

Defining ‘Partnership’ for Federal Tax Purposes

By Ethan Yale

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This report examines the case law and statutory history of the terms “partner” and “partnership,” including the seminal Supreme Court cases of the late 1940s, the 1951 amendments that added the language now codified at section 704(e)(1), and the check-the-box regulations added in 1996. The central conclusions are as follows: (1) the existence of a partnership and the identity of its partners should be jointly determined under a single test; (2) the test for partnership validity and partner status most consistent with the text of the code, the case law, and the regulations is easier to pass than the test the government has argued for in recent litigation, and it does not depend on taxpayer purpose; (3) there is a strong argument that the check-the-box regulations harmonized the rules for partnerships and corporations regarding the tests used to assess the validity of business entities and to identify their owners; and (4) the economic substance doctrine should not make purpose relevant to the question of entity validity.

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Introduction

Several recent cases have turned on the federal tax definitions of the terms “partner” and “partnership.” Somewhat surprisingly, the precise definitions of those terms remain elusive even though the code has assigned meanings to both for almost eight decades.¹ In this report, I examine some of the case law and statutory history of partner and partnership, including the seminal Supreme Court cases of the late 1940s, the amendments in 1951 that added the language now codified at section 704(e)(1), and the check-the-box regulations added to the entity classification rules in 1996. Based on the history and structure of the rules, I explore some of the conceptual connections between the definitions of partner and partnership and also the relationship between the definitions of those terms on one hand and of “shareholder” and “corporation” on the other.

My central conclusions are as follows: First, the existence of a partnership and the identity of its partners should be jointly determined under a single test. Second, the test for partnership validity and partner status most consistent with the text of the code, the case law, and the regulations is easier to pass (less demanding on taxpayers) than the test the government has argued for in recent litigation. The government continues to believe taxpayer purpose is central to a finding of partnership validity. I explain why that position is misguided. Third, there is a strong argument that the check-the-box regulations harmonized the tests used to assess the validity of business entities (corporations and partnerships) and identify their owners (shareholders and partners). Fourth, the economic substance doctrine does not make purpose relevant to the question of entity validity. As the Joint Committee on Taxation has explained, the economic substance doctrine is “not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages.”² In my view, the choice to form a partnership is one such basic business transaction.

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¹Revenue Act of 1932, section 1111(a)(3).

²JCT, “Technical Explanation of the Revenue Provisions of the ‘Reconciliation Act of 2010,’ as Amended, in Combination (Footnote continued on next page.)”

Culbertson

In its 1949 decision in *Commissioner v. Culbertson*, the Supreme Court announced the following test to be used when determining whether the relationship between putative partners constitutes a partnership for federal income tax purposes:

The question whether [a] partnership is real for income tax purposes depends upon “whether the partners really and truly intended to join together for the purpose of carrying on business and sharing of profits or losses or both. And their intention in this respect is a question of fact, to be determined from testimony disclosed by their agreement, considered as a whole, and by their conduct and execution of its provisions.”³

The facts of *Culbertson* are straightforward. Culbertson, a cattle rancher and the patriarch of his family, had been in a partnership with Coon. Coon was old and in ill health, and Culbertson wished to buy him out. Coon agreed to wind up the Coon and Culbertson partnership by allowing the partnership to sell its assets (some 1,500 head of cattle) to Culbertson on the condition that Culbertson would then sell a one-half stake in the herd to Culbertson’s four sons.⁴ As planned, Culbertson purchased the herd from the partnership and then resold an undivided one-half stake to his four sons for a note. The sons repaid the note in part from ranch profits and in part from gifts from their father (that is, Culbertson forgave part of the note).⁵

The Tax Court, holding in the IRS’s favor, found that the partnership was invalid. It interpreted *Commissioner v. Tower*⁶ and *Lusthaus v. Commissioner*,⁷ both decided by the Supreme Court in 1946, as requiring “that each partner contribute to the partnership either vital services or capital originating with him.”⁸ The Tax Court found that none of Culbertson’s sons had satisfied either of those re-

quirements. The Fifth Circuit reversed, concluding that Culbertson and his sons had entered into the venture without thought of tax avoidance and that the resulting partnership should be recognized regardless of whether any of the sons contributed capital or services during the tax years in question, provided that the partnership was formed “with the full expectation of purpose that the boys would, in the future, contribute their time and services to the partnership.”⁹

The Supreme Court reversed and remanded. The Court first rejected the idea, espoused by the Fifth Circuit, that the prospects of rendering services in the future could, standing alone, suffice to make someone a partner. The Court explained that to count as partners, “persons who contribute nothing during the tax period would violate the first principle of income taxation: that income must be taxed to him who earns it.”¹⁰ Continuing, the Court explained:

The intent to provide money, goods, labor, or skill sometime in the future cannot meet the demands . . . of the Code that he who presently earns the income through his own labor and skill and the utilization of his own capital be taxed therefor. The vagaries of human experience preclude reliance upon even good-faith intent as to future conduct as a basis for the present taxation of income.¹¹

Having undercut the Fifth Circuit’s rationale for validating the partnership, the Court turned its attention to the Tax Court’s approach to what the Court referred to as the “family partnership problem.”¹² Following *Tower* and *Lusthaus*, the Tax Court had been routinely striking down family partnerships when the putative partner — usually the wife or child of the patriarch overseeing the family’s business — did not perform vital services for the partnership, or contribute original capital.¹³ In the Supreme Court’s view, the Tax Court had been ignoring the ultimate issue, namely, “whether the partnership is real within the meaning of the federal revenue laws.”¹⁴ Instead, the Tax Court had been focusing on the provision of vital services or original capital, making the absence of those two features determinative, even when the weight of the evidence pointed to the existence of a genuine partnership. *Culbertson* can be read essentially as an

With the ‘Patient Protection and Affordable Care Act,’ JCX-18-10 (Mar. 21, 2010), at 152, *Doc 2010-6147*, 2010 TNT 55-23. See also H.R. Rep. No. 111-443 at 296. For a discussion of whether the JCT report and House report are technically part of the legislative history of the Reconciliation Act of 2010, see New York State Bar Association Tax Section: “Report on Codification of the Economic Substance Doctrine” (Jan. 5, 2011), at 13 n.33, *Doc 2011-314*, 2011 TNT 5-14.

³337 U.S. 733, 741-742 (1949) (quoting *Commissioner v. Tower*, 327 U.S. 280 (1946), internal citation omitted).

⁴Coon apparently thought that Culbertson was too old to run the cattle ranch alone, and Coon had a personal relationship with Culbertson’s sons. *Id.* at 736.

⁵*Id.*

⁶327 U.S. 280 (1946).

⁷327 U.S. 293 (1946).

⁸*Culbertson*, 337 U.S. at 737.

⁹*Id.* at 738 (quoting *Culbertson v. Commissioner*, 168 F.2d 979, 982 (5th Cir. 1948)).

¹⁰*Id.* at 739-740 (citing *Lucas v. Earl*, 281 U.S. 111 (1930)).

¹¹*Id.* at 740.

¹²*Id.* at 741.

¹³*Id.* at 741 and n.9.

¹⁴*Id.* at 741.

instruction to trial courts (including, most importantly, the Tax Court) to validate partnerships when the court is convinced that the partners really intended to join together in the conduct of the business and to invalidate them when the court thinks taxpayers are using the partnerships for nefarious purposes (such as to split income and avoid high marginal tax rates). The Supreme Court cautioned that the genuineness of a partnership is to be determined based on all the facts and circumstances,¹⁵ rather than the simple rules of thumb like those the Tax Court had been using.

The Supreme Court claimed that there was “nothing new or particularly difficult” about applying the facts and circumstances test described in *Culbertson*.¹⁶ In hindsight, that proved to be wishful thinking. *Culbertson* spawned an “interminable number of court disputes.”¹⁷ That development should not have been surprising in the least: A vague legal test defining partnership, marginal rates as high as 90 percent, and the absence of a so-called kiddie tax is a recipe for aggressive tax planning and resultant litigation if ever there was one.¹⁸

Section 704(e)

Dissatisfaction with the rampant litigation and the overly restrictive view being taken by some courts led Congress to enact section 340 of the Revenue Act of 1951, which added section 191 to the code and modified section 3797(a)(2).¹⁹ Section 3797 was the definitions section of the 1939 code, and paragraph (a)(2) contained the definitions (of a peculiar sort²⁰) of partner and partnership. The text of section 3797(a)(2) is set out below. The italicized

final sentence was the 1951 modification. That sentence is now codified at section 704(e)(1).²¹

SEC. 3797. DEFINITIONS.

- (a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof

—
* * *

(2) PARTNERSHIP AND PARTNER. —

The term “partnership” includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term “partner” includes a member in such a syndicate, group, pool, joint venture, or organization. *A person shall be recognized as a partner for income tax purposes if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.*

Section 191 added the family partnership rules now codified at section 704(e)(2) and (3). Roughly speaking, these latter rules validate the distributive share of a donee or purchaser of a partnership interest when the gift or purchase is from a family member, provided that the partnership sharing arrangement allows for reasonable compensation for services rendered or capital supplied by the donor or seller.²²

Application of the pre-1951 case law had created an incongruity at the boundary between (a) gifts of property outside the partnership context and (b) indirect gifts of property held by partnerships (that is, transfers of partnership interests). In committee reports proposing the 1951 revisions, Congress correctly observed that beyond the sphere of partnership tax law, taxpayers could (and still can) make a gift of property so that future income accruing on the property would be taxable to the donee.²³ In

¹⁵The Court went on to list the factors that should be considered in the more involved analysis required following *Culbertson*: “the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent.” *Id.* at 742.

¹⁶*Id.* at 743.

¹⁷Note, “Family Partnerships and the Revenue Act of 1951,” 61 *Yale L.J.* 541, 544 (1952).

