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Making Tax Law Work: Improvisation and Forgotten Taxpayers in Partnership Tax

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MAKING TAX LAW WORK: IMPROVISATION AND FORGOTTEN TAXPAYERS IN PARTNERSHIP TAX

Andrea Monroe*

ABSTRACT

There is a growing awareness that federal tax law caters to a small number of wealthy and well-advised taxpayers without regard for the rest of the taxpaying public, and partnership tax is a prime example. This Article explains how complexity and indeterminacy have transformed partnership tax, harming millions of forgotten taxpayers who struggle to comply with their annual filing obligations. A root cause of this phenomenon is the professional culture among elite practitioners, policymakers, and scholars at the heart of the partnership tax system.

The most troublesome provisions of partnership tax are also its most fundamental—namely the allocation rules that regulate how partners share a partnership's taxable items. Complexity is a universal problem faced by partnerships at all levels of wealth, status, and sophistication, and the vast majority of taxpayers respond with improvisational tax compliance. Indeed, in remarkably diverse contexts, improvisation has replaced technical compliance as the norm in partnership allocations. Wealthy partnerships make a strategic choice to improvise, using “target allocations,” while poorer partnerships improvise because they have no other choice, routinely following “intuitive” tax law and hoping for the best.

Reframing this complexity problem as a shared experience of all partnerships exposes the technical and cultural fractures of partnership tax in a new and different light. First, the technical rules governing partnership allocations do not work as designed for any category of partnership. A second, less explored fracture is the professional culture of partnership tax, which takes for granted the technical sophistication of substantive tax law without appreciating the distributional consequences of sustained complexity and improvisation.

Partnership allocations require more than technical solutions. One necessary step is addressing the professional culture of partnership tax to rethink what it means for tax law to work. This Article proposes that partnership reforms developed by experts and directed at wealthy and well-advised partnerships should be accompanied by reforms addressing parallel problems faced by forgotten partnerships. The solutions will necessarily differ, but a bilateral focus on the universal problems of all partnerships would represent meaningful progress, signaling a commitment to a fair, principled, and representative system of partnership tax.

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INTRODUCTION

The federal income tax system is in crisis. It is a subtle, “hidden in plain sight” crisis, often masked by recent events like presidential elections, novel tax legislation, and a global pandemic and its related economic shockwaves.¹ Yet the normalization of complexity and dysfunction have transformed substantive tax law, producing deep fractures within the system and among taxpayers. Practitioners, policymakers, and scholars largely agree that substantive tax law is too complicated

1. See American Rescue Plan Act of 2021, Pub. L. No. 117-2, 135 Stat. 4; Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, 134 Stat. 1182 (2020); Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, 134 Stat. 281 (2020); Pub. L. No. 115-97, 131 Stat. 2195 (2017) (2017 tax legislation originally called the Tax Cuts and Jobs Act); see, e.g., David Kamin, David Gamage, Ari D. Glogower, Rebecca M. Kysar, Darien Shanske, Reuven S. Avi-Yonah, Lily L. Batchelder, J. Clifton Fleming, Daniel J. Hemel, Mitchell Kane, David S. Miller, Daniel Shaviro & Manoj Viswanathan, *The Games They Will Play: Tax Games Road Blocks and Glitches Under the 2017 Tax Legislation*, 103 MINN. L. REV. 1439 (2019); Ari Glogower & David Kamin, *The Progressivity Ratchet*, 104 MINN. L. REV. 1499 (2020); Reuven S. Avi-Yonah, *COVID-19 and U.S. Tax Policy: What Needs to Change?* (Univ. of Mich. L. Sch., Pub. L. and Legal Theory Rsch. Paper Series, Paper No. 679, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3584330; Hiba Hafiz, Shu-Yi Oei, Diane Ring & Natalya Shnitser, *Regulating in Pandemic: Evaluating Economic and Financial Policy Responses to the Coronavirus Crisis* (Bost. Coll. L. Sch. Legal Stud. Rsch. Paper No. 527, 2020), <http://ssrn.com/abstract=3555980>. See generally Reuven S. Avi-Yonah & Kimberly Clausing, *Toward a 21st Century International Tax Regime*, 95 TAX NOTES INT'L 839 (2019); Jennifer Bird-Pollan, *Revising the Tax Law: The TCJA and Its Place in the History of Tax Reform*, 45 OHIO N.U. L. REV. 501 (2019); Karen C. Burke, *The Spurious Allure of Pass-Through Parity*, 52 LOY. U. CHI. L.J. 351 (2020).

and that such complexity erodes the integrity of the federal income tax system.² Even so, little has changed, and substantive tax law has become increasingly complicated over time. If complexity is such an insidious problem in substantive tax law, why is there so little progress in addressing it? Without better answers to that question, reforms risk perpetuating well-known pathologies.

Overlooking complexity has profound costs, including distributional divides among taxpayers and decreased legitimacy of the federal income tax system. All too often, our tax system operates on two tracks—one for the wealthy and well-advised and one for everyone else.³ Complexity has transformed substantive tax law into a concierge-based system where taxpayers are valued based on their wealth, their status, or their advisors' hourly billing rates. Under this system, tax law is treated as functional when it caters to a small number of elite taxpayers and the experts they employ. Challenges for the broader taxpaying public in navigating complicated and oftentimes inaccessible tax laws are not part of the equation.

2. See, e.g., JOINT COMM. ON TAX'N, 114TH CONG., JCX-49-15, COMPLEXITY IN THE FEDERAL TAX SYSTEM (Joint Comm. Print 2015), <http://www.jct.gov/publications.html?func=startdown&id=4738> [<https://perma.cc/6HPN-JBDN>]; NAT'L TAXPAYER ADVOC., 2016 ANNUAL REPORT TO CONGRESS, VOLUME 1 at 305, 315–24, https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/08/ARC16_Volume1.pdf [<https://perma.cc/3W7M-LHS9>] (“In prior reports, the National Taxpayer Advocate has designated the complexity of the tax code as the most serious problem facing taxpayers and has recommended general principles and specific areas for reform . . . we reiterate those recommendations in this report.”) (footnotes omitted).

3. See e.g., NAT'L TAXPAYER ADVOC., *supra* note 2, at 312 (noting the various ways that complexity benefits taxpayers who can afford sophisticated tax advice and discriminates against those who cannot); Thomas Piketty, Emmanuel Saez & Gabriel Zucman, *Distributional National Accounts: Methods and Estimates for the United States*, 133 Q.J. ECON. 553, 573–89 (2018) (examining trends in income inequality in the United States since 1913); Lily Batchelder & David Kamin, *Policy Options for Taxing the Rich*, in MAINTAINING THE STRENGTH OF AMERICAN CAPITALISM 200–05 (Melissa Kearney & Amy Ganz eds., 2019). In a recent article, ProPublica analyzed financial and tax information regarding the twenty-five wealthiest individuals in the United States, highlighting how little in federal income taxes these individuals paid relative to the wealth they accumulated over the same period. Jesse Eisinger, Jeff Ernsthause & Paul Kiel, *The Secret IRS Files: Trove of Never-Before-Seen Records Reveal How the Wealthiest Avoid Income Tax*, PROPUBLICA (June 8, 2021), <https://www.propublica.org/article/the-secret-irs-files-trove-of-never-before-seen-records-reveal-how-the-wealthiest-avoid-income-tax> [<https://perma.cc/9RRE-F5WE>]; see also Greg Leiserson & Danny Yagan, *What Is the Average Federal Individual Income Tax Rate on the Wealthiest Americans?*, WHITE HOUSE: COUNCIL OF ECON. ADVISORS BLOG (Sept. 23, 2021), <https://www.whitehouse.gov/cea/written-materials/2021/09/23/what-is-the-average-federal-individual-income-tax-rate-on-the-wealthiest-americans/> [<https://perma.cc/8NYG-G63N>] (estimating an average individual income tax rate of 8.2% for the 400 wealthiest families in the United States during the period from 2010 to 2018). Likewise, income inequality is not the only fracture exacerbated by tax law complexity. Racial inequality is also amplified by the tax law's myriad pathologies, including complexity. See generally, DOROTHY A. BROWN, *THE WHITENESS OF WEALTH* (2021); Joshua D. Blank & Leigh Osofsky, *The Inequity of Informal Guidance*, 75 VAND. L. REV. (forthcoming 2022); Emily A. Satterthwaite, *Entrepreneurs' Legal Status Choices and the C Corporation Survival Penalty*, 16 J. EMPIRICAL LEGAL STUD. 542 (2019).

This is a terrible failure of modern tax law. One step forward is to fundamentally reconsider what it means for tax law to “work.” This Article starts with the commonsense notion that tax law works when technical compliance with substantive legal requirements is possible for most, if not all, taxpayers. In simplest terms, tax law works when taxpayers are able to meaningfully participate in the federal income tax system, most importantly by satisfying their annual tax filing obligations.⁴

This Article explores the technical and cultural forces that have transformed substantive tax law, especially for the millions of taxpayers who struggle when filing their tax returns each year.⁵ Partnership tax, in particular, offers a stark illustration of the fractures resulting from the normalization of complexity in tax law. Partnerships play a vital role in the federal income tax, both in terms of the number of entities taxed as partnerships and the amount of net income they generate. In 2019, the most recent year for which tax filing data are available, approximately 3.8 million partnerships, representing almost 25.3 million partners, filed federal income tax returns.⁶ These partnerships held close to \$36.1 trillion in assets and generated more than \$760.6 million in net income.⁷

4. As part of the Taxpayer Bill of Rights, taxpayers have a right to be informed. I.R.C. § 7803(a)(3)(A). According to the IRS, this means that “[t]axpayers have the right to know what they need to do to comply with the tax laws.” *Taxpayer Bill of Rights*, INTERNAL REVENUE SERV., <http://www.irs.gov/taxpayer-bill-of-rights> [<https://perma.cc/3W7M-LHS9>]. For a thoughtful analysis of the history and potential implications of the Taxpayer Bill of Rights, see generally Alice G. Abreu & Richard K. Greenstein, *Embracing the TBOR*, 157 TAX NOTES 1281 (2017).

5. Although this Article’s primary focus is the complexity of partnership tax, there are myriad examples of dysfunctional federal income tax provisions, including many that impact individual taxpayers, like the Earned Income Tax Credit and the qualified business income deduction. I.R.C. §§ 32, 199A. As part of his testimony before the Senate Finance Committee on the complexity of federal income tax law, Professor Mihir Desai provided the anonymous responses of twenty-one tax law experts when asked about areas of tax law complexity. The list is long, and it includes various provisions of partnership tax, particularly the rules governing partnership allocations, the Earned Income Tax Credit, the foreign tax credit rules, and the dual consolidated loss rules. *Tax Complexity, Compliance, and Administration: The Merits of Simplification in Tax Reform: Hearings Before the S. Comm. on Finance*, 114th Cong. 40–49 app. A (2015) (statement of Mihir A. Desai, Mizuho Financial Group Professor of Finance and Professor of Law, Harvard University). For scholarship on the impact of the 2017 tax legislation on tax law complexity, see, e.g., Michael J. Graetz, *Foreword—The 2017 Tax Cuts: How Polarized Politics Produced Precarious Policy*, 128 YALE L.J.F. 315 (2018); Kamin et al., *supra* note 1; Shu-Yi Oei & Leigh Osofsky, *Legislation and Comment: The Making of the §199A Regulations*, 69 EMORY L.J. 209 (2019).

6. Ron DeCarlo, Tuba Ozer-Gurbuz & Nina Shumofsky, *Partnership Returns, Tax Year 2019*, 41 INTERNAL REVENUE SERV., STAT. INCOME BULL., Winter 2022, 21, 22 fig.B, <https://www.irs.gov/pub/irs-pdf/pi136.pdf> [<https://perma.cc/C9K4-HRTS>].

7. *Id.* at 23 fig.D. More generally, partnerships and other non-corporate entities have been responsible for at least fifty percent of annual reported business net income since 2004. See *SOI Tax Stats—Integrated Business Data*, INTERNAL REVENUE SERV., tbl.1, <https://www.irs.gov/statistics/soi-tax-stats-integrated-business-data> [<https://perma.cc/MR3A-VKE4>]; see also WHITE HOUSE & TREAS. DEP’T, *THE PRESIDENT’S FRAMEWORK FOR BUSINESS TAX REFORM* 8 (2012), <https://www.treasury.gov>

Yet there are dramatic differences among partnerships, with a tiny percentage holding the overwhelming majority of partnership assets. In 2018, less than one percent of partnerships held more than seventy-seven percent of partnership assets, and approximately ninety percent of partnerships held less than one percent of partnership assets.⁸ The partnership tax world is thus bifurcated—a small number of “elite” partnerships fall at one extreme, and the vast majority of “forgotten” partnerships fall at the other extreme.⁹

The tax rules that govern these partnership entities are set forth in subchapter K of the Internal Revenue Code,¹⁰ and they are notoriously complicated.¹¹ Indeed, partnership tax uniquely illustrates problems of

/resource-center/tax-policy/tax-analysis/Documents/OTA-Report-Business-Tax-Reform-2012.pdf [https://perma.cc/4YT6-KZ72].

Although the 2017 tax legislation, which, among other things, reduced the corporate income tax rate from thirty-five percent to twenty-one percent, has impacted the choice-of-entity calculus for many firms, it has not spurred an exodus from subchapter K. *See, e.g.*, James R. Repetti, *The Impact of the 2017 Act's Tax Rate Changes on Choice of Entity*, 21 FLA. TAX REV. 686 (2018); Bradley T. Borden, *Income-Based Effective Tax Rates and Choice-of-Entity Considerations Under the 2017 Tax Act*, 71 NAT'L TAX J. 613 (2018); Burke, *supra* note 1; Karen C. Burke, *Section 199A and Choice of Pass Through Entity*, 72 TAX LAW. 551 (2019); Glogower & Kamin, *supra* note 1; Daniel Halperin, *Choice of Entity—A Conceptual Approach*, 159 TAX NOTES 1601 (2018); Michael S. Knoll, *The TCJA and the Questionable Incentive to Incorporate*, 162 TAX NOTES 977 (2019); Michael S. Knoll, *The TCJA and the Questionable Incentive to Incorporate, Part 2*, 162 TAX NOTES 1447 (2019).

8. SOI Tax Stats—Partnership Data by Size of Total Assets, INTERNAL REVENUE SERV., tbl.15, <https://www.irs.gov/statistics/soi-tax-stats-partnership-data-by-size-of-total-assets> (under “All Partnerships,” select “2019” to download an excel file of tbl.15). A total of 3,821,470 partnerships filed federal income tax returns, and these partnerships held 36,048,324,019 in assets. *Id.* There were 37,599 partnerships with assets of \$100 million or more, and they held total assets of \$27,862,629,390. *Id.* By contrast, 3,447,781 partnerships held assets of \$1 million or less, and these partnerships held total assets of \$1,912,004,794. *Id.*

9. This Article divides partnerships into two broad categories: “elite” and “forgotten” partnerships. In very general terms, forgotten partnerships tend to be less wealthy or sophisticated than their elite counterparts. They are, in turn, less likely to have access to substantive partnership tax law or high-priced partnership tax experts. This Article thus uses the term “forgotten” to describe these partnerships, which comprise the overwhelming majority of partnerships, because they are often overlooked by substantive partnership tax law and the experts at its intellectual center. Nonetheless, these are admittedly blunt categories, and partnership characteristics are surely more fluid than this binary “forgotten versus elite” categorization reflects. Yet, this split between elite and forgotten partnerships provides a useful illustration of the rough distribution of partnerships across the spectrum.

10. I.R.C. §§ 701–61. These rules govern all unincorporated entities with two or more members, including limited liability companies that elect to be treated as partnerships for federal income tax purposes under the check-the-box regulations. *See* Treas. Reg. §§ 301.7701-1–7701-3.

11. *See, e.g.*, GEORGE K. YIN & DAVID J. SHAKOW, AM. L. INST., FEDERAL INCOME TAX PROJECT: TAXATION OF PRIVATE BUSINESS ENTERPRISES: REPORTERS' STUDY (1999) [hereinafter ALI 1999 REPORTERS' STUDY]; George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141 (1999); Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 FLA. TAX REV. 249 (1999); Stuart L. Rosow & Rachel A. Hughes, *Reforming Subchapter K: The Partnership Tax Simplification Act of 20__*, 94 TAXES 361 (2016); Curtis J. Berger, *W(h)ither Partnership Taxation?*, 47 TAX L. REV. 105 (1991); Jeffrey L. Kwall, *Taxing Private Enterprise in the New Millennium*, 51 TAX LAW. 229 (1997); Martin J. McMahon, Jr., *Rethinking Taxation of Privately Held Businesses*, 69 TAX LAW. 345 (2016); Philip F. Postlewaite, *I Come to Bury Subchapter K, Not to Praise It*, 54 TAX LAW. 451 (2001).

complexity because its most impenetrable rules lie at its operational and theoretical core.¹² Unlike other areas of tax law where the most complicated rules often appear at the margins, subchapter K's worst technical challenges appear within the basic operating rules that every partnership must navigate every year.¹³ When taken together, subchapter K's distinctive combination of scale, distributional polarization, and complexity offers a powerful example of the forces that are currently eroding partnership tax and, more broadly, federal income tax law as a whole.

