INTEGRITY IN TAXATION: RETHINKING PARTNERSHIP TAX

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INTRODUCTION

Today is a remarkable moment in the history of the federal income tax. Our system of taxation, its functionality, and its future have all become topics of pressing national debate.[1] This public discourse has exposed longstanding political and philosophical fractures in the federal income tax system, and individuals are deeply divided about the proper path to reform.[2] Even so, there is consensus on one key issue—the need for change. Whether liberal, conservative, rich, or poor, taxpayers seem to

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1. For instance, growing concerns about income equality have recently become the focus of significant national attention. *See, e.g.*, Brody Mullins et al., *Romney's Taxes: $3 Million*, WALL ST. J., Jan. 24, 2012, http://online.wsj.com/article_email/SB10001424052970204624204577179740171772850-lMyQjAxMTAyMDAwNzEwNDcyWj.html; Nicolas Confessore et al., *Romney Shares Some Tax Data; Critics Pounce*, N.Y. TIMES, Jan. 17, 2012, http://www.nytimes.com/2012/01/18/us/politics/facing-pointed-attacks-romney-urges-focus-on-obama.html; Ian Ayres & Aaron S. Edlin, Editorial, *Don't Tax the Rich. Tax Inequality Itself*, N.Y. TIMES, Dec. 18, 2011, http://www.nytimes.com/2011/12/19/opinion/dont-tax-the-rich-tax-inequality-itself.html; Warren Buffet, Editorial, *Stop Coddling the Super-Rich*, N.Y. TIMES, Aug. 14, 2011, http://www.nytimes.com/2011/08/15/opinion/stop-coddling-the-super-rich.html; David Kocieniewski, *G.E.'s Strategies Let It Avoid Taxes Altogether*, N.Y. TIMES, Mar. 24, 2011, http://www.nytimes.com/2011/03/25/business/economy/25tax.html.

2. As a general illustration, consider the tax reforms proposed by the Obama administration, the House Republicans, and the Republican candidate for president, Mitt Romney. *See* OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2013, at 37–40 (2012), *available at* http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/cutting.pdf (proposing individual income tax reforms designed to create jobs, provide broad tax cuts for the middle class, and reduce long-term deficits through the observation of the "Buffet Rule" that "[n]o household making over $1 million annually should pay a smaller share of its income in taxes than middle-class families pay"; the expiration of the 2001 and 2003 "Bush" tax cuts for those with annual household income greater than $250,000; the reduction of the value of itemized deductions to 28% for those with annual household income greater than $250,000, and the taxation of carried partnership interests as ordinary income); THE WHITE HOUSE & THE DEP'T OF THE TREASURY, THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM 1 (Feb. 2012), *available at* http://www.treasury.gov/press-center/news/Pages/02222012-tax.aspx [hereinafter THE WHITE HOUSE & DEP'T OF THE TREASURY, FRAMEWORK FOR BUSINESS TAX REFORM] (proposing pro-growth corporate tax reforms including a reduction in the corporate income tax rate to 28%, a ceiling on the effective corporate tax rate on manufacturing of 25%, the adoption of a minimum tax on foreign corporate earnings, and overall simplification for small businesses and entrepreneurs); HOUSE BUDGET COMM., FISCAL YEAR 2013 BUDGET RESOLUTION 66 (2012), *available at* http://www.budget.house.gov/uploadedfiles/pathtoprosperity2013.pdf (proposing pro-growth reforms such as consolidating the six current individual income tax brackets into two brackets of 10% and 15%, reducing the corporate income tax rate to 25%, and shifting from a worldwide system of taxation to a territorial system of taxation); Press Release, Mitt Romney Press, Restore America's Promise: More Jobs, Less Debt, Smaller Government (Feb. 22, 2012), *available at* http://mittromney.com/news/press/2012/02/restore-americas-promise-more-jobs-less-debt-smaller-government (proposing tax reforms focused on jobs and growth including an across-the-board 20% cut in individual income tax rates, the retention of a 15% capital gains rate, a reduction of the corporate income tax rate to 25%, the adoption of a territorial system of taxation, and the repeal of the alternate minimum tax for individuals and corporations).

agree that the taxation of individuals and corporations is broken and requires large-scale reform.[3]

Existing debates about taxation, however, are curiously incomplete because they lack adequate discussion of partnership taxation. From a revenue perspective, partnerships play a vital and ever-increasing role in the federal income tax system.[4] The most recent tax return data show that partnerships in 2009 held approximately $18.8 trillion in assets and generated approximately $410 billion in net income.[5] In fact, more than half of the business net income reported in recent years has been attributable to partnerships and other non-corporate entities.[6]

Taxing partnerships presents formidable challenges. Unlike corporations, a partnership is not a taxpayer for federal income tax purposes.[7] Rather, its partners are the taxpayers, paying tax on their respective shares of the partnership's income.[8] The rules governing the taxation of partners and partnerships, set forth in subchapter K of the Internal Revenue Code, therefore perform a largely allocative function. Instead of taxing partnerships directly, these rules determine the amount and timing of each partner's share of partnership income. Over time, these rules have become enormously complicated and have strained the voluntary compliance mechanism on which the federal income tax depends. As a consequence, partnership taxation has become utterly dysfunctional.

Despite subchapter K's importance and deep flaws, policymakers have seldom proposed the comprehensive reform of partnership taxation.[9]

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3. "Democrats and Republicans, liberals and conservatives, independents all believe our tax code is broken . . . ." Jonathan Weisman, *A Year of Tax-Code Reckoning*, N.Y. TIMES, Feb. 11, 2012, http://www.nytimes.com/2012/02/12/business/yourtaxes/tax-code-faces-another-year-of-reckoning.html (quoting Senator Orrin Hatch on the subject of fundamental tax reform).

4. In this Article, the term "partnership" is used to refer to any entity, including a limited liability company, electing to be treated as a partnership for federal income tax purposes. Treas. Reg. §§ 301.7701-1 (as amended in 2009), -2 (as amended in 2009), -3 (as amended in 2006).

5. *See* Nina Shumofsky & Lauren Lee, *Partnership Returns, 2009*, STAT. OF INCOME BULL., Fall 2011, at 71 fig.D (noting that the total assets held by partnerships in 2009 was $18,798,108,367 and the total net income of these partnerships was $409,878,549).

6. In 2008, pass-through entities represented approximately 73% of the net business income generated. INTERNAL REVENUE SERV., STATISTICS OF INCOME INTEGRATED BUSINESS DATASET, TABLE 1, http://www.irs.gov/pub/irs-soi/80ot1all.xls; THE WHITE HOUSE & DEP'T OF THE TREASURY, FRAMEWORK FOR BUSINESS TAX REFORM, *supra* note 2, at 8. More generally, pass-through entities have accounted for approximately one-half of net business income since 2004. THE PRESIDENT'S ECONOMIC RECOVERY ADVISORY BOARD, THE REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE, AND CORPORATE TAXATION 74–75 (Aug. 2010), *available at* http://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report.pdf [hereinafter PERAB, REPORT ON TAX REFORM]; Pamela F. Olson, *And Then Cnut Told Reagan . . .* , 131 TAX NOTES 993, 995 (May 30, 2011) [hereinafter Olson, *And Then Cnut Told Reagan*].

7. I.R.C. § 701 (2006).

8. *Id.*

9. The Obama administration recently released a framework for corporate income tax reform. THE WHITE HOUSE & DEP'T OF THE TREASURY, FRAMEWORK FOR BUSINESS TAX REFORM, *supra* note

Likewise, the theoretical problems in partnership taxation remain largely unexplored by current tax scholarship. There are many articles examining particular provisions of subchapter K,[10] and an equally rich literature explores the taxation of business entities generally,[11] but little attention has been paid to the intellectual foundations of partnership taxation.[12] Perhaps this omission is due to subchapter K's daunting complexity, or to a guild's delight in lawyerly craft.[13] Whatever the reason, what is missing from

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2. As part of this framework, the administration proposed treating certain large pass-through entities as corporations for federal income tax purposes. *Id*. at 7, 10. Although the framework does not specify what entities would be treated as "large" pass-through entities, it references prior proposals that targeted "firms with certain 'corporate' characteristics—publicly traded businesses, businesses satisfying certain income or asset thresholds, or businesses with a large number of shareholders." PERAB, REPORT ON TAX REFORM, *supra* note 6, at 75; *see also* THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 129 (Nov. 2005), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/Simple-Fair-and-Pro-Growth-Proposals-to-Fix-Americas-Tax-System-11-2005.pdf. This framework is best viewed as a proposed reform of the business entity classification rules, rather than a reform of the rules of partnership taxation. It does not propose any fundamental changes in the treatment of entities classified as partnerships for federal income tax purposes. On the contrary, it merely proposes a change in entity classification for certain large pass-through entities currently treated as partnerships or S corporations.

10. *See, e.g.*, William D. Andrews, *Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 TAX L. REV. 3 (1991); Karen C. Burke, *Partnership Distributions: Options for Reform*, 3 FLA. TAX REV. 677 (1997); Laura Cunningham, *Use and Abuse of Section 704(c)*, 3 FLA. TAX REV. 93 (1996) [hereinafter Cunningham, *Use and Abuse*]; Noël B. Cunningham, *Needed Reform: Tending the Sick Rose*, 47 TAX L. REV. 77 (1991); Mark P. Gergen, *Reforming Subchapter K: Contributions and Distributions*, 47 TAX L. REV. 173 (1991); Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008); William S. McKee, *Partnership Allocations: The Need for an Entity Approach*, 66 VA. L. REV. 1039 (1980).

11. *See, e.g.*, GEORGE K. YIN & DAVID J. SHAKOW, AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: TAXATION OF PRIVATE BUSINESS FIRMS AS CONDUITS, TAXATION OF PRIVATE BUSINESS ENTERPRISES: REPORTERS' STUDY (1999) [hereinafter ALI, 1999 REPORTERS' STUDY]; Curtis J. Berger, *W(h)ither Partnership Taxation?*, 47 TAX L. REV. 105 (1991); Jeffrey L. Kwall, *Taxing Private Enterprise in the New Millennium*, 51 TAX LAW. 229 (1997); Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 FLA. TAX REV. 249 (1999) [hereinafter Lokken, *Future Without Subchapter K*]; Philip F. Postlewaite, *I Come to Bury Subchapter K, Not to Praise It*, 54 TAX LAW. 451 (2001) [hereinafter Postlewaite, *I Come to Bury Subchapter K*]; Walter D. Schwidetzky, *Integrating Subchapters K and S—Just Do It*, 62 TAX LAW. 749 (2009); George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141 (1999) [hereinafter Yin, *Future Taxation of Private Business Firms*].

12. For notable exceptions, see Bradley T. Borden, *Aggregate-Plus Theory of Partnership Taxation*, 43 GA. L. REV. 717 (2009); Philip F. Postlewaite et al., *A Critique of the ALI's Federal Income Tax Project—Subchapter K: Proposals on the Taxation of Partners*, 75 GEO. L.J. 423 (1986) [hereinafter Postlewaite, *ALI Critique*].

13. *See generally* Peter H. Schuck, *Legal Complexity: Some Causes, Consequences, and Cures*, 42 DUKE L.J. 1, 1 (1992) ("[Scholars] have a strong taste for complexity; indeed complexity amounts to a craft value . . . ."); *see also* Richard M. Lipton, *"We Have Met the Enemy and He is Us": More Thoughts on Hyperlexis*, 47 TAX LAW. 1, 3–9 (1993) (discussing the role of tax professionals and their continuous demands for administrative guidance as a primary source of the tax law's complexity); Bayless Manning, *Hyperlexis and the Law of Conservation of Ambiguity: Thoughts on Section 385*, 36 TAX LAW. 9, 15 (1982) ("[I]n part because we have often indulged our own impulse to elaborate, we lawyers must share responsibility for the spreading tangle [of complexity] that is slowly strangling our legal system."); Bayless Manning, *Hyperlexis: Our National Disease*, 71 NW. U. L. REV. 767, 767 (1977) (describing "hyperlexis" as the continual creation and complication of laws, statutory codes, and

current legal scholarship is a comprehensive analysis of partnership taxation, its problems, and a start forward.

This article takes some early steps toward reform, proposing a holistic approach to partnership taxation. Dysfunction has enveloped subchapter K, and the time has come to rethink everything in partnership taxation, from first principles to individual provisions. A starting point in this project is to think about the basic architecture of subchapter K, beginning with the values that form its core.

The history of subchapter K is a tale of four competing values: flexibility, efficiency, equity, and simplicity. Dissonance among these values has compromised the functionality of partnership taxation, thwarting the achievement of each individual value and creating the perception that subchapter K is unfair and unprincipled. Discordant values and public illegitimacy have caused some disillusioned partners to turn to vigilantism, correcting the perceived injustices of partnership taxation through abusive tax shelters. In turn, this decrease in partner compliance jeopardizes subchapter K's ability to achieve its systemic ends, with costs that are ultimately borne by the public at large.

Despite these pathologies, subchapter K's history also suggests a solution: unifying partnership taxation through a reorientation and recalibration of its values. To that end, this Article looks to the principle of integrity to make subchapter K more harmonious and functional. The concept of integrity is a bedrock of legal philosophy, most famously developed by Ronald Dworkin as a means of reconciling the foundational principles of justice and fairness.[14] For Dworkin, integrity is a third foundational principle that requires a legal system to resolve conflicts between justice and fairness in a principled manner. Integrity seeks to create a cohesive and unified legal system that its members consider just and fair even when the pursuit of system-wide coherence demands the sacrifice of some justice or fairness in individual instances. Integrity thus fosters a legal system's legitimacy, cultivating loyalty to the system despite disagreements about particular laws.

The principle of integrity is seldom applied in tax scholarship.[15] Yet integrity has a natural appeal in thinking about the discordant values of

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case law); Pamela F. Olson, *Now that You've Caught the Bus, What Are You Going to Do with It? Observations from the Frontlines, the Sidelines, and Between the Lines, So to Speak*, 60 TAX LAW. 567, 576 (2007) [hereinafter Olson, *Observations from the Frontlines*] ("Aided and abetted by lawyers. We hear a constant clamor in Washington for more rules . . . .").

14. RONALD DWORKIN, LAW'S EMPIRE (1986).

15. For rare examples, see Patrick B. Crawford, *Analyzing Fairness Principles in Tax Policy: A Pragmatic Approach*, 76 DENV. U. L. REV. 155 (1998); Brian Galle, *Tax Fairness*, 65 WASH. & LEE L. REV. 1323 (2008); Marjorie E. Kornhauser, *Choosing a Tax Rate Structure in the Face of Disagreement*, 52 UCLA L. REV. 1697 (2005); Edward J. McCaffrey, *Tax's Empire*, 85 GEO. L.J. 71 (1996).

partnership taxation, which have left the system complicated, fractured, and bereft of a unifying core. Integrity also highlights the importance of legitimacy in subchapter K, where a system of voluntary compliance allows most partnerships to operate under an "honor code," with little risk of government audit.

This Article draws on aspects of Dworkin's principle of integrity to develop a coherent vision of subchapter K. It uses integrity as a compass, directing partnership taxation away from its historic dysfunction. To improve the functionality of partnership taxation through greater levels of integrity requires a reconsideration of the system's values, including their relationship to subchapter K and to each other. Subchapter K's values should operate as a unifying force in partnership taxation, providing a principled means of binding the system together. Similarly, subchapter K's values should be balanced in a manner that reduces discord, allowing them to work together in service of systemic ends.

This Article's effort to rethink the role of values in partnership taxation provides a novel perspective on subchapter K, its problems, and its future. All experts agree that subchapter K is flawed, and that complexity plays a central role in its struggles. What this Article offers is a different formulation of the problem, which may lead to a different way of thinking about the solution. The goal is to take partnership taxation apart and put its pieces back together, setting the system on a path to greater functionality. In doing so, this Article does not recommend particular reforms to subchapter K; it seeks a broader vantage point, outlining an intellectual groundwork for the reform of partnership taxation.

