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DIVORCING THE HUSBAND AND WIFE BUSINESS: AN ANALYSIS AND CRITIQUE OF I.R.C. § 761(f)

Adam S. Winger*

INTRODUCTION

Congress extended a unique benefit to husband-and-wife businesses in its 2007 modification of I.R.C. § 761(f).¹ The subsection now allows a spousal venture to elect out of federal partnership status in favor of a newly created hybrid entity, the “qualified joint venture.”² By splitting the existing partnership into two distinct sole proprietorships, the qualified joint venture relieves couples of complex compliance burdens associated with partnership taxation.³ Additionally, I.R.C. § 761(f) calls for a proportionate division of income between the spouses, thus each will be correctly awarded Social Security and Medicare credit for their efforts.⁴ Although the subsection’s benefits are clear, Congress’ failure to resolve several related issues may unfortunately limit the legislature’s benevolent intent.⁵

This article provides an analysis of I.R.C. § 761(f), highlighting some of its benefits and shortcomings and also provides a few recommendations for improvement.⁶ Part I investigates several benefits I.R.C. § 761(f) seeks to extend.⁷ Part II offers both an

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1. U.S. Troop Readiness, Veterans’ Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007, Pub. L. No. 110-28, § 8215, 121 Stat. 112, 193 (codified as amended at I.R.C. § 761(f) (West 2007)).

2. I.R.C. § 761(f) (West 2007).

3. I.R.C. § 761(f)(1); *see also* I.R.S. 2002 Report to Congress, NAT’L TAXPAYER ADVOC. 181 (2002) [hereinafter I.R.S. Report].

4. I.R.C. § 761(f)(1).

5. *See* discussion *infra* Part I.

6. *See* discussion *infra* Parts I–III.

7. *See* discussion *infra* Part II.

analysis and critique of the subsection's provisions.⁸ Finally, Part III provides functional recommendations for improvement.⁹

I. I.R.C. § 761(f) BENEFITS

I.R.C. § 761(f) achieves three core objectives, and does so without detrimentally impacting national revenue.¹⁰ First, it relieves husband-and-wife businesses of unnecessary compliance burdens; second, it ensures the integrity of the Internal Revenue Service (IRS); third, it corrects an existing problem with family Social Security and Medicare crediting.¹¹

A. Reduces the Compliance Burden

Whether they know it or not, a couple working together is most likely operating a partnership for federal tax purposes.¹² As a result, the spouses are expected to understand and comply with Subchapter K of the Internal Revenue Code.¹³ Subchapter K's provisions, however, are "distressingly complex and confusing" and present immense challenges even to "one who is sophisticated in tax matters with many years of experience in the tax field."¹⁴ By enabling a couple to elect out of partnership status, I.R.C. § 761(f) relieves couples of the majority of these hardships.¹⁵

To illustrate the compliance burdens, the following is an example of the potential annual filing requirements. The partnership is recognized as an entity apart from its owners.¹⁶ Consequently, the

8. See discussion *infra* Part III.

9. See discussion *infra* Part IV.

10. See I.R.S. Report, *supra* note 3, at 181.

11. *Id.*

12. See S.S.R. 84-11, 42 (1984), available at http://www.ssa.gov/OP_Home/rulings/oasi/47/SSR84-11-oasi-47.html (indicating the couple may not know of their partnership status).

13. U.S. Income Portfolios: Partnerships, Portfolio 710-2nd (BNA TAX AND ACCT. CENTER.) § I.

14. Foxman v. Comm'r, 41 T.C. 535, 551 n.9 (1964) [hereinafter U.S. Income Portfolios 710]; accord SUSAN KALINKA, LOUISIANA CIVIL LAW TREATISE LIMITED LIABILITY COMPANIES AND PARTNERSHIPS, § 3.7 (3d ed. 2007).

15. See I.R.S. Report, *supra* note 3, at 181.

16. Treas. Reg. § 301.7701-2(c)(2)(iii) (2006).

couple must file a Form 1065 on the entity's behalf reporting all income, deductions, gains, and losses from operations.¹⁷ Next, two Schedule K-1s must be completed that reflect each spouse's allocable share of the income or loss.¹⁸ The couple must then transcribe the Schedule K-1 information onto individual Schedule Es, reporting the partnership income as their own.¹⁹ Next, because partners are not considered employees for federal tax purposes, both must complete Schedule SEs, characterizing their distributive share of income as earned from self-employment.²⁰ Finally, all personal schedules merge onto the couple's joint Form 1040, which ultimately determines the net tax liability on partnership earnings.²¹ The IRS estimates the partnership forms alone—Form 1065 and Schedule K-1s—take approximately 165–200 hours to prepare and file.²² Translated into economic terms, a family business has the option to either sacrifice more than a month of productive labor or pay lofty fees to a tax practitioner just to comply with Subchapter K.²³

By allowing married couples qualified joint venture status, Congress removes nearly all federal compliance burdens.²⁴ In contrast to the partnership, the qualified joint venture's two sole proprietorships are not separate legal entities for federal income tax purposes.²⁵ Consequently, no entity-level filings are required.²⁶ Instead, the spouses simply divide net income in accordance with their respective ownership interests and report this information on

17. See I.R.S., INSTRUCTIONS TO FORM 1040 (2008), at C-2, available at <http://www.irs.gov/pub/irs-pdf/i1040.pdf> [hereinafter 1040 INSTRUCTIONS].

18. I.R.S. Report, *supra* note 3, at 175.

19. See I.R.S., INSTRUCTIONS TO SCHEDULE E (FORM 1040), at E-1, E-5 (2006), available at <http://www.unclefed.com/IRS-Forms/2006/i1040se.pdf>. Schedule E relates to "Supplemental Income and Loss" from a partnership.

20. See *id.* at SE-2.

21. See generally *id.*

22. I.R.S. Report, *supra* note 3, at 172.

23. See generally CHARLES RANGEL, TAXPAYER PROTECTION ACT OF 2007, H.R. REP. NO. 110-84, at 8 (2007) (indicating husband-and-wife business owners "may be subject to unnecessary complexity under present law") [hereinafter RANGEL ACT].

24. Andrew R. Biebl, *Tax Bill du Jour*, TOP PRODUCER, Summer 2007, at 34.

25. U.S. Income Portfolios: Partnerships, Portfolio 700-3d: Choice of Entity (BNA TAX AND ACCT. CENTER.) § II-B [hereinafter U.S. Income Portfolios 700].

