *supra* Part III.A (discussing significance of combination of services in determining whether arrangement constitutes a partnership). This is the view adopted by the IRS. See Prop. Treas. Reg. § 1.761-1(b), 70 Fed. Reg. 29683, 29683 (May 24, 2005) ("If a partnership interest is transferred in connection with the performance of services, and the partnership interest is substantially nonvested . . . , then the holder of the partnership interest is not treated as a partner solely by reason of holding the interest, unless the holder makes an election with respect to the interest under section 83(b).").

Partnership profits interests also raise questions about the characterization of income apportioned to a service provider who receives a profits interest. Some commentators believe that income apportioned to a service provider pursuant to a profits interest should be treated as compensation.<sup>309</sup> Their rationale is that the service provider received the partnership interest in exchange for services, and income from services is compensation.<sup>310</sup> Other commentators believe that income from a profits interest should reflect the character of partnership income.<sup>311</sup> Both of these views miss the mark to some extent. Again, the aggregate-plus theory helps focus the analysis and produce the correct tax result.

Viewed as an aggregate, a partnership is a community of interests, including contributed property and services.<sup>312</sup> Each partner has an ownership interest (i.e., control) in the property and services of the partnership.<sup>313</sup> The coordinated use of partnership property and services will generate partnership income. Because the property and services are integrated within the partnership, the partners cannot separate the partnership's income into categories of property income and services income.<sup>314</sup> Income apportioned to partners will include some property income and some services income. Thus, all partners who receive a share of the partnership's profits receive some partnership property income and some partnership services income.

The same applies to a profits-interest partner who only contributes services to the partnership. This partner is apportioned income from both the property and services of the partnership. If

---

<sup>309</sup> See, e.g., Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 4 (2008) (arguing that profits interests should be treated like other forms of compensation).

<sup>310</sup> See *id.* at 24–26 (arguing that profits interests should not be treated differently from economically similar transactions taxed as compensation).

<sup>311</sup> See, e.g., David A. Weisbach, *Professor Says Carried Interest Legislation Is Misguided*, 116 TAX NOTES 505, 505 (2007) (arguing that treating carried interests as ordinary income is inconsistent with basic principles of tax law).

<sup>312</sup> See *supra* Part III.A.

<sup>313</sup> See *supra* notes 202–04, 209–11 and accompanying text. The discussion in this Part of the Article assumes that the partnership has property and services. If the partnership is a pure services partnership, characterizing apportioned partnership income would be a moot point because all partnership income would be from services.

<sup>314</sup> See *supra* notes 209–10, 225–29 and accompanying text.

the law treated all income apportioned to that partner as income from services, the law would mischaracterize any portion of the partnership's income constituting property income. The character of partnership income apportioned to a profits-interest partner should reflect the character of income recognized by the rest of the partnership. Thus, partnership income apportioned to a profits-interest partner should not be characterized solely as compensation if the partnership has property income.

Commentators are critical of this result, but their criticism is misplaced. They criticize the outcome because wealthy taxpayers may receive profits interest and apply favorable tax rates to a significant amount of income.<sup>315</sup> But the correct characterization of the income depends upon the partnership's income. To the extent the amount of tax imposed upon that income does not reflect an equitable distribution of the tax burden, the law should address the equity arguments through other means.<sup>316</sup> Partnership tax law should strive to accurately reflect the nature of partnership and the income apportioned to partners. In the case of profits interests, the law accurately reflects the nature of partnerships by first recognizing that partnerships are aggregates of their members, and second by recognizing that income from the partnerships includes income from property and services of the partnership. Treating such income solely as services income could seriously mischaracterize the income.<sup>317</sup> The aggregate-plus theory takes this into account and reaches the correct result. Furthermore, the aggregate-plus theory would allow lawmakers to create entity rules to facilitate tax administration.

---

<sup>315</sup> See, e.g., Fleischer, *supra* note 309, at 5 ("This quirk in the partnership tax rules some of the richest workers in the country to pay tax on their labor income at a low effective rate.").

<sup>316</sup> Commentators have recognized that the current system does not fairly tax the super rich in this country. See generally Martin J. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 993 (2004) (discussing trend of enacting disproportionately large tax cuts for those at top of income pyramid in United States). The law should deal with such inequities through graduated tax rates, not by amending rules that have broad effect and that mischaracterize income or inadvertently shift the tax burden, as many entity provisions have done in partnership taxation. See *supra* Part IV.B.

<sup>317</sup> Purported partnership arrangements and partnership interests may actually be disguised employment arrangements. See Borden, *supra* note 162 (arguing that interests in investment partnerships may represent employment arrangements).



## V. CONCLUSION

Partnership taxation is important and is gaining in importance as more people use partnerships for more purposes and as the size of partnerships grows. Changes in business practices and partnership law could stress the structure of partnership taxation. This Article recommends that as lawmakers consider partnership tax questions in the future, they should rely on a comprehensive theory of partnership taxation to direct their actions. The aggregate-plus theory is the comprehensive theory that will provide a level of certainty and predictability to lawmaking. It also caters to the nature of partnerships. It will help eliminate the inefficiencies and inaccuracies that the entity concept needlessly or carelessly imposes upon partnerships and partners. The aggregate-plus theory also recognizes the nature of partnerships, in all their forms. It provides latitude to lawmakers, allowing them to address administrative complexities that are inherent in aggregate taxation. The accuracy, efficiency, and flexibility of the aggregate-plus theory of partnership taxation make it the superior theory of partnership tax law. This Article therefore recommends it as a comprehensive theory of partnership taxation.