This Article proceeds in two parts. Part I begins with a brief introduction to subchapter K, its persistent importance, and its unique challenges. This Part traces the history of partnership taxation as told through its discordant values, and concludes that the time has come to rethink the system altogether. Part II proposes a vision of subchapter K based on the principle of integrity. This Part suggests a reorientation and recalibration of values designed to promote functionality in partnership taxation. An integrity-based subchapter K would reflect a system-wide commitment to coherent values, emphasizing simpler provisions directed at, and accessible to, the majority of partnerships—partnerships that are not engaged in sophisticated tax-sheltering activities. Reprioritizing simplicity in partnership taxation would foster all the system's values and nurture a perception of fairness among partners. Indeed, rethinking the values of partnership taxation would lay the foundation for subchapter K's values to work harmoniously in service of systemic ends.

I. THE PROBLEM OF PARTNERSHIP TAXATION

Partnership taxation has been described as a mess, a disaster, and a magic circle of tax abuse.[16] Simply stated, it is a deeply flawed system. This Part offers a novel perspective on the problem of partnership taxation. It tells the story of subchapter K from the vantage of its values, analyzing their discord and their effect on partnership taxation throughout the years.

A. The Basics of Partnership Taxation

Before its codification in 1954, partnership taxation was described as "one of the most complex and confused subjects in the entire area of the income tax."[17] The most immediate goal of codification was to establish order and uniformity, yet that goal was astonishingly ambitious in scope. Partnerships are incredibly diverse, ranging from "mom-and-pop" businesses to sophisticated commercial arrangements. Even so, Congress sought to create one regime to rule them all in an organized and sensible manner. The result was subchapter K, which this Part will briefly introduce.

1. The Pass-Through Model

Subchapter K is a pass-through system of taxation. Unlike corporate tax where earnings are taxed at both the entity and shareholder levels, a partnership's earnings are subject to only one level of taxation. To that end, a partnership is not a taxpayer; instead, its partners pay tax on their shares of the partnership's income.[18]

This single-level tax structure is a defining characteristic of partnership taxation, contributing to its appeal in the marketplace and also to its problems. In addition to all the ordinary transactions that any business tax system must regulate—such as contributions, distributions, and mergers—

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16. Lokken, *Future Without Subchapter K*, *supra* note 11, at 250 ("Subchapter K is a mess."); Andrea R. Monroe, *What's in a Name: Can the Partnership Anti-Abuse Rule Really Stop Partnership Tax Abuse*, 60 CASE W. RES. L. REV. 401, 402 (2010) [hereinafter Monroe, *What's in a Name*] ("Partnership taxation is a disaster."); Lee A. Sheppard, *Partnerships, Consolidated Returns and Cognitive Dissonance*, 63 TAX NOTES 936, 936 (1994) ("A partnership is a magic circle. Anything that is dropped into it becomes exempt from taxation. Forever. . . . Adherents to this view of subchapter K understand the word 'flexible' to mean that you can do absolutely anything you want without incurring tax.").

17. J. Paul Jackson et al., *A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners—American Law Institute Draft*, 9 TAX L. REV. 109, 112 (1954) [hereinafter Jackson et al., *1954 ALI Project*]; see also J. Paul Jackson et al., *The Internal Revenue Code of 1954: Partnerships*, 54 COLUM. L. REV. 1183, 1183 (1954) [hereinafter Jackson et al., *Internal Revenue Code of 1954*].

18. I.R.C. § 701 (2006).

subchapter K's single-tier tax structure must also perform a unique allocative function, dividing the partnership's income among its partners annually.[19]

Over time, subchapter K's allocative function has grown increasingly complicated.[20] A partnership's taxable income equals the sum of its items of income, gain, loss, and deduction.[21] When allocating such taxable income to its partners, a partnership can choose between two basic methods. The partnership may either allocate its total taxable income among its partners, or it may allocate some or all of its taxable items separately.[22] These latter allocations of individual taxable items are called "special" allocations, and they need not be proportional to the partners' economic interests in the partnership.[23] On the contrary, a partnership may make special allocations based on any ratio that the partners agree to, subject only to a loose anti-abuse regime.[24]

In permitting special allocations, subchapter K challenges one of the most foundational tenets of the federal income tax system—that a transaction's tax consequences should match its corresponding economic consequences.[25] Ordinarily, income is taxed to the person who receives the corresponding economic benefit because she either earned the income or owned the property that produced such income.[26] Special allocations, however, allow partnerships to shift particular taxable items contractually

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19. *Id.* § 704(b).

20. For a detailed discussion of the history and complexity of subchapter K's allocation provisions, see generally WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 11.02 (4th ed. 2007); ARTHUR B. WILLIS & PHILIP F. POSTLEWAITE, PARTNERSHIP TAXATION, ¶¶ 10.01–10.05 (7th ed. 2011); Andrea R. Monroe, *Too Big To Fail: The Problem of Partnership Allocations*, 30 VA. TAX REV. 465 (2011).

21. I.R.C. § 703(a).

22. *Id.* § 704(a)–(b).

23. *Id.*

24. *Id.* § 704(b). For a discussion of this complicated allocation regime, *see infra* Part I.B.3.b.

25. *See, e.g.*, Mark P. Gergen, *Subchapter K and Passive Financial Intermediaries*, 51 SMU L. REV. 37, 65 (1997) ("[G]iven the plasticity of the partnership form, people often can achieve their economic goals using a partnership through a variety of arrangements that have different tax consequences. This thought is troubling because we expect that people will select the partnership arrangement that bears the least aggregate tax."); Lokken, *Future Without Subchapter K*, *supra* note 11, at 264 ("[P]artnership allocations can be used to divorce tax consequences from economic consequences.").

26. Helvering v. Horst, 311 U.S. 112, 118 (1940) ("The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment and hence the realization of the income by him who exercises it."); Lucas v. Earl, 281 U.S. 111, 114–15 (1930) ("There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us . . . .").

from the proper partner to someone else.[27] Thus, these allocations operate in perpetual tension with the larger federal income tax system.[28] Simply put, subchapter K allows partners to achieve tax results that they could not achieve simply as co-owners of the partnership's property.[29] Indeed, this is one reason that individuals might choose to operate their enterprises as partnerships. And herein lies the problem—the aspects of subchapter K that make it popular with taxpayers also make it problematic for the Internal Revenue Service (Service) and, ultimately, for the public at large.

2. A Conceptual Model

Alongside this practical introduction to subchapter K, it might be useful to consider a theoretical portrayal of partnership taxation. The conceptual architecture of subchapter K is animated by three foundational elements: values, legitimacy, and systemic ends. As this Subpart explains,

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27. Indeed, all partnership allocations have the potential to shift taxable income contractually. "The pooling of income is essential to the meaningful existence of subchapter K. If partners were not able to share profits in an amount disproportionate to the ratio in which they earned the underlying income, the partnership provisions of the Code would, to some extent, be rendered unnecessary." Schneer v. Comm'r, 97 T.C. 643, 658 (1991).

28. In many respects, this tension reflects the foundational question of how to think of the partnership itself for federal income tax purposes. On one hand, a partnership can be thought of as simply an aggregate of its owners. Under this aggregate theory, a partnership is effectively disregarded, and its partners are treated as direct co-owners of the partnership's property. On another hand, a partnership can be thought of as an entity separate and distinct from its owners. Under this entity theory, a partnership is treated as an independent person for tax purposes. Partners are thought of much like shareholders in a corporation, owning an interest in the partnership entity rather than an interest in its underlying property.

Instead of adopting a uniform theory of partnerships, different provisions of subchapter K reflect these two different theories. For instance, subchapter K's basic pass-through model embodies the aggregate theory, taxing partners directly on their share of a partnership's income. I.R.C. § 701. Yet subchapter K also contains numerous provisions reflecting the entity theory. For instance, a partnership computes its own taxable income and makes all necessary character determinations. *Id*. §§ 702(b), 703(a). Likewise, a partnership is treated as a separate entity for timing purposes, adopting its own taxable year and method of accounting. *Id*. §§ 703(b), 706(b).

29. For example, in *Schneer*, the Tax Court began its opinion with a discussion of the tension between partnership taxation and the federal income tax system more generally.

> We consider here basic principles of income taxation. There is agreement that the amounts paid to [Schneer] by his former employer-law firm are income in the year of receipt. The question is whether [Schneer] (individually) or the partners of [Schneer's] partnerships (including [Schneer]) should report the income in their respective shares.
>
> The parties have couched the issue in terms of the anticipatory assignment-of-income principles. Equally important to this case, however, is the viability of the principle that partners may pool their earnings and report partnership income in amounts different from their contribution to the pool.

Schneer, 97 T.C. at 646 (citation omitted); *see also* Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1, 1 (1990) [hereinafter Gergen, *Special Allocations*] ("The flexibility of subchapter K, one of its most celebrated features, has given partners license to shift income and loss among themselves and dispose of assets while deferring recognition of gain in ways that are not otherwise possible under the income tax.") (footnote omitted).

values are the lifeblood of partnership taxation, supporting each other, nurturing legitimacy, and serving systemic ends. The result is an intricate system in which the implementation of properly harmonized values through well-designed provisions fosters the perception that subchapter K is fair and principled. This sense of public legitimacy, in turn, works together with subchapter K's values to attain the systemic ends of partnership taxation.

a. Values. Partnership taxation is organized around four primary values, each reflecting principles that Congress and the larger partnership tax community of scholars, practitioners, and taxpayers consider important norms for evaluating subchapter K. When it codified subchapter K in 1954, Congress identified three principle values of partnership taxation—flexibility, equity, and simplicity.[30] Efficiency, subchapter K's fourth value, emerged as an important value in partnership taxation, and the federal income tax more generally, in the decades following codification.

The first value of partnership taxation is flexibility. Since subchapter K's codification, Congress has remained steadfast in its commitment to partnership flexibility, allowing partnerships to structure and operate in whatever manner the partners themselves consider commercially optimal.[31] Because a diverse array of business enterprises have traditionally chosen to operate as partnerships, Congress has required high levels of flexibility in subchapter K.

Efficiency is subchapter K's second value. Efficiency in the context of federal income taxation is best explored through two components—administrative efficiency and tax neutrality. The first of these looks to minimize the "administrative" costs of partnership taxation, including the costs to partnerships of understanding and applying the law and the costs to the Service of enforcing the law.[32] The higher these administrative costs, the less efficient subchapter K becomes. In contrast to such administrative efficiency, efficiency as tax neutrality seeks to minimize subchapter K's

30. *See* H.R. REP. NO. 83-1337, at 65 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4091 (noting that the principle objectives of subchapter K were "simplicity, flexibility, and equity as between the partners"); S. REP. NO. 83-1622, at 89 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4722.

31. H.R. REP. NO. 83-1337, at 65; S. REP. NO. 83-1622, at 89; *see also* Gergen, *Special Allocations*, *supra* note 29, at 1; Darryl K. Jones, *Towards Equity and Efficiency in Partnership Allocations*, 25 VA. TAX REV. 1047, 1078 (2006); Jerome Kurtz, *The Limited Liability Company and the Future of Business Taxation: A Comment on Professor Berger's Plan*, 47 TAX L. REV. 815, 821–22 (1992); Lokken, *Future Without Subchapter K*, *supra* note 11, at 254.

32. *See, e.g.*, JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 31 (1985); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 573 (1992); Xuan-Thao Nguyen & Jeffrey A. Maine, *Equity and Efficiency in Intellectual Property Taxation*, 76 BROOK. L. REV. 1, 5 (2010); Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1, 4 (1992) [hereinafter Shaviro, *Efficiency Analysis*].

interference with the economic decision making of partnerships.[33] Under tax neutrality, subchapter K is inefficient to the extent that partnerships modify their behavior or restructure their transactions to account for the system's particular provisions.

As a third value, Congress wants subchapter K to be equitable.[34] Like efficiency, equity has two components that seek to ensure that partners' relative tax burdens are fair in light of their particular circumstances.[35] Whereas horizontal equity requires that similarly situated partners be taxed in the same manner,[36] vertical equity requires that partners with greater income be taxed more than those with less income.[37] Together, these formulations of equity share a commitment to preventing abusive tax shelters, which compromise subchapter K's ability to treat partners fairly based on their relative economic positions.

Simplicity is the final value of partnership taxation. Congress wants subchapter K to be workable for the large number of small and unsophisticated enterprises that are treated as partnerships for federal income tax purposes.[38] Partnership taxation thus has to be simple.

Simplicity, however, is not an intellectually easy concept to define.[39] Perhaps the best way to think about the meaning of simplicity is by reference to its opposite—complexity. A generally accepted definition of tax complexity focuses on taxpayers' problems in interpreting the law, complying with the law, and structuring transactions to benefit from the

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33. *See, e.g.*, WITTE, *supra* note 32, at 30; Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 260 (1974); Shaviro, *Efficiency Analysis*, *supra* note 32, at 4; David A. Weisbach, *Formalism in the Tax Law*, 66 U. CHI. L. REV. 860, 870 (1999) [hereinafter Weisbach, *Formalism in Tax Law*].

34. *See* H.R. REP. NO. 83-1337, at 65; S. REP. NO. 83-1622, at 89; s*ee also* Jackson et al., *Internal Revenue Code of 1954*, *supra* note 17, at 1183; Jackson et al., *1954 ALI Project*, *supra* note 17, at 113.

35. *See, e.g.*, Boris I. Bittker, *Tax Reform and Tax Simplification*, 29 U. MIAMI L. REV. 1, 6 (1974); Stanley S. Surrey & Gerard M. Brannon, *Simplification and Equity as Goals of Tax Policy*, 9 WM. & MARY L. REV. 915, 915 (1968).

36. *See, e.g.*, WITTE, *supra* note 32, at 30; Galle, *supra* note 15, at 1325; Nguyen & Maine, *supra* note 32, at 3.

37. *See, e.g.*, WITTE, *supra* note 32, at 30.

38. *See* S. REP. NO. 83-1622, at 89; H.R. REP. NO. 83-1337, at 65; *see also* Berger, *supra* note 11, at 110 ("Partnerships of [the 1954] era were rather simple ventures: the neighborhood hardware store or lumber yard, the law firm or brokerage house, the band of theatrical angels or the oil and gas syndicate. These typified the general and limited partnerships that were familiar to the drafters of subchapter K."); Emily Cauble, *Making Partnerships Work for Mom and Pop and Everyone Else*, 2 COLUM. J. TAX L. 247, 249–50 (2011).

