are required to make returns of income under the provisions of section 6031 and the regulations thereunder. For definition of the terms ''partner'' and ''partnership'', see sections 761 and 7701(a)(2), and the regulations thereunder. For provisions relating to the election of certain partnerships to be taxed as domestic corporations, see section 1361 and the regulations thereunder.

§ 1.701–2 Anti-abuse rule.

(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. Implicit in the intent of subchapter K are the following requirements—

(1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose.

(2) The form of each partnership transaction must be respected under substance over form principles.

(3) Except as otherwise provided in this paragraph (a)(3), the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, *proper reflection of income*). However, certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. Thus, the proper reflection of income requirement of this paragraph (a)(3) is treated as satisfied with respect to a transaction that satisfies paragraphs (a)(1) and (2) of this section to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision. See, for example, paragraph (d) *Example 6* of this section (relating to the value-equals-basis rule in §1.704–1(b)(2)(iii)(*c*)), paragraph (d) *Example 9* of this section (relating to the election under section 754 to adjust basis in partnership property), and paragraph (d) *Examples 10 and 11* of this section (relating to the basis in property distributed by a partnership under section 732). See also, for example, §§1.704–3(e)(1) and 1.752–2(e)(4) (providing certain de minimis exceptions).

(b) *Application of subchapter K rules.* The provisions of subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of subchapter K as set forth in paragraph (a) of this section (*intent of subchapter K*). Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances. Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K—

(1) The purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners;

(2) One or more of the purported partners of the partnership should not be treated as a partner;

(3) The methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or the partner's income;

(4) The partnership's items of income, gain, loss, deduction, or credit should be reallocated; or

(5) The claimed tax treatment should otherwise be adjusted or modified.

(c) *Facts and circumstances analysis; factors.* Whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. The factors set forth below may be indicative, but do not necessarily establish, that a partnership was used in such a manner. These factors are illustrative only, and therefore may not be the only factors taken into account in making the determination under this section. Moreover, the weight given to any factor (whether specified in this paragraph or otherwise) depends on all the facts and circumstances. The presence or absence of any factor described in this paragraph does not create a presumption that a partnership was (or was not) used in such a manner. Factors include:

(1) The present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly;

(2) The present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. For example, this analysis may indicate that it was contemplated that a partner who was necessary to achieve the intended tax results and whose interest in the partnership was liquidated or disposed of (in whole or in part) would be a partner only temporarily in order to provide the claimed tax benefits to the remaining partners;

(3) One or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities (through distribution preferences, indemnity or loss guaranty agreements, or other arrangements), or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;

(4) Substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another;

(5) Partnership items are allocated in compliance with the literal language of §§1.704–1 and 1.704–2 but with results that are inconsistent with the purpose of section 704(b) and those regulations. In this regard, particular scrutiny will be paid to partnerships in which income or gain is specially allocated to one or more partners that may be legally or effectively exempt from federal taxation (for example, a foreign person, an exempt organization, an insolvent taxpayer, or a taxpayer with unused federal tax attributes such as net operating losses, capital losses, or foreign tax credits);

(6) The benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the contributing partner (or a related party); or

(7) The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed to the distributee partner (or a related party).

(d) *Examples.* The following examples illustrate the principles of paragraphs (a), (b), and (c) of this section. The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. Unless otherwise indicated, parties to the transactions are not related to one another.

