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# The Allure and Illusion of Partners' Interests in a Partnership

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# THE ALLURE AND ILLUSION OF PARTNERS' INTERESTS IN A PARTNERSHIP

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*Favorable tax treatment and management flexibility make tax partnerships very popular. For starters, tax partnerships, unlike tax corporations, are not subject to entity-level taxes. Partnership taxable income flows through to the partners, and the partners report their shares of partnership taxable income on their individual tax returns. Partnership tax allocation rules determine the partners' shares of partnership taxable income. Those rules rely upon the alluring concept of partners' interests in a partnership. It seems intuitive that partners would know their interests in a partnership and be able to allocate partnership taxable income accordingly. This Article illustrates, however, that the concept is illusory and that it undermines the tax allocation rules, crippling the effectiveness of partnership taxation. Some partners therefore allocate partnership income to reduce their overall tax liability and unfairly deplete government revenue.*

*The Article attributes the concept's allure and illusion to path dependency and tax myopia—partnership tax experts expend considerable effort mastering difficult rules, which they cling to, and they focus narrowly on the tax aspects of those rules. The Article introduces three correlatives to end the myopia and improve the tax allocation rules: (1) economic items and tax items; (2) state law and tax law; and (3) economic interests and partners' interests in a partnership. The Article illustrates that aspects of the current rules are tax-centric (i.e., economic results follow tax allocations) and*

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*illusory. The rules' tax-centricity may create unintended legal consequences for unsuspecting partners; their illusion creates opportunities for tax abuse. After illustrating the current rules' shortcomings, the Article recommends fundamental reform of the partnership tax allocation rules. It recommends a move to item-specific economic-centric rules that will eliminate the unintended legal and economic consequences of the current rules and curb tax abuse.*



## INTRODUCTION

Tax partnerships are no longer the sole province of ma-and-pa shops and other small businesses. Now, the largest multinational corporations,

other businesses, and property owners use them for various reasons.[1] In fact, tax partnerships hold one-fifth of the business assets and account for one-third of total business entities in the United States.[2] That presence is the result of unprecedented growth over the last several years—growth that promises to continue based on recent trends. In fact, tax partnerships are increasing in number, and their business activity is growing in both absolute and relative terms.[3] For example, during the eight-year period ending with 2007, the number of tax partnerships increased 50%.[4] The value of assets held by tax partnerships increased almost threefold to $20 trillion, the amount of tax partnership income doubled to $4 trillion, and the amount of depreciation deductions taken by tax partnerships increased significantly.[5]

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1. To illustrate the size of tax partnerships, in 2007, the largest 18,417 (of 3 million) tax partnerships held more than $15 trillion in total assets and had $2 trillion of total income. On average, each of those partnerships held $814 million of assets and had $109 million of total income. *See* INTERNAL REVENUE SERV., ALL PARTNERSHIPS: TOTAL ASSETS, TRADE OR BUSINESS INCOME AND DEDUCTIONS, PORTFOLIO INCOME, RENTAL INCOME, AND TOTAL NET INCOME BY SIZE OF TOTAL ASSETS, 2007 tbl. 15 (2007), *available at* http://www.irs.gov/taxstats/bustaxstats/article/0,,id=130919,00.html (follow "2007" hyperlink under "All Partnerships" heading). *See also infra* text accompanying notes 211–218 (illustrating the use of tax partnerships by a smaller property owner and a multinational corporation).

2. *See infra* notes 6–7 and accompanying text.

3. Commentators note with fascination the proliferation of unincorporated entities (most of which are likely tax partnerships) over the last several years. *See, e.g.*, Robert J. Rhee, *Bonding Limited Liability*, 51 WM. & MARY L. REV. 1417, 1445–46 (2010) (illustrating that the number of limited liability company filings in three major states for the five-year period ended in 2008 increased by 10.6%, while the number of corporate filings decreased by 1.2% during the same period and suggesting states should require such entities to post bond to do business in the states); Larry E. Ribstein, *Uncorporating the Large Firm* 34 (Ill. L. & Econ. Research Paper Series, Research Paper No. LE08-016, 2008), *available at* http://papers.ssrn.com/pape.tar?abst ract_id=1003790 (examining the use of unincorporated entities as vehicles for equity funds and large publicly traded ventures). The amount of assets partnerships hold and the income and deductions they account for also speak to the role partnerships now play in the economy. *See* INTERNAL REVENUE SERV., ALL PARTNERSHIPS: TOTAL ASSETS, TRADE OR BUSINESS INCOME, RENTAL INCOME, AND TOTAL NET INCOME, BY SELECTED INDUSTRIAL GROUP, 2007 tbl. 1 (2007) [hereinafter THE 2007 PARTNERSHIP STATISTICS], *available at* http://www.irs.gov/taxstats/ article/0,,id=201174,00.html (follow "2007" hyperlink). Based on 2007 estimates, partnerships hold $20 trillion of assets, have $4.2 trillion of income, and receive $3.9 trillion of deductions. *Id.*

4. In 2000, the IRS reported 2 million tax partnerships. *See* INTERNAL REVENUE SERV., ALL PARTNERSHIPS: TOTAL ASSETS, TRADE OR BUSINESS INCOME AND DEDUCTIONS, PORTFOLIO INCOME, RENTAL INCOME, AND TOTAL NET INCOME FOR SELECTED INDUSTRIAL GROUPS, 2000 tbl. 1 (2000) [hereinafter THE 2000 PARTNERSHIP STATISTICS], *available at* http://www.irs.gov/taxstats/article/0,,id=201174,00.html (follow "2000" hyperlink). In 2007, the IRS reported approximately 3 million tax partnerships. *See* THE 2007 PARTNERSHIP STATISTICS, *supra* note 3. The Article uses this time period because its recent and relevant data are easily accessible for the years under observation.

5. Tax partnerships held approximately $6.7 trillion of assets in 2000, *see* THE 2000 PARTNERSHIP STATISTICS, *supra* note 4, and $20 trillion in 2007, *see* THE 2007 PARTNERSHIP STATISTICS, *supra* note 3. Tax partnership income was approximately $2.2 trillion in 2000, *see* THE 2000 PARTNERSHIP STATISTICS, *supra* note 4, and $4.2 trillion in 2007, *see* THE 2007 PARTNERSHIP STATISTICS, *supra* note 3. Tax partnerships claimed approximately $59 billion of depreciation

The relative growth of tax partnerships is staggering. The number of tax partnerships as a percent of total business entities increased from 29% to 33% between 2000 and 2007.[6] The percent of business assets held by tax partnerships increased from 13% to 20% during that same time period.[7] Comparing tax partnership income to U.S. Gross Domestic Product (GDP) reveals that partnership income grew significantly faster than GDP.[8] These comparisons, as summarized in Table 1, illustrate that tax partnerships are a significant part of the economy; analysts and commentators can no longer neglect their presence.

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deductions in 2000, *see* THE 2000 PARTNERSHIP STATISTICS, *supra* note 4, and approximately $86 billion in 2007, *see* THE 2007 PARTNERSHIP STATISTICS, *supra* note 3.

6. In 2000, the IRS reported approximately 5 million tax corporations and 2 million tax partnerships. *See* INTERNAL REVENUE SERV., NUMBER OF BUSINESSES, BUSINESS RECEIPTS, NET INCOME, AND DEFICIT, BY FORM OF BUSINESS AND INDUSTRY, TAX YEAR 2000 tbl. 3 (2000) [hereinafter THE 2000 GENERAL BUSINESS STATISTICS] *available at* http://www.irs.gov/taxstats/bustaxstats/article/0,,id=152029,00.html (follow "2000" hyperlink). In 2007, the IRS reported approximately 5.9 million tax corporations and approximately 3 million tax partnerships. *See* INTERNAL REVENUE SERV., NUMBER OF BUSINESSES, BUSINESS RECEIPTS, NET INCOME, AND DEFICIT, BY FORM OF BUSINESS AND INDUSTRY, TAX YEAR 2007 tbl. 3 (2007) [hereinafter THE 2007 GENERAL BUSINESS STATISTICS], *available at* http://www.irs.gov/taxstats/bustaxstats/article/0,,id=152029,00.html (follow "2007" hyperlink). The number of business entities does not include sole proprietors.

7. Tax corporations held approximately $81 trillion of assets in 2007. *See* INTERNAL REVENUE SERV., 2007 CORPORATION SOURCE BOOK OF STATISTICS OF INCOME: U.S. TOTAL: RETURNS WITH AND WITHOUT NET INCOME (2007), *available at* http://www.irs.gov/taxstats/article/0,,id=165716,00.html. Tax corporations held approximately $47 trillion of assets in 2000. *See* INTERNAL REVENUE SERV., 2000 CORPORATION SOURCE BOOK OF STATISTICS OF INCOME: U.S. TOTAL: RETURNS WITH AND WITHOUT NET INCOME (2007), *available at* http://www.irs.gov/taxstats/bustaxstats/article/0,,id=178035,00.html.

8. In 2000, U.S. GDP was approximately $10.3 trillion (compared to $2 trillion of tax partnership income) and approximately $14 trillion (compared to $4 trillion of tax partnership income) in 2007. *See* Bureau of Econ. Analysis, National Economic Accounts: National Income and Produce Accounts Table: Table 1.1.5, Gross Domestic Product, http://www.bea.gov/national/nipaweb/SelectTable.asp (follow "Table 1.1.5. Gross Domestic Product (A) (Q)" hyperlink) (last visited Feb. 5, 2011).

Table 1
Recent Growth of Tax Partnerships

| **Absolute Growth of Tax Partnerships** | | |
|---|---|---|
| **Metric** | **2000** | **2007** |
| Number of Tax Partnerships | 2 Mill. | 3 Mill. |
| Assets held by Tax Partnerships | \$7 Trill. | \$20 Trill. |
| Tax Partnership Income | \$2 Trill. | \$4 Trill. |
| Tax Partnership Depreciation Deductions | \$59 Bill. | \$86 Bill. |
| **Relative Growth of Tax Partnerships** | | |
| Tax Partnerships/Total Business Entities | 29% | 34% |
| Tax Partnership Assets/Total Business Assets | 13% | 20% |
| Tax Partnership Income: U.S. GDP | 1:5 | 1:3.6 |

This information about the growth of tax partnerships and the potential abuses identified in this Article signal a troubling trend. Business and property owners often form tax partnerships to avoid the corporate double tax.[9] Once in tax-partnership form, many owners will take further steps to reduce their tax liabilities. The partnership tax allocation rules appear to facilitate such efforts, and with trillions of dollars at stake, tax-reduction schemes could further cripple the government's ability to raise tax revenue and tame the unwieldy deficit.

Tax-planning opportunities exist with tax partnerships because of complex (and often ambiguous) partnership tax rules. Partnership tax rules generally apply to all non-corporate multiple party business arrangements.[10] Thus, general partnerships, limited partnerships, and limited liability companies are generally subject to partnership tax rules.[11] Arrangements that are subject to partnership tax rules are tax partnerships. The complexity of the partnership tax rules derives in part from the nature of tax partnerships. Tax partnerships do not pay income tax; instead, all partnership income flows through to the partners, and they report it on their individual returns.[12] Each partner reports a share of the income in accordance with the partnership tax allocation rules.[13]

9. *See* I.R.C. § 11 (a) (2006) (imposing a tax on corporations); I.R.C. § 61(a)(7) (2006) (including corporate dividends in gross income).

10. *See* I.R.C. §§ 701–777 (2006) (governing the taxation of partners and partnerships); Treas. Reg. § 301.7701-2 (as amended in 2009) (defining tax corporation generally as an incorporated entity); Treas. Reg. § 301.7701-3 (as amended in 2006) (providing that business entities with more than two members that are not tax corporations are tax partnerships).

11. Such arrangements may, however, elect to be taxed as corporations subject to corporate tax. *See* Treas. Reg. § 301.7701-3(a) (as amended in 2006).

12. *See* I.R.C. § 701 (2006).

13. *See* I.R.C. §§ 702, 704 (2006).

Tax partnerships are entities that own partnership property and provide services in which partners have indirect interests. Partnership property and services combine to generate taxable income. The partners cannot trace partnership taxable income directly from its source to the partner who contributed a particular resource.[14] For example, partners cannot determine the extent to which a partnership's rental income derives respectively from partnership property and the partners' efforts to manage the property. Consequently, tax law cannot rely upon general principles of income taxation to determine each partner's share of partnership taxable income.[15] Instead, partnership tax allocation rules determine the partners' shares of the income.[16]

In fact, allocating partnership income to the partners is the fundamental purpose and challenge of partnership taxation.[17] The allocation rules rely heavily upon "partners' interests in a partnership"—a unique tax concept.[18] The allocation rules are, in turn, the heart of partnership taxation.[19] Furthermore, the allocation rules can affect the partners' legal rights and obligations in the partnership.

Despite the central importance of the concept of partners' interests in a partnership, commentators and politicians have largely neglected to critically examine it.[20] This Article is the first to claim that partners'

14. *See* Bradley T. Borden, *Aggregate-Plus Theory of Partnership Taxation*, 43 GA. L. REV. 717, 752–61 (2009) (discussing the use of allocations to reduce agency costs in tax partnerships and the resultant difficulties such allocations present).

15. *See* Bradley T. Borden, *Taxing Shared Economies of Scale*, 61 BAYLOR L. REV. 721, 736 (2009) ("General principles of income tax become inadequate when parties integrate resources.").

16. *See* I.R.C. § 704 (2006) (governing the allocation of partnership taxable income).

17. *See* Gregg D. Polsky, *Deterring Tax-Driven Partnership Allocations* 1–2 (FSU Coll. of Law, Pub. Law Research Paper No. 436, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1571542 ("How to allocate a partnership's tax items is the most fundamental issue in" partnership taxation.); Andrea Monroe, *Saving Subchapter K: Substance, Shattered Ceilings, and the Problem of Contributed Property*, 74 BROOK. L. REV. 1381, 1384 (2009) (claiming that the partnership tax allocation rules are "absolutely fundamental to the theory and practice of" partnership taxation.).

18. *See* I.R.C. § 704(b) (2006).

19. This Article follows the convention in the regulations and uses the terms "partners' interests in the partnership," "partner's interest in the partnership," "partner's interest in a partnership," and similar terms interchangeably as appropriate to refer to the concept. *See* Treas. Reg. § 1.704-1(b)(3) (as amended in 2008).

20. At least two articles have considered the technical aspects of the concept. *See* Bradley T. Borden, *Allocations Made in Accordance with Partners' Interests in the Partnership*, 11 BUS. ENT. 4 (2009) (focusing on the technical shortcomings of the factors used to determine partners' interests in a partnership); Stephen Utz, *Allocation and Reallocation in Accordance with the Partners' Interests in the Partnership*, 56 TAX LAW. 357 (2002) (observing two possible approaches for allocating items in accordance with partners' interests in a partnership). Other articles focus on allocation rules, but they neglect the importance and deficiencies of the concept of partners' interests in a partnership. *See, e.g.*, Walter D. Schwidetzky, *The Partnership Allocation Rules of Section 704(b): To Be or Not to Be*, 17 VA. TAX REV. 707, 717 (1998) (describing the allocation rules and observing that they should not be

interest in a partnership is illusory in the tax context and its use seriously flaws partnership taxation. This Article demonstrates that the flaws bleed over into legal and economic aspects of tax partnerships. This Article claims that because of the central role of partners' interests in a partnership, its illusory nature undermines partnership taxation, and nothing short of a fundamental reform will remedy the deficiency.

Commentators and politicians' neglect appears to derive from two phenomena. The first is path dependency; partnership tax experts expend considerable time and energy mastering the complicated partnership tax allocation rules, and they embrace that which they master. The second is tax myopia; partnership tax experts often focus narrowly on tax law and neglect the broader context in which tax issues arise.

This Article introduces three correlatives to place the rules in a broader context, to break down tax myopia, to help frame the issues, and to lead to better rules. It suggests that the allocation rules must account for the correlation between: (1) economic items and tax items; (2) state law and tax law; and (3) partners' economic interests and partners' interests in the partnership. The three correlatives, as depicted in Table 2, are crucial to analyzing partners' interests in a partnership, and the analysis this Article models illustrates how the correlatives will facilitate analyses of other aspects of partnership taxation.

Table 2
Partnership Correlatives

| | | |
|---|---|---|
| Economic Items | ⟷ | Tax Items |
| State Law | ⟷ | Tax Law |
| Economic Interests | ⟷ | Partners' Interests |

Part I of this Article explores the first correlative. That Part illustrates the responsibility the law has to govern the allocation of tax items and how taxpayers may take advantage of deficient allocation rules to reduce the amount of tax they would otherwise owe. Part II of this Article discusses the second correlative—the distinction between state law allocation rules and the partnership tax allocation rules. That Part illustrates that the two bodies of law are intertwined and that taxpayers

reformed); Lawrence Lokken, *Partnership Allocations*, 41 TAX L. REV. 545, 613 (1986) (discussing the allocation rules generally but noting specifically that "partners' interests are not as easily determined in many cases"). Recent scholarship in this area calls for changes to other parts of the allocation rules. *See, e.g.*, Polsky, *supra* note 17 (recommending changes to the test for substantiality and the rules governing allocation of built-in gains and losses, respectively); Monroe, *supra* note 17 (same).

may unwittingly alter their intended legal and economic arrangement by adopting the partnership tax allocation rules' economic effect safe harbor. That Part also demonstrates how the current allocation rules are tax-centric because they cause economic items to follow the allocation of tax items. Part III describes partners' interests in a partnership as a unique tax concept and distinguishes it from partners' economic interests. That Part also illustrates that the concept is illusory when used in the tax context. Part IV proposes fundamental changes to the rules that would eliminate the shortcomings in the current law and move to item-specific economic-centric tax-item allocations.