The allocation rules that determine how partners share a partnership's taxable income are subchapter K's most foundational provisions, and also its most dysfunctional.¹⁴ The rules governing partnership allocations are essential to subchapter K, regulating the annual tax consequences reported by every partner in every partnership required to file a tax return. In theory, these allocation rules elegantly require partners to share a partnership's taxable income and loss in the same way that they share the corresponding economic consequences.¹⁵ Yet in practice, that notion has spawned some of the most complicated and byzantine regulations in any area of federal income tax law.¹⁶

All partnerships struggle with the indeterminacy of subchapter K's allocation rules and the compliance challenges they produce. Complexity is therefore a universal problem that elite and forgotten partnerships address by resorting to improvisational tax compliance. The fact that all partnerships are improvising when it comes to partnership allocations highlights the tax community's widespread acceptance of these rules' dysfunctionality. In remarkably diverse contexts, improvisation has replaced technical compliance as the norm in partnership allocations, thus indicating that these foundational rules do not work well for any partnership—whether rich or poor, elite or forgotten.

Recognizing and reframing the complexity of partnership allocations as a shared experience of all partnerships sheds new light on subchapter K's deep technical and cultural fractures. Improvisational tax compliance looks markedly different depending on a partnership's wealth and status. Subchapter K's allocation rules are mostly unintelligible for forgotten partnerships, and participation in substantive tax law is therefore impossible.¹⁷ Forgotten partnerships are relegated to what many scholars describe as an "intuitive subchapter K," where partnerships that cannot access substantive tax law do the best they can

12. Lawrence Lokken, *As the World of Partnership Tax Turns*, 56 SMU L. REV. 365, 366 (2003).

13. See *infra* Part I.

14. I.R.C. § 704; see *infra* Section I.B.

15. I.R.C. § 704(b).

16. See, e.g., Treas. Reg. § 1.704-1(b); see also *infra* Subsection I.B.3.

17. See *infra* Section II.A.

with available resources and hope to avoid scrutiny from the IRS.¹⁸ Partnerships operating under an intuitive subchapter K rely on instinct and luck rather than law to fulfill their annual tax filing obligations. Forgotten partnerships improvise because they have no other choice.

By contrast, elite partnerships make a strategic choice to improvise. They also struggle with subchapter K's complicated allocation rules, but the result is not exclusion from substantive tax law. Elite partnerships instead use their formidable resources and expert advisors to work around key aspects of current law, using an alternative allocation methodology—often called “target allocations”—to structure their partners' tax sharing arrangements.¹⁹ Anecdotal evidence suggests that many partnership tax experts advise elite partnership clients to use target allocations despite their legal status as an improvisational allocation method that the Treasury has not publicly sanctioned.²⁰

Target allocations are best characterized as a form of improvisational tax compliance undertaken on the advice of high-priced counsel. Indeed, elite partnerships choose to improvise because their paid experts have created, recommended, and implemented a legally uncertain allocation methodology that they consider superior to current law. This kind of improvisational tax compliance serves as a point of access and opportunity for elite partnerships, amplifying their powerful participation in tax law rather than serving as a barrier.

To use improvisational tax compliance as an analytical starting point necessarily shifts one's perspective on subchapter K's fractures. From there, two distinct problems emerge. The first problem is technicality—the rules governing partnership allocations are deeply flawed and impossibly complicated. Measured by access and compliance, subchapter K's allocation rules do not work as designed for any category of partnership. The time has come to reform partnership allocations by

18. This notion of an intuitive subchapter K is often used in tax scholarship to describe the experience of many partnerships, particularly those that are not wealthy or well-advised, in navigating their annual tax filing obligations without adequate access to substantive partnership tax law. See, e.g., ALI 1999 REPORTERS' STUDY, *supra* note 11, at 105–10; Lokken, *supra* note 12, at 367; Lokken, *supra* note 11, at 252; Andrea Monroe, *What We Talk About When We Talk About Complexity*, 5 MICH. BUS. & ENTREPRENEURIAL L. REV. 193, 198 (2016); Yin, *supra* note 11, at 201.

19. See, e.g., N.Y. STATE BAR ASS'N TAX SECTION, REPORT ON PARTNERSHIP TARGET ALLOCATIONS (2010), <http://nysba.org/app/uploads/2020/03/1219-Report.pdf> [<https://perma.cc/72SB-AXAM>]; William G. Cavanagh, *Targeted Allocations Hit the Spot*, 129 TAX NOTES 89 (2010); Todd D. Golub, *Target Allocations: The Swiss Army Knife of Drafting (Good for Most Situations—but Don't Bet Your Life on It)*, 87 TAXES 159 (2009); Daniel S. Goldberg, *The Target Method for Partnership Special Allocations and Why It Should Be Safe Harbored*, 69 TAX LAW. 663 (2016); Rosow & Hughes, *supra* note 11; Zhiyuan Zuo, *A Gain Must Lie Where It Falls: Matching Tax with Economics in Subchapter K*, 11 COLUM. J. TAX L. 103 (2019); Terence Floyd Cuff, *Working with Target Allocations—Idiot-Proof or Drafting for Idiots?*, 35 REAL EST. TAX'N 116 (2008).

20. Despite their ubiquity, the Treasury has yet to issue any formal guidance regarding target allocations. See *infra* note 125 and accompanying text.

providing streamlined and functional rules that make technical compliance with substantive tax law a viable possibility for all partnerships.

The second, less explored problem is subchapter K's professional culture. Complexity and improvisation have become normalized features of partnership tax. So too has the notion of an intuitive subchapter K, despite the wealth- and status-based divisions it represents. The partnership tax experts at subchapter K's intellectual center have tolerated—sometimes even facilitated—these pernicious aspects of partnership tax.²¹ They have become numb to subchapter K's dysfunctionality, taking for granted the technical sophistication of its rules without appreciating the distributional consequences of sustained legal complexity and improvisation.

Consider, for instance, various responses to complexity and indeterminacy across the partnership spectrum. Elite partnerships and their expert advisors regularly seek guidance from government officials, arguing that the market cannot function properly without clear tax rules.²² Official guidance is not always forthcoming, and that has been the case with target allocations.²³ Nonetheless, expert requests for guidance are often acknowledged through informal communications between private experts and government officials.²⁴

The opposite is true for forgotten partnerships—their experience with the rules governing partnership allocations is rarely a topic of interest. The taxpaying realities of forgotten partnerships, including the notion of an intuitive subchapter K, are largely abstractions for partnership tax experts, who are often far removed from these challenges by their academic training and professional experience. Thus, the problems of forgotten partnerships never seem as urgent to these experts as the commercial needs of their elite partnership clients.

Forgotten partnerships are, however, formally subject to the same tax laws and annual filing obligations as elite partnerships. Likewise, they are subject to government enforcement actions if the IRS disagrees with a particular computation, choice of methodology, or tax return position. When considered in this light, subchapter K's professional cul-

21. This author counts herself among the guilty. For an autobiographical classroom confessional, see Andrea Monroe, *Subchapter K, Gateway Drugs, and Tax Reform*, 148 TAX NOTES 1229 (2015).

22. See, e.g., N.Y. STATE BAR ASS'N TAX SECTION, *supra* note 19. See generally DAVID F. BRADFORD, *UNTANGLING THE INCOME TAX* 266–67 (1986).

23. See *supra* note 20.

24. For instance, substantive tax law questions are often the topic of discussion at the meetings of professional organizations, like the American Bar Association and the New York State Bar Association, or at conferences like the University of Chicago Federal Tax Conference. See, e.g., Amy S. Elliot, *Experts Debate Partnership Tax Simplification*, 149 TAX NOTES 874 (2015) (discussing partnership panel at the University of Chicago Federal Tax Conference); Amy S. Elliot, *Basic Guidance on Target Allocations Is Inevitable*, 139 TAX NOTES 1362 (2013) (discussing a partnership panel at the Texas Federal Tax Institute).

ture and its role in producing fractures within partnership tax are especially troublesome. A small number of elite partnerships operate in a system that is narrow, complex, and curated by partnership tax experts who serve high-status commercial and compliance needs. In contrast, forgotten partnerships operate in a seemingly lawless world governed by substantive tax law that they can neither apply nor understand.

Fixing the rules governing partnership allocations requires more than technical solutions. A necessary first step is addressing the professional culture of partnership tax and rethinking what it means for subchapter K to work. A functional tax law system should not acquiesce in an intuitive subchapter K that effectively relegates millions of partnerships and their taxpaying partners to a lawless tax regime. Denying forgotten partnerships access to substantive tax law erodes the vital notion that subchapter K is a fair, principled, and representative system of taxation. Likewise, ignoring forgotten partnerships raises corrosive questions about taxpayer dignity, inequality, and the legitimacy of federal income tax law. In today's world of economic and social upheaval, soaring deficits, and grave income inequality, these are not abstract risks. On the contrary, the cost of ignoring forgotten partnerships is too high.

This Article proceeds in three parts. Part I explains the complicated mechanics of partnership allocations. Part II turns to improvisational tax compliance. It offers a novel perspective on partnership allocations, focusing on common compliance challenges faced by all partnerships—forgotten and elite—in navigating subchapter K's complicated and indeterminate allocation rules. Improvisational tax compliance, in turn, reveals the dual problems of technicality and professional culture that plague subchapter K. Part III addresses the path toward a more functional and equitable system of partnership allocations. Reforming partnership allocations requires technical changes to substantive tax law, and this Article thus proposes two interrelated changes: a regulatory safe harbor for target allocations and a streamlined allocation regime for partnerships qualifying as "small partnerships." Yet meaningful reform also requires a full recognition of the cultural problems that have marginalized forgotten partnerships and normalized the notion of an intuitive subchapter K. Solutions for elite partnerships, standing alone, are no longer adequate responses to shared partnership problems. This Part suggests that partnership reforms developed by experts and directed at elite partnerships should be accompanied by reforms addressing parallel complexity problems faced by forgotten partnerships. The solutions may differ, but this Article's dual focus on the universal problems of all partnerships represents one step forward, signaling a commitment to all partnerships regardless of wealth, status, or representation in subchapter K.

I. THE COMPLICATED WORLD OF PARTNERSHIP ALLOCATIONS

The rules governing partnership allocations are the heart of partnership tax, bringing to life its distinctive model of business taxation. Partnership allocations are ubiquitous in subchapter K. They impact every partnership, every transaction, and every partner required to file a federal income tax return. And the hallmark of the rules governing partnership allocations is complexity—these rules are virtually impossible to navigate for all but the most sophisticated partnership tax expert. All partnerships struggle with the complexity of subchapter K's allocation rules, as evidenced by the widespread shift from technical to improvisational tax compliance among partnerships at all levels of wealth and status.²⁵ This Part tells the complicated story of partnership allocations, exploring how a simple idea spawned some of the most technical and divisive rules in federal income tax law.

A. *The Simple Idea*

Partnerships have long been a popular form of business entity due largely to subchapter K's status as a pass-through system of taxation.²⁶ Unlike a corporation whose income is taxed twice—once at the corporate level and a second time when distributed to its shareholders—a partnership's income is only subject to one level of tax.²⁷ A partnership is thus not a taxpayer for federal income tax purposes. Instead, partnership income “passes through” to its partners, who pay tax on their respective shares of the partnership's income each year.²⁸ In many respects, the partnership is simply disregarded, and its partners are treated as if they earned their respective share of the partnership's annual income directly.²⁹

25. See *infra* Part II.

26. While the theoretical appeal of a pass-through system of taxation is relatively straightforward when compared to a corporate model of taxation, passage of the Tax Reform Act of 1986, particularly the repeal of the General Utilities doctrine, had a profound impact on the choice-of-entity question, driving increasing numbers of business entities to organize as partnerships instead of corporations. Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, 2272 (codified at I.R.C. § 311(b)); see, e.g., Matthew Smith, Danny Yagan, Owen M. Zidar & Eric Zwick, *The Rise of Pass-Throughs and the Decline of the Labor Share* (Nat'l Bureau of Econ. Rsch, Working Paper No. 29400, 2021), <http://www.nber.org/papers/w29400>.

27. I.R.C. § 701; see also *id.* §§ 11(a), 301.

28. I.R.C. § 701. The same is true for taxable losses. *Id.* For ease, all subsequent references to partnership income apply equally to partnership losses.

29. See *id.* §§ 701, 704. This is consistent with the aggregate theory of partnerships, where the partnership is treated as an aggregate of its owners, rather than a separate and distinct entity. Under this aggregate theory, partners are essentially treated as direct co-owners of each item of partnership property. In other respects, a partnership is thought of as an entity separate from its owners. To this end, many of subchapter K's computational and administrative provisions are

Partnership allocations are the technical mechanism that operationalizes subchapter K's pass-through function. In very basic terms, a partner's annual tax obligations are determined based on partnership allocations—they determine how a partnership divides its taxable income among its partners, and what amount is then “allocated” to each partner.³⁰ That is, the rules governing partnership allocations regulate how partners share a partnership's taxable income each year. Additionally, they provide a unifying framework for the “regular” transactions that any system of business taxation must oversee, like contributions, distributions, mergers, and liquidations.³¹ From both a theoretical and practical perspective, partnership allocations are the heart of partnership tax, and subchapter K works only as well as these allocation rules work.

Since subchapter K's codification in 1954, Congress has prioritized two values—flexibility and equity—in the rules governing partnership allocations.³² Partnerships need freedom to structure their allocations in whatever manner their partners consider commercially optimal.³³ To Congress, this flexibility is necessary to accommodate broadly diverse enterprises, ranging from mom-and-pop operations to sophisticated multinational firms, that are treated as partnerships for federal income tax purposes.³⁴ Likewise, it is essential to accommodate the wide variety of arrangements—whether oral, written, formal, or informal—that represent partners' agreements with respect to their annual tax obligations. For one set of allocation rules to govern all partnerships, they must be sufficiently elastic to meet the needs of a broad and dynamic commercial community.

Consistent with the congressional goal of maximizing flexibility, a partnership may take two basic approaches to its allocations under subchapter K. A partnership may allocate its aggregate, bottom-line income using a single sharing ratio.³⁵ Alternatively, a partnership may

grounded in an entity theory of partnerships. For instance, a partnership computes its taxable income each year, selects its own method of accounting, and determines the character of any gains it recognizes during the taxable year. *See id.* §§ 702(b), 703.

30. *Id.* § 704.

31. Treas. Reg. § 1.704-1(b)(2)(iv).

32. Internal Revenue Act of 1954, Pub. L. No. 83-591, § 704, 68A Stat. 3, 240–41; Lokken, *supra* note 11, at 250.

33. *See, e.g.*, Berger, *supra* note 11, at 108; Darryll K. Jones, *Towards Equity and Efficiency in Partnership Allocations*, 25 VA. TAX REV. 1047, 1078 (2006); Jerome Kurtz, *The Limited Liability Company and the Future of Business Taxation: A Comment on Professor Berger's Plan*, 47 TAX L. REV. 815, 821–22 (1992); Lokken, *supra* note 11, at 250.

34. *See, e.g.*, S. REP. NO. 83-1622, at 89 (1954).

35. Treas. Reg. § 1.704-1(b)(1)(vii). For instance, two partners may contractually agree to share all partnership income and loss equally. This sharing arrangement is an example of a single sharing ratio—fifty percent of the partnership's annual income or loss is allocated to each individual partner.

separately allocate particular items of partnership income, gain, loss, or deduction through “special” allocations, using different sharing ratios that need not be proportional to the partners’ economic interests in the partnership.³⁶

If left unchecked, special allocations allow partners to achieve results through a partnership that may not be possible in the partners’ individual capacities.³⁷ A foundational notion of federal tax law is that a transaction’s tax consequences should correspond with its economic consequences.³⁸ Accordingly, income is ordinarily taxed to the person who earns the income or owns the property generating such income.³⁹ In other words, the taxpayer receiving the economic benefit of the income bears the associated tax burden. Special allocations operate in perpetual tension with this principle, allowing partners to shift income from one partner to another at will.⁴⁰

As a consequence, subchapter K’s allocation rules place limits on the flexibility afforded to partnerships in allocating taxable items among their partners. In particular, they attempt to prevent partnerships from using allocations strategically—especially special allocations—to obtain an improper tax advantage in violation of equitable norms.⁴¹ The rules governing partnership allocations draw a line between permissible allocations and impermissible tax sheltering—and therein lies their foundational challenge. These rules try to achieve two seemingly irreconcilable goals: maximizing partnership choice while identifying a single correct, equitable answer for tax purposes.

