

Winter 2006

# The Federal Definition of Tax Partnership

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## Recommended Citation

43 Hous. L. Rev. 925 (2006-2007)

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# ARTICLE

## THE FEDERAL DEFINITION OF TAX PARTNERSHIP

*Bradley T. Borden\**

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## I. INTRODUCTION

“When an entity must be classified for purposes of a Federal income tax statute, policy considerations of Federal income tax law should govern that classification . . . .”<sup>1</sup> Thus spoke the Tax Court, honoring federal income tax policy with its pen, but remaining far from it in application.<sup>2</sup> In fact, although the federal definition of tax<sup>3</sup> partnership has been at issue in over 150 statutes, cases, regulations, and rulings,<sup>4</sup> it is the rare occasion that tax policy has governed attempts to define tax partnership.<sup>5</sup> This neglect of tax policy has contributed to the vast tangle of legal authority that addresses the definition of tax partnership. This Article unravels that tangled mess, identifies the several tests that have been used to define tax partnership, and evaluates each of them using a tax policy platform.<sup>6</sup> It then

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1. *Wheeler v. Comm’r*, 37 T.C.M. (CCH) 883, 889 (1978).

2. *Id.* at 889–91 (citing precedent for a multifactor test and then looking to the parties’ contributions to hold that the arrangement was a tax partnership, but failing to discuss why the factors or contributions are relevant under tax policy); *see also Mark 7:6* (“Well hath Esaias prophesied of you hypocrites, as it is written, ‘This people honoureth me with their lips, but their heart is far from me.’”).

3. All subsequent references to “tax” are to federal income tax, unless stated otherwise.

4. This number is based on the Author’s count of statutes, cases, regulations, and rulings discussed and cited in this Article and others the Author either read or came across in his research. These sources will hereinafter be referred to as “*Article Sources & Author’s Research Findings*.”

5. Congress and a small handful of courts have directly addressed tax policy. *See, e.g., Haley v. Comm’r*, 203 F.2d 815, 818 (5th Cir. 1953) (“Substance rather than form controls in applying the federal tax statutes, and ‘the realities of the taxpayer’s economic interest, rather than the niceties of the conveyancer’s art, should determine the power to tax.’” (quoting *Helvering v. Safe Deposit & Trust Co.*, 316 U.S. 56, 58 n.1 (1942))); *Maletis v. United States*, 200 F.2d 97, 97–98 (9th Cir. 1952) (discussing the tax policy of the estoppel test); H.R. REP. NO. 72-708, at 53 (1932) (indicating that Congress enacted a broad definition of tax partnership to require arrangements that are similar to partnerships to make similar returns and account for their operations similarly); *see also infra* Part III.B (concluding that congressional mandates regarding partnership accounting aimed to increase equity, simplicity, and administrability).

6. Some commentators have considered the definition of tax partnership, but those considerations usually only cover a few cases and adopt an approach similar to that adopted by the courts and the Internal Revenue Service (IRS). *See, e.g.,* Richard M. Lipton, *When Is a Partner Not a Partner?*, in 1 TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 845, 849–60 (Louis S. Freeman & Clifford M. Warren eds., 2005) (examining a handful of cases that have addressed the definition of tax partnership); E. John Wagner II & Susan Barrett Hecker, *Evaluating and Making a Choice of “No Entity” for Real Property Held for Investment or Lease*, FLA. B.J., July–Aug. 2001, at 43, 44–45 (advising on how to avoid tax partnership classification in real property co-ownership situations and citing a handful of cases as support); Donald J. Weidner, *The Existence of State and Tax Partnerships: A*

proposes a policy-based definition of tax partnership. In essence, the Article reviews and evaluates the results of almost a century of lawmaking and proposes that the law take a new direction.<sup>7</sup>

Although the definition of tax partnership has a significant history, three recent developments have drawn renewed attention to it. First, taxpayers have used elaborate partnerships to create artificial tax losses and allocate income to foreign entities not subject to U.S. income tax.<sup>8</sup> The Internal Revenue

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*Primer*, 11 FLA. ST. U. L. REV. 1, 18–24 (1983) (discussing several general tax partnership concepts and examining through the lens of a handful of cases whether an assignee of a partnership interest becomes a partner, whether tenants in common are partners, and whether certain other arrangements create tax partnerships). Other commentators claim to consider the definition of the tax partnership but focus instead on the definition of tax corporation and the distinction between tax partnership and tax corporation. *See, e.g.*, Richard S. Bobrow, Steve Montgomery & David R. Cohen, *Washington Tax Watch*, 6 J. PARTNERSHIP TAX'N 68, 68–70 (1989) (distinguishing between tax partnerships and tax corporations); William B. Brannan, *Lingering Partnership Classification Issues (Just When You Thought It Was Safe to Go Back into the Water)*, 1 FLA. TAX REV. 197, 199–204 (1993) (contrasting tax partnerships and tax corporations). This Article, for the first time, systematically analyzes and evaluates the definition of tax partnership by conducting a comprehensive coverage of the legal authority addressing the issue and distilling the numerous tests that have been used to find tax partnerships.

7. In 1913, Congress enacted the first income tax to pass constitutional muster. *See* sources cited *infra* note 69; *see also* *Brushaber v. Union Pac. R.R. Co.*, 240 U.S. 1, 9, 25–26 (1916) (upholding the constitutionality of the Tariff Act of 1913). That first income tax bill specifically disregarded partnerships for all tax purposes other than reporting. *See infra* text accompanying note 72. The IRS considered the definition of tax partnership as early as 1923. *See infra* note 270 and accompanying text (discussing whether parties who co-owned, operated, and shared the profits from a farm constituted a partnership). Thus, the definition of tax partnership has been an issue for the last ninety-three years. Without forsaking hope that this Article will have an immediate effect on the development of the definition of tax partnership, the Author predicts that the issue will most likely be at play on the fast-approaching 100th anniversary of the income tax.

8. *See, e.g.*, *Boca Investorings P'ship v. United States*, 314 F.3d 625, 627–29, 632 (D.C. Cir. 2003) (unwinding an elaborate arrangement where a U.S. taxpayer claimed to have formed a tax partnership in the Netherlands Antilles, a favorable tax jurisdiction, with an unrelated foreign financial institution). The recent increased use of tax shelters has received considerable attention. *See, e.g.*, JOINT COMM. ON TAXATION, 106th CONG., COMPARISON OF RECOMMENDATIONS RELATING TO CORPORATE TAX SHELTERS MADE BY THE DEPARTMENT OF TREASURY AND THE STAFF OF THE JOINT COMMITTEE ON TAXATION (2000) (comparing legislative proposals addressing corporate tax shelters); OFFICE OF TAX POLICY, DEPT OF THE TREASURY, REPORT TO CONGRESS ON PENALTY AND INTEREST PROVISIONS OF THE INTERNAL REVENUE CODE (1999) (examining the widespread use of tax shelters and recommending changes to the Internal Revenue Code's penalty and interest provisions); DEPT OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS ix–xxi (1999) (proposing changes to disclosure requirements and penalty provisions aimed at curbing the proliferation of the corporate tax shelter); JOINT COMM. ON TAXATION, 106th CONG., STUDY OF PRESENT-LAW PENALTY AND INTEREST PROVISIONS AS REQUIRED BY SECTION 3801 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998 (INCLUDING PROVISIONS RELATING TO CORPORATE TAX SHELTERS) (Comm. Print 1999) (reporting on then-current Internal Revenue Code penalty and interest provisions and recommending changes to curtail corporate tax shelters); Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775, 1775–77, 1792–95 (1999) (presenting an overview of tax shelters and likely governmental responses to their

Service (IRS)<sup>9</sup> and Department of Justice have challenged that use of the partnership tax rules, claiming the arrangements<sup>10</sup> do not come within the definition of tax partnership.<sup>11</sup> Second, to qualify for section 1031<sup>12</sup> nonrecognition, real estate investors are creating new ownership structures to invest in real estate with others without becoming tax partnerships.<sup>13</sup> Third, some states

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increased use in the past few years); Marvin A. Chirelstein & Lawrence A. Zelenak, Essay, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1939–42 (2005) (critiquing current governmental efforts to prevent tax shelters); James S. Eustice, *Abusive Corporate Tax Shelters: Old "Brine" in New Bottles*, 55 TAX L. REV. 135, 139–40 (2002) (arguing that corporate tax shelters are a problem that may lead to the erosion of the corporate tax base); John Hembera, *ITEP Report Exposes Corporate Tax Avoidance*, 89 TAX NOTES 439, 439 (2000) (finding that while corporate profits of the 250 largest corporations rose by 23.5% from 1996 through 1998, federal corporate income tax rose by only 7.7% during that same period); Anthony C. Infanti, *Eyes Wide Shut: Surveying Erosion in the Professionalism of the Tax Bar*, 22 VA. TAX REV. 589, 609–12 (2003) (arguing that lawyers who help structure tax shelters are violating the duty of professional responsibility owed to the clients they assist); Richard Lavoie, *Subverting the Rule of Law: The Judiciary's Role in Fostering Unethical Behavior*, 75 U. COLO. L. REV. 115, 117, 119–20 (2004) (asserting that "the judiciary's . . . strict statutory construction has . . . created a legal environment that fosters unethical behavior" such as the use of corporate tax shelters); Sheldon D. Pollack, *Revenge of the Muckrakers*, 75 TAX NOTES 255, 256–57 (1997) (describing the attention garnered by elaborate tax regulations); Lawrence H. Summers, *Summers Speech on Corporate Tax Shelters*, TAX NOTES TODAY, Feb. 29, 2000, available at LEXIS 2000 TNT 40-34 (estimating that by closing a small percentage of the tax shelters, the government will save an estimated \$80 billion in tax revenue over the next ten years); see also Symposium, *Business Purpose, Economic Substance, and Corporate Tax Shelters*, 54 SMU L. REV. 1 (2001) (presenting articles discussing recent uses of corporate tax shelters); Symposium, *Corporate Tax Shelters*, 55 TAX L. REV. 125 (2002) (presenting various articles and points of view on the use of corporate tax shelters and partnerships).

9. This Article uses the term "IRS" to refer to the Internal Revenue Service and its predecessor organization, the Bureau of Internal Revenue, which was renamed as part of the 1953 reorganization. THE AMERICAN WAY IN TAXATION: INTERNAL REVENUE, 1862–1963, at 38 (Lillian Doris ed., 1994).

10. The term "arrangement" as used in this Article refers to any multiperson relationship that is not a tax corporation or tax trust, incorporating the definition of person in section 7701. I.R.C. § 7701(a)(1) (2000 & Supp. 2005).

11. See, e.g., TIFD III-E, Inc. v. United States, No. 05-0064-cv, 2006 WL 2171519, at \*15–16 (2d Cir. Aug. 3, 2006) (finding that no tax partnership existed due to a lack of an equity investment); Andantech L.L.C. v. Comm'r, 331 F.3d 972, 980 (D.C. Cir. 2003) (denying tax partnership status where no parties intended to join together in a business and the "partnership" did not have a legitimate nontax purpose); Boca Investorings P'ship, 314 F.3d at 632 (finding that without a legitimate nontax business purpose, a tax partnership does not exist "where taxpayers use an 'elaborate partnership' with entities created solely for the purpose of the questioned transaction"); Saba P'ship v. Comm'r, 273 F.3d 1135, 1140–41 (D.C. Cir. 2001) (agreeing that "the absence of a non-tax business purpose is fatal" when attempting to establish tax partnership status); ASA Investorings P'ship v. Comm'r, 201 F.3d 505, 516 (D.C. Cir. 2000) (finding no tax partnership when "none of the supposed partners had the intent to form a real partnership").

12. All section references are to the Internal Revenue Code of 1986 as amended ("Code"), unless stated otherwise.

13. I.R.C. § 1031(a)(1) (2000) ("No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such

have adopted series limited liability company statutes, which allow members to establish distinct series that isolate liabilities within that series and vest only the series's members with control and interests in its profits and losses.<sup>14</sup> The definition of

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property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.”). Generally all real estate, including undivided interests in a single piece of real estate, is like kind to other real estate. Treas. Reg. § 1.1031(a)-1(b) to -1(c) (as amended in 1992). Interests in tax partnerships are specifically excluded from section 1031 nonrecognition. I.R.C. § 1031(a)(2)(D). Undivided interests in real estate may, however, qualify for section 1031 nonrecognition. Bradley T. Borden & W. Richey Wyatt, *Syndicated Tenancy-in-Common Arrangements: How Tax-Motivated Real Estate Transactions Raise Serious Nontax Issues*, PROB. & PROP., Sept.–Oct. 2004, at 18, 19–20. Certain real estate interests may not, however, satisfy the like-kind-property requirement. See Kelly E. Alton & Louis S. Weller, *Does State Law Really Determine Whether Property Is Real Estate for Section 1031 Purposes?*, 32 REAL EST. TAX’N 30, 30–31 (2004) (discussing three IRS releases limiting the applicability of the like-kind requirement under Section 1031); Bradley T. Borden, *The Whole Truth About Using Partial Real Estate Interests in Section 1031 Exchanges*, 31 REAL EST. TAX’N 19, 19–20 (2003) (reporting that property interests such as water rights, leases, remainder and reversionary interests, life interests, mineral interests, timber rights, and easements may need to be re-examined to “ensure they are like kind to a fee in real estate”). A cottage industry now sells undivided interests in real estate to parties attempting section 1031 exchanges. The arrangements in which such parties invest are known as syndicated tenancy-in-common (TIC) arrangements. See Borden & Wyatt, *supra*, at 18–19 (presenting the requirements for TIC interests and section 1031 applicability); Terence Floyd Cuff, *Rev. Proc. 2002-22 and Section 1031 Exchanges Involving Tenancies-in-Common*, 29 REAL EST. TAX’N 148, 148 (2002) (discussing the IRS requirements for TIC recognition); Terence Floyd Cuff, *Section 1031 Exchanges Involving Tenancies-in-Common*, 29 REAL EST. TAX’N 53, 53–54 (2002) (analyzing the issues surrounding the purchase of TIC arrangements); Richard M. Lipton, *New Rules Likely to Increase Use of Tenancy-in-Common Ownership in Like-Kind Exchanges*, 96 J. TAX’N. 303, 303 (2002) (discussing the current laws surrounding TICs). Some industry participants estimate that between the years 2002 and 2004, the amount of exchange money invested annually in syndicated TIC arrangements grew 1,333% from \$150 million to \$2 billion. Kevin Thomason, Louis S. Weller, Darryl Steinhouse, and Richard M. Lipton, *The Evolution of TICs and Section 1031*, Mid-Year Meeting of the Real Estate Committee of the Tax Section of the American Bar Association, San Diego, California (Jan. 21, 2005) (citing *Real Estate Alert*, Dec. 15, 2004) (estimating that over \$4.3 billion of real estate was purchased in the syndicated TIC format). Others estimate even greater growth, with 2004 volume reaching \$3.7 billion, up from \$150 million after the end of 2001. William Winn, *The TIC Industry Enters the Mainstream*, SHOPPING CENTER BUS., May 2005, at 422, 422; see also Joe Gose, *An Up-TIC in Realty Swaps*, BARRON’S, July 18, 2005 (“Before [Rev. Proc. 2002-22], fewer than 10 TIC sponsors had raised \$157 million in equity to fund some \$700 million in property acquisitions. [In 2004], 46 sponsors raised \$1.8 billion in equity to finance \$4.5 billion in real estate . . . . And the total value of such holdings could run as high as \$9 billion, since deals by dozens of small sponsors fly under industry trackers’ radar.”). Investors may also form such arrangements to avoid the liability of being a member of a partnership. See *infra* text accompanying note 259.

14. See DEL. CODE ANN. tit. 6, § 18-215(a) to (b), (d) (2005) (“A limited liability company agreement may establish or provide for the establishment of 1 or more designated series of members, managers or limited liability company interests having separate rights, powers or duties with respect to specified property or obligations of the limited liability company or profits and losses associated with specified property or obligations, and any such series may have a separate business purpose or investment objective. . . . [I]f notice of the limitation on liabilities of a series as referenced in this

tax partnership must consider whether a limited liability company with multiple series is one tax partnership or multiple tax partnerships.<sup>15</sup>

Lacking a certain statutory foundation and being subject to numerous uncoordinated interpretations, the current definition of tax partnership may not be able to address these recent developments. By deconstructing the development of partnership tax law, this Article identifies the types of arrangements Congress intended tax partnership law to govern and explains that Congress intended to disregard partnerships and enacted partnership tax rules only when necessary to simplify partnership tax accounting and reporting and to facilitate partner tax administration. The Article's evaluation of the tests reveals that many are uncertain and do not incorporate these purposes of partnership tax law and therefore haphazardly grant

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subsection is set forth in the certificate of formation . . . , then the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to a particular series shall be enforceable against the assets of such series only, and not against the assets of the limited liability company generally or any other series thereof . . . . A limited liability company agreement may provide for classes or groups of members or managers associated with a series having such relative rights, powers and duties as the limited liability company agreement may provide, and may make provision for the future creation in the manner provided in the limited liability company agreement of additional classes or groups of members or managers associated with the series . . . ."; *see also* 805 ILL. COMP. STAT. 180/37-40(a) to (e) (2005) ("An operating agreement may establish or provide for the establishment of designated series of members, managers or limited liability company interests having separate rights, powers or duties with respect to specified property or obligations of the limited liability company or profits and losses associated with specified property or obligations . . . . [I]f the limited liability company has filed a certificate of designation for each series which is to have limited liability under this Section, then the debts, liabilities and obligations incurred, contracted for or otherwise existing with respect to a particular series shall be enforceable against the assets of such series only . . . ."); IOWA CODE ANN. § 490A.305(1)–(2), (4) (West 1999) ("An operating agreement may establish or provide for the establishment of designated series of members, managers, or membership interests having separate rights, powers, or duties with respect to specified property or obligations of the limited liability company or profits and losses associated with specified property or obligations . . . . [T]he debts, liabilities, and obligations incurred, contracted for, or otherwise existing with respect to a particular series shall be enforceable against the assets of that series only . . . ."); OKLA. STAT. ANN. tit. 18, § 2054.4(A)–(D) (West Supp. 2006) ("An operating agreement may establish or provide for the establishment of one or more designated series of members, managers or membership interests having separate rights, powers or duties with respect to specified property or obligations of the limited liability company or profits and losses associated with specified property or obligations . . . . [I]f notice of the limitation on liabilities of a series as referenced in this subsection is set forth in the articles of organization of the limited liability company, then the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to a particular series shall be enforceable against the assets of such series only . . . .").

15. *See* Charles T. Terry & Derek D. Samz, *An Initial Inquiry into the Federal Tax Classification of Series Limited Liability Companies*, 110 TAX NOTES 1093, 1097 (2006) (suggesting that each series should be classified as a separate entity under the Illinois statute).



or deny access to the partnership tax rules. To remedy this, the Article proposes a definition of tax partnership that incorporates the purposes of partnership tax law and limits its applicability to arrangements that merit such treatment under tax policy. The proposed definition also provides certainty by adopting tax terminology. Being so constructed, the proposed definition is suited to address traditional, current, and future questions regarding the definition of tax partnership.

Part II of the Article begins the analysis by distinguishing the definitions of tax corporation and tax trust, both of which are fairly well established, from the definition of tax partnership. That section also establishes that arrangements that are neither tax corporations nor tax trusts shall be either tax partnerships or arrangements disregarded for tax purposes (tax nothings),<sup>16</sup> depending on the definition of tax partnership.

Part III begins the examination of the definition of tax partnership by reviewing the history of partnership taxation. That review identifies simplification and administrability as primary purposes for the partnership tax rules and anti-abuse concerns as a secondary purpose. Such rules should, however, apply only if tax policy otherwise prohibits disregarding an arrangement. The definition of tax partnership should incorporate the purposes of partnership tax law by including only arrangements that the partnership tax rules were enacted to address. To demonstrate the significance of the definition of tax partnership, Part IV illustrates how partnership tax rules affect tax liability.

Part V distills ten tests from the vast body of law that addresses the definition of tax partnership. Part VI establishes the policy platform for examining each test. Part VII uses the policy platform to evaluate each of the tests, exposing the strengths and weaknesses of each test. This exercise is a natural selection process, the result of which reveals the strongest tests—those that should remain viable—and the weakest tests—those that should be eliminated. Based on the evaluations, Part VIII proposes a definition of tax partnership rooted in the purposes of partnership tax law and recommends that courts, the Department of Treasury (Treasury), and the IRS adopt the proposed definition immediately.

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16. Such arrangements include sole proprietorships and divisions and branches of companies.

## II. THE DEFINITIONS OF MULTIMEMBER TAX ENTITIES

The tax system has three multimember tax entities: (1) tax corporations, (2) tax trusts, and (3) tax partnerships.<sup>17</sup> The definition of each of these determines the tax classification of multimember arrangements and the tax treatment of the resulting tax entities and their members.<sup>18</sup> For example, a tax corporation is subject to an entity-level tax,<sup>19</sup> and distributions to its members are subject to tax.<sup>20</sup> A tax trust must pay tax on undistributed income, possibly subjecting it to an entity-level tax.<sup>21</sup> A tax partnership is not subject to an entity-level tax,<sup>22</sup> but it must follow the partnership tax accounting and reporting rules.<sup>23</sup> An arrangement that is not within one of these three definitions is a tax nothing.<sup>24</sup> The law clearly defines tax corporation and provides a workable definition of tax trust, but leaves the definition of tax partnership in disarray.<sup>25</sup>

### A. The Established Definitions

The “check-the-box regulations” clearly define tax corporation.<sup>26</sup> Prior to those regulations, courts and Treasury

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17. See Treas. Reg. § 301.7701-2(a)(1) to (2) (as amended in 1996) (“The term ‘association’ refers to an organization whose characteristics require it to be classified for purposes of taxation as a corporation rather than as another type of organization such as a partnership or a trust.”).

18. See *infra* notes 19–24 and accompanying text.

19. See I.R.C. § 11 (2000) (“A tax is hereby imposed for each taxable year on the taxable income of every corporation.”). But see I.R.C. § 1363(a) (2000) (excepting S corporations from corporate tax).

20. I.R.C. § 301(c)(1) (2000).

21. I.R.C. §§ 1(e), 641(a) (2000).

22. See I.R.C. § 701 (2000) (“A partnership as such shall not be subject to the income tax imposed by this chapter.”).

23. See *id.* (“Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.”); I.R.C. § 702 (2000) (directing the proper treatment of a partner’s income and credits).

24. See *Arthur Venneri Co. v. United States*, 340 F.2d 337, 343 (Ct. Cl. 1965) (holding that the arrangement was not a tax partnership so the taxpayer was not liable for employment taxes as an employer); Treas. Reg. § 301.7701-1(a)(4) (as amended in 2005) (“[C]ertain organizations that have a single owner can choose to be recognized or disregarded as entities separate from their owners.”); Treas. Reg. § 301.7701-1(a)(3) (as amended in 2004) (“An entity formed under local law is not always recognized as a separate entity for federal tax purposes. For example, an organization wholly owned by a State is not recognized as a separate entity for federal tax purposes if it is an integral part of the State.”).

25. See Treas. Reg. § 301.7701-2(b) (as amended in 2006) (defining a tax corporation); Treas. Reg. § 301.7701-4(a) (as amended in 1996) (defining a tax trust). But see Treas. Reg. § 301.7701-2(c) (as amended in 2006) (providing a definition of a tax partnership by contrasting it to a corporation).

26. Treas. Reg. §§ 301.7701-1 to -4 (as amended in 2006). These regulations are

used a fact-intensive test to define tax corporation.<sup>27</sup> The check-the-box regulations eliminated the uncertainty of that definition and provided a bright-line definition of tax corporation that focuses on the form of legal entity.<sup>28</sup> For example, under the check-the-box regulations, an arrangement that is a corporation under state law is a tax corporation.<sup>29</sup> Commentators have criticized corporate tax law for violating equity<sup>30</sup> and have criticized the current regulatory definition of

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referred to as the “check-the-box” regulations because arrangements are given the choice to elect to be treated as a tax corporation if they are not otherwise so treated under the regulations. Treas. Reg. § 301.7701-3(a) (as amended in 2005); see also Thomas M. Hayes, *Checkmate, the Treasury Finally Surrenders: The Check-the-Box Treasury Regulations and Their Effect on Entity Classification*, 54 WASH. & LEE L. REV. 1147 (1997) (discussing the history and application of the check-the-box regulations).

27. See Treas. Reg. § 301.7701-2(a)(1) (as amended in 1996) (“There are a number of major characteristics ordinarily found in a pure corporation which, taken together, distinguish it from other organizations. These are: (i) Associates, (ii) an objective to carry on business and divided [sic] the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests.”); see also *United States v. Kintner*, 216 F.2d 418, 421–24 (9th Cir. 1954) (applying a six-characteristic test: (1) associates, (2) an objective to carry on a business and divide the profits therefrom, (3) continuity of life, (4) centralized management, (5) limited liability, and (6) free transferability of interests); Henry J. Lischer, Jr., *Elective Tax Classification for Qualifying Foreign and Domestic Business Entities Under the Final Check-the-Box Regulations*, 51 SMU L. REV. 99, 103–04 (1997) (recounting the development of the six factors deemed to indicate that an organization was a corporation rather than a partnership or trust); Peter B. Oh, *A Jurisdictional Approach to Collapsing Corporate Distinctions*, 55 RUTGERS L. REV. 389, 405–15 (2003) (discussing the development and use of multicharacteristic tests for determining if an organization was a corporation or a partnership).

28. See *Littriello v. United States*, No. Civ.A.3:04CV-143-H, 2005 WL 1173277, at \*3 (W.D. Ky. May 18, 2005) (“The newer regulations allow similar flexibility to the Kintner regulations, with more certainty of results and consequences.”). But see Gregg D. Polsky, *Can Treasury Overrule the Supreme Court?*, 84 B.U. L. REV. 185, 187–88 (2004) (questioning the validity of the check-the-box regulations based on their inconsistency with Supreme Court precedent). The court ultimately found that the check-the-box regulations are consistent with prior case law. See *Littriello v. United States*, No. Civ.A.3:04CV-143-H, 2005 WL 1862156, at \*1 (W.D. Ky. Aug. 3, 2005) (denying the taxpayer’s motion to reconsider based on Professor Polsky’s article).

29. Treas. Reg. § 301.7701-2(b) (as amended in 2006) (providing that the definition of tax corporation also includes federal law corporations, associations, state joint-stock companies and joint-stock associations, state-chartered business entities conducting banking activities, business entities wholly owned by a state or foreign government, and certain enumerated foreign entities). Other arrangements may elect to be tax corporations. Treas. Reg. § 301.7701-3(a) (as amended in 2005).

30. See, e.g., Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C. L. REV. 613, 633–34 (1990) (noting that double taxation violates principles of horizontal equity); Charles E. McLure, Jr., *Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 HARV. L. REV. 532, 538–40 (1975) (arguing that corporate double taxation violates horizontal equity because it results in similarly situated individuals bearing different tax burdens); Fred W. Peel, *A Proposal for Eliminating Double Taxation of Corporate Dividends*, 39 TAX LAW. 1, 2 (1985) (“Put simply, the double tax on corporate dividends is unfair. It violates the principle of horizontal equity. A shareholder who is

tax corporation for violating both neutrality and equity.<sup>31</sup> One commentator has even questioned its legality.<sup>32</sup> Corporate taxation's unclear tax policy<sup>33</sup> may be the catalyst for the 100-year debate over the definition of tax corporation.<sup>34</sup> While the debate may continue, currently the definition of tax corporation is clear.<sup>35</sup>

A tax trust is "an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts."<sup>36</sup> Generally the beneficiaries do nothing more than accept the benefits of the trust property.<sup>37</sup> This does not, however, prohibit the beneficiaries from creating the trust or making contributions to the trust.<sup>38</sup> The question is generally whether the arrangement vests "trustees [with] responsibility for the protection and conservation of property for

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taxed on a dividend out of earnings that already have been taxed at the corporate level is bearing a heavier tax burden than an individual in the same tax bracket receiving equivalent income . . . as a sole proprietor."). For a discussion of standard equity, see *infra* Part VI.B.1.

31. See, e.g., Anthony P. Polito, *Advancing to Corporate Tax Integration: A Laissez-Faire Approach*, 55 S.C. L. REV. 1, 46-48 (2003) (arguing that the current tax rate structure results in tax shelters, the selective availability of which violates horizontal equity); David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1646-48 (1999) (discussing theories of equity and efficiency).

32. Polsky, *supra* note 28, at 187-88.

33. See Steven A. Bank, *A Capital Lock-in Theory of the Corporate Income Tax*, 94 GEO. L.J. 889, 890-91, 895 (2006) (noting that "commentators have tried in vain to explain the corporate/partnership divide in taxation"); Patrick E. Hobbs, *Entity Classification: The One Hundred-Year Debate*, 44 CATH. U. L. REV. 437, 441 (1995) ("As it turns out, Congress based its decision more on an effort to soothe the psyche of the American public than on any theoretical underpinnings."); Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 53 (1990) (arguing that the tax laws developed out of an intersection of competing policies). *But see* Reuven S. Avi-Yonah, *The Story of the Separate Corporate Income Tax: A Vehicle for Regulating Corporate Managers*, in BUSINESS TAX STORIES 11, 18-19 (Steven A. Bank & Kirk J. Stark eds., 2005) (arguing that other reasons include the benefits theory of viewing the corporate tax as an indirect tax on shareholders); Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 338-42 (1995) (positing that corporate tax policy is a mix of two clear tax policies, one from the side of the shareholders and one from the side of corporate managers).

34. Congress first distinguished corporations from other entities in the Revenue Act of 1894, beginning the debate regarding the type of entity that came within the classification of tax corporation. See Hobbs, *supra* note 33, at 437-38.

35. If certain commentators ever get their wish and the corporate tax is repealed, the definition of tax partnership would increase in importance because classifying arrangements as tax partnerships would be the significant classification task.

36. Treas. Reg. § 301.7701-4(a) (as amended in 1996).

37. *Id.*

38. *Id.*

beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.”<sup>39</sup> Arrangements referred to as trusts or registered as trusts (i.e., commercial or business trusts) are not tax trusts, however, if they are “created by the beneficiaries simply as a device to carry on a profit-making business.”<sup>40</sup> Thus, the definition of tax trust is also fairly well established, leaving only the definition of tax partnership unclear.

### *B. The Open Definition: Tax Partnership*

This Article focuses on the definition of tax partnership, which distinguishes tax partnerships from tax nothings. Section 7701(a)(2) defines partnership to include “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 title, a trust or estate or a corporation.”<sup>41</sup> That definition establishes tax partnership as the default tax entity.<sup>42</sup> Thus, an arrangement can be a tax partnership only if it is not a tax corporation or a tax trust or estate.<sup>43</sup> Otherwise, the statutory definition is vague. Only a few courts have carefully considered its language.<sup>44</sup> Instead, the definition of tax partnership has developed through tax common law, Treasury regulation, and IRS rulings.<sup>45</sup>

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39. *Id.*

40. Treas. Reg. § 301.7701-4(b) (as amended in 1996). *But see* Rev. Rul. 2004-86, 2004-33 I.R.B. 191 (ruling that a Delaware statutory trust formed to hold real estate was a tax trust, in part because the trust document significantly restricted the trustee’s authority to conduct business).

41. I.R.C. § 7701(a)(2) (2000); *see also* I.R.C. § 761(a) (Supp. III 2005) (defining “partnership” the same way).

42. Treas. Reg. § 301.7701-3(b) (as amended in 2005).

43. This Article does not address the classification of single-member entities because they only have one member and fail to raise the tax partnership question. Treas. Reg. § 301.7701-3(a) (as amended in 2005) (“[A]n eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.”); *see also infra* Part III (stating that the purposes for the partnership tax rules were to address multimember entities).

44. *See, e.g., Wheeler v. Comm’r*, 37 T.C.M. (CCH) 883, 889 n.15 (1978) (suggesting that the statute illustrates the concept of arrangements treated as tax partnerships). “[T]he key determination using this approach would not be whether a joint venture or any other of the enumerated entities had been formed, but rather whether an entity is of the same generic class as those entities and is, therefore, taxable as a partnership.” *Id.* Other than this type of reference, courts rarely attempt to read much into the statutory definition of tax partnership.

45. *See Article Sources & Author’s Research Findings, supra* note 4 (referencing a catalogue of legal authority that addresses the definition of tax partnership).

The check-the-box regulations provide a labyrinthine multi-step process for classifying tax entities, but they ultimately adopt the statutory default for tax partnerships.<sup>46</sup> That process could be avoided by simply asking whether an arrangement is a tax corporation or tax trust.<sup>47</sup> An arrangement that is not a tax trust or tax corporation is a tax partnership, if within the definition of tax partnership.<sup>48</sup> Otherwise, such arrangement is a tax nothing.<sup>49</sup> This Article asks whether an arrangement that is neither a tax trust nor a tax corporation is a tax partnership.<sup>50</sup>

Over the past ninety-three years, the courts, Treasury, and the IRS have approached the definition of tax partnership haphazardly. Courts and the IRS have considered whether an arrangement is a tax partnership or, alternatively, (1) a co-ownership of property;<sup>51</sup> (2) a principal-

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46. To determine if an entity is a partnership, one must first determine whether an arrangement is a "separate entity." T.D. 8697, 1997-1 C.B. 215, 216 (1997); Treas. Reg. § 301.7701-1(a) (as amended in 2006). Second, if an arrangement is a separate entity, one must determine whether it is a "business entity." Treas. Reg. § 301.7701-2(a) (as amended in 2006). A business entity is any separate entity that is not a tax trust. *Id.* Third, one must determine if a business entity is a tax corporation; if it is not, it is a tax partnership. Treas. Reg. § 301.7701-3(a) to (b) (as amended in 2005).

47. Treas. Reg. § 301.7701-2(a) (as amended in 2006); Treas. Reg. § 301.7701-3(a) (as amended in 2005).

48. See Treas. Reg. § 301.7701-2(a) (as amended in 2006); Treas. Reg. § 301.7701-3(a) (as amended in 2005).

49. Treas. Reg. § 301.7701-3(a) (as amended in 2005) ("[A]n eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.").

50. For those wedded to the analysis in the check-the-box regulations, the analysis is equivalent to asking whether an arrangement that is neither a tax corporation nor a tax trust is a separate entity.

51. See, e.g., *Bergford v. Comm'r*, 12 F.3d 166, 166-68 (9th Cir. 1993) (finding that a computer-leasing arrangement is a tax partnership); *Luckey v. Comm'r*, 334 F.2d 719, 720-22 (9th Cir. 1964) (holding that the acquisition, development, and disposition of realty by tenants in common is a tax partnership); *Gilford v. Comm'r*, 201 F.2d 735, 735-36 (2d Cir. 1953) (holding that tenants in common are not tax partners because the facts do not show a desire by either party to form a partnership); *Coffin v. United States*, 120 F. Supp. 9, 10-11 (S.D. Ala. 1954) (holding that tenants in common did not establish a tax partnership); *Alhouse v. Comm'r*, 62 T.C.M. (CCH) 1678, 1679, 1682 (1991) (finding that a computer-leasing arrangement is a tax partnership because the two parties took "joint action towards a common goal"), *aff'd sub nom. Bergford*, 12 F.3d 166; *Bussing v. Comm'r*, 88 T.C. 449, 450-51, 460-62 (1987) (holding that computer-leasing arrangement is a tax partnership); *Underwriters Ins. Agency v. Comm'r*, 40 T.C.M. (CCH) 5, 5-9 (1980) (holding that co-owners of fishing boats established a tax partnership because the participants treated their arrangement as such for federal tax purposes); *Estate of Levine v. Comm'r*, 72 T.C. 780, 785-86 (1979) (determining that tenants in common created a tax partnership because they "engaged in an active business, performed various services, and shared the gains and losses"); *McShain v. Comm'r*, 68 T.C. 154, 160 (1977) (holding that a co-ownership of triple-net leased property was not a tax partnership); *Podell v. Comm'r*, 55 T.C. 429, 430-32 (1970) (holding that individuals who acquired, renovated, and

agent relationship;<sup>52</sup> (3) a financing relationship;<sup>53</sup> (4) nothing;<sup>54</sup> or (5) an oil and gas, electrical, mining, or similar co-owned joint-production arrangement.<sup>55</sup> In some situations, the courts and the

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disposed of properties had formed a tax partnership); *Estate of Appleby v. Comm'r*, 41 B.T.A 18, 20–21 (1940) (finding a tenancy in common arrangement not a tax partnership), *aff'd*, 123 F.2d 700 (2d Cir. 1941); Rev. Rul. 75-374, 1975-2 C.B. 261 (holding that ownership as tenants in common does not mandate finding the existence of a tax partnership where co-owners do not share in revenue from additional services provided to tenants); I.T. 2082, III-2 C.B. 176, 177 (1924) (ruling that co-owners of property and retail merchandise business did not form a tax partnership); I.T. 1604, II-1 C.B. 1, 1–3 (1923) (ruling that co-ownership of farm was not a tax partnership).

52. See, e.g., *Bartholomew v. Comm'r*, 186 F.2d 315, 315–16, 319 (8th Cir. 1951) (holding that an out-of-state engineer is not a tax partner); *Luna v. Comm'r*, 42 T.C. 1067, 1078–79 (1964) (deciding that an agreement between an insurance company and agent is not a tax partnership).

53. See, e.g., *Joe Balestrieri & Co. v. Comm'r*, 177 F.2d 867, 871 (9th Cir. 1949) (concluding that making an investment in a partnership venture does not make the investor a partner when the individual does not have any control over the partnership); *Allison v. Comm'r*, 35 T.C.M. (CCH) 1069, 1071, 1078 (1976) (finding no tax partnership where lender received a fixed fee for financing a subdivision); *S. & M. Plumbing Co. v. Comm'r*, 55 T.C. 702, 703, 709 (1971) (holding that an individual who contributed capital for a construction bond was a partner).