39. *See, e.g.*, Bittker, *supra* note 35, at 1–2 ("Neither 'tax simplification' nor its mirror image, complexity, is a concept that can be easily defined or measured. I know of no comprehensive analytic framework for these ideas, nor are there any empirical studies supplying a 'simplicity index' of particular areas of tax law or practice."); Edward J. McCaffery, *The Holy Grail of Tax Simplification*, 1990 WIS. L. REV. 1267, 1269 (1990) [hereinafter McCaffery, *Holy Grail of Simplification*] ("It is not easy to arrive at ready definitions of 'simplicity' and its cognates and antonyms. No single, uncontroversial definitions of these terms exist.") (footnote omitted).

law.[40] Complex provisions typically involve opaque terminology, elaborate definitional schemes, computations, or multifactored tests.[41] As a consequence, complying with these provisions requires specialized knowledge that most partnerships do not possess.[42] Acquiring such expertise thus requires the expenditure of resources, including the retention of a partnership tax specialist.[43] More problematic, each layer of tax complexity tends to breed further complexity.[44] Technical provisions often produce their own loopholes, which Congress and the Department of the Treasury (Treasury) must then fill with other technical provisions. As this pattern continues, newer generations of complicated provisions increasingly crowd out the simpler partnership provisions of the past.[45]

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40. DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 266–67 (1986). There is a wealth of scholarship addressing the complexity of the federal income tax system. *See, e.g.*, Bittker, *supra* note 35; Cauble, *supra* note 38; Steven A. Dean, *Attractive Complexity: Tax Deregulation, The Check-the-Box Election, and the Future of Tax Simplification*, 34 HOFSTRA L. REV. 405 (2005); James S. Eustice, *Tax Complexity and the Tax Practitioner*, 45 TAX L. REV. 7 (1989) [hereinafter Eustice, *Tax Complexity and the Tax Practitioner*]; McCaffery, *Holy Grail of Simplification*, *supra* note 39; Paul R. McDaniel, *Federal Income Tax Simplification: The Political Process*, 34 TAX. L. REV. 27 (1978); Martin J. McMahon, Jr., *Reflections on the Regulations Process: "Do the Regulations Have to Be Complex" or "Is Hyperlexis the Manna of the Tax Bar?"*, 51 TAX NOTES 1441 (1991); Sidney I. Roberts et al., *A Report on Complexity and the Income Tax*, 27 TAX. L. REV. 325 (1972); Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 LAW & CONTEMP. PROBS. 673 (1969) [hereinafter Surrey, *Complexity and the Internal Revenue Code*]. Beyond the federal income tax, there is equally rich scholarship examining legal complexity. *See generally* Schuck, *supra* note 13, at 3 (evaluating the complexity of a legal system on the basis of the extent to which "its rules, processes, institutions, and supporting culture possess four features: density, technicality, differentiation, and indeterminacy").

41. *See, e.g.*, Bittker, *supra* note 35, at 1–2; Eustice, *Tax Complexity and the Tax Practitioner*, *supra* note 40, at 7; Surrey, *Complexity and the Internal Revenue Code*, *supra* note 40, at 674–77.

42. For an interesting discussion of the desirability of knowledge of the tax law, see David A. Weisbach, *Is Knowledge of the Tax Law Socially Desirable?* (Univ. of Chi. Law & Econ., Olin Working Paper No. 563, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1895572 (suggesting that the desirability of knowledge of the tax law depends on three factors, each of which is often hard to observe: beliefs about the tax law, the quality of the tax law, and the type of tax).

43. *See, e.g.*, Bittker, *supra* note 35, at 1–2; McCaffery, *Holy Grail of Simplification*, *supra* note 39, at 1289; Surrey, *Complexity and the Internal Revenue Code*, *supra* note 40, at 673.

44. *See, e.g.*, BRADFORD, *supra* note 40, at 5; Dean, *supra* note 40, at 410; McCaffery, *Holy Grail of Simplification*, *supra* note 39, at 1277–78.

45. The discussion of simplicity versus complexity may bring to mind the ubiquitous debate between rules and standards. While a detailed examination of rules and standards is beyond this Article's scope, an admittedly summary explanation may be useful. Rules and standards are best viewed as opposing ends of a continuum describing the form that legal provisions take. The distinction essentially relates to when content is given to the law: rules provide content to the law ex ante, whereas standards provide content ex post. *See* Kaplow, *supra* note 32; Weisbach, *Formalism in Tax Law, supra* note 33. For recent, thoughtful discussions of rules and standards in the federal income tax, see generally Alice G. Abreu & Richard K. Greenstein, *Defining Income*, 11 FLA. TAX REV. 295 (2011); Ellen P. Aprill, *Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines*, 54 SMU L. REV. 9 (2001); Joseph Bankman, *The Business Purpose Doctrine and the Sociology of Tax*, 54 SMU L. REV. 149 (2001); Mark P. Gergen, *The Common Knowledge of Tax Abuse*, 54 SMU L. REV. 131 (2001); Edward D. Kleinbard, *Corporate Tax Shelters and Corporate Tax Management*, 51 TAX EXEC. 235 (1999).

Conceptually, the four values of flexibility, efficiency, equity, and simplicity can be viewed as elemental forces shaping subchapter K, working together to create a stable and functional system of taxation. At the same time, these values can also be thought of as a guide, moving partnership taxation toward legitimacy and, ultimately, toward its systemic ends.

b. Legitimacy. The notion of legitimacy focuses on taxpayer perceptions, most importantly whether partners consider subchapter K to be fair and principled. In many respects, legitimacy is a measure of the functionality of values in partnership taxation, as operationalized through subchapter K's provisions. Simple and efficient partnership provisions allow larger numbers of partners to participate in subchapter K and "see" how it works. If these provisions are also equitable, then partners can appreciate that subchapter K applies equally to all partners, whether rich, poor, sophisticated, or unsophisticated. Respect for partnership taxation would increase under such circumstances, strengthening the bonds that foster fidelity to the law.

The opposite scenario is also possible. Discordant values erode respect for partnership taxation, creating the perception that subchapter K is unfair and arbitrary. Disillusioned partners might then turn to tax shelters because "everyone else is doing it." And a vicious cycle would begin, with tax abuse triggering government responses, government responses leading to additional tax abuses, and partners increasingly losing confidence in the legitimacy of subchapter K.

Legitimacy is immensely important in a system of taxation like subchapter K that relies heavily on voluntary compliance. A voluntary compliance system is one where each taxpayer is responsible for assessing and paying her own tax liability in the first instance. The majority of taxpayers are not subject to audit and, hence, a voluntary compliance system operates largely on an honor code basis.[46] This is especially true in partnership taxation where limited enforcement resources have driven down audit rates.[47] Indeed, voluntary compliance has contributed to

46. In 2011, the Service examined 1.11% of all individual income tax returns filed for the 2010 taxable year. INTERNAL REVENUE SERV., FISCAL YEAR 2011 ENFORCEMENT AND SERVICE RESULTS 2 (2012), http://www.irs.gov/pub/newsroom/fy_2011_enforcement_results_table.pdf.

47. *See id*. at 5. In 2011, the Service examined 0.40% of all partnership returns (13,770 partnership returns examined out of 3,434,905 filed for the 2011 calendar year). *Id*. Since 2001, the Service has examined an average of 0.36% of all partnership returns annually. *Id*. In addition, with few exceptions, the percentage of partnership returns examined each year since 2001 has been lower than the percentage of any other type of income tax return. *Id*. The only exception was S corporation returns for fiscal years 2003, 2004, 2005, and 2008, but the difference was never larger than 0.07%. *Id*. (demonstrating that for fiscal years 2003–2005 and 2008, the Service examined 0.35%, 0.26%, 0.33%, and 0.42%, respectively, of all partnership returns, and it examined 0.30%, 0.19%, 0.30%, and 0.40%, respectively, of all S corporation returns).

subchapter K's popularity, with many taxpayers believing that partnership taxation offers the opportunity to play the audit lottery with little risk that the Service will detect their questionable activities.[48]

Public legitimacy is thus vital to partnership taxation. Developing a perception of fairness and principle in subchapter K is a crucial step in setting partnership taxation on a path to greater compliance. Compliance, in turn, is equally vital to partnership taxation, working alongside subchapter K's values to attain systemic ends.[49]

c. Systemic Ends. Like any tax system, identifying the ends of partnership taxation is a difficult and contested enterprise. Raising revenue plays a central role in federal income taxation; thus, that systemic end has remained relatively stable throughout the evolution of modern political thought.[50] By contrast, there is disagreement surrounding the other systemic ends of the federal income tax system. For instance, one might consider economic growth to be an additional systemic end.[51] Or, one might believe that the redistribution of wealth or the administration of social benefit programs is a proper systemic end of the federal income tax system.[52]

Because this article outlines a conceptual model designed to spur thinking about subchapter K in the broadest possible terms, I adopt raising

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48. *See, e.g.*, Noël B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1, 26 n.123 (2004); James S. Eustice, *Abusive Corporate Tax Shelters: Old "Brine" in New Bottles*, 55 TAX L. REV. 135, 161 (2002); Lokken, *Future Without Subchapter K*, *supra* note 11, at 252.

49. Voluntary compliance also serves an expressive function, allowing partnerships to participate in one of our most foundational democratic rituals. The federal income tax is one of the most visible contact points between individuals and the federal government and, thus, compliance lies at a decisive junction in the relationship between citizen and state, offering the government an important opportunity to make an impression on a large number of taxpayers. *See* Arthur E. Sutherland, Jr., *A New Society and an Old Calling*, 23 CORNELL L.Q. 545 (1938).

> The pyramidal administration of justice, with an awe-inspiring appellate court at the apex, nevertheless exists for the great mass of individuals at the base; and no matter what form of tribunal is considered, if it is administering a complex regulatory system, the individual members of the public can not make effective use of it without skilled assistance. That assistance may take many forms: tax agents, "adjusters", trust officers, conscientious magistrates, social workers, or trained advocates and counsellors; but unless the public finds that fair treatment from the government is readily available it is resentful and suspicious.

Id. at 549.

50. The Service's Mission Statement identifies raising revenue as an end of the federal income tax system. The mission of the Service is to "[p]rovide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all." *The Agency, Its Mission and Statutory Authority*, IRS.GOV, http://www.irs.gov/uac/The-Agency,-its-Mission-and-Statutory-Authority (last visited Oct. 20, 2012).

51. *See, e.g.*, Olson, *And Then Cnut Told Reagan*, *supra* note 6, at 993.

52. *See, e.g.*, NAT'L TAXPAYER ADVOCATE, REPORT TO CONGRESS, FISCAL YEAR 2012 OBJECTIVES, app. IX, at 9 (June 30, 2011), *available at www.irs.gov/pub/irs-utl/fy2012_ntaobjectives.pdf* (raising the possibility that the Taxpayer Advocate Service "will make recommendations that require a paradigm shift for the IRS (*e.g.*, revising the IRS mission statement to explicitly acknowledge the IRS role in delivering social benefits . . . .)").

revenue as the primary systemic end of partnership taxation. Raising revenue may be an end in itself, but raising revenue can also be viewed as an intermediate "stand-in" end. We can all agree that the federal government should raise money, and that it should use such funds in a procedurally proper manner to do something. What we cannot agree on is the "something." Whatever one considers the appropriate use of government revenues—whether stimulating the economy, administering social benefit programs, or maintaining global international order—raising revenue is a necessary step in achieving these desired outcomes. Thus, raising revenue functions as a stand-in for other, more controversial systemic ends, all of which are promoted by the government's collection of federal income tax revenues.[53]

B. The Discordant Values of Partnership Taxation

Based on the foregoing conceptual model, the success of partnership taxation depends on the functionality of its four values. In other words, the values of partnership taxation only serve one another, foster legitimacy, and promote subchapter K's systemic ends if such values operate in a unified and cohesive manner. This Subpart tells the story of subchapter K through the history of its values, tracing the government's efforts to achieve harmony and stability in partnership taxation.

1. The Reign of Flexibility

When Congress codified subchapter K in 1954, the system's initial balance of values prioritized flexibility. Partnerships were traditionally viewed as diverse enterprises requiring little organizational formality, and Congress wanted subchapter K to reflect this ideal.[54] To this end, the government's role in subchapter K was viewed more as a neutral referee of intra-partnership issues than as an interested stakeholder.[55] Congress thus

53. Although I adopt raising revenue as the primary systemic end of partnership taxation, I shall refer to subchapter K's systemic ends throughout this Article. The use of the plural form is intended to highlight the dynamic nature of systemic ends in the federal income tax system.

54. *See supra* note 31 and accompanying text.

55. Contemporary commentators also shared this view. *See Forty Topics Pertaining to the General Revision of the Internal Revenue Code—Topic 29—Partnerships: Hearing Before the H. Comm. on Ways & Means*, 83d Cong. 1368, 1370 (1953) (statement of Mark H. Johnson, American Bar Association); see also Jackson et al., *1954 ALI Project*, supra note 17, at 112 ("Most of the problems encountered in the partnership area are concerned with the distribution of the burden of taxation among the members of the group. Since the Treasury from the standpoint of tax policy is not greatly concerned about this allocation, the issues are essentially not between Treasury and taxpayer-partner but between partner and partner. Consequently, tax technicians should be able to agree on the formulation of rules to govern the complex partnership relationship, and this formulation should not raise issues that pass beyond technical tax policy.").

took a uniquely laissez-faire approach to partnership taxation, designing subchapter K to provide partnerships with maximum flexibility in structuring their affairs.[56]

Simplicity was subchapter K's secondary focus. As previously discussed, Congress wanted to design simple provisions that small and unsophisticated partnerships could comprehend. To the extent possible, such provisions would also conform to partners' commercial expectations. If partners were dissatisfied with the results of a simple provision, partnerships had the ability to correct statutory distortions contractually through the partnership agreement. In most instances, subchapter K was sufficiently flexible to make the desired adjustments.

Unlike subchapter K's other values, equity did not factor heavily into the early design of partnership taxation. This lack of attention, however, was not a reflection of congressional indifference to equity. On the contrary, the limited role of equity in partnership taxation reflected Congress's initial appraisal of the revenue stakes in subchapter K. As noted, Congress viewed most partnership issues as intra-partnership matters not raising significant revenue issues for the federal government.[57] Equity-centered provisions were thus considered unnecessary; partnerships were largely left alone to address equitable concerns internally.

In those limited instances where Congress was concerned about abusive partnership transactions, it adopted anti-abuse provisions with an affirmative focus on equity.[58] In other instances where Congress struggled to balance simplicity and equity, it turned to a "menu" approach. Under this approach, partnerships would choose the tax treatment of a particular transaction from a menu of choices, typically including a simple default provision and an alternative provision designed to provide a more equitable result for electing partnerships at some cost to simplicity.[59]

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56. The dominance of flexibility in subchapter K is best illustrated by the provisions that operate as its lifeblood—the partnership allocation provisions. I.R.C. § 704(b) (2006); Treas. Reg. § 1.704-1 (as amended in 2008). As originally codified, these provisions permitted partnerships to allocate taxable items as agreed to by the partners so long as the principle purpose of such allocations was not tax avoidance or evasion. I.R.C. § 704(b) (1954). Congress amended these provisions in 1976, and they now require partnership allocations to have substantial economic effect in order to be respected as drafted. The substantial economic effect safe harbor is discussed in greater detail *infra* Part I.B.3.b.

57. *See supra* note 55.

58. For instance, Congress was concerned with character-based abuses at the time of subchapter K's codification. In 1954, the highest marginal individual income tax rate was 91%, and the tax rate on capital gains was 25%. I.R.C. §§ 1(a) (providing tax rates for individuals), 1201(b) (providing capital gains rate for individuals) (1954). Thus, Congress included several provisions in subchapter K designed to prevent partnerships from converting ordinary gains into capital gains. *See, e.g.*, *id.* § 751(b).

59. Subchapter K's menu approach is best illustrated by the rules governing allocations attributable to contributed property. I.R.C. § 704(c)(1)(A) (2006); Treas. Reg. § 1.704-3 (as amended in 2010). These rules are discussed below and *infra* Part I.B.3.a.

From the beginning, subchapter K's balance of values was tenuous, and signs of tension quickly emerged. Despite congressional efforts to keep subchapter K's provisions simple, the few anti-abuse rules adopted in 1954 were enormously complicated. Even today, one of these original equity-based provisions, Section 751(b), is generally considered subchapter K's most complicated and least understood rule.[60] Similarly, the balance between flexibility and equity was quite fragile. Flexible provisions emphasized partnership choice, whereas equitable provisions constrained choice, seeking to identify the "right" answer that properly reflected a partnership's relative economic circumstances.

What kept the tensions among subchapter K's values in check was Congress's belief that the revenue stakes in subchapter K were not terribly high and, hence, equity did not need to be a high priority in partnership taxation. If, however, this view of partnership taxation were to change, the original balance of values in subchapter K risked unraveling.