The rules governing partnership allocations are deceptively straightforward. Section 704(a) confirms Congress’s commitment to partnership flexibility, providing that a partner’s share of partnership “income, gain, loss, deduction, or credit” is determined based on the partnership agreement.⁴² The equitable counterweight, in turn, appears in section 704(b), which states that a partnership allocation will be re-

36. *Id.*

37. *See, e.g.*, ALI 1999 REPORTERS’ STUDY, *supra* note 11, at 79; Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1, 1 (1990); Yin, *supra* note 11, at 155–56.

38. *See, e.g.*, Mark P. Gergen, *Subchapter K and Passive Financial Intermediation*, 51 SMU L. REV. 37, 65 (1997).

39. *Lucas v. Earl*, 281 U.S. 111, 114–15 (1930); *Helvering v. Horst*, 311 U.S. 112, 118 (1940).

40. *Lokken*, *supra* note 11, at 264; *see Schneer v. Comm’r*, 97 T.C. 643, 658 (1991) (“The pooling of income is essential to the meaningful existence of subchapter K. If partners were not able to share profits in an amount disproportionate to the ratio in which they earned the underlying income, the partnership provisions of the Code would, to some extent, be rendered unnecessary.”).

41. For instance, a partnership could manipulate its allocations to produce an improper tax benefit by shifting income from a partner subject to a high tax rate to a partner subject to a lower rate. Or, it could shift deductions or losses from a partner subject to a low rate of tax to a partner subject to a higher rate of tax. In doing so, the partners’ overall tax liability would decline, and the federal government would suffer a revenue loss.

42. I.R.C. § 704(a).

spected as drafted only if it has substantial economic effect.⁴³ Absent substantial economic effect, the underlying taxable item will be reallocated in accordance with the partner's interest in the partnership.⁴⁴ With this statutory skeleton, Congress left the task of operationalizing subchapter K's allocation rules to the Treasury. It took the Treasury nearly a decade to write the section 704(b) regulations, and the result is a transformative set of rules unmatched in their complexity, indeterminacy, and dysfunctionality.⁴⁵

B. *The Complicated Rules*

Section 704(b) is the operational driver of partnership allocations. Under the section 704(b) regime, the default rule for all partnership allocations is the partner's interest in the partnership.⁴⁶ Substantial economic effect, by contrast, functions as a safe harbor provision.⁴⁷ If a partnership wants its allocations to be respected, as set forth in its partnership agreement, such allocations must have substantial economic effect. In designing the section 704(b) regulations, the Treasury's goal was to funnel the vast majority of partnership allocations through the substantial economic effect safe harbor.⁴⁸

As discussed below, the partner's interest in the partnership default rule and the substantial economic effect safe harbor are polar opposites. The partner's interest in the partnership takes an expansive, multi-factored approach to partnership allocations.⁴⁹ By contrast, the substantial economic effect safe harbor offers partnerships a hypertechnical, accounting-based series of interconnected rules de-

43. See *infra* Subsection I.B.2. As originally enacted, section 704(b) provided that a partnership's allocation of a particular item would not be respected as drafted if the allocation's principal purpose was the avoidance or evasion of any tax. I.R.C. § 704(b) (1954). In this case, a partnership was required to reallocate the offending item among the partners in the same manner as they generally shared the partnership's taxable income or loss. *Id.* Congress amended section 704(b) in 1976 due largely to concerns that it was too permissive, providing partnerships with great flexibility but failing to prevent abusive allocations at great expense to the federal government. Tax Reform Act of 1976, Pub. L. No. 94-455, § 213, 90 Stat. 1520, 1548; see also STAFF OF THE JOINT COMM. ON TAX'N, 94TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 95 (Comm. Print 1976); S. REP. NO. 94-938, at 100 (1976); H.R. REP. NO. 94-658, at 125 (1976).

44. I.R.C. § 704(b).

45. T.D. 8065, 1986-1 C.B. 254 (as amended by T.D. 8099, 1986-2 C.B. 84). See generally Mark P. Gergen, *The End of the Revolution in Partnership Tax?*, 56 SMU L. REV. 343, 343 (2003).

46. I.R.C. § 704(b).

47. *Id.*

48. See Treas. Reg. § 1.704-1(b)(2); see also WILLIAM MCKEE, GARY HUFFMAN, JAMES WHITMIRE, ROBERT WHITMIRE & WILLIAM NELSON, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 11.02[3] (4th ed. 2007); Paul Carman, *In Search of Partner's Interest in the Partnership: The Alternative of Substantial Economic Effect*, 107 J. TAX'N 214, 223 (2007); Cavanagh, *supra* note 19; Lawrence Lokken, *Partnership Allocations*, 41 TAX L. REV. 547, 613-15 (1986).

49. Treas. Reg. § 1.704-1(b)(3)(i).

signed to avoid the uncertainty of the partner's interest in the partnership.⁵⁰ Yet both approaches to partnership allocations are grounded in the shared goal of ensuring that a partnership allocates taxable items among its partners in the same manner as they share the corresponding economic benefits or burdens.⁵¹

1. Partner's Interest in the Partnership

The partner's interest in the partnership, section 704(b)'s default allocation rule, signifies "the manner in which the partners have agreed to share the economic benefits and burdens (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated."⁵² Apart from this general statement, the regulations provide few details about the partner's interest in the partnership and how it applies to a partnership that allocates taxable items using this default rule. Instead, the regulations provide that a partnership must consider all facts and circumstances related to its partners' economic sharing arrangement, including the partners' relative contributions to the partnership, the partners' interests in the economic profits, losses, and cash flow, and the partners' rights to liquidating distributions.⁵³ Likewise, the regulations note that the partner's interest in the partnership need not be a single ratio; rather, it can vary depending on the taxable item at issue.⁵⁴

In the simplest partnerships, this regulatory guidance may be sufficient to determine the partner's interest in the partnership. For instance, if two individuals form a partnership, agreeing to make equal contributions and to share equally all profits, losses, cash flow, and liquidation proceeds, then the partner's interest in the partnership is straightforward—it is an equal 50/50 split. Any change to this simple arrangement, however, reveals the difficulty in determining the partners' economic sharing arrangement.⁵⁵ What if one partner contributes

50. *Id.* § 1.704-1(b)(2).

51. Gregory J. Marich, *Substantial Economic Effect and the Value Equals Basis Conundrum*, 42 TAX L. REV. 509, 510 (1987) (describing the partner's interest in the partnership default rule and the substantial economic effect safe harbor as two sides of the same coin).

52. Treas. Reg. § 1.704-1(b)(3)(i).

53. *Id.* § 1.704-1(b)(3)(i)–(ii). The partner's interest in the partnership default rule originally contained a simplifying presumption that partners agreed to share all taxable items equally, as determined on a per capita basis. *Id.* § 1.704-1(b)(3)(i) (1985). A partnership or the IRS could rebut this presumption with evidence of an alternate formulation of the partner's interest in the partnership. *Id.* The Treasury removed this presumption in 2008, believing that it rarely achieved the right result. T.D. 9398, 2008-1 C.B. 1143.

54. Treas. Reg. § 1.704-1(b)(3)(i).

55. See, e.g., Lokken, *supra* note 48, at 613–14; George K. Yin, *The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the "Check-the-Box" Regulations*, 51 SMU L. REV. 125, 154

money to the partnership, and the other provides services? What if the partners' economic sharing arrangement changes over time? As both cases illustrate, minor changes in the partners' economic arrangement can make it far more difficult to identify the partner's interest in the partnership.⁵⁶

2. Substantial Economic Effect

Substantial economic effect provides a safe harbor to partnerships wishing to avoid the uncertainty of the partner's interest in the partnership.⁵⁷ Although the basic notion is straightforward—partners should share a partnership's taxable items in the same manner as they share its economic benefits and burdens—everything about the safe harbor is complicated, including its architecture. Substantial economic effect has two primary requirements: an allocation must have economic effect, and the economic effect of such allocation must be substantial.⁵⁸ In turn, economic effect and substantiality each have three sub-requirements, and each of these sub-requirements involves its own elaborate multi-factored analysis for partnerships to navigate.⁵⁹ If a partnership complies with these various requirements, discussed below, its allocations, as set forth in the partnership agreement, will be respected.⁶⁰

Capital Accounts. Determining whether an allocation has substantial economic effect necessarily involves comparing a partnership's tax allo-

(1997). *But see* Darryll K. Jones, *Partners Interest in the P'Ship: An Existentialist's View*, 129 TAX NOTES 603 (2010) (asserting that the partner's interest in the partnership is both knowable and capable of application); Walter D. Schwidetzky, *In Defense of the PIP Regulations*, 72 TAX LAW. 519 (2019) (chronicling the cases in which courts were required to interpret the partner's interest in the partnership and concluding that the regulations do provide sufficient guidance, at least to judges, with respect to the partner's interest in the partnership).

56. *See* sources cited *supra* note 55. In one instance, the regulations do provide partnerships with additional guidance. Treas. Reg. § 1.704-1(b)(3)(iii). If a particular allocation lacks substantial economic effect, even though the partnership complies with the capital account maintenance rules and agrees to make all liquidating distributions based on the partners' positive capital account balances, the partner's interest in the partnership is determined using a method often referred to as the "comparative liquidation" approach. *Id.* Under this approach, a partnership considers the consequences if it were to sell all of its assets for their book value—that is, fair market value at the time of contribution, purchase, or revaluation—and liquidate at the end of the current taxable year. *Id.* The partnership then compares those consequences to a similar constructive liquidation occurring at the end of the prior taxable year, focusing on the amount that each partner would receive in liquidation of her partnership interest at the end of each year. *Id.* The change in the distributed amounts then determines how the relevant taxable item is reallocated under the partner's interest in the partnership. *Id.*

57. I.R.C. § 704(b); Treas. Reg. § 1.704-1(b)(1)(i).

58. Treas. Reg. § 1.704-1(b)(2)(i).

59. *Id.*

60. I.R.C. § 704(b); Treas. Reg. § 1.704-1(b)(1)(i).

cation to its allocation of the corresponding economic benefit or burden. That is, substantial economic effect requires an economic benchmark for evaluating a partnership's allocation of a particular taxable item. Capital accounts serve as that mechanism, quantifying and tracking the economic sharing arrangement among partners.⁶¹

A partner's capital account provides a snapshot of her economic investment in a partnership, measuring her realized economic gain at a specific moment in time. A partner's capital account reflects any contributions made to the partnership, and it is adjusted over time to reflect her share of the partnership's economic benefits and burdens—increasing to reflect gains and decreasing to reflect losses, as well as distributions received.⁶²

Capital accounts are an admittedly artificial proxy for the partners' economic sharing arrangement, converting long-term economic expectations into concrete, annual accounting adjustments and, in turn, equating such adjustments with economic realization.⁶³ Yet they are the most viable measure of how the partners would share their partnership's realized economic benefits and burdens if such items were instead earned by them directly. Maintaining proper capital accounts is thus a vital element of substantial economic effect. In order to comply with the safe harbor, a partnership must allocate its taxable items in the same manner in which its partners share the corresponding economic benefits and burdens, as reflected in their capital accounts.⁶⁴ This equilibrium between tax and economic allocations is a foundational tenet of the substantial economic effect safe harbor, and capital accounts are the system's central operating feature.

Economic Effect. The economic effect requirement implements this equilibrium between a partnership's tax and economic allocations by providing that an allocation has economic effect if it is consistent with the partners' underlying economic arrangement.⁶⁵ More precisely, if a partnership allocates a particular taxable item to a partner, economic effect requires that the partner also receives the economic benefit or burden corresponding to such taxable item.⁶⁶ To the extent that a part-

61. See, e.g., ALI 1999 REPORTERS' STUDY, *supra* note 11, at 81; Lokken, *supra* note 48, at 552.

62. Treas. Reg. § 1.704-1(b)(2)(iv).

63. See, e.g., ALI 1999 REPORTERS' STUDY, *supra* note 11, at 92–93; Lokken, *supra* note 11, at 265.

64. See ALI 1999 REPORTERS' STUDY, *supra* note 11, at 81. As Professors Yin and Shakow noted, “the basic idea is simple: if tax allocations follow comparable adjustments to the partners' capital accounts, which are economic accounts, and if those adjustments affect account balances which ultimately have real economic significance to the partners, then the tax allocation will be consistent with the economic share.” *Id.* Put another way, if tax allocations must parallel the partners' economic arrangements, then economic considerations, not tax considerations, will ultimately drive the partners' decision-making process. See *id.* at 81–82.

65. Treas. Reg. § 1.704-1(b)(2)(ii)(a).

66. *Id.*

nership's tax and economic allocations mirror one another, the desired equilibrium exists.

As a technical matter, economic effect requires a partnership to comply with three rules. First, a partnership must maintain its partners' capital accounts in compliance with an elaborate, accounting-based series of rules that govern virtually every aspect of a partnership's life, including formation, annual operations, the entrance of a new partner, and liquidation.⁶⁷ The second and third requirements of this "basic" test for economic effect focus on liquidations, mandating that a partnership make all liquidating distributions to its partners in accordance with their positive capital account balances.⁶⁸ Additionally, any partner with a deficit balance in her capital account at the time of liquidation must unconditionally agree to restore such deficit amount to the partnership.⁶⁹ When taken together, these two liquidation rules serve as a bulwark, ensuring that capital accounts are meaningful reflections of each partner's economic investment in the partnership. To that end, they force a partnership to rely on the capital accounts when it matters most—when a partner's interest in the partnership is liquidated.⁷⁰

67. *Id.* § 1.704-1(b)(2)(ii)(b)(1), (b)(2)(iv). The capital account maintenance rules are set forth in Treasury Regulation § 1.704-1(b)(2)(iv).

68. *Id.* § 1.704-1(b)(2)(ii)(b)(2).

69. *Id.* § 1.704-1(b)(2)(ii)(b)(3). Unlimited obligations to restore deficit capital account balances are problematic for many partners, particularly those with limited liability. The Treasury thus provided an "alternate" test for economic effect in order to offer a larger population of partners a commercially viable means of complying with the substantial economic effect safe harbor. *Id.* § 1.704-1(b)(2)(ii)(d). The first two rules of the alternate test for economic effect are identical to the basic test—a partnership must comply with the capital account maintenance rules, and it must make liquidating distributions in accordance with the partners' positive capital account balances. *Id.* § 1.704-1(b)(2)(ii)(d)(1). The third rule is different, requiring the partnership to include a "qualified income offset" provision in its partnership agreement. *Id.* § 1.704-1(b)(2)(ii)(d)(3). A qualified income offset provision requires a partnership to make disproportionate allocations of income or gain to a partner whose capital account falls into deficit following certain enumerated events in order to eliminate the deficit balance as quickly as possible. *Id.* § 1.704-1(b)(2)(ii)(d)(6) (flush language). It therefore operates as the alternate test's last line of defense with respect to partners who are not unconditionally obligated to restore deficit capital account balances. If these three requirements are met, then a particular partnership allocation will be respected under the alternate test for economic effect to the extent that it does not create or increase a deficit balance in any partner's capital account. *Id.* § 1.704-1(b)(2)(ii)(d).