## I. CORRELATIVE ONE: ECONOMIC ITEMS AND TAX ITEMS

The analysis of partners' interests in a partnership begins with the distinction between economic items and tax items. An economic item is a metric that expresses economic activity; a tax item is an amount reported on a tax return. An example of an individual taxpayer illustrates the difference between economic items and tax items.

Employees receive cash payment for services. The cash payment is an economic item. It has a corresponding tax item—compensation income. Tax law requires employees to report compensation income on their tax returns.[21] Because the tax item corresponds to an economic item, it is a corresponding tax item.[22] Employers often pay a portion of their employees' health insurance premiums as a part of their compensation, and those payments are economic items. Tax law does not require employees to report such payments as income on their tax returns.[23] Therefore, employees often receive an economic item that has no accompanying tax item.

Finally, an individual may own depreciable property. Tax law allows the individual to claim a depreciation deduction regardless of fluctuations in the property's value.[24] Thus, the property owner will generally have a tax item that does not correspond to an economic item. Tax items that have no corresponding economic items are independent tax items. Allocating corresponding and independent tax items to individuals is fairly simple. An individual who provides services must

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21. *See* I.R.C. § 61(a)(1) (2006).

22. *See infra* Part I (discussing the allocation of economic items and corresponding tax items).

23. *See* I.R.C. § 106 (2006).

24. *See* I.R.C. § 167(a) (2006) (allowing the deduction for depreciation); Simon v. Comm'r, 103 T.C. 247, 261 (1994), *aff'd* 68 F.3d 41 (2d Cir. 1995) ("[S]ection 168 does not support [the] proposition that a taxpayer may not depreciate a business asset . . . due to the fact that the asset may have appreciated in value over time.").

report the tax items associated with those services,[25] and an individual who owns property must report the tax items associated with the property.[26]

Allocating tax items in the partnership context can be difficult. A tax partnership with $100,000 of rent receipts will also have $100,000 of rental income, which is a corresponding tax item. Intuition suggests that the partnership should allocate the corresponding tax item in the same manner in which it allocates the economic item. Partners dissociate economic items and tax items when they allocate them in different ratios to the partners. The allocation rules should prevent the partners from dissociating economic items and corresponding tax items.

A tax partnership with depreciable property will have a depreciation deduction—an independent tax item. Because of the flow-through nature of tax partnerships, the partnership must allocate independent tax items to partners, even though the tax items do not correspond to economic items. The allocation of independent tax items may not be intuitive, but the allocation rules must address the allocation of such items.

If the allocation rules do not prevent the dissociation of economic items and corresponding tax items and adequately address the allocation of independent tax items, partners will be able to use partnership tax items to reduce their overall tax liability and commit other abuses.[27] This Article claims that the current partnership tax allocations rules fail to adequately prevent partners from dissociating tax items from corresponding economic items, and that the rules governing the allocation of independent tax items are deficient. A more detailed example illustrates why partners might try to dissociate corresponding tax items and demonstrates how partners can use the allocation rules abusively.

### *A. Economic and Tax Items of a Typical Tax Partnership*

The following fact pattern is fairly typical, and it helps illustrate concepts discussed throughout this Article. Sam and Claire form Samaire Partnership on January 1, Year 1. Sam contributes $800,000, and Claire contributes $200,000 to the partnership. The partnership immediately uses the money to purchase an office building, which it

25. *See* Lucas v. Earl, 281 U.S. 111, 114–15 (1930) (providing that a taxpayer may not assign the obligation report income from services to another person).

26. *See* Helvering v. Horst, 311 U.S. 112, 114, 119–20 (1940) (requiring the owner of property to report income derived from the property).

27. *See infra* Part II.B (illustrating the potential for such abuse).

rents out. The annual tax depreciation on the depreciable portion of the office building is $20,000. Table 3 illustrates the partnership's economic performance over the first three years of the partnership's existence.[28] The partnership's accumulated profit equals its cash receipts minus its cash expenditures. The value of the property reflects the changes in the property's market value over the years. The residual value reflects the amount that would be available for distribution at the end of each year, assuming the partnership makes no distributions in prior years.

Table 3
Performance of Hypothetical Partnership

| Year | Accumulated Profit | Property Value | Residual Value |
|---|---|---|---|
| **Formation** | | $1,000,000 | $1,000,000 |
| 1 | $100,000 | $930,000 | $1,030,000 |
| 2 | $206,000 | $999,000 | $1,205,000 |
| 3 | $310,000 | $1,088,000 | $1,397,000 |

The economic performance generates economic and tax items. The partnership has two economic items: (1) operating profit, which is the difference between rent receipts and rental expenses; and (2) changes in the value of its property. In Year 1, the partnership has $100,000 of operating profit and $70,000 of lost value. The tax items of Samaire Partnership include tax income, depreciation deductions, and the gain or loss the partnership would recognize upon the sale of the property.[29] The partnership must allocate the $100,000 of tax income and the

28. The table randomly assigns a value to the change in profit. It uses a lognormal distribution to determine the property's appreciation, based upon a separately assigned random change in value. The performance is something that is very possible in an actual partnership.

| Performance of Hypothetical Business | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Year** | **Profit** | **% Profit Increase** | **Accum'd Profits** | **Property Apprec.** | **% Value Increase** | **Property Value** | **Residual Value** | **Book Value** |
| 1 | $100,000 | | $100,000 | ($69,529) | (7.21%) | $1,000,000 | $1,030,471 | $1,100,000 |
| 2 | $106,304 | 6.30% | $206,304 | $68,930 | 7.15% | $930,471 | $1,205,705 | $1,206,304 |
| 3 | $103,575 | (2.73%) | $309,880 | $88,170 | 8.45% | $999,401 | $1,397,451 | $1,309,880 |

29. Tax items generally include all income, gain, loss, deductions, and credits. *See* I.R.C. § 702(b) (2006). This Article uses the nontechnical term "tax income" to refer to gross income minus all tax deductions, other than the depreciation deductions.

$20,000 of depreciation deduction to the partners in Year 1. The partners will report those items on their individual tax returns based upon the tax-item allocation rules.[30] Table 4 lists the economic items and tax items for each of Samaire's first three years.

Table 4
Economic and Tax Items

| Year | Economic Items | Tax Items |
|---|---|---|
| 1 | $100,000 Profit<br>$70,000 Lost Value | $100,000 Income<br>$50,000 Unrealized Loss[31]<br>$20,000 Depreciation |
| 2 | $106,000 Profit<br>$69,000 Appreciation | $106,000 Income<br>$39,000 Unrealized Gain[32]<br>$20,000 Depreciation |
| 3 | $104,000 Profit<br>$88,000 Appreciation | $104,000 Income<br>$148,000 Unrealized Gain[33]<br>$20,000 Depreciation |

The allocation of economic items generally establishes the partners' rights to the partnership's residual value. If the partnership were to liquidate at the end of Year 1, Sam and Claire would each have a claim to a portion of the partnership's $1,030,000 residual value.[34] Their claims to the residual value generally would depend upon their contributions and the allocations of the partnership's economic items in Year 1.[35] To illustrate, assume the partnership allocates the $100,000 profit and the $70,000 lost value equally to each partner, and then liquidates at the end of Year 1. Each partner's net share of the economic items would be $15,000 ($50,000 of profit minus $35,000 of lost value). Sam's share of the residual value would therefore equal $815,000, and

30. *See* I.R.C. §§ 701, 702(a) (2006).

31. The unrealized loss equals the excess of the property's adjusted tax basis at the end of Year 1 ($980,000) over the property's value ($930,000). The adjusted tax basis is the cost of the property minus the depreciation deduction. *See* I.R.C. §§ 1011(a), 1012(a), 1016(a)(2) (2006).

32. The unrealized gain equals the excess of the property's value ($999,000) over the property's adjusted tax basis ($960,000).

33. The unrealized gain equals the excess of the property's value ($1,088,000) over its adjusted tax basis ($940,000).

34. *See infra* notes 67–70 and accompanying text.

35. *See* Part II.A. Some partnerships determine the partners' claims to residual value using a distribution formula similar to those common in corporations. *See* Bradley T. Borden, *Residual-Risk Model for Classifying Business Arrangements*, 37 FLA. ST. L. REV. 245, 276–78 (2010).

Claire's would equal $215,000.[36]

Contrast the partnership's economic items with its tax items. Samaire Partnership's tax income is the net of gross rental income minus rent activity deductions.[37] Gross rental income and rent deductions correspond respectively to the economic items of rent receipts and rent expenses. Thus, they are corresponding tax items.

Tax law allows a depreciation deduction but that deduction does not necessarily correspond to the economic performance of a depreciable asset.[38] For example, Samaire Partnership has a $20,000 tax depreciation deduction in each of its first three years of operation.[39] Those deductions do not correspond with changes in the property's value.[40] They also do not correspond to changes in the partnership's profit.[41] Thus, they are independent tax items.

Gain or loss is also a tax item. It represents the difference between the property's fair market value and its adjusted basis at the time of a taxable disposition of the property.[42] The property's adjusted basis reflects depreciation deductions the partnership can take.[43] The difference between the tax gain or loss and the property's change in value is the cumulative depreciation deductions. Thus, gain or loss is a function of both a corresponding tax item (changes in the property's value) and an independent tax item (depreciation deduction). It is therefore a hybrid tax item.

### *B. Economic Significance of Tax-Item Allocations*

In the absence of tax allocation rules, partners would have significant leeway to use tax-item allocations to their personal advantage, at the expense of the tax system. Specifically, without effective rules, partners could dissociate tax items from corresponding economic items and freely allocate independent tax items. Examples illustrate the opportunities for abuse in a world with no tax-item allocation rules.

The potential economic benefit tax-item allocations provide may attract attention from Sam and Claire. They must allocate the $100,000

36. Sam's $815,000 equals his $800,000 contribution plus $15,000 of net economic items, and Claire's $215,000 equals her $200,000 contribution plus $15,000 of net economic items.

37. *See* I.R.C. §§ 61(a)(5), 162(a)(1) (2006).

38. *See supra* note 24 and accompanying text.

39. *See supra* p. 1087, Table 4.

40. In Year 1 the property's value decreases by $70,000, and it increases in value by $70,000 and $90,000 in Year 2 and Year 3, respectively. *See id.*

41. Profit fluctuates from $100,000 in Year 1, to $106,000 in Year 2, and to $104,000 in Year 3.

42. *See* I.R.C. § 1001(a) (2006).

43. *See* I.R.C. §§ 1011(a), 1016(a)(2) (2006).

of tax income and the $20,000 tax depreciation.[44] Assume the partnership allocates the tax items equally to the partners. Sam will report $50,000 of partnership tax income and $10,000 of partnership depreciation deduction or a taxable income of $40,000. One economic aspect of tax-item allocations is that they can affect the partners' respective tax liabilities.

Recall that the partnership allocated $15,000 of net economic items to Sam. That allocation provides him a before-tax economic benefit of $15,000. His after-tax economic benefit depends upon the tax he will owe on the allocated tax items. Assuming Sam is taxed at 20%, he would owe $8,000 on the $40,000 of taxable income allocated to him.[45] Thus, the after-tax economic benefit of the partnership tax-item allocation is $7,000 ($15,000 of net economic items minus $8,000 of tax).

If tax law did not restrict the manner in which partners allocate tax items, perhaps Sam would agree to report $60,000 of tax income instead of $50,000. That would give Sam a net tax income from the partnership of $50,000 instead of $40,000.[46] Thus, he would owe $10,000 of taxes ($50,000 times his 20% tax rate) instead of $8,000 on his share of partnership tax items. Because the economic-item allocations do not change, his after-tax economic benefit would be $5,000 instead of $7,000.[47] This example illustrates that tax-item allocations may affect partners' economic situations. It is also an example of partners dissociating a tax item from a corresponding economic item, i.e., the partners allocated tax income in a different manner than they allocated operating profit.

Partners may seek to dissociate tax and economic items for two reasons. First, the dissociation may reduce the partners' aggregate tax liability without altering other legal and economic aspects of the partnership. For example, assume Claire pays tax at 30%. If Sam reports $10,000 more of the partnership tax income, Claire would report $10,000 less. As a consequence, Claire would pay $3,000 less in taxes.[48] The amount of tax Sam paid would increase by only $2,000, so

44. Tax law does not permit the allocation of unrealized loss, so the partners will not allocate that item in Year 1. *See* I.R.C. § 1001(a) (2006) (requiring a sale or other disposition to trigger gain or loss recognition).

45. *See* I.R.C. § 1(a)–(d) (2006) (imposing a tax on individuals equal to their taxable income multiplied by a tax rate).

46. The new net tax income derives from the allocation of $60,000 tax income and $10,000 of depreciation deduction the partners allocate to Sam.

47. Sam's after-tax economic benefit is the $15,000 of net partnership economic items allocated to him, minus the $10,000 tax he owes on net partnership tax items allocated to him.

48. Claire's reduction in tax owed would equal her 30% tax rate multiplied by the $10,000

changing the allocation decreases Sam and Claire's aggregate tax liability by $1,000.

Second, by agreeing to report more tax income Sam in effect agrees to satisfy a $3,000 liability to the government on Claire's behalf.[49] That $3,000 liability relief would ordinarily be gross income to Claire,[50] but Sam probably would not make the payment unless he received property or services in return from Claire.[51] Claire would therefore probably transfer something to Sam in exchange for the allocation, and the tax-item allocation would become consideration for that transfer.[52] Tax law does not appear to require Sam and Claire to include in their gross incomes the benefits they receive from the tax-item allocation.[53] Thus, absent tax-item allocation rules that prohibit tax-item dissociation, partners could keep from the government the tax owed on the tax-item transaction.

Allocations of independent tax items also affect after-tax economic consequences and provide similar opportunities for abuse. If an individual takes a deduction for depreciation, the amount reduces the individual's taxable income.[54] That reduction provides an economic benefit to the individual equal to the amount by which the deduction reduces the individual's tax liability. The reduction generally equals the amount of the deduction multiplied by the individual's tax rate. Thus, a $20,000 depreciation deduction for an individual with a 20% tax rate will provide a $4,000 economic benefit to the individual.

As an independent tax item, the depreciation deduction only affects the individual's tax liability. Consequently, the economic benefit of depreciation is the amount of tax it owes the person claiming the deduction. Nonetheless, when an individual disposes of depreciable property, tax law requires the individual to recapture that depreciation deduction as ordinary income or a § 1250 gain.[55] Depreciation recapture therefore affects the character of gain the individual

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decrease in the amount of partnership tax income she reports.

49. The allocation that reduces Claire's tax liability is economically equivalent to Sam paying Claire $3,000 and Claire using those proceeds to pay her tax liability. *See* Old Colony Trust Co. v. Comm'r, 279 U.S. 716, 729 (1929) (recognizing that the payment of tax on behalf of another is equivalent to receipt of cash by the person for whom the tax is paid).

50. *See id.* at 731.

51. Even if Claire owed no tax on the extra income allocated to her, she might ask for something in return for helping Sam improve his economic situation.

52. *See* Bradley T. Borden, *Partnership Tax Allocations and the Internalization of Tax-Item Allocations*, 59 S.C. L. REV. 297, 338–40 (2008) (describing a partnership tax-item transaction).

53. *See id.*

54. *See* I.R.C. § 63(a) (2006) (defining taxable income as gross income minus deductions); *see also* I.R.C. § 167(a) (2006) (allowing a deduction for depreciation).

55. *See* I.R.C. §§ 1(h)(1)(D), 1245(a) (2006).

recognizes on the disposition of the property and the tax rate applicable to that gain.[56] The upshot of this system is that an individual may take a depreciation deduction, but also must recapture those deductions at ordinary rates on the disposition of the property. The lack of adequate tax-item allocation rules would allow partners to allocate depreciation and recapture differently.

Consider Samaire Partnership's depreciation deduction. Assume that over the first three years, the partners allocate the partnership's depreciation deduction equally to the partners (a total of $30,000 to each). Sam's (who has a 20% tax rate) tax benefit from the allocations would be $6,000 and Claire's (who has a 30% tax rate) would be $9,000.[57] The depreciation would therefore reduce the partners' aggregate tax liability by $15,000.