¹⁸*Id.* at 541 n.2 (estimating that there were as many as 930,000 family partnerships by 1948).

¹⁹P.L. 83-183, section 340.

²⁰As Justice Felix Frankfurter explained in his concurring opinion in *Culbertson*, use of the phrase “‘partnership’ includes” in section 3797 shows it was presupposed that the term “partnership” had a recognized meaning under the general law of partnership and that section 3797 was meant to supplement, not supplant, that recognized meaning. *Culbertson*, 337 U.S. 733, 751 n.1 (Frankfurter, J., concurring) (emphasis added).

²¹The phrase “for income tax purposes” in the second (and final) sentence of section 3797(a)(2) has been replaced with the phrase “for purposes of this subtitle,” *i.e.*, subtitle A (income taxes) of title 26. This was a conforming amendment during recodification, not a substantive modification.

²²William S. McKee et al., *Federal Taxation of Partnerships and Partners*, para. 15.05[1] (4th ed. 2007).

²³H.R. Rep. No. 82-586 at 32 (1951). See, e.g., *Blair v. Commissioner*, 300 U.S. 5 (1937); *Caruth Corp. v. United States*, 865 F.2d 644

(Footnote continued on next page.)

other words, not every transfer of income-producing property is susceptible to attack as an anticipatory assignment of income.

Before the 1951 legislation, however, courts (particularly the Tax Court) were applying a more restrictive (taxpayer-unfavorable) rule in the partnership context. In circumstances in which there was an intra-family gift of a partnership interest such that complete ownership and dominion over the gifted partnership interest — and hence indirect ownership over the partnership's assets — was transferred, the courts were finding no valid partnership between the donor and the donee. Cast in the terms of Justice Oliver Holmes's famous dictum from *Lucas*,²⁴ transfers of partnership interest were being judicially invalidated even when the transferred property constituted tree, not fruit. According to legislative history, the purpose of the 1951 amendments — including the language now codified at section 704(e) — was to eliminate that incongruity.²⁵

Section 704(e)(1) establishes a three-part test for determining when a person is recognized as a partner for federal income tax purposes.²⁶ To be a partner, the taxpayer must (1) own (2) a capital interest (3) in a partnership in which capital is a material income-producing factor. (To save words, I will describe a partnership in which capital is a material income-producing factor as a “capital-intensive partnership.”) As applied to cases like those that spawned the enactment of section

704(e)(1), the import of the new rule is not this three-part test for partner status. Instead, the crucial passage is the final clause of section 704(e)(1), which makes it irrelevant whether the putative partner acquired the interest in question by gift, purchase, or the provision of “vital services.” It was this last clause that upended the judicial precedents that had led to the invalidation of so many partnerships by trial courts (particularly the Tax Court) attempting to apply *Tower*, *Lusthaus*, and *Culbertson*. Congressional intent was that “however the owner of a partnership interest may have acquired such interest, the income is taxable to the owner, if he is the real owner. If the ownership is real, it does not matter what motivated the transfer to him or whether the business benefited from the entrance of the new partner.”²⁷

Culbertson vs. Section 704(e)(1) Must Culbertson and Section 704(e)(1) Be Reconciled? On its face, the test announced by the Court in *Culbertson* is used to determine if a putative partnership should be respected as a real partnership for federal income tax purposes. The test laid out in section 704(e)(1), by contrast, is used to determine whether a putative partner will be respected as a real partner for federal income tax purposes. Thus, the *Culbertson* test appears to be aimed at the question of *partnership validity*, whereas section 704(e)(1) is aimed at the question of *partner status*. An argument can therefore be made that *Culbertson* and section 704(e)(1) have different, non-overlapping domains and that it is not necessary to reconcile them. As discussed later in this report, the government has sometimes taken this position, which has some superficial appeal. If this is correct — if the tests for partnership validity and partner status are independent — resolving which takes precedence over the other is unnecessary. It turns out, however, the idea that there is no conflict between the tests is overly simplistic.²⁸

The two tests are interdependent, so resolving whether *Culbertson* trumps section 704(e)(1) or vice versa is necessary. It is also important because this issue has practical significance in many cases. To see why reconciling section 704(e)(1) and *Culbertson* is necessary, begin with a simple example: Suppose A and B wish to join together in the conduct of a business, call it AB. AB is a partnership for tax

(5th Cir. 1989); Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts*, para. 75.3 (3d ed. 1999).

²⁴281 U.S. at 115.

²⁵H.R. Rep. 82-586, *supra* note 23, explains as follows:

Section 312 of your committee's bill is intended to harmonize the rules governing interests in the so-called family partnership with those generally applicable to other forms of property or business. Two principles governing attribution of income have long been accepted as basic: (1) income from property is attributable to the owner of the property; (2) income from personal services is attributable to the person rendering the services. There is no reason for applying different principles to partnership income. If an individual makes a bona fide gift of real estate, or of a share of corporate stock, the rent or dividend income is taxable to the donee. Your committee's amendment makes it clear that, however the owner of a partnership interest may have acquired such interest, the income is taxable to the owner, if he is the real owner. If the ownership is real, it does not matter what motivated the transfer to him or whether the business benefited from the entrance of the new partner.

Identical language appears in the Senate report. See S. Rep. 82-781 (1951).

²⁶Section 704(e)(1) does not by its terms establish *the* test for determining whether someone is a partner, but rather announces a set of conditions that if satisfied, are sufficient to establish partner status. It is possible for partnership validity to be established otherwise. See, e.g., discussion *infra* note 26.

²⁷H.R. Rep. 82-586, *supra* note 23.

²⁸There is no conflict between section 704(e)(1) and *Culbertson* for non-capital-intensive partnerships, because section 704(e)(1) has no application to those cases. Hence the validity of those partnerships was unambiguously controlled by *Culbertson* until the check-the-box regulations took effect. The implications of the check-the-box regulations are discussed below.

purposes only if A and B are partners. If, in substance, A is a proprietor and B is A's employee, then AB does not exist as an entity recognized for federal income tax purposes (AB flunks the requirement that a partnership must have multiple partners). It is equally true that A and B are partners in AB only if AB is a partnership. If AB were incorporated, then A and B might be shareholders, but neither could be a partner, at least for tax purposes, because partner status presupposes the existence of a partnership.

Interdependence is obvious in cases involving only two partners, because there is a biconditional (if and only if) relationship between partnership validity and partner status. The statement "the AB partnership is respected as a partnership *if and only if* A is respected as a partner" is logically equivalent to the statement "A is respected as a partner *if and only if* the AB partnership is respected as a partnership." Either the partnership validity and partner status tests are both passed or neither is passed; it is logically impossible for A, B, and AB to pass one test and flunk the other. To suggest otherwise is to imply the existence of partnerless partnerships and taxwise partners without an underlying partnership.

The implication of this example is that at least for two-person partnerships, the test used to resolve the partner status question is equivalent to the test used to resolve the partnership validity question, so the partnership validity question and the partner status question depend on a single inquiry. Roughly speaking, the partnership validity test (*Culbertson*) turns on motive, and the partner status test (section 704(e)(1)) turns on genuineness of ownership.²⁹ The partnership validity test is passed if the would-be partners have an acceptable motive for associating with one another, and it is failed otherwise. The partner status test is passed if a would-be partner is the genuine owner of her interest, and it is failed otherwise. In examples like the one involving AB, partner status and partnership validity are jointly determined based on the motives of the putative partners and the quality of their ownership stakes. In other words, there are two questions but only one answer. That answer depends on a single, two-part test.

²⁹Section 704(e)(1) is the partner status test for capital-intensive partnerships. For partnerships in which capital is not a material income-producing factor, the partner status test (until the check-the-box regulations) was taken from *Culbertson*. See McKee et al., *supra* note 22, at para. 3.02[3] (explaining that in *Culbertson* (and *Tower*) there was no partnership unless the putative partners were respected as such; accordingly, partner status and partnership validity was resolved by the Court "under the same analysis").

How Should *Culbertson* and Section 704(e) Be Reconciled? To say that there is a single, two-part test used to resolve partnership validity and partner status is too imprecise to resolve the relationship between *Culbertson* and section 704(e)(1), at least when they point in opposite directions. First, though, let's dispense with the uncomplicated scenarios. If ownership is sufficiently genuine to satisfy section 704(e)(1) and the partners' motivation satisfies *Culbertson*, the partnership is valid and A and B are partners. If both parts of the test are failed — lack of genuine ownership *and* a bad motive — no partnership exists and neither A nor B is a partner. Everyone agrees that these are, and should be, the results in those cases.

What happens, however, when one part of the test is passed and the other part is flunked? It could be that A and B are both the true owners of their interests but neither one has the right motive to establish partnership validity under *Culbertson*. Or it could be that the AB venture is animated by the right motive but that A or B or both are not the genuine owners of their interests. Are the partner status and partnership validity tests conjunctive, such that to pass muster both tests must be satisfied? Or are they disjunctive, so that satisfying either one is sufficient to establish both status and validity?

Both the text of the code and the legislative history indicate that there is a disjunctive relationship between section 704(e)(1) and *Culbertson*. If A and B are the real owners of their interests in AB, it doesn't matter whether A or B or both are motivated to join together for reasons that would satisfy *Culbertson*. To see why, imagine the opposite were true. Imagine every two-person partnership had to pass both section 704(e)(1) and *Culbertson*. The first, most important problem with this approach is that it is inconsistent with the language of the statute. Section 704(e)(1) is categorical: "A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership." The phrase "shall be recognized as a partner" is the unambiguous announcement of a sufficient condition to be recognized as a partner. It would flatly contradict the language of the code to conclude that a partner will be recognized as such only if she meets additional unspecified conditions.

