§ 207.46 Investigations concerning certain countervailing duty orders.

(a) *Definitions.* For purposes of this section:

(1) *Requesting party* means an interested party described in section 771(9) (C), (D), (E), (F), or (G) of the Act.

(2) *Order* means a countervailing duty order issued under section 303 of the Act as to which the requirement of an affirmative determination of material injury under section 303(a)(2) of the Act was not applicable at the time such order was issued.

(3) *WTO Agreement* means the Agreement Establishing the World Trade Organization entered into on April 15, 1994.

(b) *Request for review.* A requesting party may file with the Commission a request for an investigation under section 753 of the Act within the time period established by section 753(a)(3) of the Act. The request should contain the following information:

(1) A description and identification of the relevant domestic like product, the industry in the United States producing that product that is likely to be materially injured by reason of imports of the subject merchandise if the Order is revoked, and each individual member of that industry.

(2) Information reasonably available to the requesting party concerning the names and addresses of all known enterprises believed to be manufacturing, producing, exporting, or importing the subject merchandise;

(3) Information reasonably available to the requesting party documenting that the industry described in paragraph (b)(1) of this section is likely to be materially injured by reason of subject imports if the Order is revoked, including:

(i) Information concerning the capacity, production, sales, market share, inventories, employment, wages, productivity, profits, ability to raise capital, and development and production efforts of the industry described in paragraph (b)(1) of this section.

(ii) Information concerning current and projected production capacity in the exporting country of the subject merchandise, inventories of the subject merchandise, and the existence of barriers to the importation of such merchandise into countries other than the United States.

(4) Information concerning any scope and anticircumvention rulings issued by the administering authority with respect to the Order.

(c) *Initiation of Investigation.* (1) Upon the receipt of a timely filed request for a section 753 investigation satisfying the requirements of paragraph (b) of this section, the Secretary shall publish a notice of initiation of such investigation in the **Federal Register**.

(2) Subject to paragraph (c)(3) of this section, a section 753 investigation shall be completed within one year of the date of publication of the notice of initiation of such investigation in the **Federal Register**.

(3) The Commission may take more than one year to complete section 753 investigations for which requests for investigations are received within one year after the date on which the WTO Agreement enters into force with respect to the United States. All such investigations must be completed within four years of that date, however. In determining whether to extend the completion date for a section 753 investigation, the Commission shall consult with the administering authority. Grounds for extending completion include, but are not limited to, the desire to conduct investigations involving the same or similar domestic industries and domestic like products on a simultaneous basis, and the desire to efficiently manage the Commission's caseload.

(d) *Conduct of Investigations.* The procedures set forth in subparts A and C of this part shall apply to all investigations initiated under this section.

(e) *When No Request for Review Is Filed.* When there has been no properly filed and sufficient request for a section 753 investigation of an Order, the Commission shall notify the administering authority that a negative determination has been made under section 753(a) of the Act with respect to that Order.

(f) *Pending and Suspended Section 303 Investigations.* If, on the data on which a country becomes a signatory to the Agreement on Subsidies and Countervailing Measures referred to in section 101(d)(12) of the Uruguay Round Agreements Act, there is a section 303 countervailing duty investigation in progress or suspended with respect to that country's merchandise for which the requirement of a material injury determination under section 303(a)(2) of the Act was not applicable at the time the investigation was initiated, the Commission shall commence an investigation pursuant to the provisions of section 753(c) of the Act with respect to pending investigations and suspended investigations to which section 704(i)(1)(B) of the Act applies.

(g) *Request for Simultaneous Expedited Section 751(c) Review.* (1) A requesting party who requests a section 753 review may at the same time request from the Commission and the administering authority an expedited review under section 751(c) of the Act of a countervailing or antidumping duty order involving the same or comparable subject merchandise. The request for review under section 751(c) of the Act should set forth evidence to establish why revocation of the order to be reviewed under section 751(c) of the Act would be likely to lead to continuation or recurrence of material injury and should additionally contain any information required by the regulations of the administering authority.

(2) Should the administering authority, after consulting with the Commission, determine to initiate a section 751(c) review, the Commission shall conduct a consolidated review under sections 751(c) and 753 of the Act of the orders involving the same or comparable subject merchandise. The procedures set forth in subparts A and C of this part shall apply to any such consolidated review.