26. *Id.*

two Schedule Cs.²⁷ Unlike the partnership, “[t]he IRS estimates that it takes the average taxpayer about [eleven] hours to complete a Schedule C.”²⁸ Although each spouse will remain responsible for reporting self-employment income, the qualified joint venture relieves couples of the most oppressive burdens associated with Subchapter K.²⁹

B. Assisting in Maintaining the Integrity of the IRS

Due to either a lack of awareness or the substantial cost of compliance, family businesses have traditionally shirked the responsibilities connected to their partnership status.³⁰ This continuing neglect triggered the IRS’s issuance of Revenue Procedure 81-11.³¹ Instead of punishing the couples, however, the procedure exacerbated the problem by waiving penalties for small businesses that “historically had not filed partnership returns.”³² Interestingly, the waiver did not “eliminate the filing requirement for partnerships . . . ; it merely provide[d] that a penalty for failure to file will not be assessed.”³³ The National Tax Advocate took issue with this leniency, stating:

Respect for the integrity of the tax system suffers when rules are imposed that place an unnecessarily heavy compliance burden on taxpayers, that many taxpayers ignore . . . , that the IRS . . . does not enforce, and that have no impact on tax liability. It is

27. *Id.* § II-B, -A-4 n.28; see 1040 INSTRUCTIONS, *supra* note 17, at C-2. The Schedule C is used to report “Profit and Loss from Business” operations. Note also that Schedule F is used for similar items in farming contexts.

28. I.R.S. Report, *supra* note 3, at 172.

29. *Id.* at 181. Note also that in Chief Counsel Advice 200816030, guidance was issued to confirm that rental real estate income, which would otherwise be exempt from Self Employment tax, will retain its exempt status in the hands of a qualified joint venture. Qualified Joint Ventures and Rental Business Income, I.R.S. Chief Counsel Advisory 200816030 (Apr. 18, 2008).

30. See Revenue Procedure. 81-11, 1981-1 C.B. 651 (superseded by Rev. Proc. 84-35).

31. *Id.*

32. *Id.* (listing additional requirements); accord *Royer v. Apfel*, No. IP-99-1387-CH/G, 2000 WL 1707955, at *3 (S.D. Ind. Oct. 16, 2000) (indicating many small family partnerships do not comply with business formalities).

33. Social Security Ruling 84-11, at *3 (1984).

confusing and pointless for the Internal Revenue Code to require all partnerships to file a partnership tax return, while the IRS . . . does not enforce the requirement³⁴

Congress effectively mitigated the risk of compromising its integrity via modification of I.R.C. § 761(f).³⁵ By splitting the husband-and-wife business into two sole proprietorships, thereby taking them out of partnership status, the legislature eliminated the need to prosecute for couples' noncompliance with Subchapter K.³⁶

C. Curing Issues with Social Security and Medicare Crediting

The new law also resolves a complication arising from improper Social Security and Medicare crediting.³⁷ Where both spouses actively participate in a business, each is entitled a portion of the "distributive share . . . of income or loss."³⁸ This income is correctly reportable as "net earnings from self-employment."³⁹ The government then imposes a tax for Social Security and Medicare.⁴⁰ In return, each spouse becomes eligible to receive future health and retirement benefits.⁴¹

Frequently, however, one spouse will lose credit for their earned income due to incorrect return filing.⁴² In *Royer v. Apfel*, for instance, a husband and wife jointly operated a farm for more than twenty-five years.⁴³ Not knowing a partnership had been formed, the husband recognized all earnings under his name as sole-proprietorship

34. I.R.S. Report, *supra* note 3, at 179.

35. See *id.* (encouraging Congress to "simply change the law to reflect the desired policy" as was done in adopting I.R.C. § 761(f)).

36. *Id.* at 179–80.

37. See generally *Ardolina v. Comm'r*, 186 F.2d 176 (3d Cir. 1951); *Nickerson v. Ribicoff*, 206 F. Supp. 232 (D. Mass. 1962) (reallocating credits).

38. I.R.C. § 1402(a) (2006).

39. *Id.*

40. See I.R.S., INSTRUCTIONS TO SCHEDULE SE (FORM 1040) (2006), available at <http://www.unclefed.com/IRS-Forms/2006/i1040sse.pdf>.

41. See generally S.S.R. 84-11 (1984).

42. *Id.*

43. *Royer v. Apfel*, No. IP-99-1387-CH/G, 2000 WL 1707955, at *1 (S.D. Ind. Oct. 16, 2000).

income.⁴⁴ When the couple divorced, the wife learned that the mistake deprived her of all governmental benefits.⁴⁵ The court corrected the error by reallocating the benefits and ordered the husband to reimburse the government for the value of benefits he had unjustly received.⁴⁶ Although the court was able to resolve the issue, the filing mistake needlessly cost both parties time and considerable legal fees on top of those already expended for their divorce.⁴⁷

The qualified joint venture seeks to eliminate this potential of improper employment tax reporting.⁴⁸ Because I.R.C. § 761(f) demands that the new entity's income be divided in accordance with each spouse's interest in the venture, both spouses must recognize their distributive share as proceeds from their own self-employment.⁴⁹ Though this may increase the venture's immediate tax burden, it will ensure the proper crediting of Social Security and Medicare and remove the potential of a costly, *Royer*-like reallocation upon divorce.⁵⁰

D. Negligible Impact on National Tax Revenue

I.R.C. § 761(f) achieves all the aforementioned benefits while simultaneously avoiding any negative impact to the national budget.⁵¹ Just as all income, deductions, gains, and losses flow from a partnership down to its partners, all net earnings pass through to the owner of a sole proprietorship.⁵² As a result, "[r]egardless of how the net earnings from the business are reported—either as a flow-through item from the partnership return or as net earnings from Schedule

44. *Id.* at *3 (acknowledging the husband made the mistake unintentionally).

45. *Id.*

46. *Id.* at *6.

47. *See generally id.*

48. *See* I.R.C. § 761(f) (West 2007); *see also* RANGEL ACT, *supra* note 23, at 183.

49. 1040 INSTRUCTIONS, *supra* note 17, at C-2 (instructing that "[e]ach . . . [spouse] must also file a separate Schedule SE to pay self-employment tax, as applicable").

50. I.R.S. Report, *supra* note 3, at 181.

51. *Id.*

52. *See* U.S. Income Portfolios 700, *supra* note 25, § II-B.

C—the income tax liability of the husband and wife generally will be the same.”⁵³

II. I.R.C. § 761(f): ANALYSIS & CRITIQUE

Although I.R.C. § 761(f) offers helpful benefits to married co-owners, its qualification prerequisites may frustrate Congress's benevolent intent.⁵⁴ I.R.C. § 761(f) has four eligibility requirements, all of which risk excluding qualifying couples from qualified joint venture status: (1) the only members of such joint venture are a husband and wife; (2) both spouses materially participate in the trade or business; (3) both spouses elect for the subsection to apply, and; (4) the couple files jointly.⁵⁵

A. Introduction to Entity Formation and Classification

As stated, both spouses must make an affirmative election before Congress extends the benefits of the qualified joint venture.⁵⁶ Unfortunately, many married taxpayers may never know to make such an election.⁵⁷ In *Royer*, the court acknowledged the husband had no intent to mislead the IRS in misclassifying the family business as a sole proprietorship.⁵⁸ Instead, like many others, he was simply unaware of his family's partnership status.⁵⁹ If he never knew he was subject to Subchapter K, it is impossible that he would know to elect

53. I.R.S. Report, *supra* note 3, at 181. For additional qualified joint venture benefits, see discussion on income shifting and divorce settlements, *id.* at 177–78.