A second problem with requiring every partner to prove that both the partnership validity and partner status tests are satisfied is that the legislative history of section 704(e)(1) demonstrates that when Congress enacted the predecessor of section 704(e)(1) in 1951, it intended that when the partner's claim of ownership over her interest is real, her status as partner is to be respected for tax purposes without regard to her motivation for joining the

partnership.³⁰ Congress was explicit that it wanted to brush away the confusion in the lower courts that had grown up in the wake of *Tower*, *Lusthaus*, and *Culbertson*. The intended effect of section 704(e)(1) was to refocus the inquiry from subjective motive to whether the putative partner really owned her interest, and to make other factors, such as whether she performs vital services for the partnership or whether her participation will enhance the partnership's business, irrelevant.³¹ To require that a genuine owner of a partnership interest prove good motive to validate a partnership is to ignore this legislative history.³²

To be clear, it is not enough for the putative partner to demonstrate that the underlying activity held by the putative partnership is capital intensive and that she is the real owner of her interest. Since 1932 the code has made clear that the concepts of partner and partnership occupy a residual category for entities and owners that are neither corporations and shareholders nor trusts and beneficiaries.³³ Section 704(e)(1) did not change this. Someone who

³⁰See, e.g., *Pflugrad v. United States*, 310 F.2d 412, 415-416 (7th Cir. 1962) ("The test is no longer whether the parties acted in good faith with a business purpose in joining together to conduct the partnership business. . . . To be recognized for tax purposes, a transfer of a partnership interest must vest dominion and control in the transferee").

³¹*Id.*

³²See *supra* note 25. Commentary published at the time confirms that the intended effect of section 704(e)(1)'s predecessor was to displace *Culbertson* for capital-intensive partnerships. See Israel Packel, "The Next Inning of Family Partnership," 100 *U. Pa. L. Rev.* 153, 158 (1951); Note, *supra* note 17, at 544-545 (In passing the 1951 amendments, "Congress wiped out *Culbertson*'s intent criterion as well as the factual standards of *Tower*. The amendment substitutes a blanket rule that all partnerships are good, no matter how created, if there was an actual transfer of a capital interest.").

Case law also supports this approach. For example, in *Evans v. Commissioner*, 54 T.C. 40 (1970), 447 F.2d 547 (7th Cir. 1971), the taxpayer (Evans) transferred his half-stake in a two-person partnership to his wholly owned corporation. The other partner did not know that the transfer had taken place; indeed, the other partner did not even know of the existence of the corporation at the time of the transfer. It was impossible that the other partner and Evans's wholly owned corporation met the *Culbertson* intent test. See *supra* text accompanying note 2. Evans's partner could not have "truly intended" to join together with a corporation whose existence he was unaware of. Nonetheless, the court held that a valid partnership existed between the other partner and Evans's corporation because they both owned capital interests in a capital-intensive partnership.

³³See section 1111(a)(3) of the Revenue Act of 1932 ("The term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this Act, a trust or estate or corporation; and the term 'partner' includes a member in such syndicate, group, pool, or joint venture, or organization.").

is the real owner of an indirect stake in a given asset pool or activity is not classified as a partner in a partnership if she is properly classified as the beneficiary of a trust or a shareholder of a corporation. A capital interest might also be classified as debt, rather than equity — a classification that would preclude a finding that the owner is a partner (at least on account of the debt claim, standing alone).³⁴

Further, a purported partnership might not constitute an entity of any sort. The code has always drawn a distinction between mere co-ownership of property and agreements to share expenses, on the one hand, and "organization[s] through or by means of which any business, financial operation, or venture is carried on," on the other hand.³⁵ Only organizations falling into the latter category have the potential to be partnerships (and then only if the organization is not a trust or a corporation).

Thus, satisfying section 704(e)(1) alone is insufficient to resolve partner status and partnership validity. The key point, however, is that the additional requirement that there be some "business, financial operation, or venture" that is not a trust or a corporation is far more permissive than the requirement announced in *Culbertson* that "the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both."³⁶

To this point I have demonstrated two propositions: (1) There is a biconditional relationship between the partnership validity test (*Culbertson*) and the partner status test (section 704(e)(1)); and (2) status and validity are jointly determined by a disjunctive linking of the two tests, so that if either status or validity is established the other follows, as long as there is some underlying business, financial operation, or venture. Both propositions were

³⁴For an excellent discussion of the debt-equity distinction in the partnership context, see Robert H. Scarborough, "Partnerships as an Alternative to Secured Loans," 58 *Tax Law.* 509 (2005). As William T. Plumb Jr. explained long ago, taxpayer motive and the existence of a non-tax business purpose are not useful factors in distinguishing between debt and equity. Plumb called these factors "merely rhetorical expression of a result, having no proper evidentiary weight in themselves." Plumb, "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 *Tax L. Rev.* 369, 412, 538-549 (1971).

³⁵*Id.*; see also section 7701(a)(2); section 761(a) and (b); see also reg. section 301.7701-1(a)(2) ("A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom"); section 708(b)(1) (partnership considered terminated if "no part of any business, financial operation, or venture of the partnership continues to be carried on").

³⁶*Culbertson*, 337 U.S. at 741.

shown in the context of a two-person partnership. I will now explain why this same logic extends to all capital-intensive partnerships, even those with more than two partners.

Take a three-partner case: C, D, and E endeavor to form an entity respected as a partnership for federal income tax purposes. Grouping C, D, and E into pairs, there are three combinations: C-D, C-E, and D-E. Each of these combinations is a potential two-person partnership for which the partnership validity and partner status tests are biconditional. Concluding that the union of C and D is taxed as a partnership is equivalent to concluding that C and D are partners for tax purposes. The idea is that every circumstance with more than two potential partners can be decomposed into a set of pairs. Once a partnership exists for at least one pair, the other putative partners need only establish that they pass the partner status test, validity of the partnership having already been established.

The only way this is not true is if the partnership validity test (*Culbertson*) must be satisfied taking into account every would-be partner and if every would-be partner must also pass the partner status test. Interrelating the tests this way necessarily implies that partnership validity and partner status are not separate inquires. Rather, if both tests must be passed for every putative partner in a multi-partner partnership, it pushes us back into the situation in which a single two-part test is used to resolve status and validity. Under this reading, however, the two parts of the test would be joined conjunctively.

Continuing with the CDE example will demonstrate why this approach is nonsensical. Suppose that C, D, and E all pass the section 704(e)(1) partner status test (they are all the real owners of their interests), that C and D pass the partnership validity test (their motive for joining together passes muster under *Culbertson*), but that the C-E and D-E pairs both flunk the partnership validity test (because one or both members of the pair lacks a satisfactory motive under *Culbertson*). The facts of the example are summarized in Table 1.

Pair	Status Test (Section 704(e)(1))	Validity Test (<i>Culbertson</i>)
CD	Pass	Pass
CE	Pass	Fail
DE	Pass	Fail

If treating the CDE partnership as a partnership for tax purposes requires that every partner pass the partner status test and the partnership validity test, CDE is not a partnership. This cannot mean that the CD pair is not a partnership. C and D have passed

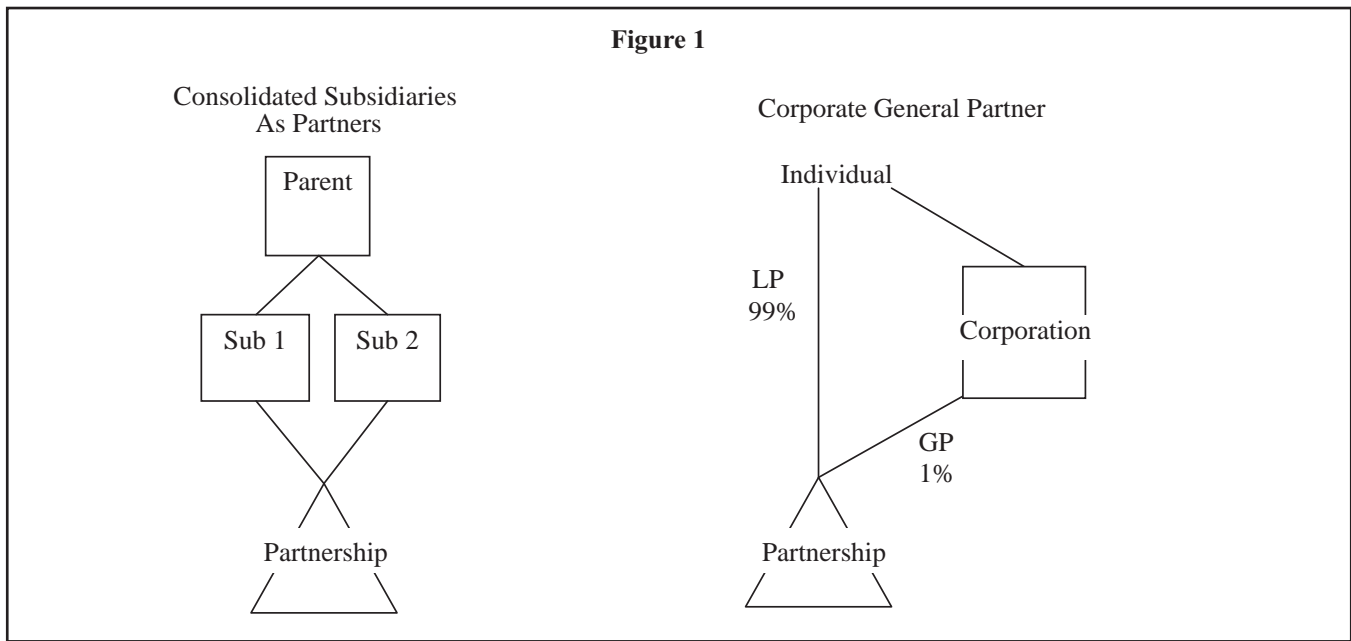
both the *Culbertson* test and section 704(e)(1), and as discussed in the two-person example above, this is the easy case for finding a valid partnership. If the CD pair is a partnership, what justification exists for the assertion that E's motivation for purporting to join with C and D is relevant to the CDE partnership's existence? Section 704(e)(1) categorically dictates that as long as E owns her interest, she "shall be recognized as a partner for purposes of this subtitle" however she happened to have acquired her interest.³⁷ It would be surprising indeed if what would be a valid partnership established for a real business purpose were invalidated by the addition of one or more persons with improper motives (in this example, E). On a good day, even the IRS acknowledges that E's status as a partner depends on section 704(e)(1), not *Culbertson*, assuming an otherwise valid partnership exists between C and D.³⁸