(3) Should the administering authority, after consulting with the Commission, determine not to initiate a section 751(c) review, the Commission will consider the request for a section 753 review pursuant to the procedures established in this section.

By order of the Commission:

Issued: December 24, 1994.

Donna R. Koehnke,

Secretary.

[FR Doc. 94–32127 Filed 12–30–94; 8:45 am]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8588]

RIN 1545–AS70

Subchapter K Anti-Abuse Rule

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document contains a final regulation providing an anti-abuse rule under subchapter K of the Internal Revenue Code of 1986 (Code). The rule authorizes the Commissioner of Internal Revenue, in certain circumstances, to recast a transaction involving the use of a partnership. The final regulation affects partnerships and the partners of those partnerships and is necessary to provide guidance needed to comply with the applicable tax law.

EFFECTIVE DATES: This regulation is effective May 12, 1994, except that § 1.701–2 (e) and (f) are effective December 29, 1994.

FOR FURTHER INFORMATION CONTACT: Mary A. Berman or D. Lindsay Russell, (202) 622–3050 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Introduction

This document adds § 1.701–2 to the Income Tax Regulations (26 CFR part 1) under section 701 of the Code.

Background

Subchapter K was enacted to permit businesses organized for joint profit to be conducted with ''simplicity, flexibility, and equity as between the partners.'' S. Rep. No. 1622, 83d Cong., 2d Sess. 89 (1954); H.R. Rep. No. 1337, 83d Cong., 2d Sess. 65 (1954). It was not intended, however, that the provisions of subchapter K be used for tax avoidance purposes. For example, in enacting subchapter K, Congress indicated that aggregate, rather than entity, concepts should be applied if such concepts are more appropriate in applying other provisions of the Code. H.R. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954). Similarly, in later amending the rules relating to special allocations, Congress sought to ''prevent the use of special allocations for tax avoidance purposes, while allowing their use for bona fide business purposes.'' S. Rep. No. 938, 94th Cong., 2d Sess. 100 (1976).

On May 12, 1994, the IRS and Treasury issued a notice of proposed rulemaking (59 FR 25581) under section 701 of the Code. That document proposed to add an anti-abuse rule under subchapter K. Comments responding to the notice were received, and a public hearing was held on July 25, 1994. After considering the comments that were received in response to the notice of proposed rulemaking and the statements made at the hearing, the IRS and Treasury adopt the proposed regulation as revised by this Treasury decision. The anti-abuse rule in this final regulation applies to the operation and interpretation of any provision of the Code and the regulations thereunder that may be relevant to a particular partnership transaction (including income, estate, gift, generation-skipping, and excise tax). The anti-abuse rule in the final regulation is expected primarily to affect a relatively small number of partnership transactions that make inappropriate use of the rules of subchapter K. The regulation is not intended to interfere with bona fide joint business arrangements conducted through partnerships.

Explanation of Provisions

A. Overview of Provisions

As noted above, 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 three requirements. First, the partnership must be bona fide and each partnership transaction (or series of related transactions) must be entered into for a substantial business purpose. Second, the form of each partnership transaction must be respected under substance over form principles. Third, 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 (referred to in the final regulation as proper reflection of income), except to the extent that a provision of subchapter K that is intended to promote administrative convenience or other policy objectives causes tax results that deviate from that requirement. In those cases, if the application of that provision of subchapter K and the ultimate tax results to the partners and the partnership, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision, the transaction is treated as properly reflecting the partners' income. In determining whether a transaction clearly reflects the partners' income, the principles of sections 446(b) and 482 apply.

The provisions of subchapter K must be applied to partnership transactions in a manner consistent with the intent of subchapter K. The final regulation clarifies the authority of the Commissioner to recast transactions that attempt to use partnerships in a manner inconsistent with the intent of subchapter K as appropriate to achieve tax results that are consistent with this intent, taking into account all the facts and circumstances.

In addition, the final regulation provides that 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 Code or regulations, except to the extent that (1) a provision of the Code or regulations prescribes the treatment of the partnership as an entity, and (2) that treatment and the ultimate tax results, taking into account all of the facts and circumstances, are clearly contemplated by that provision.

