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THE TAXATION OF PRIVATE BUSINESS ENTERPRISES: SOME POLICY QUESTIONS STIMULATED BY THE "CHECK-THE-BOX" REGULATIONS

George K. Yin*

WITH remarkable speed, the Internal Revenue Service has proposed and now implemented a brand-new system for the classification of business firms for tax purposes. Under the new procedure, commonly referred to as the "check-the-box" regulations, many private firms, no matter what their characteristics under state law, may choose the set of rules that will control how the income of the firm is taxed.¹ Thus far, the check-the-box approach has been greeted with enthusiasm and widely praised as an important, simplifying improvement in the tax law.² In this Article, I argue that such praise is very premature, and that several important policy questions need to be resolved before we can accurately gauge the wisdom of the new rule. There is also serious debate whether the check-the-box regulations will ultimately prove to be a simplifying change in the law.

Part I of this Article briefly sketches out the background behind the check-the-box regulations. Part II presents a series of policy issues raised by the new regulations and some of the reasons why one might doubt whether the change will constitute a simplifying one. Part III provides a detailed illustration of one of the difficult questions made more significant by the check-the-box regulations—the proper allocation of "nonre-

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² See, e.g., Hugh M. Dougan et al., 'Check-the-Box'—Looking under the Lid, 75 TAX NOTES 1141, 1155 (1997) ("The regulations clearly are a bold effort to fashion a simpler and more administrable classification system for the future."); Victor E. Fleischer, "If It Looks Like A Duck: Corporate Resemblance and Check-the-Box, 71 TAX NOTES 345, 366 (1996); Michael J. Grace, Proposed "Check-the-Box" Regulations Would Streamline But Not Eliminate Entity Classification Process, 37 TAX MGMT. (BNA) 295, 295 (1996); Roger F. Pillow et al., Check-the-Box Proposed Regs. Simplify the Entity Classification Process, 85 J. TAX'N 72, 72 (1996); Michael L. Schler, Initial Thoughts on the Proposed 'Check-the-Box' Regulations, 71 TAX NOTES 1679, 1681 (1996).
course deductions” among the owners of a private business firm. Part IV contains a brief conclusion.

I. BACKGROUND

Under current law, the income of firms engaged in general business activities may be taxed under one of three possible sets of tax rules. In general, incorporated firms are taxed under Subchapters C or S of the Internal Revenue Code (the Code). Unincorporated firms not treated as corporations are generally taxed under Subchapter K. There are many differences in these sets of rules, and it is often advantageous for a firm to be taxed under one set rather than another.3

Prior to the check-the-box regulations, the taxation of a firm’s income was based largely on the state law characteristics of the firm. In general, incorporated firms as well as unincorporated firms that “resembled” corporations because they had a sufficient number of corporate characteristics—centralized management, continuous life apart from the lives of the owners of the firm, free transferability of ownership interests, and limited liability for the owners from the activities and debts of the business—were treated as corporations for tax purposes. Therefore, both incorporated and unincorporated firms resembling corporations were subject to either Subchapters C or S.4 Unincorporated firms without enough of those characteristics were generally treated as partnerships and taxed under Subchapter K.5

Over the years, the implementation by the IRS of the “corporate resemblance” classification test was greatly criticized.6 For example, the regulations required a straightforward, numerical counting of the corporate characteristics of the firm, without any evaluation of the importance of each characteristic in the particular case, to determine whether an unincorporated entity should be classified as a corporation for tax pur-

3. See infra notes 49-51 and accompanying text.
5. See id.; former Treas. Reg. § 301.7701-3 (as amended in 1993).
poses. In *Larson v. Commissioner*, the Tax Court felt constrained by this directive to conclude that a limited partnership should not be classified as a corporation for tax purposes, and strongly suggested that the IRS might want to revise its regulations to change this wooden interpretation of the statute.

Additionally, the regulations sometimes incorporated an artificial interpretation of the meaning of the various factors. Consider, for example, the meaning of "limited liability," a characteristic viewed by many as a fundamental distinction between corporations and partnerships. In general, corporations have this characteristic, but general partnerships do not. But is the characteristic present in a limited partnership? The regulations dealt with this issue by saying that limited liability is present only if "there is no member" liable for the entity's debts, thereby generally treating a limited partnership as lacking that corporate characteristic. The regulations then acknowledged, however, that a limited partnership might have limited liability if its general partner, the only partner liable for the entity's debts, lacked substantial assets.

Unfortunately, before reaching that conclusion, the regulations also required a finding that the general partner constituted a mere "dummy" acting as the agent of the limited partners. As the Court of Claims explained in *Zuckman v. United States*, this additional requirement effectively made it impossible for any limited partnership to have the limited liability characteristic because, if the general partner were a "dummy" in that sense, the limited partners would be personally liable under state law for the debts of the entity. In other words, because someone—either the limited partners or the general partner—would be liable for the entity's debts in all cases considered by the regulations, a limited partnership could not have limited liability.

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7. See former Treas. Reg. § 301.7701-2(a)(3) (as amended in 1993) ("[A]n unincorporated organization shall not be classified as an association [and therefore be taxable as a corporation] unless such organization has more corporate characteristics than noncorporate characteristics.").
9. The IRS made two attempts to revise the regulations, but both efforts were unsuccessful. See 42 Fed. Reg. 1038 (1977); 45 Fed. Reg. 75,709 (1980).
12. See id.
13. 524 F.2d 729, 741 (Ct. Cl. 1975).
14. See former Treas. Reg. § 301.7701-2(d)(2) (as amended in 1993) ("Notwithstanding the formation of the organization as a limited partnership, when the limited partners act as the principals of [a 'dummy'] general partner, personal liability will exist with respect to such limited partners.").
15. But see Larson v. Commissioner, 66 T.C. 159, 197-98 (1976) (Simpson, J., dissenting). The language of the regulation actually was somewhat ambiguous regarding whether a corporate general partner had to lack substantial assets and be a mere dummy in order for the limited partnership to be treated as having limited liability. See former Treas. Reg. § 301.7701-2(d)(2) (as amended in 1993); *Stephen Utz, Federal Income Taxation of Partners and Partnerships* 34 n.76 (3d ed. 1995).
During the time the corporate resemblance regulations were in effect, important changes began taking place at the state level. In 1977, Wyoming became the first state to adopt a limited liability company (LLC) act and it was followed by Florida five years later. The special feature of these laws was to ensure that mere ownership of an LLC did not expose an owner, termed a “member,” to personal liability for the LLC’s debts, much like the protection afforded the shareholders of a corporation. Moreover, just like shareholders but unlike the limited partners of a partnership, LLC members could generally be actively involved in the activities of the business. The initial reaction of the IRS was to classify LLCs as corporations for tax purposes, but that position was soon withdrawn and ultimately replaced by a ruling holding that a Wyoming LLC could be classified as a partnership. That ruling opened the floodgates, as state after state proceeded to adopt LLC statutes of their own, and the IRS proceeded to issue classification rulings applicable to other state provisions consistent with the conclusions of its Wyoming ruling. At present, all fifty states and the District of Columbia have adopted LLC acts.

It was against this backdrop that the IRS issued Notice 95-14 announcing the Service’s willingness to consider permitting the classification question to be resolved through an explicit taxpayer election. The impetus behind the notice was the IRS’s realization that the existing classification standards had become meaningless, and that taxpayers could achieve partnership tax status under them for organizations “virtually indistinguishable” from a corporation. Accordingly, the Service concluded that an explicit taxpayer election would accomplish the same substantive outcome but with reduced transaction costs for both taxpayers and the government.

The final regulations, effective January 1, 1997, implement the elective approach. In general, domestic business entities may elect to be treated as either a corporation or a partnership for tax purposes. There are two principal categories of firms which are ineligible for the election and automatically taxed as corporations: (1) firms incorporated under state law and (2) those classified by statute as a corporation, such as a publicly traded partnership. Thus, a firm not excepted from the election, such as

19. See, e.g., Rev. Rul. 93-38, 1993-1 C.B. 233 (Delaware LLC may be classified as partnership for federal tax purposes.).
21. See id.
22. See id. at 298.
24. See Treas. Reg. § 301.7701-2(b)(1) and (7) (1996). Both of these exceptions apparently result from the limited scope of the IRS’s authority to change the classification rules. The IRS could not allow state law corporations to make the election because of all of the specific Code provisions applicable to “corporations.” See, e.g., I.R.C. § 11(a) (1994 &
an LLC, has the option of being taxed under either Subchapter C, Sub-
chapter S (assuming the eligibility requirements for that subchapter can
be satisfied and an S election is made), or Subchapter K.

II. SOME POLICY QUESTIONS RAISED BY THE CHECK-THE-
BOX REGULATIONS

This part briefly discusses a series of policy questions left unresolved by
the adoption of the check-the-box regulations. In summary, the ques-
tions relate to whether an elective approach is appropriate at all (ques-
tion A), who should be entitled to make the election if one is provided
(questions B and C), and what operating rule choices should be available
to those making the election (questions D and E).

A. SHOULD THE INCOME TAXATION OF BUSINESS FIRMS BE
DETERMINED BY EXPLICIT TAXPAYER ELECTION?

As noted, the principal argument of the IRS in favor of an explicit elec-
tion was that the law had evolved to the point where there was no longer
any meaningful classification standard to enforce. Therefore, it was best
to drop the pretense of an existing standard, thereby saving taxpayers the
cost of seeking out pro forma classification rulings and saving the IRS the
cost of issuing those rulings. An election also eliminated the need for
state legislators to design statutes authorizing the formation of unincor-
porated entities with the former classification regulations in mind.
Rather, state statutes could be designed with the objective of creating the
most optimal, economic form of business organization.

