Partners’ Interest in the P’ship: An Existentialist’s View

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Jones argues that the partners’ interest in the partnership standard is not an unknowable concept and that those who assert otherwise are engaging in jurisprudential existentialism.

When President Clinton uttered his now infamous line, “It depends on what the definition of ‘is’ is,” he was engaging in a disingenuous exercise in existentialism. My colleagues in the academy are not necessarily disingenuous, but they seem inordinately inclined toward existentialism. Existentialists, by the way, believe that individuals exist in an unfathomable universe where almost nothing can be known with any certainty. Academicians, at least in the legal field, love to point out the ambiguity impossible to avoid in language. The judiciary doesn’t have the luxury of deconstructing things into unrecognizable parts. No, the judiciary is called on to decide, not demur. The point occurred to me when I considered the juxtaposition of a recent court decision applying the partners’ interest in the partnership (PIP) standard with recent academic scholarship on the same topic. On the latter, most of my colleagues assert with a certainty they claim is lacking in the regulations that a PIP is entirely unknowable. Existentialism is obvious in the assertion that we cannot even know what common terms mean. In other words, we cannot know what PIP means because we don’t know what “is” is. I am going to use one academic discourse as representative of the majority of academic discourse. The few judicial opinions are uniformly opposed to the assertions made in most of the scholarly discourse. In any event, the contrast demonstrates the extent to which academics have strayed from the real world. First, a disclaimer is in order. I do not pretend to be better versed in the

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1President Clinton’s statement was made during a deposition in response to a question regarding an improper relationship with a White House intern:

In claiming that this statement was true, the President was apparently relying on the same tense-based distinction he made during the Jones deposition. See Clinton 8/17/98 GJ at 59-61 ("It depends on what the meaning of the word ‘is’ is. If the — if the — if ‘is’ means is and never has been, that is not — that is one thing. If it means there is none, that was a completely true statement. . . . Now, if someone had asked me on that day, are you having any kind of sexual relations with Ms. Lewinsky, that is, asked me a question in the present tense, I would have said no. And it would have been completely true.").

2See supra note 4.


4There are only a few judicial opinions on the PIP standard, all of which demonstrate fairly reasonable applications of the standard. See Holder v. Commissioner, T.C. Memo. 2010-175 (Aug. 4, 2010), Doc 2010-17437, 2010 TNT 150-16 (relying on the presumption of equal allocations in the previous PIP regulations to hold that partners shared partnership items equally); Estate of Tobias v. Commissioner, T.C. Memo. 2001-37 (Feb. 14, 2001), Doc 2001-4654, 2001 TNT 32-12 (applying the PIP standard to a partnership agreement providing for preferred or waterfall distributions); Vecchio v. Commissioner, 103 T.C. 170 (Aug. 15, 1994), Doc 94-7636, 94 TNT 160-11 (applying the PIP rules to waterfall distributions).

5Bradley T. Borden, “The Allure and Illusion of Partners’ Interest in a Partnership,” 79 U. Cin. L. Rev. ____ (forthcoming, 2011). Other scholars with forthcoming articles include Greg D. Polsky, “Deterring Tax-Driven Partnership Allocations,” and Andrea Monroe, “Too Big to Fail: The Problem of Partnership Allocations.” The working hypothesis underlying nearly every scholarly article is that the PIP regulations are hopelessly impenetrable, as if there is no discernable truth in the regulations; hence, my use of the label “existentialism.”

6See supra note 4.
intricacies of subchapter K than any of my colleagues. Lord knows I have made some knuckle-headed mistakes in prior K-Ration commentaries. But I know what “is” is and I feel comfortable enough to label those who claim not to know common terms in the PIP regulations as practicing existentialists. Moreover, I use the term with the same sort of alarm with which Joseph McCarthy used the term “communist.” In other words, there is a gang of secret existentialists hiding in our academies and, for the sake of clarity, they should be rooted out. My only hope is that history will not judge me as harshly as it has McCarthy.

So let us begin. In “The Allure and Illusion of Partners’ Interest in a Partnership,” Borden (a closet existentialist if ever I have seen one) asserts that we can never really know what PIP means and so we ought to jettison the entire concept. He indictles lesser adherents because of their “path dependency,” which he describes as the practice of expending too much “effort mastering difficult rules” and then clinging to those rules in the practice of partnership taxation. Imagine that. Practicing tax professionals spending their time figuring out what the regulations mean and then actually applying those regulations! The insidiousness of these efforts cannot be understated, Borden implies. I don’t mean to be entirely facetious, although I will admit to some degree of sarcastic jest. Without a doubt, the detailed articulation of a partner’s interest in the partnership is elusive. This does not mean the regulations are an illusion; the regulations actually exist and are in fact knowable, at least to judges and practitioners. I insist that the regulations are applicable, in the sense that they are capable of application in any particular case even if they are not subject to easy generalization.

