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Proposed Legislative Solutions to Tax Shelter Partnership Abuses - The End of the Aggregate Concept?

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Proposed Legislative Solutions to Tax Shelter Partnership Ahuses—The End of the Aggregate Concept?†

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I. INTRODUCTION

In recent years the Treasury Department, the Internal Revenue Service, and the Ways and Means Committee of the United States

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House of Representatives have perceived that the present procedural provisions of the Internal Revenue Code (IRC) dealing with partnerships allow abuses by certain tax shelter partnerships. In the Treasury Department's and Ways and Means Committee's view, these abuses arise through the operation of—and limitations on—the present audit procedures applicable to partnership returns. Thus, both the Treasury Department and the Ways and Means Committee have recently proposed amendments to the Procedures and Administration subtitle of the IRC. Although these amendments purport to be procedural, they could effectively eliminate much of the flexibility presently given to individual partners and could alter the substantive law of Subchapter K. In particular, certain of the amendments threaten to alter the premise upon which Subchapter K is based—that a partnership is an aggregate of individuals rather than a separate taxpaying entity.

This Note first will set forth the Treasury Department's perception of the present abuses of tax shelter partnerships and will analyze existing procedural rules, the Treasury Department's proposed amendments, and the House of Representatives' proposed amendments in light of these abuses. Next, the Note will examine the substantive law of Subchapter K and will attempt to point out the probable effects of the proposed amendments on the aggregate concept of partnerships, on substantive partnership tax law, and on the viability of the partnership form of business. Finally, this Note will propose a solution to the problem of tax shelter partnership abuse that will eliminate existing abuses without producing the negative effects that may result under the proposed amendments.

II. Background of Proposed Amendments

A. *Treasury Department's Perception of Tax Shelter Partnership Abuses*

Tax shelter partnerships are limited partnerships designed to permit investor limited partners to take very large deductions in the first few years after they purchase an interest.[1] Tax shelter partnerships have flourished in this country as a result of at least two distinct stimuli. First, tax shelter operators view the partnership as a very simple means of raising relatively large sums of capital with-

1. *See* U.S. Department of the Treasury, The President's 1978 Tax Program 64-68 (1978) [hereinafter cited as Tax Program]. *See generally* Livsey, *Limited Partnerships: How Far Can I.R.S. Go in Limiting Their Use in Tax Shelters?*, 39 J. Tax. 123 (1973); Lurie, *Bolger's Building: The Tax Shelter That Wore No Clothes*, 28 Tax L. Rev. 355 (1973); McDaniel, *Tax Shelters and Tax Policy*, 26 Nat'l Tax J. 353 (1973).

out submitting themselves to the close scrutiny of such federal agencies as the Securities and Exchange Commission (SEC) and the Internal Revenue Service (Service). The operators can often use the exceptions from reporting requirements under the securities laws to avoid disclosing their scheme to federal regulators. They likewise can use the absence of any detailed statutory scheme for the audit of partnerships under the IRC to escape the close Service scrutiny often applied to corporations. With these dual exemptions, tax shelter operators receive close scrutiny only from state regulators administering state Blue Sky Laws.

The second stimulus for the growth of tax shelter partnerships is the desire among higher income groups to achieve tax advantages not ordinarily available under the IRC. Tax shelter operators can appeal to this desire by utilizing the aggregate characteristics of the partnership. For example, operators may select investment property, such as real estate, oil and gas leases, or motion picture films, that has relatively high initial tax deductible expenses. Deductions may be increased if operators include a fee for their services. The operator sets up the partnership, and the partnership either purchases the investment property or receives the property as a contribution from the operator in return for a partnership interest. Then the operator syndicates the partnership by contacting interested investors. Once investor limited partners are selected (and sometimes even before), the operator secures maximum nonrecourse financing secured by the partnership's investment property. The operator allows the partnership to operate just long enough to utilize tax deductions arising from the investment property. As soon as the property begins to generate taxable income in excess of the deductible expenses, the operator sells the investment property or simply abandons it.

Normally, the operator is responsible for filing partnership tax returns. Many operators use extremely aggressive and somewhat questionable interpretations of the tax laws to maximize deductions for their limited partners and for themselves. In addition, some operators set up multi-tiered partnerships to make their schemes almost unauditable by the Service. Pressured by the three-year statute of limitations for proposed assessments of additional tax, the Service is unable to locate and control the individual returns of the taxpayers at the bottom of these complex schemes. The Treasury Department believes that this potential exploitation of the administrative problems arising under current audit procedures requires

changes in existing law.[2]

Under current law, the Service can propose audit adjustments resulting in changed tax liabilities only at the individual partner level.[3] To locate and effectively audit the individual partner's return, however, the Service must often wade through a complex maze of interlocking partnerships, tax-option corporations (Subchapter S corporations), and trusts or estates.[4] Locating the partner's return is often the most difficult task in auditing tax shelter partnerships. Currently, there is no penalty imposed for failure to file a partnership return;[5] therefore, some tax shelter operators avoid audit scrutiny by failing to file a partnership return or by filing the return after the statute of limitations has run on the returns of the individual partners. Also, the operator may file the return in a Service processing center far from the location of the partnership's principal place of business and, in addition, fail to include vital information such as principal place of business, the partnership's identifying number, the name and address of the person who has custody of the partnership books and records, and the names, addresses, and identifying numbers of the partners.[6] Without this information, the Service cannot go forward with audit procedures directed at the partnership.

Even if the Service succeeds in discovering the partnership return, the location of the partnership books and records, and the identities of the partners themselves, additional obstacles may impede an efficient audit process. The partners of the partnership under examination may be other partnerships.[7] If so, the Service must gather information concerning each new partnership. Further, all of the ultimate taxpayers' returns must be located and controlled to avoid statute of limitations problems.[8] Normally, the Service requests the individual partners to execute a waiver of the statute

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2. *See* TAX PROGRAM, *supra* note 1, at 129. The Treasury Department believes that one significant reason for the proliferation of tax shelter partnerships is that promoters and investors perceive little risk that the Service can conduct an effective audit against the investors in the shelter.

3. *Id.* at 121.

4. *Id.* at 125-29 (note especially the schematic diagrams). *See also* H.R. REP. No. 1445, 95th Cong., 2d Sess. 74-75 (Comm. Print 1978).

5. *See* I.R.C. §§ 6671-6697 (absence of any late filing penalty in relevant IRC sections).

6. Kurtz, *Auditing Partnerships*, 6 TAX NOTES 581, 582 (1978).

7. *See* TAX PROGRAM, *supra* note 1, at 125. The Treasury's explanation of the proposal cites one case in which a group of promoters established over 350 partnerships with more than 3000 separate limited partner interests. The investors in these tax shelters are located in all seven Service regions, and in 52 out of the 58 Service districts across the country. *Id.*

8. I.R.C. § 6501 provides a general statute of limitations of three years from the date of filing the return for the assessment of taxes due under the IRC.

of limitations pursuant to IRC section 6501(c)(4).[9] The Service, however, has no authority to force the individual taxpayers to sign such a waiver. If the taxpayer refuses, the Service must issue a statutory notice of deficiency to protect its right to collect taxes due.[10] In a situation involving many individual partners, the Service often receives waivers from some and is forced to issue notices of deficiency to others.[11] When the Service issues a notice of deficiency before completing an audit of the partnership, the controversy will frequently be settled or decided without full and adequate consideration of all relevant facts. Until the partnership audit is concluded, the Service and the individual partner will not have all the facts necessary to make a fully informed judgment.

Multi-tiered tax shelter partnerships increase the possibility of inconsistent administrative or judicial decisions concerning similarly situated partners.[12] Each partner controls the course of his individual audit.[13] The Service cannot require all partners to report the results of partnership operations in the same manner. For example, if the partnership conducts farming operations and also makes investments and incurs interest expenses, the partners could take different positions regarding whether the interest paid constituted investment interest subject to the limitations of IRC section 163(d).[14] One partner might agree to the additions to taxable income as a result of the limitation on investment interest expense deductibility, while a second partner might decide to litigate the issue. In such a case, the court would not be bound by the first partner's agreement with the Service and therefore might reach an entirely different result.

B. *Audit Procedures Under Current Law*

The Service now utilizes what is known as a "front door" approach.[15] Partnership returns are segregated as soon as they reach the Service Centers and are then stratified according to the size of

9. *See* H.R. REP. No. 1445, *supra* note 4, at 75.

10. I.R.C. § 6503(a)(1).

11. *See* TAX PROGRAM, *supra* note 1, at 122.

12. *Id.* at 123; *see* Kurtz, *supra* note 6, at 582.

13. Each partner may pursue settlement or judicial remedies independently of his fellow partners. Furthermore, each partner may force the Service to issue him a notice of deficiency by refusing to sign a waiver of the statute of limitations.

14. I.R.C. § 163(d).

15. *See* Kurtz, *supra* note 6, at 582. Formerly, the Service utilized a "back door" approach, under which partnership returns were picked up for audit by agents auditing the individual partner's return. This audit technique constituted a very inefficient check on tax shelter abuse hecause the partnership return picked out might be part of the second or third tier of a multi-tiered partnership structure.

the income or loss shown.[16] Based on these groupings, a certain percentage of the returns are selected by Service Center computers and/or personnel for audit. The selected returns are forwarded to a Service agent who determines whether the return, on its face, merits further examination. If the agent decides against examination, the return is marked accepted on survey and the examination is finished.

If the agent decides to pursue the examination further, he contacts the partner believed to be in possession of partnership books and records.[17] The agent also reviews the return to determine where all of the partners reside.[18] If any partners reside outside the district in which the partnership return is being examined, the agent must notify the other districts so that they may obtain and control all of the partners' individual returns.[19]

Once the partnership examination is completed, the agent completes a report proposing changes in the partnership information return. A copy of the report is forwarded to all other agents working on the case, who then propose changes to the individuals' returns of income based on their pro rata share of the partnership changes. If any of the partnership issues are litigated by any of the partners, the agents attempt to stay any proceedings on the other individuals' returns until one or more test cases have been decided.[20] As of May 1978, the Service had more than 70,000 individual returns in a suspended category pending final judicial decision.[21] The number of returns in this suspended category in future years is expected to increase because of the large increase in the size of partnerships over the past ten years.[22]

16. *Id.* The groupings are as follows: (1) income of $25,000 or more; (2) income of less than $25,000; (3) losses of less than $25,000; (4) losses of $25,000 or more. *Id.*

17. *Id.* at 583. Even though the IRC requires that the name and address of the custodial partner be disclosed on the partnership information return, the information is often omitted.