Interestingly, the IRS's resignation regarding the state of prior law did
not differentiate between a nonexistent standard for classifying business
entities for tax purposes and an existing one which was simply not being
implemented effectively. One view is that there is a valid basis for distin-
guishing between corporations and partnerships for tax purposes, perhaps
along the lines of the state law characteristics of the entity, such as limited
liability, or other factors.25 Under this view, the problem with the former

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25. See Goldberg, supra note 6, at 998, 1011-15, 1016; Keyser, supra note 6, at 531;
Peel, supra note 6, at 1007-09; Postlewaite et al., supra note 6, at 459-60; Sexton & Osteen,
supra note 6, at 145-46.
classification regulations was not in their identification of appropriate factors to consider, but rather in their artificial application of those factors. As applied, the rules simply failed to separate firms with and without the identifying characteristics. But an explicit taxpayer election would not be the way to remedy such a defect.

Another view, however, is that there is no meaningful way to distinguish between corporations and partnerships for tax purposes. But even under this position, there remains the question of why certain business firms should be entitled to choose the set of rules controlling how their income is taxed. In general, the tax system does not permit taxpayers to elect the rules applicable to them. Rather, the system generally attempts to impose tax rules that follow and are consistent with some economic characteristic of the taxpayer or the taxpayer's activities. It is unclear why the check-the-box regulations should deviate from this usual approach.

If the taxpayer is well-advised, the election, which has ramifications for tax purposes only, will always be to the detriment of the fisc. One recent study of a pre-1986 Act year found, not surprisingly, that the “S” election—another election of significance for tax purposes only—was driven largely by tax factors. For example, “S” status was chosen by a higher proportion of corporations with losses than those with positive taxable income. In contrast, “C” status tended to be chosen by corporations with very low levels of positive taxable income, to take advantage of the graduated corporate tax rates. Taxpayers might also try to change elections as their tax situations change. There is no particular policy reason for the entity classification decision to always result in the minimization of tax liabilities for the well-advised.

Finally, elections are inherently costly and complex for the taxpayer. The taxpayer must incur the transaction cost of evaluating all tax consequences of the available options before making an informed choice. Furthermore, there is always the possibility of error in making that choice. In that regard, the twelve-year experience with former Subchapter R of the Code may be instructive. Subchapter R was enacted in 1954 to provide certain proprietorships and partnerships with an election to be taxed as corporations. The provision was repealed in 1966 because fewer than 1000 businesses had elected the option and in a number of cases, it had proved to be a trap for the unwary. Specifically, certain subsequent changes to the business were found to result in an unexpected liquidation.

27. The check-the-box regulations generally require an election to remain in effect for at least five years unless there is a greater than 50% change in the ownership of the firm. See Treas. Reg. § 301.7701-3(c)(1)(iv) (1996).
tax being imposed on the enterprise.  

B. Should Public Firms Be Ineligible to Make the Explicit Classification Election?

Assuming that there is an election, should public firms be entitled to make it? With certain exceptions, section 7704(a) classifies a publicly traded partnership as a corporation for tax purposes. Thus, public firms generally must be taxed under Subchapter C and cannot elect to be taxed under Subchapters K or S. The question is whether such a classification line is sensible from a policy standpoint.

Section 7704 was enacted in 1987 largely as a stopgap measure in response to changes effected by the Tax Reform Act of 1986 that made partnership classification for tax purposes much more attractive than previously. Just four years earlier, the Treasury had testified that it had serious doubt that one would conclude that the degree of marketability of an organization's equity interests should determine the manner in which the organization is taxed. We are also not convinced that access to a rational system of pass-through taxation should be restricted on the basis [of whether the organization's ownership interests are publicly traded].

Yet in the face of Burger King, the Boston Celtics, and other business organizations transforming themselves into publicly traded partnerships, and the consequent specter of an eroding corporate tax base, the Treasury changed its view and supported enactment of section 7704.

Part of the rationale behind section 7704 was that the presence of public trading tipped the balance in favor of "corporation" status when one attempted to weigh the various corporate resemblance factors. As the Treasury stated in 1986 in explaining its change of view:

As we did in 1983, we recognize now that some publicly traded limited partnerships will differ in only minor respects from other widely held, but not publicly traded, limited partnerships. The proposal we make today is not based on the view that publicly traded limited

31. There is an important exception to § 7704(a) for publicly traded partnerships that have at least 90% of their gross income consisting of passive-type income such as interest and dividends, or income and gains from real property and mineral or natural resource exploration or development. See I.R.C. § 7704(c), (d) (1994). Such partnerships, though publicly traded, may apparently make the check-the-box election.
32. Reform of Corporate Taxation, Hearing Before the Comm. on Finance, U.S. Senate, 98th Cong. 63 (1983) (statement of Ronald A. Pearlman, Deputy Assistant Secretary for Tax Policy, Dep't of the Treasury) [hereinafter Pearlman Statement].
partnerships are different in kind from all other partnerships, but on
the view that public trading in the interests of a limited partnership is
indicative of the existence of the other, more relevant, classification
factors . . . that may, to a lesser extent, be present in many other
partnerships.\textsuperscript{34}

But in a world where the "other, more relevant, classification factors"
have been rejected as a basis for distinguishing between corporations and
partnerships for tax purposes, the question is whether the presence of
public trading \textit{alone} is sufficient to classify a business entity as a corpora-
tion. As the Treasury originally stated in 1983, it is difficult to see why it
should. If one starts with the proposition that the mere free transferabil-
ity of ownership interests does not, by itself, cause partnership status to
be unavailable—and the provisions of Subchapter K certainly contem-
plate some degree of transferability of interests\textsuperscript{35}—then it is hard to un-
derstand why the transfer of such interests in a more efficient manner,
upon creation of some type of market for the interests, should jeopardize
the attainment of that status.\textsuperscript{36}

One argument is that the liquidity resulting from public trading pro-
vides better access to capital markets and that it is therefore appropriate
to tax that special benefit of organizations with publicly traded inter-
ests.\textsuperscript{37} But the corporate tax is not typically thought of as a tax in ex-
change for benefits received, and in any event, there is no indication that
the amount of the tax properly reflects the value of the benefit. More-
over, private firms can also gain access to public capital markets through
financial intermediaries. Thus, it is not logical to penalize (through differ-
tential taxation) firms merely because they can access the markets di-
rectly. Finally, access to capital markets may simply mean access to
capital provided by smaller investors who may be less willing and able to
make illiquid investments. It is not clear why non-publicly traded firms
with access to investors willing to make large capital investments should
be provided with a competitive advantage over publicly traded firms.

Another argument is that public trading is a relatively inelastic feature
of a firm which is not likely to be affected by the existence of an addi-
tional tax burden.\textsuperscript{38} Thus, imposing an extra tax on firms because their
interests are publicly traded might be in the nature of a nondistortive
lump-sum tax. In fact, however, the tax may not have that effect. The tax
may simply cause capital flows to shift from publicly traded firms to non-

\textsuperscript{34} \textit{Mentz} 1986 statement, \textit{supra} note 33, at 31; \textit{see also} Sexton & Osteen, \textit{supra} note 6, at 147-48.

\textsuperscript{35} \textit{See} I.R.C. §§ 741-743 (1994).

\textsuperscript{36} \textit{See} Keyser, \textit{supra} note 6, at 532-33. Moreover, under the former classification
regulations, free transferability of interests was considered a corporate characteristic only
if it applied to the transfer of \textit{governance} rights. Free transferability of \textit{economic} rights,
alone, did not count as a corporate characteristic. \textit{See} Former Treas. Reg. § 301.7701-
2(e)(1); \textit{see also} Brannan, \textit{supra} note 6, at 222-23. Yet presumably, the advantage of public
trading relates much more to the transfer of economic rights rather than governance rights.

\textsuperscript{37} \textit{See} Fleischer, \textit{supra} note 2, at 365.

\textsuperscript{38} \textit{See} Rebecca S. Rudnick, \textit{Corporate Tax Integration: Liquidity of Investment}, 42
\textit{TAX NOTES} 1107, 1114 (1989).
publicly traded ones until a new equilibrium is established.\textsuperscript{39} Moreover, inelasticity assumes a rather radical discontinuity between public and non-public trading that may not exist, given the many shades of trading leading up to, but not qualifying as, public trading. Finally, even if it were true, the inelastic nature of public trading, on its own, does not provide a normative basis for imposition of the tax.

A final argument concerns the difficulty of applying operating rules such as those in Subchapter K to an organization with publicly traded ownership interests. The 1984 ALI Subchapter K report, for example, recommended that publicly traded entities not qualify for partnership treatment primarily because of the audit difficulties created.\textsuperscript{40} The legislative history to section 7704 reveals a similar concern:

[B]ecause of the trading in interests, these partnerships present unique administrative difficulties and enforcement concerns if the tax law relating to partnerships is applied to them. The partnership tax rules under present law contemplate an entity in which the identity of the investors is known and transfers of interests are easily identifiable, and public trading in partnership interests does not conform to this model.\textsuperscript{41}

Partnership audit rules and computer advances may have mitigated some of these concerns. To the extent they have not, the question is whether the public trading aspect of the firm's ownership interests creates a measurably different and more difficult problem than that encountered by virtually every business entity beyond the most basic. For example, the IRS would presumably face many of the same problems in auditing a multi-member LLC with easily transferable ownership interests. Indeed, a publicly traded and registered entity may actually be easier to audit than a large non-publicly traded firm because of the federal and state reporting requirements imposed on the former and the resulting greater public scrutiny.\textsuperscript{42}

In summary, if difficulty with the administration and enforcement of operating rules is the underlying rationale for excluding publicly traded organizations from making the classification election, then the limitation may be too narrow. Similarly situated organizations, though without publicly traded ownership interests, may present the same or greater problems and should therefore be subject to the identical exclusion. For