In concept, it would be possible to create a network of rules in which sequencing was important so that for instance, *Culbertson* would be applied once — at the inception of the partnership — to assess the federal tax validity of the entity constituted by whichever putative partners owned stakes in that venture at that time (even if there were more than two partners), and thereafter — assuming partnership validity at formation — the status of any new partners would be judged under section 704(e)(1). If current law works this way, the arguments I have made thus far regarding more-than-two-person partnerships would be suspect. For example, in assessing whether the CDE group is a valid partnership, the outcome could be different if C and D were members at inception and E joined later, compared with a situation in which C, D, and

³⁷Reg. section 1.704-1(e)(1)(iii) (last sentence) provides that "a partnership may be recognized for income [tax] purposes as to some partners but not as to others." Read in context, this cryptic statement seems to indicate that not every putative partner in a partnership is the genuine article, but that declaring that a putative partner fails the test under section 704(e)(1) does not imply that the whole partnership is to be disregarded. Although it would have been more natural if the statement were couched in terms of the status of individuals as partners (which can vary by would-be partner) rather than the validity of the partnership (an all-or-none proposition), Treasury's decision to articulate a rule about the breadth of section 704(e) in terms of partnership validity rather than partner status reinforces the tight connection between these issues.

³⁸In its appeal from an adverse decision on remand in *Castle Harbour (TIFD III-E Inc. v. United States*, 660 F. Supp.2d 367 (2009), Doc 2009-23570, 2009 TNT 205-17, appeal pending, No. 2010-70 (2d Cir.)), the government argues that the "plain language of the statute [section 704(e)(1)] makes clear that it applies to transfers of interests in *existing* partnerships, and not to the formation of new partnerships," Brief for Appellant at 52, 2010 WL 2591896 (emphasis in original).

Figure 1



E all joined together concurrently, to take two of the four possible sequences. Arguments made by the government in litigation indicate that it might maintain that partnership validity can turn on the sequence in which partners join (although it is not totally clear).³⁹

A reconciliation of *Culbertson* and section 704(e)(1) that depends on the order in which partners join the partnership is untenable. It would create arbitrary distinctions between cases that should in principle be treated the same (hence it would be unfair), it would be inefficient, and it would invite gamesmanship. To see why, imagine two groups, the CDE group and the C'D'E' group, with characteristics that are identical in every way, save one. The only difference between the two groups is that C, D, and E joined together concurrently, whereas the would-be C'D'E' partnership was initially between C' and D' — suppose E' joined some time later (assume a sufficient delay to avoid the step transaction doctrine).

If the outcomes of the partnership validity and partner status tests are as depicted in Table 1 and if sequencing is important, C'D'E' is a valid partnership only because E' joined the partnership after it was formed. Had E' been present together with C' and D' at inception, it would not have been true that C', D', and E' "really and truly intended to join together for the purpose of carrying on business

and sharing in the profits or losses or both."⁴⁰ That is, the *Culbertson* test — which we are assuming for the moment applies once at inception and not thereafter — would have been flunked.

Observe that the objective characteristics of the two groups are identical from the first moment E' joins the venture. From then on, what justifies imposing different rules on these identical groups? To make the same point more generally, under a sequence-dependent rule, similarly situated groups of taxpayers will be treated differently based on what will, in at least some cases, be a trivial factor: the order in which they acquired their interests.

A second problem with a sequence-dependent rule, besides its arbitrariness and resulting unfairness, is that taxpayers sophisticated enough or well enough advised to understand such a rule would not be deterred by it. The most obvious way to plan around an order-dependent rule is for the organizer of the venture seeking partnership status first to add corporate partners for plausible nontax reasons at inception and then wait a suitable period before adding any additional partners whose participation might call into question the entity's ability to pass muster under *Culbertson*.

Several revenue rulings support the proposition that multiple wholly owned subsidiaries of a corporate parent, or a corporation and its shareholders, can form a valid partnership with one another

³⁹See discussion *supra* note 38.

⁴⁰*Culbertson*, 337 U.S. at 741. This would have been true for C and D, but not E, and we are assuming here that all the partners, not just a subset, must pass the *Culbertson* test at the partnership's inception.

without the participation of any outside party.⁴¹ Two simple examples of these configurations are depicted in Figure 1.

The IRS's view has been that the corporate partners in these configurations are respected as valid partners even though there is, indirectly, a single owner of the partnership's assets and income, and even though the sole owner has the unilateral power to make all decisions regarding the partnership. If arrangements such as these are respected for tax purposes, any reconciliation of *Culbertson* and section 704(e)(1) that depends on sequencing simply means that careful taxpayers will have more hoops to jump through at the inception of their transactions to ensure validity and that entity structure charts will be more crowded.

That is undesirable, first, because it is inefficient. It will generate additional steps that can and must be made to appear necessary for some nontax reason germane to the partnership's business, which is usually not difficult but can add pointless friction to the system. Second, it will generate fact-intensive litigation over issues such as the genuineness of the nontax reasons for adding entity partners at the inception, which will consume enforcement resources. Ultimately it is also likely to reward those taxpayers who add the window dressing to their transactions with the greatest care. This is exactly the type of litigation (and concomitant incentive structure) that sprung up after *Culbertson* and that section 704(e)(1) was designed to curtail.

To sum up, a partnership will be respected for tax purposes if it satisfies *Culbertson*, that is, if "the partners really and truly intended to join together for the purpose of carrying on business and sharing

in the profits or losses or both."⁴² Satisfying *Culbertson*, although sufficient, should not be necessary, at least for capital-intensive partnerships. An entity also should be respected as a partnership if: (1) it conducts some trade, business, financial operation, or venture in which capital is a material income-producing factor; (2) it is not properly classified as a corporation or trust; and (3) the putative partners are the true owners of equity interests in the entity.

The IRS's Position

Although no regulation, revenue ruling, or other authoritative pronouncement from the IRS explicitly speaks to the relationship between section 704(e)(1) and *Culbertson*, something about the government's view on the issue can be gleaned from positions it has taken in litigation. The central argument that can be distilled from the government's briefs in cases in which the relationship between *Culbertson* and section 704(e)(1) is or was at issue is that partner status is a secondary question that arises only if a court first determines that the partnership is valid under the *Culbertson* test. For example, the IRS has frequently argued that if a putative partnership between A and B flunks the *Culbertson* test, it makes no difference whether A and B are the real owners of their interests in AB (and hence pass muster under section 704(e)(1)) because without a valid partnership there can be no partners.⁴³

The government made this argument in several of the cases involving the installment sale tax shelter marketed by Merrill Lynch (the shelter at issue in *ACM Partnership v. Commissioner*).⁴⁴ Recall that the basic transaction at issue in each of those cases was the same: The sheltering taxpayer formed a partnership with a tax-indifferent foreign bank; the partnership then entered into a contingent payment installment sale in which a private placement note was sold for cash and a contingent note. The idea, or trick, at the heart of the shelter was to qualify the transaction for ratable basis recovery

⁴¹*E.g.*, Rev. Rul. 75-19, 1975 C.B. 382 (four wholly owned subsidiaries of a common parent formed a valid partnership when the corporate partners "each had business reasons for existence independent of the business to be performed under the partnership agreement, and the agreement was not entered into for the purpose of avoiding or evading Federal income tax"); Rev. Rul. 93-4, 1993-1 C.B. 225, *Doc 93-13*, 92 *TNT* 256-9 (wholly owned subsidiaries of a common parent respected as separate members of a German GmbH for purposes of determining the GmbH's status under the pre-check-the-box entity classification regulations); LTR 7934096 (joint venture between two wholly owned foreign subsidiaries of U.S. parent respected as partnership even though there was a single beneficial owner); *cf.* Rev. Rul. 77-214, 1977-1 C.B. 408; LTR 8115029.

Although these rulings predate the check-the-box regulations, they still represent the IRS's view on the issue of partnerships among commonly controlled entities. The preamble to the check-the-box regulations confirms that: "Although the determination of whether an organization has more than one owner is based on all the facts and circumstances, the fact that some or all of the owners of an organization are under common control does not require the common parent to be treated as the sole owner." T.D. 8697, *Doc 96-32494*, 96 *TNT* 248-12.

⁴²*Culbertson*, 337 U.S. at 741.

⁴³A more general (but logically equivalent) way to express this argument is to claim that there is a conjunctive relationship between the partnership validity test and the partner status test, *i.e.*, that a valid partnership depends on passing both tests.

⁴⁴157 F.3d 231 (3d Cir. 1998), *Doc 98-31128*, 98 *TNT* 202-7; *Boca Investorings Partnership v. United States*, 314 F.3d 625 (D.C. Cir. 2003), *Doc 2003-1175*, 2003 *TNT* 8-7; *Saba Partnership v. Commissioner*, 273 F.3d 1135 (D.C. Cir. 2001), *Doc 2001-31675*, 2001 *TNT* 249-5; *ASA Investorings Partnership v. Commissioner*, 201 F.3d 505 (D.C. Cir. 2000), *Doc 2000-3346*, 2000 *TNT* 23-11. Although *ACM* is the most well-known of the cases involving this transaction, the argument was not raised in that case.

under the contingent payment installment regulations⁴⁵ in the face of cash flows on the sale that were heavily front-loaded (approximately 80 percent of the proceeds in the contingent payment sales was cash; the contingent note was the balance, only around 20 percent of the total consideration).