54. See, e.g., *Comm'r v. Culbertson*, 337 U.S. 733, 735–36, 748 (1949) (holding that a father and son cattle operation could be a tax partnership); *Lusthaus v. Comm'r*, 327 U.S. 293, 295–97 (1946) (holding that a husband and wife were not a tax partnership); *TIFD III-E, Inc. v. United States*, No. 05-0064-cv, 2006 WL 2171519, at \*9 (2d Cir. Aug. 3, 2006) (holding that the banks did not have a bona fide equity participation, so the arrangement was not a tax partnership); *Andantech L.L.C. v. Comm'r*, 331 F.3d 972, 978 (D.C. Cir. 2003) (finding an absence of a nontax business purpose, so the arrangement was not a tax partnership); *Boca Investorings P'ship v. United States*, 314 F.3d 625, 632 (D.C. Cir. 2003) (holding that in the case of an “elaborate partnership” taxpayers must show a nontax business purpose); *Saba P'ship v. Comm'r*, 273 F.3d 1135, 1141 (D.C. Cir. 2001) (instructing the Tax Court to consider whether the arrangement had a nontax business purpose); *ASA Investorings P'ship v. Comm'r*, 201 F.3d 505, 516 (D.C. Cir. 2000) (holding that lack of nontax business purpose indicates that the arrangement is not a tax partnership); *Estate of Winkler v. Comm'r*, 73 T.C.M. (CCH) 1657, 1658, 1663–64 (1997) (concluding that family members joined together as tax partners to buy lottery tickets); see also *Ballou v. United States*, 370 F.2d 659, 664 (6th Cir. 1966) (deferring to the lower court's finding that no partnership was created when parents transferred a company interest to children's trusts); *Earp v. Jones*, 131 F.2d 292, 293–94 (10th Cir. 1942) (finding an arrangement between husband and wife “more fanciful than real” and, therefore, not a tax partnership); *Comm'r v. Olds*, 60 F.2d 252, 254–55 (6th Cir. 1932) (holding that parties' intent to form a tax partnership is sufficient to overcome IRS's challenge that family arrangement was a sham).

55. See, e.g., *Bentex Oil Corp. v. Comm'r*, 20 T.C. 565, 571 (1953) (holding that co-ownership and operation of oil and gas property was a tax partnership); Rev. Rul. 83-129, 1983-2 C.B. 105, 105 (classifying a mineral lease as a tax partnership); Rev. Rul. 68-344, 1968-1 C.B. 569, 569-71 (ruling that the co-ownership and operation of power generating units constituted a tax partnership); Rev. Rul. 65-118, 1965-1 C.B. 30, 30–31 (ruling that the co-ownership and operation of oil and gas property was a tax partnership); Rev. Rul. 56-500, 1956-2 C.B. 464, 466–67 (ruling that joint extraction operations were part of a tax partnership); Rev. Rul. 54-42, 1954-1 C.B. 64, 64 (ruling that co-ownership and operation of oil and gas property was a tax partnership); I.T. 3930, 1948-2 C.B. 126, 129 (same); I.T. 3713, 1945 C.B. 178, 178–80 (ruling that a timber-cutting operation was a tax partnership); I.T. 2749, XIII-1 C.B. 99, 99–100 (1934) (ruling that co-ownership of oil and

IRS concluded that no tax partnership existed;<sup>56</sup> in others, with seemingly similar facts, they concluded that a tax partnership existed.<sup>57</sup> The IRS and courts have not been particular in identifying prior case law or rulings with similar facts when relying on precedent.<sup>58</sup> Some courts cited no authority for the

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gas property was a tax partnership); I.T. 2785, XIII-1 C.B. 96, 96 (1934) (ruling that co-owners of oil and gas could file an information return); I.R.S. Priv. Ltr. Rul. 83-15-003 (June 17, 1982) (ruling that co-ownership and joint operation of a mine was a tax partnership); I.R.S. Priv. Ltr. Rul. 79-19-065 (Feb. 12, 1979) (ruling that co-ownership and operation of nuclear generating plant was a tax partnership).

56. See, e.g., *Joe Balestrieri & Co.*, 177 F.2d at 869, 871 (holding that a guarantee did not make guarantor of a mining venture a tax partner); *Coffin*, 120 F. Supp. at 10-11 (holding that tenancy in common arrangement was not a tax partnership); *McShain*, 68 T.C. at 155-56, 160 (holding that co-ownership involving passive obligations of triple-net leased property was not a tax partnership); *Allison*, 35 T.C.M. (CCH) at 1078 (finding no tax partnership where lender received fixed-fee for financing subdivision); *Luna*, 42 T.C. at 1068, 1078-79 (holding that an employment agreement between an insurance company and its agent was not a tax partnership due to a lack of evidence of a joint venture); *Hahn v. Comm'r*, 22 T.C. 212, 214 (1954) (determining that a TIC arrangement was not a tax partnership); Rev. Rul. 75-374, 1975-2 C.B. 261, 261 (concluding that ownership as tenants in common is not a tax partnership where co-owners do not share in revenue from additional services provided to tenants); Rev. Rul. 56-500, 1956-2 C.B. 464, 466-67 (ruling that joint extraction operations may elect to be a tax partnership or a tax corporation).

57. See, e.g., *Bergford v. Comm'r*, 12 F.3d 166, 166-68 (9th Cir. 1993) (finding a computer-leasing arrangement a tax partnership); *Luckey v. Comm'r*, 334 F.2d 719, 720, 722-23 (9th Cir. 1964) (holding that acquisition, development, and disposition of realty by tenants in common was a tax partnership); *Alhouse v. Comm'r*, 62 T.C.M. (CCH) 1678, 1679, 1682 (1991) (concluding that a computer-leasing arrangement is a tax partnership), *aff'd sub nom. Bergford*, 12 F.3d 166; *Underwriters Ins. Agency v. Comm'r*, 40 T.C.M. (CCH) 5, 6-7, 9 (1980) (holding that co-owners of a fishing boats established a tax partnership because the participants treated it as such for federal tax purposes); *Estate of Levine v. Comm'r*, 72 T.C. 780, 785-86 (1979) (determining that tenants in common created a tax partnership because they "engaged in an active business, performed various services, and shared the gains and losses"); *S. & M. Plumbing Co.*, 55 T.C. at 709 (holding that capital contributor for a construction bond was a tax partner); *Podell v. Comm'r*, 55 T.C. 429, 430-32 (1970) (holding that individuals who acquired, renovated, and disposed of properties had formed a tax partnership); Rev. Rul. 68-344, 1968-1 C.B. 569, 569-71 (ruling that co-ownership and operation of power generating units constituted a tax partnership); I.R.S. Priv. Ltr. Rul. 83-15-003 (June 17, 1982) (ruling privately that co-ownership and joint operation of a mine was a tax partnership); I.R.S. Priv. Ltr. Rul. 79-19-065 (Feb. 12, 1979) (ruling privately that co-ownership and operation of nuclear generating plant was a tax partnership).

58. See, e.g., *Bergford*, 12 F.3d at 167-69 (citing *Luna*, an employment case, *Madison Gas & Elec. Co. v. Comm'r*, 633 F.2d 512 (7th Cir. 1980), an electrical cooperative case, and *Comm'r v. Tower*, 327 U.S. 280 (1946), a family assignment of income case, in a computer-leasing case); *Bartholomew v. Comm'r*, 186 F.2d 315, 315, 318 (8th Cir. 1951) (citing *Tower* in an employment versus tax partnership case); *Alhouse*, 62 T.C.M. (CCH) at 1679-81 (listing the factors from *Luna* and citing *Tower* in a computer-leasing case); *Bussing v. Comm'r*, 88 T.C. 449, 450-51, 460 (1987) (citing *Tower* and *Comm'r v. Culbertson*, 337 U.S. 733 (1949), another assignment of income in the family context case, in a computer leasing case); *Underwriters Ins. Agency*, 40 T.C.M. (CCH) at (citing *Tower*, *Culbertson*, *Luna* in a co-ownership versus tax partnership case); *Estate of Levine*, 72 T.C. at 781-82, 785 (citing *Tower* and *Culbertson* in a co-ownership versus tax partnership case); *Allison*, 35 T.C.M. (CCH) at 1071, 1076-77 (citing *Culbertson* and *S. & M. Plumbing*, a financing versus tax partnership case, in a co-ownership versus tax



definition of tax partnership or appear to have ruled based on the plain language of the statute.<sup>59</sup> In some cases, the courts looked at whether the parties intended to form a partnership,<sup>60</sup> but in others, the courts said that intent was not relevant.<sup>61</sup> Indeed, courts and the IRS have confirmed the definition's uncertainty by alternatively relying on state law,<sup>62</sup> flatly rejecting state law,<sup>63</sup> and providing no indication of the source of authority.<sup>64</sup> This

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partnership case); *S. & M. Plumbing Co.*, 55 T.C. at 706–07 (citing *Podell*, a co-ownership case, in a financing versus tax partnership case).

59. See, e.g., *Gilford v. Comm'r*, 201 F.2d 735, 736 (2d Cir. 1953) (holding that there was no partnership based on the statutory definitions of “capital assets,” “real property,” and “trade or business” without reference to case law).

60. See, e.g., *Culbertson*, 337 U.S. at 748 (remanding case to the Tax Court to consider the intent question); *Alhouse*, 62 T.C.M. (CCH) at 1680 (stating that the existence of a tax partnership question “is a question of fact, that turns on the parties’ intent”); *Estate of Levine*, 72 T.C. at 785 (stating that the crucial question is whether parties “intended to create, as evidenced by their actions, a partnership.”); *Allison*, 35 T.C.M. (CCH) at 1076 (stating that the tax partnership question is generally factual with emphasis on intent).

61. *Evans v. Comm'r*, 447 F.2d 547, 550–51 (7th Cir. 1971) (concluding that “[i]f the corporation’s ownership is real then the subjective intent of the parties is not a determinative test,” and *Commissioner v. Culbertson* is no longer the test since it was decided before the enactment of section 704(e)(1)).

62. See, e.g., *Joe Balestrieri & Co. v. Comm'r*, 177 F.2d 867, 871–72 (9th Cir. 1949) (relying on California state laws and California common law); *Fishback v. United States*, 215 F. Supp. 621, 626 (D.S.D. 1963) (discussing several state interpretations of a joint venture, including the lack of a South Dakota Supreme Court ruling on the point of law); *Frazell v. United States*, 213 F. Supp. 457, 461–62 (W.D. La. 1963), *rev’d on other grounds*, 335 F.2d 487 (5th Cir. 1964) (applying Louisiana Civil Code to determine the definition of a joint venture); *Flanders v. United States*, 172 F. Supp. 935, 942–43 (N.D. Cal. 1959) (“Both [plaintiffs] were residents of Carmel, California . . . California law accordingly applies in determining whether there was a joint venture.”); *Copeland v. Ratterree*, 57-2 U.S. Tax Cas. (CCH) ¶ 9895, at 58,195–96 (N.D.N.Y. 1957) (utilizing Vermont law to determine if a joint venture existed); *Tate v. Knox*, 131 F. Supp. 514, 516 (D. Minn. 1955) (using Minnesota substantive law to determine if a joint venture was created).

63. See, e.g., *Estate of Kahn v. Comm'r*, 499 F.2d 1186, 1189 (2d Cir. 1974) (“First, it is clear that whether [the plaintiffs were] a partnership *for tax purposes* is a matter of federal, not local, law.”); *Haley v. Comm'r*, 203 F.2d 815, 818 (5th Cir. 1953) (“[N]either local law nor the expressed intent of the parties as to the legal nature and effect of their written agreements are conclusive . . . for federal tax purposes.”); *First Mechs. Bank v. Comm'r*, 91 F.2d 275, 278–79 (3d Cir. 1937) (applying federal case law); *Arthur Venneri Co. v. United States*, 340 F.2d 337, 340–41, 343 (Ct. Cl. 1965) (applying federal law); *Herzberg v. United States*, 176 F. Supp. 440, 444 (S.D. Ind. 1959) (applying the Internal Revenue Code to the definition of partnership); *Wheeler v. Comm'r*, 37 T.C.M. (CCH) 883, 887–88 (1978) (applying federal law to determine if a partnership is formed); *Luna v. Comm'r*, 42 T.C. 1067, 1077 (1964) (“[T]he Internal Revenue Code prescribes its own standards for qualification of an unincorporated association as a partnership and supersedes local law.”); *Beck Chem. Equip. Corp. v. Comm'r*, 27 T.C. 840, 849 (1957) (applying the Internal Revenue Code because “it supercedes local law for Federal income tax purposes”).

64. See, e.g., *S. & M. Plumbing Co. v. Comm'r*, 55 T.C. 702, 707, 709 (1971) (referencing case law as authority for indicia of the existence of a joint venture without reference to state or federal definitions); *Au v. Comm'r*, 40 T.C. 264, 267–68 (1963)

kaleidoscope of cases, regulations, and rulings evinces the need for a certain definition of tax partnership. Such a definition should be governed by tax policy, including the purposes of partnership tax law.

### III. HISTORY AND PURPOSE OF PARTNERSHIP TAXATION

Tax law originally disregarded partnerships.<sup>65</sup> Later, Congress enacted partnership tax rules and the definition of tax partnership to address tax accounting and reporting concerns and purportedly to subject similarly situated arrangements to the same accounting and reporting rules.<sup>66</sup> Congress also enacted laws governing the allocation of partnership tax items, and Treasury promulgated extensive regulations interpreting allocation rules in the statute.<sup>67</sup> Even later, Congress enacted anti-abuse rules.<sup>68</sup> A review of the history of partnership taxation reveals those purposes.

#### A. *The Effort to Disregard*

Partnerships were disregarded under the Tariff Act of 1913, which imposed income tax on individuals and corporations.<sup>69</sup> Congress acknowledged partnerships merely to require the partners to report partnership income individually.<sup>70</sup> That act also required partnerships to report profits and identify individual partners, when requested by the IRS.<sup>71</sup> Thus, although

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(addressing the issue of partnership without reference to any definition and ultimately deciding the case on other grounds); *Smith v. Comm'r*, 8 T.C. 1319, 1323–25 (1947) (applying principles of both Texas and federal law without clearly deciding on either basis).

65. See *infra* note 69 and accompanying text.

66. See *infra* notes 80–87 and accompanying text.

67. See *infra* notes 125–48 and accompanying text.

68. See *infra* notes 150–51 and accompanying text.

69. Tariff Act of 1913, ch. 16, § II.A, 38 Stat. 114, 166 (imposing the first income tax); see also Bradley T. Borden, Sandra Favelukes & Todd E. Molz, *A History and Analysis of the Co-Ownership-Partnership Question*, 106 TAX NOTES 1175, 1175–80 (2005) (discussing the history of partnership taxation).

70. See Tariff Act of 1913, § II.G(a) (imposing a “normal tax” on individuals for income derived from corporations, joint-stock companies or associations, and insurance companies, but excluding partnerships).

71. *Id.* § II.D (“[A]nd any such firm, when requested by the Commissioner of Internal Revenue, or any district collector, shall forward to him a correct statement of such profits and the names of the individuals who would be entitled to the same, if distributed . . .”). The 1916 Act was more specific, providing that

such partnership, when requested by the Commissioner of Internal Revenue, or any district collector, shall render a correct return of the earnings, profits, and income of the partnership, except income exempt under section four of this Act, setting forth the item of the gross income and the deductions and credits allowed

Congress generally disregarded partnerships, it recognized them enough to allow the IRS to obtain information about partnerships and to administer partner taxation.<sup>72</sup> These early rules establish that partnership taxation should first attempt to disregard partnerships and then recognize them only to facilitate tax administration, but not to impose a tax on partnerships.<sup>73</sup>

This initial disregard of partnerships reflects two perspectives. First, at the time the income tax was enacted, the view was that a partnership was an aggregate of its members, not a separate entity.<sup>74</sup> Congress adopted this view by not subjecting partnerships to an entity-level tax.<sup>75</sup> Second, by disregarding partnerships, Congress attempted to treat partner taxpayers similarly to the standard taxpayer who would conduct similar business or own property individually.<sup>76</sup> To preserve partnership disregard, Congress enacted minimally intrusive rules necessitated by tax administration.<sup>77</sup> Tax administration also justified treating partner taxpayers differently from the standard taxpayer.<sup>78</sup>

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by this title, and the names and addresses of the individuals who would be entitled to the net earnings, profits, and income, if distributed.

Revenue Act of 1916, ch. 463, § 8(e), 39 Stat. 756, 762–63. In 1932, Congress required all tax partnerships to make a return. Revenue Act of 1932, ch. 209, § 189, 47 Stat. 169, 223 (“Every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this title, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners.”).

72. Without requiring such information, Congress would impede the IRS’s ability to assess and collect income tax from partners.

73. By and large, the current tax rules adhere to this same principle. The complexity of the current rules stems from the intricate nature of administering an income tax that derives from flow-through entities, such as partnerships.

74. See *First Mechs. Bank v. Comm’r*, 91 F.2d 275, 279 (3d Cir. 1937) (noting that under common law, a partnership was not considered a legal entity).

75. See *supra* notes 69–70 and accompanying text. Since the enactment of the first partnership tax rules, that view has changed. See, e.g., UNIF. P’SHIP ACT § 201(a) (amended 1997), 6 U.L.A. 91 (2001) (“A partnership is an entity distinct from its partners.”). This change of view has not affected the partnership tax rules significantly enough to result in repeal of all partnership tax rules based on the aggregate theory. Thus, the original justification of partnership tax rules—the aggregate substantive-law theory—no longer exists, but the rules remain.

76. See *infra* Part VI.B.1 (discussing standard equity).

77. Tariff Act of 1913, ch. 16, § II.A, 38 Stat. 114, 166–67.

78. See *id.* § II.G(a) (excluding partnerships from taxation at the entity level).

### *B. The Imposition of Tax Reporting Requirements*

If partnerships were completely disregarded for tax purposes, they should not have been required or allowed to compute income at the partnership level. Instead, each item of income or loss should have been allocated to a partner as though the partnership did not exist. Each partner should have separately reported the income and loss from partnership operations, as the partnership would not have been recognized.<sup>79</sup> The War Revenue Act of 1917 moved away from disregarding partnerships by allowing partnerships to compute taxable income at the partnership level.<sup>80</sup> A partnership that computes taxable income needs a taxable year to avoid computing income multiple times during the year.<sup>81</sup> Thus, Congress enacted rules that allowed partnerships to compute income once a year based upon their own fiscal years.<sup>82</sup> This

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79. Thus, as a partnership incurred expenses, those expenses would be allocated to the partners. As the partnership recognized income, that income would be allocated to the partners. For example, if a partnership with two equal partners were to receive \$100,000 for services provided to a customer, the partners would each include \$50,000 in their respective gross incomes as compensation. See I.R.C. § 61(a)(1) (2000) (directing taxpayers to include in gross income amounts received in compensation for services). If the partnership were to pay \$2,000 in rent for the office space used for the partnership's business, each partner would deduct \$1,000 of the rental expense. See I.R.C. § 162(a)(3) (2000) (allowing a deduction for rental costs incurred by a business). Each partner would recognize the items separate from the other, according to the partner's method of tax accounting and taxable year. A cash method calendar year partner would recognize partnership income and deductions for the calendar year as the partnership recognizes them. Thus, if during the calendar year the partnership received \$1,200,000 in fees from services and paid \$24,000 for rent, the partner would recognize half of those amounts for the calendar year. An accrual method partner on a fiscal year from May 1 through April 30 would recognize income and deductions accrued by the partnership during that period of time. Therefore, if the partnership accrued \$1,000,000 of fees and \$22,000 of rent during that period, the accrual method partner would recognize those amounts. The potentially different tax treatment of these items led to the enactment of the partnership tax rules. See *infra* notes 99–101 and accompanying text.

80. War Revenue Act of 1917, ch. 63, § 1204(1)(e), 40 Stat. 300, 331–32.

81. For example, if a partnership had three partners who respectively had taxable years ending on July 31, October 31, and December 31, partnership income would have to be computed on each of those dates to allocate the partners' respective shares of partnership income. Although this is an administratively inconvenient task for the partners, it would produce a more accurate computation of income for each partner and subject partners to rules more similar to the rules to which the standard taxpayer is subject.

82. War Revenue Act of 1917, § 1204(1)(e) ("A partnership shall have the same privilege of fixing and making returns upon the basis of its own fiscal year as is accorded to corporations under this title."). In the War Revenue Act of 1917, Congress also provided greater specificity regarding the exclusion of interest from U.S. obligations:

That from the net distributive interests on which the individual members shall be liable for tax, normal and additional, there shall be excluded their proportionate shares received from interest on the obligations of a State or any political or taxing subdivision thereof, and upon the obligations of the United

appears to have been an attempt to simplify partnership tax accounting.<sup>83</sup>

Congress next enacted a rule to address the situation in which a partnership's taxable year straddled calendar years with different rates.<sup>84</sup> That rule (1) alleviated the administrative burden of partnerships having to compute income and loss multiple times during the year, (2) identified the rates to which income of a partnership straddling two tax years would be subjected, and (3) created a reporting entity (the tax partnership).<sup>85</sup> The straddle rule also appears to have been an attempt to subject partner taxpayers to the same rates to which the standard taxpayer would have been subject.<sup>86</sup>

After permitting partnerships to compute taxable income, Congress enacted rules governing the computation of partnership taxable income to assure that all partnerships computed income similarly.<sup>87</sup> In 1918, Congress required partnerships to compute net income in the same manner and on the same basis as

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States (if and to the extent that it is provided in the Act authorizing the issue of such obligations of the United States that they are exempt from taxation), and its possessions, and that for the purpose of computing the normal tax there shall be allowed a credit, as provided by section five, subdivision (b), for their proportionate share of the profits derived from dividends.

*Id.* Prior acts did not require the language in the authorizing act. *See* Revenue Act of 1916, ch. 463, § (8)(e), 39 Stat. 756, 762-63 (excluding language pertaining to the authorization of a tax exemption). The War Revenue Act of 1917 also provided that income of a partnership reported as requested by the Commissioner should not include exempt income. War Revenue Act of 1917, § 1204(1)(e).

83. *See* Borden et al., *supra* note 69, at 1176 (noting that Congress implemented a fiscal year system for partnership tax accounting in order to establish consistency among taxpayers).

84. War Revenue Act of 1917, § 1204(1)(e). For example, the statutory rate of income for individuals was 1% in 1915 and 2% in 1916. Tariff Act of 1913, ch. 16, § II.A, 38 Stat. 114, 166; Revenue Act of 1916, § 1(a). If a partnership's taxable year straddled those two years, the income could be subject to different tax rates. Congress required the income to be split between the two years:

If a fiscal year ends during nineteen hundred and sixteen or a subsequent calendar year for which there is a rate of tax different from the rate for the preceding calendar year, then (1) the rate for such preceding calendar year shall apply to an amount of each partner's share of such partnership profits equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year, and (2) the rate for the calendar year during which such fiscal year ends shall apply to the remainder.

War Revenue Act of 1917, § 1204(1)(e).

85. *See supra* Part III.B (pertaining to the War Revenue Act of 1917).

86. *See* Borden et al., *supra* note 69, at 1176 (discussing Congress's intent to "consistently tax individuals who invested in partnerships").

87. *See* Revenue Act of 1918, ch. 18, § 218(d), 40 Stat. 1057, 1070 (1919) (stating the requirements for computation of net income of a partnership). For example, without such a rule, one partnership may have used corporate tax rules while another may have used individual tax rules to compute taxable income.

individuals.<sup>88</sup> The 1918 Act also required partners to include their “distributive share[s] . . . of the net income of the partnership” in their respective individual incomes for the individual tax years during which the partnership’s tax year ended.<sup>89</sup> These rules imposed the same accounting and reporting rules on all partnerships and partners.<sup>90</sup> Thus, they created the first uniform method for computing partnership taxable income and reflected a change in congressional focus from standard equity to deviation equity (i.e., the focus turned to whether arrangements similar to partnerships were subject to partnership tax law).<sup>91</sup>

Although Congress did not state its purpose for enacting these rules in 1918, it later referred to uniform reporting and its desire to “make it easier for the members to determine the distributive shares in the [partnership] gains and losses which are to be included in their own returns.”<sup>92</sup> This explanation refers to equity (uniform reporting), simplicity, and administrability (ease of determination).<sup>93</sup> The reference to ease indicates that

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88. *Id.* (“The net income of the partnership shall be computed in the same manner and on the same basis as provided in section 212 [(rules for computing the net income of an individual)], except that the deduction provided in paragraph (11) of subdivision (a) of section 214 [(the deduction for charitable contributions)] shall not be allowed.”).

89. *Id.* § 218(a) (“There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year, or, if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner’s net income is computed.”). The Act also addressed the partners’ shares of partnership credit: “The partner shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) [(addressing credits for corporate dividends received)] and (b) [(addressing credits for interest on United States and War Finance Corporation bonds)] of section 216 as are received by the partnership.” *Id.* This did not alter the flow-through status of partnerships. See H.R. REP. NO. 65-767, at 11 (1918) (“Under the proposed bill the partners will be liable to income tax the same as under existing law. The partnership as such is not liable to income tax, but each partner will pay his income tax upon his share of the partnership profits whether the same are distributed or not.”).

90. Subsequent legislation addressed which taxable year a partnership could adopt. I.R.C. § 706(b) (1958); I.R.C. § 706(b) (1982 & Supp. IV 1987). These rules are intended to limit partners’ ability to defer the inclusion of income through partnership taxable year manipulation. See *infra* note 164–66 and accompanying text. For an in-depth discussion of the history and purpose of the partnership taxable year rules, see Christopher H. Hanna, *A Partnership’s Business Purpose Taxable Year: A Deferral Provision Whose Time Has Passed*, 45 TAX LAW. 685, 688–94, 701–02 (1992).

91. Indeed, in subsequent years, Congress confirmed this intent. See *infra* note 100 and accompanying text (noting that Congress avoids “uncertainty” by requiring syndicates to file information returns comparable to partnership returns).

92. H.R. REP. NO. 72-708, at 53 (1932) (referring to the statutory definition of tax partnership).

93. *Id.*

Congress recognized a difference between the standard taxpayer's computation of net income and a partner taxpayer's computation. This difference justified treating the partner taxpayer differently from the standard taxpayer.

*C. The Statutory Definition of Tax Partnership*

The legislative history accompanying the 1932 Act reveals that Congress focused on deviation equity in enacting the definition of tax partnership.<sup>94</sup> The 1932 Act defined "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."<sup>95</sup> This language has largely survived until this day.<sup>96</sup> The Committee Report indicates that Congress believed that taxpayers were not making partnership returns for "income from the operations of joint ventures, syndicates, pools, and similar organizations."<sup>97</sup> Some taxpayers would not account for the income of such ventures on an annual basis but would wait and report the income from the entire operation when it was wound up.<sup>98</sup> Congress was also concerned that members of such arrangements would have to account for operations on the basis of their own accounting periods and according to their own accounting methods, irrespective of the arrangement's accounting period or method—an issue addressed with respect to partnerships in prior tax acts.<sup>99</sup> Congress believed that by defining tax partnership

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94. See *infra* Part VI.B.2 (discussing deviation equity).

95. Revenue Act of 1932, ch. 209, § 1111(a)(3), 47 Stat. 289, 289.

96. See *supra* Part II.B.

97. H.R. REP. NO. 72-708, at 53 (1932) ("Some confusion has existed over the requirements of the prior acts as to the time and manner of returning income from the operations of joint ventures, syndicates, pools, and similar organizations. If the syndicate was not an association, partnership, or trust within the meaning of the act, there was no express requirement in the act or regulations for the filing of a syndicate return, and the sole responsibility of making returns of the annual gains and losses of the syndicate was placed upon the several members.").

98. *Id.* ("Quite frequently, however, the members of such a syndicate overlooked the necessity of their making returns each year of their shares in the annual gains and losses from syndicate operations and assumed that they were required only to make returns of their shares in the ultimate gain or loss from the entire syndicate operations in the year when the syndicate was wound up or liquidated."). This treatment differed from the reporting required of partnerships, which were required to compute and report income on an annual basis. See *supra* note 82.

99. H.R. REP. NO. 72-708, at 53 (1932) ("Moreover, a strict observance of the letter of the prior acts would have required each member to determine his annual share in the syndicate gains or losses upon the basis of his own accounting period and according to his

broadly, it could eliminate that uncertainty and subject all similar arrangements to the partnership tax accounting and reporting rules.<sup>100</sup> The focus on the similarity of arrangements reflects a commitment to deviation equity.<sup>101</sup>

By identifying specific arrangements in the definition, Congress also focused on the legal form of arrangements. The focus on deviation equity and the legal forms of entities is partly to blame for the current status of the definition of tax partnership.<sup>102</sup> Instead of considering whether treating the members of the various arrangements differently from the standard taxpayer was justified by the difference between such arrangements and the standard taxpayer, Congress clumped the several arrangements into a single category.<sup>103</sup> This may not reflect, in all situations, the purposes for which Congress enacted the partnership tax rules and has the potential of violating standard equity.

Conspicuously omitted from the statutory definition of tax partnership is the type of partnership with which syndicates, groups, pools, joint ventures, and other unincorporated organizations should be compared. The tax laws had referred to partnerships for almost twenty years before Congress enacted a definition of tax partnership.<sup>104</sup> The omission of a definition of tax partnership in the early acts indicates that Congress enacted the rules to govern substantive-law partnerships in these early laws. Early rulings and cases that adopted the substantive-law definition of partnership support this conclusion.<sup>105</sup>

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own method of accounting, irrespective of the accounting period or method of accounting upon which the books or records of the syndicate were kept.”).

100. *Id.* (“The bill does away with this uncertainty by placing all joint ventures, syndicates, pools, and similar organizations, which do not constitute associations or trusts, in the category of partnerships, and the members of such syndicates, pools, etc., in the category of partners. This provision will have the effect of requiring the syndicate to file an information return similar to the return of a partnership and will thus make it easier for the members to determine the distributive shares in the syndicate gains and losses which are to be included in their own returns.”).

101. *Estate of Appleby v. Comm’r*, 41 B.T.A. 18, 21 (1940) (stating that the new statute “was intended primarily to provide a more definite category for syndicates, and for organizations similar to them, to pools, and to joint ventures, the taxation of the income of which had been troublesome”), *aff’d*, 123 F.2d 700 (2d Cir. 1941).

102. *See infra* text accompanying notes 431–35 (noting that Congress and courts have relied heavily on deviation equity to define tax partnership, and explaining the confusion stemming from this reliance).

103. *See* I.R.C. § 761(a) (1958) (defining the term “partnership”).

104. *See supra* Parts IIIA–B.

105. *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)



*D. The 1954 Code: An Amalgam of the Entity and Aggregate Theories*

The Internal Revenue Code of 1954 ("1954 Code") adopted comprehensive partnership tax rules, which were codified in subchapter K of that code.<sup>106</sup> These rules are an amalgam of the aggregate and entity theories.<sup>107</sup> Their enactment followed significant debate among practitioners, academics, and Treasury.<sup>108</sup> The survival of the aggregate theory in the 1954 Code and subsequent acts signals a departure from substantive law, which now treats partnerships as separate entities.<sup>109</sup> The rules that adopt the aggregate theory demonstrate Congress's desire to treat partner taxpayers similarly to the standard taxpayer when possible. The rules that adopt the entity theory largely reflect Congress's commitment to simplicity and administrative convenience in partnership taxation.<sup>110</sup>

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("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)); *see also infra* Part V.A-B.1 (defining substantive-law partnership and listing tax cases that adopt the substantive-law definition).

106. Internal Revenue Code of 1954, Pub. L. No. 591-736, 68 Stat. 3, 239; *see also* J. Paul Jackson et al., *The Internal Revenue Code of 1954: Partnerships*, 54 COLUM. L. REV. 1183 (1954) (providing an in-depth description of the tax rules in the 1954 Code). The partnership tax rules remain codified in subchapter K of the Code. *See* I.R.C. § 761 (2000).

107. Several provisions of the 1954 Code adopt the aggregate theory that attempts to disregard the partnership for tax purposes. *See, e.g.*, I.R.C. § 701 (1958) (subjecting partners, not partnerships, to tax on partnership income); I.R.C. §§ 734, 743 (1958) (allowing basis adjustments to partnership property on certain distributions and sales of partnership interests); I.R.C. § 751 (1958) (considering partnership assets to determine the character of any gain or loss realized on the disposition of a partnership interest). Other provisions adopt the entity theory, recognizing partnerships for tax purposes. *See, e.g.*, I.R.C. § 702(b) (1958) (characterizing tax items at the partnership level); I.R.C. § 703(a) (1958) (requiring partnerships to compute taxable income); I.R.C. § 706(b) (1958) (providing rules for determining the partnership taxable year); I.R.C. § 707 (1958) (providing rules for transactions between partners and the partnership); I.R.C. § 708 (1958) (providing rules for determining when a tax partnership terminates); I.R.C. § 741 (1958) (treating the interest in a partnership as property for tax purposes). Some provisions adopt aspects of both. *See, e.g.*, I.R.C. § 721 (1958) (providing that neither the partners nor the partnership recognize gain or loss on the contribution of property to the partnership); I.R.C. §§ 722-723 (1958) (providing rules for determining the basis of contributed property); I.R.C. § 731 (1958) (providing rules for recognizing gain or loss on distributions from a partnership to a partner). The application of the entity and aggregate theories calls for careful policy scrutiny, leaving work for a future article.

108. *See* Mark P. Gergen, *The Story of Subchapter K: Mark H. Johnson's Quest*, in BUSINESS TAX STORIES, *supra* note 33, at 207.

109. UNIF. P'SHIP ACT § 201(a) (amended 1997), 6 U.L.A. 91 (2001).

110. *See, e.g.*, I.R.C. § 703(a) (1958) (requiring, with only a few exceptions, that partnership taxable income be computed in the same manner as individual income); I.R.C. § 706(b)(1) (1958) (determining the partnership's taxable year the same as if the partnership were a taxpayer); I.R.C. § 741 (1958) (requiring that gain or loss be recognized to the "transferor partner" in the partnership); *see also supra* text accompanying notes 82-83 (noting that the requirement to compute taxable income at the

The 1954 Code also replicated the statutory definition of tax partnership and adopted rules that allow certain types of arrangements to elect out of subchapter K ("section 761 elections").<sup>111</sup> Although such elections may only affect the application of subchapter K, they create de facto nontax partnerships, at least with respect to subchapter K.<sup>112</sup> Thus, the section 761 elections effectively exclude certain arrangements from the definition of tax partnership, at least in part.<sup>113</sup> One of these elections appears to be a codification of the joint-profit test.<sup>114</sup> The origin of the others is less clear.<sup>115</sup>

Although the section 761 elections create a partial exception from the definition of tax partnership, the interaction with

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tax partnership level and the taxable year rules were adopted for simplicity and administrative convenience). Treating interests in tax partnerships as property simplifies accounting on a disposition or acquisition of an interest, because parties are not required to account for each asset of the partnership. *But see* I.R.C. § 751 (2000) (requiring partners to identify and account for gain attributable to partnership accounts receivable and inventory).

111. See I.R.C. § 761(a) (1958) (defining the term "partnership").

112. See *id.* (offering three arrangements which may be elected by an unincorporated organization to exclude the organization from tax partnership status). The IRS has created an interdependence test to determine what provisions outside of subchapter K apply to tax partnerships, including those eligible for the section 761 elections. I.R.S. Gen. Couns. Mem. 39,043 (Oct. 5, 1983) ("[I]f a particular section of the Code is 'interdependent' with section 761(a), the [qualified] partnership should not be treated as a partnership for purposes of such section."); I.R.S. Gen. Couns. Mem. 36,982 (Jan. 13, 1977). If, however, the other section is not interdependent with section 761(a), the qualified partnership will be treated as a partnership for purposes of such other section. *Id.* A section is interdependent with section 761(a) if the other section can be applied without requiring the partnership to compute income at the partnership level. I.R.S. Gen. Couns. Mem. 39,043 (Oct. 5, 1983). Several sections of the Code are not interdependent with section 761(a) and, therefore, will treat qualified tax partnerships as tax partnerships for purposes of the other sections. See, e.g., *Madison Gas & Elec. Co. v. Comm'r*, 633 F.2d 512, 516-17 (7th Cir. 1980) (determining that section 195 is not interdependent with section 761(a)(1)); Rev. Rul. 65-118, 1965-1 C.B. 30, 30-31 (applying former section 48(c)(2)(A)'s dollar limitation at the qualified tax partnership level even though the taxpayers had elected out of partnership treatment for purposes of subchapter K). *But see* I.R.C. § 1031(a)(2)(D) (2000) (disregarding a qualified tax partnership for section 1031 purposes).

113. See *Madison Gas & Elec. Co.*, 633 F.2d at 515 (noting that section 761(a) allows certain qualifying organizations to be excluded from subchapter K partnership provisions).

114. *Id.* at 515-16; see *supra* Part V.B.3 (explaining the joint-profit test).

115. See, e.g., Bradley T. Borden, *Revisiting the Federal Tax Definition of Partnership and the § 761(a)(1) Election in the TIC Environment*, 47 TAX MGMT. MEMORANDUM 51, 59-62 (2006) (discussing the possible origin and application of section 761(a)(1)). This issue deserves further attention and consideration in addition to Professor McMahon's seminal work on the section 761 elections. See Martin J. McMahon, Jr. *The Availability and Effect of Election out of Partnership Status Under Section 761(a)*, 9 VA. TAX REV. 1, 3 (1989) (discussing tax consequences pertaining to oil and gas joint operating agreements classified as partnerships).

section 7701 is considered a two-part analysis.<sup>116</sup> First, the analysis asks whether an arrangement is a tax partnership under section 7701(a)(2).<sup>117</sup> Second, if the arrangement is a tax partnership, the analysis asks whether the arrangement may elect out of subchapter K under section 761.<sup>118</sup> This analysis does not explicitly treat section 761(a) as a partial carve-out from the definition of tax partnership, but by excluding certain arrangements from subchapter K, the effect is the same as an explicit exception.

Following the enactment of the 1954 Code, Treasury promulgated a regulatory definition of tax partnership.<sup>119</sup> That regulation repeated the statutory definition of tax partnership, providing, "The term 'partnership' is broader in scope than the common law meaning of partnership, and may include groups not commonly called partnerships."<sup>120</sup> The definition incorporated concepts from the substantive-law definition of tax partnership and common law.<sup>121</sup> When check-the-box regulations were

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116. See, e.g., *Madison Gas & Elec. Co.*, 633 F.2d at 517 (concluding that the arrangement was a tax partnership under sections 7701(a)(2) and 761(a) of the Code); *Baughn v. Comm'r*, 28 T.C.M. (CCH) 1447, 1455-57 (1969) (allowing a section 7701 partnership to make the section 761(a)(2) election).