54. See generally I.R.C. § 761(f) (West 2007).

55. *Id.* at § 761(f)(2)(A)–(C).

56. *Id.* at § 761(f)(2)(C).

57. See Telephone Interview with Eric Sloan, Managing Principal, Deloitte & Touche LLP, Joint Venture and Pass Through Service Group, in Washington D.C. (Oct. 30, 2007) [hereinafter Sloan Interview].

58. *Royer v. Apfel*, No. IP-99-1387-CH/G, 2000 WL 1707955, at *3 (S.D. Ind. Oct. 16, 2000) (concluding husband was without fault).

59. See S.S.R. 84-11, at 42 (1984) (indicating “it is quite possible that a couple may have actually operated their business as a partnership without recognizing that fact”); see also *Ardolina v. Comm’r*, 186 F.2d 176 (3d Cir. 1951); *Garrison v. Garrison*, 726 So. 2d 723 (Ala. Civ. App. 1999).

out of it.⁶⁰ Although the willful avoidance of partnership status may make up some of the government's family compliance problem, *Royer* represents another faction: those unaware of their operation's partnership designation.⁶¹

History has shown that determining whether a relationship constitutes a partnership is less than self-evident.⁶² I.R.C. § 761(a) offers the only statutory guidance, stating a partnership may take the form of a "syndicate, group, pool, joint venture, or other unincorporated organization"⁶³ The subsection does not, however, answer the question of what level of activity is required to establish a syndicate, group, pool, joint venture, or other unincorporated organization.⁶⁴

The IRS has offered limited guidance—clarifying that relationships such as employer-employee, debtor-creditor, purchaser-seller, and co-owners are all by themselves insufficient to create a partnership.⁶⁵ Problems arise, however, when more complex factual scenarios are considered.⁶⁶ For instance, while mere co-ownership of rental property does not constitute a partnership, if the owners "provide services to the occupants," the relationship will likely be transformed.⁶⁷ Consequently, the taxpayer is left to make a thorny legal conclusion of whether their activities constitute "services," and

60. Sloan Interview, *supra* note 57. Note that Sloan believes this conclusion may have been reached by another practitioner and does not take credit for the concept.

61. See generally *id.* (suggesting the families who do not know they are subject to Subchapter K likely will not know to make the necessary election).

62. For a discussion on the historical confusion associated with entity classification, see Patrick E. Hobbs, *Entity Classification: The One Hundred-Year Debate*, 44 CATH. U. L. REV. 437, 441–80 (1995).

63. I.R.C. § 761(a) (West 2007).

64. See generally Eric Sloan, *Opening Pandora's Box: Who Is (or Should Be) a Partner?*, in 746 TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 291, at § II (Louis S. Freeman & Clifford M. Warren eds., Practising Law Institute 2007) [hereinafter *Pandora's Box*] (turning to the "*Culbertson* trilogy" for clarification).

65. U.S. Income Portfolios 710, *supra* note 14, § II-B.

66. See generally Rev. Rul. 75-374, 1975-2 C.B. 261 (stating the "furnishing of additional service will render a co-ownership a partnership").

67. *Id.*; see also 26 C.F.R. § 301.7701-1(a), (a)(2) (2006) (stating "a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and *in addition* provide services to the occupants either directly or through an agent") (emphasis added).

neither option is without consequences.⁶⁸ On one hand, the couple can file as a sole proprietor risking subsequent interest, penalties, and *Royer*-like legal fees in the event the IRS finds a partnership.⁶⁹ On the other, they can recognize the partnership and face the complex compliance burdens associated with a sea of technical tax law.⁷⁰ Not surprisingly, taxpayers have chosen the former and frequently found themselves before the court arguing over the existence of a partnership.⁷¹

1. *Classification Litigation: The Culbertson Trilogy*

Partnership disputes of this nature spurred the creation of a multi-factored test which was fleshed out in three foundational decisions commonly referred to as the “*Culbertson* trilogy.”⁷² In *Commissioner v. Tower*, decided first, the Supreme Court held the parties’ intent to be the primary partnership indicia.⁷³ Justice Black, writing for the majority, stated that “whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses” will determine the existence of a partnership.⁷⁴ Following *Tower* came *Commissioner v. Culbertson* and *Commissioner v. Luna*, instructing courts to consider the following factors in addition to the intent element:

- 1) the agreement of the parties; 2) the conduct of the parties in execution of the provisions of the agreement; 3) the statements of the parties; 4) testimony of disinterested persons; 5) the relationship of the parties; 6) their respective abilities and capital

68. See generally Rev. Rul. 75-374, 1975-2 C.B. 261 (providing additional factors to be used to make a conclusive partnership decision). It is uncertain whether the lenient treatment of Rev. Proc. 81-11 will continue to apply to couples eligible for qualified joint venture treatment.

69. See I.R.S. Pub. 541 (2003) (delineating harsh penalties for noncompliance).

70. See *Foxman v. Comm’r*, 41 T.C. 535, 551 n.9 (1964).

71. See generally *Hobbs*, *supra* note 62.

72. See, e.g., *Comm’r v. Culbertson*, 337 U.S. 733, 742 (1949); see also *Pandora’s Box*, *supra* note 64, at 299; *Comm’r v. Tower*, 327 U.S. 280 (1946); *Comm’r v. Luna*, 42 T.C. 1067 (1964).

73. *Tower*, 327 U.S. at 287.

74. *Id.*

contributions; and 7) the actual control of the income and the purposes for which it is used.⁷⁵

For years, these *Culbertson*-trilogy factors served to conclusively identify the existence of a partnership.⁷⁶

2. *The New Classification Challenge: The Hybrid Entity*

A new set of classification issues arose, however, with the inception of the “hybrid form of business entity.”⁷⁷ A hybrid entity is one containing characteristics of two or more business structures.⁷⁸ The limited liability company (LLC), for instance, extends the limited liability of a corporation while retaining the flow-through tax advantages of a partnership.⁷⁹ Because the entity is a creation of state law, the originating state determines the entity’s legal rights and obligations.⁸⁰ For purposes of federal taxation, however, it is federal law that controls, not state law.⁸¹

This legal disparity resulted in varying and unexpected judicial results.⁸² In *Evans v. Commissioner*, for example, a taxpayer transferred his partnership interest to a closely-held corporation in exchange for corporate stock.⁸³ The taxpayer was under the

75. *Culbertson*, 337 U.S. at 742; *Luna*, 42 T.C. at 1077–78; *Pandora’s Box*, *supra* note 64, at 302.

76. Compare Treas. Reg. § 301.7701-1 to -3 (1997) (effective 1997), with *Culbertson*, 337 U.S. at 742 (decided in 1949).

