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Bradley T. Borden
Brooklyn Law School, bradley.borden@brooklaw.edu

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PARTNERSHIP TAX ALLOCATIONS AND THE INTERNALIZATION OF TAX-ITEM TRANSACTIONS

BRADLEY T. BORDEN*

*Associate Professor of Law, Washburn University School of Law, Topeka, Kansas; LL.M. and J.D., University of Florida Levin College of Law; M.B.A. and B.B.A., Idaho State University. I thank Brant Hellwig, Darryll Jones, and Walter Schwidetzky for helpful comments on earlier drafts of this Article and Patty Cates for helping prepare this Article for publication. I thank Washburn University School of Law for supporting scholarship. Finally, I thank my wife Samantha and daughter Claire for their unwavering support and encouragement in all my writing efforts. All opinions expressed herein and any errors are my own.

I. INTRODUCTION

In *Napoleon Dynamite*, the movie's namesake spends a day working on a chicken farm to raise money for an upcoming date.[1] At the end of the day, the owner of the farm pats his pockets and says, "I can't find my checkbook. I hope you don't mind if I pay you in change."[2] Napoleon ends up with six dollars for his labor.[3] Variations of that simple transaction play out in numerous contexts throughout the economy every day. Regardless of the apparent complexity of a transaction, the transaction in *Napoleon Dynamite* reflects the fundamentals of many transactions: namely, parties exchanging property or services. In *Napoleon Dynamite*, Napoleon performed services for money, and the farmer received Napoleon's services in exchange for money. Each transaction carries with it tax implications—here Napoleon had income from compensation,[4] and the farmer should have had a business deduction.[5]

The medium of exchange is not limited to money or negotiable instruments. A party to an exchange may use anything that has value to the other party. In fact, tax items[6] and tax effects[7] may have value to the parties to an exchange and may be effective media of exchange. For example, the farmer in *Napoleon Dynamite* could have offered, "I can't find my checkbook or any change. I hope you don't mind if I assign you some tax deductions." Using the deduction as the medium of exchange, Napoleon and the farmer could accomplish the same economic result they accomplished with currency as the medium of exchange. For instance, if Napoleon

1. NAPOLEON DYNAMITE (Fox Searchlight Pictures 2004).
2. *Id.*
3. *Id.*
4. *See* I.R.C. § 61(a)(1) (2000).
5. *See id.* § 162(a)(1) (2000).
6. A tax item is something that a taxpayer reports on a tax return. *See infra* Part III.A (discussing tax-item transactions). Tax items include income, gain, loss, and deductions.
7. A tax effect reflects the tax consequence of a tax item. *See id.* (discussing tax effects). For example, if reported income increases a taxpayer's tax liability by $5,000, the tax effect of the income item is the $5,000 increase in tax liability.

and the farmer were both subject to a twenty percent tax rate and otherwise had income, the farmer's assignment of thirty dollars of depreciation to Napoleon would decrease Napoleon's tax liability by six dollars and increase the farmer's tax liability by the same amount.[8] The change in their respective tax liabilities is the economic equivalent of the farmer paying Napoleon six dollars of cash. Because the tax-item assignment is economically equivalent to a cash payment, the transaction should be taxed the same regardless of the medium of exchange.[9] Thus, tax law should treat the farmer's assignment of the deduction to Napoleon the same way it treats the farmer's payment of currency to Napoleon.

If parties are able to obtain favorable tax consequences by disguising the transactions, undoubtedly, they will look for such cloaking devices. For example, the farmer might encourage Napoleon to enter into a partnership with him. Having entered into the partnership, the partnership tax allocation rules would allow the farmer to allocate the thirty dollars of deduction to Napoleon, as long as the allocation had substantial economic effect.[10] Tax law allows the assignment of tax items within a partnership but does not tax the assignment as a tax-item transaction. Thus, the internalized tax-item transaction does not produce the same gross income that the open-market tax-item transaction produces.

This Article argues that by allowing such an allocation, the partnership tax allocation rules allow partners to do what the tax law prohibits or taxes on the open market.[11] It also argues that the test for determining whether an allocation has substantial economic effect is a tax-centric test—the test allows tax-item allocations and then tests whether the partner to whom the allocation is made receives the economic benefit or burden that accompanies the allocation. This Article suggests that more effective allocation rules would focus on the economic arrangement the partners agree to and require tax allocations to follow the partners' apportionment of economic items. Such deal-centric rules would help eliminate internal tax-item transactions.

This Article begins with a discussion of the nature of partnerships that draws from theories of the firm. That discussion reveals important aspects of partnerships that should inform the drafting of partnership tax allocation rules. First, the complex nature of partnerships prevents matching partner inputs with partnership output. Second, the nature of the partnership as a community of interest makes determining the specific source of partnership income difficult, if not impossible.

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8. This assumes Napoleon has taxable income that the deduction will offset. If the deduction reduces Napoleon's taxable income by thirty dollars, it will reduce his tax liability by twenty percent of that amount. By relinquishing the deduction, the farmer will increase his own taxable income by thirty dollars, which will increase his tax liability by six dollars.

9. *See* Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955) (providing that gross income includes any accession to wealth that a taxpayer "clearly realize[s]" and over which the taxpayer has "complete dominion"); Old Colony Trust Co. v. Comm'r, 279 U.S. 716, 729 (1929) (holding that payment of another's obligation is equivalent to paying cash to that person and that gross income includes the amount of tax liabilities paid by one party on behalf of another taxpayer).

10. *See infra* Part IV.A (discussing the partnership tax allocation rules).

11. This Article uses "open market" to refer to transactions that occur outside partnerships. Thus, an assignment of a tax item outside a partnership would be an open-market transaction.

Third, partnerships internalize transactions that they would otherwise enter into on the open market to reduce transaction costs. These factors suggest that rigid per-capita or capital-account allocation rules will fail to match tax items with consideration partners receive from the partnership. These factors also suggest that partners should not be able to internalize tax-item transactions that tax law prohibits on the open market. To inform the analysis of the internal tax-item transactions, this Article then explains the tax treatment of open-market tax-item transactions. In particular, it explains that tax law imposes tax on the assignment of the several components of a transaction—assignment of consideration, tax items, and tax effects.

Having established the nature of partnerships and the tax treatment of open-market tax-item transactions, this Article demonstrates how the current tax-centric partnership tax allocation rules allow partners to internalize tax-item transactions without corresponding tax consequences that should follow such transactions. This Article suggests that deal-centric partnership tax allocation rules would help to eliminate the disparate treatment of internal partnership tax-item transactions and open-market tax-item transactions.

II. THE ECONOMIC NATURE OF PARTNERSHIPS

Partnership taxation derives its significance from the nature of partnerships.[12] The definition of partnership has historically been difficult to frame.[13] Most

12. Congress enacted the first statutory definition of tax partnership in 1932. *See* Revenue Act of 1932, ch. 209, § 1111(a)(3), 47 Stat. 169, 289 (defining "partnership" for federal tax purposes as "a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this Act, a trust or estate or a corporation"). Although that definition did not explicitly include partnerships, the partnership tax rules clearly applied to substantive law partnerships. *See, e.g.*, Newell v. Comm'r, 17 B.T.A. 93, 96 (1929) ("No rigid rules can be laid down as to the requirements to establish the relationship. Ordinarily where two or more persons associate themselves together for a common undertaking for profit, and share in the profits or losses, a partnership results."); Kier v. Comm'r, 15 B.T.A. 1114, 1117 (1929) ("Partnership is the association of two or more persons, for the purpose of carrying on business together, and dividing its profits between them." (quoting CAL. CIV. CODE § 2395 (1929) (repealed 1949)) (internal quotation marks omitted)); Bradley T. Borden, *The Federal Definition of Tax Partnership*, 43 HOUS. L. REV. 925, 947 (2006) (recognizing that the partnership tax rules "had referred to partnerships for almost twenty years before Congress enacted a [statutory] definition of tax partnership"). Currently the accepted substantive law definition of partnership is "an association of two or more persons to carry on as co-owners of a business for profit." UNIF. P'SHIP ACT § 101(6) (amended 1997), 6 U.L.A. 61 (2001). The federal definition of tax partnership generally includes such partnerships, limited liability companies, limited partnerships, and other nonincorporated arrangements. *See* Treas. Reg. § 301.7701-3(a) (as amended in 2007) (providing that all two member business entities that are not tax corporations, either by definition or by election, shall be a tax partnership). The phrase "nature of partnerships" derives from Ronald Coase's influential work on the theory of the firm. *See* R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

13. *See* FLOYD R. MECHEM, ELEMENTS OF THE LAW OF PARTNERSHIP 2 (2d ed. 1920) ("An attempt to frame a satisfactory definition of partnership is probably a somewhat hazardous undertaking."); JOSEPH STORY, COMMENTARIES ON THE LAW OF PARTNERSHIP, AS A BRANCH OF COMMERCIAL AND MARITIME JURISPRUDENCE, WITH OCCASIONAL ILLUSTRATIONS FROM THE CIVIL AND

definitions of partnership require two or more persons to combine ownership of property and services,[14] and to share profits from that combination.[15] The label attached to an arrangement generally will not determine the nature of the arrangement or whether it is a partnership.[16] Skilled lawyers are able to create needed relationships using forms and labels of various entities. For example, a skilled lawyer could introduce partnership attributes into a corporation or introduce corporate attributes into a partnership.[17] Similarly, a skilled lawyer can use an employment contract or a lease to create an arrangement that has all of the attributes of a partnership.[18] By modifying a limited liability company operating

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FOREIGN LAW § 2, at 2–3 (William S. Hein & Co. 1980) (1841) (listing the following definitions of partnership: "a voluntary contract between two or more competent persons to place their money, effects, labor, and skill, or some or all of them, in lawful commerce or business, with the understanding, that there shall be a communion of the profits thereof between them"; "a contract, whereby two or more persons put, or contract to put, something in common to make a lawful profit in common, and reciprocally engage with each other to render an account thereof"; "a contract between two or more persons, by which they join in common either their whole substance or a part of it, or unite in carrying on some commerce, or some work, or some other business, that they may share among them all the profit or loss, which they may have by the joint stock, which they have put into partnership"; and "a contract, by which two or more persons agree to put something in common, with a view of dividing the benefit, which may result from it" (citations omitted)).

14. *See* William Mitchell, *Early Forms of Partnership*, *in* 3 SELECT ESSAYS IN ANGLO-AMERICAN LEGAL HISTORY 183, 183–84 (Association of American Law Schools ed., 1909) (describing the earliest partnerships as combinations of capital contributed by one party and services and perhaps a small amount of capital contributed by the other party). Under the most common form of early partnership, the "commendator" contributed capital and the "tractator" dealt with the operations of the partnership. *Id.* at 184–85.

15. *See id.* at 184 ("The usual share in the profits of a tractator who brought no capital into the partnership was a quarter, while in the case where he contributed to the general fund, his share of the profits amounted to a half."). The substantive law definition of partnership contemplates the combination of service and property contributions to an enterprise and the sharing of profits. *See* STORY *supra* note 13.

16. *See* Borden, *supra* note 12, at 983–84.

17. *See* Robert Hessen, *A New Concept of Corporations: A Contractual and Private Property Model*, 30 HASTINGS L.J. 1327, 1331–33 (1979) (describing how corporations can contract away traditional corporate attributes of limited liability and terminate, losing their perpetual existence, while partners may use contracts to obtain limited liability and use agreements to continue in the event of a partner's withdrawal). Of course, partners may now use limited liability companies to obtain many, if not all, the attributes they could obtain using a corporation. *See* Anthony P. Polito, *Advancing to Corporate Tax Integration: A Laissez-Faire Approach*, 55 S.C. L. REV. 1, 38, 85 (2003).

18. For example, if a lease agreement provides for profit sharing and gives the lessee any residual interest in the property, it could create a partnership. *See* Haley v. Comm'r, 203 F.2d 815, 816, 818–20 (5th Cir. 1953) (holding that an arrangement labeled a lease by the parties was a tax partnership). A purported employment agreement could create a partnership if the employee shares profits with the employer and has an interest in property and operations of the business. Courts consider several factors in determining whether an arrangement is an employment arrangement or a partnership. *See* First Mechs. Bank of Trenton, N.J. v. Comm'r, 91 F.2d 275, 278–80 (3d Cir. 1937) (considering intent, contributions, control, sharing of profits, and communication to third parties about the arrangement in holding that the arrangement was a tax partnership); Luna v. Comm'r, 42 T.C. 1067, 1077–79 (1964) (listing several factors to consider in deciding whether an arrangement is an employment arrangement or tax partnership and holding that the arrangement was not a tax partnership because only one party had control over operations); Beck Chem. Equip. Corp. v. Comm'r, 27 T.C. 840, 850–53 (1957)

agreement, a skilled lawyer can create an arrangement that is very similar to an employment agreement or a lease.[19] The various forms of arrangements are mere contracts that a skilled lawyer may manipulate to provide parties with an arrangement they desire.[20] Because the label does not determine the nature of an arrangement, the analysis focuses on whether the parties co-own property and contribute services to an arrangement.[21] Thus, the discussion that follows does not focus on the form of a particular transaction or the labels the parties attach to it. Instead, it considers the characteristics of particular arrangements that should be tax partnerships that create the need for tax allocation rules. The discussion demonstrates that the combination of property co-ownership and contributed services, or simply the combined services of two or more people, is a *sine qua non* of partnerships, if the contribution is for profit.[22]

Although beneficial for business ventures, combining property and services, or simply services, of two persons creates significant difficulties for our income tax system. In particular, such combinations create difficulty in tracing income and expenses from their sources to the contributors of the property or services generating the income or expenses. A partnership is also a community of interest, so partners are unable to separate the income and losses that come from the various interests within that community. The inability to trace the sources of income and losses places the burden on partners to decide how to apportion among themselves the product of their property and services. Theory-of-the-firm concepts provide insight into what motivates partners to apportion income in a particular manner. Understanding that motivation is critical in analyzing the partnership tax allocation rules.

(considering, among other factors, the parties' mutual proprietary interests and intent to be co-proprietors in holding that the arrangement was a tax partnership).

19. The lawyer would do this by giving one party control of the property and operations of the arrangement through voting or other control mechanisms, such as buy-sell agreements. If one party was deemed to own the limited liability company's property and control its operations and the other party was merely providing services, the arrangement would not look like a partnership.

20. *See* Hessen, *supra* note 17, at 1331–33. This view is contrary to the concessions theory, which provides that a corporation is a creature of the state. *See* William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 433–34 (1989). The concession theory began losing support in the last quarter of the 20th century. *See id.* at 434–36.

21. The IRS and courts have recognized that substantive-law classification of an arrangement does not determine the tax classification of the arrangement. *See* Comm'r v. Tower, 327 U.S. 280, 287–88 (1946) (disregarding Michigan law in determining the federal classification of an arrangement); Linsenmeyer v. Comm'r, 25 T.C. 1126, 1132 (1956) (noting the irrelevance of state law in entity classification for federal tax purposes); Stern v. Comm'r, 15 T.C. 521, 526–28 (1950) (disregarding state law prohibition of certain persons being partners); Treas. Reg. § 301.7701-1(a)(1) (as amended in 2007) (providing that whether an organization is a separate entity for federal tax purposes does not depend upon local law).

22. The term *profit* raises some difficulties when used as a criterion for the definition of tax partnership. *See* Borden, *supra* note 12, at 1017–23. This Article uses the term *profit* to indicate that the members of the arrangement have a profit motive, as opposed to an eleemosynary purpose.

A. Input-Output Matching and Reward Apportionment

Work done by economists considering the theory of the firm illuminates the tracing problem that partnerships create. Economists recognize that "[t]wo key demands are placed on an economic organization—metering input productivity and metering rewards."[23] The output of one individual working with the individual's property may be traced directly from the individual's input—the individual's services and property. The challenge of tracing output from input with a partnership is twofold. First, matching output with the input that created it is difficult, if not impossible, in many situations. That matching problem creates difficulties in rewarding input providers based on output because simply observing output will not show the relative contributions of the input providers. Second, the total output of an arrangement may not equal the sum of the separate inputs from individual members of the arrangement.[24] The parties therefore must decide how to apportion any extra output created by combining inputs.