117. See, e.g., *Madison Gas & Elec. Co.*, 633 F.2d at 517 (concluding that the arrangement was a tax partnership under sections 7701(a)(2) and 761(a) of the Code); *Baughn v. Comm'r*, 28 T.C.M. (CCH) 1447, 1455-57 (1969) (allowing a section 7701 partnership to make the section 761 (a)(2) election).

118. Determining the availability of the election is also a difficult task. See, e.g., *Borden*, *supra* note 115, at 59-61 (speculating as to the type of arrangements to which section 761(a)(1) election applies).

119. T.D. 6175, 1956-1 C.B. 211, 213.

120. Treas. Reg. § 1.761-1(a)(1) (as amended in 1956). Treasury's reference to common law is unclear. At the time the regulation was promulgated, courts had rejected the state-law definition of partnership. See, e.g., *Haley v. Comm'r*, 203 F.2d 815, 818-20 (5th Cir. 1953) (looking to the definition of partnership under section 3797 of the Code to determine whether a partnership existed between the parties); *Earp v. Jones*, 131 F.2d 292, 293 (10th Cir. 1942) (analyzing whether the parties' arrangement satisfied the definition of a partnership under federal, not state law). However, some courts still looked to state law. See, e.g., *Winmill v. Comm'r*, 93 F.2d 494, 496 (2d Cir. 1937) (determining that under state law, a partnership existed between the parties for tax purposes), *rev'd on other grounds sub nom.* *Helvering v. Winmill*, 305 U.S. 79, 84 (1938); *First Mechs. Bank v. Comm'r*, 91 F.2d 275, 279 (3d Cir. 1937) (acknowledging that under the Revenue Act of 1932, joint ventures are included as partnerships). Perhaps most significantly, courts relied on substantive law to define tax partnership. See, e.g., *Comm'r v. Tower*, 327 U.S. 280, 282-83 (1946) (relying on sections 181 and 182 of the Code in determining the parties' tax consequences in their "individual capacity"). Thus, the reference to common law is not certain.

121. See Treas. Reg. § 1.761-1(a) (as amended in 1956) (codifying the rule from tax cases, stating that "[m]ere coownership of property which is maintained, kept in repair, and rented or leased does not constitute a partnership," and adopting a substantive-law rule: "[I]f an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a partnership thereby"); see also *Brown v. Coates*, 420 S.W.2d 822, 824 (Tex. Civ. App.—Corpus Christi

promulgated, Treasury amended section 761 regulations, which included the definition in the check-the-box regulations by reference.<sup>122</sup> The check-the-box regulations adopted a significant portion of the definition in the old section 761 regulations.<sup>123</sup> The check-the-box regulations, however, dropped the reference to common law and instead state that the definition of tax partnership “does not depend on whether the organization is . . . an entity under local law.”<sup>124</sup> They also use the term “separate entity” instead of “partnership.”<sup>125</sup> This regulatory definition indicates that Treasury considered an arrangement’s substance more important than its form. It does not, however, describe the standard for assessing the arrangement’s substance.

*E. The Section 704(b) Allocation Rules and Assignment of Income*

Perhaps the most significant provision in the 1954 Code is section 704, which allowed partners to allocate partnership items to the partners by agreement, so long as such allocations were not for the principal purpose of avoiding or evading tax.<sup>126</sup> That provision was later amended to prevent agreed allocations that do not have “substantial economic effect.”<sup>127</sup> Following that change, Treasury promulgated very complicated regulations for testing whether allocations have substantial economic effect.<sup>128</sup> Those allocation rules treat partner taxpayers differently from

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1967) (holding that payment of a fixed portion of crops did not create a substantive-law partnership).

122. Treas. Reg. § 1.761-1 (as amended in 1997); T.D. 8717, 1997-1 C.B. 125, 128.

123. See Treas. Reg. § 301.7701-1(a)(2) (as amended in 2006) (adopting the examples from section 761 regulations but changing the terminology from “partnership” to “separate entity”).

124. Treas. Reg. § 301.7701-1(a)(1) (as amended in 2006).

125. Compare Treas. Reg. § 1.761-1(a)(1) (as amended in 1956) (excluding the term “separate entity” from the definition of “partnership”), with Treas. Reg. § 301.7701-1(a)(1) to (2) (as amended in 2006) (acknowledging that some arrangements may give rise to a “separate entity” for taxation purposes).

126. See I.R.C. § 704(a)–(b) (1958) (providing for the allocation of a partner’s distributive share as determined by a partnership agreement); see also WILLIAM S. MCKEE ET AL., 1 FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ch. 10 (1977) (describing the partnership allocation rules); ARTHUR B. WILLIS ET AL., PARTNERSHIP TAXATION ¶ 10.01[3], at 10-8 to -12 (6th ed. Supp. No. 3 2006) (discussing the partnership allocation rules and their development).

127. I.R.C. § 704(b)(2) (2000); see also Tax Reform Act of 1976, Pub. L. No. 94-455, § 213(d), 90 Stat. 1520, 1548 (requiring that a partner’s distributive share be determined by a partner’s interest in the partnership if the allocation “does not have substantial economic effect”).

128. T.D. 8065, 1986-1 C.B. 254–55; Treas. Reg. § 1.704-1(b) (as amended in 2005).

the standard taxpayer, who is required to adhere to the assignment-of-income doctrine.<sup>129</sup>

The assignment-of-income doctrine provides that the person who owns property or performs services should recognize the income from such property or services.<sup>130</sup> The Supreme Court has referred to the doctrine as the “first principle of income taxation,” the tenet that “income must be taxed to him who earns it.”<sup>131</sup> The doctrine considers the source of income.<sup>132</sup> Under the assignment-of-income doctrine, courts and the IRS have disallowed attempts to sever and reassign income from the owner of property or service provider.<sup>133</sup> Taxpayers have attempted to use the tax partnership allocation rules to shift income to family members,<sup>134</sup>

129. See Treas. Reg. § 1.704-1(b).

130. See, e.g., *Harrison v. Schaffner*, 312 U.S. 579, 583 (1941) (holding that the assignment amount was includible as taxable income); *Burnet v. Leininger*, 285 U.S. 136, 141–42 (1932) (requiring that a husband include his distributive share of net income despite assignment of a one-half interest to his wife); *Lucas v. Earl*, 281 U.S. 111, 114–15 (1930) (“[H]e was the only party to the contracts by which the salary and fees were earned, and it is somewhat hard to say that the last step in the performance of those contracts could be taken by anyone but himself alone.”); see also *Comm’r v. Banks*, 543 U.S. 426, 430–31 (2005) (holding that a litigant must include as taxable income the amount payable to the attorney as a contingent fee). But see Brant J. Hellwig, *The Supreme Court’s Casual Use of the Assignment of Income Doctrine*, 2006 U. ILL. L. REV. 751 (2006) (arguing that the assignment-of-income doctrine should be used only for gratuitous assignments of income and other tax principles should apply to compensatory assignments).

131. *Comm’r v. Culbertson*, 337 U.S. 733, 739–40 (1949).

132. *Earl*, 281 U.S. at 114–15 (“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 skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it . . . . [F]ruits [cannot be] attributed to a different tree from that on which they grew.”).

133. See, e.g., *Banks*, 543 U.S. at 430 (holding that a contingent fee paid to attorney out of a money judgment is included in plaintiff’s income); *Earl*, 281 U.S. at 114–15 (holding that income earned by husband must be allocated to the husband).

134. See, e.g., *Culbertson*, 337 U.S. at 748 (holding that recognition of a partnership between a father and his sons depends on whether a bona fide intent that the sons take part in the business exists); *Lusthaus v. Comm’r*, 327 U.S. 293, 295 (1946) (rejecting an attempt to shift income between husband and wife by means of a family partnership); *Comm’r v. Tower*, 327 U.S. 280, 291–92 (1946) (holding that no meaningful partnership existed between husband and wife when the husband actually earned all the income of the partnership and the wife had no role in the business); *Ballou v. United States*, 370 F.2d 659, 664 (6th Cir. 1966) (deferring to lower court’s finding that parents transferred tax partnership interest to children’s trusts and finding no tax partnership); *Maletis v. United States*, 200 F.2d 97, 97 (9th Cir. 1952) (attempting to shift income from father to sons by means of a partnership); *Earp v. Jones*, 131 F.2d 292, 292–93 (10th Cir. 1942) (attempting to shift income between husband and wife by means of a family partnership); *Comm’r v. Olds*, 60 F.2d 252, 253, 255 (6th Cir. 1932) (holding that a bona fide family partnership between father and daughters existed); *Sherman v. United States*, 141 F. Supp. 369, 370 (E.D. Pa. 1956) (attempting to shift income from father to wife and sons by means of a partnership); *Estate of Winkler v. Comm’r*, 73 T.C.M. (CCH) 1657, 1658 (1997) (attempting to shift income from lottery winnings to family partnership); *Linsenmeyer v.*

and have more recently made attempts to shift income to foreign entities exempt from U.S. tax.<sup>135</sup> Courts have held that such arrangements are not tax partnerships, reassigning income to the owner of property or provider of service.<sup>136</sup> In each of these instances, the court looked to the source of the income and traced it to the party who owned or controlled the services or property generating the income.<sup>137</sup> The partnership tax rules should not disrupt the application of this doctrine, unless some overriding policy consideration justifies the departure.<sup>138</sup> That overriding consideration is tax administration.<sup>139</sup>

The tax partnership allocation rules respond to a fundamental difficulty of conduit taxation—determining whose tax base gets credited with income and expenses from a tax partnership.<sup>140</sup> The tax partnership allocation rules provide that

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Comm'r, 25 T.C. 1126, 1130–31 (1956) (attempting to shift income to children in the partnership although the father never intended that the children, though listed as partners, operate the business or contribute capital); *Stern v. Comm'r*, 15 T.C. 521, 526–27 (1950) (attempting to shift income from father to sons by means of a partnership).

135. See, e.g., *TIFD III-E, Inc. v. United States*, No. 05-0064-cv, 2006 WL 2171519, at \*3–4, (2d Cir. Aug. 3, 2006) (attempting to shift income to a foreign entity); *Andantech L.L.C. v. Comm'r*, 331 F.3d 972, 973 (D.C. Cir. 2003) (same); *Boca Investorings P'ship v. United States*, 314 F.3d 625, 627 (D.C. Cir. 2003) (same); *Saba P'ship v. Comm'r*, 273 F.3d 1135, 1136 (D.C. Cir. 2001) (same); *ASA Investorings P'ship v. Comm'r*, 201 F.3d 505, 506 (D.C. Cir. 2000) (same).

136. See, e.g., *Lusthaus*, 327 U.S. at 297 (holding that allocation rules are not applicable because no genuine partnership exists); *Tower*, 327 U.S. at 291–92 (holding that no meaningful partnership existed between husband and wife where the husband actually earned all the income of the partnership and the wife had no role in the business); *Andantech L.L.C.*, 331 F.3d at 973 (finding that a nontax business purpose did not exist, so the arrangement was not a tax partnership); *ASA Investorings*, 201 F.3d at 516 (holding that lack of a nontax business purpose indicates the arrangement does not qualify as a tax partnership); *Ballou*, 370 F.2d at 663–64 (holding that no bona fide partnership existed between a husband and wife and their minor children because the children contributed no capital to the partnership); *Earp*, 131 F.2d at 294 (holding that an arrangement between husband and wife was more fanciful than real and was therefore not a tax partnership); *Linsenmeyer*, 25 T.C. at 1134 (holding that no bona fide family partnership existed because it was never intended that the children, although listed as partners, operate the business or contribute capital).

137. See *supra* note 136.

138. See *infra* Part VI.B (discussing equity, one of the fundamental principles of a sound tax system); see also Darryll K. Jones, *Towards Equity and Efficiency in Partnership Allocations*, 25 VA. TAX REV. 1047, 1069–70 (stating that tax law should also assign nontransferable burdens and benefits to taxpayers based on their economic benefits and burdens).

139. Because of the extreme complexity of the partnership tax allocation rules, partnership tax pundits may doubt whether this is a sincere statement. Although complex, the partnership tax allocation rules provide a workable model. Tracing would be very difficult (if not impossible), making the complex allocation rules more desirable than the impossibility of tracing.

140. See George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141, 154 (1999) (“The source of the difficulty is the fact that income and other items realized by many business entities are treated under state law as belonging to the entity

partners may establish their own allocation methods by agreement, subject to the substantial economic effect test.<sup>141</sup> Congress could attempt to draft complicated rules to trace income from partnership property or services to the member who owns the property or provides the service, but such an attempt could not accomplish its intended purpose in many situations.<sup>142</sup>

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and not to the owners. The receipt by the owners of the entity's income, for example, may arise only upon a distribution from the entity. Yet consistent with basic income tax principles, tax reporting of the income cannot await distribution. Someone must include it in that person's tax base when the income arises. Thus, if there is no distribution of the income by the entity, there must nevertheless be a current allocation of the income among the owners to permit them to report currently their share of it.”).

141. See I.R.C. § 704(a)–(b) (2000) (permitting partners to set forth in the partnership agreement the manner in which the partnership items will be allocated to the partners); see also Yin, *supra* note 140, at 154 (“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.”). Although the partnership tax rules leniently allow partnerships to allocate items of income, gain, expense, and loss, there are parameters intended to prevent the abusive use of allocation. See I.R.C. § 704(b)(2) (2000) (disregarding partnership allocations if they do not have substantial economic effect); see also Treas. Reg. § 1.704-1(b)(1) (as amended in 2005) (noting three ways an allocation will be respected: (1) “the allocation [has] substantial economic effect,” (2) “the allocation [is] in accordance with the partner’s interest in the partnership,” or (3) “the allocation [is] deemed to be in accordance with the partner’s interest in the partnership”); Treas. Reg. § 1.704-1(b)(2)(i) (as amended in 2005) (deeming an allocation to have substantial economic effect if it has economic effect and if it is substantial); Treas. Reg. § 1.704-1(b)(2)(ii) (as amended in 2005) (“In order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners.”); Treas. Reg. § 1.704-1(b)(2)(iii) (as amended in 2005) (noting that an allocation “is substantial if there is a reasonable possibility that the allocation . . . will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. Notwithstanding the preceding sentence, the economic effect of an allocation . . . is not substantial if, at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation . . . were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation . . . were not contained in the partnership agreement.”). The partnership tax allocation rules are the source of much concern for many people. This area of tax law is perhaps the most complex. See, e.g., *Twenty Mile Joint Venture, PND, Ltd. v. Comm’r*, 200 F.3d 1268, 1275 (10th Cir. 1999) (“We are mindful that ‘[p]artnership taxation is . . . generally recognized as the most difficult area of the Internal Revenue Code.’” (quoting HAROLD GILL REUSCHLEIN & WILLIAM A. GREGORY, *THE LAW OF AGENCY AND PARTNERSHIP* 411 (2d ed. 1990))).

142. But see Yin, *supra* note 140, at 164 (“The central flaw of the conduit model is its inability to provide assurance that the proper *amount* of business income and loss for any given year is allocated and taxed to the proper owner.”). Commentators have criticized the partnership tax rules as being overly complicated. See Curtis J. Berger, *W(h)ither Partnership Taxation?*, 47 TAX L. REV. 105, 108 (1991) (“[Subchapter K] has become one of the most inaccessible and burdensome features of the entire tax system.”). Nonetheless, any attempt to trace income and expenses from the property owned or services provided by the parties back to the arrangement would create even more difficult administrative

In fact, any such attempts would likely create extremely complex rules and accomplish little more than the current rules accomplish.<sup>143</sup> The current allocation rules reflect a compromise between the assignment-of-income doctrine and the administrative inconvenience of attempting to trace income from partnership property or services to the member who owns the property or performs the services.

Unlike the assignment-of-income doctrine, the allocation rules do not focus on the source of income.<sup>144</sup> Instead, they generally allow allocations of tax items, look to the economic treatment of an allocation, and require that the tax treatment follow the economic allocation of such items.<sup>145</sup> In essence, the allocation rules allow partners to agree on the economic allocation of items but require that the partner to whom an item is allocated recognize the tax consequence of that allocation.<sup>146</sup> Thus, unlike the assignment-of-income doctrine, substantial economic effect generally ignores the source of the item. The closest the substantial economic effect test comes to retaining some semblance of the assignment-of-income doctrine is by requiring that allocations not decrease the partners' overall tax liability.<sup>147</sup> In this manner, the allocation rules consider the

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problems for taxpayers, tax advisors, and the IRS.

143. Treasury could establish some general principles to partially address some of these concerns. For example, it could require that income be allocated among different types of investor groups (e.g., capital investors and service investors), and within those groups tracing may be possible. For example, within the investor group, tracing may be possible based on the proportionate investment of each member of the group. While these are important issues to consider, they are beyond the scope of this Article and warrant a separate article that thoroughly examines the allocation rules. Commentators have further suggested that partnership items be allocated according to the members' interest in the arrangement. See generally Yin, *supra* note 140, at 154 (discussing the possibilities for allocating partnership income).

144. Treas. Reg. § 1.704-1(b)(2)(ii)(a) (as amended in 2005).

145. *Id.* ("In order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation [of the tax item] is made must receive such economic benefit or bear such economic burden.").

146. Treas. Reg. § 1.704-1(b)(1)(i) (as amended in 2005) ("To the extent an allocation under the partnership agreement of income, gain, loss, deduction, or credit (or item thereof) to a partner . . . is not in accordance with the partner's interest in the partnership, . . . such income, gain, loss, deduction, or credit (or item thereof) will be reallocated in accordance with the partner's interest in the partnership . . .").

147. Treas. Reg. § 1.704-1(b)(2)(iii) (as amended in 2005) ("[T]he economic effect of an allocation (or allocations) is not substantial if, at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the



source of income only to determine an allocation's effect on the overall taxability of the taxpayers, but they focus on the back-end of the allocation.<sup>148</sup> The purpose of the allocation rules appears to be to overcome the administratively impossible task of tracing income and expenses from property and services of members of certain arrangements.<sup>149</sup> Because the rules disregard the assignment-of-income doctrine, the definition of tax partnership should make them available only when tracing is not possible.

#### *F. The Anti-Abuse Rules*

Congress has amended the 1954 Code several times, often for anti-abuse purposes.<sup>150</sup> For example, anti-abuse rules prevent taxpayers from using tax partnerships to alter the character of unrealized gain or loss,<sup>151</sup> and from transferring property among partners tax free.<sup>152</sup> Thus, the final purpose of the partnership tax rules is to prevent the abusive use of the rules.

This brief review of the history of partnership taxation reveals that Congress attempts to disregard partnerships and enacts partnership rules to (1) simplify partnership tax accounting and reporting, (2) facilitate the administration of the tax, and (3) prevent taxpayers from using the partnership tax

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allocation (or allocations) were not contained in the partnership agreement.”).

148. For example, the substantial economic effect test considers whether a special allocation of capital gain reduces the overall tax liabilities of the partners. The source of the income is important only to determine substantiality, not to consider assignment of income.

149. When an entity is formed to own property, the arrangement becomes different from the direct ownership of the property. See Yin, *supra* note 140, at 163–64 (“[T]he conduit model requires the existence of an economic baseline against which a tax allocation can be tested. Yet so long as there is state law separation between the entity and the owners—that is, the owners do *not*, in fact, own the assets directly but instead only own interests in the firm which owns the assets—the economic baseline against which the tax allocation needs to be compared is necessarily missing.”). In situations where there is no activity other than owning the property, however, income can be traced from the property to the owners in proportion to their ownership in the entity.

150. See Jennifer C. Root, *The Commissioner's Clear Reflection of Income Power Under § 446(B) and the Abuse of Discretion Standard of Review: Where Has the Rule of Law Gone, and Can We Get It Back?*, 15 AKRON TAX J. 69, 83 (2000) (“[L]egislators have instituted anti-abuse laws that try to prevent . . . circumvention of the purposes behind taxation.”).

151. See, e.g., I.R.C. § 724(a)–(c) (2000) (providing that unrealized receivables, inventory, and loss property retain their character after being contributed to a tax partnership); I.R.C. § 735(a) (2000) (providing that gain from distributed inventory remains ordinary to distributee partners for at least five years).

152. See, e.g., I.R.C. § 704(c)(1)(B) (2000) (requiring the contributing partner of property to recognize gain or loss from property contributed to the partnership); I.R.C. § 737 (2000) (restricting partners from selling and exchanging property through a partnership).

rules for abusive purposes.<sup>153</sup> When possible, Congress attempts to treat partner taxpayers the same as the standard taxpayer by adopting the aggregate theory.<sup>154</sup> The definition of tax partnership should take these purposes into account to ensure only those arrangements that would otherwise have complicated accounting and reporting concerns and tax administration difficulties come within the definition. The consequences of negligently granting or denying access to the rules are significant.<sup>155</sup>

#### IV. EFFECT OF THE DEFINITION OF TAX PARTNERSHIP

Although tax partnerships are not subject to an entity-level tax, as tax corporations and tax trusts are, tax partnership classification may affect timing of income and loss recognition, the character of gain or loss, the time the statute of limitations tolls, and the applicability of other tax concepts, each of which may significantly affect a taxpayer's tax liability. The myriad cases and rulings addressing the definition of tax partnership stand as a testimony of the significance of the definition.<sup>156</sup> The definition of tax partnership can affect three general types of tax rules: (1) timing and accounting rules, (2) transactional rules, and (3) procedural rules.

##### A. *Timing and Accounting Rules*

The definition of tax partnership determines whether the rules of subchapter K apply to an arrangement.<sup>157</sup> If an arrangement is a tax partnership, subchapter K generally applies to the arrangement.<sup>158</sup> Alternatively, if an arrangement is not a tax

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153. See *supra* Part III.B (discussing the purpose behind the adoption of tax reporting rules).

154. See *supra* Part III.D ("The rules that adopt the aggregate theory demonstrate Congress's desire to treat partner taxpayers similarly to the standard taxpayer when possible.").

155. See *supra* Part III.E ("Because the rules disregard the assignment-of-income doctrine, the definition of tax partnership should make them available only when tracing is not possible.").

156. See, e.g., *Luckey v. Comm'r*, 334 F.2d 719, 722 (9th Cir. 1964) (holding that section 735 applied because the arrangement was a partnership); *Bryant v. Comm'r*, 46 T.C. 848, 862-64 (1966) (excluding subchapter K from applying to the partnership).

157. See *Bryant*, 46 T.C. at 862-64 (ruling that subchapter K does not apply to the partnership); I.R.S. Priv. Ltr. Rul. 83-15-003 (June 17, 1982) (determining whether an entity is a tax partnership prior to allowing the entity to elect out of subchapter K).

158. See *Demirjian v. Comm'r*, 457 F.2d 1, 5-6 (3d Cir. 1972) (holding that if a partnership exists, section 703(b) requires that the election be made at the partnership level); *Luckey*, 334 F.2d at 722 (applying section 735 because the arrangement was a partnership); *Estate of Levine v. Comm'r*, 72 T.C. 780, 788 (1979) (holding that a partner

partnership, subchapter K does not apply to the arrangement.<sup>159</sup> Subchapter K can affect whether gross income and deductions are reported by members or whether they individually report shares of taxable income from an arrangement.<sup>160</sup> In at least one case, this distinction affected the application of a limit based upon gross income.<sup>161</sup>

The definition of tax partnership can be important in determining the proper tax year for recognizing gain or loss.<sup>162</sup> The current partnership tax rules provide that partnerships compute taxable income on an annual basis.<sup>163</sup> Partners then report income from the partnership based on the year during which the partnership's taxable year ends.<sup>164</sup> Without these rules, partners

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must include partnership income in the partner's taxable income for the partner taxable year during which the partnership's taxable year ends). *But see* I.R.C. § 761(a) (2000) (providing that certain unincorporated organizations may elect out of the partnership tax rules); *supra* text accompanying notes 111–15 (regarding section 761 election).

159. *See, e.g.,* *Hahn v. Comm'r*, 22 T.C. 212, 214 (1954) (holding that because no partnership existed, the co-owners were not allowed to use the partnership tax rules and a co-owner's gross income included gross income from the property); *see also* *Comm'r v. Tower*, 327 U.S. 280, 288–89 (1946) (holding that allocation rules are not applicable because there was no partnership); *Lusthaus v. Comm'r*, 327 U.S. 293, 297 (1946) (same). *But see* *Borden et al.*, *supra* note 69, at 1187 (speculating about whether the Tax Court created elective partnership treatment in *Cusick v. Commissioner*, 76 T.C.M. (CCH) 241 (1998), because the arrangement otherwise did not appear to be a partnership).

160. *Hahn*, 22 T.C. at 214 (holding that income from rental property owned as tenants in common must be individually reported because the arrangement is not a partnership).

161. *See* *Estate of Langer v. Comm'r*, 16 T.C. 41, 47–48 (1951) (holding that the arrangement was a partnership and the taxpayer was only required to include his allocable share of partnership net income in gross income for purposes of applying section 107(d), limiting the amount of tax attributable to back pay determined by whether the back pay exceeded fifteen percent of the taxpayer's gross income, but noting if the arrangement had not been a tax partnership, the taxpayer would have been required to include gross receipts from the arrangement in gross income).

162. *See, e.g.,* *Joe Balestrieri & Co. v. Comm'r*, 177 F.2d 867, 872–73 (9th Cir. 1949) (holding that no partnership existed between the taxpayer and the partnership where the taxpayer made a payment pursuant to a loan guarantee to the partnership and could only take a deduction if it could demonstrate that the taxpayer was unable to be reimbursed for the payment from the partnership); *Estate of Levine*, 72 T.C. at 788 (holding that because a partnership existed, the partner was required to include partnership income in his individual income during the year the partnership tax year ended); *Bentex Oil Corp. v. Comm'r*, 20 T.C. 565, 571–72 (1953) (holding that because a partnership existed, an election at the partnership level to deduct expenses currently requires the partner to deduct currently instead of capitalizing the costs).

163. I.R.C. § 703(a) (2000) ("The taxable income of a partnership shall be computed in the same manner as in the case of an individual . . ."); I.R.C. § 441(a) (2000) ("Taxable income shall be computed on the basis of the taxpayer's taxable year.").

164. I.R.C. § 706(a) (2000) ("In computing the taxable income of a partner for a taxable year, the inclusions required by section 702 and section 707(c) with respect to a partnership shall be based on the income, gain, loss, deduction, or credit of the partnership for any taxable year of the partnership ending within or with the taxable year of the partner.") Thus, whether a partnership's taxable year ends on January 31,

would have leeway in choosing when to report partnership income.<sup>165</sup> Time-value-of-money principles give timing rules significance.<sup>166</sup> If a partnership does not exist, the members of an arrangement must report income from the arrangement based on their respective taxable years.<sup>167</sup> Disregarding the arrangement may move the date of inclusion forward,<sup>168</sup> but never back.<sup>169</sup> Timing rules also could affect whether the tax year is closed with respect to an item.<sup>170</sup>

The definition of tax partnership helps establish the person to whom income or loss should be allocated.<sup>171</sup> If an arrangement is a tax partnership, partners can agree to allocate items of income and loss among the partners in any manner, so long as such allocations have substantial economic effect.<sup>172</sup> Alternatively, if an arrangement is not a tax partnership, items of income and loss must be traced

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2005, or December 31, 2005, a partner whose taxable year ends on December 31, 2005, reports partnership taxable income on its 2005 tax return. Current rules require the partnership taxable year to be determined by reference to the partners' taxable years. I.R.C. § 706(b)(1)(B) (2000) ("Taxable year determined by reference to partners."). Thus, in many situations, the partnership's and the partners' taxable years will be the same.

165. See *supra* note 162. For example, partners could disregard the partnership's taxable year and compute income of the partnership on a monthly basis. This would match the partnership's taxable year with the taxable year of each of the partners.

166. If a partnership taxable year ends on January 31 and a partner's taxable year ends on December 31, the partner has an eleven-month delay in reporting income of the partnership. See MCKEE ET AL., *supra* note 126, ¶ 9.04 ("[T]he partnership's accounting method can be different from the partners' accounting methods.").

167. See I.R.C. § 441(a) (2000).

168. If an arrangement was classified as a tax partnership with a taxable year ending on January 31, a partner whose taxable year ends on December 31 would not be required to include partnership taxable income from February 1 to December 31 in the partner's gross income for the year. If the same arrangement was not a tax partnership, the same member would be required to include the arrangement's income for the entire year in the member's gross income.

169. See I.R.C. § 441(a) ("Taxable income shall be computed on the basis of the taxpayer's taxable year."). If an arrangement is disregarded for tax purposes, income of the arrangement for an individual member's tax year will be included in the individual's income for the year. The arrangement's income for a portion of the year may not be included in a member's income until a subsequent year if the arrangement is respected for tax purposes. See *supra* notes 164–66.

170. See, e.g., *First Mechs. Bank v. Comm'r*, 91 F.2d 275, 279 (3d Cir. 1937) (holding that the arrangement was a tax partnerships and the statute of limitations began the year during which the amount should have been included in partner's income).

171. See, e.g., *Comm'r v. Culbertson*, 337 U.S. 733, 742 (1949) (holding that the existence of a partnership determines whether income can be divided); *Lusthaus v. Comm'r*, 327 U.S. 293, 297 (1946) (allocating all business income to a husband who attempted to shift income to his wife by placing his business in a tax partnership with her); *Comm'r v. Tower*, 327 U.S. 280, 289 (1946) (holding that no tax partnership existed where husband placed an entire business in partnership form to shift income to his wife through partnership allocations and allocating all the business income to the husband).

172. See *supra* Part III.E (discussing agreements by partnerships regarding the proper allocation of partnership income).

from the property and services to the members who own such property or provide such services.<sup>173</sup> The ability to allocate items of income and loss, subject only to the substantial economic effect test, is one of the significant benefits of the partnership tax rules.

The tax definition of partnership also affects the method of accounting a taxpayer may use.<sup>174</sup> If an arrangement is a tax partnership, the partnership items must be accounted for using the tax partnership's method of accounting, even though the partners may use a different method.<sup>175</sup> Thus, if the tax partnership uses the accrual method of accounting, but an individual member uses the cash method, the accrual method will apply to partnership items.<sup>176</sup> If the arrangement is not a tax partnership, the individual's cash method will apply.<sup>177</sup> This can affect the year during which the partners report income from the arrangement,<sup>178</sup> affecting the tax value of the item under time value of money principles.

### B. Transactional Rules

The definition of tax partnership also determines whether subchapter K applies.<sup>179</sup> Generally, the formation of a partnership is a tax-free event.<sup>180</sup> Thus, if one person contributes real estate and

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173. See *id.* (describing the assignment-of-income doctrine).

174. See, e.g., *Bartholomew v. Comm'r*, 186 F.2d 315, 317–18 (8th Cir. 1951) (holding that if an arrangement to perform planning and engineering services was a partnership, income with respect to those services would be accounted for using the accrual method; otherwise, the member's cash method of accounting would be used).

175. See *id.* (recounting the taxpayers' arguments that if a partnership had existed, the members would have reported income currently under the accrual method).

176. See *id.* at 317 (noting that since the partnership used the accrual method, the accrual method applied to a partner).

177. See *id.* at 318 (holding that income from a nonpartnership project should be reported on the cash receipts and disbursement basis of accounting).

178. See *id.* (holding that because no partnership existed, the cash method members should report income when payments were received in a subsequent year). This can be important if a prior taxable year is closed for audit purposes.

179. Subchapter K includes rules relating to the purchasing and selling of a partnership interest. See I.R.C. § 741 (Supp. III 2005) (determining when a gain or loss is capital or noncapital); I.R.C. § 751 (2000) (same). Subchapter K also includes rules regarding the allocation of partnership income and expenses. See I.R.C. § 704(b) (2000) (explaining how to determine a partner's distributive share of income, gain, loss, deduction, or credit and the regulations promulgated thereunder).

180. See I.R.C. § 721(a) (2000) (providing that "[n]o gain or loss shall be recognized to a partnership" upon a contribution of property). *But see* Treas. Reg. § 1.721-1(b)(1) (as amended in 1996) ("The value of an interest in [a partnership] transferred to a partner as compensation for services constitutes income to the partner under section 61."). The IRS has proposed regulations and issued a notice that will change the manner in which partners and partnerships account for profits interests exchanged for services. See Prop. Treas. Reg. § 1.761-1(b), 70 Fed. Reg. 29,683, 29,683 (May 24, 2005) ("If a partnership interest is transferred in connection with the performance of services, . . . then the holder of the partnership interest is not treated as a partner solely by reason of holding the

another contributes cash to a tax partnership, neither person shall recognize gain or loss on the contribution.<sup>181</sup> On the other hand, if one person pays another for an interest in property to become a tenant-in-common of the property, the transfer will likely be a taxable event to the person selling the interest.<sup>182</sup>

The definition of tax partnership affects the nature of property transferred.<sup>183</sup> Simply put, if an arrangement is treated as a tax partnership, a member's transfer will be treated as a transfer of an interest in the tax partnership, not a transfer of the underlying property.<sup>184</sup> This can affect the application of other Internal Revenue Code provisions.<sup>185</sup> For example, if an arrangement is treated as a tax partnership, an interest in that arrangement does not qualify for section 1031 nonrecognition.<sup>186</sup> If, on the other hand, an

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interest . . . ."); Prop. Treas. Reg. § 1.704-1(b)(4), 70 Fed. Reg. 29,681, 29,681 (May 24, 2005) (explaining how to account for substantially nonvested interests); Prop. Treas. Reg. § 1.83-3(l), 70 Fed. Reg. 29,680, 29,680-81 (May 24, 2005) (providing special rules for the transfer of a partnership interest); Prop. Treas. Reg. § 1.721-1(b)(4)(ii), 70 Fed. Reg. 29,683, 29,683 (May 24, 2005) (providing that a partnership interest "[t]ransferred in connection with the performance of services rendered to a partner . . . is not deductible by the partnership, but is deductible only by such partner to the extent allowable under Chapter 1 of the Code"); I.R.S. Notice No. 2005-43, 2005-24 I.R.B. 1221 (proposing procedures for partnership interests transferred in connection with the performance of services).

181. I.R.C. § 721(a). For example, if A contributes real estate worth \$100,000 for a 2/3 partnership interest and B contributes cash worth \$50,000 for a 1/3 partnership interest to form a partnership, neither party recognizes gain on the formation of that partnership. Economically, however, A would have a 2/3 interest in the \$50,000 cash, and B would have a 1/3 interest in the real estate.

182. See I.R.C. § 1001(c) (2000) ("[T]he entire amount of the gain or loss . . . on the sale or exchange of property shall be recognized."). For example, if B were to pay A \$33,000 for a 1/3 interest in A's real estate, A would recognize gain or loss on the transaction if A's basis in that 1/3 interest were anything other than \$33,000. See I.R.C. § 1001(a) (2000) (providing that gain equals the amount realized over the adjusted basis of transferred property and loss is the adjusted basis over the amount realized on the transfer of property); I.R.C. § 1001(c) (2000) (providing that all gain shall be recognized unless otherwise provided in the Code).

183. See, e.g., Rev. Rul. 75-374, 1975-2 C.B. 261 (ruling that the co-ownership arrangement was not a partnership, so the interest acquired was an interest in the underlying property, not an interest in a partnership).

184. See I.R.C. § 741 ("In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 . . . ."). But see I.R.C. § 751(a) ("The amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to (1) unrealized receivables of the partnership, or (2) inventory items of the partnership, shall be considered as an amount realized from the sale or exchange of property other than a capital asset.").

185. See, e.g., I.R.C. § 1031(a)(2)(D) (2000) (excepting nonrecognition of gain or loss from exchanges solely in kind when a partnership exists).

186. See *id.* ("This subsection shall not apply to any exchange of . . . interests in a partnership . . . ."). But see I.R.C. § 1031(a)(2) (2000) ("For purposes of this section, an

arrangement is disregarded, a member's interest in the underlying property may qualify for section 1031 nonrecognition.<sup>187</sup> Thus, the definition of tax partnership affects the applicability of section 1031 and other nonrecognition provisions.<sup>188</sup>

The definition of tax partnership also determines the effect liabilities have on the basis of property owned by the members of an arrangement.<sup>189</sup> If an arrangement is a tax partnership, complicated rules determine the partners' shares of partnership liabilities, which in turn determine the bases partners take in their respective partnership interests.<sup>190</sup> If an arrangement is not a tax partnership, the traditional rules used to compute basis determine the members' bases in the underlying property.<sup>191</sup>

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interest in a partnership which has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership."). *See also* Karen C. Burke, *An Aggregate Approach to Indirect Exchanges of Partnership Interests: Reconciling Section 1031 and Subchapter K*, 6 VA. TAX REV. 459, 461 (1987) (suggesting that a strict aggregate approach to indirect exchanges of partnership interests would not violate the policy for excluding partnership interests from section 1031 nonrecognition).

187. *See supra* note 13 (noting that nonpartnership real estate interests may qualify for section 1031 nonrecognition).

188. *See, e.g.*, I.R.C. § 1031(a) (2000) (prohibiting section 1031 nonrecognition of gain or loss for interests in a partnership).

189. *See* I.R.C. § 752 (2000) (providing rules for the increase or decrease of a partner's liabilities); *see also* STAFF OF JOINT COMM. ON TAX'N, 108TH CONG., *OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES* 165-66 (2005) (recommending that nonrecourse debt not be included in a partner's outside basis).

190. *See* I.R.C. § 752(a) (2000) ("Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership."); I.R.C. § 722 (2000) ("The basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution . . ."); I.R.C. § 752(b) (2000) ("Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership."); I.R.C. § 733 (2005) ("In the case of a distribution by a partnership to a partner other than in liquidation of a partner's interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by (1) the amount of any money distributed to such partner . . ."); Treas. Reg. § 1.752-2 (as amended in 1991) (providing extensive rules for determining a partner's share of recourse partnership liabilities); Treas. Reg. § 1.752-3 (as amended in 2000) (providing rules for determining a partner's share of nonrecourse partnership liabilities).

191. *See* I.R.C. § 1012 (2000) (providing that the basis in property is the cost of the property). The basis of property acquired with borrowed funds includes the amount of borrowed funds used to acquire the property. *Comm'r v. Tufts*, 461 U.S. 300, 307 (1983) ("[T]he taxpayer is entitled to include the amount of the loan in computing his basis in the property."); *Crane v. Comm'r*, 331 U.S. 1, 11 (1947) ("We conclude that the proper basis . . . is the value of the property, undiminished by mortgages . . ."). Money borrowed against existing property does not increase the basis of the property because it is not part of the cost of the property.