Before proceeding, it might be useful to consider an example of how Congress initially reconciled flexibility, simplicity, and equity in subchapter K, and partnership contributions offer an apt illustration.[61] When a partner contributes property to a partnership, the contribution is treated as a nonrecognition event. The contributing partner recognizes no gain;[62] instead any pre-contribution gain is preserved for future recognition.[63] If the partnership subsequently sells the contributed property, it will recognize this pre-contribution gain as well as any gains attributable

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60. I.R.C. § 751(b). As a general matter, Section 751(b) seeks to preserve the character of each partner's share of partnership income and loss following a distribution. *Id*. One commentator described Section 751(b) as follows:

> Let me pass in a few remaining minutes that I have to some specific partnership and subchapter S provisions which I think ought to be changed. Section 751(b) of subchapter K, the collapsible partnership provision dealing principally with partnership distributions, I would say its application is not recognized in 90 percent of the cases to which it applies.
>
> In half the cases in which its applicability is recognized, the other remaining 10 percent, it is ignored because the cost of complying is far greater than any revenue gain, and in, I would say, half of the remaining 5 percent, when people including the Internal Revenue Service, attempt to apply it , they do so incorrectly.

Hearings Before the Subcomm. on Select Revenue Measures of the U.S. H. Comm. on Ways & Means on Issues Relating to Passthrough Entities, 99th Cong., 2d Sess. 56 (1986) (statement of Joel Rabinovitz). His words remain true today.

61. For a more comprehensive history of subchapter K's contributed property allocation provisions, see generally Cauble, *supra* note 38; Cunningham, *Use and Abuse*, *supra* note 10; Andrea Monroe, *Saving Subchapter K: Substance, Shattered Ceilings, and the Problem of Contributed Property*, 74 BROOK. L. REV. 1381 (2009) [hereinafter Monroe, *Saving Subchapter K*].

62. I.R.C. § 721. For ease of reading, the following discussion focuses on pre-contribution gains only. Section 721, as well as subchapter K's other provisions governing contributed property, apply equally to pre-contribution losses.

63. *Id*. §§ 722 (partner's basis in partnership interest), 723 (partnership's basis in contributed property). Under each of these provisions, post-contribution basis is determined by reference to the contributing partner's basis in the property immediately before contribution. *Id*.

to post-contribution changes in the property's value.[64] Determining how to allocate these amounts, particularly the pre-contribution gain, has been a perennial challenge for subchapter K.

From a purely theoretical perspective, the answer is straightforward: any pre-contribution gain recognized on the sale of contributed property should be allocated to the contributing partner. Allocating pre-contribution gains in this manner would align the contributing partner's economic investment in the partnership, which reflects the fair market value of the contributed property, with her tax investment in the partnership.[65] Indeed, equity would require this result. If the contributing partner did not bear the full tax burden of her economic investment in the partnership, income would have been inappropriately shifted among the partners.[66] Another partner would have borne the tax burden for the contributing partner's economic investment, likely improving the partners' aggregate tax position at the expense of the public at large.

When originally codified, however, subchapter K did not require partnerships to allocate pre-contribution gains to the contributing partner.

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64. *Id.* § 1001(a). The realized gain on the sale of contributed property will equal the net sum of the pre-contribution and post-contribution gains or losses.

65. An example might be useful. Let's assume that *A* and *B* form an equal partnership with *A* contributing $100 cash and *B* contributing Blackacre, which has a fair market value of $100 and a basis of $60. *A*'s and *B*'s initial economic interests in the partnership are $100, the fair market value of the property each contributed to the partnership, and each partner's economic interest is reflected in an initial capital account of $100. Treas. Reg. § 1.704-1(b)(2)(iv)(d)(1). Partner *A* would similarly take a basis in her partnership interest of $100, but *B*'s basis would be only $60, reflecting her $60 basis in Blackacre immediately before the contribution. I.R.C. § 722. Thus, *B*'s economic investment in the partnership is $100, but her tax investment is only $60. This $40 "book-tax disparity" is attributable to Blackacre's $40 pre-contribution gain.

If the partnership subsequently sells Blackacre for $100, the sale would generate no economic gain or loss, and each partner's economic investment would remain unchanged. In contrast, the partnership would recognize a $40 taxable gain on the sale ($100 amount realized less $60 basis), which should be allocated entirely to *B*, the contributing partner. In so doing, *B*'s book-tax disparity would be eliminated. Her economic investment in the partnership would be $100, and she would have borne the full tax burden of such amount.

66. Consider again the partnership between *A* and *B*. If the partnership had allocated the $40 taxable gain on Blackacre's sale in the same manner as it allocated other partnership items—equally—income would have been shifted between the partners. The partnership would have allocated $20 of taxable gain to each partner, thereby shifting $20 of pre-contribution gain from *B* to *A*. After the sale, *A*'s economic investment in the partnership would have been $100, but her tax investment would have been $120. *B*'s economic investment in the partnership would also have been $100, but her tax investment would only have been $80. Thus, *B* would have been entitled to receive $20 on the partnership's liquidation for which she would not have borne the corresponding tax burden. On the contrary, *A* would have borne that burden, as reflected in her post-sale book-tax disparity.

It is important to note that this income shift is temporary, reversing itself on the contributing partner's sale or liquidation of her partnership interest. Nonetheless, this type of income shifting, and the resulting deferral effect, remains problematic because the offsetting allocations may not occur for many years, if at all. The longer it takes to reverse the income shift, the more the deferral effect begins to look like a permanent exemption. *See, e.g.*, William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1124 (1974).

On the contrary, subchapter K's flexible allocation provisions allowed partnerships to allocate pre-contribution gains just like any other taxable item.[67] Partnerships were thus free to allocate pre-contribution gains in any manner their partners deemed optimal, so long as the principal purpose of the allocation was not tax avoidance.[68] Despite the risk of income shifting, Congress believed that this approach to contributed property allocations was justified by its simplicity and conformity to commercial expectations.[69]

Nonetheless, Congress provided elective relief for partnerships seeking more equitable results, even at the price of greater complexity. To that end, it adopted a menu-based approach to contributed property allocations, offering partnerships the option of allocating pre-contribution gains to the contributing partner.[70] Subject to certain limitations, this alternative allocation method required partnerships to take into account the contributed property's ownership history when allocating pre-contribution gains.[71] The menu-based approach thus granted partnerships the possibility of a more equitable outcome through reduced income shifting. Perhaps more importantly, it gave individual partnerships the freedom to prioritize equity and simplicity in their treatment of contributed property.

2. *The Rise of Equity*

By the late 1970s, Congress realized that the revenue stakes in partnership taxation were anything but minimal. Subchapter K's flexible provisions offered partnerships myriad opportunities to engage in abusive tax shelters, and partnerships freely exploited these opportunities, structuring transactions in a manner intended to reduce their partners' federal income tax liability.[72] Congress was thus forced to acknowledge a

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67. I.R.C. § 704(c)(1) (1954).

68. *Id.* § 704(a), (b)(1) (1954).

69. H.R. REP. NO. 83-1337, at 66 (1954) ("This general treatment was adopted because of its extreme simplicity as contrasted with any other alternative and because it conforms to the usual expectations of partners."); S. REP. NO. 83-1622, at 380 (1954). Commentators shared Congress's opinion of contemporary commercial expectations. *See, e.g.*, Jackson et al., *1954 ALI Project*, *supra* note 17, at 128 ("It is felt that the average partner in a small partnership would reasonably expect any potential gains or losses with respect to contributed property to accrue to the partnership as a whole and to the partners at the time that the contributed property is sold or depreciated, to be so reflected in each partner's distributive share at the end of the partnership's taxable year . . . .").

70. I.R.C. § 704(c)(2) (1954).

71. Specifically, Section 704(c)(2) required partnerships to account for the difference between the contributed property's fair market value and its basis at the time of contribution. *Id.* It is important to note, however, that Section 704(c)(2) itself had limits that prevented it from achieving equitable results in all instances. For a discussion of this limitation, referred to as the ceiling rule, see *infra* note 94.

72. *See, e.g.*, Gergen, *Special Allocations*, *supra* note 29, at 1 ("The flexibility of subchapter K, one of its most celebrated features, has given partners license to shift income and loss among themselves and dispose of assets while deferring recognition of gain in ways that are not otherwise possible under the income tax.") (footnote omitted); Mark P. Gergen, *The End of the Revolution in*

misalignment of values in partnership taxation. Partnerships could not be given unlimited freedom with the government simply policing subchapter K's parameters; the revenue cost of the resulting tax shelter activity was much too high.

Rebalancing the values of partnership taxation to combat tax shelters required a more direct focus on equity. Even so, Congress remained steadfast in its commitment to flexibility in subchapter K. Alongside these historic values, efficiency was becoming an important value in partnership taxation during this period. Accordingly, subchapter K's second-generation provisions had to walk a tightrope, preventing abusive partnership transactions without restricting the flexibility or efficiency of legitimate partnership transactions.

The challenge of reconciling equity, flexibility, and efficiency left little margin for design error. If these second-generation provisions were underinclusive, abuses would persist, but if they were overinclusive, the market for legitimate partnership transactions might be chilled. In order to minimize both types of mischaracterization problems, subchapter K's second-generation provisions were narrowly tailored to address the activities of partnerships engaged in tax sheltering. To this end, these provisions were typically quite elaborate, containing a combination of technical language, computational requirements, and multifactored analyses.[73]

While the design of second-generation provisions reflected a new calibration of values, the emerging method of rulemaking in partnership taxation was largely shaped by subchapter K's initial, mistaken balance of values. By the time Congress decided to pursue partnership tax abuse more aggressively, it was too late; the government had already fallen behind in the fight against tax shelters. The Treasury possessed neither the time, money, nor resources to match the cadre of professionals who marketed abusive partnership transactions. The government thus found itself perpetually responding to the last tax shelter rather than preventing the next tax shelter.[74] The result was a piecemeal approach to rulemaking in

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Partnership Tax?, 56 SMU L. REV. 343, 348 (2003); Lokken, *Future Without Subchapter K*, *supra* note 11, at 250 ("The flexibility of the original conduit model facilitated devices to shift income, deductions, and other tax attributes from partner to partner and from property to property in ways that Congress found unacceptable.").

73. For two paradigmatic examples of this type of design complexity, see *infra* Part I.B.3.

74. In 1994, IRS Deputy Associate Chief Counsel Monte Jackel described this problem in the following manner:

> We're talking about the world of today. There's been too many transactions that are too close to the line—results and opinions about the interaction of rules which we believe are inappropriate . . . . We need help in crafting a rule to police the partnership area. We have decided as an institution that we are not going to pursue these problems on a case-by-case basis anymore.

subchapter K, driven by ad hoc gap filling rather than a comprehensive vision of partnership taxation.

Despite best intentions, this piecemeal style of anti-abuse rulemaking created an unwelcome dynamic in partnership taxation. Partnerships manipulated subchapter K; Congress or the Treasury responded with elaborate, ad hoc "fixes"; and partnerships developed new abusive schemes that, in many instances, exploited the newly enacted remedial measures.[75] Indeed, these second-generation partnership provisions were typically so intricate that they themselves implied effective roadmaps to the next tax shelter transaction.[76] And the dynamic continues, all the while transforming subchapter K into a diffuse superstructure of elaborate and technical provisions.

Again, partnership contributions provide a useful illustration of the second-generation balance of values and the related piecemeal approach to rulemaking in subchapter K. As previously discussed, Congress initially made no distinction between pre-contribution gains and other partnership gains, treating pre-contribution gains as if they had been generated while the partnership, rather than the contributing partner, owned the property.[77] Thirty years of experience with this approach proved Congress's mistake; disregard for the unique nature of pre-contribution gains led to improper income shifting among partners at tremendous public cost. In response, Congress amended subchapter K in 1984 to require partnerships to allocate pre-contribution gains in a manner sensitive to the contributed property's history.[78] Like many second-generation partnership provisions, the resulting allocation provisions reflect a delicate balance of equity,

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Lee A. Sheppard, *Partnership Antiabuse Rule: Dirty Minds Meet Mrs. Gregory*, 64 TAX NOTES 295, 295 (1994). Unfortunately, the Service's efforts to police partnership transactions did not succeed; the partnership anti-abuse regulation was an utter failure. *See generally* Monroe, *What's in a Name*, *supra* note 16.

75. Professor Lawrence Lokken offered an apt comparison: "The revolutionary accretion of detail in subchapter K is largely a response to aggressive uses of partnerships for tax avoidance, resembling a steady build-up in the arsenal of an army caught in an unwinnable guerilla war." Lawrence Lokken, *As the World of Partnership Taxation Turns*, 56 SMU L. REV. 365, 367 (2003) [hereinafter Lokken, *As the World Turns*]. *See also* BRADFORD, *supra* note 40, at 5; Dean, *supra* note 40, at 436; McCaffery, *Holy Grail of Simplification*, *supra* note 39, at 1277.

76. *See, e.g.*, Margaret Milner Richardson, Commissioner, Internal Revenue Serv., Remarks at the ABA Tax Section Annual Meeting (Aug. 6, 1994) *reprinted in Full Text: Richardson's Speech to ABA Tax Section Annual Meeting*, 94 TNT 157-67 (Aug. 11, 1994) [hereinafter Richardson Remarks] ("As all of you know from experience, precise, mechanical rules cannot possibly cover all conceivable situations. Moreover, such rules tend to be the oil fields into which the perennial loophole seekers punch holes looking for a gusher.").

77. *See supra* notes 67–69 and accompanying text.

78. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 71, 98 Stat. 494 (codified at I.R.C. § 704(c)).

efficiency, and flexibility.[79] Yet the contributed property allocation provisions also retain their predecessor's menu-based structure.

Although the second-generation contributed property allocation provisions were a significant improvement from an equitable perspective, they highlight the flaws of piecemeal rulemaking in subchapter K. The provisions are imperfect, with internal gaps in their intricate balancing of values. Similarly, they are incomplete, only addressing the shifting of pre-contribution gains through events giving rise to allocations, like sales, exchanges, and depreciation. These second-generation provisions do not govern other events, like distributions, that also allow partnerships to shift pre-contribution gains among partners.

Such unintentional gaps and intentional limits in the treatment of pre-contribution gains have led to a superstructure of second-generation anti-abuse provisions. For instance, income shifting through distributions became increasingly popular after Congress amended the contributed property allocation provisions; hence, Congress was forced to address these improper transactions in 1989.[80] Similarly, more recent statutory and regulatory anti-abuse provisions designed to "fix" holes in the contributed property allocation provisions have been added to subchapter K.[81] Each of these second-generation provisions hopes to prevent a particular type of abusive transaction. The problem is that—even for highly trained experts—each of these provisions is independently technical and complicated. In the aggregate, this superstructure of contributed property provisions presents a formidable challenge to many, if not most, partnerships. Indeed, it risks overwhelming them with complexity, which has become an all-too-common problem in partnership taxation.

3. *The Fall of Simplicity*

Rebalancing the values of partnership taxation did not occur without sacrifice. Simplicity was effectively abandoned in Congress's piecemeal efforts to reconcile equity, flexibility, and efficiency.[82] Equity required

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79. These complicated provisions are discussed in greater detail *infra* Part I.B.3.a.

80. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7642, 103 Stat. 2106 (codified at I.R.C. § 704(c)(1)(B)). Alongside the "mixing bowl" rule of Section 704(c)(1)(B), subchapter K contains several other provisions addressing the improper use of partnership contributions and distributions. *Id.* §§ 707(a)(2)(B) (disguised sale rule), 737 (mixing bowl rule) (2006).

81. *Id.* § 704(c)(1)(C) (anti-shifting provision governing pre-contribution losses); Treas. Reg. § 1.704-3(a)(10) (as amended in 2010) (general anti-abuse provision).