Simple examples demonstrate the ability to trace output from an individual's input and the inability to trace an arrangement's output from the separate inputs of the arrangement's members.[25] In the first example, Amanda lifts cargo into trucks. All of the cargo Amanda lifts into the truck is the output from Amanda's input—her lifting. Because Amanda's input produced the output, Amanda should receive all of the compensation (reward) for lifting the cargo into the truck. In the second example, Amanda and Brenda work together to lift cargo into the truck. All of the items are too heavy for either individual to lift alone, so Amanda and Brenda lift each item together. The arrangement's input thus consists of Amanda and Brenda lifting items together. The cargo Amanda and Brenda load into the truck is the output. Any compensation for lifting the cargo into the truck will be the reward. Without employing sophisticated monitoring techniques, Amanda and Brenda cannot measure their respective inputs or the effect each input has on output.[26] Perhaps Brenda lifted the lighter side of each item, so her inputs are less than Amanda's. Perhaps Amanda had to bear the bulk of the load if they carried any of the cargo up an incline. Even if the parties were able to determine that Brenda shirked some of the work and thereby contributed less inputs than Amanda, they may not be able to determine the proportionate difference of the inputs. Unable to

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23. Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 778 (1972). Alchian and Demsetz use the term *team production* to refer to the production of an arrangement and define the term as "production in which 1) several types of resources are used and 2) the product is not a sum of separable outputs of each cooperating resource." *Id.* at 779. As used in this context, *meter* means to both measure and apportion. *Id.* at 778 n.1.

24. *See id.* at 779 ("Team production of Z involves at least two inputs, X_i and X_j, with $\partial^2 Z/\partial X_i \partial X_j \neq 0$. The production function is *not* separable into two functions each involving only inputs X_i or only inputs X_j. Consequently there is no *sum* of Z of two separable functions to treat as the Z of the team production function. (An example of a *separable* case is $Z=aX_i^2+bX_j^2$ which is separable into $Z_i=aX_i^2$ and $Z=bX_j^2$, and $Z=Z_i+Z_j$. This is not team production.)" (footnote omitted)).

25. This example is adapted from an example in Alchian & Demsetz, *supra* note 23, at 779.

26. Monitoring input is costly and difficult, but if the parties know that they are not being monitored, they will also be inclined to shirk their responsibilities. *See id.* at 780.

determine the inputs, the parties cannot determine the extent to which each party's inputs contributed to the output. Thus, they cannot accurately apportion the reward based on output as a function of the separate inputs of the arrangement's members.

The inability to accurately apportion rewards based on inputs will lead to shirking.[27] By hiring managers to monitor inputs,[28] firms are able to apportion rewards based on inputs and reduce shirking.[29] Thus, the use of reward apportionment may help reduce shirking.[30] It will not, however, perfectly match inputs to productivity—output resulting directly from a particular input. Thus, if the owner of the firm employing Amanda and Brenda hired Bob to manage Amanda and Brenda, Bob could reduce the parties' shirking by monitoring their inputs and giving revenue based on the measured inputs. If Amanda and Brenda are partners, they may have a general tendency to shirk but would not have centralized management to monitor their behavior. Because Amanda's shirking reduces total output and in turn reduces Brenda's reward, Brenda will monitor Amanda's behavior (and for the same reasons, Amanda will monitor Brenda's behavior).[31] Among other monitoring techniques, Brenda may negotiate the apportionment of rewards, require Amanda to perform fiduciary duties as a partner,[32] or threaten dissociation to help reduce Amanda's shirking.[33] Thus, by agreement, partners apportion rewards as a tool of monitoring each others' behavior and to reduce the other party's shirking. The apportionment of rewards may not, however, reflect the proportionate contributions each party makes to the partnership's output. Although such monitoring may help reduce shirking, it does not remove the inability of tracing output from input.

Added to the difficulties of the inability to trace output from input is the need to account for any excess output created by the combination of multiple inputs. Output, although a function of inputs, does not necessarily reflect the sum of the

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27. *See id.* at 780–81 (describing the tendency to shirk and providing that "completely effective control cannot be expected from individualized market competition").

28. *See id.* at 782 ("*Managing or examining the ways to which inputs are used in team production is a method of metering the marginal productivity of individual inputs to the team's output.*").

29. *See id.* at 782–83 (listing powers that should be granted to the monitor and providing that the coalescing of powers "resolves the shirking-information problem of team production better than does the noncentralized contractual arrangement").

30. This approach is no guarantee, however. If an input provider disagrees with the manager's allocation of rewards, the input provider may leave the firm. *See id.* at 783 ("The employee 'orders' the owner of the team to pay him money in the same sense that the employer directs the team member to perform certain acts. The employee can terminate the contract as readily as can the employer . . . .").

31. *See id.* at 786 ("Profit sharing to encourage self-policing is more appropriate for small[er] teams. . . . [because it] permits more effective reciprocal monitoring among inputs.").

32. *See* Jason Scott Johnston, *Opting In and Opting Out: Bargaining for Fiduciary Duties in Cooperative Ventures*, 70 WASH. U. L.Q. 291, 324 (1992) (discussing the effect fiduciary duties have on minimizing partners' opportunistic behavior).

33. Larry E. Ribstein, *A Statutory Approach to Partner Dissociation*, 65 WASH. U. L.Q. 357, 364–68 (1987) (discussing the principle of dissociation and conditions under which partners may dissociate).

separate inputs.[34] Through observation of each others' inputs, partners agree on how to divide the excess of the sum of the separate inputs. Partners may divide that excess in a manner that they believe will best discourage shirking, and thus the apportionment of the excess may not reflect the proportionate contribution each partner's input makes to the excess output. The difficulties manifest themselves in simple examples of service partnerships and property-services partnerships.

1. *Reciprocal Monitoring in Service Arrangements*

A simple law firm demonstrates the inability to trace outputs from inputs.[35] Claire is a very successful attorney. Because of her innate rainmaking skills, she is able to attract very good work. Claire is limited, however, in the time she is able to devote to clients' work. If she were able to handle all of the work she could bring in, she would increase the $250,000 annual income she currently makes. Abby is also a lawyer and an outstanding technician. Abby finds, however, that she has a significant amount of spare time because she is unable to attract a sufficient flow of client work. As a result, her annual income is limited to $200,000 per year. She could make significantly more, however, if she had a sufficient amount of work to fill the time she would like to allot to lawyering.

Claire and Abby realize that by combining their efforts they can make more. They join forces, and because of Abby's efforts at the office, Claire no longer has to turn away work, and Abby no longer has to worry about having work because Claire's rainmaking efforts generate enough work to fill the time Abby allots to lawyering. Through their combined efforts, Abby and Claire can make $750,000 of income together, assuming neither person shirks her responsibilities.[36]

For the sake of analysis, assume that Abby's input is her time spent doing client work and the relationships that she builds with clients whom Claire attracts to the firm. Assume that Claire's input is her time spent generating new business and doing some client work. Further assume that the output generated by Abby and

34. *See supra* note 24. If the combined inputs did not produce output in excess of the sum of the separate inputs, the members would have no economic reason to form a partnership.

35. The same difficulties would arise in large partnerships. *See* Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327, 334–37 (1983) (suggesting that each partner's residual claim and flexible profit-sharing rules help reduce the agency costs of partners and that members of large professional services partnerships can be regarded as a fluid association of small partnerships); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 315–17 (1983) [hereinafter Fama & Jensen, *Ownership and Control*]. To introduce the application of theory-of-the-firm concepts to the analysis of partnership tax allocation rules, this Article uses simple partnerships to illustrate concepts. This Article leaves to future work the application of these theories to tax allocations in larger partnerships.

36. The $750,000 of income is the excess of the firm's total collections for the year less the amount paid to operate the firm. Thus, it represents the amount the partnership may distribute to Abby and Claire. The combination of their respective talents helps them raise considerably more than either could raise on her own. *See supra* note 24 (presenting mathematical support for such an outcome).

Claire's input is the firm's income.[37] Having determined that the source of the firm's output is the collective inputs of Abby and Claire, the challenge is to determine the effect each input has on the output and apportion the firm's income accordingly. Because all of the income derives from the input of both partners, Abby and Claire cannot trace a specific amount directly from either partner's input. Additionally, the parties must apportion the excess income resulting from their combined efforts. Thus, even if Abby and Claire were able to determine that $300,000 of income was derived directly from Claire's input and $350,000 was derived directly from Abby's input, they would still have to decide how to allocate the remaining $100,000 of income.

Although Abby and Claire are unable to match inputs and outputs directly, they may have ideas about the allocations that will discourage shirking. Such reciprocal monitoring may produce a complicated apportionment formula. For example, Abby may realize that she stands to make more if Claire is always generating more work. Based on that realization, Abby may agree to a formula that apportions a larger share of the income to Claire when Claire generates more work. Thus, Abby's monitoring of Claire may result in the apportionment of partnership income in a ratio that differs from the partners' estimate of the relative contribution of the separate inputs.[38] Partnership tax allocation rules must recognize the inability to trace output from input, that combined inputs often create output in excess of the sum of the separate inputs, and that partners apportion rewards to monitor each other's behavior.

2. *Reciprocal Monitoring in Property-Service Arrangements*

Partnerships that combine significant assets and services raise similar matching and monitoring difficulties. To illustrate, assume Mason owns Bridgestone, an apartment complex, and Bryce is a professional apartment manager. For several years Mason has managed Bridgestone himself. Over the last several years, Bridgestone has generated about $500,000 per year in rental income and $300,000

37. If income is the output, Abby's and Claire's inputs should also include the cost-effective manner in which each of them practices law. The fewer costs each incurs practicing law, the more income the firm will have. Thus, cost savings could also be an input. To keep the analysis simple, this Article focuses on only the income-generating input.

38. *See* Alchian & Demsetz, *supra* note 23, at 786. The authors argued,

> We conjecture that the cost of managing team inputs increases if the productivity of a team member is difficult to correlate with his behavior. In "artistic" or "professional" work, watching a man's activities is not a good clue to what he is actually thinking or doing with his mind. . . . As a result, artistic or professional inputs, such as lawyers, advertising specialists, and doctors, will be given relatively freer reign with regard to individual behavior. If the management of inputs is relatively costly, or ineffective, as it would seem to be in these cases, but, nonetheless if team effort is more productive than separable production with exchange across markets, then there will develop a tendency to use profit-sharing schemes to provide incentives to avoid shirking.

Id.

in deductible expenses, including operating expenses and depreciation. Mason is growing weary of managing Bridgestone and is looking for an opportunity to turn the management responsibilities over to someone else; however, he does not want to lose the income stream. He also believes that Bridgestone will appreciate in value if managed properly and wants to share in any increase in Bridgestone's appreciation.

Although Bryce is young, he has developed a reputation as an excellent manager of apartments. Apartment owners generally pay Bryce roughly twenty percent of gross rental receipts for the properties he manages.[39] Bryce would like to find a way to obtain an ownership interest in an apartment complex. Recognizing that a partnership would help each achieve his respective goals, Mason and Bryce begin discussing combining Mason's property with Bryce's services. They both realize the complementary nature of their respective goals, abilities, and interests.[40] Although Mason is not ready to sell Bridgestone, he is willing to work out an arrangement with Bryce that will transfer an interest in Bridgestone to Bryce over time, provided that Bryce is able to generate rental income from Bridgestone and increase its value. Bryce would be comfortable with that arrangement, so long as he shares in the operating income of Bridgestone from the beginning of the arrangement.[41]

After further discussion, Mason and Bryce work out the following arrangement. They agree to form a partnership, which they decide to call "Brason Partners."[42] Pursuant to the agreement, Mason will transfer Bridgestone to the partnership. Bryce will take an interest in the partnership that provides him a vote in decisions

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39. Bryce's sharing in the rental revenue does not constitute a tax partnership arrangement. *See* Harlen E. Moore Charitable Trust v. United States, 9 F.3d 623, 625–27 (7th Cir. 1993) (holding that a sharecropping arrangement was not a partnership even though the lessor and lessee shared the farm's production and some of the farming costs). Thus, Bryce is either an employee or independent contractor, depending upon the arrangement he has with the property owner.

40. Alchian and Demsetz described this phenomena as follows:

> There exist production techniques in which the Z [output] obtained is greater than if X_i [input from one party] and X_j [input from another party] had produced separable Z [output]. Team production will be used if it yields an output enough larger than the sum of separable production of Z to cover the costs of organizing and disciplining team members . . . .

Alchian & Demsetz, *supra* note 23, at 779.

41. This reflects the type of arrangement used in the earliest partnerships. *See* Mitchell, *supra* note 14, at 183 ("[The popularity of this form of partnership] was due to the fact that it enabled the capitalist to turn his money to good account without violating the canonical laws against usury, and the small merchant or shipper to secure credit and to transfer the risk of the venture to the capitalist.").

42. In this example, the form of the partnership is not important. Therefore, Bryce and Mason may choose to form a general partnership, limited partnership, or limited liability company. Formation of any one of these entities will allow them to meet their income tax goals, and the arrangement will be treated as a tax partnership for federal tax purposes. *See* Treas. Reg. § 301.7701-3(a) (as amended in 2007) (providing that a two-member business entity that is not a corporation within the definition of Treasury Regulation section 301.7701-2(b)(1), (3)–(8) can be classified as a partnership for tax purposes, unless it elects to be a corporation).

regarding management and sale of the property.[43] Bryce will also receive twenty percent of the income generated from Brason Partners and will have a fifty percent interest in the increase of Bridgestone's value after the formation of the arrangement.[44]

During its first year, Brason Partners has $500,000 of gross rental income and $300,000 of deductible expenses, or $200,000 of income. Bridgestone's value increases from $10,000,000 (the value at the time of Brason Partners' formation) to $10,500,000. Bryce's twenty percent share of the $200,000 income would be $40,000,[45] and he would have a $250,000 interest in Bridgestone.[46]

Before Bryce began managing Bridgestone, it generated the same amount of rental income that it generated under Bryce's first year of management. Bridgestone increased in value by five percent under Bryce's management. Mason and Bryce cannot, however, trace the output—income and increase in value of the property—from the input—Bryce's services and Mason's property. The income may be attributable to several factors; for example, the property's location[47] and the structure of the facilities affect the income generated.[48] Bryce's marketing efforts and responsiveness to tenants may also affect the income the apartments generate.[49] Another factor contributing to the income may be a combination of property and

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43. Mason's retention of some control is important in determining whether the arrangement is a tax partnership. Fishback v. United States, 215 F. Supp. 621, 626 (D.S.D. 1963) (providing that equal control among members is not a requisite to finding a tax partnership); Copeland v. Ratterree, 57-2 U.S. Tax Cas. (CCH) ¶ 9895, at 58,195–96 (N.D.N.Y Aug. 21, 1957) (emphasizing the importance of control over profit-sharing in determining whether an arrangement is a tax partnership); Borden, *supra* note 12, at 998 (discussing the relevance of control in determining whether the combination of capital and services creates a tax partnership).

44. This arrangement only provides Bryce a capital interest because if the partnership were to liquidate immediately after the formation, all proceeds would go to Bryce. Rev. Proc. 93-27, § 2.01, 1993-2 C.B. 343 ("A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership."). Both Bryce and Mason will have a profits interest in the partnership. *See id.* § 2.02 ("A profits interest is a partnership interest other than a capital interest.").

45. Bridgestone Apartments' rental revenue was $500,000. That amount reduced by the $300,000 of deductible expenses results in $200,000 of income.

46. The partnership owns Bridgestone Apartments. *See* UNIF. P'SHIP ACT § 203 (amended 1997), 6 U.L.A. 96 (2001) ("Property acquired by a partnership is property of the partnership and not of the partners individually."); *id.* § 204(b)(1), at 97 ("Property is acquired in the name of the partnership by a transfer to . . . the partnership in its name . . . ."). Mason's interest represents the value he would receive if the partnership were liquidated, and he received the value of his share of the increase in property value in cash. Because the value increased by $500,000, Mason's fifty percent share of that income would be $250,000. Before the property was liquidated, Mason could not know the actual value of the property. The numbers are presented here to illustrate the problems partnerships raise.

47. Tenants would pay more to live in a desirable, safe, and convenient location.

48. The structure includes, for example, the size of each unit, the layouts of the apartments, the ease of access, and parking. These are factors that management cannot influence without making major structural changes.

49. Management responsiveness includes the time it takes management to address the concerns of tenants.

services, such as the condition of the facilities.[50] Similarly, the increase in the value of Bridgestone may be attributed to both the property and services. Bryce's upkeep of the facilities may add to the value of the property, but the property's location may be the more significant factor. At any rate, Bryce and Mason cannot accurately account for the output from the inputs alone, but they have agreed to an apportionment formula that allocates income and increases in Bridgestone's value. Undoubtedly, Bryce and Mason considered monitoring issues when they agreed to the apportionment formula.

Consider why the parties may have agreed to their particular apportionment formula. As a co-owner of the property, Mason wants Bryce to do things that increase the value of the property. The generous sharing of the increase in Bridgestone's value will help discourage Bryce from shirking his responsibility to maintain Bridgestone. Alternatively, Mason could have insisted that Bryce bear the cost of any decline in the property's value after formation to achieve the same goal. The parties could have accomplished such an apportionment by offsetting income apportioned to Bryce against any decrease in the property's value. Bryce also could have structured the transaction as a purchase. By entering into a partnership that rewards Mason based on the value of the property, Bryce is able to use the apportionment to monitor Mason's input. If Mason had been aware of some aspect of Bridgestone that would cause it to decline in value after the partnership formation, he certainly would have preferred to sell it to Bryce, leaving Bryce to bear the burden of the property's declining value. Bryce is able to monitor Mason's input, however, by only taking an interest in the property and income it produces. The interest Mason retains helps encourage him to contribute good property, with income-producing potential, to the partnership. Thus, the parties use apportionment to monitor each others' inputs. The apportionment does not necessarily reflect each party's contribution to the partnership or the proportionate effect each party's input has on the partnership's output. Regardless, the partnership agreement fixes the parties' share of partnership income and share of increases in Bridgestone's value.