70. In addition to the basic and alternate tests for economic effect, there is a final relief-based test for economic effect. Under this "economic effect equivalence" test, an allocation is deemed to have economic effect if a liquidation at the close of the partnership's taxable year, as well as at the close of any future taxable year, would bring about the same economic consequences to the partners as if the partnership had met the requirements of the basic test for economic effect, regardless of the economic performance of the partnership. *Id.* § 1.704-1(b)(2)(ii)(i). This rule has often been referred to as the "dumb-but-lucky rule." The IRS even noted that the rule "can protect allocations based on unsophisticated but unabusive partnership agreements from falling outside the parameters of the economic effect safe harbor." INTERNAL REVENUE SERV., MARKET SEGMENT SPECIALIZATION PROGRAM AUDIT TECHNIQUE GUIDE ON PARTNERSHIPS 6-8, reprinted in, *MSSP Audit Technique Guide for Partnership Returns Is Available*, 2003 TAX NOTES TODAY 241-26 (Dec. 1, 2002) [hereinafter IRS PARTNERSHIP AUDIT TECHNIQUE GUIDE]. Although there is scant authority address-

Substantiality. Although the economic effect requirement casts a wide net with its capital account-based approach to allocations, it requires a backstop to prevent abusive allocations. The problem is that economic effect does not account for partnership-level attributes like character and source that—when combined with differences in the partners' tax rates—create opportunities for partnerships to use allocations strategically.⁷¹ The safe harbor's substantiality requirement is designed to police partnerships desiring an improper tax advantage through allocations that capitalize on the interaction of partner- and partnership-level tax attributes.⁷²

An allocation having economic effect will fall within the safe harbor only if its economic effect is also substantial.⁷³ To satisfy the substantiality requirement, there must be “a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.”⁷⁴ The regulations provide three specific tests, all designed to identify situations where the economic effect of an allocation is not substantial.⁷⁵ Each test is quite elaborate. The following discussion focuses on only one of the tests: the after-tax substantiality test.

ing the operation of the economic effect equivalence test, it would seem to require an alternative mechanism—whether a contractual provision of the partnership agreement or operative state law—to ensure that, consistent with the basic test for economic effect, partners are obligated to restore negative capital account balances in the event that their partnership interests are liquidated. Treas. Reg. § 1.704-1(b)(2)(ii)(i), (b)(5), ex. 4(ii).

71. For instance, consider a partnership with equal amounts of ordinary income and long-term capital gain. From a capital account perspective, these two items have identical effects, increasing the partners' capital accounts by the same amount. *Id.* § 1.704-1(b)(2)(iv)(b)(3). Yet from a tax perspective, these items are quite different. If the partners are subject to different tax rates, they may agree to specially allocate the long-term capital gain—which is eligible for a lower, preferential rate—to the partner subject to a higher tax rate and the ordinary income to the partner with a lower tax rate. These special allocations would have economic effect because each partner would receive a tax allocation matching the increase in their capital account. But the special allocations, when combined with the partners' different tax rates, would produce a tax advantage for the partners, inappropriately reducing their aggregate tax liability at the federal government's expense. See, e.g., ALI 1999 REPORTERS' STUDY, *supra* note 11, at 84; Alan Gunn, *The Character of a Partner's Distributive Share Under the “Substantial Economic Effect” Regulations*, 40 TAX LAW. 121, 124–25 (1986); Lokken, *supra* note 11, at 259.

72. See, e.g., ALI 1999 REPORTERS' STUDY, *supra* note 11, at 84; Gergen, *supra* note 37, at 12; Gunn, *supra* note 71, at 125–26; Thomas W. Henning, *Partnership Exit Strategies and the Failure of the Substantiality Test*, 63 TAX LAW. 43, 96 (2009); Andrea Monroe, *Too Big to Fail: The Problem of Partnership Allocations*, 30 VA. TAX REV. 465, 489 (2011).

73. Treas. Reg. § 1.704-1(b)(2)(iii)(a).

74. *Id.*

75. *Id.* § 1.704-1(b)(2)(iii)(a)–(c). If an allocation fails any one of the three substantiality tests, it will not satisfy the safe harbor. The two additional substantiality tests—the shifting and transitory tests—are virtually indistinguishable apart from their time frames: the shifting test applies to offsetting allocations made by a partnership during a single taxable year, and the transitory test applies when the offsetting allocations occur over a series of taxable years. *Id.* § 1.704-1(b)(2)(iii)(b)–(c). Under the shifting test, the economic effect of an allocation or series of allocations is not substantial if there is a strong likelihood at the time the allocations become part of the partnership

The after-tax substantiality test is often referred to as the “no loser” rule, focusing on allocations that improve the after-tax position of one partner without adversely impacting the after-tax position of any other partner.⁷⁶ In other words, the after-tax substantiality test seeks to eliminate tax allocations that are “too good to be true” from the partners’ perspective while producing a revenue loss for the federal government. To this end, the after-tax substantiality test provides that the economic effect of an allocation or series of allocations is not substantial if (1) the after-tax economic consequences to any partner improve as compared to the after-tax consequences had the partnership agreement not included the allocations in question; and (2) there is a strong likelihood that no partner’s after-tax consequences will be substantially diminished as a result of the allocations.⁷⁷

3. Partnership Allocations Today

It would be impossible to overstate the importance of the rules governing partnership allocations, particularly their underlying capital ac-

agreement that (1) the net changes to the partners’ capital accounts will not differ substantially from the net changes to the partners’ capital accounts that would have occurred in the absence of these allocations; and (2) the allocations reduce the partners’ aggregate tax liability. *Id.* § 1.704-1(b)(2)(iii)(b). In making this determination, a partnership is required to consider tax consequences resulting from the interaction of the allocations in question and the partners’ tax attributes that are unrelated to the partnership. *Id.* The transitory test for substantiality operates in the same manner as the shifting test, just with a longer-term focus, targeting offsetting allocations spanning multiple taxable years. *Id.* § 1.704-1(b)(2)(iii)(c). Nonetheless, the Treasury included a limiting presumption in the transitory test—an allocation will not run afoul of the transitory test if a strong likelihood exists that an offsetting allocation will not occur, in large part, within five years of the initial allocation. *Id.*

76. *Id.* § 1.704-1(b)(2)(iii)(a); see IRS PARTNERSHIP AUDIT TECHNIQUE GUIDE, *supra* note 70, at 6–8; Henning, *supra* note 72, at 68.

77. Treas. Reg. § 1.704-1(b)(2)(iii)(a). The after-tax consequences to each partner are determined on a present value basis. *Id.* Likewise, the partnership must consider the tax consequences resulting from the interaction of the allocation in question and the partner’s tax attributes unrelated to the partnership. *Id.* In hopes of making the substantiality requirement more manageable, the regulations require a partnership to assume that the fair market value of all partnership property equals its adjusted basis. *Id.* § 1.704-1(b)(2)(iii)(c). As a consequence of this “value equals basis” assumption, a partnership is never expected to recognize gain on the disposition of property for purposes of the substantiality requirement, even if the partnership’s own predictions suggest otherwise. Any allocation of this gain or loss is essentially disregarded for substantiality purposes. In other words, the value equals basis assumption means that an allocation will not be deemed insubstantial simply because it will be offset by an allocation of gain recognized on the disposition of partnership property. *Id.* The value equals basis assumption applies to all three substantiality tests, and it also applies when making certain determinations under the alternative test for economic effect and the partner’s interest in the partnership default rule. *Id.* § 1.704-1(b)(2)(ii)(d)(6), (b)(3)(iii). For thoughtful discussions of the assumption and its many problems, see generally Marich, *supra* note 51; MCKEE ET AL., *supra* note 48, ¶ 11.02[2].

count analysis, in subchapter K.⁷⁸ Capital accounts revolutionized subchapter K, paving the way for myriad allocation rules that isolate tax and economic consequences and allow a partnership to link those consequences to particular partners and even particular properties.⁷⁹ This matching approach, first embodied in the substantial economic effect safe harbor, now permeates subchapter K.⁸⁰ Section 704(b) touches virtually every aspect of partnership tax, building a formidable web that spreads deep into the periphery of subchapter K's transactional rules.

The hallmark of this elaborate system is complexity.⁸¹ Like any open-textured analysis, the partner's interest in the partnership default rule is incredibly uncertain, and the Treasury has provided little guidance on its application.⁸² As a result, a perfectly ordinary series of allocations in commercial arrangements can produce significant confusion for a partnership attempting to decipher its partners' "true" economic sharing arrangement.⁸³ The partner's interest in the partnership is thus a mystery to many experts, who often describe the default rule as unknowable in all but the most rudimentary partnerships.⁸⁴

78. See generally Gergen, *supra* note 45, at 343 (describing the rise of capital account analysis in subchapter K as nothing less than a "quiet intellectual revolution").

79. See Gergen, *supra* note 45; Lokken, *supra* note 12, at 371.

80. Although a detailed examination of the myriad partnership rules drawing on section 704(b) is beyond this Article's scope, several examples of the reach of its capital account-based approach may be useful. Numerous transactional rules incorporate key aspects of substantial economic effect in determining the tax consequences of particular partnership events like distributions, sales of partnership interests, and recourse borrowing. See, e.g., I.R.C. §§ 704(c)(1)(B), 737, 743(b), 751(a)–(b); Treas. Reg. § 1.752-2. In each of these transactions, a partnership must rely on a constructive sale or liquidation in order to determine the tax consequences of the actual transaction. In doing so, a partnership is required to work through a series of hypothetical allocations subject to the real rules of section 704(b). In addition, subchapter K contains a number of gap-fillers necessitated by the limits of substantial economic effect. There are certain types of allocations that, by their nature, cannot have economic effect, thereby falling outside the statutory safe harbor. Rather than subject these allocations—many of which are quite common, commercially significant items—to the vagaries of the partner's interest in the partnership default rule, the Treasury provided alternative allocation rules for these taxable items, which include allocations attributable to tax credits, certain foreign tax expenditures, nonrecourse deductions, and contributed property. See, e.g., I.R.C. § 704(c); Treas. Reg. §§ 1.704-1(b)(4)(ii), (iii), (v)–(x), 1.704-2, 1.704-3. Thus, the substantial economic effect safe harbor itself has spawned a complicated universe of secondary allocation rules, all designed to regulate the allocation of partnership items falling beyond the reach of substantial economic effect.

81. Section 704(b)'s legendary complexity is well chronicled in decades of rich scholarship. See, e.g., ALI 1999 REPORTERS' STUDY, *supra* note 11; Bradley T. Borden, *The Allure and Illusion of Partners' Interests in a Partnership*, 79 U. CIN. L. REV. 1077 (2011); Emily Cauble & Gregg D. Polsky, *The Problem of Abusive Related-Partner Allocations*, 16 FLA. TAX REV. 479 (2014); Simon Friedman, *Partnership Capital Accounts and Their Discontents*, 2 N.Y.U. J.L. & BUS. 791 (2006); Gergen, *supra* note 37; David Hasen, *Partnership Special Allocations Revisited*, 13 FLA. TAX REV. 349 (2012); Henning, *supra* note 72; Lokken, *supra* note 48; Gregg D. Polsky, *Deterring Tax-Driven Partnership Allocations*, 64 TAX LAW. 97 (2010).

82. See *supra* notes 52–56 and accompanying text.

83. See, e.g., Lokken, *supra* note 48, at 613–14; Yin, *supra* note 55, at 154.

84. See, e.g., Bradley T. Borden, *Allocations Made in Accordance with Partners' Interests in the Partnership*, 11 BUS. ENT. 4, 11 (2009); Carman, *supra* note 48, at 217; Stephen Utz, *Allocation and Reallocation*

A very different but no less complicated approach, the substantial economic effect safe harbor is a confusing combination of hyper-technical rules and vague arithmetic. The economic effect requirement, particularly its capital account maintenance rules, is a model of byzantine drafting, with targeted rules designed to regulate the capital account consequences of virtually every aspect of a partnership's life.⁸⁵ Technical compliance with these rules is therefore a challenge, even for the most experienced partnership tax experts.⁸⁶

More generally, capital accounts are an imperfect proxy for the partners' economic sharing arrangement, thus raising foundational concerns about whether they form a sufficiently reliable snapshot of a partner's economic interest in a partnership at a particular moment in time.⁸⁷ The concept of economic effect relies on a partnership's ability to determine how its partners share realized economic benefits and burdens and adjust their capital accounts accordingly. Yet the partners may not have contemplated how they will ultimately share these amounts, especially if the partnership has no plans to distribute funds to them.⁸⁸ To the extent that partners have considered their economic sharing arrangement, they have likely considered it over a multi-year investment horizon, rather than in annual terms as assumed by the economic effect requirement.⁸⁹ Thus, an inevitable gap lies between the theory and reality of capital accounts as a measure of a partner's economic investment in a partnership. This type of gap, in turn, raises

tion in Accordance with the Partners' Interests in the Partnership, 56 TAX LAW 357 (2003). *But see* Jones, *supra* note 55; Darryll K. Jones, *Waterfalls and Targets: Understanding PIP*, 2008 TAX NOTES TODAY 10–28 (Jan. 25, 2008).

85. See Treas. Reg. § 1.704-1(b)(2)(iv). Indeed, the capital account maintenance rules go so far as to include a specific rule addressing mistakes, providing that discrepancies in a partner's capital account will not invalidate an allocation so long as it is minor and attributable to good faith. *Id.* § 1.704-1(b)(2)(iv)(p).

86. See, e.g., ALI 1999 REPORTERS' STUDY, *supra* note 11, at 104–05; Cavanagh, *supra* note 19, at 91; Lokken, *supra* note 48, at 621; Rosow & Hughes, *supra* note 11, at 363; Michael J. Close & Dan A. Kusnetz, *The Final Section 704(b) Regulations: Special Allocations Reach New Heights of Complexity*, 40 TAX LAW 307, 336 (1987).

87. See, e.g., ALI 1999 REPORTERS' STUDY, *supra* note 11, at 92–93; Lokken, *supra* note 11, at 265.

88. See, e.g., ALI 1999 REPORTERS' STUDY, *supra* note 11, at 84–86; Gergen, *supra* note 37, at 11–14; Lokken, *supra* note 11, at 265; Yin, *supra* note 11, at 157–58.

89. Similarly, the economic effect requirement implicitly assumes that a partner realizes the economic benefits and burdens of the partnership's operations in the same year that such amounts are recorded in her capital account. However, that is not often the case. Absent a corresponding distribution from the partnership, a partner will not realize these economic consequences in the same year that her capital account is adjusted. See, e.g., ALI 1999 REPORTERS' STUDY, *supra* note 11, at 82–84; Cavanagh, *supra* note 19, at 94; Gergen, *supra* note 37, at 13; Lokken, *supra* note 11, at 255–59; Rosow & Hughes, *supra* note 11, at 365–66; Yin, *supra* note 11, at 154. Indeed, the partner may not realize these economic benefits and burdens until her partnership interest is liquidated, which may be years into the future. See, e.g., ALI 1999 REPORTERS' STUDY, *supra* note 11, at 82; Friedman, *supra* note 81, at 796; Lokken, *supra* note 11, at 265.

concerns that capital accounts may reflect a distorted view of the partners' economic sharing arrangement.

The substantiality requirement is equally problematic. Although the Treasury designed the substantiality requirement as a series of objective, mathematical tests, it failed to define key terminology—like “strong likelihood” or “substantially diminished”—necessary to apply the tests.⁹⁰ Likewise, the design of the substantiality tests relies on the partner's interest in the partnership default rule, thereby introducing additional dysfunctionality into this requirement. The substantiality tests each require a partnership to compare an actual allocation to the hypothetical allocation that it would have made absent the allocation being tested.⁹¹ The Treasury's choice of the partner's interest in the partnership as the comparative baseline for the substantiality tests is curious at best.⁹² Substantiality is part of a safe harbor provision specifically designed to provide partnerships with relief from the uncertainty of the partner's interest in the partnership default rule. Incorporating the partner's interest in the partnership into the safe harbor itself thus seems terribly counterproductive. And it has had precisely the effect one might imagine: exacerbating substantiality's existing pathologies, both from a complexity and an indeterminacy perspective.

When considered independently, each component of the section 704(b) regulations—the partner's interest in the partnership, economic effect, and substantiality—suffers from different flaws, all of which have produced complexity and operational challenges across the partnership spectrum. However, the real problem is their combined dysfunction, which far exceeds the sum of the individual parts. As a consequence, the collective regulatory picture is one of chronic complexity

90. Treas. Reg. § 1.704-1(b)(2)(iii)(a); see, e.g., Edward J. Buchholz, *Substantiality Under Section 704(b)—Some Forgotten Issues and Some Ancient Concepts Revisited*, 19 VA. TAX REV. 165, 201-08 (1999); Terence Floyd Cuff, *Proposed Regulations Try—Unsuccessfully—to Fix a Broken Set of Substantiality Rules*, 104 J. TAX'N 280, 293 (2006); Polsky, *supra* note 81, at 102-08. The same is true of the term “differ substantially,” which appears in both the shifting and transitory substantiality tests. Treas. Reg. § 1.704-1(b)(2)(iii)(b)-(c). More generally, this indeterminate terminology suggests a larger design defect in the substantiality requirements—substantiality is an anti-abuse rule masked in a series of superficially objective mathematical rules. This effort to provide partnerships with greater certainty than anti-abuse rules typically offer ultimately proved counterproductive. Rather than eliminating the uncertainty characteristic of anti-abuse rules, the Treasury simply distributed it among the three “objective” substantiality tests. See, e.g., ALI 1999 REPORTERS' STUDY, *supra* note 11, at 86-89; Cuff, *supra*, at 282; Henning, *supra* note 72, at 44; Gergen, *supra* note 37, at 14.