\textsuperscript{42} See Pearlman Statement, supra note 32, at 64. See also Issues Relating to Passthrough Entities, Hearings Before the Subcomm. on Select Revenue Measures of the Comm. on Ways and Means, House of Representatives, 99th Cong. 40, 42 (1986) (statement of William S. McKee) (publicly-traded partnerships are "probably the cleanest tax report entities that we have").
the same reason, publicly traded firms with income and gain mostly from
real estate, mineral, and oil and gas activities should lose their exception
from section 7704 and should be barred from making the election. More importantly, however, permitting the legitimate concern with rule
administration and enforcement to dictate the level of tax liability would
seem to put matters exactly backwards. As one commentator has said,
administrative rules should carry out substantive provisions, including the
policy determination of how much tax should be paid, and not vice-
versa.44

C. SHOULD STATE LAW CORPORATIONS BE INELIGIBLE TO MAKE
THE CLASSIFICATION ELECTION?

Prohibiting state law corporations from making the election would
seem to throw the classification issue back into the hands of state legisla-
tors. For example, states might respond to the prohibition by enacting
business organization statutes mirroring existing corporation statutes, ex-
cept that the business would be required to file “articles of organization”
instead of “articles of incorporation” so that it would not technically be a
state law corporation. The new business form might be called an “un-
corporation,” but with all the same rights and responsibilities as existing
corporations.45 Obviously, such mirror statutes would be vulnerable
under a “substance over form” challenge, yet it is exactly that type of
challenge that the IRS has relinquished by adopting the check-the-box
regulations.46 If the state law characteristics of an entity no longer matter
in determining how the entity should be taxed, then firms organized
under “uncorporation” statutes should be entitled to make the check-the-
box election.

It would be neither wise nor efficient to force states to enact such stat-
utes one by one, or gradually to amend their LLC or other statutes to
provide businesses with more and more “corporate” rights and responsi-
bilities.47 Rather, under an elective classification approach, it would be

43. See I.R.C. § 7704(c), (d) (1994).
44. See Donna D. Adler, Master Limited Partnerships, 40 U. FLA. L. REV. 755, 784
(1988).
45. See Robert R. Keatinge, Corporations, Unincorporated Organizations, and
Unincorporations: Check-the-Box and the Balkanization of Business Organizations, 1 J.
SMALL & EMERG. BUS. LAW, 201, 241 (1997).
46. To challenge the eligibility of “uncorporations” to make the election, the IRS
would have to assert that firms organized under such a statute so closely resemble a corpo-
ration that they should be treated like one. Yet it is exactly such a test—a “corporate
resemblance” standard—that was previously in place and that the check-the-box regula-
tions have specifically overturned. It therefore would be nonsensical for the IRS to try to
resurrect the argument so soon after its repudiation.
47. This process has already begun. For example, during its 1997 session, the Virginia
General Assembly deleted the provision in Virginia’s LLC statute requiring that the arti-
cles of organization of such an entity state the latest date on which the entity must be
(resulting in a rule that permits LLCs to have perpetual duration just like corporations);
see also Payson R. Peabody, Check-the-Box Treasury Regs. Encourage States to Authorize
Single-Member LLCs, 7 J. MULTISTATE TAX’N 79 (1997) (describing other amendments to
much more sensible to permit state law corporations to “check the box” as well.\textsuperscript{48} Such a step would at least preserve the established jurisprudence of corporate law rather than encouraging the case-by-case development of “uncorporation” law. It would also clearly establish “public trading” as the only remaining classification factor for general business firms. Assuming that public firms are not allowed to check the box, they would be taxed under the rules of Subchapter C and all other firms (including private corporations) would be entitled to elect the tax regime under which they will be taxed.

D. Why Should Private Business Firms Be Entitled to Choose Among Subchapters C, S and K As Their Applicable Method of Taxation?

There remains the further question of why private business firms should be able to choose among Subchapters C, S and K for their applicable tax rules. In other words, assuming such firms are entitled to “check the box,” why are there so many boxes to check, and why should there be these particular boxes? The three sets of tax rules were each designed with a particular business organization form in mind—Subchapters C and S for corporations and Subchapter K for a general partnership—yet the clear message of the check-the-box regulations is that business organization form and characteristics generally do not matter for tax purposes.

If the three sets of rules produced more or less the same tax consequences in most situations, the choice among them would not be especially significant. But that is not the case. In any given situation, Subchapters C, S or K might provide an advantageous tax result for particular taxpayers. For example, Subchapter C generally offers graduated tax rates for the business income of firms subject to those rules,\textsuperscript{49} and there are a host of special tax provisions limited to Subchapter C firms.\textsuperscript{50} Subchapter K offers the purest form of conduit taxation under which the entity is not taxed and business income and losses are passed through to

\textsuperscript{48} The REMIC and FASIT legislation disregards the organizational form of the business entity and permits state law corporations, partnerships, and trusts all to elect the special pass-through tax treatment authorized by the legislation. \textit{See} I.R.C. §§ 860D(a), 860L(a)(1) (1994); \textit{Tax Reform Act of 1986, Conf. Report to Accompany H.R. 3838, H. CONF. REP. No. 99-841, vol. II, at 226 (1986) (any entity, including a corporation, partnership, or trust, meeting certain requirements may elect to be treated as a REMIC).}

\textsuperscript{49} \textit{See} I.R.C. § 11(b). If the shareholder tax of a Subchapter C firm is deferred or reduced sufficiently or eliminated altogether, the graduated rate structure can mean that business income is taxed more favorably under Subchapter C than under either Subchapters S or K.

\textsuperscript{50} \textit{See, e.g.,} I.R.C. §§ 465(a)(1)(B), 469(a)(2)(B) (1994) (at risk and passive activity loss rules generally applicable only to certain closely held C corporations).
the owners of the firm. Subchapter S offers another form of conduit taxation that is in many cases less advantageous than Subchapter K, but in certain cases, more advantageous.51

In short, even assuming that there is a good policy basis for taxing private firms differently from public ones, there does not seem to be any particular theory to support the current outcome under check-the-box, where private firms are entitled to select among Subchapters C, S, and K for their applicable tax regime. By providing such disparate choices without any apparent underlying conceptual foundation, the law has simply provided a tax benefit for the well-advised and a trap for the ill-advised. But if the existing choices are irrational, how should the law be changed? How should private firms be taxed? These issues are addressed in the next part.

E. How Should the Income of Private Business Firms Be Taxed?

With the loss of the “anchor” of state law characteristics to guide how a business should be taxed, there would seem to be only two choices available to policymakers. One option is to adopt “conduit” taxation of all private business firms, no matter how organized, and to disregard the firm as a taxpayer separate and apart from its owners. Rather, the firm would be transparent for tax purposes; its various tax characteristics would pass through to the owners of the firm, the real (and only) taxpayers in interest. Under current law, the purest form of conduit taxation is found in the partnership tax rules of Subchapter K.

The other choice is to adopt “entity” taxation of private business firms, and to treat the firm as a taxable entity in its own right. Although entity taxation is often associated with “double taxation,” it need not have that consequence. For example, in 1992, the Treasury Department recommended exploration of an approach, termed the Comprehensive Business Income Tax (CBIT), which would subject the income of all business enti-

51. For example, § 752 generally permits the owners of a Subchapter K firm to include their share of entity-level debt in their basis in the ownership interests of the firm whereas there is no comparable rule for Subchapter S firms. Also, contributions and distributions of property between an owner and the firm are more likely to be tax-free under Subchapter K than Subchapter S. Compare I.R.C. §§ 721, 731 (1994) with I.R.C. §§ 351, 311, 336, 331, 1368 (1994). Furthermore, Subchapter K but not Subchapter S firms may specially allocate their tax items among their owners. Compare I.R.C. § 704(a), (b) (1994) with I.R.C. § 1377(a) (1994). Finally, only Subchapter K contains an elective procedure for adjusting the inside basis of the firm’s assets to be consistent with the outside basis of the owners in their ownership interests in the firm. See I.R.C. § 754 (1994). This last provision is particularly advantageous to taxpayers where there is a death of an owner and the inside basis of the firm’s assets can be changed to take into account the resulting § 1014 adjustment to the basis in the ownership interests.

On the other hand, there exists in subchapter K but not subchapter S a variety of complicated rules designed to prevent tax advantages in selected situations. See, e.g., I.R.C. §§ 704(c), 707(a)(2), 707(b), 724, 731(c), 735, 737, 751 (1994). In addition, conversion of a firm from C to S corporation status is tax-free (not so for C to K conversions), and S corporations, but not Subchapter K firms, can participate in a tax-free reorganization.
ties (except for extremely small ones in terms of gross receipts), including sole proprietorships, partnerships, corporations, and firms organized in other business forms, to a single, comprehensive entity-level tax, with generally no further income tax consequences at the owner level. 52 Other similar proposals have been made over the years. 53 The Treasury estimated that CBIT would produce greater welfare gains than any other form of corporate integration, including the Treasury's version of partnership-style integration.

The next sections briefly explore some of the pros and cons of conduit and entity taxation.

1. The Basic Case for Conduit Taxation

The most basic form of business is the sole proprietorship. Sole proprietors have historically been taxed directly on their proprietorship income as it arises and been entitled to deduct currently any losses of the enterprise as they arise. The business itself has not been subject to a separate federal income tax. It would theoretically be possible to treat a proprietorship as a taxpayer separate from its proprietor, but such a system would be very problematic, depending upon the applicable tax rate structure. For example, if all proprietorships were treated as taxpayers subject to a flat thirty percent income tax rate, then taxpayers in marginal tax brackets higher than thirty percent might be encouraged to redesign their economic arrangements to generate proprietorship income for themselves rather than wages or other income. 55 Meanwhile, proprietors in marginal tax brackets less than thirty percent might be encouraged to employ the opposite strategy. For instance, they might increase the level of deductible salary payments paid by their proprietorship to themselves. Given the absence of arm's length dealing in a proprietorship, it would presumably be extremely difficult for the IRS to monitor and prevent purely tax-motivated recharacterizations of this sort.