77. Hobbs, *supra* note 62, at 510–12.

78. *Id.*

79. *Id.* at 510. Following the initial authoring of this Note, the I.R.S. released its position that “only businesses that are owned and operated by spouses as co-owners, and not in the name of a state law entity (including a general or limited partnership or limited liability company)” are to be eligible for qualified joint venture treatment. See I.R.S., <http://www.irs.gov/businesses/small/article/0,,id=177376,00.html> (heading entitled “Definition of a qualified joint venture”) (last visited Mar. 21, 2009). Although this contention is beyond the scope of this Note, it is arguable whether this limitation will persist.

80. See generally *Kandi v. United States*, No. C05-0840C, 2006 WL 83463 (W.D. Wash. Jan. 11, 2006).

81. E.g., *Gulley v. Comm’r*, 79 T.C.M. (CCH) 2171, at *5 (2000) (stating federal law, not state, controls to determine whether a partnership was terminated for federal tax purposes).

82. Victor E. Fleischer, “If It Looks Like a Duck”: *Corporate Resemblance and Check-The-Box Elective Tax Classification*, 96 COLUM. L. REV. 518, 553 (1996) (identifying the need for a more predictable entity classification system).

83. *Evans v. Comm’r*, 447 F.2d 547, 548 (7th Cir. 1971).

impression that because he remained a partner for state law purposes, he would remain so under the federal tax code as well.⁸⁴ The court held otherwise, stating “after the assignment [the taxpayer] could no longer be regarded as a partner for federal income tax purposes, even though he remained one for state purposes.”⁸⁵ In 1997, the Treasury Department responded to this confusion with the “Check-the-Box” Regulations.⁸⁶

3. *Check-the-Box Regulations Simplify the Classification Struggle*

Where the *Culbertson* trilogy aided in determining whether a partnership was formed, the check-the-box regulations attempt to clarify whether an unincorporated entity should be taxed as a corporation or partnership.⁸⁷ The regulations created an elective regime, where the taxpayer, not the government, decides the entity’s tax classification.⁸⁸ Under the regulations, “[a] business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership.”⁸⁹ Alternatively, “[a] business entity with only one owner is classified as a corporation or is disregarded.”⁹⁰ Finally, if no election is made, the regulations provide for the partnership or the disregarded entity to serve as default classifications.⁹¹ Therefore, under the check-the-box regulations, so long as the relationship constitutes a “business entity,” the entity classification issue appears settled.⁹²

84. *Id.* at 549.

85. *Id.* at 552.

86. Treas. Reg. § 301.7701-1 to -3 (1997). Before the Check-the-Box regulations were issued, courts relied on the *Kintner* Regulations. For a discussion of the *Kintner* Regulations and the history of the classification issue, see Hobbs, *supra* note 62.

87. See generally Treas. Reg. § 301.7701-1 to -3 (1997).

88. See Treas. Reg. § 301.7701-2(a) (1997) (making entity status entirely elective and creating the partnership as the default entity for businesses with two or more owners).

89. Treas. Reg. § 301.7701-2(a) (1997). But see I.R.S. Priv. Ltr. Rul. 199911033 (Dec. 18, 1998) (disregarding an LLC owned by a trust and a corporation when the corporation had no economic interest in the entity).

90. Treas. Reg. § 301.7701-2(a) (1997).

91. *Id.* § 301.7701-3(b).

92. See *id.*

Absent from the regulations, however, is guidance indicating when exactly a “business entity” is formed.⁹³ For instance, suppose a husband and wife co-own real property and file as an LLC with their state.⁹⁴ Although the formality of a state filing may suffice to create a “business entity” under state law, as stated previously, “mere coownership [sic] of property . . . does not constitute a partnership” for purposes of federal taxation.⁹⁵ Instinctively, a taxpayer may revert to the “*Culbertson* trilogy” for clarification, but reputable commentators argue those concepts no longer apply in a check-the-box world.⁹⁶ Thus, the taxpayer is again thrown back in the predicament of making an extremely subjective legal conclusion as to whether his or her operation constitutes a business entity, and therefore a partnership.⁹⁷

4. The Impossible Challenge of Exclusion Without Knowledge of Inclusion

In sum, couples may justifiably be unaware they are subject to Subchapter K for two reasons, and consequently, will not know to make the necessary I.R.C. § 761(f) election.⁹⁸ First, because many family businesses ignore their tax status, the couple may not know (or care) that they are operating a partnership.⁹⁹ Second, couples operating in the grey area of the “business entity” requirement, such as real estate owners, may not know that their relationship has risen

93. U.S. Income Portfolios 710, *supra* note 14, § II-B.

94. See Terence F. Cuff, *Community Property Partnerships and Like-Kind Exchanges*, in 746 TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 225, 232–236 (Louis S. Freeman & Clifford M. Warren eds., 2005).

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

96. WILLIAM S. MCKEE, WILLIAM F. NELSON, & ROBERT L. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS*, ¶ 3.01.2 (stating “the analysis in *Tower* and *Culbertson* should become irrelevant to determining partnership tax classification”); see also I.R.S. Priv. Ltr. Rul. 199911033 (Mar. 19, 1999) (applying the *Culbertson* analysis after the check-the-box regulations to determine the partnership formation issue). *But see Pandora’s Box*, *supra* note 64, at 304 (arguing this “view . . . has little merit”).

97. See generally U.S. Income Portfolios 710, *supra* note 14, § II-B (indicating no real guidance exists on the business entity element).

98. See discussion *supra* Part II(A)(1)–(3).

99. *Royer v. Apfel*, No. IP-99-1387-CH/G, 2000 WL 1707955, at *3 (S.D. Ind. Oct. 16, 2000).

to the level of a partnership.¹⁰⁰ Unfortunately, I.R.C. § 761(f) addresses neither,¹⁰¹ and as a result, many qualifying families may be without the knowledge to elect out of partnership status.¹⁰²

B. A Closer Look into the Material Participation Requirement—I.R.C. § 469(h)

The provision in I.R.C. § 761(f)(2)(B), requiring the material participation of both spouses, may also conflict with the subsection's general intent.¹⁰³ I.R.C. § 496(h) defines "material participation" as "regular, continuous, and substantial" involvement in the operations of the activity.¹⁰⁴ The IRS augmented this definition issuing Treasury Regulation § 1.469-5T in 1998.¹⁰⁵

Even with this addition, however, "[t]he rules for determining what constitutes material participation are complex."¹⁰⁶ In fact, it has been noted that the restrictions in I.R.C. § 469 "comprise one of the more complicated areas of the tax law."¹⁰⁷ Consequently, by making material participation a condition of qualification, Congress requires a group historically troubled by the complexities of the tax law to understand and comply with one of the law's most intricate provisions.¹⁰⁸ This result does nothing to simplify family taxation as suggested in the section's title: "Family Business Tax Simplification."¹⁰⁹ Instead, it complicates things by adding a complex

100. See Sloan Interview, *supra* note 57; see also U.S. Income Portfolios 710, *supra* note 14, § II-B (indicating no real guidance exists on the business entity element).