Applying the contingent payment sale regulations by their terms to those transactions resulted in massive gain to the partnership in the year of the installment sale and corresponding losses in subsequent years. If the foreign bank was respected as a partner in the year of the sale, it would absorb the massive gain (but to no ill effect, given that it is exempt from U.S. tax). That would leave equal and offsetting tax losses — unaccompanied by any economic loss — to be reaped by the sheltering taxpayer after it bought out the foreign bank for the amount of the bank's investment plus an accommodation fee for helping facilitate the transaction.

Some of the taxpayers in the cases argued, on the authority of section 704(e)(1), that the foreign banks were partners as owners of capital interests in capital-intensive partnerships. The IRS's response to their arguments, articulated nearly verbatim, was that section 704(e)(1)

provides an objective standard for determining whether a particular "person" is a "partner" in an extant partnership. Section 704(e), however, does not provide any standard for determining whether an arrangement constitutes a bona fide *partnership*, but rather assumes the existence of a genuine partnership. . . . [Section 704(e)], therefore, does not apply to sham partnerships created to implement tax-avoidance schemes, since if there is no genuine partnership, there can be no actual partners.⁴⁶

The IRS's position — that section 704(e) applies only to genuine partnerships — is unobjectionable if one accepts the view that the whole undertaking (including formation of the partnership lying at the heart of the tax shelter) is a sham.⁴⁷ The position might even be appealing, at least to those who believe that curtailing aggressive tax planning jus-

tifies whatever means the government has at its disposal, regardless of whether the result squares with legislative text or the purpose of the rules in question.

One problem with the government's argument is that it teases out only one of the two necessary implications of the biconditional relationship between the definitions of partner and partnership, and hence the interdependence of the tests used to establish partnership validity and partner status. The basis for the conclusion that *Culbertson* is applied before section 704(e) is that "if there is no genuine partnership, there can be no actual partners."⁴⁸ It is equally true, however, that without partners there can be no partnership.⁴⁹ If (as the government argues) the idea that "without a partnership there can be no partners" implies that partnership validity must be resolved first, before resolving partner status, then it is also true that "without partners there can be no partnership" implies that partner status must be resolved first, before resolving partnership validity. Both arguments have the same form, and the predicates for both arguments are true, so if one argument is correct, the other argument is correct, too. But this cannot be right; the arguments' conclusions are contradictory. Essentially, then, the government's argument proves too much. As discussed at length above, the apparent contradiction is resolved once one recognizes that partnership validity and partner status are biconditional, implying they are jointly determined based on a single test.

Another problem with the idea that *Culbertson* is applied first and section 704(e)(1) is applied second is that for several decades, questions of partner status and partnership validity have been treated as interdependent. Most notably, in the seminal Supreme Court cases addressing these issues — *Tower*⁵⁰ and *Culbertson*⁵¹ — whether a partnership existed depended on whether specific individuals would be respected as partners, and whether specific individuals would be respected as partners depended on whether the entity would be respected as a partnership. Nothing in the language of those opinions or any subsequent legislation or

⁴⁵Temp. reg. section 15a.453-1(c)(1)(i).

⁴⁶Reply Brief of Cross Appellant, *Saba*, 2001 WL 36037991, at 12. See also Brief for Appellee, *ASA Investorings*, 1999 WL 34833901, at 51.

⁴⁷Recall that in *ACM* the Third Circuit found that the principal transaction at issue — the installment sale generating a large gain followed by an equally large loss — was a sham. 157 F.2d at 247-248. The court went on to hold, however, that a portion of the transaction had economic substance because it had "objective economic consequences apart from tax benefits." *Id.* at 262. Thus, the *ACM* court did not invalidate the partnership or declare that any of the partners should not be respected as such. But see *Boca Investorings*, 314 F.3d 625; *Saba*, 273 F.2d 1135; *ASA Investorings*, 201 F.3d 505.

⁴⁸Reply Brief of Cross Appellant, *Saba*, 2001 WL 36037991, at 12.

⁴⁹Sections 761(a) and 7701(a)(2). The litany in the statutory definition of partnership — "syndicate, group, pool, joint venture, or other unincorporated organization," *id.* — has been described as offering little analytical help except "to make it abundantly clear that a partnership requires multiple members," McKee et al., *supra* note 22, at para. 3.02[1], n.46, an idea that has never been in doubt.

⁵⁰327 U.S. 280.

⁵¹337 U.S. 733.

regulation addressing the question commands that these issues be decided in series.

Nonetheless, the government persists in making arguments such as that “the plain language of the statute makes clear that [section 704(e)(1)] applies to transfers of interest in existing partnerships, and not in the formation of partnerships.”⁵² The folly of that view is apparent if one considers the facts of *Culbertson* itself. Recall that Culbertson transferred stakes in the family business to his four sons. Whether there was a partnership among Culbertson and his sons depended on whether they were partners in the business. If identical facts arose today and the government’s argument were accepted, validity of the partnership would be determined by asking whether Culbertson and his sons “really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both.” If the court found that the *Culbertson* intent test had been met, it follows that the validity of the partnership has conclusively been established. In addition — and this is the crucial point — *the status of Culbertson and his sons as partners has conclusively been established*. If partner status has already been resolved under *Culbertson*, what useful purpose does section 704(e)(1) serve? The government’s argument turns section 704(e)(1) into deadwood: It is left to apply only after the ramifications of its application have already been settled. That defies common sense.

Perhaps one could overlook the logical and conceptual problems with the government’s argument that *Culbertson* must be applied first, before section 704(e)(1), if there were some support in the code or regulations. However, the provisions that the government cites for support are unhelpful to its position. The government argues that by using the term “partnership” in section 704(e)(1) — “a person shall be recognized as a partner . . . if he owns a capital interest in a *partnership*” (emphasis added) — Congress intended that section 704(e)(1) be applied only after partnership validity has already been resolved. Based on the language of the code, it seems just as likely that Congress intended partnership validity and partner status to be decided concurrently. There is no explicit statement regarding the hierarchy or ordering of partnership validity and partner status definitions in section 704(e)(1) or in any of the other relevant definition provisions,⁵³ even though Congress clearly knows how to design such a provision when it intends to do so.⁵⁴

The regulation the government has cited in support of its argument that section 704(e)(1) presupposes the existence of a partnership is perhaps even weaker support for its position than the text of the statute. The government has repeatedly cited regulation 1.704-1(e)(1)(iv) and quoted the following sentence from that regulation: “Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the *partnership*” (emphasis added). Apparently the idea is that because of its use of the word “partnership,” the regulation should be read as supplying an ordering rule that elevates the partnership validity test above the partner status test. Read in context, that sentence offers no support for this idea. The regulation speaks to the question of when capital is a material income-producing factor in a business. Nothing in the cited paragraph, including the language quoted in many of the government’s briefs, speaks to how *Culbertson* and section 704(e)(1) should be interrelated. The government’s invocation of the regulation is a non sequitur.

Finally, the government has argued that the legislative history of section 704(e)(1) indicates that Congress intended the *Culbertson* “totality of the facts and circumstances” analysis to persist even after the enactment of section 704(e)(1). That argument is unsupported.⁵⁵ Although the legislative history does indicate Congress intended that courts inquire into whether a putative partner’s ownership stake in a partnership is real or a sham, it is apparent that in enacting section 704(e)(1), Congress intended courts to inquire into whether the putative partner’s claim of *ownership* was genuine or a sham, not into whether the partnership itself was a sham.⁵⁶ (As noted above, if the partnership

⁵⁵See excerpt from H.R. Rep. 82-586, *supra* note 25.

⁵⁶H.R. Rep. 82-586, *supra* note 23 (“Your committee’s amendment makes clear that, however the owner of a partnership interest may have acquired such interest, the income is taxable to the owner, if he is the real owner.”). This does not exhaust the government’s stockpile of arguments against applying section 704(e)(1) according to its text and purpose, but the remaining arguments are even weaker than those discussed thus far. For instance, the government has sometimes argued that the heading of section 704(e), “Family Partnerships,” should constrict its domain. See United States Response Brief Regarding 704(e) (docket no. 117), *TIFD*, at 7 n.6 (“The title of this subsection, ‘Family Partnerships,’ accurately reflects the purpose and intended scope of the statute.”). On its good days, however, the government acknowledges the weakness of this position. Brief for Appellant at 52, *TIFD*, 2010 WL 2591896; McKee et al., *supra* note 22, at para. 3.04[3][a] n.151 (collecting sources from the IRS acknowledging section 704(e)’s broad application); Arthur B. Willis et al., *Partnership Taxation*, para. 1.03[2][b] (6th ed. 1997) (“Although section 704(e) is headed ‘Family Partnerships,’ the

(Footnote continued on next page.)

⁵²Brief for Appellant at 52, *TIFD*, 2010 WL 2591896.

⁵³Sections 761(a) and 7701(a)(2).

⁵⁴See, e.g., sections 161 and 262.

itself is a sham — in the sense that it carries on no business, financial operation, or venture, and is formed solely to generate tax benefits for its partners — it does not meet the minimum requirements for entity validity under sections 761(a) and 7701(a)(2).⁵⁷

To sum up, the IRS proposes to mesh the partnership validity and partner status tests so that the taxpayer must convince the court first that the partnership satisfies the *Culbertson* test, and second that each putative partner is the owner of her interest. The argument is based on the observation that the existence of partners presupposes the existence of a partnership, so partnership validity must be decided before partner status. The oversight here, which seems obvious once it is brought to light, is that the same logic can support the opposite conclusion just as persuasively: The existence of a partnership presupposes the existence of partners, so partner status must be decided before partnership validity. Neither of the arguments is flawed if viewed on its own, but once they are considered together, both arguments collapse. If one is right, they both must be. But they both can't be right, because they point to contradictory conclusions.