Assuming proprietors are to continue to be taxed directly on their business income and losses, it follows that businesses with more than one owner should likewise be taxed as conduits. If the proprietorship is not treated as a separate taxpayer, it is difficult to see why, for example, a two-person general partnership should be so treated. Further analogies then might suggest that no business firm should be separately taxed. As an economic matter, if proprietors are taxed directly on their proprietor-

54. See TREASURY INTEGRATION REPORT, supra note 52, at 134 (table 13.8), 139.
55. This discussion ignores the potentially significant effect of employment and state and local taxes on the choice of compensation arrangement.
ship income, but partnerships (and not the partners) are taxed on the 
partnership income, then the tax system will have created an undesirable 
barrier against, or inducement in favor of, the pooling of resources via a 
partnership.

True, the state law characteristics of a proprietorship may be different 
from those of many other business forms. Unlike a proprietorship, other 
forms of business organization are treated for an increasing number of 
state law purposes as legal entities separate from their owners. For exam-
ple, under the recently Revised Uniform Partnership Act (RUPA), the 
withdrawal of a partner from a partnership causes the dissolution of 
the partnership only in limited circumstances. RUPA also makes clearer 
that a partner is not co-owner of the underlying property of the part-
nership; rather, the only transferable interest of a partner in the partnership 
is the right to share in profits and losses and to receive distributions. 
Other forms of doing business, such as limited partnerships, LLCs, lim-
ited liability partnerships (LLPs), limited liability limited partnerships 
(LLLPS), and of course, corporations, justify an entity interpretation of 
the business because, among other things, they generally insulate the 
owners from the entity's liabilities. Further, for reasons previously men-
tioned, the check-the-box regulations may accelerate these state law 
trends, with future approval by the states of non-corporate business forms 
having more and more entity characteristics.

But perhaps such state law differences among business entities should 
be largely ignored in deciding upon the method of taxing such entities. 
Given the ineffectiveness of the corporate resemblance classification test, 
the nature of the check-the-box substitute, the recent history of state law 
experimentation regarding forms of business organizations, and the likeli-
hood that such experimentation will continue, perhaps state law charac-
teristics should generally not be a factor in determining how the income 
of an entity should be taxed. Rather, we should consider the relevant tax 
policy considerations.

The strongest tax policy argument in favor of the conduit approach is 
that people pay taxes, not entities, and that people should pay income

57. See id. § 801. See generally id. § 201 ("[a] partnership is an entity distinct from its 
partners"), id. § 201 ("RUPA embraces the entity theory of the partnership"). As of the 
end of 1995, seven states had adopted the RUPA. Although the Uniform Partnership Act 
(UPA) included certain entity-type characteristics for partnerships, particularly relating to 
the rights of the entity to own and convey property, the Act generally favored an aggregate 
interpretation of the partnership. See Uniform Partnership Act §§ 8, 10, 25, 26, 6 
U.L.A. 125 (1995) [hereinafter UPA]. Examples of the UPA's aggregate approach 
included its provisions relating to the joint and several liability of partners for partnership 
debts, the rights of all partners to manage and conduct the business of the partnership, and 
the dissolution of a partnership upon any partner's ceasing to be associated with the 
business. See id. §§ 15, 18(e), 29.
58. See RUPA, §§ 501, 502.
(1972) (arguing that correlation between taxation method and relationship under state law 
of an entity to its owner has "relatively limited explanatory value").
taxes in accordance with their ability to pay. The use of an entity to generate income should not interfere with that basic objective. Hence, the entity should be disregarded for tax purposes and the income of the entity should be taxed directly to its owners. Entity losses should similarly be passed through and netted against any income of the owners. A further argument, as mentioned initially, is that adoption of a tax system other than a conduit approach would seem to distort the choice of business form, given how proprietorships are taxed.

But these arguments may only be applicable to a theoretically ideal form of conduit taxation. For reasons detailed in the next section, if a conduit approach is considered in actual practice, it may be that such an approach does not accomplish either policy objective very well while, at the same time, spawning significant transactions costs.

2. The Fundamental Difficulty of Conduit Taxation and the Case for Entity Taxation

The theoretical reasons favoring conduit taxation would lead one to conclude that entity taxation is unacceptable. For example, if we take as a given that people and not entities pay taxes, and that people should pay income taxes in accordance with their ability to pay, then it would seem odd and inconsistent with those premises to impose a separate income tax on the business entity itself. Despite the nominal incidence of the tax on the business, some people will still pay it; we just will not know who. Similarly, it would seem impossible to determine the proper rate for an entity tax. For instance, if the owners of the firm indirectly bear the burden of the entity-level income tax, then the proper rate for the tax should presumably be tied to their ability to pay. But how should the entity tax rate be determined when the ability to pay of the owners is different from one another?

But the case for entity taxation is essentially a negative one. Specifically, if it is not possible to design a workable conduit tax system that is broadly applicable to most private business firms and consistent with general income tax principles, then an entity tax approach may be worth a second look. To illustrate some of the difficulties with conduit taxation, the balance of the discussion will focus mainly on the partnership tax rules—Subchapter K—because they represent the most refined example of conduit taxation in existence.

Under conduit taxation, if a business firm earns $300 in taxable profits in a given year, a total of $300 of taxable income must be currently included in the tax base of the owners of the firm. But how much should be included in whose base? The difficulty in answering that question is the fundamental problem of any conduit system.

The source of the difficulty is the fact that income and other items realized by many business entities are treated under state law as belonging to the entity and not to the owners. The receipt by the owners of the entity's income, for example, may arise only upon a distribution from the
entity. Yet consistent with basic income tax principles, tax reporting of the income cannot await a distribution. Someone must include it in that person's tax base when the income arises. Thus, if there is no distribution and the income is retained by the entity, there must nevertheless be a current allocation of the income among the owners to permit them to report currently their share of it.

How is the allocation of income and other items determined for tax purposes under current law? Subject to several conditions to be described in part III of this Article, current law permits the allocation of tax items to be made with great flexibility. Indeed, the general rule for a partnership allows the determination to be made by the partners in their partnership agreement. Hence, the partners might agree to allocate the income equally among themselves, or to allocate all of the income to only one partner, or to provide for any other sharing arrangement. The only limitation is that all of the partnership's taxable income must be reported by some partner or partners for the year. The partners also may allocate to themselves different shares of each partnership tax item in any given year, and may vary the allocation of each such item from year to year.

Why are the tax rules so liberal in permitting partners to divide up the tax consequences of their partnership's activities? The principal reason is to accommodate the economic flexibility desired by the partners. In a typical law partnership, for example, the partners might share the economic benefits and burdens of the firm arising during the year based on a host of factors, including the number of hours billed, the amount of new business obtained, the profitability of the branch of the firm in which most services were performed, the time spent on firm management responsibilities, and so forth. Similarly, in a real estate partnership, the partners might look to the relative contributions by the partners of capital and services, the nature and timing of the services provided, the comparative risk aversion or desire for reward of the partners with respect to certain of the properties of the firm, and other factors. There are presumably welfare gains in permitting the partners the flexibility to arrange their economic affairs in this manner. Thus, the tax sharing rules are flexible to permit consistency with flexible economic sharing arrangements. Indeed, the tax shares can even be determined with hindsight, that is, after the end of the year in question, again to accommodate the often hindsight determinations of economic shares.

But flexible tax sharing rules also may be used simply to minimize the collective tax liabilities of the partners, to the detriment of the Treasury and all other taxpayers. By allocating items to the partner who is in a position to utilize them most favorably for tax purposes, the partners can put their respective tax advantages to best use and share in the resulting tax savings. As Professor Surrey and others stated with some concern when special allocations were first permitted in 1954:

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60. See I.R.C. § 704(a) (1994).
parties, perhaps for the first time in the history of the tax laws, will be permitted to agree on the incidence of tax; to agree as to which of several co-earners of income shall be entitled to specific items of income and of income tax deduction and credits. Capital gains could be allocated on one basis, dividends on another, tax-free interest in accordance with still another ratio. By agreement, operating expenses, depletion or depreciation could all be allocated in differing proportions.

The ability to contract with respect to specific items of income, and particularly with respect to specific items of deduction and credit, would give the ingenious businessman and his lawyers the utmost flexibility in devising a variety of novel and unique business arrangements.61

Is there anything wrong with the partners minimizing their collective tax liabilities in that manner? The objection, often unstated, is the concern that the partnership vehicle permits the taxpayer to obtain a more favorable tax result than the one that would arise had the taxpayer simply owned a share of the business's assets directly.62 Thus, assume a taxpayer would have had $100 of taxable income from a share of certain real estate assets had the taxpayer owned that share directly. Assume that with $100 of income for the year from the asset, a portion of the taxpayer's net operating loss carryover would have expired unused. To preserve the integrity of the taxable unit, the tax laws presumably should not permit the taxpayer to join up with two others, obtain a special $300 allocation of taxable income for the year (representing the taxpayer's share of income from the asset and the share of the taxpayer's partners), offset it with a disproportionately small allocation of income in future years, and thereby make greater use of the carryover than would otherwise have been possible. A tax system allowing that result neither protects vertical equity objectives nor is neutral in the choice of business form, the two strengths initially identified for the conduit approach.

Can such tax advantages be prevented? The basic technique, and the one attempted in the partnership tax area, is to link the allocation made for tax purposes to the economic allocation of the parties. Thus, for example, if the $300 in income from the real estate asset were all distributed to the taxpayer because of some priority interest the taxpayer had in the asset generating the income, then it might be appropriate to allocate the $300 of taxable income all to that taxpayer. Again, it is worth comparing the partnership investment to a direct ownership in the assets. Had the partners owned the assets directly and only one of the partners received all of the income, it might be perfectly consistent with income tax princi-

62. Cf. Treas. Reg. § 1.701-2(c)(1) (as amended in 1995) (potential applicability of partnership anti-abuse regulation if "[t]he present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly").
amples to tax that same partner, and none of the others, on all of the income.