The definition of tax partnership can affect the character of gain or loss a person recognizes.<sup>192</sup> For example, gains and losses recognized on the sale of a partnership interest are generally treated as capital gains and losses.<sup>193</sup> Gains and losses recognized on the sale of certain real property used in a trade or business for more than one year are not capital.<sup>194</sup> Thus, if an arrangement that owns

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192. See, e.g., *Winmill v. Comm'r*, 93 F.2d 494, 495–96 (2d Cir. 1937) (holding that partnership gains can be offset by losses because they are expenses incurred in business, but individual gains cannot be offset by losses because they are personal losses); *Estate of Appleby v. Comm'r*, 41 B.T.A. 18, 21 (1940) (showing that under the law in effect at the time, because an individual was not a member of the partnership, the character of gain at the partnership level did not flow through to the partner (citing *Johnston v. Comm'r*, 86 F.2d 732 (2d Cir. 1936)), *aff'd*, 123 F.2d 700 (2d Cir. 1941). Under current law, character of gain or loss at the partnership level would carry to the partners. See I.R.C. § 702(b) (2000) (“The character . . . shall be determined as if such item were realized directly from the source from which realized by the partnership . . .”); *Luckey v. Comm'r*, 334 F.2d 719, 722 (9th Cir. 1964) (holding that property held by an arrangement classified as a partnership was inventory and retained its character as inventory for five years after being distributed to the partner, and finding that gain or loss on a disposition of the property within that period of time would be ordinary pursuant to section 735(a)); *Gilford v. Comm'r*, 201 F.2d 735, 736 (2d Cir. 1953) (holding that the loss from the sale of real property held by tenants in common for use in a trade or business was ordinary, but if a partnership had existed, the sale would have been of a partnership interest and the loss may have been a capital loss); *Coffin v. United States*, 120 F. Supp. 9, 11 (S.D. Ala. 1954) (holding that the sale of an interest in the underlying property would not produce a capital gain, but if the arrangement had been a partnership, the gain on the sale of the partnership interest would have produced a capital gain); *Allison v. Comm'r*, 35 T.C.M. (CCH) 1069, 1078 (1976) (holding that no partnership existed and the transfer of real property to the taxpayer was for services rendered, and thus ordinary income); *S. & M. Plumbing Co. v. Comm'r*, 55 T.C. 702, 706–09 (1971) (holding that payments made from an arrangement classified as a partnership were treated as payments for the use of capital and were ordinary income to the partner); *Podell v. Comm'r*, 55 T.C. 429, 431, 433 (1970) (holding that the co-ownership arrangement was a partnership engaged in the activity of buying and selling real property, and gain realized from the sale of the property was ordinary income); *Luna v. Comm'r*, 42 T.C. 1067, 1076–77 (1964) (holding that because an arrangement was an employment contract rather than a partnership, the amount paid by the employer to the employee to terminate the contract was ordinary income to the employee rather than capital gain); see also I.R.C. § 731(a)(1) (2000) (providing for nonrecognition of gain in distribution by a partnership to a partner under certain circumstances); *Underwriters Ins. Agency v. Comm'r*, 40 T.C.M. (CCH) 5, 9 (1980) (holding that an arrangement involving fishing boats was a partnership and the loss from the sale of the partnership interest was a capital loss).

193. I.R.C. § 741 (2000 & Supp. III 2005) (“In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items).”). Taxpayers generally prefer capital gains because they may be taxed at a lower rate. See I.R.C. § 1(h) (2000) (determining a taxpayer’s capital gain tax rate). On the other hand, taxpayers generally prefer ordinary loss because it is not subject to the limitation imposed on capital losses. See I.R.C. § 1211 (2000) (restricting capital losses to the amount of capital gains).

194. I.R.C. § 1231(a)(2) (2000) (“If (A) the section 1231 gains for any taxable year, do not exceed (B) the section 1231 losses for such taxable year, such gains and losses shall not be treated as gains and losses from sales or exchanges of capital assets.”). Section



real property used in a trade or business is a tax partnership, gain or loss on the sale of the interest in the arrangement will generally be treated as the gain or loss from the sale of a capital asset.<sup>195</sup> If the arrangement is not treated as a partnership, loss from the sale of the interest could be treated as an ordinary loss.<sup>196</sup>

The definition of tax partnership affects whether certain costs may be deducted or must be capitalized.<sup>197</sup> For example, if an arrangement is a tax partnership, costs to form the partnership must be capitalized as organization costs and costs incurred before business operations begin must be capitalized as start-up expenditures.<sup>198</sup> If an arrangement is not a tax partnership, costs incurred to create the arrangement may be deductible currently as expansion costs.<sup>199</sup>

### C. Procedural Rules

Partnership classification also may affect the application of certain tax elections.<sup>200</sup> If a partnership exists, the partnership

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1231 gain and loss mean any recognized gain or loss on the sale or exchange of property used in a trade or business. I.R.C. § 1231(a)(3)(A)(i), (B) (2000) (defining section 1231 gain and section 1231 loss). Property used in a trade or business includes real property used in a trade or business held for more than one year, subject to certain exclusions. I.R.C. § 1231(b)(1) (2000) (defining property used in a trade or business).

195. *But see* I.R.C. § 751(a) (2000) (providing that gain from the sale of a partnership interest attributable to unrealized receivables and inventory of the partnership will be ordinary income to the selling partner).

196. *See Gilford*, 201 F.2d at 736 (holding that an arrangement was not a tax partnership, triggering ordinary loss treatment); *see also* *Tate v. Knox*, 131 F. Supp. 514, 516–17 (D. Minn. 1955) (holding that an arrangement was not a tax partnership, so the payment was for the termination of an employment contract and thus ordinary income). *But see Coffin*, 120 F. Supp. at 11 (holding that an arrangement was not a tax partnership, so the taxpayer is a dealer and the gain is ordinary).

197. *See, e.g.,* *Madison Gas & Elec. Co. v. Comm'r*, 633 F.2d 512, 517 (7th Cir. 1980) (ruling that a partnership existed and the costs to form the partnership had to be capitalized as start-up expenditures).

198. *See* I.R.C. § 709 (2000) (defining the tax treatment of partnership organization costs); I.R.C. § 195(a) (2000) (prohibiting deduction for start-up expenditures unless an exception applies).

199. *See Colo. Springs Nat'l Bank v. United States*, 505 F.2d 1185, 1193 (10th Cir. 1974) (holding that costs to create new credit card services were deductible currently); *Briarcliff Candy Corp. v. Comm'r*, 475 F.2d 775, 787 (2d Cir. 1973) (holding that costs to open a new retail outlet were deductible currently); Rev. Rul. 2000-4, 2000-1 C.B. 331, 332 (distinguishing expansion costs from other future benefits required to be capitalized). The taxpayer in *Madison Gas & Electric Co.* argued that the costs for training and other related expenses incurred by a public utility in the expansion of its generating capacity through the joint construction and operation of a nuclear plant with two other utilities were deductible as ordinary and necessary expenses. *Madison Gas & Electric Co.*, 633 F.2d at 514. The court ruled, however, that the arrangement was a tax partnership, requiring the taxpayer to capitalize the expenditures. *Id.* at 517.

200. *See, e.g.,* *McShain v. Comm'r*, 68 T.C. 154, 159–60 (1977) (holding that the absence of a partnership meant that the individual taxpayer's election under section 1033

generally must make tax elections, which apply to all partners.<sup>201</sup> For example, section 1033 allows a property owner to elect to defer gain realized on the disposition of condemned property if the proceeds are reinvested within a certain period of time.<sup>202</sup> An election made by the owner of an undivided interest in condemned property will not be effective if the arrangement in which the owner holds the interest is a tax partnership and the individual is treated as a partner.<sup>203</sup>

If a tax partnership is deemed to own the property, the tax partnership must make the election.<sup>204</sup> If the arrangement is not a

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to exclude the gain on the involuntary disposition of his share of a piece of real property was valid, but if the ownership arrangement had been a partnership, the partnership would have had to make the election); I.T. 3713, 1945 C.B. 178, 179–80 (ruling that the partnership, not the partners, makes the election to have timber cut during a particular year, so the election does not “constitute an election by any of the partners as to his own individual assets or as to the assets of any other partnership of which one or more of such individuals may be members”); Rev. Rul. 83-129, 1983-2 C.B. 105, 105 (ruling that partners of a partnership with an effective section 761 election may separately make the election under section 616(b) to deduct certain expenditures incurred during the year “on a ratable basis as the units of produced ores or minerals benefited by the expenditures are sold”); Rev. Rul. 68-344, 1968-1 C.B. 569, 571 (ruling that members of an arrangement that is a partnership may, under certain circumstances, elect to be excluded from the application of all or a part of subchapter K); Rev. Rul. 54-42, 1954-1 C.B. 64, 64 (“The election to charge to expense intangible drilling and development costs incurred in connection with the oil operations of a partnership that files its return and computes its income on Form 1065 is exercisable by the partnership. The partnership election is controlling irrespective of the elections of the individual partners as to their own operations.”).

201. See I.R.C. § 703(b) (2000) (“Any election affecting the computation of taxable income derived from a partnership shall be made by the partnership, except that any election under (1) subsection (b)(5) or (c)(3) of section 108 (relating to income from discharge of indebtedness), (2) section 617 (relating to deduction and recapture of certain mining exploration expenditures), or (3) section 901 (relating to taxes of foreign countries and possessions of the United States), shall be made by each partner separately.”).

202. I.R.C. § 1033(a)(2)(A)–(B) (2000) (allowing nonrecognition of gain when condemned property is converted into similar property or money used for an investment). *But see* *Demirjian v. Comm’r*, 457 F.2d 1, 5–6 (3d Cir. 1972) (holding that a partnership that failed to make election did not qualify for section 1033 nonrecognition).

203. *Demirjian*, 457 F.2d at 4–6 (finding that two individuals who acquired undivided interests in real property upon liquidation of a corporation were a partnership, and upon subsequent disposition of the property, the partnership had elected to not recognize gain under section 1033).

204. *Id.* at 5–6 (“[Section] 703(b) requires that the election . . . under [section] 1033 be made by the partnership . . . . Section 703(b) provides, with exceptions not relevant here, that any election which affects the computation of taxable income derived from a partnership must be made by the partnership. The election for nonrecognition of gain on the involuntary conversion of property would affect such computation and is the type of election contemplated by [section] 703(b).”); *see also* H.R. REP. NO. 83-1337, at 66 (1954) (“The bill provides that all elections with respect to income derived from a partnership (other than the election to claim a credit for foreign taxes) are to be made at the partnership level and not by the individual partners. This rule recognizes the partnership as an entity for purposes of income reporting. It avoids the confusion which would occur if each partner were to determine partnership income separately for his own purposes.”).

tax partnership, the members of the arrangement make the elections individually.<sup>205</sup>

The definition of tax partnership also determines whether the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)<sup>206</sup> partnership audit rules apply.<sup>207</sup> The TEFRA audit rules provide that "the tax treatment of any partnership item (and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item) shall be determined at the partnership level."<sup>208</sup> The period of assessing a tax deficiency of any member of a partnership is based upon when the partnership tax return is required to be filed or actually filed.<sup>209</sup> Thus, even though a partner's statute of limitations has otherwise lapsed with respect to a certain year, the IRS may assess a tax on a partner with respect to partnership items of that year.<sup>210</sup>

Failure to realize that an arrangement is a tax partnership can subject parties to penalties.<sup>211</sup> Partnerships are required to file information returns each year and furnish each partner with information regarding partnership operations.<sup>212</sup> The penalty for

205. This does not affect the interdependence test that applies if an arrangement is a partnership under the section 7701 regulations but has made a valid section 761 election. If the provision in the Code granting the election is interdependent with subchapter K, then the election will be made at the partner level. Otherwise, the election is made at the partnership level. *See supra* note 112 (discussing in greater detail the interdependence test and its use to determine which regulations apply to partnerships).

206. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 402(a), 96 Stat. 648, 648-67 (codified at I.R.C. §§ 6221-6232); *see* Jay Rosen, *TEFRA's New Partnership Auditing Procedures: Was the Small Partner Left Out?*, 38 TAX L. REV. 479 (1983) (reviewing the TEFRA audit rules in greater detail and criticizing the Act for negatively affecting small partners).

207. *See, e.g.,* *Alhouse v. Comm'r*, 62 T.C.M. (CCH) 1678, 1682 (1991) (finding an arrangement a partnership and dismissing for lack of jurisdiction a deficiency reapportionment request because the IRS had not conducted an audit at the partnership level as required by section 6221), *aff'd sub nom. Bergford v. Comm'r*, 12 F.3d 166 (9th Cir. 1993).

208. I.R.C. § 6221 (2000).

209. I.R.C. § 6229(a) (2000).

210. *Press v. Comm'r*, 52 T.C.M. (CCH) 285, 286-87 (1986) (holding that the arrangement is a partnership, the TEFRA audit rules apply, and the taxpayer's signing of Form 872-A extended the statute of limitations for the partnership items). *See* WILLIAM S. MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 9.07[1] (3d ed. E-book 2006) (1977) ("The statute of limitations runs separately for partnership items. With respect to each partner, therefore, the statute may be open with respect to partnership items even though the nonpartnership aspects of his return may be closed under the rules generally applicable to individual and corporate taxpayers.").

211. *See infra* note 213 and accompanying text (describing penalties imposed on partnerships for failure to file tax returns).

212. *See* I.R.C. § 6031(a) (2000) ("Every partnership (as defined in section 761(a)) shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowable by subtitle A, and such other information, for the purpose of carrying out the provisions of subtitle A as the Secretary may by forms and regulations

failing to file such returns and furnish information to the partners can be significant.<sup>213</sup>

The definition of tax partnership also affects whether certain limits apply at the arrangement level or apply separately to the arrangement's members.<sup>214</sup> For example, if an arrangement is a tax partnership, a limit on the amount of credit allowed with respect to property owned by the partnership may apply at the partnership level, and the partners would be limited to their pro rata shares of the credit.<sup>215</sup> If an arrangement were not a tax partnership,

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prescribe, and shall include in the return the names and addresses of the individuals who would be entitled to share in the taxable income if distributed and the amount of the distributive share of each individual.”); I.R.C. § 6031(b) (2000) (“Each partnership required to file a return under subsection (a) for any partnership taxable year shall (on or before the day on which the return for such taxable year was required to be filed) furnish to each person who is a partner or who holds an interest in such partnership as a nominee for another person at any time during such taxable year a copy of such information required to be shown on such return as may be required by regulations.”).

213. See I.R.C. § 6698(a) (2000) (“In addition to the penalty imposed by section 7203 (relating to willful failure to file return, supply information, or pay tax), if any partnership required to file a return under section 6031 for any taxable year (1) fails to file such return at the time prescribed therefor (determined with regard to any extension of time for filing), or (2) files a return which fails to show the information required under section 6031, such partnership shall be liable for a penalty determined under subsection (b) for each month (or fraction thereof) during which such failure continues (but not to exceed 5 months), unless it is shown that such failure is due to reasonable cause.”); I.R.C. § 6698(b) (2000) (“For purposes of subsection (a), the amount determined under this subsection for any month is the product of (1) \$50, multiplied by (2) the number of persons who were partners in the partnership during any part of the taxable year[.]”); I.R.C. § 6722(a) (2000) (“In the case of each failure described in subsection (b) by any person with respect to a payee statement, such person shall pay a penalty of \$50 for each statement with respect to which such a failure occurs, but the total amount imposed on such person for all such failures during any calendar year shall not exceed \$100,000.”); I.R.C. § 6722(b) (2000) (“For purposes of subsection (a), the failures described in this subsection are (1) any failure to furnish a payee statement on or before the date prescribed therefor to the person to whom such statement is required to be furnished, and (2) any failure to include all of the information required to be shown on a payee statement or the inclusion of incorrect information.”); I.R.C. § 6724(d)(2) (2000) (“The term ‘payee statement’ means any statement required to be furnished under (A) section 6031(b) . . .”). If the failure to file is due to intentional disregard of the rules, the \$100,000 limit is removed and instead capped at 10% of the aggregate amount of the items required to be reported. See I.R.C. § 6722(c) (2000) (describing penalties issued for “intentional disregard of the requirement to furnish a payee statement”).

214. See, e.g., *Bussing v. Comm’r*, 88 T.C. 449, 461–63 (1987) (holding that because a partnership existed, partners were able to deduct only losses to the extent to which their bases were at risk within the meaning of section 465); Rev. Rul. 65-118, 1965-1 C.B. 30, 31 (ruling that a dollar limitation on the section 38 property investment credit applied at the partnership level and was unavailable to the individual partners).

215. See *Bryant v. Comm’r*, 46 T.C. 848, 862–64 (1966) (concluding that despite an arrangement's valid election under section 761(a)(2) to be excluded from subchapter K treatment, a tax partnership existed and the investment credit provisions of sections 38 and 48 should be applied at the partnership level, leaving each partner entitled to a pro rata share of the credit), *aff’d*, 399 F.2d 800 (5th Cir. 1968). The Internal Revenue Service has opined that provisions of the Code that are interdependent with section 761 (i.e.,

however, the limit may apply to each member individually, multiplying the amount of the limit available.<sup>216</sup>

The definition of tax partnership may affect whether certain parties are liable for unpaid employment taxes.<sup>217</sup> In particular, if a partnership exists, each partner may be liable for any unpaid employment taxes owed by the partnership.<sup>218</sup> If

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income does not have to be computed at the partnership level to apply the other section) can be applied at the individual partner level if a valid section 761 election is in effect. I.R.S. Gen. Couns. Mem. 36,982 (Jan. 13, 1977). Thus, if a valid section 761 election is in effect, partners should individually make the election to expense or capitalize intangible drilling or development costs. *Id.* If a provision of the Code is not interdependent with section 761, that section must be applied at the partnership level even if a valid section 761 election is in effect. *Id.*; see also I.R.S. Gen. Couns. Mem. 39,043 (Oct. 5, 1983) ("[Because the section 48 credit limit can be applied without computing partnership income,] it is not inconsistent with the purpose and effect of section 761(a) to continue to recognize the partnership as such for purposes of the investment credit limitation. Merely because a partnership elects not to be subject to the provisions of subchapter K, does not mean that the partnership can escape limitations generally applicable to partnerships if those limitations can be applied despite the fact that income and deductions are computed at the partner rather than the partnership level. The question in each instance is whether the limitation or rule outside of subchapter K can be applied without doing violence to the concept of electing out of subchapter K and computing income and deductions at the partner level.").

216. Cf. Rev. Rul. 65-118, 1965-1 C.B. 30, 31.

217. See *Baily v. United States*, 350 F. Supp. 1205, 1206-07, 1210 (E.D. Pa. 1972) (rejecting the taxpayer's argument that he had merely lent money and was not partners with a playhouse owner who failed to pay the federal withholding taxes allegedly owed by the Lakewood Summer Playhouse in Tamaqua, Pennsylvania).

218. I.R.C. § 3401(d) (2000) ("[T]he term 'employer' means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person . . ."); I.R.C. § 3402(a)(1) (2000) ("[E]very employer making payment of wages shall deduct and withhold upon such wages a tax . . ."); I.R.C. § 3403 (2000) ("The employer shall be liable for the payment of the tax required to be deducted and withheld under this chapter . . ."); Treas. Reg. § 31.3401(d)-1(c) (as amended in 1970) ("An employer may be an individual, a corporation, a partnership, a trust, an estate, a joint-stock company, an association, or a syndicate, group, pool, joint venture, or other unincorporated organization, group, or entity."). If the partnership is a general partnership, it would be an employer and the partners would be jointly and severally liable for unpaid employment taxes. See *Baily*, 350 F. Supp. at 1207; see also I.R.C. § 6672(a) (2000) ("Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over."). This is known as the "100% penalty" because "the responsible person is held liable for the entire amount of withheld trust fund taxes that are not paid by the employer. Liability for this penalty attaches to 'responsible persons' who 'willfully' fail to pay over withheld taxes." FEDERAL TAX PRACTICE AND PROCEDURE, § 16.02[2], at 16-13 to -14 (Leandra Lederman & Ann Murphy eds., 2003) (footnote omitted). Partners may or may not be responsible persons. *Id.* § 16.02[2], at 16-14. Thus, the evidence of a partnership in this case may not have subjected the taxpayer to the 100% penalty. *Baily*, 350 F. Supp. at 1207-09. Since the partnership was a general partnership and the taxpayer was jointly and severally liable under substantive law for the tax liability of the partnership, the IRS did not have to resort to the 100% penalty to collect the tax from the

a tax partnership does not exist, only the employer would be liable for unpaid employment taxes.<sup>219</sup> If a tax partnership exists, a general partner will owe self-employment tax on allocated partnership income,<sup>220</sup> whereas the same person may not owe self-employment tax if an arrangement is not a tax partnership.<sup>221</sup>

#### D. Call for Certainty

These several examples illustrate that the definition of tax partnership has serious repercussions. These examples do not, however, reveal whether the definition of tax partnership generally favors taxpayers or generally favors the government.<sup>222</sup> In fact, classifying an arrangement as a tax

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taxpayer. *Id.* at 1207, 1209–10. Instead, the court was able to proceed under common law joint and several liability of the partners. *Id.* This is an example of a situation in which the state-law classification of a partnership affects the tax liability of a partner. *Id.* at 1209–10.

219. I.R.C. § 3403 (2000) (“The employer shall be liable for the payment of the tax required to be deducted and withheld under this chapter, and shall not be liable to any person for the amount of any such payment.”).

220. See I.R.C. § 1401 (2000) (imposing a tax on self-employment income); see also I.R.C. § 402(a)–(b) (2000) (defining self-employment income to include “income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member”).

221. To be subject to self-employment tax, the partnership would have to carry on a trade or business. See *supra* note 220 (examining provisions which apply the self-employment tax to income derived from a trade or business). While trade or business activity generally indicates the existence of a tax partnership, an arrangement with some business activity may not be a tax partnership. See *Gilford v. Comm’r*, 201 F.2d 735, 736 (2d Cir. 1953) (concluding that although maintenance of rental property was a “necessarily regular and continuous activity . . . [that fell] within the concept of trade or business[,] . . . the mere holding of business property by tenants in common does not make such tenants partners in the tax sense”). But see I.R.C. § 1402(a)(13) (2000) (excluding from the definition of self-employment income a limited partner’s distributive share of a partnership’s income or loss). Whether members of limited liability companies must include their distributive shares of income and loss from the limited liability arrangement in self-employment income is an unanswered question. See, e.g., David C. Culpepper et al., *Self-Employment Taxes and Passthrough Entities: Where Are We Now?*, 109 TAX NOTES 211 (2005) (discussing section 1402 self-employment tax provisions and the confusion surrounding their application to limited liability entities).

222. Creating a score card that determines what favors the government may be difficult. If increased revenue for the government and decreased taxes for taxpayers is the only measure for determining whether tax laws favor one party over the other, the score would be difficult to determine because partnerships are pass-through entities for tax purposes, and the issues that will be affected by tax partnership classification may be difficult to predict. Furthermore, the effect of the issue may be equally unpredictable. The relevant advantage a law provides merits greater attention. Tax laws should be certain, equitable, neutral, and administrable. See *infra* Part VI (discerning a sound tax system

partnership may benefit the taxpayer in certain situations but the government in other situations.<sup>223</sup> The inability to predict the issues that will involve the tax partnership question does not justify an uncertain definition. To the contrary, that inability demands that the definition be certain. Otherwise, taxpayers and the IRS can raise the tax partnership definition as needed to argue for a desired tax result. This makes the tax partnership classification elective. Elective classification violates principles of equity by creating opportunities for the well-advised taxpayers and traps for others.<sup>224</sup> It also creates complexity by requiring taxpayers to evaluate the tax results of being classified as a tax partnership and of being disregarded.<sup>225</sup> Thus, the definition of tax partnership should be both certain and nonelective.

## V. THE DEFINITIONS OF PARTNERSHIP

As stated above, Congress appeared to enact the partnership tax law to govern substantive-law partnerships.<sup>226</sup> Also, some of the tests derive from the substantive-law definition.<sup>227</sup> To eliminate confusion, this Article discusses the substantive-law definition of partnership to distinguish it from the definition of tax partnership.

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based on four fundamental principles of certainty, equity, neutrality, and simplicity/administrability). Evaluating tax laws based on these criteria makes looking to the effect on revenue not sufficient in determining who the law favors. Congress can moderate the tax laws as needed to adjust federal revenue. Tax laws should satisfy other criteria, even if used to increase or decrease federal revenues.

223. For example, in *Gilford*, the taxpayer argued that a partnership existed to obtain capital loss treatment that could be carried forward to subsequent years. *Gilford*, 201 F.2d at 736; see also *infra* notes 369–74 and accompanying text (discussing the court's finding that an arrangement was not a partnership despite the existence of business activity). If the taxpayer's situation had been different, however, the taxpayer would have preferred that the arrangement not be classified as a partnership to obtain ordinary loss that could offset ordinary income without limit. See I.R.C. § 1211 (2000) (limiting the amount of loss recognized from the sale of capital assets).

224. See George K. Yin, *The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the "Check-the-Box" Regulations*, 51 SMU L. REV. 125, 130–31 (1997) (describing the relative disadvantages of transaction costs, risk of error, and complexity that unwary taxpayers face in an elective tax system, as opposed to advantages of tax liability minimization by well-advised taxpayers in a similar system).

225. See Steven A. Dean, *Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification*, 34 HOFSTRA L. REV. 405, 451–55 (2005) (arguing that the check-the-box regulations do not simplify corporate classification because taxpayers in the elective regime must pay counsel to advise them concerning the tax consequences of the alternative classifications).

226. See *supra* note 105 and accompanying text (chronicling Congress's path to establishing partnership tax law).

227. For example, the substantive-law test, the joint-profit test, and the degree-of-activity test all derive from the substantive-law definition of partnership.

### A. *The Substantive-Law Definition of Partnership*

The substantive-law definition of partnership originated in British common law.<sup>228</sup> Under substantive law, a partnership is “an association of two or more persons to carry on as co-owners a business for profit.”<sup>229</sup> Courts considering the definition of tax partnership frequently refer to three elements of the definition: (1) profit-sharing, (2) intent, and (3) control.<sup>230</sup> Profit-sharing is generally thought to be “a *necessary* condition for the existence of [a] partnership.”<sup>231</sup> A substantive-law partnership may, however, exist without a profit-sharing relationship “if there is strong evidence of other indicia of co-ownership or subjective partnership intent, as when a mere wage earner is a party to an agreement that explicitly labels the business as a partnership.”<sup>232</sup> Thus, substantive law appears to adopt a test similar to the estoppel test discussed below.<sup>233</sup> If the parties choose to treat an arrangement like a partnership, they will be a partnership, even

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228. See, e.g., *Comm'r v. Tower*, 327 U.S. 280, 286–87 (1946) (citing *Cox v. Hickman*, (1860) 11 Eng. Rep. 431, 449 (H.L.) (establishing British precedent)).

229. UNIF. P'SHIP. ACT § 101(6) (amended 1997), 6 U.L.A. 61 (2001). That definition is very similar to the definition that existed at the time Congress enacted the first income tax statute. For example, the English Partnership Act of 1890 provided, “Partnership is the relation which subsists between persons carrying on business in common with a view to profit.” 1 J.M. BARRETT & ERWIN SEAGO, *PARTNERS AND PARTNERSHIPS LAW AND TAXATION* ch. 2, § 1, at 19 (1956) (quoting English Partnership Act, 1890, 53 & 54 Vict., c. 39, § 1(1)). Contemporary commentators similarly stated, “Partnership . . . is a legal relation, based upon the express or implied agreement of two or more competent persons whereby they unite their property, labor or skill in carrying on some lawful business as principals for their joint profit.” *Id.* ch. 2, § 1, at 19 & n.3 (citing FLOYD R. MECHEM, *LAW OF PARTNERSHIP* 1 (2d ed. 1920)). At the time the first U.S. income tax was enacted, courts also used this definition as they considered the partnership question in the substantive law context. See, e.g., *id.* ch. 2, § 1, at 20 & n.4 (citing *Eilers Music House v. Reine*, 133 P. 788, 790 (Or. 1913) (“A partnership is an agreement . . . between two or more persons to unite their labor, skill, money, and property, or either or all of them, in a lawful business for mutual account.”)).

230. See *infra* notes 240–46, 249–50 and accompanying text (identifying the importance of profit sharing, intent, and control in the finding of a partnership).

231. ALAN R. BROMBERG & LARRY E. RIBSTEIN, *BROMBERG AND RIBSTEIN ON PARTNERSHIP*, § 2.07(b)(2) (2005).

232. *Id.*

233. See *infra* Part V.B.9 (examining in greater detail the estoppel test as an equitable tool). See also UNIF. P'SHIP ACT § 308(a) (amended 1997), 6 U.L.A. 128 (2001) (“If a person, by words or conduct, purports to be a partner, or consents to being represented by another as a partner, in a partnership or with one or more persons not partners, the purported partner is liable to a person to whom the representation is made, if that person, relying on the representation, enters into a transaction with the actual or purported partnership.”). This is a continuation of “the basic principles of partnership by estoppel from UPA Section 16.” UNIF. P'SHIP ACT § 308(a) cmt. (amended 1997), 6 U.L.A. 129 (2001).



in the absence of profit sharing.<sup>234</sup> Otherwise, it appears profit-sharing is required.

Profit-sharing may depend upon one of three possible definitions of profit: (1) the accounting definition, (2) the balance sheet definition, or (3) the dictionary definition. The accounting definition of profits is "net income, or [the] difference between revenues and expenses, for a given accounting period."<sup>235</sup> The balance sheet definition refers to profits as money that remains after a partnership pays all liabilities and returns partner contributions.<sup>236</sup> This definition would take into account the appreciated value of partnership assets.<sup>237</sup> The dictionary definition identifies profit as the "benefit or advantage accruing from the management, use, or sale of property from the carrying on of any process of production, or from the conduct of business."<sup>238</sup> As discussed below, courts and the IRS have applied different definitions of profit to define tax partnerships under the joint-profit test, leading to different results.<sup>239</sup>

At one time, substantive law considered profit sharing sufficient to establish a partnership.<sup>240</sup> That doctrine has become obsolete.<sup>241</sup> Now, intent to form a partnership also plays an important role in defining substantive-law partnerships.<sup>242</sup> Courts have looked to both subjective and objective intent to determine whether a substantive-law partnership exists.<sup>243</sup> Subjective intent is evidenced by "the parties' own expressions of intent in their written agreement (if any), their utterances, or in

234. BROMBERG & RIBSTEIN, *supra* note 231, § 2.07(b)(2).

235. *Id.* § 2.07(b)(4).

236. *Id.* § 2.07(b)(4) & n.19.

237. *Id.*

238. *Id.* § 2.07(b)(4) n.21 (quoting *City of Englewood v. Commercial Union Assurance Cos.*, 940 P.2d 948, 956–57 (Colo. Ct. App. 1996) (holding that cost sharing supported partnership classification because the resulting savings were a benefit to the parties), *aff'd in part, rev'd in part sub nom.* *Compass Ins. Co. v. City of Littleton*, 984 P.2d 606 (Colo. 1999)).

239. *See infra* text accompanying notes 348, 355 (identifying the initial use of the accounting definition of profit and the later use of the dictionary definition).

240. BROMBERG & RIBSTEIN, *supra* note 231, § 2.07(b)(3) ("Every man who has a share of the profits of a trade ought also to bear his share of the loss. And if any one takes part of the profit, he takes a part of that fund on which the creditor of the trader relies for his payment.") (quoting *Grace v. Smith*, (1775) 96 Eng. Rep. 587, 588 (K.B.)).

241. *Id.* (citing *Cox v. Hickman*, (1860) 11 Eng. Rep. 431, 449 (H.L.); UNIF. P'SHIP ACT § 7(4) (1914), 6 U.L.A. 418 (2001); UNIF. P'SHIP. ACT § 202(c)(3) (amended 1997), 6 U.L.A. 93 (2001)).

242. *Id.* § 2.05(a) (citing *Comm'r v. Culbertson*, 337 U.S. 733, 741–42 (1949) (noting that the existence of partnership depends on the intent of the parties)). "[I]ntention is inherent in the word 'association' in the statutory definition of partnership." *Id.* (citing UNIF. P'SHIP. ACT § 6 cmt. (amended 1914), 6 U.L.A. 394 (2001)).

243. *Id.* § 2.05(b)–(c).

documents relating to the business.”<sup>244</sup> Parties demonstrate an objective intent to form a partnership when they “do the acts that in law constitute [a] partnership.”<sup>245</sup> “[P]rofit and loss sharing, control [sharing], and capital contributions” are acts that constitute a partnership in law and demonstrate subjective intent.<sup>246</sup>

Examining the parties’ intent presents some difficulties. As one commentator observed:

It is one thing . . . to say that partnership is voluntary, and another to define precisely under what circumstances partnership is intended. The problem of defining partnership intent is complicated by a number of considerations. First, partnership is often an informal relationship among lay people who do not speak or act with regard to technical, legal rules. Second, it is not possible in many cases to draw definite conclusions as to intent from the form of the relationship the parties have entered into, since many of the elements of the standard form of partnership set forth in the partnership statute are subject to the contrary agreement of the parties. The parties may have intended partnership even if several of these elements are not present. Third, the determination of partnership may depend on the context of the determination. Of particular relevance to the role of intent is the distinction between third-party and *inter sese* cases.<sup>247</sup>

Difficulties also arise in the tax context when courts use intent to determine the existence of a tax partnership.<sup>248</sup>

“Joint control is . . . a significant indicator of partnership.”<sup>249</sup> In particular, joint control indicates co-ownership.<sup>250</sup> In cases where joint control is absent but parties share in the profits, the arrangement often is not a partnership.<sup>251</sup> For example, debtor-creditor relationships, principal-agent relationships, and

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244. *Id.* § 2.05(b) (providing the following examples of conduct or verbal expressions that indicate subjective intent: “verbal statements of the purported partners, whether the parties used a trade name, holding or applying for business licenses, keeping of accounts reflecting partnership [operations], whether business bank accounts were maintained, whether the parties filed partnership tax returns, [and] deliberately operating the business in the [partnership] form” (footnotes omitted)).

245. *Id.* § 2.05(c).

246. *Id.*

247. *Id.* § 2.05(a) (emphasis added) (footnote and citations omitted).

248. *See, e.g.,* *Boca Investorings P’ship v. United States*, 314 F.3d 625, 630–32 (D.C. Cir. 2003) (requiring the district court to apply the business-purpose test to meet the *Culbertson* intent test).

249. BROMBERG & RIBSTEIN, *supra* note 231, § 2.07(c)(1).

250. *Id.* (citing UNIF. P’SHP ACT § 6 cmt. (1914), 6 U.L.A. 393 (2001)).

251. *Id.* § 2.07(c)(2).

landlord-tenant relationships are not partnerships, but any of these could be a profit-sharing arrangement.<sup>252</sup> In each of these relationships, the lack of control indicates that the parties do not co-own the business.<sup>253</sup> Nonetheless, joint-control is not *prima facie* evidence of partnership.<sup>254</sup> More, such as sharing profits, is needed to satisfy the definition of partnership.<sup>255</sup> Control is also important in determining whether an arrangement is a tax partnership.<sup>256</sup>

These elements of substantive-law partnerships reflect the reasons partnership classification is important in the substantive law context, which differ from tax policy. "The existence of partnership is never the immediate issue in a case, but only part of the answer to the question at hand."<sup>257</sup> Nonetheless, the issue at hand should govern the definition of partnership.<sup>258</sup> In the substantive law context, the existence of a partnership may be important to determine whether certain parties are liable for debts,<sup>259</sup> whether a person is entitled to benefits as an employee,<sup>260</sup> whether a party is receiving payments as a creditor,<sup>261</sup> and whether a noncompete agreement is enforceable.<sup>262</sup> Each of these various reasons giving the substantive-law definition of partnership significance may have its own policy considerations, which should govern the substantive-law definition of partnership.<sup>263</sup> Such policy

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252. UNIF. P'SHIP ACT § 202(c)(3) (amended 1997), 6 U.L.A. 93 (2001) ("A person who receives a share of the profits . . . is presumed to be a partner in the business, unless the profits were received in payment: (i) of a debt by installments or otherwise; (ii) for services as an independent contractor or of wages of other compensation to an employee; (iii) of rent . . .").

253. BROMBERG & RIBSTEIN, *supra* note 231, § 2.07(c)(2).

254. *Id.* § 2.07(c)(3).

255. *Id.*

256. *See supra* notes 249–50 and accompanying text (necessitating the existence of joint control for a finding of a partnership).

257. BROMBERG & RIBSTEIN, *supra* note 231, § 2.02(a).

258. *Wheeler v. Comm'r*, 37 T.C.M. (CCH) 883, 887, 889–96 (1978) (determining whether the parties' relationship was a partnership in the context of the fair market value of stock, debentures, and notes).

259. BROMBERG & RIBSTEIN, *supra* note 231, § 2.02(a).

260. *Id.* § 2.02(b)(2).

261. *Id.* § 2.02(b)(3) (providing that if a person receives payments as a creditor, they may be void under state usury laws).

262. *Id.* § 2.02(b)(4).

263. For example, whether parties are jointly and severally liable may affect whether a creditor will extend financing to a partnership. If the parties' actions demonstrate a subjective intent to form a partnership, and the creditor relies upon those actions to make a loan to one of the parties, substantive-law policy would dictate that the arrangement should be treated as a partnership to allow the creditor to proceed against the partners jointly and severally to obtain repayment of the loan.

considerations may, however, differ significantly from tax policy considerations.<sup>264</sup> If the respective policy considerations differ, the definitions they govern should also differ. Many of the tests used to define tax partnership fail to consider this and work from the substantive-law definition or are derived from that definition.<sup>265</sup>

### *B. The Ten Tests Used to Define Tax Partnership*

An in-depth study of the authority addressing the definition of tax partnership reveals that the following ten tests are used haphazardly to define tax partnerships: (1) the substantive-law test, (2) the state-law test, (3) the joint-profit test, (4) the expense-sharing test, (5) the degree-of-activity test, (6) the type-of-activity test, (7) the source-of-activity test, (8) the business-purpose test, (9) the estoppel test, and (10) the fact-question test. At times, the authority addressing the tax partnership question identifies the test it used.<sup>266</sup> Most often, however, the authority is silent as to the test used, and at times the test used is indeterminable.<sup>267</sup> In no place other than this Article are the ten tests identified separately and presented to be evaluated using tax policy. Although some would argue that some of the tests are mere subsets of other tests (e.g., the degree-of-activity test and type-of-activity test are subsets of the substantive-law test, and the expense-sharing test is a subset of the joint-profit test), this Article lists them separately to reflect the manner in which Congress, the courts, Treasury, and the IRS apply the tests.