Moreover, if the government were right that *Culbertson* can deny partnership validity (and hence partner status to the potential partners) for capital-intensive partnerships, then section 704(e)(1) did not lower the bar for partner status qualification. Rather, if the government were right, section 704(e)(1) imposed a new condition on top of *Culbertson* that stands in the way of achieving partner status. That, however, is exactly the opposite of what section 704(e)(1) says and according to the legislative history, the opposite of what Congress intended. To accept the government's logic that *Culbertson* must first be satisfied and then section 704(e)(1) must also be satisfied is to undermine the language and purpose of section 704(e)(1).

Impact of Check-the-Box Regulations

The check-the-box regulations should be construed as having altered at least some of the legal definitions relevant to the classification of business entities (such as partner, partnership, and corporation).⁵⁸ Maintaining different tests for the existence

of a business entity that depend on whether that entity is classified as a corporation or as a partnership, and different tests for determining if the owner of an equity stake is a partner or shareholder, is fundamentally incompatible with an elective classification regime like the check-the-box regulations.⁵⁹

The check-the-box regulations contemplate and in some cases, depend on, the existence of a single test to determine the validity of a business entity and the identity of the entity's members. (The regulations use "members" as a generic term that encompasses both shareholders and partners; the regulations also refer to members euphemistically as "owners."⁶⁰) If there is a valid business entity with two or more members, the taxpayer (that is, the entity and its members) may elect whether the entity is classified as a corporation (making the members shareholders) or as a partnership (making them partners).⁶¹ Taxpayer electivity is the whole idea behind the check-the-box regime.⁶² But electivity is sometimes a chimera unless member status and entity validity are equivalent concepts for partnerships and corporations.

The partnership validity test derived from *Culbertson* is harder to satisfy than the analogous case law test for corporations derived from *Moline Properties Inc. v. Commissioner*.⁶³ As detailed above, the *Culbertson* Court announced that partnership validity depends on whether the "partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both,"⁶⁴ making intent the sole criterion. In contrast, the *Moline Properties* Court decided that the corporate form must be respected if either (a) the corporate form is employed for the purpose of carrying on a business or (b) the corporation carries on a business.⁶⁵ The difference between the two standards is that a valid business purpose is essential under *Culbertson*, but under *Moline Properties*, as

Tax Court in *Evans v. Commissioner*, 54 T.C. 40 (1970), *aff'd* 447 F.2d 547 (7th Cir. 1971) (acq.), established that its scope encompasses all partnerships."

The government also has argued that section 704(e) has never been applied for a multimillion-dollar partnership, as though there is an unwritten size limit to its application. Brief for Appellant at 53-54, *TIFD*, 2010 WL 2591896.

⁵⁷See *supra* text accompanying notes 34 and 35.

⁵⁸See, e.g., McKee et al., *supra* note 22, at para. 3.04.

⁵⁹See Monte A. Jackel and Robert J. Crnkovich, "Castle Harbour Strikes Again," *Tax Notes*, Nov. 2, 2009, p. 591, Doc 2009-22694, or 2009 TNT 209-14 ("Intent to be a partner is no longer relevant as a matter of law in a check-the-box world [because] a business purpose to make the check-the-box election is not required.").

⁶⁰Reg. section 3.01.7701-2(a); McKee et al., *supra* note 22, at para. 3.01.

⁶¹Reg. section 301.7701-3(a).

⁶²See Notice 95-14, 1995-1 C.B. 297, Doc 95-7226, 95 TNT 145-25.

⁶³319 U.S. 436, 438-439 (1943). See McKee et al., *supra* note 22, at para. 3.03.

⁶⁴*Culbertson*, 337 U.S. at 741 (quoting *Tower*, 327 U.S. at 287).

⁶⁵*Moline Properties*, 319 U.S. at 438-439.

long as a business is actually carried on by the entity, the purpose animating its formations is irrelevant.⁶⁶

Before check-the-box, the shareholder status test was at least as easy to satisfy as the partner status test — sometimes easier. To be a shareholder for federal income tax purposes required only legal or beneficial ownership of stock, and nothing more.⁶⁷ The content of the partner status test depended on whether the partnership was capital intensive. If so, the test under section 704(e)(1) was essentially the same as the corporate test, turning on the genuineness of ownership. For non-capital-intensive partnerships, however, the partner status test was the same as the partnership validity test, that is, qualification as a partner depended on whether the partner in question intended to join together in the conduct of a business.⁶⁸

Incorporating these case law entity validity and member status tests into the check-the-box framework without first harmonizing them produces incongruous results. To illustrate, suppose (a) that *Culbertson* and *Moline Properties* transcend the check-the-box regulations for questions of partnership and corporate validity and (b) that the business in question is not capital intensive, so section 704(e)(1) is inapplicable. The owners of an eligible entity⁶⁹ satisfying the requirements to be a valid corporation but falling short of the requirements to be a valid partnership⁷⁰ are, under the check-the-box regulations, given the right to choose whether the entity is to be classified as a corporation or partnership. But the choice is not real. Choosing partnership will not bind the IRS because (by assumption) the Service can disqualify the entity as a partnership if it points out to the court that *Culbertson* is flunked. So much for electivity (and for predictability in the law).

⁶⁶See McKee et al., *supra* note 22, at para. 3.03; Martin D. Ginsburg and Jack S. Levin, *Mergers, Acquisitions, and Buyouts*, para. 901 (2010 ed.) (valid corporate formation requires no business purpose).

⁶⁷McKee et al., *supra* note 22, at para. 3.04[1]. It bears emphasis that the instrument in question must be stock, not debt. See *supra* note 34.

⁶⁸McKee et al., *supra* note 22, at para. 3.04[2] (explaining that the *Culbertson* and *Tower* tests, though articulated as tests of partnership validity, are also member status tests because in both *Culbertson* and *Tower*, “whether a partnership existed depended on whether certain individuals were partners and vice versa”).

⁶⁹An “eligible entity” is an entity with at least two owners that is not classified as a per se corporation under reg. section 301.7701-2(b). See reg. section 301.7701-3(a) (first sentence).

⁷⁰In other words, the assumption is that the entity passes the *Moline Properties* test but flunks *Culbertson*, as would be true if the entity actually carries on some operation or venture even though it was not organized for that purpose.

Similar problems exist if a different rule is used to judge when partners and shareholders will be respected as such. The check-the-box regulations contemplate that every business entity with two or more members will be classified as either a partnership or a corporation.⁷¹ If member means something different for partnerships than it does for corporations, it confounds the regulations. Whether a business entity has two or more members will sometimes depend on whether the entity is classified as a partnership or corporation. Take, for instance, a valid business entity with two members, one of whom satisfies the member status test applicable to both partners and shareholders, and the other of whom satisfies the member status test applicable to shareholders but flunks the member status test applicable to partners. If this is an eligible entity (that is, not a per se corporation),⁷² how is the entity classified?

The answer is not clear. The regulations contemplate that an eligible entity with two members must be either a partnership (by default) or a corporation (by election).⁷³ In this case, if no election is made, the default classification — partnership — does not work, because we are entertaining a hypothetical in which one of two members flunks the partner status test and hence the business entity has only one member. If it has only one member, arguably it is a disregarded entity (DE).⁷⁴ Classifying it as a DE is problematic, however. If the taxpayer had chosen to classify the entity as a corporation, it would have had two members, and under the check-the-box regulations, entities with two members cannot be DEs.⁷⁵ More generally, if member has a different meaning for partnerships and corporations, even simple examples result in circularity.⁷⁶

Problems like these are avoided only if (1) the rules regarding what it means to be a member of a partnership and a corporation are equated, and (2) the rules regarding what is required for all business entities — partnerships and corporations — to be respected for federal income tax purposes are

⁷¹See *infra* notes 79 and 82.

⁷²Reg. section 301.7701-2(b).

⁷³Reg. section 301.7701-3.

⁷⁴Reg. section 301.7701-3(b).

⁷⁵*Id.*

⁷⁶Monte Jackel and Robert Crnkovich have argued that the status of putative members must be resolved before classification of an eligible entity can take place under the check-the-box regs. See Jackel and Crnkovich, *supra* note 59, at 597. This does not solve the problem of circularity unless member is given the same meaning for corporations and partnerships (an idea they endorse). If the meaning of member is different for partners and shareholders and the difference matters in a given case, status of at least one would-be member *cannot* be resolved before the election given the assumption that status *depends on* the election.

equated. Unless that is done, the check-the-box regulations will not permit at least some eligible entities⁷⁷ to freely elect their federal income tax classification, despite the explicit statement in the regulation's text (and universal understanding) that eligible entities are free to select how they are to be classified for federal tax purposes.

Concluding that to function correctly the check-the-box regulations require unified definitions of member and entity for all business entities does not resolve if or how those regulations changed the relationship between the statutory and case law authorities that predate the check-the-box regs.⁷⁸ The key questions raised by the check-the-box regulations in this regard are (1) how member is defined, (2) how business entity is defined, and (3) how the definitions of member and business entity relate to one another.

Take the last of these three issues first. The identity of members and the existence of business entities they own must be jointly defined under a single test. Unless this is true, there will be cases in which the regulations suggest the existence of members (be they partners or shareholders) even in the absence of an underlying business entity (that is, even without a partnership or corporation), or vice versa. This cannot be. As discussed at length above regarding partnerships, unless the definitions of member and business entity are linked so that both or neither are found to exist in a given case, literal application of the check-the-box regulations would sometimes generate nonsensical results (entities with no members or vice versa).

