

## RESIDUAL-RISK MODEL FOR CLASSIFYING BUSINESS ARRANGEMENTS

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### ABSTRACT

Tax law classifies business arrangements as one of three general structures: (1) disregarded arrangements, (2) tax partnerships, or (3) tax corporations. Since the enactment of the income tax in 1913, tax law has struggled unsuccessfully to develop a good model for classifying business arrangements. The current model's sole virtue is its simplicity, derived from formalistic, elective attributes. Its greatest shortcoming may be that it disregards the reasons parties form business arrangements and their use of economic items to reduce rent-seeking behavior and agency costs. That disregard often allows business participants to choose their tax classification and minimize their taxes, which erodes the tax base and shifts tax burdens to others but does not alter the parties' economic relationships. This Article rejects the current model and presents a classification model based on the economic theory of the firm. Economic theory aids classification in three respects. First, it helps explain why parties form business arrangements. Second, it views business arrangements as nexuses of contracts composed of various parties. That view helps identify the economic aspects of business arrangements and the economic rights of business participants, irrespective of legal form. Third, it demonstrates that residual risk (the right to the residual assets of a business) measures the economic interests parties have in business arrangements. In particular, residual risk helps distinguish arrangements that can trace income from its source to the owner of the source or from allocations to the beneficiaries of those allocations from those arrangements that cannot. That knowledge clarifies the appropriate tax regime for all arrangements and leads to the residual-risk model for classifying business arrangements.

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## I. INTRODUCTION

Properly classifying business arrangements is essential to preserving the integrity of the income tax system. The income tax system uses various tax regimes, including partnership tax and corporate tax, to tax business participants. The application of those tax regimes depends upon an arrangement's classification as either a tax partnership or tax corporation. If the classification model does not properly match a business arrangement with a tax regime, members of the arrangement may receive the economic benefit from the arrangement without shouldering the corresponding tax burden. That result occurs when the classification model fails to consider economic attributes of an arrangement. The current classification model fails to consider relevant economic aspects of business arrangements and undermines Congressional efforts to enact income tax laws to achieve specific tax policy objectives.<sup>1</sup> Economic theory, on the other hand,

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1. Commentators generally agree on fundamental policy criteria such as equity, efficiency, simplicity, and administrability. See, e.g., Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807, 829–30, 848–49, 892–93 (2005) (evaluating transfer taxes using the principles of equity, efficiency, and simplicity); Joseph M. Dodge, *Taxes and Torts*, 77 CORNELL L. REV. 143, 146–47 (1992) (analyzing the equity and efficiency of certain recoveries for injuries); Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 568, 569–72, 586–90 (1965) (arguing that a tax system should, among other things, supply adequate revenue, impose equal taxes, avoid impairment of the market-oriented economy (i.e., promote efficiency)). They may not, however, agree upon the best system to achieve such policies. For example, they may disagree on the concept of income—some commentators believe consumption is the best concept of income while others believe a broader definition is more important. See, e.g., Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413 (2006)

provides residual risk (the right to the residual assets of a business) as a method for measuring parties' economic interests in business arrangements. Residual risk, as a measure of economic interest, should dictate the tax regime that applies to the various types of business arrangements, and it should order their classification.

Two examples illustrate deficiencies of the current classification model. First, the current model allows parties to alter the character of the arrangement's income. The income tax system imposes a tax rate structure on income earned as compensation for services (which can be as high as thirty-five percent<sup>2</sup>) and a separate rate structure on gains from the sale of certain capital assets (which generally will not exceed fifteen percent).<sup>3</sup> Traditionally, employment contracts memorialize service arrangements, and payments made to the service provider pursuant to such contracts should be compensation. Parties may, however, create an economically equivalent arrangement using a limited liability company or limited partnership.<sup>4</sup> The current model disregards an arrangement memorialized by an employment contract, but it most likely treats the same arrangement as a tax partnership if memorialized by partnership agreement or limited liability company agreement.<sup>5</sup> That different classification may affect the character of income a service provider reports on a tax return. Income a partnership allocates to a service-providing partner could be long-term capital gain taxed at favorable rates, while amounts paid under an

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(arguing in favor of a consumption definition of income); Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax*, 89 YALE L. J. 1081 (1980) (arguing that consumption tax unfairly excludes a significant portion of wealth from the tax base); Alan Gunn, *The Case for an Income Tax*, 46 U. CHI. L. REV. 370 (1979); (arguing that the income tax has worked well and the cost of changing to another system would be too costly); Alvin Warren, *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 931 (1975) (criticizing Andrews's argument in favor of a consumption tax); William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974) (arguing that a cash flow tax is the ideal income tax). Although such concepts are crucial to a just tax system, the discussion of classifying business arrangements does not have to consider which decision is preferable. Instead, this Article argues, classification should help preserve the general tax system by creating definitions that help ensure that tax items follow economic items.

2. See I.R.C. § 1(i)(2) (2000) (setting the maximum individual tax rate at thirty-five percent for tax years beginning in 2003).

3. See I.R.C. § 1(a)–(d) (2000) (imposing a tax on individuals and providing the general graduated rate structures for individual tax liability); I.R.C. § 1(h)(1)(C) (2000) (providing preferential rates for adjusted net capital gain).

4. See Gregg D. Polsky, *Private Equity Management Fee Conversion*, 122 TAX NOTES 743, 746–52 (Feb. 9, 2009) (demonstrating that investment advisors use entity structures to convert the character of income without altering the economic aspects of an employment arrangement).

5. See David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715, 731–33 (2008) (concluding with thinly-constructed analysis that such arrangements are tax partnerships and the partners act in a partnership capacity). *But see* Bradley T. Borden, *Profits-Only Partnership Interests*, 74 BROOK. L. REV. \_\_\_\_ (forthcoming 2009), [ssrn.com/abstract=1262493](https://ssrn.com/abstract=1262493) (arguing that such arrangements should not be tax partnerships or the service providers should be treated as nonpartners); Douglas Longhofer, *The Lost Regulations: Section 707 and the Definition of Partner Capacity*, \_\_\_\_ BUS. ENT. \_\_\_\_ (forthcoming 2009) (suggesting that a more rigorous analysis is needed to determine if service-providing partners act in partner capacity).

employment contract would be compensation taxed at higher rates.<sup>6</sup> Thus, the current model allows business participants to alter the character of income, undermining an aspect of income tax law and policy.

Second, the current model allows business participants to skirt the assignment-of-income doctrine. The assignment-of-income doctrine provides generally that a person who realizes an economic benefit must report the corresponding tax item on a tax return.<sup>7</sup> Consequently, a person who receives compensation for providing services must report compensation income on a tax return.<sup>8</sup> A person who realizes economic gain on the disposition of property must report a corresponding tax gain.<sup>9</sup> The current model allows parties to shift the incidence of taxation by contributing property or services to an arrangement classified as a tax partnership or tax corporation.<sup>10</sup> Thus, the current model frustrates the assignment-of-income doctrine. Other examples could further illustrate the importance of tax law's classification model,<sup>11</sup> but these two examples illustrate its significance. The shortcomings of the current model exist because the model developed independent of economic theory.

Section II of this Article traces the evolution of the current classification model. That discussion reveals three significant points. First, the model undergoes significant changes every few decades.<sup>12</sup> Second, the

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6. See Polsky, *supra* note 4 at 752–62 (describing the managers' tax goal in fee conversions and suggesting the proper tax treatment should be to disallow favorable tax treatment).

7. See generally Brant J. Hellwig, *The Supreme Court's Casual Use of the Assignment of Income Doctrine*, 2006 U. ILL. L. REV. 751, 765–81 (2006) (discussing the assignment of income doctrine generally but arguing that it should apply only to gratuitous assignments of income); Stanley S. Surrey, *Assignments of Income and Related Devices: Choice of the Taxable Person*, 33 COLUM. L. REV. 791, 796–815 (1933) (discussing the application of the assignment-of-income doctrine in various contexts).

8. See *Lucas v. Earl*, 281 U.S. 111, 114–15 (1930) (holding that a husband could not shift the tax liability of his compensation to his wife).

9. See *Helvering v. Horst*, 311 U.S. 112, 114, 124–25 (1940) (holding that the person who owns property must recognize income from that property).

10. See Bradley T. Borden, *Partnership Tax Allocations and the Internalization of Tax-Item Transactions*, 59 S.C. L. REV. 297, 333–45 (2008) (demonstrating how partners may use the partnership allocation rules to separate the incidence of taxation from the economic items allocated to partners).

11. For example, if corporate marginal tax rates are lower than individual marginal tax rates, individuals, particularly high-income individuals, may be able to shelter some income from higher tax rates by using a tax corporation for income-producing functions. See John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie But the Numbers Never Do"*, 78 TEX. L. REV. 885, 903–22 (2000) (discussing the use of entities taxed as corporations to shelter some income from higher taxes). Parties will also structure ownership arrangements as open tenancies in common, which the IRS may not classify as tax partnerships, to obtain section 1031 nonrecognition. See generally Bradley T. Borden, *Open Tenancies in Common*, 39 SETON HALL L. REV. \_\_\_\_ (forthcoming 2009), [ssrn.com/papers=1327086](http://ssrn.com/papers=1327086) (describing and analyzing a safe harbor provided by the IRS for parties seeking to avoid tax partnership classification).

12. The classification model originated in 1909 with the enactment of the 1909 Corporate Excise Tax and the Supreme Court's 1911 decision in *Eliot v. Freeman*, 220 U.S. 178, 185–87 (1911), which held that the definition of tax corporation depended upon whether the arrangement was organized under state law (adopting the grant theory). See *infra* text accompanying notes 64–70. The enactment of the corporate income tax in 1913 and a 1918 statutory definition of tax corporation that included

model lags behind development of legal and economic theory, sometimes adopting concepts decades after they have lost relevance in other areas of the law.<sup>13</sup> Third, the model lacks tax policy support. As the current model passes its ten-year anniversary, commentators have begun recognizing chinks in its armor, calling for changes or further examination of the model.<sup>14</sup> Furthermore, changing business practices mandate periodic reviews of established legal and tax rules, and this is the current economic climate compels a review of the current model for classifying tax entities. Finally, developments in economic theory shed new light on the analysis of the classification model.

A review of the current model reveals that it is wanting in many respects. For instance, it relies upon legal formalities, labels, and elections to classify business arrangements. That scheme enables business participants to privately influence the placement of the incidence of taxation.<sup>15</sup> For example, if partnership tax law allows untaxed assignments of tax items,<sup>16</sup> business people may elect tax partnership classification to exploit the allocation rules and use tax items as consideration.<sup>17</sup>

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associations led to the corporate resemblance test of tax corporation as expressed in 1934 regulations and the Supreme Court's 1935 decision in *Morrissey v. Comm'r*, 296 U.S. 344, 359 (1935) (adopting the entity theory). See *infra* text accompanying notes 71–82. The 1954 Ninth Circuit decision in *Kintner v. United States*, 216 F.2d 418, 420 (9th Cir. 1954) led to the promulgation of the Kintner Regulations in 1960, which adopted a bright-line multi-factor test for determining whether an arrangement was a tax corporation. See *infra* text accompanying notes 83–96. In 1977, Wyoming enacted the first limited liability company statute and the IRS privately ruled in 1980 that such an entity could be a tax partnership, creating a *de facto* classification election. See *infra* text accompanying notes 100–105. Finally, in 1997, Treasury created the current model by promulgating the check-the-box regulations, which formalized and simplified the classification election (abandoning theory for the sake of simplicity). See *infra* text accompanying notes 106–112. Thus, the important dates in the evolution of the classification model are 1909–11, 1913–18, 1934–35, 1954–60, 1977–80, and 1997. Significant changes therefore appear to occur every fifteen to twenty years, suggesting another major change may occur over the next three to seven years.

13. Corporate law's concept of corporations evolved from the original grant/concession theory (accepted into the nineteenth century), which recognized that states granted corporations the privilege of existence, see *infra* text accompanying notes 47–54, to the entity theory, which recognized corporations as entities separate from their owners (well established by the beginning of the twentieth century). See *infra* text accompanying notes 55–59. The entity theory is now being eroded by the economic view of corporations as nexuses of contracts. See *infra* text accompanying notes 141–144.

14. See, e.g., Heather M. Field, *Checking in on "Check-the-Box,"* 42 LOY. L.A. L. REV. (forthcoming 2009), [ssrn.com/abstract\\_id=1161318](https://ssrn.com/abstract_id=1161318) (suggesting that eleven years after the promulgation of the check-the-box classification regulations the time is ripe for reconsidering them); Steven A. Dean, *Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification*, 34 HOFSTRA L. REV. 405 (2005) (concluding that the current classification model adds attractive complexity to the tax system and results in tax deregulation).

15. This Article uses the term "incidence of taxation" to refer to the obligation to pay tax, or the statutory incidence of taxation. See HARVEY S. ROSEN & TED GAYER, *PUBLIC FINANCE* 304–29 (8th ed. 2008) (discussing tax shifting that occurs when the economic incidence of taxation differs from the statutory incidence of taxation).

16. Tax items are items that factor into the computation of taxable income. They include items of income, gain, loss, deduction, and credit.

17. See Borden, *supra* note 10 at 338–46 (demonstrating how taxpayers may use the partnership tax allocation rules to engage in tax-item transactions).

Additionally, if entity tax law does not concern itself with the accurate allocation of tax items, parties may elect corporate form and shift the incidence of taxation using the corporate form.<sup>18</sup> The review also demonstrates that the current model fails to justify the various tax regimes. The model does not explain why entity tax is important or why tax law imposes a double tax on distributions from arrangements subject to entity taxation. The current model also fails to contemplate why tax law needs aggregate-plus taxation. Those failures make classification arbitrary and the application of the tax regimes inconsistent. Thus, the shortcomings of the current model threaten the integrity of the tax system.

The Article accepts as a premise of entity classification that classifying business arrangements should help ensure that tax items follow economic items. That premise requires a person who realizes an economic benefit from providing services or owning property to report a corresponding tax item on a tax return. If tax items follow economic items, participants in business arrangements would not be able to alter the character of income, delay the recognition of income, or otherwise shift the tax burden using the classification rules. Such results help promote the accurate placement of the tax burden, which in turn helps promote both equity and efficiency, two linchpins of tax policy.<sup>19</sup> To ensure that tax items follow economic items, the classification model should adopt a metric that accurately measures business participants' economic interest.

Section III suggests that the economic concept of residual risk (rights to the residual assets of a business) is such a metric and demonstrates how it measures economic interests. Residual risk is an important component of the neoclassical theory of the firm, a theory that ignores the legal form of business arrangements and views them as nexuses of contracts.<sup>20</sup> That theory considers the rights and obligations of management, bearers of

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18. For example, a person with property that has significant built-in gain (i.e., the value of the property exceeds the property's tax basis) may contribute such property to an entity taxed as a corporation with at least one other member. If the corporation later sells the property and pays tax on the property, the noncontributing shareholder bears a portion of the incidence of tax on the built-in gain, which should have been borne solely by the contributing shareholder who held the property while the built-in gain accrued. See I.R.C. § 362(a) (2000) (providing that a corporation takes a shareholder's basis in contributed property, if the contribution is tax free). Partnership tax law recognizes this potentiality and helps ensure that the contributing partner bears the incidence of tax on the built-in gain, to the extent reasonably possible. See I.R.C. § 704(c) (2000); Treas. Reg. § 1.704-3(a)(1) (as amended in 2005).

19. See *id.* at 353–77; Sneed, *supra* note 1 at 574–80. Vertical equity, or distributive justice, is another important aspect of tax policy. See *id.* at 581–86. Accuracy is important to vertical equity because it identifies the different economic situations of different taxpayers. Vertical equity is less relevant to tax entity classification because once income is accurately determined, the appropriate distribution of the tax is a matter of political debate and social taste. See Richard A. Musgrave, *Horizontal Equity, Once More*, 43 NAT'L TAX J. 113, 113 (1990).

20. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 311 (1976) (using the term “firm” to refer to a legal fiction that serves as a nexus for contracting relationships).

residual risk, and other market participants.<sup>21</sup> It also helps explain why parties form arrangements and how they use economic items to influence behavior. Because tax law has traditionally drawn significantly from economic theory, its disregard of the economic theory of the firm in tax entity classification is unusual.<sup>22</sup>

The Article introduces three types of residual risk that help measure business participants' economic interests: (1) unitary residual risk, (2) allocation-dependent residual risk, and (3) distribution-dependent risk. These various types of residual risk help classify business arrangements and determine the appropriate tax regime for each type of business arrangement. The Article demonstrates that members of arrangements with unitary residual risk can trace economic items such as income and loss directly from the resources they control. The tax regime that naturally fits such arrangements is aggregate taxation. Members of arrangements with allocation-dependent residual risk cannot trace economic items directly from controlled resources. They may, however, trace economic items from privately-ordered allocations that have independent economic significance. Aggregate-plus taxation is the natural fit for such arrangements. Finally, members of arrangements with distribution-dependent residual risk can trace economic items directly from neither controlled resources nor from privately-ordered allocations. Thus, such arrangements are the natural subject of entity taxation.

Section IV draws from the analysis of the different types of residual risk and the matching tax regimes to create the residual-risk model for classifying business arrangements. The residual-risk model adopts the nexus of contract view of business arrangements and moves away from legal forms and elective regimes. By focusing on the economic rights of

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21. See Harold Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J. L. & ECON. 375, 377 (1983) ("The chief mission of neoclassical economics is to understand how the price system coordinates the use of resources, not to understand the inner workings of real firms."); Oliver E. Williamson, *Organization Form, Residual Claimants, and Corporate Control*, 26 J. L. & ECON. 351, 357 (1983) ("The corporation, after all, is one member of a family of complex organizations, a common theory of which applies to all. Specifically, the same principles of hierarchical decomposition apply to every member of the set."). Legal scholars use economic principles to understand business law generally and to explain developments in business law and the evolution of legal forms of entities. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991) (explaining the structure of corporate law from an economic perspective); Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1335 (2006) (providing a detailed analysis of the evolution of the various legal forms of business entities available to business owners today).

