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PARTNERSHIPS, LIMITED LIABILITY COMPANIES, AND TAXES: A COMMENT ON THE SURVIVAL OF ORGANIZATIONAL FORMS

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In *The Deregulation of Limited Liability and the Death of Partnership*, Professor Larry Ribstein predicts the "Death of Partnership" in two easy steps. In the first step, Ribstein argues that most investors and agents prefer both limited liability and the organizational advantages of the corporate invention, but that they nevertheless may choose the partnership form because the corporate form results in two-tier taxation. The second step of the analysis points to the development of the "Limited Liability Company" [LLC], which allows some firms, in some states, to enjoy limited liability without the extra tax cost, or additional level of taxation, traditionally associated with incorporation. Essentially, the claim is that firms would prefer to enjoy *both* one-tier taxation and limited liability. Ribstein predicts that partnerships will disappear because they offer the former but not the latter of these attributes. Large, widely held corporations also would overwhelmingly prefer the LLC form, under this view, but for Congress' barring their migration to one-tier taxation.[1]

There are a number of reasons to question Ribstein's prediction and normative posture. In Part I, I offer a few cautionary reminders from history. In Part II, I discuss the problem and perspective of creditors of the firm. In Part III, I draw on an earlier work[2] that argues that two-tier taxation may have desirable aspects. Finally, Part IV suggests a different way of understanding choices as to organizational form. Professor Ribstein implies that choice and flexibility are almost always a good thing; I

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* Class of 1962 Professor of Law, University of Virginia. I am grateful to Hideki Kanda for ideas and comments.

1. *See* Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211, 250-51 (1991) (widely traded corporations remain unable to migrate to master limited partnership form); Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417 (1992) (disapproving of this policy while noting that the policy encourages the death of partnerships).

2. *See* Kanda & Levmore, *supra* note 1.

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attempt to demonstrate that the problem is more complicated than it first appears.

I.

Despite Ribstein's ambitious prediction, the historical record indicates that partnerships multiplied even when the corporate tax rate was relatively low. During many eras of tax history, even when incorporation was both a tax bargain (at least for firms that could defer distributions) and the easiest route to unlimited liability, many investors elected the partnership form. Ribstein is satisfied to note that because partnerships were formed before 1909—before the enactment of the first corporate income tax—they may have unusual origins.[3] The larger point, however, is that in many years since that time, corporations were thought to be tax advantaged, yet there has never been much of a partnership shortage. Similarly, it is useful to note that the present two-tier corporate taxation substantially burdens corporations because the first, or corporate level, tax rates are higher than individual rates and because the Internal Revenue Code now taxes appreciated assets (when sold or distributed) at both the corporate and shareholder levels. Nevertheless, firms that might appear to benefit from the tax treatment of partnerships, in particular the ability to pass losses through and not merely carry them forward with restrictions, still gravitate toward the corporate form. Examples of enterprises that seem to find the corporate form worthwhile, even though the partnership form would seem to be tax advantaged, are readily found in Silicon Valley.[4]

It is also noteworthy that partnership tax treatment often is more favorable than the simple aggregate of individual treatments. As partners come and go, they may be able to shift interests among themselves to defer recognition.[5] Stated simply, it is difficult for the Internal Revenue Code to have provisions that make all investors indifferent between operating as a proprietorship or as a partnership. When a partner leaves a partnership, the question is which inside assets should be viewed as sold to, or sold for the benefit of paying off, this partner. This either requires rules of thumb, which are generally inexact and thus either too friendly

3. Ribstein, *supra* note 2, at 420.

4. *See* Joseph Bankman, *The Effect of the Net Operating Loss Rules on Investment in the Venture Capital Industry* (forthcoming paper) (copy on file with author).

5. *See* William D. Andrews, *Partnership Distributions: Inside Basis Adjustments and Hot Assets* (forthcoming in *Tax Law Review*) (copy on file with author).

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or unfriendly, or gives the partnership's tax planner a chance to identify specific assets, tailored to the tax circumstances associated with the departing partner. A truly neutral rule, on the other hand, might require partnerships to identify, on an ongoing basis, all the assets they acquire as belonging to one partner or another. Thus there would be no more or less flexibility when a partner departs than when a proprietorship is sold. It goes without saying that this sort of system would involve enormous administrative costs.

