REPORT #797

TAX SECTION

New York State Bar Association

REPORT ON THE PROPOSED PARTNERSHIP ANTI-ABUSE RULE

July 1, 1994

Table of Contents

TAX SECTION

New York State Bar Association

July 1, 1994

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: Partnership Anti-Abuse Regulation

Dear Secretary Samuels and Commissioner Richardson:

Enclosed are copies of a Report by the New York State Bar Association Tax Section concerning Proposed Treasury Regulation § 1.701-2 (PS-27-94), the proposed partnership anti-abuse rule.

The Report takes the following positions (among others):

1. We strongly support the adoption of a general anti-abuse rule applicable to tax-motivated partnership transactions.

2. We generally support the proposed regulation. However, we believe it is

important that the regulation be revised in certain specific respects to narrow its scope and that additional examples be added clarifying that narrowed scope.

3. We believe the revisions we suggest are fully consistent with the purpose, spirit and intended scope of the regulation, and would not adversely affect the Service's ability to attack abusive partnership transactions. Our suggested revised text of the regulation, including examples, appears as the Appendix to the Report.

4. We believe the Treasury has the authority to issue the regulation, at least in the modified form we suggest.

We are aware of the substantial controversy that this proposed regulation has generated. Nevertheless, at a meeting of our Tax Section Executive Committee attended by over 50 members, following a full discussion this Report was approved by almost a 2-to-l margin.

Please let me know if the Tax Section can be of further help in the development of these regulations.

Sincerely,

Michael L. Schler
Chair, Tax Section

Tax Report #797

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON PARTNERSHIPS

REPORT ON THE PROPOSED PARTNERSHIP ANTI-ABUSE RULE

July 1, 1994

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON PARTNERSHIPS */

Report on the Proposed Partnership Anti-Abuse Rule

July 1, 1994

I. Introduction and Summary of Conclusions

This Report comments upon Proposed Treasury Regulation §1.701-2 (the “Proposed Regulation”), which was released on May 12, 1994. The Proposed Regulation sets forth a broad anti-abuse rule for partnership transactions, authorizing the Internal Revenue Service to recharacterize tax-motivated partnership transactions that comply with the mechanical rules of Subchapter K but produce tax results inconsistent with the economic arrangement of the parties.

We strongly support the adoption of a general anti-abuse rule applicable to tax-motivated partnership transactions. Many abusive partnership transactions involving large sums of money have occurred in recent years, and for a variety of reasons the Service has not been successful in stopping them. We believe an anti-abuse rule will significantly reduce the number of these transactions.

*/ The principal authors of this report are Andrew N. Berg, William B. Brannan and Michael L. Schler. Helpful comments were provided by David H. Brockway, Dickson G. Brown, Herbert L. Camp, Peter C. Canellos, Richard G. Cohen, John A. Corry, Peter L. Faber, Arthur A. Feder, Michael Hirschfeld, Stephen B. Land, Carolyn Joy Lee, Richard 0. Loengard, Jr., David P. Mason, Stephen L. Millman, Kevin J. O'Brien, Richard L. Reinhold, Dennis E. Ross, Stanley I. Rubenfeld, Esta E. Stecher, Willard B. Taylor, David E. Watts and Philip R. West. These persons do not necessarily agree with the conclusions of the Report.

Moreover, we generally support the Proposed Regulation. We discuss in this Report a number of particular features of the regulation that we believe are appropriate. However, we believe it is important that the scope of the Proposed Regulation be narrowed in certain specific respects and that new examples should be added to clarify that narrowed scope. We also recommend that the aspects of the Proposed Regulation dealing with entity/aggregate issues [1/] be deleted from the Section 701 regulations and at the same time be amplified and adopted as a regulation under Section 702.[2/]

We believe that the modifications to the Proposed Regulation that we suggest are fully consistent with the purpose, spirit and intended scope of the regulation, and that the modifications would not adversely affect the Service's ability to attack abusive partnership transactions. The Appendix to this Report contains our suggested revised text of the Proposed Regulation under Sections 701 and 702, including additional examples under Section 701.

The principal reason for our suggested revisions to the Proposed Regulation is that in certain respects its broad scope could create some uncertainty as to the tax consequences of legitimate partnership transactions. This would impede planning for such transactions and expose them to undue risk of challenge on audit. There is some disagreement among ourselves concerning the extent to which the Proposed Regulation actually would create uncertainty as to the tax consequences of nonabusive partnership

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[1/] In this Report we adopt the usual convention (which is used in the Proposed Regulation) of referring to “aggregate” treatment of a partnership to mean that for certain purposes the partners are treated as directly owning the assets and carrying on the activities of the partnership. Some have suggested that “pass-through” treatment would be more accurate.