Example 1. Choice of entity; avoidance of entity-level tax; use of partnership consistent with the intent of subchapter K. (i) A and B form limited partnership PRS to conduct a bona fide business. A, the corporate general partner, has a 1% partnership interest. B, the individual limited partner, has a 99% interest. PRS is properly classified as a partnership under §§301.7701–2 and 301.7701–3. A and B chose limited partnership form as a means to provide B with limited liability without subjecting the income from the business operations to an entity-level tax.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. Although B has retained, indirectly, substantially all of the benefits and burdens of ownership of the money or property B contributed to PRS (see paragraph (c)(6) of this section), the decision to organize and conduct business through PRS under these circumstances is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 2. Choice of entity; avoidance of subchapter S shareholder requirements; use of partnership consistent with the intent of subchapter K. (i) A and B form partnership PRS to conduct a bona fide business. A is a corporation that has elected to be treated as an S corporation under subchapter S. B is a nonresident alien. PRS is properly classified as a partnership under §§301.7701–2 and 301.7701–3. Because section 1361(b) prohibits B from being a shareholder in A, A and B chose partnership form, rather than admit B as a shareholder in A, as a means to retain the benefits of subchapter S treatment for A and its shareholders.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. Although it may be argued that the form of the partnership transaction should not be respected because it does not reflect its substance (inasmuch as application of the substance over form doctrine arguably could result in B being treated as a shareholder of A, thereby invalidating A's subchapter S election), the facts indicate otherwise. The shareholders of A are subject to tax on their pro rata shares of A's income (see section 1361 *et seq.*), and B is subject to tax on B's distributive share of partnership income (see sections 871 and 875). Thus, the form in which this arrangement is cast accurately reflects its substance as a separate partnership and S corporation. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 3. Choice of entity; avoidance of more restrictive foreign tax credit limitation; use of partnership consistent with the intent of subchapter K. (i) X, a domestic corporation, and Y, a foreign corporation, form partnership PRS under the laws of foreign Country A to conduct a bona fide joint business. X and Y each owns a 50% interest in PRS. PRS is properly classified as a partnership under §§301.7701–2 and 301.7701–3. PRS pays income taxes to Country A. X and Y chose partnership form to enable X to qualify for a direct foreign tax credit under section 901, with look-through treatment under §1.904–5(h)(1). Conversely, if PRS were a foreign corporation for U.S. tax purposes, X would be entitled only to indirect foreign tax credits under section 902 with respect to dividend distributions from PRS. The look-through rules, however, would not apply, and pursuant to section 904(d)(1)(E) and §1.904–4(g), the dividends and associated taxes would be subject to a separate foreign tax credit limitation for dividends from PRS, a noncontrolled section 902 corporation.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS in order to take advantage of the look-through rules for foreign tax credit purposes, thereby maximizing X's use of its proper share of foreign taxes paid by PRS, is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 4. Choice of entity; avoidance of gain recognition under sections 351(e) and 357(c); use of partnership consistent with the intent of subchapter K. (i) X, ABC, and DEF form limited partnership PRS to conduct a bona fide real estate management business. PRS is properly classified as a partnership under §§301.7701–2 and 301.7701–3. X, the general partner, is a newly formed corporation that elects to be treated as a real estate investment trust as defined in section 856. X offers its stock to the public and contributes substantially all of the proceeds from the public offering to PRS. ABC and DEF, the limited partners, are existing partnerships with substantial real estate holdings. ABC and DEF contribute all of their real property assets to PRS, subject to liabilities that exceed their respective aggregate bases in the real property contributed, and terminate under section 708(b)(1)(A). In addition, some of the former partners of ABC and DEF each have the right, beginning two years after the formation of PRS, to require the redemption of their limited partnership interests in PRS in exchange for cash or X stock (at X's option) equal to the fair market value of their respective interests in PRS at the time of the redemption. These partners are not compelled, as a legal or practical matter, to exercise their exchange rights at any time. X, ABC, and DEF chose to form a partnership rather than have ABC and DEF invest directly in X to allow ABC and DEF to avoid recognition of gain under sections 351(e) and 357(c). Because PRS would not be treated as an investment company within the meaning of section 351(e) if PRS were incorporated (so long as it did not elect under section 856), section 721(a) applies to the contribution of the real property to PRS. See section 721(b).