22. Much of the early scholarly work on taxation and income tax came from economists. See, e.g., DAVID RICARDO, *PRINCIPLES OF POLITICAL ECONOMY AND TAXATION* (1817); EDWIN ROBERT ANDERSON SELIGMAN, *THE INCOME TAX* (1911); HENRY C. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* (1938); A.C. PIGOU, *A STUDY IN PUBLIC FINANCE* (1928). This Article uses the term "tax law" to refer specifically to income tax law. The importance of entity taxation extends beyond income tax law, but the analysis of all aspects of tax law would be too unwieldy for this project. Future work should consider whether the proposed model works for other areas of the law.

business participants, the residual-risk model will help ensure that tax items follow economic items and help eliminate the private ordering of the incidence of taxation. Its reliance on economic principles helps to reduce inaccuracies, inequity, and inefficiency and would help classification of business arrangements more closely mirror current economic theory.

## II. CURRENT CLASSIFICATION MODEL

Tax law currently has three general tax regimes – aggregate taxation, aggregate-plus taxation, and entity taxation – with several subsets. The tax regimes are complex, but a few words describe each sufficiently to frame the discussion of business-arrangement classification. Entity taxation recognizes entities separate from their members and imposes a tax at the entity level.<sup>23</sup> Thus, arrangements subject to entity taxation report income and pay an income tax.<sup>24</sup> Entity taxation applies to tax corporations. Aggregate taxation completely disregards a business arrangement and taxes each member of the arrangement separately on income from the arrangement’s property or services.<sup>25</sup> Aggregate taxation applies to disregarded arrangements. Aggregate-plus taxation disregards arrangements to the extent possible, but it adds entity tax components as needed to address the economic aspects and administrative needs of such arrangements.<sup>26</sup> Arrangements subject to aggregate-plus taxation file information returns but do not pay tax.<sup>27</sup> Instead, the members of such arrangements pay tax on their allocable share of the arrangement’s income.<sup>28</sup> Aggregate-plus taxation applies to tax partnerships. The current entity classification model also includes S corporations, which are qualified

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23. Under the current tax system owners of tax corporations are subject to double taxation—tax at the entity level and tax on distributions. See I.R.C. § 11(a) (2000) (imposing a tax on corporations); I.R.C. § 301(c) (2000) (including distributions and dividends in gross income). Entity taxation does not, however, require double taxation. See *Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (1992), available at <http://www.ustreas.gov/offices/tax-policy/library/integration-paper/integration.pdf> [hereinafter, “Treasury Report”]; Edward D. Kleinbard, *Rehabilitating the Business Income Tax*, 2007 TNT 114-42 (June 2007) (recommending that corporate tax system be modified to tax corporate income only once). This Article focuses on the policy reasons for entity tax and for the most part leaves the debate over double taxation for a different venue. Nonetheless, to accurately place the incidence of taxation, the law may need to modify the rate structure of taxes on dividends or eliminate the tax.

24. See I.R.C. § 11(a) (2000) (imposing a tax on corporations).

25. See, e.g., *Hahn v. Comm’r*, 22 T.C. 212, 214 (1954) (holding that members of a tenancy in common have income from the property equal to their ownership interests in the property).

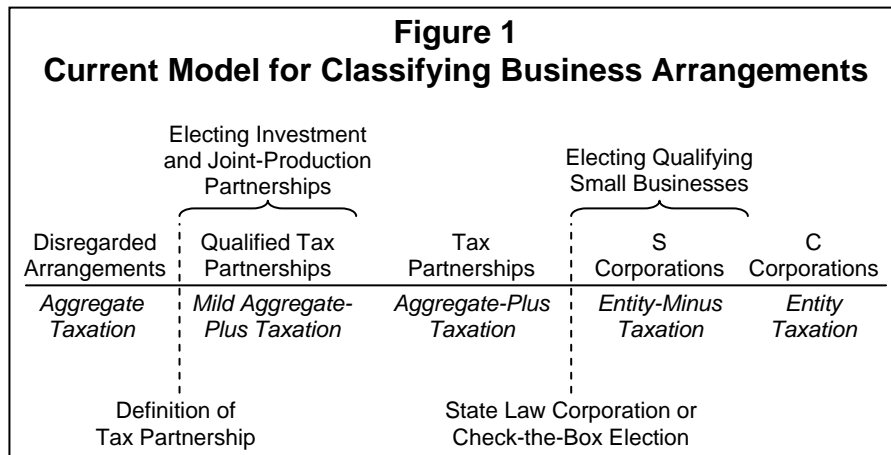
26. See Bradley T. Borden, *The Aggregate-Plus Theory of Partnership Taxation*, 43 GA. L. REV. \_\_\_\_ (forthcoming 2009), [ssrn.com/abstract\\_id=1121351](http://ssrn.com/abstract_id=1121351) (describing the history, theory, and policy justification for aggregate-plus taxation).

27. See I.R.C. § 701 (2000) (providing that partnerships are not subject to tax); Treas. Reg. § 1.6031(a)-1(a) (as amended in 2005) (requiring partnerships to file returns).

28. See I.R.C. § 701 (2000) (providing that partners are liable in their individual capacities for tax on income of a partnership).

closely-held corporations.<sup>29</sup> Originally, such arrangements were subject to entity taxation, Congress realized that they should not pay an entity tax. Therefore, it removed certain components from entity taxation to allow tax items to flow from the arrangement to the members, who pay tax on such items.<sup>30</sup> The removal of entity components created entity-minus taxation.

Finally, the current classification model includes qualified tax partnerships. Qualified tax partnerships are arrangements that come within the definition of tax partnership but elect out of partnership taxation.<sup>31</sup> Such arrangements include investment partnerships and joint-production partnerships.<sup>32</sup> Even though qualified tax partnerships are not subject to partnership tax rules, other provisions of the tax law may recognize them as tax partnerships.<sup>33</sup> Thus, they are not subject to pure aggregate taxation. Instead, they are subject to a mild form of aggregate-plus taxation. Figure 1 represents the current model for classifying business arrangements.<sup>34</sup>



29. See I.R.C. § 1361(a) (2000) (providing that an S corporation is an electing small business corporation); I.R.C. § 1361(b) (2000) (defining small business corporation to include only closely held corporations).

30. See Jerald David August, *Benefits and Burdens of Subchapter S in a Check-the-Box World*, 4 FLA. TAX REV. 287, 322–30 (1999) (discussing the history of S corporations).

31. See I.R.C. § 761(a) (2000).

32. See I.R.C. § 761(a)(1) (2000) (providing an election for tax partnerships availed of for investment purposes); I.R.C. § 761(a)(2) (2000) (providing an election for certain tax partnerships availed of for joint production of services or property).

33. See *Bryant v. Comm'r*, 46 T.C. 848, 864 (1966) (“The partnership remains intact and other sections of the Code are applicable as if no exclusion existed.”).

34. A more complete model would also include arrangements such as real estate investment trusts and foreign entities. For the sake of introducing the residual-risk model, this Article focuses only on those arrangements identified in Figure 1. Future work should consider the model that classifies other arrangements. See Bradley T. Borden, *Policy and Theoretical Dimensions of Qualified Tax Partnerships*, 56 U. KAN. L. REV. 317, 320 (2008) (introducing the tax entity classification spectrum).

Figure 1 depicts the current classification model as a continuum. Tax law moves from aggregate taxation by degrees to entity taxation. The arrangements move concurrently from disregarded to entity status. As Figure 1 depicts, the definition of tax partnership separates disregarded arrangements from tax partnerships. The line separating tax partnerships from tax corporations (S corporations and C corporations<sup>35</sup>) is state law classification or a check-the-box election.<sup>36</sup> Qualified tax partnerships and S corporations are sub-sets of tax partnerships and tax corporations, respectively. The figure also depicts how the various tax regimes track the classification of business arrangements. The following discussion reveals the origin and evolution of the current model. The discussion demonstrates that tax law has lagged behind legal and economic theories, and that it fails to match tax regimes with relevant economic and legal concepts of business arrangements.

#### A. Grant Theory and Corporate Resemblance

The origin and evolution of business arrangements sets the stage for discussing tax classification. The natural form of business entity is the partnership, originating thousands of years ago.<sup>37</sup> A typical ancient merchant partnership divided investment and management among the partners.<sup>38</sup> Such arrangements were attractive because investors, who exercised no control over the operations of the arrangement, were liable only to the extent of invested capital.<sup>39</sup> Managers, on the other hand, brought little if any capital to the arrangement but bore liability for losses incurred due to their neglect.<sup>40</sup> Such arrangements usually lasted only a short period, generally the duration of a single venture.<sup>41</sup> The short duration and immediate settling of accounts provided liquidity for the

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35. A C corporation is a tax entity subject to the entity tax provision in subchapter C of the Internal Revenue Code.

36. The modern classification model actually includes within the definition of tax corporation other state-created and foreign entities. See Treas. Reg. § 301.7701-2(b) (as amended in 2008). To simplify the discussion, this Article uses state-law corporation to refer to all of the arrangements listed in the definition.

37. See ABRAHAM L. UDOVITCH, *PARTNERSHIP AND PROFIT IN MEDIEVAL ISLAM* (1970) (discussing medieval Islamic partnerships); Hansmann, Kraakman & Squire, *supra* note 21 at 1356–61 (tracing partnerships to ancient Rome); Henry Fr. Lutz, *Babylonian Partnerships*, 4 J. ECON. & BUS. HIST. 552, 557–59 (1932) (tracing partnerships to the first recorded private business enterprises in ancient Babylon during the Hammurabi period (2057 to 1758 B.C.); Borden, *supra* note 26.

38. See Hansmann, Kraakman & Squire, *supra* note 21 at 1361 (describing the Roman *societas publicanorum*, which included investors who exercised control and those who lacked control), 1372–74 (describing the medieval Italian *commenda*, which had “two partners: a passive investor who provided capital, and a traveling trader (often ship captain) who contributed labor and initiative”).

39. See Lutz, *supra* note 37 at 559.

40. See *id.*

41. See *id.* at 566.

investor.<sup>42</sup> Because the manager was often away from the creditors of the investor, the investor's creditors could not disrupt the venture, providing the arrangement with a weak form of entity shielding.<sup>43</sup> In a simple economy with relatively small ventures, such unsophisticated short-term arrangements were suitable. In other arrangements, the investors had the right to withdraw capital, recouping their investments and any rightful returns on the investment.<sup>44</sup> Such arrangements provided liquidity to the investors.

The evolution of business made simple arrangements inadequate for large-scale ventures. Longer distances traveled required investors to wait longer for ventures to complete prescribed activities. Frequent asset liquidations were cumbersome and inefficient, and the right to withdraw would threaten the longevity and success of larger ventures.<sup>45</sup> Financially and geographically larger enterprises also needed greater sums of capital, but had to provide investors with liquidity and limited liability.<sup>46</sup> Tools that provided limited liability, liquidity, and entity shielding in a simpler arrangements in a simpler economy became insufficient. Without preferred features in place, the cost of capital would have become prohibitive. The law reacted to the economic needs of larger enterprises by creating state-chartered publicly-traded joint stock companies as early as the fourteenth century.<sup>47</sup>

Joint stock companies granted investors the right to sell their interests in the company without the consent of other owners, satisfying the investors' need for liquidity.<sup>48</sup> Investors in joint stock companies also enjoyed limited liability, and the law provided entity shielding.<sup>49</sup> Such features made the cost of capital affordable and facilitated the growth of private business enterprises. The state's creation of early joint stock companies provided the company a monopoly to trade in a particular area, operate a particular asset, or perform some other specific function.<sup>50</sup> The monopolies allowed businesses to grow financially and geographically.

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42. See Hansmann, Kraakman & Squire, *supra* note 21 at 1376–77 (explaining that tradable interests were necessary for entities with perpetual existence to provide investors with liquidity).

43. See *id.* at 1368, 1372–73 (noting that the manager's liability for shortfalls also discouraged distributions, providing another form of entity shielding). “[Entity] shielding refers to rules that protect a firm's assets from the personal creditors of its owners.” *Id.* at 1337 (emphasis in original).

44. See *id.* at 1388–92.

45. See *id.* at 1376.

46. See *id.* at 1376–79.

47. Genoa appears to have created the first joint stock company as early as 1346. See William Mitchell, *Early Forms of Partnership*, 3 SELECT ESSAYS IN ANGLO-AMERICAN LEGAL HIST. 183, 193 (1909). England, Holland, and France created joint stock companies in the seventeenth century. See *id.* at 193–94. Joint stock companies descended from chartered trade guilds. See Samuel Williston, *History of the Law of Business Corporations Before 1800*, 2 HARV. L. REV. 105, 108–10 (1888).

48. See Hansmann, Kraakman & Squire, *supra* note 21 at 1376–77.

49. See *id.* at 1378.

50. See *id.*; Williston, *supra* note 47 at 111 (listing banks, trading companies, and mines as examples of early joint stock companies).

The monopolistic nature of joint stock companies carried over to early corporations chartered in the Colonies and later in the United States.<sup>51</sup> Through the early nineteenth century states granted corporate monopolies for quasi-governmental functions, such as operating canals, building roads, or providing financial services.<sup>52</sup> From the grant of such monopolies emerged the “grant” or “concession” theory of corporations, which considered state law incorporation a grant or privilege for the pursuit of a public purpose.<sup>53</sup> The grant theory recognized the corporation as an artificial being created by the state with powers strictly limited by its charter.<sup>54</sup> Legislative bribery, political favoritism, and monopoly eventually led to free incorporation, which made corporations universally available in the United States by the end of the eighteenth century.<sup>55</sup> Such free incorporation undermined the grant theory and corporations became the preferred entity for large enterprises.<sup>56</sup> Even though the rise of free incorporation undermined the grant theory, some commentators and law makers still considered incorporation a privilege into the twentieth century.<sup>57</sup>

The entity concept followed on the heels of the grant theory and lawmakers and commentators developed a list of entity characteristics.<sup>58</sup> Early twentieth century characteristics were: (1) free transferability of interests, (2) continuity of life, (3) limited liability, and (4) centralized management.<sup>59</sup> At the turn of the twentieth century, partnerships, in contrast to corporations, were not considered entities.<sup>60</sup> They were considered aggregates of their members.<sup>61</sup>

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51. See Simeon Eben Baldwin, *History of the Law of Private Corporations in the Colonies and States*, 3 SELECT ESSAYS IN ANGLO-AMERICAN LEGAL HIST. 236, 243–55 (1909) (giving examples of early chartered corporations in the colonies and early United States and identifying early corporate statutes).

52. See Hansmann, Kraakman & Squire, *supra* note 21 at 1394 (“In the late eighteenth and early nineteenth centuries, state legislatures granted charters primarily to the same kinds of firms that Parliament had typically allowed to incorporate: those that built and ran canals, bridges, and turnpikes.”).

53. See *Dartmouth College*, 17 U.S. 518, 637 (1819) (“They are deemed beneficial to the country; and this benefit constitutes [sic] the consideration, and in most cases, the sole consideration of the grant.”); Morton J. Horowitz, *Santa Clara Revisited: The Development of Corporate Theory*, 88 W. VA. L. REV. 173, 181 (1985).

54. See Horowitz, *supra* note 53 at 181.

55. See *id.* Free incorporation did not immediately eliminate monopolistic corporate grants, which existed through the early nineteenth century. See *supra* note 52.

56. See Horowitz, *supra* note 53 at 181.

57. See, e.g., *Flint v. Stone Tracey Co.*, 220 U.S. 107, 141, 151–52 (1911) (recognizing that the corporate excise tax was a tax on the privilege to doing business in corporate or quasi-corporate form).

58. See Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L. J. 53, 58–59 (1990).

59. See Kornhauser, *supra* note 58 at 61.

60. See Horowitz, *supra* note 53 at 182.

61. See UNIF. P’SHIP ACT, Prefatory Note (1914), 6 U.L.A. 276 (2001).

The formalities of early corporate laws made them unavailable to smaller businesses.<sup>62</sup> Thus, smaller businesses generally could not enjoy limited liability and strong entity shielding at the turn of the twentieth century.<sup>63</sup> The use of partnerships and corporations during that period reveals an understanding that large businesses (operated as corporations) needed entity shielding and limited liability to raise sufficient capital. The more intimate nature of small business did not mandate those protections, so the partnership form sufficed for smaller arrangements.

In that environment, Congress enacted the Corporate Excise Tax of 1909, imposing a tax on the privilege of conducting business in corporate form.<sup>64</sup> The limited scope of that act (it applied to corporations and joint stock companies or associations<sup>65</sup>) gave tax entity classification its modern significance.<sup>66</sup> As interpreted by the Supreme Court, the corporate excise tax applied only to corporations and statutory joint stock companies organized under state law.<sup>67</sup> That original model for classifying tax entities was formalistic, depending on the manner in which the arrangement was formed.

The excise tax on corporations reflected the grant theory's focus on the corporate privilege.<sup>68</sup> The Supreme Court's narrow reading of the act's scope also reflects that view,<sup>69</sup> even though substantive law's understanding of corporations had adopted the entity view several years

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62. See Hansmann, Kraakman & Squire, *supra* note 21 at 1395.

63. See Hansmann, Kraakman & Squire, *supra* note 21 at 1394–95; Kornhauser, *supra* note 58 at 55 (noting that the turn of the century also witnessed a transformation of capitalism from a system of owner-managed firms to large nonowner-managed corporations). See also Richard Winchester, *Corporations that Aren't: The Early Years of the Income Tax*, (draft of unpublished article on file with Author) (describing particular aspects of the corporate tax in its earliest years in the United States).

64. See Revenue Act of 1909, ch. 6, § 38, 36 Stat. 11, 112 (“shall be subject to pay annually a special excise tax with respect to *carrying on or doing business* by such corporation”) (emphasis added).

65. The wording of the statute left some ambiguity about its scope. It applied to “every corporation, joint stock company or association, organized for profit, and having a capital stock represented by shares[.]” Revenue Act of 1909, ch. 6, § 38, 36 Stat. 11, 112. Treasury interpreted that language in a manner that applied the statute to corporations, joint stock companies, and associations. See Treas. Reg. 31, T.D. 1571, 12 Treas. Dec. Int. Rev. 131 (1909). The Supreme Court appeared to agree that associations, as long as they were organized under state law, could be an independent concept. See *Flint v. Stone Tracey Co.*, 220 U.S. 107, 141, 151–52 (1911) (identifying the tax as on the privilege to doing business in corporate or quasi-corporate form).