## APPENDIX A

Section Number	Rule	Function	Year Enacted
701	Flow-through of tax items	Aggregate <sup>318</sup>	1913
702(a)	Separately stated items	Aggregate	1954
702(b)	Flow-through of tax item character	Aggregate	1954
703(a)	Computation of partnership taxable income	Entity <sup>319</sup>	1918
703(b)	Effect of partnership elections	Entity	1954
704(a) & (b)	Allocation rules	Aggregate	1954
704(c)	Contributions of appreciated/depreciated property	Aggregate	1984
704(d)	Loss limitation	Entity	1954
704(e)	Allocations within family partnerships	Anti-abuse	1954
705(a)	Outside basis adjustments	Entity	1954
706(a) & (b)	Partnership taxable year	Entity	1917
706(c)	Close of partnership taxable year	Entity	1917
706(d)	Allocations when partnership interest changes	Entity	1984
707(a)	Partner not acting as partner	Entity	1954
707(b)	Sales to or exchanges with controlled partnership	Entity	1954
707(c)	Guaranteed payments	Entity	1954
708(a)	Partnership continuation	Entity	1954
708(b)(1)	Partnership termination	Entity	1954
708(b)(2)	Partnership mergers and divisions	Entity	1954
709	Treatment of organization and syndication fees	Entity	1976
721(a)	No gain/loss on contribution to partnership	Neither/ nonrecognition <sup>320</sup>	1954

<sup>318</sup> A provision of law serves an aggregate function if it results in disregarding the arrangement for tax purposes.

<sup>319</sup> A provision of law serves an entity function if it recognizes an entity separate from its owners for any tax purpose.

<sup>320</sup> Section 721, which provides for nonrecognition on contributions of property to a partnership, is neither entity nor aggregate. The provision facilitates formation of partnerships by not requiring gain recognition. It could apply to either aggregate or entity regimes.

Section Number	Rule	Function	Year Enacted
721(b)	Contributions to investment partnerships	Neither/ nonrecognition	1976
722	Effect of contribution on outside basis	Entity	1954
723	Partnership's basis in contributed property	Entity	1954
724(a)	Contributions of unrealized receivables	Aggregate/anti-abuse	1984
724(b)	Contributions of inventory items	Aggregate/anti-abuse	1984
724(c)	Contributions of capital-loss property	Aggregate/anti-abuse	1984
731(a)	Gain/loss to partners on distribution	Entity/nonrecognition	1954
731(b)	No gain/loss to partnership on distribution	Entity/nonrecognition	1954
731(c)	Distribution of marketable securities	Anti-abuse	1994
732(a)-(c)	Partner's basis in distributed property	Entity	1954
732(d)	Transferee partner's basis in distributed property	Aggregate	1954
733	Distributee partner's basis in the partnership	Entity	1954
734(a)	General prohibition of partnership property basis adjustment on distribution	Entity	1954
734(b)	Adjustment of partnership property basis on distribution	Aggregate	1954
735(a)	Gain or loss on sale of distributed unrealized receivables and inventory	Aggregate/anti abuse	1954
735(b)	Holding period of distributed unrealized receivables and inventory	Aggregate/anti abuse	1954
737	Anti-mixing-bowl rules	Aggregate/anti-abuse	1992
741	Tax treatment of sale of partnership interest	Entity	1954
742	Basis of transferee partner's interest in the partnership	Entity	1954
743(a)	General prohibition partnership property basis adjustment on sale of partnership interest	Entity	1954
743(b)	Adjustment of partnership property basis on sale of partnership interest	Aggregate	1954

Section Number	Rule	Function	Year Enacted
751	Effect of unrealized receivables and inventory items on distributions and sales of partnership interests	Aggregate/anti-abuse	1954
752	Effect of partnership liability allocated to partners	Entity <sup>321</sup>	1954
755	Rules for allocating section 734 and 743 basis adjustments	Aggregate	1954
761(a)	Definition of partnership	Entity	1932
761(b)	Definition of tax partner	Entity	1954

---

<sup>321</sup> The table labels section 752 as an entity provision because it treats partners as making contributions to or receiving distributions from the partnership, even though one may argue that it is an aggregate provision because the basis adjustments facilitate the flow-through of losses.

## APPENDIX B

Type of Provision	Total Provisions	Provisions Enacted in 1954 or Earlier	Provisions Enacted After 1954
Major provisions	44	35	9
Aggregate provisions	17	12	5
Entity provisions <sup>322</sup>	24	22	2
Entity provisions addressing the partnership-interest-basis rules <sup>323</sup>	11	11	0
Entity provisions addressing tax accounting <sup>324</sup>	6	5	1
Entity provisions addressing partner-partnership transactions and change of partnership ownership/structure <sup>325</sup>	6	6	0
Nonrecognition provisions	4	3	1
Anti-abuse provisions	9	4	5
Aggregate/anti-abuse provisions	7	3	4

---

<sup>322</sup> In addition to the provisions addressing the partnership-interest-basis rules, tax accounting, and partnership-partner transactions, and changes in partnership ownership/structure, the entity provisions include the definition of partnership and partner in section 761(a) and (b).

<sup>323</sup> The provisions include sections 705(a), 722, 723, 731(a), 731(b), 732(a)-(c), 733, 741, 742, and 752.

<sup>324</sup> The provisions include sections 703(a), 703(b), 704(d), 706(a) & (b), 706(c), and 706(d).

<sup>325</sup> The provisions include sections 707(a), 707(b), 707(c), 708(a), 708(b)(1), and 708(b)(2).