This discussion of input-output matching and reward apportionment reveals that partners are unable to account for outputs directly from inputs. Thus, partners cannot allocate rewards based exclusively on the proportionate effect that partner inputs have on partnership output. Partners may, however, use reward apportionment to discourage each other from shirking their respective responsibilities. The analysis of partnership tax allocations presented below suggests that tax allocation rules should account for these effects and require that tax items correspond to the economic items partners apportion to each other. The analysis must also consider issues that communities of interest present.

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50. The condition of the facilities includes routine maintenance, such as painting, plumbing, and other items that enhance the comfort of a dwelling unit. It also includes cleanliness and maintenance of the grounds.

B. *Partnership as a Community of Interest*

A partnership is a community of interest,[51] and that community creates complexity that the partnership allocation rules must take into account. Thus, understanding partnerships as communities of interest is important because "every partnership is founded in a community of interest; but every community of interest does not constitute a partnership . . . ."[52] For example, tenants-in-common form a community of interest with respect to property they own, but they are not partners.[53] For federal tax purposes, the relevant difference between mere communities of interest and tax partnerships is the type of interests that the members of an arrangement have in common. As taxpayers become vested in more types of common interests, open-market transactional tax rules become insufficient for determining the tax consequences of the community. Therefore, the focus shifts to determining the type of community of interests that make open-market transactional tax rules inadequate.

Control and ownership determine the extent of a community of interest. Indeed, courts often consider control the central concern in determining whether an arrangement with a service provider is a partnership.[54] Generally, control is a right of ownership,[55] but an owner's control of property may not be absolute. For example, the owner of property may assign the right of possession to a lessee or grant a security interest to a creditor. Such arrangements limit the owner's control of the property during the period governed by the lease or security interest. While property is under lease, the owner may not have the right to enter the property or grant others the right to possession. While the property is security for a loan, the owner may not have the power to transfer the property without the creditor's

51. *See* STORY, *supra* note 13, § 3, at 4 ("[P]artnership and community are not the same thing. . . . The first is founded upon the contract of the parties, which thus creates the community; the last may exist independent of any contract whatsoever.").

52. *Id.*

53. *See id.* (explaining that joint heirs and joint legatees have a community of interest but are not necessarily partners).

54. *See, e.g.*, Comm'r v. Banks, 543 U.S. 426, 436–37 (2005) (holding that because an attorney, as a service provider, is duty bound to act only in the interest of the principal, the arrangement between the attorney and the client was not a tax partnership); Arthur Venneri Co. v. United States, 340 F.2d 337, 343 (Ct. Cl. 1965) (finding that the capital contributor did not have an equal right of control, so the arrangement was not a partnership), *abrogated on other grounds by* Consol. Flooring Servs. v. United States, 42 Fed. Cl. 878 (1999); Luna v. Comm'r, 42 T.C. 1067, 1078 (1964) (stating that (1) control over income and the right to make withdrawals, and (2) mutual control and responsibilities for the enterprise are two of several factors to consider when determining whether an arrangement is a tax partnership or employment arrangement).

55. OLIVER WENDELL HOLMES, THE COMMON LAW 193 (Mark DeWolfe Howe ed., Belknap Press 1963) (1881) ("But what are the rights of ownership? They are substantially the same as those incident to possession. Within the limits prescribed by policy, the owner is allowed to exercise his natural powers over the subject-matter uninterfered with, and is more or less protected in excluding other people from such interference. The owner is allowed to exclude all, and is accountable to no one.").

approval.[56] The key to determining ownership is identifying who holds the residual right of control.[57] If multiple parties hold the residual right of control to property, they would appear to have a community of interest.[58]

The residual right of control is "the right to control all aspects of . . . [property] that have not been . . . given away by contract."[59] An example illustrates the residual right of control. Assume a printer and a publisher enter into a contract to print 2,000 copies of a particular book.[60] The publisher has some control over the printing press until the printer completes the 2,000 copies.[61] After the initial printing—the 2,000 copies—is complete, the publisher may learn that the market demand for the book is greater than 2,000 copies and may request the printer do an additional run. If the printer has fulfilled its duty to print 2,000 copies of the book, the printer is not duty bound to print any additional copies, and the printer decides whether to do an additional printing.[62] The printer's right to decide how to use property after the initial contract expires is the residual right of control.

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56. Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691, 694 (1986) ("Of course, control or ownership is never absolute. For example, a firm that owns a machine may not be able to sell it without the permission of the lenders for which the machine serves as collateral; more generally, a firm may give another firm specific authority over its machines. However, ownership gives the owner all rights to use the machine that he has not voluntarily given away or that the government or some other party has not taken by force.").

57. *See id.* at 693–95. Instead of focusing on ownership, some economists focus on the difference between residual risks, "the risk of the difference between stochastic inflows of resources and promised payments to agents," Fama & Jensen, *Ownership and Control*, *supra* note 35, at 302, decision management, and residual control in analyzing the firm. *See id.* at 302–04.

58. *See supra* note 53.

59. Grossman & Hart, *supra* note 56, at 695. In *Commissioner v. Banks*, the Supreme Court concluded that the plaintiff, not the attorney working on a contingency-fee basis, controlled the rights to the claim. 543 U.S. at 435. Because the plaintiff controlled all of the rights to the claim not given away by contract, the plaintiff owned the claim. *Id.* at 436–37.

60. This example is adapted from an example in Grossman & Hart, *supra* note 56, at 695.

61. At a minimum, the publisher can receive damages if the printer breaches its contract to print. To enforce specific performance of the printing, the publisher would likely have to show that the printer's services were unique. *See* Anthony T. Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351, 357–58 (1978). Courts tend to grant specific performance if a remedy of monetary damages is inadequate. *Id.* at 355. If other printers are available to complete the print job, courts may find that monetary damages are an adequate remedy.

62. The publisher could avoid the possibility of the printer's refusing to do an additional run by purchasing the printing press, thereby integrating ownership: "[I]ntegration by common or joint ownership is more likely, the higher the appropriable specialized quasi rents of the assets involved." Benjamin Klein, Robert G. Crawford & Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297, 307 (1978). Thus, the publisher would be more likely to acquire the printing press if other printers were generally not available. *See, e.g.*, *id.* at 308–10 (describing the contractual relationship between General Motors and Fisher Body leading up to their merger and asserting that the merger occurred because of the specialized quasi-rent of the Fisher Body giant presses used for stamping body parts for General Motors vehicles).

1. *Integrating Residual Right of Control of Property and Services*

The residual right of control determines the relationship between a property owner and a service provider. A property owner determines the extent to which a service provider may perform services with respect to the property. For example, Mason, as the owner of Bridgestone, controls services that are provided with respect to Bridgestone.[63] Mason can provide the services himself, or he may hire an employee or independent contractor to perform the services. Another person may not, however, provide services with respect to Bridgestone without Mason's consent. The extent to which Mason grants a service provider discretion in carrying out the details of the job will determine whether the service provider is Mason's employee or an independent contractor.[64] Grant of discretion does not, however, give the service provider the residual right of control over the property.

Service providers retain the residual right of control over their services.[65] They may, however, contract away the right to perform certain services. By agreeing to provide services with respect to Mason's property, Bryce relinquishes some of his rights with respect to those services. Although Mason cannot legally compel Bryce to provide services, he may sue for breach of contract if Bryce fails to provide services. If Mason's legal action is successful, he may receive damages and a possible injunction prohibiting Bryce from performing the services elsewhere.[66] Thus, by contracting to receive Bryce's services, Mason becomes entitled to the

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63. *See supra* Part II.A.2 (setting forth the facts of this example).

64. For tax purposes, the distinction between employee and independent contractor is significant because it determines whether the service recipient must withhold taxes on the wages of an employee. *See* I.R.C. § 3402(a)(1) (2000). A service provider is an employee "if the relationship [with the service recipient] is the legal relationship of employer and employee." Treas. Reg. § 31.3401(c)-1(a) (as amended in 1970). The more discretion a property owner grants a service provider, the more the service provider will appear to be an independent contractor. Treas. Reg. § 31.3401(c)-1(b) (as amended in 1970) (providing that the relationship of employer and employee exists if the service recipient has the right to control and direct the service provider, and enumerating relevant factors—such as furnishing of tools and a place to work—in determining whether a service provider is an employee or independent contractor); *see also* Grossman & Hart, *supra* note 56, at 717 ("An employer-employee relationship is typically characterized by the fact that many details of the job to be carried out are left to the employer's discretion; that is, the employer has many of the residual rights of control. In a contractor-contractee relationship, the job is specified in much greater detail, and the contractee typically has many of the residual rights of control over nonspecified actions."). The question of whether a service provider is an employee or independent contractor is separate from the question of whether the arrangement is a partnership. As this Article discusses, the relevant issue with the latter question becomes who owns and controls the property and services of the parties. *See infra* p. 315–16.

65. The Thirteenth Amendment of the Constitution effectively prohibits one party from compelling another to provide services. U.S. CONST. amend. XIII, § 1.

66. If monetary damages are adequate, the courts will likely award such damages instead of imposing an injunction. E. ALLAN FARNSWORTH, CONTRACTS § 12.5, at 745 (4th ed. 2004). ("A court will not, however, grant an injunction unless the remedy in damages would be inadequate."). A court would be likely to grant an injunction "if the employee's services are unique or extraordinary, either because of special skill that the employee possesses . . . or because of special knowledge that the employee has acquired of the employer's business." *Id.* An employee's special skill or knowledge of the employer's business are precisely the attributes that give the employee appropriable specialized quasi-rents. *See* Klein, Crawford & Alchian, *supra* note 62, at 307.

economic equivalent of the services Bryce agrees to provide. To that extent, Bryce can sell the economic value of his services. After performing the contracted services or paying the damages (including complying with an injunction), Bryce would have the full economic value of his services. Thus, Bryce retains the residual right of control of his services.

If a property owner retains the residual right of control of property and pays the service provider to perform services, payment to the service provider will be compensation. The method used to compute the amount of compensation will not affect the nature of the relationship between the property owner and service provider.[67] Whether the payment is a fixed amount, a percentage of the property's revenue, or a percentage of the property's profit does not determine the ownership of the property.[68] The payment from the property owner to the service provider will be compensation for services regardless of the mode of determining the amount of the compensation.[69] Accounting for compensation is not a difficult task.

The inverse of an employment arrangement is a lease. Through a lease, a service provider acquires the right to use property and thereby obtains an interest in the property.[70] Any payment the service provider makes to the property owner with respect to the leased property should be rent.[71] The method of computing the amount paid for the use of the property should not affect whether the arrangement is a lease.[72] Accounting for rental payments is not a difficult task. As long as property ownership remains separate from the provision of services, an arrangement will not create insurmountable accounting challenges. If, however, property ownership and the provision of services become a community of interest, difficult

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67. *See* Luna v. Comm'r, 42 T.C. 1067, 1077–78 (1964) (providing the following factors to consider in determining whether an arrangement is a partnership or an employment arrangement, which ostensibly does not include mode of payment for services: (1) agreement and conduct executing agreement; (2) contributions made to the venture; (3) control over income and the right to make withdrawals; (4) whether parties were co-proprietors or principal-agent; (5) whether the parties used joint names in the operation of the business; (6) whether the parties filed a partnership tax return; (7) whether the venture maintained separate books; and (8) control and responsibilities for the enterprise).

68. *See* Comm'r v. Banks, 543 U.S. 426, 435–37 (2005) (holding that the plaintiff retained ownership of the income producing asset—the cause of action—and the relationship between the plaintiff and the attorney was a principal-agent relationship, even though the attorney would share in any awarded damages).

69. *See* Grossman & Hart, *supra* note 56, at 694 ("A firm may pay another firm or person by the piece or a fixed amount (salary), irrespective of the ownership of the machines.").

70. This contrasts with an employer acquiring a right in a service provider's services.

71. *See, e.g.*, Place v. Comm'r, 17 T.C. 199, 205–06 (1951) (holding that the arrangement between the husband and wife that granted the husband use of the wife's property was a lease and that the husband and wife's sharing in profits was not sufficient to show that the arrangement was a tax partnership), *aff'd*, 199 F.2d 373 (6th Cir. 1952).

72. *See, e.g.*, Harlen E. Moore Charitable Trust v. United States, 9 F.3d 623, 625–27 (7th Cir. 1993) (holding that a lessor's payment of some of the costs of farming rental property and receipt of rent as a percentage of the crop produced did not make the arrangement a tax partnership); *Place*, 17 T.C. at 205–06 (holding that a rental payment arrangement under which a husband paid his wife a share of his business's profits in return for the use of property and equipment did not constitute reasonable rent where the payments were ten to thirty times greater than they had been under the previous fixed rent arrangement), *aff'd*, 199 F.2d 373 (6th Cir. 1952).

accounting challenges arise. The theory of the firm helps define when a combination of property ownership and provision of services becomes a community of interest that is a partnership.

The separation of property ownership and provision of services gives rise to opportunistic behavior and agency costs.[73] For example, assume Mason and Bryce agree that Bryce will manage Bridgestone for ten years and receive fifteen percent of Bridgestone's gross revenue during that period. Within a few years after entering into the agreement, the market rate for services comparable to Bryce's is only twelve percent. The change in market conditions creates a specialized quasi-rent that Mason may seek to appropriate.[74] If the most Bryce could receive from another apartment owner is twelve percent of gross rental revenue, the appropriable portion of the quasi-rent is the difference between the fifteen percent Mason is paying Bryce and the twelve percent another property owner would pay him.[75] To appropriate the specialized quasi-rent, Mason may claim that he is no longer able to pay Bryce more than thirteen percent of gross rental revenue. To justify the change in contract terms, Mason may cite increased fixed costs, such as insurance, maintenance costs, and property taxes, that are making Bridgestone unprofitable to continue to operate with the high management fee.[76]

Alternatively, after Bryce and Mason enter into the contract, the market may shift, creating appropriable quasi-rents for Bryce. For example, following the execution of the contract, Bryce may develop relationships with referral sources and marketing agencies that become critical to attracting new tenants. He also may develop relationships with tenants that create tenant loyalty. If Mason were able to subdivide some of the units and increase rental revenue without incurring a proportionate increase in costs, Bryce would have an appropriable specialized quasi-rent if Mason could not easily replace Bryce.[77] To appropriate that specialized quasi-rent, Bryce may plead that managing the apartments and maintaining the relevant relationships require more effort than before, or he may plead that the obligations of managing the apartments have increased and that he should have fewer responsibilities. To ensure that Bryce maintains the same level of service he

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73. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976). ("We define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. . . . We define *agency costs* as the sum of: (1) the monitoring expenditures by the principal, (2) the bonding expenditures by the agent, [and] (3) the residual loss." (footnote omitted)); Klein, Crawford & Alchian, *supra* note 62, at 298–302 (describing how unscrupulous parties may appropriate quasi-rents if ownership of assets are separated).

74. *See* Klein, Crawford & Alchian, *supra* note 62, at 298 ("After a specific investment is made and such quasi-rents are created, the possibility of opportunistic behavior is very real.").

75. *See id.* ("The quasi-rent value of the asset is the excess of its value over its salvage value, that is, its value in its next best *use* to another renter. The potentially appropriable specialized portion of the quasi-rent is that portion, if any, in excess of its value to the second highest-valuing *user*.").

76. *See id.* at 300.

77. *See id.* at 313–19 (discussing a crop-picking situation in which service providers may have an appropriable specialized quasi-rent if they can prohibit the farmer from hiring other pickers).

was providing before the subdivision, Mason may have to increase Bryce's share of rental revenue.