82. *See, e.g.*, Berger, *supra* note 11, at 108 ("In order to keep tax planners from wholly abusing the partnership's privileged status, while not denying them all remaining flexibility, Congress and Treasury have had to fashion a statutory and regulatory apparatus which . . . has become one of the most inaccessible and burdensome features of the entire tax system."); Gergen, *Special Allocations*,

subchapter K's second-generation provisions to be more nuanced, but increasing the number of factors a partnership had to consider in determining the tax consequences of a transaction introduced additional complexity into the regime.[83] Similarly, preventing tax shelters without impairing flexibility or efficiency forced Congress and the Treasury to draw lines between permissible tax planning and impermissible tax abuse, which introduced enormous complexity into partnership taxation.

Subchapter K now consists of hundreds of pages of provisions, exceptions to provisions, and exceptions to exceptions to provisions.[84] Additionally, there are thousands of pages of rulings, memoranda, and guidance, both formal and informal, clarifying the application of these provisions in specific situations.[85] Although the sheer quantity of partnership authority introduced great complexity into subchapter K, the deeper problem relates to its design. As previously discussed, subchapter K's provisions are largely technical, involving specialized language, multifactored tests, and computational analyses that challenge all but the most experienced partnership tax specialist.[86]

Equally troublesome, these complicated provisions are generally designed to target a small number of sophisticated partnerships engaged in tax shelter transactions.[87] Yet by their terms, such provisions apply equally to all partnerships, whether characterized as "sheltering" partnerships or "non-sheltering" partnerships.[88] As a consequence, the vast majority of partnerships, which are not engaged in tax shelter activities, are subject to an ever-expanding number of complicated provisions that have little to do

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supra note 29, at 1 ("The reforms have done little good and have made an already difficult body of rules even more difficult.").

83. *See, e.g.*, Bittker, *supra* note 35, at 2. More generally, many commentators believe that equity and simplicity invariably trade off with one another and, hence, any heightened focus on equity necessarily increases the complexity of the federal income tax. *See, e.g.*, Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 VA. TAX REV. 645, 681 (2003) ("Tax complexity is . . . a necessary cost to provide an equitable taxing system. Congress has often sacrificed simplicity for the cause of equity . . . .").

84. The statutory provisions of subchapter K span 33 pages, and the regulatory provisions of subchapter K span another 286 pages. I.R.C. §§ 701–777; Treas. Reg. §§ 1.701-1–1.777-1.

85. To illustrate, a simple search on Lexis for administrative guidance containing the term "partnership" at least five times returned more than 3,000 documents. Narrowing the search to items using the term "partnership" at least five times and the term "passthrough" returned 2,897 items. LEXIS, www.lexis.com (follow "Area of Law – By Topic: Taxation" hyperlink; then follow "Find Federal Administrative Materials" hyperlink; then follow "Agency Decisions" hyperlink; then follow "IRS Bulletins, Letter Rulings & Memoranda Decisions, Combined"; then search for "partnership" at least five times and "passthrough") (last visited Feb. 14, 2012).

86. *See supra* note 73 and accompanying text.

87. *See, e.g.*, Kwall, *supra* note 11, at 237; Lokken, *As the World Turns*, *supra* note 75, at 367.

88. *See* Lokken, *As the World Turns*, *supra* note 75, at 367 ("The dilemma of subchapter K is that rules considered essential to the effective application of the tax laws to some partnerships and their partners apply to all partnerships, including those utterly lacking in capability to apply the rules, which likely comprise a large majority of all partnerships.").

with their day-to-day operations.[89] For these non-sheltering partnerships, this complexity has made it virtually impossible to navigate subchapter K without the expenditure of significant resources.[90]

In many respects, complexity has become the hallmark of partnership taxation. To illustrate the scope of subchapter K's complexity problem, this Subpart concludes with two examples, each of which highlights a paradigmatic form of complexity in partnership taxation.

a. Complexity Through Partnership Choice. In certain instances, subchapter K's provisions allow a partnership to choose from a menu of options when determining the tax consequences of a particular transaction. This menu approach offers partnerships the freedom to choose between a default provision, which is typically designed to be simple, and an alternative provision designed to produce more equitable results at the price of greater complexity.

As previously discussed, subchapter K's contributed property allocation provisions illustrate the menu approach.[91] Since 1984, these provisions generally require a partnership to allocate pre-contribution gains to the contributing partner.[92] Yet ensuring that pre-contribution gains are allocated to the contributing partner can be quite complicated, and Congress thus allows a partnership to choose, on a property-by-property basis, from a menu of options designed to offer a choice among allocation

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89. The Treasury has repeatedly asserted that many of these anti-abuse provisions are intended solely to combat the activities of sheltering partnerships and, hence, they should not interfere with the legitimate activities of non-sheltering partnerships. *See, e.g.*, Prop. Treas. Reg. § 1.701-2, 59 Fed. Reg. 25,581, 25,582 (May 17, 1994) ("The proposed regulation is not intended to interfere with bona fide joint business arrangements involving partnerships."). While these statements may be correct, a careful non-sheltering partnership must nonetheless consider such provisions in determining its federal income tax consequences. Accordingly, non-sheltering partnerships, although not the target of these anti-abuse provisions, are still adversely affected by their complexity.

90. *See* Foxman v. Comm'r, 41 T.C. 535, 551 n.9 (1964) ("The distressingly complex and confusing nature of the provisions of subchapter K present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field."). Indeed, "generalist" tax practitioners increasingly struggle to navigate subchapter K. *See* Lokken, *As the World Turns*, *supra* note 75, at 366 ("Even highly competent tax generalists may stumble badly on partnership issues not resolved by the basic pass-through idea of subchapter K."); McMahon, *supra* note 40, at 1450 ("[R]egulations that are not too complex for a tax practitioner who specializes in the area with which the regulations deal often are too intricate to be understandable by the typical generalist who nevertheless must deal with those regulations in order to serve clients. We can't all be specialists, and generalists can't refer all their problems to specialists.").

91. *See supra* notes 70–71 and accompanying text. Other provisions following a menu approach include the provisions governing a purchasing partner's basis in her partnership interest and the provisions governing a partnership's basis in its assets following certain partnership distributions. I.R.C. §§ 734 (partnership inside basis following distribution), 743 (partner outside basis following purchase of partnership interest) (2006).

92. I.R.C. § 704(c)(1)(A); Treas. Reg. § 1.704-3(a)(1) (as amended in 2010). For a more thorough discussion of allocations attributable to contributed property, including the menu-based approach discussed in this Subpart, see generally sources cited *supra* note 61.

methods with varying levels of complexity.[93] Under the current default provision, a partnership makes contributed property allocations using a relatively simple method that is potentially inequitable.[94] If, however, the partnership prefers a more equitable result at the price of greater complexity, it can apply one of two alternative allocation methods.[95]

Each allocation method has its own quirks and technicalities. For instance, concepts like the "ceiling rule,"[96] "curative allocations,"[97] and "remedial items"[98] require appreciable specialized knowledge.[99] Yet the

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93. Treas. Reg. § 1.704-3(a)(2).

94. The "simple" allocation method is called the traditional method. *Id.* § 1.704-3(b)(1). Under the traditional method, a partnership allocates pre-contribution gains to the contributing partner, but such allocation cannot exceed the actual amount recognized by the partnership. *Id.* This limitation is commonly referred to as the ceiling rule, and it applies in all instances, without exception. To illustrate, consider again the partnership described *supra* note 65. Let's assume that the fair market value of Blackacre drops from $100 to $70 after contribution, and the partnership sells the property for $70. The partnership now recognizes an economic loss of $30 ($70 amount realized less $100 book value) and a taxable gain of $10 ($70 amount realized less $60 basis) on Blackacre's sale. The partnership would allocate the economic loss equally between *A* and *B*, reducing each partner's economic investment from $100 to $85. *Id.* § 1.704-1(b)(2)(iv)(b)(7). In contrast, the $10 taxable gain would be allocated entirely to *B* under the traditional method, increasing her tax investment in the partnership from $60 to $70. *Id.* § 1.704-3(b)(1). Ideally, the partnership would have allocated a $15 tax loss to *A* to match her $15 allocated economic loss. But the partnership did not recognize a tax loss and, hence, the ceiling rule prevents this result.

Herein lies the problem. As a result of the ceiling rule, a portion of Blackacre's pre-contribution gain was shifted from *B* to *A*. After Blackacre's sale, *A* and *B* would each have an economic investment of $85 in the partnership. *B*'s tax investment, however, would be only $70. Thus, *B* would not have borne the full tax burden of her economic investment. Rather, *A* would have borne some of it. Despite this income shift and the resulting inequity, the appeal of the traditional method is that it is based on "actual" numbers and, therefore, is relatively straightforward in application. *See* AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT—SUBCHAPTER K: PROPOSALS ON THE TAXATION OF PARTNERS 139 (1984) ("[T]he ceiling limitation has one important advantage. It restricts any allocation to readily ascertainable factors—the property's basis and its sales price.").

95. These alternate allocation methods are called the traditional method with curative allocations and remedial allocation method. Treas. Reg. § 1.704-3(c), (d). Both of these methods seek to ameliorate the distortions created by the ceiling rule and, in doing so, prevent the shifting of pre-contribution gain. Accordingly, both methods offer a more equitable, less abuse-prone means of making contributed property allocations, but they do so by introducing greater complexity into subchapter K. For a general discussion of these contribution property allocation methods, see MCKEE ET AL., *supra* note 20, at ¶ 11.04; WILLIS & POSTLEWAITE, *supra* note 20, at ¶ 10.08.

96. Treas. Reg. § 1.704-3(b)(1). For a discussion of the ceiling rule, see *supra* note 94.

97. *Id.* § 1.704-3(c)(1). Curative allocations are allocations intended to cure ceiling rule distortions under the traditional method with curative allocations. *Id.* More specifically, curative allocations are allocations of taxable items that differ from the partnership's allocation of the corresponding book items. *Id.*

98. *Id.* § 1.704-3(d)(1). Remedial items are offsetting notional allocations made under the remedial allocation method to cure ceiling rule distortions. *Id.*

99. Alongside specialized terminology, the three contributed property allocation methods contain other quirks and technicalities. For instance, the remedial allocation method requires a partnership to allocate depreciation deductions based on a complicated approach that involves bifurcating the contributed property into two separately depreciable assets. *Id.* § 1.704-3(d)(2). Likewise, the application of the traditional method with curative allocations is not limited to the year of the ceiling rule distortion; instead, it might apply over a series of years. *Id.* § 1.704-3(c)(3)(ii).

complexity of each menu option, standing alone, pales in comparison to the combined effect of three distinct allocation methods, which a partnership must choose among every time a contribution occurs.[100] In order to make this choice, a partnership must first understand each allocation method.[101] The partnership must then determine how the particular item of contributed property would be treated over time under all three methods. Only after completing these steps can a partnership select the allocation method best suited for its contributed property. For many partnerships, this process has become enormously complicated and resource intensive, effectively denying them access to the menu options subchapter K provides for contributed property allocations.

b. Complexity Through Line Drawing. A second category of subchapter K's provisions grants partnerships broad freedom in structuring their affairs. These flexible provisions illustrate the regulatory complexity of identifying the point at which legitimate tax planning shades into abusive tax sheltering. Nowhere has this line drawing project been more difficult than with the general provisions governing partnership allocations.[102]

As previously discussed, a partnership may allocate taxable items in any manner agreed to by its partners, including in ratios disproportionate to their economic interests in the partnership.[103] Even so, Congress feared that partnerships would use this freedom strategically, allocating taxable items in a manner that reduced their partners' aggregate tax liability at the

100. Additionally, Congress introduced a fourth allocation method in 2004 that applies to certain items of contributed built-in loss property. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 833(a), 188 Stat. 1418 (codified at I.R.C. § 704(c)(1)(C)). This mandatory rule was intended to prevent the shifting of certain pre-contribution losses among partners, including partners purchasing partnership interests from partners who previously contributed built-in loss property to the partnership. Although the Treasury has yet to issue regulations explaining the application of this allocation method, this provision appears to be as complicated (and perhaps even more complicated) than Section 704(c)'s three historic menu options. For a discussion of the problems of new Section 704(c)(1)(C), see Daniel L. Simmons, *Built-in Gain and Built-in Loss Property on Formation of a Partnership: An Exploration of the Grand Elegance of Partnership Capital Accounts*, 9 FLA. TAX REV. 599 (2009); Monroe, *Saving Subchapter K*, *supra* note 61.

101. *See, e.g.*, Cauble, supra note 38, at 292; *see generally* 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 (1997) [hereinafter Yin, *Taxation of Private Business Enterprises*] ("[E]lections are inherently costly and complex for the taxpayer. The taxpayer must incur the transaction cost of evaluating all tax consequences of the available options before making an informed choice.").

102. Treas. Reg. § 1.704-1. Other provisions following this flexible approach include the provisions governing allocations attributable to nonrecourse liabilities and the provisions governing the allocation of nonrecourse liabilities. Treas. Reg. §§ 1.704-2 (allocations attributable to nonrecourse liabilities), 1.752-3 (allocation of nonrecourse liabilities).

103. *See supra* notes 22–24 and accompanying text.

expense of the public fisc.[104] Accordingly, subchapter K's general allocation provisions have always tried to specify the boundary beyond which special allocations would no longer be permissible. Under current law, a partnership allocation will be respected so long as it reasonably tracks the partnership's allocation of the corresponding economic item and is not merely a device to shift income among partners in a tax-advantaged manner. Congress expressed these concepts in a safe harbor that requires an allocation to have substantial economic effect.[105]

Designing a functional regulatory scheme to implement this substantial economic effect safe harbor, however, has proven to be a formidable challenge for the Treasury. A partnership can satisfy the safe harbor's economic effect requirement in one of three ways,[106] all of which require it

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104. *See, e.g.*, ALI, 1999 REPORTERS' STUDY, *supra* note 11, at 78 ("But flexible tax-sharing rules also may be used simply to minimize the collective tax liabilities of the partners, to the detriment of the Treasury and all other taxpayers. By allocating items to the partner who is in a position to utilize them most favorably for tax purposes, the partners can put their respective tax advantages to best use and share in the resulting tax savings."); Gregg D. Polsky, *Deterring Tax-Driven Partnership Allocations*, 64 TAX LAW. 97, 97 (2010) ("One could envision a purely elective regime that allows partnerships to allocate items in any manner they desire. But in that case partnerships would choose to allocate items in such a way as to minimize the partners' aggregate tax liability . . . .").

105. Treas. Reg. § 1.704-1(b)(2)(i). Substantial economic effect is a two-part determination, requiring an allocation to have economic effect and then requiring such economic effect to be substantial. *Id*. Allocations have economic effect if they are "consistent with the underlying economic arrangement of the partners." *Id*. § 1.704-1(b)(2)(ii)(a). Put another way, a partner that is allocated one dollar of partnership income must also receive the economic benefit of such dollar. In contrast, substantiality requires that there be a reasonable possibility that an allocation meaningfully affect the dollar amounts to be received by a partner, independent of tax consequences. *Id*. § 1.704-1(b)(2)(iii)(a).

If an allocation lacks substantial economic effect, then the partnership must reallocate the taxable item based on a similarly complicated default standard, the partner's interest in the partnership. I.R.C. § 704(b) (2006); Treas. Reg. § 1.704-1(b)(3). The partner's interest in the partnership standard requires a partnership to allocate a taxable item in the same manner as it allocates the corresponding economic benefit or burden. *Id*. § 1.704-1(b)(3)(i). In making this determination, a partnership may consider any relevant fact or circumstance, and the proper economic allocation may vary on an item-by-item basis. *Id*. Although relatively straightforward in the simplest of partnerships, this standard becomes impossibly indeterminate the moment disproportionate economic arrangements are introduced into a partnership. *See, e.g.*, Bradley T. Borden, *The Allure and Illusion of Partners' Interest in a Partnership*, 79 U. CIN. L. REV. 1077, 1106–07 (2011); Lawrence Lokken, *Partnership Allocations*, 41 TAX L. REV. 547, 613–14 (1986); Yin, *Taxation of Private Business Enterprises*, *supra* note 101, at 154.