B. Discussion of Comments Relating to Provisions in the Regulation

Comments that relate to the application of the proposed regulation and the responses to them, including an explanation of the revisions made to the final regulation, are summarized below.

1. Scope of the Regulation

Several comments stated that, as drafted, the language in the proposed regulation was too broad and too vague to provide adequate guidance to taxpayers as to which transactions are affected by the regulation. Similarly, some comments suggested that the intent of subchapter K as stated in the proposed regulation (upon which the regulation operates) was overbroad and potentially conflicted with explicit statutory or regulatory provisions. Several comments expressed concern that the regulation, if finalized as proposed, would adversely affect the legitimate use of partnerships. Other comments suggested that additional examples should be added to clarify the scope of the regulation, which would provide the necessary guidance. Some of the comments requested that the regulation be withdrawn, or revised and reproposed.

On the other hand, other comments supported the approach in the proposed regulation, noting that it was well established that the provisions of the Code must be interpreted consistent with their purpose. Some of these comments noted that the regulation would in large part simply be codifying aspects of existing judicial doctrines, such as substance over form and business purpose, as they relate to partnership transactions. Finally, some of these comments suggested that the regulation be modified in various respects, including by adding additional examples of its application.

In response to these comments, the IRS and Treasury have revised the final regulation in three principal respects. First, the scope of the regulation has been clarified substantially by revising the portion captioned *Intent of Subchapter K,* in paragraph (a) of the proposed regulation. Paragraph (a) of the final regulation now specifically requires that (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, and (3) the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must, subject to certain exceptions, accurately reflect the partners' economic agreement and clearly reflect the partner's income (*proper reflection of income*). However, certain provisions of subchapter K that were adopted to promote administrative convenience or other policy objectives may, under certain circumstances, produce tax results that do not properly reflect income. To reflect the conscious choice in these instances to favor administrative convenience or such other objectives over the accurate measurement of income, the final regulation provides that proper reflection of income will be treated as satisfied with respect to the tax consequences of a partnership transaction that satisfies paragraphs (a) (1) and (2) of the final regulation to the extent 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. Examples of such provisions include section 732, the elective feature of section 754, and the value-equals-basis rule in § 1.704–1(b)(2)(iii)(*c*), as well as regulatory de minimis rules such as those reflected in §§ 1.704–3(e)(1) and 1.752–2(e)(4). A number of examples in the final regulation demonstrate the proper application of these rules.

In addition, the revised *Intent of Subchapter K* set forth in paragraph (a) no longer provides that the provisions of subchapter K are not intended to permit taxpayers ''to use the existence of the partnerships to avoid the purposes of other provisions of the Internal Revenue Code.'' Many comments expressed confusion regarding the scope of this clause. Other comments suggested that this clause should be limited to questions of the appropriate treatment of a partnership as an entity or as an aggregate of its partners for purposes of applying another provision of the Code. Some comments further suggested that the correct application of the aggregate/entity concept does not depend on the intent of the taxpayer in structuring the transaction.

This clause was principally intended to address aggregate/entity issues that exist under current law. The final regulation clarifies this aspect of the regulation by removing the clause from paragraph (a) and adding a new paragraph (e) to address inappropriate treatment of a partnership as an entity. Paragraph (e) confirms the Commissioner's authority to 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 Code or the regulations thereunder. As stated in some comments, as well as under current law, the Commissioner's authority to treat a partnership as an aggregate of its partners is not dependent on the taxpayer's intent in structuring the transaction. However, the Commissioner may not treat the partnership as an aggregate of its partners under paragraph (e) to the extent that a provision of the Code or the regulations thereunder prescribes the treatment of a partnership as an entity, in whole or in part, and that treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision. Underlying the promulgation of paragraph (e) is the belief that significant potential for abuse exists in the inappropriate treatment of a partnership as an entity in applying rules outside of subchapter K to transactions involving partnerships. Examples in new paragraph (f) illustrate the application of paragraph (e).

Paragraph (c) contains the second principal revision reflected in this final regulation. The corresponding paragraph in the proposed regulation provides that the purposes for structuring a transaction involving a partnership will be determined based on all of the facts and circumstances. In response to comments requesting guidance concerning the factors that will indicate that the taxpayers had a principal purpose to reduce substantially their aggregate federal tax liability in a manner inconsistent with the intent of subchapter K, paragraph (c) of the final regulation sets forth several of those factors.