101. See I.R.C. § 761(f) (West 2007).

102. Sloan Interview, *supra* note 57.

103. I.R.C. § 761(f)(2)(B).

104. I.R.C. § 469(h)(1)(A)–(C) (2006); see also *id.* at (h)(2) (excluding all limited partners from material participation status).

105. Treas. Reg. § 1.469-5T(a)(1)–(7) (1998).

106. Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-Ups*, 57 TAX L. REV. 137, 154 (2004) (citing Joseph Bankman, *The Case Against Passive Investments: A Critical Appraisal of the Passive Loss Restrictions*, 42 STAN. L. REV. 15, 24 (1989)).

107. Bankman, *supra* note 106, at 24.

108. See generally Royer v. Apfel, No. IP-99-1387-CH/G, 2000 WL 1707955, at *3 (S.D. Ind. Oct. 16, 2000) (noting many family businesses do not follow partnership law).

109. See H.R. REP. NO. 110-84, at 7 (2007) (labeling the provision "Family Business Tax Simplification") (emphasis added).

analytical layer, thereby risking frustration of I.R.C. § 761(f)'s intent.¹¹⁰

1. The Material Participation Issue for Limited Partnerships

Another unintended conflict related to the participation requirement arises when a husband-and-wife business currently operates as a limited partnership with one spouse serving as a limited partner.¹¹¹ I.R.C. § 469(h) categorically prohibits a limited partner from satisfying the material participation requirement.¹¹² Consequently, even if both spouses meet the baseline participation requirement, because one is a limited partner, they will be precluded from qualified joint venture treatment.¹¹³ This result seems to conflict with the subsection's intent.¹¹⁴ According to the National Tax Advocate, a primary purpose in amending I.R.C. § 761(f) was to alleviate *partnership* compliance burdens.¹¹⁵ Couples operating limited or family limited partnerships are subject to these burdens, but cannot avail themselves of the beneficial treatment due to their current status.¹¹⁶ Thus, the very taxpayers I.R.C. § 761(f) seeks to assist are those categorically restricted from enjoying its benefits.¹¹⁷

C. Interaction of § 761(f) with Revenue Procedure 2002-69

Both Revenue Procedure (Rev. Proc.) 2002-69 and I.R.C. § 761(f) afford similar entity options to qualifying husband-and-wife businesses.¹¹⁸ The two differ, however, in how couples qualify.¹¹⁹ As

110. See generally Bankman, *supra* note 106; H.R. REP. NO. 110-84, *supra* note 109.

111. See generally I.R.C. § 469(h)(2) (2006).

112. *Id.* But cf. I.R.C. § 469(i)(6) (allowing some exceptions for material participation in rental activities).

113. See generally I.R.C. § 469(h)(2) (stating limited partnership interests shall not be treated as material participation and also referring to exceptions in Treas. Reg. § 1.469-5T(e)).

114. See I.R.S. Report, *supra* note 3, at 183 (noting the goal of removing the partnership compliance burdens).

115. *Id.* at 181.

116. See I.R.C. § 761(f) (2007); I.R.C. § 469(h)(2).

117. *Id.*

118. Compare Rev. Proc. 2002-69, 2002-45 I.R.B. 831, with I.R.C. § 761(f) (2007).

119. *Id.*

explained in the subsections below, this disparity has the potential to undermine the requirements of I.R.C. § 761(f).¹²⁰

1. *An Overview of Revenue Proc. 2002-69*

The IRS issued Rev. Proc. 2002-69 to provide guidance on the classification of husband-and-wife entities in community property states.¹²¹ The distinction became necessary when community property law intersected with the check-the-box regulations.¹²² The basic tenant of community property gives both spouses equal ownership in all marital assets.¹²³ These joint ownership characteristics arise whether both spouses generate or manage the assets or not.¹²⁴ For instance, it was noted in *Yokochi v. Yoshimoto* that although company stock was held in the husband's name and controlled entirely by the husband, these factors in no way diminished the wife's equal ownership rights in the stock.¹²⁵ The shared ownership aspects of community property raised questions about a spouse's ability to serve as an entity's sole owner, and this distinction became crucial when the taxpayer attempted to exchange like-kind property pursuant to I.R.C. § 1031.¹²⁶

2. *Introduction to I.R.C. § 1031 Exchanges*

Section 1031 provides for the deferral of gain or loss recognition on exchanges of like-kind business properties.¹²⁷ Traditionally, taxpayers will rely on lender financing to fund their new investment

120. Compare Rev. Proc. 2002-69, 2002-45 I.R.B. 831, with I.R.C. § 761(f) (West 2007).

121. Rev. Proc. 2002-69, 2002-45 I.R.B. 831.

122. See Cuff, *supra* note 94, at 233 (noting that a husband-and-wife "LLC may be treated as having two owners and therefore could be treated as a partnership").

123. See 15A AM. JUR. 2D *Community Property* §§ 2, 6 (2000) (stating that "[c]ommunity property is a unitary concept of ownership," therefore, "with certain exceptions, property acquired during a marriage is as much that of the wife as of the husband").

124. See, e.g., *Yokochi v. Yoshimoto*, 353 P.2d 820, 824 (Haw. 1960) (citing *Bulgo v. Bulgo*, 41 Haw 578, 587 (1957)).

125. See, e.g., *Yokochi*, 353 P.2d at 824 (reasoning that although the husband maintains full control over property, such control "does not negat[e] the wife's present interest").

126. See Cuff, *supra* note 94; Treas. Reg. § 301.7701-1(a)(2).

127. See I.R.C. § 1031 (2006).

in the replacement property.¹²⁸ After sustaining massive losses in the 1980s, however, commercial lenders began taking precautionary measures before extending such credit.¹²⁹ Financial institutions now typically demand replacement property to be held in a “bankruptcy remote entity.”¹³⁰ For instance, instead of the individual taxpayer holding the asset directly, leaving the property exposed to creditors, the lender may insist that the asset be held in a bankruptcy remote LLC.¹³¹ This requirement, however, found married real estate owners in community property states at risk of violating I.R.C. § 1031’s “exchange element.”¹³²

The implicit “exchange element” of I.R.C. § 1031 requires the same taxpayer both to relinquish the existing property and receive the replacement property.¹³³ The potential violation occurs when the husband and wife’s dual-ownership in the LLC is treated as the operation of a partnership under the check-the-box regulations.¹³⁴ Although owning the LLC should equate to “mere co-ownership,”¹³⁵ as stated previously, it is uncertain whether the formation of a state entity automatically satisfies the check-the-box “business entity” requirement.¹³⁶ If it does, because the husband and wife would then co-own a “business entity,” not just property, the entity must be classified as either a corporation or tax partnership.¹³⁷ Therefore,

128. See generally Cuff, *supra* note 94, at 230. (“Most attorneys who deal with real property transactions have observed the growth of single member LLCs as special purpose entities to hold real property in connection with securitized financing.”). See also Bradford Updike, *Exploring the Frontier of Non-Traditional Real Estate Investments: A Closer Look at 1031 Tenancy-In-Common Arrangements*, 40 CREIGHTON L. REV. 271, 274 (2007) (defining replacement property as “the real estate the taxpayer ultimately ends up with once the exchange is completed”).

