

## Regulation Examples Not Supported By Text: A Partnership Response

In his interesting recent Tax Notes article on regulation examples being promulgated without supporting regulatory text (Jasper L. Cummings, “*Regulation Examples Are Not Guidance*”, Tax Notes Federal, Jan. 16, 2023, p.391, <https://www.taxnotes.com/tax-notes-federal/code-and-regulations/regulation-examples-are-not-guidance/2023/01/16/7fj19>), Jack Cummings of the law firm of Alston & Bird makes a compelling case that supports the title of his article quite well. Given that he is a well-known and respected corporate federal tax specialist, it is not surprising that most of the illustrations given by him in his article are federal corporate tax transactions. However, there are several prominent federal partnership tax examples in regulations under those parts of the Internal Revenue Code that fit the bill as well.

Perhaps the clearest case of regulation examples supplying the governing rules that a reader of those examples would have trouble finding in the regulation text are the section 704(b) regulations, regulation §1.704–1(b)(5). Those regulations govern the economic effect of partnership allocations to partners, whether those allocations have what is known as substantial economic effect, what is the partners’ interest in the partnership, partnership options, partnership foreign tax expenditures, and the like. The regulation examples are very detailed and mostly over three-decades old. They commit most of the errors in drafting that Jack Cummings references: rules not supplied by the text of the regulation; example facts that rely on previously stated facts as alternative fact patterns appearing pages earlier and so hard to find; examples involving lots of third grade or perhaps higher math; and so on. Now, it may be said that these regulation examples, which are in many ways both objective and subjective determinations, do a good comprehensive job at explaining these concepts. But the detail in those examples makes them a very difficult read.

An additional illustration of the regulation example problem highlighted in the Jack Cummings article in Tax Notes is the partnership anti-abuse rule, regulation §1.701-2, where a series of examples in §1.701-2(d) beg the question of whether the examples are the rule, not the substantive text. As one of the drafters and reviewers of that regulation at the IRS Office of Chief Counsel back then (in the mid-90s), I must admit that some of the examples in that regulation were written before the dust had settled on the substantive rules of the text. If the examples were written first, which they mostly were, how could the examples illustrate the text? The examples also suffer from involving now changed and outdated law and some of them have been expanded by practitioners into non-challenged positions of the bar and taxpayers. For example, the approval of UPREITs in one of those examples has led to the proliferation of UP-Cs, which are very prevalent in certain federal tax planning today. Billions of dollars of tax revenue are at stake there.

On regulation examples generally, a question that occurs to me is, if an example illustrates one point but fails to address another point that could (should) have been addressed as well, is there any implication created that the omission of another point means that you can interpret the omission as condoning something, approving something, disapproving something, etc.? Must all regulation examples have a caveat at the beginning of the examples defining and limiting their scope, such as changed facts could lead to a different result? Inconsistency in drafting is the rule of the day in those cases. The Up-C transaction involves different facts from those in the regulation example and the preface to those examples say the result could be different if the facts were changed. Nevertheless, the tax industry adopted the transaction structure and the IRS does not appear to have the appetite to challenge them. The so-called “Wall Street rule” rears its head again!

However, it must be said that some examples in federal tax regulations are very helpful, necessary and appreciated by those who have to apply them because they illustrate the

operation of a substantive textual regulation rule where it is hard to understand its meaning without illustrating it. A very good illustration of this is in regulation §1.163(j)-6, the section of the regulations dealing with the limitation of interest expense to what can be called business income at both the partnership and partner levels. The examples do a very good job there of illustrating the opaque rules of the regulation text.

Finally, what of the accuracy related penalties and regulation examples underlying IRC section 6662? Regulation §1.6662-4(d)(3)(iii) references regulations “construing” a statute as authority in defending against imposition of the penalty by the IRS. Does this reference include regulation examples since those examples are not textual rules? Most likely yes but clarification would be welcome. (There is a similar issue with regulation preambles. See Monte A. Jackel, “*What Is a Preamble Worth*”, Tax Notes Federal, Jan. 25, 2021, p.615, <https://www.taxnotes.com/tax-notes-today-federal/tax-system-administration/what-preamble-worth/2021/01/25/2l6yk>).