In Defense of the PIP Regulations

Walter D. Schwidetzky

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Abstract

The section 704(b) allocation Regulations contain a highly complex safe harbor, the substantial economic effect rules. If an allocation fails to comply with the safe harbor, it will only survive scrutiny if it is in accordance with the "partners' interests in the partnership" (PIP). Given the complexity of the safe harbor, one might expect the PIP Regulations to be similarly complex, but nothing could be further from the truth. The PIP Regulations are, by tax standards, concise and straightforward. Some have argued that the PIP Regulations do not provide enough guidance, and that a more complex and comprehensive set of regulations would be preferable. In this Article, I argue that judges have made successful use of the PIP Regulations, and that a more complex set of PIP Regulations would achieve little and indeed might cause more problems than they solve. Accordingly, I argue against any substantial amendment to the PIP Regulations, though I would provide a safe harbor for target allocations.

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I. Introduction

A "partner's interest in a partnership" (PIP) over time has played an increasingly large role in partnership allocation structures that practitioners design and hope comply with section 704(b). It is surprising, therefore, that PIP has received relatively modest attention in scholarly and professional articles.[1] This Article is an attempt to help remedy that imbalance. What attention the Regulations on PIP have received has often been critical. I believe that much of this criticism is unfair. I hope to persuade the reader that the PIP Regulations are, in fact, reasonable in their length and scope and about the best we can expect from the Service under the circumstances. That said, I believe the addition of a safe harbor or two would make the allocation Regulations more predictable.

II. Background

A. *Tax Partnerships*

Throughout this Article when I use the term partnership, I mean an entity that is classified as a partnership for federal tax purposes. That includes, of course, any state-law partnership but also most LLCs with two or more members. Under the default rule of the Check-the-Box Regulations, an LLC with two or more members is classified as a partnership for tax purposes.[2]

B. *Passthrough Taxation*

To begin at the beginning, in the United States, businesses ordinarily have two passthroughs to choose from, partnerships and S corporations. They are called passthroughs because they are normally not taxed at the entity level. Income and deductions flow through and are taken into account by the partners or shareholders. For the most part, S corporations have no allocation

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[1] My research turned up three scholarly articles, none recent. *See* Bradley T. Borden, *The Allure and Illusion of Partners' Interests in a Partnership*, 79 U. Cin. L. Rev. 1077 (2011); Paul Carman, *In Search of Partner's Interest in the Partnership: The Alternative of Substantial Economic Effect*, 107 J. Tax'n 214 (Oct. 2007); Stephen Utz, *Allocation and Reallocation in Accordance with the Partners' Interests in the Partnership*, 56 Tax Law. 357 (2003).

[2] Reg. § 301.7701-3(b)(1)(i).

flexibility; income and deductions must be allocated to the shareholders based on their ownership interests.[3] Partnerships, on the other hand, have great flexibility and are often the preferred vehicle for that reason. Partnership allocations of income and deduction do not necessarily need to be made in accordance with the partners' interests in partnership capital. Someone who, for example, contributed ten percent of the capital to a partnership can be allocated all of the section 168(k) bonus depreciation deductions, provided the partnership complies with section 704(b).

C. *Substantial Economic Effect Rules*

Section 704(b) provides that a partner's allocable share of income and deduction is determined based on PIP if (1) the partnership agreement does not provide how partnership income and deductions should be allocated, or (2) the allocations in the partnership agreement do not have "substantial economic effect." The regulations contain extensive rules on the definition of substantial economic effect. Professor Lawrence Lokken may have made the most oft-quoted statement about the substantial economic effect rules: They are "a creation of prodigious complexity . . . essentially inpenetrable [*sic*] to all but those with the time, talent, and determination to become thoroughly prepared experts on the subject."[4] The legal literature is not wanting for discussions of these rules.[5] Alas, a brief discussion is nonetheless necessary as it is important to know when a partnership has diverged from these rules.

The substantial economic effect rules require the partnership to keep capital accounts for the partners that meet the following requirements:[6]

A partner's capital account is increased by:

1. The amount of money contributed to the partnership.
2. The fair market value of property contributed to the partnership (net of liabilities secured by the property that the partnership is considered to assume or take subject to under section 752).
3. Allocations of partnership book income and gain, including tax-exempt income.

A partner's capital account is decreased by:

1. The amount of money distributed to the partner.

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[3]There is a bit of wiggle room. One has to be careful to avoid creating what could be counted as a second class of stock (which would end the S election), but under some circumstances employees or shareholders can be given stock options, bonuses, etc., which can give them a bigger share of income than their stock ownership alone would permit.

[4]Lawrence Lokken, *Partnership Allocations*, 41 Tax L. Rev. 545, 621 (1986).

[5]Professor Lokken's outstanding article was followed by many other efforts. I cannot resist mentioning one: Richard M. Lipton, Paul Carman, Charles Fassler & Walter D. Schwidetzky, Partnership Taxation ch. 5 (4th ed. 2017). This Article is informed by our effort, though I will not necessarily cite each instance.

[6]Reg. § 1.704-1(b)(2)(iv)(*b*).

2. The fair market value of property distributed to the partner (net of liabilities secured by the property that the partner is considered to assume or take subject to under section 752).
3. Allocations of expenditures of the partnership that can neither be capitalized nor deducted in computing taxable income.
4. Allocations of partnership book loss and deduction.

Capital accounts are increased or decreased for "book" gain, loss, income, and deduction, which very roughly correspond to economic gain, loss, income, and deduction.[7] Tax items and book items can be the same. If a partnership has gross income of $100,000, the gross income is the same for book and tax purposes. But tax items and economic items can also be different. Assume, for example, that a partner contributes property to a partnership with a tax basis of $10,000 and a fair market value of $15,000. The partner's capital account is increased by the full $15,000, while her tax basis in the partnership interest is increased by $10,000 under section 722. The partnership's "book value" for the property is $15,000, but its tax basis in the property is $10,000 under section 723. The capital accounts are adjusted for any "book" depreciation which is calculated as a percentage of book value. Under these facts, book depreciation would be greater than tax depreciation. If the property in the example goes up in value in the hands of the partnership to $22,000, upon a sale—ignoring depreciation deductions or other adjustments—the partnership has book gain equal to $22,000 – $15,000 = $7,000. That amount is reflected in the partners' capital accounts. The tax gain is computed as $22,000 – $10,000 = $12,000 and is not, as such, reflected in the capital accounts.[8] Tax gain is allocated under the rules of section 704(c), which, thankfully, are beyond the scope of this Article.

The substantial economic effect test is actually two tests in one. An allocation must have economic effect, and that economic effect must be substantial. To meet what might be called the "regular" economic effect test, the partnership allocations must comply with these rules:[9]

1. The partnership must keep capital accounts in accordance with the rules described above.
2. When an interest of a partner is liquidated, the partner must be paid any positive balance in her capital account.
3. If a partner has a deficit balance in her capital account, she must pay the deficit to the partnership by the end of the tax year in

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[7] *See* Lipton et al., *supra* note 5, at §§ 5.02, 5.05.

[8] *Id. See also* Borden, *supra* note 1, at 1099 (stating that capital accounts are adjusted for *taxable* income and for *tax* loss and deduction). As my discussion shows, the capital accounts are adjusted for book income, loss, and deduction, which can be equal to taxable income, loss, and deduction but need not be.

[9] Reg. § 1.704-1(b)(2)(ii)(*b*).

which her partnership interest is liquidated (or, if later, 90 days after liquidation).

This last rule is sometimes called a "deficit restoration obligation" (DRO).

At the risk of oversimplifying, for the economic effect of an allocation to be substantial, after the allocation, on a present-value, after-tax basis, there must be a strong likelihood that at least one partner is better off and at least one other partner is worse off than if the allocation had not been made.[10] Example 5 from the Regulations is a fairly easy illustration of an allocation that has economic effect but lacks substantiality.[11] In Example 5, a partnership has two otherwise equal partners, one in a low income tax bracket and the other in a high income tax bracket. The partnership earns reliable, equal amounts of taxable and tax-exempt income. All of the taxable income and a portion of the tax-exempt income are allocated to the low-bracket taxpayer, and the rest of the tax-exempt income is allocated to the high-bracket taxpayer. The Example does the calculations, which I will spare the reader, but suffice it to say that on a present-value, after-tax basis, both partners are better off than if each had been allocated a 50% share of each kind of income. Assuming there is a strong likelihood that this outcome will occur, as is the case under the facts of the Example, the economic effect of the allocation is not substantial, and the allocation is not allowed. I will address how the Regulation reallocates the income below.[12]

Note that the substantial economic effect rules constitute a safe harbor. Typically, however, a partner will not want to comply with the regular economic effect test given the unlimited DRO, which effectively can subject the partner to unlimited liability. As a consequence, there is an "alternate economic effect test"—and thus an alternative safe harbor—in which an allocation to a partner can have economic effect even if the partner does not have an unlimited—or any—DRO.[13] There is also an "economic effect equivalence test" that provides that even if the partnership does not formally meet the economic effect test, the allocation will still be allowed if, as of the end of each relevant taxable year, a liquidation of the partnership would produce the same economic results to the partners as would have occurred if the requirements of the regular test for economic effect had been satisfied, regardless of the performance of the partnership—a bit of a long shot.[14] There are also many variations on the substantiality theme in the Regulations. There are "shifting" and "transitory" allocation tests that provide that the economic

[10] Reg. § 1.704-1(b)(2)(iii)(*a*).