In short, it is probably a mistake to think of one-tier partnership taxation as the ideal against which to measure the corporate tax system. The details of partnership taxation, and especially its aggregation and disaggregation rules, almost inevitably make it attractive or unattractive to particular investors (both as compared to corporations and as compared to individual tax treatments). Any migration to the LLC form—or, for that matter, any disinclination of firms to become LLCs despite some of that form's advantages—is at least in part a comment on whether various types of taxpayers can exploit the applicable pass-through taxation rules.

II.

Imagine that Professor Ribstein's prediction is correct and that partnerships decrease in number while LLCs increase. Imagine further that this development does not reflect a tax regime in which the LLC (that is, the partnership) form is simply more attractive than both the corporate and individual forms. The obvious way to interpret such a development would be to say that investors willingly accepted the legislature's offering of limited liability and that noncontractual creditors lost in the bargain. Ribstein is sufficiently impressed with contractual creditors' ability to protect themselves (with higher interest rates or personal guarantees that essentially return the arrangement to one with unlimited liability) and sufficiently unimpressed with the existing tort system (which generates most of the creditors who are unable to bargain in advance with the debtor firm) to welcome this predicted shift to limited liability. Indeed, it appears that he favors permitting the *midstream* migration of existing firms from partnership to LLC form, even though many of these firms' contractual creditors will be caught by surprise.

My views on the tort system and the transaction costs of changing contract default rules differ, but in this Comment I wish to focus on another aspect of the problem. LLCs can be understood as the product of competition for tax revenue among states and of competition among in-

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terest groups within a state. Because partnerships may wish to become LLCs precisely because such a change of form alters the rules of the game and transfers wealth from some creditors to the LLC,[6] one naturally might wonder how responsive state legislatures are likely to be to investors in partnerships and to the creditors of these partnerships.

Arguably, state legislatures favor the partners (and offer them limited liability in midstream) simply because debtor firms are likely to be a potent interest group with the ability to threaten to move to a competing state. Accordingly, it is possible that states perceive that they must offer the LLC form or risk losing an important part of their tax base to other states. In contrast, it is plausible that the disadvantaged creditors are harder to identify and organize, and somewhat less mobile. This view of the origin and spread of the LLC form suggests that it is more an unfortunate product of interest-group politics than a frontier-expanding innovation.

Of course, there are contrary arguments. For instance, existing taxes, constraints on raising capital, and other regulations and arrangements themselves could be the products of such interest-group pressures. If so, the best public policy would allow winning coalitions to form and reform without any sporadic cries and interventions by academic (or judicial) referees. There is thus reason to express caution in the face of Professor Ribstein's enthusiastic welcome of the LLC form. I would prefer to think about the interest group stories this development represents and to examine the possibility that some competition among states is better than others. In other words, Ribstein essentially asserts both that firms should be able to choose among forms as they like and that limited liability should be freely available, even when unnecessary for the pooling of capital. In contrast, the prospect of undeterred negligence, increased creditor transaction costs, inefficient interstate competition, and problematic capture by one interest group leads me to think that Ribstein's assertions need more support.

6. The wealth transfer would occur either because the creditors are past or potential tort claimants who cannot bargain with the debtor firm, or because the change increases the risk associated with contracts that have already been bargained. It also should be noted that both Ribstein and I assume that LLC status conferred in one state in fact would be worth something in a battle against creditors litigating in another state.

III.

In a recent article,[7] Professor Hideki Kanda and I suggested that the separate tax on corporations may facilitate organizational efficiency. We explored the possibility that the separate tax causes differently situated shareholders to agree on the timing of dispositions of corporate assets. Without the separate tax, and with pass-through tax treatment, high-tax-bracket investors would prefer to defer sales and other recognition events when low-tax-bracket shareholders might be more eager for the corporation to recognize gain in order to invest elsewhere or to substitute other assets in place of those just sold. Two-tier taxation, we argued, can be understood as a means of minimizing agency costs that otherwise would be expended in organizing disparate investors and instructing their agents who control disposition decisions. Professor Ribstein argues that, if we are correct, we have only identified a reason investors and their agents might choose the corporate form, even when it comes at a tax cost, and that we have not established a need for *mandatory* corporate taxation. Investors who valued this agency-cost-minimizing device could opt for two-tier taxation, while other investors could prefer single taxation. From Ribstein's perspective, everyone should be entitled to one-tier taxation and limited liability, while those who wish to do so can pay a tax price for an agency-cost-reducing device. Although our argument was primarily a positive argument about a hidden virtue and an explanation of the separate corporate tax, a few points should be noted regarding the case for mandatory corporate taxation.