66. The first U.S. tax law to distinguish between corporations and other entities was the Revenue Act of 1894, which imposed an entity level income tax on corporations, but not on partnerships. See Revenue Act of 1894, ch. 349, § 32, 28 Stat. 509, 556. The Supreme Court declared the act unconstitutional within a year of its enactment. See *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, 586 *modified*, 158 U.S. 601 (1895). For a comprehensive review of the definition of tax corporation up to 1995, see generally Patrick E. Hobbs, *Entity Classification: The One Hundred-Year Debate*, 44 CATHOLIC U. L. REV. 437 (1995).

67. See *Eliot v. Freeman*, 220 U.S. 178, 185–87 (1911) (placing emphasis on whether an entity is organized under a state's statute).

68. See *supra* note 64.

69. See *Eliot*, 220 U.S. 185–87 (emphasizing organization under state law).

earlier. This demonstrates that modern tax law's original entity classification model lagged behind the legal understanding of corporations. To the Supreme Court's credit, however, an excise tax on the corporate privilege does have some policy appeal. Because the state grants the corporate privilege and provides a setting for corporations to flourish, a tax on such privilege does not seem unreasonable.<sup>70</sup> With that justification, the tax should only apply to state-law corporations, so the Supreme Court's ruling was consistent with the policy justification for the tax.

Congress enacted the corporate excise tax because it was concerned that the Supreme Court might declare an income tax unconstitutional or be forced to overturn its earlier decision.<sup>71</sup> The corporate excise tax was also a stop gap to appease income tax proponents while lawmakers worked to amend the Constitution to grant Congress the power to tax income.<sup>72</sup> Following the ratification of the sixteenth amendment (which gave Congress the power to tax income from whatever source derived without apportionment<sup>73</sup>) in 1913, Congress enacted a corporate income tax.<sup>74</sup> That act specifically provided that partnerships were not subject to income tax, but partners would pay tax on their respective shares of partnership income.<sup>75</sup> The corporate income tax applied only to "corporations, joint stock companies, or associations however created or organized."<sup>76</sup> That language eliminated the requirement that tax corporations be organized under a state statute and elevated legal substance over legal form. Some doubt lingered, however, about whether the definition included associations. Subsequent legislation clarified that the corporate tax applied to associations.<sup>77</sup> That modification required Treasury and courts to define association.

Early on Treasury adopted regulations defining association to include certain state-law partnerships and business trusts.<sup>78</sup> Later, Treasury

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70. See Kornhauser, *supra* note 58 at 100 (quoting President Taft as supporting the tax on the privilege of doing business as an artificial entity).

71. See Hobbs, *supra* note 66 at 454–55.

72. See Kornhauser, *supra* note 58 at 93. Although commentators and lawmakers debated whether *Pollock* truly prevented the enactment of an income tax, enough doubt existed to warrant the amendment to the Constitution in 1913. See ERIK M. JENSEN, *THE TAXING POWER: A REFERENCE GUIDE TO THE UNITED STATES CONSTITUTION* 56–66 (2005).

73. See U.S. CONST. amend. XVI.

74. See Revenue Act of 1913, ch. 16, § II.G.(a), 38 Stat. 114, 172.

75. See Revenue Act of 1913, ch. 16, § II.D., 38 Stat. 114, 169.

76. See Revenue Act of 1913, ch. 16, § II.G.(a), 38 Stat. 114, 172. That statute was not without its problems, however, respecting the definition of taxable entities. See Hobbs, *supra* note 66 at 463–66 (explaining that the statute left unresolved whether the term "however created or organized" applied to each of the listed terms or only to insurance companies).

77. See Revenue Act of 1918, ch. 18, § 1, 40 Stat. 1057, 1058 (defining tax corporation to include "associations, joint-stock companies, and insurance companies").

78. The regulations provided that a trust would be an association for tax purposes if it engaged in business and the beneficiaries controlled the trustees' activities. See Treas. Reg. 45, art. 1504, 23 Treas. Dec. Int. Rev. 591. Under the regulations, a partnership was an association for tax purposes if

clarified the definition with regulations that listed entity characteristics: (1) profit-seeking activity, (2) continuity of existence, (3) centralization of management, (4) ability to hold property, (5) ability to sue and be sued, and (6) limited liability.<sup>79</sup> Shortly thereafter, in 1935, the Supreme Court used the entity characteristics to hold that a trust resembling a corporation was a tax corporation.<sup>80</sup> The Court's use of the entity characteristics became known as the corporate resemblance test.<sup>81</sup> Thus, more than thirty years after substantive law adopted an entity view of corporations, tax law incorporated that view into its classification model.

The classification model's use of the entity characteristics is a mystery from a tax policy perspective. The statute required a division between arrangements subject to the corporate tax and arrangements not subject to the corporate tax. An accurate division would require a clear policy position for entity taxation. Such position was nonexistent.<sup>82</sup> The lack of clear policy reasons for the corporate income tax indicates that the courts and Treasury adopted the corporate resemblance test merely to clarify ambiguous terms. The characteristics themselves do not define parties' economic interests but the law did not adequately express the economic interests the corporate tax should cover.

In 1954, the corporate resemblance test cost the IRS a challenge of a taxpayers' corporate classification.<sup>83</sup> Treasury followed that defeat by amending its regulations to state the characteristics, give each characteristic equal weight, and provide that an arrangement must possess more than half the characteristics to be a tax corporation.<sup>84</sup> The new regulations became known as the Kintner Regulations, taking the name of the case the IRS lost.<sup>85</sup> The Kintner Regulations ended any connection between the substantive law understanding of entity classification and tax law's classification model. Substantive law recognized entity characteristics but

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the interests were freely transferable and some of the members were passive investors. *See* Treas. Reg. 45, art. 1503, 23 Treas. Dec. Int. Rev. 591-92. A limited partnership was an association for tax purposes if the partnership provided limited liability, freely transferable interests, and the right to sue in the name of the partnership. Treas. Reg. 45, art. 1506, 23 Treas. Dec. Int. Rev. 592.

79. *See* Treas. Reg. 86, art. 801-3 (1934) (describing characteristics that cause a trust to be a tax corporation); Hobbs, *supra* note 66 at 476.

80. *See* *Morrissey v. Comm'r*, 296 U.S. 344, 359 (1935) (finding that the trust held title to property, had centralized management, continuity of existence, provided owners limited liability, and carried on a real estate development business).

81. *See* Hobbs, *supra* note 66 at 478.

82. *See infra* text accompanying note 89-95.

83. *See* *Kintner v. United States*, 216 F.2d 418, 420 (9th Cir. 1954) (holding that an unincorporated association to practice medicine and "endowed with the 'attributes of incorporation'" by the members was a tax corporation).

84. *See* Treas. Reg. § 301.7701-2(a)(2), -2(a)(3) (1960) (listing the following slightly different characteristics: (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for corporate debts limited to corporate property, and (6) free transferability of interests).

85. *See* Hobbs, *supra* note 66 at 485.

did not have a bright-line scorecard for classifying arrangements. Recall from above that the substantive law developed legal forms with entity characteristics to meet the demands of economic activity.<sup>86</sup> Owners of capital and labor needed entity shielding, limited liability, perpetual business forms, centralized management, and investor liquidity to successfully and efficiently conduct business in the expanding economy.<sup>87</sup> Such characteristics are attractive to members of smaller business arrangements and, as corporations became accessible to all forms of business, more small businesses incorporated.<sup>88</sup> The business and economic need for such characteristics explains their existence, but the characteristics do not justify a model for classifying tax entities. Such characteristics may not affect the economic rights of the parties.

The Kintner regulations' lack of support may stem from the general lack of policy support for corporate income tax. None of the reasons espoused for enacting a corporate tax provide a satisfactory justification for entity taxation and its boundaries.<sup>89</sup> An examination of just one convincing explanation reveals the general lack of tax policy justifications in this area. One explanation for the early corporate income tax is that Congress used it to obtain information from corporations that had grown significantly but remained unregulated.<sup>90</sup> That explanation may very well describe the motivation for the early corporate tax provisions, but subsequent securities regulation would have made the rationale obsolete.<sup>91</sup> Furthermore, the rationale does not reflect sound tax policy. The use of tax law to regulate business disguises Congress's exercise of police power and diverts the taxing authority from its primary purpose of raising revenue equitably and efficiently.

Over the decades, tax law has taxed corporate distributions at varying rates, which generally imposed a double tax on corporate income.<sup>92</sup>

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86. See *supra* text accompanying note 44–61.

87. See *supra* text accompanying notes 44–50.

88. See Hansmann, Kraakman & Squire, *supra* note 21 at 1396.

89. For an in-depth critique of the various theories, see Field, *supra* note 14. One commentator argues in favor of the corporate income tax based largely on its progressive venture, ability to raise revenues efficiently, prevent unlimited deferral, political acceptance, entrenchment in our current system, and the significant costs that would result from its repeal. See Kim Brooks, *Learning to Live with an Imperfect Tax: A Defence of the Corporate Tax*, 36 U. BRIT. COLUM. L. REV. 621, 630–54 (2003). Those arguments, although compelling in the existing environment, do not support the original enactment of the corporate income tax. Other commentators have begrudgingly agreed that anti-deferral justifies entity taxation. See, e.g., J. Clifton Fleming, Jr. & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, 27 VA. TAX. REV. 437, 503–06 (2008) (suggesting that the entity tax is a “crude, second-best anti-deferral device”).

90. See Kornhauser, *supra* note 58 at 113–33.

91. See Securities Act of 1933, § 5(a), 15 U.S.C. § 77e(a)(1) (2000) (requiring registration of securities); Securities Act of 1933, § 7, 15 U.S.C. § 77g (2000) (describing the information required in a registration statement).

92. See generally Winchester, *supra* note 63.

Commentators have bemoaned the double tax and called for its repeal,<sup>93</sup> and have generally been unable to offer a satisfactory policy explanation for its existence. One explanation is the lock-in theory, which provides generally that management prefers the tax on corporate distributions because it creates a disincentive for the owners to demand distributions.<sup>94</sup> Although that may explain the continued existence of the tax on dividends from a public-choice perspective, it does not provide a satisfactory tax policy argument. Management's business preferences should not dictate the direction of tax law. Finally, the entity characteristics that make lock-in possible, in particular entity shielding, are available to many arrangements that are not taxed as corporations.<sup>95</sup>

With no satisfactory reason for the corporate tax and second tax on distributions, current corporate tax appears to be a product of tradition, surviving from the original 1909 act, and an extra source of revenue.<sup>96</sup> Tax law appears to have merely adopted the substantive law concept of entity and the entity characteristics to define tax corporation. With no policy direction supporting such adoption, however, the law eventually became formalistic, abandoning any notion of policy support.

## B. Elective Model and Private Ordering of Tax Liability

Despite their significant shortcomings, the Kintner Regulations became entrenched in the law. Tax planners began to obtain the classification that provided business owners the most favorable tax treatment.<sup>97</sup> Using the Kintner Regulations and skilled document drafting, lawyers could create either a tax partnership or tax corporation according to

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93. See, e.g., Treasury Report *supra* note 23 at 1–12 (identifying the distortive nature of a double-tax regime); Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055, 1098–1103 (recounting the equity and efficiency arguments against the corporate tax); George K. Yin, *Corporate Tax Integration and the Search for the Pragmatic Ideal*, 47 TAX. L. REV. 431, 431,480–501 (1992) (recognizing that the double-tax on corporate income distorts the basic choice of entity and the choice between debt and equity financing, and recommending two-low rate taxes on distributed income to help eliminate distortions); Fred W. Peel, *A Proposal for Eliminating Double Taxation of Corporate Dividends*, 39 TAX. LAW. 1, 2–5 (1985) (recounting the objections to double taxation).

94. See generally, Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 GEO. L. J. 889 (2006) (presenting historical evidence that the corporate income tax and tax on distributions is intended to discourage capital distributions from corporations); Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L. J. 325, 359–62 (1995) (arguing that managers often do not support the double tax, but they may if their interests diverge from shareholders and they prefer retaining earnings within the corporation).

95. See UNIF. P'SHIP ACT § 502, 504 (1997), 6 U.L.A. 156, 160 (2001) (limiting a partner's judgment creditor's claim to a partner's transferable interest in the partnership). *But see* UNIF. P'SHIP ACT § 801(1) (1997) (providing that the withdrawal of a partner in an at-will partnership will dissolve the partnership, which would eliminate the lock-in effect). The limited use of at-will partnerships suggests that the lock-in effect is fairly prevalent in businesses.

96. See Brooks, *supra* note 89 at 647–51.

97. See Field, *supra* note 14.

their clients' tax preferences.<sup>98</sup> Creating entity characteristics through contract can, however, be cumbersome and adds to the cost of business formation. To make characteristics more accessible to noncorporations, business people began lobbying states to create hybrid entities that would provide desired characteristics but grant leeway to avoid some entity characteristics.<sup>99</sup> The Wyoming legislature responded to those efforts, creating the first limited liability company in 1977.<sup>100</sup> Limited liability companies provide their members limited liability and sufficient drafting flexibility that they can avoid other entity characteristics and tax corporation classification. After Wyoming created the limited liability company, the IRS blessed the classification of a properly-structured limited liability company as a tax partnership.<sup>101</sup> A subsequent 1988 ruling ignited an explosive growth of limited liability company acts.<sup>102</sup>

The spread of limited liability company popularity is the result of economic needs converging with tax wants. Business arrangements of all sizes needed some of the entity characteristics, but they also wanted the greatest possible flexibility in managing their tax affairs. State limited liability company acts and the IRS ruling allowed those two preferences to merge. Although an attractive combination to business owners, the merger of economic needs and tax wants neglects tax policy.

By ruling that limited liability companies could be tax partnerships the IRS created a *de facto* elective regime for classifying tax entities. Such a classification model has serious policy deficiencies. First, an elective regime taxes similarly situated taxpayers differently. For example, two entities could possess all of the same corporate characteristics other than continuity of life and free transferability of interests (which are arguably immaterial from a tax policy perspective), and tax law could treat them differently.<sup>103</sup> Second, the elective regime created administrative complexity as taxpayers had to spend more resources to obtain the desired tax treatment and the IRS had to spend more resources to consider tax entity classification.<sup>104</sup> Such treatment favors the well-advised taxpayers

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98. See Victor E. Fleischer, Note, "If it Looks Like a Duck": Corporate Resemblance and Check-the-Box Elective Tax Classification, 96 COLUM. L. REV. 518, 527 (1996).

99. See William J. Carney, *Limited Liability Companies: Origins and Antecedents*, 66 U. COLO. L. REV. 855, 857 (1995).

100. See Wyoming Limited Liability Company Act, ch. 158, 1977 Wyo. Sess. Laws 577 (March 4, 1977).

101. See Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980) (ruling that a limited liability company lacking continuity of life and free transferability of interests was a tax partnership).

102. See Rev. Rul. 88-76, 1988-2 C.B. 360 (ruling that a Wyoming limited liability company could be a tax partnership); Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 MICH. L. REV. 393, 403-04 (1996) (identifying limited liability company statutes for all fifty states by 1996).

103. See Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980).

104. See Dean, *supra* note 14 at 453-55 (describing complexity that arises when the choice of entity classification intersects with other provisions of a complex income tax structure and distinguishes between well-advised taxpayers and others).

and places a larger tax burden on the unrepresented taxpayer.<sup>105</sup> Third, the *de facto* election allows business owners to privately affect the placement of the incidence of taxation by modifying legal documents. Therefore, the regime is not efficient.

Even though the first two concerns (inequity) and the third (efficiency) are legitimate policy concerns, attention focused on the significantly less substantial concern of administrative complexity. Commentators began advocating a *de jure* elective model that would replace the *de facto* elective model in the Kintner Regulations.<sup>106</sup> The rationale appeared to be fairly straight forward: the current system was elective and complex, so a simple elective regime would be better.<sup>107</sup> The promulgation of the check-the-box regulations is evidence that Treasury embraced the simplicity argument.<sup>108</sup> The check-the-box regulations provide that all entities incorporated under state law are tax corporations, and all other multiple-member business entities shall be tax partnerships by default.<sup>109</sup> Tax partnerships and single-member business entities may, however, elect to be tax corporations<sup>110</sup>—thus the appellation, “check-the-box regulations.”

The check-the-box regulations simplified the elective classification model, but exacerbated inequity and inefficiency.<sup>111</sup> Under the check-the-box regulations, tax law may treat two identical legal entities differently. For example, an electing partnership is a tax corporation while a non-electing partnership is a tax partnership, even though they are legally and economically identical. Tax policy does not support sacrificing equity for

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105. This assumes that government revenue needs remain constant and where one individual's tax burden decrease another's increases.

106. See Field, *supra* note 14.

107. See Susan Pace Hamill, *The Taxation of Domestic Limited Liability Companies and Limited Partnerships: A Case for Eliminating the Partnership Classification Regulations*, 73 WASH. U. L. Q. 565, 600 (1995) (suggesting the check-the-box election would simplify the classification process and recognizing that “the well advised have always been able to avoid corporate tax by forming as a partnership or LLC that complies with the classification regulations or a corporation that pays out its earnings in deductible items or elects Subchapter S”).

108. See Preamble to the Simplification of Entity Classification Rules, 61 Fed. Reg. 21,989 (1996) (Proposed May 13, 1996) (“Treasury and the IRS believe that it is appropriate to replace the increasingly formalistic rules under the [Kintner Regulations] with a much simpler approach that is generally elective.”). Commentators and practitioners generally hailed the promulgations of the check-the-box regulations as a good thing. See, e.g., Michael L. Schler, *Initial Thoughts on the Proposed “Check-the-Box” Regulations*, 71 TAX NOTES 1679, 1681 (June 17, 1996) (suggesting that the regulations were good because they made the election easier for sophisticated taxpayers, enabled less-sophisticated taxpayers to make the election, and eliminated arbitrary rules). *But see* Aaron Brooks, *Chuck the Box: Proposed Entity Classification Regulations Bring Bad Policy*, 70 TAX NOTES 1669, 1674–76 (Mar. 18, 1996) (arguing that the check-the-box regulations would produce inequities).

109. See Treas. Reg. § 301.7701-3(a) (as amended in 2006). “Business entity” is a term used in the check-the-box regulations to refer to any arrangement recognized as separate from its members. See Treas. Reg. § 301.7701-2(a) (as amended in 2007).