18. *Id.* This task is also often difficult because not all partnership returns list all partners. Sometimes the partners' names are listed but their addresses or identifying numbers (social security or employer identification number) are not shown. Since the Service relies on a computer data base premised on identifying numbers for each tax paying entity, an unscrupulous tax shelter operator can obstruct an effective "front door" examination by failing to provide identifying numbers and waiting for the statute of limitations to run on the individual partners' returns.

19. *Id.*

20. *Id.* If certain partners will not sign the waivers, the Service is forced to issue a notice of deficiency. Also, the agents responsible for examination of the individual returns will normally complete the examination as to all items except partnership items.

21. *Id.*

22. *Id. See also* TAX PROGRAM, *supra* note 1, at 123-24. The change in audit procedure from a "back door" approach to a "front door" approach is also expected to increase the number of returns in the suspended category.

C. *The Proposed Amendments*

(1) Introduction

On April 12, 1978, Representative Al Ullman (D., Ore.) introduced the President's Revenue Bill of 1978 (H.R. 12078).[23] This bill contains the Administration's and Treasury Department's proposed amendments to the present IRC. Section 245 of the bill proposes a major change in the way partnerships and partners are audited.[24] Section 245 treats partnerships as an entity for purposes of administrative and judicial proceedings. This proposal represents a clear break from prior law, under which the partnership has been treated merely as a tax-reporting entity, and has serious ramifications for the existing substantive partnership tax law of Subchapter K of the IRC. The Administration justifies its proposal by claiming that the proposal will allow the Service to scrutinize adequately certain multi-tiered tax shelter partnership schemes.[25]

On August 10, 1978,[26] the House of Representatives passed a bill (H.R. 13511)[27] containing provisions that provide an alternate solution to tax shelter partnership audit problems. The House bill has a much narrower scope than the Administration's proposal.[28] Nevertheless, the House bill will negatively affect the fundamental premise of partnership tax law that a partnership is an aggregate of individuals.

Both the legislative proposals promote values that are in direct conflict with those presently reflected in Subchapter K. Each proposal at least partially adopts an entity theory of partnership taxation, and is offered as a solution to the administrative nightmare facing the Service anytime it attempts to audit and propose changes in the individual returns of partners of multi-tiered tax shelter partnerships. The policies advanced by these legislative proposals are administrative convenience and, possibly, a favorable effect on the taxpaying public's perception of United States tax administration

23. H.R. 12078, 95th Cong., 2d Sess. (1978). *See generally* TAX PROGRAM, *supra* note 1. The Administration's proposals in this bill cover a wide range of tax issues from individual tax rate reductions to repeal of the communications tax.

24. H.R. 12078, *supra* note 23, § 245.

25. *See* TAX PROGRAM, *supra* note 1, at 79.

26. 124 CONG. REC. 8367 (daily ed. Aug. 10, 1978).

27. H.R. 13511, 95th Cong., 2d Sess. (1978).

28. Although the Administration's proposal was not reported out of the House Ways and Means Committee, it has continuing importance. An official of the Treasury Department's Office of the Tax Legislative Counsel has indicated that the Administration, the Treasury Department, and the Internal Revenue Service, believe that H.R. 12078, as introduced on April 12, 1978, is the best solution to the partnership audit problem.

as an equitable system.[29] The aggregate theory of Subchapter K, on the other hand, expressly advances the policies of simplicity, flexibility, and equity among partners.[30] The task presently facing Congress is to remedy the abuse of tax shelter partnerships while balancing these competing policies. If Congress is unsuccessful in this balancing process, the partnership form of doing business may well become much less desirable and charges of inequity under the tax laws will increase.

(2) Treasury Department's Solution

(a) *Policy Considerations*

The Treasury Department contends that the policy considerations embodied in Subchapter K of Chapter 1 of the IRC are no longer paramount[31] and has therefore ignored these values in drafting its proposal. The values of simplicity, flexibility, and equity among partners acquired importance at a time when partnerships were used by small businesses comprised of individuals living in close proximity to each other.[32] Today's large tax shelter partnerships more closely resemble corporations:[33] limited partners are widely dispersed geographically, limited in their liability to the amount of their investments, and required by law to refrain from taking part in the day-to-day management of partnership business. Furthermore, the taxpaying public perceives that tax shelter participants successfully avoid or evade their proper tax liability through the tax shelter mechanism. This perception leads to frustration on the part of the great mass of taxpayers and tends to encourage actual tax evasion.[34] The Treasury proposal reflects the belief that an administrative solution must be found to eliminate this potential danger to the United States system of voluntary tax compliance.

29. The equity discussed here refers to the overall horizontal and vertical equity of the federal income tax laws. The equity referred to in the text accompanying note 30 *infra* means equity of treatment as between the individual partners in a partnership.

30. S. REP. No. 1622, 83d Cong., 2d Sess. 90, 93, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621, 4722.

31. *See* TAX PROGRAM, *supra* note 1, at 121-29. In its discussion of present law and the reasons for the proposed change, the Treasury never mentions the traditional values expressed in Subchapter K. See discussion in text accompanying note 76 *infra*. In fact the Treasury never discusses what effect, if any, the instant proposal will have on those values.

32. *See* Kurtz, *supra* note 6, at 582.

33. *Id.*

34. *See* TAX PROGRAM, *supra* note 1, at 71.

(*b*) *Proposed Changes in Audit Procedures*

H.R. 12078 does not propose any direct changes in the substantive partnership tax laws of Subchapter K. Instead, section 245 of the bill proposes several changes in the administrative and judicial procedures sections of the IRC. Section 245 contains three subdivisions: general procedural rules for the examination of partnership returns and audit adjustments arising from that examination, jurisdictional prerequisites for judicial review of administrative determinations concerning partnerships, and technical and conforming amendments to other parts of the IRC required by the first two parts of section 245.[35]

The first part of section 245 breaks with prior procedural law by providing that administrative and judicial determinations made at the partnership level shall be binding on the individual partners. All partnership items and items affected by or related to partnership items must be treated by individual partners on their returns in a manner consistent with the way in which the items are reflected on the partnership return.[36] The original return is binding on the partnership and all partners unless the partnership, through administrative or judicial proceedings, obtains permission to change the treatment of specific items.[37] Only the Secretary of the Treasury or an authorized representative of the partnership may initiate an administrative proceeding.[38] Extensive notice requirements to partners and real parties[39] in interest are imposed on the Secretary, the partnership, and the individual partners as a prerequisite to binding administrative proceedings.[40] All partners and real parties in inter-

35. *See* H.R. 12078, *supra* note 23, §§ 245(a)-(c).

36. *Id.* § 245(a) (§ 6121(a)).

37. *Id.* § 245(a) (§ 6121(b)). Apparently the partnership may no longer file an amended return. Section 6131(a)(2) of § 245(a) defines partnership return as "the first return filed for that year . . . ."

38. *Id.* § 245(a) (§ 6122(a)). Authorized representative of the partnership is defined at § 6131(a)(3) of § 245(a) as a person who is a partner authorized to carry out all of the discretionary powers granted to the partnership under § 245(a). Furthermore, the same section provides that each general partner is presumed to be an authorized representative unless the partnership has filed a power of attorney under which one or more persons have exclusive authority to exercise the partnership's discretionary powers under § 245(a).

39. A real party in interest with respect to any partnership for any taxable year of the partnersbip is a person (other than a partner) whose income tax liability under Subtitle A of tbe IRC is determined in whole or in part by taking into account partnership items or items related to or affected by partnership items. *Id.* § 245(a) (§ 6131(a)(4)).

40. *Id.* § 245(a) (§§ 6122(b), 6126(f)). The Secretary bears the initial burden of notice. The partnership and the individual partners bear the burden of notifying all other real parties in interest, of keeping partners and real parties in interest informed as to where and when administrative or judicial proceedings are to take place, and of giving the Secretary the names and current addresses of all real parties in interest not reflected on the partnership return.

est are given the right to participate in the administrative proceedings.[41]

Section 245 also proposes several new statutes of limitations concerning partnership returns. The Secretary has three years from the date a return is filed to make a final administrative determination as to partnership items.[42] In the event that a false or fraudulent return is filed with the intent to evade tax, this period increases to six years.[43] Similarly, if the partnership return omits items of includable gross income in excess of twenty-five percent of the gross income stated in the return, the Secretary may make a final administrative determination of partnership items anytime within six years from the date the return is filed.[44] The partnership, on the other hand, may request an administrative adjustment of partnership items as reflected on the partnership return anytime within three years after the partnership return is filed.[45]

Section 245(a) also proposes to give the partnership the right, through its authorized representative, to seek judicial review of an adverse administrative determination by filing a petition with the Tax Court.[46] If the Secretary mails a notice of final administrative determination or settlement, and if the partnership fails to file a timely Tax Court petition or has waived its right to do so, then each partner and real party in interest must file an amended return taking into account the partnership items as finally determined by the

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The Secretary bears the responsibility of notifying all partners and real parties in interest disclosed to him of any final administrative determination or settlement pursuant to § 6122(d) of § 245(a).

41. *Id.* § 245(a) (§ 6122(c)).

42. *Id.* § 245(a) (§ 6123(a)). The Secretary and an autborized representative of the partnership (as defined in note 38 *supra*) may extend the statute of limitations pursuant to proposed § 6123(b).

43. *Id.* § 245(a) (§ 6123(c)(1)). With respect to those partners and real parties in interest wbo participated in the fraud, the Secretary may make a final administrative determination regarding partnership items at any time. *Id.*

44. *Id.* § 245(a) (§ 6123(c)(2)). If the Secretary executes the partnership return pursuant to I.R.C. § 6020(b), such event shall not constitute a filing of the return so as to begin the running of the various statutes under proposed § 6123. *Id.* § 245(a) (§ 6123(c)(3)).

45. *Id.* § 245(a) (§ 6124(a)). Only an authorized representative of the partnership may request an administrative adjustment of partnership items. *Id.* The three-year period will not expire with respect to the partnership until six months after the expiration of the period within which the Secretary may make a final administrative determination of partnership items. *Id.* § 245(a) (§ 6124(b)). The period referred to above means the period when the statute of limitations has been extended by an agreement between the Secretary and an authorized partnership representative. *Id.*

46. *Id.* § 245(a) (§ 6125(a)). The authorized representative may file the petition anytime within 90 days after the Secretary mails the notice of final administrative determination. *Id.* The authorized representative may also waive the partnership's right to file a petition with the Tax Court. *Id.* § 245(a) (§ 6125(b)).