[11] Reg. § 1.704-1(b)(5), Ex. (5).

[12] *See infra* text accompanying notes 30–32.

[13] *See* Reg. § 1.704-1(b)(2)(ii)(*d*).

[14] *See* Reg. § 1.704-1(b)(2)(ii)(*i*). Some practitioners have argued that target allocations, discussed below (*see infra* Part II.F.1), can meet this test. That generally should not be true. Target allocations will not reliably yield the same results year in and year out as the economic effect test.

effect of the allocation is not substantial when there is a strong likelihood that the capital account balances of the partners would not differ substantially if the allocation were not present, and the allocation causes the tax liabilities of the relevant partners to drop.[15] Thus, these rules attempt to control the same abuses as illustrated in Example 5, prohibiting a tax benefit without a corresponding shift in the partners' economic positions. The focus of this Article is on PIP, not the substantial economic effect test, so I will not probe the intricacies of the substantial economic effect test further.

D. *Associated Safe Harbors*

There are times when the Regulations provide a safe harbor that deems an allocation that does not have substantial economic effect nonetheless to be in accordance with PIP, making it permissible. The Regulations have a highly detailed safe harbor for allocating nonrecourse deductions, *i.e.*, deductions attributable to nonrecourse debt.[16] These latter rules are necessary since allocations attributable to nonrecourse debt cannot have economic effect inasmuch as the creditor, not the partners, bears the ultimate economic risk. Similarly, the allocation of tax credits also cannot have economic effect. Tax credits are, to state the obvious, a tax and not an economic item. Tax credits are not reflected in capital accounts. A safe harbor was created under which tax credits can be safely allocated.[17] While the nonrecourse debt and tax credit safe harbors constitute reasonable solutions to the problems posed, they provide no real guidance on how to determine PIP in other circumstances.

E. *PIP*

Ordinarily, when a partnership fails to comply with the regulatory safe harbors, the relevant allocation must be tested to determine whether it is in accordance with PIP. If it is not, it must be redone in accordance with PIP. PIP is thus the ultimate backstop of the Regulations—as well, of course, of section 704(b).

Given the backstop status of PIP, it may seem strange that Regulations contain relatively little detail on the calculation of PIP. Regulation section 1.704-1(b)(3), which provides the core rules, states:

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[15] *See* Reg. § 1.704-1(b)(2)(iii)(*b*), -1(b)(2)(iii)(*c*).

[16] *See* Reg. § 1.704-2. Regulation section 1.704-2(b)(1) states: "If [the safe harbor test for allocating nonrecourse deductions] is not satisfied, the partners' distributive shares of nonrecourse deductions are determined under § 1.704-1(b)(3), according to the partners' overall economic interests in the partnership."

[17] Regulation section 1.704-1(b)(4)(ii) states:

> With respect to other tax credits, if a partnership expenditure (whether or not deductible) that gives rise to a tax credit in a partnership taxable year also gives rise to valid allocations of partnership loss or deduction (or other downward capital account adjustments) for such year, then the partners' interests in the partnership with respect to such credit (or the cost giving rise thereto) shall be in the same proportion as such partners' respective distributive shares of such loss or deduction (and adjustments).

(i) *In general*.—References in section 704(b) and this paragraph to a partner's interest in the partnership, or to the partners' interests in the partnership, signify the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated. Except with respect to partnership items that cannot have economic effect (such as nonrecourse deductions of the partnership), this sharing arrangement may or may not correspond to the overall economic arrangement of the partners. Thus, a partner who has a 50 percent overall interest in the partnership may have a 90 percent interest *in a particular item* of income or deduction. (For example, in the case of an unexpected downward adjustment to the capital account of a partner who does not have a deficit make-up obligation that causes such partner to have a negative capital account, it may be necessary to allocate a disproportionate amount of gross income of the partnership to such partner for such year so as to bring that partner's capital account back up to zero.) The determination of a partner's interest in a partnership shall be made by taking into account all facts and circumstances relating to the economic arrangement of the partners.

(ii) *Factors Considered.* In determining a partner's interest in the partnership, the following factors are among those that will be considered:

(a) The partners' relative contributions to the partnership,

(b) The interests of the partners in economic profits and losses (if different than that in taxable income or loss),

(c) The interests of the partners in cash flow and other non-liquidating distributions, and

(d) The rights of the partners to distributions of capital upon liquidation (emphasis supplied).

Thus, outside of certain safe harbors that deem the partnership to allocate in accordance with PIP, PIP is determined under a facts and circumstances test, with modest guidance from the Regulations,[18] with one exception. The Regulations give specific guidance as to how to determine PIP where the allocation meets the first two parts of the regular economic effect test but lacks an unlimited DRO—and would not meet any of the alternative tests.[19] In this circumstance, the partners' interests in the partnership are determined by comparing the manner in which distributions—and contributions—would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the taxable year to which the allocation relates, with the manner in which distributions—and contributions—would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the prior taxable year, adjusted for certain items specified in the Regulations. This is sometimes called the "comparative liquidation test" and has limited real world value, though it was once litigated.[20] That said, the specific guidance does look at how the ultimate economic burdens are shared and aligns well with Regulation section 1.704-1(b)(3)(ii). To that extent, it is, if nothing else, a useful reminder, along with the listed PIP facts and circumstances, that bottom-line economics should be the focus.[21]

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[18] Willis, Postlewaite, and Alexander conclude that "[t]here is not a conflict between a partner's interest in the partnership and substantial economic effect. They both rely on the same overriding principle that the tax effects of partnership operations must conform to the economic effects of those operations." Arthur B. Willis et al., Partnership Taxation ¶ 10.02[1] (8th ed. 2018). On the other hand, McKee, Nelson, and Whitmire caution that "it is far from clear that identical results would in fact be achieved under both the partner's-interest-in-the-partnership rule and the substantial economic effect safe harbor, and thus drafters of partnership agreements who stray from the safe harbor do so at their peril." William S. McKee et al., Federal Taxation of Partnerships and Partners ¶ 11.02[3] (4th ed. 2007).

The Regulations at one time contained a (fairly silly) rebuttable presumption that partners have an equal interest in the partnership. Reg. § 1.704-1(b)(3)(i) (1985) (stating that "[a]ll partners' interests in the partnership are presumed to be equal (determined on a per capita basis)"). *See* Estate of Ballantyne v. Commissioner, 83 T.C.M. (CCH) 1896, 1904, 2002 T.C.M. (RIA) ¶ 2002-160, at 1020; Barron v. Commissioner, 64 T.C.M. (CCH) 1034, 1038, 1992 T.C.M. (RIA) ¶ 92,598, at 3077. This tracked similarly silly presumptions under provisions in the various versions of the Uniform Partnership Act. *See* Unif. P'ship Act (1997), § 401(h) (amended 2013), 6 pt. II U.L.A. 85 (2015) (stating that "[e]ach partner has equal rights in the management and conduct of the partnership's business"); Unif. P'ship Act (1997), § 401(f), 6 pt. II U.L.A. 405 (2015) (same); Unif. P'ship Act (1914), § 18(e), 6 pt. III U.L.A. 410 (2015) (same). The regulatory presumption was removed in 2008.

[19] Reg. § 1.704-1(b)(3)(iii).

[20] The Tax Court upheld the Regulation in *Interhotel Co. v. Commissioner*, 74 T.C.M. (CCH) 819, 1997 T.C.M. (RIA) ¶ 97,449, *vacated and remanded*, 221 F.3d 1348 (9th Cir. 2000), *on remand*, 81 T.C.M. (CCH) 1804, 2001 T.C.M. (RIA) ¶ 2001-151. On remand, the court said that minimum gain, *i.e.*, the amount by which nonrecourse debt exceeds a property's book value, must be taken into account in computing the partners' capital accounts when applying the comparative liquidation test. *See* Richard M. Lipton, *A Lesson in Doing It the Hard Way: On Remand Tax Court Finds for Taxpayer in* Interhotel, 95 J. Tax'n 69 (Aug. 2001).

[21] *See* Willis et al., *supra* note 18, at ¶¶ 10.02[1], 10.02[2].

As the italicized language from the quoted portion of Regulation section 1.704-1(b)(3) shows, PIP need not be the same for each item of partnership income and deduction. Thus, PIP is not the same as, for example, a partner's average economic interest in the partnership. Instead, one must look at each relevant item of income and deduction and determine PIP for that item. Some have been troubled by the fact that PIP can vary in this fashion.[22] While the Regulation's definition of PIP is perhaps counter-intuitive at first blush, it makes perfect sense to those well-grounded in partnership taxation. The reality is that partnerships have the lawful ability to allocate different items of income and deductions differently to different partners. Thus, it often will not be possible to have a single PIP percentage for all partnership items. As I will discuss, somewhat surprisingly this issue turns out to play little role in the litigated cases, however.

Some have suggested that a partner's individual tax circumstance could be a relevant PIP fact and circumstance.[23] Likely, this confuses the substantiality rules of the substantial economic effect test with the PIP rules. As Example 5 shows, a partner's individual tax picture is a factor in determining whether or not the economic effect of an allocation is substantial.[24] If, in light of that individual tax picture, the economic effect of the allocation is not substantial, then the allocation must be redone in accordance with PIP. A partner's personal tax picture should not, however, be relevant to the determination of PIP. In Example 5, the Regulations do not consider the partners' individual tax picture in doing the reallocation but rather focus on the economics.[25] Further, all of the Regulations' listed PIP factors focus on a partner's economic rights in the partnership, *i.e.,* the economic relationship between the partner and the partnership. A partner's individual tax picture plays no role in that regard and should not be relevant in determining PIP.