The problem, however, is that so long as there is state law separation between the entity and the owners—that is, the owners do not, in fact, own the assets directly but instead only own interests in the firm which owns the asset—the economic baseline against which the tax allocation needs to be compared is necessarily missing. We simply do not know how the partners would have shared the $300 if it is retained rather than distributed by the firm. Indeed, in many cases, the partners themselves do not even know how they would have shared the money because their "deal" may extend far beyond the economic results of the first year. But without that piece of information, it is not possible to fashion a workable rule that can ferret out purely tax-advantaged allocation arrangements under a conduit method of taxation.\(^6\)

In summary, the central flaw of conduit taxation is its inability to provide assurance that the proper amount of business income and loss for any given year is allocated and taxed to the proper owner. Under the conduit method, allocations of entity tax items may have no grounding in economic substance due to the absence of an economic baseline against which the allocation can be tested. In addition, the validity of allocations cannot even be tied to matters of legal form because it is the entity, and not the owners, that maintains legal ownership of the items in question. As a result, the conduit approach is unable to protect vertical equity norms; that objective may be thwarted, for example, by allocating to a high-bracket owner a disproportionately small share of the entity’s income for a given year. Further, the choice of business form is distorted by the existence of tax advantages available only to businesses with more than one owner, which are taxed as conduits. Although the law has certainly evolved well beyond its state in 1954, Professor Surrey’s concerns at that time with the potential flexibility of special allocations still seem to be appropriate.\(^6\)

3. **Administrability Concerns**

The discussion thus far would seem to have exposed major flaws in both conduit and entity taxation. Although the latter would tax the business income at the wrong rate, the former cannot provide assurance that the proper amount of business income is to be taxed to the right taxpayer. So which approach is preferable?

There is no easy answer to that question. Concerns about the ease with which the IRS can administer the rules and taxpayers can comply with them, however, should obviously play a role in deciding the preferred approach. Otherwise, any rules developed risk being a mere facade, a

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\(^6\) See supra note 61 and accompanying text.
nice theoretical way of imposing taxes on business income that is not matched by real world consequences to most taxpayers. Administrability concerns are particularly significant given the liberal access to the rules provided by the check-the-box regulations to taxpayers with widely differing levels of sophistication and tolerances for complexity. Based on this factor, the conduit system epitomized by Subchapter K begins with a couple of very black marks.

For one thing, Subchapter K is notoriously difficult to comprehend and apply. Many analysts have suggested that there may be widespread disregard of one or more of the existing rules because of the inability of firms and their advisors to apply them correctly and of the IRS to administer them. Indeed, back in 1986—which is practically the Dark Ages from the standpoint of the development and resulting complexity in Subchapter K—one tax expert estimated a mere two and one-half percent compliance rate with one particular partnership provision. More recently, another distinguished tax expert, a former Chief Counsel of the IRS and Chair of the ABA Section of Taxation, has conceded the need to enlist expert assistance to give advice on core portions of the partnership tax law. In addition, the General Accounting Office has reported on the ineffectual nature of the IRS’s strategy for ensuring compliance among partnerships and their partners.

Second, the partnership tax rules were recently made even more difficult by the adoption of a general “anti-abuse” regulation in Subchapter K. The regulation expressly grants the Commissioner authority to recast a partnership transaction if a principal purpose of the transaction is to reduce substantially the present value of the partners’ aggregate federal income tax liability in a manner that is inconsistent with the intent of

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65. See Issues Relating to Passthrough Entities: Hearings on H.R. 1658, 2571, 3397, 4448 Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means, 99th Cong. 56 (1986) (statement of Joel Rabinovitz) (section 751(b) is probably overlooked in 90% of the cases in which it applies, is ignored in another 5% of the cases because the cost of compliance would be so high, and is misapplied by the IRS in another 2-1/2% of the cases). See Sheldon I. Banoff, The Use and Misuse of Anti-Abuse Rules, 48 TAX LAW. 827, 829 n.17 (1995). Banoff describes how most taxpayers and their advisors employ a “common sense” approach to the tax law (i.e., it is cheaper to guess the right answer than to research it thoroughly; it is easier to take an aggressive reporting position than it is to plan prophylactically; it is simpler to make a “reasonable” estimate than to compile detailed records of substantiation).

Subchapter K. The recharacterization may take place “even though the transaction may fall within the literal words of a particular statutory or regulatory provision.” In addition, regarding the intersection between the partnership provisions and other aspects of the Internal Revenue Code, the regulation authorizes the Commissioner to treat a partnership as “an aggregate of its partners” if appropriate to carry out the purpose of such other parts of the Code. “Aggregate” treatment apparently means that the partners are deemed to own directly the assets, and participate directly in the activities, of the partnership.

Although there continues to be some disagreement as to the meaning and scope of the regulation, as well as its wisdom and validity, the adoption of the regulation is certainly not a positive sign regarding the general health of the Subchapter K rules. Indeed, some of the commentary published in response to the proposed version of the regulation illustrates examples of transactions meeting the literal terms of the statute or regulations yet reaching seemingly nonsensical results. The approach of the final regulation is to modify the result of dysfunctional cases only where that result was the motivating factor for the parties to the transaction.

Yet, it is unclear why tax results should turn on one’s state of mind, even if that state could be accurately ascertained. Put another way, the dys-

68. See Treas. Reg. § 1.701-2(b) (as amended in 1995).
69. Id.
71. See Treas. Reg. § 1.701-2(f) ex. (1), (2) and (3).
74. Cf. Treas. Reg. § 1.701-2(d), (8), (9), (10), (11).
75. See ALI 1984 Subchapter K Proposals, supra note 40, at 245 (arguing against subjective intent test in determining validity of tax allocation); Walter J. Blum, Motive, Intent and Purpose in Federal Income Taxation, 34 U. CHI. L. REV. 485, 515 (1967) (“If tax-reducing actions are to pass muster but tax avoidance actions are to be penalized, some way of distinguishing between the two must be found. The trouble is that, as a mental
functional rule would seem to be the source of the problem, not the taxpayer’s state of mind.

Finally, whatever one might think of the merits of the anti-abuse regulation, it is evident that if one were writing on a clean slate, one would not adopt a set of operating rules like Subchapter K that first touts their flexibility, then proceeds to restrict that flexibility with a series of highly complex mechanical and sometimes subjective tests, and then overlays on top of those tests a relatively amorphous supertest authorizing the disregard of the consequences of earlier tests despite plain compliance with them. Indeed, the general anti-abuse rule may apparently apply to negate a taxpayer’s successful navigation of other anti-abuse rules adopted to monitor particular types of partnership-related transactions. Something very fundamental must be awry in the basic structure of the rules for the law to have evolved into this unhappy state.

4. Summary

The key question facing policymakers in a post-check-the-box world is how private business firms should be taxed. Until now, the tax rules have been tied at least in part to the state law organizational form and characteristics of the firm. But with removal of that important anchor by the check-the-box regulations, more creative solutions are needed.

The two basic choices are to tax all private business firms, regardless of organizational structure, as a conduit or as a separate entity. Each option contains a fundamental flaw. Entity taxation can result in the taxation of business income at the wrong rate. Conduit taxation, however, can permit a misallocation of the tax base among the taxpayers involved. Therefore, no obvious answer exists regarding which option is preferable. The choice should perhaps be resolved based upon administrability concerns: which tax system would be the simplest from the standpoint of taxpayer compliance and IRS review? Part III considers that question in the context of one important issue.

phenomenon, a desire to minimize taxes does not differ from a desire to avoid taxes”); Edwin S. Cohen, Taxing the State of Mind, 12 TAX EXECUTIVE 200, 218 (1960) (“[t]o [make tax consequences] depend upon selecting and weighing the motives or state of mind which prompted his action is a far more complex assignment, and one which I believe we should endeavor to avoid.”).

78. See Treas. Reg. § 1.701-2(d), ex. (8)(iii) (general anti-abuse rule may recast transaction already subject to (and presumably satisfying the requirements of) anti-abuse disguised sale rule in section 707).
III. THE PROPER ALLOCATION OF NONRECRUSE DEDUCTIONS IN A POST-CHECK-THE-BOX WORLD

A. INTRODUCTION

This part concerns one issue illustrating the conceptual and administrative difficulties of implementing a conduit tax system for private business enterprises in a post-check-the-box world. The issue is the proper tax treatment of liabilities incurred by a business firm providing limited liability protection to all of its owners. Under entity taxation, such liabilities would be treated by the entity for tax purposes under normal income tax principles. For example, liabilities incurred in acquiring an asset would ordinarily be included in the entity's basis in that asset. If the asset is depreciable, the depreciation deductions of the entity would be a function of the entity's liability-included basis in the asset. Finally, if the debt is nonrecourse, then upon disposition of the property secured by the liability, the amount realized by the firm in the disposition would ordinarily include the full amount of the liability still outstanding.

Conduit taxation relies on the same principles but introduces one additional issue. Because the owners of the firm, and not the entity itself, are the taxpayers under a conduit system, some method needs to be developed to determine the share of each owner in the liabilities of the firm and the tax items (such as depreciation deductions) arising from those liabilities. This task is made more difficult if, under state law, the owners of the firm are insulated from liability for the entity's debts. In that case, the owners must be allocated for tax purposes shares of the entity's liabilities for which they bear no economic risk.