Parties may attempt to reduce the appropriation of specialized quasi-rent by anticipating future contingencies and providing for them in contract. However, identifying and enforcing all future contingencies is difficult, if not impossible.[78] Parties may therefore attempt to rely upon market forces to help enforce contracts.[79] For example, parties may offer a future premium that will exceed the appropriable specialized quasi-rents to be obtained through opportunistic behavior.[80] The cost to draft a contract that anticipates all future contingencies and premiums is likely "positively related to the level of appropriable [specialized] quasi-rents."[81] Thus, parties should be expected to use contractual and market mechanisms only when appropriable specialized quasi-rents are low.[82]

If appropriable specialized quasi-rents are high, parties will tend to integrate property ownership and the provision of services to help reduce opportunistic behavior.[83] For example, if appropriable specialized quasi-rents in the apartment business are high, Bryce may attempt to acquire Mason's property, or Mason may attempt to acquire the right to all of Bryce's management services, perhaps through an employment agreement. Mason and Bryce could integrate their property and services by agreeing to a co-ownership of the property and right to services. Co-ownership of just the property would help prevent Mason from engaging in opportunistic behavior,[84] but it would not prohibit Bryce from engaging in opportunistic behavior.[85] To prevent Bryce from engaging in opportunistic behavior, Mason would have to acquire a co-ownership interest in the right to Bryce's services.[86] The integration of property and services to reduce opportunistic

78. *See id.* at 301 ("For some assets it may be essentially impossible to effectively specify all elements of quality . . . . But even for those assets used in situations where all relevant quality dimensions can be unambiguously specified in a contract, the threat of production delay during litigation may be an effective bargaining device. A contract therefore may be clearly enforceable but still subject to postcontractual opportunistic behavior.").

79. *See id.* at 303–04. For example, "business firms are said to generally rely on effective extralegal market sanctions, such as the depreciation of an opportunistic firm's general goodwill because of the anticipated loss of future business, as a means of preventing nonfulfillment of contracts." *Id.* at 304.

80. *See id.* at 304.

81. *Id.* at 306–07.

82. *See id.* at 307.

83. *See, e.g.*, *id.* at 308–10 (describing the General Motors-Fisher Body merger that resulted from the inability to control opportunistic behavior contractually).

84. As a co-owner, Bryce should have a voice and a vote in deciding who would manage the property.

85. *See supra* note 77.

86. The concept of co-owning services is repugnant at first because it conjures up ideas of slavery. Yet, the law allows parties to transfer rights in their services that are very similar to co-ownership. For example, a singer can assign to another party all of the benefits of her singing during a specific period of time. The assignee of those rights may not compel the singer to sing but may prohibit the singer from singing anywhere else during that period of time. *Lumley v. Wagner*, 42 Eng. Rep. 687, 693 (Ch. 1852). A contract assigning all of an individual's services would be against public policy, just as requiring specific performance would be. Therefore, individuals always retain the residual right to control of their

behavior creates the complex community of interest that is a partnership.[87] Because the parties co-own the property and the right to services, they cannot identify the income they receive as income from property or services. In the more simple employment or lease arrangements, the parties can identify the character of payments. Payments to a property owner are rent, and payments to an employee are compensation. A partnership of co-owned property receives income from both property and services, but the parties cannot identify which dollars of income derive from property and which derive from services. The community of interest that is a partnership is more complex than a mere co-ownership arrangement, lease, or employment contract. The complexity makes accounting for income especially difficult, if not impossible. Given that complexity, the partners' apportionment of income becomes important.

2. *Integrating Different Services*

Two service providers may cross-integrate services to reduce opportunistic behavior. The integration of services by multiple parties forms a community of interest in the services, which is a partnership. Consider the example of Abby and Claire.[88] Claire could have hired Abby as an employee to help with the work that exceeded Claire's capacity.[89] Appropriable specialized quasi-rents could arise under an employment arrangement between Abby and Claire. Claire, as employer, would own the firm's book of business. If another person could perform Abby's job for less, Claire might fire Abby and hire another person or tell Abby that she has to work for less. If Abby became an expert in a particular area, she could demand more compensation.

To reduce the likelihood of such opportunistic behavior, the parties may form the partnership described above.[90] If they do, Abby will take an ownership interest in the right to Claire's services and the book of business. Claire will take an interest in Abby's services and relationships that Abby forms with clients. As a result, the parties will receive income from their individual services *and* from the services of

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services. Nonetheless, an individual can assign all of the rights to a certain type of service, subject to some restrictions. For example, an individual may enter into a covenant not to compete, but to be valid, such a restraint must protect a "legitimate interest of the promisee," must be reasonable in scope, and must not result in unreasonable injury to the public or hardship to the promisor. *See* FARNSWORTH, *supra* note 66, § 5.3, at 326–28. Because the restriction on the individual's provision of services is limited, the individual retains the residual right to control.

87. Some scholars claim that integration is no different from a long-term contract. *See generally* Friedrich Kessler & Richard H. Stern, *Competition, Contract, and Vertical Integration*, 69 YALE L.J. 1 (1959) (discussing long-term contracts as a form of integration). Some economists assume that opportunistic behavior can only occur without integration. *See* Klein, Crawford & Alchian, *supra* note 62, at 302. Thus, integration is a situation that is free from opportunistic behavior regardless of the legal form an arrangement takes.

88. *See* discussion *supra* Part II.A.1.

89. As discussed above, Abby would be Claire's employee regardless of the compensation structure. *See supra* text accompanying notes 67–69.

90. *See* discussion *supra* Part II.A.1.

the other party, but they will be unable to distinguish between the sources of the income.[91]

As partners, Abby and Claire will both have an interest in each client matter.[92] Abby will earn income from work she does for the client on each matter and also from work Claire does for the client or to generate the client matter. The complexity of such a community of interest prevents them from distinguishing the portion of Abby's income that derives from Claire's services. In many situations, the inability to deconstruct the partnership income requires rules that generalize the character of partnership income. Relying upon the partners' apportionment formula may be the most desirable way to determine each party's share of the partnership's income.

C. *Transaction Internalization*

In addition to explaining how partners use apportionment to monitor behavior and reduce opportunistic behavior, the theory of the firm explains that partnerships may reduce transaction costs. The Coasean description of a firm focuses on the cost savings obtained by internalizing transactions that otherwise occur on the open market.[93] Coase theorized that "[t]he main reason why it is profitable to establish a firm would seem to be that there is a cost of using the price mechanism."[94] By forming firms, entrepreneurs are able to minimize the costs of obtaining price information on the open market by internalizing transactions and placing them under the direction of the entrepreneurs.[95] Although this theory has been subjected to some criticism,[96] the focus on internalizing transactions informs the analysis of partnership allocations. To the extent partners form partnerships to reduce transaction costs, partnerships come within the Coasean concept of a firm. Thus,

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91. *See supra* text accompanying notes 22–26 (describing the inability to accurately account for output from input in a partnership).

92. To the extent a client matter is property, the partnership between Abby and Claire is not a pure service partnership. Indeed, this may indicate that all partnerships are a combination of property and services. Nonetheless, considering arrangements that raise income through services as pure service arrangements is not uncommon. *See* Borden, *supra* note 12, at 994–95.

93. Coase, *supra* note 12, at 392.

94. *Id.* at 390. This is not inconsistent with other theories of the firm. *See, e.g.*, Klein, Crawford & Alchian, *supra* note 62, at 298 (providing that parties form firms, instead of creating contractual arrangements, when the tendency for opportunistic behavior is high).

95. *See* Coase, *supra* note 12, at 390. Coase also claimed that long-term contracts help reduce transaction costs because parties are able to incur one set of costs for one long-term contract as opposed to several sets of costs of many short-term contracts. *Id.* at 390–91. Klein, Crawford and Alchian demonstrate that long-term contracts may also become costly as market conditions change. Klein, Crawford & Alchian, *supra* note 62, at 308–10 (providing an example of a long-term contract that the parties renegotiated several times before finally merging). In such situations, parties will merge if the appropriable specialized quasi-rents of the assets are too high. *Id.* at 309–10.

96. *See, e.g.*, Alchian & Demsetz, *supra* note 23, at 783–85 (acknowledging that their theory of the firm is not necessarily inconsistent with the Coasean theory but recognizing that the various forms for organization of the firm are difficult to resolve on the basis of market transaction costs only, and adding to Coase's theory by explaining why the person to whom the control monitor is responsible receives the residual right of control); *see also supra* Part II.A.1 (discussing aspects of the contributions of Alchian and Demsetz to the theory-of-the-firm concept).

they would represent arrangements that internalize transactions that would otherwise occur on the open market. For example, Mason and Bryce internalized the leasing and provision of services when they formed Brason Partners.[97] If partnerships merely internalize what are functionally open-market transactions, partners cannot do internally what does not otherwise occur on the open market. Thus, as discussed below, partnerships should not be able to internalize tax-item transactions that are prohibited on the open market.[98] Tax-item transactions that are allowed on the open market should receive the same tax treatment within a partnership that they receive on the open market.

Subsequent explorations of the firm as an internalization of transactions have contended that a firm is merely a nexus of contracts.[99] To the extent a partnership is merely a nexus of contracts, it is a nexus of contracts that occur on the open market. Therefore, a partnership cannot create transactions that do not occur on the open market. Open-market tax-item transactions therefore retain their character within the nexus of contracts that is a partnership. If parties are not able to deal in tax items on the open market, they should not be able to deal in tax items through partnerships.

D. *Economic Principles that Should Direct Partnership Tax Allocation Rules*

The analysis of the nature of partnerships reveals three principles that are important in analyzing partnership tax allocations. First, partners cannot directly match inputs with outputs. To remedy this, partners usually agree upon partnership allocations to monitor each other. Because partners use allocations as a monitoring tool, the allocations are not necessarily proportional to the property and services each partner contributes to the partnership. Second, partnerships, as communities of interest, encompass many different transactions that are inseparable. Thus, partners cannot separately account for the various transactions that occur within a partnership. Third, partnerships internalize transactions that occur on the open market to help reduce transaction costs that would arise from repeatedly entering into open-market transactions. Because a partnership is a nexus of contracts that would otherwise occur on the open market, partnerships should not be able to create internal transactions that they cannot enter into on the open market.

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97. *See supra* text accompanying notes 67–87.

98. *See* discussion *infra* Part IV.B.

99. *See, e.g.*, Jensen & Meckling, *supra* note 73, at 311 ("The . . . firm is simply one form of *legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals.*"). Emphasizing the firm as a nexus of contracts "focuses attention on a crucial set of questions—why particular sets of contractual relations arise for various types of organizations, what the consequences of these contractual relations are, and how they are affected by changes exogenous to the organization." *Id.* Although Jensen and Meckling claim that trying to distinguish between things inside and outside the firm makes little or no sense but for tax purposes, *id.*, the internalization of transactions makes a significant difference because of the community of interest it creates. *See supra* Part II.B (discussing partnerships as communities of interest).

III. TAX-ITEM TRANSACTIONS ON THE OPEN MARKET

Having considered the nature of partnerships, the next step is to review the tax consequences of open-market, tax-item transactions. This review will help demonstrate how tax law should treat internalized tax-item transactions. This Part considers the feasibility and legality of tax-item transactions on the open market. This Part begins by classifying the components of a transaction and then continues by discussing the appropriate tax treatment of open-market tax-item transactions.

A. Components of a Transaction

Under an income tax regime, taxable transactions include three components: (1) consideration, (2) tax items, and (3) tax effects. The examples from above illustrate and help define each of these components. Recall that Mason owns Bridgestone and Bryce manages apartments.[100] Assume that Mason hires Bryce to manage Bridgestone and agrees to pay Bryce $75,000 in exchange for the management services. Mason and Bryce each have consideration, a tax item, and a tax effect from this transaction.

In exchange for money paid, Mason receives services. The services Mason receives constitute his consideration. Because Mason pays for the services, his tax item is a $75,000 deduction.[101] The tax effect of that tax item is the amount by which the deduction reduces Mason's tax liability. The tax effect is calculated by multiplying the amount of the deduction by the rate by which the deduction reduces Mason's tax liability.[102] Thus, if Mason's tax rate was twenty percent, the tax effect of a $75,000 deduction would be a $15,000 reduction in Mason's tax liability.[103]

Bryce's consideration is the $75,000 he receives in exchange for providing services. Bryce's tax item is the $75,000 he must include in gross income.[104]

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100. *See* discussion *supra* Part II.A.2.

101. Mason will generally be able to deduct Bryce's salary if Bridgestone is a trade or business. *See* I.R.C. § 162(a)(1) (2000). If Bridgestone is not a trade or business, Mason should be able to deduct the amount as an individual investment expense. *See id.* § 212(2) (2000).

102. The rate by which the deduction reduces Mason's tax liability depends upon Mason's tax bracket and the type of deduction. The rate may not be the same for each dollar of the deduction. If the deduction were to move Mason from one income bracket to a lower bracket, two different tax rates would apply to different portions of the deduction. Assume Mason's taxable income fluctuates between a twenty percent rate bracket and a twenty-five percent rate bracket. If, without the $25,000 deduction, Mason's taxable income was $15,000 above the minimum amount of income subject to a twenty-five percent tax rate, a $25,000 deduction would remove Mason from the twenty-five percent tax bracket and leave him in the twenty percent bracket. The reduction in tax liability would equal twenty-five percent of $15,000 (the amount of taxable income within the twenty-five percent bracket reduced by the deduction) and twenty percent of $10,000 (the amount of taxable income within the twenty percent bracket reduced by the deduction). *See id.* § 1(a)–(d) (2000) (providing for a graduated tax system with several tax brackets). To keep the analysis simple, however, this Article assumes that Mason is subject to a flat twenty percent rate and that he may deduct the entire amount he pays to Bryce.

103. These examples assume that each party would have a tax liability before considering the tax item at issue and that the tax liability would be sufficient to offset any reduction created by the tax item.

104. *See id.* § 61(a)(1) (2000) (providing that gross income includes compensation for services).

Assuming a twenty percent tax rate, the tax effect of that $75,000 of gross income would be a $15,000 increase in Bryce's tax liability. The following table summarizes the components of this simple transaction.

Components of a Simple Transaction			
Transaction	Consideration Received	Tax Item	Income Tax Effect
Bryce provides services in exchange for $75,000	$75,000 of cash	$75,000 of compensation as gross income	$15,000 tax liability increase
Mason pays $75,000 in exchange for services	$75,000 of services	$75,000 tax deduction	$15,000 tax liability reduction

This example demonstrates the components of a simple primary transaction. This Article uses the term "primary transaction" to refer to a transaction that gives rise to a tax item and tax effect. By contrast, a "secondary transaction" is one in which a tax item or a tax effect is the consideration. The tax-item, or tax-effect, consideration of a secondary transaction should give rise to a separate tax item and tax effect. As the discussion below demonstrates, caselaw provides guidance with respect to the proper tax treatment of some secondary transactions. The tax treatment of other secondary transactions should be apparent.

B. Gratuitous Assignments of Components in Secondary Transactions

Parties to a primary transaction may assign any of its components for no consideration. For example, a wage earner may assign the right to receive future compensation as a gift. The following discussion reveals how parties may gratuitously transfer any component of a primary transaction. It also discusses the tax consequences of such assignments.

1. Assignment of Primary Transaction Consideration

The assignment-of-income doctrine governs assignments of primary transaction consideration. This tax doctrine provides that a service provider's gross income includes income from the services and that a property owner's gross income includes income from the property, regardless of who receives the proceeds from the services or the property.[105] Thus, if Bryce were to assign to another party his right to receive any portion of the $75,000 of compensation from Mason,[106] he would still have $75,000 of income from compensation.[107]

Consider the results if Bryce were to gratuitously assign the $75,000. Assume that Bryce receives the $75,000 from Mason and transfers it to his daughter Noelle as a gift.[108] The transfer of the cash to Noelle will be subject to the gift tax rules,[109] but Noelle will have no gross income.[110] In this transaction, Bryce receives the consideration, reports the tax item as gross income, and bears the tax effect of the primary transaction. The secondary transaction is clearly separate from the *first*. Now, assume that Bryce wishes to make the same $75,000 gift to Noelle but would like Noelle to report the tax item and bear the tax effect of the $75,000. In an effort to accomplish those goals, Bryce restructures the secondary transaction. He directs Mason to pay the $75,000 directly to Noelle. The parties—Mason, Bryce, and Noelle—enter into an agreement that legally obligates Mason to pay the $75,000 directly to Noelle. The assignment-of-income doctrine dictates that the tax consequences in the second iteration of the facts—the assignment of the right to receive the compensation—will be the same as the tax consequences in the first iteration—the direct transfer of money.[111] In the case of personal service income, any gratuitous assignment of the income from services should be subject to the assignment-of-income doctrine.[112] Thus, although Bryce assigns the consideration, he retains the tax item and the tax effect of the consideration. The following table

105. *See* Comm'r v. Tower, 327 U.S. 280, 291–92 (1946) (holding that a husband could not shift income from his business to his wife through a state-law partnership formed with his wife, if, after formation of the partnership, the husband ran and controlled the business in the same manner he had prior to the formation of the partnership); Lucas v. Earl, 281 U.S. 111, 114–15 (1930) (refusing to allow an assignment of income from a husband to his wife, where the husband assigned a portion of all of his earnings from services to his wife).

106. *See supra* Part III.A (presenting the facts of the employment arrangement between Bryce and Mason).

107. *See Lucas*, 281 U.S. at 114–15.

108. To simplify the analysis, the examples assume the parties have other resources available to meet tax obligations. If the $75,000 compensation represented Bryce's only resources, he would not be able to make a $75,000 gift. His gift would be limited to the after-tax amount ($60,000) of the compensation.