129. See Howard J. Levine & David A. Weintraub, *Two-Member LLC Can Be Disregarded in 1031 Exchange Where One Member Has No Economic Interest*, 90 J. TAX’N, 138 (Mar. 1999).

130. For a discussion of the bankruptcy remote entity, see Updike, *supra* note 128, at 274 n.167.

131. See Cuff, *supra* note 94, at 232–33.

132. Levine & Weintraub, *supra* note 129.

133. *Limited Liability Companies: Legal Aspects of Organization, Operation, and Dissolution*, Tax & Acct. Center (BNA) § IX(A)(3)(d)(2) (2008).

134. See Cuff, *supra* note 94.

135. See Treas. Reg. § 301.7701-1(a)(2) (2006) (indicating mere co-ownership of property does not transform a relationship to an entity apart from its owners).

136. See generally Cuff, *supra* note 94 (recognizing uncertainty in husband-and-wife like-kind exchanges).

137. Treas. Reg. § 301.7701-2(a) (2006).

although the couple is considered the taxpayer relinquishing the property, the LLC, recognized as a separate taxable entity, may be found to have received the replacement property.¹³⁸ This result violates the exchange requirement, thereby destroying any deferral allowed under I.R.C. § 1031.¹³⁹

Had this situation arisen in a non-community property state, both the original ownership and the LLC interest would be disregarded for federal tax purposes.¹⁴⁰ The assets and obligations of a disregarded entity “are treated as owned directly by the owner of the entity.”¹⁴¹ As a result, the replacement property, although housed in an LLC, would be treated as owned directly by one of the spouses, thereby preserving the exchange element.¹⁴² Community property taxpayers grew frustrated with this disparity, and turned to the IRS for clarification.¹⁴³

The IRS responded with Rev. Proc. 2002-69, which allows a husband-and-wife in a community property state to choose whether their entity is taxable as a disregarded entity or partnership for federal tax purposes.¹⁴⁴ As a result, even if the family operation did in fact constitute a federal tax partnership, it could elect out of Subchapter K in favor of disregarded entity status.¹⁴⁵ This clarification removed the barrier obstructing the successful effectuation of tax-deferred, like-kind exchanges, but as indicated below, it now runs counter to I.R.C. § 761(f) in a number of ways.¹⁴⁶

138. See Cuff, *supra* note 94.

139. See *id.*

140. See generally I.R.S. Priv. Ltr. Rul. 97-51-012 (Sept. 15, 1997) (“The acquisition of the replacement property by each nonelecting LLC, wholly-owned by Taxpayer, will be deemed an acquisition by Taxpayer.”).

141. *Disregarded Entities and Specific Code Provisions*, Tax & Acct. Center. (BNA) 704-1st, § III (2008).

142. See Cuff, *supra* note 94, at 233.

143. *Id.*

144. Rev. Proc. 2002-69, 2002-45 I.R.B. 831; see also Cuff, *supra* note 94.

145. See Cuff, *supra* note 94, at 236–37.

146. See *id.*

3. *Rev. Proc. 2002-69 Directly Conflicts with I.R.C. § 761(f)*

Rev. Proc. 2002-69 conflicts and undermines I.R.C. § 761(f) by affording the same disregarded treatment to families without imposing the most stringent of the qualified joint venture requirements.¹⁴⁷ To qualify as a qualified joint venture under I.R.C. § 761(f), a couple must (1) file jointly; (2) be the only members of the joint venture; (3) materially participate; and (4) both spouses must make the necessary election.¹⁴⁸ In contrast, to be eligible for functionally identical treatment under Rev. Proc. 2002-69, a couple in a community property state must only prove to be the sole owners of the business.¹⁴⁹ Consequently, community property couples are afforded equally beneficial tax treatment even though it is possible that neither spouse materially participates in the entity's operations.¹⁵⁰ In this situation, so long as one of the spouses owns the company outright, community property laws will attribute ownership to the other. By imposing this requirement on couples in separate property states, but not those in community property states, the IRS renders the subsection's provisions meaningless in community property states.¹⁵¹

D. *A New Employment Tax Liability for Couples*

By separating the partnership into two disregarded entities, both spouses may potentially become personally liable for unpaid employment taxes.¹⁵² This result creates a significant disincentive for couples to make the I.R.C. § 761(f) election if they currently enjoy the protection of an LLC.¹⁵³ For instance, because an LLC taxed as a

147. Compare I.R.C. § 761(f) (West 2007), with Rev. Proc. 2002-69, 2002-45 I.R.B. 831.

148. I.R.C. § 761(f)(2) (West 2007).

149. See Rev. Proc. 2002-69, 2002-45 I.R.B. 831 § 3 (defining requirements of a "Qualified Entity").

150. *Id.*

151. See generally I.R.C. § 761(f); see also Rev. Proc. 2002-69, 2002-45 I.R.B. 831.

152. See *Steam & Co., LLC v. United States*, 499 F. Supp 2d 899, 902 (2007) (holding the sole owner of LLC liable because the entity was disregarded (citing *Littrillo v. United States*, 484 F.3d 372, 378 (6th Cir. 2007))).

153. E-mail from Cassady V. Brewer, Tax Partner, Morris, Manning & Martin, LLP (Nov. 6, 2007, 11:47 EST) (on file with author) [hereinafter Cassady E-mail]. As noted *supra*, note 79, the I.R.S.

partnership is recognized as an entity separate from its owners for federal tax purposes,¹⁵⁴ the LLC, not its members, is considered the employer and thus liable for employment taxes.¹⁵⁵ Should the couple split, however, both entities would become disregarded for tax purposes.¹⁵⁶ If state law mirrors this treatment, two single-member LLCs would then exist,¹⁵⁷ and courts consistently hold the owner of a single member LLC liable for unpaid employment taxes.¹⁵⁸

In Treasury Decision 9356, issued August of 2007, the IRS parted ways with this common holding finding that a single-member LLC should be treated “as [a] separate entit[y] for purposes of employment tax[es].”¹⁵⁹ Therefore, going forward, the LLC, not the individual, will be considered the employer responsible for the employment tax burden regardless of its number of owners.¹⁶⁰ These regulations, however, were not applicable until January 1, 2009.¹⁶¹ Before that date, the sole owner remains personally liable for all employment taxes, consistent with existing case law.¹⁶² Consequently, couples may be encouraged to postpone making an I.R.C. § 761(f) election until after 2009 in order to avoid shedding their employment tax liability shield.¹⁶³

Even if the couple chooses to wait, however, additional uncertainty leaves the couple facing continued exposure. Treasury Decision 9356 provides for entity-level protection only for “single-owner eligible

currently considers “only businesses that are owned and operated by spouses as co-owners, and not in the name of a state law entity (including a general or limited partnership or limited liability company)” to be eligible for qualified joint venture treatment. Although the author disagrees with the legitimacy of this position, a full discussion of the issue is beyond the scope of this Note.