Secretary.[47] The President's proposed legislation also gives district courts and the Court of Claims jurisdiction over partnership tax controversies under jurisdictional prerequisites closely paralleling those courts' jurisdictional prerequisites for individual and corporate taxpayers' cases.[48] If there is a final judicial determination of

47. *Id.* § 245(a) (§ 6126(a)(1)). The amended returns must be filed within 90 days after the earliest of the following events: (1) the date on which the partnership's right to file a Tax Court petition expires; (2) the date on which the Secretary mails notice that the partnership has waived the right to file a Tax Court petition; and (3) the date on which the Secretary mails notice of a settlement. *Id.* § 245(a) (§ 6126(a)(2)). If the partners and real parties in interest do not file amended returns, the Secretary may assess them for deficiencies arising from the redetermined partnership items at any time within one year after the earliest of the three dates outlined above. *Id.* § 245(a) (§ 6126(b)(1)). In addition, if all real parties have not been identified to the Secretary at the earliest of the three dates set forth above, the Secretary has one year from the date such real party in interest is identified to assess such person. *Id.* § 245(a) (§ 6126(b)(2)).

If any partner or real party in interest is entitled to a refund due to a final administrative determination or settlement, he must file a claim for refund within one year from the earliest of the three dates specified above. *Id.* § 245(a) (§ 6126(c)). In computing any set-off to a claim for refund, the Secretary may claim only those items arising from or related to the partnership determination. *Id.* § 245(a) (§ 6126(d)). Therefore, the Secretary may not revive the statute of limitation as to nonpartnership items on the individual partner's return by attempting to use them as an offset to a claim for refund. If the Secretary has failed to send notice to a partner or real party in interest, the statutes of limitation found in proposed § 6126 do not apply to the person not notified. *Id.* § 245(a) (§ 6126(f)). Apparently, the person not notified would be forced to rely on I.R.C. § 6511(a) to find the relevant statute of limitation for claims for refund.

48. *Id.* § 245(a) (§ 6127). First, an authorized partnership representative must file a claim of administrative error with the Secretary within two years of the date on which the Secretary mails notice of the final administrative determination. *Id.* § 245(a) (§ 6127(a)(1)). If the final administrative determination would result in higher tax liabilities for individual partners or real parties in interest, the authorized representative filing the claim of administrative error must show that the partners or real parties in interest, owning at least 25% of partnership interests with respect to which there would be an increase in tax liability, have paid the resulting deficiencies, or that the partners or real parties in interest have paid an amount equal to 10% of the sum of adjustments to net partnership gain or loss and net partnership increase or decrease in credits. *Id.* § 245(a) (§ 6127(a)(2)). No petition for review by a district court or the Court of Claims may be filed unless the authorized partnership representative has first filed a claim of administrative error. *Id.* § 245(a) (§ 6127(b)(1)). Venue for the petition is proper only in the district court for the district in which the partnership's principal place of business is located or in the Court of Claims. *Id.* § 245(a) (§ 6127(b)(2)). The petition for review may not be filed until six months after the claim of administrative error is filed. *Id.* § 245(a) (§ 6127(b)(3)). The petition must be filed within two years after the earlier of: (1) the date on which the Secretary mails notice of denial of the claim in whole or in part, or (2) the date on which an authorized representative waives notice of denial. *Id.*

The proposed legislation gives the partnership the right to judicial review of a partial determination by the Secretary pursuant to a request for an administrative determination from an authorized partnership representative. *Id.* § 245(a) (§ 6128). If an authorized representative requests an administrative adjustment and the Secretary grants a preliminary determination allowing the requested adjustments in whole or in part, the Secretary must send notice of the preliminary determination to all partners and real parties in interest. The mailing of the notice will invoke the procedures of proposed § 6126 as if the authorized partnership representative had waived the partnership's right to petition the Tax Court for

partnership items, the Secretary must mail notice of the determination to all partners and real parties in interest.[49] When the Secretary has made a final administrative determination within the applicable statute of limitations, he may assess deficiencies insofar as the final judicial determination coincides with the final administrative determination.[50] Regardless of whether the Secretary has made a final administrative determination, he may assess deficiencies arising from any reallocation of partnership items from one partner or real party in interest to another as a result of a final judicial determination.[51]

The President's proposal would implement two new penalties relating to partnership returns. First, the partnership is subject to a failure to file penalty of fifty dollars per partner per month (not to exceed five months) unless the failure to file is due to reasonable cause and not to willful neglect.[52] In addition, if any partner or real party in interest fails to file an amended return as required by proposed section 6126,[53] that person shall be assessed a penalty equal to five percent of any deficiency determined under the notice

review. *Id.* § 245(a) (§ 6128(a)). If the Secretary fails to grant a request for administrative adjustment, in whole or in part, within six months of filing, an authorized representative may file a petition for review in the district court for the district in which the partnership's principal place of business is located or in the Court of Claims. *Id.* § 245(a) (§§ 6128(b)(1)-(2)). The petition may be filed six months after the request for administrative adjustment has been filed with the Secretary and not later than two years after the earlier of: (1) the date on which the Secretary mails notice of denial of the request in whole or in part, and (2) the date on which an authorized representative waives notice of denial of the request. *Id.* § 245(a) (§ 6128(b)(3)).

49. *Id.* § 245(b) (§ 7430(g)). This notice triggers the running of all the statutes of limitation under proposed § 6126. *Id.* § 245(a) (§ 6129(a)).

50. *Id.* § 245(a) (§ 6129(b)(2)). In general the Secretary may not assess any deficiency arising from a final judicial determination when the petition beginning the judicial action was filed after the expiration of the period under §§ 6126 and 6127 in which the Secretary may make a final administrative determination of partnership items. *Id.* § 245(a) (§ 6129(b)(1)).

The individual partners or real parties in interest are limited to the recovery of the amount of deficiencies arising from the Secretary's final administrative determination when the petition for judicial review results from the Secretary's denial of a claim of administrative error rather than a denial of a request for adjustment. *Id.* § 245(a) (§ 6129(c)).

51. *Id.* § 245(a) (§ 6129(b)). Note that proposed § 6129 regarding rules in the event of a final judicial determination of partnership items does not apply to any partner or real party in interest to whom the Secretary was required (but failed) to send notice of administrative proceedings unless that person had actual knowledge of the administrative proceeding at least 90 days before the date on which the Secretary mails the notice of final administrative determination. *Id.* § 245(a) (§ 6129(d)(1)). Proposed § 6129 also does not apply to any partner or real party in interest to whom the Secretary was required (but failed) to send notice of final judicial determination. *Id.* § 245(a) (§ 6129(d)(2)).

52. *Id.* § 245(a) (§ 6130(a)). The general partners are jointly and severally liable for the penalty. *Id.*

53. *Id.* § 245(a) (§ 6126(a)(1)).

requiring that an amended return be filed.[54] Section 245 gives the Secretary statutory authority to promulgate regulations "necessary or appropriate to determine the proper income, gain, loss, deduction and credit of a partnership, to allocate such items among partners and real parties in interest, and otherwise to carry out the purposes of this subchapter."[55]

The second part of section 245 provides for the first time a statutory provision for the judicial review of partnership items.[56] Any authorized partnership representative may file a petition in the partnership name for judicial review of partnership items in accordance with proposed sections 6126, 6128, or 6129.[57] All partners and real parties in interest may participate in all proceedings after the petition is filed.[58] Any settlement entered into by an authorized representative after a petition is filed is subject to the approval of the court.[59] The reviewing court has jurisdiction to determine all partnership items and the proper allocation of such items among the partners and real parties in interest.[60]

The third part of proposed section 245 contains a host of technical and conforming amendments. Section 702, which deals with partnership items of income and credit, is cross-referenced to proposed sections 6121-6132 and to proposed section 7430 "for rules relating to partnership determinations."[61] Section 6123(f)(2) is amended to define a failure by a partner or a real party in interest to treat a partnership item as it is treated on the partnership return or as it is required to be treated by a final administrative or judicial determination or settlement as a mathematical error.[62] The remaining amendments have little substantive effect.

54. *Id.* § 245(a) (§ 6130(b)).

55. *Id.* § 245(a) (§ 6132). This section comes dangerously close to direct conflict with I.R.C. § 702, which provides the suhstantive law of partnerships in the area of determination and allocation of partnership items.

56. *Id.* § 245(h) (§ 7430(a)). This proposed section would be the only statutory provision for judicial review of partnership items or proceedings at the entity level.

57. *Id.* § 245(b) (§ 7430(b)). The petitioner for the partnership must send notice of the impending proceedings to all partners and real parties in interest within 30 days after the petition is filed. *Id.* § 245(b) (§ 7430(c)). The Secretary must notify all partners or real parties in interest of the final judicial determination within 90 days after a decision of the court becomes final and not subject to review. *Id.* § 245(b) (§ 7430(g)).

58. *Id.* § 245(b) (§ 7430(d)).

59. *Id.*

60. *Id.* § 245(b) (§ 7430(e)). Any decision by the reviewing court shall have the force and effect of a decision of the Tax Court or a final judgment or decree of the district court or the Court of Claims and shall be reviewable as such. *Id.* § 245(b) (§ 7430(f)). Only an authorized representative may appeal tbe court's decision. *Id.*

61. *Id.* § 245(c)(1). *See* text accompanying note 55 *supra* & Part IV(A) *infra.*

62. *Id.* § 245(c)(4). This provision means that the Secretary can assess the partner or real party in interest without any possible appeal from the assessment.

(3) House of Representatives' Solution

(a) Policy Considerations

The House proposal accepts the theory that partnerships are not taxable entities, but are instead a conduit through which partnership items are allocated to the individual partners for inclusion in their respective returns.[63] The House believes that the Service could better cope with the responsibility of auditing complex partnership entities if it had complete and timely return information,[64] and also believes that the current statute of limitations for the audit of partnerships is too short.[65] Based on these express findings, the House has apparently decided that administrative convenience in the audit of partnerships outweighs the values of simplicity, flexibility, and equity among partners.

(b) Proposed Changes in Audit Procedure

The House has proposed relatively few changes in the administrative procedures portion of the IRC. The partnership audit provisions of H.R. 13511 are found in sections 211 and 212.[66] Section 211 provides a penalty for failure to file a partnership tax return. Section 212 extends the statute of limitations for assessing a deficiency against a newly defined federally registered partnership.