If tax law did not restrict the allocation of independent tax items, Sam and Claire could use them to reduce their aggregate tax liability and to facilitate tax-item transactions. For example, Sam could agree to allocate all of the depreciation deduction to Claire. The allocation of an additional $30,000 of depreciation deduction to Claire would provide her with an additional $9,000 tax benefit, and Sam would lose the tax benefit of the deduction. Because Claire is subject to a high tax rate, the depreciation deduction would reduce the partners' aggregate tax liability by $18,000, instead of the $15,000 reduction that resulted from an equal allocation.[58]

The additional tax benefit would be similar to Claire's receiving $9,000 of cash from Sam.[59] Assume that Claire transfers a $9,000 piece of property to Sam, and Sam could pay Claire $9,000 for the property. That transaction would have tax consequences to Claire.[60] Instead of paying $9,000 to Claire, Sam could simply agree to allocate all the depreciation deduction to Claire. If the tax allocation rules do not prohibit tax-item transactions, Sam and Claire could avoid taxes and deplete tax revenue.

If the partnership later sold the property, absent adequate allocation

56. *See* I.R.C. § 1(h) (2006) (subjecting ordinary income, adjusted net capital gain, and unrecaptured § 1250 gain to different tax rates).

57. Sam's economic benefit will equal his 20% tax rate multiplied by his $30,000 share of the $60,000 of depreciation deduction. Claire's economic benefit will equal her 30% tax rate multiplied by her $30,000 share of the depreciation deduction.

58. With all $60,000 of the depreciation allocated to Claire, the benefit would equal her 30% tax rate multiplied by the $60,000 of depreciation deduction.

59. This is the same result that obtains if the partners allocate corresponding tax items as consideration. *See supra* text accompanying notes 49–52.

60. *See* I.R.C. § 61(a)(3) (2006) (including gains from sale in gross income); *see also* I.R.C. § 1001(a) (2006) (defining gain and loss from the sale or disposition of property).

rules, the partners could allocate the gain, including any depreciation recapture, in any manner they choose. They could allocate the depreciation recapture to Sam, who is subject to a lower tax rate. They could allocate a significant portion of the remaining gain, which could be subject to favorable capital gain rates, to Claire, who is subject to a higher tax rate. Thus, without any rules prohibiting abuse, the parties could allocate corresponding tax items, independent tax items, and hybrid tax items to reduce their aggregate tax liability or enter into tax-item transactions.

To stop abusive tax-item allocations, the allocation rules must prevent partners from dissociating tax items from corresponding economic items. The rules also must govern the allocation of independent tax items and appropriately address hybrid tax items. To recognize that the current allocation rules fail all respects, one must understand how state law and tax law affect partnership allocations of economic items and tax items.

## II. CORRELATIVE TWO: STATE LAW AND TAX LAW

Both state law and tax law adopt partnership allocation rules. State law governs the allocation of economic items; tax law governs the allocation of tax items. The two bodies of law often overlap, however, and each may affect the allocation of both tax and economic items. Despite the importance and confluence of the respective bodies of law, they do not complement each other well.

### *A. Allocating Economic Items Under State Law*

State law allows partners to agree upon the manner in which they will allocate the entity's economic items.[61] The variations of partner-directed allocations of economic items are unlimited. Generally, partners will specifically agree to allocate economic items in a certain manner. For example, Sam and Claire might allocate economic items to help reduce agency costs.[62] To help motivate Claire to provide excellent management services, Sam might agree to allocate 55% of the operating profit to Claire. Sam and Claire may also believe that superior

61. *See* UNIF. P'SHIP ACT § 103(a) (amended 1997), 6 U.L.A. 73 (2001); UNIF. LTD. P'SHIP ACT § 110(a) (2001), 6A U.L.A. 378 (2008); UNIF. LTD. LIAB. CO. ACT § 110(a) (2006), 6B U.L.A. 442 (2008).

62. *See* Borden, *supra* note 14, at 752–61 (illustrating possible uses of partnership economic-item allocations to reduce agency costs); Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 786 (1972) (observing that members of partnerships may use profit-sharing to self-police and help reduce shirking).

maintenance will affect the long-term value of the property. Claire might therefore agree to allocate 65% of the property's change in value to Sam. Those allocations should motivate the parties to provide their respective services with greater diligence. Thus, the allocation of partnership economic items fills an important role in many partnerships.

Despite the important role partner-directed items may play, some partners neglect to use them. The reasons for neglecting to include such provisions in a partnership agreement are undoubtedly numerous, but some are recurring.[63] Perhaps the partners lack the sophistication required to include such provisions,[64] or they may worry about the perception of suggesting such an agreement.[65] Some partners may not realize they are forming a partnership when they enter into an agreement and consequently do not consider economic-item allocations.[66] Or some partners who realize they are forming a partnership may believe the state default allocation rules create the economic arrangement they seek. For any such reason, partnership agreements may not include economic-item allocations. In the event partners do not allocate economic items, state default rules allocate them.

The state default allocation rules vary depending on the type of legal entity the partners use. The default allocation rules determine the partners' distribution rights and obligations, so they also determine the partners' rights to the partnerships' residual value. Thus, the default rules are important. Although state default allocation rules may vary from state to state, this Article uses the rules in the Uniform Acts, which many states have adopted, to illustrate possible default allocations. The discussion begins with rules governing the general partnership, and then considers the rules governing limited partnerships and limited liability companies, respectively.

*General Partnerships.* In the absence of allocation provisions in a general partnership agreement, state law deems general partners to have

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63. *See* Dennis S. Karjala, *Planning Problems in the Limited Liability Company*, 73 WASH. U. L.Q. 455, 477 (1995) (observing that many small businesses will not incur the cost to negotiate and draft a carefully worded agreement).

64. *See* Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1805 (2001) (suggesting that failure to contract in close business arrangements may be a symptom of the parties' "ignorance, lack of imagination, or poor legal advice").

65. *See* Manuel A. Utset, *A Theory of Self-Control Problems and Incomplete Contracting: The Case of Shareholder Contracts*, 2003 UTAH L. REV. 1329, 1348 (stating that members of close business arrangements may not formalize agreements because they choose to rely upon mutual trustworthiness and fear undermining fragile trust that exists at the beginning of a venture).

66. *See* ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP § 201(a) (2007 & Supp. 1 2010).

accounts. State law credits (i.e., increases) the partners' accounts by the amount a partner contributes and the partners' shares of partnership profits.[67] It charges (i.e., decreases) partner accounts for distributions and the partners' shares of partnership losses.[68] State default rules also provide that partnerships divide partnership profits and losses equally among the partners.[69] Upon liquidation, the partnership distributes assets to the partners in accordance with their accounts.[70]

State law does not precisely define profits and losses. The lack of a clear definition can be a source of confusion.[71] For the sake of analysis, this discussion assumes that for state law purposes profits and losses are the difference between revenue and expenditures, including any changes in the property's value. This Article refers to this definition as state law profit. Thus, the analysis assumes that state law profit is broader than operating profit.

If the partners allocate economic items equally, at the end of Year 1, Sam's account balance would be $815,000 and Claire's would be $215,000.[72] Notice that the sum of the partners' accounts ($1,030,000) equals the partnership's residual value at the end of Year 1.[73] The balance of the partners' accounts thus represents their right to the partnership's residual value.

*Limited Partnerships.* State default rules do not specifically allocate the profits and losses of limited partnerships.[74] Instead, they assume that "[n]early all limited partnerships will choose to allocate profits and losses in order to comply with applicable tax, accounting and other regulatory requirements. Those requirements, rather than [the limited partnership act], are the proper source of guidance for that profit and loss allocation."[75] That assumption is misguided because tax, accounting, and other regulatory requirements should not dictate the allocation of economic items.

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67. *See* UNIF. P'SHIP ACT § 401(a) (amended 1997), 6 U.L.A. 133 (2001).

68. *See id.*

69. *See* UNIF. P'SHIP ACT § 401(b) (amended 1997), 6 U.L.A. 133 (2001).

70. *See* UNIF. P'SHIP ACT § 807(b) (amended 1997), 6 U.L.A. 206 (2001) (requiring the partnership to distribute the excess of credits over charges in partners' accounts to the partners and requiring partners to contribute the excess of charges over credits in the accounts).

71. *See* BROMBERG & RIBSTEIN, *supra* note 66, § 2.07(b)(4); *infra* text accompanying notes 144–148 (discussing possible different definitions of "profit").

72. *See supra* note 36 and accompanying text (illustrating the manner in which the partnership would allocate economic items equally).

73. *See supra* p. 1086, Table 3 (presenting the partnership's residual value).

74. *See* UNIF. LTD. P'SHIP ACT § 503, cmt. (2001), 6A U.L.A. 444 (2008).

75. *Id.*

First, tax concerns should not drive the allocation of economic items. Tax should reflect the allocation of economic items. Second, tax provisions dictate the allocation of economic items only if partners include tax-item allocation provisions in the partnership agreement. Third, accounting principles do not determine partners' legal rights to partnership property; they direct information reporting about an arrangement's economic performance.[76] Fourth, some limited partnerships may fail to include tax and accounting allocations. If the partnership agreement is silent, state law should allocate the economic items. When it comes to the allocation of economic items, the law should not defer to tax and accounting allocations.

Because state law does not expressly direct the allocation of economic items in limited partnerships, default allocation rules must derive from the state law distribution rules. State law provides that limited partnerships shall make distributions based upon the value of contributed property.[77] Mandating distributions based on contributions appears to require limited partnerships to make distributions in proportion to the value contributed by the partners. A limited partnership may make liquidating distributions in proportion to the value of contributed property only if it allocates the economic items in proportion to the contributions.

An example illustrates how partners can derive economic-item allocation rules from state limited partnership distribution rules. If Samaire Partnership were to make a liquidating distribution at the end of Year 1, state law would require it to distribute the assets based upon the partners' contributions. Sam contributed 80% of the total partner contributions and Claire contributed the other 20%. Thus, the partnership would distribute 80% of the partnership assets to Sam and 20% to Claire upon liquation. At the end of Year 1, Samaire Partnership's residual value is $1,030,000. If the partnership were to liquidate at the end of Year 1, Sam's 80% distribution would be $824,000. That is $24,000 more than he contributed, so in effect, the partnership must allocate $24,000 to Sam. The $24,000 is 80% of the partnership's $30,000 state law profit.[78] Claire's 20% distribution ($206,000) would similarly require an effective allocation of 20% of the

76. *See* FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 1: OBJECTIVES OF FINANCIAL REPORTING BY BUSINESS ENTERPRISES ¶ 9 (1978) ("Financial reporting is not an end in itself but is intended to provide information that is useful in making business and economic decisions—for making reasoned choices among alternative uses of scarce resources in the conduct of business and economic activities.").

77. *See* UNIF. LTD. P'SHIP ACT § 503 (2001), 6A U.L.A. 444 (2008).

78. The partnership had $100,000 of profits in Year 1 from operations, and the property decreased in value $70,000. Thus, its state law profit was $30,000.

partnership's state law profit in Year 1. To ensure future distributions will be in proportion to contributions, the partnership would make the same proportionate allocations of its economic items in each of the following years.[79]

*Limited Liability Companies.* As with limited partnerships, state law provides default rules for making distributions to the members of limited liability companies, but it does not provide default allocation rules.[80] The rules provide that limited liability companies generally make pro rata non-liquidating distributions.[81] Upon liquidation, limited liability companies make distributions first to return contributions,[82] and then distribute any remaining property to the members in equal shares.[83] These rules effectively allocate profit equally to the members of limited liability companies.[84]

An example illustrates the allocations. Assume Samaire Partnership is a limited liability company and distributes $120,000 to the members at the end of Year 1. The distribution would appear to consist of $30,000 of state law profits and $90,000 (the difference between the $120,000 distribution and $30,000 of state law profit) of contributed property. Each partner's distribution would consist in part of state law profit and in part of partnership capital. Thus, the partnership would distribute $15,000 of profits (half of the partnership's $30,000 state law profits) to each partner and would return to each partner $45,000 of their original contributions. After the distributions, Sam's remaining account would be $755,000 and Claire's would be $155,000.

Assume the limited liability company liquidates at the end of Year 2. First, the partnership would distribute $755,000 to Sam and $155,000 to Claire to return their undistributed contributions.[85] Second, the limited liability company would distribute the remaining $225,000 equally to Sam and Claire. Sam's total liquidating distribution at the end of Year 2

79. This assumes no other contributions or distributions in a different proportion, which would alter the partners' distribution rights.

80. *See* UNIF. LTD. LIAB. CO. ACT § 404, cmt. (2006), 6B U.L.A. 480–81 (2008).

81. *See id.* § 404(a).

82. *See* UNIF. LTD. LIAB. CO. ACT § 708(b)(1) (2006), 6B U.L.A. 514 (2008).

83. *See id.* § 708(b)(2).

84. To simplify the analysis, this Article does not consider the consequences of an unprofitable limited liability company. If a limited liability company liquidated following years of only losses (during which it made no distributions), it would allocate those losses in proportion to contributions.

85. Recall that Sam had contributed $800,000 and the partnership distributed $45,000 to him at the end of Year 1 as a return of his contribution. Claire had contributed $200,000 and the partnership distributed $45,000 to her at the end of Year 1 as a return of her contribution. Thus, Sam's and Claire's undistributed contributions at the end of Year 1 were $755,000 and $155,000, respectively.

would equal $867,500,[86] and over the two-year period, Samaire's total distributions to Sam would equal $902,500.[87] As a result of the state default rules, Sam would receive his original $800,000 contribution plus one-half of the partnership's $205,000 of state law profits.[88] Claire would similarly receive her contribution plus one-half of the partnership's state law profits. Because the rules effectively divide the profits equally among the partners, their rights to the partnership's residual value would appear to be the same as their rights under the general-partnership default rules.[89]

*Tax Partnerships with Loss.* The discussion to this point has focused on partnerships with positive residual values. In each of the examples above, the partners had rights to distributions. Some tax partnerships, however, may not have positive residual values, or the allocation of losses may cause some partners to have negative accounts. In such situations, partners may incur obligations to make contributions to the partnership. The distinction between general partnerships, limited partnerships, and limited liability companies is critical when considering partners' obligations to make contributions to the partnership.

The state default rules impose joint and several liability on all members of a general partnership.[90] Furthermore, if partnership losses cause the partnership to have residual obligations, the partners will have to make contributions to the partnership to satisfy those obligations.[91] Similarly, state default rules subject general partners of limited partnerships to the obligations of a limited partnership.[92] Thus, a general partner may have to make contributions to a limited partnership to satisfy the partnership's obligations.

By contrast, state default rules generally protect limited partners and members of limited liability companies from the obligation to make

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86. That amount equals the $755,000 return of his remaining contribution plus his $112,500 share of the $225,000 remaining after the distribution of contributed property.

87. Sam's Year 1 distribution was $60,000 and his Year 2 distribution was $867,500, so his total distribution was $902,500.

88. Year 1 profits were $100,000 and Year 2 Profits were $106,000, *see supra* p. 1087, Table 4, and the property was worth $1,000 less at the end of Year 2 than it was when the partnership purchased it on the date of formation, *see supra* p. 1086, Table 3. Thus, total state law profits for the first two years would be $205,000.

89. *See supra* text accompanying notes 67–73. If the limited liability company sustained losses sufficient to deplete both Sam's and Claire's contributions, the losses allocated after Claire's contribution had been depleted would be allocated solely to Sam. Thus, if the arrangement has significant losses, the economic-item allocations probably would not be equal.

90. *See* UNIF. P'SHIP ACT § 306(a) (amended 1997), 6B U.L.A. 117 (2001).

91. *See* UNIF. P'SHIP ACT § 807(b) (amended 1997), 6 U.L.A. 206 (2001).

92. *See* UNIF. LTD. P'SHIP ACT § 404 (2001), 6A U.L.A. 57 (2008).

additional contributions.[93] Nonetheless, limited partners and members of limited liability companies can contract away the liability protection state law affords them.[94] In fact, as the next section illustrates, some limited partners and members of limited liability companies may unwittingly contract away such protection through tax-item allocations. That possibility derives from the structure of the partnership tax allocation rules.

### *B. Allocating Tax Items Under Tax Law*

The tax-item allocation rules generally grant partners significant discretion in allocating the partnership's tax items.[95] Nonetheless, the Internal Revenue Service (IRS) may challenge the validity of partner-directed tax-item allocations. To avoid such challenges, taxpayers may seek to come within tax law's economic-effect safe harbor. Generally, the IRS will not challenge allocations made pursuant to the economic-effect safe harbor,[96] but to come within the safe harbor, partner-directed tax-item allocations must have "economic effect."[97] "Economic effect" is a term of art, providing that the benefit or burden of an economic item must follow the allocation of the corresponding tax item.[98] Thus, allocations made pursuant to the economic-effect safe harbor are tax-centric. The following discussion demonstrates that these tax-centric allocations can be problematic.

To come within the economic-effect safe harbor, the partnership must satisfy three requirements: (1) maintain capital accounts according to rules in the regulations; (2) liquidate in accordance with positive capital account balances; and (3) require partners to restore deficit capital account balances on liquidation.[99] These three requirements of the economic-effect safe harbor supplant the state default rules, dictate the allocation of economic items, and determine the partners' distribution

93. *See* UNIF. LTD. P'SHIP ACT § 303 (2001); UNIF. LTD. LIAB. CO. ACT § 304 (2006), 6B U.L.A. 475 (2008).