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS, thereby avoiding the tax consequences that would have resulted from contributing the existing partnerships' real estate assets to X (by applying the rules of sections 721, 731, and 752 in lieu of the rules of sections 351(e) and 357(c)), is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. Although it may be argued that the form of the transaction should not be respected because it does not reflect its substance (inasmuch as the present value of the partners' aggregate federal tax liability is substantially less than would be the case if the transaction were integrated and treated as a contribution of the encumbered assets by ABC and DEF directly to X, see paragraph (c)(2) of this section), the facts indicate otherwise. For example, the right of some of the former ABC and DEF partners after two years to exchange their PRS interests for cash or X stock (at X's option) equal to the fair market value of their PRS interest at that time would not require that right to be considered as exercised prior to its actual exercise. Moreover, X may make other real estate investments and other business decisions, including the decision to raise additional capital for those purposes. Thus, although it may be likely that some or all of the partners with the right to do so will, at some point, exercise their exchange rights, and thereby receive either cash or X stock, the form of the transaction as a separate partnership and real estate investment trust is respected under substance over form principles (see paragraph (a)(2) of this section). The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 5. Special allocations; dividends received deductions; use of partnership consistent with the intent of subchapter K. (i) Corporations X and Y contribute equal amounts to PRS, a bona fide partnership formed to make joint investments. PRS pays $100x for a share of common stock of Z, an unrelated corporation, which has historically paid an annual dividend of $6x. PRS specially allocates the dividend income on the Z stock to X to the extent of the London Inter-Bank Offered Rate (LIBOR) on the record date, applied to X's contribution of $50x, and allocates the remainder of the dividend income to Y. All other items of partnership income and loss are allocated equally between X and Y. The allocations under the partnership agreement have substantial economic effect within the meaning of §1.704–1(b)(2). In addition to avoiding an entity-level tax, a principal purpose for the formation of the partnership was to invest in the Z common stock and to allocate the dividend income from the stock to provide X with a floating-rate return based on LIBOR, while permitting X and Y to claim the dividends received deduction under section 243 on the dividends allocated to each of them.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. Section 704(b) and §1.704–1(b)(2) permit income realized by the partnership to be allocated validly to the partners separate from the partners' respective ownership of the capital to which the allocations relate, provided that the allocations satisfy both the literal requirements of the statute and regulations and the purpose of those provisions (see paragraph (c)(5) of this section). Section 704(e)(2) is not applicable to the facts of this example (otherwise, the allocations would be required to be proportionate to the partners' ownership of contributed capital). The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 6. Special allocations; nonrecourse financing; low-income housing credit; use of partnership consistent with the intent of subchapter K. (i) A and B, high-bracket taxpayers, and X, a corporation with net operating loss carryforwards, form general partnership PRS to own and operate a building that qualifies for the low-income housing credit provided by section 42. The project is financed with both cash contributions from the partners and nonrecourse indebtedness. The partnership agreement provides for special allocations of income and deductions, including the allocation of all depreciation deductions attributable to the building to A and B equally in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the building. The section 42 credits are allocated to A and B in accordance with the allocation of depreciation deductions. PRS's allocations comply with all applicable regulations, including the requirements of §§1.704–1(b)(2)(ii) (pertaining to economic effect) and 1.704–2(e) (requirements for allocations of nonrecourse deductions). The nonrecourse indebtedness is validly allocated to the partners under the rules of §1.752–3, thereby increasing the basis of the partners' respective partnership interests. The basis increase created by the nonrecourse indebtedness enables A and B to deduct their distributive share of losses from the partnership (subject to all other applicable limitations under the Internal Revenue Code) against their nonpartnership income and to apply the credits against their tax liability.

(ii) At a time when the depreciation deductions attributable to the building are not treated as nonrecourse deductions under §1.704–2(c) (because there is no net increase in partnership minimum gain during the year), the special allocation of depreciation deductions to A and B has substantial economic effect because of the value-equals-basis safe harbor contained in §1.704–1(b)(2)(iii)(*c*) and the fact that A and B would bear the economic burden of any decline in the value of the building (to the extent of the partnership's investment in the building), notwithstanding that A and B believe it is unlikely that the building will decline in value (and, accordingly, they anticipate significant timing benefits through the special allocation). Moreover, in later years, when the depreciation deductions attributable to the building are treated as nonrecourse deductions under §1.704–2(c), the special allocation of depreciation deductions to A and B is considered to be consistent with the partners' interests in the partnership under §1.704–2(e).