1. *The Substantive-Law Test.* Under the substantive-law test, an arrangement is a tax partnership if several factors

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264. For example, the partnership tax rules were justified on simplicity and administrability grounds. This differs from the policy for holding parties jointly and severally liable. If parties hold themselves out as partners to a creditor but do not have accounting and reporting complexity, they should not be treated as partners for tax purposes.

265. See *infra* Part V.B (recounting in greater detail the disorganized application of ten tests used to define tax partnerships).

266. See, e.g., *Maletis v. United States*, 200 F.2d 97, 98 (9th Cir. 1952) (recognizing that the court could apply the estoppel doctrine to prevent the taxpayer from arguing that no tax partnership exists); *Earp v. Jones*, 131 F.2d 292, 293–94 (10th Cir. 1942) (recognizing that the partnership had to have a business purpose); *Tate v. Knox*, 131 F. Supp. 514, 516–17 (D. Minn. 1955) (relying on Minnesota law to determine whether a “joint adventure” was created).

267. See, e.g., *United States v. U.S. Nat’l Bank of Portland*, 239 F.2d 475, 476–80 (9th Cir. 1956) (employing an undeterminable test); *Bartholomew v. Comm’r*, 186 F.2d 315, 318–19 (8th Cir. 1951) (same); *I.T. 2082*, 3-2 C.B. 176 (1924) (using the substantive-law test but not identifying it as such); *I.T. 1604*, 2-1 C.B. 1 (1923) (concluding that no partnership existed, despite co-ownership and sharing of profits, without announcing which test was utilized).

indicate the parties' intent to form a partnership.<sup>268</sup> Prior to the enactment of the statutory definition of tax partnership, the IRS applied the substantive-law test to determine that an arrangement was not a tax partnership.<sup>269</sup> The IRS ruled in several cases that no tax partnership existed even though two or more individuals co-owned property and used it in a trade or business.<sup>270</sup>

The IRS cited no prior tax decisions in accord with its ruling,<sup>271</sup> but it did cite substantive law<sup>272</sup> and listed elements of the substantive-law definition to rule that the arrangement was not a tax partnership.<sup>273</sup> Specifically, the IRS ruled that the arrangements were tenancies-in-common and not partnerships.<sup>274</sup>

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268. See *infra* text accompanying notes 280–82 (listing authorities that led to the establishment of intent as an indicator of a tax partnership).

269. See *infra* notes 270–73 and accompanying text (noting the IRS's decision to apply substantive-law elements to issues concerning the existence of a partnership).

270. I.T. 2082, 3-2 C.B. 176 (1924) (concerning family members who co-owned a merchandise store that they managed); I.T. 1604, 2-1 C.B. 1 (1923) (involving parties who co-owned, and operated, and shared the profits from a farm).

271. The IRS may not have cited prior tax decisions on this issue because this was the first time it had encountered this issue. Apparently, however, the IRS had considered the issue in the oil and gas context. It stated:

It seems that the courts are unanimous in upholding this proposition of law and the Bureau has unqualifiedly followed it in several instances. The cases in which the rule has been applied by the Bureau have been mostly those involving the coownership of oil leaseholds and vessels operated by an agent in the business of importing and exporting. In the former class it has been consistently held that participation in the profits is not conclusive evidence of a partnership and that mere coownership and operation of oil leaseholds, each coowner contributing a pro rata share of the investment or cost of operation and each sharing the product, do not, without more, create a partnership. And in the case of vessels it has been held that, in the absence of special facts affirmatively showing a partnership, where a vessel is owned by several parties and operated by a managing owner or agent for the account of all, the relation does not constitute a partnership for income tax purposes.

I.T. 1604, 2-1 C.B. at 2.

272. *Id.* ("A few of the cases bearing upon this proposition might be referred to in brief. It is essential to a partnership that there be a community of interest in the subject of it, other than that of mere joint tenants or tenants in common. The common ownership of property used as a place of business does not of itself make the owners partners. The common ownership of real property upon and with which a business is conducted for the benefit of the tenants in common does not in itself constitute them partners. Neither do the common ownership of a productive property and an agreement by the owners to divide what it produces, of themselves, prove a partnership. The common ownership of woodland and an agreement to cut and sell the timber therefrom, dividing equally the expenses and proceeds, do not make a partnership." (citations omitted)).

273. *Id.* at 1. The IRS stated that the "absence of mutual dependence or agency between the coowners and [the ability of] any one of the coowners [to] sell his interest without securing the consent of other part owners, which is contrary to one of the fundamental attributes of a partnership" demonstrates a partnership did not exist. *Id.*

274. The court identified mutual dependence, agency, and the right to alienate property as the bases for its decision. *Id.* at 3. Those factors may or may not affect the

Because tenancy-in-common (TIC) arrangements are excluded from the substantive-law definition of partnership, taxpayers establish that an arrangement is not a tax partnership by showing that it is a tenancy-in-common.<sup>275</sup>

Prior to the enactment of the statutory definition of tax partnership, Treasury adopted the tenancy-in-common safe harbor, stating that "joint investment in and ownership of real and personal property not used in the operation of any trade or business and not covered by any partnership agreement does not

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timing and computation of the income and loss of an arrangement. Mutual dependence and agency describe important legal relationships that exist among partners. Agency is different from partnership because the agent is subject to the control of the principal. See BROMBERG & RIBSTEIN, *supra* note 231, § 2.01(b); 4 THOMPSON ON REAL PROPERTY § 32.07 (David A. Thomas ed., 2d Thomas ed., Matthew Bender & Co. 2004) ("[E]ach tenant in common has a share that is alienable, devisable, and inheritable."). See also MECHEM, *supra* note 229, § 11, at 15–16 (showing how co-ownership differs from partnership by providing a contemporary list which includes, "1. Co-ownership is not necessarily the result of an agreement to create it, while partnership is. 2. Co-ownership does not necessarily involve community of profit or loss, while partnership does. 3. One co-owner may, without the consent of the others, assign his interest in such a way that his assignee will assume his relations to the other co-owners, but one partner cannot do this. 4. One co-owner is not as such the agent of the others, while a partner is. 5. One co-owner has no lien on the common property for expenses or outlays, or for what may be due from the others as their share of a common debt, while a partner has such a lien" (footnotes omitted)).

These considerations only become important in the partnership tax context when they affect the source of income. See *infra* text accompanying notes 393–97 (explaining that the distinction between tax partnerships and principal-agent relationships turns on the lack of a party's control over income and lack of a party's contributed services). Restrictions on alienation may affect the value of an interest, but should not affect the computation and timing of income and loss of the property.

275. I.T. 2082, 3-2 C.B. at 177 (1924) (ruling with little analysis that the arrangement was a TIC); I.T. 1604, 2-1 C.B. at 2 (1923) ("Citations are unnecessary in support of the proposition that a mere tenancy in common does not create a partnership."); see also UNIF. P'SHIP ACT § 202(c)(1) (amended 1997), 6 U.L.A. 92, 92–93 (2001) ("Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not by itself establish a partnership, even if the co-owners share profits made by the use of the property."). In *Estate of Appleby v. Commissioner*, the Board of Tax Appeals considered whether two brothers who co-owned, improved, and leased certain property were partners for federal income tax purposes. *Estate of Appleby v. Comm'r*, 41 B.T.A. 18, 20–21 (1940) (citing I.T. 1604, 2-1 C.B. 1; I.T. 2082, 3-2 C.B. 176), *aff'd*, 123 F.2d 700 (2d Cir. 1941). The Board ruled that they were not partners, recognizing that a TIC arrangement had never before been classified as a partnership, although the IRS had formerly recognized the existence of TIC arrangements. *Id.* Although the co-owners had developed the property, the Board stated that they did so at the insistence of the lessee, and the lessee operated the improvements once constructed. *Id.* The Board was concerned that if it ruled that the tenancy in common were a partnership, it would be difficult to exclude other arrangements such as marital communities or tenancies by the entirety from the statutory definition of partnership. *Id.* Therefore, it ruled that no partnership existed. *Id.* It also predicted with accurate foresight that "it will probably continue to be difficult to classify many of the imaginable varieties of businesses and interests in which more than one person share." *Id.* at 21.

constitute a partnership."<sup>276</sup> Treasury removed this provision from the regulations after the enactment of the federal statutory definition of tax partnership.<sup>277</sup> That indicates that the statutory definition of tax partnership, which included syndicates, groups, pools, and joint ventures, was broader than the substantive-law definition of partnership and might even include substantive-law tenancies-in-common.<sup>278</sup>

Courts focused on the parties' intent, and eventually multifactor tests became important under the substantive-law test.<sup>279</sup> Decisions that have become bellwethers in defining tax partnership—*Commissioner v. Tower*,<sup>280</sup> *Lusthaus v. Commissioner*,<sup>281</sup> and *Commissioner v. Culbertson*<sup>282</sup>—introduced intent to the definition of tax partnership.<sup>283</sup> In those cases, the

276. Regulations 74, Art. 1317 (Dec. 1, 1931).

277. Regulations 77 did not include Art. 1317; see also I.T. 2749, 8-1 C.B. 99, 99-100 (1934) ("The omission of the provisions of article 1317 of Regulations 74 from Regulations 77 . . . was occasioned by the definition of a partnership contained in section 1111(a)(3) of the Revenue Act of 1932, which definition did not appear in the Revenue Act of 1928." (citation omitted)).

278. See MECHEM, *supra* note 229, § 16, at 19-21 (stating that joint ventures and syndicates "frequently have some of the characteristics of partnership, but they are usually not partnerships, at least of the commercial or trading class, and the rights and liabilities of the parties, where there are no elements of estoppel, are to be worked out by a consideration of the terms of the contract and of the powers and authorities in fact conferred. The implied authority of the associates to bind each other by contracts is usually very limited. Persons so situated who have acquired property which they are to hold until they unite in disposing of it do not usually contemplate or require any acts of agency by one; there are ordinarily no incidental contracts to be made; the parties intend to act unitedly when they act at all; and consequently there is no ground for implying any general authority in one to act for all. Only the consent of all, or the rare case of overpowering necessity, would create an authority." (footnotes omitted)).

279. *Comm'r v. Culbertson*, 337 U.S. 733, 738-39 (1949); *Lusthaus v. Comm'r*, 327 U.S. 293, 297 (1946); *Comm'r v. Tower*, 327 U.S. 280, 287 (1946).

280. *Tower*, 327 U.S. at 286-87.

281. *Lusthaus*, 327 U.S. at 297.

282. *Culbertson*, 337 U.S. at 738-39.

283. Although these cases have become bellwethers, reliance on them may not be justified in situations in which capital is a significant income-producing factor because the question in these cases was later addressed by legislation. See I.R.C. § 704(e)(1) (1958) ("A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person."). Section 704(e) may be a codification of the dissenting opinion in *Lusthaus v. Commissioner*, which provided that if the husband made a gift of property to his wife, and the wife contributed that property to a partnership with the husband, the arrangement should be a tax partnership. *Lusthaus*, 327 U.S. at 301-03 (Reed, J., dissenting). Also, the facts and issues raised in other cases rarely resemble the facts in these cases. See *supra* note 58 (identifying cases with different facts relying on the *Culbertson*, *Lusthaus*, and *Tower* cases). *Commissioner v. Culbertson* is often cited in nontax cases for its holding regarding intent. See BROMBERG & RIBSTEIN, *supra* note 231, § 2.05(a) n. 1 ("An often-quoted case is *Commissioner v. Culbertson* . . .").

parties attempted to form state-law partnerships.<sup>284</sup> In *Tower*, the Supreme Court acknowledged that the arrangement might have been a partnership under Michigan law.<sup>285</sup> The Court held, however, that it was not bound by state law in determining whether the arrangement was a tax partnership.<sup>286</sup> The Court considered whether the partnership was formed for the sole purpose of shifting income earned by a husband to his wife who was not formerly involved in the operation or management of the husband's business enterprise.<sup>287</sup> Citing two substantive-law cases, the Court stated, "A partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses."<sup>288</sup>

The Court focused on the substantive-law factor of intent to decide the case,<sup>289</sup> stating that the participants' "intention in this

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284. *Culbertson*, 327 U.S. at 736-37 ("The partnership agreement between taxpayer and his sons was oral. The local paper announced the dissolution of the Coon and Culbertson partnership and the continuation of the business by respondent and his boys under the name of Culbertson & Sons. A bank account was opened in this name, upon which taxpayer, his four sons and a bookkeeper could check. At the time of formation of the new partnership, Culbertson's oldest son was 24 years old, married, and living on the ranch, of which he had for two years been foreman under the Coon and Culbertson partnership."); *Lusthaus*, 327 U.S. at 296 ("Pennsylvania issued petitioner and his wife a certificate authorizing them to carry on the business as a partnership."); *Tower*, 327 U.S. at 287 ("Respondent contends that the partnership arrangement here in question would have been valid under Michigan law and argues that the Tax Court should consequently have held it valid for tax purposes also.").

285. *Tower*, 327 U.S. at 287-88 ("Thus, Michigan could and might decide that the stock-transfer here was sufficient under state law to pass title to the wife, so that in the event of her death it would pass to whatever members of her family would be entitled to receive it under Michigan's law of descent and distribution.").

286. *Id.* at 288 ("But Michigan cannot by its decisions and laws governing questions over which it has final say, also decide issues of federal tax law and thus hamper the effective enforcement of a valid federal tax levied against earned income.").

287. *Id.* at 291-92 ("And the wife drew on income which the partnership books attributed to her only for purposes of buying and paying for the type of things she had bought for herself, home and family before the partnership was formed. Consequently the result of the partnership was a mere paper reallocation of income among the family members. The actualities of their relation to the income did not change."). The Court relied on the *Tower* analysis to rule similarly in *Lusthaus v. Commissioner*. See *Lusthaus*, 327 U.S. at 297 ("For the reasons set out in our opinion in *Commissioner v. Tower*, the decision of the circuit court of appeals is affirmed." (citation omitted)).

288. *Tower*, 327 U.S. at 286 (citing *Meehan v. Valentine*, 145 U.S. 611 (1892) (determining whether a lender became liable as a partner for debts of a partnership based on the terms of the loan); *Ward v. Thompson*, 63 U.S. (22 How.) 330 (1859) (determining whether an arrangement between co-owners of a vessel was a partnership or charter arrangement for purposes of determining jurisdiction of a court of admiralty)).

289. See *Tower*, 327 U.S. at 286-87 ("When the existence of an alleged partnership arrangement is challenged by outsiders, the question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in



respect is a question of fact, to be determined from testimony disclosed by their 'agreement, considered as a whole, and by their conduct in execution of its provisions.'"<sup>290</sup> Although couched by the Court as federal law doctrine, intent is derived from substantive law.<sup>291</sup> The Court concluded its opinion by stating "that while the partnership was 'clothed in the outer garment of legal respectability' its existence could not be recognized for income tax purposes."<sup>292</sup> Thus, the Court rejected any form the arrangement might have had.<sup>293</sup> The Court appears to provide two levels of assurance: first, the Court concluded that the arrangement was not a tax partnership under the intent element of the substantive-law definition, and second, it rejected the arrangement's form.

In *Culbertson*, the Supreme Court instructed the Tax Court to reconsider which of the family members had "a bona fide intent [to] be partners in the conduct of the cattle business, either because of services to be performed during those years, or because of contributions of capital of which they were the true owners."<sup>294</sup> In oft-quoted language,<sup>295</sup> the Supreme Court focused on intent: "The question is . . . whether, considering all the facts . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."<sup>296</sup> Later, the D.C. Circuit connected intent to the business-purpose test, requiring that an arrangement have a

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the profits or losses or both."). Again the court is looking to substantive law for this part of the analysis. Under substantive law both subjective intent and objective intent are important in considering whether parties have formed a partnership. See *supra* text accompanying notes 243-46.

290. *Tower*, 327 U.S. at 287 (quoting *Drennen v. London Assurance Co.*, 113 U.S. 51, 56 (1885), and citing *Cox v. Hickman*, (1860) 11 Eng. Rep. 431 (H.L.)).

291. See *supra* text accompanying notes 243-46.

292. *Lusthaus*, 327 U.S. at 297 (quoting 3 T.C. 540, 542 (1944), *aff'd*, 149 F.2d 232 (3d Cir. 1945), *aff'd*, 327 U.S. 293 (1946)).

293. *Tower*, 327 U.S. at 292. The court probably could have reached the same conclusion relying exclusively on the business-purpose test, as the Tenth Circuit did a few years earlier in *Earp v. Jones*, 131 F.2d 292 (10th Cir. 1942).

294. *Comm'r v. Culbertson*, 337 U.S. 733, 748 (1949). In that case, four sons used a note to buy an undivided one-half interest in a herd of cattle from their father and contributed the interest to a partnership with their father, who contributed his remaining one-half interest to the partnership. *Id.* at 736. Shortly after the partnership was formed in 1940, two of the sons entered the Army. *Id.* at 737. The two younger sons went to school during the winter and worked with the cattle during the summer. *Id.* The taxpayers filed a partnership tax return for 1940 and 1941, but the Tax Court, relying on the decisions in *Tower* and *Lusthaus*, disallowed the division of income among the father and his sons based on a finding that none of the sons had contributed capital or services to the partnership. *Id.*

295. BROMBERG & RIBSTEIN, *supra* note 231, §2.05(a) n.1.

296. *Culbertson*, 337 U.S. at 742.

nontax business purpose to satisfy the *Culbertson* intent requirement.<sup>297</sup>

The intent question requires a definition of tax partnership.<sup>298</sup> The substantive-law test attempts to define tax partnership using multifactor lists.<sup>299</sup> Considering joint ventures to be equivalent to tax partnerships,<sup>300</sup> courts derived several factors from state-law definitions of joint venture and other sources of substantive law.<sup>301</sup> The number of factors adopted varies from three to fifteen.<sup>302</sup> Before the publication of Revenue Procedure 2002-22, the lists generally included no more than eight factors, which derived from the substantive-law definition of partnership or joint venture.<sup>303</sup> The IRS's fifteen factors in Revenue Procedure 2002-22 incorporate some of these eight factors,<sup>304</sup> neglect others,<sup>305</sup> add new

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297. *ASA Investorings P'ship v. Comm'r*, 201 F.3d 505, 513 (D.C. Cir. 2000).

298. *See SABA P'ship v. Comm'r*, 273 F.3d 1135, 1140 (D.C. Cir. 2001) (explaining that the tax partnership question, although fact-intensive, is a question of law).

299. *See infra* notes 300–07 and accompanying text (identifying several such multifactor lists and their sources).

300. *See Winmill v. Comm'r*, 93 F.2d 494 (2d Cir. 1937) (construing section 1696(2) of the Revenue Act of 1932 to include joint ventures as partnerships for federal tax purposes), *rev'd on other grounds sub nom. Helvering v. Winmill*, 305 U.S. 79 (1938).

301. *See Ayrton Metal Co. v. Comm'r*, 299 F.2d 741, 742 (2d Cir. 1962) (relying upon *Beck Chemical Equipment Corp. v. Commissioner*, 27 T.C. 840, 848–49 (1957) (relying upon the definition of joint venture in *Corpus Juris Secundum* and New York law)); *Fishback v. United States*, 215 F. Supp. 621, 625 (D.S.D. 1963) (relying upon *American Jurisprudence* and *Blackner v. McDermott*, 176 F.2d 498 (10th Cir. 1949) (dealing with nontax issues)); *Flanders v. United States*, 172 F. Supp. 935, 942–43 (N.D. Cal. 1959) (relying upon *California Juris*, California cases, and *Tate v. Knox*, 131 F. Supp. 514, 517 (D. Minn. 1955) (relying upon the Minnesota definition of joint venture)); *Alhouse v. Comm'r*, 62 T.C.M. (CCH) 1678, 1680 (1991) (relying upon *Luna v. Commissioner*, 42 T.C. 1067, 1077 (1964) (relying upon *Beck Chemical Equipment Corp.*)) *aff'd sub nom. Bergford v. Comm'r*, 12 F.3d 166 (9th Cir. 1993); *Podell v. Comm'r*, 55 T.C. 429, 431 (1970) (relying upon *Flanders* and *Tate*); Rev. Proc. 2002-22, 2002-1 C.B. 733, 734 (relying upon *Bergford*, *Bussing v. Commissioner*, 89 T.C. 1050 (1987), and *Alhouse*).

302. *See Ayrton Metal Co.*, 299 F.2d at 743 (adopting three factors); Rev. Proc. 2002-22, 2002-1 C.B. 733, 735–37 (adopting fifteen factors).

303. *See Luna*, 42 T.C. at 1077–78 (including (1) the agreement of the parties and their conduct; (2) the parties' contributions; (3) the parties' control over income and capital, including each party's right to make withdrawals; (4) whether the parties were co-proprietors, employee/employer, or principal/agent; (5) whether the parties conducted business under a joint name; (6) whether the parties filed a partnership tax return; (7) whether the parties exercised mutual, although perhaps unequal, control and assumed mutual responsibilities; and (8) whether the arrangement maintained separate books); *see also Fishback*, 215 F. Supp. at 626 (noting that equal control is not required).

304. For example, the IRS lists treating the arrangement as an entity, incorporating *Luna* factors (1), (5) and (6); lists restrictions on alienation, incorporating factors (3) and (7); and lists management or brokerage agreements, incorporating factor (4). Rev. Proc. 2002-22, 2001-1 C.B. 733, 735–37; *see also supra* note 303 (listing the eight factors as described in *Luna*).

305. The IRS does not list the keeping of separate books in Revenue Procedure

factors from other tests,<sup>306</sup> and create new factors from whole cloth.<sup>307</sup> Thus, as the substantive-law test now stands, it considers several factors to determine whether the parties intended to create a partnership.

2. *The State-Law Test.* The state-law test adopts the state-law classification of an arrangement.<sup>308</sup> Thus, if an arrangement is a partnership under state law, it will be a tax partnership under the state-law test. Under the state-law test, any legal entity with two or more members that is not a corporation or other entity defined as a tax corporation or tax trust will be a tax partnership.<sup>309</sup> Thus, under the state-law test, limited liability companies, limited partnerships, and limited liability partnerships are tax partnerships.<sup>310</sup> The state-law test looks to intent and the multifactor lists only if the state-law definition of partnership relies upon intent and the factors. The state-law test does not necessarily consider tax policy. It simply includes all noncorporate state-law entities as tax partnerships, so long as they do not come within the definition of tax trust.<sup>311</sup>

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2002-22. *Id.*

306. For example, the IRS lists tenancy in common ownership and restrictions on alienation, drawing from the substantive-law definition of TIC. *See supra* note 274 (noting factors that the IRS has considered include mutual dependence, agency, and the right to alienate property). The IRS lists no business activity, drawing from the degree-of-business activity test. *See infra* Part V.B.5 (describing the degree-of-activity test). Additionally, the IRS lists payments to sponsor, drawing from the source-of-activity test. *See infra* Part V.B.7 (defining the source-of-activity test).

307. For example, the IRS limits the number of members to thirty-five, requires unanimous consent from the members for certain actions, requires the immediate distribution of sale proceeds, restricts the members' rights to option their interests, and prohibits members' borrowing from related parties. Rev. Proc. 2002-22, 2002-1 C.B. 733, 736-37.

308. *See, e.g.,* *Copeland v. Ratterree*, 57-2 U.S. Tax Cas. (CCH) ¶ 9895, at 58,195 (N.D.N.Y. 1957) (noting that Vermont state law should apply when the agreement was made in Vermont and contemplated performance in Vermont).

309. *See* Rev. Rul. 2004-86, 2004-33 I.R.B. 191, 193 ("Generally, when participants in a venture form a state law entity and avail themselves of the benefits of that entity for a valid business purpose, such as investment or profit, and not for tax avoidance, the entity will be recognized for federal tax purposes.").

310. These legal entities do not come within the definition of tax corporation. *See supra* note 29 (defining a tax corporation). They generally would not be tax trusts. *But see* Rev. Rul. 2004-86, 2004-33 I.R.B. 191, 193-94 (ruling that a Delaware Statutory Trust was a separate entity as defined in Treasury Regulation § 301.7701-1(a)). If a Delaware Statutory Trust can be a tax trust, *id.*, it is possible that other state-law entities may also be tax trusts if subject to the same restrictions to which Delaware Statutory Trusts are subject.

311. But tax law may disregard some state-law government entities. *See supra* note 24.

Many courts have shunned the state-law test,<sup>312</sup> as Treasury has appeared to do in the check-the-box regulations.<sup>313</sup> Nonetheless, the state-law test may still have life. Some courts have relied exclusively upon the state-law characterization of an arrangement in deciding whether an arrangement was a tax partnership.<sup>314</sup> Taxpayers seeking tax partnership classification may be able to rely upon the existing case law to invoke the state-law test.<sup>315</sup> The IRS, on the other hand, is bound by rules it promulgates.<sup>316</sup> Since it sets forth that state law does not determine the definition of tax partnership,<sup>317</sup> the IRS should not be able to invoke the state-law test. Its only recourse in such

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312. See, e.g., *Comm'r v. Tower*, 327 U.S. 280, 287–88 (1946) (refusing to apply Michigan law to the federal tax issue); *Press v. Comm'r*, 52 T.C.M. (CCH) 285, 286 (1986) (emphasizing that the court is not bound by state-law definitions); *Kelly v. Comm'r*, 29 T.C.M. (CCH) 1090, 1101 (1970) (stating that the definition of tax partnership is broader than state law); *Linsenmeyer v. Comm'r*, 25 T.C. 1126, 1132 (1956) (noting that status under state law is irrelevant); *Stern v. Comm'r*, 15 T.C. 521, 526–28 (1950) (disregarding whether state law allows person to be a partner).

313. *Treas. Reg. § 301.7701-1(a)(1)* (as amended in 2005) (“[The definition of tax partnership] is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.”).

314. See, e.g., *Joe Balestrieri & Co. v. Comm'r*, 177 F.2d 867, 871 (9th Cir. 1949) (finding arrangement not a tax partnership because it did not satisfy the California definition of joint venture); *Winmill v. Comm'r*, 93 F.2d 494, 495–96 (2d Cir. 1937) (holding that since arrangement was a joint venture it was a tax partnership), *rev'd on other grounds sub nom. Helvering v. Winmill*, 305 U.S. 79 (1938); *First Mechs. Bank v. Comm'r*, 91 F.2d 275, 280 (3d Cir. 1937) (holding that since arrangement was a joint venture it was a tax partnership); *Comm'r v. Olds*, 60 F.2d 252, 254 (6th Cir. 1932) (relying upon Michigan law); *Powell v. Comm'r*, 26 T.C.M. (CCH) 161, 163–64 (1967) (holding arrangement to be a TIC under state law); *Copeland v. Ratterree*, 57-2 U.S. Tax Cas. (CCH) ¶ 9895, at 58,195 (N.D.N.Y. 1957) (concluding that arrangement having been made in Vermont, it should be interpreted according to the laws of the state of Vermont); *Estate of Appleby v. Comm'r*, 41 B.T.A. 18, 20–21 (1940) (holding arrangement not a tax partnership because it was a TIC under state law); see also *Estate of Strangi v. Comm'r*, 115 T.C. 478, 486–87 (2000) (relying upon state-law classification to hold that a tax partnership existed for purposes of applying the minority discount to determine the value of a gift), *aff'd in part, rev'd in part*, 293 F.3d 279 (5th Cir. 2002).

315. Although the Supreme Court in *Tower* held that state-law definitions did not bind the court, see *Tower*, 327 U.S. at 288, other subsequent decisions have applied state law to define tax partnership. See *supra* note 314 (listing multiple decisions in which courts have relied upon the state-law characterization of a tax partnership). Perhaps these later decisions indicate the state-law test is still viable.

316. See, e.g., *Estate of McLendon v. Comm'r*, 135 F.3d 1017, 1024–25 (5th Cir. 1998) (holding that IRS is bound by position stated in revenue ruling); *Rauenhorst v. Comm'r*, 119 T.C. 157, 183 (2002) (“Certainly, the Commissioner’s failure to follow his own rulings would be unfair to those taxpayers, such as petitioners herein, who have relied on revenue rulings to structure their transactions. Moreover, it is highly inequitable to impose penalties, which respondent has done in this case. Accordingly, in this case, we shall not permit respondent to argue against his revenue ruling, and we shall treat his revenue ruling as a concession.”); I.R.S. Notice, CC-2003-014 (May 8, 2003) (“[IRS] litigating positions should be derived from, and consistent with, the Internal Revenue Code and our published guidance.”). Published guidance includes regulations.

317. *Treas. Reg. § 301.7701-1(a)(1)* (as amended in 2005).

situations may be to invoke the estoppel test, which considers state-law classification.<sup>318</sup> This, however, would require more than a mere showing of the existence of a state-law entity.<sup>319</sup> The state-law test, at a minimum, appears to have life in practice. Competent tax advisors would hesitate to advise a client to join a state-law entity if the client wished to avoid becoming a member of a tax partnership.<sup>320</sup>

3. *The Joint-Profit Test.* The joint-profit test excludes from the definition of tax partnership arrangements that lack a joint-profit motive.<sup>321</sup> Joint profit is an element of the substantive-law test,<sup>322</sup> but it has found special application defining qualified tax partnerships.<sup>323</sup> Qualified tax partnerships are those arrangements that meet the definition of tax partnership but are not required to follow the partnership tax accounting and reporting rules.<sup>324</sup> Generally, only co-owned joint-production arrangements are considered qualified tax partnerships.<sup>325</sup>

Co-owned joint-production arrangements are those whose members co-own property and pool resources to produce something from the co-owned property.<sup>326</sup> The arrangement

318. See *infra* text accompanying note 408 (describing the estoppel test).

319. *Id.*

320. See *supra* note 13 (describing the TIC industry, which has grown up from this hesitancy).

321. I.R.C. § 183 (2000).

322. See *supra* text accompanying note 231 (explaining that profit sharing is a component of a partnership for taxation purposes).

323. Such arrangements were first referred to as qualified partnerships in I.T. 3930, 1948-2 C.B. 126, 129 ("The Bureau, under [(I.T. 2749 and I.T. 2785)], has consistently treated all such operating agreements as creating qualified partnerships . . .").

324. *Id.* ("That being true, such organizations may be classified for Federal income tax purposes as joint ventures or partnerships only in a qualified sense. Under I.T. 2749 and I.T. 2785, such joint operators are required to file qualified partnership returns showing only items of gross income and deduction." (citations omitted)); see also I.R.C. § 761(a)(2) (2000) (allowing members of certain co-owned joint-production arrangements to elect out of subchapter K).

325. I.T. 3930, 1948-2 C.B. at 128-29.

326. See, e.g., *id.* at 126-27. Under a typical oil and gas co-owned joint-production arrangement, members own an interest in property that produces oil. *Id.* at 126. Often, such interest is an oil lease. *Id.* This interest allows the interest holder (or the agent of an interest holder) to enter the land under which the oil and gas is located to obtain the oil and gas. *Id.* The members may provide the services necessary to obtain the oil and gas or may hire others to perform such services. *Id.* Arrangements may allow members to take production in kind or provide that the arrangement will sell the oil and gas and distribute the income to the members in proportion to their interest in the arrangement. *Id.* The features listed include:

(1) The costs of development and expenses of operation are to be prorated among the parties in accordance with their respective interests. (2) Division of oil proceeds is usually accomplished by payment of the purchase price by the pipeline company or other purchaser directly to the several parties in accordance

distributes the product in kind to the members who dispose of it individually.<sup>327</sup> Members of arrangements of this sort often co-own oil and gas property, co-produce oil and gas, and distribute it to the members who sell the oil and gas individually;<sup>328</sup> co-own power plants and distribute co-produced electricity in kind to the members;<sup>329</sup> or co-own and co-mine mineral or other extractive property, the product of which the arrangement distributes to its members in kind.<sup>330</sup> Distributing the product in kind raises the question of whether members of such an arrangement have a joint-profit motive and should be tax partnerships or lack a joint-profit motive and should be qualified tax partnerships or tax nothings. The IRS has ruled that members of co-owned joint-production arrangements lack a joint-profit motive,<sup>331</sup> but the Tax Court<sup>332</sup> and the Seventh Circuit<sup>333</sup> have held that the members possess a joint-profit motive. The source of these disparate

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with their respective shares as indicated by division orders signed by them. Generally, any party may take his share of the oil in kind. Where that right exists, any authority given the operator to market the oil may be revoked upon proper notice. Sometimes, however, the operator is authorized without qualification to market the product. (3) The operator is required to carry adequate insurance and to make an accounting. (4) Operating agreements remain in force until the mineral is exhausted or, in the case of unit operating agreements, for the term of the lease or leases or renewals thereof. Sometimes an express provision is made for withdrawal of one of the parties by assignment of his rights to the others. (5) The parties having voting power proportionate to their interests to choose and advise the operator (in cases in which only one lease is involved, broad powers are commonly vested in the operator named in the agreement), to change the operator, to determine drilling and operating plans, to audit and pass on the operator's accounting, and to pass on transactions for disposal of surplus equipment. (6) Any party may sell or encumber his entire interest, but may not subdivide or sell without giving the others preferential option (in the case of agreements covering single leases, the contract may not contain express provisions to that effect). (7) The liabilities of the parties are to be separate and not joint.

*Id.* at 126-27.

327. Rev. Rul. 83-129, 1983-2 C.B. 105 (describing an arrangement in which minerals produced as a result of a mineral claim lease are distributed in kind to the partners).

328. See, e.g., *id.*; Rev. Rul. 65-118, 1965-1 C.B. 30, 31. If the members have no control over the disposition of the property received from the arrangement, the arrangement would not satisfy this definition of co-owned joint-production arrangement.

329. See, e.g., *Madison Gas & Elec. Co. v. Comm'r*, 633 F.2d 512, 517 (7th Cir. 1980) (holding an arrangement to be a tax partnership); Rev. Rul. 68-344, 1968-1 C.B. 569, 572 (finding arrangement a tax partnership, eligible for the section 761(a)(2) election).

330. See, e.g., I.R.S. Priv. Ltr. Rul. 83-15-003 (June 17, 1982) (holding a mining arrangement to be a tax partnership).

331. I.T. 3930, 1948-2 C.B. 126, 129 ("In such cases there is no joint profit contemplated . . . by the associates.").

332. *Madison Gas & Elec. Co. v. Comm'r*, 72 T.C. 521, 562 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980).

333. *Madison Gas & Elec. Co.*, 633 F.2d at 515-17.

positions appears to be the respective definitions of profit that each adopts.

Following the enactment of the statutory definition of tax partnership, the IRS ruled that a co-owned joint-production arrangement that was a substantive-law joint venture was a tax partnership.<sup>334</sup> The IRS stated that “ordinarily joint or coownership of property does not of itself constitute a partnership . . . [but,] when the coowners or joint owners agree to employ such property in the carrying on of a trade or business they become partners.”<sup>335</sup> The statutory definition of tax partnership (which included joint ventures at the time) bound the IRS to rule that the arrangement was a tax partnership once it found that the arrangement was a substantive-law joint venture. In a subsequent ruling, the IRS ruled that the same type of tax partnership was not required to follow the partnership tax accounting and reporting rules.<sup>336</sup>

This created the first qualified tax partnership.<sup>337</sup> Unfortunately, the IRS left no clue at the time of the ruling about

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334. I.T. 2749, 8-1 C.B. 99, 99-100 (1934) (citing *Hobart-Lee Tie Co. v. Goodsky*, 46 S.W.2d 859 (Mo. 1931); 47 C.J. § 98 (1929)) (concluding that “[i]n the instant case the coownerships of the oil and gas leases and the operations thereunder may be fairly considered as falling within the broad scope of the term ‘joint venture.’ While the term ‘joint venture’ is usually, but not necessarily, limited to a single transaction, it has been held that the business of conducting such a venture to a successful termination may continue for a number of years. It is true that ordinarily joint or coownership of property does not of itself constitute a partnership but it is also true that when the coowners or joint owners agree to employ such property in the carrying on of a trade or business they become partners” (citations omitted)).

This ruling is opposite of a regulation the IRS revoked not long before the ruling. See Regulations 74, Art. 1317 (1931) (“Coowners of oil lands engaged in developing the property through a common agent are not necessarily partners.”).

335. I.T. 2749, 8-1 C.B. at 100 (citing 47 C.J. § 98 (1929)). The arrangement between the members provided that (1) the gross revenue from such properties would be paid to and accounted for by the co-owners monthly, (2) the co-owners would pay expenditures in the development and operation of the properties monthly, (3) gross and net income would be settled monthly, and (4) the accounting method would result in a complete periodical account for revenue and expense in the same manner as in the case of a separate piece of property. *Id.* at 99-100.