To illustrate, consider a partnership that is capitalized with $3,000 from its partners. The partnership borrows an additional $7,000 to purchase a $10,000 piece of depreciable equipment to be used in the partnership's business. Assume that the equipment can be written off for tax purposes over ten years in a straight-line manner. If the partnership were taxed as a separate entity, then it would be entitled to a $1,000 depreciation deduction ($10,000 total basis + 10) in its first year. If, however, the partnership is taxed as a conduit, then the $1,000 deduction must be allocated among the partners, to be claimed on their own tax returns. In addition, because the partners collectively have only invested $3,000 in the partnership, their basis in their partnership interests must in some way be increased by the $7,000 liability in order to replicate the $10,000 basis they would have had if they had made the same investment directly. And the same allocations must be made even if the firm is organized as an LLC.

80. See I.R.C. §§ 167(c), 1016(a) (1994).
and the owners therefore never have any personal obligation to repay the firm's $7,000 debt.

The following sections summarize the current law rules, explain why the rules are inadequate, and offer some ideas for possible improvement.

**B. Current Law**

As previously mentioned, current law permits partners to determine their respective shares of the tax items of their partnership by private agreement. They may determine different shares for each tax item and may change the shares from year to year. They may also make the determination with the benefit of hindsight, that is, after the tax items of the partnership have been completely ascertained. To be sustained by the IRS, however, an allocation must have "substantial economic effect." If it does not, or if the partners do not agree upon an allocation, a partner's share of tax items is determined in accordance with the partner's interest in the partnership (PIP).

To have substantial economic effect, an allocation must satisfy both the "economic effect" and "substantiality" tests. The purpose of the "economic effect" test is to ensure that any allocation for tax purposes is consistent with the economic allocation of the partners. In other words, if there is an economic burden or benefit corresponding to a particular tax item, the partner to whom the tax item is allocated must receive the economic benefit or bear the economic burden. In general, the regulations implement the "economic effect" test by requiring that the capital accounts of the partners—the accounts that keep track of the economic arrangement of the partners between and among themselves—be maintained in a certain way, be adjusted in the same manner as the allocation of tax items, and be respected by the partners in determining their economic interests in the partnership. By maintaining, adjusting, and respecting capital accounts in the manner indicated, the hope is that tax allocations are matched by corresponding economic consequences.

"Economic effect" focuses, however, only on the pre-tax consequences of an allocation: whether the dollar amount of burden or benefit allocated for tax purposes is matched by a like amount allocated for economic purposes. Although dollars of income or loss may be all the same for economic purposes, they are not all the same for tax purposes. Whether a dollar of income is capital gain, interest income from a tax-exempt bond, or proceeds from the sale of a section 1231 asset, makes a difference for tax purposes. Thus, if "economic effect" were the only test, it would be a simple matter for partners to allocate consistent amounts of partnership items for tax and economic purposes, while at the same time allocating matters such as the character of the item in a tax-favorable way.

82. See I.R.C. § 704(a)-(b) (1994).
84. See id. § 1.704-1(b)(2)(ii)(a).
85. See id. § 1.704-1(b)(2)(ii)(b).
For example, two 50/50 partners might each be allocated $100 of income for tax and economic purposes, except that one partner (with otherwise unusable and expiring capital loss carryforwards) might be allocated all capital gain income, and the other all tax-exempt income.

To address these concerns, the regulations include the “substantiality” test to make sure the pre-tax economic consequences of the allocation are substantial in comparison with its tax consequences. Thus, substantiality is met if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners, independent of tax consequences. Conversely, allocations are considered “shifting” or “transitory,” and therefore not substantial and invalid, if there is a strong likelihood that they will not affect substantially the partners’ capital account balances yet will reduce the collective tax liabilities of the partners after taking into account their individual tax characteristics.

Furthermore, in the strongest version of the test, substantiality is flunked and an allocation is invalid for tax purposes if, after the tax effects of the allocation are taken into account, no partner is worse off and at least one partner is better off (both determined from a present value standpoint) compared to the results had the special allocation not been made.

As noted, the default rule when there is no allocation specified by the partners or the allocation does not have substantial economic effect is to allocate the tax item in accordance with the PIP. In general, this rule requires that the item be shared for tax purposes in the same manner that the economic burden or benefit corresponding to the item is shared. In determining what the economic share is, there is a starting presumption that all items are shared equally on a per capita basis. Among the factors that may be considered to rebut that presumption include the partners’ relative contributions to the partnership, their interests in economic profits and losses, cash flow, and other non-liquidating distributions, and their rights to distributions of capital upon liquidation. In certain circumstances, a partner’s economic share may be determined by comparing the partner’s proceeds from a hypothetical complete liquidation of the partnership at the end of the current year with the proceeds from a similar liquidation taking place at the end of the immediately preceding year.

In general, nonrecourse deductions are deductions attributable to partnership liabilities for which “no partner . . . bears the economic risk of loss.” The allocation of such deductions cannot have economic effect

86. See id. § 1.704-1(b)(2)(iii).
87. See id.
88. See id.
89. See id.
90. See I.R.C. § 704(b) (1994).
92. See id. § 1.704-1(b)(3)(ii).
93. See id. § 1.704-1(b)(3)(iii)(b).
94. See id §§ 1.704-2(b)(1) and (3); Treas. Reg. § 1.752-1(a)(2) (1991).
because, by definition, no partner bears the economic burden that corresponds to the tax deduction. Hence, such deductions must be allocated in accordance with the PIP. For partnership items like nonrecourse deductions, which have no economic effect, the PIP is generally the overall economic sharing arrangement of the partners. The regulations, however, provide a safe harbor test, which, if met, deems an allocation of nonrecourse deductions to be in accordance with the PIP.

The safe harbor contains four requirements. Two of them—the required maintenance and adjustment of, and respect for, capital accounts in accordance with the economic effect test and a requirement that all other material allocations be respected for tax purposes—are largely mechanical in nature. A third rule requires the allocation of nonrecourse deductions to be reasonably consistent with an allocation having a "substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities" (the "significant item consistency" rule). The regulations interpret this requirement quite liberally, permitting a partner to be allocated a share of nonrecourse deductions as low as the partner's lowest share, and as high as the partner's highest share, of the significant other item relating to the property. The final condition of the safe harbor is the required allocation to a partner, at an appropriate point in the future, of an amount of partnership income or gain equal to the nonrecourse deductions allocated to such partner (the "minimum gain chargeback" provision).

Under section 752, a partner's share in partnership liabilities is reflected in the adjusted basis of the partner's interest in the partnership. The regulations under section 752 regarding a partner's share in recourse and nonrecourse liabilities of a partnership have been coordinated with the section 704(b) regulations to ensure that a partner who is validly allocated a loss or deduction under the latter provisions has sufficient outside basis to utilize such loss or deduction for tax purposes.

C. The Inadequacy of Current Law

The regulatory interpretation of substantial economic effect basically relies upon a capital account analysis of special allocations consistent with the Tax Court's approach in Orrisch v. Commissioner. Under a capital account analysis, the key question is whether the claimed tax allocation is matched by a corresponding economic allocation as evidenced by the im-

96. See id. § 1.704-1(b)(3)(i).
97. See id. § 1.704-2(c).
100. See id. § 1.704-2(m), ex. (1)(ii)-(iii) (as corrected by 62 Fed. Reg. 34,634 (1997)).
101. See id. § 1.704-2(e)(1) and (4). See id. § 1.704-2(m), ex. (1)(ii)-(iii) (as corrected by 62 Fed. Reg. 34,634 (1997)).
impact of the allocation on the partners' capital accounts. The regulations also include the substantiality test generally to ensure the predominance of non-tax factors to support the claimed allocation.

Although a capital account analysis constitutes a superficially appealing method of evaluating the validity of allocation of partnership tax items that have corresponding economic burdens and benefits, it is completely ineffective in testing allocations of other items, such as nonrecourse deductions, which lack such correspondence. As the regulations state, the allocation of nonrecourse deductions cannot have economic effect because the economic burden associated with the deduction is not borne by any partner. It is for this reason that the regulations provide a separate set of rules to test the validity of allocations of nonrecourse deductions.

In 1983, the Treasury Department first proposed to treat allocations of nonrecourse deductions as consistent with the PIP, and therefore valid, if, in general, there was a minimum gain chargeback provision in the partnership agreement. In other words, an allocation of nonrecourse deductions to a partner would be respected as long as, at an appropriate point in the future, an equal amount of partnership income or gain created by the nonrecourse deductions would be allocated to such partner. This rule was criticized by various commentators who argued that—a partner's obligation to bear the burden of taxation on the minimum gain that resulted from loss and deduction attributable to nonrecourse debt was not necessarily a good indication of a partner's interest in the partnership. For example, under the proposed rule, so long as the partnership agreement contained a minimum gain chargeback provision, 100 percent of the loss and deduction attributable to nonrecourse debt could be allocated to a partner even though such partner's interest in every other partnership item was substantially less than 100 percent.

Indeed, an allocation of deductions accompanied by an offsetting allocation of future income would generally be treated as a transitory set of allocations and invalid under the substantiality test. Thus, the original, proposed safe harbor for an allocation of nonrecourse deductions would likely have flunked both the economic effect and substantiality tests of substantial economic effect had those tests been applied to it.

The Treasury Department’s response was to include in the final regulations an additional requirement to the safe harbor: “The Treasury Department . . . agrees that a partnership should not be allowed to allocate loss and deduction attributable to nonrecourse debt in the manner described [in the example quoted above]. Accordingly, the proposed rule has been modified to preclude this and similar types of tax-motivated arrangements.”

Treasury added the “significant item consistency” rule, which requires that the allocation of nonrecourse deductions be reasonably consistent with an allocation having substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liability. This rule, however, was accompanied by the liberal interpretation of the meaning of “reasonably consistent.”