F. *Does PIP Rule the Roost?*

Given that the substantial economic effect rules constitute a safe harbor, one might expect that practitioners would try to comply with them whenever possible rather than trying to come within the ill-defined PIP rules. While I am aware of no hard data on this point, my sense from attending ABA Tax Section meetings for over 30 years is that there was a time when practitioners did give priority to complying with the safe harbor, but over the years this has changed.[26] Practitioners increasingly have intentionally violated the substantial economic effect rules and gambled that their clients' allocations would be in accordance with PIP. There are doubtless many reasons for this, some very

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[22] *See* Utz, *supra* note 1, at 366.

[23] *Id.* at 367.

[24] *See supra* text accompanying notes 11–12; *see also* Reg. § 1.704-1(b)(5), Ex. (6).

[25] *See* Reg. § 1.704-1(b)(5), Ex. (5)(ii).

[26] *See also* Carman, *supra* note 1, at 214; Lipton et al., *supra* note 5, at § 5.04A (acknowledging this reality). A liquidating distribution that does not match the capital account balance likely would give the partner a gain or loss on the liquidating distribution under section 731.

fact specific. Many are gambling that the partnership will not be audited. But a repeated concern is that it can be difficult to comply with the safe harbor, even when acting in good faith.

1. *Target Allocations*

The "target allocation method" is perhaps the most common alternative to the substantial economic effect rules. Typically, this method violates the substantial economic effect rules but is believed to accord with PIP. Again, at the risk of oversimplifying, a target allocation focuses on how much cash a partner should receive at a given point in time—perhaps simulating a liquidation—and then attempts to allocate income or loss to the partner's capital account so that it equals the cash the partner should receive. The target allocation approach violates the Regulations' rules on capital accounts because distributions effectively govern capital accounts balances. Under the substantial economic effect rules, it is just the opposite. One determines a partner's capital account under the rules, and the partner then is entitled to a distribution equal to that balance. Also, in a partnership liquidation, a target allocation agreement often provides that the partner receives a stated amount of cash even if the partnership has insufficient income or loss to make his capital account match the distribution, which would also violate the Regulations' capital account rules—and would also generate a gain or loss to the distributee partner on the liquidating, cash distribution under section 731.[27] Of course, violating the capital account rules means violating the substantial economic effect test.

Many believe that because the target allocation method causes the allocation to "follow the cash," one is more likely to get to the right result and less likely to make a drafting error. As deals get more complex with "waterfalls" (*i.e.*, different classes of partners receive allocations and distributions in different orders) and flips (*e.g.*, increased allocation to the managing partners when certain goals are met), the risk of a drafting error is no small thing. Often, though not always, the parties could get to the same result using the substantial economic effect test but prefer to avoid the drafting challenges

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[27] *See* Daniel S. Goldberg, *The Target Method for Partnership Special Allocations and Why It Should Be Safe-Harbored*, 69 Tax Law. 663 (2016); William G. Cavanagh, *Targeted Allocations Hit the Spot*, 129 Tax Notes (TA) 89 (Oct. 4, 2010); Todd D. Golub, *Target Allocations: The Swiss Army Knife of Drafting (Good for Most Situations—But Don't Bet Your Life on It)*, 87 Taxes 157 (Mar. 2009); Terence Floyd Cuff, *Working with Target Allocations—Idiot-Proofing or Drafting for Idiots?*, 35 Real Est. Tax'n 116 (No. 3, 2008); Terence Floyd Cuff, *Some Selected Issues in Drafting Real Estate Partnership and LLC Agreements*, *in* Prac. L. Inst.: The Corp. Tax Practice Series: Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financing, Reorganizations & Restructurings ch. 52 (Louis S. Freeman ed., 2007); Robert L. Whitmire et al., Structuring and Drafting Partnership Agreements: Including LLC Agreements ¶ 5.05[2] (3d ed. 2003). Some partnership agreements that wish to comply with the substantial economic effect test contain "savings clauses" designed to address circumstances such as these. These savings clauses can create problems of their own. *See* Goldberg, *supra*, at 715–16.

involved. In the typical case, target allocations are not being used to game the tax system but are instead being used to allow the partners to reach the correct economic result more safely than using the substantial economic effect safe harbor.

2. *Is More Better?*

A consistent concern expressed about the PIP regulations is their inherent uncertainty[28]—aside from the noted exception.[29] One cannot know with complete confidence whether a given allocation that fails the substantial economic effect test will qualify under PIP. In the current formulation, this uncertainty is unavoidable. The Regulations spend less than 100 words on relevant PIP facts and circumstances. As I hope to show, there would be little value in lengthening the list of relevant facts and circumstances or creating a more complex PIP regime or both.

III. PIP in the Regulatory Examples

There are relatively few examples in the Regulations that state how reallocation in accordance with PIP should occur. When the Regulations do so, the reallocation is done in a way that offers little guidance outside of the four corners of the example. The examples typically involve partnerships with two partners where it is a straight-forward matter to figure out PIP. In Example 5, discussed above,[30] the partners were equal in all respects outside of the attempted allocation. One might assume that on reallocation in accordance with PIP the taxable and tax-exempt income must be allocated equally. The Regulations, though, look at the percentage of total income—taxable and not—actually allocated to each partner under the agreement and then allocate that percentage of each kind of income to each partner. The Regulations do not try to change the partners' deal—which a 50–50 PIP allocation would have done—and instead keep the amount of income allocated to each partner the same as in the original agreement but change the tax consequences by allocating the taxable and tax-exempt income proportionately.

Some have questioned this approach.[31] Their argument is that if the partners had known the allocation would not have been respected, they would have allocated everything 50–50, but because they, in fact, did not receive a 50–50 share, there has been a taxable transfer from the high-tax partner to the low-tax partner. While not without some theoretical cogency—at least for those residing in the ivory tower—Treasury and the Service probably lack the authority to create a taxable transfer between the partners when none actually occurred. Further, creating taxable transfers between partners out of

[28] *See* sources cited, *supra* note 1; Lokken, *supra* note 4.

[29] *See supra* text accompanying notes 19–20.

[30] *See supra* text accompanying notes 11–12.

[31] *See* David Hasen, *Partnership Special Allocations Revisited*, 13 Fla. Tax Rev. 349, 377–82 (2012); Gregg D. Polsky, *Deterring Tax-Driven Partnership Allocations*, 64 Tax Law. 97, 114–16 (2010).

whole cloth as part of a PIP reallocation would wreak havoc in more complex fact patterns such as those with waterfalls and preferred returns on capital. What if, for example, a section 754 election were in effect. How would that be accounted for?

The Service's more straight-forward approach works better in the real world. Further, as others have noted, it builds in a penalty. By failing to create an allocation with substantial economic effect, the partners are placed in a different position—and in the case of the higher taxed partner a worse one—than if they played by the rules.[32] If partners could go back to their baseline structure, in the example 50–50, and if the allocations do not hold up, they are in a win-win situation. If the allocations survive scrutiny, they have a tax advantage; if not, they are not worse off than if they had never made the attempt. By forcing the partners to stick with the economic consequences they created, but not the tax consequences, the Regulations are putting the partners in a win-lose situation, perhaps encouraging them to restrain their wilder allocation urges.

Another typical example is Example 4 which involves a two-person partnership in which the contributions to the partnership were made 75%–25%.[33] The partnership agreement also provided that distributions would be 75%–25%—and thus, contrary to the economic effect test, not in accordance with capital account balances. The partnership agreement provided that all income and deduction would be allocated 50%–50%. Since that allocation lacked economic effect, it had to be redone in accordance with PIP, which the example—of course—states would be 75%–25%. Other examples that make the PIP calculation are similar.[34] In real life, PIP is often anything but obvious, though in the litigated cases, discussed below, PIP is usually fairly easy to identify.

IV. Case Law

There is hardly a plethora of cases on PIP, but there have been some. I discuss most of these next. The years at issue in many of the cases predate the adoption of the relevant Regulations in 1985.[35] The courts in these cases, however, essentially applied the equivalent of the regulatory rules. Indeed, the Regulations to a large extent adopted the analysis of prior case law, which

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[32] *See* Polsky, *supra* note 31, at 115–16.

[33] Reg. § 1.704-1(b)(5), Ex. (4).

[34] *See, e.g.*, Reg. § 1.704-1(b)(5), Exs. (6)–(8), (10). There are other examples in which the Regulations conclude that an allocation lacks substantial economic effect and must be reallocated in accordance with PIP but don't actually calculate PIP. Notably, these examples tend to be more complex. *See* Reg. § 1.704-1(b)(5), Exs. (9), (16).

[35] Though the Regulations were retroactive to tax years beginning after December 31, 1975. *See* T.D. 8095, 1986-1 C.B. 254, 255.

looked at substantial economic effect, capital accounts, DROs, and PIP.[36] Accordingly, in the discussion, I don't make a point of distinguishing between pre-1985 and post-1985 tax years that are under discussion.