Existentialism, as represented by our subject article, claims the opposite. Existentialism argues that we cannot know what certain key and otherwise common business terms actually mean. We can never apply the regulations with anything close to certainty because the regulations are an illusion. Simple, commonly used words and phrases such as “contributions,” “profit,” “cash flow and other non-liquidating distributions,” or even “capital” are said to be incapable of definition or any degree of certain meaning. Incidentally, the difference between a tax lawyer and a tax accountant is that the former more often assumes and seeks to resolve or exploit the ambiguity inherent in words. The latter deals more with the relative certainty of numbers. The line between the two is blurring. Regardless, the primary role of the tax professional is to take on the ambiguity of language, not to simply throw up one’s hands and declare that some words are unknowable. Tax lawyers, and lawyers in most every other field, are called on to give certainty to inherently ambiguous words in the context in which they are used. Not an easy task by any means, but not an impossible task — and certainly not one confined to tax law. Only in this regard do I agree with the existentialist argument that tax professionals are too often myopic and fail to take into account the intent or context of the law. The relativistic assertion that context is relevant to what is true is not entirely invalid. In many instances, however, myopia is intentional because the literal application of a tax rule may well result in an advantage to the client. Whether that literal application is consistent with the public good is not necessarily a question the tax professional should be concerned about. A debatable point, no doubt, and legitimate enough to preclude us from easily dismissing strict fidelity to the literal language of the law.

Existentialism, as much as myopia, is the stuff of tax shelters. When Clinton feigned ignorance of the word “is,” he was seeking to avoid responsibility for a known fact of his own making. Intellectual honesty required less existentialism — and even less myopia, but only if he ought to have placed the public interest ahead of his own. It was a legitimate act of myopia when he placed his own interests first — at the time he was acting as a defendant, rather than a president. One can hardly argue that insisting on the literal language of the tax code is improper and, even if it is, the tax professional must first master and seek adherence to that literal meaning. It is a curious objection, indeed, to complain...
that too much time is spent mastering and then applying the actual language of the law.

Another characteristic common to existentialism in tax jurisprudence is the insistence on finding solutions in search of problems. In addition to the alleged inability to decipher the meaning of terms commonly used in business, existentialists argue that the present PIP regulations suffer from a fatal “tax centricity” meaning that tax regulations dictate changes in economic behavior to facilitate tax goals. While this may be a legitimate objection anywhere in the tax code, it seems particularly inappropriate with regard to subchapter K. There are a few anecdotal phrases known to partnership tax practitioners and scholars alike, although not explicitly stated in the PIP regulations. The first is “economic flexibility.” Almost every discussion of partnership allocations repeats the flexibility mantra: flexibility to structure tax consequences in a way that implements the economic agreement of the partners. Nothing in the regulations dictate any particular economic arrangement. In fact, the detailed regulations are explicit in the drafter’s insistence on tax neutrality for the sake of laissez faire and all the associated ills. It is only by reading the PIP regulations in isolation — and even then it is questionable — that one can label them “tax centric.” It is an existentialist argument, in a “the sky is falling” sort of way. This standard is set forth in the regulations:

(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.

I am not quite sure that existentialists really believe the preceding to suggest that the PIP regulations dictate any particular economic arrangement. That is, one has to strain to grasp the “tax centricity” objection. In many respects, subchapter K is like a foreign language that takes less time to learn than does German or French. “Partnership minimum gain,” “ceiling rule,” and “nonrecourse deductions” are simply terms in a new vernacular.

As with any language, there are certain rules helpful to the translation into one’s native tongue. The rule that “tax follows book” is precisely one such rule. The phrase itself is the second of the anecdotal phrases not explicitly articulated in the PIP regulations, but binding nonetheless. It simply means that tax outcomes are to be determined by economic outcomes, not vice versa. Stated with more sophistication, tax-follows-book means:

The complexity and detail of these Regulations should not obscure the overriding principle of economic substance upon which they are based. If a partner will benefit economically from an item of partnership income or gain, that item must be allocated to him so that he bears the correlative tax burden. Conversely, if a partner will suffer the economic burden of an item of partnership loss or deduction, he must be allocated the associated tax benefit. In other words, tax must follow economics. This principle is explicated in copious detail by the Regulations and should be kept in mind in order to fully understand the Regulations’ complexities.