The significant item consistency rule has apparently not been effective at limiting the sharing of nonrecourse deductions to arrangements consistent with the partners’ interest in the partnership. One commentator has stated that

the [“significant item consistency”] limitation on allocations of tax items attributable to third-party nonrecourse debt often leaves partnerships with a wide range of choices in making such allocations. Even if the desired allocation of tax items attributable to third-party nonrecourse debt is not supported by the other allocations that naturally would occur by reason of the business arrangement of the partners, it is possible in many circumstances to provide for a special allocation of a significant partnership tax item in order to support the desired allocation of tax items attributable to third-party nonrecourse debt.

Thus, current law does not seem to be significantly different from the 1983 Treasury proposal, which according to the Treasury, permitted tax-
motivated sharing arrangements.\textsuperscript{114}

The failure to impose significant restrictions on the allocation of nonrecourse deductions is inconsistent with the statutory requirement that allocations of partnership items must have substantial economic effect or else be consistent with the PIP.\textsuperscript{115} Indeed, under current law, the rules regarding the allocation of nonrecourse deductions are less restrictive than those relating to the allocation of other partnership items, such as partnership income, gain, and deductions and loss attributable to equity capital investments or recourse indebtedness. Given the fact that allocations of nonrecourse deductions "often are highly tax-motivated,"\textsuperscript{116} the existing state of affairs seems nonsensical.\textsuperscript{117} It also allows taxpayers through a partnership investment to obtain more favorable tax results than those available from direct investment.\textsuperscript{118}

The significance of the inadequacy of current law is heightened by the growth of LLCs and similar forms of business organizations that provide limited liability protection to all owners of the entity. For one thing, all deductions attributable to liabilities incurred by such business entities subsequent to formation constitute "nonrecourse deductions"—even deductions attributable to debt, which is nominally recourse at the entity level—because no owner of the entity ultimately bears the economic burden corresponding to such deductions.\textsuperscript{119} Thus, the scope and resulting

\begin{footnotesize}
\bibitem{114} See \textit{Brannan, supra} note 73, at 123 ("The current system imposes no meaningful limitation on the ability of partnerships to make tax-motivated allocations of tax items attributable to third-party nonrecourse debt"); \textit{cf.} \textit{Carter G. Bishop \& Daniel S. Kleinberger, Limited Liability Companies: Tax and Business Law} 4-63 (1994) ("A special allocation of loss or deduction items, coupled with an income offset or gain chargeback, will therefore produce a pure deferral advantage for the member receiving the allocation, since no economic loss actually occurred. This deferral may create substantial tax savings.")
\bibitem{115} See \textit{NYSBA Report, supra} note 107, at 1132.
\bibitem{116} \textit{Brannan, supra} note 73, at 123; \textit{see} Jonathan B. Dubitzky, \textit{Rethinking Retroactive Partnership Allocations}, 52 \textit{TAX NOTES} 1533, 1540 (1991) ("We all know that nonrecourse deductions typically will be apportioned before the fact with tax considerations the only relevant factor . . . .").
\bibitem{117} See \textit{NYC Bar Letter, supra} note 107, at 3 ("It is . . . highly irrational to permit allocations based on nonrecourse debt which would not be allowed if based on recourse debt . . . . Allocations based on nonrecourse debt have the least economic restraints and should . . . be the most circumscribed.").
\bibitem{118} \textit{See Sherwin Kamin, Partnership Income and Loss Allocations Before and After the Tax Reform Act of 1976}, 30 \textit{TAX LAW} 667, 693 (1977) ("[H]ad each partner owned his interest in common, his \textit{Crane} benefit would have been limited to his percentage of ownership. It is only in following the partnership mechanics that a partner can be allowed a greater proportion of the loss than would be justified by his investment or interest in the partnership profits."); \textit{cf.} \textit{Treas. Reg. § 1.701-2(c)(1) (as amended in 1995).}
\bibitem{119} \textit{See Bishop \& Kleinberger, supra} note 112, at 4-64 to 4-65; \textit{see also} Kenneth Heller \& James Boyd, \textit{Partnership Liabilities: IRS Interpretation Helpful but Further Guidance Needed}, 13 \textit{J. Partnership Tax'N} 243, 252 (1996); \textit{Snoe, supra} note 65, at 1916; \textit{cf.} \textit{Temp. Treas. Reg. § 1.752-1T(e)(2), 1T(d)(3)(ii)(B)(4)(ii) (1988), reprinted in 1989-1 C.B. 180, 188 (according to prior version of regulations, "if an entity that is treated as a partnership for federal income tax purposes is organized and operated under a local law which provides that none of the members of that entity is liable for its debts and other obligations, then all the liabilities of that entity will generally constitute [nonrecourse] liabilities"). The reference in the text to "nonrecourse deductions" does not include deductions of an LLC attributable to entity debt to which an LLC member bears the economic risk of
\end{footnotesize}
importance of the current law rule is increased.\textsuperscript{120}

A further problem involves the interpretation of the "significant item consistency" rule in the context of the allocation of LLC deductions. Both the significant item consistency rule and the minimum gain chargeback provision were drafted in contemplation of nonrecourse financing which is secured by specific pieces of the business entity's property. For example, the significant item consistency rule requires the allocation of nonrecourse deductions to be reasonably consistent with an allocation having "substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities."\textsuperscript{121} But it is not clear how such rules should be applied where nonrecourse deductions arise as a result of the limited liability protection offered to all owners of the enterprise itself, rather than in the traditional setting.

One reasonable interpretation is to treat for this purpose any LLC debt as a "floating lien" with a security interest in all of the assets of the enterprise.\textsuperscript{122} If this were the rule, then the significant item consistency rule would be converted into one where the allocation of nonrecourse deductions must be reasonably consistent with any significant item of the enterprise having substantial economic effect. Given the liberal interpretation in the regulations of "reasonably consistent," such a rule would seem to permit virtually any allocation arrangement desired by the parties. As with the original, unsatisfactory 1983 Treasury proposal, the only remaining "restraint" of current law would be to require an appropriate chargeback of income or gain to the partner allocated the nonrecourse deductions.

Finally, allocation of LLC deductions creates various technical problems under the regulations. In general, these problems are caused by the failure of the regulations to envision the possibility of recourse debt of an entity being classified as nonrecourse debt for purposes of the allocation rules, due to the limited liability protection afforded the owners of the entity.\textsuperscript{123}

For example, the concept of "minimum gain" in the regulations is based on the Tufts holding that upon the disposition of property secured by a nonrecourse liability, the amount realized includes the full amount of the liability, regardless of the value of the encumbered assets at the

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{120} The utilization of nonrecourse deductions allocated to a taxpayer may, however, be limited by sections 465 and 469.
\item \textsuperscript{121} See Brannan, supra note 73, at 125; Bryan P. Collins et al., Allocating Debt-Financed Losses of an LLC under Section 704(b), 2 J. LLCs 135, 137 (1995). Cf. Heller & Boyd, supra note 119, at 259-61.
\end{enumerate}
\end{footnotesize}
time of disposition. Thus, for instance, if property financed by nonrecourse debt is depreciated, there is ordinarily a one-to-one correspondence between the amount of nonrecourse deductions and the future minimum amount of gain to be recognized upon disposition of the property. But if property subject to a recourse liability is disposed of, the liability is included in amount realized only if another person agrees to pay the liability. Hence, the one-to-one correspondence between nonrecourse deductions and minimum gain that is relied upon in the regulatory scheme may no longer be present.

D. SOME IDEAS FOR IMPROVEMENT

Because the economic burden associated with nonrecourse deductions is not borne by any partner, the allocation of such deductions cannot be made to have economic effect through a capital account analysis. Therefore, the only appropriate rule consistent with the statute is to require that such deductions be allocated in accordance with the overall economic sharing arrangement of the partners. Current law imposes this general requirement, but then relaxes it through its safe harbor provision. Neither the significant item consistency rule nor the other conditions of the safe harbor adequately restricts allocations of nonrecourse deductions to arrangements that are consistent with the overall economic shares of the partners.

Determining economic shares in any given case, however, is a difficult task. In certain business arrangements, the relative capital contributions of the partners, the manner in which they share economic profits, losses, or cash flow, their rights to distributions, or other factors may be indicative of the true economic shares of the partners. In contrast, in other arrangements, one or more of the same factors may be completely irrelevant. Economic shares can only be determined on a case-by-case basis.

To provide some degree of certainty and predictability for taxpayers, however, it might be possible to create a few elective safe harbors which define the likely “overall economic shares” in certain common business arrangements. Some of the safe harbors might be created by statute with the rest promulgated through regulations. The regulatory safe harbors, however, should attempt to identify, and limit the permissible allocation scheme to, the overall economic shares of the partners. Thus, for exam-

126. The definition of minimum gain also contemplates the disposition of the property subject to the nonrecourse liability whereas debt of an LLC may not be secured by any property unless the “floating lien” assumption is made. See Treas. Reg. § 1.704-2(d)(1); Collins et al., supra note 122, at 137. One possible effect of this technical problem, if left uncorrected, is to postpone the time of the minimum gain chargeback requirement for nonrecourse deductions of an LLC. See Reynolds, supra note 123, at 402.
127. Once again, although this discussion refers generally to “partners” and “partnerships,” it is intended to apply more broadly to any business firms, which are taxed as conduits.
ple, it would not be appropriate to include as a regulatory safe harbor a requirement such as the significant item consistency rule.

One possible safe harbor would be to permit an allocation of nonrecourse deductions that is consistent with the relative capital contributions of the partners. This option should probably be limited to cases in which the aggregate capital contributions and the recourse indebtedness of the partnership represent more than some nominal amount, such as at least ten percent, of the total capitalization of the partnership, and the partners do not expect the partnership to earn substantial profits in excess of a reasonable return on the capital contributions. Where capital contributions and recourse debt represent more than a nominal amount of the total capitalization and the partners anticipate the earning of profits consistent with a reasonable return on such contributions, the capital contribution share would seem to constitute the likely economic sharing arrangement of the partners.\footnote{See Brannan, supra note 73, at 123 n.11; see also Letter from Lawrence Katz, Piper & Marbury, to John E. Chapoton, Ass't Sec'y of the Treasury, Ronald A. Pearlman, Deputy Ass't Sec'y of the Treasury, and Mark L. Kuller, Assoc. Tax Legislative Counsel of the Treasury, reprinted in 20 Tax Notes 687 (1983); cf: Ad Hoc Committee Letter, supra note 107, at 1138.}

Hence, it would be appropriate to permit nonrecourse deductions to be allocated in a manner consistent with those shares.