94. *See* UNIF. P'SHIP ACT § 110(a) (amended 1997), 6B U.L.A. 117 (2001); UNIF. LTD. LIAB. CO. ACT § 110(a) (2006), 6B U.L.A. 442 (2008).

95. *See* I.R.C. § 704(a) (2004).

96. *See* Treas. Reg. § 1.704-1(b)(1)(i) (as amended in 2008).

97. *See* I.R.C. § 704(b) (2006); Treas. Reg. § 1.704-1(b)(2)(ii)(*a*) (as amended in 2008).

98. *See id.* § 1.704-1(b)(2)(ii)(*a*) (as amended in 2008).

99. *See id.* § 1.704-1(b)(2)(ii)(*b*) (requiring the partnership agreement to include provisions that satisfy those requirements). An allocation can also have economic effect, if the partnership satisfies the first two requirements of the safe harbor, has a limited deficit restoration obligation, and includes a qualified income offset (this is the alternative test for economic effect). *See id.* § 1.704-1(b)(2)(ii)(*d*). Finally, an allocation has economic effect if the end result of the allocation is the same as the result obtained under the safe harbor or alternative test. *See id.* § 1.704-1(b)(2)(ii)(*i*).

rights and contribution obligations. Thus, provisions that the partners include in the partnership agreement for tax purposes affect the partners' rights to the partnership's residual value.

An example illustrates the legal significance of coming within the economic-effect safe harbor and demonstrates how tax-item allocation can create fictitious economic items. Assume Sam and Claire focus solely on allocating tax items. They agree to allocate all tax items, except the depreciation deduction, equally. They agree to allocate the depreciation deduction 60% to Sam and 40% to Claire. They structure their partnership agreement to come within the economic-effect safe harbor.

The economic-effect safe harbor requires the partners to increase their capital accounts by the amount of money contributed to the partnership.[100] Consequently, Sam's beginning capital account balance will be $800,000 and Claire's will be $200,000. Over the first three years, Samaire Partnership allocates the $310,000 of tax income equally to Sam and Claire. It allocates the $60,000 of depreciation deduction as follows: $36,000 (60%) to Sam and $24,000 (40%) to Claire. The capital account maintenance rules require the partnership to increase the capital accounts by the amount of tax income allocated to the partners.[101] The partnership must decrease the capital accounts by the amount of tax loss or deduction allocated to the partners.[102] The partnership will therefore increase Sam's and Claire's capital accounts each by $155,000—their shares of partnership tax income. The partnership will decrease Sam's capital account by $36,000 and Claire's by $24,000 for the allocated depreciation deduction. After those adjustments, Sam's capital account balance will be $919,000 and Claire's will be $331,000.

Recognize that although the depreciation deduction is an independent tax item, the capital account maintenance rules require the partnership to adjust the partners' capital accounts to reflect the tax-item allocation.[103] To consider the effect of the rules, assume Samaire Partnership liquidates at the end of Year 3 by selling its property and distributing all of its cash. At the end of Year 3, Samaire Partnership would sell the property for its $1,088,000 fair market value and recognize $148,000 of taxable gain.[104] Pursuant to the partnership agreement, Samaire

100. *See id.* § 1.704-1(b)(2)(iv)(b)(*1*)(*2*).

101. *See id.* § 1.704-1(b)(2)(iv)(*b*)(*3*).

102. *See id.* § 1.704-1(b)(2)(iv)(*b*)(*7*).

103. *See id.* § 1.704-1(b)(5), ex. (1) (reducing the partners' capital accounts by the amount of depreciation allocated to the partners).

104. At the end of Year 3, the property's adjusted basis would be the original $1,000,000 basis

Partnership would allocate that gain to Sam and Claire and adjust their capital accounts accordingly.[105] Thus, Sam's capital account would become $993,000 and Claire's would become $405,000. The partnership would distribute the $1,398,000 of cash to the partners in those respective amounts, i.e., in accordance with their positive capital account balances.

The distributions the partners would receive under the economic-effect safe harbor vary from the amounts the partnership would distribute to the partners if the state default rules applied. If the state default rules applied, the partnership would allocate profit and losses equally to the partners.[106] Over the three years, the partnership has $310,000 of operating profit, and the property appreciates $88,000.[107] The partnership would therefore allocate $199,000 (one half of $398,000) of the economic items to each of Sam and Claire. After those allocations, Sam's account would be $999,000 and Claire's would be $399,000. The allocation of the independent tax item pursuant to the economic-effect safe harbor therefore shifted $6,000 of economic items from Sam to Claire over three years.

If the partners are not aware that tax-item allocations affect their legal rights and obligations, they may inadvertently alter their distribution rights by making tax-item allocations. The partners may be even more surprised if a tax-item allocation causes a partner to have a deficit capital account balance, which obligates the partner to contribute additional capital to the partnership. Such obligation could arise in particular if the partners simply adopt boilerplate tax language to satisfy the economic-effect safe harbor.

The legal form of the tax partnership will be irrelevant in such situations. The language in the partnership agreement that adopts the economic-effect safe harbor will supplant state law, so limited partners and members of limited liability companies could become obligated to make additional capital contributions. Such obligations may shock partners who thought the legal form of the arrangement shielded them from obligations to make additional contributions. That potential to trap the misinformed is a serious deficiency of the current rules.

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reduced by the $60,000 of depreciation or $940,000. *See* I.R.C. § 1011(a) (2010). The difference between the $1,088,000 received on the sale and the $940,000 adjusted basis produces the $148,000 of gain recognized. *See* I.R.C. § 1001(a), (c) (2010).

105. Sam and Claire could have agreed to allocate the depreciation recapture in the same proportion in which they allocated the depreciation. *See* Treas. Reg. § 1.704-1(b) (as amended in 2008). If they had done so, the allocation would have not altered the economic interests they would have had under state law.

106. *See supra* note 69 and accompanying text.

107. *See supra* p. 1086, Table 3.

The adoption of the economic-effect safe harbor may, however, have unintended consequences for partners who understand that partner-directed tax-item allocations can affect the allocation of economic items. Those partners may inadvertently overlook some potentialities. The inability to foresee all contingencies prohibits even the most sophisticated partners from predicting the effect tax-item allocations may have when made pursuant to the economic-effect safe harbor.

Tax-item allocations made pursuant to the economic-effect safe harbor may cause problems that partners and tax advisors prefer to avoid. Others may adopt the economic-effect safe harbor because it provides certainty that the IRS generally will not challenge the allocations. In either case, the partners' interests in the partnership will be important. For the group that avoids the economic-effect safe harbor, tax-item allocations generally must be in accordance with partners' interests in the partnership.[108] For the group that adopts the economic-effect safe harbor, the allocations must be substantial.[109] The test for substantiality uses partners' interests in a partnership.

The test for substantiality is designed to prevent tax-item allocations that reduce the overall tax liability of the partners or improve the after-tax economic consequences of one partner without diminishing after-tax situations of other partners.[110] The test requires a comparison of the after-tax economic results of safe-harbor allocations to the after-tax economic results of allocations made in accordance with the partners' interests in the partnership.[111] If an allocation lacks substantiality, tax law reallocates tax items in accordance with the partners' interests in the partnership.[112] This rule suggests that allocations made in accordance with partners' interests in the partnership should be different from allocations made pursuant to the economic-effect safe harbor.

Using partners' interests in a partnership as a baseline for the substantiality test is problematic. An allocation that has economic effects is part of the partnership agreement and establishes the partners'

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108. *See* I.R.C. § 704(b) (2006). This assumes that the partners do not otherwise satisfy the test for economic effect.

109. *See* Treas. Reg. § 1.704-1(b)(2)(iii) (as amended in 2008).

110. *See id.* § 1.704-1(b)(2)(iii)(*a*). For example, an allocation of a depreciation deduction from one partner, who has no taxable income outside the partnership, to the other partner, who has significant taxable income outside the partnership, may benefit one partner but not diminish the economic situation of the other partner. *See id.* § 1.704-1(b)(5), ex. 5. *See also id.* § 1.704-1(b)(2)(iii)(*b*) (prohibiting shifting allocations that reduce the overall tax liability of the partners). *See also* Richard M. Leder, *Tax-Driven Partnership Allocations with Economic Effect: The Overall After-Tax Present Value Test for Substantiality and other Considerations*, 54 TAX LAW. 753 (2000) (critiquing the present-value test for substantiality).

111. *See* Treas. Reg. § 1.704-1(b)(2)(iii) (as amended in 2008).

112. *See id.* § 1.704-1(b)(1)(i).

distribution rights and contribution obligations. The allocations supplant state default rules.[113] If the partners' interests in a partnership were a valid concept, surely it would depend upon the partners' distribution rights and contribution obligations.[114] If so, safe-harbor allocations would be identical to allocations made pursuant to the partners' interests in the partnership. That result would render a comparison futile.[115]

Because that interpretation of the test produces an absurd result, the test for substantiality appears to require the partners to consider allocations that would occur if tax item allocations were not in the partnership agreement.[116] The test for substantiality may require a comparison of the consequences under the state default rules to the consequences that result from partner-directed tax-item allocations. That interpretation of the rule is also problematic. The state default rules do not apply because the partners have supplanted them with the capital account maintenance rules.[117] The default rules therefore represent a partnership that does not exist. Using the state default rules as a point of comparison therefore requires a deviation from reality. Furthermore, as the following discussion demonstrates, partners will have difficulty determining their interests in the partnership regardless of the applicable allocation rules.

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113. *See supra* text accompanying note 99–106.

114. Indeed, the definition of partners' interests in a partnership relies upon the partners' distribution rights and contribution obligations. *See* Treas. Reg. § 1.704-1(b)(3)(i)(d) (as amended in 2008).

115. Despite the effect tax-item allocations have on partners' rights and obligations, the regulations provide an example of a partnership that allocates tax-exempt income to partners in a ratio that differs from the ratio in which it allocates taxable income. *See id.* § 1.704-1(b)(5), ex. 5(i). The example provides that the allocations lack substantiality because the partners expect to be in different tax brackets and the allocations will benefit one partner without hurting the other. *See id.* The example then requires the partners to reallocate the items in accordance with the partners' interests in the partnership, but the example does not appear to consider the legal consequences of the tax-item allocation. This Article therefore rejects the example. In fact, the IRS recognized the problems of relying on the partnership agreement to determine partners' interests in a partnership for purposes of applying the test for substantiality. *See* TIFD III-E Inc. v. United States, 342 F. Supp. 2d 94, 118–19 (D. Conn. 2004), *rev'd*, 459 F.3d 220 (2d Cir. 2006) ("[A]llowing a partner's interest in a particular item of the partnership to be determined by looking at the way the item is allocated by the agreement makes the . . . rule meaningless.").

116. This is the interpretation some commentators appear to accept. *See, e.g.*, Polsky, *supra* note 17.

117. *See supra* note 61 (citing rules that recognize the primacy of tax-partnership agreements).

## III. CORRELATIVE THREE: ECONOMIC INTERESTS AND PARTNERS' INTERESTS

The focus on partners' interests in a partnership implicates the third correlative—the correlation between partners' economic interests and partners' interests in the partnership. "Partners' economic interests" is a general concept; "partners' interests in a partnership" is a unique tax concept. Neither concept is sufficient to govern the allocation of tax items.

### *A. Partners' Economic Interests in a Partnership*

The partners' rights to the residual value of the partnership represent their economic interests in the partnership. Partners' rights to the residual value of the partnership equal their contributions to the partnership adjusted by economic items allocated to them.[118] A quick examination of partners' economic interests in a partnership reveals that it is not a viable metric for allocating tax items, but provides a point of reference for examining partners' interests in a partnership. Using economic interests to allocate tax items is not viable for two reasons.

First, computing the partners' economic interests requires perfect information, such as the fluctuations in the value of the partnership's property. The examples above used perfect information created for the hypothetical, but perfect information generally is unavailable or difficult to obtain. Consequently, tax law often relies upon historical cost. For example, the capital account maintenance rules rely upon historical cost, allowing adjustments to the value of property only when certain events occur.[119] The regulations also use the historical cost to reallocate certain tax items in accordance with the partners' interests in the partnership.[120] The use of historical cost will often affect the determination of the partners' economic interests, so tax law should not rely upon it to allocate tax items.

Recall from the examples above that after the first year of operating as a state default general partnership, Sam and Claire would have received $815,000 and $215,000, respectively, if the partnership had liquidated.[121] Thus, at the end of the first year, Sam's and Claire's economic interests in the partnership would have been 79% and 21%, respectively. That example used the actual value of the partnership

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118. *See supra* Part II.A.

119. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(f) (as amended in 2008).

120. *See id.* § 1.704-1(b)(3)(iii).

121. *See supra* text accompanying notes 72–73.

assets to determine the partners' distribution rights. If the example relied upon historical cost, the result would have been different. At the end of Year 1, the historical cost of the partnership assets would have been $1,100,000.[122] Sam's share of that amount would have been $850,000 or 77% of the total amount.[123] Claire's share would have been $250,000 or 23% of the total amount. The lack of perfect information returns a result that does not reflect the partners' economic interests in the partnership. Allocating tax items based upon historical cost will therefore dissociate tax items from economic items.

The difference that results from using historical cost can be significant. For example, the amount of depreciation deduction allocated to Sam at the end of Year 1 using perfect information would be $15,800.[124] If the partners use the historical cost, the allocation to Sam would be $15,400.[125] The allocation based on historical cost is roughly 2.5% less than the allocation based on market value.[126] If the historical cost and market value diverge over time, the difference would increase. Thus, the lack of perfect information could significantly affect tax-item allocations.

Second, partners' economic interests is a unitary concept reflecting the partners' distribution rights, which may consist of numerous allocated economic items. Recall, for example, that to reduce agency costs Sam and Claire may allocate the operating profits 55% to Sam and 45% to Claire, and they may allocate fluctuations in the property's value 35% to Sam and 65% to Claire.[127] Tax law may apply different rates to the tax items that correspond to those economic items.[128] If tax law allocates all tax items according to unitary economic interests, the tax-item allocations could easily dissociate from the economic-item allocations. For example, based on the historical cost of the partnership's assets, Sam's unitary economic interest could be 77%. If the partnership allocates tax income to him in that percentage, it will

122. To simplify the illustration, this example disregards the depreciation deduction, which tax law would normally take into account in determining the book value of partnership assets. *See* Treas. Reg. § 1.704-3(b)(2), ex. 1(ii) (as amended in 2005), (illustrating the reduction in book value for depreciation to illustrate allocations made with respect to property with built-in gain).

123. Sam's share would be his $800,000 contribution plus his 50% share of the partnership's profit for Year 1. As a percentage of total book value, it would be 77% ($850,000/$1,100,000).

124. The allocation derives from multiplying the $20,000 depreciation deduction by Sam's 79% interest based on actual value.

125. That allocation derives from multiplying the $20,000 depreciation deduction by Sam's 77% interest based on historic cost.

126. The percentage difference is the $400 difference divided by $15,800.

127. *See supra* text accompanying note 62.

128. *See* I.R.C. § 1(h) (2006) (subjecting ordinary income and adjusted net capital gain to different tax rates).

dissociate the tax income allocation from the 55% operating-profit allocation. That dissociation confirms that partners' economic interests are not good metrics for allocating tax items.

### *B. Partners' Interests in a Partnership*

Because partners' economic interests in the partnership are not good for allocating partnership tax items, tax law wisely avoided relying upon them. Instead, tax law adopted "partners' interests in a partnership," a unique tax concept. Unfortunately, the definition of partners' interests in a partnership is woefully lacking.[129] First, the law does not establish whether partners' interests in a partnership is a unitary or item-specific concept. The concept would be unitary if one value dictated the partners' interests in the entire partnership and every economic item. The concept is item-specific if it recognizes a partner's varying interests in the various economic items of the partnership. Second, the definition consists in part of multiple factors which create more questions than they answer. Ultimately, the examination of the concept reveals that the shortcomings are the natural product of an illusory concept.

The regulations provide that the partners' interests in a partnership "signify the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated."[130] That sentence appears to indicate that to determine the partners' interest in the partnership, the partners should look to specific economic items of the partnership that correspond to tax items. The next sentence states that the arrangement to share specific economic items may not correspond with the overall economic arrangement of the partners.[131] Taken together, those two sentences appear to imply that the term "partners' interests in a partnership" is an item-specific concept.

The regulations use an example to illustrate that the sharing of economic benefits and burdens may not correspond to the partners' overall economic arrangement. The example provides that a partner may have a 50% overall interest in the partnership but have a 90% interest in a particular item.[132] That example contrasts unitary interests

129. *See* Treas. Reg. § 1.704-1(b)(3) (as amended in 2008).

130. *See id.* § 1.704-1(b)(3)(i). The language of the provision appears to be tax-centric, i.e., it appears to suggest that the economic benefit or burden follows the tax item that is allocated. Because the question is the proper allocation of the tax item, the tax item should follow the corresponding economic item. That concept would be more clearly expressed if the sentence finished, "credit (or item thereof), that must be allocated."