106. The first "basic" economic effect test requires a partnership to satisfy three requirements: (1) it must maintain capital accounts in accordance with the regulations, (2) it must make all liquidating distributions in accordance with its partners' positive capital account balances, and (3) each partner must agree to restore a deficit balance in her capital account if one exists at the time her partnership interest is liquidated. Treas. Reg. § 1.704-1(b)(2)(ii)(b). Unlimited obligations to restore deficit capital account balances have proven problematic, particularly for partners with limited liability. Thus, the Treasury provides relief for these partners in the form of a second "alternate" economic effect test. *Id*. § 1.704-1(b)(2)(ii)(d). The economic effect requirement contains an additional relief-based test for partnerships. *Id*. § 1.704-1(b)(2)(ii)(i). Under this "economic effect equivalence" test, an allocation will be deemed to have economic effect if, as of the end of the relevant taxable year, a liquidation of the partnership would produce the same economic results that would have occurred had the partnership complied with the basic economic effect test. For a general discussion of the economic effect requirement, see MCKEE ET AL., *supra* note 20, at ¶ 11.02[2][a]; WILLIS & POSTLEWAITE, *supra* note 20, at ¶ 10.04[2].

to master an intricate series of tax accounting rules that govern virtually every aspect of a partnership's life.[107] Additionally, the economic effect requirement introduces myriad technical terminology into subchapter K's general allocation regime, including "capital accounts,"[108] "deficit restoration obligations,"[109] "qualified income offsets,"[110] and the "value-equals-basis" assumption.[111] After satisfying the economic effect requirement, a partnership must then establish that its allocations comply with the safe harbor's substantiality requirement. To prove substantiality, a partnership must demonstrate that its allocations satisfy three alternative tests, each combining mathematical rules, open-textured standards, and economic projections.[112]

Congress's desire to provide partnerships with flexible allocation provisions, coupled with the line drawing that such an approach requires, has burdened partnerships with enormous complexity. Under the substantial economic effect safe harbor, a partnership must apply multiple layers of intricate, mathematical provisions to every allocation it makes, every year.[113] Even worse, this complexity has proven counter-productive, blurring the line between legitimate and abusive partnership allocations.[114]

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107. Treas. Reg. § 1.704-1(b)(2)(iv). These accounting rules are referred to as the capital account maintenance requirements, and they govern almost every partnership transaction, from formation to liquidation.

108. *Id.* § 1.704-1(b)(2)(iv).

109. *Id.* § 1.704-1(b)(2)(ii)(b)(3). A deficit restoration obligation is a provision requiring a partner to restore a deficit in her capital account if one exists at the time her partnership interest is liquidated. *Id.*

110. *Id.* § 1.704-1(b)(2)(ii)(d)(3), (d)(6) (flush language). A qualified income offset requires that, if certain enumerated events occur under the alternate test for economic effect, a partnership make disproportionate allocations to a partner with a capital account deficit so as to eliminate such deficit balance. *Id.*

111. *Id.* § 1.704-1(b)(2)(iii)(c). Under this assumption, a partnership is required to assume that the fair market value of partnership property equals its adjusted basis. *Id.*

112. The first substantiality test is the after-tax substantiality test, and it targets allocations that are too good to be true, harming no partner but causing a revenue loss to the government. *Id.* § 1.704-1(b)(2)(iii)(a). An allocation violates the after-tax substantiality test if (1) it improves at least one partner's after-tax consequences as compared to the tax consequences that would have occurred if the partnership agreement had not included such allocation, and (2) there is a strong likelihood that no partner's after-tax consequences will be substantially diminished as a result of such allocation. *Id.* The second and third substantiality tests, the shifting and transitory tests, are almost indistinguishable, differing primarily in their relevant time frames. *Id.* § 1.704-1(b)(2)(iii)(b), (c). An allocation violates these substantiality tests if there is a strong likelihood at the time such allocations become part of the partnership agreement that (1) the net adjustments to the partners' capital accounts will not differ substantially from those that would have occurred if the partnership agreement had not included such allocations, and (2) the allocations reduce the partners' aggregate federal income tax liability. *Id.* § 1.704-1(b)(2)(iii)(b), (c). For a general discussion of the substantiality requirement, see MCKEE ET AL., *supra* note 20, at ¶ 11.02[2][b]; WILLIS & POSTLEWAITE, *supra* note 20, at ¶ 10.04[4].

113. *See* ALI, 1999 REPORTERS' STUDY, *supra* note 11, at 81 ("The [704(b)] rules are lengthy and complex, and the burden on those taxpayers who attempt to comply with them is considerable . . . ."). Even so, other commentators have noted that some partnerships, although not in technical compliance with the substantial economic effect safe harbor, will naturally achieve

C. The Crisis in Partnership Taxation

To analyze the history of partnership taxation through its values shows the system's problems in a new light. Congress's initial preference for flexibility in subchapter K led to abuse; abuse forced Congress to more actively pursue equity in partnership taxation; and the dual commitment to flexibility and equity, coupled with the emergence of efficiency, transformed subchapter K.

From this perspective, partnership taxation's modern dysfunction is due largely to discord among its values.[115] The fight against tax shelters, and the resulting piecemeal approach to rulemaking, have prevented the organic development of a comprehensive vision of partnership taxation. Instead, subchapter K has become a patchwork of technical provisions that lack principled ties to one another or to the system as a whole. The design of these provisions, intended to reconcile equity, flexibility, and efficiency with surgeon-like precision, has only exacerbated subchapter K's problems.

Subchapter K today is a diffuse system directed at tax shelters and at the unpredictable activities of sophisticated partnerships. Yet subchapter K's provisions govern all partnerships, even entities whose commercial activities share nothing in common with the elaborate transactions of sheltering partnerships. In the polarized world of modern partnerships, subchapter K focuses virtually all of its attention on the minority of partnerships at the tax shelter extreme, thereby leaving large numbers of non-sheltering partnerships in a precarious position—wanting to comply with the law, but finding themselves unable to do so without the expenditure of excessive, often cost-prohibitive, resources.

This Subpart examines the crisis in partnership taxation, and traces the effect of discordant values on subchapter K's conceptual architecture. Dissonance among subchapter K's four values has frustrated each and every one, leaving partnership taxation inflexible, inefficient, inequitable, and complex. Dysfunctional values have also compromised subchapter K's legitimacy, creating the perception that partnership taxation is unfair and

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compliance with the spirit of the safe harbor. *See, e.g.*, Cauble, *supra* note 38, at 286 n.122; Postlewaite, *I Come to Bury Subchapter K*, *supra* note 11, at 473.

114. *See, e.g.*, ALI, 1999 REPORTERS' STUDY, *supra* note 11, at 82 ("Unfortunately, the economic-effect requirement fails to achieve its intended purpose and does not preclude purely tax-motivated allocations."); Edward J. Buchholz, *Substantiality under Section 704(c)—Some Forgotten Issues and Some Ancient Concepts Revisited*, 19 VA. TAX REV. 165, 267–69 (1999); Thomas W. Henning, *Partnership Exit Strategies and the Failure of the Substantiality Test*, 63 TAX LAW. 43, 44 (2009); Polsky, *supra* note 104, at 99.

115. It is important to note that this dissonance among values is not unlike other areas of law where discordant values impede systemic functionality. Yet discordant values in partnership taxation are particularly problematic because of their effect on tax shelters, the high costs of which are ultimately borne by the public at large. Indeed, this relationship will be discussed in greater detail in this Subpart.

unprincipled. In turn, public illegitimacy has stymied compliance, as non-sheltering partnerships struggle to understand and apply subchapter K's complicated provisions and sheltering partnerships continue to abuse them. As compliance has declined, subchapter K's ability to achieve its systemic ends has been severely impaired, and the cost of such failure is ultimately borne by the public at large.

1. Values Frustrated

Historically, subchapter K's values have worked at cross-purposes, undermining one another at every turn. We have already seen how simplicity was sacrificed in an effort to reconcile flexibility, efficiency, and equity.[116] But simplicity is not the only casualty of subchapter K's pursuit of multiple values; great inequities also exist in partnership taxation. Despite congressional and regulatory efforts to combat abusive partnership transactions, subchapter K's complex web of provisions continues to offer partnerships myriad opportunities to exploit in violation of horizontal equity norms.[117] Tax shelters remain a problem in partnership taxation, preventing partners from paying tax based on their relative circumstances.[118]

Subchapter K's discordant values have similarly compromised vertical equity norms, failing to account for deep divides within the partnership tax community. As previously discussed, the universe of partnerships has become increasingly polarized, with partnerships being characterized as either sheltering partnerships or non-sheltering partnerships.[119] Notwithstanding the fundamental differences between these partnerships, they are all subject to the same subchapter K, which, in its modern form, is primarily focused on the abusive activities of a small number of sophisticated, sheltering partnerships. Non-sheltering partnerships are thus forced to bear a disproportionate burden for the abusive behavior of sheltering partnerships.[120]

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116. *See supra* Part I.B.3.

117. *See supra* notes 75–76 and accompanying text.

118. At present, the "tax shelter wars" are relatively quiet and, hence, one might wonder whether I am downplaying the efficacy of subchapter K's anti-abuse provisions. While true that partnership tax shelter activity is relatively low at the moment, subchapter K's individual provisions are not responsible for this positive development. Unfortunately, the sluggish economy is; demand for loss generating tax shelters has declined in recent years. *See* Calvin H. Johnson & Lawrence Zelenak, *Codification of General Disallowance of Artificial Losses*, 122 TAX NOTES 1389, 1391 (2009). Likewise, to the extent that the Treasury has achieved success in the fight against tax shelters, such success is not attributable to subchapter K. As will be discussed *infra* Part II.C.1, provisions external to subchapter K deserve the praise.

119. *See supra* notes 87–88 and accompanying text.

120. *See* Lokken, *As the World Turns*, *supra* note 75, at 367; Yin, *Future of Private Business Firms*, *supra* note 11, at 199.

This burden, and the underlying inequity, is further exacerbated by the financial realities of current law. Partnerships increasingly need the advice of a partnership tax specialist to navigate subchapter K, but such elite advice is cost-prohibitive for many partnerships. As a consequence, the substantive content of partnership taxation is characteristically accessible only to wealthy and well-advised partnerships.[121]

Alongside equity, efficiency has also been stymied by the imbalanced values of partnership taxation. The proliferation of provisions and complexities in subchapter K has imposed immense administrative costs on partnerships and the Service in terms of time, effort, and resources. Likewise, Congress and the Treasury remain enormously involved in partnership taxation, supplying partnerships with formal and informal guidance on a near-constant basis. Together, these inefficiencies have increased the cost of doing business as a partnership, thereby raising the perennial concern that the commercial market for partnership transactions might contract.

In addition, the continuing presence of partnership tax shelters violates tax efficiency norms. Tax shelters distort economic decision making, diverting resources from economic to non-economic activities designed principally to obtain an improper tax advantage.[122] To effectuate these transactions, sheltering partnerships employ armies of legal, accounting, and financial experts, all of which generate excessive transaction costs.[123] And then there is the cost of the tax shelter itself, producing no economic benefits but imposing significant costs on the public at large.

Perhaps most surprising, dissonant values have rendered the ideal of flexibility a virtual impossibility for many partnerships, especially unsophisticated, non-sheltering partnerships. If these partnerships cannot understand the choices that subchapter K's flexible provisions offer, then it cannot be said that they really have choices. To this category of partnerships, subchapter K surely must appear quite inflexible.

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121. *See generally* Heather M. Field, *Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System*, 47 HARV. J. ON LEGIS. 21, 31 (2010) ("[A]n election, while technically available to all eligible taxpayers, may be functionally available only to the wealthiest, most sophisticated group of taxpayers, who can best navigate the complexity of the election process. As with tax planning in general, other taxpayers may lack the knowledge or resources to pay for advice that would enable them to take full advantage of the election.") (footnote omitted).

122. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-1009SP, UNDERSTANDING THE TAX REFORM DEBATE: BACKGROUND, CRITERIA, & QUESTIONS 5 (2005), *available at* http://www.gao.gov/new.items/d051009sp.pdf ("Taxes impose efficiency costs by altering taxpayers' behavior, inducing them to shift resources from higher valued uses to lower valued uses in an effort to reduce tax liability.") (emphasis omitted).

123. *See, e.g.*, Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775, 1780 (1999).

2. *Legitimacy Frustrated*

Discordant values have created the perception that partnership taxation is unfair and unprincipled, thereby jeopardizing subchapter K's legitimacy and breaking the bonds that foster fidelity to the law. Partners that cannot understand and apply subchapter K's complex provisions are effectively excluded from participation in the system.[124] In turn, the inaccessibility of partnership taxation has led to disillusionment and alienation among partners.[125] It also has fostered the belief that our country has a dual tax system: one for the wealthy and sophisticated, and one for everyone else.[126] Together, the result has been to erode respect for partnership taxation and to increase the risk that partners will turn to abusive transactions in order to remedy subchapter K's perceived unfairness.[127]

The combination of public illegitimacy and dissonant values has had a destructive effect on compliance rates, which appear to be falling at both extremes of the partnership spectrum. Although there is little aggregate empirical evidence regarding partner compliance, anecdotal evidence suggests that fewer and fewer partners are complying with subchapter K.[128] As previously discussed, unsophisticated, non-sheltering partnerships currently struggle to understand and apply subchapter K's complicated provisions.[129] Left with few viable options, many of these partners have simply given up trying to comply with the law, instead following what

124. Lokken, *Future Without Subchapter K*, *supra* note 11, at 252 ("Americans have traditionally prided themselves as being a society of laws. Laws that cannot feasibly be understood and obeyed are the equivalent of no law at all.").

125. *See* DEP'T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS, at 3 (1999) [hereinafter DEP'T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS], *available at* http:www.treasury.gov/resource-center/tax-policy/Documents/ctswhite.pdf.

126. *See* DEP'T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS, *supra* note 125, at 3; Sheldon I. Banoff, *The Use and Misuse of Anti-Abuse Rules*, 48 TAX LAW. 827, 828–30 (1995); McCaffery, *Holy Grail of Simplification*, *supra* note 39, at 1281. For recent examples of this sentiment, see sources cited *supra* note 1.

127. *See* JOHN BRAITHWAITE, MARKETS IN VICE, MARKETS IN VIRTUE 32 (2005) ("While most people are crudely but acutely aware of the existence of tax shelters that are available to the rich but not to them, their response is not political resistance so much as privatised cheating in smaller ways they can manage to get away with."); Richardson Remarks, *supra* note 76 ("I am concerned that voluntary compliance with the tax law can be severely damaged by the perception that taxpayers with sophisticated advisors are able to creatively use the tax laws to their undue advantage. If some taxpayers can find ways to circumvent the law, then compliance will be seriously jeopardized.").

128. *See* ALI, 1999 REPORTERS' STUDY, *supra* note 11, at 105; Lokken, *As the World Turns*, *supra* note 75, at 367; Lokken, *Future Without Subchapter K*, *supra* note 11, at 252 ("[U]nless the partnership receives and follows tax advice of the highest sophistication, the tax rules are likely violated. In a large number, perhaps a large majority, of such situations, the costs of such advice are prohibitive, given the partnership's size.").

129. *See supra* Part I.C.1.

some scholars refer to as an "intuitive subchapter K."[130] A partner adopting this approach just tries to do the best she can with available resources and hopes her tax positions are "close enough" to avoid attracting the Service's attention.

The Service does not in fact discover much of this noncompliance because it too struggles with partnership taxation. Enforcement resources dedicated to subchapter K are low; thus creating formidable challenges for enforcement personnel.[131] In order to effectively administer subchapter K, governmental officers must master its complicated provisions. Yet the Service, like partners themselves, lacks the time and resources necessary to develop such mastery, further diminishing its ability to enforce the technical provisions of partnership taxation.