For example, assume $A$ and $B$ contribute $20,000$ and $40,000$, respectively, to partnership $AB$, which purchases an office building for $600,000$. The balance of the purchase price is financed through nonrecourse debt. The aggregate capital contributions by the partners constitute at least ten percent of the total capitalization of the partnership. Therefore, assuming the partners do not expect the partnership to earn substantial profits in excess of a reasonable return on their capital contributions, they might be permitted to allocate any nonrecourse deductions $1/3$ to $A$ and $2/3$ to $B$.

Now assume the same facts as above but that some years after owning and operating the office building, partnership $AB$ is in need of some additional capital to finance some improvements to the property. $C$ agrees to contribute $25,000$ to the partnership in exchange for a $1/4$ interest in the partnership after the interests of $A$ and $B$ are booked up to $25,000$ and $50,000$, respectively. Assuming the aggregate capital contributions by the partners, including the booked-up amounts of $A$ and $B$, represent at least ten percent of the total capitalization of the partnership and the partners still do not expect to earn substantial profits in excess of a reasonable return on their capital contributions, they might, under the first safe harbor, be entitled to allocate any nonrecourse deductions $1/4$ to $A$ and $C$ and $1/2$ to $B$.

A second possible safe harbor would be to permit the allocation of nonrecourse deductions in accordance with the sharing arrangement for the expected, residual economic profits of the business. Obviously, this
option should be allowed only if there exists a reasonable expectation of significant residual profits at the time of the election. In that circumstance, the manner in which the partners propose to share such residual profits may constitute the likely economic sharing arrangement of the partners.\textsuperscript{129} If this option is permitted, the statute of limitations for assessing a deficiency resulting from a misallocation of nonrecourse deductions should probably be held open until some period following the actual realization of residual economic profits by the firm, to ensure that the allocation of nonrecourse deductions is consistent with the actual sharing of such profits.\textsuperscript{130}

For example, assume developer $D$ joins together with $E$ and $F$ to form partnership $DEF$ to acquire, develop, and manage various properties. The partners agree to allocate initial losses one percent to $D$, fifty percent to $E$, and forty-nine percent to $F$, and to allocate profits in the same manner until all prior losses have been offset. Thereupon, the partners agree to allocate profits twenty percent to $D$, forty percent to $E$, and forty percent to $F$. Assuming that at the time of the election, there exists a reasonable expectation of significant residual profits to be allocated 20/40/40, the parties might be allowed under the second safe harbor to allocate any nonrecourse deductions in the same manner. In that circumstance, the 20/40/40 division likely represents the real economic deal of the parties.\textsuperscript{131}

Now suppose the same facts as above except that after all prior losses have been recouped, the parties agree to share any partnership income or gain differently. Any operating income of the partnership will be shared forty percent by $D$, thirty percent by $E$, and thirty percent by $F$, and any gain from the sale of the property will be shared ten percent by $D$, forty-five percent by $E$, and forty-five percent by $F$. If, at the time of the election, there exists a reasonable expectation of significant residual profits and the parties reasonably anticipate those profits to be evenly divided between operating income and gain, then the parties might be allowed to allocate nonrecourse deductions twenty-five percent to $D$ (50% x 40% + 50% x 10%), 37.5% to $E$, and 37.5% to $F$.\textsuperscript{132}

\textsuperscript{129} See NYSBA Report, supra note 107, at 1133; NYC Bar letter, supra note 107, at 4-6. Cf. Kamin, supra note 116, at 692; Treas. Reg. § 1.752-1(e) (1956) (now superseded); Treas. Reg. § 1.752-3(a)(3) (1997); \textit{ALI 1984 Subchapter K Proposals}, supra note 40, at 236-37 (example illustrating nonrecourse deductions being allocated in accordance with relative capital contributions and residual profit shares of partners).

\textsuperscript{130} Where significant residual profits are not expected until some time in the future, this rule is intended to prevent a change in the sharing ratio of such profits from one designed to support the initial allocation of nonrecourse deductions to one representing the true economic share agreed upon by the parties.

\textsuperscript{131} Cf. Thomas J. McMahon, \textit{Coordinating Partners' Profit and Loss Allocations with Economic Sharing Agreements}, 10 J. PARTNERSHIP TAx'n 220, 228-29 (1993). If no significant residual profits are expected, the 1/50/49 sharing arrangement may constitute the economic deal of the parties. Cf. \textit{ALI 1984 Subchapter K Proposals}, supra note 40, at 239.

\textsuperscript{132} Cf. NYC Bar Letter, supra note 107, at 6. Obviously, how "reasonable" these various expectations are will be one of the difficult questions that would have to be resolved. A more sophisticated though more complicated approach would take into account
It would seem that any partnership should be permitted to make only one election. For example, a partnership probably should not be allowed to allocate nonrecourse deductions consistent with relative capital contributions for certain years and with residual economic profits for other years, even though the terms of those safe havens can otherwise be satisfied by the partnership. The same rule should apply to any additional elections, which are authorized by regulation.

If options similar to those described above are allowed, they should replace only the significant item consistency rule of current law. All other aspects of the current law safe harbor, including in particular the minimum gain chargeback provision, should be retained. Thus, a partner who is allocated nonrecourse deductions must still be allocated an offsetting amount of future partnership income or gain at the same time and in the same manner provided under current law.

If no valid election is in effect for any year, then the allocation of nonrecourse deductions would have to be consistent with the overall economic sharing arrangement of the partners for that year, as measured by the PIP. This determination would be made on a case-by-case basis, taking into account all of the factors identified in current law.

Finally, conforming changes should be made to section 752 to ensure that a partner who is validly allocated nonrecourse deductions under one of the options described above would have sufficient outside basis to utilize such deductions for tax purposes. In addition, certain technical changes should be made to the regulations to make them applicable to nonrecourse deductions of business entities which provide limited liability protection for all owners of the entity. For example, all debt of such entities, whether recourse or nonrecourse, might be treated for tax purposes (including for purposes of sections 704(b), 752, and 1001) as "nonrecourse" debt secured by all of the property of the entity. Calculation of minimum gain would then generally be the difference between the aggregate debt of the entity and the aggregate adjusted basis in its assets.\textsuperscript{133}

\textbf{E. Summary}

This part of the Article has illustrated the difficulty of taxing private business firms as conduits in a post-check-the-box world. A conduit tax system would ordinarily require the firm's debt and any tax items arising from that debt to be allocated among the firm's owners. But if the firm, such as an LLC or a corporation, provides all of its owners with limited liability protection, no owner bears the economic burden of the debt having to be repaid. Thus, there is no economic baseline available against which the required allocation for tax purposes can easily be tested.

The problem described is similar to the allocation of a firm's nonrecourse deductions under current law. Unfortunately, the current law

\textsuperscript{133} See Treas. Reg. § 1.704-2(m), ex. 2; Heller & Boyd, supra note 119, at 259-61.

\textsuperscript{133} See Krane & Sheffield, supra note 107, at 947-50.
rules for allocating nonrecourse deductions do not adequately preclude purely tax-motivated sharing arrangements of those deductions. Moreover, the rules were not drafted to apply to debt and tax items belonging to a firm all of whose owners have limited liability protection. Yet as a result of the check-the-box regulations, such cases will become increasingly common.

A possible improvement would be to require all nonrecourse deductions to be allocated among the owners of the firm in accordance with their overall economic sharing arrangement. Safe harbors might then be provided in select circumstances to give taxpayers some degree of certainty and predictability. One possible option would be to allocate the deductions consistent with the relative capital contributions of the owners. Another possibility would be to permit the deductions to be allocated in accordance with the sharing arrangement for the expected, residual economic profits of the business. The purpose of the safe harbors would be to provide a relatively easy to administer rule applicable to common business arrangements. Allocations of nonrecourse deductions in other, more complicated arrangements would then have to be determined on a case-by-case basis.

Another possible way to deal with the issue is to revisit whether entity debt and tax items arising from that debt should be allocated among the owners of a business firm where the all of the owners are provided with limited liability protection. Basic conduit principles would seem to require that allocation to be made, yet if the administrative cost of doing so is too great, perhaps some deviation from those principles is justified.

IV. CONCLUSION

With the check-the-box regulations, the IRS has simplified the eligibility criteria for determining how many private businesses will be taxed. The rules could not be much simpler: for the most part, the state law characteristics and business organization form of the business are irrelevant in determining how the business will be taxed. In part II of this Article, I have suggested that whether a firm is incorporated under state law will soon be a similarly irrelevant factor for tax purposes, either because of evolving state law developments or amendments of the federal tax statute to permit corporations to “check the box” as well. I have also questioned whether firms should be distinguished for tax purposes based upon the public trading of their ownership interests.

But exactly what has this newly liberalized eligibility policy entitled all of these firms to do? That question represents the “dark side” of the check-the-box regulations. At present, they are entitled to choose how they are to be taxed, and to choose among Subchapters C, S, or K. Why should they have a choice, and why should they have these particular choices? In a post-check-the-box world where state law characteristics and business organization form are no longer relevant for tax purposes, there does not seem to be any rational answer to these questions. But the
genie is out of the bottle; there is little chance of reversion to a more restrictive eligibility scheme in which there is some effort to match up firms with the tax operating rule systems available under current law. Thus, whether the new regulations represent real improvement and simplification, or merely an ironic surprise, must await revision and reform of the tax operating rules themselves.