154. Treas. Reg. § 301.7701-2(c)(2)(iii) (2006).

155. See *United States v. Galletti*, 541 U.S. 114, 121 (2004) (finding partnership, not partners, responsible as employer). According to I.R.S. Notice 99-6, 1999-1 C.B. 321, the general rule is that the employer is liable for employment tax liabilities.

156. Treas. Reg. § 301.7701-2(a); see generally 1040 INSTRUCTIONS, *supra* note 17, at C-2 (requiring both spouses to file separate Schedule Cs).

157. See Treas. Reg. § 301.7701-3(b)(1)(ii).

158. *E.g.*, *Stearn & Co., LLC v. United States*, 499 F. Supp 2d. 899, 902 (2007).

159. T.D. 9356, 2007-39 I.R.B. 675 (2007).

160. See *id.*

161. *Id.*

162. *Id.*

163. See generally Cassady E-mail, *supra* note 153 .

entities that currently are disregarded as entities separate from their owners”¹⁶⁴ It is currently uncertain how the spouses will be treated should they split for tax purposes.¹⁶⁵ Above, it was assumed that state law would automatically mimic the tax-law division, thereby creating two single-member LLCs.¹⁶⁶ Without the proper documentation filed, however, this result seems unlikely.¹⁶⁷ Instead, the couple’s state law designation will probably remain unchanged.¹⁶⁸ Consequently, although the spouses are separated for tax purposes, they will remain one, dual-member LLC under state law.¹⁶⁹ Under this scenario, it may be found that they represent two sole proprietorships for tax purposes. Should this be the case, because a sole proprietorship is not an “entity separate from its owner,”¹⁷⁰ both would face personal liability for any unpaid employment taxes.¹⁷¹ This risk creates yet another disadvantage to electing treatment as a qualified joint venture under I.R.C. § 761(f).

III. RECOMMENDATIONS

Many of the difficulties associated with I.R.C. § 761(f) stem from the various requirements the subsection imposes.¹⁷² For instance, to elect out of partnership status, the couple must first know that they are subject to Subchapter K.¹⁷³ Also, the taxpayers must be able to conclude that both spouses meet the complex requirements of material participation.¹⁷⁴ Unless these burdens are removed,

164. T.D. 9356, 2007-39 I.R.B. 675.

165. *See generally* I.R.C. § 761(f) (West 2007) (failing to clarify what entity status the separated couple would take for employment tax purposes.)

166. *See supra* text accompanying note 159.

167. *See, e.g.*, O.C.G.A. § 14-11-203 (2003) (requiring the delivery of “articles of organization to the Secretary of State” in order to create an LLC).

168. *See, e.g.*, O.C.G.A. § 14-11-210 (2003) (setting forth specific procedures for amending existing articles of organization).

169. *Id.*

170. *See* U.S. Income Portfolios 700, *supra* note 25, § II-B.

171. *See* T.D. 9356, 2007-39 I.R.B. 675, 675 (2007) (affording protective treatment only to entities separate from its owners).

172. *See* discussion *supra* Part II.

173. *See* discussion *supra* Part II.

174. *See* discussion *supra* Part II; I.R.C. § 761(f)(2)(B) (West 2007).

qualifying taxpayers may not receive the beneficial treatment Congress intended.¹⁷⁵

A. Eliminate the Material Participation Requirement

The material participation requirement should be eliminated from I.R.C. § 761(f).¹⁷⁶ Although it is arguable that doing so leaves a potential for awarding Social Security and Medicare credits to inactive spouses,¹⁷⁷ this result is already checked statutorily by § 162(a)(1) as well as by the government's ability to reallocate credits.¹⁷⁸

Individuals are awarded Social Security and Medicare benefits in return for taxes paid on net income from self-employment.¹⁷⁹ The business paying the compensation is awarded a corresponding deduction under I.R.C. § 162(a)(1).¹⁸⁰ I.R.C. § 162(a)(1) provides for an income tax deduction "for salaries or other compensation for personal *services actually rendered*."¹⁸¹ Therefore, any amounts taken against income for services not "actually rendered" are disallowed.¹⁸² Because, by improperly obtaining the Social Security and Medicare crediting, the family also violates I.R.C. § 162(a)(1), the IRS also has the authority to monitor and identify the fraudulent activity.¹⁸³ Should a mechanism be put in place to report such abuses to the Social Security Administration, the IRS can effectively serve as the first line of defense against improper crediting.

In addition to the IRS's ability to reject crediting for unearned income, the government also has the authority to reallocate credit,

175. See generally Sloan Interview, *supra* note 57.

176. See *id.*

177. See *supra* Part I.C.

178. See 42 U.S.C. § 405(c)(5)(G) (2006).

179. Royer v. Apfel, No. IP-99-1387-CH/G, 2000 WL 1707955, at *3 (S.D. Ind. Oct. 16, 2000).

180. I.R.C. § 162(a)(1) (2006).

181. *Id.* (emphasis added).

182. *Id.*

183. I.R.S., <http://www.irs.gov/irs/article/0,,id=98141,00.html> ("The IRS is organized to carry out the responsibilities of the secretary of the Treasury under section 7801 of the Internal Revenue Code. The secretary has full authority to administer and enforce the internal revenue laws and has the power to create an agency to enforce these laws. The IRS was created based on this legislative grant.").

which provides a further check on fraudulent income shifting.¹⁸⁴ The Commissioner of the Social Security Administration is expressly authorized “to correct errors made in the allocation . . . of wages or self-employment income” in 42 U.S.C. § 405(c)(5)(G).¹⁸⁵ Thus, even if the IRS fails to identify the error, the Social Security Administration has another effective tool to take corrective action.¹⁸⁶ These two combined capabilities render the participation requirement unnecessary.¹⁸⁷

B. Make Qualified Joint Venture the Default Status

In addition to removing the participation requirement, Congress should eliminate the requirement that a formal election be made.¹⁸⁸ Instead, the qualified joint venture should serve as the default entity choice for couples jointly operating a business.¹⁸⁹ This will achieve both the desired result of sidestepping Subchapter K while also eliminating the need for Rev. Proc. 2002-69.¹⁹⁰ As a result, the Rev. Proc. should also be retracted, to remove the current conflict between it and I.R.C. § 761(f).¹⁹¹

1. Retract Revenue Procedure 2002-69

Rev. Proc. 2002-69 allows taxpayers in community property states to remove themselves from Subchapter K without meeting any of the I.R.C. § 761(f) requirements.¹⁹² Although it provides for the successful completion of an I.R.C. § 1031 exchange, the result undermines I.R.C. § 761(f) by affording preferential treatment

184. 42 U.S.C. § 405(c)(5)(G) (2006).

185. *Id.*

186. *Id.*

187. *See generally* Royer v. Apfel, No. IP-99-1387-CH/G, 2000 WL 1707955, at *3 (S.D. Ind. Oct. 16, 2000).