Now return to the first two issues. For cases arising after the effective date of the check-the-box regs, the courts should define business entity by reference to *Moline Properties* and its progeny (and hence diminish further the continuing significance of *Culbertson*), and they should define member using the minimal requirements applicable to assessing the status of corporate shareholders and partners in capital-intensive partnerships. In other words, courts should inquire whether the putative

shareholder or partner, as the case may be, is the true owner of her claim and whether the claim is properly classified as an equity interest in the business entity, and nothing more. This is the preferred approach for functional reasons and out of respect for precedent and the language of the code.

Begin with the idea that the putative owner of a partial equity stake in a capital-intensive business will be respected as a partner for tax purposes if she is the true owner of her interest, assuming the business is not in corporate form. That result is dictated by section 704(e)(1). It must be true that the joint venture between all the partners is a partnership for tax purposes. The only way that is not true is if one insists on clinging to the idea, sometimes floated by the government in litigation and occasionally accepted by the courts, that *Culbertson* can still apply in that situation to invalidate a partnership. But as explained above, that line of reasoning would read section 704(e)(1) out of the code. Further, it is inconsistent with the history of the 1951 legislation enacting the predecessor of section 704(e)(1), which teaches that the permissive definition of partner in section 704(e)(1) is designed to displace the *Culbertson* intent test in just these circumstances.⁷⁹

If *Culbertson* does not (or at least should not) supply the definition of business entity (the generic term for partnership or corporation, as the case may be), the question becomes whether there is some other extant definition that is congruent with section 704(e)(1). Happily, there is. In particular, if business entity is defined by reference to *Moline Properties*, the business entity validity test is satisfied if the entity is formed for the purpose of engaging in some business activity or if some actual business is conducted by the entity.⁸⁰ That accords with the statement in the check-the-box regulations that a "joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom."⁸¹ Note the absence of any requisite intent in that locution.

Defining business entity by reference to *Moline Properties* has additional virtues besides being in accord with section 704(e)(1). Doing so meshes with the idea, implicit in the language and structure of the entity classification regulations, that the two general categories of entities — trusts and business

⁷⁷See *supra* note 69 (defining eligible entity).

⁷⁸Willis et al., *supra* note 56, at para. 1.06[3][c] ("the check-the-box Regulations may make the technical existence of a partnership irrelevant because those Regulations define a partnership as a business entity that is not a corporation and has at least two members"); McKee et al., *supra* note 22, at para. 3.03 ("As of this writing, it seems clear that the substantive requirements for partnership and corporate entity recognition must merge because every multi-member 'business entity' must be classified as either a corporation or a partnership. . . . What is not clear, however, is whether the traditional, and arguably more exacting, substantive requirements for partnership recognition will yield completely to lower threshold requirements" applied to corporations.).

⁷⁹See *supra* notes 23 and 30-32.

⁸⁰*Moline Properties*, 436 U.S. at 439.

⁸¹Reg. section 301.7701-1(a)(2).

entities — are both mutually exclusive and collectively exhaustive.⁸² Wholly passive investment trusts with multiple classes of ownership interest are ordinarily excluded from the definition of trust under these regulations (and hence classified as a business entity).⁸³ No one would argue seriously that the owner of a certificate representing a beneficial interest in such an investment trust “really and truly intend[s] to join together for the purpose of carrying on business”⁸⁴ with the other certificate holders, as is required to pass the *Culbertson* intent test. Yet, if the investment trust cannot be a valid trust for tax purposes under the regulations and it is likewise precluded from qualifying as a business entity because of lack of the intent required by *Culbertson*, some entities fall into a hinterland between business entities and trusts. It is unclear how entities falling into this gap would be classified for federal tax purposes. That is antithetical to the certainty and predictability Treasury sought when it designed the check-the-box regulations and to the idea that the classification regulations exhaustively delineate the federal tax status of all entities.⁸⁵

Moreover, there is an established line of case law predating the check-the-box regulations that applies *Moline Properties* to questions of partnership validity.⁸⁶ There is no similar line of case law applying *Culbertson* to the question of corporate validity. It follows that defining business entity by reference to *Moline Properties* corresponds more closely with the case law history of entity classification, which, after all, was the point of departure for the check-the-box regulations.

Surprisingly, taxpayers are not making the argument that the check-the-box regulations forced a harmonization of the membership status and entity validity rules, even when the argument would strengthen their case. *Southgate Master Fund LLC v.*

United States is an example.⁸⁷ The case involves the transfer of high-basis/low-value distressed debt from a foreign owner (an organ of the Chinese government) to a U.S. investor. The U.S. investor and the foreign owner formed a partnership. The U.S. investor contributed cash, and the foreign owner contributed built-in-loss debt. The U.S. investor then purchased the foreign owner’s partnership interest and hence stepped into the foreign owner’s shoes for purposes of section 704(c) as to the built-in-loss debt. (The partnership did not make a section 754 election, and the transaction was consummated before the 2004 amendment of section 704(c) that prevents the use of partnerships to traffic in built-in-loss property.) The district court sustained the IRS’s assessment against the partnership, finding that the entity used to shift the tax loss to the U.S. investor was a sham partnership.⁸⁸

On appeal, the parties disputed what standard should be used to judge the validity of the partnership. The taxpayer argued that the partnership is valid regardless of what validity test is applied, but that the applicable test should be taken from either *Moline Properties* or section 704(e)(1).⁸⁹ The government argued that *Culbertson* controls and that the taxpayer’s reliance on *Moline Properties* is “misplaced” because “*Moline* involved corporations, not partnerships” and thus has “no bearing on the question whether parties have formed a genuine partnership for tax purposes.”⁹⁰ The government cited in support of its proposition cases involving tax years before the effective date of the check-the-box regulations.⁹¹ In response, the taxpayer pointed out that courts, including the Tax Court, have applied *Moline Properties* to assess partnership validity.⁹² Surprisingly, however, the taxpayer did not make the argument that for years after the effective date of the check-the-box regulations, there is a single test governing the validity of all business entities and so the government’s argument — that

⁸²Reg. section 301.7701-2(a) (“a business entity is any entity recognized for federal tax purposes . . . that is not property classified as a trust under section 301.7701-4”) (emphasis in original); reg. section 301.7701-1(b) (stating that all organizations are classified according to the entity classification regulations, with explicit exceptions).

⁸³Reg. section 301.7701-4(c)(1). The exception to this rule is for cases in which (1) the trust is formed to facilitate direct investment in the trust corpus and (2) the existence of multiple classes is incidental to facilitating that direct investment. See reg. section 301.7701-4(c)(2), Example 4.

⁸⁴*Culbertson*, 337 U.S. at 741.

⁸⁵T.D. 8697 (“An organization that is recognized as a separate entity for federal tax purposes is either a trust or a business entity”); McKee et al., *supra* note 22, at para. 3.02[4] (explaining that the business entity and trust classifications are collectively exhaustive); Bittker and Lokken, *supra* note 23, at para. 58.2.1 (same); see also *supra* note 82.

⁸⁶See McKee et al., *supra* note 22, at para. 3.03[2] n.125 (collecting cites).

⁸⁷651 F. Supp.2d. 596 (N.D. Tex. 2009), *Doc 2009-18785*, 2009 TNT 160-6, *appeal docketed*, No. 09-11166 (5th Cir.).

⁸⁸*Id.* at 658. The legal conclusion that the partnership is a sham is ripe for reversal given the trial court’s findings that the partnership was formed to pursue “a transaction that had a very reasonable expectation of profit,” *id.* at 655, and that the principals “believed that they could earn a profit . . . and would have done this deal regardless of whether or not it had any tax benefits.” *Id.* at 617.

⁸⁹Brief for Appellant at 46-49, *Southgate Master Fund*, No. 09-11166 (5th Cir.).

⁹⁰Brief for Appellee/Cross-Appellant at 58-59, *Southgate Master Fund*.

⁹¹*Id.* (citing *ASA Investments*, 201 F.3d 505, and *Saba*, 273 F.3d 1135). These cases are mentioned above. See *supra* text accompanying note 44.

⁹²Appellant/Cross-Appellee’s Response and Reply Brief at 28-29, *Southgate Master Fund*.

there are separate tests for corporate and partnership validity — is no longer true, if it ever was.⁹³

Why aren't taxpayers raising the argument that the check-the-box regs further undercut the continuing vitality of *Culbertson*? This is puzzling, particularly given the preeminent counsel employed by the taxpayers in these cases and identification of the argument in the leading treatises on partnership taxation.⁹⁴ Whether taxpayers will raise the argument in future cases remains to be seen.

To summarize, for the check-the-box regulations to function correctly, a single meaning must be assigned to the term "member" (the generic moniker for partner and shareholder) and also to the phrase "business entity" (generic for partnership and corporation). If, for example, partnership is defined by reference to *Culbertson* and corporation is defined by reference to *Moline Properties*, the basic goals of the regulations — simplicity and electivity — are frustrated. In applying the check-the-box regulations, the definition of business entity should be drawn from *Moline Properties* and the definition of member should be drawn from the rule used to determine the identity of shareholders (or, equivalently, partners in capital-intensive partnerships⁹⁵). This approach is most (although not perfectly) consistent with existing authorities, including the rule that the entity classification regulations determine the classification of all organizations respected as separate entities for tax purposes.⁹⁶

Relationship to Economic Substance Doctrine

How do questions of partnership validity and partner status relate to the economic substance doctrine?⁹⁷ Questions of partnership validity and

partner status frequently arise in the context of highly engineered transactions involving aggressive tax planning. Of course, those are the very same types of transactions that most often provoke economic substance doctrine arguments by the government. Because application of the doctrine depends at least in part on the taxpayer's motive for entering into the transaction, it is possible that what I have said to this point is largely moot. The organizing principle of this article has been that no particular taxpayer motive should be necessary to establish entity validity or member status for partnerships — indeed, for reasons explained at length in the preceding section, this should be true for business entities more generally.⁹⁸ This principle would be moot if some supervening legal rule such as the economic substance doctrine elevates inquiry into taxpayer motive to a brooding omnipresence.