Section 211 proposes to add to the IRC new section 6698 to be entitled "Penalty for Failure to File Partnership Return."[67] This section imposes a penalty for failure to file a timely return and for filing a return that fails to show the information required by statute.[68] The partnership itself is liable for the penalty,[69] but the penalty will not be imposed if the partnership can show that failure to file a complete or timely return is due to reasonable cause.[70] The

63. *See* H.R. REP. No. 1445, *supra* note 4, at 74.

64. *Id.* at 75.

65. *Id.*

66. H.R. 13511, *supra* note 27, at 50-55.

67. *Id.* at 50.

68. *Id.* at 50-51. *See* I.R.C. § 6072(a) (for filing deadline on partnership information returns (April 15 for calendar year partnerships, fifteenth day of the fourth month following the close of the year for fiscal year partnerships)); I.R.C. § 6031 (combined with the regulations thereunder, this section details the information required to be included in partnership information returns under present law).

69. *See* H.R. 13511, *supra* note 27, at 51 (§ 6698(c)). The normal deficiency procedures do not apply to the proposed penalty. *Id.* at 51 (§ 6698(d)). Thus the partnership (and presumably the individual partners) cannot contest the penalty in the Tax Court. H.R. REP. No. 1445, *supra* note 4, at 76.

70. *Id.* at 75. The Committee Report states that a small partnership which does not file a return will be considered to have complied with the filing requirement if each partner files

penalty is fifty dollars per month per partner for the number of months or fractions thereof the partnership delays in filing a timely and complete return.[71]

Section 212 proposes to amend IRC sections 6501 and 6511 by providing a special statute of limitations for partnership information returns. Proposed section 6501(g) provides a four-year statute of limitations within which an individual whose name and address appear in the information return of a federally registered partnership may be assessed for deficiencies attributable to any partnership item.[72] If the individual partner's name is not shown on the partnership return, the statute of limitations does not run until one year after the date the omitted information is furnished to the Secretary of the Treasury in the manner prescribed by the Secretary.[73] The statute of limitations may be extended with respect to all partners by agreement of the Secretary with a general partner or any person authorized by the partnership to agree to such an extension.[74] Proposed section 6501 affects only federally registered partnerships.[75]

The proposed amendment to section 6511 will affect the statute of limitations for credit or refund of individual income taxes paid

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a detailed statement of his share of partnership income and deductions with his own return. *Id.*

71. H.R. 13511, *supra* note 27, at 50-51 (§§ 6698(a)-(b)).

72. *Id.* at 52 (§ 6501(q)(1)(A)). The four-year period begins to run on the date the return was actually filed or was due to be filed, whichever is later. *Id.* Partnership items are defined as any item required to be taken into account for the partnership taxable year under any provision of Subchapter K of the IRC to the extent that regulations prescribed by the Secretary provide that for purposes of procedure and administration such item is more appropriately determined at the partnership level than at the partner level. *Id.* at 52 (§ 6501(q)(2)(A)). Any item affected by an item described in the previous sentence is also defined to be a partnership item. *Id.* at 53 (§ 6501(q)(2)(B)).

73. *Id.* at 52 (§ 6501(q)(1)(B)).

74. *Id.* at 53 (§ 6501(q)(3)). The partnership may limit the power of a general partner to extend the statute of limitations by notifying the Secretary in writing. *Id.* at 53 (§ 6501(q)(3)(A)).

75. *Id.* at 53 (§ 6501(q)(4)). A federally registered partnership is defined to be a partnership in which interests have been offered for sale at any time during such taxable year or a prior taxable year in any offering required to be registered with the Securities and Exchange Commission. *Id.* at 53 (§ 6501(q)(4)(A)). The term federally registered partnership also includes a partnersbip which, at any time during such taxable year or a prior taxable year, was subject to the annual reporting requirements of the Securities and Exchange Commission (SEC). *Id.* at 53 (§ 6501(q)(4)(B)). The Committee Report provides that a partnership may not avoid the extension of tbe period of limitations by failing to register or report as required by the SEC. H.R. REP. No. 1445, *supra* note 4, at 77. The Report provides that a partnership excused from registration or reporting by either a statutory or a regulatory exemption of the SEC is not to be treated as a federally registered partnership for purposes of the statute of limitations. *Id.* The Report also provides that a partnership item is attributable to a federally registered partnership if it arose in a federally registered partnership or is taken into account by tbe taxpayer by reason of a chain of ownership that includes a federally registered partnership. *Id.*

by individual partners. This section provides that the statute of limitations for filing a claim for credit or refund of any overpayment of income tax attributable to any partnership item of a federally registered partnership shall not expire before the later of four years after the required filing date for the partnership information return for the partnership taxable year in which the item arose or six months after the expiration of the extended period of limitation concerning such partnership items agreed to under proposed section 6501(c)(4).[76]

III. Substantive Partnership Tax Law

A. *Introduction*

The proper rule for determining whether the entity[77] or the aggregate[78] concept applies to partnership questions in federal taxation is uncertain under present law. The individual partners' tax liabilities may be substantially different under these two conflicting theories.[79] Pure entity theory forces the individual partner to treat the partnership as a separate entity for purposes of collecting items

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76. H.R. 13511, *supra* note 27, at 54 (§ 6511(g)(1)). The amount of the credit or refund may exceed the portion of the tax paid within the period provided in present I.R.C. § 6511(b)(2) or (c). *Id.* at 55 (§ 6511(g)(1)). The definitions of partnership item and federally registered partnership for purposes of proposed § 6511(g) are the same as found in proposed § 6501(q), notes 72 & 75 *supra*. *Id.* at 55 (§ 6511(g)(2)).

77. Under the entity partnership theory, the partnership is treated as a distinct legal entity, separate and independent of the individual partners. This separate identity manifests itself in the power given to the partnership entity to adopt a different accounting method than that used by an individual partner. *See* 6 J. Mertens, Law of Federal Income Taxation § 35.01 (J. Malone ed., rev. ed. 1975).

78. Under the aggregate partnership theory, the partnership is treated as a legal fiction maintained as a vehicle for gathering and reporting information on partnership income and expense. Once that information has been gathered and reported, however, the individual partners are treated as if they received their pro rata share of partnership items of income and expense directly without those items ever having passed through the partnership's hands. This concept is also known as the conduit theory. *Id.*

79. For example, the aggregate theory was applied to determine the amount of additional first year depreciation allowed to be claimed on partnership depreciable assets prior to the 1976 Tax Reform Act. If the partnership acquired $1,000,000 of I.R.C. § 179 property in the current year, and if the partnership had at least 50 partners, each of the individual partners could claim $20,000 ($10,000 if partner is single rather than married) of property basis available for the 20% additional first year depreciation allowance under § 179. However, the Tax Reform Act of 1976 amended § 179 by adding subsection (d)(8), which employs entity theory to impose the § 179(b) limitation at the partnership level rather than at the individual partner level. The effect of this amendment is that on the same $1,000,000 investment in § 179 property, each partner is now entitled to only 1/50th (assuming that there are exactly fifty partners in the partnership) of $10,000 of § 179 basis. Under pre-1976 law, each partner in the above example would be entitled to a § 179 deduction of 20% of $20,000 or $4000 ($2000 if partner is single rather than married). Under post-1976 law, each partner would be entitled to a § 179 deduction of 20% of 1/50th of $10,000 or $40.

of partnership income and expense and reporting those items to the taxing authority. Pure aggregate theory, on the other hand, permits the individual partner to take into account each separate item of income and expense derived from the partnership business as if he had received the item directly from the source. The pure entity concept requires the determination of the nature of the income items at the partnership level. The pure aggregate concept allows each individual partner to determine the character of items of partnership income independently of his fellow partners. The entity approach is consistent with efficient administration. The aggregate approach creates administrative problems but eliminates the hardships and inequities of the entity approach. The Internal Revenue Code of 1954 adopted a very detailed statutory scheme for determining the accumulation and reporting of partnership income, expenses, credits, and other items.[80] Some sections adopt an entity approach; others adopt the aggregate approach; and a number of sections adopt neither approach.[81] Consequently, the courts, the Treasury Department, and the Service have had to fill gaps in the law by relying on implied congressional intent and analogues drawn from common law and statutory partnership rules outside the IRC.

This section will first scan the statutory and regulatory scheme treating partnerships under the IRC to discover how the two conflicting concepts are applied. It will then examine the legislative history of Subchapter K to determine the underlying congressional intent. Finally the section will analyze the cases interpreting Subchapter K of the IRC, focusing on the standards used by courts to determine when the aggregate approach will be used and when the entity approach will be used.

B. *Statutory and Regulatory Schemes*

The first statutory taxation scheme affecting partnerships was adopted in the Internal Revenue Code of 1939. There were only nine sections in Supplement F on Partnerships made up of approximately 1000 words. The 1939 Code basically provided that the partnership was not a taxable entity.[82] The only items required to be passed through to the individual partner as if he had received them directly were capital gains and losses, tax exempt interest, foreigu

80. *See* I.R.C. § 702(a). *See generally* I.R.C. §§ 701-761.

81. *See, e.g.*, I.R.C. § 702(a)(7) (for such items as investment tax credit allowable under I.R.C. § 38). The Congress gave no indication as to wbether the limitation on the investment tax credit was to be imposed at the partnership or at tbe individual partner level.

82. *See* Int. Rev. Code of 1939, ch. 1, § 181, 53 Stat. 69 (current version at I.R.C. § 701).

taxes, and charitable contributions.[83] Supplement F was narrowly drawn and did not answer many of the questions concerning the taxation of partners.[84] The courts therefore had to rely on a common law ad hoc approach to analyze the problems that were not solved by the Code of 1939.[85]

Chapter 1, Subchapter K of the IRC purports to provide a comprehensive system for the treatment of partnerships.[86] Subchapter K contains three parts entitled Determination of Tax Liability; Contributions, Distributions, and Transfers; and Definitions. The Definitions part of Subchapter K provides no indication whether the underlying concept of the statute is the aggregate or entity rule. Section 761 simply defines a partnership as being an organization (other than a corporation, trust, or estate) through which a business is carried on.[87] Further, the Treasury Regulations promulgated under section 761 provide no insight as to which basic rule is to be used in applying Subchapter K.