109. *Compare* I.R.C. § 2501(a)(1) (2000) (imposing a tax on transfers of property by gift), *with id.* § 2505(a)(1) (Supp. I 2001) (allowing the donor to exclude the equivalent of $1,000,000 of gifts from the computation of taxable gifts).

110. *See id.* § 102(a) (2000) (excluding from gross income the value of property acquired by gift).

111. *See, e.g.*, Helvering v. Eubank, 311 U.S. 122, 124–25 (1940) (holding that an insurance salesman must recognize income from the assignment of insurance renewal commissions for prior years' sales); Helvering v. Horst, 311 U.S. 112, 114, 119–20 (1940) (applying the assignment-of-income doctrine to the assignment of income from property where the assignor retained the underlying property); *Lucas*, 281 U.S. at 114–15 (refusing to allow an assignment of compensation from a husband to his wife).

112. *See* Ronald H. Jensen, Schneer v. Commissioner*: Continuing Confusion over the Assignment of Income Doctrine and Personal Service Income*, 1 FLA. TAX REV. 623, 630 (1993) ("[I]ncome is taxable to him who earns it . . . ."). The same result would occur if a property owner were to assign the right to receive income from the property. *See Horst*, 311 U.S. at 119–20.

illustrates the similarities between consequences of giving a cash gift and the consequences of gratuitously assigning the right to receive income.

Components of a Simple Secondary Transaction (Gratuitous Transfer of Consideration)				
Transaction	Consideration Transferred	Tax Item	Income Tax Effect	Effect on Primary Transaction
Bryce gratuitously transfers $75,000 of cash to his daughter Noelle	$75,000 of cash	$75,000 gift excluded from Noelle's gross income under § 102	None	None. Bryce includes $75,000 from Mason in gross income and has $15,000 tax liability
Bryce gratuitously assigns the right to receive $75,000 to his daughter Noelle	Right to receive $75,000 payment	$75,000 gift excluded from Noelle's gross income under § 102	None	None. Bryce includes $75,000 from Mason in gross income and has $15,000 tax liability

2. *Assignment of Primary Transaction Tax Items and Tax Effects*

Imagine now that Bryce's father Mitt wishes to give him a gift worth $15,000. Instead of simply giving Bryce $15,000, Mitt agrees to include the $75,000 of Bryce's compensation in his own gross income. According to the agreement, Mitt includes $75,000 in his gross income and Bryce excludes it from his. This would be an example of a tax-item transaction. If tax law respected tax-item transactions, Bryce also would have transferred the accompanying tax effect, the $15,000 in tax liability, of that item. Thus, the transaction would be the economic equivalent of Mitt giving Bryce a cash gift of $15,000.[113] By including the $75,000 in his gross

113. If Bryce had included the $75,000 in his gross income, he would have paid $15,000 of income tax on the amount. If Mitt is in the same tax bracket, he would pay the same $15,000 of income tax on the amount. If Bryce were an independent contractor and the compensation were self-employment income to Bryce, Mitt would have to treat the $75,000 as self-employment income, *see* I.R.C. § 1402(b) (2000), to pay the same amount of tax that Bryce would have paid. Mitt could, however, be in the same income tax bracket as Bryce but already exceed the ceiling for Social Security tax. If this were to occur, Mitt's Social Security tax would be less than the Social Security tax Bryce would have paid. For example, if the ceiling for Social Security was $90,000—and Bryce made less than that with the $75,000 in income—the entire $75,000 would be subject to Social Security tax. If Mitt included the $75,000 received from Bryce in his income and his total yearly income thereby totaled $95,000, then $5,000, the amount of Mitt's income in excess of $90,000, would not be subject to the Social Security tax.

income, Mitt, in effect, agrees to pay Bryce's taxes on the $15,000 of Bryce's tax liability. Mitt could have accomplished the equivalent of that transaction by simply paying Bryce's tax liability. An assignee's acceptance of a tax item of income is equivalent to the assignee paying the assignor's tax liability. The tax treatment of the payment of another's tax liability, therefore, should dictate the proper tax treatment of the assignment of a tax item. The payment of another's tax obligation is income to the obligor,[114] unless otherwise excluded. In this case, Mitt's acceptance of the tax item was gratuitous, so Bryce should not include the reduced tax liability in gross income.[115] The following table illustrates that acceptance of a tax item of income is equivalent to paying another's tax liability. The assignment of a tax item would therefore be income to the assignor.

Components of a Simple Secondary Transaction (Gratuitous Assumption of Tax Item/Tax Effect)

Transaction	Consideration Transferred	Tax Item	Income Tax Effect	Effect on Primary Transaction
Mitt agrees to gratuitously include in his gross income $75,000 of Bryce's compensation	Bryce receives a $75,000 reduction in gross income	$15,000 gift equal to the amount of tax liability reduction excluded from Bryce's gross income under § 102	None	If assignment of tax item allowed, Bryce would not include the $75,000 in his gross income and his tax liability would not include the $15,000
Mitt agrees to gratuitously pay $15,000 of Bryce's tax liability	Bryce receives a $15,000 relief of an obligation	$15,000 gift excluded from Bryce's gross income under § 102	None	None

C. *Compensatory Assignments of Components in Secondary Transactions*

Thus far, the discussion of secondary transactions has focused on gratuitous assignments of primary transaction components. Not all assignments of such items are gratuitous. For example, instead of assigning the right to receive the $75,000 payment to Noelle as a gift, Bryce may decide to assign it as consideration to

114. *See* United States v. Kirby Lumber Co., 284 U.S. 1, 2–3 (1931) (holding that liability relief is an accession to wealth because the relief of liability frees up assets; therefore, liability relief is gross income); Old Colony Trust Co. v. Comm'r, 279 U.S. 716, 731 (1929) (holding that an employee must include in gross income the amount of the employee's tax liability paid by the employer pursuant to an employment agreement).

115. If the payor makes the payment with donative intent, the relief of the obligation should be excluded from the gross income of the obligor as a gift. *See* I.R.C. § 102(a) (2000).

Yvonne in exchange for a painting Yvonne owns. Although recent legal developments indicate that the assignment-of-income doctrine applies to compensatory assignments of income,[116] some commentators are skeptical about whether that is the correct result.[117] This Article accepts the recent Supreme Court decision as the law. A comparison of an assignment-of-income transaction with a cash transaction, however, reveals that applying the assignment-of-income doctrine to compensatory assignments may produce the same result that would be obtained otherwise.[118]

1. Assignment of Primary Transaction Consideration

Assume Bryce wishes to acquire a painting from Yvonne for $75,000. After receiving $75,000 of compensation from Mason, Bryce pays $75,000 to Yvonne and acquires the painting. Bryce will have $75,000 of compensation income when he receives the money from Mason,[119] and he will take a $75,000 cost basis in the painting he receives from Yvonne.[120] Yvonne will recognize gain on that transaction equal to the difference between the $75,000 she receives from Bryce and the adjusted basis she has in the painting.[121] If the assignment-of-income

116. *See* Comm'r v. Banks, 543 U.S. 426, 433–36 (2005) (holding that the assignment-of-income doctrine applies to an assignment of income utilized for consideration).

117. *See, e.g.*, Stephen B. Cohen, *Misassigning Income: The Supreme Court and Attorneys' Fees*, 25 VA. TAX REV. 415, 430–35 (2005) (arguing that the court in *Commissioner v. Banks* reached the wrong result because the plaintiff had transferred an asset to the attorney—a right to a portion of the award—and income from that asset should not be income to the plaintiff); Brant J. Hellwig, *The Supreme Court's Casual Use of the Assignment of Income Doctrine*, 2006 U. ILL. L. REV. 751, 793–97 (2006) (arguing that the assignment-of-income doctrine should be used only for gratuitous assignments of income and other tax principles should apply to assignments of income for consideration); Jensen, *supra* note 112, at 636 ("Thus the courts have firmly established two rules in the case of assignments of personal service income: first, all amounts collected by an assignee under a gratuitous assignment of personal service income will be taxed to the assignor; second, a taxpayer who exchanges his right to such income for bona fide consideration will be taxed on the consideration he receives and no more."); Lee A. Sheppard, *Partnership Mysticism and the Assignment-of-Income Doctrine*, 54 TAX NOTES 8, 8–9 (1992) (arguing that the court in *Schneer* was incorrect; the attorney-assignor should have included the assigned fees in his income and the partnership's receipt of the proceeds should have been treated as a contribution to the partnership from the attorney-assignor).

118. An argument for not applying the assignment-of-income doctrine to compensatory assignments is that such assignments do not affect government revenue. *See, e.g.*, Hellwig, *supra* note 117, at 773–75 (arguing that the doctrine is unnecessary in this context because the tax consequences are governed generally by income realization principles); Jensen, *supra* note 112, at 627 (arguing that the application of the doctrine simply promotes the shifting of income between taxpayers in different tax brackets). As the discussion in this Part demonstrates, however, the failure to apply the assignment-of-income doctrine to compensatory assignments may indeed negatively affect government revenue.

119. *See* I.R.C. § 61(a)(1) (2000).

120. *See id.* § 1012 (providing that the cost basis of property is the cost of the property to the purchaser).

121. *See id.* § 1001(a) (providing the formula for computing gain or loss from a "sale or other disposition of property").

doctrine does not apply to this type of transaction, Bryce could possibly convert his income from services into gains from dealings in property.[122]

Assuming the assignment-of-income doctrine does not apply to the transaction between Bryce and Yvonne, the transaction would be a transfer of Bryce's right to receive $75,000 from Mason in exchange for Yvonne's painting.[123] If Bryce's right to the $75,000 is property,[124] his basis in that property should be zero.[125] Transferring that right to Yvonne in exchange for the painting would be a property transaction,[126] and Bryce's gain on the transaction should equal the fair market value of the painting he receives.[127] Assuming the transaction between Bryce and Yvonne is an arm's-length transaction and that the painting is worth $75,000,[128] Bryce would recognize and include $75,000 in gross income.[129] That gain should be taxed at ordinary income rates,[130] so Bryce's income tax liability for the

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122. *See id* § 61(a)(3).

123. *But see* Hellwig, *supra* note 117, at 776–81 (describing an analytical framework which treats the assigned right to income as a promise to pay the assignee that amount in the future, and once the payment is made to the assignee, the assignor is relieved of the obligation to pay and has income from liability relief).

124. As Professor Hellwig points out, under Treasury Regulation § 1.83-3(e), the right to receive money may not be property if it is a mere promise to pay. *Id.* at 776 (quoting Treas. Reg. § 1.83-3(e) (as amended in 2005)). The implication of the example in this Article, though, is that Bryce's right to receive the $75,000 from Mason is more than Mason's mere promise to pay.

125. *See* I.R.C. § 1011(a) (providing that adjusted tax basis is the "[§] 1012" cost basis "adjusted as provided in [§] 1016"); *id.* § 1012(a) (providing that basis in property is the taxpayer's cost to acquire the property); *id.* § 1016(a)(1)–(3) (providing that taxpayers must adjust basis for items such as the cost of improvements and depreciation deductions).

126. *See* Treas. Reg. § 1.61-6(a) (as amended in 1966) (providing that gross income includes gains derived from sales and exchanges of property, which includes tangible and intangible items).

127. *See* I.R.C. § 1001(a) (providing that gain equals the excess of the amount realized from the "sale or other disposition of property" less the adjusted tax basis of the property transferred); *id.* § 1001(b) (providing that amount realized equals the "sum of money received plus the fair market value of the property . . . received"); *id.* § 1011(a) (providing that a property's adjusted tax basis is its "section 1012" cost "adjusted as provided in [§] 1016").

128. If the transaction is at arm's length, the fair market value of the painting should equal the fair market value of the right to receive the $75,000 from Mason. *See* Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184, 189 (Ct. Cl. 1954). The value of the right to receive the $75,000 from Mason will depend upon Mason's creditworthiness and the estimated date of payment. These factors would make the fair market value of the right to receive the future payment some amount less than what Mason owes. To keep the discussion simple, the example assumes that the value of the right to receive the payment equals the amount of the payment.

129. *See* I.R.C. § 1001(c) (requiring gain or loss recognition on all property transactions unless another provision of the statute specifically allows nonrecognition); *id.* § 61(a)(3) (providing that gross income includes gains from dealings in property).

130. Gains from dealings in property qualify for lower long-term capital gains rates only if the property is a capital asset and the taxpayer holds the property for more than one year. *See* I.R.C. § 1(h) (Supp. IV 2004) (providing favorable capital gains rates to net capital gains); *id.* § 1222(11) (2000) ("The term 'net capital gain' means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year."); *id.* § 1222(3) (providing that long-term capital gain is the gain from the sale of a capital asset held for more than one year). The right to receive the $75,000 should be an account or note receivable that Bryce acquired in the "ordinary course of his trade or business for services rendered . . . ." *Id.* § 1221(a)(4). As such, the right to receive the money should not be a capital asset to Bryce. *See id.* (excluding accounts and notes receivable from the definition of

transaction should be $15,000. The assignment of income therefore does not alter Bryce's income tax position, but if the transaction converts compensation to gains from dealings in property, the assignment could reduce the amount of employment taxes he would otherwise owe.[131] Yvonne may recognize gain or loss on the transaction, depending upon the adjusted tax basis she had in the painting. Any gain she recognizes could be taxed at favorable long-term capital gains rates.[132]

If the assignment-of-income doctrine does apply to the transaction between Bryce and Yvonne, then Bryce will have $75,000 of compensation income when Mason pays Yvonne.[133] The law will treat Bryce as paying Yvonne $75,000 for the painting, and Bryce will take a $75,000 basis in the painting.[134] Yvonne's gain will equal the difference between the $75,000 she is deemed to receive from Bryce and her basis in the painting. That gain could also receive favorable tax treatment.[135] Under the assignment-of-income doctrine, the result is the same as it would have been if Bryce had received the payment from Mason and paid Yvonne for the painting. The following table illustrates the different consequences obtained if the assignment-of-income doctrine does or does not apply to the transaction.

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a capital asset when acquired under these circumstances).

131. *See id.* § 1401(a)–(b) (imposing employment taxes on self-employment income). Bryce would owe employment tax on the secondary transaction if he was engaged in the business of selling rights to receive income from his services. *See id.* § 1402(b) (defining self-employment income generally to mean net earnings from self-employment); *id.*§ 1402(a) (Supp. IV 2004) (defining net earnings from self-employment to mean "gross income derived by an individual from any trade or business" the individual carries on). This analysis assumes he is not in such a business. If the right to receive payment from Mason is a property right, Bryce's receipt of such property could be compensation income under § 83(a). *See* I.R.C. § 83(a) (2000). If that were the result, Bryce would owe employment tax on the $75,000.

132. If the painting is a capital asset that Yvonne has held for more than a year, the gain would be a long-term capital gain subject to favorable tax rates. *See supra* note 130.

133. *See* Lucas v. Earl, 281 U.S. 111, 114–15 (1930) ("There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skil[l]fully devised to prevent the salary when paid from vesting even for a second in the man who earned it."). This assumes that Bryce is a cash method taxpayer who would otherwise be taxed at the time he received payments from Mason.

134. *See* I.R.C. § 1012 (2000).

135. *See supra* note 132. Under the assignment-of-income analysis, Yvonne should be treated as receiving a promise to pay from Bryce. To keep the analysis simple, this discussion assumes that Yvonne will receive all of the payments in the current year and will not have the option to use the installment sale method. *See* I.R.C. § 453(b)(1) (requiring at least one payment to occur in a year following the transfer for the transaction to qualify for installment sale treatment).

Components of a Simple Secondary Transaction (Compensatory Assignment of Consideration)				
Transaction	Consideration Assigned	Tax Item	Income Tax Effect	Effect on Primary Transaction
Bryce pays $75,000 to Yvonne for a painting	$75,000 cash	Yvonne has a $75,000 amount realized and Bryce takes a $75,000 basis in the painting	Yvonne will pay tax on any gain recognized; Bryce will take a basis in the painting	None
Bryce, in exchange for the painting, assigns to Yvonne his right to receive $75,000 from Mason	Right to receive $75,000	If no assignment-of-income, $75,000 amount realized by both Yvonne and Bryce	Yvonne and Bryce will pay tax on gain recognized	Bryce may not have income from compensation, which may reduce his employment taxes
Bryce, in exchange for the painting, assigns to Yvonne his right to receive $75,000 from Mason	Right to receive $75,000	If an assignment-of-income, Yvonne has a $75,000 amount realized and Bryce takes a $75,000 basis in the painting	Yvonne will pay tax on any gain recognized; Bryce will take a basis in the painting	None

As the table indicates, if the assignment-of-income doctrine applies to Bryce's compensatory assignment of his right to receive payment from Mason, the transaction would be taxed the same as Bryce's cash purchase of the painting. If the assignment-of-income doctrine does not apply to Bryce's compensatory assignment of his right to receive payment from Mason, tax law may treat the compensatory assignment of income differently from a cash transaction. The different treatment may allow Bryce to convert income from compensation to income from dealings in property. The conversion may eliminate employment taxes that Bryce would owe on the $75,000.[136] It could also affect the timing of income inclusion.