Applying the economic substance doctrine to questions of entity validity makes little sense as a conceptual matter. Recall that some business activity must be conducted by an entity for it to be valid for tax purposes. We know this because the entity classification regulations require that all business entities conduct some business, financial operation, or venture.⁹⁹ If the underlying activity is undertaken solely to generate tax savings, the activity does not count in favor of validity.¹⁰⁰ Hence, a partnership formed to conduct an activity motivated solely by tax avoidance does not pass the minimum requirements for entity validity. That conclusion does not depend on the economic substance doctrine. Rather, it is intrinsic to the entity classification rules themselves.

However, if the underlying activity conducted by the partnership has some legitimate nontax purpose, the choice to pursue that activity in partnership rather than corporate form (or vice versa)

⁹³Another recent case involving whether individuals are partners in tax years postdating the effective date of the check-the-box regulations is *Virginia Historic Tax Credit Fund 2001 LLC v. Commissioner*, T.C. Memo. 2009-295, Doc 2009-28093, 2009 TNT 244-23, *rev'd*, No. 10-1333 (4th Cir. 2011), Doc 2011-6626, 2011 TNT 61-14. The taxpayer argued that the controlling test for partner status is section 704(e), and the government responded by arguing that the partnership in question was not capital intensive, so *Culbertson* controlled. The Tax Court applied *Culbertson* but held in the taxpayer's favor nevertheless. Like the taxpayer in *Southgate Master Fund*, the taxpayer in *Virginia Historic Tax Credit Fund* did not make an argument based on the check-the-box regulations even though, if accepted, that argument would have worked in its favor. The Fourth Circuit assumed *arguendo* that the partnership was valid and held in the commissioner's favor under section 707. See also *Historic Boardwalk Hall LLC v. Commissioner*, 136 T.C. No. 1 (Jan. 3, 2011), Doc 2011-80, 2011 TNT 2-15.

⁹⁴McKee et al., *supra* note 22, at para. 3.03; *supra* note 78.

⁹⁵See section 704(e)(1).

⁹⁶See *supra* note 82.

⁹⁷In this section, I focus on the economic substance doctrine. Similar questions can be asked regarding related doctrines and

(Footnote continued in next column.)

rules (such as the sham transaction doctrine, the sham entity doctrine, and the partnership antiabuse regulation). Some of these doctrines and rules are arguably subsumed by the codified economic substance doctrine but to a degree that is currently unclear. For analyses of the relationship between the codified economic substance doctrine and the partnership antiabuse regulation, see Howard E. Abrams, "Did Health Care Reform Repeal the Partnership Anti-Abuse Rule?" 51 *Tax Mgmt. Memo.* 299 (2010); James B. Sowell, "The Partnership Anti-Abuse Rules: Where Have We Been and Where Are We Going?" 89 *Taxes* 69 (2011); Monte A. Jackel, "Subchapter K and the Codified Economic Substance Doctrine," *Tax Notes*, July 19, 2010, p. 321, Doc 2010-13951, or 2010 TNT 138-4.

⁹⁸Although no particular motive ought to be necessary, proof of a nontax business motive might be sufficient to validate an entity or its members. See *supra* note 20.

⁹⁹Reg. section 301.7701-1(a)(2); see also sections 761(a) and 7701(a)(2).

¹⁰⁰*Boca Investorings*, 314 F.3d 625; *Saba*, 273 F.3d 1135; *ASA Investorings*, 201 F.3d 505.

should not be scrutinized under the economic substance doctrine. It is usually the case that taxpayers choose to form partnerships, in contrast to corporations, solely or at least primarily for tax reasons. Applying the economic substance doctrine to the choice to do business in one form rather than another will result in inappropriate application of the doctrine in situations to which it ought not apply. Taken alone, the choice to conduct business through a partnership rather than a corporation is utterly benign. That choice should not justify disregarding the application of technical rules in favor of supervening judge-made doctrines like the economic substance doctrine and its kin.

The essential difficulty with applying the economic substance doctrine to the formation of a fictitious legal entity is that there is never any substance to such an entity apart from its form. In that context, form is substance in the truest sense since the entity is imaginary. As the JCT has observed, the economic substance doctrine is “not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages.”¹⁰¹ The choice to use the partnership form is just such a basic business transaction and should be immune from attack under the economic substance doctrine.¹⁰² As Charles Kingson pointed out long ago, an “attempt to attribute economic substance to what is only a change in form of asset ownership must end in confusion and futility. . . . The fallacy [common to such attempts is the] assumption that economic substance can be found in a transaction whose essence is form.”¹⁰³

Although there are outliers, most cases discussing the application of the economic substance doctrine to questions of entity validity are consistent with that view. Historically, the government has prevailed on the “sham entity” theory, shorthand for the idea that the entity itself lacks economic substance, only when the business activity or venture conducted by the entity was itself motivated solely by tax avoidance.¹⁰⁴ In cases in which there has been some nontax purpose for the underlying

activity conducted by the entity, the entity has been respected even when courts have found that tax avoidance was among the main reasons for the entity’s formation.¹⁰⁵ Cases diverging from this pattern are often badly reasoned.¹⁰⁶

My own view, therefore, is as follows: Questions regarding antiabuse rules, including the economic substance doctrine, should be independent of questions of partnership validity and partner status, merging only when there is no nontax purpose for a partnership’s formation. In cases of the latter type, invalidity can be predicated on alternative, although essentially equivalent, grounds: that the partnership was formed for no legitimate business, financial operation, or venture and hence flunks the requirements of sections 761(a) and 7701(a)(2) and reg. section 301.7701-1(a)(2); or that the entity itself is a sham.

As reflected by the position it has taken in recent litigation, the government also argues that the law surrounding partnership validity is distinct from the economic substance doctrine, although the government’s reasoning is different from mine. In *Castle Harbour*, for example, the government has abandoned its argument that the underlying transaction lacks economic substance, having lost on that issue at trial and again on remand.¹⁰⁷ In its second appeal to the Second Circuit, however, the government persists in asserting that the partnership should not be respected as a valid entity.¹⁰⁸ Likewise, in *Southgate Master Fund*, the government articulates its position on appeal as being premised on alternative arguments, including that the partnership should be disregarded as a sham partnership (because it does not satisfy *Culbertson*) and that the underlying transaction lacks economic substance.¹⁰⁹ The government is quite clear that it believes it could win on any of the various theories it has articulated on appeal.¹¹⁰

By arguing that the taxpayers in these cases must surmount the *Culbertson* test, the government is in essence arguing that nontax business purpose for the underlying transaction is conceptually distinct

¹⁰⁵E.g., *ACM*, 157 F.3d 231; *Chisholm v. Commissioner*, 79 F.2d 14 (2d Cir. 1935); *Salina Partnership v. Commissioner*, T.C. Memo. 2000-352, Doc 2000-29371, 2000 TNT 221-7.

¹⁰⁶*Merryman v. Commissioner*, 873 F.2d 879 (5th Cir. 1989).

¹⁰⁷Brief for Appellant at 32 and n.14, *TIFD*, 2010 WL 2591896.

¹⁰⁸*Id.* at 45 (listing as the first argument on appeal whether *Castle Harbour* was “a valid partnership from its inception”). As pointed out by *Castle Harbour*’s lawyers, this is not really the issue given that the partnership existed among General Electric subsidiaries before the transaction that the government objects to was undertaken. Brief for the Plaintiff-Appellee at 30, 2010 WL 2591896.

¹⁰⁹Brief for the Appellee/Cross-Appellant, 2010 WL 3761118.

¹¹⁰*Id.*

¹⁰¹See JCT, *supra* note 2, at 152. See also H.R. Rep. No. 111-443 at 296.

¹⁰²If the partnership engages in a transaction that lacks economic substance, the government should be free to attack that underlying transaction.

¹⁰³Charles I. Kingson, “The Deep Structure of Taxation: Dividend Distributions,” 85 *Yale L.J.* 861, 865 (1976).

¹⁰⁴E.g., *Slifka v. Commissioner*, 182 F.2d 345 (2d Cir. 1950). See also cases cited at *supra* note 44.

from and does not automatically satisfy the intent test for entity validity. In other words, the government has been pressing the argument that partnerships should be subject to even more searching inquiry into taxpayer purpose than that required by the economic substance doctrine. However, by arguing that section 704(e) validates the *Southgate Master Fund* and *Castle Harbour* partnerships, the taxpayers are arguing (consistent with the thesis of this report) that questions of entity validity and member status do not necessarily depend on taxpayer purpose.

To summarize, the economic substance doctrine, which depends in part on taxpayer purpose, is often brought to bear on tax-focused transactions undertaken in partnership form. A question therefore arises whether the economic substance doctrine and similar rules in effect reinserted considerations of taxpayer purpose into entity validity and member status determinations that many believe were stricken from those validity and status determinations by section 704(e) and the check-the-box regulations. The economic substance doctrine should not apply to questions of entity validity or member status. The choice to form an entity is among the basic business transactions that should be immune from attack under the economic substance doctrine

“because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages.”¹¹¹

Concluding Comment

We have come full circle: In the congressional reports accompanying section 704(e)(1), both the House and Senate committees explained that they saw “no reason for applying different principles to partnership income.”¹¹² Given the schemes then popular, the legal principle at play was the assignment of income doctrine rather than the economic substance doctrine. Considering things at a higher level of generality, though, the commonality in the government’s position then and now is apparent: Despite congressional attempts to “harmonize the rules”¹¹³ governing partnerships and other forms of business and property ownership, some continue to believe that partnerships should be singled out for special scrutiny.

¹¹¹See JCT, *supra* note 2, at 152. See also H.R. Rep. No. 111-443 at 296.

¹¹²H.R. Rep. 82-586; S. Rep. 82-781.

¹¹³*Id.*