The Determination of Tax Liability part of Subchapter K provides conflicting ideas on which of the two theories is paramount. Section 701 states that the partnership is not taxable, but rather, that the individual partners are liable for the tax on partnership earnings,[88] indicating that the partnership is a tax reporting, not a tax paying, entity. Section 702 sets forth the statutory scheme for disclosing the items of partnership income and expense to be included by the individual partners in their returns. The section requires a long list of items to be separately stated on the partnership information return, including capital gains and losses, charitable contributions, and foreign taxes paid.[89] The last two items in the list are other items required by the Secretary of the Treasury to be stated separately and partnership income or loss computed after all the items mentioned previously in the section are separately stated.[90] The statute provides that those items required to be separately stated shall be reported by the individual partners as if earned or incurred directly.[91] The statute does not indicate why

83. Int. Rev. Code of 1939, ch. 1, §§ 182-184, 186, 53 Stat. 69 (now I.R.C. §§ 702-703).

84. For example, the 1939 Code does not indicate whether the partnership or the individual partners are responsible for making binding elections as to the method of reporting certain items of income such as installment gains under § 49 of the 1939 Code.

85. *See* 6 J. MERTENS, *supra* note 77, § 35.01.

86. *Id.*

87. *See* I.R.C. § 761(a).

88. *Id.* § 701.

89. *Id.* § 702(a).

90. *Id.* §§ 702(a)(7)-(8).

91. *Id.* § 702(b).

some items must be separately stated while others may be netted together in partnership income or loss. The most probable reason is that all these items are subject to limitations under other provisions of the IRC[92] and must be separately stated to permit the individual partners to determine these limitations on their individual returns. The requirement under section 702 that certain items be separately stated is an aggregate rule; but the lumping together of all other items into partnership income or loss is an entity rule. Treasury Regulation section 1.702-1 suggests which rule has been adopted for the regulatory scheme.[93] Under Treasury Regulation section 1.702-1(a)(8)(i), the partnership is required to set forth separately several items such as recoveries of bad debts and gains and losses from wagering transactions. These items must be separately stated because they are subject to special limitations under provisions in the IRC outside of Subchapter K.[94] Next, under Regulation section 1.702-1(a)(8)(ii), each partner is required to take into account separately any partnership item that "if separately taken into account by any partner would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately."[95] Therefore, both the statute and the regulation under IRC section 702 use the aggregate rule whenever a failure to do so would make it difficult for the individual partner to comply with limitations imposed on individuals under sections of the IRC outside of Subchapter K.

Subchapter K of the IRC vests the power to make almost all elections with the partnership.[96] Section 703(b) provides that all elections affecting income derived from a partnership shall be made by the partnership except those elections concerning foreign taxes paid, deduction and recapture of certain mining expenditures, definition of net leases, and limitations on investment indebtedness interest.[97] This rule is an application of the entity concept and precludes the individual partner from taking advantage of beneficial

92. For example, see the limitation imposed on deduction of charitable contributions. *Id.* § 170.

93. Treas. Reg. § 1.702-1, T.D. 7192, 1972-2 C.B. 289.

94. For example, see the limitation imposed on taking recoveries of bad debts into income under I.R.C. § 111(a).

95. For example, if any partner would qualify for the retirement income credit under I.R.C. § 37 if he took into account separately his pro rata share of partnership items constituting unearned income, then such items must be separately stated for all partners.

96. I.R.C. § 703(b).

97. *Id. See also id.* § 901 (individual taxpayer's election concerning foreign taxes paid); *id.* § 617 (concerning deduction and recapture of certain mining exploration expenditures); *id.* § 57(c) (definition of net leases); *id.* § 163(d) (limitation on investment indebtedness interest).

elections outside Subchapter K, such as the installment gain reporting method under IRC section 453, unless the partnership decides to make the election. Section 702 may, through its use of the words "election affecting the computation of taxable income derived from a partnership," conflict with section 702(a)(7). If an item is excluded from the computation of partnership taxable income pursuant to section 702(a)(7) and Treasury Regulation section 1.702-1(a)(8)(ii), then the vesting of power to make an election related to that item under section 703(b) should not apply. But if the partner's election would be different than the partnership's election under section 703(b) and the partner's election would cause his tax liability to be different, then under a strict reading of Treasury Regulation section 1.702-1(a)(8)(ii), the partnership should state that item separately and exclude it from the computation of taxable income. Neither the Treasury Regulations, the courts, nor the remaining provisions of Subchapter K provide any guidance for resolution of this conflict. In enacting section 703(b) and section 702(a)(7), Congress apparently attempted to insure that individuals would retain the power to coordinate the treatment of their pro rata shares of certain partnership items with the treatment of items that are received independently of the partnership.

In the remaining sections of the Determination of Tax Liability part of Subchapter K, the same conflict between the entity and the aggregate rules appears. The conflict continues in the Treasury Regulations interpreting the statutes. The general rule appears to be that the entity concept will apply except in cases when a limitation related to particular partnership items is imposed on the individual partner by a provision of the IRC outside Subchapter K. For example, an allocation of certain partnership items different from the profit-sharing ratios will be honored only if the allocation has substantial economic effect. Whether the allocation has substantial economic effect is to be decided on the basis of several different factors, including whether the partnership—not the individual partner—has a business purpose for the allocation.[98] Section 707 of the IRC provides that transactions between a partner and a partnership are to be treated in general as if they were arms length transactions.[99] This scheme follows the entity concept; the aggregate concept would require that no gain or loss be recognized to the extent that the partner deals with himself. The section also provides, however, that transactions between the partnership and partners own-

98. *See* Treas. Reg. § 1.704-1(b)(2) (1956).
99. I.R.C. § 707(a).

ing more than a fifty percent interest in the partnership will not result in recognition of loss.[100] This provision carries out the aggregate concept. The reason for this different treatment is probably the danger that a controlling partner could manipulate the partnership entity to his tax advantage.

The mixed themes of aggregate and entity theory carry over into the Contributions, Distributions, and Transfers part of Subchapter K. Section 721 applies aggregate theory in requiring that a partner shall not recognize gain or loss when he contributes property to the partnership.[101] This rule recognizes that such a contribution constitutes merely a change in the form of doing business rather than an unconditional surrender of title to the property in exchange for money or its equivalent. Treasury Regulation section 1.721-1 provides, however, that gain or loss will be recognized if the partner engages in the transaction outside of his role as partner.[102] This regulation is an application of the entity principle because it provides for recognition of gain or loss on the contribution of property by the partner to the partnership entity in exchange for something other than a partnership interest.

Sections 734, 743, and 754 apply the aggregate rule in order to insure equity among the partners.[103] These sections permit a new partner to receive credit for the full amount he paid for his partnership interest by increasing or decreasing the tax basis of his pro rata share of partnership assets.[104] The increase or decrease is measured by the difference between the consideration he paid and the pro rata share of tax basis in partnership assets appurtenant to the partnership interest he purchases.[105] These sections achieve the same result that would occur if the partnership were dissolved and then reformed. All of the continuing partners retain their previous pro rata share of tax basis in partnership assets. The new partner, however, receives a pro rata share of tax basis in partnership assets equal to his tax basis in the partnership interest. Note that this adjustment is optional at the revocable election of the partnership.[106] Allowing the partnership to make this adjustment follows the aggregate model of partnership theory. But the fact that the adjustment is optional allows the partnership to choose the entity rule. Under the

100. *Id.* § 707(b)(1)(A).
101. *Id.* § 721.
102. Treas. Reg. § 1.721-1 (1960).
103. I.R.C. §§ 734, 743, 754.
104. *See id.* § 743(b).
105. *Id.*
106. *See id.* § 754.

entity rule, the new partner receives the same pro rata share of tax basis in partnership assets that his predecessor held, regardless of his tax basis in the partnership interest. Sections 734, 743, and 754 probably make the entity concept the general rule because of its relative simplicity. If the partnership elects the optional basis adjustment, relatively burdensome record-keeping requirements are imposed.[107]

C. *Legislative History*

Prior to the enactment of the IRC, no comprehensive statutory scheme treated partners and partnerships under the income tax laws.[108] The House Report on the IRC stated that the existing treatment of partners and partnerships was among the most confused in the income tax field.[109] The Report also found that as a result of this confusion, partners could not form, operate, or dissolve a partnership with any certainty of the resulting tax consequences.[110] The Ways and Means Committee indicated that its purpose in proposing the new Subchapter K on partnerships was to establish a broad pattern of general applicability.[111] The Committee also stated that its principal objectives had been simplicity, flexibility, and equity among the partners.[112]

The House Report proposed to treat the partnership as a "mere conduit" to the individual partners for items of income and loss.[113] The Report also adopted the entity approach, however, in making the partnership responsible for all elections with respect to income derived from the partnership.[114] The Committee believed that for

107. *See* Treas. Reg. §§ 1.743-1(b), 1.755-1 (1960). *See also* I.R.C. § 755. Most of the conflicts between the aggregate and entity concepts arising under the IRC and the Treasury Regulations can and should be avoided by appropriate drafting of the partnership agreement. I.R.C. § 704(a) provides that a partner's distributive share of income, gain, loss, deduction, or credit shall be determined by the partnership agreement, unless provided otherwise in Subchapter K. I.R.C. § 704(a). *See also* I.R.C. §§ 704(c)(2), 743(b), 761(c).

108. H.R. REP. No. 1337, 83d Cong., 2d Sess. 65, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4017, 4091.

109. *Id.*

110. *Id.*

111. *Id.*

112. *Id.* The Report indicated that the proposed legislation retained the existing scheme of regarding the partnership as merely as income-reporting, and not a taxable, entity. *Id.*

113. *Id.* The items were to retain their original character in the hands of the partner as if realized directly by him.

114. *Id.* at 66, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS, at 4092. The election made at the partnership level would be binding on all individual partners. The only election not made by the partnership under the House bill related to the taking of a credit or deduction for foreigu taxes paid by the partnership. No reason is given for exempting foreign taxes from the entity approach in the Report. The answer probably lies in the two different limitations on foreigu tax credit imposed by I.R.C. § 904(a). If the partnership elected to take credit

transactions between the partner and the partnership the entity approach was simpler than the aggregate approach.[115] The Committee also chose the entity approach in allowing the partnership to elect to receive a new, stepped-up tax basis in the individual assets when a new partner enters the business.[116] The Committee adopted the aggregate approach to prevent partners from converting items of ordinary income or loss, such as the sale of inventory or unrealized receivables, into items of capital gain or loss by selling the inventory as part of the sale of a partnership interest.[117] Thus, although the Committee employed the entity theory whenever that approach simplified tax administration, the aggregate concept dominated its general approach to the regulation of partnerships under the IRC.