336. See I.T. 2785, 8-1 C.B. 96, 96-97 (1934). The ruling allowed the operating co-owner to file Form 1065 and an attached schedule provided by the IRS. *Id.* The schedule was required to show the (1) “total working interest,” (2) “names and addresses of the coowners,” (3) “the percentage of each coowner’s interest in the coownership,” (4) “total costs and expenses billed each coowner with respect to drilling for and producing the oil and gas,” and (5) “the total revenue credited in those cases where the operating coowner distributed revenue to the other coowners (by way of credit or cash) from the sale or other disposition of the coowners’ oil and gas.” *Id.*

337. Qualified partnerships are preserved under today’s tax laws. See I.R.C. § 761(a) (2000) (defining “partnership” and explaining how qualified partnerships can be exempted from the application of subchapter K); Borden et al., *supra* note 69, at 1182 (“Later IRS Rulings and court decisions . . . appear to interpret section 761 as a codification of I.T.

why it exempted qualified tax partnerships from the partnership tax accounting and reporting requirements.<sup>338</sup>

Later the IRS articulated the joint-profit test and applied it to rule that a co-owned joint-production oil and gas arrangement was a qualified tax partnership.<sup>339</sup> The primary issue was whether the arrangement was a tax corporation or a tax partnership.<sup>340</sup> Nonetheless, the IRS applied the joint-profit test

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3930.”). *But see* *Madison Gas & Elec. Co.*, 633 F.2d at 515–16 (“Section [761(a)] has generally been interpreted, in the absence of any legislative history, as approving the *Bentex* decision while providing relief from certain resulting hardships. . . . This interpretation is surely correct . . .” (citations omitted)); McMahon, *supra* note 115, at 10 (“Most consider . . . that Congress enacted [section 761(a)] in reaction to the *Bentex Oil* decision.” (citing Marvin K. Collie & Joseph P. Driscoll, *Partnership Oil and Gas Operations Under Provisions of the Internal Revenue Code of 1954*, 33 TEX. L. REV. 792, 794–95 (1955); Joseph Taubman, *Oil and Gas Partnerships and Section 761(a)*, 12 TAX L. REV. 49, 58 (1957))). Section 761(a)(2) “simultaneously confirms and ameliorates the result in *Bentex Oil*.” *Id.*

338. The IRS probably acted illegally in creating qualified partnerships. In 1934, there was no other legal authority allowing an arrangement that was a tax partnership under the statutory definition to not follow the partnership accounting and reporting rules. Since the IRS provided no basis in the law to support its ruling, we are left to speculate why it created qualified tax partnerships. Commentators have since questioned the IRS’s authority to circumvent the established rule of law enumerated in statute and by the courts for administrative convenience in entity classification. *See* Polsky, *supra* note 28, at 221–39 (arguing that the Treasury acted beyond the scope of its authority in promulgating the check-the-box regulations, which conflict with prior case law (*Morrissey v. Commissioner*, 296 U.S. 344 (1935)) and the statutory definition of tax corporation in sections 7701(a)(2) and (a)(3), and that if these rules favor taxpayers, taxpayers are unlikely to challenge them). *But see* Littriello v. United States, 2005-1 U.S. Tax Cas. (CCH) ¶ 50,385, at 88,059 (W.D. Ky. 2005) (rejecting the taxpayer’s claim that the check-the-box regulations are invalid). The qualified tax partnership ruling did not impose an apparent burden on taxpayers since they in effect gave taxpayers involved in oil and gas co-ownership joint-production arrangements the election to follow the partnership tax accounting and reporting rules or to not follow them. With this opportunity to choose, it is unlikely that the rules will be challenged. *But see* *Bentex Oil Corp. v. Comm’r*, 20 T.C. 565, 571 (1953) (involving a taxpayer challenge to the partnership classification in oil and gas co-ownership joint-production arrangement).

339. *See* I.T. 3930, 1948-2 C.B. 126, 128–29 (explaining that “if the joint objective is limited to development and the extraction and processing of mineral . . . for division in kind or for sale for the accounts of the several participants individually, the test of a joint venture for joint profit is not met”).

340. Indeed, in I.T. 3930, the IRS considered whether an oil and gas co-owned joint-production arrangement was a tax corporation. *Id.* at 126–29. First, the IRS distinguished the subject agreements from general partnerships

principally in that (1) they can arise only between joint operators, (2) they extend to and are terminated by exhaustion of the mineral deposit, (3) the majority in interest controls policies, and (4) the death of a participant or the transfer of his interest does not interrupt the relation—the heir or transferee becoming a participant.

*Id.* at 127. Second, the IRS stated that both a joint-profit motive and the carrying on of a business indicate the existence of either a tax partnership or a tax corporation, but does distinguish them from each other. *Id.* Third, the IRS stated that arrangements that have centralized management and continuity of interest are not tax partnerships. *Id.* at 128. Fourth, the IRS nonetheless disregarded centralized management and continuity of life



to rule that the arrangement was a qualified tax partnership.<sup>341</sup> As articulated by the IRS, the joint-profit test provides that a co-ownership arrangement is a qualified tax partnership if it (1) is not a state-law corporation, (2) has sufficient business-like activity, and (3) does not have a joint-profit motive.<sup>342</sup> Under the definition of tax corporation, a state-law corporation could not have been a tax partnership.<sup>343</sup> Thus, to be considered a tax partnership, the arrangement had to be something other than a state-law corporation. The first factor of the IRS's test addresses this. The second and third factors are elements of the substantive-law definition of partnership.<sup>344</sup> Because co-owned joint-production arrangements have significant business activity,<sup>345</sup> the third factor's joint profit is the focus with such arrangements. Whether such an arrangement is a tax partnership under the joint-profit test depends upon the definition used to define profit.<sup>346</sup>

The IRS originally appeared to adopt the accounting definition of profit.<sup>347</sup> It ruled that a joint-profit motive exists if a product is sold through the joint efforts of two or more parties.<sup>348</sup>

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and focused on joint-profit motive to rule that the arrangement was a tax partnership. *Id.* Because there was no joint profit, the IRS classified such arrangements as qualified tax partnerships. *Id.* at 129. This ruling is fascinating because it classified an arrangement with continuity of life and centralized management as a qualified tax partnership, after stating that those were the two defining characteristics of a tax corporation. Arguably, the arrangement was a tax corporation under the laws in effect at the time. *See also Morrissey*, 296 U.S. at 361–62 (applying the corporate-resemblance test later adopted in the *Kintner* regulations).

341. I.T. 3930, 1948-2 C.B. at 129.

342. Later, the absence of a joint-profit motive became important to co-ownership joint-production arrangements wishing to elect out of subchapter K under section 761(a)(2). *See* Treas. Reg. § 1.761-2(a)(3) (as amended in 1994) (allowing members of co-owned joint-production arrangements to elect out of subchapter K if they own property as co-owners, reserve the right to take product in kind, and do not jointly sell the product). *But see Madison Gas & Elec. Co.*, 633 F.2d at 516–17 (indicating that distributions of property in kind may be a form of profit sharing).

343. *See supra* text accompanying note 27 (illustrating the fact-intensive, six-characteristic test used to define tax partnership).

344. *See supra* text accompanying note 229 (defining what partnership means under substantive law). The second factor's business activity is the same as the substantive-law definition's requirement that the parties carry on a business. The factor is analogous to the profit sought by the parties under the substantive-law definition.

345. *See* *Madison Gas & Elec. Co. v. Comm'r*, 72 T.C. 521, 559–60 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980) (declaring that in order to be partners, the parties must "actively carry on a trade, business, financial operation, or venture").

346. The substantive-law test may adopt all definitions of profit. In which case, these arrangements would be tax partnerships under the substantive-law test. Whether they are excluded, at least in part, from the definition of tax partnership under the joint-profit test, turns on the definition of profit incorporated by the test.

347. I.T. 3930, 1948-2 C.B. 126, 128–29.

348. *Id.* at 126 ("[W]here agreements irrevocably vest the operator in his

In such cases, the joint sale of the product vests the arrangement with ownership of the product and of the revenue derived from the sale of the product.<sup>349</sup> The arrangement also has expenses, which it deducts from its revenue, creating an arrangement-level profit (under the accounting definition).<sup>350</sup> Dividing this profit among the members creates a joint profit.<sup>351</sup> No joint-profit motive exists, however, if the arrangement distributes the product to the members who sell the product individually.<sup>352</sup> In such a situation, the arrangement has no revenue, so it can have no profit under the accounting definition of profit.<sup>353</sup> Such an arrangement may be a qualified tax partnership.<sup>354</sup>

In *Madison Gas & Electric Co. v. Commissioner*,<sup>355</sup> the Seventh Circuit later used the dictionary definition of profit to hold that if the definition of tax partnership requires a joint-profit motive, co-owned joint-production arrangements possess

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representative capacity with the authority to extract and sell the mineral, there are created for income tax purposes associations taxable as corporations, which associations are the owners of the depletable economic interests in the oil and gas in place and of the income derived from operations.”).

349. *Id.*

350. *See supra* text accompanying note 238 (identifying the dictionary definition of profit).

351. I.T. 3930, 1948-2 C.B. at 128-29.

352. *Id.* at 129 (“As such agreements commonly allow the participants to take their shares of the mineral in kind (or provide for the sale of the shares of the respective participants for their individual accounts under revocable agency powers), the sale of the mineral, even though made by the operator, is a sale by or on behalf of the individual participants. In such cases, there is no joint profit contemplated or realized by the associates. . . . [I]t is held that the participants, through the partnership thus created, individually own depletable economic interests in the oil and gas in place and must report the proceeds therefrom as their income.” (citations omitted)).

353. *See id.*

354. *See, e.g.,* Rev. Rul. 68-344, 1968-1 C.B. 569, 569-72 (involving a group of electrical power corporations that owned several large power-generating units as tenants-in-common and had the right to take their respective shares of power generated and sell them to their respective end-users). In Revenue Ruling 68-344, the IRS, relying on I.T. 3930, ruled that the joint ownership and operation of the arrangement was “substantially like the conduct of a business,” but “there [was] no division of [profits] . . . because all gain [was] derived from sales of power by each . . . participant for its own account.” *Id.* at 570. Because the arrangement was not a tax trust, a tax estate, or a tax corporation, and something more than a mere expense-sharing arrangement, the IRS ruled it was a tax partnership eligible for the section 761(a)(2) election or a qualified tax partnership. *Id.* at 571.

355. *Madison Gas & Elec. Co. v. Comm’r*, 633 F.2d 512, 514-17 (7th Cir. 1980) (involving a typical co-owned joint-production arrangement in which one co-owner wished to deduct certain employee training expenses related to a co-owned electricity plant). In *Madison Gas & Elec. Co.*, the IRS took the position that the expenses were incurred in the start up of a new tax partnership and therefore were not deductible currently. *Id.* at 514. The court rejected the taxpayer’s argument that there must be a joint-profit motive for a tax partnership to exist as defined by sections 7701 and 761. *Id.* at 515-17.

the requisite joint-profit motive. The Seventh Circuit adopted the Tax Court's reasoning:

[T]he test of . . . profit motive for purposes of finding a Federal tax partnership is clearly met in the situation at hand where a group of business organizations decide to band together to produce with economies of scale a common product to be distributed to the members of the venture in kind.<sup>356</sup>

Addressing the profit motive, the Tax Court stated, "To the extent a profit motive may be required for an unincorporated organization to be a partnership for Federal tax purposes, we hold that it is present in this case with the in kind distribution of electricity produced by the nuclear power plant."<sup>357</sup> This mirrors the dictionary definition of profit, which provides that profits are the "benefit or advantages accruing from . . . the carrying on of any process of production."<sup>358</sup> Under the dictionary definition of profit, the economies of scale are the benefits accruing from carrying on the production process jointly. As this holding demonstrates, the dictionary definition of profit abolishes the joint-profit test as all arrangements that carry on business as co-owners will realize some benefit from doing so; otherwise they would not join together.

The accounting-definition-based joint-profit test is preserved in section 761(a)(2), which allows certain arrangements that co-own property and distribute production from the property in kind to its members to elect out of subchapter K.<sup>359</sup> The arrangement in *Madison Gas & Electric Co.* should have satisfied the requirements in section 761(a)(2) and been able to elect out of subchapter K.<sup>360</sup> Section 761(a)(2) requires that the arrangement

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356. *Madison Gas & Elec. Co. v. Comm'r*, 72 T.C. 521, 562 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980).

357. *Id.* at 563. *But see* Harlan E. Moore Charitable Trust v. United States, 9 F.3d 623, 624-25 (7th Cir. 1993) (holding that even though the landlord paid some of the farming costs, rent received pursuant to a sharecropping agreement in the form of one-half of all grain produced on the farm did not constitute a share of the profits because "[p]rofits are sales net of [all] cost").

358. *See supra* text accompanying note 238 (denoting the dictionary definition of profit).

359. *See* Rev. Rul. 68-344, 1968-1 C.B. at 571 (providing the requirements that the organization must meet in order to choose to be exempted from subchapter K).

360. *See id.* (containing a pre-*Madison Gas and Elec. Co.* ruling that the Seventh Circuit did not overturn). The court in *Madison Gas and Elec. Co.* did not consider the validity of the partnership's section 761(a)(2) election. It did, however, indicate that its decision does not affect the partnership's ability to make the election. *Madison Gas & Elec. Co.*, 72 T.C. at 563. It quoted the Tax Court, stating "[i]f distribution in kind of jointly produced property is enough to avoid partnership status, we do not see how such distribution could be used as a test for allowing an election to be excluded from the

not sell produced property to qualify for the election.<sup>361</sup> Thus, the rule adopts the IRS's joint-profit motive test. Unfortunately, section 761(a)(2) appears to be the extent of its applicability today.<sup>362</sup>

4. *The Expense-Sharing Test.* The expense-sharing test is closely related to the joint-profit test. The expense-sharing test provides that "a joint undertaking merely to share expenses [is not a tax partnership]."<sup>363</sup> For example, "if two or more persons jointly construct a ditch merely to drain surface water from their properties," they are not partners.<sup>364</sup> This test is similar to the joint-profit test because both tests apply to arrangements that engage in significant activity but do not market or sell a product. The expense-sharing test is, however, different from the joint-profit test because it applies only to arrangements that do not produce a product or services, whereas the joint-profit test applies to arrangements that produce a product or services.<sup>365</sup>

5. *The Degree-of-Activity Test.* The degree-of-activity test provides that if two or more parties co-own property and carry on more than a certain degree of activity, they will be a tax partnership.<sup>366</sup> One court has articulated the degree-of-activity

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partnership provisions of subchapter K." *Id.*

361. I.R.C. § 761 (a)(2) (2000).

362. See McMahon, *supra* note 115, at 11–12 (observing that section 761(a)(2) would be rendered meaningless if the lack of joint-profit motive precludes partnership classification and the I.T. 3930 standard for joint-profit motive applies).

363. Treas. Reg. § 301.7701-1(a)(2) (as amended in 2006).

364. *Id.*

365. See *Madison Gas & Elec. Co.*, 72 T.C. at 561–62 (distinguishing the co-owned joint-production arrangement at issue from the expense-sharing arrangement in the regulations). Under the dictionary definition of profit, members of an expense-sharing arrangement could have a joint profit. See *supra* text accompanying note 238 (addressing the dictionary definition of profit). For example, in the ditch-digging hypothetical, the parties benefit from the ditch draining water from their properties, which they constructed through joint efforts. Thus, some may argue that the expense-sharing test is identical to the joint-profit test. However, the regulation still preserves the distinction.

366. See, e.g., *Gilford v. Comm'r*, 201 F.2d 735, 736 (2d Cir. 1953) (declaring that services required to maintain property in rental condition are not sufficient for establishing a tax partnership); *Cusick v. Comm'r*, 76 T.C.M. (CCH) 241, 243 (1998) (performing services necessary to maintain property and co-owners' testimonies that arrangement was a tax partnership sufficient to be tax partnership); *Gabriel v. Comm'r*, 66 T.C.M. (CCH) 1283, 1287 (1993) (finding that an arrangement with little or no business activity was not a tax partnership); *Marinos v. Comm'r*, 58 T.C.M. (CCH) 97, 100 (1989) ("[T]he distinction between mere co-owners and co-owners who are engaged in a partnership lies in the degree of business activity of the co-owners or their agents."); *Estate of Levine v. Comm'r*, 72 T.C. 780, 785–86 (1979) (involving a tax partnership where partners engaged in an active business and performed various services); *McShain v. Comm'r*, 68 T.C. 154, 160 (1977) (leasing under a net lease not sufficient activity to make co-owners tax partners); *Hahn v. Comm'r*, 22 T.C. 212, 214 (1954) ("Tenants in

test: "The regulations and relevant case law indicate that the distinction between mere coowners and coowners who are engaged in a partnership lies in the degree of business activities of the coowners or their agents."<sup>367</sup> As thus articulated, the degree-of-activity test focuses on the arrangement's degree, or quantum, of activity. If an arrangement performs more than a specific quantum of business activity, it will be a tax partnership.

6. *The Type-of-Activity Test.* Under the type-of-activity test, two or more parties who co-own property are not a tax partnership if they hire someone to provide services that only support the income-producing function of the property.<sup>368</sup> The Second Circuit appears to be one of the first appellate courts to rely upon the type-of-activity test to rule that an arrangement was not a partnership, even though the arrangement conducted some business activity.<sup>369</sup> The court found that the regular and continuous activity of maintaining the property in rental condition and supplying such services for the tenants as were needed to rent the property to good advantage constituted a trade or business under section 1231.<sup>370</sup> Because they satisfied the section 1231 trade or business requirement they should also satisfy the business activity requirement of the substantive-law

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common who rent their property are not ipso facto tax partners for tax purposes."); Rev. Rul. 75-374, 1975-2 C.B. 261 (noting that a co-ownership arrangement is not a tax partnership if the manager hired by the co-owners' only provides customary tenant services); Treas. Reg. § 301.7701-1(a)(2) (as amended in 2006) (stating that a separate entity may exist if co-owners provide services to the occupants).

367. *Cusick*, 76 T.C.M. (CCH) at 243. The court discussed the level of business activity, but because the degree of business activity seemed to be so low, it appears this was not the sole basis of the court's decision. *Id.*; see also, e.g., *Gilford*, 201 F.2d at 736 (holding that an arrangement with similar degree of activity was not a tax partnership).

368. As the discussion in this Part of the Article indicates, the cases and rulings that apply the type-of-activity test always involve a manager who performs the services.

369. The court used the term "degree", but its discussion and holding indicate it was considering the type of business activity. *Gilford*, 201 F.2d at 736. In *Gilford*, two individuals hired a real estate agent to manage the real property and account to them. *Id.* The case was before the court because the taxpayer wished to deduct losses from the sale of the property as capital losses to obtain carry forward opportunities. *Id.* If the taxpayer had been deemed to be in a tax partnership with the other co-owners, the sale would have been of a partnership interest and the loss would have been a capital loss. The IRS prevailed and the court's holding that the arrangement was not a tax partnership resulted in the loss being ordinary. *Id.*

370. *Id.* These are the same type of activities the IRS has referred to as customary tenant services. See Rev. Rul. 75-374, 1975-2 C.B. 261 (explaining that such provisions as heat, air conditioning, and normal repairs are customary tenant services). The Treasury also allows arrangements to perform such services without becoming tax partnerships. See Treas. Reg. § 301.7701-1(a)(2) (as amended in 2006) ("[M]ere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes.").

test.<sup>371</sup> Because the members of the arrangement also shared in the profit of the arrangement,<sup>372</sup> the arrangement would be a tax partnership under the substantive-law test.<sup>373</sup> Nonetheless, the court held that the co-ownership arrangement was not a tax partnership.<sup>374</sup>

Services provided to maintain the property in rental condition are customary tenant services.<sup>375</sup> Such services support the income-producing function of rental property and are thus support services. The type-of-activity test does not address arrangements that provide additional services. Nor does it address arrangements that provide only support services if a member provides the services. In fact, of the various types of services arrangements, the type-of-activity test only governs two.

a. Pure Co-Ownership Arrangements. Two individuals, Ali and Bill, create a pure co-ownership arrangement. They each own an equal share of a piece of raw land that they lease long-term to a rancher who grazes cattle on the land. The lease requires the lessee to maintain the property and pay all the taxes and other expenses associated with the property, so the owners provide no services to the lessee. The sole source of Ali and Bill's income from this arrangement is the rent which the property generates.<sup>376</sup> In this simple economic arrangement, the property generates income without the members providing any services. The arrangement has no activity, so the arrangement would not be a tax partnership under the type-of-activity test, or the degree-of-activity test for that matter.

b. Manager-Provided Support Services Arrangements. Manager-provided support services are support services provided by a person other than a member of the arrangement (i.e., a

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371. See I.R.C. § 1231(a)(3), (b)(1) (2000) (explaining that a section 1231 loss is a loss from the sale of property used in a trade or business).

372. *Gilford*, 201 F.2d at 736.

373. See *supra* text accompanying note 229 (defining partnership under substantive law).

374. *Gilford*, 201 F.2d at 736 (looking in part to the intent of the parties to determine that they had not formed a partnership but basing its holding on the type of activity and explaining that "the mere holding of business property by tenants in common does not make such tenants partners in the tax sense, in the absence of any showing of an intention to become partners").

375. Rev. Rul. 75-374, 1975-2 C.B. at 261.

376. This assumes the lease is long term, not requiring frequent negotiation. Although the co-owners would be required to negotiate the original lease, such services would be nominal. Such nominal amounts of services have generally been ignored in considering the definition of tax partnership. See *supra* note 366 (identifying cases in which services were provided but no tax partnership held to exist).

manager). If the services are provided by a manager who is paid a fair market management fee,<sup>377</sup> the type-of-activity test will exclude the arrangement from the definition of tax partnership. Thus, if, in the example above, Ali and Bill agreed to maintain the fences on their property merely to keep it in rental condition, the arrangement would not be a tax partnership if they hired Carol to maintain the fences and paid her market rate. The type-of-activity test does not answer whether the arrangement would be a tax partnership if either Ali or Bill provided the services. The source-of-activity test addresses that issue.

c. **Additional-Services Arrangements.** Additional-services arrangements are co-ownership arrangements that provide more than customary tenant services.<sup>378</sup> For example, in addition to maintaining the fences, Ali and Bill may agree to ride herd on the tenant's cattle for a separate fee. Riding herd does not merely enhance the income-producing function of the property; it generates additional income. Therefore, the type-of-activity test would not exclude this arrangement from the definition of tax partnership. The type-of-activity test does not, however, answer whether providing additional services creates a separate tax partnership.<sup>379</sup> Perhaps the property and customary tenant services should be treated as a tax partnership separate from the provision of additional services. The additional-services arrangement should be treated like a pure services arrangement.

d. **Pure Services Arrangements.** A simple two-member law firm is an example of a pure services arrangement. The attorneys' services generate income. They do not support the income-producing function of any property. Therefore, the

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377. The fee paid to the manager does not have to be a fixed fee to avoid tax partnership classification. Several courts have allowed agents to receive a share of profits in exchange for services without being treated as tax partners. *See, e.g.,* Comm'r v. Banks, 543 U.S. 426, 436 (2005) (finding that client retained control of lawsuit, so no tax partnership existed even though attorney shared in profits); *Estate of Kahn v. Comm'r*, 499 F.2d 1186, 1190 (2d Cir. 1974) (stating that employee had a subordinate interest in profits, so there was not a tax partnership); *Badger Co. v. Comm'r*, 26 T.C.M. (CCH) 869, 873-74 (1967) (concluding that because compensation was stated as "an amount equal to" a percentage of payments and not as a share of payments, the agent was not a tax partner); *Luna v. Comm'r*, 42 T.C. 1067, 1079 (1964) (finding that no tax partnership existed even though taxpayer compensation was determined as a share of profits); *Copeland v. Ratterree*, 57-2 U.S. Tax Cas. (CCH) ¶ 9895, at 58,195 (N.D.N.Y. 1957) (emphasizing that control, not profit-sharing, is the most important factor).

378. Rev. Rul. 75-374, 1975-2 C.B. at 261.

379. In Revenue Ruling 75-374, the IRS implied that sharing in profits from the additional services would create a tax partnership. *Id.* That ruling does not, however, indicate whether the tax partnership would consist of the property ownership and provision of additional services or just of the provision of additional services.

arrangement does not satisfy the type-of-activity test, so it will not be excluded from the definition of tax partnership under that test.

e. **Dealer Arrangements.** Dealer arrangements involve both property and services, but the property supports the income-producing function of the services, which are the primary source of the arrangement's income. The classic example of this is the subdivision and disposition of real estate.<sup>380</sup> For example, if Developer and Seller each pay 50% of the acquisition cost of property and Developer subdivides it and Seller sells it, income is derived from the subdivision and selling activity, not the appreciation in the investment property.<sup>381</sup> Because the activity generates separate income, the arrangement would not be excluded from the definition of tax partnership under the type-of-activity test.

7. *The Source-of-Activity Test.* Under the source-of-activity test, an arrangement is a tax partnership if at least one member of the arrangement contributes services, the arrangement's property and services provide an economic benefit, and all the members of the arrangement share in that economic benefit.<sup>382</sup> This test was most prominently applied in the computer-leasing cases of the 1980s and 90s.<sup>383</sup> In those cases, investors borrowed

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380. Dealers in other property experience the same phenomenon. For example, securities dealers may own securities, but the economic benefit comes from their skills of buying and selling, not from holding the property for investment. The question of whether a party is a dealer or investor is not a simple question. There are a significant number of cases that address the issue with no apparent consistency. *Compare* *Suburban Realty Co. v. United States*, 615 F.2d 171, 181–82 (5th Cir. 1980) (holding that taxpayer was a dealer on basis of sufficient activity), *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 416–17 (5th Cir. 1976) (concluding that taxpayer was a dealer as a result of the subdivision and selling activities), *and* *Bynum v. Comm'r*, 46 T.C. 295, 300 (1966) (same), *with* *Estate of Barrios v. Comm'r*, 29 T.C. 378, 383–85 (1957) (holding that taxpayer was not a dealer despite subdivision and selling activity). In the tax partnership context, having established that an arrangement is a dealer, the economic benefit comes from the services, not the property.

381. By treating the income from the sale of dealer property as ordinary income, the tax system treats the gain as derived from the activities of the owners, not from the investment in the property. *See* Marjorie E. Kornhauser, *The Origins of Capital Gains Taxation: What's Law Got to Do with It?*, 39 Sw. L.J. 869, 890 (1985) ("The distinction between investor and businessman is critical here, as it was in Britain, because the former held his capital to produce income in the form of rents, dividends, or interest; the latter used his capital to buy and sell assets such that the act of buying and selling produced income in the form of the gains realized from the increased value.").

382. *See* Borden, *supra* note 115, at 56 (explaining what the source-of-activity test requires for a tax partnership to exist).

383. *Bergford v. Comm'r*, 12 F.3d 166, 166–67 (9th Cir. 1993); *Alhouse v. Comm'r*, 62 T.C.M. (CCH) 1678, 1678 (1991), *aff'd sub nom. Bergford*, 12 F.3d 166; *Bussing v. Comm'r*,



money from an unrelated party—the manager—and, with additional personal money, acquired undivided interests in computer equipment.<sup>384</sup> The manager arranged to triple-net lease the property to unrelated parties and performed all other activities necessary to lease the property.<sup>385</sup> These activities appear to be nothing more than support services. Because a member of the arrangement contributed them to the arrangement,<sup>386</sup> however, the type-of-activity test did not apply to the computer-leasing cases.

The source-of-activity test connects the source of activity to the source of economic benefit.<sup>387</sup> The Tax Court stated that “the economic benefits to the individual participants were not derivative of their coownership of the computer equipment, but rather came from their joint relationship toward a common goal.”<sup>388</sup> The joint relationship consisted of the investor’s contribution of property and the manager’s contribution of services, both of which created an economic benefit that was shared by all members.<sup>389</sup> The following examples demonstrate the connection between contributions and economic benefit.

An arrangement may provide services in one of three ways: (1) one or more of the members may contribute services to the arrangement, (2) the members may hire an unrelated party at fair market value to provide the services, or (3) the arrangement may pay one or more of the members fair market compensation (not a share of the profits) to perform the services.

a. **Member-Contributed Services.** Assume two individuals, Ephraim and Fran, own an apartment complex. Their standard lease agreement provides that they will perform all services

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89 T.C. 1050, 1051–52 (1987); *Bussing v. Comm’r*, 88 T.C. 449, 449–51 (1987).

384. *Bergford*, 12 F.3d at 167; *Alhouse*, 62 T.C.M. at 1678–79; *Bussing*, 89 T.C. at 1052; *Bussing*, 88 T.C. at 452.

385. *Bergford*, 12 F.3d at 167; *Alhouse*, 62 T.C.M. at 1679; *Bussing*, 89 T.C. at 1052; *Bussing*, 88 T.C. at 453–54. A triple-net lease is a lease that generally requires the lessee to pay the tax, insurance, and other expenses of the property. *United States v. Stoddard*, 875 F.2d 1233, 1235 (6th Cir. 1989). The lessor generally takes a passive role and merely receives rental payments. See *Estate of Abraham v. Comm’r*, 408 F.3d 26, 28 n.1 (1st Cir.), *amended by* 429 F.3d 294 (1st Cir. 2005).

386. See *Bergford*, 12 F.3d at 170 (opining that although the manager did not have an interest in the income from property’s operation, the interest in the gain from the property (i.e., the property’s residual value) was an economic benefit the manager shared with the owners).

387. See *Cusick v. Comm’r*, 76 T.C.M. (CCH) 241, 241–42 (1998) (showing the connection between the activity (maintenance tasks and bookkeeping) and the economic benefit (collecting rent and splitting the profits)).

388. *Bergford*, 12 F.3d at 169.

389. *Id.* at 169–70.

needed to maintain and repair the complex. In addition, the co-owners negotiate and execute leases for the apartment units; collect rent payments from the tenants; and pay taxes, assessments, and insurance premiums with respect to the property. These are customary tenant services that merely support the property's income-producing function. Because Ephraim and Fran provide the services instead of hiring a manager, the type-of-activities test will not exclude the arrangement from the definition of tax partnership.<sup>390</sup> Instead, their providing the services brings them within the source-of-activity test and the definition of tax partnership.

b. **Third-Party-Compensated Services.** Assume, alternatively, that Ephraim and Fran hire a manager to perform the support services and pay the manager a fair market management fee. This arrangement is very similar to Bill's and Ali's manager-provided-support-services arrangement, which would be excluded from the definition of tax partnership under the type-of-activity test.<sup>391</sup> Since the services are paid for, instead of being contributed, the source-of-activity test would not include this arrangement within the definition of tax partnership.

The distinction between this arrangement and the member-contributed-services arrangement is that although the members derive economic benefit from the manager's services (enhanced rental income), the members and the manager do not share a common goal. The members derived their economic benefit from the apartment complex, enhanced by the manager's services. The manager separately derived economic benefit solely from the services sold to the arrangement in exchange for the management fee.

c. **Member-Compensated Services.** An arrangement that pays a fair market fee to a member of a co-ownership arrangement to provide support services should not be a tax partnership under the source-of-activity test. If the member is compensated at fair market rates for the services, the service-providing member's separate capacities must be distinguished for tax purposes.<sup>392</sup> The member, as a service provider, individually

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390. See, e.g., *Cusick*, 76 T.C.M. at 241, 243 (finding members who contributed customary tenant services to be tax partners).

391. See *supra* Part V.B.6.b (applying the type-of-activity test to manager-provided support-services arrangements).

392. This is common in the tax partnership context. For example, partners can interact with the partnership in their capacities as partners or in their capacities as nonpartners. See I.R.C. § 707(a)(1) (2000) ("If a partner engages in a transaction with a

derives economic benefit from selling services to the arrangement. The members, as co-owners, derive economic benefit from the property, enhanced by the service-providing member's separately compensated services. This separates the provision of services for a fee from the common goal of owning the property for a profit. Thus, the arrangement would not be a tax partnership under the source-of-activity test.

d. *Profits Interest as Compensation.* The source-of-activity test does not include principal-agent relationships within the definition of tax partnership. It is not unusual for principals to compensate agents with a share of profits.<sup>393</sup> The distinction between tax partnerships and principal-agent relationships is the service provider's control.<sup>394</sup> If one party retains control over the income of and the right to make withdrawals from the arrangement, the relationship is a principal-agent relationship.<sup>395</sup> One party's lack of control over the income indicates that such a party is an agent who has sold, not contributed, services to the arrangement.<sup>396</sup> The agent's lack of contributed services keeps principal-agent relationships outside the scope of the source-of-activity test.<sup>397</sup>

8. *The Business-Purpose Test.* Under the business-purpose test, courts may disregard an arrangement if the members' purpose for forming the arrangement is "not the creation and

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partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.").

393. See, e.g., *Copeland v. Ratterree*, 57-2 U.S. Tax Cas. (CCH) ¶ 9895, at 58,195 (N.D.N.Y. 1957) (sharing in profits is not important to the tax partnership question); *Tate v. Knox*, 131 F. Supp. 514, 515 (D. Minn. 1955) (describing a buy-in provision for the general manager to be paid by forgoing his share of profits); *Luna v. Comm'r*, 42 T.C. 1067, 1074 (1964) (finding that profit share was compensation to an employee); *Bartholomew v. Comm'r*, 9 T.C.M. (CCH) 302, 303 (1950) (noting that an engineer was "paid a per diem of \$50 plus expenses and participate[d] in the final profits").

394. See *Tate*, 131 F. Supp. at 517 (explaining that control is often used with proprietorship).

395. See *Copeland*, 57-2 U.S. Tax Cas. (CCH) ¶ 9895, at 58,195 (concluding that because there was no equal control, there was no tax partnership).

396. See *Comm'r v. Banks*, 543 U.S. 426, 436-37 ("The relationship between client and attorney, regardless of the variations in particular compensation agreements or the amount of skill and effort the attorney contributes, is a quintessential principal-agent relationship. . . . The attorney is an agent who is duty bound to act only in the interests of the principal, and so it is appropriate to treat the full amount of the recovery as income to the principal. . . . The portion paid to the agent may be deductible, but absent some other provision of law it is not excludable from the principal's gross income." (citations omitted)).

397. But see *Fishback v. United States*, 215 F. Supp. 621, 626 (D.S.D. 1963) (declaring that equal control is not required for tax partnership).

carrying on of a new joint enterprise or uniting their joint efforts or substance in a new undertaking[,] . . . [but] the[ir] real purpose . . . [is] to minimize income taxes.”<sup>398</sup> This test was used to deny tax partnership classification to simple family partnerships.<sup>399</sup> In the family partnership context, courts were concerned that the parties were using partnerships to shift income from husbands to wives.<sup>400</sup>

Courts disallow the use of tax partnerships as a device for assigning income:

[I]n considering a gift of income by assignment, the court held that the operation of the taxing statute was not controlled by attenuated subtleties, but rather by the import and reasonable construction of the Act; that the court was not so much concerned with the refinements of title as with the command over the income. Concerning attempts to avoid the effect of a taxing statute by various devices, the court held that one having the right to enjoy income could not escape the tax by any kind of anticipatory arrangement, however skillfully devised, by which he procured payment to another.<sup>401</sup>

Courts have also used the business-purpose test in the shelter cases which involve taxpayers attempting to create tax losses and siphon taxable gain to tax-exempt foreign entities through the use of “elaborate partnerships.”<sup>402</sup> In holding that

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398. See *Earp v. Jones*, 131 F.2d 292, 293–94 (10th Cir. 1942). *Earp v. Jones* appears to be the first case to apply the business-purpose test to the definition of tax partnership, preceding *Commissioner v. Tower* by a few years, but having similar facts (i.e., a husband and wife formed a partnership to shift the husband's income to the wife). Courts had previously disregarded the formal structure of arrangements to decide other issues. See *Helvering v. Clifford*, 309 U.S. 331, 336–37 (1940) (“[W]here, as in this case, the benefits directly or indirectly retained blend so imperceptibly with the normal concepts of full ownership, we cannot say that the triers of fact committed reversible error when they found that the husband was the owner of the corpus for the purposes of § 22(a). To hold otherwise would be to treat the wife as a complete stranger; to let mere formalism obscure the normal consequences of family solidarity; and to force concepts of ownership to be fashioned out of legal niceties which may have little or no significance in such household arrangements.”).

399. See *Earp*, 131 F.2d at 293–94 (holding that no partnership existed between husband and wife despite their agreement giving her full rights as a partner because it was never intended that she have any control of the business).

400. See *id.* at 294 (declaring that “[t]he real purpose of the partnership was to minimize income taxes”).

401. *Id.* at 293 (emphasis omitted) (citing *Harrison v. Schaffner*, 312 U.S. 579 (1941)).

402. See *Boca Investorings P'ship v. United States*, 314 F.3d 625, 632 (D.C. Cir. 2003) (“[W]here taxpayers use an ‘elaborate partnership’ with entities created solely for the purpose of the questioned transaction, ‘the absence of a non-tax business purpose’ is fatal to the recognition of the entity for the tax purposes.” (quoting *ASA Investorings P'ship v. Comm'r*, 201 F.3d 505, 512 (D.C. Cir. 2000)); see also *TIFD III-E Inc. v. Comm'r*,

such arrangements were not tax partnerships, the D.C. Circuit focused on language in *Commissioner v. Culbertson*, which provides that the existence of a tax partnership depends on whether, “considering all the facts[,] . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.”<sup>403</sup> The D.C. Circuit interpreted this language to require “that a legitimate non-tax business necessity exist for the creation of the otherwise sham entity . . . in order to meet the [*Culbertson*] intent test.”<sup>404</sup> In one of the tax shelter cases, the court noted that the taxpayer could have purchased the assets acquired through the partnership without incurring the significant costs of creating the partnership and paying premiums to the foreign partners.<sup>405</sup> This indicated that the partnership had no nontax business purpose and should be disregarded for tax purposes.<sup>406</sup> Thus, the business-purpose test requires that an arrangement have a nontax business purpose to be a tax partnership. The business-purpose test thus serves as an overriding anti-abuse tool for the courts and the IRS.

9. *The Estoppel Test.* The estoppel test subjects taxpayers to the form of an arrangement they choose if they also otherwise operate in that form.<sup>407</sup> Thus, if parties form a valid state-law partnership, represent the arrangement is a partnership to obtain licenses from the federal government, file a federal partnership tax

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No. 05-0064-cv, 2006 WL 2171519, at \*5 (2d Cir. Aug. 3, 2006); *Andantech L.L.C. v. Comm’r*, 331 F.3d 972, 973–74 (D.C. Cir. 2003); *SABA P’ship v. Comm’r*, 273 F.3d 1135, 1136 (D.C. Cir. 2001); *ASA Investorings P’ship*, 201 F.3d at 513, 516 (describing the rationale of the business-purpose test and applying it to find that the arrangement was an “elaborate partnership—with a pair of partners concocted for the occasion”).

403. *ASA Investorings P’ship*, 201 F.3d at 511 (quoting *Comm’r v. Culbertson*, 337 U.S. 733, 742 (1949)).

404. *Boca Investorings P’ship*, 314 F.3d at 630.

405. *Id.* at 631.

406. *Id.* at 631–32.