At the opposite extreme, subchapter K's dysfunctionality also facilitates the noncompliance of sheltering partnerships. Discordant values are not the only source of modern tax shelter problems, but they are complicit in the abusive behavior of sheltering partnerships. As previously discussed, subchapter K offers partnerships myriad opportunities for tax sheltering.[132] Likewise, the system's complexity functions as a shield, burying the voluntary noncompliance of sheltering partnerships in a larger mass of partnership noncompliance, thereby further reducing the risk that abusive transactions will be detected.[133]

Even worse, a vicious cycle emerges where noncompliance, public illegitimacy, and dissonant values reinforce one another. Discordant values breed frustration among partners who feel excluded from partnership

130. Lokken, *Future Without Subchapter K*, *supra* note 11, at 252 ("A large number of partnerships thus seem to be governed by what might be called an 'intuitive subchapter K.' Taxpayers and tax advisers who want to comply account for partnership transactions in ways that are consistent with their conceptions of the basic aims of subchapter K . . . ."); Lokken, *As the World Turns*, *supra* note 75, at 367 ("[W]e already have a K lite, consisting of the present subchapter K stripped of all the rules and nuances that tax practitioners serving ordinary partnerships do not understand and simply ignore."). Yin, *Future of Taxation of Private Business Firms*, *supra* note 11, at 201 ("[I]t may well be that many small firms . . . already utilize a watered-down, intuitive version of subchapter K.").

One might wonder why an intuitive subchapter K is problematic, especially if most partnerships can approximate the right result without incurring the expense of navigating subchapter K's complexity. *See* Postlewaite, *I Come to Bury Subchapter K*, *supra* note 11, at 473. Ultimately, this is an empirical question, and the answer depends on how "close" the results are under an intuitive subchapter K. Yet the empirical work necessary to analyze this claim regarding partnership compliance has not been done, and the substantive work of reforming partnership taxation must proceed. Thus, we must proceed provisionally using reasonable working assumptions about partnership compliance. To that end, this Article assumes that non-sheltering partnerships want to follow the law and, thus, a system where large numbers of partnerships are excluded from the possibility of "perfect" compliance is problematic.

131. *See supra* note 47.

132. *See supra* Part I.B.2.

133. *See generally* Steve Johnson, *The 1998 Act and the Resources Link Between Tax Compliance and Tax Simplification*, 51 U. KAN. L. REV. 1013, 1049 (2003) ("When taxpayers do understate their liabilities—either because of honest error or because they were aggressive—complexity decreases the chance that the IRS will detect the understatement.").

taxation. Frustrated partners, in turn, are less inclined to respect subchapter K and more inclined to pursue tax shelters. That breakdown in legitimacy then compromises subchapter K's already compromised values by triggering governmental responses that, consistent with historical practice, lead to greater complexity, inequity, and inefficiency in partnership taxation.

3. *Systemic Ends Frustrated*

When compliance falters, subchapter K cannot achieve its systemic ends because noncompliance deprives the public fisc of revenue. The cost of tax shelters is difficult to quantify, but some estimates put their cost in excess of $10 billion annually over the past two decades.[134] Although these estimates are not partnership-specific, partnerships have traditionally been the preferred vehicle for tax sheltering.[135] It is thus likely that a significant portion of this cost is attributable to partnership tax shelters. The revenue effect of noncompliance among non-sheltering partnerships is even harder to determine, but the net effect of such noncompliance is almost certainly large and negative.[136]

To conclude, partnership taxation is a system in crisis. Its values are broken, frustrating one another, eroding public legitimacy, and ultimately failing to support subchapter K's systemic ends. The time has thus come to rethink partnership taxation, beginning with the values that lie at its intellectual core.

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134. *See, e.g.*, DEP'T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS, *supra* note 125, at 31; Cunningham & Repetti, *supra* note 48, at 3; Janet Novack & Laura Saunders, *The Hustling of X Rated Shelters*, FORBES, Dec. 14, 1998, at 199. The Government Accountability Office estimated that the monetary loss from tax shelters in 1998 was between $13.6 and $17.3 billion. JANE G. GRAVELLE, CONG. RESEARCH SERV., ANTI-TAX-SHELTER AND OTHER REVENUE-RAISING TAX PROPOSALS CONSIDERED IN THE 108TH CONGRESS 8 (2005), *available at* http://digital.library.unt.edu/govdocs/crs/permalink/meta-crs-6773. The same study estimated cumulative losses from tax shelters between 1989 and 2003 to be $85 billion. *Id.*

135. *See, e.g.*, INTERNAL REVENUE SERV., PARTNERSHIP-AUDIT TECHNIQUE GUIDE Ch. 9 (2007) ("In recent years, there has been a continuous growth of the use of partnerships in tax shelters."); Cunningham & Repetti, *supra* note 48, at 57–58 ("[S]ubchapter K was the vehicle of choice for abusive transactions that the Treasury was unable to address by adopting more rules.").

136. Although noncompliance from non-sheltering partnerships could technically lead to underpayments or overpayments of federal income tax, evidence from the individual income tax would suggest that the revenue effect is likely negative. *See* Press Release, Senator Max Baucus, Hearing Statement of Senator Max Baucus (D-Mont.) Regarding Tax Code Complexity and the Tax Gap (Jun. 28, 2011) (statement of Sen. Max Baucus, Member, Senate Committee on Finance), *available at* http://finance.senate.gov/imo/media/doc/06282011%20Baucus%20Statement%20Regarding%20Complexity%20and%20the%20Tax%20Code2.pdf; *see also* GOV'T ACCOUNTABILITY OFFICE, GAO-06-851T, TAX COMPLIANCE: CHALLENGES TO CORPORATE TAX ENFORCEMENT AND OPTIONS TO IMPROVE SECURITIES BASIS REPORTING 21 (2006), *available at* http://www.gao.gov/new.items/d06851t.pdf.

II. RETHINKING PARTNERSHIP TAXATION

Just as conceptual analysis of subchapter K's discordant values brings new focus to the problem of partnership taxation, it may also lay the groundwork for thinking about solutions. This Article takes intellectual first steps toward reform by reimagining subchapter K's values, their relationship to one another, and their relationship to subchapter K.

I propose a holistic approach to subchapter K grounded in unified and harmonious values. To that end, I draw on aspects of Ronald Dworkin's principle of integrity to develop a comprehensive vision of partnership taxation. Although rarely applied in tax scholarship, integrity has a natural appeal in thinking about subchapter K's values. Integrity would operate as a compass, guiding partnership taxation away from its historic dysfunction and toward greater stability.

As will become evident, this Article takes a broad perspective in outlining an intellectual framework for reforming subchapter K; it does not propose particular changes to current law. Like other members of the partnership tax community, I have made specific proposals before and will likely do so again. But this Article's project is more foundational, offering a novel path toward a more coherent and principled subchapter K.

A. Integrity

Integrity's most famous proponent is Ronald Dworkin, who developed the principle of integrity as a means of reconciling conflicts between the principles of justice and fairness that he considered foundational to any legal system.[137] For readers unfamiliar with Dworkin's work, two short examples might illustrate the tension between justice and fairness, as well as the importance of integrity. Consider, for example, a law that permits abortions for women born in odd-numbered years but prohibits them for women born in even-numbered years.[138] This law may be procedurally fair, representing a compromise that reflects the public's deeply divided views about abortion.[139] But the law is not just.[140] On the contrary, it treats

137. DWORKIN, *supra* note 14, at 176–86.

138. *Id.* at 178.

139. *Id.* at 179 ("Allowing each of two groups to choose some part of the law of abortion, in proportion to their numbers, is fairer (in our sense) than the winner-take-all scheme our instincts prefer . . . ."). More generally, Dworkin considers fairness "a matter of finding political procedures—methods of electing officials and making their decisions responsive to the electorate—that distribute political power in the right way. That is now generally understood, in the United States and Britain at least, to mean procedures and practices that give all citizens more or less equal influence in the decisions that govern them." *Id.* at 164–65.

140. To Dworkin, justice "is concerned with the decisions that the standing political institutions . . . ought to make. If we accept justice as a political virtue, we want our legislators and

similarly situated women differently based solely on their year of birth, and thus appears arbitrary and unprincipled.[141]

A second example involves a criminal justice system that applies criminal sanctions in a manner intended exclusively to promote justice. Apart from this focus on justice, however, the system does not include evidentiary standards, constraints on police tactics, random jury pools and judicial assignments, or other procedural protections. Such a criminal system would be designed to achieve just results, yet the system would not be fair because it would lack the procedural structure and safeguards that many consider foundational to a legal system.

For Dworkin, integrity is a third, conceptually dominant principle of law that mediates these conflicts between justice and fairness. Integrity reconciles these principles of law through its focus on more universal ends such as equality of moral and political rights among citizens.[142] To that end, integrity demands that the state act in a principled manner, reflecting a unified vision of "justice and fairness in the right relation."[143] A legal system with integrity almost inevitably sacrifices some justice and some fairness in individual instances to provide a system that, as a whole, is considered just and fair. Such an integrity-based system speaks with a coherent voice, applying the same balance of justice and fairness to all its citizens, thereby easing the discord between these fundamental principles of law.[144]

Integrity also fosters a state's legitimacy, which provides support for governmental action.[145] For Dworkin, integrity nurtures a sense of community among citizens and encourages them to think of the law as an organic and participatory system.[146] Likewise, integrity allows citizens to see the law as a commitment to certain principles.[147] This encourages citizens to remain loyal to the state even when they disagree about particular state actions or, more broadly, about underlying applications of justice and fairness.[148]

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other officials to distribute material resources and protect civil liberties so as to secure a morally defensible outcome." *Id*. at 165.

141. *Id*. at 179 ("But we reject a division between parties of opinion when matters of principle are at stake. We follow a different model: that each point of view must be allowed a voice in the process of deliberation but that the collective decision must nevertheless aim to settle on some coherent principle . . . .").

142. *Id*. at 185, 221.

143. *Id*. at 219.

144. *Id*. at 188–90.

145. *Id*. at 191–92.

146. *Id*. at 188–90.

147. *Id*. at 189–90.

148. *Id*. at 190.

B. Integrity in Partnership Taxation

There is much in Dworkin's principle of integrity that resonates with partnership taxation. Yet adapting Dworkin's highly abstract notion of integrity to a specific legal system such as subchapter K necessarily involves departures from Dworkin's more universal theory of law. For instance, where Dworkin looks to legal and moral philosophy in evaluating legal systems as a whole, I will look to Congress and to the partnership tax community of scholars, practitioners, and partners in determining the conceptual components of an integrity-based subchapter K. In this context of partnership taxation, the values of flexibility, efficiency, equity, and simplicity replace Dworkin's conflicting principles of justice and fairness, and raising revenue replaces Dworkin's more abstract moral and philosophical ends. Likewise, my specific analysis of partnership taxation shifts discussion from Dworkin's treatment of broad social legitimacy toward a tighter focus on the perceived fairness of subchapter K.[149]

As we have seen, subchapter K epitomizes a legal system that lacks integrity. Discordant values have subverted partnership taxation, overwhelming partnerships with complexity and creating the perception that subchapter K's individual provisions are unfair and unprincipled. Congress's and the Treasury's piecemeal, shelter-focused approach to rulemaking in subchapter K has similarly hindered thoughtful, comprehensive thinking about the system as a whole. Simply stated, partnership taxation lacks a compass—political, moral, or otherwise—to guide it toward a coherent vision of how partners ought to be taxed.

Subchapter K's dependence on legitimacy also parallels Dworkin's theory of law as integrity. For Dworkin, integrity fosters legitimacy and, thus, facilitates support for state action, even in the face of public disagreement.[150] Integrity's effect on the perception of fairness in subchapter K, and thus on voluntary compliance, serves a similar function in partnership taxation, where the system operates based on the affirmative behavior of individual partners rather than strong government enforcement.[151]

149. One additional adjustment to Dworkin's principle of integrity warrants brief mention. Dworkin's primary concern is the adjudicative process, "which instructs that the law be seen as coherent." *Id*. at 176. Yet he also acknowledges a second principle of integrity—legislative integrity—which "asks lawmakers to try to make the total set of laws morally coherent." *Id*. Although legal systems like subchapter K, which are largely statutory and regulatory constructs, are not Dworkin's primary concern, the principle of integrity has much to offer partnership taxation and its discordant values.

150. *Id*. at 190.

151. *See supra* Part I.A.2.b.

This Article reimagines subchapter K from an integrity-based perspective, with stable and harmonious values working in service of systemic ends. To that end, I propose a reorientation and also a recalibration of subchapter K's historically dissonant values to promote coherence in partnership taxation. On one hand, reorienting subchapter K would require changing the scale and focus we use to think about values. On another hand, recalibrating subchapter K's values would require shifting their internal balance with the goal of minimizing discord.

This Article does not demand perfect unity or harmony among subchapter K's values. Such a goal is neither possible nor desirable in the ever-evolving commercial partnership marketplace.[152] What this project seeks instead is to improve the stability and functionality of partnership taxation by reducing the tension among its values. Progress, not perfection, should be the overriding goal.

1. Reorientation: The Unification Project

Partnership taxation today is best described as a loose collection of ad hoc measures designed, in large part, to combat tax shelters. And herein lies a problem with subchapter K—it is a conglomerate of provisions tied together by little more than necessity, political force, and the fact that its provisions all begin with the section number "700."[153] Each of subchapter K's provisions seems to operate as a being in itself, with its own internal logic and balance of values. Yet these provisions do not combine into a coherent whole. Further exacerbating this problem is subchapter K's diffuse focus on the unpredictable activities of sheltering partnerships, which has burdened the vast majority of partnerships with myriad, haphazard provisions having little or nothing to do with their legitimate commercial needs.

What is needed is a coherent vision of partnership taxation to guide our thinking about subchapter K and its reform. As a first step in that process, this article proposes a reorientation of subchapter K's values designed to unify partnership taxation. Integrity-based thinking would require us to consider the system as a whole, cultivating a singular balance of values in partnership taxation. It would also require subchapter K to orient its provisions toward the larger audience of non-sheltering partnerships. Rescaling and refocusing partnership taxation in this manner would allow the system to speak with one voice to partnerships interested in complying

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152. *See* Kornhauser, *supra* note 15, at 1704.
153. I.R.C. §§ 701–77 (2006).

with the law. Stable, consistently ranked values would become the ties binding subchapter K together and shaping its future development.[154]

2. Recalibration: The Harmony Project

Another step in the process of developing a coherent vision of partnership taxation is to recalibrate the balance among subchapter K's values. In theory, identifying the "right" calibration of values in partnership taxation is straightforward: the optimal balance of simplicity, equity, efficiency, and flexibility in subchapter K is one that minimizes discord and allows these values to work together harmoniously in service of systemic ends. Achieving that balance in practice, however, is a far greater challenge.

The starting point is non-sheltering partnerships. An integrity-based subchapter K would be oriented toward these non-sheltering partnerships; hence, the guiding principle in rebalancing subchapter K's values should be accommodating their needs. To that end, the greatest need of many non-sheltering partnerships is to have a system of partnership taxation with provisions that can be understood and applied without excessive cost. Simply put, these partnerships need a simpler subchapter K.

An integrity-based subchapter K would flip current law's balance of values. Simplicity would emerge as the dominant priority in partnership taxation, emphasizing the importance of accessibility to partnerships and administrability by the Service. Equity and efficiency would also remain important values, but the role of flexibility would be sharply diminished, perhaps even eliminated. Although the notion of partnership freedom may seem sensible in theory, it has not worked in practice.