Some courts and commentators believe that the purpose of the assignment-of-income doctrine is to preserve the progressive tax system and to protect the

136. *See supra* note 131.

government's revenue.[137] The preservation of the progressive tax system does not dictate the proper tax treatment of liability relief that occurs when an employer pays an employee's tax obligation.[138] Instead, notions of equity should serve as a policy foundation for the assignment-of-income doctrine.

Tax law provides that a person generally must include in gross income any clearly realized accession to wealth over which the person has complete dominion.[139] Equity suggests that the law should apply to similarly situated taxpayers in the same manner.[140] If tax law did not apply the assignment-of-income doctrine to compensatory assignments of income, in some situations tax law would treat assignments of income and cash transactions differently. Such inconsistent treatment would be inequitable. It would treat parties differently based upon the form and timing of secondary transactions. Such an inconsistent law would also likely encourage parties to engage in compensatory assignments of income.[141]

The assignment-of-income doctrine also helps preserve the efficiency of the tax system. A tax law is inefficient if it alters behavior without raising any tax revenue.[142] Without the assignment-of-income doctrine, taxpayers would assign

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137. United States v. Basye, 410 U.S. 441, 450 (1973) (noting that the prohibition on assignment of income is "a cornerstone of our graduated income tax system" (citations omitted)); Foglesong v. Comm'r, 621 F.2d 865, 868 (7th Cir. 1980) ("The impact of the graduated income tax is eroded when income is split artificially among several entities or over several tax years."); BORIS I. BITTKER, MARTIN J. MCMAHON, JR. & LAWRENCE ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 34.1, at 34-3 (3d ed. 2002) ("[T]he courts recognized at the outset that transfers within the family, if honored by federal tax law, could seriously undermine the progressive rate schedule."); Jensen, *supra* note 112, at 632 ("[T]he essence of the assignment of income doctrine [is] the concern that the progressive tax rate schedule not be subverted by permitting income to be artificially split among formally separate taxpayers who in fact constitute a single economic unit." (citation omitted)).

138. Old Colony Trust Co. v. Comm'r, 279 U.S. 716, 729 (1929). The Court focused solely on the effect the payment of the employee's taxes had on the employee and stated that "[t]he discharge by a third person of an obligation to him is equivalent to receipt by the person taxed." *Id.*

139. Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

140. *See* HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 30 (1938) ("[W]e may say that tax burdens should bear similarly upon persons whom we regard as in substantially similar circumstances, and differently where circumstances differ."); Borden, *supra* note 12, at 1003–04 (providing that horizontal equity requires a comparison of all taxpayers to a standard taxpayer: tax law should treat other taxpayers differently from the standard taxpayer only if the other taxpayer's situation is different from the standard taxpayer's situation). Although equity supports taxing tax-item transactions, some may argue that such arguments are tautological. *See* Peter Westen, *The Empty Idea of Equality*, 95 HARV. L. REV. 537, 547–48 (1982) ("Equality is an undeniable and unchangeable moral truth because it is a simple tautology."). An equity analysis requires a point of reference. If the point of reference is the definition of income in *Glenshaw Glass*, a taxpayer would have gross income from a tax-item transaction if the transaction resulted in an accession to wealth that the taxpayer clearly realized and over which the taxpayer had complete dominion. *Glenshaw Glass Co.*, 348 U.S. at 431. If the taxpayer had gross income under that test, an equity analysis would add little to the existing analysis. For an in-depth discussion of the difficulties presented by an equity analysis, see Bradley T. Borden, *The Like-Kind Exchange Equity Conundrum*, 60 FLA. L. REV. (forthcoming 2008), *available at* http://www.ssrn.com/article=1005384.

141. One can predict that taxpayers would regularly engage in secondary tax-item transactions, if tax law did not recognize such transactions and impose a tax on any income realized as a result.

142. *Cf.* HARVEY S. ROSEN & TED GAYNOR, PUBLIC FINANCE 331–35 (8th ed. 2008) (describing an inefficient tax as one that causes welfare loss beyond the tax collected).

income instead of receiving it in circumstances where the tax consequences of secondary transactions were more favorable than the tax consequences of primary transactions. For example, Bryce would prefer the income-assignment approach in the transaction between Yvonne and himself if it accelerated income recognition and allowed him to offset the income with an expiring deduction or credit. He also might assign his income if he could avoid employment taxes.[143] Because the assignment-of-income doctrine may help eliminate such tax-motivated decision-making, it helps preserve the efficiency of the tax system. In the partnership context, however, assignment of tax items and tax effects provide the greatest opportunity for abuse. Consider the tax treatment of assignments of the tax items and tax effects on the open market.

2. *Assignment of Primary Transaction Tax Items and Tax Effects*

If taxpayers could strip the tax item from the consideration,[144] tax items could become media of exchange in compensatory transactions. Consider how Mason would be able to use a tax deduction as a unit of exchange. Recall that Mason pays $75,000 to Bryce for Bryce's services, which results in a $75,000 tax deduction for Mason.[145] The tax effect of that deduction was a $15,000 reduction in Mason's tax liability.[146] Assume now that Mason hires Rafael to do $15,000 of electrical maintenance work to Bridgestone, the payment of which is deductible by Mason as an ordinary and necessary business expense.[147] Consider three different ways in which Mason could compensate Rafael for the services. First, Mason could pay Rafael $15,000 in cash. Second, assuming Rafael is in the same tax bracket as Mason, Mason could assign the $75,000 deduction to Rafael, if allowed by law.[148] Third, Mason could agree to pay $15,000 of Rafael's tax liability. The tax consequences of each of those three compensation methods should be the same.

If Mason pays Rafael $15,000, he should be able to deduct the payment as an ordinary and necessary business expense.[149] That transaction reduces Mason's assets by $15,000 and increases Rafael's by the same amount. The effect of Mason assigning Rafael the $75,000 deduction would be the same as Mason paying Rafael $15,000. By assigning the $75,000 deduction to Rafael, Mason increases his own tax liability by $15,000. Thus, Mason would have to pay an increased amount in taxes, which would reduce his assets by $15,000. Conversely, by taking the

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143. Bryce would prefer the assignment transactions because it would provide him with favorable after-tax consequences, as compared to Yvonne's after-tax consequences under the nonassignment transaction. In this situation, the difference would be the reduction in employment taxes that Mason would have to pay under the nonassignment approach.

144. *See* discussion *supra* Part III.B.2.

145. *See supra* text accompanying note 101.

146. *See supra* text accompanying note 103.

147. I.R.C. § 162(a)(1) (2000).

148. If Mason and Rafael are in different tax brackets, Mason may be able to receive the services worth $15,000 by paying less than that amount. For example, if Rafael were in a higher tax bracket, Mason could assign less than $75,000 of deduction to grant Rafael a $15,000 benefit.

149. *Id.* § 162(a)(1).

deduction, Rafael's tax liability is decreased by $15,000, which frees up $15,000 worth of his assets.[150] Mason paying $15,000 of Rafael's taxes is equivalent to Mason paying $15,000 directly to Rafael, followed by Rafael paying the taxes.[151] The tax effects, assuming a twenty percent tax rate for both Mason and Rafael, would be a $3,000 decrease in tax liability for Mason and $3,000 increase in tax liability for Rafael, regardless of the payment method. The following table illustrates how the three methods generally produce the same tax results.

Components of a Simple Secondary Transaction (Compensatory Assignment of Tax Item/Tax Effect)

Transaction	Consideration Received	Tax Item	Income Tax Effect	Effect on Primary Transaction
Mason pays Rafael $15,000 for services	Mason receives services	$15,000 business expense deduction	$3,000 tax liability deduction	None
Rafael performs services for Mason	$15,000	$15,000 compensation for services	$3,000 tax liability increase	N/A
Mason assigns $75,000 of deduction to Rafael	Mason receives services	$15,000 business expense deduction	$3,000 tax liability reduction	Mason forfeits $75,000 deduction
Rafael performs services for Mason	$75,000 deduction	$15,000 compensation for services	$3,000 tax liability increase	N/A
Mason pays $15,000 of Rafael's tax	Mason receives services	$15,000 business expense deduction	$3,000 tax liability reduction	None
Rafael performs services for Mason	$15,000 tax liability relief	$15,000 compensation for services	$3,000 tax liability increase	N/A

150. *See* United States v. Kirby Lumber Co., 284 U.S. 1, 1–2 (1931) (holding that the issuer's purchase of its own bonds at less than par value frees up the issuer's assets in the amount of the difference between the purchase price and the bonds' par value, which is the amount of the former obligation that becomes extinct as a result of the transaction).

151. Old Colony Trust Co. v. Comm'r, 279 U.S. 716, 729 (1929) ("The form of the payment is expressly declared to make no difference. . . . The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed." (citation omitted)).

The first alternative, the $15,000 payment, and the third alternative, payment of $15,000 of Rafael's tax liability, are familiar transactions.[152] The second alternative, assignment of a tax item, is not as common. The tax item in question is a $75,000 deduction for ordinary and necessary business expenses.[153] To claim that deduction, Rafael must make a payment, or, if he is an accrual method taxpayer, he must incur an obligation to make the payment.[154] Therefore, tax law does not permit Rafael to deduct an expense incurred by another party.

Even if Rafael were to pay Bryce's salary for Mason, tax law would require an analysis of the transaction between Rafael and Mason to determine the nature of the payment. If Rafael made the payment out of "detached . . . disinterested generosity," the payment should be a gift from Rafael to Mason.[155] If Rafael agreed to pay Mason's obligation in return for property, the payment should be consideration for the property Rafael receives.[156] If Rafael agreed to pay Mason's obligation in return for services from Mason, the payment should be a deductible business expense,[157] a capitalized expenditure,[158] or a nondeductible personal expenditure.[159] Thus, the tax consequences of an agreement to pay another's obligations and actual payment of the obligation must be analyzed in the context

152. The first alternative is merely compensation paid, which results in a deduction for Mason and gross income for Rafael. *See* I.R.C. § 162 (a)(1) (allowing a deduction for ordinary and necessary amounts paid as compensation); *see also id.* § 61(a)(1) (requiring taxpayers to include compensation in gross income). The third alternative is the payment of a service provider's obligation in exchange for services, which tax law treats as a payment of cash to the service provider. *See Old Colony*, 279 U.S. at 729.

153. *See* I.R.C. § 162(a)(1) (allowing a deduction for amounts paid or incurred for compensation in the ordinary course of carrying on any trade or business).

154. *See id.* § 461(a) (allowing accrual method taxpayers to take deductions under the accrual method); *id.* § 461(h)(1) (providing that economic performance must occur before an accrual method taxpayer may take a deduction); *id.* § 461(h)(2)(A)(I) (providing that economic performance occurs when a service provider provides services for the taxpayer).

155. *See* Comm'r v. Duberstein, 363 U.S. 278, 285 (1960) (noting that a gift is a transfer that "proceeds from a detached and disinterested generosity" (quoting Comm'r v. LoBue, 351 U.S. 243, 246 (1956) (internal quotation marks omitted)).

156. *See* Treas. Reg. § 1.1001-2(a)(2), (c) ex. 8 (1980) (providing that relief of recourse liability in exchange for property is consideration for the property to the extent of the value of the property, and cancellation of indebtedness is considered to the extent the liability relief exceeds the value of the property).

157. For example, if Rafael agreed to pay Mason's compensation obligation in exchange for use of part of Bridgestone as a business office for less than twelve months, Rafael should be allowed to deduct the amount of Mason's obligation that he paid. *See* I.R.C. § 162(a)(3) (allowing a deduction for rent paid in the ordinary course of a trade or business); Treas. Reg. § 1.263(a)-4(f)(1)(I), (f)(8) ex. 6 (2004) (providing that taxpayers do not have to capitalize prepaid rent if the term of a created lease is less than twelve months).

158. For example, if Rafael agreed to pay Mason's compensation obligation in exchange for use of part of Bridgestone as a business office for five years, Rafael would have to capitalize the payment. *See* Treas. Reg. § 1.263(a)-4(d)(3)(I), (ii) ex. 2 (2004) (requiring taxpayers to capitalize prepaid expenses, such as prepaid rent).

159. For example, if Rafael agreed to pay Mason's compensation obligation in exchange for personal use of a residential unit in Bridgestone as a residence, Rafael would be unable to deduct the amount. *See* I.R.C. § 262(a) (disallowing deductions for "personal, living, or family expenses").

of the relationship between the obligor (Mason in this example) and the payor (Rafael in this example). The relationship between the obligee (Bryce in this example) and the payor is not relevant, nor is the relationship between the obligee and obligor.

D. Price Equilibrium of Tax-Item Transactions

In each example discussed thus far, the parties have been subject to the same tax rates. If the law permitted tax-item transactions, parties in different tax brackets would buy and sell such items on the open market.

Assume the law allowed parties to determine who would report tax items. Krista has $10,000 of gross income, the tax effect of which is a $3,500 tax liability. Juanita is in a lower tax bracket than Krista, so the tax effect of the same $10,000 of gross income to Juanita would be a $2,500 tax liability. If the law allowed Krista to put[160] the $10,000 gross income to Juanita, she would pay Juanita some amount less than $3,500 to put the $10,000 of gross income. Juanita would report the $10,000 of gross income if Krista paid her some amount greater than $2,500. Because both parties stand to gain from this transaction if the law permitted it, they would likely find a price point for the put and enter into the transaction.[161] Tax law should prohibit such tax-item puts. As a practical matter, parties would deal in tax items only if the tax effect of the tax item to assignee were lower than the tax effect of the tax item would have been to the assignor.[162] Thus, tax-item puts must reduce

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160. This Article uses the term *put* in this context much as it is used in the options context. The holder of a "put" option has the right to put the subject property to the other party in the option agreement. *See* RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 544 (8th. ed. 2006). In the tax context, if the law allowed tax-time transactions, one party could put a tax-item to another.

161. *See* Vernon L. Smith, *An Experimental Study of Competitive Market Behavior*, 70 J. POL. ECON. 111, 116–26 (1962) (describing and illustrating the results of an experiment that showed supply and demand move toward equilibrium price). Even if the transaction were taxed, Krista's relief of a $3,500 liability in exchange for a sufficient amount of money would justify the transaction to her. Krista should be able to offset the amount she is required to include in gross income because of the debt relief by the amount she pays Juanita to put the tax item to Juanita. Thus, if Krista paid $3,000 to Juanita to put the $10,000 tax item to Juanita, Krista would have $500 of gross income from the liability relief. Even after a thirty-five percent tax on the $500, Krista comes out ahead in the transaction. Juanita, on the other hand, would receive $3,000 of income from Krista that she would be required to include in gross income, but she should be able to offset that amount by the $2,500 liability she incurred. Thus, even after paying tax at twenty percent on the $500 difference between the amount received and the increase in her tax liability, Juanita stands to gain from the transaction.

162. For example, the tax effects were $3,500 of tax liability to Krista and only $2,500 of tax liability to Juanita. Thus, the tax-item transaction reduced the tax effect of the $10,000 tax item by $1,000, which is the amount of revenue the government would lose on the transaction. *See infra* note 163 (discussing the appropriate tax consequence of the tax-item transaction, should the tax law permit such transactions). In the case of a tax-item deduction, the assignment would make economic sense only if the tax effect to the assignee of the deduction were greater than the tax effect to the assignor. In such a case, the assignee would pay the assignor more than the amount of the benefit the assignor would recognize. However, the amount paid would have to be less than the benefit the assignee would receive from the benefit. For example, if the benefit of the deduction to the assignee were $3,500, the assignee would pay some amount less than $3,500 to receive the deduction. If the tax effect of the deduction to

government revenue.[163] If the transactions reduce taxpayer welfare by altering behavior without increasing government revenue, the transactions are also inefficient.[164] Furthermore, tax-item puts violate notions of equity because Krista would pay an amount of tax on her compensation income different from the amount of tax another similarly situated nonputting taxpayer would pay on the same amount of compensation income. Using the amount of income earned from services as the criteria for comparison, the only difference between Krista and another taxpayer would be Krista's successful efforts to reduce her tax liability through a tax-item transaction. This difference does not justify different tax treatment.

E. *Tax Principles that Should Direct Partnership Tax Allocation Rules*

The discussion of tax-item transactions reveals three principles that should direct partnership tax allocation rules. First, the assignment-of-income doctrine should govern any assignments of income or deductions within partnerships. The partnership tax allocation rules should not allow taxpayers to use partnerships as devices to assign consideration without appropriate tax consequences. Second, the assignment of a tax item is economically equivalent to the assignment of a tax effect. Partnership tax allocation rules should recognize tax-effect assignments and tax them based on the economic arrangement of the parties. Third, tax-item transactions between parties subject to different tax brackets erode the tax base and have no independent economic significance. The partnership tax allocation rules should not permit such transactions.