407. See *Maletis v. United States*, 200 F.2d 97, 97–98 (9th Cir. 1952) (appearing to be the first case to apply the estoppel test to define tax partnership). Several later cases relied upon it. See, e.g., *Demirjian v. Comm’r*, 457 F.2d 1, 5 (3d Cir. 1972) (relying on *Sterno Sales Corp. v. United States*, 345 F.2d 552, 554 (Ct. Cl. 1965) (disallowing taxpayer’s adjustment of reported gross income downward after also disallowing excessive deductions); *Sherman v. United States*, 141 F. Supp. 369, 370 (E.D. Pa. 1956) (denying an attempt to revoke a partnership in order to gain tax advantages because the partnership was held to be a bona fide one). Under substantive law, partners can similarly form partnerships by estoppel. See UNIF. P’SHP ACT § 308(a) (amended 1997), 6 U.L.A. 128 (2001) (“If a person, by words or conduct, purports to be a partner, or consents to being represented by another as a partner, in a partnership or with one or more persons not partners, the purported partner is liable to a person to whom the representation is made, if that person, relying on the representation, enters into a transaction with the actual or purported partnership.”). Thus, partnership by estoppel under substantive law requires reliance upon a representation.

return, and obtain the tax benefits of being a tax partnership for some tax years, the IRS may later prevent the parties from claiming that the arrangement is not a tax partnership.<sup>408</sup> Even if the arrangement may not otherwise be a valid tax partnership, the estoppel test allows courts and the IRS to estop the parties from disclaiming the tax partnership.<sup>409</sup> Thus, the estoppel test, like the business-purpose test, is an anti-abuse tool.

*10. The Fact-Question Test.* The fact-question test treats an arrangement as a tax partnership if the facts indicate that it is a tax partnership. The test does not state a legal definition of tax partnership, even though an inquiry into facts requires a legal definition of tax partnership.<sup>410</sup> Nonetheless, several courts have adopted what appears to be a pure fact-question test.<sup>411</sup> Other courts state that the determination of tax partnership is a question of fact, but apply some other test.<sup>412</sup>

## VI. THE ANALYTICAL PLATFORM FOR EVALUATING THE TESTS

The analysis now turns to evaluating the tests. The analysis begins by establishing an analytical platform based on four fundamental principles of a sound tax system: (1) certainty,

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408. *Maletis*, 200 F.2d at 97–98. Although a valid state-law partnership, this arrangement may not have been a tax partnership under other tests. For example, it may have been a co-ownership arrangement that provided only customary tenant services and would thus have been excluded under the type-of-activity test. *See supra* text accompanying note 375; *see also supra* text accompanying notes 368–74.

409. *Demirjian*, 457 F.2d at 5; *Maletis*, 200 F.2d at 97–98; *Sherman*, 141 F. Supp. at 370–71.

410. *See, e.g.*, *Estate of Kahn v. Comm’r*, 499 F.2d 1186, 1189 n.4 (2d Cir. 1974) (“[I]t follows that since the Tax Court applied the proper legal standard, both its findings on each individual factor and its overall assessment of their varying weights must be upheld unless clearly erroneous.”).

411. *See, e.g.*, *Leahy v. Comm’r*, 87 T.C. 56 (1986) (looking only to the facts of the case and never stating the definition of tax partnership); *Melbourne Ranches, Inc. v. Comm’r*, 30 T.C.M. (CCH) 1132, 1138 (1971) (“The question of the existence of a joint venture is essentially factual. All of the facts and circumstances, and not just the written agreements, must be examined. The record herein contains substantial evidence to support both the position of Melbourne, that a joint venture was formed, and the position of the Government, that such a venture was not established. We have carefully reviewed the record as a whole, and although the matter is by no means free from doubt, we have concluded that petitioner has met its burden of proof and has established the existence of a joint venture.” (citations omitted)).

412. *See, e.g.*, *Kelly v. Comm’r*, 29 T.C.M. (CCH) 1090, 1101 (1970) (applying the substantive-law test, and opining that “[w]hether the arrangement among McCartan, Chamberlin, and Robinson constituted a partnership with McCartan as a partner under section[s] 761(a) and 7701(a)(2), and the regulations promulgated thereunder, is a question of fact to be determined from all existing circumstances”); *Baughn v. Comm’r*, 28 T.C.M. (CCH) 1447, 1455 (1969) (same); *Badger Co. v. Comm’r*, 26 T.C.M. (CCH) 869, 873 (1967) (same).

(2) equity, (3) neutrality, and (4) simplicity/administrability. Using these criteria, the Article evaluates each of the ten tests used to define tax partnership. Although these policy considerations are often used to evaluate tax laws,<sup>413</sup> this section of the Article reviews each and adjusts them as needed to suit the task at hand.

### A. Certainty

Certainty requires that “the time, manner, and amount of [tax] payment[s] . . . be clear and certain.”<sup>414</sup> Both the taxpayer and the tax collector should be certain of their obligations under the law.<sup>415</sup> Part IV of the Article discussed how the application of the tax rules may affect the obligations of taxpayers and tax collectors.<sup>416</sup> The definition of tax partnership determines the applicability of those rules. Thus, a certain definition of tax partnership is required to inform taxpayers and tax collectors of their respective obligations under the law. The evaluation of each test will ask whether the test is certain.

### B. Equity

The accepted definition of equity “require[s] that taxpayers with equal economic income before imposition of a tax have equal economic income after imposition of the tax.”<sup>417</sup> Defined more

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413. See, e.g., Joseph Bankman, *The Case Against Passive Investments: A Critical Appraisal of the Passive Loss Restrictions*, 42 STAN. L. REV. 15, 48–49 (1989) (applying equity and neutrality to evaluate the passive loss restrictions); Fred B. Brown, *Proposal to Reform the Like Kind and Involuntary Conversion Rules in Light of Fundamental Tax Policies: A Simpler, More Rational and More Unified Approach*, 67 MO. L. REV. 705, 708–14 (2002) (using efficiency, equity, and administrability to evaluate sections 1031 and 1033); Joseph M. Dodge, *Taxes and Torts*, 77 CORNELL L. REV. 143, 146–47 (1992) (considering whether laws excluding certain recoveries for injuries are equitable and neutral); John E. Donaldson, *The Future of Transfer Taxation: Repeal, Restructuring and Refinement, or Replacement*, 50 WASH. & LEE L. REV. 539, 545 (1993) (critiquing the income and compensation tax using neutrality and equity); Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807, 829–30, 848–49, 892–93 (2005) (applying equity, neutrality, and simplicity to evaluate transfer taxes); Robert J. Peroni, *A Policy Critique of the Section 469 Passive Loss Rules*, 62 S. CAL. L. REV. 1, 103 (1988) (arguing that the enactment of section 469 has increased inefficiency, complexity, and inequity in the federal income tax system).

414. Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 572 (1965).

415. *Id.* at 573.

416. See *supra* Part IV (explaining that the definition of tax partnership affects timing, accounting, transactional and procedural rules).

417. Bankman, *supra* note 413, at 41; see also Peel, *supra* note 30, at 2 (arguing that “the double tax on corporate dividends is unfair . . . [and it] violates . . . horizontal equity”). Another goal of equity is vertical equity, which “requires that individuals be taxed according to their ability to pay.” Mark L. Louie, Note, *Realizing Appreciation*

generally, equity requires “treating like taxpayers alike.”<sup>418</sup> The negative inference of this principle is that unlike taxpayers may be treated differently by subjecting each to different tax rules. This negative inference does not, however, provide license for treating different taxpayers differently in all cases. Disparate tax treatment should be allowed only if a difference between two taxpayers justifies disparate treatment.<sup>419</sup>

Congress appeared to consider the effect of the partnership tax rules when it adopted them.<sup>420</sup> It also recognized that the rules would treat members of tax partnerships differently from other taxpayers.<sup>421</sup> This being the case, Congress attempted to enact rules that were justified by some other policy criteria, generally simplicity and administrability.<sup>422</sup> Because the definition of tax partnership determines which taxpayers will be subject to the partnership tax rules, it should include only those arrangements that have the accounting and reporting concerns the partnership tax rules were enacted to alleviate. Reaching this objective generally requires the application of standard equity, as opposed to deviation equity.

*1. Standard Equity.* Standard equity compares all taxpayers to the standard taxpayer.<sup>423</sup> If a taxpayer’s situation differs from the

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*Without Sale: Accrual Taxation of Capital Gains on Marketable Securities*, 34 STAN. L. REV. 857, 863 (1982); see Sneed, *supra* note 414, at 581 (“[T]he magnitude of the inequality between two taxpayers should be measured on the same scale employed to determine the presence or absence of equality.”); see also Paul R. McDaniel & James R. Repetti, Commentary, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607, 607 (1993) (providing definitions for both vertical and horizontal equity).

418. Bankman, *supra* note 413, at 41. Vertical equity generally applies when considering the appropriate rate structure to apply to taxpayers with different economic income. Since rate structure is beyond the scope of this Article, it does not address vertical equity.

419. See McDaniel & Repetti, *supra* note 417, at 611 (suggesting that vertical equity is a “derivative” concept, based on what is considered “appropriate” in terms of distinguishing between taxpayers); see also Jones, *supra* note 138, at 1062 (arguing that there must be something different about the taxpayers to justify different tax treatment).

420. See *supra* Part III (discussing the history and purpose of partnership taxation).

421. See, e.g., *supra* note 81 and accompanying text (delineating how each individual partner in a partnership could conceivably operate under a different tax structure).

422. See, e.g., *supra* note 82 and accompanying text (discussing the once yearly income tax computation requirement for a tax partnership, which was introduced by the Revenue Act of 1917).

423. The standard taxpayer would be an individual. In the business context, the standard taxpayer would be a sole proprietor. If an arrangement conducted similar business activity, its rulings would be compared to the sole proprietor to apply standard equity. See, e.g., Yin, *supra* note 224, at 137 (“If the proprietorship is not treated as a separate taxpayer, it is difficult to see why, for example, a two-person general partnership should be so treated.”); see also Jones, *supra* note 138, at 1067–77 (observing that prior



standard taxpayer's, standard equity allows, or perhaps requires, that the taxpayer and the standard taxpayer be subject to different tax rules.<sup>424</sup> The difference between the taxpayer and the standard taxpayer must, however, be such as to justify the different tax treatment. For example, Congress created the partnership taxable year so a partnership would not have to compute taxable income multiple times during the year.<sup>425</sup> The use of a separate taxable year by a tax partnership may treat partner taxpayers differently from the standard taxpayer by deferring a partner taxpayer's recognition of partnership taxable income.<sup>426</sup> Congress justifies this disparate treatment on the grounds of simplicity. Without a separate partnership taxable year, the arrangement would be required to compute taxable income several times during the year.<sup>427</sup> Other differences between the standard taxpayer and members of other arrangements may not justify the application of the partnership taxable year rule. For example, if Ali and Bill triple-net lease their property to a cattle rancher,<sup>428</sup> they can each compute their income from the land without computing partnership income. Thus, the administrative convenience justification is absent, and Ali and Bill's co-ownership arrangement should not be allowed to use the partnership taxable year rule.

2. *Deviation Equity.* Once a deviation from the standard is justified, the temptation arises to compare other taxpayers to the deviant taxpayer. If other taxpayers are similar to the deviant taxpayer, logic would appear to dictate that the similarly situated taxpayer should be subject to the same rules to which the deviant taxpayer is subject. This may create mischief if the other taxpayer, although similar to the deviant taxpayer, is not exactly like the deviant taxpayer. Factors that make the other taxpayer similar to the deviant taxpayer may not be the factors that justified treating the deviant taxpayer differently from the

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attempts to assign tax benefits and burdens have improperly ignored or skipped over the relationship between partnership taxation and individual taxation). In the property context, the standard taxpayer would be the sole owner of property.

424. See *supra* text accompanying note 418 (noting that equity requires "treating like taxpayers alike").

425. See *supra* text accompanying note 82 (addressing the purpose behind the Revenue Act of 1917).

426. See *supra* text accompanying notes 164–69 (explaining the policy intent behind effective deferral).

427. See *supra* note 81 (providing an illustration of such an administrative inconvenience).

428. See *supra* Part V.B.6.a (discussing pure co-ownership arrangements).

standard taxpayer.<sup>429</sup> For example, members of Partnership A may be treated differently from the standard taxpayer due to the administrative inconvenience of determining the members' income from Partnership A.<sup>430</sup> Partnership A may be a Texas limited partnership. Partnership B similarly may be a Texas limited partnership, but have no business activity. If deviation equity only considers the legal form of these two arrangements, Partnership B should be a tax partnership because it is similar to Partnership A. Without business activity, Partnership B may have none of the characteristics that justify the application of the partnership tax rules. Thus, treating the members of Partnership B differently from the standard taxpayer would violate deviation equity.

Congress and courts have relied, to a large extent, on deviation equity to define tax partnership.<sup>431</sup> Deviation equity recognizes the existence of tax partnerships and strives to ensure that all members of arrangements similar to tax partnerships are taxed similarly.<sup>432</sup> This has contributed to the confusion in this area for two reasons.<sup>433</sup> First, a standard definition of tax

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429. An algebraic formula illustrates this point. Assume "S" is the standard and "D" is the deviant. That relationship can be signified with this formula:  $S \neq D$ . If another arrangement "A" is exactly like D, then  $A = D$ . Thus, the following also would be true:  $S \neq A$ . If, however, A is not exactly like D, then it follows that  $A \neq D$ , and  $S \neq D$ . Under these facts, it is impossible to conclude that  $S \neq A$ . If, however, A is compared to S, it is possible to determine whether A is sufficiently dissimilar from S to justify treating A differently from S for tax purposes. Understanding the difference between standard equity and deviation equity is critical in analyzing the definition of tax partnership. Standard equity requires that the definition test arrangements by comparing them to the standard taxpayer. This will produce a better result by guaranteeing that only members of those arrangements that justify a deviation from the standard are subject to rules different from those to which the standard taxpayer is subject. On the other hand, the use of deviation equity may produce the wrong result by comparing arrangements to a deviant taxpayer, instead of to the standard taxpayer. Unless the two comparison arrangements are identical, deviation equity may not produce the correct result. Under deviation equity, comparing an arrangement to the deviant taxpayer produces the correct result only if the other taxpayer is exactly like the deviant.

430. See *supra* text accompanying notes 80–82 (explaining that Congress allowed partnerships to compute taxable income and have a taxable year for administrative convenience).

431. See *supra* text accompanying notes 58, 94–95 (showing that the legislative history of the Revenue Act of 1932 supports reliance on deviation equity and demonstrating that courts have applied the concept of "relevant" case law broadly, frequently analogizing unrelated areas to each other, such as family income assignment cases to employment or business cases).

432. See *supra* text accompanying notes 100–01 (noting that Congress believed such a broad definition would eliminate uncertainty as to tax treatment).

433. For almost ninety years, the definition of tax corporation relied on deviation equity. Arrangements were compared under a multifactor test to determine if they were similar to corporations. See *supra* note 27 and accompanying text. The check-the-box regulations change this practice. See *supra* text accompanying note 28. Corporate tax is

partnership was never established.<sup>434</sup> Thus, comparison was initially difficult. Second, with no criteria against which to test different arrangements, the application of the definition became haphazard and precedent became confused.<sup>435</sup> Perhaps the starkest example of this is the Tax Court's statement that the statutory definition of tax partnership "does not require a profit motive; rather it merely requires 'an unincorporated organization, through or by means of which any business, financial operation, or venture is carried on.'"<sup>436</sup> This example of double-deviation equity<sup>437</sup> demonstrates how deviation equity can create uncertainty. The partnership tax rules were enacted to govern substantive-law partnerships.<sup>438</sup> Since joint profit is an element of substantive-law partnerships, Congress enacted the rules to govern arrangements with joint profit.<sup>439</sup> The Tax Court's statement demonstrates how deviation equity disregarded that original purpose.

### C. *Neutrality*

Neutrality requires that tax laws not affect taxpayer decisionmaking.<sup>440</sup> In the partnership tax context, the definition of tax partnership should not affect taxpayer decisions to join a particular arrangement or to use a particular type of legal form in structuring the arrangement.<sup>441</sup> To apply the neutrality

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difficult to evaluate on policy grounds because of its uncertain tax policy. *See supra* text accompanying note 33.

434. *See supra* notes 34–35 and accompanying text (indicating that the debate over the precise definition has been ongoing for a hundred years).

435. *See supra* text accompanying notes 51–64 (noting the lack of predictability in the IRS's conclusions on whether a tax partnership exists under a given set of facts).

436. *Madison Gas & Elec. Co. v. Comm'r*, 72 T.C. 521, 561–62 (1979) (quoting I.R.C. § 761(a) (2000)).

437. The statutory definition listed arrangements similar to partnerships. *See supra* text accompanying note 95. The Tax Court extended the statute by comparing the listed arrangements to the arrangement it was considering. *Madison Gas & Elec. Co.*, 72 T.C. at 561–62.

438. *See supra* text accompanying notes 104–05 (suggesting that the absence of a definition for tax partnerships in the early revenue acts signals Congress's intent for the rules to govern substantive-law partnerships only).

439. *See supra* notes 342–46 and accompanying text (outlining the IRS's joint-profit test).

440. *See McCaffery, supra* note 413, at 849 ("Tax policy typically invokes neutrality in a specifically economic sense. Economic efficiency is obtained when tax systems are neutral relative to a hypothetical no-tax world. This means that taxes do not distort the relative prices that emerge from such a no-tax state . . . . As long as any tax equally impacts all pretax prices, there is no relative change in prices, and hence no distortion in the allocation of resources, which is the exclusive concern of economic efficiency." (footnotes omitted)).

441. This ought to be the result if the neutrality principle is properly embedded in

principle in evaluating the definition of tax partnership, the analysis inquires whether a particular definition will be more likely to affect taxpayers' decisions. In particular, the analysis asks whether a test used to define tax partnership encourages taxpayers to use a particular type of legal entity over some other form. Thus, if a test used to define tax partnership includes limited liability companies but not limited partnerships, taxpayers who wish to have an arrangement be a tax partnership will choose to form a limited liability company instead of a limited partnership.

#### *D. Simplicity/Administrability*

Tax law should be simple and administrable, but equity should not be sacrificed to ensure that a system is simple.<sup>442</sup> The efficient administration of the tax system depends, however, on simplicity,<sup>443</sup> and a system that cannot be administered is not equitable.<sup>444</sup> One example of how complexity can negatively affect equity is a complex tax law that requires taxpayers to incur costs to comply with it and encourages them to organize their affairs to minimize taxes.<sup>445</sup> Because tax planning is available only to taxpayers who can afford such services, laws of this sort violate equity.<sup>446</sup> More important, tax laws must be administrable to be equitable. "Otherwise, any rules developed risk being a mere facade, a nice theoretical way of imposing taxes . . . that is not matched by real world consequences to most taxpayers."<sup>447</sup> This builds on simplicity because a tax law that is too complex cannot be administered,<sup>448</sup> and taxpayers will invariably treat similar

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the rules.

442. Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 VA. TAX REV. 645, 739 (2003) ("Congress should reject simple rules that thwart equity or efficiency. . . . Unlike equity and efficiency, simplicity lacks inherent virtue.").

443. *Id.* at 741. "[T]he benefit of simplicity is its advancement of the standards of efficiency[, which encompasses administrability]." *Id.* at 743.

444. MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* 27 (4th ed. 2001) ("[C]omplexity is inequitable because taxpayers with equal abilities to pay may have different tax burdens because of their unequal abilities to understand or manipulate the tax rules.").

445. *Id.*

446. Yin, *supra* note 140, at 149–50 ("The elective tax treatment of private firms under current law undermines . . . equity . . . . Although in theory, similarly situated businesses have the same opportunity to be treated in the same tax-advantageous manner under current law, the practical reality is probably to the contrary, due to disparities in the quality of advice the businesses receive. By permitting such disparate choices without any apparent underlying conceptual foundation, current law has simply provided a tax benefit for the well-advised and a trap for the ill-advised.").

447. Yin, *supra* note 224, at 142–43.

448. DAVID F. BRADFORD, *UNTANGLING THE INCOME TAX* 266–67 (1986) (referring to

items differently. Thus, complexity and inability to administer a law may make it inequitable. As demonstrated above, simplicity and administrability are the criteria justifying many of the partnership tax rules.<sup>449</sup>

## VII. THE EVALUATIONS

The following evaluations approach each test systematically. First, they consider whether the subject test is certain. Second, they consider whether the test promotes or violates equity. In that part of the evaluation the focus is on standard equity, asking whether the test considers how arrangements that come within it create accounting and reporting complexity or curb abuse, justifying the use of the partnership tax rules. The equity analysis often requires consideration of tax principles. For example, analyzing the joint-profit test requires an examination of the use of both the accounting and dictionary definitions of profit in the partnership tax context. Also, two of the “of-services” tests<sup>450</sup> require an examination of the assignment-of-income doctrine and the partnership tax allocation rules. Third, the evaluations consider whether the subject test is neutral. Based on those evaluations, the analysis either rejects a test outright, recommends that it be modified, or accepts it.

### A. *Tests That Fail Tax Policy Scrutiny*

The following tests fail to satisfy any of the criteria of the analytical platform. Those attempting to define tax partnership should abandon these tests.

1. *The Substantive-Law Test.* The substantive-law test is uncertain. The substantive-law test has grown from the deceptively simple substantive-law definition of partnership to a metastasizing multifactor list.<sup>451</sup> The recent factor proliferation demonstrates a potential problem of multiple-factor tests: the number of factors can grow uncontrollably, with no policy justification.<sup>452</sup> Multiple-factor tests are popular with the courts and may provide a sense of wellness,<sup>453</sup> but they do not provide a

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the complexity in complying with the law as “compliance complexity”).

449. See *supra* Part III.B (discussing the imposition of tax reporting requirements).

450. These refer to the type-of-services test and the source-of-services test.

451. See *supra* text accompanying notes 280–307 (providing an overview of the evolution of the substantive-law test).

452. See *supra* notes 300–07 and accompanying text (discussing the increased number of factors in the substantive-law test).

453. See Frederick Schauer, *The Tyranny of Choice and the Rulification of*

definition. Instead, they are merely unweighted items to be considered in determining whether an arrangement is a tax partnership<sup>454</sup> and appear to be little more than a list of factors to consider in examining parties' intent. Additionally, they provide significant leeway for interpreting the multiple factors, making the test uncertain.<sup>455</sup> To the extent the factors refer to the substantive-law definition, the IRS has had difficulty applying the definition.<sup>456</sup> Furthermore, although Congress enacted partnership tax law to govern substantive-law partnerships, the substantive-law definition (even with the subsequent permutations) is inadequate for partnership tax law because (1) it does not consider tax policy, (2) its terminology and concepts often have no meaning or relevance in tax law, and (3) it evolves independent of tax laws and policy.<sup>457</sup> All of these factors contribute to the substantive-law test's uncertainty to the extent it still relies upon the substantive-law definition of partnership.

The substantive-law test violates standard equity. The test does not address whether the arrangement creates tax accounting and reporting concerns that justify treating the arrangement as a tax partnership. For example, a co-ownership arrangement may perform significant business activity for profit and be a tax partnership under the substantive-law test, but as discussed below, business activity and profit sharing alone do not necessarily cause tax accounting and reporting complexity.<sup>458</sup> By failing to draw this distinction, the substantive-law test may treat as tax partnerships some arrangements that do not present the concerns the partnership tax rules were enacted to address. Thus, the substantive-law test treats members of certain arrangements differently from the standard taxpayer, even though tax policy may justify such disparate treatment.

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*Standards*, 14 J. CONTEMP. LEGAL ISSUES 803, 805–06, 809–10 (2005) (hypothesizing that law makers convert standards to rules to maximize their own policy preferences over time, to reduce the number of available choices that may be disturbing or paralyzing, to reduce the number of choices available in areas of the law considered less interesting, and to concentrate wisdom into a single rule to help them make decisions better).

454. *Luna v. Comm'r*, 42 T.C. 1067, 1077 (1964) ("The following factors, none of which is conclusive, bear on the issue . . .").

455. See, e.g., *supra* text accompanying notes 356–57, 436 (exemplifying that the Tax Court rejected the substantive law's joint-profit requirement).

456. See *supra* text accompanying note 270–78 (discussing the substantive-law test and the IRS's struggle to devise a consistent definition).

457. See *supra* Part V.A–B.1 (describing the evolution of the test, and the manifold challenges *vis-à-vis* a disconnect between the test, its nomenclature, and tax policy).

458. See *infra* Part VII.B.2, C.3 (showing that the type or source of activity triggers partnership tax and reporting complexity).

The substantive-law test also violates neutrality. Some taxpayers will structure arrangements to fail one of the elements of the substantive-law definition of partnership or one of the factors of the substantive-law test to avoid tax partnership classification.

2. *The State-Law Test.* The state-law test is uncertain. State laws defining the various entities that would be tax partnerships are not uniform across jurisdictions.<sup>459</sup> The lack of uniformity creates uncertainty.<sup>460</sup> Additionally, the state-law definitions of entities that are treated as tax partnerships have proliferated over the years and continue to change, making the state-law test even more uncertain.<sup>461</sup> Finally, the jurisdiction that would govern the state-law determination of an arrangement's classification may not be clear.<sup>462</sup> These several factors make the state-law test uncertain and place an undue burden on the IRS to apply the various states' laws.<sup>463</sup>

The example of Ali and Bill demonstrates how the state-law test violates equity. Recall that Ali and Bill owned raw land as tenants in common.<sup>464</sup> They leased the land to a rancher who grazed cattle on the land, but they provided no services. This was

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459. Only thirty-three states have adopted the Uniform Partnership Act of 1997. UNIF. P'SHIP ACT § 101 (amended 1997), 6 U.L.A. 24-27 (Supp. 2006). Even states that have adopted uniform acts may interpret them differently. See BROMBERG & RIBSTEIN, *supra* note 231, § 1.04 ("[D]espite the U.P.A.'s and R.U.P.A.'s exhortations for uniform interpretation, it is evident throughout this book that courts have not construed it uniformly. Now that variations on R.U.P.A. and limited liability partnership provisions are being adopted by legislatures, partnership law is becoming less uniform than ever." (footnotes omitted)).

460. The lack of uniformity may also result in similar arrangements being treated differently for tax purposes, violating both standard and deviation equity. See *Palmer v. Bender*, 287 U.S. 551, 555-56 (1933) (stating that technical distinctions of local laws will be disregarded and tax statutes will be applied uniformly). For example, an arrangement that is a partnership in one state may not be a partnership under the laws of another state. Thus, two arrangements that are identical in every other way may be treated differently under the laws of two separate jurisdictions. This has also become an issue in the like-kind property area where taxpayers have traditionally looked to state law to determine whether property was real or personal to answer whether two properties were of a like kind. See *Alton & Weller*, *supra* note 13, at 36 (demonstrating that identical property may be classified differently in different states).

461. See, e.g., *supra* note 14 (describing the recent development of series limited liability companies).

462. See generally BROMBERG & RIBSTEIN, *supra* note 231, § 1.04 (discussing difficulties that arise in determining the applicable law).

463. See, e.g., *supra* text accompanying note 270-75 (questioning whether the IRS correctly applied the substantive-law test). Requiring the IRS to interpret and apply the laws of each state would place unrealistic responsibility on that administrative body.

464. See *supra* Part V.B.6.a (addressing pure co-ownership arrangements).

not a tax partnership under the type-of-activity test.<sup>465</sup> Now assume that Ali and Bill contribute the property to a limited liability company, but otherwise the economic arrangement remains the same. Under the state-law test, the limited liability company would be a tax partnership.<sup>466</sup> Indirectly owning the property through the limited liability company does not create the complexity or administrative inconvenience the partnership tax rules were enacted to alleviate.<sup>467</sup> Thus the state law creates unjustified disparate tax treatment, violating standard equity in this situation.

The state-law test also violates neutrality. Taxpayers wishing to have an arrangement classified as a tax partnership will use a limited liability company or other state-law entity.<sup>468</sup> Taxpayers wishing to avoid being a tax partnership will structure arrangements that are not state-law entities.<sup>469</sup> The explosion of syndicated tenancy-in-common structures is a present-day example of how the state-law test affects entity structure.<sup>470</sup> Real estate investors are buying interests in so-called syndicated TIC arrangements to avoid the use of state-law entities.<sup>471</sup>

3. *The Fact-Question Test.* The fact-question test egregiously violates certainty, leading to inequity. Because the fact-question test provides no standard, neither taxpayers nor the IRS can know, prior to a judge's decision, whether a particular arrangement is a tax partnership. Because courts have no standard against which to compare the facts of various arrangements, similarly situated taxpayers will invariably be classified differently. The fact-question test does not violate neutrality, however, because it provides no basis for taxpayers to rely upon when making decisions.<sup>472</sup> Finally, the fact-question

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465. See *supra* Part V.B.6 (discussing the type-of-activity test).

466. See *supra* Part V.B.2 (examining the state-law test).

467. See *supra* notes 82–100 and accompanying text (discussing Congress's ongoing attempt to streamline partnership tax rules).

468. See *supra* note 140 and accompanying text (noting that under state law, income realized by a business may be classified as belonging to the entity, and not the owners).

469. See *supra* note 320 and accompanying text (citing the TIC industry as one such avoidance mechanism).

470. In Revenue Procedure 2002-22, the IRS adopted the state-law test by identifying direct ownership of property as a condition for obtaining a no-tax-partnership ruling for a co-ownership arrangement. See Rev. Proc. 2002-22, 2002-1 C.B. 733, 735–36. The IRS also acknowledged the state-law test in Revenue Ruling 2004-86. See Rev. Rul. 2004-86, 2004-33 I.R.B. 191, 193 (acknowledging that if an entity is formed under state law for valid business reasons, it will generally be recognized for federal tax purposes).

471. See *supra* note 13 (discussing TIC arrangements).

472. See *supra* Part V.B.10 (reviewing the fact-question test).



test does not provide for consideration of the policy justification for the partnership tax accounting and reporting rules. Therefore, the fact-question test fails the certainty and equity criteria, overshadowing any positive neutrality score.

### *B. Tests That Pass Tax Policy Scrutiny*

The following tests satisfy certain of the tax policy criteria, but not all of them, or they satisfy all of the tax policy criteria, but only in limited situations. Thus, they are not completely without merit, but nor are they meritorious.

1. *The Degree-of-Activity Test.* The degree-of-activity test receives only a passing score, helped along by the potential of the *de minimis* exception of the source-of-activity test. The degree-of-activity test violates both certainty and standard equity. It violates certainty because it does not identify the threshold degree or quantum of activity that transforms a co-ownership arrangement into a tax partnership. Courts have referred to degree of activity but have not identified the threshold degree.<sup>473</sup>

Three examples demonstrate how the degree-of-activity test violates standard equity. Consider a power-generating co-owned joint-production arrangement. Such arrangement may conduct significant business-like activity but not be subject to subchapter K.<sup>474</sup> An increase or decrease in the degree of such arrangement's activity would not affect its eligibility to make the section 761(a)(2) election.<sup>475</sup> The lack of a joint-profit motive, not the degree of activity, exempts the arrangement from full tax partnership classification.<sup>476</sup>

The ditch-digging arrangement in the regulations further illustrates weaknesses of the degree-of-activity test. The regulations may refer solely to two individuals joining forces, with shovels in hand, to dig a small ditch to drain surface water off adjoining properties. More likely, however, the regulations refer to an arrangement that requires bulldozers, backhoes, trucks, a surveyor, and machine operators to dig and maintain a

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473. See *supra* note 366 (providing a list of cases implementing the degree-of-activity test).

474. See Rev. Rul. 68-344, 1968-1 C.B. 569 (concluding that an arrangement consisting of a group of electrical power corporations co-owning a power plant and coproducing power is eligible for the section 761(a)(2) election).

475. See I.R.C. § 761(a)(2) (2000) (noting that an organization is not excluded from the application of the subchapter "if it is availed of . . . for the purpose of selling services or property produced or extracted").

476. See *supra* note 340 (discussing an IRS ruling where the absence of joint profit led to the classification on an arrangement as a qualified tax partnership).

large ditch needed to properly drain hundreds of acre-feet of water each year. Such an undertaking would require a significant degree of activity.<sup>477</sup> Although both the co-owned joint-production and the expense-sharing arrangements have significant business activity, they have no gross income.<sup>478</sup> Furthermore, each member of such an arrangement would be required to contribute to the costs of digging the ditch, and each member could individually account for the amount so contributed. With no gross income, and traceable expenditures, such arrangements should not be tax partnerships, even though they have significant business activity. Because the substantive-law test may classify them as such, it violates equity.

The degree-of-activity test satisfies standard equity in one application: the *de minimis* exception to the source-of-activity test.<sup>479</sup> That exception would ignore contributed services if the amount of services were nominal, contributed for the sole purpose of obtaining tax partnership classification. The *de minimis* exception epitomizes standard equity in this respect. The premise of standard equity is that all taxpayers similar to the standard taxpayer should be subject to the same tax rules that apply to the standard taxpayer.<sup>480</sup> Tax rules should deviate from the standard only if a taxpayer is sufficiently different from the standard taxpayer.<sup>481</sup> The *de minimis* exception would attempt to quantify the point at which members of an arrangement sufficiently deviate from the standard taxpayer to justify the application of different tax rules.<sup>482</sup>

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477. See generally MARK FIEGE, *IRRIGATED EDEN: THE MAKING OF AN AGRICULTURAL LANDSCAPE IN THE AMERICAN WEST* (1999) (describing the significant undertaking of digging the ditches that irrigate (and drain water from) Idaho's Magic Valley, many of which the author spent time around while working on an Idaho farm during his youth). See also *Mt. Morris Drive-In Theatre Co. v. Comm'r*, 25 T.C. 272, 272 (1955) (involving a taxpayer who spent \$8,224 in 1950 to construct a drainage system to carry water from its property across an adjacent piece of property to a public drain), *aff'd*, 238 F.2d 85 (6th Cir. 1956).

478. See *infra* text accompanying note 502–03 (discussing co-owned joint-production arrangements).

479. See *infra* text accompanying notes 540–43 (delineating the source-of-activity test).

480. See *supra* Part VI.B.1 (discussing standard equity).

481. *Id.*

482. Identifying the threshold would prove difficult. It adopts the degree-of-activity test's concept of materiality. As stated earlier, the degree-of-activity test has not identified the point at which the degree of services becomes sufficiently high enough to treat an arrangement as a tax partnership. See *supra* text accompanying note 473. If administrability justifies tax partnership classification, the threshold should compare the tax attributable to allocation of items to the service-providing member with the costs that would be incurred to determine income without classifying the arrangement as a tax partnership. If the arrangement allocates one percent of the arrangement's \$100,000 of

The degree-of-activity test probably does not violate neutrality. Except in borderline cases, members of an arrangement would not increase or decrease activity merely to obtain tax benefits, because doing so would significantly alter the economic arrangement. In borderline cases, however, where the modest increase or decrease in activity would alter the arrangement's classification, taxpayers may make adjustments to obtain the more favorable tax classification.

2. *The Type-of-Activity Test.* The type-of-activity test, by focusing on classifiable activities, provides more certainty than the degree-of-activity test. Under the type-of-activity test, an arrangement is not a tax partnership if it only provides support services. Since support services can be defined,<sup>483</sup> that part of the test is certain. It leaves unanswered, however, whether a tax partnership exists between property owners and parties who provide additional services.<sup>484</sup> It does not answer whether such arrangements are single partnerships consisting of the property ownership and the provision of the additional services, or whether the ownership of the property is separate from the tax partnership that provides the additional services.<sup>485</sup>

To the extent the type-of-activity test excludes from the definition of tax partnership those arrangements that provide only compensated support services, it satisfies standard equity. Members of such arrangements can trace income from the property directly to the owners based on the owners' respective ownership interests in the property. Thus, the arrangements do not need the partnership accounting and reporting rules or the allocation rules. Each member can compute income from the property at the member level with relative ease. Thus, the simplicity and administrability purposes of the partnership tax rules do not justify treating members of such arrangements differently from the standard taxpayer.

The type-of-activity test generally satisfies neutrality. To earn income from property, the property owners must provide the

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income, or \$1000, and it costs only \$500 to determine income without classifying the arrangement as a tax partnership, the arrangement should not be a tax partnership.

483. See Rev. Rul. 75-374, 1975-2 C.B. 261 (finding that co-ownership of property whereby the owners merely provide maintenance services for the property is not a tax partnership).

484. See *supra* text accompanying note 379 (stating that type-of activity test does not explain whether providing additional services alone creates a separate tax partnership entity).

485. See *supra* text accompanying note 379.

support services.<sup>486</sup> The decision to provide additional services would most likely turn on whether the property owners wished to participate in a venture requiring such services. This decision would be influenced by economic and business factors, such as the owners' risk tolerance, their desire to join a venture that provides additional services, and the income potential of the services. If the property owners wished to keep the additional services separate from the property ownership to prevent having the services and property be treated as a single tax partnership, they would structure the provision of the additional services in such a way that providing them would be treated separately. This causes the type-of-activity test to receive negative results on neutrality.

3. *The Estoppel Test.* The estoppel test is certain. It provides the IRS and courts the opportunity to estop taxpayers from disclaiming a chosen business form.<sup>487</sup> Taxpayers may not be able to predict every situation in which the IRS will use the estoppel test. In some situations, the IRS may disregard a taxpayer's treating an arrangement as a tax partnership.<sup>488</sup> In others, the IRS may invoke the estoppel test.<sup>489</sup> The issue in the case will determine what course the IRS takes. Nonetheless, taxpayers know courts can estop them from disclaiming tax partnership treatment.<sup>490</sup> Thus, its meaning is fairly certain.

Courts are concerned that without the estoppel test, "the taxpayer could commence doing business as a . . . partnership and, if everything goes well, realize the income tax advantages therefrom; but if things do not turn out so well, [the taxpayer] may turn around and disclaim the business form he created in

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486. See Rev. Rul. 75-374, 1975-2 C.B. 261 (holding that ownership as tenants in common does not constitute a tax partnership where co-owners do not share in revenue from additional services provided to tenants).

487. See, e.g., *Earp v. Jones*, 131 F.2d 292, 294 (10th Cir. 1942) (holding that a change in classification must be real and substantial to be recognized by the government and the courts for taxation purposes); *Gregory v. Helvering*, 293 U.S. 465, 467-69 (1935) (allowing the government to disregard the taxpayer's chosen business classification).

488. See, e.g., *Comm'r v. Tower*, 327 U.S. 280, 292 (1946) (holding that although the wife was added as a partner, the "mere paper reallocation" would not override the actualities of the relationship by which the husband still earned the income, and therefore no tax partnership existed); *Earp*, 131 F.2d at 294 (showing that the government is free to ignore the change in classification if the change is not real and substantial).