The Report of the Senate Finance Committee on Subchapter K did not differ materially from the House Report. One difference, however, was that the Senate Committee wished to give partners more flexibility in apportioning the tax basis of assets contributed to the partnership. The Senate Report recommended that partners who contributed property with a fair market value substantially in excess of the property's tax basis should be permitted to give the partner who contributed cash a larger proportionate share of the tax basis in the interest of equity among the partners.[118] The Senate

treatment for taxes paid to a foreign government, any partner who could not meet the higher of the two limitations with regard to his pro rata share of foreign taxes paid might lose forever the tax benefits related to the foreign taxes paid. But if the individual partner was given the election to take a credit or a deduction for the foreign taxes paid, he would be able to take full advantage of the taxes paid. This exemption extended by the Report to foreign taxes paid was probably an effort to prevent discrimination against the partnership form of business in favor of sole proprietorships.

The Report justified the choice of the partnership as the income-reporting and election-making entity by asserting that confusion would result if each individual partner were responsible for separately determining his share of partnership income. *Id.*

115. *Id.* at 67, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS, at 4093. *See also* I.R.C. § 707.

116. H.R. REP. No. 1337, *supra* note 108, at 70, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS, at 4096. *See also* I.R.C. §§ 734, 743, 754. The Committee's theory was that the partnership should receive a stepped-up tax basis in individual assets when a new partner entered by purchasing or inheriting a partnership interest. H.R. REP. No. 1337, *supra* note 108, at 70, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS, at 4096. The Report stated that this result was the same that would be reached if the partnership had been dissolved and reformed with the new partner contributing new assets. *Id.*

117. *Id.* at 70-71, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS, at 4097. *See also* I.R.C. § 751.

118. S. REP. No. 1622, 83d Cong., 2d Sess. 90, 93, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS, at 4621, 4722, 4725. *See also* I.R.C. § 704(c). The problem addressed by the Senate arises, for example, when partner *A* contributes $100 of cash and partner *B* contributes depreciable property with a fair market value of $100 but a tax basis of $50. If the entity approach applies, *A* would receive a depreciable basis of $25, one-half of the $50 basis contributed by *B*. If the aggregate approach applies, however, *A* would receive a depreciable

Report also differed from the House Report in the rationale used to allow a stepped-up basis in individual partnership assets when a new partner acquired a partnership interest by purchase or inheritance. The Senate Committee allowed the stepped-up basis only to the new partner.[119] This construction of the optional basis adjustment rule was clearly an aggregate concept because it allowed the adjustment to benefit only the new partner who triggered the adjustment. The Senate also tempered many of the House proposals in Subchapter K that built on the entity concept by offering the partners an alternative aggregate solution.

The Conference Report on the IRC adopted the position that the partnership would be viewed as an entity for tax reporting purposes,[120] but at the same time endorsed the aggregate concept as the fundamental principle underlying Subchapter K.[121] The conferees stated that: "No inference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions."[122]

The House Ways and Means Committee began work on a revision of Subchapter K in 1956 to correct unintended benefits and hardships in the income tax treatment of partners under the IRC.[123] The Committee appointed an Advisory Group on Subchapter K to assist in proposing corrections.[124] The Group concluded that section 702(a) of Subchapter K should be amended to provide that the partnership would be purely a conduit through which the character

basis in the partnership assets of $50, one-half of the $100 fair market value assigned to the property contributed by *B*. Under the entity approach, *B* would receive a depreciable basis in partnership assets of $25. Under the aggregate approach, *B* would receive a depreciable basis in partnership assets of $0. The Report recognized that the entity approach for contributed property was simpler, but concluded that the aggregate approach was more equitable as between the partners. *Id.* at 93, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS, at 4725.

119. *Id.* at 97, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS, at 4729-30.

120. H.R. REP. No. 2543, 93d Cong., 2d Sess. 58, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS, at 5280, 5319.

121. *Id.* at 59, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS, at 5319-20. The Conference Report also adopted the Senate committee's amendments concerning the contributed partnership assets' tax basis between partners and the optional basis adjustment when new partners acquire a partnership interest by purchase or inheritance. *Id.* at 58, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS, at 5319. *See also* text accompanying note 116 *supra*.

122. H.R. REP. No. 2543, *supra* note 120, at 59, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS, at 5319-20.

123. *See* 16 CONG. Q. ALMANAC 366 (1960).

124. *Id.* The Advisory Group submitted a comprehensive report in May of 1958. ADVISORY GROUP ON SUBCHAPTER K TO THE HOUSE COMM. ON WAYS AND MEANS, 85TH CONG., 2D SESS., REPORT ON PARTNERS AND PARTNERSHIPS (Comm. Print 1957).

of all partnership items would carry over into the hands of the partners.[125] The Advisory Group found that the IRC did not make clear whether limitations from other parts of the IRC were to be imposed at the partner or partnership level. The Advisory Group recommended that any limitations on the includability or deductibility of an item should be imposed at the partner level.[126] Testimony from Mr. Arthur Willis, Chairman of the Advisory Group, before the House Ways and Means Committee identified the cause of the complexity in administering Subchapter K.[127] In an exchange with Chairman Mills, Willis stated that most of the complications of partnership taxation arise from special benefits granted under other provisions of the tax laws.[128] The substance of the Advisory Group's Report was adopted by the House Committee in H.R. 9662.[129] The Senate did not pass H.R. 9662, however, apparently as a result of opposition to items in the bill not affecting Subchapter K.[130] The overall effect of H.R. 9662 would have been to adopt the aggregate rule for administering all provisions of Subchapter K not expressly requiring that the entity rule be employed.

D. *Case Law Analysis*

(1) Early Decisions

Early cases considering partnerships tended to rely on common law aggregate principles to fill gaps in statutory schemes regulating partnerships. For example, Justice Holmes, in *Francis v. McNeal,*[131]

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125. *Id.* at 1.

126. *Id.* The Group noted that if limitations imposed by other IRC provisions were imposed at the partnership level, individual taxpayers could exceed those limitations by forming several partnerships. *Id.* at 2. For example, there are limitations imposed by I.R.C. § 175 on deduction of soil and water conservation expenditures, by § 116 on exclusion of dividends, and by § 170 on deduction of charitable contributions. Likewise, if the limitations were imposed at both the partnership and partner levels, the IRC would discriminate against the partnership form of business. *Id.* The discrimination would arise because if the partner were doing business as a sole proprietor, the limited items would be subjected to the limitation only once, on the sole proprietor's individual income tax return. For example, if the partnership *AB*, composed of Mr. *A* and Mr. *B*, received $200 of dividends qualifying for exclusion under I.R.C. § 116, and if the exclusion limitation were imposed at the partnership level first, only $100 of the dividends would be excludable with *A* and *B* each reporting $50 of dividends qualifying for exclusion when the limitation was imposed the second time at the individual partner level. If *A* and *B* had each been a sole proprietor, however, and each had received $100 of dividends qualifying for exclusion, each could have excluded the full $100 in dividends from his taxable income.

127. HOUSE COMM. ON WAYS AND MEANS, 86TH CONG., 1ST SESS., PANEL DISCUSSION, INCOME TAX REVISION 931 (Comm. Print 1960).

128. *Id.*

129. *See* 16 CONG. Q. ALMANAC 366 (1960).

130. *Id.*

131. 228 U.S. 695 (1913).

utilized the common law in interpreting the Bankruptcy Act as it applied to partnerships. He found that the Bankruptcy Act had transformed the partnership into an entity for purposes of marshalling the assets of the bankrupt partnership estate.[132] After reaching that conclusion, however, Justice Holmes stated that "we see no reason for supposing that it [the Bankruptcy Act] was intended to erect a commercial device for expressing special relations into an absolute and universal formula—a guillotine for cutting off all the consequences admitted to attach to partnerships elsewhere than in the bankruptcy courts."[133] Yet a relatively short time later, Judge Learned Hand, speaking for the majority in *Helvering v. Walbridge*,[134] stated that the partner's interest in the joint ownership of assets had long since lost most of the legal incidences accorded under common law and equity. The majority therefore held that the Commissioner improperly assessed a partner for his pro rata share of the gain on a sale of securities held by the partnership but originally contributed by the petitioning partner. The Commissioner had argued that the basis of the securities in the contributing partner's hands prior to contribution was the proper basis for calculating his taxable gain on the sale of the securities by the partnership. *Walbridge* clearly treated the partnership as an entity for purposes of computing gain or loss on the sale of partnership assets. Yet the opinion did not discuss the legislative history behind the Internal Revenue Code. Judge Hand seemed simply to decide that since the Commissioner's regulatory scheme made the partnership responsible for choosing the method of accounting, the partnership was an entity. That interpretation directly conflicts with Justice Holmes' observation in the *Francis* case that courts should apply common law principles to partnerships unless the legislature has expressly altered the common law scheme by statute.

(2) Presumptive Entity Theory Analysis

For a considerable period after the enactment of the first internal revenue laws, the courts applied very mechanistic analyses to partners' claims that the partnership should be treated as an aggregate rather than an entity. In *Wheelock v. Commissioner*,[135] the court held that a partner was bound by the partnership's election of the completed contract method of accounting. The partnership,

132. *Id.* at 700.
133. *Id.*
134. 70 F.2d 683 (2d Cir.), *cert. denied*, 293 U.S. 594 (1934).
135. 10 B.T.A. 540 (1928).

which was engaged in the construction business, reported no income and claimed no expenses related to a project until the contract was completed. The partner sought to offset his ratable share of partnership income by expenses incurred but not applied on uncompleted contracts. The court found that since the partnership was an entity for tax reporting purposes and had chosen the completed contract method, the partner could not select a different method.

In *Scherf v. Commissioner,*[136] the court held that a partnership is a tax reporting entity under the IRC. The court reasoned that the accounting period and method chosen by the partnership are incidental to its status as a tax reporting entity. Therefore, the individual partners were bound to report partnership income and expense on their returns in accordance with the accounting period and method chosen by the partnership.[137] The decision in *Scherf,* combined with those in *Walbridge* and *Wheelock,* indicates that courts will apply entity theory when scrutinizing partnership accounting methods.[138]

(3) Current Trend Toward Aggregate Analysis

The Commissioner changed positions in *Moradian v. Commissioner*[139] and urged the court to apply aggregate theory in dealing with the investment credit on used property.[140] The partner taxpayer had used certain property subject to the investment credit under IRC section 38 in a former partnership. When he joined a new partnership in which he acquired a fifty percent capital interest, the new partnership bought out his old partner's one-half undivided interest in the used property. The new partnership claimed an investment credit on the purchased one-half interest in used property.