91. See *supra* notes 75-77 and accompanying text.

92. Treas. Reg. § 1.704-1(b)(2)(iii)(a). The Treasury added the partner's interest in the partnership baseline to the substantiality requirement in 2008 in order to provide partnerships with guidance on this important determination. T.D. 9398, 2008-1 C.B. 1143. Since then, however, the Treasury has been characteristically spartan in its guidance on the baseline, noting only that the partner's interest in the partnership for substantiality purposes need not be the same as the partner's interest in the partnership for purposes of the default rule. Treas. Reg. § 1.704-1(b)(2)(iii)(a); see also Cuff, *supra* note 90, at 282.

and uncertainty. The partner's interest in the partnership is impossibly vague, specifically designed to create a strong incentive for partnerships to structure their tax allocations in compliance with the substantial economic effect safe harbor.⁹³ Yet substantial economic effect is similarly indeterminate, in part because it incorporates the pathologies of the partner's interest in the partnership, and in part because of its own well-documented pathologies. The result is a failed system of partnership allocations.

II. THE SHARED FAILURE OF PARTNERSHIP ALLOCATIONS

Complexity is the defining characteristic of modern partnership allocations, and this Part explores the deep technical and cultural fractures produced by these dysfunctional rules. This Part begins with the often-overlooked premise that the complexity of the rules governing partnership allocations is a shared problem faced by all partnerships. Complexity has produced compliance challenges for all partnerships at all income and sophistication levels, which means that subchapter K's allocation rules do not work as designed for any constituency within the partnership tax community. As a result, these rules—particularly the substantial economic effect safe harbor—are honored largely in the breach as improvisational tax compliance has emerged as an acceptable response to the common problem of partnership allocations, shared across a diverse swath of the partnership spectrum.

Even so, the improvisational responses of forgotten and elite partnerships to the complexity of partnership allocations are dramatically different. For forgotten partnerships attempting to meet their annual filing obligations, improvisation is the only available option. These partnerships cannot apply or understand subchapter K's complicated allocation rules, and technical compliance is a luxury that forgotten partnerships do not possess. By contrast, elite partnerships *choose* to improvise, typically opting for a legally uncertain allocation method—target allocations—on the recommendation of their expert advisors. Complexity therefore presents these partnerships with opportunities to participate in substantive tax law not available to forgotten partnerships.

The differences in improvisational tax compliance between forgotten and elite partnerships shed new and important light on the deep cultural fractures and inequities in subchapter K. Complexity and improvisation have both become “normal” features of substantive partner-

93. See MCKEE ET AL., *supra* note 48, ¶ 11.02[3]; Carman, *supra* note 48, at 223; Cavanagh, *supra* note 19; Lokken, *supra* note 48, at 613–15.

ship tax law. So too has the concept of an intuitive subchapter K, which signals forgotten partnerships' inability to meaningfully participate in partnership tax law. Taken together, this represents a failure of professional culture. The experts at the intellectual center of partnership tax have created, legitimized, and often profited from subchapter K's culture of complexity. Yet their role in the incredible dysfunctionality of subchapter K—particularly its allocation rules—is often overlooked. For many experts, forgotten partnerships are simply abstractions, and the urgent problems facing forgotten partnerships and their taxpaying partners are too removed from these experts' training and experience to factor into the equation.

A. *Forgotten Partnerships and Intuitive Subchapter K*

Forgotten partnerships experience complexity as an insurmountable barrier to legal access. To these partnerships, the rules governing partnership allocations are impossibly technical and elaborate, preventing meaningful participation in the federal income tax system. Put another way, the distance between forgotten partnerships and substantive partnership tax law effectively serves as a barrier for the vast majority of partnerships subject to subchapter K.

In many instances, the IRS itself takes affirmative steps to bridge this complexity gap, “translating” substantive tax law into comprehensible language that non-experts can understand.⁹⁴ IRS publications in particular are designed to explain substantive tax law in non-technical, accurate terms, thus allowing taxpayers to navigate their annual filing obligations.⁹⁵ To the extent that IRS publications mediate the complexity and indeterminacy of the rules governing partnership allocations, they make substantive tax law more accessible to forgotten partnerships.

94. Andrea Monroe, *Hidden in Plain Sight: IRS Publications and a New Path to Tax Reform*, 21 FLA. TAX REV. 81, 91–93 (2017). In forthcoming work, Professors Joshua Blank and Leigh Osofsky describe IRS informal guidance, including IRS Publications, as part of a two-tiered legal drafting system, where a small number of wealthy or sophisticated taxpayers can access substantive tax law through a “private system of law,” and the rest of the taxpaying public is limited to a “public system of law” based on informal tax guidance. Blank & Osofsky, *supra* note 3, at 15.

95. See INTERNAL REVENUE SERV., PUB. NO. 5206, PLAIN WRITING ACT COMPLIANCE REPORT, at 2–3, 5 (2017), <https://www.irs.gov/pub/irs-pdf/p5206.pdf> [<https://perma.cc/ZT4P-MRMG>]; INTERNAL REVENUE SERV., INTERNAL REVENUE MANUAL 4.10.7.2(8) (2018), https://www.irs.gov/irm/part4/irm_04-010-007.html [<https://perma.cc/AU34-BNBE>] (“IRS Publications explain the law in plain language for taxpayers and their advisors. They typically highlight changes in the law, provide examples illustrating Service positions, and include worksheets.”); see also U.S. GEN. ACCT. OFF., GAO /GGD-95-34, TAX ADMINISTRATION: IRS EFFORTS TO IMPROVE FORMS AND PUBLICATIONS 1–2 (1994), <http://www.gao.gov/products/GGD-95-34> [<https://perma.cc/DQA5-3TL5>].

Unfortunately, IRS publications are completely silent on the rules governing partnership allocations.⁹⁶ Partnership allocations are the central operating feature of subchapter K, yet there is literally no mention of section 704(b), the partner's interest in the partnership default rule, or the substantial economic effect safe harbor anywhere in the relevant publication.⁹⁷ Partners reading the publication therefore have no idea that subchapter K contains any rules governing their contractual tax sharing arrangement, let alone the complicated universe of allocation rules set forth in the section 704(b) regulations.

Rather than provide much-needed access to partnership tax law, IRS publications may in fact lead forgotten partnerships to conclude that there are no rules regulating how taxable items are allocated among their partners. As a result, IRS publications may prove counterproductive, exacerbating the already formidable problem of partnership allocations for forgotten partnerships.

Even so, forgotten partnerships are required to comply with their annual filing obligations, and they risk audit if the IRS disagrees with a particular return position, computation, or methodological approach.⁹⁸ And herein lies the problem for forgotten partnerships: if they cannot understand subchapter K's elaborate allocation rules, how can they satisfy these legal obligations? The answer is that many, if not most, forgotten partnerships cannot comply with subchapter K.⁹⁹ These partnerships instead follow an intuitive version of subchapter K, doing the best they can with available information and hoping that their tax filing positions are "close enough" to avoid the IRS's attention.¹⁰⁰ In most instances, this means that tax compliance is largely improvisational, and

96. INTERNAL REVENUE SERV., PUB. NO. 541, PARTNERSHIPS (2019), <https://www.irs.gov/pub/irs-pdf/p541.pdf> [<https://perma.cc/SE2B-KBSH>].

97. Likewise, the Instructions to Form 1065, *U.S. Return of Partnership Income*, fail to provide partnerships with useful information about the rules governing partnership allocations. *Instructions for Form 1065*, INTERNAL REVENUE SERV. (2021), <https://www.irs.gov/pub/irs-pdf/i1065.pdf> [<https://perma.cc/XP9F-TLEH>]. The instructions contain a small section entitled "How Income Is Shared Among Partners" that directs a partnership to allocate taxable items among its partners according to the terms of the partnership agreement. *Id.* As part of this section, the instructions note that a partnership may specially allocate taxable items using an allocation ratio that differs from the ratio it generally uses to allocate taxable income. *Id.* However, what is most notable about this short explanation is its silence regarding how a partnership determines whether its allocations will be respected as drafted. Indeed, this section's purpose is administrative, informing partnerships of the proper place to record particular allocations on its tax forms, which differs depending on whether the item is a special or bottom-line allocation. This section does end by noting that a partnership must allocate taxable items in accordance with the partner's interest in the partnership default rule if any of its allocations lack substantial economic effect. *Id.* Without further explanation, the instructions then refer partnerships to the section 704(b) regulations for additional information. *Id.*

98. I.R.C. § 6031(a).

99. See ALI 1999 REPORTERS' STUDY, *supra* note 11, at 110; Lokken, *supra* note 12, at 367; Lokken, *supra* note 11, at 252; Yin, *supra* note 11, at 201. See generally Blank & Osofsky, *supra* note 3, at 35.

100. See *supra* note 18 and accompanying text.

forgotten partners are forced to take filing positions based on chance, emotion, or instinct.

Considered in this light, the complexity of subchapter K's allocation rules—particularly the substantial economic effect safe harbor—is distinctively problematic for forgotten partnerships. Unlike many complex tax law provisions, subchapter K is neither a narrow nor a specialized area of substantive tax law.¹⁰¹ On the contrary, millions of partnerships are subject to subchapter K, and these partnerships must allocate taxable items among their partners each year in a manner that complies with section 704(b).¹⁰² Forgotten partnerships are effectively required to do so in reliance on an intuitive subchapter K, not substantive law. No matter the results—whether lucky, unlucky, close enough, or far away—an intuitive subchapter K is lawless, as legal complexity denies forgotten partnerships access to the actual rules governing partnership allocations.¹⁰³

B. *Elite Partnerships and Target Allocations*

When turning focus to elite partnerships, one might expect a very different story. Elite partnerships, through their expert advisors, have incomparable access to substantive partnership tax law.¹⁰⁴ Their commercial needs and tax planning strategies drive the legislative and regulatory trajectory of partnership tax. Indeed, modern subchapter K often resembles a curated list of elaborate rules designed specifically for a narrow band of elite partnerships and their well-connected advisors. One might easily presume that these elite partnerships and experts do not struggle with the complexity and indeterminacy of subchapter K's allocation rules.

Surprisingly, they do. Like forgotten partnerships, elite partnerships face formidable challenges in navigating the rules governing partnership allocations, especially the substantial economic effect safe harbor and its capital account-based approach to allocations. Complexity and indeterminacy again lead to improvisational tax compliance.

101. See Lokken, *supra* note 12, at 366.

102. See *supra* note 6 and accompanying text.

103. See Lokken, *supra* note 11, at 252. As Professor Lokken noted, “Americans have traditionally prided themselves as being a society of laws. Laws that cannot feasibly be understood and obeyed are the equivalent of no law at all.” *Id.* His words remain equally apt twenty years later.

104. See Monroe, *supra* note 18, at 201. See generally Shu-Yi Oei & Leigh Z. Osofsky, *Constituencies and Control in Statutory Drafting: Interviews with Government Tax Counsel*, 104 IOWA L. REV. 1291, 1316–18 (2019) (concluding that government lawyers consider tax experts, rather than ordinary taxpayers, the target audience for tax legislation).

Yet improvisation by elite partnerships takes a very different form from the intuitive subchapter K of forgotten partnerships. For elite partnerships, improvisational tax compliance involves an exodus from the substantial economic effect safe harbor. Many elite partnerships use an alternative, legally uncertain “target allocation” method to allocate taxable items among their partners.

From the perspective of elite partnerships and their expert advisors, the complexity and indeterminacy of the substantial economic effect safe harbor risk economic distortions. That is, the safe harbor and its capital account-based approach to allocations are too flawed, from both a technical and a design perspective, to reliably produce results consistent with the economic expectations of the partners.¹⁰⁵ The complexity of substantial economic effect makes the experts’ “ordinary” legal task of translating the partners’ economic sharing arrangement into effective tax allocation provisions especially challenging.¹⁰⁶ As a result, many partnership tax experts worry about their own ability to draft allocation provisions that comply with the safe harbor while also conforming to the partners’ economic expectations.¹⁰⁷

Even for experts comfortable with their ability to successfully navigate the substantial economic effect safe harbor, the artificiality of capital accounts as a measure of the partners’ economic arrangement introduces additional distortions into partnership allocations.¹⁰⁸ Because capital accounts are, at best, an imperfect proxy, there is no guarantee that a partner’s capital account will match her economic expectations regarding the amount she is entitled to receive from the partnership over time.¹⁰⁹

The Treasury designed subchapter K’s allocation rules, including the substantial economic effect safe harbor, to ensure that a partnership’s allocation of taxable items tracks the corresponding allocation of economic benefits and burdens, as reflected in the partners’ capital accounts.¹¹⁰ But the Treasury built this allocation system on the fiction that capital accounts are an accurate measure of the partners’ economic sharing arrangement and, more precisely, each partner’s economic in-

105. See, e.g., Goldberg, *supra* note 19, at 667; Golub, *supra* note 19, at 158; N.Y. STATE BAR ASS’N TAX SECTION, *supra* note 19, at 4.

106. See Cavanagh, *supra* note 19, at 90–91; Goldberg, *supra* note 19, at 700; N.Y. STATE BAR ASS’N TAX SECTION, *supra* note 19, at 4; Brian J. O’Connor & Steven Schneider, *Capital Account-Based Liquidations: Gone with the Wind or Here to Stay*, 102 J. TAX’N 21, 22 (2005).

107. See Goldberg, *supra* note 19, at 702–14; Golub, *supra* note 19, at 158; N.Y. STATE BAR ASS’N TAX SECTION, *supra* note 19, at 4; O’Connor & Schneider, *supra* note 106, at 22.

108. See *supra* notes 87–89 and accompanying text.

109. See, e.g., N.Y. STATE BAR ASS’N TAX SECTION, *supra* note 19, at 4; O’Connor & Schneider, *supra* note 106, at 24.

110. See *supra* notes 57–58 and accompanying text.

vestment in the partnership.¹¹¹ As previously noted, capital accounts are the driver of the substantial economic effect safe harbor—a partnership must record the consequences of all its economic activity in the partners' capital accounts and, in turn, it must make all liquidating distributions to partners based on their positive capital account balances.¹¹² And this is the case whether the theoretical fiction of capital accounts holds true or practical distortions arise because the capital accounts fail to perfectly reflect the partners' economic sharing arrangement. To the extent that a partnership fails to comply with these requirements throughout its life, its allocations will lose the benefit of the substantial economic effect safe harbor and be reallocated in accordance with the partner's interest in the partnership default rule.¹¹³

Elite partnerships are therefore presented with a stark choice between risks when making their tax allocations. An elite partnership may opt for the tax certainty of the substantial economic effect safe harbor, but only by assuming the commercial risk that the amounts ultimately received by its partners on liquidation of their interests will not conform to their economic expectations. For most elite partnerships and their expert advisors, however, maximizing economic certainty requires ensuring that, when partners receive liquidating distributions from their partnerships, such distributions match their understanding of the partners' overall economic sharing arrangement.¹¹⁴

Elite partnerships and their expert advisors have largely concluded that the substantial economic effect safe harbor is too complicated and indeterminate to reliably ensure this result. On the contrary, the safe harbor exposes elite partnerships to the risk of economic distortions that may prevent them from operating in a manner consistent with their partners' commercial expectations. Accordingly, elite partnerships and their expert advisors have rejected the substantial economic effect safe harbor, and instead have turned to target allocations.¹¹⁵

Target allocations flip the safe harbor's architecture upside down, building from the partners' economic sharing arrangement, as reflected

111. See *supra* note 87 and accompanying text.

112. See *supra* notes 67–68 and accompanying text.

113. See *supra* notes 46–48 and accompanying text.

114. A partner realizes the economic benefits and burdens of her investment in a partnership when she receives a liquidating distribution from the partnership. It is thus a moment where any gaps between the technical operation of the partnership agreement, including its allocation provisions, and the partner's economic expectations would be exposed. See Goldberg, *supra* note 19, at 691; Golub, *supra* note 19, at 158; N.Y. STATE BAR ASS'N TAX SECTION, *supra* note 19, at 7.