Finally, in response to comments that the examples in the proposed regulation do not provide adequate guidance regarding the application of the regulation, as well as to suggestions that additional examples would help clarify the scope of the regulation, the final regulation contains numerous examples that illustrate the application of the regulation to specifically described transactions, including the weight to be given to relevant factors listed in paragraph (c) in the particular situations involved. The examples include transactions that are consistent with the intent of subchapter K as well as transactions that are inconsistent with the intent of subchapter K.

2. A Principal Purpose

The proposed regulation provides that if a partnership is formed or availed of in connection with a transaction or series of related transactions with a principal purpose of substantially reducing the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K, the Commissioner can disregard the form of the transaction. Some comments stated that all partnership transactions have a principal purpose of reducing federal taxes, and therefore, the standard should be changed from *a* principal purpose to *the* principal purpose. Other comments supported an ''*a* principal purpose'' standard, because the Commissioner can recast the transaction only if the tax results are also found to be inconsistent with the intent of subchapter K. Other comments stated that the taxpayer's intent should be irrelevant in all cases; rather, the inquiry should only be whether the results are inconsistent with the intent of subchapter K. Still other comments suggested that the taxpayer's intent should be irrelevant only in the case of aggregate/entity determinations.

The IRS and Treasury continue to believe that an inquiry into the taxpayer's intent generally is appropriate for an anti-abuse rule of this nature. As noted above, the regulation applies only if *both* (1) the taxpayer has a principal purpose to achieve substantial federal tax reduction, *and* (2) that tax reduction is inconsistent with the intent of subchapter K. Having a principal purpose to use a bona fide partnership to conduct business activities in a manner that is more tax efficient than any alternative means available does not establish that the resulting tax reduction is inconsistent with the intent of subchapter K. In those cases, the Commissioner cannot recast the transaction under this regulation. A number of examples in the final regulation demonstrate this point. Thus, the additional requirement in the regulation that the tax results be inconsistent with the intent of subchapter K sufficiently restricts the potential application of the regulation, so that the requirement of *a* principal purpose of federal tax reduction is appropriate.

By contrast, as noted above, the entity/aggregate determination under paragraph (e) of the final regulation does not require the taxpayer to have a principal purpose of substantially reducing taxes through misapplication of that principle. In this context, the IRS and Treasury agree with those comments that suggested that the entity/aggregate principle is properly applied, as under current law, solely on the basis of carrying out the purpose of the particular provision to be applied.

3. Scope of Commissioner's Ability To Recast Transactions

The proposed regulation provides that if a transaction is determined to be inconsistent with the intent of subchapter K and the taxpayer acted with the requisite principal purpose of federal tax reduction, the Commissioner can disregard the form of the transaction. The proposed regulation describes several ways in which a transaction could appropriately be recast. Some comments interpreted this language as attempting to provide the Commissioner with unlimited discretionary recharacterization powers, without guidance as to which recharacterization applies to a particular transaction. To address these concerns, paragraph (b) of the final regulation has been revised to clarify that the Commissioner may recast transactions only as appropriate to ensure that the tax treatment of each transaction is consistent with the intent of subchapter K.

4. Effective Date of the Regulation

The regulation was proposed to be effective for all transactions relating to a partnership occurring on or after May 12, 1994, the date the proposed regulation was issued. Some comments requested that, in order to address the regulation's effect on bona fide partnership transactions, it apply prospectively only from the date the final regulation is issued. In light of the significant revisions made in the final regulation that clarify and narrow its potential scope and application, the final regulation generally continues to be effective as of May 12, 1994. However, to preclude the possibility that the regulation could be interpreted to apply, for example, when a partner who received an asset from a partnership before the effective date disposes of the asset after the effective date, the final regulation has been revised to clarify that it applies only to transactions *involving a partnership* after the effective date. Also, in light of the elimination of the proposed requirement that the taxpayer must have a principal purpose to achieve substantial tax reduction in the case of aggregate/entity determinations under paragraph (e), paragraphs (e) and (f) are effective for all transactions involving a partnership on or after December 29, 1994. No inference is intended as to the treatment of partnership transactions prior to the applicable effective date of the regulation.