188. *See generally* Sloan Interview, *supra* note 57.

189. *See generally id.*

190. *See generally* I.R.C. § 761(f) (West 2007); Rev. Proc. 2002-69, 2002-45 I.R.B. 831; I.R.C. § 701-77 (2006).

191. *See* I.R.C. § 761(f); Rev. Proc. 2002-69, 2002-45 I.R.B. 831.

192. Rev. Proc. 2002-69, 2002-45 I.R.B. 831; I.R.C. § 761(f).

without addressing the Social Security and Medicare issues.¹⁹³ Because I.R.C. § 761(f) and Private Letter Ruling (PLR) 199911033 offer equally effective solutions to the I.R.C. § 1031 problem, Rev. Proc. 2002-69 is no longer needed and should therefore be retracted.¹⁹⁴

a. A Cure for Social Security and Medicare Crediting

In requiring both spouses to participate materially in the venture, Congress forces couples to recognize the economic realities of their operation.¹⁹⁵ Because both spouses are actively involved in the business, both should receive income and earn eligibility for governmental benefits via self employment taxes.¹⁹⁶ By allowing disregarded entity status without such participation, Rev. Proc. 2002-69 frustrates this legitimate purpose.¹⁹⁷

b. § 761(f) Facilitates Like-Kind Exchange Tax Deferrals

Use of the qualified joint venture in an I.R.C. § 1031 exchange will effectively facilitate the sought after tax deferral.¹⁹⁸ Community property taxpayers were concerned that the check-the-box regulations would mechanically transform their newly created entity into a tax partnership, thereby violating the implicit *exchange requirement*.¹⁹⁹ With I.R.C. § 761(f), however, the same entity and the qualified joint venture will both relinquish and receive the like-kind property.²⁰⁰ Therefore, regardless of how the IRS decides the “business entity” issue, I.R.C. § 761(f) removes any concerns of an exchange violation.²⁰¹

193. See Rev. Proc. 2002-69, 2002-45 I.R.B. 831.

194. See generally I.R.C. § 761(f) (2007); I.R.S. Priv. Ltr. Rul. 199911033 (Mar. 19, 1999).

195. See generally I.R.C. § 761(f) (2007).

196. See *Royer v. Apfel*, No. IP-99-1387-CH/G, 2000 WL 1707955, at *3 (S.D. Ind. Oct. 16, 2000); see generally I.R.C. § 761(f) (2007) (requiring both spouses to materially participate).

197. Compare I.R.C. § 761(f) (2007), with Rev. Proc. 2002-69, 2002-45 I.R.B. 831.

198. See generally I.R.C. § 761(f) (2007).

199. See discussion *supra* Part II.

200. Cuff, *supra* note 94, at 232–237.

201. See *id.*

Should the revenue procedure be retracted and the material participation requirement not be removed, however, the community property issue will reemerge.²⁰² For instance, if only one spouse participates in the real estate venture, the non-participating spouse's lack of material participation will disqualify the couple for I.R.C. § 761(f) treatment.²⁰³ Consequently, the couple will again need clarification as to the automatic conversion of their new bankruptcy remote entity.²⁰⁴ Fortunately, however, PLR 199911033 sufficiently addresses this issue and leaves no justification for Rev. Proc. 2002-69's continued existence.²⁰⁵

c. No Purely Mechanical Entity Classification System

PLR 199911033 dispelled the notions that the check-the-box regulations produced a strict and mechanical entity classification system.²⁰⁶ There, similar to the situation addressed in Rev. Proc. 2002-69, taxpayers were concerned that a newly created, two-member LLC would, by definition, violate I.R.C. § 1031's exchange requirement.²⁰⁷ In the PLR, the lender required that the replacement property be held in a bankruptcy remote entity and that the lender obtain a membership role in the entity to disallow a voluntary bankruptcy filing.²⁰⁸ The effect of this arrangement, however, left the newly-created LLC with two members, the taxpayer and the lender.²⁰⁹ In deciding whether the LLC would violate the exchange requirement, the IRS surprisingly ventured beyond the regulations and analyzed the relationship under the *Culbertson* principles.²¹⁰ Eventually, the IRS found the two had no intent to "come together to

202. *See id.*

203. I.R.C. § 761(f)(2)(B) (West 2007).

204. *See discussion supra* Part II.

205. *See* I.R.S. Priv. Ltr. Rul. 199911033 (Mar. 19, 1999).

206. *Id.*

207. *Id.*

208. *Id.*

209. *Id.*

210. *Id.*

form a partnership,” and therefore denied the existence of the entity.²¹¹

This ruling confirms the IRS’s willingness to look beyond the regulations’ rigid constructs to make a correct, fact-based finding.²¹² In doing so, the IRS breathed life back into the *Culbertson* trilogy, demanding that at the very least, parties intend to join together to create a partnership.²¹³ Accordingly, no partnership should be found if co-ownership, which is merely a product of community property law, is not coupled with a corresponding intent to form a partnership.²¹⁴ Therefore, even if the participation requirement remains, PLR 199911033 provides adequate assurances that an automatic conversion will not affect community property couples performing like-kind exchanges.²¹⁵ Because the PLR, coupled with I.R.C. § 761(f), achieve the same results as Rev. Proc. 2002-69, the Rev. Proc. should be retracted, thus removing the current I.R.C. § 761(f) conflict.²¹⁶

CONCLUSION

I.R.C. § 761(f) extends benefits to married taxpayers unnecessarily burdened by the complexities of federal partnership law.²¹⁷ However, before the spouses can appreciate these benefits, the subsection insists that a number of requirements be met.²¹⁸ Unfortunately, history has shown these requirements will likely interfere with and deny the beneficial treatment to many deserving couples.²¹⁹ As a result, Congress should remove those obstacles making the qualified

211. I.R.S. Priv. Ltr. Rul. 199911033 (Mar. 19, 1999).

212. *See generally id.*

213. *Id.* (stating that “[t]he primary inquiry is whether the parties had the intent to join together to operate a business and share in its profits and losses”).

214. *Id.*

215. *See* Rev. Proc. 2002-69, 2002-45 I.R.B. 831; I.R.C. § 761(f) (West 2007); I.R.S. Priv. Ltr. Rul. 199911033 (Mar. 19, 1999).

216. *See* Rev. Proc. 2002-69, 2002-45 I.R.B. 831; 26 I.R.C. § 761(f); I.R.S. Priv. Ltr. Rul. 199911033 (Mar. 19, 1999).

217. I.R.S. Report, *supra* note 3, at 183.

218. *See* I.R.C. § 761(f)(2) (West 2007).

219. *See* discussion *supra* Part II.

joint venture the default entity choice for businesses run exclusively by husband and wives.²²⁰ Doing so achieves all I.R.C. § 761(f) benefits and also removes any further need for the conflicting Rev. Proc. 2002-69.²²¹

220. See discussion *supra* Part III.

221. See discussion *supra* Part III.