131. *See id.*

132. *See id.*

and item-specific interests and appears to suggest partners' interests in a partnership is an item-specific concept. The example is, however, very narrow and does not appear to definitively support item-specific determinations generally.[133]

Other provisions suggest the concept is unitary. For example, the regulations provide that the determination "shall be made by taking into account all of the facts and circumstances relating to the economic arrangement of the partners."[134] Finally, the regulations list four factors that should help define the partners' interests in a partnership: (1) the partners' relative contributions to the partnership; (2) the partners' interests in the partnership's economic profits and losses if the interests are different from their interests in taxable income or loss; (3) the partners' interests in cash flow and other non-liquidating distributions; and (4) the partners' rights to distributions of capital upon liquidation.[135] This language appears to support a unitary concept of partners' interests in a partnership. Thus, the regulations have language that supports both an item-specific and unitary concept of partners' interests in a partnership.

Deficiencies in the four factors exacerbate the ambiguity of the concept of partners' interests in a partnership. Treasury populated the four factors with non-technical terminology, making them ambiguous. The regulations fail to provide the relative weight of each factor. Thus, if the factors were not ambiguous, they each could return a unique result, and taxpayers would not know how to resolve those differences. Finally, perhaps because of the non-technical language in the regulations, the factors appear to overlap significantly. An examination of each factor illuminates these shortcomings.

*Factor One: Partners' Relative Contributions.* The first factor is the partners' relative contributions to the partnership.[136] Tax law uses the term "contribution" in numerous contexts to mean a transfer by a partner to a partnership.[137] For the sake of analysis, this Article assumes that definition applies to the first factor. Tax law recognizes that partners can contribute property including cash and services to a partnership.[138] Unfortunately, this factor does not specify whether it refers to

133. Based upon the parenthetical in that provision, the regulations appear to refer to a qualified income offset as defined in Treas. Reg. § 1.704-1(b)(2)(ii)(*d*) (as amended in 2008).

134. *See id.* § 1.704-1(b)(3)(i).

135. *See id.* § 1.704-1(b)(3)(ii).

136. *See id.* § 1.704-1(b)(3)(ii)(a).

137. *See, e.g.*, I.R.C. §§ 721(a), 722, 724, 752(a) (2006).

138. *See* Treas. Reg. § 1.721-1(b) (as amended in 1996).

contributions of both property and services. If it refers to contributions of services, it provides no guidance respecting the method for valuing the contributed services, an apparently impossible task.

Contributed services have at least three possible values: (1) the market value, as expressed by the opportunity cost of the services; (2) the extent to which the services contribute to the partnership's success; or (3) the amount allocated to a service-contributing partner. The opportunity cost is the amount a partner could make providing the same services to a third party. That amount may not, however, represent the value of the services to the partnership. The division of capital and labor may put the service provider in a weak bargaining position, preventing the service provider from claiming compensation equal to the income-generating potential of the services.

The true value of the services may be the extent to which they benefit the partnership. Determining the extent to which services benefit the partnership is one of the difficulties tax partnerships present.[139] Many resources contribute to a partnership's success. In most situations, the partners cannot determine the extent to which property and services generate the partnership output.[140] For example, Sam and Claire can never know with accuracy the relative effect their services and the partnership property will have on the partnership's output. Thus, they cannot determine the extent to which the services benefit the partnership. This inability makes valuing contributed services difficult.

The temptation may arise to use partner-directed economic-item allocations to determine the value of contributed services. For example, the partners may allocate partnership income to a service-contributing partner in a ratio that varies from the ratio of the value of contributed properties. The temptation may be to use the allocation to establish the value of contributed services. That method of valuation would require a baseline against which the partners could compare the partner-directed economic-item allocations. In the case of a general partnership or limited liability company, if the partners do not specially provide for allocations, state law will allocate the economic items equally to the partners.[141] If the parties moved away from an equal allocation, then the services would appear to be worth the difference between the equal

139. *See* Campbell v. Comm'r, 943 F.2d 815, 823 (8th Cir. 1991) (holding that the value of a profits-only partnership interest received in exchange for services is too speculative to include in gross income); *see generally* Bradley T. Borden, *Profits-Only Partnership Interests*, 74 BROOK. L. REV. 1283 (2009) (applying the economic theory of partnership taxation to profits-only interests received in exchange for services and the difficulty of taxing such transactions).

140. *See* Borden, *supra* note 139, at 1209–1303.

141. *See* UNIF. P'SHIP ACT § 401(b) (amended 1997), 6 U.L.A. 133 (2001); *supra* text accompanying notes 80–89.

allocation and the partner-directed allocation. That conclusion is, however, problematic for two reasons.

First, the state default rules do not necessarily represent the allocation formula the partners would have adopted in the absence of service contributions. Perhaps the partners would have adopted an allocation ratio that tracked the value of contributed property. If such a ratio would have been something other than an equal allocation, the comparison should be between that other ratio and the ratio of the partner-directed allocation. Then again, the partners may have considered only the allocation they adopted, so there may be no other allocation with which to compare. Knowing whether the ratio would have been something other than the partner-directed allocation may be impossible.

Second, an allocation for services may reflect more than the partners' understanding of the value of the services. For example, the allocation could represent an economic incentive provided by one partner to another to improve the partnership's overall performance and may not reflect the value of the services or their effect on a partnership's performance.[142] The non-service-providing partner may allocate more of specific economic items to the service-providing partner to motivate the service-providing partner to exert extra effort. Extra effort by the service-providing partner may increase the partnership's overall performance and consequently increase the total amount of economic items allocated to the non-service-providing partner.[143]

The first factor does not definitively provide that partner contributions include contributions of services, and partners will have significant difficulty determining the value of contributed services. That ambiguity and difficulty will often prevent the partners from determining their relative contributions with respect to services. For those reasons, the first factor probably does not include contributed services.

*Factor Two: Partners' Interests in Economic Profits and Losses.* The second factor is the partners' interests in the partnership's economic profits and losses, if the interests are different from their interests in the partnership's taxable income or loss. "Profit" is not a technical tax term, so it does not have a clear tax definition. This Article has used the terms "operating profit" and "state law profit" to facilitate analysis. There is no indication that either of those definitions would apply to the second factor. Perhaps the factor intends some other definition to apply.

The term "profit" can have various, broad definitions and lacks

142. *See* Borden, *supra* note 14, at 754–61.

143. *See id.* at 753–54 (describing the possible effect of allocations on the amount of total partnership output).

technical significance in other disciplines.[144] Accounting uses the term sparingly in a general sense but does not give it technical significance or define it specifically.[145] Economists also use the term, but they have long debated the definition of profit and do not have an agreed upon definition for it.[146] Finally, as discussed above, state law uses the term to help establish the partners' legal rights to partnership resources.[147] State law does not, however, provide a definition of profits as used in that context.[148] Thus, there is no single place to turn for a definition of economic profits and finding a definition of losses may be equally difficult. The lack of clear definitions of profits and losses make the second factor difficult to apply, and taxpayers as well as the IRS may apply it inconsistently.

*Factor Three: Partners' Interests in Cash Flow and Non-Liquidating Distributions.* The third factor is the partners' interests in cash flow and other non-liquidating distributions. Once again, the regulations fail to define the key terms: namely "cash flow and other non-liquidating distribution." The regulations present the terms in conjunctive form, suggesting that cash flow may be distinct from non-liquidating distributions. That interpretation could return different values for this factor.

Apparently the reference to cash flow is to the partnership's cash flow, not the partners'.[149] The partnership's cash flow would appear to

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144. *See* FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 6: ELEMENTS OF FINANCIAL STATEMENTS ¶ 16 n.9 (1985) [hereinafter ELEMENTS OF FINANCIAL STATEMENTS] ("*Profit* is used in this and the following paragraphs in a broad descriptive sense to refer to an enterprise's successful performance during a period. It is not intended to have a technical accounting meaning or to imply resolution of classification and display matters that are beyond the scope of this Statement, and no specific relation between *profit* and either *comprehensive income* or *earnings* . . . is implied. *Loss* as in *profit or loss* (in contrast to *gain or loss*) is also used in a broad descriptive sense to refer to negative profit or unsuccessful performance and is not intended to have a technical accounting meaning."); BELVERD E. NEEDLES, FINANCIAL ACCOUNTING 113 (4th ed. 1992) ("Profit has many meanings. One definition is the increase in owners' equity resulting from business operations. However, even this definition can be interpreted differently by economists, lawyers, business people, and the public. Because the word *profit* has more than one meaning, accountants prefer to use the term *net income*, which has a precise definition from an accounting point of view."); Bradley T. Borden, *The Federal Definition of Tax Partnership*, 43 HOUS. L. REV. 925, 972 (2006) (discussing the accounting, balance sheet, and dictionary definitions of profit).

145. *See* ELEMENTS OF FINANCIAL STATEMENTS, *supra* note 144.

146. *See* FRANK H. KNIGHT, RISK, UNCERTAINTY AND PROFIT 19–38 (Dodo Press 2009) (presenting various interpretations of profit).

147. *See supra* text accompanying notes 71–72.

148. *See* BROMBERG & RIBSTEIN, *supra* note 71, § 2.07(b)(4).

149. The language in the regulations does not specifically provide that it refers to partnership cash flow, but flows of cash and property between partners and the partnership generally take either the contribution or distribution label. The regulations' failure to refer to contributions or distributions

include cash receipts and cash payments, a common definition of cash flow.[150] If the partnership uses the cash method of accounting, its operating profits would often be similar to its net operating cash flow.[151] Therefore, in the example above, the partnership's net operating cash flow would probably equal $100,000 in Year 1.

If the partnership agreement is silent on the issue, state law should establish the partners' interests in the partnership's cash flow. State law provides generally that property acquired by the partnership is the partnership's property and not the property of partners individually,[152] so the partners will not have a direct interest in cash flow received by the partnership. The partners' interests in cash flow may include both their direct and indirect interests; thus, the analysis should consider both.

The partners have direct interests in distributed cash flow and indirect interests in undistributed cash flow. State law provides that partnerships credit partners' accounts with their shares of partnership profit.[153] Partners may not be able to immediately access amounts credited to their accounts through distributions,[154] but they could sell their rights to the amounts credited to their accounts by selling their economic interests in the partnership.[155] Thus, they would appear to be able to access the value of the partnership's undistributed cash flow through the profits credited to their accounts, giving them an indirect interest in such amounts. Based on that analysis, this factor appears to overlap the second factor.

Non-liquidating distributions would appear to include any distribution to a partner other than a liquidating distribution.[156] State law does not

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suggests the cash flow reference is at the partnership level.

150. *See* FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 5, RECOGNITION AND MEASUREMENT IN FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES ¶¶ 52–54 (1984) (describing the statement of cash flows as representing cash receipts and cash payments).

151. *See* DAVID SPICELAND ET AL., INTERMEDIATE ACCOUNTING 7 (5th ed. 2009) ("Cash basis accounting produces a measure called *net operating cash flow*. This measure is the difference between cash receipts and cash disbursements during a reporting period from transactions related to providing goods and services to customers."). Items such as depreciation would, however, distinguish cash flow from taxable income of a strict cash method taxpayer. *See id.* at 198 (showing adjustments to statements of cash flows to account for the depreciation deduction).

152. *See* UNIF. P'SHIP ACT § 203 (amended 1997), 6 U.L.A. 96 (2001).

153. *See* UNIF. P'SHIP ACT § 401(a)(1) (amended 1997) , 6 U.L.A. 133 (2001).

154. *See* UNIF. P'SHIP ACT § 501 (amended 1997), cmt. 6 U.L.A. 155 (2001) ("[A] partner who misappropriates partnership property is guilty of embezzlement . . . .").

155. *See* UNIF. P'SHIP ACT § 502 (amended 1997), 1 U.L.A. 156 (2001) ("The only transferable interest of a partner in the partnership is the partner's share of the profits and losses of the partnership and the partner's right to receive distributions.").

156. The regulations do not define non-liquidating distributions, but they distinguish this factor from the fourth factor (rights to distributions of capital upon liquidation). *See* Treas. Reg. § 1.704-

provide rules regarding non-liquidating distributions.[157] Consequently, partners may withdraw property from the partnership only if the partnership agreement allows withdrawals.[158] The partners' interests in non-liquidating distributions may therefore consist only of their shares of non-liquidating distributions made during the year. Those interests may not equal the partners' interests in cash flow as determined by allocations of profits.[159]

This factor could, however, refer to the partners' interests in non-liquidating distributions expressed in terms of partnership cash flow. If that interpretation is correct, the partners would determine the value of this factor by dividing the amount of their non-liquidating distribution by the partnership's total cash flow. That amount could be different from the amount determined using either of the other two methods.[160]

*Factor Four: Partners' Rights to Capital upon Liquidation.* The fourth factor is the partners' rights to capital upon liquidation. The regulations do not define partnership capital. Accountants use the term "capital" to refer to the equity portion of a balance sheet.[161] Used in this manner, capital includes both the partners' contributions and the partnership's retained earnings. In fact, accounting may divide capital into two categories: (1) paid-in-capital and (2) retained earnings.[162] Consequently, if an accounting definition of capital applies, the fourth factor could refer to the non-debt portion on the right-hand side of the partnership's balance sheet, i.e., the partners' equity. If that were the case, partnership capital would include partner contributions, undistributed partnership cash flow, and increases in the value of partnership property. The broad interpretation appears to be consistent with the state law liquidation rules.[163] If that is the case, the fourth factor subsumes the other factors and adopts the partners' economic interests in the partnership. As shown above, partners' economic

1(b)(3)(ii)(*d*) (as amended in 2008). Treasury therefore appears to limit non-liquidating distributions to distributions made other than in liquidation of the partnership. Another distinguishing interpretation would treat any distributions of cash flow as non-liquidating distributions. Unfortunately, the regulations provide no further guidance about the use of the term in this context. Thus, this Article assumes, for the sake of analysis, that "non-liquidating distributions" refers to distributions made other than in liquidation of the partnership.

157. *See* BROMBERG & RIBSTEIN, *supra* note 71, ¶ 6.02(b)(2); UNIF. P'SHIP ACT § 807(b) (amended 1997), 6 U.L.A. 206 (2001) (governing liquidating distributions).

158. *See* UNIF. P'SHIP ACT § 807(b) (amended 1997), 6 U.L.A. 206 (2001).

159. *See infra* text accompanying notes 172–176 (illustrating this potential outcome).

160. *See id.*

161. *See* SPICELAND ET AL., *supra* note 151, at 946–50.

162. *See id.*

163. *See supra* Part II.A.

interests are not a viable metric for allocating tax items.[164] Thus, the fourth factor appears to be useless. The following discussion reveals the futility of attempting to determine partners' interests in a partnership with accuracy. That inability appears to provide taxpayers significant opportunities to dissociate tax items from corresponding economic items and to broadly allocate independent tax items.

### *C. Partners' Interests' Inability to Guide Tax-Item Allocations*

Partners can create partnerships with varying levels of sophistication. Even with basic arrangements, determining the partners' interests in the partnership using the four factors may be impossible. Additionally, any attempt to apply a universal concept of partners' interest in a partnership will often prove futile. The following examples illustrate the futility of such attempts and demonstrate that the law's shortcomings provide partners with the opportunity to allocate tax items to reduce their overall tax liability and enter into tax-item transactions.

#### 1. Partnership with Minimalist Partnership Agreement

Assume Sam and Claire form a default general partnership, i.e., they fail to agree how they will allocate their economic and tax items.[165] In addition to contributing the cash indicated above,[166] Sam agrees that he will maintain the partnership's office building, and Claire agrees to manage it.[167] They each withdraw a reasonable amount of money from the partnership as needed, so Sam withdraws $25,000 and Claire withdraws $30,000 in Year 1. Because the partnership agreement does not allocate tax items, they turn to the four factors to allocate the tax items in accordance with their interests in the partnership. Notice the factors are not conclusive.

*Factor One: Partners' Relative Contributions.* Sam and Claire must decide what constitutes a contribution to determine the first factor. Sam contributed $800,000, and Claire contributed $200,000. If that is all the factor includes, Sam contributed 80% and Claire contributed 20% of the

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164. *See supra* text accompanying notes 118–128.

165. Possible reasons for such failure could be numerous. *See supra* notes 63–66 and accompanying text.

166. *See supra* text accompanying note 28.

167. Property maintenance refers to painting, infrastructural repairs, and capital improvements. Property management refers to negotiating lease terms, handling tenant concerns, arranging garbage disposal, and cleaning.

total contributions. If the factor also includes services, the task of determining relative contributions is more difficult.[168] For the sake of analysis, assume the factor only requires them to consider their cash contributions. The relative contributions thus would be 80% by Sam and 20% by Claire.

*Factor Two: Partners' Interests in Economic Profits and Losses.* The partnership agreement does not allocate the partnership's economic items; therefore, state law will govern those allocations.[169] Under state law "each partner is entitled to an equal share of the partnership profits and is chargeable with a share of the partnership losses in proportion to the partner's share of the profits."[170] Thus, the partners each appear to have a 50% interest in the partnership's economic profits and losses.