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136. 20 T.C. 346 (1953).

137. *Id.* at 348. The court held that the partner could not elect to report capital gain received from the sale of partnership assets on the installment gain method. The partnership's failure to elect the installment gain reporting method was conclusive against the partner. The majority opinion rejected an argument that since the 1939 Code provided for the separate statement of capital gains and losses in the partnership information return, the individual partner should be allowed to elect the installment gain method as to those separately reported gains. *Id.* at 348-49. The majority found that Congress' intent in requiring separate statement of capital gains and losses was to allow partners to take advantage of the favorable individual tax rates on capital gains. *Id.* at 350.

138. *See also* Resnick v. Commissioner, 555 F.2d 634 (7th Cir. 1977); Holloman v. Commissioner, 551 F.2d 987 (5th Cir. 1977); Pratt v. Commissioner, 64 T.C. 203 (1975); Moradian v. Commissioner, 53 T.C. 207 (1969), *nonacq.* 1973-1 C.B. 2.

139. 53 T.C. 207 (1969), *nonacq.* 1973-1 C.B. 2.

140. *See also* Kipperman v. Commissioner, 46 T.C.M. (CCH) ¶ 77,032 (1977) (later case with same holding on similar facts); Holloman v. Commissioner, 44 T.C.M. (CCH) ¶ 75,309 (1975) (same facts).

The Commissioner disallowed the credit, reasoning that since a partnership was essentially an aggregate of individuals, the partner common to both partnerships had used the same equipment before and after the sale of the interest in the property. The court reversed the Commissioner based on its interpretation of legislative intent in drafting IRC section 48(c). The court found that the legislature intended to increase new investment in tangible assets through the passage of section 48(c). The court also found that by including a partnership in the definition of a person under IRC section 7701(a)(1), and by limiting the allowance of the investment credit on sales between partnerships to those in which no common partner owned more than fifty percent of the interests in either partnership, Congress intended the credit to be allowed in a case such as *Moradian*. Therefore, the majority held that entity theory applied and allowed the investment credit. A strong dissent relied on the legislative history to show that Congress had identified aggregate theory as the dominant principle behind Subchapter K. The dissent noted that the House Report stated that although entity theory had been used specifically in some places, aggregate theory should be employed when more appropriate.[141] Thus the dissent would have applied aggregate theory to disallow the investment credit.[142]

In *Stafford v. United States*,[143] the court employed aggregate principles to hold against the Commissioner. The taxpayer in *Stafford* received a limited partnership interest valued at $100,000 in return for his contribution to the partnership of a ground lease and a loan commitment finalized by the contributor prior to the formation of the partnership.[144] The Commissioner reasoned that the transaction had been conducted as though the individual was not a partner,[145] and therefore that Stafford actually realized $100,000 of ordinary income from the rendering of services in return for the partnership interest.[146] The court held that because Stafford had already completed the negotiation of the ground lease before assigning the agreements, and because the loan commitment was binding on him and not the future partnership, the partnership had

141. 53 T.C. at 215.

142. *Id.* at 215-16. In this particular case, the court decided that the overriding legislative intent of increasing investment in tangible assets was best advanced by the entity theory. *Id.* at 211-12.

143. 435 F. Supp. 1036 (M.D. Ga. 1977).

144. *Id.* at 1038.

145. *Id.* at 1038-39. The Commissioner contended that what Stafford contributed was not property under I.R.C. § 721.

146. *Id.* at 1038.

received property and not services.[147] The court apparently found that the contribution in this case more closely resembled an aggregate of individuals combining to operate a business, rather than one individual selling or exchanging his property to a different entity in return for an equity interest.

In *Pratt v. Commissioner*,[148] the court employed aggregate principles in holding that payments to partners were in the nature of distributive shares of partnership income and not guaranteed payments deductible as ordinary and necessary expenses of the partnership. The partnership took the position that management fees paid to general partners pursuant to the limited partnership agreement should be treated as payments to persons who were not partners and therefore should be deductible by the partnership in computing net partnership income or loss under IRC section 702(a).[149] The court rejected this argument, finding that the overall scheme of Subchapter K reflected aggregate theory.[150] The court reasoned that the business of the partnership was managing shopping centers.[151] Since the payments received by the general partners were expressly stated to be management fees, such payments were actually redistributions of net partnership income or loss.[152]

The decisions in *Stafford* and *Pratt*, as well as the dissenting opinion in *Moradian*, indicate a growing willingness on the part of courts to apply aggregate theory. These opinions suggest that the partnership theory to be applied will depend on the court's perception of which theory will best advance the overriding legislative intent.[153] The cases also provide support for the theory that the aggregate principle should be applied as a rule of law in partnership questions unless Congress has expressly designated the entity rule as appropriate in a specific case.

E. Summary

Congress and the courts have struggled with problems in taxing the partnership form since the passage of the first revenue laws. A

147. *Id.* at 1039. The court distinguished both United States v. Frazell, 335 F.2d 487 (5th Cir. 1964), and James v. Commissioner, 53 T.C. 63 (1969), which had held that an interest in corporations received by stockholders was in the nature of compensation for services rendered. 435 F. Supp. at 1039.

148. 550 F.2d 1023 (5th Cir. 1977).

149. *Id.* at 1026.

150. *Id.* The court further found that Subchapter K adopted the entity concept in "certain specific instances." *Id.*

151. *Id.*

152. *Id.*

153. *See* text accompanying notes 121-22 *supra*.

primary problem has been whether entity or aggregate theory should be applied in deciding tax questions. Congress has repeatedly chosen the aggregate concept as the fundamental principle underlying partnership tax laws. Yet it has also applied the entity concept to specific partnership problems. These specific applications have occurred whenever Congress has chosen administrative convenience and simplicity of application over fairness to partners. Entity theory has also been applied to prevent abuses of certain tax incentives by partnerships, such as the additional first year depreciation allowance pursuant to IRC section 179. Congress appears to ignore the possibility that many of the abuses of partnership tax laws exist because of complexities in other sections of the IRC taxing the individual partners. As taxation of individual partners becomes more complex, Congress appears more willing to impose harsh new entity restrictions on the partnership form. The partnership form of business will lose much of its attractiveness if this trend leads ultimately to taxation of the partnership itself.[154]

The partnership is an appealing form of business because it permits individuals to combine their funds as in a corporation without subjecting the business to the exacting regimes of federal and state taxation. If the partnership entity is taxed, or if the taxing authority is allowed to make binding determinations at the partnership level, the individual partners will lose considerable personal and business flexibility. In many respects, they would be operating as a corporation, but without the limited liability of the corporate form. Because of the value of the partnership form to the American economy, Congress should reject any attempt to implement entity theory. The aggregate concept more accurately reflects the realities of doing business in the partnership form today. Congress should therefore revise partnership tax laws with aggregate theory constituting the guiding principle. H.R. 9662 of the second session of the eighty-fifth Congress would provide an excellent model for such a scheme.[155]

Until Congress establishes a broad statutory scheme based on the aggregate principle, the courts are faced with the problem of deciding those questions not specifically answered by Subchapter K. Thus far their analysis has centered on whether the question presented concerns accounting period or method. If so, they have

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154. *See generally* J. BARRETT & E. SEAGO, 1 PARTNERS AND PARTNERSHIPS LAW AND TAXATION 5-6 (1956); Z. CAVITCH, 1 BUSINESS ORGANIZATIONS § 3.02 (rev. ed. 1977); S. ROWLEY, 1 ROWLEY ON PARTNERSHIP, iii-iv (2d ed. 1960). All three works discuss the relative advantages and disadvantages of the partnership form of business.

155. *See* text accompanying note 129 *supra*.

rigidly applied the entity method. Unfortunately, the courts have tended to cast almost all issues as questions concerning accounting period or method. Instead of following this restrictive course, courts should adopt the test formulated in Treasury Regulation section 1.702-1(a)(8)(ii). This regulation test would require that the aggregate concept be applied to any partnership item that would lead to a different tax liability for individual partners if passed directly through instead of being included in the computation of partnership income. If a different tax liability would not arise, then the entity concept should be applied to insure as much administrative simplicity as possible. The adoption of this test would contribute significantly toward neutralizing the effects of the tax laws on individual partners relative to sole proprietors.

IV. Critique of Proposed Amendments and Conclusion

A. *Probable Effects on Substantive Partnership Law*

The aggregate concept is the principal theory underpinning the tax treatment of partnerships under the IRC.[156] This concept evolved from the common law but has been greatly altered by statutory schemes such as the Uniform Partnership Act. Public discontent over manipulation of the partnership vehicle by tax shelter operators, however, may have begun to erode congressional support for the aggregate concept. The Administration's proposal seeks to give the Secretary authority to bind all partners through an audit conducted at the partnership level.[157] The House amendments give the Secretary and the partnership authority to enter into a binding extension of the statute of limitations with regard to all partners,[158] and gives the Secretary authority to assess individual partners for additional taxes due with regard to partnership items for a period of one year after that partner's name and address is reported, even if that partner was not responsible for filing the partnership return.[159] Further, both sets of proposed amendments would allow the Secretary to promulgate rules to determine partnership items of income, expense, and credits at the partnership level and to determine the allocation of those items between partners.[160] If enacted, the proposals would fundamentally alter substantive partnership law.

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156. *See* text accompanying notes 63, 113, & 122 *supra. See also* H.R. Rep. No. 1445, *supra* note 4, at 74.