5. Relationship of the Regulation to Established Legal Doctrines

Several comments questioned the relationship between the regulation and established legal doctrines, such as the business purpose and substance over form doctrines (including the step transaction and sham transaction doctrines), which are designed to assure that the tax consequences of transactions under the Code are governed by their substance and that statutes and regulations are interpreted consistent with their purposes.

Partnerships, like other business arrangements, are subject to those doctrines. The application of those doctrines to partnership transactions is particularly important in light of (i) the flexibility of partnership arrangements, which can take myriad forms that are often of substantial complexity, and (ii) the tax rules for partnerships, which are also often complex and, in many cases, appear purely mechanical. A literal application of these partnership tax rules in contexts not contemplated by Congress has, in certain circumstances, resulted in taxpayers claiming tax results that are contrary to those doctrines.

The final regulation confirms certain fundamental principles that must, in all cases, be satisfied in applying the provisions of subchapter K to partnership transactions, to assure that those provisions are not used to achieve inappropriate tax results. While the fundamental principles reflected in the regulation are consistent with the established legal doctrines, those doctrines will also continue to apply.

So viewed, the uncertainty regarding the application of the regulation reflects the uncertainty that already exists in properly evaluating transactions under current law, including the proper application of existing legal doctrines. As a result, the regulation should not impose any undue administrative burdens on either taxpayers or the IRS.

C. Other Comments

1. Suggested Alternatives to the Regulation

While some comments stated that it is appropriate to include a general anti-abuse rule in the regulations to limit the misuse of the provisions of subchapter K, others claimed that was not necessary. These comments stated that the IRS and Treasury already have sufficient means to challenge abusive partnership transactions and that existing authority should be used to address specific transactions as they are discovered. These comments suggested using the established legal doctrines, amending the section 704(b) regulations, and increasing partnership audits. These comments are discussed below.

In the past, the IRS and Treasury have attempted to address partnership transactions on a case-by-case basis. However, as recognized in those comments supporting a regulatory anti-abuse rule, experience has demonstrated that the case-by-case approach has been inadequate. A case-by-case approach arguably encourages non-economic, tax-motivated behavior by inappropriately putting a premium on being the first to engage in a transaction that would violate the principles of this regulation. The IRS and Treasury believe that the final regulation is a reasonable and effective way to reduce the number and magnitude of these abusive transactions. Moreover, the IRS and Treasury believe that proper application of the principles embodied in the regulation will forestall additional complexity in the Code and the regulations, by reducing the pressure for case-by-case legislative or regulatory revisions to prevent inappropriate use of the provisions of subchapter K.

Although the section 704(b) regulations are one example of the provisions of subchapter K that may be used inappropriately to reach results that are inconsistent with the intent of subchapter K, there are many other provisions of subchapter K that are being inappropriately applied to partnership transactions in a manner inconsistent with the intent of subchapter K. Therefore, an amendment to the section 704(b) regulations, by itself, is not sufficient.

Significant efforts are already underway to reduce the inappropriate use of subchapter K through increased resource allocation to partnership audits. This regulation is part of that focus on partnership transactions, and should not be viewed as an alternative to increased audits of partnerships. As part of this overall focus, a new team under the Industry Specialization Program has been established that will coordinate partnership audits and (together with the IRS National Office) the application of this regulation to partnership transactions. Thus, the IRS and Treasury believe that the regulation complements the increased enforcement of partnership transactions through enhanced audit activity.

2. Application by Revenue Agents

Many comments expressed concern that the regulation, if finalized as proposed, will not be applied appropriately by Revenue Agents. As stated in Announcement 94–87, 1994–27 I.R.B. 124, when an issue that may be affected by the regulation is considered on examination, any application of the regulation must be coordinated with *both* the Issue Specialist on the Partnership Industry Specialization Program team *and* the IRS National Office. The IRS and Treasury believe that this coordination, together with the many clarifying changes made in the final regulation, will result in fair and consistent treatment of taxpayers in the application of the final regulation to partnership transactions.