*Factor Three: Partners' Interests in Cash Flow and Non-Liquidating Distributions.* Sam and Claire's partnership agreement does not appear to be completely silent regarding the third factor. Sam and Claire allow each other to withdraw funds from the partnership as needed. Assuming the partnership did not agree to compensate the partners for their services, the withdrawals would be partnership distributions.[171] The partners must determine how those distributions affect their interests in cash flow and non-liquidating distributions.

Consider three different alternatives discussed above for determining the partners' interests in cash flow and non-liquidating distributions.[172] First, the partners might determine their interests in partnership cash flow by considering the portion of cash flow in which they have an economic interest. The partners' economic interests in cash flow should equal the amount of operating profits allocated to them,[173] which would be 50% for each partner.[174] Second, the partners could consider their interests in non-liquidating distributions to be a percent of partnership's total annual distributions. In Year 1, Sam's percent of total distributions was 45% and Claire's was 55%.[175] Third, the partners could consider

168. *See supra* text accompanying notes 138–143.

169. *See supra* note 67 and accompanying text.

170. *See* UNIF. P'SHIP ACT. § 401(b) (amended 1997), 6 U.L.A. 133 (2001). The same result obtains for members of limited liability companies under state law. *See supra* text accompanying notes 80–89.

171. *See* UNIF. P'SHIP ACT § 401(h) (amended 1997), 6 U.L.A. 133 (2001).

172. *See supra* text accompanying notes 149–160.

173. *See supra* note 151 and accompanying text.

174. *See supra* text accompanying note 170.

175. Sam received the following proportions of total non-liquidating distributions in each year: Year 1 $25,000/$55,000 = 45%; Year 2 $33,000/$60,000 = 55%; and Year 3 $20,000/$52,000 = 38%.

their interest in cash flow or non-liquidating distributions to be their distributions for the year as a percent of total partnership cash flow for the year. The partnership's cash flow in Year 1 was $100,000. Sam's Year 1 distribution as a percent of the total partnership cash flow was 25% and Claire's was 30%.[176] Each of the three possible methods returns a different result, and none of the methods appears unreasonable, so the partners cannot determine a single value for this factor.

*Factor Four: Partners' Rights to Capital upon Liquidation.* To accurately apply the fourth factor at any time other than liquidation, the partners would need perfect information regarding the value of partnership assets.[177] That information would often be unavailable. Sam and Claire would likely have to rely upon the historical cost of the partnership's property to estimate their liquidation rights. At the end of Year 1, based upon the historical cost, the partnership would have $1,045,000 to distribute in liquidation.[178] The amount each partner would be entitled to receive if the partnership were to liquidate at the end of Year 1 would equal the partner's contribution, plus the amount of operating profit allocated to the partner, minus the partner's Year 1 distribution. Sam would thus be entitled to $825,000 and Claire to $220,000. Expressed as percentages, Sam has a 79% right and Claire has 21% right to partnership capital at the end of Year 1.[179]

Table 5 summarizes the findings for each of the four factors. The table reveals that the four factors do not conclusively establish the partners' interests in the partnership. Based upon the four factors, Sam's interest appears to vary from 25% to 80% and Claire's from 20% to 55%.

Claire received the following proportions of total non-liquidating distribution in each year: Year 1 $30,000/$55,000 = 55%; Year 2 $27,000/$60,000 = 45%; and Year 3 $32,000/$52,000 = 62%.

176. Sam and Claire, respectively, received the following proportions of total partnership cash flow in Year 1: $25,000/$100,000 = 25% and $30,000/$100,000 = 30%.

177. *See supra* text accompanying notes 119–126.

178. The analysis does not consider tax depreciation deductions in determining historical cost because depreciation deductions do not accurately express changes in property values.

179. Sam contributed $800,000, was allocated $50,000 of profits, and took a $25,000 distribution. Claire contributed $200,000, was allocated $50,000, and took a $30,000 distribution.

Table 5
Factors Summary:
Partnership with Minimalist Partnership Agreement

| **Factor** | **Sam** | **Claire** |
|---|---|---|
| Relative Contributions | 80% | 20% |
| Interests in Profits and Losses | 50% | 50% |
| Interests in Cash Flow | 25–50% | 30–55% |
| Rights to Capital upon Liquidation | 79% | 21% |

With this information, Sam and Claire must report the $100,000 of partnership tax income and the $20,000 depreciation deduction.[180] With no way to determine the relative weight of the factors or to resolve the discrepancies among the factors, perhaps the partners could allocate tax items in any ratio that comes within the ranges the factors return. If so, Sam and Claire may decide to allocate the tax income 80% to Sam and 20% to Claire.

That tax-item allocation differs from the equal allocation of operating profit, a corresponding economic item, which state law mandates, so the allocation would dissociate a tax item from a corresponding economic item. The tax-item allocation is similar to the partners' relative contributions, and it is an action (contributing property) the parties took. The state default rule determines their interests in the operating profits. The application of the default rule may be evidence that they did not consider profit allocations, so they may argue that less emphasis should be on that factor. They may argue that the law should focus on the factor that reflects their actions. If that argument is successful, Sam and Claire may have significant allocation flexibility.

If Sam and Claire have leeway in allocating the corresponding tax item, they should have at least as much freedom in allocating the depreciation deduction (an independent tax item). They might consider allocating the depreciation deductions 45% to Sam and 55% to Claire. With such apparent leeway they would likely consider the economic consequences of tax-item allocations and begin negotiating for the allocations of the respective items. Such negotiations would likely reduce the partners' aggregate tax liability and may result in untaxed tax-item transactions. They would appear to have similar freedom with other types of partnerships.

180. *See* I.R.C. § 702(a) (2006).

2. Partnership with Uniform Economic-Item Allocations

Sam and Claire could decide to allocate economic items in a manner that reflects their relative capital contributions. Therefore, they may agree to allocate all economic items 80% to Sam and 20% to Claire to reflect their understanding of their relative contributions. Their agreement does not, however, allocate tax items, so the partners must allocate the tax items in accordance with their interests in the partnership, and they would likely use the four factors to determine those interests.

*Factor One: Partners' Relative Contributions.* The partners' relative contributions do not change with the change of facts in this scenario.

*Factor Two: Partners' Interests in Economic Profits and Losses.* In this scenario, Sam and Claire agree that the partnership will allocate 80% of the profits and losses to Sam and 20% of them to Claire. Those percentages should represent the partners' respective interests in economic profits and losses.

*Factor Three: Partners' Interests in Cash Flow and Non-Liquidating Distributions.* Assuming Sam and Claire withdraw the amounts identified above, the new partnership agreement does not help them determine their interests in cash flow and non-liquidating distributions. Their legal rights to partnership property do, however, change. Sam would have an 80% interest in the partnership's economic profits and losses and Claire would have a 20% interest. Their distributions as a percentage of total distributions and partnership cash flow would not change.

*Factor Four: Partners' Rights to Capital upon Liquidation.* Because the partnerships made disproportionate distributions during the year, the partners' rights to capital will not reflect their proportionate contributions. Instead, Sam's rights, based on the historical cost of partnership property, will be 82% and Claire's will be 18%.[181]

Table 6 summarizes the four factors. The four factors are closer to uniform under this scenario, but they are still not perfectly uniform. The lack of uniformity would appear to provide some leeway to the partners for allocating tax items in accordance with their interests in the

181. Sam's share of $1,045,000 will be $855,000 (his $800,000 contribution, plus his $80,000 share of operating profits, minus the $25,000 distribution), Claire's share will be $190,000 (her $200,000 contribution, plus her $20,000 share of operating profits, minus the $30,000 distribution).

partnership. They may, however, have more difficulty under this scenario convincing a judge that their interests in the partnership were not 80% and 20%, but the four factors do not definitively establish the partners' interests in the partnership. Thus, a window of opportunity for abuse may remain open.

Table 6
Factors Summary:
Partnership with Uniform Allocations

| **Factor** | **Sam** | **Claire** |
|---|---|---|
| Relative Contributions | 80% | 20% |
| Interests in Profits and Losses | 80% | 20% |
| Interests in Cash Flow | 25–80% | 20–55% |
| Rights to Capital upon Liquidation | 82% | 18% |

### 3. Partnership with Specially-Allocated Economic Items

A more complicated partnership exacerbates the inability to determine the partners' interests in the partnership. Sam and Claire may use economic-item allocations to influence each other's behavior.[182] For example, they may allocate 55% of the profit to Claire (with the balance going to Sam) and 65% of the change in property value to Sam (with the balance going to Claire). Assume the partners make the allocations of those economic items a part of the partnership agreement, but they do not provide for the allocation of tax items. The partners therefore must allocate the tax items in accordance with the partners' interests in the partnership, and they turn to the four factors to do that.

*Factor One: Partners' Relative Contributions.* The temptation may arise to use economic-item allocations to value contributed services. This scenario helps illustrate that valuing contributed services is probably impossible.[183] First, the partners may have agreed to allocations, even though they knew the specific allocations may not reflect the value of services. For example, Sam may have been willing to grant Claire a greater percentage of the operating profits to motivate her to provide services that increase operating profits. Assume, for instance, that the profit from the partnership would be $90,000 if Claire

182. *See supra* text accompanying notes 61–62.

183. *See supra* text accompanying notes 139–143 (claiming that valuing contributed services is probably impossible).

shirked under an equal allocation of the profits. Sam's equal share of that profit would be $45,000. If the disproportionate sharing of profits motivated Claire to work and increase profits to $110,000, Sam's 45% interest in the increased profits would be $49,500. Sam would therefore be willing to accept a smaller percentage of the partnership's total profit, if the total dollar value allocated to him increased.

Second, the partners may consider using the change in operating profits as the value of Sam's services. If profits increased from $90,000 to $110,000 because of Claire's services, the value of the services would appear to be $20,000. Based upon the effect Claire's services have on partnership profits, they appear to be worth $20,000. One problem with this analysis is that the partners cannot be certain what the partnership's profits would have been without the allocation. Therefore, they cannot be certain that the services generated an additional $20,000 in profits.

Third, the partners could treat the value of Claire's services as her portion of the operating profits, which would be $60,500. The problem with that analysis is that the profits derive only in part from Claire's services—Sam's services and the property also contribute to the partnership's profits.[184] Perhaps the property would have generated a portion of that profit even without Claire's services. The parties cannot determine the extent to which each of the partnership's resources contribute to the partnership's profit,[185] so they probably cannot accurately measure Claire's contribution of services in dollar-denominated units.

The partners will have similar troubles determining the value of Claire's services, so disproportionate allocations do not appear to help determine the partners' relative contributions to the partnership. The value of the property contributions is certain in this example because both parties contribute cash. The partners will likely have to rely upon property contributions only to determine the amounts under the first factor. Therefore, the use of partner-directed economic-item allocations does not appear to improve the determination of the relative contributions. Thus, based upon their case contributions, the amounts they use for the first factor probably remain 80% and 20% respectively.

*Factor Two: Partners' Interests in Economic Profits and Losses.* To accurately apply the second factor to the altered facts, Sam and Claire need an accurate definition of profits and losses. If profits and losses only include operating profits, the analysis is fairly straight forward.

184. *See* Borden, *supra* note 139, at 1299–303.

185. *See id.*

The parties have agreed that the partnership shall allocate 55% of the operating profits to Claire and 45% to Sam. If the terms include changes in the value of partnership property, Sam and Claire may not be able to determine a value for this factor because they may not know the value of the property. If they know that value, the result for this factor would likely change because they allocate changes in value in a different ratio. For the sake of analysis, assume profits and losses only refers to operating profits and losses, and Sam's share of partnership economic profits is 55% and Claire's is 45%.

*Factor Three: Partners' Interests in Cash Flow and Other Non-Liquidating Distributions.* Sam and Claire make the same withdrawals in this scenario that they made in the earlier scenarios, but they allocate operating profits differently. Perhaps their interests in cash flow are the same as their allocations of operating profit—45% for Sam and 55% for Claire. Their shares of distributions as a percent of total distributions and their shares of distributions as a percent of cash flow should not change.

*Factor Four: Partners' Rights to Capital upon Liquidation.* As with the other scenarios, the partners' rights to capital on liquidation will equal their contributions, plus the operating profit allocations, minus distributions. Thus, based on historical cost, Sam would have a right to 78% of the capital, and Claire would have a right to 22%.[186] Table 7 summarizes the factor results for the partnership with specially-allocated economic items. Again, the results are not definitive and provide a range of possible answers.

Table 7
Factors Summary:
Partnership with Specially-Allocated Economic Items

| **Factor** | **Sam** | **Claire** |
|---|---|---|
| Relative Contributions | 80% | 20% |
| Interests in Profits and Losses | 45% | 55% |
| Interests in Cash Flow | 25–80% | 20–55% |
| Rights to Capital upon Liquidation | 78% | 22% |

186. Sam's share of the $1,045,000 will be $820,000 (his $800,000 contribution, plus $45,000 of allocated operating profit, minus $25,000 distribution) and Claire's share will be $225,000 (her $200,000 contribution, plus $55,000 of allocated operating profit, minus $30,000 distribution).

In this scenario potential dissociation of operating profit and tax income allocations is perhaps most troubling. Sam and Claire agreed to specific allocations of operating profits. Intuition suggests that they should report the tax items that correspond to those allocations in the same ratio as the economic-item allocations. The regulations do not, however, appear to bind Sam and Claire to their economic-item allocations, even with respect to corresponding tax items. The possible notion that partners' interests is a unitary concept would also suggest that dissociation is not only permitted, but could be required. Therefore, they may be able to dissociate tax items from specially-allocated economic items. Perhaps they can allocate tax items in any proportion between 25% and 80% to Sam and between 20% and 55% to Claire.

4. Partnership with Allocated Tax Items

In this scenario, assume that Sam and Claire include tax-item allocations in their partnership agreement. Assume that they agree to allocate partnership tax income 45% to Sam and 55% to Claire. They also agree to allocate the taxable gain or loss from the sale of the property 65% to Sam and 35% to Claire. Finally, they agree to allocate the tax depreciation 75% to Sam and 25% to Claire. If the partners do not come within the economic-effect safe harbor, the tax-item allocations will be valid if in accordance with the partners' interests in the partnership. State default rules will govern the allocation of economic items, so their interests in the partnership should be the same as the interests considered above for the minimalist partnership. Because the tax-item allocations come within the ranges in Table 5, Sam and Claire might successfully argue that the allocations are in accordance with their interests in the partnership.

Assume alternatively that Sam and Claire adopt the economic-effect safe harbor. Accordingly, they agree to maintain capital accounts, make liquidating distributions in accordance with positive capital account balances, and restore deficit capital account balances.[187] Because the allocations satisfy the economic-effect safe harbor, they will be valid unless they fail the test for substantiality.[188] To test the tax-item allocations for substantiality, the parties will have to compare them to allocations made in accordance with the partners' interests in the partnership.[189] This example illustrates the proposition stated above—

187. *See* Treas. Reg. § 1.704-1(b)(2)(ii)(*b*) (as amended in 2008); *supra* text accompanying note 99.

188. *See id.* § 1.704-1(b)(2)(i).

189. *See id.* § 1.704-1(b)(2)(iii).

tax-item allocations made within the economic-effect safe harbor affect the partners' interests in the partnership, and applying the test for substantiality is impossible.[190] Examining the four factors illustrates the effect the allocations have on the partners' rights and obligations.

*Factor One: Partners' Relative Contributions.* Sam's and Claire's relative contributions do not appear to change in this scenario.

*Factor Two: Partners' Interests in Economic Profits and Losses.* The legal consequences of the partners' self-directed tax-item allocations should determine the partners' interests in the partnership's economic profits and losses. The allocation of depreciation deductions appears to differentiate this scenario from the other scenarios. When the partners comply with the economic-effect safe harbor, the allocation of tax depreciation affects the partners' rights and obligations in the partnership.[191] Consequently, depreciation deductions most likely affect the partners' interests in economic profits and losses. Assuming the analysis must use historical cost and depreciation reduces the historical cost, depreciation would reduce the amount of operating profits available for distribution.[192] Sam and Claire would both have a $40,000 interest in the $80,000 partnership profits left after accounting for the depreciation deduction.[193] Thus, they each appear to have a 50% interest in the profits.

*Factor Three: Partners' Interests in Cash Flow and Non-Liquidating Distributions.* Because the partnership comes within the economic-effect safe harbor, the tax-item allocations could affect the partners' interests in cash flow and non-liquidating distributions. The partners' interests in cash flow should be equal because cash flow and operating profit are synonymous.[194] The partners' distributions as a percent of total distributions should remain the same, but their distributions as a

190. *See supra* Part II.B.

191. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(*b*)(7) (as amended in 2008); *supra* text accompanying notes 99–109.

192. The deemed value of the property at the end of Year 1 would be its historical cost reduced by the depreciation deduction, so the analysis must assume the partnership would have no gain or loss from the property to allocate, if the partnership sold it in a hypothetical liquidation. The depreciation deduction would reduce their rights to partnership property, including profits. Thus, the partners would have rights in their contributions and the profits, net of allocated depreciation.