[2/] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended to date (the “Code”).

transactions. Nevertheless, there is general agreement that a more focused anti-abuse rule along the lines suggested herein is appropriate to reduce such uncertainty, and thereby to strike an appropriate balance between such concerns of taxpayers and the compliance concerns of the Treasury.

Finally, we believe the Treasury has the authority to issue the Proposed Regulation, at least in the modified form we suggest.

II. Summary of the Proposed Regulation

The Proposed Regulation states that the intent of Subchapter K is to permit taxpayers to conduct business for joint economic profit through a flexible arrangement that accurately reflects the partners' economic agreement. It goes on to state that Subchapter K is not intended to permit taxpayers either:

> (a) to structure transactions using partnerships to achieve results that are inconsistent with the underlying economic arrangement of the parties or the substance of the transaction, or
>
> (b) to use the existence of the partnership to avoid the purposes of other provisions of the Code.

The regulation then states that Subchapter K must be applied in a manner consistent with this stated intent. Accordingly, even if a transaction complies with the literal language of the Code or regulations, if it involves a partnership that is formed or availed of with a principal purpose of substantially reducing the partners' Federal income tax liability in a manner inconsistent with the intent of Subchapter K, the Service can disregard the form of the transaction and recast it as appropriate. Such recasting can involve disregarding the partnership, treating one or more purported partners as not being partners, treating the partners as owning partnership assets directly, adjusting the method of accounting of the partnership or a partner to clearly reflect income, reallocating tax items of the partnership, or otherwise precluding the intended tax treatment.

The regulation adds that a reduction in tax liability from the use of a partnership is not, in itself, inconsistent with the intent of Subchapter K. Moreover, the Service can continue to challenge abusive transactions in reliance upon existing authority (e.g., substance over form, step transaction, and sham transaction doctrines). The regulation contains three examples of transactions consistent with the intent of Subchapter K and one example of a transaction inconsistent with such intent.

The regulation (except for the explicit reference to the Service's ability to rely upon existing authority) is effective for all transactions relating to a partnership occurring on or after May 12, 1994.

In addition, on June 13, 1994, the Service issued Announcement 94-87, 1994-27 I.R.B. That Announcement stated that the Service would designate an Issue Specialist to provide expertise to field examiners on all issued raised under the Proposed Regulation. In addition, a field examiner considering an issue under the Proposed Regulation would be required to coordinate the appropriateness of the determination with the Issue Specialist and the National Office.

III. Need for an Anti-Abuse Rule

A. Proliferation of Abusive Partnership Transactions

In recent years, tax practitioners have become increasingly aware of many partnership transactions, often involving sophisticated corporate taxpayers and large sums of money that are intended to achieve tax results that (most observers would agree) are inconsistent with the intent of Subchapter K and are not appropriate as a tax policy matter. These types of transactions are referred to in this Report as "abusive" transactions. The most aggressive of these transactions lack any meaningful economic substance and are entered into primarily to reduce the tax liabilities of one or more partners. Other transactions have some real economic substance but are carried out in an unusual manner. In all these transactions, the specific steps are designed to take advantage of the mechanical application of the rules of Subchapter K and other provisions of the Code to achieve the desired tax result, without regard to the underlying purposes of those rules.

A number of well-known transactions of this nature (which we assume are now defunct) are memorialized in existing rulings, regulations and notices promulgated specifically to stop such transactions. [3/] However, other partnership transactions that we would characterize as highly questionable if not abusive have continued to be successfully marketed (at least until issuance of the Proposed Regulation). Some of the transactions in current use are illustrated by the examples of abusive transactions contained in the Appendix to this report. Some have found their way into print, [4/] and still others have not.

The Service can presently challenge these transactions, either by applying established common law principles or by seeking ad hoc remedies through new regulations, rulings or statutory provisions designed to prevent specific types of transactions. However, neither approach has been adequate to stop the proliferation of abusive partnership transactions.