A. Hogan v. Commissioner

Hogan v. Commissioner is one of the first cases to address PIP.[37] Honey Hill Farm Partnership was formed in Pennsylvania in 1973 to breed and show quarter horses. It had three partners, Joseph Hogan, Frederick DeClement, and William Hogan. The partnership operated at a loss, and Joseph, the litigating taxpayer, claimed that he was entitled to two-thirds of the losses. He did make larger capital contributions than Frederick. William, Joseph's brother, did not make any capital contributions but contributed services instead. He was charged with managing the daily operations of the business. The partners did not have a written agreement but orally agreed that profits would be allocated one-third to each partner; whereas, losses would be allocated two-thirds to Joseph and one-third to Frederick. The terms of the partners' oral agreement likely would have been effective if they had executed a written partnership agreement that complied with the substantial economic effect rules. The partners did properly maintain capital accounts, and Joseph had a negative capital account. The partners were unable to prove, however, that there was any oral or written agreement under which a partner was obligated to restore a deficit capital account balance on liquidation of the partnership.

Interestingly, the partners tried to argue, not without some cogency, that state law required a partner to restore a deficit capital account. Pennsylvania followed section 18(a) of the 1914 Uniform Partnership Act, which provided that

> [e]ach partner shall be repaid his contributions, whether by way of capital or advances to the partnership property and share equally in the profits and surplus remaining after all liabilities, including those to partners, are satisfied; and must contribute towards the losses, whether of capital or otherwise, sustained by the partnership according to his share in the profits.[38]

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[36] *See* Hogan v. Commissioner, 59 T.C.M. (CCH) 870, T.C.M. (P-H) ¶ 90,295 (1990); Ogden v. Commissioner, 84 T.C. 871, 881–84 (1985), *aff'd per curiam*, 788 F.2d 252 (5th Cir. 1986); Gershkowitz v. Commissioner, 88 T.C. 984, 1017–19 (1987); Elrod v. Commissioner, 87 T.C. 1046, 1082–86 (1986); Goldfine v. Commissioner, 80 T.C. 843, 852 (1983).

[37] 59 T.C.M. (CCH) 870, T.C.M. (P-H) ¶ 90,295 (1990). But it is not the first. There are several earlier cases that I do not discuss due to the minor role that the PIP issue played or because I felt the cases were too long in the tooth. *See generally* Orrisch v. Commissioner, 55 T.C. 395 (1970); Harris v. Commissioner, 61 T.C. 770 (1974); Allison v. United States, 701 F.2d 933 (Fed. Cir. 1983); Hamilton v. United States, 687 F.2d 408 (Ct. Cl. 1982); *Goldfine*, 80 T.C. 843; Miller v. Commissioner, 48 T.C.M. (CCH) 409, T.C.M. (P-H) ¶ 84,336 (1984); Schumaker v. Commissioner, 51 T.C.M. (CCH) 1, T.C.M. (P-H) ¶ 85,582 (1985); Mammoth Lake Project v. Commissioner, 61 T.C.M. (CCH) 1630, T.C.M. (P-H) ¶ 91,004 (1991).

[38] Unif. P'ship Act (1914), § 18(a), 6 pt. III U.L.A. 410 (2015).

But the Tax Court had previously ruled in *Goldfine*[39] that similar language in an Illinois statute did not create a DRO. While Joseph's argument was not specious, neither was the court's analysis. Although the Pennsylvania statue was hardly a model of clarity, it was not inevitable that a partner's obligation to "contribute towards the losses" was synonymous with a DRO. Losses, for example, could be interpreted to mean any debts owed to creditors at the time of the liquidation. If none were owed, no payment by a partner might be due. Further, the unspecific nature of the statue makes it difficult to align it with the substantial economic effect Regulations. Finally, the court may not have been unduly sympathetic, inasmuch as the partners could have created a written agreement that would have unambiguously complied with the Regulations.

Given the lack of compliance with the substantial economic effect test, the court relied on PIP; and Joseph's battle was lost. The partners' own testimony made it clear that they generally regarded themselves as equal partners, and, accordingly, the court required equal allocations. Ultimately, the case really hinged on the interpretation of the state partnership statute. If the Tax Court was correct in this regard, then its holding is unassailable. And the Tax Court's holding with regard to the statute, while perhaps not inescapable, was a fair one. It was reasonable to conclude that an ambiguous statute did not comply with the terms of an unambiguous—with respect to the economic effect test—Regulation.

B. PNRC Limited Partnership v. Commissioner

The facts in *PNRC LP v. Commissioner* are complex, though the underlying issue is reasonably straight forward.[40] Peter Carlino was the sole limited partner of PNRC Limited Partnership (PNRC LP). A corporation, PNRC, was the general partner. PNRC was, in turn, controlled by the Carlino Family Partnership (CFP), another limited partnership controlled by Carlino and his family. Carlino was the general partner of CFP. The limited partners were his wife and children. Carlino successfully ran several race track businesses. Carlino had leased the Penn National Race Course through an entity, Mountainview Thoroughbred Racing Association (Mountainview), which he controlled. The race track was profitable to Mountainview. Because Mountainview was not allowed to renew its lease, in 1982 CFP and the newly formed PNRC LP entered into a contract to buy the race track, which included the assumption of an existing $8 million mortgage. That mortgage was also guaranteed by Carlino, his wife, and entities he controlled—including PNRC and Mountainview. CFP and PNRC LP in turn leased the race track to Mountainview and the Turf Club; at the time, Turf Club was a public corporation. The opinion did not state what the sharing arrangement was between CFP and PNRC LP.

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[39] *Goldfine*, 80 T.C. at 852–53.

[40] 66 T.C.M. (CCH) 265, 1993 T.C.M. (RIA) ¶ 93,335.

The PNRC LP partnership agreement (the Agreement) initially allocated losses 1% to the general partner, PNRC, and 99% to the limited partner, Carlino. The original Agreement inversely allocated profits 99% to the general partner and 1% to the limited partner. But the Agreement was amended three days after it was executed, on December 31, 1982, to provide for an allocation of 60% of any profits to the general partner and 40% to the limited partner. The Agreement did not reflect the parties' capital contributions, but the partnership was capitalized with $420,000. The Agreement further provided that upon termination of the partnership, the general partner was to either sell the partnership's assets and distribute the net proceeds or distribute the partnership's property to the partners in proportion to their percentage interests. The Agreement provided that any reference to a partner's percentage interest was to his interest in net profits. PNRC LP sustained losses in all of the years at issue.

The Tax Court concluded that the allocations in the limited partnership agreement lacked economic effect because the partnership agreement did not contain any of the "regular" economic effect provisions and, indeed, specifically provided that the general partner was not obligated to restore a negative capital account. The agreement did not meet any of the alternate regulatory tests. Carlino apparently tried to argue that his guarantee of the $8 million debt constituted a DRO, but the court rejected this argument because Carlino was, of course, not unqualifiedly obligated to pay on the guarantee. Payment would only have needed to be made if the primary obligor was insolvent—which was not the case—and other guarantors did not pay—which was unknowable in the abstract.

Accordingly, the partnership losses had to be reallocated in accordance with PIP. The court felt that the contributions to the partnership were most indicative of PIP and reallocated the losses in accordance with those contributions. This resulted in PNRC being allocated approximately 71% of the losses in the first two years under consideration and approximately 39% for the final two years, with the balance being allocated to Carlino. I will spare the reader the complexities of the court's math. Note that the losses allocated to PNRC, apparently a C corporation, would have been useless in the near term because PNRC would not have had any income to offset them.

This is not the only case I will discuss in which the attorney advising the taxpayer did not seem to be paying attention to relevant tax law. It is hard to argue with the court's choice to base its allocations on the partners' contributions because the contributions were the only truly available and relevant fact. The other factors listed in the Regulations did not apply. The interests of the partners in economic profits and losses were not different from those in taxable income or loss, and there were apparently no identifiable rights to cash flow and other nonliquidating distributions. It did not make much sense to use liquidation rights for a partnership not contemplating liquidation that had operated exclusively at a loss and had substantial debt. It might have nothing to distribute in liquidation. And there were no other facts on which the court could hang its hat. So, whatever the regulatory paucity, the court likely reached the right answer. Note that here the court was focused on PIP for losses. Since PIP can be different for different items, had the court been in a position to allocate net partnership income, it may not have reached the same answer.

C. Vecchio v. Commissioner

It is not entirely clear why *Vecchio v. Commissioner* is a regular Tax Court decision, rather than a memorandum decision.[41] In light of the cases discussed above, *Vecchio* did not break new ground. The PIP rules were triggered because the allocations in the partnership agreement did not have substantial economic effect. The facts of the case are complex, involving partner changes, disputes among the partners, two Ohio state court judgments that overrode, in parts, the partnership agreement, and revisions by the Service of its assessment during the litigation. I will focus on the basics. Sam J. Vecchio, Equity Johanna (a limited partnership), and Lawrence Berzon were partners in a partnership, the main asset of which was a commercial building. The partnership agreement allocated operating income 47.5% to Vecchio, 49% to Equity, and 3.5% to Berzon. The partnership agreement allocated a disproportionately large share of losses and depreciation to Equity from 1974 through 1978, so that at the beginning of 1980, Equity had a negative capital account balance of $1,251,898. Vecchio and Berzon had positive capital account balances.

As a result of a dispute between Equity and Vecchio as to whether to retain or distribute profits, Equity filed suit in an Ohio court. On May 8, 1980, the state court ordered Vecchio to purchase Equity's interest in the partnership on or before September 30, 1981, or to transfer one-half of his interest in the partnership to Equity. Apparently prompted by the state court's judgment, the partnership sold its real property on December 10, 1980, on the installment basis.[42] Equity argued that it was entitled to be paid out of the first installment proceeds. Vecchio refused that payment, resulting in a second round of state-court litigation. The Ohio court concluded that the sale terminated the partnership and advanced the date for implementation of the court's first order. The state court ordered Vecchio to pay the balance of the purchase price to Equity for its partnership interest, after making certain adjustments.