Simplifying partnership taxation would better align subchapter K with the large number of non-sheltering partnerships that are the central focus of this integrity-based framework. As a first step in this recalibration process, Congress and the Treasury should devote greater attention to intelligibility in the design of subchapter K's provisions. Partnership taxation should be comprehensible to non-sheltering partnerships and, to the extent possible, should be consistent with their commercial expectations. To that end, the provisions of an integrity-based subchapter K, particularly those of general operation, should reflect a less technical drafting style, with minimal use of specialized terminology, computational tests, and multi-factored analyses.

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154. One might question this recalibration project and its effect on sheltering partnerships and their abusive transactions. For instance, critics of an integrity-based approach to partnership taxation might concede that a deliberate, comprehensive vision of subchapter K would be preferable, but nonetheless argue that the partnership tax shelter problem is too severe to ignore. This concern will be discussed *infra* Part II.C.1.

Additionally, the sheer number of provisions in subchapter K should be reduced to yield a more transparent and streamlined system of taxation. For instance, subchapter K's "superstructures" of complex, interrelated anti-abuse provisions should be replaced with a small number of comprehensible provisions. Similarly, the "menu" approach to partnership taxation should be eliminated. The needs of non-sheltering partnerships would be better served by uniform provisions, even if slightly more complicated than the simplest menu options currently available, because they would no longer be required to navigate multiple options in determining the tax consequences of a particular transaction.

More generally, each of subchapter K's values might be sacrificed in individual instances in pursuit of the optimal system-wide calibration of simplicity, equity, efficiency, and flexibility. As previously discussed, an integrity-based system would tolerate this sacrifice exactly insofar as it leads to the improved functionality of partnership taxation as a whole.

C. A New Beginning for Partnership Taxation

Rethinking subchapter K's values could mark a new beginning for partnership taxation. Integrity would offer the possibility of a simpler, more equitable, and more efficient subchapter K. It would also nurture the perception that subchapter K is fair and principled. This newfound legitimacy, combined with coherent values, would improve compliance rates; thus moving partnership taxation closer to its systemic ends. Put another way, integrity would promote functionality in partnership taxation, with unified and harmonious values working together toward common, systemic ends.

1. Values Harmonized

An integrity-based subchapter K would better promote all the values that animate partnership taxation. The most notable change would be simplification.[155] As previously discussed, integrity would reorient

155. One, however, might object that an integrity-based framework does not go far enough in simplifying partnership taxation because it sidesteps the system's most formidable question—the aggregate versus entity question. See *supra* note 28 for a discussion of the aggregate and entity theories of partnerships. This critic would likely concede that subchapter K's discordant values have been enormously problematic, but she would argue that meaningful reform must address the question of whether a partnership is best thought of as an aggregate of its partners or an entity separate and distinct from them.

I disagree. Improving the functionality of partnership taxation does not require a singular theory of partnerships. In reimagining partnership taxation from an integrity-based perspective, this Article focuses on subchapter K's values, their relationship to one another, and their relationship to the system as a whole. The goal is to develop a system of partnership taxation where harmonious values work

subchapter K to focus on non-sheltering partnerships and, therefore, prioritize the development of accessible provisions that these partnerships could apply without excessive time or expense.[156] Streamlining subchapter K would also help the Service administer subchapter K. Like non-sheltering partnerships, the Service would benefit from fewer, simpler provisions, allowing its geographically dispersed workforce to more effectively administer the large volume of returns filed annually.

Additionally, an integrity-based subchapter K would temper the risk of "creeping" complexity. A streamlined system would allow partnerships and the Service alike to see subchapter K as a unified, principled whole, and this new vision of partnership taxation would allow the system to develop organically.[157] Because partnerships would better understand the system as a whole, less administrative guidance would be required in applying subchapter K's provisions to novel transactional structures. Likewise, partnership taxation itself would be more nimble, allowing the system to better navigate the ever-evolving commercial partnership marketplace without the need for elaborate responses every time a new issue emerged.

Simplicity, however, would not be the only value promoted through an integrity-based framework; partnership taxation would also be more equitable. A simpler, refocused subchapter K would afford partnerships, especially non-sheltering partnerships, a clearer perspective on the system, thereby fostering a deeper understanding of how its individual provisions fit together as an integrated whole. In turn, this more principled vision would allow partnerships to perceive that, consistent with horizontal equity norms, similarly situated partners are in fact treated similarly under subchapter K.

Of equal importance, an integrity-based subchapter K would ameliorate much of the vertical inequity that currently exists in partnership taxation. Non-sheltering partnerships would no longer be forced to bear the burden of complex provisions intended to address the activities of a small number of sophisticated sheltering partnerships. Likewise, accessible provisions would allow all partnerships to participate in subchapter K, not just those wealthy enough to afford elite partnership tax advice.

Finally, the efficiency of partnership taxation would improve. Simplification would lower the administrative cost of understanding and applying subchapter K's provisions for most partnerships as well as for the Service. Transaction costs would also decline as partnerships developed a more coherent understanding of subchapter K; hence requiring less

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together in service of systemic ends. Values and ends are the dominant factors in designing an integrity-based subchapter K; the proper theory of partnerships is not.

156. *See supra* Part II.B.2.

157. DWORKIN, *supra* note 14, at 188–89.

guidance in adapting its provision to novel situations. In reducing the government's ongoing role in partnership taxation, integrity would promote tax neutrality, leaving partnerships free to operate in the commercial partnership market without continual governmental interference.

Critics, however, might object to an integrity-based reorientation and recalibration of subchapter K's values, particularly the shift to simpler, more obtuse provisions. To these critics, streamlining partnership taxation might jeopardize the fight against tax shelters, perhaps even spurring a rise in abusive transactions in violation of equitable and efficiency norms. Blunt provisions risk being overinclusive or underinclusive; thus increasing the probability that a transaction will be mischaracterized under the provisions of subchapter K. These critics would argue that concerns about mischaracterization are particularly salient in taxation because mischaracterization can transform an uncommon transaction into a common tax shelter.[158] Faced with increasing opportunities to exploit partnership taxation, critics might fear that large numbers of partnerships would turn to tax shelter transactions and, thereby, neutralize the progress that an integrity-based subchapter K would otherwise have made.

Before proceeding, it is important to note that current law's approach to fighting abusive partnership transactions has not worked. Neither subchapter K's balance of values nor its piecemeal, shelter-focused approach to rulemaking has stemmed the tide of tax shelter activity. Despite subchapter K's intricate web of anti-abuse provisions, current law remains porous, providing partnerships with ample opportunities to engage in tax shelter transactions.

An integrity-based subchapter K would provide a fresh start, offering a novel approach to the problems of partnership taxation. In light of current law's struggles with partnership tax shelters, there is little downside to reimagining partnership taxation from a different perspective. And, as will be discussed in the following Subpart, there is reason to believe that an integrity-based subchapter K would be less susceptible to tax abuse.

Nonetheless, this concern does highlight the deeper question of how best to combat partnership tax shelters. Answers have proven elusive, and this article does not offer a comprehensive solution to the tax shelter problem.[159] Yet it does offer a suggestion: reorienting and recalibrating

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158. *See* Weisbach, *Formalism in Tax Law*, *supra* note 33, at 886.

159. For excellent examples of articles directly tackling the tax shelter problem, see Aprill, *supra* note 45; Peter C. Canellos, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47 (2001); Alan Gunn, *The Use and Misuse of Antiabuse Rules: Lessons from the Partnership Antiabuse Regulations*, 54 SMU L. REV. 159 (2001); Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters, and the Compaq Case*, 88 TAX NOTES 221 (2000); David A. Weisbach, *The Failure of Disclosure as an Approach to*

subchapter K's values to focus more directly on non-sheltering partnerships would force us to rely more heavily on tax provisions of general application—provisions outside of subchapter K—in addressing the abusive transactions entered into by sheltering partnerships.[160] Unlike subchapter K's "internal" provisions, generally applicable tax provisions like the economic substance doctrine,[161] an enhanced penalty regime,[162] and disclosure rules[163] all proved useful in combating the most recent generation of tax shelters.[164] Accordingly, as we prepare for the partnership tax shelters of the future, we should focus greater attention on strengthening those mechanisms that have shown promise in fighting the tax shelters of the past, even if they fall outside the confines of subchapter K.

Sharing responsibility for the partnership tax shelter problem with provisions outside subchapter K would also serve an expressive function, reflecting the reality of modern partnerships. The activities of sheltering partnerships are unpredictable, and their transactions are increasingly individualized. Even worse, the partnership tax provisions that target these abusive transactions have proven problematic for the large number of partnerships that are not engaged in tax shelters themselves, but are nonetheless forced to bear the complexity of subchapter K's formidable anti-abuse regime. In the increasingly polarized world of partnership taxation, it may simply no longer be possible (if it ever was) to design

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Shelters, 54 SMU L. REV. 73 (2001); George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. REV. 209 (2001).

160. *See* Weisbach, *Formalism in Tax Law*, *supra* note 33, at 876 (defending the use of anti-abuse rules because they "attempt to allow the tax law to use simple rules without all of the associated costs") (footnotes omitted).

161. *See, e.g.*, Klamath Strategic Inv. Fund *ex rel.* St. Croix Ventures v. United States, 568 F.3d 537 (5th Cir. 2009); Coltec Indus., Inc. v. United States, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 549 U.S. 1206 (2007); ACM P'ship v. Comm'r, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999). In 2010, the economic substance doctrine was codified. Healthcare and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a), 124 Stat. 1029 (codified at I.R.C. § 7701(o) (2006 & Supp. IV 2010)). Under this provision, a transaction will only be treated as having economic substance if: (1) the transaction changes the taxpayer's economic position in a meaningful way apart from its federal income tax consequences and (2) the taxpayer has a substantial purpose for entering into such transaction apart from its federal income tax consequences. I.R.C. § 7701(o)(1).

162. *Id.* §§ 6662, 6664. In connection with the codification of the economic substance doctrine, these penalty provisions were also amended, subjecting economic substance violations to a strict liability penalty. *Id.* §§ 6662(b)(6) (applying the accuracy-related penalty to underpayments attributable to the disallowance of a claimed tax benefit arising from a transaction lacking economic substance), 6664(c)(2) (disallowing reasonable cause exception for underpayments attributable to a transaction lacking economic substance).

163. *Id.* §§ 6111, 6112.

164. *See* Olson, *Observations from the Frontlines*, *supra* note 13, at 567; Jeremiah Coder, *Korb Reflects on Long Tenure, Cites Recruiting and Litigation Successes*, 2008 TNT 246-3 (Dec. 22, 2008) (recounting the view of Donald Korb, outgoing IRS Chief Counsel, that the Treasury has turned the corner on corporate tax shelters).

functional provisions that prevent the abusive behavior of sheltering partnerships and simultaneously promote the legitimate commercial interests of non-sheltering partnerships.

Partnership tax shelters are surely a problem in desperate need of a solution, but subchapter K alone cannot provide the solution. On the contrary, all the resources of the federal income tax system must be harnessed to address the problem of partnership tax shelters. Indeed, there is reason to believe that an integrity-based subchapter K combined with greater reliance on mechanisms external to partnership taxation would offer a more promising approach to the fight against partnership tax shelters.

2. Legitimacy Improved

An integrity-based subchapter K, with unified and harmonious values, would rehabilitate the public legitimacy of partnership taxation. Partners would begin to see subchapter K as a fair and principled collection of provisions tied together by a shared set of values. Likewise, a deeper understanding of partnership taxation would lead to greater participation, thereby fostering a sense of community among partners who would increasingly view subchapter K as a system designed for all and applied equally to all. Simply stated, a more functional subchapter K might begin to earn the loyalty of the partners subject to its provisions.

This newfound legitimacy, in turn, would work together with subchapter K's reconfigured values to improve compliance among partners. Most importantly, subchapter K itself would no longer compromise non-sheltering partnerships' efforts at compliance. Simpler partnership provisions directed at non-sheltering partnerships would allow partners to better comply with the law. An integrity-based framework would also provide longer-term compliance benefits, fostering a more coherent vision of subchapter K within the partnership tax community. This shared, cohesive sense of partnership taxation would better equip non-sheltering partnerships to address the issues that will inevitably arise as the commercial partnership market evolves.

In turn, the improved compliance of non-sheltering partnerships would ripple throughout partnership taxation. Like partnerships, the Service would benefit from an integrity-based subchapter K. Because the number of noncompliant partner returns would decline, the Service would be freed to redirect a greater portion of its resources toward partnership tax shelters. By more aggressively targeting abusive transactions, the Service would make tax shelters riskier, thereby tempering some of the historic appeal of the audit lottery.

Additionally, rising compliance among non-sheltering partnerships would make the abusive activities of sheltering partnerships more

transparent. As previously discussed, these sheltering partnerships have historically relied on the high volume of overall noncompliance to shield their abusive behavior from detection.[165] An integrity-based subchapter K, with its improved compliance rates, would eliminate this shield; partnerships intent on engaging in tax shelters would be forced to look elsewhere to obfuscate their transactions.

Together, increased compliance and more aggressive enforcement would likely make partnership tax shelters riskier and costlier. And in doing so, an integrity-based subchapter K might deter some partnerships from engaging in abusive transactions. Integrity is surely not a panacea; it alone cannot eliminate partnership tax shelters. But an integrity-based approach to partnership taxation, as well as greater reliance on tax provisions outside subchapter K, would take important first steps in the right direction, making it more difficult for sheltering partnerships to engage in abusive transactions.

3. *Systemic Ends Fostered*

In nurturing public legitimacy, the unified and harmonious values of an integrity-based subchapter K would also better serve systemic ends. The most immediate impact of reorienting and recalibrating subchapter K's values would be its effect on tax revenues; as compliance improves, the government's ability to collect federal income tax revenues would similarly improve.

And the cycle would be complete—unified and harmonious values would foster a sense of legitimacy in partnership taxation; public legitimacy, in turn, would promote partner compliance; and compliance, legitimacy, and cohesive values together would serve systemic ends. Put another way, an integrity-based subchapter K would be a better, more functional subchapter K.

CONCLUSION

This Article takes early steps toward subchapter K's reform, proposing a more coherent approach to partnership taxation. Subchapter K is deeply flawed, and the time has come to think about the conceptual architecture of partnership taxation, pulling its pieces apart and putting them back together again. A starting point is subchapter K's discordant values. Subchapter K's values should unify the system, bonding its provisions together through a principled vision of partnership taxation. Similarly, these values should

165. *See supra* note 133 and accompanying text.

operate harmoniously, promoting each other as well as subchapter K's systemic ends. A reimagined subchapter K, guided by integrity, would do precisely this, improving functionality through a rethinking of values.

With integrity as our compass, we can thus begin the difficult work of reforming partnership taxation. Myriad areas of subchapter K, including contributions, distributions, and allocations, are in desperate need of reform, yet specific reform proposals are likely to vary among members of the partnership tax community. Consider, for example, partnership contributions. One might assert that an integrity-based subchapter K requires partnership contributions to be treated as fully taxable events. Or one might take an alternative approach, agreeing that partnership contributions should be treated as taxable events but allowing the contributing partner to defer the recognition of gain until a future triggering event occurs. As should be obvious, the best manner of implementing integrity in specific areas of partnership taxation is likely to be a subject of great debate in the early stages of the reform process.

Yet all reform proposals will benefit from an integrity-based approach to partnership taxation. Integrity as an intellectual vehicle will require these proposals to be internally coherent, as well as coherent with subchapter K as an integrated whole. In doing so, future reforms will be more persuasive and also more effectual.

Indeed, the process of grounding subchapter K's reform in integrity may shed welcome light on the deeper fractures in partnership taxation, and the federal income tax more broadly. Questions about the proper values of partnership taxation, the appropriate ends of the federal income tax system, and the role of taxation itself would all rise to the surface as we rethink subchapter K from an integrity-based perspective. Addressing these foundational questions would be a transformative step in the reform of subchapter K, producing a more coherent, more organic, and more functional system of partnership taxation.