3. Special Analyses and the Secretary's Authority

Some comments questioned the determination that the notice of proposed rulemaking was not a significant regulatory action as defined in EO 12866, as well as the determination that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply. Some comments also questioned the Secretary's authority to issue the regulation as proposed. The IRS and Treasury believe that the regulation complies with all statutory and regulatory requirements relating to the issuance of the notice of proposed rulemaking, and that it is clearly within the Secretary's authority to issue the final regulation. The final regulation clarifies that the authority for the regulation includes sections 701 through 761.

4. De Minimis Rule

In the preamble accompanying the proposed regulation, the IRS and Treasury solicited comments on the appropriateness of a safe harbor or de minimis rule. Some comments responded that a de minimis rule would be appropriate, and suggested delineating the rule on the basis of the number of partners, the value of the partnership assets, or the amount of the reduction in the present value of the partners' aggregate federal tax liability resulting from the transaction.

The requirement in the regulation that the present value of the partners' aggregate federal tax reduction must be substantial assures that the regulation will not be applied where the amounts involved are not significant. In addition, the IRS and Treasury believe that the clarifications made in the final regulation provide sufficient safeguards for bona fide joint business arrangements involving partnerships. For example, the exception from the proper reflection of income standard set forth in paragraph (a)(3) for transactions that are clearly contemplated by a particular provision of subchapter K provides appropriate safeguards for these business arrangements. Finally, the final regulation explicitly recognizes the application of specific statutory and regulatory de minimis rules in subchapter K. In light of these safeguards, the IRS and Treasury believe no additional specific safe harbor rules are needed.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to this regulation, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business. Comments were submitted and are addressed in the Supplementary Information section of this document.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.701–2 also issued under 26 U.S.C. 701 through 761 * * *

Par. 2. Section 1.701–2 is added under the heading ''Determination of Tax Liability'' to read as follows:

§ 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 8* of this section (relating to the value-equals-basis rule in § 1.704–1(b)(2)(iii)(*c*)), paragraph (d) *Example 11* of this section (relating to the election under section 754 to adjust basis in partnership property), and paragraph (d) *Examples 12 and 13* 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. Family partnership to conduct joint business activities; valuation discount; use of partnership consistent with the intent of subchapter K. (i) H and W, husband and wife, form limited partnership PRS by contributing their interests in actively managed, income-producing real property that PRS will own and operate. H holds a general partnership interest, and W holds a limited partnership interest. At a later date, W makes a gift of a portion of her limited partnership interest to each of H and W's two children, S and D. Appropriate discounts, consistent with the taxpayers' treatment of the arrangement as a partnership, were applied in determining the value of W's gifts to the children.

(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 PRS is owned entirely by related parties (see paragraph (c)(4) 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. Therefore, absent other facts (such as the creation of the partnership immediately before the gifts by W), the Commissioner cannot invoke paragraph (b) of this section to recast the transaction. But see sections 2701 through 2704 for special valuation rules applicable to family arrangements for estate and gift tax purposes. See also sections 2036 through 2039.

(iii) The special valuation rules provided under chapter 14 of the Code, in particular section 2701, prescribe certain special rules in valuing gifts of family controlled partnership interests. These special rules clearly contemplate that a bona fide partnership like PRS be treated as an entity and not as an aggregate of its partners for that purpose. Accordingly, under paragraph (e) of this section, the Commissioner cannot treat PRS as an aggregate of its partners for purposes of valuing the gifts from W to S and D.

Example 6. Family partnership not engaged in bona fide joint business activities; valuation discount; use of partnership not consistent with the intent of subchapter K. (i) H and W, husband and wife, form limited partnership PRS and contribute to it their respective interests in their vacation home. H holds a general partnership interest, and W holds a limited partnership interest. At a later date, W makes a gift of a portion of her limited partnership interest to each of H and W's two children, S and D. Discounts, consistent with the taxpayers' treatment of the arrangement as a partnership, were applied in determining the value of W's gifts to the children.