(iii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a) (1), (2), and (3) of this section have been satisfied. Section 704(b), §1.704–1(b)(2), and §1.704–2(e) allow partnership items of income, gain, loss, deduction, and credit to be allocated validly to the partners separate from the partners' respective ownership of the capital to which the allocations relate, provided that the allocations satisfy both the literal requirements of the statute and regulations and the purpose of those provisions (see paragraph (c)(5) of this section). Moreover, the application of the value-equals-basis safe harbor and the provisions of §1.704–2(e) with respect to the allocations to A and B, and the tax results of the application of those provisions, taking into account all the facts and circumstances, are clearly contemplated. Accordingly, even if the allocations would not otherwise be considered to satisfy the proper reflection of income standard in paragraph (a)(3) of this section, that requirement will be treated as satisfied under these facts. Thus, even though the partners' aggregate federal tax liability may be substantially less than had the partners owned the partnership's assets directly (due to X's inability to use its allocable share of the partnership's losses and credits) (see paragraph (c)(1) of this section), the transaction is not inconsistent with the intent of subchapter K. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 7. Partner with nominal interest; temporary partner; use of partnership not consistent with the intent of subchapter K. (i) Pursuant to a plan a principal purpose of which is to generate artificial losses and thereby shelter from federal taxation a substantial amount of income, X (a foreign corporation), Y (a domestic corporation), and Z (a promoter) form partnership PRS by contributing \$9,000x, \$990x, and \$10x, respectively, for proportionate interests (90.0%, 9.9%, and 0.1%, respectively) in the capital and profits of PRS. PRS purchases offshore equipment for \$10,000x and validly leases the equipment offshore for a term representing most of its projected useful life. Shortly thereafter, PRS sells its rights to receive income under the lease to a third party for \$9,000x, and allocates the resulting \$9,000x of income \$8,100x to X, \$891x to Y, and \$9x to Z. PRS thereafter makes a distribution of \$9,000x to X in complete liquidation of its interest. Under §1.704–1(b)(2)(iv)(*f*), PRS restates the partners' capital accounts immediately before making the liquidating distribution to X to reflect its assets consisting of the offshore equipment worth \$1,000x and \$9,000x in cash. Thus, because the capital accounts immediately before the distribution reflect assets of \$19,000x (that is, the initial capital contributions of \$10,000x plus the \$9,000x of income realized from the sale of the lease), PRS allocates a \$9,000x book loss among the partners (for capital account purposes only), resulting in restated capital accounts for X, Y, and Z of \$9,000x, \$990x, and \$10x, respectively. Thereafter, PRS purchases real property by borrowing the \$8,000x purchase price on a recourse basis, which increases Y's and Z's bases in their respective partnership interests from \$1,881x and \$19x, to \$9,801x and \$99x, respectively (reflecting Y's and Z's adjusted interests in the partnership of 99% and 1%, respectively). PRS subsequently sells the offshore equipment, subject to the lease, for \$1,000x and allocates the \$9,000x tax loss \$8,910x to Y and \$90x to Z. Y's and Z's bases in their partnership interests are therefore reduced to \$891x and \$9x, respectively.

(ii) On these facts, any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transaction were respected for federal tax purposes (see paragraph (c) of this section). Accordingly, the transaction lacks a substantial business purpose (see paragraph (a)(1) of this section). In addition, factors (1), (2), (3), and (5) of paragraph (c) of this section indicate that PRS was used with a principal purpose to reduce substantially the partners' tax liability in a manner inconsistent with the intent of subchapter K. On these facts, PRS is not bona fide (see paragraph (a)(1) of this section), and the transaction is not respected under applicable substance over form principles (see paragraph (a)(2) of this section) and does not properly reflect the income of Y (see paragraph (a)(3) of this section). Thus, PRS has been formed and availed of with a principal purpose of reducing substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under judicial principles or the validity of the allocations under §1.704–1(b)(2) (see paragraph (h) of this section)), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

Example 8. Plan to duplicate losses through absence of section 754 election; use of partnership not consistent with the intent of subchapter K. (i) A owns land with a basis of \$100x and a fair market value of \$60x. A would like to sell the land to B. A and B devise a plan a principal purpose of which is to permit the duplication, for a substantial period of time, of the tax benefit of A's built-in loss in the land. To effect this plan, A, C (A's brother), and W (C's wife) form partnership PRS, to which A contributes the land, and C and W each contribute \$30x. All partnership items are shared in proportion to the partners' respective contributions to PRS. PRS invests the cash in an investment asset (that is not a marketable security within the meaning of section 731(c)). PRS also leases the land to B under a three-year lease pursuant to which B has the option to purchase the land from PRS upon the expiration of the lease for an amount equal to its fair market value at that time. All lease proceeds received are immediately distributed to the partners. In year 3, at a time when the values of the partnership's assets have not materially changed, PRS agrees with A to liquidate A's interest in exchange for the investment asset held by PRS. Under section 732(b), A's basis in the asset distributed equals \$100x, A's basis in A's partnership interest immediately before the distribution. Shortly thereafter, A sells the investment asset to X, an unrelated party, recognizing a \$40x loss.

(ii) PRS does not make an election under section 754. Accordingly, PRS's basis in the land contributed by A remains \$100x. At the end of year 3, pursuant to the lease option, PRS sells the land to B for \$60x (its fair market value). Thus, PRS recognizes a \$40x loss on the sale, which is allocated equally between C and W. C's and W's bases in their partnership interests are reduced to \$10x each pursuant to section 705. Their respective interests are worth \$30x each. Thus, upon liquidation of PRS (or their interests therein), each of C and W will recognize \$20x of gain. However, PRS's continued existence defers recognition of that gain indefinitely. Thus, if this arrangement is respected, C and W duplicate for their benefit A's built-in loss in the land prior to its contribution to PRS.