193. Sam's interest in profits would equal his $55,000 allocation of tax income minus his $15,000 allocation of depreciation. Claire's interest would equal her $45,000 allocation of tax income minus her $5,000 share of depreciation. The equal interests in the profits are random, based on the tax income and depreciation for the year. The interests would likely fluctuate from year to year.

194. *See supra* text accompanying note 151.

percent of cash flow should change to reflect the effect the depreciation deduction appears to have on cash flow. Sam's $20,000 distribution is 25% of the $80,000 of economic profits and Claire's $35,000 distribution is 44%.

*Factor Four: Partners' Rights to Capital upon Liquidation.* The allocation of the depreciation deduction affects the balance of partners' capital accounts and therefore affects their rights to capital upon liquidation.[195] Based on historical values adjusted for depreciation values, Sam would have a right to 79% and Claire would have a right to 21% of the capital at the end of Year 1.[196] Table 8 summarizes the results for each factor.

Table 8
Factors Summary:
Partnership with Allocated Tax Items

| Factor | Sam | Claire |
|---|---|---|
| Relative Contributions | 80% | 20% |
| Interests in Profits and Losses | 50% | 50% |
| Interests in Cash Flow | 25–50% | 44–55% |
| Rights to Capital upon Liquidation | 79% | 21% |

All of the partnership's tax-item allocations come within the range that the factors establish, so the allocations appear to be in accordance with the partners' interests in the partnership. Thus, they probably would not change to provide a point of comparison to apply the test for substantiality. The IRS may be unable to reallocate the tax items in any other manner which could better reflect the partners' interests. Thus, even if the allocations appear to increase Sam's after-tax economic position without diminishing Claire's, the IRS may not be able to successfully challenge the allocations using the substantiality test. Perhaps more significantly, the tax-item allocations under the economic-effect safe harbor determine the partners' legal rights and obligations.

195. *See supra* text accompanying notes 99–109.

196. Based on historical costs, Sam would receive $805,000 (his $800,000 contribution plus $45,000 of allocated tax income, minus the $25,000 distribution, minus the $15,000 of the allocated depreciation deduction) if the partnership liquidated at the end of Year 1, which would be 79% of the $1,025,000 available for distribution. Claire would receive $220,000 (her $200,000 contribution, plus $55,000 of allocated tax income, minus the $30,000 distribution, minus $5,000 of the allocated depreciation deduction), which would be 21% of the $1,025,000 deemed available for distribution.

### 5. Partnership with Target Allocations

The final scenario considers a partnership that adopts target allocations. Target allocations have become popular in recent years.[197] They transform an arrangement into something that differs from traditional partnerships. As the discussion thus far illustrates, the partners' rights to the residual value of a partnership depend upon the partners' contributions and economic-item allocations (as may be dictated by tax-item allocations in some situations). Because the partners' rights to the residual value of the partnership depend upon allocations, such arrangements have allocation-dependent residual risk.[198]

In contrast, target allocations create distribution-dependent residual risk.[199] Instead of using allocations to determine partners' rights in partnership residual value, target allocations use a distribution formula to establish rights in partnership residual value.[200] They then allocate partnership tax items in accordance with distribution rights.[201] Earlier work illustrates that partnership tax is not equipped to address the difficulties that arise in structures with target allocations.[202] The following discussion demonstrates the difficulty of determining the interests of partners who adopt target allocations.

Target allocation provisions generally use a multi-tier distribution structure to determine the partners' rights to partnership residual value. The partnership agreement then requires tax allocations to follow the tiered distribution structure.[203] To illustrate, assume Sam and Claire adopt a three-tier structure. Tier One requires the partnership to make distributions of available cash to partners who contribute property in a manner that provides the contributing partners an 8% return on their contributions. If the partnership does not have sufficient funds to make all of the distributions under Tier One, it will make distributions in proportion to the distributions it would have made with sufficient funds. Tier Two requires the partnership to distribute any funds remaining after the Tier One distributions in proportion to contributed capital. Tier Three requires the partnership to equally distribute any funds remaining

197. *See*, Terence Floyd Cuff, *Working with Target Allocations—Idiot-Proofing or Drafting for Idiots*, 35 REAL EST. TAX'N 116, 116 (2008).

198. *See* Borden, *supra* note 35, at 273–75.

199. *See id.* at 275–78.

200. *See* Cuff, *supra* note 197, at 126–28.

201. *See id.* at 126.

202. *See* Borden, *supra* note 35, at 286–91.

203. *See* Terence Floyd Cuff, *Working with Target Allocations—Drafting in Wonderland*, 35 REAL EST. TAX'N 162, 163 (2008).

following the Tier One and Tier Two distributions.

A partnership with target allocations may attempt to come within the economic-effect safe harbor and adopt the capital account maintenance rules. The partnership agreement may also require the partnership to allocate tax items to capital accounts in a manner that reflects the partners' rights to distributions under the tiered structure.[204] On an annual basis, ongoing partnerships will encounter significant difficulty in attempting such allocations. The partners' rights to distributions depend upon the value of the partnership's property which often will be indeterminable. Without sufficient information about the value of the partnership's property, the partners may be unable to determine, with accuracy, their distribution rights. Consequently, they will be unable to accurately allocate tax items in accordance with their rights to distributions under the tiered structure. Determining the partners' interests in the partnership will also be difficult, and the four factors are unhelpful.

*Factor One: Partners' Relative Contributions.* Sam's and Claire's relative contributions would not change if they adopted target allocations.

*Factor Two: Partners' Interests in Economic Profits and Losses.* The partners will have difficulty determining their interests in partnership economic profits and losses. Because of the multiple tier distribution formula, the interests depend upon the portion of profits and losses the partnership would distribute to the partners if it were to liquidate. The amounts of those distributions depend upon the value of the partnership's assets. For example, if the partnership only had sufficient funds to make Tier One distributions, the partners' shares of profits would equal their relative contributions. If the partnership had sufficient funds to make all of the Tier One and Tier Two distributions, the partners' shares of the profit would be based in part on their relative contributions and in part on the Tier Three allocations. The inclusion of Tier Three allocations would change the partners' interests. Because the partners do not know the actual value of the partnership property, they may have difficulty determining how much the partnership would distribute in each tier.

The partners may attempt to determine their interests using the property's historical cost. Using that value, at the end of Year 1, the partnership would have $1,000,000 of profit and $100,000 of operating

204. *See id.*; Cuff, *supra* note 197, at 126.

cash flow to distribute. The distribution would occur as presented in Table 9.

Table 9
Year 1 Distributions Pursuant to Target Allocations

| | **Sam** | **Claire** | **Total** |
|---|---|---|---|
| Tier One (8% of contribution) | $64,000 | $16,000 | $80,000 |
| Tier Two (return of contribution) | $800,000 | $200,000 | $1,000,000 |
| Tier Three ($20,000 residual) | $10,000 | $10,000 | $20,000 |
| Total | $874,000 | $226,000 | $1,100,000 |

This table suggests that Sam would receive $74,000 more than he contributed, and Claire would receive $26,000 more than she contributed. The sum of those amounts equals the partnership's economic profits, so Sam appears to have a 74% interest and Claire a 26% interest in the partnership's economic profits.

*Factor Three: Partners' Interests in Cash Flow and Non-Liquidating Distributions.* The partners' interests in cash flow and non-liquidating distributions will also depend upon the value of the partnership assets. The partners' interests in cash flow should equal the interests in partnership profits. Similar to the other scenarios, their distributions as a percent of the total distributions and as a percent of the cash flow should remain the same.

*Factor Four: Partners' Rights to Capital upon Liquidation.* The tiered distributions establish the partners' rights to capital upon liquidation. Based on the analysis above, Sam would receive $874,000 and Claire would receive $226,000 if the partnership liquidated, based upon historical cost, at the end of Year 1. Thus, Sam's percentage right to capital would be 79% and Claire's would be 21%. Table 10 summarizes the results obtained for each of the four factors.

Table 10
Factors Summary:
Partnership with Target Allocations

| Factor | Sam | Claire |
|---|---|---|
| Relative Contributions | 80% | 20% |
| Interests in Profits and Losses | 74% | 26% |
| Interests in Cash Flow | 25–74% | 26–55% |
| Rights to Capital upon Liquidation | 79% | 21% |

Based on this information, the partnership must allocate the tax items to the partners and determine whether they are in accordance with the partners' interests in the partnership. If the allocations are within the range set forth in Table 10, the IRS should respect the allocations. The analysis raises two problems however. First, the analysis does not establish the extent to which the partners must allocate specific tax items, such as tax income and the depreciation deduction. As with other scenarios, they may be able to allocate those items to reduce the partners' aggregate tax liability. Second, the analysis uses historical cost. The partnership's actual residual value at the end of Year 1 was $1,030,000.[205] If the analysis had used that figure, the results would have varied. As time passes and historical cost and actual values likely deviate, the variance of results would increase. The results derived using market value would return more accurate values. Using historical values could lead to allocations that do not reflect reality. Partnerships with target allocations thus raise very complicated tax issues.

In fact, economic theory of entity classification suggests that tax law should not treat partnerships with target allocations as tax partnerships.[206] Economically, a partnership with target allocations is like a corporation with multiple classes of stock.[207] Corporations with complex capital structures cannot trace the income of the corporation to a specific shareholder and therefore require the corporate tax regime.[208] Because partnerships with target allocations face a similar problem, tax law should treat partnerships with target allocations as tax corporations.[209] Nonetheless, the current definition of a tax corporation does not include partnerships that make target allocations.[210] The

205. *See supra* p. 1086, Table 3.

206. *See* Borden, *supra* note 35, at 286–94.

207. *See id.* at 275–78.

208. *See id.*

209. *See id.* at 286–91.

210. A partnership may, however, elect to be a tax corporation. *See* Treas. Reg. § 301.7701-3(a)

example of Samaire Partnership using target allocations further illustrates a needed change in the law.

These several examples illustrate that the current version and use of partners' interests in a partnership does not work. Partners in even the simplest partnerships will have difficulty determining their interests in the partnership under the current definition. The factors are filled with ambiguity and other shortcomings, and they beg the question of how such poor rules could end up in the regulations. One or more of three possible reasons may explain the regulations' inadequacies. First, Treasury may have been lazy in drafting the rules. That is highly unlikely because Treasury is staffed with some of the country's best and most conscientious tax lawyers.

Second, the drafters of rules may have believed at the time of drafting that the concept of partners' interests in a partnership is intuitive. They may have thus provided a mere skeletal outline of the rules and left the rest to common knowledge and practice. That would explain part of the allure of the concept, but over time practitioners focus on the literal language of the rules and begin to exploit weaknesses in the rules. Third, the concept may simply be illusory, and despite its allure as a tool fit for allocation rules, drafting a workable definition is impossible. This Article claims that a combination of the second and third explanations capture reality. That reality suggests the rules are ripe for fundamental reform.

## IV. PROPOSAL: FUNDAMENTALLY REFORM PARTNERSHIP TAX ALLOCATION RULES

At first blush, partners' interests in a partnership are an alluring tool for allocating tax items. The above examination of the concept reveals, however, that it is illusory—one cannot determine partners' interests in a partnership. Because of the problems inherent in the current system, this Article recommends fundamental reform to the partnership allocation rules in general and the reliance on partners' interests in particular. Such reform is needed for two reasons. First, allocations made pursuant to the tax-centric economic-effect safe harbor generate legal economic consequences that may surprise even the most sophisticated partners and tax advisors. Second, because partners' interests in a partnership is an illusory concept, its use will cause problems. In particular, the use of the concept may prevent the IRS from successfully challenging tax-item allocations that dissociate corresponding tax and economic items with

(as amended in 2006). Assuming the partners are rational, a partnership would make that election only if it provided the partners with a tax advantage.

tax-item transactions. Taxpayers appear to understand the leniency of the partnership tax allocation rules. Two case studies suggest taxpayers of all sizes engage in such practices, and their efforts potentially affect billions of dollars of tax revenue.

Shortly before the publication of this Article, the author spoke with an attorney who represents the tax-exempt foundation of a small state university. The foundation owns a piece of real property. A developer proposed a partnership with the foundation. The partnership would borrow $20 million, construct a building on the foundation's property, and rent it out. For the first several years, the partnership's cash flow would break even, but it would have taxable income. The developer recommended that the partnership allocate the taxable income to the tax-exempt foundation until the partnership generated positive cash flow and began making distributions. The developer's plan was to allocate taxable income to an entity that did not pay tax, thereby reducing the aggregate tax liability of the partners.[211] The developer claimed that the arrangement was simple and similar to other arrangements the developer was part of. If the plan would work, it illustrates an abuse of the rules, but the IRS may hesitate to challenge the strategy under the current allocation rules.

A tax shelter case illustrates the IRS's reluctance to challenge the validity of allocations. Several years ago, two tax-neutral Dutch banks—ING Bank N.V. and Rabo Merchant Bank N.V.—and a subsidiary of GE Capital Corporation entered into an arrangement to acquire and dispose of financial instruments.[212] The arrangement provided a fixed-rate of return to the banks and arguably no real non-tax economic benefits to the GE subsidiary.[213] The parties agreed to allocate most of the taxable income to the tax-exempt foreign banks.[214] The arrangement would appear to violate the underlying principle of the test for substantiality,[215] but the Second Circuit did not consider the

211. Unless the income the partnership would generate was related to the foundation's tax-exempt purpose, the income allocated to the foundation would be unrelated business taxable income. *See* BRADLEY T. BORDEN, REAL ESTATE TRANSACTIONS BY TAX-EXEMPT ENTITIES: PORTFOLIO 591 (2d ed. 2008). Thus, the developer's plan would fail to accomplish its purposes if the partnership's income did not relate to the foundations tax-exempt purposes. Even if the plan ultimately would not achieve the developer's objective, the anecdote illustrates the types of strategies taxpayers attempt to employ using the partnership allocation rules.

212. *See* TIFD III-E, Inc. v. United States, 459 F.3d 220, 223 (2d Cir. 2006).

213. *See id.* at 226–27.

214. *See id.*

215. Indeed, this is the argument the IRS made at the trial court, but the court rejected it. *See* TIFD III-E, Inc. v. United States, 342 F. Supp. 2d 94, 117–21 (D. Conn. 2004), *rev'd*, 459 F.3d 220 (2d Cir. 2006).

validity of the allocations on appeal.[216] Instead, it considered the classification of the arrangement (one of the most difficult questions in tax law[217]), and ruled the taxpayer owed $62 million of taxes because the arrangement was not a tax partnership.[218] The IRS's position suggests that the allocation rules' deficiencies make them unreliable and perhaps unenforceable.

These two anecdotes provide further evidence that allocation rules are ready for reform. The reform must consider the argument presented in favor of the current tax-centric tax-item allocation rules. That argument is that the current rules promote efficiency by allowing transactions that will attract parties to partnerships.[219] The argument fails, however, to recognize the difference between tax laws that do not interfere with economic transactions and those that promote abusive tax avoidance. Recall from the discussion above that partners allocate economic items for various reasons, including reducing agency costs.[220] For example, to help reduce agency costs, Sam and Claire may decide to allocate partnership operating profit using one ratio and allocate gains or losses from the disposition of property using a different ratio.[221] A tax law that alters their decision to allocate the economic items in that manner could be inefficient because it would distort the partners' behavior.[222] Distorted behavior is a negative consequence that derives from regulating the allocation of economic items.

Tax policy does not suggest, however, that the partners should be able to allocate tax items freely. Here, the distinction between tax items and economic items is important. Tax law should attempt to match tax-item allocations to economic-item allocations whenever possible. Tax law should regulate tax-item allocations to help accomplish that purpose. Such regulation should not adversely affect the economic behavior of partners. The following discussion considers alternative modifications

216. *See TIFD III-E, Inc.*, 459 F.3d at 224, n.1.

217. *See* WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 3.01 (3d ed. 2004) ("The most basic, and perhaps the most difficult, problem in the taxation of partnerships and partners is the determination whether a particular . . . arrangement constitutes a partnership for income tax purposes.").

218. *See TIFD III-E, Inc.*, 459 F.3d at 224 (identifying the tax liability), 241 (holding that the Dutch banks did not have an equity interest in the arrangement).

219. *See, e.g.*, Darryll K. Jones, *Towards Equity and Efficiency in Partnership Allocations*, 25 VA. TAX REV. 1047, 1078–93 (2006) (discussing and referencing different arguments for and against flexibility in partnership allocations).

220. *See supra* note 62 and accompanying text.

221. *See id.*

222. *See* HARVEY S. ROSEN & TED GAYER, PUBLIC FINANCE 331 (8th ed. 2008) (defining inefficiency as a distortion in economic behavior caused a tax that creates a loss of welfare above and beyond the tax revenues collected).

to the partnership tax-item allocation rules. It recommends avoiding or rejecting two of the alternatives and embracing the third.

### *A. Abandon Tax-Centric Allocation Rules*

One alternative is to require all partnerships to comply with the economic-effect safe harbor.[223] This alternative would be attractive to many tax lawyers and academics because they are familiar with the capital account maintenance rules. Requiring all partnerships to adopt capital accounts would appear to create uniformity and provide rules with which a significant portion of the tax lawyers are familiar. Nonetheless, the costs of mandatory capital account maintenance would exceed the benefits such a rule may bestow.