157. *See* text accompanying notes 35-62 *supra.*

158. *See* text accompanying note 74 *supra.*

159. *See* text accompanying note 73 *supra.*

160. *See* note 72 *supra;* text accompanying note 55 *supra.*

The power of a general partner to enter agreements with the Service that are binding on limited partners could have a substantial effect on substantive partnership tax law. General partners operating tax shelters are often in a position adverse to the investor limited partners, and therefore often prefer quick settlements with the Service rather than long negotiations that might jeopardize their tax shelter operations. This is especially true when, as is generally the case, the tax shelter operator sells the limited partners the major portion of the partnership equity. Therefore, any settlement with the Service will have little effect on the operator's personal tax liability. Further, any reallocations of income or loss pursuant to a settlement will normally involve an allocation of loss from investor limited partners to operator general partners, thereby giving a benefit to the persons designated under both sets of proposed amendments to represent the limited partners. These amendments therefore directly attack the fundamental partnership value of equity between partners.[161]

Another feature of both sets of amendments that may have a far-reaching effect on substantive partnership tax law is the authority given to the Secretary to issue regulations governing determination of items of income, expense, and credit at the partnership level and allocation of these items among partners. Subchapter K of the IRC sets forth a detailed scheme for determination of partnership items,[162] and the Secretary has promulgated regulations pursuant to his authority under that scheme.[163] These regulations basically provide that partnership items, other than items specifically set forth in the statute, shall be separately stated in the partnership return if doing so would lead to a different tax liability for some individual partners than if the item was included in net partnership income or loss.[164] Nevertheless, the existence of the problems of administration of partnership audits cited by both the Treasury and the House indicate that the proposed rulemaking authority for the Secretary will be used to denigrate this regulatory scheme. This is true even though the scheme has been approved by the Congress through its decision to leave intact the Secretary's statutory authority under IRC section 702. If this portion of the amendments is passed, courts will be left with the confusing task of determining when rules promulgated by the Secretary are purely procedural and when they are

161. *See* text accompanying notes 32 & 65 *supra*.
162. *See* I.R.C. § 702.
163. *See* Treas. Reg. § 1.702 (1960).
164. *Id.* at § 1.702-1(a)(8)(ii).

substantive, since the Secretary may not properly use the proposed rulemaking authority to make substantive law.

B. Positive Effects on Tax Shelter Abuse

Both the House and Treasury proposals purport to attack two principal problems. First, both proposals seek to make it easier for the Service to conduct an effective audit of tax shelter partnerships.[165] Second, the proposals seek to insure that tax shelter operators comply with the substantive laws of the IRC. The means chosen by the Treasury[166] and the House[167] will undoubtedly deter tax shelter operators from failing to file partnership returns, since they will ultimately be responsible for payment of the failure to file penalty. It is difficult to understand, however, how the Treasury's proposal to bind the partnership administratively and judicially through an authorized representative will appreciably add to the Service's ability to audit, since the operator can avoid the problem by providing in the partnership agreement that a notification stating that no partner is designated as the authorized representative will be filed with the Service. Undoubtedly, the agreement will either provide that each partner is his own authorized representative as his interests shall appear or that all partners must consent as to each and every action of the one person designated as the authorized representative. Because Subchapter K of the IRC places great emphasis on the partnership agreement as the governing instrument for tax purposes, courts will probably not permit the Service to do an "end-run" around the substantive law by invoking this proposed procedural change.

The House's proposal for extending the statute of limitations as a means of attacking tax shelter abuse is unlikely to produce any measurable benefit. The amendments apply only to federally registered partnerships,[168] and any partnership that is required to register with the SEC has already laid out an audit trail that the Service should have no problem following even under present law. Registrants must provide a wealth of information concerning principal owners, location of books and records, principal place of business, and, even more significantly, opinion of counsel as to the validity of proposed tax treatment of the investment vehicle.[169] The real

165. *See* text accompanying notes 34 & 64 *supra.*

166. *See* text accompanying notes 35-62 *supra.*

167. *See* text accompanying notes 66-76 *supra.*

168. *See* text accompanying note 75 *supra.*

169. Securities Act of 1933, §§ 10(a)(1), Schedule A(4), (23), 15 U.S.C. §§ 77j(a)(1), 77aa Schedule A(4), (23) (1976).

problem of tax shelter abuse would seem to arise only in those categories of partnerships that do not file with the SEC and thereby attempt to hide their operations from all government scrutiny. The House has apparently conceded that its proposal would have little real effect on tax shelter abuse because the Ways and Means Committee report stated that it believed that if the individual partners took the items of partnership income and expense into account separately on their individual returns, the failure to file a partnership return should not subject the partnership to the failure to file penalty.[170]

C. *Negative Effects on Partnership Form of Doing Business*

The business partnership has long been a durable, flexible vehicle for the operation of small businesses.[171] It is particularly well-suited for enabling small businessmen to pool their talents and financial resources without subjecting themselves to the onerous reporting and taxing requirements for corporations. Congress wisely has recognized the value of this business form by preserving its essential attributes under the tax laws. Tax shelter partnerships, on the other hand, are newcomers to the partnership scene. Until the first individual income tax laws were passed in this country in 1916, there was no reason for tax shelter partnerships. Until the tax rate structure of the federal individual income tax began to rise steeply in the 1950's, few people could benefit from the phenomenon of the tax shelter. As individual tax rates began to rise, however, two functionally distinct partnership forms evolved—the general or limited business partnership formed for the purpose of pooling resources and carrying on business activities to accumulate economic wealth for the owners, and the tax shelter limited partnership formed for the principal purpose of generating large amounts of tax write-offs for the limited partners while allowing the general partners to receive handsome syndication and management fees. The owners of this second type of partnership would be appalled if they thought their "business" might generate any economic profits other than the benefit of the tax write-offs on their individual returns. Unfortunately, neither the House nor the Treasury proposal makes any distinction between these two types of functionally disparate partnerships.

Both sets of amendments are aimed at deterring tax shelter operators from abusing substantive partnership tax laws by avoid-

170. *See* H.R. Rep. No. 1445, *supra* note 4, at 75.
171. *See* S. Rowley, *supra* note 154, ¶ 1.1.

ing audits and by adopting aggressive and questionable tax positions on partnership returns. Both proposals give the Secretary the authority to make binding administrative determinations at the partnership level, apparently irrespective of partnership agreements to the contrary, and provide that the general partners are the only persons authorized to negotiate on the behalf of all partners.[172] The Treasury's proposal goes even further by binding the partners and the partnership in a similar fashion when seeking a judicial determination.[173] The net effect of these proposals is to make the partnership form a less attractive vehicle for tax shelters. Tax shelter operators, however, can continue operations by turning to an alternative investment vehicle such as a trust, or by avoiding the effect of the proposed amendments through more complex partnership agreements drafted with the help of expensive legal counsel.

These proposals will have an unfortunate detrimental effect on the attractiveness of the first functional form of partnership—the business partnership. Such partnerships are often formed by two or more small businessmen as a means of pooling their capital resources and business talents to generate profits. They are not vehicles for producing tax write-offs. If the Treasury's proposed amendments are passed, these small businessmen would be placed in a position similar to that of shareholders in a corporation. Even under the House proposal, which is somewhat mitigated by the language in the Committee report,[174] the statutory language transforms the aggregate of individual partners into an entity represented by one general partner for purposes of executing extension of statute of limitations agreements. Both proposals also give the Secretary the authority to determine partnership items at the partnership level, just as if these businessmen-partners were shareholders in a Subchapter S corporation. Under the Treasury's proposals the partnership would be treated strictly as an entity for purposes of the administrative and judicial determination process.[175] Small businessmen who have in the past carried on their business largely as if they shared income and expenses will now be faced with the prospect of keeping substantially the same kinds of records they would have to maintain if they were operating as a corporation. Worst of all, they will probably be required to retain expensive legal counsel to aid them in drafting the complex partnership agreement necessary to avoid the effects of the proposed amendments or to represent the

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172. *See* text accompanying notes 38 & 74 *supra*.
173. *See* text accompanying notes 47 & 57 *supra*.
174. *See* text accompanying notes 168-69 *supra*.
175. *See* text accompanying notes 35-36 *supra*.

partnership at the various administrative and judicial determination levels. In either case, the business partnership will no longer be as attractive a form for doing business.

D. A Proposed Solution

The amendments embodied in the House and Treasury proposals represent reasoned attempts to curb tax shelter abuse. The flaw in the proposals, however, lies in their assumption that the problem is created by the partnership form of doing business. The problem can be resolved without damaging the partnership form.

First, the failure to file penalty of both proposals should be retained, since the Service must have a timely, complete return if it is to determine whether tax shelter operators have complied with substantive laws. Also, the penalty should be assessed at the partnership level, since the administrative convenience of this method far outweighs any minor deviation from the fundamental aggregate concept. The penalty should not be imposed, however, whenever the individual partners have substantially complied with the intent of the law by taking into account on their individual returns their pro rata share of all items of income and expense. They should be able to fulfill the notice requirement to the Service by filing a simple information return setting forth the employer identification number of the partnership (required for employee tax withholding purposes) and the names, addresses, and social security numbers of the individual partners. This reporting option should be available only to those partnerships having a small number of partners, such as ten or less.[176]

Second, the difference between business partnerships and tax shelter partnerships should be defined by statute. One workable definition is that a tax shelter partnership is one which generates net losses (ordinary or capital) in four out of the first five years of its existence. Or since some tax shelter partnerships are short-lived, the loss requirement might be reduced to two out of the first three years of existence. A business partnership would be unlikely to continue to operate if it incurred losses in four out of five years. The full procedures outlined in the Treasury proposal[177] should then be applied to tax shelter partnerships as statutorily defined.

A third proposal is to expand the questions required to be an-

176. The larger partnerships would be required to maintain extensive internal accounting records to keep up with partners' accounts at the very least and would therefore not he placed in undue hardship to comply with the failure to file penalty.

177. *See* text accompanying notes 35-62 *supra.*

swered on the partnership information return. The Service should develop questions aimed at determining whether certain questionable tax positions have been taken. For example, the partnership should be required to disclose whether it has deducted for tax purposes interest expense prepaid for more than twelve months in the future. These questions should be as specific as possible to avoid confusing the taxpayer and to make clear that the response is required to avoid perjury penalties. By continually reassessing and revising these questions, the Service can adjust to changes in tax shelter operators' schemes. For example, if the tax shelter operators invest heavily in coal or oil and gas shelters in one particular year, the Service should include questions to ferret out the particular abuses associated with those investment shelters. These questions naturally require the Service and the Treasury to remain sensitively attuned to the newest tax shelter schemes to anticipate their appearance on partnership returns with the proper questions.

E. Conclusion

Both the House and Treasury proposals contain provisions that may change substantive partnership law. The Congress must weigh these proposals carefully to select those provisions that properly balance the need for administrative convenience with the long-recognized values of simplicity, flexibility, and equity between partners. This Note takes the position that the failure to file penalty is a positive step in correcting tax shelter partnership abuse. The remaining provisions in both the Treasury and House plans, however, risk damaging the vitality of the partnership form of business yet provide little hope of reducing tax shelter partnership abuse. As a workable alternative, Congress should consider three proposals—institution of a limited failure to file penalty, statutory definition of tax shelter partnerships, and institution of an expanded questionnaire in partnership information returns aimed at ferreting out tax shelter partnership abuse.

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