110. See Treas. Reg. § 301.7701-3(a) (as amended in 2006).

111. See, e.g., Field, *supra* note 14; Brooks, *supra* note 108 at 1674–76.

simplicity, and now commentators criticize the elective classification model because it adds complexity to the tax system.<sup>112</sup> Thus, the regulations arguably have no policy support.

The continuing evolution of legal entities provides business owners significant leeway to privately order their tax affairs. From the relative statutory rigidity of the corporation to the almost unrestricted flexibility of statutory business trusts and general partnerships, business owners are able to choose the legal characteristics their entities will take.<sup>113</sup> The check-the-box regulations allow business owners to choose from an array of tax alternatives and regardless of business owners' economic arrangements.<sup>114</sup> Now, arrangements of all sizes possess entity characteristics and can choose their favored tax classification.<sup>115</sup> Tax law has therefore by and large turned entity classification over to business owners.<sup>116</sup> The current entity classification model relegates economic reality, which is so important throughout the rest of tax law, to second place behind simplicity.

### C. Tax Partnership versus Disregarded Arrangement

An often overlooked classification issue is the difference between tax partnerships and disregarded arrangements, which include employment, financing, leasing, and co-ownership arrangements.<sup>117</sup> Business arrangements that are not tax corporations should generally be tax partnerships or disregarded arrangements.<sup>118</sup> Unlike the bright-line test that distinguishes tax partnerships from tax corporations, the undeveloped and

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112. See Field *supra* note 14. See Dean, *supra* note 14 at 453–55; George K. Yin, *The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the “Check-the-Box” Regulations*, 51 SMU L. REV. 125, 130 (1997) (“The taxpayer must incur the transaction cost of evaluating all tax consequences of the available options before making an informed choice.”).

113. See Hansmann, Kraakman & Squire, *supra* note 21 at 1396–97 (describing the evolution of the law of business entities as a result of the tax entity classification rules and the most recent emergence of the statutory business trust, which grants entity shielding and limited liability but otherwise leaves the contractual arrangement to the owners).

114. Commentators have also criticized the check-the-box regulations for their shortcomings with respect to non-U.S. entities. See, e.g., Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05 at 182–185 (Jan. 27, 2005); American Bar Association, *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 669 (2006). Tax entity classification requires significant attention. Unfortunately, the length of this Article does not permit a consideration of the entity classification rules that apply to foreign entities.

115. See Treas. Reg. § 301.7701-3(a) (as amended in 2006) (providing an elective classification regime); Hansmann, Kraakman & Squire, *supra* note 21 at 1394–99 (explaining that business participants have a significant variety of legal forms to choose from when forming an entity).

116. The only exception is for certain publicly traded arrangements, which the law treats as tax corporations. See I.R.C. § 7704(a) (2000).

117. See Bradley T. Borden, *The Federal Definition of Tax Partnership*, 43 HOUS. L. REV. 925, 936–41 (2006).

118. Some business arrangements may be real estate investment trusts or other type of tax arrangement. This Article confines its consideration to tax corporations, tax partnerships, and disregarded arrangements. The Article leaves such other arrangements for future consideration.

confusing definition of tax partnership distinguishes tax partnerships from disregarded arrangements.<sup>119</sup> An arrangement that comes within the definition of tax partnership may use the partnership tax accounting and reporting rules for abusive purposes. For example, recent tax shelter transactions used sham partnerships to shield hundreds of millions of dollars of taxes from the government.<sup>120</sup> Investment advisors use tax partnerships to convert compensation into long-term capital gain.<sup>121</sup> Partners may also use the allocation rules to gain tax advantages.<sup>122</sup>

History partially explains the unclear definition of tax partnership. Tax law originally disregarded tax partnerships, in an era when legal theory was uncertain about the nature of tax partnerships but generally considered them aggregates of their owners.<sup>123</sup> Partnership tax law added entity components to partnership tax law to facilitate tax administration, but it has retained the aggregate view of tax partnerships to the extent possible.<sup>124</sup> The initial disregard and later addition of entity components describe aggregate-plus taxation. Tax policy therefore suggests that the definition of tax partnership should include only arrangements that require partnership tax accounting and reporting rules for the efficient administration of taxes. The evolution of the definition does not, however, appear to recognize that policy norm. A review of existing law uncovers tests used to define tax partnerships,<sup>125</sup> but nothing more than very general statements summarize the existing definition of tax partnership.

Questions regarding the federal definition of tax partnership fall into one of two categories. The first question is whether an arrangement is a tax

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119. See Bradley T. Borden, *A Catalogue of Legal Authority Addressing the Federal Definition of Tax Partnership*, 804 TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES, 763, 777–824 (2008) (summarizing more than 125 statutes, cases, regulations, and rulings that have considered the definition of tax partnership); Borden, *supra* note 117 at 970–1031 (exploring the current state of the definition of tax partnership); WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS*, ¶ 3.01 (3d ed. 2004) (“The most basic, and perhaps the most difficult, problem in the taxation of partnerships and partners is the determination whether a particular financial, business, or otherwise economic arrangement constitutes a partnership for income tax purposes.”).

120. See, e.g., *TIFD III-E Inc. v. Comm’r*, 459 F.3d 220 (2d Cir. 2006); *Andantech L.L.C. v. Comm’r*, 331 F.3d 972 (D.C. Cir. 2003); *SABA P’ship v. Comm’r*, 273 F.3d 1135 (D.C. Cir. 2001).

121. See Gregg Polsky, *supra* note 4 at 752 (“The goal of management fee conversions is to convert current ordinary compensation income into deferred capital gain without affecting the basic economic arrangement between managers and investors.”).

122. See Borden, *supra* note 10 at 338–44.

123. See Revenue Act of 1913, ch. 16, § II.D., 38 Stat. 114, 169 (disregarding partnerships). The debates of Professors Judson A. Crane and William Draper Lewis illustrate the disagreement about the nature of partnerships at the time Congress enacted the income tax. See Judson A. Crane, *The Uniform Partnership Act: A Criticism*, 28 HARV. L. REV. 762 (1915) (arguing that several provisions of the UPA treat partnerships as entities); William Draper Lewis, *The Uniform Partnership Act—A Reply to Mr. Crane’s Criticism*, 29 HARV. L. REV. 158 (1915) (arguing that the UPA does not adopt an entity concept of partnerships).

124. See Borden, *supra* note 26.

125. See Borden, *supra* note 117 at 975–1001 (discussing ten tests that emerge from the case law and rulings).

partnership or an employment, financing, or leasing arrangement. A question of this sort generally turns upon whether the parties share control of the arrangement.<sup>126</sup> Such arrangements join services and property. If the owner of property controls the arrangement, it should be an employment arrangement; if the owner of service controls the arrangement, it would likely be a lease or a loan.<sup>127</sup> If the parties jointly control the property and provide services, the arrangement should be a tax partnership.<sup>128</sup> The law does not clearly define the level of control the member must have for the arrangement to be a tax partnership, so definition is not clear.

The second question is whether an arrangement is a tax partnership or a tenancy in common. The answer to that question generally turns on the source and type of services provided with respect to co-owned property.<sup>129</sup> If co-owners provide no services with respect to the property and do not hire anyone to provide services with respect to the property, the arrangement should be a tenancy in common.<sup>130</sup> Furthermore, if the co-owners provide no services and hire a manager to provide customary tenant services, the arrangement should be a tenancy in common.<sup>131</sup> If, however, one of the co-owners provides services with respect to the property, or if a hired manager provides more than customary tenant services, the arrangement should become a tax partnership.<sup>132</sup>

Those general concepts derive from the authority addressing the definition tax partnership, but reasonable people may disagree about the accuracy of such general conclusions. They also may dispute the extent to which state law classification, other than corporate classification, should affect the definition of tax partnership. For example, the Author argues that state law classification should not control the definition of tax partnership.<sup>133</sup> If two parties own property in a limited liability company and no services are provided with respect to the property, the Author argues that the arrangement should not be a tax partnership.<sup>134</sup> Otherwise, the definition of tax partnership could subject identical economic arrangements (a co-ownership and a limited liability company, each with no activity) to different tax regimes.<sup>135</sup> Other commentators may believe that all limited

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126. See, e.g., *Tate v. Knox* 131 F. Supp. 514, 515 (D. Minn. 1955) (explaining that control is important in classifying an arrangement).

127. See *Borden*, *supra* note 26.

128. See *Cusick v. Comm'r*, 76 T.C.M. (CCH) 241, 243(1998) (finding that co-owners who contributed customary tenant services were partners).

129. See *Borden*, *supra* note 117 at 995–98.

130. See *id.* at 991–98.

131. See Rev. Rul. 75-374, 1975-2 C.B. 261.

132. See *Cusick v. Comm'r*, 76 T.C.M. (CCH) 241, 243 (1998) (finding that co-owners who contributed customary tenant services were partners); *Borden*, *supra* note 117 at 994.

133. See *Borden*, *supra* note 117 at 1010–11.

134. See *id.*

135. See *id.* at 1011.

liability companies or other state law business entities (other than corporations and entities making the check-the-box election) should be tax partnerships, regardless of the lack of entity-level activity.

That lack of a clear definition of tax partnership grants business participants leeway in structuring arrangements to qualify for the partnership tax rules. The choice between disregarded arrangement and tax partnership can therefore be elective for some arrangements. Choosing between the two types of arrangements empowers business participants to privately order the placement of the tax burden.<sup>136</sup> Once within the definition of tax partnership, business people may further shift the tax burden using the allocation rules.<sup>137</sup> The current definition of tax partnership thus neglects fundamental tenets of tax policy.

In summary, state law and legal labels fail to provide a policy-supported tax-classification model for business arrangements. Instead, such factors make tax classification elective and empower taxpayers to privately order the tax burden. The shortfall of the current classification model is its neglect of the economic aspects of business arrangements. The economic theory of the firm helps explain the economic aspects of business arrangements. In particular, residual risk helps measure the economic aspects of an arrangement and provides a basis for classifying tax entities and subjecting them to the various tax regimes.

### III. RESIDUAL RISK

Residual risk is an economic concept that measures the economic rights and obligations of parties. Economic measures should significantly affect the classification of business arrangements. Non-tax terms such as corporation, partnership, limited liability company, limited partnership, and statutory trust become mere descriptions of various levels of off-the-rack state-law contractual terms.<sup>138</sup> The default terms vary in degree of rigidity from the rigid provisions in corporate statutes to significant freedom of contract available to members of partnerships, limited liability companies, and statutory business trusts. Members of corporations often cannot “term-down” (i.e., relax the rules found in corporate statutes) corporate

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136. For example, if parties choose to structure an arrangement for services as an employment contract, payments to the service provide to terminate the contract will be ordinary income. *See* *Luna v. Comm’r*, 42 T.C. 1067, 1076–77 (1964). If the same arrangement were a limited liability company taxed as tax partnership, payments to terminate the partnership could be capital gain. *See* I.R.C. §§ 731(a), 741 (2000). *See also supra* text accompanying notes 4–6 (describing the use of limited liability companies to alter the classification of employment arrangements).

137. *See* Borden, *supra* note 10 at 338–40 (describing tax-item transaction within tax partnerships).

138. *See* Easterbrook & Fischel, *supra* note 21 at 34–35 (suggesting that state entity laws provide rules that are common in many contracts and save the parties having to negotiate such terms upon the formation of every new entity).

documents with corporate governing documents.<sup>139</sup> Members of other legal entities can, however, “term-up” (i.e., add contractual provisions that create corporate-like attributes for noncorporations) governing documents to create arrangements that are economically and legally identical to corporations.<sup>140</sup> That ability to create economic and legal equivalents with various types of legal forms suggests that the classification model should disregard legal forms.

The neoclassical economic understanding of the firm neglects legal formalities. It views the “private corporation or firm [as] simply one form of *legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization . . .*”<sup>141</sup> “[E]mphasizing the essential contractual nature of firms and other organizations focuses attention on why particular sets of contractual relations arise for various types of organizations [and] what the consequences of these contractual arrangements are[.]”<sup>142</sup> Such focus leads to a policy-based model for classifying business arrangements. Viewing a business arrangement as a nexus of contracts allows tax law to consider the economic essence of the arrangement and assess the parties’ rights and obligations. Tax law can then apply a tax regime to the arrangement based upon the economic attributes that flow to the respective members of the arrangement.

In addition to viewing the firm as a nexus of contracts, economic theory embraces the concept of residual risk. Residual risk is “the difference between stochastic inflows of resources and promised payments to agents.”<sup>143</sup> Consequently, bearers of residual risk share the residual assets of an arrangement after the arrangement has satisfied all of its obligations. In a corporation, the residual risk bearers are the shareholders; in a partnership, the residual risk bearers are the partners. A sole proprietor or sole owner of property bears the residual risk of the business or property.

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139. For example, state law generally requires corporations to have at least one class of stock, make distributions according to the outstanding stock, and to follow certain governance formalities. See MODEL BUS. CORP. ACT § 6.01(b) (1984) (amended 2007) (requiring at least one class of stock); MODEL BUS. CORP. ACT § 14.05(a) (1984) (amended 2007) (requiring distributions in accordance with outstanding stock); MODEL BUS. CORP. ACT §§ 7.01–8.70 (1984) (amended 2007) (providing rules about meetings, voting, and directors and officers).

140. See, e.g., UNIF. LTD. LIAB. CO. ACT, § 110 (2006), 6B U.L.A. 442–44 (2008) (allowing members of limited liability companies to adopt governing partnership agreements).

141. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 311 (1976) (emphasis in original). See, e.g., The nexus of contract view of the firm is not without its skeptics. See, e.g., William W. Bratton, Jr., *The “Nexus of Contracts” Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407 (1989) (describing the nexus of contract theory and suggesting that the economic theories cannot always be transported into the corporate law context). Many legal scholars have, nonetheless, incorporated the concept into their work. See *id.* at 408, nn. 5, 6 (listing legal articles that incorporate the theory of the firm).

142. See Jensen & Meckling, *supra* note 141 at 311.

143. See Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301, 302 (1983).

The residual risk bearer's claim to the residual assets of an arrangement, represent that person's residual claim. "The central contracts in any organization specify . . . the nature of residual claims[.]"<sup>144</sup> In the case of corporations, state law and the type and number of outstanding shares determine the shareholders' residual claims.<sup>145</sup> Members of the other commonly-used legal entities establish the nature of residual claims by contract or rely upon state default rules.<sup>146</sup> If an arrangement's central contracts specify the nature of the parties' residual claims, they should take precedence over the form or label given to an arrangement.

A simple business model sets the stage for considering residual risk and identifying parties' residual claims.<sup>147</sup> Assume two people join together to form a business. Adrian contributes property worth \$1,000,000 and agrees to help manage the business, and Bakke agrees to provide services. During the first year of operation, the business has \$100,000 of profits. Every year thereafter, the profit of the business randomly fluctuates, reasonably representing the performance of a typical business. The value of the property log-normally fluctuates over the years, representing the expected gain or loss of a typical piece of property. Assuming the business does not make any distributions, the value of its residual assets will be the sum of the property value (the original \$1,000,000 adjusted to reflect changes in its value following the formation of the business) and accumulated profits.<sup>148</sup> The model assumes that the business has no goodwill or going concern value and that it can liquidate its assets with no transaction costs.<sup>149</sup>

Using information from the hypothetical business's performance and the arrangement's governing rules, the parties could determine their shares of the arrangement's residual value (i.e., their residual claims), at the end of each year. Their residual claims depend upon the type of entity they choose, the property's change in value, and, if they choose a noncorporation, the method they use to allocate the profits. The hypothetical company helps describe the three types of residual risk that the

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144. See Fama & Jensen, *supra* note 143 at 302.

145. See *infra* text accompanying notes 171–175.

146. See *infra* text accompanying notes 177–190 (describing the various types of residual risk and the legal source of such risk).

147. Table 1 of the Appendix summarizes the hypothetical business's performance over a ten-year period.

148. The use of profits as a metric incorporates expenses into the model. Profits for this purpose simply mean the excess of revenue over expenses. For the sake of analysis, the discussion assumes that profits equal taxable income, exclusive of any gain that may be realized on the disposition of the property.

149. Goodwill or going concern value will not substantively affect the analysis, as such items will merely add to the residual value of the firm. If the parties do not agree upon how to allocate any income from goodwill and going concern value, state law will determine the allocation of such amounts in the case of a partnership. See UNIF. P'SHIP. ACT § 103(a) (1997), 6 U.L.A. 73 (2001). Table 1 illustrates the performance of the hypothetical business over a ten-year period.

parties may use: (1) unitary residual risk, (2) allocation-dependent residual risk, and (3) distribution-dependent residual risk.

#### A. Unitary Residual Risk

Unitary residual risk is the residual risk born by a single person. Sole proprietors and sole owners of property bear the unitary residual risk of the businesses and property. The residual claim in a piece of property is “the right to control all aspects of the asset that have not been explicitly given away by contract.”<sup>150</sup> A contract between a printer and a publisher illustrates unitary residual risk.<sup>151</sup> If the contract provides for a specific print job and contains no provision for an additional run, the party who has the right to decide whether to expand the print job or do another run holds the residual claim of the printer and bears its residual risk.<sup>152</sup> Similarly, a person who controls the performance of services with respect to a piece of property, bears the residual risk of that property.<sup>153</sup>

Consider how this concept of unitary residual risk informs the analysis of various disregarded arrangements. Adrian agrees that in exchange for Bakke providing services with respect to Adrian’s property, Adrian will pay forty-five percent of the income from the property to Bakke. The agreement does not have a specified duration. Bakke can stop providing services at any time and Adrian can dispose of the property at any time. If Bakke unilaterally terminates his services, Adrian may arrange for someone else to provide the services. Adrian may also alter the use of the property unilaterally (i.e., convert it from apartments to condominiums) and may borrow against it without Bakke’s consent. The arrangement is an employment agreement, and because Adrian controls all aspects of the asset that have not been explicitly contracted away, Adrian bears the unitary residual risk of the property.

Instead of hiring Bakke, Adrian may decide to grant Bakke the use of all or a portion of the property for a fixed period of time. The terms of the agreement may provide that Bakke will pay to Adrian forty-five percent of any income from the property in exchange for the right to use the property. Upon termination of the agreement, Adrian determines what to do with the property. This appears to be a lease, and Adrian bears the unitary residual risk of the property.