(iii) On these facts, any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transaction were respected for federal tax purposes (see paragraph (c) of this section). Accordingly, the transaction lacks a substantial business purpose (see paragraph (a)(1) of this section). In addition, factors (1), (2), and (4) of paragraph (c) of this section indicate that PRS was used with a principal purpose to reduce substantially the partners' tax liability in a manner inconsistent with the intent of subchapter K. On these facts, PRS is not bona fide (see paragraph (a)(1) of this section), and the transaction is not respected under applicable substance over form principles (see paragraph (a)(2) of this section). Further, the tax consequences to the partners do not properly reflect the partners' income; and Congress did not contemplate application of section 754 to partnerships such as PRS, which was formed for a principal purpose of producing a double tax benefit from a single economic loss (see paragraph (a)(3) of this section). Thus, PRS has been formed and availed of with a principal purpose of reducing substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under judicial principles or other statutory authorities, such as the substance over form doctrine or the disguised sale rules under section 707 (see paragraph (h) of this section)), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

Example 9. Absence of section 754 election; use of partnership consistent with the intent of subchapter K. (i) PRS is a bona fide partnership formed to engage in investment activities with contributions of cash from each partner. Several years after joining PRS, A, a partner with a capital account balance and basis in its partnership interest of \$100x, wishes to withdraw from PRS. The partnership agreement entitles A to receive the balance of A's capital account in cash or securities owned by PRS at the time of withdrawal, as mutually agreed to by A and the managing general partner, P. P and A agree to distribute to A \$100*x* worth of non-marketable securities (see section 731(c)) in which PRS has an aggregate basis of \$20*x*. Upon distribution, A's aggregate basis in the securities is \$100*x* under section 732(b). PRS does not make an election to adjust the basis in its remaining assets under section 754. Thus, PRS's basis in its remaining assets is unaffected by the distribution. In contrast, if a section 754 election had been in effect for the year of the distribution, under these facts section 734(b) would have required PRS to adjust the basis in its remaining assets downward by the amount of the untaxed appreciation in the distributed property, thus reflecting that gain in PRS's retained assets. In selecting the assets to be distributed, A and P had a principal purpose to take advantage of the facts that A's basis in the securities will be determined by reference to A's basis in its partnership interest under section 732(b), and because PRS will not make an election under section 754, the remaining partners of PRS will likely enjoy a federal tax timing advantage (i.e., from the \$80*x* of additional basis in its assets that would have been eliminated if the section 754 election had been made) that is inconsistent with proper reflection of income under paragraph (a)(3) of this section.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1) and (2) of this section have been satisfied. The validity of the tax treatment of this transaction is therefore dependent upon whether the transaction satisfies (or is treated as satisfying) the proper reflection of income standard under paragraph (a)(3) of this section. A's basis in the distributed securities is properly determined under section 732(b). The benefit to the remaining partners is a result of PRS not having made an election under section 754. Subchapter K is generally intended to produce tax consequences that achieve proper reflection of income. However, paragraph (a)(3) of this section provides that if the application of a provision of subchapter K produces tax results that do not properly reflect income, but application of that provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision (and the transaction satisfies the requirements of paragraphs (a)(1) and (2) of this section), then the application of that provision to the transaction will be treated as satisfying the proper reflection of income standard.