IV. INTERNALIZING TAX-ITEM TRANSACTIONS WITHIN TAX PARTNERSHIPS

Having established the economic and tax principles that should inform the analysis of the partnership tax allocation rules, the discussion now turns to those rules. The irony of the current tax rules is that those present at the codification of the first partnership allocation rules foresaw the potential for abuse that allocation

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the assignor were $2,500, the assignor would accept some amount more than $2,500 to assign the deduction.

163. Taxing tax-item puts would not sufficiently increase tax revenue to offset the amount lost through the put. For example, the tax consequences of the tax-item put to Krista would be gross income of $500 ($3,500 tax liability relief offset by the $3,000 paid for the put). Assuming Krista is subject to a thirty-five percent tax rate, she would pay $175 of tax on the put transaction. Juanita would have $500 of gross income from the transaction, which is the difference between the $3,000 received from Krista as consideration for the put and the $2,500 of tax liability that Juanita would pay. Assuming Juanita's tax rate is twenty-five percent, she would have $125 of tax liability as a result of the transaction. Thus, the government would receive $2,500 from Juanita for payment on the $10,000 of assigned gross income, $175 from Krista on the gross income to her on the transaction, and $125 from Juanita on the gross income to her form the transaction. The total revenue the government would collect would be $2,800. That is $700 less than it would have received had Krista paid $3,500 in taxes on her $10,000 of gross income.

164. *See* ROSEN & GAYNOR, *supra* note 142, at 331 ("Because a tax distorts economic decisions, it creates *excess burden*—a loss of welfare above and beyond the tax revenues collected.").

rules could create. They observed that if allocations did not depend upon the economic reality of a partnership agreement, "for the first time in the history of the tax laws, [parties] will be permitted to agree on the incidence of tax; to agree as to which of several co-earners of income shall be entitled to specific items of income and of income tax deduction and credits."[165] Allocations that do not reflect the partners' business agreement provide "the ingenious businessman and his lawyers the utmost flexibility in devising a variety of novel and unique business arrangements."[166] Examples of such unique business arrangements include allocations of amortization, depreciation, or depletion allowances to capital providers in lieu of interest payments.[167] Such arrangements free up cash for partnership operations while providing a tax item to the capital provider, who receives a benefit from a reduced tax liability that would be the equivalent of a cash payment.

Another danger foreseen was tax avoidance. Allowing partners to specially allocate tax items allows them to internalize tax-item transactions while ostensibly not avoiding tax: "two unrelated partners in the same income tax bracket dealing at arms length might agree that one partner is to be entitled to all depreciation or depletion deductions even though the partners are to share equally in net operating income."[168] Even though such an allocation may not reduce the overall tax liability of the parties—and thus does not have a tax avoidance motive—it would be a tax-item transaction that the partners could not conduct outside the partnership without tax consequences.[169]

The discussion below demonstrates Treasury-promulgated tax-centric allocation rules.[170] The tax-centric rules facilitate tax-item transactions within the partnerships. The rules allow partners to agree upon the allocation of tax items but

165. J. Paul Jackson et al., *The Internal Revenue Code of 1954: Partnerships*, 54 COLUM. L. REV. 1183, 1187 (1954).

166. *Id.* at 1188.

167. *Id.*

168. *Id.*

169. *See* discussion *supra* Part III.C.1.

170. Another commentator has referred to the allocation rules in the regulations as "tax-driven allocations." 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, 754 (2001) ("There are numerous situations in which U.S. tax benefits among partners may be optimized through special allocations, allocations that would not be made, but for the tax effect ('Tax-Driven Allocations'). The desire for Tax-Driven Allocations arises in many contexts including those in which the involvement of tax-exempt, tax loss or other tax-indifferent partners, foreign partners who wish to minimize their U.S. source income, U.S. taxpayers with excess foreign tax credits or an overall foreign loss who wish to maximize foreign source income and avoid foreign source deductions, CFCs who wish to avoid allocations of subpart F income, taxpayers with expiring tax attributes who covet income acceleration, and individuals who prefer capital gains to ordinary income." (footnote omitted)); *see also* Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1, 2 (1990) (summarizing the difficulties presented by tax allocation rules and proposing solutions to those difficulties). The term *tax-driven allocations* refers to the purpose for which partners allocate items. The reference to tax-centric allocations, on the other hand, refers to the allocation rules that focus first on the allocation of tax items, and then on whether the economic aspects of the tax item follow the tax-item allocation.

require the economic benefits or burdens of the allocations to follow the tax allocation. These rules allow partners to shift the incident of taxation as predicted several decades ago.[171]

A. *Partnership Tax Allocation Rules*

The partnership tax allocation rules generally require partnerships to allocate tax items to partners in accordance with their interests in the partnership.[172] Consider the statutory language governing the allocation of partnership tax items: "A partner's distributive share of . . . [tax items] shall be determined in accordance with the partner's interest in the partnership . . . ."[173] Absent from this rule is a definition of a partner's interest in the partnership. As discussed above, partners may apportion economic items to discourage opportunistic behavior and reduce agency costs.[174] To the extent the definition of a partner's interest in the partnership does not account for the apportionment of economic items, the tax allocation rules may fail to match partnership tax items and partnership economic items.

The Treasury provides a somewhat open-ended definition of a partner's interest in a partnership.[175] The definition generally provides that a partner's interest in a partnership depends upon the "manner in which partners share . . . the economic benefit and burden" corresponding to allocated tax items.[176] The definition also presumes that interests in a partnership are equal but provides that either the partners or the IRS may rebut that presumption by showing the "partners' interests in the partnership are otherwise."[177]

Both the general statutory rule allocating partnership tax items in accordance with the partners' interests in the partnership and the regulatory definition of partners' interests in a partnership raise several interesting issues. First, the general rule and the definition are somewhat circular. The general rule requires allocations of tax items to follow partners' interests in the partnership.[178] The definition indicates that interests in a partnership refer first to the allocation of tax items and then to partners' sharing of the economic benefit or burden of the consideration that

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171. *See supra* text accompanying notes 165–68. *See generally* Gergen, *supra* note 170 (discussing the substantive character of many transactions carried out within a partnership that would be taxed differently but for the partnership tax allocation rules).

172. I.R.C. § 704(b) (2000). The statute lists income, gain, loss, deduction, or credit as tax items. *Id.*

173. *Id.*

174. *See* discussion *supra* Part II.A–B.

175. *See* Treas. Reg. § 1.704-1(b)(3)(I) (as amended in 2006); *see also* Lawrence Lokken, *Partnership Allocations*, 41 TAX L. REV. 547, 614 (1986) (claiming that the definition of a partner's interest in a partnership is a standard about which a meaningful generalization is not possible).

176. Treas. Reg. § 1.704-1(b)(3)(I).

177. *Id.* The factors to consider include (1) the partners' contributions to the partnership, (2) the partners' interests in the partnership's economic profits and losses, (3) the partners' interest in "cash flow and other non-liquidating distributions," and (4) the partners' rights to distributions on liquidation. *Id.* § 1.704-1(b)(3)(ii)(a)–(d).

178. *Id.* § 1.704-1(b)(3)(I).

corresponds with the tax item.[179] Thus, according to the regulations, the starting point is the tax item, not the economic consideration.

Second, the definition presumes that partners share equally in the partnership.[180] This presumption is consistent with the Uniform Partnerships Act's default rule for sharing partnership profits and losses,[181] but it neglects the apportionments that partners are likely to use to monitor each other.[182] The facts-and-circumstances test in the regulations would likely consider the partners' apportionment of economic items.[183] If the partners apportion economic items to monitor each other, arguably apportionment of economic items should either be the presumption of a partnership interest or the basis for the general rule. The partnership tax allocation rules become deal-centric by not focusing first on the partners' economic arrangement.

The partnership tax allocation rules provide an exception to the general tax allocation rule. This exception allows partners to specially allocate tax items by agreement.[184] The only qualification to the rule is that the special tax-item allocation must have substantial economic effect.[185] This exception to the general rule further establishes the tax-centric nature of the partnership tax allocation rules. The exception does this by allowing partner discretion in allocating tax items, if the tax-item allocations have substantial economic effect. Contrast that with a deal-centric tax-item allocation, which requires the tax items to follow the apportioned economic items. Even with the two-part requirement that tax-item allocations must have substantial economic effect, the tax-item allocation rules remain tax-centric.

1. *Economic Effect*

The fundamental principles of the economic effect test further establish the tax-centric nature of the partnership tax allocation rules.[186] The regulations explain these principles in a manner that would indicate that partners cannot strip tax items from foundation items: "In order for an allocation to have economic effect, it must

179. *Id.*

180. *Id.*

181. UNIF. P'SHIP ACT § 401(b) (amended 1997), 6 U.L.A. 133 (2001) ("Each partner is entitled to an equal share of the partnership profits . . . .").

182. *See supra* Part II.A (describing the use of apportionment of partnership economic items to monitor partners).

183. *See* Treas. Reg. § 1.704-1(b)(3)(ii)(b) (listing partners' interests in economic profits and losses as a factor to consider in determining partners' interests in the partnership).

184. *See* I.R.C. § 704(b)(1) (2000); *see also* George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141, 154 (1999) ("Hence, by private agreement, the partners might decide to allocate the income of the partnership equally among themselves, or to allocate all of the income to only one partner, or to provide for any other sharing arrangement. Assuming the allocation has 'substantial economic effect,' . . . the only limitation is that all of the partnership taxable income must be reported by some partner or partners for the year.").

185. *See* I.R.C. § 704(b)(2).

186. The regulations use the heading "Fundamental principles" to introduce the rules on economic effect. Treas. Reg. § 1.704-1(b)(2)(ii)(a) (as amended in 2006).

be consistent with the underlying economic arrangement of the partners."[187] The next sentence, which expounds the first, foreshadows what is to follow in the economic effect test[188]: "This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden."[189] This language allows partners to specially allocate tax items, as long as the corresponding economic benefit or burden follows the tax-item allocation.

The regulations generally use capital accounts to determine which partner bears the economic benefit or burden of an allocation.[190] The capital account maintenance rules in turn rely upon tax-item allocations.[191] Thus, if a partnership follows the capital account maintenance rules, the economic benefit or burden of a tax-item allocation will generally follow the tax-item allocation. The burden or benefit of the allocation is delayed, however, until the partnership liquidates the partner's interest in the partnership, at which time the partner will either receive the balance in a positive capital account or pay the amount of a capital account deficit.[192] Thus, the allocation delivers an immediate tax item and corresponding tax effect, with, at best, a delayed economic benefit or burden. The analysis below shows how this provides partners with an opportunity to internalize tax-item transactions that tax law either prohibits or taxes on the open market. The analysis will also demonstrate that by beginning from the economic transaction and requiring tax items to follow consideration, the allocation rules could tax or eliminate tax-item transactions.

2. *Substantiality*

The substantiality requirement is ostensibly designed to prevent tax avoidance through partnership tax allocations. As drafted, the substantiality rules focus on preventing the use of allocations to reduce the overall tax burden of the partners in the case of shifting (intra-year) allocations and transitory (offset in later years) allocations.[193] Otherwise, the substantiality rules require partners to demonstrate that if an allocation will enhance the present value of the "after-tax economic consequences" of one partner, it will also likely substantially diminish the present

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187. *Id.*

188. Note how the sentence gives primacy to the tax item in ordering the allocation of tax items and economic items.

189. Treas. Reg. § 1.704-1(b)(2)(ii)(a).

190. *See id.* § 1.704-1(b)(2)(ii)(b) (providing a safe harbor for satisfying economic effect, all the requirements of which focus on capital account maintenance and balances).

191. *See id.* § 1.704-1(b)(2)(iv)(b)(3) (providing that allocations of income and gain, including tax-exempt income, increase a partner's capital account balance); *id.* § 1.704-1(b)(2)(iv)(b)(7) (providing that allocations of deductions decrease a partner's capital account balance).

192. *See id.* § 1.704-1(b)(2)(ii)(b)(2), -1(b)(2)(ii)(b)(3).

193. The substantiality rules generally provide that an allocation will be deemed substantial if it is reasonably possible to substantially affect "the dollar amounts to be received by the partners . . . , independent of tax consequences." *Id.* § 1.704-1(b)(2)(iii)(a). Even if that test returns a positive result, partners must show that the allocations do not reduce the overall tax effect of the partners in the case of shifting and transitory allocations. *See id.* § 1.704-1(b)(2)(iii)(b), -(b)(2)(iii)(c).

value of the "after-tax economic consequences" of another partner.[194] This focus is different from the focus of tax law governing open-market transactions,[195] and it does not discourage partners from engaging in tax-item transactions. In fact, the focus of the substantiality rules and the tax-centric economic effect test allows partners to engage in tax-item transactions and shift the incidence of taxation.[196] The following discussion provides examples that illustrate such opportunities.

B. Separation of Tax Items and Tax Effects from Consideration

The current tax allocation rules allow partners to do within a partnership what tax law prohibits them from doing outside the partnership. Recall from above that Mason could not assign his deduction to Rafael without tax consequences following the assignment.[197] Such an assignment, if allowed, would be the economic equivalent of Mason paying a portion of Rafael's tax liability.[198] Assume now that Mason and Bryce need extra money for operations or improvements to Bridgestone when they initially form their partnership. They decide to raise that money by having the partnership borrow $500,000 from Rafael. Assume that in exchange for the use of the money, the partnership agrees to allocate $200,000 of depreciation to Rafael for five years, after which time the partnership will repay the $500,000 loan. Rafael's tax rate is twenty percent, so the allocation provides him with a $40,000 reduction in tax liability, which is a simple eight percent interest on his $500,000 loan. Even if tax law allowed the assignment of the tax item, the result should still be $40,000 of interest income to Rafael.[199] Tax law should disregard the form of the transaction and treat the financing arrangement as the partnership paying $40,000 of interest to Rafael.

Now assume that upon formation of the partnership, Mason and Bryce decide to admit Rafael as a member of the partnership in exchange for him contributing $500,000 to the partnership. They also agree to apportion no income to Rafael. Instead, they will allocate $200,000 of depreciation deductions to Rafael for five years, after which the partnership will distribute $500,000 to Rafael. This transaction is the economic equivalent of the loan from Rafael. For the allocation to have economic effect, however, the partnership agreement must obligate Rafael to restore any deficit capital account balance caused by the allocation of depreciation upon liquidation of his interest in the partnership.[200] Following the allocation of the depreciation and the distribution of $500,000, Rafael should have

194. *See id.* § 1.704-1(b)(2)(iii)(a).

195. *See* discussion *supra* Part III.

196. *See supra* text accompanying note 165 (recognizing that a tax-avoidance focus of the allocation rules, and not economic-reality focus, would provide partners the opportunity to shift the incidence of taxation).

197. *See* discussion *supra* Part III.C.2.

198. *See supra* text accompanying notes 150–51.

199. *See supra* text accompanying notes 150–51.

200. *See* Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3) (as amended in 2006).

a deficit capital account.[201] If the partnership never liquidates Rafael's interest, Rafael will never have to restore the obligation.[202]

Even if Rafael restores his capital account deficit at some point in the future, permitting him to take a deduction violates current general rules of deductibility.[203] Tax law generally does not allow a taxpayer to take a deduction for ordinary business expenses until the taxpayer makes a payment or incurs a liability.[204] In this example, Rafael did not make a payment; rather, he lent money to the partnership. The liability he incurred—the obligation to restore a deficit capital account balance on the termination of his interest in the partnership[205]—would give rise to a deduction only if Rafael were an accrual method taxpayer and the deduction was otherwise allowed.[206] Considering Rafael would owe the $200,000 to Bryce and Mason for becoming a partner in their partnership, imagining a basis for a deduction is difficult.

Finally, if the partnership has tax-exempt income, Rafael may be able to avoid restoring the deficit account balance all together. Assuming the partnership had tax-exempt income, it could allocate that income to Rafael to increase his capital account balance and eliminate his deficit.[207] The allocation of depreciation and subsequent allocation of tax-exempt income would appear to satisfy the economic effect test, assuming Rafael, Mason, and Bryce are all in the same tax bracket.[208] Therefore, the IRS and courts should respect the allocation. This example demonstrates, however, a weakness of the allocation rules: they allow partners to internalize tax-item transactions that are prohibited on the open market.

Recall that economists theorize that individuals form firms to internalize open-market transactions.[209] Under that theory, a firm would not create transactions that are not available on the open market. Those who believe a firm is a nexus of contracts[210] should also recognize that a partnership should not be able to do

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201. *See id.* § 1.704-1(b)(2)(iv)(b)(1), -1(b)(2)(iv)(b)(7) (as amended in 2006) (providing that contributions increase capital accounts and allocations of partnership deductions and distributions decrease capital accounts).