Some arrangements obfuscate who bears the residual risk of property. For example, the property may be farm land, and Adrian and Bakke may

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150. See Stanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical Integration*, 94 J. POL. ECON. 691, 695 (1986).

151. See *id.*

152. See *id.*

153. See Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119, 1121 (1990).

agree that Bakke will manage the land for a fixed period of time.<sup>154</sup> The parties agree to share the produce from the farm equally. They also agree to share some of the costs of farming the land and growing the crops. Together, they decide which crops to plant. Nonetheless, after the contract terminates, Adrian has the right to control all aspects of the land. Therefore, Adrian retains the unitary residual risk in the farmland, and the arrangement is a lease.

Notice that unitary residual risk is not concerned with the control of the property for the duration of an existing agreement.<sup>155</sup> The focus is on who controls all aspects of the property following the termination of the arrangement. To illustrate, Adrian may allow Bakke to use \$1,000,000 for a given period of time and repay the entire amount plus fifty-five percent of any profit Bakke earns at the end of that period. After Bakke returns the \$1,000,000 Adrian controls all aspects of the property. Bakke's use of the money throughout the duration of the arrangement is irrelevant. Adrian bears the unitary residual risk of the \$1,000,000, and the arrangement would be a loan.<sup>156</sup>

Arrangements with unitary risk are fairly simple, but they may present opportunities for parties to exploit appropriable quasi-rents.<sup>157</sup> For example, if the demand for Bakke's services increases while he is under contract to provide services with respect to Adrian's property, Bakke may demand a greater share of profits. Alternatively, if Adrian realizes that Bakke's situation prevents him from changing employment, Adrian may require more from him.<sup>158</sup> Economic theory suggests that parties in unitary-risk arrangements can help reduce appropriable quasi-rents by integrating their resources.<sup>159</sup> Parties may integrate their resources by contributing them to some sort of legal entity. For example, Adrian and Bakke could integrate their property and services contributing them to a limited liability company or corporation. After the parties integrate their

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154. This example is from *Harlan E. Moore Charitable Trust v. U.S.*, 9 F.3d 623, 624–25 (7th Cir. 1993).

155. Control during the duration of an existing agreement is, however, important in determining whether an arrangement is a hired-property or hired-services arrangement. See Borden, *supra* note 10 at 312–16.

156. Even though the residual-risk analysis determines the arrangement is a loan, the parties may prefer to classify it as something else to avoid usury laws.

157. An appropriable quasi rent exists when an assets value exceeds its salvage value, i.e., "its value in its next best use to another renter." See Benjamin Klein, Robert G. Crawford & Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. L. & ECON. 297, 298 (1978) (emphasis in original).

158. For example, if the property is an apartment complex, Adrian may subdivide the units and require Bakke to manage more units for the same compensation.

159. See Klein, Crawford & Alchian, *supra* note 157 at 307; Borden *supra* note 26. Parties also integrate resources to reduce transaction costs. See R. H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386, 390–91 (1937). To integrate their property and services, Adrian and Bakke must believe that forfeiting unitary residual risk is a lower cost than the appropriable rents each party would have in a nonintegrated arrangement.

resources, they will have to concern themselves with reducing agency costs.<sup>160</sup> They can share residual risk in one of two ways to help reduce agency costs.

## B. Allocation-Dependent Residual Risk

After integrating their resources, Adrian and Bakke may decide that the best way to reduce agency costs is to use an allocation formula to determine each party's residual risk. Such use of an allocation formula creates allocation-dependent residual risk. Allocation-dependent residual risk is the quintessential residual risk that members of partnerships bear. Partnership law provides that upon liquidation of a partnership, each partner shall receive the amount contributed to the partnership, plus any profit allocated to the partner, minus any distributions made to the partner.<sup>161</sup> Professor Gary S. Rosin describes two approaches courts use to determine the amount partners receive on liquidation: the unitary approach and the dualistic approach.<sup>162</sup> Both approaches determine partners' residual claims as a function of contributions, plus allocations, minus distributions.<sup>163</sup> Thus, residual risk in partnerships depends upon the allocation formula.

Consider allocation-dependent residual risk as expressed in a hypothetical partnership. Assume that Adrian and Bakke are partners, and they agree to allocate fifty-five percent of the partnership profits to Adrian and forty-five percent to Bakke. They also agree to allocate any

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160. See Jensen & Meckling, *supra* note 19 at 309 (recognizing that even the most basic arrangements (such as co-authoring an article) create agency costs); Borden *supra* note 10 at 309 (describing how parties may use allocations to reduce agency costs).

161. See UNIF. P'SHIP ACT §§ 401, 807(b) (1997), 6 U.L.A. 133, 206 (2001).

162. See Gary S. Rosin, *The Entity-Aggregate Dispute: Conceptualism and Functionalism in Partnership Law*, 42 ARK. L. REV. 395, 446-65 (1989).

163. If partnership expenses exceed revenue, the partnership will have negative profits and the residual value of the partnership may be less than the amount of contributions. Decreases in the value of contributed assets may also cause the residual value of partnership assets to be less than the amount contributed. Because members of partnerships are jointly and severally liable for partnership liabilities (see UNIF. P'SHIP ACT § 306(a) (1997), 6 U.L.A. 117 (2001)), a partnership could have negative residual value. If a partnership with negative residual value were to liquidate, the partners would be required to make additional contributions to satisfy the claims of creditors (See UNIF. P'SHIP ACT § 807(b) (1997), 6 U.L.A. 206 (2001)). To avoid that potentiality, most business owners use a legal entity, such as a limited liability company, to obtain limited liability-liability protection. Because the members of a limited liability company are not liable for the debts of the business, a limited liability company with negative residual value does not expose the members to liability. Similarly, members of a limited liability company may agree that rights on distribution shall equal their contributions, plus shares of profits, minus distributions. See UNIF. LTD. LIAB. CO. ACT § 103(a) (1996), 6A U.L.A. 567 (2003). Otherwise, the default statute provides that the limited liability company will distribute residual assets in accordance with members' interests in the company. See UNIF. LTD. LIAB. CO. ACT § 806(b) (1996), 6A U.L.A. 625 (2003). From a residual risk standpoint, limited liability companies can be very similar to partnerships, so going forward this Article refers to all legal arrangements that determine residual risk as a function of allocations as partnerships, unless stated otherwise. State law gives all such partnerships allocation-dependent residual risk by default.

appreciation from the property thirty-five percent to Adrian and sixty-five percent to Bakke. They use these allocation formulae to reduce agency costs. More specifically, to help ensure that Adrian contributes property with strong income-producing potential, Bakke insists that Adrian share significantly in the property's income. To help encourage Bakke to fully perform services that improve the property's value, Adrian agrees that Bakke will receive a significant portion of any gain realized on the disposition of the property. Thus, Adrian and Bakke use the allocation rules to help reduce agency costs. Those allocations in turn largely determine the parties' residual claims.<sup>164</sup>

Tax law does not attempt to measure the residual risk of partners on an annual basis. Instead, it carries partnership assets at historic cost and uses historic cost to determine partners' capital account balances.<sup>165</sup> Partnership tax law uses capital accounts to gauge the validity of partnership tax item allocations.<sup>166</sup> The partnership tax rules provide generally that partners' capital accounts adjust only for allocations of partnership recognized tax items (e.g., gains on dispositions of partnership property).<sup>167</sup> Under aggregate-plus taxation, partners report their share of partnership income only when the partnership recognizes income, even if the partnership does not make distributions.<sup>168</sup>

Despite tax law's delay in recognizing economic items or a partnership's delay in making distributions, partners take an interest in partnership economic item as residual claimants. Upon liquidation, they would have a right to such amount, and as partners, they exercise some control over the items' use and disposition.<sup>169</sup> Those rights help explain the parties' economic interests in an arrangement. Tax law should recognize partners' interests in the economic performance of partnerships as expressed in their residual claims and tax them accordingly.

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164. Table 2 of the Appendix illustrates the parties' residual claims over a ten-year period.

165. See Treas. Reg. § 1.704-1(b)(2)(iv)(b) (as amended in 2006) (requiring partners to adjust their capital accounts for the fair market value of contributed property but adjusting capital accounts thereafter only for realized items).

166. See Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2) (as amended in 2006) (providing that for an allocation to have economic effect under the economic effect safe harbor, the partnership agreement must provide for distributions to be made in accordance with positive capital account balances). But see Borden, *supra* note 10 at 334–38 (arguing that capital accounts are tax-centric and imperfectly measure the economic aspects of a partnership).

167. See Treas. Reg. § 1.704-1(b)(iv)(b) (as amended in 2006). An exception to this rule is adjustments to the book value of assets on the occurrence of certain events, such as liquidating distributions and the admission of a new partner. See Treas. Reg. § 1.704-1(b)(2)(iv)(f) (as amended in 2006).

168. See I.R.C. § 702(c) (2000).

169. See, e.g., *Luna v. Comm'r*, 42 T.C. 1067 (1964) (considering whether the parties shared control and responsibilities of the enterprise in holding that no partnership existed); *Fishback v. United States*, 215 F.Supp. 621 (D.S.D. 1963) (finding that parties were joint proprietors and holding that arrangement was a tax partnership); *Beck Chem. Co. v. Comm'r*, 27 T.C. 840 (1957) (finding that the parties had mutual proprietary interest in profits and holding that arrangement was a tax partnership).

### C. Distribution-Dependent Residual Risk

Adrian and Bakke may decide that they can best reduce agency costs using distribution-dependent residual risk. They can obtain that objective using a state-law corporation. Assume, the corporation issues two classes of stock: cumulative preferred and common. The cumulative preferred stock provides the holder with a cumulative eight percent annual dividend and a return-of-capital preference on dissolution of the corporation. The common stock provides one vote for each share and a right to distributions upon liquidation in proportion to shares held. Adrian contributes \$1,000,000 to the corporation for 1,000 shares of preferred stock. The corporation issues fifty shares of common stock to each of Adrian and Bakke in exchange for services they will perform.<sup>170</sup> In this hypothetical corporation, each shareholder's residual claim depends upon the manner in which the corporation distributes the residual assets as determined by the shareholders' stock ownership.

Consider why Adrian and Bakke might use distribution-dependant residual risk instead of allocation-dependant residual risk. For example, Adrian may wish to align Bakke's economic interests generally with her own economic interests. She may believe the best way to align their interests is to provide Bakke a general interest in the sum of the business's performance and the property's appreciation. Adrian's opportunity cost of investing in the business may require Bakke to agree to an eight percent preferred coupon for Adrian's contribution. Adrian's sharing in the profit as a holder of common stock will encourage her to use her capital allocation expertise to help maximize corporate performance. The shareholders' residual claims depend upon the overall performance of the business.

State law imposes distribution-dependent residual risk on corporations, and shareholders cannot contract out of it. Corporate law provides that upon dissolution, a corporation disposes of its assets, discharges its liabilities, and distributes the remaining property to its shareholders according to their interests.<sup>171</sup> Shareholders' interests derive from the type of stock they own in relation to the type of stock owned by other shareholders. Corporate law requires corporations to issue at least one class of stock,<sup>172</sup> ensuring that at least one class of shareholders "share the ultimate residual interest in the corporation."<sup>173</sup> Corporations may issue

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170. Upon receipt of the shares of stock, Adrian and Bakke must include in their respective gross incomes the fair market value of the shares received. *See* I.R.C. § 83(a) (2000). The hypothetical assumes the value of the stock is nominal, so the income tax effect to each of Adrian and Bakke would not be significant. Table 3 of the Appendix summarizes the parties' residual claims.

171. *See* MODEL BUS. CORP. ACT § 14.05(a) (1984) (amended 2007).

172. *See* MODEL BUS. CORP. ACT § 6.01(b) (1984) (amended 2007).

173. *See* MODEL BUS. CORP. ACT § 6.01(b) cmt. at 6-8 (1984) (amended 2007).

multiple classes of stock,<sup>174</sup> which complicates the computation of shareholders' residual claims but not change its focus.<sup>175</sup> Upon liquidation, the corporation would first distribute Adrian's return on the preferred stock, then distribute Adrian's contributions for preferred stock, and finally divide any remaining assets equally according to common stock ownership.

Under the current classification model, the corporation would be a tax corporation subject to entity taxation.<sup>176</sup> Adrian and Bakke may prefer the economic benefits of an arrangement with distribution-dependent residual risk but want to be subject to aggregate-plus taxation. The primacy of contract in non-corporate legal entities allows members of noncorporations to create distribution-dependent residual risk. One increasingly popular technique for creating contractual distribution-dependent residual risk is partnership target allocations.<sup>177</sup> Such arrangements would be tax partnerships under the current classification model.<sup>178</sup>

Target allocations include two components: (1) a tiered distribution structure and (2) a distribution-dependent allocation provision.<sup>179</sup> The tiered distribution structure describes how the arrangement will distribute property to members of the arrangement and therefore describes the parties' economic arrangement. A simple tiered distribution structure of a target allocation could have three tiers. Tier One could provide that to the extent an arrangement has sufficient residual assets it will first distribute them to property contributors as a fixed return on contributions.<sup>180</sup> Tier Two could require the partnership to distribute property as a return of

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174. See MODEL BUS. CORP. ACT. § 6.01(c) (1984) (amended 2007) (allowing articles of incorporation to authorize one or more classes or series of stock that "entitle the holders to distributions calculated in any manner, including dividends that may be cumulative, noncumulative, or partial cumulative; or . . . have preference over any other class or series of shares with respect to distributions, including distributions upon the dissolution of the corporation").

175. The various classes of stock may carry different voting rights or distribution preferences. See MODEL BUS. CORP. ACT. § 6.01(c)(3), (4) (1984) (amended 2007). Only the distribution preferences would affect shareholders' residual claims. A shareholder's residual claim is merely the residual value of the corporation (i.e., the amount left after satisfying non-shareholder liability) multiplied by the shareholder's interest in the corporation. If a corporation has a single class of stock, a shareholder's interest will merely be the number of shares the shareholder owns divided by total outstanding shares. If the corporation has multiple classes of stock, with different distribution preferences, a shareholder's interest in the corporation must account for the different preferences. Table 3, *infra*, illustrates how different distribution preferences affect a shareholder's interest in a corporation.

176. See Treas. Reg. § 301.7701-2(b)(1) (as amended in 2008) (defining tax corporation to include state-law corporations).

177. Other types of arrangements in partnership agreements may create distribution-dependent residual risk. The Article's use of target allocations as an example of the potential for creating distribution-dependent residual risk is illustrative of such potential, and does not deem one method to be more or less worthy of the task than another.

178. See Treas. Reg. § 301.7701-3(a) (as amended in 2006).

179. See Terrence Floyd Cuff, *Working with Target Allocations—Idiot-Proofing or Drafting for Idiots*, 35 REAL EST. TAX'N 116, 124 (2d Quarter 2008).

180. See Terrence Floyd Cuff, *Working with Target Allocations—Drafting in Wonderland*, 35 REAL EST. TAX'N 162, 163 (3d Quarter 2008).

contributions, to the extent possible.<sup>181</sup> Finally, if property remains after Tier One and Tier Two distributions, Tier Three could require the arrangement to distribute its property to the owners in proportion to their ownership interests.<sup>182</sup>

An example illustrates the distribution structure of target allocations. Assume Adrian and Bakke form a limited liability company. Adrian agrees to contribute \$1,000,000 and Adrian and Bakke both agree to provide services with respect to the property. The parties include target allocations in the company's operating agreement. Tier One will, to the extent the company has sufficient assets, distribute a cumulative simple eight percent return on capital to members who contribute property to the company. To the extent any property remains after the Tier One distribution, Tier Two will return capital contributions. Tier Three will distribute any remaining company property between the members equally.<sup>183</sup>

Notice that Adrian's and Bakke's residual claims in a partnership with target allocations are identical to the residual claims they would have as corporate shareholders.<sup>184</sup> Upon liquidation, the company would first distribute an eight percent return to Adrian under Tier One, then it would return Adrian's contribution under Tier Two, finally, under Tier Three, it would distribute receiving assets equally to Adrian and Bakke. This simple example illustrates that members of noncorporate entities may use target allocations to create economic rights that mirror shareholders' economic rights. The tiered distribution structure of a target allocation provision is a non-tax agreement among the parties. They use the tiered structure to obtain distribution-dependent residual risk for the same reasons shareholders structure distribution-dependent residual risk.<sup>185</sup>

Having decided upon the economic arrangement, the parties simply provide that tax items must be allocated to partners in such a manner that capital accounts will equal the amount to be distributed to the partners.<sup>186</sup> Such an allocation formula for tax items makes the allocation a function of the residual claims. The allocations become a plug figure needed to match capital accounts with distribution amounts.<sup>187</sup> Such allocations create difficulty and questions for tax law.

Compare taxation allocations in partnerships with target allocations to allocations in traditional partnerships. Tax-item allocations in traditional

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181. *See id.*

182. *See id.*

183. Table 4 of the Appendix summarizes the parties' residual claim in a partnership with target allocations.

184. Compare Table 3 and Table 4 of the Appendix.

185. *See supra* text accompanying notes 176–177 (discussing reasons why parties may use arrangements with distribution-dependent residual risk).

186. *See* Cuff, *supra* note 180 at 163.

187. *See id.* at 165 (providing that tax allocations follow modified book income that the partnership allocates to the partners).

partnerships are independent of residual claims, determined by the partners' agreement or state law. The partners agree how they will allocate the economic items and each partner's total allocations equal the sum of the individually allocated items. The allocations then determine each partner's residual claim.<sup>188</sup>

On the other hand, tax-items allocated in a partnership with target allocations are a function of the partners' residual claims. The allocations fill in capital accounts to ensure capital account balances reflect distribution rights.<sup>189</sup> Thus, allocations in a partnership with target allocations depend upon the partnership's distributions. The allocations do not affect the partners' residual claims. Instead, the distribution formula determines partners' residual claim. Thus, the economics of traditional partnerships and partnerships with target allocations are fundamentally different but the two arrangements are subject to the same tax regime. The economics of a partnership with tangent allocations are similar to the economics of a corporation, but those two arrangements are subject to different tax regimes. This Article argues that tax law should recognize the fundamental economic aspects of arrangements to determine the applicable tax regime.<sup>190</sup>

#### D. Allocation-Distribution Symmetry

The prior sections describe the difference between allocation-dependent residual risk and distribution-dependent residual risk. In a stochastic economy, sophisticated allocation-dependent residual risk formulae produce a residual risk that a distribution-dependent residual risk formula cannot duplicate. For example, a distribution-dependent residual risk could not mirror the residual claims of the parties of the traditional partnership.<sup>191</sup> Perhaps a distribution-dependent formula could match residual claims in Year 1, but could not maintain the duplication consistently in subsequent years.<sup>192</sup> The non-uniform fluctuations of profits and property value make mirroring the residual claims *ex ante* impossible. That inability further illustrates the economic differences of arrangements with the different types of residual risk. If the allocation or distribution formulae are complex, they will not have symmetry in a stochastic market.