115. The practitioner shift to target allocations has occurred gradually over the past twenty years. Early articles on the subject appeared in journals beginning around the turn of the century. See Sheldon I. Banoff & Richard M. Lipton, *Shop Talk: More on 'Booking up' for Partnership Profits*, 84 J. TAX'N 191 (1996); Thomas C. Lenz, *Using the Targeted Capital Account Approach to Allocate Income and Loss—Is It Better than the Traditional Layered Approach?*, 5 J. PASSTHROUGH ENTITIES 25 (2002); O'Connor & Schneider, *supra* note 106.

in their partnership agreement. In particular, target allocations are grounded in the contractual provisions specifying how a partnership will distribute funds to its partners. For elite partnerships using target allocations, these distribution provisions—not the partners' capital accounts—control the distribution a partner will receive upon liquidation of her partnership interest, in violation of the substantial economic effect safe harbor.¹¹⁶ Yet the goal in delinking liquidating distributions from the partners' capital accounts is the same as the goal animating all of section 704—ensuring that a partnership's tax allocations match how its partners share the corresponding economic benefits and burdens.

Operationally, target allocations are driven by a partnership's contractual distribution provisions, which provide the most detailed and proximate information regarding the partners' economic entitlements. The partnership compares the consequences of two hypothetical partnership liquidations—one at the end of the current taxable year and the other at the end of the previous year. To this end, the partnership determines the amounts received by a partner in each hypothetical liquidation if: (1) the partnership sold all its assets at book value, (2) repaid its outstanding liabilities, and (3) liquidated in accordance with the terms of its partnership agreement.¹¹⁷ The aggregate amount that a partner would receive in a constructive distribution at the end of the current taxable year is the “target”—the desired ending balance in her capital account.¹¹⁸

Once the partnership identifies the target balance, it can effectively “back into” how much taxable income or loss must be allocated to a partner in order to achieve the target balance.¹¹⁹ More technically, a partnership using target allocations computes each partner's annual tax allocation by comparing the amount she would receive in a hypothetical liquidating distribution at the end of the current year to the amount she would have received if the partnership liquidated at the end of the prior

116. See *supra* note 68 and accompanying text.

117. See, e.g., Cavanagh, *supra* note 19, at 102; Goldberg, *supra* note 19, at 687; Golub, *supra* note 19, at 157–58; N.Y. STATE BAR ASS'N TAX SECTION, *supra* note 19, at 7; Rosow & Hughes, *supra* note 11, at 167.

118. A partnership using target allocations typically maintains capital accounts, but their role is more functional. For instance, target allocations often incorporate some of the traditional capital account-based rules—like the use of book value to compute the partners' hypothetical year-end distributions—in order to achieve distribution results comparable to what the substantial economic effect safe harbor would produce. See, e.g., Goldberg, *supra* note 19, at 690–91; N.Y. STATE BAR ASS'N TAX SECTION, *supra* note 19, at 8.

119. Target allocations draw much inspiration from the comparative liquidation approach to the partner's interest in the partnership. See *supra* note 56; see also Golub, *supra* note 19, at 160; N.Y. STATE BAR ASS'N TAX SECTION, *supra* note 19, at 26. Target allocations, however, are not eligible for this special rule because it is available only to partnerships that make liquidating distributions based on the partners' positive capital account balances. Treas. Reg. § 1.704-1(b)(3)(iii).

year. The partnership then allocates to the partner an amount of taxable income or loss equal to such difference.

Although target allocations are hugely popular with elite partnerships and their expert advisors, their status is legally uncertain.¹²⁰ As previously discussed, target allocations do not satisfy the substantial economic effect safe harbor.¹²¹ Accordingly, target allocations will be respected as drafted only if they conform to the notoriously indeterminate partner's interest in the partnership default rule. By relying on the partner's interest in the partnership, elite partnerships therefore increase their exposure to real tax risk.¹²²

In fairness, there is good reason to believe that target allocations, if drafted properly, conform to the partner's interest in the partnership default rule. Target allocations are specifically designed to generate tax allocations that match the manner in which partners share the economic benefits and burdens of their enterprise, just as the default rule requires.¹²³ In theory, target allocations share a common goal with the partner's interest in the partnership default rule, as well as with the substantial economic effect safe harbor. Indeed, this goal is entirely consistent with the equitable norms animating all federal income tax law, which seek to align the tax consequences of a transaction with the

120. See, e.g., Cavanaugh, *supra* note 19, at 91; Cuff, *supra* note 19, at 117; Golub, *supra* note 19, at 158; N.Y. STATE BAR ASS'N TAX SECTION, *supra* note 19, at 3; see also Amy S. Elliot, *IRS to Lay Groundwork for Guidance on Targeted Allocations*, 143 TAX NOTES 891 (2014) (noting the view of one partnership tax expert that more than ninety-five percent of partnerships were using target allocations).

121. See *supra* notes 116–17 and accompanying text. There is, however, ongoing debate among partnership tax experts about whether target allocations satisfy the economic effect equivalence test and, thus, do in fact comply with the substantial economic effect safe harbor. Some experts believe that economic effect equivalence requires partners to possess unlimited obligations to restore deficit capital account balances, as is required under the basic test for economic effect. See, e.g., Terence Floyd Cuff, *Several Thoughts on Drafting Target Allocation Provisions*, 87 TAXES 171, 188 (2009). Others disagree and assert that, in some circumstances, economic effect equivalence should be available to partners who lack an unlimited deficit restoration obligation. See, e.g., Cavanaugh, *supra* note 19, at 95–96; Goldberg, *supra* note 19, at 692–94; Golub, *supra* note 19, at 159–60; N.Y. STATE BAR ASS'N TAX SECTION, *supra* note 19, at 27–37.

122. A partnership's tax exposure may extend well beyond its section 704(b) allocations. As previously discussed, section 704(b) and the notion of substantial economic effect impact myriad peripheral partnership rules. See *supra* note 80. In certain circumstances, the proper tax treatment of a particular partnership item depends on whether the partnership complies with the substantial economic effect safe harbor. See e.g., I.R.C. § 514(c)(9)(E)(i)(II); Treas. Reg. §§ 1.704-2(e), 1.752-3(a). For instance, subchapter K contains special rules that govern the allocation of deductions attributable to nonrecourse debt, and these rules require that, throughout a partnership's life, it make all liquidating distributions in accordance with the partners' positive capital account balances. Treas. Reg. § 1.704-2(e)(1). Likewise, the fractions rule requires that all of a partnership's allocations comply with the substantial economic effect safe harbor. I.R.C. § 514(c)(9)(E)(i)(II). In these instances, a partnership that would otherwise prefer the economic certainty of target allocations may instead draft its allocation in compliance with substantial economic effect in order to avoid the ripple effect caused by violating the safe harbor. See, e.g., Golub, *supra* note 19, at 168; N.Y. STATE BAR ASS'N TAX SECTION, *supra* note 19, at 34.

123. See Cavanaugh, *supra* note 19, at 105; Golub, *supra* note 19, at 160; N.Y. STATE BAR ASS'N TAX SECTION, *supra* note 19, at 26–27.

corresponding economic consequences. Likewise, target allocations are often drafted with the goal of reaching the same economic results for partners as allocations that satisfy the substantial economic effect safe harbor.¹²⁴ Target allocations just follow a different path, one that partnership tax experts consider simpler, more reliable, and more likely to achieve results consistent with elite partners' economic expectations.

Despite their ubiquity among elite partnerships, the Treasury has provided no guidance on the subject of target allocations.¹²⁵ Their status as an IRS-sanctioned allocation methodology thus remains legally uncertain, and their use by elite partners and their expert advisors is unquestionably improvisational. Unlike forgotten partnerships, however, elite partnerships choose to improvise, largely on the advice of their expert advisors. That is, elite partnerships improvise because of their access to substantive tax law, and improvisation therefore signals their powerful participation in the law.

C. Common Problems and a Divided Subchapter K

Improvisational tax compliance offers a distinctive window into the world of partnership tax. On the one hand, improvisation has become a standard response of all partnerships—forgotten and elite—to the complexity of the rules governing partnership allocations. On the other

124. See, e.g., Cavanagh, *supra* note 19, at 102–03; Goldberg, *supra* note 19, at 687–91; Golub, *supra* note 19, at 157; N.Y. STATE BAR ASS'N TAX SECTION, *supra* note 19 at 8–9. There are, however, situations where matching the results arising under the substantial economic effect safe harbor is more challenging. Although a detailed discussion of these types of situations is beyond this Article's scope, partnership tax experts have developed alternative methods of addressing these situations. See generally Cavanagh, *supra* note 19, at 103–06; Goldberg, *supra* note 19, at 161–70; N.Y. STATE BAR ASS'N TAX SECTION, *supra* note 19, at 11–16; O'Connor & Schneider, *supra* note 106, at 22–31. For instance, preferred returns raise potential problems for partnerships using target allocations, particularly if a partnership does not have sufficient income in a given year to cover such preferred return. To address this issue, some partnerships treat the preferred return as a guaranteed payment, while others use a guaranteed payment to fill the gap in the partner's capital account between their target balance and the balance resulting from a capital account-based distribution. See, e.g., N.Y. STATE BAR ASS'N TAX SECTION, *supra* note 19, at 11. Similarly, partnerships concerned about achieving results consistent with the partners' economic expectations may compute their annual target allocation differently, allocating items of gross, rather than net, income or providing for anticipatory allocations. *Id.*, at 12–14. See generally Cavanagh, *supra* note 19; Goldberg, *supra* note 19; Golub, *supra* note 19; N.Y. STATE BAR ASS'N TAX SECTION, *supra* note 19.

125. In 2017, the Treasury included "targeted capital accounts" on its 2016–2017 Priority Guidance Plan. INTERNAL REVENUE SERV., 2016–2017 PRIORITY GUIDANCE PLAN 18 (2016), https://www.irs.gov/pub/irs-utl/2016-2017_pgp_initial.pdf [<https://perma.cc/XNC6-MM9M>]. The Priority Guidance Plan identifies the tax issues that the Treasury and the IRS consider priorities in terms of developing published guidance for taxpayers. Following its inclusion on the 2016–2017 list, targeted capital accounts were removed from future Priority Guidance Plans, and no formal guidance has yet been issued. See, e.g., INTERNAL REVENUE SERV., 2017–2018 PRIORITY GUIDANCE PLAN 17–18 (2017), https://www.irs.gov/pub/irs-utl/2017-2018_pgp_initial.pdf [<https://perma.cc/3D3P-BXPJ>].

hand, improvisation takes radically different forms depending on the wealth, sophistication, and status of a partnerships—forgotten partnerships are relegated to an intuitive and lawless version of subchapter K, while elite partnerships opt out of the substantial economic effect safe harbor, turning instead to the legally uncertain target allocation methodology. These divergent responses to the shared problem of complexity expose deep technical and cultural fractures in partnership allocations and, more broadly, in subchapter K. Likewise, improvisational tax compliance sheds important light on the role that partnership tax experts play in these fractures, most importantly in normalizing subchapter K's distributional inequities.

Technical Failures. The failure of the rules governing partnership allocations is fairly described as an open secret within the partnership tax community—their complexity is legendary and their flaws are well-chronicled in decades of scholarship.¹²⁶ Yet the emergence of target allocations is nothing short of a revolutionary break with current law, marking a wholesale rejection of a central intellectual tenet of subchapter K—substantial economic effect and its capital account-based methodology—by the partnership tax experts who created, nurtured, and legitimized section 704(b)'s elaborate allocation system.

As an initial matter, target allocations effectively abandon the architecture of subchapter K's allocation rules. As previously discussed, the Treasury specifically designed the section 704(b) regulations with the goal of funneling partnership allocations into the substantial economic effect safe harbor.¹²⁷ The uncertainty and related risks of the partner's interest in the partnership default rule are integral components of this architecture, reinforcing existing incentives for partnerships to draft allocations that comply with the safe harbor. Target allocations, however, operate in direct conflict with section 704(b)'s architecture. Elite partnerships using target allocations choose to structure their allocations outside the substantial economic effect safe harbor, instead opting to run the risk of the partner's interest in the partnership default rule. Accordingly, target allocations reflect the widespread recognition among elite circles in the partnership tax community that the basic operational structure of the section 704(b) regulations is broken.

To repeat, substantial economic effect is no ordinary rule. It is the cornerstone of the most critical rules in partnership tax—the allocation rules that implement subchapter K's pass-through function. Likewise, target allocations are the creation of partnership tax experts who pride themselves on mastering some of the most complicated and byzantine

126. See *supra* note 81 and accompanying text.

127. See *supra* note 48 and accompanying text.

rules in substantive tax law. Yet these experts are signaling in the clearest possible manner that the substantial economic effect safe harbor and its capital account-based approach to allocations are too dysfunctional, even for them. Target allocations thus raise an uncomfortable question: if substantial economic effect does not work for elite partnerships and their expert advisors, who does substantial economic effect work for?

The answer is virtually no one.¹²⁸ Target allocations are the starkest signal of technical fractures in subchapter K's allocation rules, but they are not the only one. The notion of an intuitive subchapter K for forgotten partnerships that struggle with the formidable complexity of these rules is another signal of fracture that is regrettably overlooked. As one partnership tax expert noted years ago:

[M]any sophisticated tax practitioners now use tax allocations that do not drive liquidations. Many less sophisticated tax practitioners use traditional capital account allocation provisions but miss some of the nuances and fall short of the mark. And many even less sophisticated practitioners draft simple tax allocation provisions that do not even try to hit the mark. No matter how well conceived the section 704(b) economic effect regulations may have been, they are no longer carrying the day.¹²⁹

These words remain apt today. The section 704(b) regulations do not work in theory or practice, and the time has come to address their technical problems, most notably the substantial economic effect safe harbor.

Collateral Fractures. Target allocations also signal a different, more insidious rift within subchapter K, where wealth, status, and sophistication determine one's access to substantive partnership tax law. The complexity of subchapter K's allocation rules is a problem common to all partnerships, and improvisational tax compliance is a nearly universal response. However, improvisation looks very different for forgotten and elite partnerships, thereby highlighting stark inequities within subchapter K. Forgotten partnerships are relegated to a lawless and intuitive subchapter K, where participation in substantive tax law is im-

128. As previously discussed, there are partnerships that continue to rely on the substantial economic effect safe harbor. See *supra* note 122. For some partnerships, structuring within the substantial economic effect safe harbor may be necessary—whether or not optimal—to achieve other important tax results, which may depend on whether the partnership's allocations have substantial economic effect. Other partnerships may prefer the substantial economic effect safe harbor because they rely on special, tax-advantaged allocations. Accordingly, the substantial economic effect safe harbor may work for certain partnerships, but this can hardly be considered a ringing endorsement.

129. Cavanagh, *supra* note 19, at 91.

possible. By contrast, elite partnerships choose to improvise through target allocations. For these elite partnerships, improvisation is an opportunity, rather than an obstacle, signaling their participation and power in substantive tax law.

The reaction of partnership tax experts to this complexity and improvisation reflects the same cultural fault lines. When elite partnerships struggle with the complexity or indeterminacy of partnership allocations, calls for guidance typically follow. Partnership tax experts produce scholarship, and professional associations organize panel discussions to address the problem, share potential solutions, and encourage their government colleagues to take remedial action.¹³⁰ Even when guidance is not forthcoming, informal lines of communication provide additional access to these experts and the elite partnerships willing to pay for their services.¹³¹

By contrast, the struggles of forgotten partnerships in navigating subchapter K's allocation rules rarely generate more than passing interest among partnership tax experts.¹³² Likewise, these experts have acquiesced in an intuitive subchapter K as though it were an abstraction. Improvisational tax compliance by forgotten partnerships is regrettable, but it never seems as urgent as the problems of their elite partnership clients.

The role of partnership tax experts in facilitating, sustaining, and normalizing subchapter K's cultural and distributional fractures is often overlooked. Experts play a singular role in the intellectual life of partnership tax, and it is their training, experience, and commitment to legal craft values that shape substantive partnership tax law.¹³³ Like-

130. The story of elite partnerships and target allocations is a perfect example of this phenomenon. See, e.g., Am. Inst. of Certified Pub. Accts., *Draft Revenue Ruling on Partnership Target Allocations*, reprinted in, *AICPA Offers Draft Revenue Ruling on Partnership Target Allocations*, 2014 TAX NOTES TODAY 33-12 (Feb. 11, 2014); Cavanaugh, *supra* note 19; N.Y. STATE BAR ASS'N TAX SECTION, *supra* note 19; Rosow & Hughes, *supra* note 11; see also *supra* note 24.