The partnership agreement provided that, upon the sale of the partnership's real property or the liquidation of the partnership, Equity was entitled to a return of its capital investment of $766,100 before distributions were made to other partners. The partnership realized gain of $4,659,832 on the sale of the real property, of which $1,986,913 was recognized—*i.e.*, taxable—in 1980 under section 453. The partnership partially double-allocated the gain, first allocating all of the realized gain to the partners and then also allocating the 1980 recognized gain to the partners. Of course, a double allocation cannot

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[41] 103 T.C. 170 (1994).

[42] *See* I.R.C. § 453.

stand. It is not clear from the Tax Court opinion whether the partnership agreement—as amended by the state court order—required this outcome or whether the partnership merely made a mistake in its allocations. The Tax Court apparently took the view that the allocations that the partnership made were pursuant to the partnership agreement. Given other problems with the partnership agreement, the outcome of the case would have been the same regardless of how the Tax Court interpreted the allocation provisions of the agreement in this regard.

The Tax Court concluded that the partnership agreement failed to comply with the economic effect test. In the court's—doubtless correct—view, all of the partnership's book gain, that is all of the gain realized on the sale, had to be reflected in the partners' capital accounts in the year of the sale. But the capital accounts could, of course, not again be adjusted for the 1980 gain that was taxable under the rules of section 453. The double allocation of the 1980 gain meant, of course, that the partnership failed to keep capital accounts in accordance with the regulations, which meant that the partnership's allocations did not comply with the first part of the economic effect test. As noted above, the partnership agreement also provided that Equity was to receive a return of its investment before the other partners received a distribution. But the second part of the economic effect test requires that all partners be paid the positive balance in their capital accounts, with no preference for any partner with a positive capital account balance. Consequently, the partnership agreement failed to comply with the second part of the economic effect test. Finally, the partnership agreement did not require the partners with negative capital account balances to restore the deficit on liquidation of the partnership, thereby failing the third part of the economic effect test. Thus, the partnership failed all three parts of the economic effect test. Again, one wonders why the practitioners drawing up the agreement were not paying more attention.[43]

Since the partnership agreement failed the economic effect test, the allocations had to be redetermined in accordance with PIP. It is conceivable that the Tax Court and the Service could have attacked the prior years' allocations to Equity which presumably also lacked economic effect—indeed, as I discuss below, that would have been preferable—but both the Tax Court and the Service focused on 1980. The court concluded that, because Equity had a negative capital account, gain had to first be allocated to Equity's interest in an amount necessary to bring its capital account to zero to avoid shifting the "burden" of the prior years' losses that had been deducted by Equity to the other partners. The court's language here is awkward, though the allocation in context is correct. An allocation of income to a capital account cannot really

[43] Although the tax years at issue preceded the adoption of the substantial economic effect Regulations in 1985, the baseline rules had by that time been established by case law. In this case, the court cited the Regulations, which were retroactive to tax years beginning after December 31, 1975. See *supra* note 35.

be seen as a burden. To the extent mirrored by taxable income, a tax may be due, but the partner receiving the allocation has a bigger capital account and more money in his pocket on liquidation, assuming he receives a distribution of the balance in his capital account on liquidation. That said, it made sense to make this allocation to Equity because of its preferential $766,100 liquidation rights and its lack of a DRO. To permit such a distribution on liquidation, Equity's capital account had to reflect a positive $766,100 balance, and the first step in achieving this result was to restore the deficit in the capital account. The court then allocated additional gain to Equity to bring its capital account to $766,100. The total of those two allocations to Equity, $2,176,332, was less than the realized gain of $4,659,832, but exceeded the taxable gain in the year of the sale of $1,986,913. The court concluded that, consequently, Equity had to receive all of the taxable gain as part of its $2,176,332 allocation.[44]

It has been argued that PIP in the case should have been determined by using the comparative liquidation test.[45] That Regulation only applies, however, if the partnership complies with all but the last of the three economic effect tests. In *Vecchio*, the court concluded that the partnership failed all three economic effect tests.

If one accepts the Tax Court's implied premise that the only tax year at issue was 1980, then the court's PIP allocation seems fair enough. It made allocations of income to Equity in an amount that assured that its capital account was sufficient to cover its bottom-line distribution rights. Indeed, if 1980 is the only relevant year, it is hard to see how the court could have made an alternative allocation. The court's allocation, incidentally, aligns rather nicely with the target allocation system. The allocation resulted in an adjustment of Equity's capital account to accord with Equity's distribution rights on liquidation.

But, the difficulty with the opinion is the focus on 1980. If the allocations to Equity lacked economic effect in 1980, they also lacked economic effect in the prior years since the partnership agreement was unchanged. Thus, what the court needed to do was to recalculate the allocation for all relevant years, though only open years could have changed the taxes due. Given that Equity did not have a DRO, Equity should not, at a minimum, have been given allocations of losses that caused its capital account to go negative, and those allocations should have been given to the other partners. PIP, though, would

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[44] If everything else had been equal, the balance of the realized gain would have been allocated to the other partners. But because Vecchio purchased Equity's interest, the Tax Court had to address the extent to which a portion of Equity's gain was shifted to Vecchio due to the sale. The Service claimed that Vecchio purchased the interest before the sale of the real property, but the court rejected that claim and held that Vecchio acquired the interest after the sale of the real property. The court, however, held that Vecchio's purchase of the partnership interest brought with it Equity's right to the first $766,100, causing some of the gain associated with Equity's interest to be shifted to Vecchio under section 706.

[45] *See* Utz, *supra* note 1, at 378.

have given Equity a positive capital account balance of $766,100, since it had a right to receive that amount before distributions to the other partners were made. Thus, the court's approach was correct in giving Equity a positive capital account balance of $766,100 but also wrong by effectively allowing prior years' allocations to stand when those allocations did not have substantial economic effect. *Vecchio* is thus something of a mixed bag as a precedent. It misapplied the law in important ways but was right to focus on requiring that Equity's capital account align with the parties' economic agreement.

If one assumes that the statute of limitation had expired on the prior years, however, it was more equitable to give Equity the income allocation given that it received the benefit of losses in prior years and had a capital account deficit that needed to be offset. To the extent that equitable considerations are a PIP factor, and why not, then in this circumstance the court's allocations were sound.

D. Brooks v. Commissioner

Getting shafted by your fellow partners, apparently, does not affect PIP. In *Brooks v. Commissioner*, there was no formal partnership agreement, but the taxpayer stipulated that she held a 25% interest in the partnership, resolving the PIP question.[46] She claimed, however, that she should not be taxable on the income because she had received no distributions. The argument, as one would expect, fell on deaf ears. Partners are, of course, taxable on their allocable shares of the partnership's income under section 702 whether or not the partnership makes distributions. Indeed, even fraud has been held not to relieve a taxpayer of tax liability.[47] The important point here is that disputes among partners that go to the operation of the partnership rather than the measure of their economic interests, do not—unsurprisingly—affect PIP.

E. Estate of Tobias v. Commissioner

Estate of Tobias v. Commissioner is yet another case with complex facts and ill-advised taxpayers.[48] Two brothers, James and Darwin, had an oral partnership to operate a farm and did not have a specific agreement as to allocations. They both had independent means and did not have any specific agreements as to who would do what. James did most of the work. They both made land they owned available to the partnership and agreed that both would be paid rent for the use of the land. While the rent was often paid to Darwin, James apparently often deferred being paid. Both brothers were reimbursed for expenses, but otherwise the partnership did not make distributions to them. All profits were reinvested in the business. In 1986, the brothers had a

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[46] 70 T.C.M. (CCH) 458, 1995 T.C.M. (RIA) ¶ 95,400.

[47] Stoumen v. Commissioner, 208 F.2d 903, 906 (3d Cir. 1953); Stern v. Commissioner, 48 T.C.M. (CCH) 605, T.C.M. (P-H) ¶ 84,383 (1984).

[48] 81 T.C.M. (CCH) 1163, 2001 T.C.M. (RIA) ¶ 2001-037.

falling out, and James prevented Darwin from participating in the business. James continued to operate the farm through at least 1993.

In 1986, Darwin sued James and requested dissolution of the partnership. The state court found that Darwin had been "wrongfully excluded from the business" and was entitled to dissolution of the partnership and an accounting. The state court found that James' contributions to the partnership far exceeded Darwin's contributions and concluded that under Pennsylvania law "repayment of capital investments before distribution of any profits is an essential element of every partnerships [*sic*] agreement implied as a term of law."[49] The court ordered that each partner be repaid his capital contributions and that thereafter any profits be divided equally. Before the court's order could be brought to closure, James died. In litigation that took place after James' death, the state court determined that James had made capital contributions to the partnership of $1,001,558.60, that Darwin had made capital contributions to the partnership of $2,320, and that the partnership had $23,311.87 in its bank accounts. The state court ordered payment of the outstanding liabilities of the partnership totaling $23,335.47. The state court also ordered the sale of partnership equipment at a public auction, with any funds remaining after payment to creditors to be distributed to James' estate to repay him for his contribution. The state court did not order any distributions to Darwin, apparently on the assumption that any partnership distributions that could be made would be insufficient to reimburse James for his contributions to the partnership.