202. *See* Yin, *supra* note 184, at 158 (recognizing that a partner may never realize the burden of restoring a deficit in a capital account).

203. *Id.* ("[T]he economic effect requirement attempts to match the allocation and actual claiming of a tax item with the economic burden or benefit associated with that item, yet it completely ignores the proximity or remoteness of the burden or benefit . . . .").

204. *See* I.R.C. § 162(a) (2000).

205. Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3) (as amended in 2006).

206. *See* I.R.C. § 461(a) (allowing taxpayers to take deductions under the accounting method, including the accrual method, they use to compute taxable income); Treas. Reg. § 1.461-1(a)(2)(I) (as amended in 1999) (providing general rules for applying the accrual method).

207. *Id.* § 1.704-1(b)(2)(iv)(b)(3) (as amended in 2006) (providing that any income, including tax-exempt income, allocated to a partner increases the partner's capital account).

208. If all parties are in the same tax bracket, the allocation would improve the after-tax economic position of Rafael, but it would also diminish the after-tax economic situation of Mason and Bryce. Furthermore, the allocation would not reduce the overall tax liability of the parties. *See supra* notes 193–96 and accompanying text (discussing the substantiality requirement).

209. *See supra* notes 93–97 and accompanying text.

210. *See supra* note 99 and accompanying text.

internally what it cannot do on the open market.[211] Allowing partners to engage in tax-item transactions when taxpayers on the open market cannot overlooks these attributes of the partnership as a firm.

C. Nature of Discretionary Allocations

Some commentators recommend that partnership allocations should be in proportion to capital account balances.[212] Such a rule often would not reflect the economic arrangements of many partnerships resulting in impermissible inflexibility. As discussed previously, partners often apportion partnership rewards as a reciprocal monitoring device because they are unable to trace partnership output from partner input.[213] Recall that Claire and Abby are the sole members of a law firm and the law firm has $750,000 of income.[214] When this income is apportioned equally to Claire and Abby, each will make considerably more in the partnership than each would make individually.[215] The economic aspects of the arrangement do not dictate, however, that Abby and Claire should apportion the partnership income equally or in accordance with capital account balances or property contributions.

Under theory-of-the-firm concepts, partners will have various reasons for deciding how to apportion income. Consider one possibility. Prior to joining the partnership, Abby was making $200,000.[216] Claire perhaps could have convinced Abby to work for her at some amount greater than $200,000. That arrangement would have created some agency costs that may have been avoidable by forming a partnership.[217] As a result, Abby and Claire may agree to form the partnership on the basis of an apportionment of income that is unequal. If Abby and Claire believe that the partnership will generate $750,000 of income to distribute, Abby may agree to receive only forty percent of the income ($300,000). This allocation would still

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211. *See* discussion *supra* Part II.C.

212. *See, e.g.*, Gergen, *supra* note 170, at 40 ("Special allocations should be eliminated and partners required to allocate all items according to the relative value of their capital accounts.") Darryll K. Jones, *Towards Equity and Efficiency in Partnership Allocations*, 25 VA. TAX REV. 1047, 1093 (2006) (proposing, on efficiency grounds, that "capital account allocations should constitute the norm—the accurate safe harbor—but in certain circumstances proven by the partners, the allocations might be made in a different manner to achieve optimal economic efficiency"); William J. Rands, *Passthrough Entities and Their Unprincipled Differences Under Federal Tax Law*, 49 SMU L. REV. 15, 39–40 (1995) (recommending that partnerships be subject to the Subchapter S rules because such an application would ensure that partnerships and S corporations are subject to the same rules, and because the rules in Subchapter S are easier to understand); Yin, *supra* note 184, at 203 (proposing that simple private business firms, which would include partnerships of individuals, be required to allocate all tax items "in accordance with the percentage interests of the residual interest holders").

213. *See* discussion *supra* Part II.A.

214. *See supra* text accompanying notes 35–36.

215. Recall that Abby was making $200,000 on her own and Claire was making $250,000 on her own. *See supra* text accompanying notes 35–36. If they apportion the partnership income equally, they will each receive $375,000.

216. *See supra* text accompanying notes 35–36.

217. *See* discussion *supra* Part II.A–B.

place her in a better position than the one she was in before joining the partnership. She may agree to accept the lesser percentage to encourage Claire to work harder to continue to bring in business. Any new clients that Claire brings in will become clients of the firm. Because Claire will concede some control over client matters to Abby, she may require a premium to attract clients. Thus, for various reasons, Abby and Claire may agree to an income apportionment that is unequal.

Once Abby and Claire agree on how they will apportion economic items, tax items should follow the apportionment of the nontax items. Any allocation of tax items that do not follow the economic items would shift the tax effect of the allocation without taxing it appropriately. The following example illustrates how the partnership tax allocation rules permit this result.

Assume that Abby and Claire agree to apportion partnership income equally but allocate sixty percent of the partnership's taxable income to Claire and forty percent of the partnership's taxable income to Abby. Further assume that Abby and Claire are both subject to a twenty percent tax rate. Assume the partnership agreement includes the appropriate provisions to satisfy the economic safe harbor.[218] Because the partners are subject to the same tax rates, the allocation should also satisfy the substantiality requirement.[219] Thus, the IRS should respect the tax-item allocation, even though it does not reflect Abby and Claire's economic arrangement. The inconsistency between the apportionment of partnership income and the tax allocations could be viewed as a tax-item assignment or an interest-free loan from Abby to Claire. Tax law should tax either interpretation of the transaction in the same manner it taxes similar open-market transactions.

If viewed as a tax-item assignment, Abby would be deemed to have put \$75,000 of her taxable income to Claire.[220] The consequences of that tax-item put are a \$15,000 reduction in Abby's tax liability and a \$15,000 increase in Claire's tax liability. Thus, Abby should be treated as paying \$15,000 of Claire's taxable income.[221] Because Claire effectively paid \$15,000 of Abby's tax liability, Abby should have \$15,000 of income from liability relief.[222]

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218. *See* Treas. Reg. § 1.704-1(b)(2)(ii)(b) (as amended in 2006) (providing that allocations satisfy the economic effect test if the partnership agreement requires proper capital account maintenance, liquidity distributions in accordance with "positive capital account balances," and restoration of deficits by partners with deficit capital account balances upon liquidation of such partners' partnership interests).

219. *See supra* notes 193–96 and accompanying text (discussing the substantiality requirement).

220. The \$75,000 is the difference between the \$375,000 of partnership income apportioned to Abby and the \$300,000 of taxable income she reports. Claire, on the other hand, reports \$75,000 more in taxable income than she is apportioned from the partnership.

221. *See supra* notes 147–51 and accompanying text.

222. *See* Old Colony Trust Co. v. Comm'r, 279 U.S. 716, 729 (1929) (finding no difference between payment of tax liability and compensation for services). Abby could exclude the amount from gross income if she were able to establish that it was a gift. *See* I.R.C. § 102(a) (2000). However, establishing that a payment between unrelated parties engaged in business together as a gift is very difficult. *See* Olk v. United States, 536 F.2d 876, 879 (9th Cir. 1976) ("[R]eceipts by taxpayers engaged in rendering services contributed by those with whom the taxpayers have some personal or functional contact in the course of the performance of the services are taxable income when in conformity with the practices of the area and easily valued."). Therefore, the amount will likely be income to Abby. *See*

Because the partnership agreement contains the economic effect safe harbor, Abby may eventually have to make up the difference between the income apportionment and the tax-item allocation. Abby may receive $75,000 less than Claire receives upon liquidation of the partnership, or she may have to pay some amount to restore a deficit balance in her capital account.[223] Because of the potential repayment obligations imposed by the economic effect safe harbor, Abby incurs a $75,000 liability by reporting less taxable income than she actually receives.

Of the two treatments, treatment of the allocations as puts is preferable because such treatment reflects the tax treatment of open-market tax-item transactions.[224] The tax-centric economic effect safe harbor creates a new and unnecessary treatment of a tax-assignment put. By requiring the economic benefit or burden to follow the tax-item allocation, the economic effect test creates an interest-free loan between the partners.[225] The partnership tax allocation rules would better match tax items with consideration if they required tax items to follow the economic arrangement. The following table illustrates the tax problems that incongruous tax-item allocations create.

Incongruous Apportionments and Allocations

Economic Item Apportioned	Tax Item Allocated	Tax Effect	Secondary Tax Item	Secondary Tax Effect
Abby receives $375,000 of partnership income	Abby reports $300,000 of partnership income	$15,000 tax liability reduction	$15,000 gross income	$3,000 tax liability increase
Claire receives $375,000 of partnership income	Claire reports $450,000 of partnership income	$15,000 tax liability increase	$15,000 deduction	$3,000 tax liability reduction
Abby receives $375,000 of partnership income	Abby reports $300,000 of partnership income	$75,000 loan from Claire	Imputed interest deduction	Tax liability deduction for imputed interest
Claire receives $375,000 of partnership income	Claire reports $450,000 of partnership income	$75,000 loan to Abby	Imputed interest income	Tax liability increase for imputed interest

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also supra text accompanying notes 149–51 (discussing the similarity between tax treatment of payment of tax liability and payment as compensation for services).

223. *See* discussion *supra* Part IV.A.1.

224. *See supra* Part IV.D (describing the tax consequences of a tax-item put).

225. *See* Gergen, *supra* note 170, at 13.

Requiring taxation allocations to be proportional to partnership capital account balances or per capita among partners can produce equally poor results.[226] In fact, such a rule would violate the assignment-of-income doctrine. It fails to recognize that partners may agree, for nontax reasons, to apportion partnership economic items in a manner that is not proportional to the partners' capital account balances. For example, assume Mason and Bryce form a partnership that requires Mason to contribute capital and Bryce to contribute services. The partners agree that they will apportion eighty percent of the partnership rewards to Mason and twenty percent to Bryce. As discussed above, the parties cannot trace the output—services and rental—from the property Mason contributed or the services Bryce performs.[227] The parties, however, agree to the apportionment based upon several factors, one of which is reciprocal monitoring. Furthermore, because the partnership is a community of interest in both the property and the services, the partners cannot separate the income derived from services from the income produced by the property rental.[228]

To illustrate the inadequacy of allocations based on capital accounts, consider the consequences based on the original partnership agreement between Mason and Bryce.[229] Mason contributed property worth $10,000,000 and Bryce contributed no property. Therefore, on the first day of the partnership's existence, Mason would have a $10,000,000 capital account balance and Bryce would have no money in his capital account.[230] If the partnership tax allocation rules required tax-item allocations to be proportional to positive capital account balances, the partnership would allocate all tax items to Mason. Such allocations would not follow the partners' agreed-to apportionment, which apportions twenty percent of the partnership income to Bryce. If tax law allocates no tax items to Bryce when he receives twenty percent of the partnership income, then Bryce will effectively receive consideration with no corresponding tax item. This result will be similar to Bryce putting the tax item to Mason. Mason would report the receipt of Bryce's consideration as a tax item, and Bryce would obtain the benefit of not paying the tax effect that corresponds with that tax item.[231] The following table illustrates the

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226. This Article does not discuss the consequences of per capita allocations. The focus on the apportionment of economic partnership items and the possible reasons for such apportionments should sufficiently demonstrate the weaknesses of per capita tax-item allocations. Requiring allocation of tax items on a per capita basis in situations in which the partners apportion economic items under a different apportionment formula results in incongruent tax- and economic-item allocations.

227. *See* discussion *supra* Part II.A.2.

228. *See* discussion *supra* Part II.B.1.

229. *See supra* text accompanying notes 39–46.

230. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(b)(2) (as amended in 2006) (providing that a contribution of property to a partnership increases the contributing partner's capital account by the fair market value of the contributed property).

231. If Bryce's income apportionment were $60,000 and the tax he would have paid on that amount were $12,000, allocating tax items based on positive capital accounts would result in allocation of no tax items to Bryce. Because Bryce does not receive the tax item, he will have a $12,000 benefit, which is the difference between the tax he should pay on the $60,000 partnership income and the amount he pays based on the tax-item allocation. He should report that as income under *Old Colony*. *See* Old Colony Trust Co. v. Comm'r, 279 U.S. 716, 731 (1929); *see also supra* notes 150–51 and

$60,000 put that would result if Bryce and Mason allocated tax items in proportion to their capital account balances.

Incongruous Capital Account Allocations				
Economic Item Apportioned	Tax Item Allocated	Tax Effect	Secondary Tax Item	Secondary Tax Effect
Bryce receives $60,000 of partnership income	Bryce reports no income because he has a zero capital account balance	$12,000 tax liability reduction	$12,000 compensation income	$2,400 tax liability increase
Mason receives $140,000 of partnership income	Mason reports all $200,000 of income because of his capital account balance	$12,000 tax liability increase	$12,000 deduction	$2,400 tax liability reduction
Bryce receives $60,000 of partnership income	Bryce reports no income because he has a zero capital account balance	$60,000 loan from Mason	Imputed interest deduction	Tax liability reduction for imputed interest
Mason receives $140,000 of partnership income	Mason reports all $200,000 of income because of his capital account balance	$60,000 loan to Bryce	Imputed interest income	Tax liability increase for imputed interest

These examples demonstrate that partnership tax allocation rules should require tax items to follow the partners' apportionment of economic items. Allowing or requiring partners to allocate tax items based on other criteria may result in a tax-item put or some other undesirable result.

V. DEAL-CENTRIC ALLOCATIONS

Special allocations of tax items are not consistent with the nature of partnerships. For example, when two or more people form a partnership, they each take an interest in the property and services of the partnership.[232] Those interests are

accompanying text.

232. *See supra* notes 83–87 and accompanying text.

inseparable, as each member of a partnership has an interest in the partnership's property and services.[233] Thus, both partners should share in the economic items of the property and services, as such sharing is a natural result of co-ownership. To monitor each other, partners may, however, apportion various economic items differently. In the case of Abby and Claire, Abby may agree to apportion seventy percent of the income from new clients to Claire to encourage Claire to keep bringing in new clients. On the other hand, Claire may agree to allocate fifty-five percent of income from repeat clients to Abby to encourage Abby to maintain strong relationships with those clients.

Members of a partnership with significant assets may also apportion economic items to monitor each other. If the property decreases in value, it affects all of the partners. Disproportionate apportionment of a diminution in value of property to one partner may be natural, if that partner is responsible for the maintenance and upkeep of the property and failing in those tasks would diminish the value of the property. Alternatively, the partners may give the partner with maintenance and upkeep responsibilities a disproportionately larger share of any increase in the property's value to encourage diligence in performing those responsibilities.[234] If Rafael joins the partnership as a pure capital investor, Mason and Bryce would not naturally allocate depreciation to Rafael as a monitoring technique. Such an apportionment does not affect Rafael's behavior or reduce agency costs because Rafael does not have responsibilities that affect the value of the property.[235]

Partnership tax allocation rules should account for the complex nature of partnerships. The rules should also account for the partners' use of economic items to monitor each other. If the partnership tax allocation rules focused on the economic arrangement and required tax items to follow economic items, the rules would move from being tax-centric to being deal-centric. With a deal-centric focus, the rules would not allow special allocations of tax items, but would rely solely on the economic arrangement in the partnership agreement. Thus, the partnership agreement should not reference or establish tax-item allocations. Any partnership tax-item allocations should be governed by rules that apply to open-market tax-item transactions. Such a rule would also account for the complex nature of partnerships.

VI. CONCLUSION

Recognizing partnerships as vibrant centers of economic activity does not require tax-centric partnership tax allocation rules. In fact, the opposite is the case. The examination of partnerships in this Article considered the partnership under theory-of-the-firm concepts. This examination revealed that partners apportion partnership economic items to monitor each other and discourage shirking. Because partners apportion partnership economic items to monitor each other, the apportionment of economic items often may not be consistent with contributions

233. *See supra* text following note 87.

234. *See supra* text following note 50.

235. *See supra* p. 309 (discussing reasons for apportioning decreases in value to certain partners).

to the partnership or liquidation preferences. Thus, partnership tax allocation rules should focus on the apportionment of economic items, not other factors.

The study of the various theories of the firm also reveals that some theorists view firms as centers for transactions that would otherwise occur on the open market. Thus, individuals form partnerships to internalize market transactions and reduce transaction costs. The significance of such a decision in the tax context is that partners should not be able to internalize transactions that they cannot accomplish on the open market. Because taxpayers cannot engage in tax-item transactions on the open market without incurring tax consequences, partners should not be allowed to internally engage in tax-item transactions unless such transactions are taxed.

The current partnership tax allocation rules do not appear to incorporate theory-of-the-firm concepts. Instead, the current allocation rules have become tax-centric. The rules grant partners freedom in allocating tax items and, at best, only require a delayed trailing economic consequence. A move toward deal-centric partnership tax allocation rules would help account for the nature of partnerships and would subject partners to tax rules that govern tax-item transactions.