131. See *supra* note 24 and accompanying text.

132. See Monroe, *supra* note 94, at 100-04; Oei & Osofsky, *supra* note 104, at 1295. Professors Oei and Osofsky conducted a novel empirical study of government lawyers involved in the tax legislative process and found that

a majority of those interviewed did not pay much attention to how a statute was formulated, and did not think it mattered, as long as the intended rule was accurately articulated. The reason for this was that many interviewees viewed the Code as written for experts . . . rather than for ordinary taxpayers.

Oei & Osofsky, *supra* note 104, at 1295; see also Blank & Osofsky, *supra* note 3, at 22-23.

133. This Article uses the term "legal craft values" to refer to the partnership tax experts' appreciation of and appetite for technicality in subchapter K. See, e.g., Boris I. Bittker, *Tax Reform and Tax Simplification*, 29 UNIV. MIAMI L. REV. 1, 10-11 (1974); James S. Eustice, *Tax Complexity and the Tax Practitioner*, 45 TAX L. REV. 7, 17 (1989); Richard M. Lipton, "We Have Met the Enemy and He Is Us": More Thoughts on Hyperlexis, 47 TAX LAW. 1, 3-9 (1993); Bayless Manning, *Hyperlexis and the Law of Conservation of Ambiguity: Thoughts on Section 385*, 36 TAX LAW. 9, 15 (1982); Bayless Manning, *Hyperlexis: Our National Disease*, 71 NW. U. L. REV. 767, 767 (1977); Martin J. McMahon, *Reflections on the*

wise, these experts share confidence that all of subchapter K's theoretical and technical problems, including its complexity, can be managed by skilled professionals. To these experts, complexity itself is complicated. It is unquestionably a systemic problem in partnership tax, and it is also a crucial component of their professional craft and culture.

This commitment to legal craft values has allowed many partnership tax experts to normalize complexity and dysfunctionality in partnership allocations, and in subchapter K more broadly. These experts often tolerate complexity as the necessary price for equitable, efficient, and flexible rules that promote the commercial interests of their elite partnership clients. And they do so notwithstanding complexity's marginalizing effect on the vast majority of partnerships, making technical compliance with substantive tax law virtually impossible for them.

Target allocations are a perfect example of how dysfunction has been normalized within subchapter K's professional culture. For instance, one might question this Article's characterization of target allocations as a sign of failure in modern partnerships. To some, target allocations may represent the opposite phenomenon—a triumph of innovation, craft, and progress in the chronically complicated world of partnership allocations. From that vantage, target allocations are an example of partnership tax experts doing what they do best: developing innovative solutions to seemingly intractable problems.

In fairness, there is surely some truth to that triumphant story. Target allocations do offer elite partnerships a simpler and more reliable means of allocating taxable items among their partners. Yet the story has a fatal flaw. It does not include forgotten partnerships and their millions of taxpaying partners. Likewise, it does not acknowledge the lawless and intuitive subchapter K to which these forgotten partnerships are relegated on account of the same complexity problems that gave rise to target allocations. Considered in this light, it is hard to tell any story of triumph when forgotten partnerships lack meaningful access to substantive partnership tax law and have no choice but to improvise when complying with their annual filing obligations. The fact that some do tell this story of triumph highlights just how saturated with dysfunction subchapter K's professional culture has become.

More generally, a skewed notion of success has emerged in subchapter K. Partnership tax is viewed as “working” when its rules work

Regulation Process: 'Do the Regulations Have to Be Complex' or 'Is Hyperlexis the Manna of the Tax Bar?', 51 TAX NOTES 1441 (1991); Monroe, *supra* note 18; Monroe, *supra* note 21, at 1230–31; Sidney I. Roberts, Wilbur H. Friedman, Martin D. Ginsburg & Carter T. Louthan, *A Report on Complexity and the Income Tax*, 27 TAX L. REV. 325, 367 (1972); Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 L. & CONTEMP. PROBS. 673, 698–99 (1969). See generally Peter H. Shuck, *Legal Complexity: Some Causes, Consequences, and Cures*, 42 DUKE L.J. 1, 1 (1992) (“[S]cholars have a strong taste for complexity; indeed, complexity amounts to a craft value . . .”).

for a small number of wealthy and well-advised partnerships, even if such rules do not work for anyone else. Fearsome complexity is not seen as a sign of failure in today's subchapter K. A deeply schismatic subchapter K where access hinges on wealth, sophistication, and status is also not seen as a sign of failure. And an intuitive subchapter K is not seen as a sign of failure in today's partnership tax law. On the contrary, the struggles of forgotten partnerships are rarely a topic of concern or conversation.

This Article offers a different conclusion—subchapter K is not working when it excludes the overwhelming majority of partnerships from substantive tax law. The fact that some of these forgotten partnerships are able to “get by” through dumb luck, intuition, or improvisation is irrelevant. If forgotten partnerships cannot access substantive partnership tax law, then subchapter K is effectively lawless to them. This perception of lawlessness, in turn, reinforces the notion of a dual tax system where wealth determines one's value in the eyes of the law. And that is especially corrosive in a voluntary compliance system, eroding the legitimacy of subchapter K, federal income tax law, and the basic values animating democratic society.

The federal income tax system serves as a primary contact point between individuals and the federal government, intersecting with our business activities, financial decisions, and personal lives each year.¹³⁴ Tax law is thus uniquely situated to shape perceptions about whether law and government are fair, legitimate, and inclusive.¹³⁵ And this is precisely the problem with an intuitive subchapter K—it denies forgotten partnerships the ability to participate in substantive tax law. To the extent that substantive tax law is a statement of societal values, consider the values that an intuitive subchapter K signals to forgotten partnerships about their worth, value, and role in our democracy. All too often, these notions are discussed in the abstract, but they are not abstract issues today. Questions about economic justice, racial equality, and democratic values are increasingly urgent matters of political debate. Considered in this light, the question of whether forgotten partnerships are entitled to something more than an intuitive subchapter K forces us to rethink the future trajectory of partnership tax and what it means for subchapter K to work.

134. See *Dobson v. Comm'r*, 320 U.S. 489, 494–95 (1943); see also, Joshua D. Blank & Leigh Z. Osofsky, *Simplexity: Plain Language and the Tax Law*, 66 EMORY L.J. 189, 201 (2017); Randolph E. Paul, *Simplification of Federal Tax Laws*, 29 CORNELL L.Q. 285, 293 (1944).

135. As one tax luminary noted decades ago: “Paying taxes gives citizens a very real sense of participation in Government. But . . . [t]hey cannot derive satisfaction from contact with their Government when they are befuddled by a maze of complexities.” Paul, *supra* note 134, at 287.

III. THE FUTURE OF PARTNERSHIP ALLOCATIONS

This Article offers a novel path forward for partnership allocations. Forgotten and elite partnerships face common problems in navigating subchapter K's allocation rules, and a starting point in developing functional solutions is that shared experience. The technical solutions are very different for forgotten and elite partnerships, but the focus on shared problems and collective solutions is an important step toward an inclusive professional culture in federal tax law.

A. *The Culture of Subchapter K*

Rethinking partnership allocations begins by acknowledging their deep cultural and distributional fractures. The first step has little to do with subchapter K's technical rules, and everything to do with the professional culture of partnership tax and the experts at its intellectual center. Partnership tax experts have accepted—and oftentimes profited from—an excruciating level of complexity and improvisation in subchapter K.¹³⁶ Although a challenge for all partnerships, the true costs of complexity and improvisation fall disproportionately on forgotten partnerships, who largely exist outside the experts' view.¹³⁷

The time has thus come for partnership tax experts to expand their understanding of what it means for partnership tax to work. Modern partnership allocations can work only when the rules provide realistic pathways to technical compliance for all partnerships. If subchapter K's allocation rules do not work for forgotten partnerships, then the rules do not work. A crucial step in mending subchapter K's cultural and distributional rifts is simply to acknowledge that forgotten partnerships and their millions of taxpaying partners are entitled to better than an intuitive subchapter K—they are entitled to comprehensible allocation rules that allow for meaningful participation in the law.

This Article reframes the problem of partnership allocations in order to expand the experts' lens. Forgotten and elite partnerships face a singular problem: the complexity of the rules governing partnership allocations. Likewise, their improvisational responses are best viewed as different aspects of this common complexity problem. When reconceptualized as a shared problem in need of a shared solution, the path forward looks different both in terms of the target audience and the answers. The audience now includes forgotten partnerships, which

136. See generally Jesse Drucker & Danny Hakim, *How Accounting Giants Craft Favorable Tax Rules from Inside Government*, N.Y. TIMES (Sept. 19, 2021), <https://www.nytimes.com/2021/09/19/business/accounting-firms-tax-loopholes-government.html> [<https://perma.cc/5QNQ-JTVV>].

137. See, e.g., NAT'L TAXPAYER ADVOC., *supra* note 2, at 312.

signals a transformative change in subchapter K. The answer also reflects a broader perspective as it starts with the goal of mediating improvisational tax compliance across the partnership spectrum, thus making subchapter K work better for all partnerships. While the technical solutions needed to address improvisation may vary, the overall reform project would focus on solving a singular problem experienced by all partnerships.

This reframed approach is not limited to the rules governing partnership allocations. On the contrary, it would serve as a useful tool throughout subchapter K, encouraging partnership tax experts to incorporate forgotten partnerships into their thinking as much as possible. To this end, this Article suggests that partnership reform proposals developed to address problems faced by elite partnerships should ordinarily and routinely be accompanied by reform proposals designed to address the corresponding problems of forgotten partnerships. The first step is reframing the elite partnership problem, asking whether it can be reconceptualized as one aspect of a larger problem experienced by a wider range of partnerships. The next step is then developing solutions that offer relief to all partnerships, regardless of wealth, sophistication, and status.

A more expansive approach to partnership tax, which starts with shared problems and solutions, is an essential part of any effort to mend subchapter K's deep fractures. Most urgently, it is a concrete step away from an intuitive subchapter K and toward increased access to substantive tax law for forgotten partnerships. This dual approach also signals an overdue cultural shift in the expert community. With each reframed reform effort, partnership tax experts have an opportunity to communicate to all partnerships, especially forgotten ones, that subchapter K's current, fractured state is no longer acceptable as a matter of policy, practice, or values. This elaborative process, in turn, may help normalize a more inclusive notion of partnership tax and what it means for subchapter K to work.

One might object to this reframed approach, arguing that it risks reinforcing the idea of a bifurcated subchapter K with different tiers of substantive partnership tax law based on a partnership's resources and access to high-priced expert advice. Whatever one's view of this concern in theory, today's subchapter K is already a bifurcated tax system that provides substantive tax law to elite partnerships and lawlessness to forgotten partnerships. Introducing a dual-solution norm into partnership tax represents a marked improvement for forgotten partnerships in terms of access, transparency, and equity. Any reform effort addressing the needs of forgotten partnerships is likely to reduce the number of partnerships dependent on an intuitive subchapter K. Consider partnership allocations. Reforming the rules governing partner-

ship allocations—even if reform involves different rules for forgotten and elite partnerships—would make technical compliance possible, allowing forgotten partnerships to participate in substantive partnership tax law in an entirely different way.

B. Technical Reforms

Reforming partnership allocations requires a focus on the shared problem of complexity that causes both forgotten and elite partnerships to turn to improvisational tax compliance. This Article thus proposes a package of technical reforms to subchapter K's allocation rules—one designed for elite partnerships and another for forgotten partnerships—that would provide both categories of partnerships with alternatives to the substantial economic effect safe harbor, thereby reducing the role of improvisation in partnership tax. Neither reform proposal is new, but their combination represents a novel approach to greater equity, stability, and functionality in partnership tax. Indeed, the key is thinking of these technical reforms as a collective response to the shared problems of partnership allocations.

This Article does not propose dismantling section 704(b)'s existing architecture. On the contrary, it would leave the current rules governing partnership allocations intact, supplementing them with rules aimed at remedying the complexity problems faced by both elite and forgotten partnerships. If one were writing on a clean slate, reimagining partnership allocations entirely would surely be an intriguing option. The complete overhaul of subchapter K's allocations regime, however appealing in theory, is not likely to be a viable option in today's political or economic climate. Adding functional options to current law's allocation rules offers the most expedient path toward urgently needed reform, particularly for forgotten partnerships.

Target Allocations. This Article proposes that the Treasury finally sanction the use of target allocations, incorporating a safe harbor into the partner's interest in the partnership default rule that would respect target allocations in certain circumstances.¹³⁸ As previously discussed, many target allocations likely comply with the partner's interest in the partnership default rule because they are designed to ensure that the partnership's allocation of taxable items matches the partners' economic sharing arrangement.¹³⁹ Likewise, target allocations are particularly ill-suited for partnerships seeking to shift taxable items among part-

138. See, e.g., Am. Inst. of Certified Pub. Accts., *supra* note 130; Cavanagh, *supra* note 19, at 91; Goldberg, *supra* note 19, at 728; N.Y. STATE BAR ASS'N, *supra* note 19, at 26–27.

139. See *supra* notes 123–24 and accompanying text.

ners, thus reducing some of the tax avoidance concerns historically arising in the allocation context.¹⁴⁰

In very general terms, target allocations would satisfy this new safe harbor to the extent that they result in capital account balances equal to the amount that each partner would receive if the partnership had sold its assets for book value, repaid its liabilities, and liquidated.¹⁴¹ Although the technical details of a target allocation safe harbor are beyond this Article's scope, the goal is narrow, and a partnership using these allocations would be required to meet certain threshold requirements set forth in future regulations.¹⁴² In other words, this safe harbor would protect target allocations that are designed to achieve the same results as tax allocations drafted to meet the substantial economic effect safe harbor. Target allocations reaching different results would fall outside this safe harbor and, therefore, would be respected only if consistent with the broader partner's interest in the partnership default rule.¹⁴³

Making space within section 704(b)'s allocation rules for target allocations offers distinct advantages. Most immediately, it would solve a problem faced by many elite partnerships, providing them with greater

140. See N.Y. STATE BAR ASS'N, *supra* note 19, at 9–11. *But see* Rosow & Hughes, *supra* note 11, at 367 (noting that no allocation methodology, including target allocations, will prevent all tax-motivated behavior).

141. See Cavanagh, *supra* note 19, at 91; Goldberg, *supra* note 19, at 728; N.Y. STATE BAR ASS'N, *supra* note 19, at 26–27. This proposal is modeled on the comparative liquidation approach, which currently provides additional guidance to certain partnerships meeting some, but not all, of the requirements for economic effect in determining the partner's interest in the partnership. *See supra* note 56.

142. See *supra* notes 117–18 and accompanying text; *see also* Goldberg, *supra* note 19, at 728; N.Y. STATE BAR ASS'N, *supra* note 19, at 26–27. For instance, this safe harbor may require a partnership to comply with requirements that parallel the comparative liquidation approach currently found in the partner's interest in the partnership default rule. Treas. Reg. § 1.704-1(b)(3)(iii). This would include compliance with the capital account maintenance rules or requiring partners to either agree to restore deficit balances in their capital accounts or include a qualified income offset provision in their partnership agreement. Likewise, target allocations may remain subject to the substantiality requirement under this safe harbor. *See* Goldberg, *supra* note 19, at 728.

143. As previously noted, there is ongoing debate among partnership tax experts as to whether target allocations satisfy the economic effect equivalence test in certain circumstances. *See supra* note 121. Accordingly, one might argue that a target allocation safe harbor should be added to the economic effect equivalence test rather than the partner's interest in the partnership default rule. Placement in the economic effect equivalence test would surely offer tremendous administrative advantages, not only providing partnerships with safe harbor protection but also solving a number of peripheral issues where the tax treatment of a particular item depends on whether a partnership's tax allocations have substantial economic effect. However, target allocations appear to fall outside the intended design of economic effect equivalence. As previously noted, economic effect equivalence is often described as a “dumb-but-lucky” rule designed to protect unsophisticated partnerships from inadvertently running afoul of the substantial economic effect safe harbor. *See supra* note 70. Yet target allocations are not the result of dumb-but-lucky tax planning. On the contrary, they reflect the deliberate and sophisticated work of highly talented experts. *See also* Goldberg, *supra* note 19, at 693 n.50.

certainty in allocating taxable items.¹⁴⁴ Likewise, adding a safe harbor for target allocations would have a legitimizing effect, even for those partnerships using target allocations that would fall outside the new safe harbor. Sanctioning the use of target allocations, even on a limited basis, would represent a long-overdue acknowledgment that this alternative allocation methodology shares the same goals as substantial economic effect and the partner's interest in the partnership. To the experts who recommend target allocations to their elite partnership clients, target allocations just operationalize these goals in a simpler and more stable manner than substantial economic effect.¹⁴⁵

A target allocation safe harbor also makes sense from an administrative perspective. Clarifying the status of target allocations would likely reduce the planning, drafting, and compliance costs incurred by elite partnerships choosing to structure around the substantial economic effect safe harbor. More importantly, a safe harbor would signal greater transparency and equity in tax administration. The use of target allocations is incredibly common among elite partnerships, and it is therefore impossible to imagine that the IRS has not reviewed and blessed partnership agreements employing this methodology.¹⁴⁶ Shedding light on these administrative positions would benefit all partnerships, providing greater access to information that is available today to only a small coterie of experts and the elite partnerships willing to pay them for it.