If anything is clear in subchapter K, it is that tax consequences are to depend on economic arrangements. In fact, the desire to create a business world entirely free of tax distortions is the single, solitary reason for the complexity and detail of subchapter K. As made apparent by recent economic events, freedom leads to abuse on the margins, the margins come to characterize the whole, and the sovereign responds by enacting antiabuse rules. As the scholar/practitioners point out, however, the detail in antiabuse rules should not obscure the overriding principle that tax follows book.

By the way, there is always a whiff of disingenuousness in the existentialist’s argument. He may be right that mortal human beings can never really know the difference between reality and perception. Nevertheless, the world we live in requires that we accept the apparent as real. What is apparent from the subchapter K regulations is that tax consequences are meant to depend on economic consequences, which may be decided without government supervision. It is only when we believe what our eyes tell us in subchapter K that we can provide meaning to the PIP standard. If we disbelieve our own perception, it is no wonder that we assert that PIP is incapable of meaning.

A final observation is in order. As many have pointed out, partners increasingly are opting out of


10 See reg. section 1.701-2(a) (“Intent of subchapter K. Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax.”).

11 Id.

12 Reg. section 1.704-1(b)(3).

the substantial economic effect safe harbor in favor of the PIP standard precisely because the PIP standard provides a greater ability to tailor tax allocations to partners’ economic arrangement. It is, of course, erroneous to say that partners intentionally “violate” the substantial economic effect test when they draft around it. There is no mandate, so there can be no violation. Even existentialists make note of the increasing opt-out while at the same time condemning PIP for its lack of square-peg definitiveness. If anything, the rise in opt-outs suggests that the certainty of substantial economic effect is relatively “tax centric” as compared with the PIP standard. Targeted allocations are the easiest type of allocations to be respected and, indeed, allow for a very specific instance of tax following book. Basically, at the end of the year, the partners determine how the profit (or loss) is to be divided up, and then make tax allocations consistent with the agreed on economic division. A $100 book allocation, for example, is paired with a $100 tax allocation. Nothing could demonstrate the tax follows book rule more clearly.

Ultimately, the rule with respect to partner allocations is essentially a burden shifting rule, whether we are speaking of the substantial economic effect test or the PIP standard. In all cases, if an allocation results in significant overall tax savings for the partners in the aggregate without a remarkable change in any partner’s economic results from the partnership, the allocation rules require the partners to articulate a good business explanation for the allocations. Simply put — and it cannot get any simpler than this — the one who advises the partnership and/or drafts the partnership agreement ought to ask about the reasons for the allocations whenever there is a reason to think the IRS might ask. In other circumstances, the adviser must keep in mind the economic reasons for the allocations she recommends to the partners. This is a rule of pragmatism, not an ivy-towered pontification on the nature of special allocations. The adviser should ask because the IRS will ask, ignoring for the moment the effect of the audit lottery. If the IRS asks, the partners must be able to articulate a good reason or face government intervention, normally in a way that increases the aggregate tax. Existentialists might ask what is meant by “significant,” “remarkable,” and “a good business reason.” I mean “significant,” “remarkable,” and “a good business reason”! In other words, advisers have to apply their own learned judgment, just as other professionals must apply their own judgment when trying to cure disease, stop a broken well from spewing oil into the ocean, determine troop levels needed in a war zone, or adopt a fiscal policy in a time of economic crisis. Nothing is certain, but anything is possible.

There is one — and only one — instance when it is difficult, and perhaps even impossible, to determine the proper allocation of tax items with any degree of certainty. Ironically, it is the difficult case that proves the rule. When the partners have neglected to articulate their economic agreement, it is difficult or impossible to know with certainty how the tax benefits and burdens should be allocated because the certainty of the PIP standard hinges on what the partners intended with respect to the economics of the deal. Since tax follows book, it is hard to know where tax benefits and burdens should go only when we do not know where economic benefits and burdens go. In that case, we have to determine intent from actions, just as is required in many other professions. Nevertheless, the burden is still on the partners to articulate the business purpose underlying the way in which they have divided the tax benefits and burdens.

To be most helpful in the real world, scholars should abandon existentialism in favor of empiricism. The PIP standard is one area of partnership taxation in which scholars of an existential bent have run amok. They insist that the PIP standard is unknowable simply because it is not amenable to easy generalization. There are many things in life, however, that are real, even if not easily generalized. It may be fun to play the role of Socrates or even Clinton, trying to disprove facts by insisting that they are unfathomable. Ultimately, however, nothing of our own making is beyond knowing. “Is” means “is.” In comparison to the many other human contrivances, the PIP standard is simple. It should not be elevated into a question akin to the existentialist’s futile search for the meaning of life.