Just to complicate things, from 1965 until 1992, James treated the farm business as a sole proprietorship and reported the entire income from the business on his individual tax returns. After the state court found that the business was a partnership, James caused the partnership to file returns for the years 1990 through 1993. Darwin did not participate in the preparation or filing of the partnership returns. The returns reported the two brothers as equal partners, and James reported half the income on his personal returns.[50]

The Service's response was, at first blush, perplexing. It claimed that it could not reliably determine what each partner's share of income was and so allocated 100% of the income to James and 50% of the income to Darwin—who had reported none of it—for a total of 150%. That obviously could not stand. The Service's assessment against Darwin was not as irrational as it seems or particularly unusual. The assessment against Darwin was protective in nature, in case the Service lost the argument that James should be allocated all of the income. If the Service had just proceeded against James and lost, the statute of limitations for a claim against Darwin might have expired in the interim. Further, all of the relevant parties were before the court, so a

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[49] *Estate of Tobias*, 81 T.C.M. (CCH) at 1170, 2001 T.C.M. (RIA) ¶ 2001-037 at 276 (quoting from the state court's opinion in Tobias v. Tobias, No. 4583 (Ct. C.P. Dauphin County, Pa. July 7, 1992)).

[50] Excluding, inexplicably, capital gains in 1993.

complete resolution, one way or the other, could be had in one litigation. The Service generously said that it would reduce Darwin's assessment to the extent it was successful in its claim against James.

Before the Tax Court, James' estate claimed that James should only be taxed on 50%, while Darwin claimed that, because there was no partnership, all of the income should be taxed to James, noting the state court's conclusion that all distributions should go to James. The Service essentially agreed with Darwin, arguing that James had a 100% PIP interest—apparently unbothered by the idea of a one-person partnership. The Service also argued that the partnership agreement did not provide for an allocation, which, as discussed above, is grounds for using PIP. The court agreed with the Service in this regard.

There was an important, albeit somewhat paradoxical, set of issues in the case. On one hand, Darwin had no role and seemingly no economic rights in the partnership for the years at issue, 1990 to 1993. Darwin could only receive a distribution after the partners had been repaid their capital contributions, but because James' capital contribution could not be fully repaid, there was no way for Darwin's share to be triggered. As a result of the state court's holding, Darwin thus had no effective rights to cash flow, nonliquidating, or liquidating distributions. On the other hand, the partnership remained in existence because, as the Tax Court observed, nothing in section 708 triggered a liquidation of the partnership for the years in question. The court concluded that "[i]t is evident, therefore, that during each of the years in issue James bore the economic benefit of 100 percent of the income realized by the partnership."[51] Inescapably, the court affirmed the Service's assessment against James.

Given that PIP focuses on a partner's economic rights, and James effectively held all of the economic rights in the partnership, it is hard to argue with the Tax Court's holding. One commentator has argued that since Darwin had a 50% profits interest, he should have been allocated 50% of the income for the years in question,[52] but this elevates form over substance. In light of the state court's holding, Darwin was never going to collect that profit share. There is some question of whether the state court pristinely followed the terms of the Uniform Partnership Act,[53] but it is not the Tax Court's job to relitigate an effective state court decision. Rather it is the Tax Court's job to apply tax law in light of the partners' rights under state law.

F. Ballantyne v. Commissioner

In *Ballantyne v. Commissioner,* Melvin Ballantyne and Russell Ballantyne were brothers.[54] In 1943, they formed a general partnership known as

[51] *Estate of Tobias*, 81 T.C.M. (CCH) at 1170, 2001 T.C.M. (RIA) ¶ 2001-037 at 275.
[52] *See* Utz, *supra* note 1, at 375.
[53] *Id.*
[54] 83 T.C.M. (CCH) 1896, 2002 T.C.M. (RIA) ¶ 2002-160.

Ballantyne Brothers Partnership (BBP). A written partnership agreement was never executed. The partnership was involved in two separate businesses. Russell primarily conducted a farming activity in North Dakota. Melvin primarily conducted an oil and gas exploration and production activity in Canada and various U.S. locations. In general, the brothers agreed that each brother could withdraw from the partnership the profits attributable to the activity he conducted. Melvin and Russell each also generally paid the expenses related to his respective activity. Many of the assets used by BBP in its activities were not held in the partnership's name but rather were owned by either Melvin and Russell jointly or one of them individually. Melvin died in 1994, and the partnership automatically dissolved upon his death. From 1980 to 1994, the partnership filed partnership returns showing the two brothers as equal partners. Yet again, the partnership kept poor records and did not maintain capital accounts.

After Melvin's death, his wife Jean, executrix of his estate, filed suit against Russell for an accounting of the assets and liabilities of BBP in order to establish the value of BBP's assets and liabilities and the respective interests of Melvin and Russell as of the date of Melvin's death. The estate alleged that it had not received a distribution from the farming operations Russell conducted and claimed that Russell had embezzled cash from BBP bank accounts and transferred it to his own business and personal accounts, resulting in a casualty or theft loss of $560,900. In 1998, the litigation was settled in exchange for a $2 million payment by Russell to the estate and an agreement for property division. The parties stipulated that all grain, and any proceeds from the sale thereof, held on or after November 1993 in the name of BBP were to be the sole property of Russell. They also stipulated that all assets and liabilities of BBP held on or after March 4, 1994, would be the sole property of Russell.

The Service issued a notice of deficiency on various matters. The one relevant here was a claim that Russell failed to report $751,988 of income from grain sales in 1994. That claim would fail if Melvin and Russell were 50–50 partners during the time the income was earned but succeed if Russell was the sole owner of the grain business. The estate disputed that it should be allocated any share of the income from grain sales.

The court noted that, a state court judgment notwithstanding, taxpayers cannot retroactively change tax consequences. It was clear that BBP owned the grain in 1994, not Russell individually, and that any resulting income from its sale was income of the partnership. Since the partnership agreement was oral, the partnership could not meet the economic effect test, which ultimately meant that the income had to be allocated according to PIP.[55] The court noted, but did not place special emphasis on the fact, that the Regulations at the time contained a rebuttable presumption that partners had equal interests

[55] The court also concluded that the partnership did not meet the economic effect equivalency test.

in the partnership.[56] The partnership tax returns showed the brothers to be equal partners. Several witnesses testified that they believed the brothers to be equal partners. When the estate negotiated a settlement, its objective was to obtain 50% of the partnership's assets, and the evidence indicated that this objective was achieved. Neither brother was ever heard to complain about the 50–50 arrangement. The only contrary fact related to how the partners withdrew money from the partnership. Apparently, each brother could withdraw money as he wished, and, as noted above, each typically withdrew the funds from the business he conducted. There was evidence that Melvin withdrew more funds from the partnership than Russell. But this fact was, in the court's view, insufficient to outweigh all of the other evidence that favored a 50–50 partnership, particularly since there was no legal impediment to prevent one partner from withdrawing funds from the other partner's business.

Again, it is hard to fault the court's conclusion. While the court mentioned the former regulatory presumption of equal partners more than once in the case, it is not clear how large a role that presumption played. But, given the evidence, it is hard to see how the court could have reached a different conclusion had there been no such presumption.[57] The overwhelming weight of the evidence was that Melvin and Russell were equal partners.

G. Holdner v. Commissioner

In *Holdner v. Commissioner*, son and father formed a partnership to manage a cattle farm in 1977.[58] The son was responsible for managing the farm; his duties included feeding the cattle, maintaining farm equipment, and tending to sick animals. The father was primarily responsible for managing the farm's financial affairs; his duties included arranging cattle sales, making payments to suppliers, and obtaining financing to purchase new farm properties. The son worked full time, and the father, who was also an accountant, worked about half time in the farming business. The father also agreed, at least initially, to contribute money to the farm, though it was unclear how much money he actually contributed or whether he expected to be repaid. They agreed that the son would be entitled to one-half of the farm's gross proceeds from cattle sales and that he would have an equity interest in the farm, though the precise nature of that interest was unclear. There was no credible evidence that the father and son had an agreement on the allocation of other items of income and expense.

The father believed that it was important to the success of the farm to also own income producing properties. Father and son jointly bought several properties using land sale contacts, with payments on the contract made from

[56] *See supra* note 18.

[57] Had Russell truly embezzled funds from the partnership, that might have shifted a portion of what would otherwise have been Melvin's income to him, but the court concluded that the evidence did not support the embezzlement claim.

[58] 100 T.C.M. (CCH) 108, 2010 T.C.M. (RIA) ¶ 2010-175.

income generated by the properties. These properties, including pasture, timberland, and even another farm, were fully paid for by 2004 and were owned by the father and son as tenants in common. Notwithstanding the title, the understanding was that the son would inherit the properties on the father's death. The cattle business proved successful, generating $1,000,000 of income from 2004 to 2006, the years under review. The other properties were also profitable, earning about $284,000 during the same time frame.

The partnership had a separate bank account on which both father and son had signing authority. While they never committed their agreement to writing, they did register their partnership with the state in 2003. The father prepared the tax returns. They did not file a partnership tax return. Instead, each reported half of the income on his individual return for 2004 to 2006. The father, however, deducted most of the expenses from the businesses on his return for those years, though occasionally he allocated some expenses to his son.