Small Partnerships. Standing alone, making space for target allocations would provide a benefit only to those elite partnerships in the least need of help. For forgotten partnerships, substantive partnership tax law would remain the same, and so too would the challenges these partnerships face annually in complying with subchapter K's complicated allocation rules. Forgotten partnerships need a parallel solution, one that provides them with access to substantive tax law and takes important steps toward eliminating the lawless and intuitive version of subchapter K on which they are too often forced to rely.

144. In reporting on a Practising Law Institute seminar, Amy S. Elliot of Tax Notes reported that an official in the Treasury's Office of Tax Legislative Counsel said "that because there's a consensus that targeted allocations are found in such a large percentage of partnership agreements, 'to not have guidance becomes a little awkward at some point, and that point has probably passed.'" Elliot, *supra* note 120, at 891. These comments were made in 2014, and they remain equally apt today.

145. In connection with this proposed safe harbor, the Treasury should also clarify the relationship between target allocations and the peripheral partnership rules—including the rules governing allocations attributable to nonrecourse debt, the allocation of nonrecourse liabilities, and the fractions rule—that require allocations to comply with aspects of the substantial economic effect safe harbor. *See supra* note 122.

146. *See supra* notes 120, 125.

This Article therefore proposes that Congress add a new allocation rule to section 704(b) for a statutorily defined category of “small partnerships.”¹⁴⁷ A qualifying small partnership would allocate all its taxable items using a single ratio based on its partners’ relative ownership interests.¹⁴⁸ Operationally, this small partnership provision would function as a brand new default rule, which would apply to all partnerships qualifying as small partnerships. However, partnerships would have the option to elect out of this small partnership regime. Any partnership making such an election would therefore be subject to the “regular” provisions of section 704—the partner’s interest in the partnership default rule, the substantial economic effect safe harbor, and this Article’s proposed target allocation safe harbor.

For qualifying partnerships, this approach would mitigate much of the complexity of partnership allocations. Capital account analysis would no longer serve as the central organizing feature of the rules governing small partnership allocations. Likewise, the use of a single allocation ratio would eliminate special allocations, as well as the need for the substantiality requirement.¹⁴⁹ Indeed, the only time that a partnership would need to adjust its allocation ratio is following a change in its partners’ ownership interests, which may occur in connection with a contribution to the partnership or a partner’s retirement.¹⁵⁰ When taken together, a small partnership allocation regime without these troublesome features promises to dramatically ease the compliance burdens faced by qualifying partnerships.

The key to this allocation rule is defining “small,” as only those partnerships qualifying as such would be entitled to its streamlined approach to partnership allocations. This type of line drawing is admit-

147. This “small partnership” proposal was largely inspired by the incredible work of a number of scholars, particularly Professors George Yin and David Shakow, who reimagined the taxation of private business enterprises as part of a larger conversation about business entity taxation. See ALI 1999 REPORTERS’ STUDY, *supra* note 11; see also Berger, *supra* note 11; Gergen, *supra* note 37; Lokken, *supra* note 11; Yin, *supra* note 11.

148. See ALI 1999 REPORTERS’ STUDY, *supra* note 11, at 162–63; see also Berger, *supra* note 11, at 108–09 n.3; Kwall, *supra* note 11, at 244–52; Lokken, *supra* note 11, at 272–78; Yin, *supra* note 11 at 202–03. Although the proposals vary in detail, these scholars all begin with ratable allocations based on the partners’ relative ownership interests. See sources cited, *supra*. By contrast, other scholars have proposed ratable allocations based on alternative metrics, like capital account balances. See Gergen, *supra* note 37, at 40–41; Jones, *supra* note 33, at 1093.

149. See ALI 1999 REPORTERS’ STUDY, *supra* note 11, at 187; Gergen, *supra* note 37, at 40. But see Berger, *supra* note 11, at 127–43 (proposing a general ratable allocation rule, but also allowing special allocations of bottom-line losses in order to recover a partner’s investment and the special allocation of bottom-line income when the purpose is not tax avoidance).

150. See, e.g., ALI 1999 REPORTERS’ STUDY, *supra* note 11, at 191. To properly account for such an ownership change, the partnership would allocate its taxable items on a daily basis, dividing such items each day based on the partners’ relative ownership interests. *Id.*

tedly blunt, and it presents multiple risks.¹⁵¹ A broad definition of small partnership risks overinclusion, maximizing availability to forgotten partnerships but potentially creating abuse opportunities all across the partnership spectrum. Yet a narrow rule has the opposite effect, reducing the risk of improper transactions, but doing so at the cost of leaving many forgotten partnerships without access to simpler rules.

Balancing the goals of access, simplification, and abuse prevention is thus the primary driver in defining small partnerships. Throughout the years, many scholars have grappled with this issue, and they have taken different approaches to defining small partnerships.¹⁵² Based on their thoughtful work, two factors—entity size and partner identity—have proven particularly useful in shaping the contours of a small partnership definition. This Article thus proposes that Congress consider a combination of these factors when defining small partnerships.

The primary factor is financial size, and this Article proposes that partnerships with gross receipts falling below a specified statutory threshold be treated as small partnerships.¹⁵³ The primary advantage of gross receipts as a measure of “smallness” relates to simplification. *Gross receipts* is a standard and well-understood concept from both a tax and financial perspective, and less sophisticated partnerships are far more likely to be able to understand and apply it.¹⁵⁴ Likewise, the IRS would be able to communicate this requirement—and the small partnership allocation rule more broadly—to taxpayers. Myriad provisions of substantive tax law contain gross receipts thresholds, and Congress is experienced in designing these measures in a manner consistent with equitable norms.¹⁵⁵

151. See *id.*, at 181. See generally David A. Weisbach, *Formalism in the Tax Law*, 66 U. CHI. L. REV. 860, 863–75 (1999) (exploring the connection between complexity and the historic “rules versus standards” debate and concluding that, contrary to conventional wisdom, tax rules are systematically more complex than standards).

152. See ALI 1999 REPORTERS’ STUDY, *supra* note 11, at 134–82; Berger, *supra* note 11, at 161–68; Kwall, *supra* note 11, at 242–53; Yin, *supra* note 11, at 174–201.

153. See Berger, *supra* note 11, at 163–67. But see ALI 1999 REPORTERS’ STUDY, *supra* note 11, at 178–82 (rejecting use of financial size in defining small partnerships). In addition to gross receipts, financial size may be measured by taxable income or asset value. This Article proposes gross receipts because it is less variable than taxable income and not reliant on appraisals like asset valuation. See Berger, *supra* note 11, at 162–63.

154. See ALI 1999 REPORTERS’ STUDY, *supra* note 11, at 178–79; Berger, *supra* note 11, at 164.

155. See, e.g., I.R.C. § 163(j)(3) (exempting small businesses from business interest deduction limitation rules if average annual gross receipts do not exceed \$25 million); *id.* § 263A(i) (exempting small businesses from the uniform capitalization rules if average annual gross receipts do not exceed \$25 million); *id.* § 448(c) (excluding entities with average annual gross receipts of \$25 million or less from limitations on the use of the cash receipts and disbursements method of accounting). In addition, the IRS is experienced in explaining these rules to taxpayers in a comprehensible and accessible manner. In fact, IRS Publication 538, *Accounting Periods and Methods*, contains a relatively straightforward explanation of the gross receipts test set forth in section 448(c)(3). INTERNAL REVENUE SERV., PUB. NO. 538, ACCOUNTING PERIODS AND METHODS 9 (2019), <http://www.irs.gov/pub/irs-pdf/p538.pdf> [<https://perma.cc/7MLU-W4EP>]. In particular, the publication notes that

Selecting the proper gross receipts threshold requires a balancing of factors, including congressional priorities, tax policy, and taxpayer data. The first step in defining a “small partnership” is thus further study of individual partnerships, partners, and their gross receipts. Rather than propose a particular threshold or range, this Article offers an example from current law that provides a working model for how Congress might operationalize a definition of “small partnership” in partnership allocations.¹⁵⁶ In a variety of contexts—including accounting rules, interest limitation rules, and capitalization rules—streamlined small business rules apply to taxpayers with gross receipts that do not exceed \$25 million.¹⁵⁷ To address potential fluctuations in annual gross receipts, these thresholds focus on the average annual gross receipts as measured over the prior three-year period.¹⁵⁸ Likewise, they include aggregation rules that require separate entities to combine their gross receipts in certain circumstances.¹⁵⁹ This type of aggregation rule functions as an anti-abuse rule, preventing strategic entities from dividing into smaller, separate businesses that might individually qualify as small businesses.¹⁶⁰

In addition to a gross receipts threshold, this Article recommends a definitional requirement for small partnerships that is designed to limit a small partnership’s ability to shift income among its partners in a tax-advantaged manner. To this end, partnerships with corporate, tax-exempt, and foreign partners will not qualify as small partnerships.¹⁶¹ By limiting the definition of small partnerships to partnerships whose partners have similar “tax profiles,” the goal is to reduce a partnership’s opportunities to use allocations to arbitrage its partners’ individual circumstances to obtain an improper tax advantage.¹⁶² Taken together, the combination of limits on partner identity and gross receipts will balance the need for an accessible system of partnership allocations for

certain entities with average annual gross receipts for the three preceding years exceeding \$25 million may not use the cash receipts and disbursements method of accounting. *Id.* It then explains how an entity should compute its average annual gross receipts—it should add together its gross receipts from the past three years, and then it should divide the sum by three. *Id.*

156. See Berger, *supra* note 11, at 165 (proposing a range of \$10 to \$50 million as the proper gross receipts threshold).

157. I.R.C. § 448(c) (cash receipts and disbursements accounting method for partnerships with corporate partners). Numerous other small business provisions rely on this section 448(c) gross receipts test. See, e.g., *id.* §§ 163(j)(3) (business interest deduction limitation), 263A(i) (uniform capitalization rules), 447(c) (accounting methods for farming corporations), 460 (rules for certain long-term contracts), 471(c) (accounting for inventories).

158. *Id.* § 448(c)(1).

159. *Id.* § 448(c)(2) (requiring all persons treated as a single employer under sections 52(a), 52(b), 414(m), or 414(o) to be treated as one person for purposes of this aggregation rule).

160. See ALI 1999 REPORTERS’ STUDY, *supra* note 11, at 180. See generally Kamin et al., *supra* note 1, at 1465–68.

161. ALI 1999 REPORTERS’ STUDY, *supra* note 11, at 137–61; Yin, *supra* note 11, at 174–90.

162. See ALI 1999 REPORTERS’ STUDY, *supra* note 11, at 134–70.

forgotten partnerships with the abuse concerns that introducing such a system presents.

An Objection. One might question whether this Article goes far enough in mending subchapter K's fractures to result in meaningful change, particularly for forgotten partnerships. Although it proposes significant changes to partnership allocations, one might ask whether a small partnership allocation regime, standing alone, is sufficient to address the subchapter K's deep cultural and distributional rifts.¹⁶³ Without structural reforms that stretch into the periphery of partnership tax, a piecemeal reform effort—even one focused on something as foundational as partnership allocations—risks being overwhelmed by the sheer weight of subchapter K's dysfunctionality.

Reforming partnership allocations is not a panacea, yet there is reason to believe that a small partnership allocation regime would markedly improve access and comprehensibility for forgotten partnerships, thereby diminishing the role of an intuitive subchapter K. As an initial matter, reform efforts have to start somewhere, and the rules governing partnership allocations, which are subchapter K's central operational feature, are the logical choice. Partnership allocations are uniquely situated in subchapter K, rippling through all its rules and impacting every partnership every year. There is simply no other partnership provision with comparable reach in terms of impacting partnerships and streamlining subchapter K's rules.¹⁶⁴

Simply put, a small partnership allocation regime represents an important step toward making subchapter K work. It would signal that all partnerships have value, without regard to wealth, sophistication, or status. And it would signal that all partnerships are entitled to substan-

163. This Article draws on rich scholarship reimagining subchapter K and, more broadly, business entity taxation. For further reading on the wholesale reform of subchapter K, see, for example, ALI 1999 REPORTERS' STUDY, *supra* note 11; Berger, *supra* note 11; Lokken, *supra* note 11; Postlewaite, *supra* note 11, Rosow & Hughes, *supra* note 11; Bret Wells, *Pass-Through Entity Taxation: A Tempest in the Tax Reform Teapot*, 14 HOUS. B. & TAX L.J. 1 (2013); Yin, *supra* note 11.

164. From a practical perspective, a small partnership allocation regime would allow the IRS to bridge the longstanding accessibility and compliance gaps currently filled by an intuitive subchapter K. As previously discussed, IRS publications often function as a translation tool, where the IRS explains complicated tax law to non-experts in simple language. See *supra* notes 94–95 and accompanying text. In many respects, Publication 541, *Partnerships*, does serviceably well in communicating the rules governing significant partnership transactions—including contributions, distributions, and sales of partnership interests—to partnerships. The primary exception is partnership allocations, which are simply not discussed in the publication. See *supra* notes 96–97 and accompanying text. If, however, the IRS were to include a discussion of a newly-enacted small partnership allocation regime in this publication, it would exponentially benefit forgotten partnerships who currently lack any guidance on how to allocate taxable items among their partners. The IRS has experience writing comparable provisions—for instance, the section 448(c) gross receipts test—in a simple and accessible manner in its publications. See *supra* note 155. Accordingly, there is every reason to believe that the IRS could successfully communicate the parameters of a small partnership allocation regime to non-expert partnerships, thereby mediating the need for forgotten partnerships to rely on an intuitive subchapter K.

tive tax law that they can apply and understand without the need for improvisation. There is much work to be done in partnership tax, and a small partnership allocation regime will not eliminate all of subchapter K's cultural and distributional problems. But it is an essential step toward a more equitable subchapter K.

CONCLUSION

Partnership allocations are broken, and they have been for decades. This Article takes first steps toward a solution by working backwards, reframing the problem in order to shed new light on the factors that have combined to produce such distressing cultural and distributional fractures in partnership tax. Complexity is a singular problem in partnership allocations, impacting partnerships at all income and sophistication levels. For most of these partnerships, the response is improvisational tax compliance. However, this is where the similarities end—improvisation creates opportunities for elite partnerships while creating impossible barriers for forgotten ones, relegating them to an intuitive and lawless subchapter K. The result of this normalized dysfunction is that forgotten partnerships and their taxpaying partners cannot participate in one of our most basic democratic functions—paying one's income taxes.

The time has thus come to restore access, fairness, and legitimacy to this vitally important area of federal income tax law. This Article is grounded in the straightforward premise that subchapter K only works if the vast majority of partnerships—whether rich or poor, forgotten or elite—can participate in substantive partnership tax law. This is not a particularly high benchmark in terms of what it means for subchapter K to work, but it is a benchmark that any principled system of taxation should achieve.

Questions about what it means for tax law to work and for whom it should work are part of a much larger dialogue, which raises foundational questions about economic, social, and racial justice in this country. The federal income tax is just one area in which our values as a nation are tested, but it is also the primary point of annual contact with the federal government for many individuals. Federal income tax law is therefore uniquely situated to shape perceptions about legitimacy, justice, and democracy. A tax system that works for a small number of wealthy and well-advised taxpayers and leaves everyone else behind is likely to be viewed as corrupt, and perhaps even illegitimate, by many taxpayers.¹⁶⁵

165. See Elizabeth Warren (@ewarren), TWITTER (Dec. 19, 2019, 8:56 PM), <http://twitter.com/ewarren/status/1207842216732958726> [<https://perma.cc/2LB8-29NU>] (“We have a government that works great for the wealthy and the well-connected—and for no one else. That is corruption, pure and simple, and we need to call it out for what it is.”).

From this perspective, the problems of tax law today are not simply abstractions or politics-as-usual. On the contrary, the problems of tax law, especially the status of forgotten taxpayers, shed important light on our nation's values and our future.