First, default partnerships will not include capital accounts. Two or more persons may join together in a profit-seeking activity and not realize they have formed a partnership.[224] If the partners do not realize they are forming a partnership, certainly they would not include capital account maintenance provisions in their partnership agreement. Similarly taxpayers who knowingly form a partnership may not possess the tax sophistication required to include capital account maintenance provisions in their partnership agreement. Penalizing unsophisticated taxpayers for that oversight would be draconian. Partnerships are ancient business structures,[225] and tax law cannot stop their formation and should not impede or penalize their use.

Second, sophisticated taxpayers may prefer not to use the economic-effect safe harbor because it allocates economic items based upon the allocation of tax items. The partners may fear the unintended consequences of such allocations. No one can predict all of the economic consequences that will proceed from using the safe harbor. Therefore, many partners may choose not to use the tax law's capital account maintenance rules to avoid possible negative legal consequences. Forcing sophisticated taxpayers to adopt the rules would impose an unduly harsh requirement on them.

Third, because the capital account rules are tax-centric, they may misrepresent the partners' preferred economic arrangement. In particular, independent tax items have no corresponding economic item,

223. *See supra* text accompanying notes 99–109 (discussing the economic-effect safe harbor and the Section 704(b) capital account rules).

224. *See* BROMBERG & RIBSTEIN, *supra* note 66, § 2.02 (discussing different contexts in which the question of partnership status arises).

225. *See, e.g.*, Henry Fr. Lutz, *Babylonian Partnerships*, 4 J. ECON. & BUS. HIST. 552, 558–65 (1932) (describing the origin of partnerships in Babylonian society).

so tax law creates fictitious economic items to adjust capital accounts.[226] Mandatory use of the rules could distort behavior as partners attempt to obtain a desired economic outcome while working with rules that do not accurately portray their economic arrangement. For example, if adjustments to capital accounts for the depreciation deduction alter the partners' economic arrangement, the partners may allocate other tax items to offset the depreciation-deduction allocation. Such offsetting allocations could be similar to the complex allocations of the built-in gain or loss of contributed property.[227] Requiring partners to use tax-centric allocation methods may impose unnecessary complexity on arrangements that partners would otherwise manage simply.

Fourth, if tax law could overcome all of those shortcomings, the mandatory use of capital accounts would still face the problems raised by the test for substantiality. If all partnerships adopt the capital account rules, their allocations would have economic effect, but partners may still use the allocation to reduce the partners' aggregate tax liability. As discussed above, partners must test the validity of their tax-item allocations by comparing those allocations to allocations that would be made in accordance with partners' interests in the partnership.[228] Thus, if the law adopted mandatory use of the capital account rules, it would still have to address the illusion of the concept of partners' interests in the partnership.

Finally, tax law should not force all partnerships to abide by rules that allocate economic items. Ultimately, state law governs the allocation of the partnership's economic items and determines the partners' economic interests in the partnership. Tax law could impose penalties for failure to use capital accounts, but it would still be left with the task of allocating tax items for unsophisticated partners. The penalties also would create economic inefficiency as partners would have to alter their economic arrangement to avoid the penalties. As a consequence, tax law will always have the task of considering the validity of agreed-upon allocations and of allocating tax items for partnerships that do not include relevant allocation provisions in their agreements.

Tax-centric allocations will not solve the problems inherent in the current rules, so mandating the use of capital accounts will not resolve those problems. Thus, mandatory capital accounts do not appear to be a

226. *See* Treas. Reg. § 1.704-1(b)(5), ex. 1 (as amended in 2008); *supra* text accompanying notes 100–109.

227. *See* I.R.C. § 704(c) (2006); Treas. Reg. § 1.704-3 (as amended in 2005); *see generally* Andrea Monroe, *Saving Subchapter K: Substance, Shattered Ceilings and the Problem of Contributed Property*, 74 BROOK. L. REV. 1381 (2009) (discussing the rules governing the allocation of built-in gain and loss).

228. *See supra* text accompanying note 108.

viable alternative for allocating tax items. Instead, the rules must become economic-centric.

### *B. Abandon the Concept of Partners' Interests in a Partnership*

Another alternative is to modify the current rules and develop a formula for determining a universal concept of partners' interests in a partnership.[229] For example, some may consider multiple variable integration that incorporates all relevant factors into a single formula. Such an undertaking would be extremely difficult and would likely prove futile. To develop a universal concept using the four factors, for example, the law would have to accurately define the key terms of each factor, resolve the problem of factor overlap, and provide weight for the factors. Each of those tasks would present a significant challenge.

To accurately determine the partners' interests in the partnership, the partners would also need accurate information about the value of the partnership's assets.[230] To make allocations on an annual basis, the partners would have to gather information each year. Often perfect information regarding the value of partnership assets is not available or would be costly to obtain.

Finally, a universal concept of the partners' interests in a partnership may not accurately reflect the partners' economic arrangement. Partnerships generally have allocation-dependent residual risk, meaning the partners determine their residual claims in the partnership by considering the allocations of partnership economic items.[231] Partnerships may allocate different economic items to different partners in different ratios.[232] Merely considering the partners' residual claims in the partnership assets will not accurately reflect the character of specific economic-item allocations. For example, if the partners allocate profit and fluctuations in the value of partnership property differently, a universal concept of partners' interests in the partnership will not capture that distinction.[233] Thus, allocating tax items using a universal concept may not match tax items with economic-item allocations. The solution must adopt an item-specific concept.

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229. *See, e.g.*, Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1, 40 (1990) (recommending that tax items be allocated in accordance with the relative values of capital accounts).

230. *See supra* text accompanying notes 121–123 (illustrating that historical costs and actual values return different unitary economic interests for the partners).

231. *See* Borden, *supra* note 35, at 273–75.

232. *See supra* text accompanying notes 61–62.

233. *See supra* text accompanying notes 182–186.

### *C. Adopt Item-Specific Economic-Centric Allocation Rules*

The inadequacies of the current rules and other alternatives lead to item-specific economic-centric allocations. Item-specific economic-centric allocations accomplish several feats. First, they require tax items to follow the allocation of economic items, so tax-item allocations will not affect the partners' rights and obligations. Second, item-specific allocations recognize the partners' particular allocations of economic items. Third, item-specific allocations work with any type of partnership that has allocation-dependent residual risk.[234]

Economic-centric allocations of tax items reflect general principles of taxation better than the current tax-centric allocations. Part I of this Article demonstrated that tax law generally considers the flow of economic items from the transaction and requires tax items to follow the economic items.[235] The use of a partnership structure should not alter the application of that principle. Thus, the partner to whom an economic item is allocated should recognize the corresponding tax item.[236] Economic-centric allocations help ensure that happens.

Item-specific economic-centric allocations of tax items would give tax law the flexibility needed to anticipate the various economic arrangements partners may adopt. An example helps illustrate this point. Recall that in one scenario Sam and Claire agreed to allocate profit 55% to Claire and 45% to Sam.[237] The partnership's tax income corresponds with its profit, so item-specific economic-centric allocation rules would require the partnership to allocate 55% of the tax income to Claire and 45% to Sam. If the partners failed to allocate economic items in their partnership agreement, state default rules would allocate those items. Economic-centric tax-item allocations would require the corresponding tax items to follow the allocation of the economic items. Thus, if state law allocated operating profits equally to the partners, tax

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234. As demonstrated earlier, partnership tax law will never adequately account for partnerships with distribution-dependent residual risk, such as those with target allocations. *See supra* Part III.C.5; Borden, *supra* note 35, at 286–91.

235. *See supra* text accompanying notes 21–26 (who earned the corresponding economic income); Lusthaus v. Comm'r, 327 U.S. 293, 295–97 (1946) (rejecting a sham partnership formed to shift income between a husband and wife); Comm'r v. Tower, 327 U.S. 280, 291–92 (1946) (holding that no meaningful partnership existed between a husband and wife and disregarding the allocation of income from the husband to the wife).

236. In the case of tax-exempt income or non-deductible expenditures, tax law adjusts the partners' bases in the partnership to preserve the tax effect. *See* I.R.C. § 705(a)(1)(B), (2)(B) (2006). The tax treatment does not affect the allocation of the corresponding economic item, unless the partners have adopted the Section 704(b) capital account rules, which require the partners to adjust capital accounts for allocations of tax-exempt income and non-deductible expenditures. Treas. Reg. § 1.704-1(b)(2)(iv)(*b*)(*3*), (*6*) (as amended in 2008).

237. *See supra* Part III.C.3.

law should allocate the corresponding tax item equally to the partners.

One challenge item-specific economic-centric allocations face is the allocation of independent tax items. Independent tax items, such as depreciation deductions, have no economic items to follow. Thus, tax law must deal with them specially. Simply granting the partners discretion to allocate the independent items does not seem appropriate. Some partners would abuse such freedom and enter into tax-item transactions or other tax-revenue-reducing arrangements. Consequently, tax law must govern the allocation of independent tax items.

To consider a rule that allocates independent tax items, recall how tax law treats an individual who owns depreciable property. Tax law allows the owner of certain property used in a trade or business or held for production of income to take a depreciation deduction for the property.[238] The purpose of the depreciation deduction appears to be to allow the property owner to deduct the cost of the property capitalized on acquisition.[239] Upon disposition of the property, the owner must recapture the depreciation deduction.[240] A property owner who is entitled to a depreciation deduction may not assign that deduction or the depreciation recapture to another party.[241] For example, if Sam owned a building individually, Claire could not claim the depreciation deduction for the building. Only Sam, the owner of the building, could claim the deduction. Later, if Sam sold the building, Sam would recapture the depreciation.[242] Partnership tax law should strive to achieve a similar result.

With respect to the allocation of depreciation deductions, partnership rules should require the allocation of depreciation based upon the partners' indirect ownership of the depreciable property. Partners indirectly co-own partnership property.[243] Thus, they each should report a portion of the depreciation deduction associated with the partnership's depreciable property. Tax law should require the partners to allocate the partnership's depreciation deduction in accordance with their indirect

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238. *See* I.R.C. § 167(a) (2006).

239. *See* BRIAN E. COMERFORD & MASON J. SACKS, FEDERAL TAX DEDUCTIONS 404 (1983) ("It is reasonably clear, however, that even in the beginning, Congress intended merely that the deduction for depreciation permit a taxpayer to recover its investment in a capital asset. The deduction is not designed either to permit a taxpayer to match income and expense, since the income generated by the asset is ignored, or to enable a taxpayer to replace an obsolete asset, as replacement cost is also ignored.").

240. *See* I.R.C. §§ 1(h)(1)(D), 1245(a) (2006).

241. *See* Borden, *supra* note 52, at 329–32.

242. *See* I.R.C. § 1(h)(D) (2006).

243. *See* UNIF. P'SHIP ACT § 101(6) (amended 1997), 6 U.L.A. 61 (2001) (defining partnership as a co-ownership arrangement). *But see* UNIF. P'SHIP ACT § 203 (amended 1997), 6 U.L.A. 96 (2001) (providing that the partnership, not the partners, owns the partnership property).

ownership interests in the partnership property. The partners' indirect ownership interests in the partnership property may not be obvious. Factors such as the partners' capital contributions, income-sharing arrangements related to the property, and their sharing of fluctuations in the property's value indicate the partners' indirect ownership interests in the partnership property. Those factors may vary over time and the ratio of each with respect to various properties may differ. Relying on such factors alone will therefore not completely solve the problem.[244]

The law could allow partners to determine their indirect interests in the partnership property based upon relevant factors related to the property. If the partners' determination is reasonable based upon the factors above, the law should respect the determination. If the partners fail to establish their indirect interests, tax law could defer to the state default allocation rules to establish those interests. The law should also require that the partner to whom depreciation is allocated must recognize depreciation recapture when the partnership disposes of the property in a taxable transaction. The allocation of depreciation recapture to the partner who took the depreciation deduction will help minimize abusive allocations of the depreciation deduction. The use of indirect interests may not eliminate all potential for abuse, but it will require reasonable, uniform allocations of independent tax items. Such rules will also help allocate hybrid tax items such as taxable gain or loss.

Consider how item-specific economic-centric rules might allocate depreciation deductions to Sam and Claire in the partnership with specially-allocated economic items. The rules would allocate the depreciation deduction based upon the partners' indirect ownership interests in the partnership property. Their indirect ownership interests would relate to economic items associated with the property, such as fluctuations in the property's value. Recall that they agreed to allocate fluctuations in the value of the property 65% to Sam and 35% to Claire.[245] The partnership's only asset is the property, so the partnership's profits are also associated with the property. The partners allocate profit 45% to Sam and 55% to Claire.[246] Based upon the allocation of those two economic items, Sam and Claire would have to reasonably establish their indirect ownership interests in the property. Taking into account each partner's contributions as well, any allocation between 45% and 80% for Sam and between 20% and 55% for Claire would appear to be reasonable. The interests they establish will apply to all depreciation deductions associated with the property.

244. *See supra* Part III.

245. *See supra* Part III.C.3.

246. *See id.*

Assume that Sam and Claire agree that Sam's indirect ownership interest is 60% and Claire's is 40%. Based on those interests, they would allocate the depreciation deduction 60% to Sam and 40% to Claire. Over the first three years, the partnership would have $60,000 of depreciation deductions and allocate $36,000 or 60% to Sam and $24,000 or 40% to Claire. That tax-item allocation would not affect the allocation of economic items.

Now consider the allocation of gain on the disposition of the property at the end of Year 3. Assume Samaire Partnership sells the property for $1,088,000, its fair market value. The partnership would recognize $148,000 of gain on the disposition.[247] Sam and Claire agreed to allocate the $88,000 of increased value (an economic item) 65% or $57,200 to Sam and 35% or $30,800 to Claire. $88,000 of the gain (a tax item) corresponds to the increase in the property's value (an economic item), so they should allocate that portion of the gain 65% to Sam and 35% to Claire. In that manner, the tax item follows the economic item.

The remaining $60,000 of gain is depreciation recapture attributable to the depreciation deductions. The partnership should allocate the recapture in the same ratio that it allocated the depreciation deductions. Therefore, it should allocate 60% or $36,000 of the recapture to Sam and 40% or $24,000 to Claire. These allocations ensure that corresponding tax items follow economic items and that the allocations of independent tax items follow a reasonable allocation. The tax-item allocations should not distort taxpayer behavior, and they would not affect the partners' rights and obligations in the partnership.

Tax law would also have to develop similar rules or standards for allocating other independent tax items. Such rules may not be perfect. Nonetheless, they would more closely reflect the general rules of income tax. They would also help reduce abuse by requiring the partners to determine their interests in partnership property (or other relevant factors) and use those determined interests to allocate tax items consistently. Item-specific allocations also eliminate abusive allocations of corresponding tax items by preventing the dissociation of corresponding tax items from economic items.

Item-specific economic-centric allocations would not require capital accounts. Partners may use capital accounts to report a monetary value for their legal rights and obligations in the partnership, but tax-item allocations would not affect those accounts. Tax law could therefore

247. The gain is based upon partnership's adjusted basis of $940,000, the $1,000,000 cost minus the $60,000 depreciation. *See* I.R.C. § 1011(a) (2006).

eliminate economic-effect safe harbor. Eliminating those rules would stop the unintended consequences that currently derive from their tax-centric nature. Consequently, tax-item allocations would not have legal or economic consequences and would not affect the partners' economic interests in the partnership. In short, item-specific economic-centric tax-item allocations would appear to solve many of the problems of the current system.

## CONCLUSION

Partnership tax law has the significant burden of allocating tax items to the partners. The complex nature of partnerships makes that a difficult task. Tax law has dealt with that task by granting significant leeway to partners in allocating tax items, as long as those allocations come within the economic-effect safe harbor. The IRS may, however, challenge allocations made pursuant to the economic-effect safe harbor by comparing them to allocations that the partnership would have made in accordance with partners' interests in the partnership. The IRS may reallocate invalid allocations in accordance with partners' interests in the partnership. Allocations that do not come within the economic-effect safe harbor must be in accordance with partners' interests in the partnership. Therefore, partners' interests in a partnership are a critical aspect of the current allocation rules.

Considering allocations made in accordance with partners' interests in the partnership has visceral appeal. The concept sounds so intuitive that such allocations would appear to be obvious. This Article demonstrates, however, that the concept of partners' interests in a partnership is illusory. Its use in the allocation rules creates serious problems, including opening the door for abusive allocations. Such allocations could remove billions of dollars from federal tax revenue. This Article therefore suggests that tax law should abandon its use.

Tax law should require the allocation of corresponding tax items to follow corresponding economic-item allocations and require the allocation of independent tax items to tie-in with an economic aspect of the partnership that relates to the tax item. Such a rule would more closely reflect general principles of taxation and not affect the partners' economic interests in the partnership. Finally, such a rule would help eliminate ambiguity as well as reduce abusive tax practices and traps for unsophisticated taxpayers. The result would be item-specific economic-centric rules that recognize and follow the partners' economic arrangements. Such rules would represent a fundamental change in partnership taxation, but the change is in the best interests of the tax

system and the vast majority of taxpayers.