489. See, e.g., *Maletis v. United States*, 200 F.2d 97, 98 (9th Cir. 1952) (noting that the Commissioner is free to sustain or disregard the taxpayer's fiction).

490. See, e.g., *Higgins v. Smith*, 308 U.S. 473, 477 (1940) (holding that the government need not limit its inquiry to the form chosen by the taxpayers but may look at the actualities of the relationship and choose to disregard the effect of the "fiction").

order to realize the loss as his individual loss.”<sup>491</sup> Courts further state:

[T]he burden is on the taxpayer to see to it that the form of business he has created for tax purposes, and has asserted in his returns to be valid, is in fact not a sham or unreal. If in fact it is unreal, then it is not he but the Commissioner who should have the sole power to sustain or disregard the effect of the fiction since otherwise the opportunities for manipulation of taxes are practically unchecked.<sup>492</sup>

These statements indicate that the purposes of the estoppel test are to deter abuse and mete out punishment. These are worthy purposes because they help maintain standard equity. If an arrangement is not a valid tax partnership, the members of the arrangement should generally be subject to the tax rules that apply to the standard taxpayer. Although members of an estopped partnership may not otherwise be sufficiently different from the standard taxpayer to justify different treatment, the members’ treating themselves as partners creates a distinction that may justify the deviation.

Perhaps, however, other means are more appropriate for meting out punishment and deterring behavior. For example, the law could impose penalties on taxpayers who treat themselves as partners when the arrangement is not a tax partnership.<sup>493</sup> The estoppel test requires parties to continue to treat an arrangement as a tax partnership even though they do not otherwise satisfy the tax partnership definition.<sup>494</sup> This violates standard equity. Since the purposes of the estoppel test can be achieved without treating the arrangements as tax partnerships, such other means should be adopted to preserve standard equity.

The estoppel test probably satisfies neutrality. Taxpayers estopped from disclaiming tax partnership classification probably have not made nontax business decisions that affect the economic arrangement. They have merely treated an arrangement as a tax partnership. Because the estoppel test does not affect nontax decisions, it satisfies neutrality.

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491. *Maletis*, 200 F.2d at 98.

492. *Id.*

493. Such penalties could include extending the statute of limitations, providing the IRS the opportunity to assess taxes for years that the members obtained a tax benefit from treating the arrangement as a tax partnership, and imposing a monetary penalty based on percentage of tax saved during the prior years.

494. See *Maletis*, 200 F.2d at 98 (“The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute.” (quoting *Higgins*, 308 U.S. at 477)).

Although the estoppel test satisfies certainty and neutrality, and serves an anti-abuse purpose, it should not necessarily be retained. The estoppel test treats certain arrangements as tax partnerships that otherwise may not satisfy the definition of tax partnership. Such arrangements, if not otherwise within the definition of tax partnership, do not possess those attributes that justify the partnership tax rules. Therefore, they should not be subject to those rules. To remedy this, Congress should enact other means to accomplish the purposes of the estoppel test.

### *C. Tests That Receive Exceptional Scores*

Some of the tests satisfy all of the tax policy criteria and are an indispensable part of the definition of tax partnership. Nonetheless, none of them alone is sufficient to define tax partnership. Thus, a workable definition of tax partnership must combine these tests.

1. *The Joint-Profit Test.* The joint-profit test, if based on the accounting definition of profit, satisfies the certainty criterion. According to the Tax Court and the Seventh Circuit, however, the appropriate definition of profit is the dictionary definition.<sup>495</sup> Unfortunately, the dictionary definition of profit is unworkable and should not govern the joint-profit test. The income tax system requires the computation of taxable income,<sup>496</sup> which follows the accounting definition of income.<sup>497</sup> This signals inadequacies of the dictionary definition, which does not account for the difference between revenue and expenses. Tax partnerships must compute taxable income in the same manner as an individual.<sup>498</sup> Individuals compute taxable income by subtracting deductions from gross income.<sup>499</sup> The broad definition of gross income includes accessions to wealth that a taxpayer clearly realizes and over which the taxpayer has complete dominion.<sup>500</sup> It also requires gain

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495. See *supra* text accompanying note 355–57 (illustrating how various circuits have addressed the tax motive requirement in assessing the existence of a tax partnership).

496. See I.R.C. § 1(a)–(e) (2000) (listing the various tax thresholds and rates for married couples, heads of households, unmarried individuals, married individuals filing separate returns, estates and trusts).

497. See I.R.C. § 63(a) (2000) (“[T]axable income’ means gross income minus the deductions . . .”).

498. See I.R.C. § 703(a) (2000) (describing the method of tax computation for partnerships).

499. See I.R.C. § 63(a) (defining the term “taxable income’ [as] gross income minus the deductions allowed [under the] chapter”).

500. *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

recognition.<sup>501</sup> Thus, for a tax partnership to have taxable income, the tax partnership must have gross income. Assuming, for the sake of analysis, that a co-owned joint-production arrangement accedes to wealth when it produces something using co-owned property,<sup>502</sup> the arrangement probably does not have gross income because it does not realize or recognize income and does not have complete dominion over the product.

Co-owned joint-production arrangements will struggle to identify a realization event. Consider three possible realization events: (1) the time at which the product is produced, (2) the time at which the arrangement transfers the product to the individual members, and (3) the time at which the members individually sell the product. The first alternative violates the income tax system's realization principle. The income tax system does not consider production a realization event.<sup>503</sup> Instead, it requires a disposition or change in ownership.<sup>504</sup> The arrangement could be deemed to dispose of the product when (1) it transfers the product to its members or (2) the members subsequently sell the product.

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501. See I.R.C. § 1001(c) (2000) ("Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized."). But see I.R.C. § 1033(a) (Supp. III 2005) (instructing that reinvested proceeds from the involuntary disposition of property do not constitute a recognizable gain or loss).

502. A co-owned joint-production arrangement may accede to wealth when it produces a product. Such accession would be imputed income the recognition of which the tax system has resisted. See Alan Gunn, *The Case for an Income Tax*, 46 U. CHI. L. REV. 370, 383 (1979) ("The 'sacrifice' theory is a product of the erroneous idea that income measures one's annual 'satisfactions.' We might say, pursuing this line, that a 'true' measure of income would include all forms of imputed income from owning property or performing services, and all nonpecuniary 'windfalls' like pleasant sunsets. Those who take this position concede its impracticality, and so are willing to fall back on the more conventional notions of income as a rough measure of the real thing." (footnotes omitted)).

503. Commentators have argued that gross income should include accretions, even without realization events. See, e.g., Louie, *supra* note 417, at 872 (proposing that unrealized gain on marketable securities of publicly traded companies should be subject to income tax); David A. Weisbach, *A Partial Mark-to-Market Tax System*, 53 TAX L. REV. 95, 96 (1999) (exploring whether it would be feasible to expand the mark-to-market rule to cover most liquid assets). Nonetheless, citing administrative inconvenience, courts require a disposition in most situations. See, e.g., *Eisner v. Macomber*, 252 U.S. 189, 208–09 (1920).

504. See, e.g., Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1, 12 (1992) ("In the current tax system, however, realization generally means transfer in the sense of sale or exchange, as well as the receipt of proceeds, constituting earnings rather than a return of capital, from an ongoing investment such as a share of stock or a bond." (footnote omitted)); Weisbach, *supra* note 31, at 1633 ("Under the realization requirement, income is not taxed and losses are not deducted until the income or loss is 'realized.' Although the Code does not define realization, it generally means the asset producing the income or loss is sold or exchanged." (footnote omitted)).

If the arrangement were treated as a tax partnership, the transfer of product to the arrangement's members could be either a distribution or a sale to the partners.<sup>505</sup> If the transfer were treated as a distribution, the distribution could be the realization event,<sup>506</sup> but partners generally do not recognize gain on distributions from a partnership.<sup>507</sup> Thus, the arrangement would have no gross income. If the transfer is treated as a disguised sale, the distributee partner would have to pay or be deemed to pay for the product.<sup>508</sup> The distributee partner's only actual payment is that paid as a share of the production costs. Under a disguised sale analysis, perhaps that amount could be treated as payment for the product.<sup>509</sup> If so, the purchase price should equal the cost incurred to produce the product.<sup>510</sup> This would generate no gross income for the arrangement, as the amount the arrangement received should equal the arrangement's adjusted tax basis in the produced property.<sup>511</sup> The distributee member's acquisition also would have no effect on the distributee member's basis in the property.<sup>512</sup>

Alternatively, under the disguised sale method, the members could be deemed to pay fair market value for the product acquired from the arrangement.<sup>513</sup> If this were the rule, a

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505. See I.R.C. § 707(a)(1)–(2) (2000) (defining a partner not acting in capacity as partner and addressing the treatment of payments made to partner for property or services).

506. I.R.C. § 1001(a) (2000) (instructing that realization events are sales or other dispositions).

507. I.R.C. § 731(a)(1) (2000) (“In the case of a distribution by a partnership to a partner . . . gain shall not be recognized . . .”). This is an exception to the general recognition rule in section 1001(c). See *supra* note 501.

508. See I.R.C. § 707(a) (2000) (addressing property transfers between partners and their partnerships, including situations where the partner is not acting in capacity as partner).

509. Payments made to a partnership within two years before or after a distribution from the partnership are presumed to be consideration for the property received. This presumption may, however, be overcome. Treas. Reg. § 1.707-3(c) to (d) (as amended in 1991).

510. This assumes that members' percentage of production costs equal their percentage distribution of product. If the arrangement provides otherwise, this analysis would break down, and the arrangement should be classified as a tax partnership.

511. See I.R.C. § 1001(a)–(b) (2000) (addressing methods of computing gains, losses and amount realized); I.R.C. § 1012 (2000) (mandating that basis of property is determined by its cost); I.R.C. § 1016(a)(4) (2000) (explaining adjustments to basis).

512. For example, if it cost \$100,000 to produce a member's share of product, the member's basis in that share of product would be \$100,000, whether the member was deemed to acquire the product for that amount from the arrangement or whether the arrangement was disregarded and the member was deemed to produce that amount of product. Taking the same basis in the property under either scenario, the member's subsequent disposition would produce the same tax result.

513. This appears to be the position the Seventh Circuit took in *Madison Gas &*



successful co-owned joint-production arrangement would recognize gain on the disguised sale equal to the difference between the deemed payment and the production costs.<sup>514</sup> After receiving the deemed payment, the arrangement would hold deemed cash, which would require attention.<sup>515</sup> A rule could deem the arrangement to make a distribution of the deemed cash to the respective members who were deemed to pay it to the arrangement. As part of this deemed transaction, the arrangement should allocate to each member its distributive share of gain recognized on the deemed sale of the product.<sup>516</sup> Assuming the allocations, cost-sharing, and distributions are all made in proportion to the members' interests in the arrangement, the arrangement would allocate to each member gain equal to the amount of gain the arrangement recognized on the disguised sale of property to the member.<sup>517</sup> Other than the allocation of partnership gain from the disguised sale, the members should not realize any gain, even on the subsequent deemed distribution of deemed cash.<sup>518</sup> The members would take

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*Electric Co. Madison Gas & Elec. Co. v. Comm'r*, 633 F.2d 512, 516 (7th Cir. 1980) ("The difference between the market value of MGE's share of that electricity and MGE's share of the cost of production obviously represents a profit."). I acknowledge that the discussion of the deemed sale is somewhat convoluted and presents a ridiculous proposition. The convolution and ridiculousness are, however, in harmony with the equally absurd notion of computing income of an arrangement that has no revenue. This discussion exposes that absurdity.

514. A successful arrangement would produce product at a cost below fair market value. Thus, the arrangement's adjusted tax basis in the product would be below the product's fair market value. The disguised sale would produce gain under section 1001(a). I.R.C. § 1001(a) (2000).

515. Deemed transactions are not new to partnership taxation. The partnership tax rules have deemed transfers of partnership interests in exchange for services to be transfers of partnership property in exchange for the services followed by the transferee contributing the transferred property to the partnership. See MCKEE ET AL., *supra* note 126, ¶¶ 5.07–.08 (describing a deemed transfer of assets to a service partner and that partner's deemed re-contribution of the assets to the partnership). This circular flow of partnership property will no longer be deemed to occur if recently promulgated temporary regulations are finalized as they now read. See Prop. Treas. Reg. § 1.83-3(l)(1), 70 Fed. Reg. 29,680, 29,680–81 (May 24, 2005) (treating the partnership interest received as property and requiring the taxpayer to include the value of that interest in gross income and adjust capital accounts accordingly); Prop. Treas. Reg. § 1.704-1(b)(4)(xii), 70 Fed. Reg. 29,681, 29,681 (May 24, 2005) (same).

516. See I.R.C. § 702(a) (2000) (providing the general rule for computing the income of a partner).

517. For example, if the arrangement had three equal members and each paid \$50,000 of the arrangement's expenses and the arrangement produced \$300,000 of product that was distributed equally to the members, the arrangement would have \$150,000 of gain on the deemed sale to the members. That \$150,000 would be allocated equally to the members under section 704. Any disproportionate distributions would raise uncertainty and reporting complexity requiring tax partnership classification, or would be treated as a sales transaction between the members.

518. Each partner's basis in the arrangement would equal the amount contributed

a basis in the product deemed purchased equal to the fair market price deemed paid.<sup>519</sup> When the members later sold the product, they should recognize little or no gain.<sup>520</sup> The net tax result of this disguised sale to the members is the same as the result that would be obtained if the arrangement were disregarded for tax purposes, with potential timing differences, largely negating the effect of added complexity.<sup>521</sup>

Treating the owner's subsequent sale of the product as the arrangement's realization event will not reflect the members' economic arrangement. Under this alternative, when a member sells the product, the arrangement would be deemed to have sold the product. For tax purposes, the arrangement's taxable income would include the member's gain on the sale of the product and the costs the member incurred to sell the product. Because the parties did not intend to bear the cost or enjoy the economic benefit of each others' sales efforts and results, the costs and results of such efforts should not be part of the arrangement's accounting and reporting. As the joint-profit test currently stands in the Seventh Circuit, the joint-profit test violates equity. If it was modified to focus on whether an arrangement has gross income, the test would satisfy standard equity.<sup>522</sup>

Using the established definition of beneficial ownership as a proxy for complete dominion, co-owned joint-production arrangements probably do not have complete dominion over the product. Under the definition of beneficial ownership, the party

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plus gain allocated. I.R.C. § 705(a)(1) (2000). Thus, each member would have a \$100,000 basis in its interest in the arrangement. If the arrangement distributed the \$300,000 of deemed cash received on the deemed sale of the product to the members, each member would receive \$100,000 of deemed cash, recognize no gain, and reduce its basis in the arrangement to zero. I.R.C. §§ 705(a)(2), 731(a) (2000).

519. See I.R.C. § 1012 (2000).

520. If the fair market value of the property increases after the member acquires it from the partnership, the member would recognize that difference as gain on the disposition.

521. If the arrangement were disregarded, the members would recognize gain on the sale of the product equal to the difference between the amount received for the product and the product's cost. This will equal the sum of the gain allocated to the member on the disguised sale and the gain recognized on the subsequent disposition. Under the deemed sale method, the partnership would recognize gain when the product was transferred to the members. If the arrangement were disregarded, the members would recognize gain individually when they sold the product.

522. The focus should be gross income, not taxable income, because if the arrangement has no gross income, it becomes a mere expense-sharing arrangement. In such situations, the parties must make contributions to cover the arrangement's costs. They can trace their contributions to the expenditure, which each party could account for separately. If an arrangement has gross income and the income can be traced to the respective members, the arrangement does not need the partnership tax accounting and reporting rules.

who holds legal title to the property, has an equity interest in the property, and enjoys the benefits and bears the burdens of owning property, is the tax owner of the property.<sup>523</sup> If the product were to appreciate in value, the members individually, not the arrangement, would benefit from the appreciation.<sup>524</sup>

Similarly, co-owned joint-production arrangements do not bear the burden of the produced property's risk of loss. For example, if co-mined coal was extracted from the earth awaiting shipment to a specific member, the member would individually bear the cost if the coal was destroyed. Furthermore, the members individually, not the arrangement, control the disposition of the product.<sup>525</sup> All of these factors indicate that the arrangement does not own the product or the proceeds from selling it. Thus, the arrangement has no gross income.

This focus on gross income is a shift from the substantive law's focus on profit. The shift is justified. First, gross income is a defined tax term and the definition of tax partnership will be more certain if it uses tax terms. Second, if an arrangement does not have gross income, it cannot compute taxable income and apply the partnership tax rules.<sup>526</sup> Third, if an arrangement has no gross income, its members must contribute all of the arrangement's operating costs,<sup>527</sup> which they will be able to trace.

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523. See, e.g., *Grodt & McKay Realty, Inc. v. Comm'r*, 77 T.C. 1221, 1237-38 (1981) ("Some of the factors which have been considered by courts in making this determination are: (1) Whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity was acquired in the property; . . . (5) whether the right of possession is vested in the purchaser; . . . (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property." (citations omitted)).

524. In *Madison Gas & Elec. Co.*, the several members of the arrangement received coproduced electricity. *Madison Gas & Elec. Co. v. Comm'r*, 633 F.2d 512, 513-14 (7th Cir. 1980). Each member was limited to distributing its share to the geographic area over which it could distribute its self-produced electricity. *Id.* at 513. It is conceivable that the price of electricity in the several different markets differed. If that were the case, the arrangement would not enjoy the benefit of the produced electricity, but each member would individually. Thus, the benefit of owning the property inures to the members individually, not to the arrangement.

525. *Id.* at 513-14 ("Electricity produced by the Plant is distributed to each of the utilities in proportion to their ownership interests. Each utility sells or uses its share of the power as it does power produced by its own individually owned facilities, and the profits thereby earned by MGE contribute only to MGE's individual profits. No portion of the power generated at the Plant is offered for sale by the utilities collectively, and the Plant is not recognized by the relevant regulatory bodies as a separate utility licensed to sell electricity.").

526. See *supra* notes 496-99 and accompanying text (stating that partnerships are required to calculate taxable income, which is derived from gross income computations).

527. See, e.g., *Madison Gas & Elec. Co.*, 633 F.2d at 514 ("Each utility also pays a portion of all expenditures for operation, maintenance and repair of the Plant corresponding exactly to its respective share of ownership. Under utility accounting

Thus, if the joint-profit test considers gross income instead of profit, it will satisfy equity by only subjecting arrangements that have tax and accounting complexity addressed by the partnership tax rules to such rules.

The joint-profit test satisfies neutrality. Consider an example that illustrates this: If each member of a co-owned joint-production arrangement sells product to a different geographic region, it is not likely that they would alter the economic arrangement and share the costs and income from such sales with each other to forego joint profit simply to be treated as a tax partnership. Nor would they separate the arrangement simply to avoid tax partnership classification.

2. *The Expense-Sharing Test.* The expense-sharing test is certain. If an arrangement produces no product or services that it can dispose of, it is not a tax partnership.<sup>528</sup> The expense-sharing test satisfies standard equity by excluding from the definition of tax partnership arrangements that have no gross income, where all expenses must be paid directly by the members.<sup>529</sup> The members can individually account for such expenditures.<sup>530</sup> Requiring such arrangements to compute taxable income would require them to recognize imputed income.<sup>531</sup> This, of course, is a deviation from principles of our tax system.<sup>532</sup> Because expense-sharing arrangements do not create the complexity and administrative difficulties the tax rules were enacted to alleviate, they should not be treated as tax partnerships. By producing this result, the expense-sharing test satisfies equity.

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procedures mandated by the PSC and the FERC, these expenses are combined with and treated in the same manner by MGE as expenses from its individually owned facilities.”).

528. See Treas. Reg. § 301.7701-1(a)(2) (as amended in 1997) (establishing that joint undertakings give rise to a tax partnership if the members carry on a trade or business and divide the profits).

529. See *id.*

530. In the case of a ditch-digging arrangement, the members would be required to capitalize the expenditures and add that to the bases of the property improved. See I.R.C. § 263(a) (2000) (instructing that a deduction is not allowed for permanent improvements or betterments); Treas. Reg. § 1.263(a)-1(a)(1) (as amended in 1994) (disallowing deductions for “[a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate”).

531. The imputed income might be the rent-free use of the ditch in the example in the regulation. See *supra* text accompanying note 364 (illustrating a joint venture by two property owners building a ditch to drain their land).

532. See Gunn, *supra* note 502, at 383 (criticizing the “sacrifice” theory of taxation as unnecessary and inconsistent with the “ability-to-pay” principle because it measures income in terms of the enjoyment and “satisfaction” obtained from the ownership of property).

The expense-sharing test is neutral. The taxpayers in the ditch-digging example joined together to construct a ditch that would drain water.<sup>533</sup> They would not alter this arrangement to produce product to be classified as a tax partnership. Other parties engaged in selling product or services would not discontinue such business to satisfy the expense-sharing test and avoid tax partnership classification. Thus, the expense-sharing test does not affect taxpayers' nontax decisions.

3. *The Source-of-Activity Test.* The source-of-activity test is certain, satisfies equity, and is neutral. The test provides certainty by examining whether any members of an arrangement contribute services.<sup>534</sup> Although this requires that the contributions of services be distinguished from services provided for compensation, courts have successfully made that determination by considering who controls the arrangement.<sup>535</sup> Thus, the source-of-activity test is certain.

The source-of-activity test satisfies standard equity by distinguishing between arrangements that can trace income and losses from their sources and those that cannot, subjecting only those arrangements that cannot to the partnership tax rules.<sup>536</sup> The example of Ephraim and Fran illustrates this. Recall that they co-own an apartment complex.<sup>537</sup> If they hire a manager to provide only support services, their sole source of income will remain the property.<sup>538</sup> They can trace the income from the property to themselves based upon their respective ownership interests in the property. Any other allocation of the income would violate the assignment-of-income doctrine.<sup>539</sup> Thus, they

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533. See *supra* text accompanying note 364 (illustrating that the ditch-digging endeavor would not create a tax partnership between the two property owners).

534. See, e.g., *Tate v. Knox*, 131 F. Supp. 514, 517 (D. Minn. 1955) (using whether someone "contributed his skill to [the] enterprise" as a factor in determining whether a partnership exists); *Bartholomew v. Comm'r*, 9 T.C.M. (CCH) 302, 305 (1950) (holding that although the partners shared in gains and losses there was no tax partnership because they did not both participate in the management and conduct of the enterprise), *vacated*, 186 F.2d 315 (8th Cir. 1951).

535. See *supra* notes 393–97 (discussing the various approaches to the control requirement for a finding of a tax partnership).

536. See *supra* text accompanying notes 382–97 (describing the source-of-activity test and noting that the test "connects the source of activity to the source of economic benefit" when determining tax partnership status).

537. See *supra* Part V.B.7.a (concluding that two individuals owning an apartment complex for which they perform all maintenance and repair services are not excluded from the definition of a tax partnership under the source-of-activity test).

538. See *supra* Part V.B.7.b (noting that if the two individuals who own the property hire a manager to perform these services, the arrangement would be excluded from the definition of tax partnership under both tests).

539. See *supra* text accompanying notes 130–33 (stating that the assignment-of-

should not be allowed to use the partnership tax rules. By excluding their arrangement from the definition of tax partnership, the source-of-activity test obtains this correct result.

Now assume that Ephraim and Fran contribute support services to the arrangement. By doing this, they contribute property and services toward a common goal and cease to be able to trace income separately from the property and services. They cannot know whether Fran's services, Ephraim's services, or the property generate the income or what portion of the income is produced by each. This inability to trace makes the assignment-of-income doctrine impossible to apply. It also creates complexity that justifies treating Ephraim and Fran differently from the standard taxpayer; specifically, the difference justifies their using the partnership tax allocation rules.

As with all other tests, the source-of-activity test may influence decisions regarding the structuring of arrangements. Parties may wish to treat payments made to a service provider as compensation to avoid tax partnership classification.<sup>540</sup> Members of a co-ownership arrangement may seek tax partnership classification under the source-of-activity test either by (1) granting a nominal profits interest to a service provider who will provide nominal services, or (2) allowing at least one member to perform nominal services for a share of profits.<sup>541</sup> Although performing nominal services could affect the ability to trace income and expenses from their sources, this also creates opportunities for taxpayers to game the system.<sup>542</sup> If the source-of-activity test does not recognize this, taxpayers can take advantage of tax partnership rules without creating an arrangement that is sufficiently different from the standard taxpayer. This would violate standard equity. Thus, the source-of-activity test must incorporate a *de minimis* exception that denies tax partnership classification to arrangements that admit members who provide only a *de minimis* amount of services.<sup>543</sup>

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income doctrine only considers the source of income regardless of where the funds are directed after they are produced).

540. For example, members of the arrangement may, for some reason, prefer to deduct amounts paid to the service provider.

541. The service-providing member would not have to receive a larger percentage of profits. Simply contributing services creates tracing difficulty since a portion of the profit is attributable to the services. If income from those services is not allocated to the service-providing member, the members may have assigned income from the service-providing member to other members.

542. For example, to come within the definition of tax partnership under the source-of-activity test, taxpayers may give a service provider a 0.01% interest in the partnership for the contribution of nominal services.

543. The *de minimis* exception could determine the threshold level of services as a

This would help preserve the source-of-activity test's equity and neutrality.

4. *The Business-Purpose Test.* The business-purpose test suffers from being less than certain,<sup>544</sup> but it serves such an important role in preventing the abusive use of the partnership tax rules that it must be preserved. "The business purpose doctrine reduces the incentive to engage in such essentially wasteful activity, and in addition helps achieve reasonable equity among taxpayers who are similarly situated—in every respect except for differing investments in tax avoidance."<sup>545</sup> By requiring the examination of the real relationship between parties and the purpose for which an arrangement is formed, the business-purpose test identifies those arrangements that are "more fanciful than real" and disregards them for tax purposes.<sup>546</sup> A fanciful arrangement does not create a difference between its members and the standard taxpayer that justifies members of the fanciful arrangement using the partnership tax rules. Because the business-purpose test excludes fanciful arrangements from the definition of tax partnership, it satisfies standard equity.

The business-purpose test also satisfies neutrality because it discourages taxpayers from making decisions that lack a nontax business purpose. The business-purpose test, by requiring some nontax business purpose, creates rule neutrality by minimizing the effect tax rules have on decisionmaking.

### VIII. A POLICY-BASED DEFINITION OF TAX PARTNERSHIP

Having evaluated the ten tests, the next step is to eliminate the tests that fail tax policy scrutiny; therefore, the state-law test, fact-question test, and substantive-law test must go.<sup>547</sup> Next,

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percentage of the arrangement's profits. Any aggregate profits interests transferred below that percentage would be disregarded in applying the source-of-activity test.

544. See, e.g., James M. Delaney, *Where Ethics Merge With Substantive Law—An Analysis of Tax Motivated Transactions*, 38 IND. L. REV. 295, 297–309 (2005) (discussing varying judicial interpretations of the business-purpose test and the uncertainty of the threshold level of economic substance required to satisfy it).

545. *ASA Investorings P'ship v. Comm'r*, 201 F.3d 505, 513 (D.C. Cir. 2000).

546. *Earp v. Jones*, 131 F.2d 292, 293–94 (10th Cir. 1942).

547. Others have advocated eliminating the state-law test from the definition of a tax corporation. See, e.g., Susan Pace Hamill, *The Story of LLCs: Combining the Best Features of a Flawed Business Tax Structure*, in BUSINESS TAX STORIES, *supra* note 33, at 295, 310–11 ("Given the historical background of the evolution of corporate law and especially the business and political climate of the early twentieth century as liberal general incorporation laws proliferated across the states, relying on state law to conclusively define corporate status for tax purposes may have made sense in 1913. Nearly a century

those tests that pass scrutiny must be consolidated or eliminated. The degree-of-activity test should be relegated to the *de minimis* exception of the source-of-activity test. The type-of-activity test should be used only to divide ownership arrangements from arrangements that provide additional services. After which, the ownership arrangement and the arrangement providing additional services should be separately tested for tax partnership classification.

The estoppel test should be replaced. It mainly serves deterrent and punitive functions. Treating such arrangements as tax partnerships is not supported by the purposes of the partnership tax rules (other than the general anti-abuse purpose of some rules). Instead of the estoppel test being a judicial tool for meting punishment to members of some arrangements, Congress should replace it with penalties requiring members to make equalizing payments to compensate for prior year tax savings and extend the statute of limitations to more accurately accomplish what the estoppel test was intended to accomplish.

The third step is to consolidate the remaining tests into a workable definition that tax policy supports. The source-of-activity test, the joint-profit test (including by extension, the expense-sharing test), and the business-purpose test must remain a part of the definition. Each of these tests is necessary to determine whether an arrangement is a partnership, but none of them is sufficient. For example, the source-of-activity test examines whether the parties share the economic benefit derived from the various contributions, but it does not define economic benefit. Thus, it is possible under the source-of-activity test to inappropriately treat a mere expense-sharing arrangement as a tax partnership. The joint-profit test should use the accounting definition of profit to distinguish expense-sharing arrangements and co-owned joint-production arrangements from arrangements that should be classified as tax partnerships. Finally, the business-purpose test is necessary to ensure that structures have economic significance and preserve the general anti-abuse concept of the partnership tax rules. These tests should be combined to form a working definition of tax partnership.

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later, however, those reasons are substantially less compelling because the state law designation of business entities as incorporated or unincorporated no longer carries any meaning towards identifying the true business characteristics of the firm and therefore offers no rational policy concerning the appropriate taxation of the firm and its owners." (citing Susan Pace Hamill, *The Taxation of Domestic Limited Liability Companies and Limited Partnerships: A Case for Eliminating the Partnership Classification Regulations*, 73 WASH. U. L.Q. 565, 598-608 (1995)).



Based on the above analysis and retaining the tax-entity default rule,<sup>548</sup> *a tax partnership is two or more persons, at least one of whom provides significant services, who have (or will have) common gross income.* This proposed definition incorporates all of the tests that pass policy scrutiny and are necessary for a workable definition of tax partnership, and it disposes of the tests that fail policy scrutiny. The proposed definition adopts the source-of-activity test (including the *de minimis* exception) by requiring at least one member to contribute significant services for the arrangement to be a tax partnership. Thus, mere co-ownership arrangements or co-ownership arrangements that hire a manager to provide support services would not be tax partnerships under the proposed definition.

The proposed definition also preserves the distinction between tax partnerships and principal-agent relationships, between tax partnerships and financing arrangements, and between tax partnerships and other arrangements, such as landlord-tenant agreements. The proposed definition accomplishes this by requiring that the persons have a common gross income. Gross income requires complete dominion of the income, which incorporates control.<sup>549</sup> The distinction between a tax partner and a creditor, and between a tax partner and an agent, is control over the source of income.<sup>550</sup> Only the party with control would have income from the property or services producing the income.<sup>551</sup> The party lacking control would receive compensation for providing services or the use of capital. By requiring common control of gross income, the proposed definition preserves this distinction.

The proposed definition incorporates the joint-profit test and the expense-sharing test by requiring that the persons have a common gross income. By using "gross income" instead of profit, the definition adopts tax terminology, making the definition more

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548. See *supra* text accompanying note 43 (stating that an arrangement can be a tax partnership only if it is not a tax corporation or tax trust).

549. See *supra* text accompanying note 500 (stating that gross income is any realized, clear accession to wealth over which the taxpayer has dominion); see also *supra* text accompanying notes 523–25 (stating that under both co-owned joint-production arrangements and beneficial property arrangements, the benefits and burdens of the produced property go to the members individually and not to the arrangement).

550. See *supra* Part V.B.7.d (explaining that under a principal-agent relationship, the agent has sold rather than contributed his services to the arrangement, and therefore the relationship is outside the scope of the source-of-activity test and does not qualify as a tax partnership); see also *Arthur Venneri Co. v. United States*, 340 F.2d 337, 341 (Ct. Cl. 1965) (concluding that a taxpayer without an equal right to control is a creditor and not a tax partner); *Kelly v. Comm'r*, 29 T.C.M. (CCH) 1090, 1103–04 (1970) (opining that equal control is necessary to be a tax partner).

551. See *supra* Part V.B.7.d (discussing profits interest as compensation).

certain and reflecting tax policy and the purposes of partnership taxation. If two parties have common gross income and at least one of them contributed services that help generate gross income, the arrangement, not the parties separately, will have gross income, and the parties will not be able to trace the income from property of the arrangement or the contributed services.<sup>552</sup> Requiring common gross income also requires a joint ownership in property if property is part of the arrangement. If parties do not have joint ownership, income from the property will be the income of the separate property owners. If parties make asymmetrical contributions of property to an arrangement, income will become common only if both parties take a direct or indirect ownership in the other party's property.<sup>553</sup> Otherwise, each party will earn income separately.

The proposed definition also contemplates arrangements that have begun operations but have no gross income. If such arrangements are formed to earn gross income, they should be treated as tax partnerships even before they have gross income. This concept is not new to tax law, so it should not be difficult to apply.<sup>554</sup> It does, however, require that the activities be operating activities that will generate gross income. Such activities must be distinguished from pre-operating activities (i.e., organization and syndication fees incurred to form the arrangement and bring parties together), which are performed before the creation of a tax partnership.<sup>555</sup>

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552. See *supra* Part VII.C.3 (explaining that the source-of-activity test only treats arrangements which are unable to trace income and losses from their sources as tax partnerships).

553. For example, if Rob contributes land worth \$900,000 to an arrangement and Erik contributes a tractor worth \$100,000 to the arrangement, gross income from the combined use of the land and tractor will be common to both Rob and Erik only if they both obtain an interest in the other's property. Otherwise, income from the land will remain Rob's and income from the tractor will remain Erik's. Even if stated as a percent of total income from the combined use of the land and tractor, the income will not be common if both parties do not have an interest in both properties.

554. See *Frazell v. Comm'r*, 88 T.C. 1405, 1413 (1987) (holding that an arrangement that was fully subscribed, deposited contributed capital into its operating account, employed capital in its business, and filed a partnership tax return for the year was a tax partnership even though the arrangement reported no gross income for its first year of operations).

555. See *Sparks v. Comm'r*, 87 T.C. 1279, 1284 (1986) (holding that pre-operating activities do not create a tax partnership). The Code contemplates organization and syndication expenditures and requires that they be capitalized and amortized. See I.R.C. § 709(a) (2000) (providing that generally, "no deduction shall be allowed . . . to the partnership . . . for any amounts paid or incurred to organize a partnership"). Such expenditures are "incident to the creation of the partnership." I.R.C. § 709(b)(2)(A) (2000). Because they are incident to the creation of the partnership, they are incurred before the partnership is created. Such expenditures may be deducted as a deferred expense only

The proposed definition also removes some pressure from, but does not eliminate, the business-purpose test by requiring that at least one party contribute services and both have common taxable income. For example, in the tax shelter cases and family partnership cases that have used the business-purpose test, the first inquiry under the proposed definition would be whether the parties shared control. If not, the arrangements would not have been tax partnerships under the proposed definition. Even if they share common control, at least one of the parties must contribute significant services.<sup>556</sup> If the parties could satisfy the technical requirements of the proposed definition, courts would still have access to the business-purpose test if the arrangement lacked business purpose.

An attractive feature of the proposed definition is that it does not require Congress to enact new legislation or Treasury and the IRS to significantly modify existing rules.<sup>557</sup> Nonetheless, it can have immediate effect. The current state of the law is fairly loose.<sup>558</sup> Going forward, when courts interpret the definition of tax partnership they should consider the purposes for which the partnership tax rules were enacted. Doing this, courts will arrive at the proposed definition. Treasury and the IRS should reconsider the definition of tax partnership as now stated in the check-the-box regulations and consolidate the different tests stated therein into the proposed definition.

In considering the proposed test, some may wonder if it is not simply a modified version of the substantive-law definition of partnership. Such a conclusion is not wholly unfounded. The proposed definition requires common control, activity, and sharing in gross income. These requirements are similar to the substantive law's association, business activity, and profit-sharing requirements. The proposed definition, however, differs

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after the partnership begins business. I.R.C. § 709(b)(1) (2000).

556. This definition would not abandon the allocation rules in section 704(e)(2), which require allocating the fair market value of services to the service provider in certain family partnerships. I.R.C. § 704(e)(2) (2000).

557. Although such action might be ideal, the time required to enact legislation or promulgate regulations would delay the application of the proposed definition, which is not warranted.

558. For example, jurisdictions around the country still disagree as to how much independence a partnership has from its members. *See, e.g.,* Decker Coal Co. v. Commonwealth Edison Co., 714 P.2d 155, 157 (Mont. 1986) (holding that the Uniform Partnership Act's notion that partnerships are independent from their members completely replaces the common law doctrine that partnerships are not independent from their members). *But see, e.g.,* Arpadi v. First MSP Corp., 628 N.E.2d 1335, 1338 (Ohio 1994) (holding that a partnership is not a separate legal entity but an aggregate of individuals).

significantly from the substantive-law definition. First, it incorporates tax terminology, eliminating the ambiguous term “profit” which is not a part of the partnership tax lexicon. Second, it disposes of such concepts as degree of activity, intent, and multifactor lists, which are ambiguous, and do not reflect tax policy. It replaces them with the source-of-activity test and common gross-income requirement, which are supported by tax policy.<sup>559</sup>

## IX. CONCLUSION

This Article examined the definition of tax partnership and proposed a definition of tax partnership that is workable, supported by tax policy, and supports the purposes of the partnership tax rules. It confirmed that the definition of tax partnership is currently in a state of disarray and remains the sole tax entity definition that is not certain. This confusion persists despite the significant effect the definition has on the tax liability of many taxpayers and the significant resources that have been expended to interpret the definition. A policy-based definition will help facilitate tax planning and tax administration and help curb litigation costs by providing more certainty. Tax policy also helps make the definition more durable and provides Congress, courts, Treasury, and the IRS a foundation for considering the definition in new contexts in the future. Thus, the proposed definition is able to handle those current developments drawing attention to the definition of tax partnership. It is also poised to handle future challenges. Above all, future consideration of the definition of tax partnership should be based on tax policy. Adhering to the Tax Court’s sound advice, those who make, interpret, administer, and comment on the definition of tax partnership should allow tax policy to govern their efforts.

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559. See *supra* text accompanying note 527 (asserting that replacing gross income requirements with profit requirements satisfies equity because gross income requirements subject entities lacking the addressed accounting complexities to tax partnership rules); *supra* text accompanying note 534 (explaining that the source-of-activity test is certain because it looks at who contributed noncompensatory services by identifying who controls the arrangement).

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