(ii) PRS is not bona fide and there is no substantial business purpose for the purported activities of PRS. In addition, by using a partnership (if respected), H and W's 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 H's and W's 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, such as the substance over form doctrine, see paragraph (h) of this section), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

Example 7. 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 $100 for a share of common stock of Z, an unrelated corporation, which has historically paid an annual dividend of $6. 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 $50, 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 8. 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 9. 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 $9,000, $990, and $10, respectively, for proportionate interests (90.0%, 9.9%, and 0.1%, respectively) in the capital and profits of PRS. PRS purchases offshore equipment for $10,000 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 $9,000, and allocates the resulting $9,000 of income $8,100 to X, $891 to Y, and $9 to Z. PRS thereafter makes a distribution of $9,000 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 $1,000 and $9,000 in cash. Thus, because the capital accounts immediately before the distribution reflect assets of $19,000 (that is, the initial capital contributions of $10,000 plus the $9,000 of income realized from the sale of the lease), PRS allocates a $9,000 book loss among the partners (for capital account purposes only), resulting in restated capital accounts for X, Y, and Z of $9,000, $990, and $10, respectively. Thereafter, PRS purchases real property by borrowing the $8,000 purchase price on a recourse basis, which increases Y's and Z's bases in their respective partnership interests from $1,881 and $19, to $9,801 and $99, 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 $1,000 and allocates the $9,000 tax loss $8,910 to Y and $90 to Z. Y's and Z's bases in their partnership interests are therefore reduced to $891 and $9, 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 10. 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 $100 and a fair market value of $60. 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 $30. 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 $100, 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 $40 loss.

(ii) PRS does not make an election under section 754. Accordingly, PRS's basis in the land contributed by A remains $100. At the end of year 3, pursuant to the lease option, PRS sells the land to B for $60 (its fair market value). Thus, PRS recognizes a $40 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 $10 each pursuant to section 705. Their respective interests are worth $30 each. Thus, upon liquidation of PRS (or their interests therein), each of C and W will recognize $20 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 11. 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 $100, 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 worth of non-marketable securities (see section 731(c)) in which PRS has an aggregate basis of $20. Upon distribution, A's aggregate basis in the securities is $100 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 (i) A's basis in the securities will be determined by reference to A's basis in its partnership interest under section 732(b), and (ii) 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 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 12. 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, will be liquidated with the following assets of PRS: a nondepreciable asset with a value of $60 and a basis to PRS of $40, and related equipment with two years of cost recovery remaining and a value and basis to PRS of $40. 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 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 to the nondepreciable asset and $50 to the equipment. Thus, A will have a $10 built-in gain in the nondepreciable asset ($60 value less $50 basis) and a $10 built-in loss in the equipment ($50 basis less $40 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 13. 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 and a basis of $5. 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 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. 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 basis in its partnership interest is allocated between the assets distributed to it in proportion to their bases to PRS, or $50 each. Thereafter, X plans to sell the second asset for its value of $5, recognizing a loss of $45. 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. See also paragraph (d) *Example 5* (iii) of this section (also demonstrating the application of the principles of paragraph (e) of this section).

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) *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.

Margaret Milner Richardson,

Commissioner of Internal Revenue.

Approved: December 20, 1994.

Leslie Samuels,

Assistant Secretary of the Treasury.

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26 CFR Part 301

[TD 8587]

RIN 1545–AN48

Authority to Release Levy and Return Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations regarding the authority to release a levy and to return property. The Technical and Miscellaneous Revenue Act of 1988 sets forth certain conditions under which the IRS must release a levy. In addition, the Internal Revenue Code was amended in 1979 to provide for the payment of interest in certain circumstances in which wrongfully levied upon property is returned. These final regulations describe the conditions under which a levy will be released and the procedures for obtaining such a release. Lastly, these final regulations also conform the existing regulations regarding the return of wrongfully levied upon property to provide for the payment of interest in certain circumstances.

EFFECTIVE DATE: These regulations are effective December 30, 1994.

FOR FURTHER INFORMATION CONTACT: Jerome D. Sekula, 202–622–3640 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

This document contains final regulations amending the Procedure and Administration Regulations (26 CFR part 301) under section 6343 of the Internal Revenue Code. These regulations reflect the amendment of section 6343 by section 6236(f) of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. 100–647), section 4(a) of Act of Dec. 29, 1979 (Pub. L. 96–167), and section 1511(c)(10) of the Tax Reform Act of 1986 (Pub. L. 99–514).

On October 16, 1991 a notice of proposed rulemaking concerning the authority to release and return property was published in the **Federal Register** (56 FR 51857). Written comments