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188. See Table 2 of the Appendix.

189. See Cuff, *supra* note 179 at 124.

190. See *infra* Section IV.

191. Compare Tables 3 and 4 to Table 2 of the Appendix.

192. For example, the ratio of Adrian's residual claim to Bakke's residual claim in Year 1 of Table 2 of the Appendix is approximately 1,000 to 57. A corporation could match that ratio in Year 1 by issuing common stock to its members in that ratio. In Year 2, the ratio of partners' residual claims is 1,200 to 200. That differs from Year 1's residual claims, and it would differ from the residual claims based upon stock ownership that matched the Year-1 residual claims. The differences would continue in subsequent years.

The allocation and distribution structures may, however, have symmetry if an arrangement is simple. For example, a corporation with a single class of stock must distribute the residual assets to the shareholders in proportion to the shares of outstanding stock each shareholder owns.<sup>193</sup> Adrian and Bakke may decide to form a corporation with one class of stock. Economic considerations would undoubtedly motivate that decision. For example, assume Adrian contributes the property to a corporation and causes the corporation to grant Bakke twenty shares of common stock and the remaining eighty shares to Adrian.<sup>194</sup> Adrian's and Bakke's residual claims are simple to compute; they are the value of the residual assets of the corporation multiplied by the proportion of shares each person holds.<sup>195</sup> Each year, Adrian's and Bakke's residual claims are respectively eighty percent and twenty percent of the corporation's residual value.

Assume alternatively that Adrian and Bakke form a limited liability company to take advantage of the management flexibility such an entity offers. The same economic factors motivate their decision to form the company. Adrian contributes \$1,000,000 of property and Bakke contributes services to the new company. Adrian and Bakke take eighty- and twenty-percent interests in the company, respectively.<sup>196</sup> Adrian and Bakke do not include an allocation provision in the company's operating agreement, so state law dictates that the company will allocate eighty percent of profits and losses, including gains and losses from the sale of the property, to Adrian and the other twenty percent to Bakke.<sup>197</sup>

Notice that the distribution-dependent residual claims of a corporation with a single class of stock can be identical to the allocation-dependent residual claims of a limited liability company using a simple allocation formula.<sup>198</sup> When the capital structure of a corporation and the allocation method of a partnership are simple, such allocation-distribution symmetry is possible. Because the same outcome results with both types of residual

193. See MODEL BUS. CORP. ACT § 6.01(b) (1984) (amended 2007).

194. The grant of the shares to Bakke should be a taxable event to Bakke. See I.R.C. § 83(a) (2000). The corporation should get a deduction equal to the amount of income that Bakke recognizes, assuming the corporation does not have to capitalize the expenditure. See I.R.C. § 83(h) (2000). If the corporation were to liquidate immediately, Bakke would receive \$200,000. That should roughly equal the amount of income he should recognize upon joining the corporation, adjusted as appropriate to reflect a minority discount.

195. Table 5 of the Appendix summarizes the parties' claims.

196. The formation includes a capital shift. Because Bakke becomes a twenty-percent member of the company, he should receive twenty percent of the value of any liquidating distribution. Consequently, the formation of this company includes a capital shift, so Bakke will recognize gain on the formation equal to the value of the interest he receives. See I.R.C. § 83(a) (2000); MCKEE, NELSON & WHITMIRE, *supra* note 119 at ¶ 5.07. The partnership should also get a deduction equal to the amount of income that Bakke recognizes, assuming it is not required to capitalize the amount. See I.R.C. § 83(h) (2000).

197. See UNIF. LTD. LIAB. CO. Act § 405(a) (1996), 6A U.L.A. 596 (2003). Table 6 of the Appendix summarizes the parties' claims.

198. Compare residual claims in Tables 5 and 6 of the Appendix.

risk, economic factors do not appear to dictate the parties' choice of entity. Disregarding tax considerations, other factors such as management flexibility, ease of formation, or familiarity with a particular legal entity would influence the decision.<sup>199</sup>

Certain principles emerge from the study of residual risk and business law. First, entity forms emerged to satisfy the business needs of increasingly-complex economies and business practices. In particular, the law evolved to provide entity shielding, limited liability, continuity of existence, and centralized management. Second, tax law adopted legal forms and labels to classify business arrangements, but did not justify such adoption. Third, legal forms and labels create arbitrary distinctions between the different tax entities and classify economically equivalent arrangements differently and economically different arrangements similarly. That tax treatment allows well-informed taxpayers to gain a tax advantage over others.<sup>200</sup> Fifth, residual risk measures the economic interest parties have in business arrangements. Residual risk leads to a policy-justified model for classifying business arrangements for tax purposes.

#### IV. RESIDUAL-RISK CLASSIFICATION MODEL

Accurate placement of the incidence of taxation is the standard that governs the model's residual-risk construction. The analysis begins by considering basic tax situations and progresses to more complicated arrangements. The analysis demonstrates that natural law principles support the basic forms of aggregate taxation, aggregate-plus taxation, and entity taxation, depending upon an arrangement's type of residual risk and provides a framework for the new classification model.

All economic situations require complex decision making,<sup>201</sup> but some may present relatively straight forward tax problems. For example, an employment arrangement presents relatively unsophisticated tax problems. Assume Adrian and Bakke are neighbors. After a heavy snow storm, Adrian offers to pay Bakke fifty dollars to shovel her sidewalks. Bakke's receipt of the fifty dollars represents income from services, which is subject to income tax.<sup>202</sup> Bakke recognizes and reports income upon receipt of the

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199. See Larry E. Ribstein, *Why Corporations*, 1 BERKELEY BUS. L. J. 183, 210 (2004) (“[P]artnership-type firms offer an agreement centered approach to centralized management that provides flexibility and adaptability.”).

200. See Brooks, *supra* note 108 at 1674–76.

201. See Hart & Moore, *supra* note 153 at 1121–25 (considering the economic factors that go into the decision whether to hire services or provide services oneself); *supra* text accompanying note 164 (describing plausible economic decision making).

202. See I.R.C. § 61(a)(1) (2000). Bakke may offset that income with any allowed deductions. See I.R.C. § 63(a) (2000). To keep the analysis simple and focused on the primary issues, the Article assumes that the income items in this section are more than offsetting deductions allowed to the respective parties.

payment.<sup>203</sup> Bakke's shoveling the snow and receiving payment represents a simple services arrangement. Bakke owned only services, so he easily traces the income from his services, recognizes that income, and bears the tax burden of that income.<sup>204</sup>

Wholly-owned property also presents simple tax scenarios. Assume now that Adrian owns \$1,000,000 of real property. She receives \$50,000 of rent. Her receipt of the rent is income to her.<sup>205</sup> If she later sells the land, any gain she recognizes on the sale should also be income to her.<sup>206</sup> This simple arrangement represents two important aspects of all wholly-owned property arrangements. First, the owner has income from the property (rent in this situation). Second, the owner has income from gains recognized on the sale of property.<sup>207</sup> The owner can trace either type of income directly from the property, recognizes that income, and bears tax burden of that income.

These simple services and property ownership arrangements are examples of unitary residual risk. Bakke bore the residual risk of his service, and Adrian bore the residual risk of her property. The simplicity of the arrangements makes identifying the source of the income straight forward. As sole bearer of the residual risk of his services, Bakke's income derived only from those services, and, as sole bearer of the residual risk of the real property, Adrian's income derived only from the property.<sup>208</sup> The income for the services and property easily traces to the respective risk bearer of each source of income.

This simple example demonstrates that if an arrangement has unitary risk, its parties can trace income from resources they own. Tax law can accurately match the burden of taxation to economic items if it can trace income from its source to the owner of the source. Tracing is possible in

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203. The U.S. tax system defines gross income broadly to include any accession to wealth clearly realized over which the person has complete dominion. *See Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955). Bakke's performance of services and receipt of payment for services satisfies that definition of gross income. If a person is an accrual method taxpayer, realization may occur at a time other than receipt. *See* I.R.C. § 451(a) (2000). To keep the analysis simple, this discussion assumes all parties use the cash method of accounting.

204. Assuming the sidewalks were on Adrian's personal residence, Adrian should have no deduction because tax law prohibits deductions for personal expenses. *See* I.R.C. §262(a) (2000).

205. *See* I.R.C. § 61(a)(5) (2000).

206. *See* I.R.C. § 61 (a)(3) (2000).

207. *Id.* Several provisions of the Internal Revenue Code allow for nonrecognition on certain dispositions of property. *See, e.g.*, I.R.C. § 351(a) (2000) (providing persons making qualifying property contributions to corporations in exchange for stock in the corporation do not recognize gain or loss on the contributions); I.R.C. § 1031(a)(1) (2000) (providing that property owners do not recognize gain or loss on the exchange of like property held productive use in a trade or business or for investment); I.R.C. § 1033(a) (2000) (providing that property owners who use proceeds from involuntarily converted property to acquire other qualifying property shall not recognize gain or loss on the involuntary conversion).

208. *See* *Lucas v. Earl*, 281 U.S. 111, 114–15 (1930) (holding income from services belong to the services provider); *Helvering v. Horst*, 311 U.S. 112, 114, 124–25 (1940) (holding that the person who owned property owned the income from the property).

simple nonintegrated arrangements with unitary residual risk. Tracing is not possible, however, when parties integrate resources. Integrated arrangements require aggregate-plus or entity taxation.

#### A. Case for Aggregate-Plus Taxation

Tracing income from its source becomes impossible when the parties integrate services and property,<sup>209</sup> which parties do by reciprocally transferring residual claims in the property and services. Thus, Adrian and Bakke could integrate their resources if Adrian assigned a portion of the residual claim in her property to Bakke and Bakke assigned a portion of the residual claim in his services to Adrian. If Adrian is unable to change the property's use or dispose of it without Bakke's consent, Adrian has transferred a portion of the residual claim to Bakke. Adrian retains a portion of the residual claim, however, because Bakke would be unable to unilaterally control the use and disposition of the property. Bakke transfers an interest in his services by giving Adrian a share of the service's residual claim. Adrian may not be able to legally compel Bakke to provide services, but if Bakke were to provide similar services to another arrangement, Adrian would have a claim against him for the economic damages resulting from providing such services.<sup>210</sup>

Integration obfuscates the source of the income.<sup>211</sup> Tracing income separately from integrated resources is impossible. In the integrated arrangement income allocated to the parties flows from their interests in both the property and services. The parties generally will be unable to ascertain the portion of the income from the integrated arrangement that derives from the respective resources. For example, if the arrangement has \$100,000 of profit, that profit will derive from contributions of the property and services. The parties cannot, however, deconstruct the income to determine how much flows respectively from the property and the services. The parties therefore cannot trace income directly from its source to the owner of the source. That inability to trace requires some method for determining each party's share of income from the integrated resources.

Aggregate-plus taxation uses allocation rules to address the inability to trace in integrated arrangements that have allocation-dependent residual

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209. See Borden, *supra* note 117 at 953–55.

210. See UNIF. P'SHIP ACT, § 404(b)(3) (1997), 6 U.L.A. 143 (2001) (prohibiting partners from competing with the partnership); E. ALLAN FARNSWORTH, CONTRACTS § 12.5, at 745 (4th ed. 2004) (discussing rights of parties harmed in breached service contracts).

211. Thus, even if the profit-sharing ratio and the gain-sharing ratio of the non-integrated arrangement are identical to the ratios of the integrated arrangement, identifying the source of income in the integrated arrangement is not possible. Focusing on the contributed item also fails to identify the source of income. See Borden, *supra* note 26. The essence of an integrated arrangement is the reciprocal ownership in all contributed items and a right to income from each.

risk.<sup>212</sup> Allocation rules should allow the burden of taxation to follow the allocation of economic items in such integrated arrangements.<sup>213</sup> The example above of the traditional partnership illustrates this point.<sup>214</sup> Recall that the arrangement had \$100,000 of profit in the first year.<sup>215</sup> The agreement between Adrian and Bakke provided that the partnership would allocate \$65,000 of that profit to Adrian and \$35,000 to Bakke. The agreement, however, provides that the arrangement will not distribute the amounts to the parties for some time. Nonetheless, the allocated income items become a part of the parties' residual claims because the arrangement adopted allocation-dependent residual risk.<sup>216</sup> Thus, although they do not actually receive the allocated item, they should recognize it and report it when the arrangement recognizes it. Aggregate-plus taxation requires the parties to recognize the amount allocated to them on their respective tax returns.<sup>217</sup> Aggregate-plus taxation therefore correctly addresses issues that arise in arrangements with allocation-dependent residual risk.

Imposing an entity-level tax on an arrangement that adopts allocation-dependent residual risk would generally inaccurately place the burden of taxation. Adrian and Bakke formed a partnership and agreed to allocate profits fifty-five percent to Adrian and forty-five percent to Bakke.<sup>218</sup> If Adrian and Bakke are subject to different tax rates, an entity-level tax would have to accurately reflect their rates to properly place the burden of taxation. If the total tax imposed at the entity level does not equal the aggregate tax that the parties would pay under through regime, the entity tax would not be accurate.<sup>219</sup> Furthermore, if the entity-level rate differed

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212. See Treas. Reg. § 1.704-1(b)(1) (as amended in 2006) (providing extensive and complicated partnership allocation rules).

213. The current allocation rules allow tax to follow the economic items, but probably do not require them to follow the economics. See I.R.C. § 704(b)(2) (2000) (requiring allocations to have substantial economic effect); Treas. Reg. § 1.704-1(b)(2)(ii)(a) (as amended in 2006) (requiring economic benefit or burden to follow tax item). The rules also allow for some gaming of the tax system. See Borden, *supra* note 10 at 338–44 (discussing the ability to use the current rules to internalize tax-item transactions). Lawmakers should modify the rules to ensure that the incidence of taxation always follows the allocation of the economic items. This Article recommends an ideal tax entity classification model. Such a model would demand allocation rules that require the incidence of taxation to follow economic items, in a manner discussed in Borden, *supra* note 10 at 344–45.

214. See *supra* text accompanying note 164.

215. The arrangement could have all of the characteristics of an entity without affecting this analysis. Therefore, the analysis assumes the arrangement is an entity and has income and holds property.

216. See *supra* Section III.B. (discussing allocation-dependent residual risk). The clearly has allocation-dependent residual risk because the parties allocate specific items (i.e., income and gain) to each other and each has a residual claim in the property and services of the arrangement. Thus, on liquidation, they would receive the amount they contributed plus allocations minus any distributions.

217. See I.R.C. §§ 702, 703 (2000).

218. See *supra* text accompanying note 164.

219. For example, assume the arrangement had \$100,000 of income and that Adrian's tax rate on her share of income would have been thirty percent and Bakke's tax rate would have been twenty percent on his share of income. Adrian's tax liability would have been \$16,500 (\$55,000 × 30%) and Bakke's tax liability would have been \$9,000 (\$45,000 × 20%). To place the correct incidence of

from either individual's tax rate the entity-level tax would inaccurately place the burden of taxation.<sup>220</sup> Even though entity taxation should not apply to arrangements with allocation-dependent residual risk, the current classification model allows such arrangements to elect to be tax corporations.<sup>221</sup> Thus, the current model facilitates the inaccurate placement of the tax burden.

Integrating property and services not only makes tracing impossible, it also complicates tax accounting and reporting. Tax law must address the formation, operation, and dissolution of integrated arrangements. For example, a tax system that uses a form of aggregate taxation for an arrangement's operations should consider how to allocate built-in gain or loss that exists at the time of formation.<sup>222</sup> Aggregate-plus taxation can allocate such built-in items to the property's contributor,<sup>223</sup> an entity tax system cannot. To handle all tax aspects of integrated arrangements, tax law adds some entity components to the aggregate system.<sup>224</sup> For example, it requires tax partnerships to compute taxable income and recognizes that partners own interests in the partnership, not the partnerships property.<sup>225</sup> Tax law would err, however, if it applied entity tax to integrated arrangements that adopt allocation-dependent residual risk. Tax law must recognize the parties' allocation arrangement, which makes entity taxation untenable for arrangements with allocation-dependent residual risk. Instead, aggregate-plus taxation should govern arrangements with allocation-dependent residual risk.

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taxation on this amount of income at the entity level, the entity-level rate would have to equal twenty-five and one-half percent (\$25,000 total tax divided \$100,000 total income). That rate would have to change each year that the arrangement had a different amount of income or the tax rate of one of the members changed. Additionally, for the incidence of the entity tax to place properly, the parties would have to allocate the tax liability in such a way that Adrian bears \$16,500 of the liability and Bakke bears \$9,000. The allocation ration of those amounts (65% : 35%) differs from the agreed to allocation of profits (55% : 45%).

220. For example, if Adrian's rate were thirty percent and the entity's rate were twenty percent, the entity level tax would reduce the incidence of taxation for items allocated to Adrian.

221. See Treas. Reg. §301.7701-3(a) (as amended in 2006) (allowing multiple-member noncorporate arrangements to elect to be tax corporations).

222. Built-in gain is the excess of fair market value over the basis of property at the date of contribution. See Treas. Reg. §1.704-3(a)(3)(ii) (as amended in 2005). Because built-in gain represents appreciation accruing prior to contribution, the person who contributes the property should pay tax on such gain, when it is recognized. See I.R.C. § 704(c) (2000) (requiring the contributing partner to recognize built-in gain); Jacob Rabkin & Mark H. Johnson, *The Partnership Under the Federal Tax Laws*, 55 HARV. L. REV. 909, 915-24 (1942) (discussing the tax issues that arise when a partner contributes property to a partnership with built-in gain).

223. See I.R.C. §704(c) (2000).

224. See, e.g., I.R.C. § 703(a) (2000) (requiring partnerships to compute taxable income); I.R.C. § 706 (2000) (providing rules for determining a partnership's taxable year); I.R.C. § 707 (2000) (providing rules to account for transactions between partners and partnerships); Borden, *supra* note 26 (describing the aggregate-plus theory of partnership taxation).

