Time to Banish Partnership Hybrids from Partnership Taxation?

Author : Charlene D. Luke

Date : December 16, 2019

Christine Hurt, Partnership Lost, 53 **U. Rich. L. Rev.** 491 (2019).

Christine Hurt's Partnership Lost uses the developmental history and law of corporations and "uncorporations" to examine whether a principled justification exists for the differing tax regimes for subchapter C corporations as compared to subchapter K partnerships. As her Milton-evoking title suggests, Hurt describes an early, prelapsarian partnership state, dating to the creation of the income tax. The early partnership form did not spare its owners from personal liability, did not grant them dominion over an entity with perpetual life, did not provide them with the ability to transfer ownership freely, did not permit them to rely passively on the managerial efforts of others, and did not allow them to circumvent fiduciary obligations to each other and to the partnership.

Hurt describes the modern "hybrid" partnership in comparison to this early partnership model. She sets out the developments in the uniform acts and state laws, particularly those of Delaware, that have since allowed partnership hybrids to acquire desirable corporate characteristics, such as limited liability, passive investors, and centralized management, while remaining partnerships for tax purposes. The hybrid partnership, as an "uncorporation," can avoid certain governance and other requirements. "The backstops against managerial opportunities" applicable to corporations often do not apply. The result is that "[t]he hybrid entity is more corporation-like than the corporation."

These developments did not occur in a void. As Hurt explains, tax partnerships have generally enjoyed an overall tax rate lower than the aggregate tax rate faced by corporations and their owners. Those steeped in entity taxation will recognize that the characteristics missing from the posited early partnership form are essentially the Kintner factors from tax law, which prior to 1997 were used to evaluate on a case-by-case basis whether a state law entity would be taxed as a subchapter K partnership or as a C corporation. Current tax law's check-the-box regulations, which replaced the *Kintner* entity classification regulations, now allow virtually any unincorporated, multi-owner, domestic business to be taxed under subchapter K.

The tax arbitrage possibilities opened up by the advent of check-the-box have been written about widely, but Hurt highlights that the impact of *Kintner* factor repeal was not limited to the tax sphere. Hurt explains that the general partnership constrained "agency problems more effectively than the corporate structure," and "[a]rguably, the presence of those partnership characteristics served as necessary backstops to managerial opportunism, and made other agency safeguards present in corporations unnecessary for investor-partners." Loss of the *Kintner* factors meant loss of their "attempt to isolate the fundamental tension in corporate law: the separation of ownership and control." Hurt thus provides a critique of the check-the-box regulations grounded in governance considerations that complements critiques grounded in tax policy. By gathering into one article the major developments in the tax and non-tax law of uncorporations, Hurt makes starkly clear the fig-leaf dimensions of the justifications for the check-the-box regulations.

Hurt argues that modern partnership hybrids have fallen from the early partnership form state of grace and should not enjoy the fruits of pass-through taxation. Hurt does not rule out that an integrated tax for business entities may be the better approach. But, assuming a continued division between pass-through and corporate taxation, she suggests three substantive characteristics that could provide support for offering some entities pass-through taxation. These three characteristics are (1) smaller size, including consideration of "income, revenues, or assets" and not simply the number of owners; (2) active involvement of owners, including use of the Howey test from securities law to distinguish owners who are like sole proprietors from passive investors who intend to profit "solely from the efforts of others"; and

(3) the absence of owners' ability to demand payment of investment returns through buybacks or distributions. Application of these characteristics would support allowing "active owners of small, livelihood businesses" to remain tax partnerships, but would prevent other entities and owners from accessing pass-through taxation. Elsewhere in the article, Hurt discusses differences in the contracting abilities and fiduciary obligations among entities, but stops short of discussing whether this could change which entities should be eligible for pass-through taxation.

Hurt contends that now is an opportune time to banish hybrid partnerships from pass-through taxation. Because of the reduction to the dividend tax rate (added in 2003) and to the overall corporate tax rate (added for 2018), the statutory rate differential between tax partnerships and C corporations is smaller than it has been for some time. As a result, the expulsion may be less painful. Hurt also notes that given the current similarity in tax rates among business entities, the C corporation might even be a preferred form. Hurt notes, "The ultimate question is this: If there is no tax advantage to being either a corporation or a partnership, then which form emerges the victor?" Hurt speculates that, in spite of the contractarian flexibility available to hybrid partnerships, state law corporations would be preferred because of the various transaction costs associated with subchapter K.

Hurt's article provides an engaging overview of the co-development of subchapter K access and uncorporation law. To be sure, the breadth of coverage means that the impact on that co-development of tax-focused nuances—such as the differences between the pass-through regimes of subchapter K and subchapter S—does not receive elaboration. But the article is not aimed at critiquing the details of pass-through taxation; rather, it makes an argument grounded in business entities law. Hurt writes that in a system where "entities classified as partnerships can bear more corporate characteristics than partnership characteristics, providing those entities with tax advantages originally reserved for small, livelihood businesses seems perverse." Hurt is persuasive in demonstrating that, having clothed themselves with the characteristics of corporations, hybrid entities should not continue to have access to pass-through taxation by mere avoidance of formal incorporation.

Cite as: Charlene D. Luke, *Time to Banish Partnership Hybrids from Partnership Taxation?*, JOTWELL (December 16, 2019) (reviewing Christine Hurt, *Partnership Lost*, 53 **U. Rich. L. Rev.** 491 (2019)), https://tax.jotwell.com/time-to-banish-partnership-hybrids-from-partnership-taxation/.