(iii) In general, the adjustments that would be made if an election under section 754 were in effect are necessary to minimize distortions between the partners' bases in their partnership interests and the partnership's basis in its assets following, for example, a distribution to a partner. The electivity of section 754 is intended to provide administrative convenience for bona fide partnerships that are engaged in transactions for a substantial business purpose, by providing those partnerships the option of not adjusting their bases in their remaining assets following a distribution to a partner. Congress clearly recognized that if the section 754 election were not made, basis distortions may result. Taking into account all the facts and circumstances of the transaction, the electivity of section 754 in the context of the distribution from PRS to A, and the ultimate tax consequences that follow from the failure to make the election with respect to the transaction, are clearly contemplated by section 754. Thus, the tax consequences of this transaction will be treated as satisfying the proper reflection of income standard under paragraph (a)(3) of this section. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 10. Basis adjustments under section 732; use of partnership consistent with the intent of subchapter K. (i) A, B, and C are partners in partnership PRS, which has for several years been engaged in substantial bona fide business activities. For valid business reasons, the partners agree that A's interest in PRS, which has a value and basis of \$100*x*, will be liquidated with the following assets of PRS: a nondepreciable asset with a value of \$60*x* and a basis to PRS of \$40*x*, and related equipment with two years of cost recovery remaining and a value and basis to PRS of \$40*x*. Neither asset is described in section 751 and the transaction is not described in section 732(d). Under section 732 (b) and (c), A's \$100*x* basis in A's partnership interest will be allocated between the nondepreciable asset and the equipment received in the liquidating distribution in proportion to PRS's bases in those assets, or \$50*x* to the nondepreciable asset and \$50*x* to the equipment. Thus, A will have a \$10*x* built-in gain in the nondepreciable asset (\$60*x* value less \$50*x* basis) and a \$10*x* built-in loss in the equipment (\$50*x* basis less \$40*x* value), which it expects to recover rapidly through cost recovery deductions. In selecting the assets to be distributed to A, the partners had a principal purpose to take advantage of the fact that A's basis in the assets will be determined by reference to A's basis in A's partnership interest, thus, in effect, shifting a portion of A's basis from the nondepreciable asset to the equipment, which in turn would allow A to recover that portion of its basis more rapidly. This shift provides a federal tax timing advantage to A, with no offsetting detriment to B or C.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1) and (2) of this section have been satisfied. The validity of the tax treatment of this transaction is therefore dependent upon whether the transaction satisfies (or is treated as satisfying) the proper reflection of income standard under paragraph (a)(3) of this section. Subchapter K is generally intended to produce tax consequences that achieve proper reflection of income. However, paragraph (a)(3) of this section provides that if the application of a provision of subchapter K produces tax results that do not properly reflect income, but the application of that provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision (and the transaction satisfies the requirements of paragraphs (a)(1) and (2) of this section), then the application of that provision to the transaction will be treated as satisfying the proper reflection of income standard.

(iii) A's basis in the assets distributed to it was determined under section 732 (b) and (c). The transaction does not properly reflect A's income due to the basis distortions caused by the distribution and the shifting of basis from a nondepreciable to a depreciable asset. However, the basis rules under section 732, which in some situations can produce tax results that are inconsistent with the proper reflection of income standard (see paragraph (a)(3) of this section), are intended to provide simplifying administrative rules for bona fide partnerships that are engaged in transactions with a substantial business purpose. Taking into account all the facts and circumstances of the transaction, the application of the basis rules under section 732 to the distribution from PRS to A, and the ultimate tax consequences of the application of that provision of subchapter K, are clearly contemplated. Thus, the application of section 732 to this transaction will be treated as satisfying the proper reflection of income standard under paragraph (a)(3) of this section. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 11. Basis adjustments under section 732; plan or arrangement to distort basis allocations artificially; use of partnership not consistent with the intent of subchapter K. (i) Partnership PRS has for several years been engaged in the development and management of commercial real estate projects. X, an unrelated party, desires to acquire undeveloped land owned by PRS, which has a value of \$95*x* and a basis of \$5*x*. X expects to hold the land indefinitely after its acquisition. Pursuant to a plan a principal purpose of which is to permit X to acquire and hold the land but nevertheless to recover for tax purposes a substantial portion of the purchase price for the land, X contributes \$100*x* to PRS for an interest therein. Subsequently (at a time when the value of the partnership's assets have not materially changed), PRS distributes to X in liquidation of its interest in PRS the land and another asset with a value and basis to PRS of \$5*x*. The second asset is an insignificant part of the economic transaction but is important to achieve the desired tax results. Under section 732 (b) and (c), X's \$100*x* basis in its partnership interest is allocated between the assets distributed to it in proportion to their bases to PRS, or \$50*x* each. Thereafter, X plans to sell the second asset for its value of \$5*x*, recognizing a loss of \$45*x*. In this manner, X will, in effect, recover a substantial portion of the purchase price of the land almost immediately. In selecting the assets to be distributed to X, the partners had a principal purpose to take advantage of the fact that X's basis in the assets will be determined under section 732 (b) and (c), thus, in effect, shifting a portion of X's basis economically allocable to the land that X intends to retain to an inconsequential asset that X intends to dispose of quickly. This shift provides a federal tax timing advantage to X, with no offsetting detriment to any of PRS's other partners.