225. See I.R.C. §§ 703(a), 741 (2000).

Finally, an entity-level tax would provide opportunities for abuse. For example, the current entity level tax regime provides that property contributors do not recognize gain on the contribution of property upon formation of an arrangement.<sup>226</sup> The property contributors take a basis in membership interests equal to the basis they had in contributed property,<sup>227</sup> and the entity takes the carryover basis of the property.<sup>228</sup> The nonrecognition and basis rules provide an opportunity to shift tax burdens. To illustrate the potential abuse, assume both Adrian and Bakke contribute property to an arrangement subject to entity tax. Adrian had a built-in gain in her property and Bakke had a built-in loss in his property. If the parties sold the property before contribution, Adrian would have recognized gain, and Bakke would have recognized loss. By contributing the properties to the arrangements, they share the loss and gain. Thus, Bakke's built-in loss offsets some, or all, of Adrian's built-in gain and provides a tax benefit to Adrian.<sup>229</sup> The transaction shifts the burden of taxation of Adrian's built-in gain to Bakke.

Aggregate-plus taxation also helps ensure the proper taxation of changes in value of property. Adrian and Bakke generally will not know the value of partnership property and cannot allocate appreciation on annual basis. Thus, they will only allocate shares of profit in a setting with imperfect information about changes in the property's value. A partnership only allocates changes in the property's value when the partnership disposes of the property. Under the arrangement's allocation formula, the total gain or loss allocated to each party in the year of disposition will be in the same ratio that annual gain or loss would have been allocated in a setting with perfect information. Therefore, the difference between the allocations in the two settings is a timing difference. Tax law recognizes that timing differences and provides different tax rates for gains on the dispositions of certain assets held for more than one year.<sup>230</sup> Thus, aggregate-plus taxation is well suited for arrangements with allocation-dependent residual risk.

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226. See I.R.C. §351(a) (2000).

227. See I.R.C. § 358(a) (2000).

228. See I.R.C. § 362(a) (2000).

229. For example, if Adrian's property had a \$50,000 built-in gain and Bakke's had \$50,000 built-in loss, Bakke's built-in loss would offset Adrian's built-in gain. The result is that instead of Adrian recognizing all \$50,000 of the built-in gain she would have recognized had she sold the property, she shifts half of that gain to Bakke. Adrian also obtains \$25,000 of loss that Bakke would have recognized had they not both contributed property to the arrangement. Congress is aware of some of the potential abuses that entity taxation provides. It has recently enacted a provision to limit the amount of built-in loss recognized by entities in some situations. See I.R.C. § 362(e) (2000).

230. See I.R.C. § 1(h)(1)(C) (2000); Noel B. Cunningham & Deborah H. Schenk, *The Case For a Capital Gains Preference*, 48 TAX L. REV. 319 (1993) (presenting some arguments for taxing gain from the sale of capital assets with favorable tax rates).

## B. Case for Entity Taxation

Although entity taxation is not appropriate for arrangements with either unitary or allocation-dependent residual risk, it should apply to all arrangements with distribution-dependent residual risk. Arrangements with distribution-dependent residual risk differ fundamentally from arrangements with either unitary residual risk or allocation-dependent residual risk. Parties of arrangements with unitary residual risk can trace economic items directly from property or services.<sup>231</sup> Members of arrangement with allocation-dependent residual risk can trace economic items from the arrangement's allocations.<sup>232</sup> Members of arrangements that have distribution-dependent residual risk generally cannot trace economic items from their sources or from allocations. They cannot trace from the sources because the members have integrated their resources.<sup>233</sup> The following discussion demonstrates they cannot trace from allocations. Thus, neither aggregate taxation nor aggregate-plus taxation will provide accurate tax treatment for arrangements with distribution-dependent residual risk.

Distribution-dependent residual risk determines residual claims by first computing the total residual value of an arrangement.<sup>234</sup> It divides that residual value among the arrangement's members according to a formula based on stock ownership or an agreement among members.<sup>235</sup> The distribution formula indiscriminately combines all of the arrangement's economic items to compute residual value. The indiscriminate combining of all of the arrangement's economic items cleanses the items of their unique origins and identities and groups them into a generic pool of residual assets. Thus, the profits and appreciation in the example all become part of the residual assets of the arrangement, and their independent attributes become irrelevant for economic purposes to Adrian and Bakke. That cleansing makes tracing income from allocations impossible.

Recall that in one of the scenarios above Adrian and Bakke formed a corporation that granted Adrian preferred stock and Adrian and Bakke common stock.<sup>236</sup> The corporation had profits and the value of its property fluctuated, over time.<sup>237</sup> If the corporation were to dissolve and liquidate, it would determine the residual value of its assets and distribute the residual assets to Adrian and Bakke according to their respective interests in the corporation. The residual assets would be a combination of contributed

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231. See *supra* text accompanying notes 205–208.

232. See *supra* text accompanying notes 212–229.

233. See *supra* text accompanying notes 211–212.

234. See *supra* text accompanying note 171.

235. See *id.*

236. See *supra* text accompanying note 170.

237. See Table 1 of the Appendix.

property, accumulated profits, and the change in value of the property. The corporation would distribute the residual assets to Adrian and Bakke according to the shares of stock they each own. Adrian's and Bakke's use of distribution-dependent residual risk indicates that they did not wish to use specific economic items of the arrangement to reduce agency costs. Instead, they used general distribution ordering to reduce agency costs.<sup>238</sup> In other words, they did not specifically use profits or appreciation to control agency costs. Their interests were global, and included the overall performance of the arrangement. Tax law should comprehend that distinction.

Aggregate and aggregate-plus taxation fail such arrangements. Assume that tax law has perfect information about tax profits and increases in property value. Assume further that tax law taxes profits and gain at different rates and imposes limits on loss deductions.<sup>239</sup> That being the case, the amount of each item allocated to Adrian and Bakke could affect each party's tax liability.<sup>240</sup> By working backward from the computation of the corporation's residual value, the parties determine the total amount to allocate to each of Adrian and Bakke.<sup>241</sup> They cannot, however, determine the composition of the allocations. For example, they cannot determine the parties' respective shares of profits and appreciation; they cannot know the amount of Adrian's allocation that is profits and the amount that is appreciation.

Consider the possible discrepancies that could result from applying aggregate-plus taxation to an arrangement with distribution-dependant residual risk. The analysis will first examine such arrangement in a setting with perfect information. Then it will consider the same arrangement in a setting without perfect information. Assume that in Year 3 the corporation has \$102,000 of profits and a \$72,000 decrease in the value of the property.<sup>242</sup> The sum of those numbers equals a \$30,000 increase in residual value for that year. Aggregate-plus taxation would require the arrangement to allocate profits and increases in the property's value to the

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238. See *supra* text following note 170 (discussing possible reasons why they might use distribution-dependent residual risk).

239. Tax law has different tax rates for long-term gains on disposition of capital assets. See I.R.C. § 1(h)(1)(C) (2000). Tax law currently limits capital loss deductions to the amount of capital gains plus an additional amount. See I.R.C. § 1211 (2000).

240. For example, if Bakke pays a lower rate of tax on profits and capital gain is taxed at favorable rates, Adrian and Bakke could reduce their overall tax liability by allocating a larger share of profit to Bakke in exchange for a larger share of gain allocated to Adrian. Although Bakke may require some consideration to participate in such an allocation, Adrian would be willing to make the allocation in exchange for consideration. See Borden, *supra* note 10 at 322–23, 329–32 (describing such tax-item transactions).

241. For example, if Bakke's share of the residual value of the assets increases from Year 2 to Year 3 by \$51,000, the arrangement may assume that Bakke's share of the total economic items for Year 3 was \$51,000.

242. The discussion uses figures provide in Table 1 of the Appendix and rounds the numbers to the nearest thousand for aesthetic purposes.

members. Based on the parties' distribution rights, the arrangement should allocate \$55,000 to Adrian and (\$25,000) to Bakke.<sup>243</sup> The distribution formula does not, however, determine how much profit and appreciation the arrangement should allocate to the parties. Therein lies the trouble.

The arrangement must allocate \$55,000 to Adrian using any possible combination of \$102,000 of profits and \$72,000 decrease in property value. It could do this by using anywhere from \$55,000 to \$102,000 of profits.<sup>244</sup> At the low end of that range, the ratio of profit allocation to Adrian and Bakke would be fifty-five to forty-seven (or fairly close to one to one); at the high end of that range, the ratio would be one to zero.<sup>245</sup> Some amount of the property's decrease in value would make up the difference between Adrian's total allocation and Adrian's share of profits.<sup>246</sup> As Adrian's allocated share of profits slides along the range of possibilities, her share of decrease in value would slide along its own range of possibilities from zero to \$47,000. Thus, at the low end of that range, the ratio of increase in value allocated to Adrian and Bakke would be zero to one; at the high end of the range, the ratio would be forty-seven to twenty-five.<sup>247</sup> That is a significant difference and could reflect significant tax consequences for each party.

If the parties are in different tax brackets, the allocations could affect the tax liability of either party, and the ratios in which the arrangement allocates the tax items could affect the placement of the incidence of taxation.<sup>248</sup> Aggregate-plus taxation applied to arrangements with distribution-dependent residual risk would provide taxpayers the opportunity to play games by allocating items to achieve the most favorable tax results.<sup>249</sup> For example, Adrian and Bakke may allocate more profits to Adrian because Adrian is in a lower tax bracket.<sup>250</sup>

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243. See Table 4 of the Appendix.

244. If the arrangement were to allocate only \$55,000 of profits to Adrian, it would allocate the remaining \$47,000 of profits and all \$72,000 of decrease in value to Bakke. If it were to allocate all \$102,000 of profits to Adrian, it would also allocate \$47,000 of decrease in value to Adrian and the remaining \$25,000 decrease in value to Bakke.

245. At the low end of the range, the arrangement would allocate \$51,000 of profits to each of Adrian and Bakke. At the high end of the range, the arrangement would allocate all profit to Adrian the none to Bakke.

246. For example, if Adrian's share of profits were \$55,000, his share of decrease in value would have to be \$0 to ensure that his total allocation came to \$55,000.

247. If the arrangement allocates only \$55,000 of profits to Adrian, it will allocate no decrease in value to Adrian. If it allocates all \$102,000 of profits to Adrian, it will allocate \$47,000 of decrease in value to Adrian and the remaining \$25,000 of decrease in value to Bakke.

248. See *supra* note 240 (discussing the possible effect different ratios of allocated could have on tax liability).

249. The current rules allow this to some extent, even in arrangements with allocation-dependent residual risk. See Borden, *supra* note 10 at 338–44. The opportunities would be more pronounced because the arrangement would have economic items to help satisfy the test for economic effect. The only hurdle left to overcome would be the anemic test for substantiality.

250. The allocation would have to satisfy substantial economic effect, see I.R.C. § 704(b)(2) (2000), but that test is so confusing, the IRS may have a difficult time challenging the allocations. See

The lack of specific direction in the parties' agreement further reveals the inappropriateness of aggregate-plus taxation for arrangements with distribution-dependent residual risk. Recall that the parties' concern when forming the arrangement was not the allocation of specific items, but general interests in the overall performance of the arrangement.<sup>251</sup> Tax law should recognize the parties' focus and place the burden of taxation at the entity level. Entity-level tax will not place the burden of taxation with perfect accuracy, but it should place it more accurately than aggregate-plus taxation and help eliminate tax gamesmanship. Additionally, an entity-level tax will affect the overall economic performance of the entity, recognizing the parties' interest in the arrangement's overall performance.

The problems of using aggregate-plus taxation can be exacerbated if an arrangement with distribution-dependent residual risk carries property at historic cost. Such arrangements must make allocations without taking into account changes in the property's value. With only profit to allocate, the amount of profit allocated to each of Adrian and Bakke depends upon the distribution formulae. In Year 3 for example, the amount of profit allocated to Adrian would be \$91,000 and the amount allocated to Bakke would be \$11,000 (a ratio of roughly ninety to ten).<sup>252</sup> The amounts allocated fall within the range of possible allocations made with perfect information, but they do not consider the amount of gain or loss, which is needed to determine residual claim.<sup>253</sup>

The lack of information could have a cumulative effect as the arrangement allocates profits over the years with no notion of the property's changing value. Over a number of years an arrangement may allocate a disproportionately large amount of profit to one of the parties, compared to what it would have allocated with perfect information. Ultimately, gain or loss recognized on the property's disposition should equalize the total allocations. For example, if the arrangement had allocated a disproportionately large amount of profits to Adrian, the arrangement would allocate less gain to Adrian upon disposition of the property. Such equalizing allocation could, however, have a character that differs from the allocations in prior years. Thus, long-term capital gain may offset earlier allocations of profit that were taxed at ordinary rates. Offsetting ordinary income with long-term capital gain creates a character shift over the life of the arrangement, if profits allocated to Adrian and offset those with a smaller allocation of long-term capital gain. Thus, Adrian would have paid tax at a higher rate overall. That difference

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Treas. Reg. § 1.704-1(b)(2)(iii) (as amended in 2008) (defining substantiality to include the present value of the after-tax consequences of a distribution, which may be impossible to determine).

251. See *supra* text following note 170.

252. See Table 7 of the Appendix.

253. See *supra* text accompanying note 239–247.

reflects more than a timing difference that occurs in both aggregate and aggregate-plus taxation.<sup>254</sup>

This analysis reveals that members of arrangements with distribution-dependent residual risk cannot trace economic items from the source to the owner of the source. The members are also unable to trace economic items from allocations. Aggregate or aggregate-plus taxation would inaccurately place the incidence of taxation in arrangements with distribution-dependent residual risk. Not taxing such arrangements would allow the members to defer taxation indefinitely.<sup>255</sup> The inability to trace income from the source or from allocations suggests that entity taxation should apply to arrangements distribution-dependent residual risk.

### C. Classifying Arrangements under the Residual-Risk Model

The analysis of arrangements with unitary residual risk, allocation-dependent residual risk, and distribution-dependent residual risk provides a framework for recommending the residual-risk model for classifying business arrangements. The model retains the three basic types of tax arrangements—disregarded arrangements, tax partnerships, and tax corporations—but divides them based upon type of residual risk. The new model eliminates qualified tax partnerships because they lack policy and theoretical support.<sup>256</sup> That leaves one important tax regime—entity-minus taxation—unassigned. Entity-minus taxation currently applies to S corporations.<sup>257</sup> Entity-minus taxation allows corporations with one class of stock and subject to certain stock ownership restrictions to flow corporate income through to the shareholders.<sup>258</sup> That flow-through helps simple arrangements avoid entity and double taxation that the current regime generally imposes on tax corporations.<sup>259</sup> The residual risk model retains entity-minus taxation and applies it to electing simple closely-held arrangements (as defined in subchapter S of the Internal Revenue Code<sup>260</sup>) with allocation-distribution symmetry.

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254. See *supra* text accompanying notes.

255. See Brooks, *supra* note 89 at 638–43.

256. The policy justification for qualified tax partnerships is extremely tenuous under the current classification model, see Borden, *supra* note 34 at 347–59 (describing the inadequacies of aggregate-plus taxation as applied to qualified tax partnerships), and not supported under the residual-risk model, so the Article recommends eliminating them.

257. See *supra* text accompanying notes 29–30.

258. See I.R.C. § 1361(b)(1) (2000) (restricting stock ownership); I.R.C. § 1363(a) (2000) (providing that S corporations are not subject to tax); I.R.C. § 1366(a) (2000) (requiring S corporation shareholders to recognize their pro rata shares of S corporation tax items).

259. See Arthur B. Willis, *Subchapter S: A Lure to Incorporate Proprietorships and Partnerships*, 6 UCLA L. REV. 505, 509–11 (1959) (describing the benefits of subchapter S).

260. See I.R.C. § 1361(b) (2000) (defining small business corporations that are subject to subchapter S).

Consider the arrangements described above that have allocation-distribution symmetry.<sup>261</sup> The corporation issued eighty shares of common stock to Adrian and the remaining twenty authorized shares of common stock to Bakke. Upon liquidation, the corporation will distribute eighty percent of the residual assets to Adrian and the remaining twenty percent to Bakke. If Adrian and Bakke formed the arrangement as a partnership and agreed to allocate all economic items eighty percent to Adrian and twenty percent to Bakke, the result upon liquidation would be the same.<sup>262</sup>

Entity-minus taxation is a good tax regime for arrangements with allocation-distribution symmetry because it allows tax items to flow through to the members but does not impose the complexities of aggregate-plus taxation.<sup>263</sup> The trade off for the simplicity of entity-minus taxation is that arrangements using entity-minus taxation must remain simple. Aggregate-plus taxation recognizes the concept of built-in gain or loss on the contribution of property and ensures that the contributor retains the incidence of tax related to such built-in item.<sup>264</sup> Entity-minus taxation, in its simplicity, does not have similar provisions. The entity-minus approach is, therefore, less accurate than aggregate-plus taxation, but it trades accuracy for justified simplicity. The restrictions on ownership limit the number of investors who will join an entity-minus arrangement and limit the transfer of ownership interests in such arrangements.<sup>265</sup> Those limits help reduce the occurrence and magnitude of built-in gain and loss.<sup>266</sup> Thus, only simple arrangements with ownership restrictions should qualify for entity-minus taxation.

The law should not, however, prohibit arrangements with allocation-distribution symmetry from using aggregate-plus taxation. Aggregate-plus taxation is the most accurate entity tax regime because it accounts for built-in gain and loss.<sup>267</sup> It also has more aggregate components than entity-minus taxation, for instance, aggregate-plus taxation recognizes the nature of the arrangement's assets and adjusts their bases on disposition of an

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261. See *supra* Section III.D.

262. See *supra* Section III.D. Compare Table 5 and Table 6 of the Appendix.

263. See Borden, *supra* note 26 (describing the need for some of the complexities of aggregate-plus taxation).

264. See I.R.C. § 704(c) (2000).

265. For example, subchapter S generally limits stock ownership to no more than 100 U.S. resident individuals and allows the corporation to issue only one class of stock. See I.R.C. § 1361(b)(1) (2000). Thus, many potential shareholders, such as trusts, partnerships, and non-U.S. persons, will not invest in such arrangements.