A threshold issue was whether the father and son had a partnership for tax purposes. Unsurprisingly, the court held that they did given that they jointly operated the business for profit and in fact did profit.[59] Since there was no written agreement, the partners' shares of income and expense had to be determined according to PIP. While the father had put in significantly more funds than the son, $2.5 million versus $800,000, the son contributed far more services. While it might have been possible to allocate a disproportionate share of the expenses to the father if they had followed the economic effect rules and maintained capital accounts, the partnership did neither. (Apparently, the father never took a partnership tax course.) Moreover, the father's treatment of expenses was essentially random. In some years he deducted 75% of the expenses, in other years less, and in one year he only deducted 11.4% of depreciation and section 179 expenses. There was no evidence that explained these variations. For the years at issue, the expenses were paid from farm revenue, so arguably the father did not bear a disproportionate share of the burden for the expenses in light of the fact that father and son divided the farm income equally. If the source of payment was divided equally, it strongly suggested that each bore the burden of the expenses equally. There was no evidence that either received a greater share of nonliquidating distributions, and no evidence whatsoever as to how a liquidating distribution would have been made, had the business been liquidated.

The strongest argument that the father and son were not equal partners was that the father made a much larger capital contribution. But that fact, by itself, was in the court's view insufficient to overcome the other evidence of

[59] This is roughly the definition of a partnership both for tax and state law purposes. *See, e.g.*, Podell v. Commissioner, 55 T.C. 429, 431 (1970); Luna v. Commissioner, 42 T.C. 1067, 1077 (1964); Unif. P'ship Act (1997), § 102(11) (amended 2013), 6 pt. II U.L.A. 17 (2015). Given the focus of this Article, I go into much less detail than the court in this regard.

equality or the regulatory presumption of equality that existed at the time.[60] The father's greater capital contributions might have played a larger role in the court's reasoning if they had been made closer in time to the years under review. It is not clear from the opinion when those capital contributions were made, but it appears to have been in the early years of the partnership, perhaps the late 1970's and early 1980's. Also, to the extent there was an agreement that the son would inherit the business, arguably the father shifted some of his capital interest to the son, diminishing the importance of the capital contribution difference.[61]

Accordingly, the court concluded that the father and son were equal partners both for income and expenses for the years in question. Given the totality of the evidence, it is hard to see how the court could have reached a different conclusion even if the regulatory presumption of equality had not existed. Had father and son done their homework, they likely could have had a valid agreement for a different sharing arrangement of expenses, but they did not. Incompetence rarely works in a taxpayer's favor.

H. Renkemeyer v. Commissioner

As tax cases go, *Renkemeyer v. Commissioner*[62] is fairly famous, though not for its discussion of PIP, but instead for the failed (and borderline juvenile) attempt by the partners to avoid Social Security and Medicare taxes (self-employment taxes) imposed by section 1401.[63] While the last judicial word has not been spoken on this issue, taxpayers have had some success using S corporations to avoid self-employment taxes by underpaying salaries to the shareholder or employee.[64] No case has sanctioned a similar effort using a different type of entity before *Renkemeyer*, and it is not clear why the taxpayers in *Renkemeyer* used a state-law partnership to this end. What makes the case especially entertaining is that it involved a law firm that specialized in federal tax law. One wonders what grades its partners received in their tax courses.

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[60] *See supra* note 18.

[61] The court did not discuss the potential income tax impact of any capital shift to the son. Under Regulation section 1.721-1(b)(1), a current capital shift would constitute current income to the son. Whether the promise to devise property to the son constitutes a capital shift has not been addressed, to my knowledge, but seems doubtful.

[62] 136 T.C. 137 (2011).

[63] *See* Amy S. Elliott, Renkemeyer *Could Reignite Entity-Employment Tax Debate*, 130 Tax Notes (TA) 1244 (Mar. 14, 2011) (though the potential expressed in the title is doubtful).

[64] *See* Watson v. United States, 757 F. Supp. 2d 877 (D. Iowa 2010), *aff'd*, 668 F.3d 1008 (8th Cir. 2012); Walter D. Schwidetzky, *Integrating Subchapters K and S and Beyond*, 18 Chap. L. Rev. 93 (2014); Walter D. Schwidetzky, *Integrating Subchapters K and S—Just Do It*, 62 Tax Law. 749 (2009); *see also* Karen C. Burke, *Exploiting the Medicare Tax Loophole*, 21 Fla. Tax Rev. 570 (2018).

The law firm operated through a Kansas LLP.[65] About 99% of the law firm's income was from legal services. In 2004, the partnership amended its partnership agreement to provide for two classes of ownership interests: "General Managing Partner Partnership Units" and "Investing Partnership Units," with the general managing partner partnership units having full authority to act on behalf of the partnership. All the partners were active in the law firm. In 2004 and 2005, the partnership allocated 99% of its income to the "Investing Partnership Units" and claimed that this income was exempt from self-employment taxes under section 1402(a)(13). That section of the Code exempts income of a limited partner from self-employment taxes. The court concluded that active general partners cannot qualify as limited partners under section 1402(a)(13), making all of the partnership income subject to the applicable section 1401 self-employment taxes, the only sane holding that the court could have reached.[66]

On its way to the self-employment tax holding, the court also had to address the fact that for 2004, the partnership inexplicably did not provide the court with a partnership agreement—though a written agreement apparently existed. The partnership claimed that the 2005 partnership agreement, which was provided to the court, was essentially the same as the one for 2004. The court did not accept this allegation, though it noted that even if it had, it would not have resolved the question of how income for 2004 should have been allocated to the partners.

In 2004, the partnership had three individual partners and one corporate partner, RCGW Investment Management, Inc. (RCGW), a Kansas Corporation. RCGW was owned by an ESOP, the beneficiaries of which were the individual partners of the partnership. RCGW was an S corporation that was primarily engaged in buying, selling, and leasing real estate—an ESOP structure that is not uncommon. The 2004 partnership return showed the partners' interests in profits and losses to be 30% each for the three individual partners and 10% for RCGW. The capital interests, on the other hand, were held 33⅓% each by the individual partners—thus RCGW did not have a capital interest, as such. Notwithstanding those percentages, the partnership in 2004 allocated over 87% of its ordinary income to RCGW. Given that it was an S corporation, its income flowed through to its owner, an ESOP, a nontaxable entity, making the income tax free. Needless to say, the 87% allocation to RCGW was at the center of the litigation for 2004. As the

[65] At the risk of insulting the reader's intelligence, an LLP is a general partnership that has made an election to have a liability shield. Every state has an LLP statute, and yes, it would be crazy not to make the election. *See* Mark A. Sargent & Walter D. Schwidetzky, The Limited Liability Company Handbook § 3:18 (Supp. 2018).

[66] For a failed attempt to achieve the same result using guaranteed payments, see Castigliola v. Commissioner, 113 T.C.M. (CCH) 1296, 2017 T.C.M. (RIA) ¶ 2017-062. An apparently passive LLC member was treated as a limited partner for self-employment tax purposes in Hardy v. Commissioner, 113 T.C.M. (CCH) 1070, 2017 T.C.M. (RIA) ¶ 2017-016. *See* Burke, *supra* note 64, at 612–13.

court observed, the 2005 agreement would not have permitted this allocation, making the taxpayers' argument that the court could rely on the 2005 agreement for 2004 specious.

The Service argued that the partnership's ordinary income should be allocated based on the general profit and loss percentages, *i.e.*, 30% to each of the individual partners and 10% to RCGW. Since there was no written partnership agreement before the court for 2004, the allocations had to be made according to PIP. The court noted the PIP factors in the Regulations and that those factors had been considered in reaching the holdings in *Holdner* and *Ballantyne*. As noted above, those factors are (1) the partners' relative capital contributions to the partnership, (2) the partners' respective interests in partnership profits and losses, (3) the partners' relative interests in cash flow and other nonliquidating distributions, and (4) the partners' rights to capital upon liquidation. The Regulations do not limit themselves to these factors. Rather they are examples of relevant facts and circumstances. Nevertheless, the court made the stated factors its focus. That could be a dangerous approach in some cases, but in this case it seemed justified given the evidence before the court. Running through the factors, the court noted that RCGW did not appear to have made a capital contribution, but that the partnership return showed the individual partners to each own 33⅓% of the capital. The income and loss shares were 30% each for the individual partners and 10% for RCGW. Distributions were made to the individual partners—though the amounts were not clear—but not to RCGW. Finally, there was no information in the record as to rights to distribution of capital or rights on liquidation. The court concluded that this evidence supported the Service's view that the partners' interests in income for 2004 should be based on the profit and loss shares, *i.e.*, 30% each to the individual partners and 10% to RCGW.

The court's holding was in some ways generous. Given that RCGW did not contribute capital or receive distributions, there were facts in the record to support even a smaller allocation of income to RCGW than ten percent. Further, while there may have been nothing in the record about liquidation rights, the court could have taken judicial notice of section 807(b) of the 1997 Uniform Partnership Act, which requires the partnership in liquidation to "make a distribution to a partner in an amount equal to any excess of the credits over the charges in the partner's account."[67] Given that RCGW did not contribute capital, it would potentially receive less than other partners on liquidation under state law. Conversely, the income allocation to RCGW

[67] Unif. P'ship Act (1997), § 807(b), 6 pt. II U.L.A. 498 (2015). For a reasonably accurate discussion of state law interaction with the tax rules, see Borden, *supra* note 1, at 1092–98. But Borden also states that "[u]ltimately, state law governs the allocation of the partnership's economic items and determines the partners' economic interests in the partnership." *Id.* at 1131. That statement is not entirely correct. State law could govern if the partnership agreement has no relevant provisions, a situation virtually unheard of in any agreement made with the assistance of tax counsel (though, as this case shows, not completely unheard of—tax lawyers may be their own worst clients). *See* Unif. P'ship Act (1997), § 103, 6 pt. II U.L.A. at 333–34.

would have increased its credits under the UPA and, therefore, what RCGW could have received in liquidation. Those credits would not have been reduced by distributions, as was the case for the other partners, inasmuch as RCGW did not receive any distributions. But liquidation was likely a long way off, making the present value of that liquidation right very small. Further, the fact that RCGW, unlike the other partners, did not receive current distributions might have reduced the value of RCGW's interest more than any downstream liquidation rights might have increased it. All of this argues against the full ten percent allocation given RCGW. Of course, it would have been novel for the court to award the Service with more than it had asked for the individual partners. But if it had, by how much should the court have reduced the ten percent allocation? Coming up with the amount of any reduction under these facts would be quite speculative, so the court's focus on income and loss shares is defensible, though its failure to address state law is not.