(ii) Although section 732 recognizes that basis distortions can occur in certain situations, which may produce tax results that do not satisfy the proper reflection of income standard of paragraph (a)(3) of this section, the provision is intended only to provide ancillary, simplifying tax results for bona fide partnership transactions that are engaged in for substantial business purposes. Section 732 is not intended to serve as the basis for plans or arrangements in which inconsequential or immaterial assets are included in the distribution with a principal purpose of obtaining substantially favorable tax results by virtue of the statute's simplifying rules. The transaction does not properly reflect X's income due to the basis distortions caused by the distribution that result in shifting a significant portion of X's basis to this inconsequential asset. Moreover, the proper reflection of income standard contained in paragraph (a)(3) of this section is not treated as satisfied, because, taking into account all the facts and circumstances, the application of section 732 to this arrangement, and the ultimate tax consequences that would thereby result, were not clearly contemplated by that provision of subchapter K. In addition, by using a partnership (if respected), the partners' aggregate federal tax liability would be substantially less than had they owned the partnership's assets directly (see paragraph (c)(1) of this section). On these facts, PRS has been formed and availed of with a principal purpose to reduce the taxpayers' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under applicable judicial principles and statutory authorities, such as the disguised sale rules under section 707, see paragraph (h) of this section), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

(e) *Abuse of entity treatment*—(1) *General rule*. The Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder.

(2) *Clearly contemplated entity treatment*. Paragraph (e)(1) of this section does not apply to the extent that—

(i) A provision of the Internal Revenue Code or the regulations promulgated thereunder prescribes the treatment of a partnership as an entity, in whole or in part, and

(ii) That treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.

(f) *Examples*. The following examples illustrate the principles of paragraph (e) of this section. The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. Unless otherwise indicated, parties to the transactions are not related to one another.

Example 1. Aggregate treatment of partnership appropriate to carry out purpose of section 163(e)(5). (i) Corporations X and Y are partners in partnership PRS, which for several years has engaged in substantial bona fide business activities. As part of these business activities, PRS issues certain high yield discount obligations to an unrelated third party. Section 163(e)(5) defers (and in certain circumstances disallows) the interest deductions on this type of obligation if issued by a corporation. PRS, X, and Y take the position that, because PRS is a partnership and not a corporation, section 163(e)(5) is not applicable.

(ii) Section 163(e)(5) does not prescribe the treatment of a partnership as an entity for purposes of that section. The purpose of section 163(e)(5) is to limit corporate-level interest deductions on certain obligations. The treatment of PRS as an entity could result in a partnership with corporate partners issuing those obligations and thereby circumventing the purpose of section 163(e)(5), because the corporate partner would deduct its distributive share of the interest on obligations that would have been deferred until paid or disallowed had the corporation issued its share of the obligation directly. Thus, under paragraph (e)(1) of this section, PRS is properly treated as an aggregate of its partners for purposes of applying section 163(e)(5) (regardless of whether any party had a tax avoidance purpose in having PRS issue the obligation). Each partner of PRS will therefore be treated as issuing its share of the obligations for purposes of determining the deductibility of its distributive share of any interest on the obligations. See also section 163(i)(5)(B).

Example 2. Aggregate treatment of partnership appropriate to carry out purpose of section 1059. (i) Corporations X and Y are partners in partnership PRS, which for several years has engaged in substantial bona fide business activities. As part of these business activities, PRS purchases 50 shares of Corporation Z common stock. Six months later, Corporation Z announces an extraordinary dividend (within the meaning of section 1059). Section 1059(a) generally provides that if any corporation receives an extraordinary dividend with respect to any share of stock and the corporation has not held the stock for more than two years before the dividend announcement date, the basis in the stock held by the corporation is reduced by the nontaxed portion of the dividend. PRS, X, and Y take the position that section 1059(a) is not applicable because PRS is a partnership and not a corporation.

(ii) Section 1059(a) does not prescribe the treatment of a partnership as an entity for purposes of that section. The purpose of section 1059(a) is to limit the benefits of the dividends received deduction with respect to extraordinary dividends. The treatment of PRS as an entity could result in corporate partners in the partnership receiving dividends through partnerships in circumvention of the intent of section 1059. Thus, under paragraph (e)(1) of this section, PRS is properly treated as an aggregate of its partners for purposes of applying section 1059 (regardless of whether any party had a tax avoidance purpose in acquiring the Z stock through PRS). Each partner of PRS will therefore be treated as owning its share of the stock. Accordingly, PRS must make appropriate adjustments to the basis of the Corporation Z stock, and the partners must also make adjustments to the basis in their respective interests in PRS under section 705(a)(2)(B). See also section 1059(g)(1).