266. The restrictions also reduce the occurrence of reverse built-in gain and loss. Reverse built-in gain and loss arise when a new member joins an existing arrangement that has assets with value that differs from their tax bases. See Treas. Reg. § 1.704-3(a)(6)(i) (as amended in 2005). Tax law should allocate such reverse built-in gain or loss to the pre-existing members of the arrangement, not to new members.

267. See I.R.C. § 704(c) (2000). It also accounts for reverse built-in gain or loss. See Treas. Reg. § 1.704-3(a)(6)(i) (as amended in 2005).

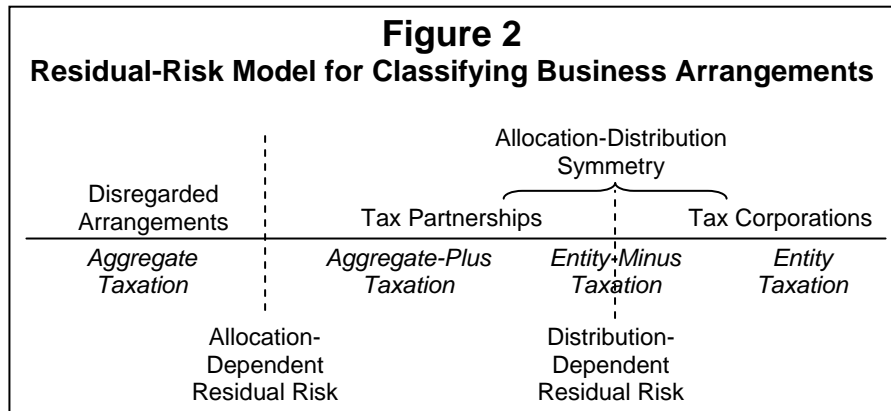
interest in the arrangement.<sup>268</sup> Because aggregate-plus taxation enhances accuracy, tax law should not prohibit arrangements with allocation-distribution symmetry from using it.

Figure 2 depicts the residual-risk model. The first dividing line, between disregarded arrangements and tax partnerships, is allocation-dependent residual risk. Arrangements with unitary residual risk should be disregarded; arrangements with allocation-dependent residual risk should be tax partnerships. The second dividing line, between tax partnerships and tax corporations, is distribution-dependent residual risk. Arrangements with allocation-dependent residual risk should be tax partnerships; arrangements with distribution-dependent residual risk should be tax corporations. Finally, simple arrangements with allocation-distribution symmetry fall between tax partnerships and tax corporations.

The model also determines the appropriate tax regime to apply to the respective arrangements. Aggregate taxation should apply to disregarded arrangements. Such arrangements have unitary residual risk and can trace income from its source to the owner of that source. Aggregate taxation therefore suits disregarded arrangements. Aggregate-plus taxation should apply to tax partnerships. Such arrangements have allocation-dependent residual risk, and members can trace their shares of the arrangement's income from the allocations. Aggregate-plus taxation therefore suits tax partnerships. Entity taxation should apply to tax corporations. Tax corporations, under the model, have distribution-dependent residual risk, and the members cannot trace income from its source or from allocations. Therefore, entity taxation is the only available alternative. Finally, either aggregate-plus taxation or entity-minus taxation should apply to simple arrangements with allocations-distribution symmetry. The members of such arrangements can allocate items based on proportionate ownership. The arrangements are simple enough that they should not be required to adopt aggregate-plus taxation.

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268. See, e.g., I.R.C. § 754 (2000) (providing an election to adjustment the basis of partnership property on distributions and sales of partnership interests); I.R.C. § 751(a) (2000) (providing that a distributee partner or seller of a partnership interest must recognize ordinary income for proportionate shares of partnership property that will generate ordinary income up on disposition or collection).



## V. CONCLUSION

This Article argues that the classification of business arrangements should be grounded in economic principle. The current model for classifying tax entities unfortunately disregards economics and instead relies upon legal forms, labels, and taxpayer elections. The current model's unjustified reliance on such factors creates arbitrary distinctions between the various tax entities. The current model also ignores the policy reasons for the various entity tax regimes. As a consequence, the classification model subjects some arrangements to tax regimes that do not accurately place the tax burden. Taxpayer elections also allow well-advised taxpayers to shift the burden of tax to others.

The Article proposes a model for classifying tax entities that considers the economic aspects of business arrangements. The Article demonstrates that economic theory helps explain why parties form business arrangements and how they use economic arrangements to reduce rent-seeking and agency costs. Tax law should recognize that use of economic arrangements and ensure that tax items follow economic items. The proposed model adopts residual risk as the preferred measure of each party's economic situation and their shares of an arrangement's economic performance.

The Article introduces three types of residual risk—unitary residual risk, allocation-dependent residual risk, and distribution-dependent residual risk—that help explain the need for the various tax regimes and suggest a natural classification model. In short, members of arrangements with unitary residual risk can trace income from its source and should be subject to aggregate taxation. Members of arrangements with allocation-dependent residual risk can only trace income from allocations, so such arrangements should be subject to aggregate-plus taxation. Finally, arrangements with distribution-dependent risk cannot trace income from its source or

allocations. Consequently, such arrangements should be subject to entity taxation. Thus, the Article recommends the residual-risk model for classifying business arrangements.

## APPENDIX OF TABLES

The tables in this Appendix summarize the performance of a hypothetical company and illustrate how agreements and state law affect parties' residual risk. They provide information that the Article uses to illustrate the importance of the residual-risk model.

<u>Year</u>	<u>Profit</u>	<u>% Profit Increase</u>	<u>Accum'd Profits</u>	<u>Property Apprec.</u>	<u>% Value Increase</u>	<u>Property Value</u>	<u>Residual Value</u>
1	100,000		100,000	120,998	11.42%	1,000,000	1,220,998
2	99,712	-0.29%	199,712	80,634	6.95%	1,201,632	1,401,344
3	102,235	2.52%	301,947	(71,742)	-6.16%	1,129,890	1,431,837
4	106,772	4.54%	408,719	(88,170)	-8.12%	1,041,720	1,450,439
5	102,310	-4.46%	511,029	39,505	3.72%	1,081,225	1,592,254
6	98,030	-4.28%	609,059	25,334	2.32%	1,106,558	1,715,618
7	97,277	-0.75%	706,336	(41,315)	-3.81%	1,065,243	1,771,579
8	99,657	2.38%	805,993	(90,007)	-8.83%	975,236	1,781,229
9	98,858	-0.80%	904,851	41,184	4.14%	1,016,420	1,921,271
10	97,761	-1.10%	1,002,612	121,502	11.29%	1,137,922	2,140,534

Table 1 tracks the business's accumulated profits (Accum'd Profits). Because the arrangement makes no distributions, profits accumulate and become part of the business's residual value. Table 1 also tracks the value of the contributed property. The residual value equals accumulated profits plus the property value for each year.<sup>269</sup>

The model uses box-Muller computation to create the log-normal distribution. With a mean of three percent and a standard deviation of six percent, the distribution skews slightly positive. The following table illustrates the derivation of the random changes in profit and property value.

Inputs for Random Number Generation								
	profit %		asset %					
mean	3%		3%					
standard deviation	6%		6%					
	Uniform Random Numbers		Intermediate Box-Muller Computations				Random Numbers to Use	
	rand1	rand2	r	theta	x1	x2	profit %	asset %
1	0.678657765	0.309233857	1.506817	1.942972	-0.547943	1.403657778	-0.29%	11.42%
2	0.197032669	0.269166747	0.662482	1.691223	-0.079588	0.657684016	2.52%	6.95%
3	0.697949816	0.776469396	1.54736	4.878697	0.256154	-1.52601096	4.54%	-6.16%

269. The author thanks Thomas J. Brennan and Brent Fisher for help creating this model.

<b>Profit/Loss Allocations</b>								
	<i>profit %</i>	<i>appr %</i>						
A	55%	35%						
B	45%	65%						
	100%	100%						
<b>Year</b>	<b>A's % Profit</b>	<b>A's % Apprec.</b>	<b>A's Total Allocation</b>	<b>B's % Profit</b>	<b>B's % Apprec.</b>	<b>B's total Allocation</b>	<b>A's RC</b>	<b>B's RC</b>
1	55,000	42,349	97,349	45,000	78,649	123,649	1,097,349	123,649
2	54,842	28,222	83,064	44,871	52,412	97,282	1,180,413	220,931
3	56,229	(25,110)	31,119	46,006	(46,633)	(627)	1,211,532	220,304
4	58,724	(30,859)	27,865	48,047	(57,310)	(9,263)	1,239,397	211,041
5	56,271	13,827	70,097	46,040	25,678	71,718	1,309,495	282,759
6	53,916	8,867	62,783	44,113	16,467	60,580	1,372,278	343,340
7	53,502	(14,460)	39,042	43,775	(26,855)	16,920	1,411,320	360,259
8	54,811	(31,502)	23,309	44,845	(58,504)	(13,659)	1,434,629	346,600
9	54,372	14,414	68,786	44,486	26,770	71,256	1,503,415	417,856
10	53,769	42,526	96,294	43,993	78,976	122,969	1,599,709	540,825

Table 2 summarizes the performance of the arrangement as a traditional partnership. Each party's total allocation is the sum of the allocation of the percentage of profit (e.g., A's % Profit) and property appreciation (e.g., A's Apprec.). In Year 1, Adrian's residual claim (A's RC) is the sum of his contribution plus the allocations of profit and appreciation. Each subsequent year, the parties' residual claims adjust to reflect annual allocations. Bakke's residual claim (B's RC) is computed in the same manner as Adrian's, but because Bakke made no contribution, his residual claim includes only his allocations of profits and appreciation.

<b>Table 3</b>					
<b>Shareholders' Residual Claims</b>					
<b>Stock Ownership</b>					
	<i>Common</i>	<i>Pfd</i>			
<i>A</i>	50	1000			
<i>B</i>	50	0			
	100	1000			
Preferred Contribution:		1,000,000			
Preferred Coupon:		8%			
<u>Year</u>	<u>Pf'd Contr. &amp; Coupon</u>	<u>RC Pf'd</u>	<u>RC Cm'n</u>	<u>A's RC</u>	<u>B's RC</u>
1	1,080,000	1,080,000	140,998	1,150,499	70,499
2	1,160,000	1,160,000	241,344	1,280,672	120,672
3	1,240,000	1,240,000	191,837	1,335,918	95,918
4	1,320,000	1,320,000	130,439	1,385,219	65,219
5	1,400,000	1,400,000	192,254	1,496,127	96,127
6	1,480,000	1,480,000	235,618	1,597,809	117,809
7	1,560,000	1,560,000	211,579	1,665,790	105,790
8	1,640,000	1,640,000	141,229	1,710,615	70,615
9	1,720,000	1,720,000	201,271	1,820,635	100,635
10	1,800,000	1,800,000	340,534	1,970,267	170,267

Table 3 identifies the sum of the contribution on preferred stock and the preferred return (Pf'd Contr. & Coupon). Each year the amount increases by \$80,000 or eight percent of the \$1,000,000 contribution. The next column identifies the residual claim of the preferred stock (RC. Pf'd), which always equals the sum of the preferred contribution and coupon. The next column presents the residual claim of the common stock (RC Cm'n). That amount is the excess of the corporation's residual value (see Table 1) over the residual claim of preferred shareholders. Because Adrian holds all of the preferred and half of the common stock, her residual claim (A's RC) is the sum of the residual claim of the preferred stock and half of the residual claim of the common stock. Bakke's residual claim (B's RC) is one half of the amount of residual claim of the common because Bakke holds half of the common stock.

<b>Table 4</b>							
<b>Partners' Residual Claim in Partnership with Target Allocations</b>							
<b>Distribution Preferences</b>							
	<i>Tier 1</i>	<i>Tier 2</i>	<i>Tier 3</i>				
A	return	contribution		50%			
B				50%			
				100%			
Tier 2 Contribution:			1,000,000				
Tier 1 Return:			8%				
<u>Year</u>	<u>Sum of Tier 1 &amp; 2</u>	<u>Tier 1 &amp; 2 RC</u>	<u>Tier 3</u>	<u>A's RC</u>	<u>B's RC</u>	<u>A's Allocation</u>	<u>B's Allocation</u>
1	1,080,000	1,080,000	140,998	1,150,499	70,499	150,499	70,499
2	1,160,000	1,160,000	241,344	1,280,672	120,672	130,173	50,173
3	1,240,000	1,240,000	191,837	1,335,918	95,918	55,246	(24,754)
4	1,320,000	1,320,000	130,439	1,385,219	65,219	49,301	(30,699)
5	1,400,000	1,400,000	192,254	1,496,127	96,127	110,908	30,908
6	1,480,000	1,480,000	235,618	1,597,809	117,809	101,682	21,682
7	1,560,000	1,560,000	211,579	1,665,790	105,790	67,981	(12,019)
8	1,640,000	1,640,000	141,229	1,710,615	70,615	44,825	(35,175)
9	1,720,000	1,720,000	201,271	1,820,635	100,635	110,021	30,021
10	1,800,000	1,800,000	340,534	1,970,267	170,267	149,631	69,631

Table 4 identifies the sum of the Tier One and Tier Two distributions (Sum of Tier 1 & 2). That amount equals the residual claim for the partner entitled to distributions under Tier One and Tier Two (Tier 1 & 2 RC). The Tier Three amount is the amount by which the residual value of the assets exceeds the residual claim of the Tier One and Tier Two members. Adrian's residual claim (A's RC) equals all of the Tier One and Tier Two amounts and half of the Tier Three amount. Bakke's residual claim (B's RC) equals half of the Tier Three amount. Adrian's allocation (A's Allocation) equals her residual claim minus her contribution (Year 1) or her residual claim for the year minus her residual claim for the prior year (all years after Year 1). Bakke's allocation (B's Allocation) equals his residual claim for the year minus his residual claim for the prior year.

**Table 5**  
**Shareholders' Residual Claims in a Corporation**  
**with a Single Class of Stock**

**Stock Ownership**

*Common*

<i>A</i>	80
<i>B</i>	20
	100

<u>Year</u>	<u>Residual</u> <u>Value</u>	<u>A's RC</u>	<u>B's RC</u>
1	1,220,998	976,798	244,200
2	1,401,344	1,121,075	280,269
3	1,431,837	1,145,469	286,367
4	1,450,439	1,160,351	290,088
5	1,592,254	1,273,803	318,451
6	1,715,618	1,372,494	343,124
7	1,771,579	1,417,263	354,316
8	1,781,229	1,424,983	356,246
9	1,921,271	1,537,017	384,254
10	2,140,534	1,712,427	428,107

The residual value of the corporation in Table 5 is from Table 1. Adrian's residual claim (A's RC) is eighty percent of the residual value Bakke's residual claim is twenty percent of the residual value.

	<i>profit %</i>	<i>appr %</i>						
A	80%	80%						
B	20%	20%						
	100%	100%						
<u>Year</u>	<u>A's %</u> <u>Profit</u>	<u>A's %</u> <u>Apprec.</u>	<u>A's Total</u> <u>Allocation</u>	<u>B's %</u> <u>Profit</u>	<u>B's %</u> <u>Apprec</u>	<u>B's Total</u> <u>Allocation</u>	<u>A's RC</u>	<u>B's RC</u>
1	80,000	96,798	176,798	20,000	24,200	44,200	976,798	244,200
2	79,770	64,507	144,277	19,942	16,127	36,069	1,121,075	280,269
3	81,788	(57,394)	24,394	20,447	(14,348)	6,098	1,145,469	286,367
4	85,417	(70,536)	14,881	21,354	(17,634)	3,720	1,160,351	290,088
5	81,848	31,604	113,452	20,462	7,901	28,363	1,273,803	318,451
6	78,424	20,267	98,691	19,606	5,067	24,673	1,372,494	343,124
7	77,822	(33,052)	44,769	19,455	(8,263)	11,192	1,417,263	354,316
8	79,725	(72,005)	7,720	19,931	(18,001)	1,930	1,424,983	356,246
9	79,086	32,947	112,033	19,772	8,237	28,008	1,537,017	384,254
10	78,209	97,201	175,410	19,552	24,300	43,853	1,712,427	428,107

Adrian's share of profit (A's % of Profit) and share of appreciation (A's % Appr.) are each eighty percent of the total of each category. Adrian's total allocation (A's Total Allocation) is the sum of her share of profit and appreciation. The same method determines Bakke's twenty percent allocation and total allocations. The parties' residual claims include the parties' interest in the property plus their allocations.

<b>Table 7</b>							
<b>Partners' Residual Claim in Partnership with Target Allocations with Imperfect Information</b>							
<b>Distribution Preferences</b>							
	<i>Tier 1</i>	<i>Tier 2</i>	<i>Tier 3</i>				
<i>A</i>	return	contribution	50%				
<i>B</i>			50%				
			100%				
Tier 2 Contribution:			1,000,000				
Tier 1 Return:			8%				
<u>Year</u>	<u>Sum of</u>	<u>Tier 1 &amp; 2</u>	<u>Tier 3</u>	<u>A's RC</u>	<u>B's RC</u>	<u>A's</u>	<u>B's</u>
	<u>Tier 1 &amp; 2</u>	<u>RC</u>				<u>Allocation</u>	<u>Allocation</u>
1	1,080,000	1,080,000	20,000	1,090,000	10,000	90,000	10,000
2	1,160,000	1,160,000	39,712	1,179,856	19,856	89,856	9,856
3	1,240,000	1,240,000	61,947	1,270,974	30,974	91,117	11,117
4	1,320,000	1,320,000	88,719	1,364,359	44,359	93,386	13,386
5	1,400,000	1,400,000	111,029	1,455,515	55,515	91,155	11,155
6	1,480,000	1,480,000	129,059	1,544,530	64,530	89,015	9,015
7	1,560,000	1,560,000	146,336	1,633,168	73,168	88,638	8,638
8	1,640,000	1,640,000	165,993	1,722,996	82,996	89,828	9,828
9	1,720,000	1,720,000	184,851	1,812,425	92,425	89,429	9,429
10	1,800,000	1,800,000	340,534	1,970,267	170,267	157,842	77,842

Table 7 is identical to Table 4, except the Tier Three amount in Table 7 is the amount by which the book value of the assets exceeds the residual claim of the Tier One and Tier Two members. The parties' residual claims and allocations reflect the use of the different amount.