V. Should Treasury and the Service Change the PIP Regulations?

One commentator complained that that the Service will have a hard time challenging allocations under the PIP Regulations.[68] That concern, as I hope this Article makes clear, is at odds with the case law. Three things are striking about the case law: (1) that there is not more of it; (2) that the courts did not have much difficulty applying the PIP Regulations; and (3) that in each case, the court generally reached the correct, or at least a defensible, decision. If the PIP Regulations were fundamentally deficient, "woefully lacking" as one commentator put it,[69] this is not the outcome one would have expected. At least for the cases the courts have faced, the PIP Regulations are getting the job done.

It is true that the Regulations are hardly overkill. As one article skillfully showed in working through a variety of fact patterns, there are many variations on the PIP theme, and there usually is no ironclad answer available for an untested fact pattern.[70] But, there is also no set of Regulations that can cover every conceivable scenario. For example, take the facts of the *Tobias* case.[71] There is no way regulatory writers could have realistically anticipated that fact pattern in a set of Regulations of reasonable length. The lack of greater regulatory specificity did not do injury in that case or any of the other litigated cases.

A benefit of the PIP Regulations is that when partners fail to abide by the substantial economic effect rules, they had better have their ducks in a row if they want their allocations to survive scrutiny. Courts have a fair amount of flexibility given the brief nature of the Regulations. There are few constraints on a judge who wants to unwind a complex deal designed to game the tax

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[68] *See* Borden, *supra* note 1, at 1127–28.

[69] *Id.* at 1105. Borden did not discuss any of the relevant case law.

[70] *See* Carman, *supra* note 1, at 217–22.

[71] *See supra* text accompanying notes 48–53.

system. Thus, tax advisors who are doing more than just playing the audit lottery will want to have strong arguments that any structure that does not comply with the substantial economic effect safe harbor is driven by economics. At the same time, the cases to date do not suggest that judges are abusing their discretion. They are looking at the substance and reaching a defensible answer, usually the only defensible answer.

I have heard the argument made, albeit not in print, that advisors try to use PIP to end-run the substantiality rules of the substantial economic effect test.[72] This effort is wholly misguided. The whole point of PIP is a focus on the economic reality of a given structure. Anyone attempting such an end-run is gaming the tax system and, by definition, making allocations that are not reflected by the underlying economics, and thus not in accordance with PIP.

It is likely not a coincidence that the PIP cases to date have involved poorly-advised taxpayers—arguably including, paradoxically, tax lawyers themselves—in fairly simple deals with few players. It seems unlikely at this point that, for example, the Service has never audited a target allocation structure. Consequently, it has either concluded that the structure meets PIP or negotiated a resolution that the taxpayers could live with that did not result in a large, additional tax bill. Otherwise, by now, one would expect to have seen a case involving the validity of target allocations.

To be sure, the fact that the courts have come to grips with PIP in the relatively simple situations discussed in the cases above, does not prove that courts will be equally successful with more complex deals. How would the courts have fared if the facts had involved such complexity as waterfalls and flips? In fact, courts have addressed very complex transactions in other contexts, and, at least on appeal, were able to reach the correct answer. If one considers the "*Castle Harbour*" line of cases, which involved a highly complex effort to game the tax system by turning lenders into alleged partners, the appellate courts did not lose the forest for the trees and concluded that no valid partnership existed.[73] (Admittedly, the federal district court trial judge

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[72] Thanks to Daryl J. Sidle, Esq. for bringing this to my attention.

[73] TIFD III-E Inc. v. United States, 342 F. Supp. 2d 94 (D. Conn. 2004), *rev'd on other grounds*, 459 F.3d 220 (2d Cir. 2006), *on remand*, 660 F. Supp. 2d 367 (D. Conn. 2009), *rev'd*, 666 F.3d 836 (2d Cir. 2012). For an excellent article that looks at this and similar cases, see Karen C. Burke & Grayson M.P. McCouch, *Sham Partnerships and Equivocal Transactions*, 69 Tax Law. 625 (2016). Borden argues that, because the Second Circuit did not address the validity of the allocations involved in that case, "[t]he IRS's position suggests that the allocation rules' deficiencies make them unreliable and perhaps unenforceable." Borden, *supra* note 1, at 1128–29. This argument in the context of the *Castle Harbour* line of cases is not coherent. Because there was no tax partnership, the allocation rules were irrelevant. The notion that the Service argued that there was no tax partnership because it could not figure out how to address the allocation rules is inconsistent with the facts and the opinions. The Service's best argument, some might say its only intelligible argument given the facts, was that there was no tax partnership. The case was a significant victory for the Service. *See* Burke & McCouch *supra*, at 636–47.

did not do as well—repeatedly.) Further, while Tax Court judges tend to have litigation rather than transactional backgrounds, they certainly have the competence to deal with complexity. There is little reason to think that the judicial system cannot handle the complexity, though to be sure, a given judge might not be up to the task.

If it were possible to craft a more comprehensive set of PIP Regulations, one that would provide reliable answers in a wider set of circumstances, it might make sense to do so. But history does not suggest that would be a successful enterprise. As we have seen over and over again, longer and more complex regulations bring with them their own problems. Professor Bayless Manning coined the term "hyperlexis" over 40 years ago and defined it as a "pathological condition caused by an overactive law-making gland."[74] I would reframe it as an overactive law and regulation-making gland. More is not always better. The more complex the regulations, the more likely it is that unexpected problems will be created. At some point the cure can be worse than the disease. Succinct regulations that are workable in most situations should be left alone. Further, and as noted above, there is simply no way a set of regulations could be written to cover all, or even most, scenarios. There are too many ways clever tax counsel can draft agreements and too many ways ill-advised taxpayers can blow it. Realistically, it would be very difficult to meaningfully improve on the current PIP Regulations, and, as also noted above, in some ways more general rules are preferable precisely because they are more flexible and less likely to lock a judge into an incorrect answer.

That said, there is an addition to the Regulations that would be helpful. Professor Daniel Goldberg proposed that the Regulations adopt a safe harbor for target allocations.[75] I think his proposal is very sensible. To the extent the Service becomes aware of a common, long-standing allocation methodology not covered by the existing Regulations, it makes sense to provide formal guidance. The guidance increases planning certainty and likely reduces transaction costs. I do not mean to suggest that the Service run down every new gimmick, but when an allocation system not covered by the Regulations has stood the test of time, it makes sense for the Service to address it. Target

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[74] Bayless Manning, *Hyperlexis: Our National Disease*, 71 Nw. U. L. Rev. 767, 767 (1977); *see* Walter D. Schwidetzky, *Hyperlexis and the Loophole*, 49 Okla. L. Rev. 403 (1996); Gordon D. Henderson, *Controlling Hyperlexis—The Most Important "Law and ...,"* 43 Tax Law. 177 (1989); Richard M. Lipton, *"We Have Met the Enemy and He Is Us": More Thoughts on Hyperlexis*, 47 Tax Law. 1 (1993); *see also* Martin J. McMahon, Jr., *Reflections on the Regulation Process: 'Do Regulations Have to be Complex' or 'Is Hyperlexis the Manna of the Tax Bar?'*, 51 Tax Notes (TA) 1441 (June 17, 1991); Peter H. Schuck, *Legal Complexity: Some Causes, Consequences, and Cures*, 42 Duke L.J. 1 (1992); John A. Miller, *Indeterminacy, Complexity, and Fairness: Justifying Rule Simplification in the Law of Taxation*, 68 Wash. L. Rev. 1 (1993); Sheldon D. Pollack, *Tax Complexity, Reform, and the Illusions of Tax Simplification*, 2 Geo. Mason L. Rev. 319 (1994). For a dissenting view, see Marc Galanter, *Reading the Landscape of Disputes: What We Know and Don't Know (and Think We Know) About Our Allegedly Contentious and Litigious Society*, 31 UCLA L. Rev. 4 (1983).

[75] *See* Goldberg, *supra* note 27, at 724–30.

allocations are clearly in this category. This approach might mean amending the Regulations, but it also might mean something as simple as issuing a revenue ruling.

VI. Conclusion

Bert Lance, President Jimmy Carter's short-lived director of the Office of Management and Budget, popularized the phrase: "If it ain't broke, don't fix it." At the end of the day, the PIP Regulations are getting the job done. Any effort to craft a more detailed set of generally applicable regulations would likely offer little benefit, and lengthy, revised regulations could easily create more problems than they resolve. Nevertheless, a safe harbor for target allocations would be a useful addition to the existing Regulations and would create a more certain regulatory environment for those making proper use of this entirely reasonable allocation structure. Should other reasonable allocation structures not covered by the existing Regulations become widely adopted, additional safe harbors for them would be sensible.