The problem with a completely voluntary system is that firms would minimize their taxes by moving back and forth between singly and doubly taxed categories irrespective of agency costs. If the separate corporate tax were relatively low and the second tax were not imposed until a distribution occurred, many firms would find it worthwhile to volunteer for two-tier taxation and defer distributions long enough to save on their taxes in comparison to the one-tier tax burden. And if the first tier were expensive, firms would opt for one-tier tax treatment even if they preferred the separate corporate tax as a clever equalizer, or agency-cost-minimizing device. Ideally, the overall costs of two-tier taxation should be the same as one-tier taxation. Investors (and their firms) could pay two smaller taxes, instead of a single, equivalent (partnership or proprietorship) tax to equalize attitudes towards asset dispositions. The prob-

7. *See* Kanda & Levmore, *supra* note 1.

lem, however, is that there is no controlling or predicting how much time will pass until investors pay the second tax. If the first tax is too high or the second tax occurs relatively soon, investors will prefer one-tier taxation; if the first tax and the present value of the second are low, investors will prefer two-tier taxation. In short, it might be desirable to offer two-tier taxation as an option, or even as a low-cost option, to firms with investors in disparate tax circumstances. It is, however, difficult to design a two-tier tax that is neither so expensive as to discourage those who could use it nor a windfall for those who have no need for an equalizer.

One way to prevent these windfalls (and inefficient choices as to form simply for the purpose of gaining tax advantages) is to limit movement between one- and two-tier tax forms—and this is the justification for mandatory two-tier taxation. Investors must choose at the outset among several available forms, and the system then prevents them from freely moving back and forth for fear that they will be motivated not to reduce agency costs but rather to reduce their taxes as their distribution plans change. I do not claim that there exists any necessary link between limited liability and two-tier taxation. I instead suggest that there is both a positive attribute of separate corporate taxation and a practical problem with a completely voluntary system regarding one- and two-tier taxation. Again, an historical analysis makes this point evident. The creation of millions of partnerships, proprietorships, and corporations under the umbrellas of many tax codes suggests organizational reasons for the choices made among these forms, despite their tax costs. If Professor Ribstein means to emphasize that at the margin there must be people driven to the wrong organizational form because of the tax laws, he is surely correct. Such logic also applies to tax-driven marriages, retirements, law schools, churches, and airline seats. To change these tax treatments, however, runs the equally obvious risk that actors will run the other way—away from forms that are sometimes efficient in organizational or other terms. Ribstein's inclination is to assume that regulation, taxation, and tort liability are always suspect. My inclination is to recognize the power of private ordering and to be impressed by the enormous number of actors who have gravitated toward tax-disfavored classifications. In any event, I would eulogize partnerships no sooner than marriages or apartment buildings or other phenomena that have stood the test of time and that go through periods of tax favor and disfavor.

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IV.

I turn finally to an underlying assumption in Professor Ribstein's paper: firms and their investors should have free choice, or expanded choice sets, as to organizational form and the associated legal (and tax) rules. I have already emphasized that there is something to be said for systems that lock in choice. Complete flexibility allows midstream strategic behavior because the tax system's ability to see through changes in form and timing of distributions is necessarily imperfect.

Constraints on midstream choices are familiar. Would most universities allow students to ignore prerequisites and take courses over any number of years before satisfying published graduation requirements? The observer who favors such deregulation might argue that employers will monitor transcripts and the employment market will force students to an efficient course of study. But this argument seems easily defeated by the suspicion that agency costs are often reduced (to the students' benefit) by the establishment of rules and packages that students must fulfill. Students must generally limit their choices in order to earn the university's form of approval. It is easy to see that it might be efficient for students and universities to choose one another up front, so that there is a market check on the universities, but then to give up a good deal of flexibility once the relationship is underway. Similarly, it is extremely unlikely that investors in a firm (and society as a whole) are best off letting managers choose whatever form they like at whatever times they please.

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In arguing that the partnership form may well survive and that, in any event, its demise (as well as the destruction of two-tier taxation) may be no reason for celebration, I have tried to second, and certainly not to criticize, Professor Ribstein's central message. I understand this message not to be the prediction of the death of partnership but rather the claim that the emergence of the Limited Liability Corporation is an interesting development that we should consider from both positive and normative perspectives. Ribstein's paper is provocative, and therefore successful in drawing attention to LLCs. It also sets the stage for debating and observing this relatively new form.

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