[3/] See, e.g., Prop. Treas. Reg. § 1.337(d)-3(h)(Example 1) (avoidance of gain through acquisition by partnership of stock of corporate partner);

Treas. Reg. § 1.704-1(b)(5)(Example 9) (uneconomic shifting of partnership income to partner with net operating losses, through uneconomic allocations);

Treas. Reg. § 1.704-3(b)(2)(Example 2) (same, through section 704(c) rules on contributions of appreciated property);

Notice 90-56, 1990-2 C.B. 344 and Treas. Reg. § 15A.453-l(c)(7)(iii) (artificial allocation of basis on installment sale so one partner has an artificial gain and the other an artificial loss);

Rev. Rul. 89-85, 1989-2 C.B. 218 and Treas. Reg. § 1.1502-13(1) (sale of partnership interest within consolidated group to obtain underlying asset basis step-up without taxation of gain on sale); and

Rev. Rul. 93-7, 1993-1 C.B. 125 (partnership acquires debt of partner at face amount and distributes it to the partner in attempt to eliminate partner's gain on partnership interest).

[4/] See, e.g., Sheppard, Partnerships, Consolidated Returns and Cognitive Dissonance, Tax Notes, May 23, 1994, at 936. More generally, see PLI, Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures and Other Strategic Alliances, Financings, Reorganizations and Restructurings (1993), which contains a number of lengthy articles concerning the use of a variety of partnership techniques to avoid taxable gain on asset dispositions.

B. Inadequacy of the Service's Reliance on Common Law

The Service has a significant amount of common law authority that could be used to attack these transactions. That authority includes the sham transaction doctrine, [5/] the substance over form doctrine, [6/] the step transaction doctrine, [7/] and the clear reflection of income principle. [8/]

Unfortunately, such common law authority has not been successfully employed by the Service to stop these transactions for a number of reasons:

(1) There is a low audit rate in the partnership area, and agents often are inexperienced in sophisticated partnership tax matters.

(2) These transactions often are extremely complex, making it difficult to determine the economic substance of the transaction and to identify an abuse that may be occurring.

(3) The common law authority is very general in nature, and there is little case law involving the application of

5/ See, e.g., Knetsch v. United States, 364 U.S. 361 (1960); Merryman v. Comm'r, 873 F.2d 879 (5th Cir. 1989).

6/ See, e.g., Gregory v. Helvering, 293 U.S. 465 (1935); Comm'r v. Court Holding Co., 324 U.S. 331 (1945); Frank Lyon v. United States, 435 U.S. 561 (1978).

7/ See, e.g., Minnesota Tea Co. v. Helvering, 302 U.S. 609 (1938); American Bantam Car Co. v. Comm'r, 11 T.C. 397 (1948), aff'd per curiam 177 F.2d 513 (3d Cir. 1949), cert. denied, 339 U.S. 920 (1950).

8/ See Section 446(b) of the Code and the Treasury Regulations thereunder; Ford Motor Co. v Comm'r, 102 T.C. No. 6 (Jan. 31, 1994) (immediate deduction of all future payments due under tort claim settlement agreement does not clearly reflect income, even though “all events test” was satisfied).

such doctrines in the partnership context. As a result, a taxpayer may have a respectable argument that the common law doctrines do not apply to a particular transaction that literally complies with Subchapter K, and an agent may tend to be reluctant to respond with common law authority that does not directly involve partnerships.

Taxpayers engaging in these transactions are aware of the foregoing considerations, and often have the perception that the Service tends to settle on a basis favorable to taxpayers rather than litigate. Likewise, taxpayers know that penalties are unlikely because of their literal compliance with the statute and regulations, and as a result believe (often with considerable justification) that even with an unfavorable settlement they will generally end up better off than if they had not engaged in the abusive transaction.

C. Inadequacy of the Service's Attacks on Specific Transactions

The Service can also combat abusive partnership transactions by obtaining statutory changes or by promulgating regulations, rulings or notices intended to prevent specific types of transactions. As discussed below, Congress has enacted numerous amendments to the Code in recent years to prevent specific types of abusive transactions (such as the “disguised sale” rules under Section 707(a)(2)(B) and the special distribution rules under Sections 704(c)(1)(B) and 737). In addition, the Treasury and the Service have attempted to stop specific transactions by regulations, rulings and notices (e.g., the Section 704(c) regulations and Section 337(d) regulations). However, there are major problems with this approach.

First, these attempts are inevitably slow in coming, thereby allowing abusive transactions to occur on a large scale before the door is shut. The delay occurs because the Service often does not become aware of a new form of transaction until sometime after it is created, the Service requires additional time to formulate a response, and it takes still more time for such a response to be implemented.

Second, past responses have frequently had a prospective effective date. As a practical matter, this approach (1) appears to put a premium on being the first to market a “secret” new transaction and to close as many transactions of the same type as possible before the Service discovers and acts on the form of transaction, (2) may confer an aura of validity on transactions completed before the Service's response, notwithstanding any statement to the contrary in the response and (3) encourages other kinds of abusive transactions in the future because taxpayers have less concern about a retroactive response applying to their transaction.