Example 3. Prescribed entity treatment of partnership; determination of CFC status clearly contemplated. (i) X, a domestic corporation, and Y, a foreign corporation, intend to conduct a joint venture in foreign Country A. They form PRS, a bona fide domestic general partnership in which X owns a 40% interest and Y owns a 60% interest. PRS is properly classified as a partnership under §§301.7701–2 and 301.7701–3. PRS holds 100% of the voting stock of Z, a Country A entity that is classified as an association taxable as a corporation for federal tax purposes under §301.7701–2. Z conducts its business operations in Country A. By investing in Z through a domestic partnership, X seeks to obtain the benefit of the look-through rules of section 904(d)(3) and, as a result, maximize its ability to claim credits for its proper share of Country A taxes expected to be incurred by Z.

(ii) Pursuant to sections 957(c) and 7701(a)(30), PRS is a United States person. Therefore, because it owns 10% or more of the voting stock of Z, PRS satisfies the definition of a U.S. shareholder under section 951(b). Under section 957(a), Z is a controlled foreign corporation (CFC) because more than 50% of the voting power or value of its stock is owned by PRS. Consequently, under section 904(d)(3), X qualifies for look-through treatment in computing its credit for foreign taxes paid or accrued by Z. In contrast, if X and Y owned their interests in Z directly, Z would not be a CFC because only 40% of its stock would be owned by U.S. shareholders. X's credit for foreign taxes paid or accrued by Z in that case would be subject to a separate foreign tax credit limitation for dividends from Z, a noncontrolled section 902 corporation. See section 904(d)(1)(E) and §1.904–4(g).

(iii) Sections 957(c) and 7701(a)(30) prescribe the treatment of a domestic partnership as an entity for purposes of defining a U.S. shareholder, and thus, for purposes of determining whether a foreign corporation is a CFC. The CFC rules prevent the deferral by U.S. shareholders of U.S. taxation of certain earnings of the CFC and reduce disparities that otherwise might occur between the amount of income subject to a particular foreign tax credit limitation when a taxpayer earns income abroad directly rather than indirectly through a CFC. The application of the look-through rules for foreign tax credit purposes is appropriately tied to CFC status. See sections 904(d)(2)(E) and 904(d)(3). This analysis confirms that Congress clearly contemplated that taxpayers could use a bona fide domestic partnership to subject themselves to the CFC regime, and the resulting application of the look-through rules of section 904(d)(3). Accordingly, under paragraph (e) of this section, the Commissioner cannot treat PRS as an aggregate of its partners for purposes of determining X's foreign tax credit limitation.

(g) *Effective date.* Paragraphs (a), (b), (c), and (d) of this section are effective for all transactions involving a partnership that occur on or after May 12, 1994. Paragraphs (e) and (f) of this section are effective for all transactions involving a partnership that occur on or after December 29, 1994.

(h) *Scope and application.* This section applies solely with respect to taxes under subtitle A of the Internal Revenue Code, and for purposes of this section, any reference to a federal tax is limited to any tax imposed under subtitle A of the Internal Revenue Code.

(i) *Application of nonstatutory principles and other statutory authorities.* The Commissioner can continue to assert and to rely upon applicable nonstatutory principles and other statutory and regulatory authorities to challenge transactions. This section does not limit the applicability of those principles and authorities.

[T.D. 8588, 60 FR 27, Jan. 3, 1995; T.D. 8588, 60 FR 9776, 9777, Feb. 22, 1995, as amended by T.D. 8592, 60 FR 18741, Apr. 13, 1995]

§ 1.702–1 Income and credits of partner.

(a) *General rule.* Each partner is required to take into account separately in his return his distributive share, whether or not distributed, of each class or item of partnership income, gain, loss, deduction, or credit described in subparagraphs (1) through (9) of this paragraph. (For the taxable year in which a partner includes his distributive share of partnership taxable income, see section 706(a) and §1.706–1(a). Such distributive share shall be determined as provided in section 704 and §1.704–1.) Accordingly, in determining his income tax:

(1) Each partner shall take into account, as part of his gains and losses