Third, such ad hoc changes are by their very nature limited to specific types of transactions. Consequently, each specific transaction stopped by a change in law is replaced by another one not specifically prohibited. Because of the hybrid nature of partnerships as a combination of entity and aggregate features in a highly flexible mix, it is inherently impossible to adopt specific rules that will prohibit all types of abusive partnership transactions.

Fourth, these narrowly focused attempts seriously complicate the partnership tax law. In the last ten years alone, there have been at least 23 significant changes in partnership tax law intended to prevent specific types of partnership transactions to which the Proposed Regulation potentially would have been applicable had it been in effect. [9/] That complexity is unfortunate, since it makes partnership tax law less

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[9/] New or amended statutory provisions (and their dates of enactment) include the following:

Section 704(c)(1)(A) (1984) (reducing ability to shift taxable income and deductions following a contribution of appreciated property to a partnership);

Section 704(c)(1)(B) (1989) (attacking "disguised sales" where contributed property is distributed to another partner within five years);

Sections 706(c) and (d) (1984) (preventing retroactive allocations of income);

Section 707(a)(2) (1984) (also attacking disguised sales where transfers and distributions in and out of a partnership have the effect of a sale);

Section 724 (1984) (preventing conversion of ordinary gain into capital gain, or capital loss into ordinary loss, through contribution of property to partnership);

Section 734(b)(flush language) (1984) (eliminating inappropriate basis step-up through the use of tiered partnerships);

Section 735 (1984) (preventing conversion of ordinary gain into capital gain through distribution of property from partnership);

Section 736(b)(3) (1993) (eliminating deduction by partnership for liquidation payments to nonservice partners, which payments were frequently allocable to goodwill and other intangibles);

Section 737 (1992) (attacking disguised sales by taxing a partner on the receipt of a property distribution within five years of the contribution of other property);

Section 751(d)(1) (1993) (disregarding a tax-motivated acquisition of inventory by a partnership to prevent other inventory from meeting the percentage test of "substantially appreciated");

Section 751(f) (1984) (disregarding tiered partnerships for purposes of tests for ordinary income under Section 751);

Section 761(e) (1984) (treating distributions of partnership interests as exchanges for purposes of constructive termination and basis adjustment rules);

Sections 386(a) and (b) (1984; repealed as deadwood in 1988) (treating corporation distributing or selling a partnership interest as subject to recapture income as on distribution of underlying assets); and

Footnote continue

comprehensible to taxpayers and agents alike. Moreover, complexity can only increase in the future if the Service continues to seek ad hoc changes in the Code and regulations, which it undoubtedly will be forced to do if a general anti-abuse rule is not adopted. Finally, attempts by the Service to stop a transaction frequently result initially in the issuance of a Notice, which itself increases complexity and uncertainty in the law because Notices are difficult to find and often are intentionally written in a broad manner.

Footnote previous

Section 386(d) (1984; replaced by Section 311(b)(3) in 1988) (authorizing regulations to prevent corporate contribution of loss assets to partnership from reducing gain on distribution of partnership interest).

New regulations (and their dates of promulgation) include the following:

Prop. Treas. Reg. § 1.337(d)-3 (1992), codifying Notice 89-37, 1989-1 C.B. 679 (dealing with tax avoidance transactions involving acquisition by a partnership of stock of a corporate partner);

Treas. Reg. § 1.704-l(b)(2)(iii) (1986) (substantiality requirement for partnership allocations);

Treas. Reg. § 1.704-2(e)(2) (1991) (restrictions on allocations of nonrecourse deductions, which inherently have no economic effect);

Treas. Reg. § 1.704-3(a)(10) (1993) (anti-abuse rule for partnership allocations relating to contributed appreciated property);

Treas. Reg. §§ 1.707-1 through -9 (1992) (elaborating on the disguised sale statutory amendments); and

Treas. Reg. § 1.752-2(j) (1991) (anti-abuse rule for allocations based on partnership recourse and nonrecourse liabilities).

New rulings and notices include the following:

Rev. Rul. 92-15, 1992-1 C.B. 215 (basis adjustments on transactions involving tiered partnerships);

Notice 90-56, 1990-2 C.B. 344 (artificial allocation of installment sale gains and losses); and

Notice 94-48, 1994-19 I.R.B. 10 (attacking interest deduction on debt of a partnership the principal asset of which is preferred stock of a partner).

D. Benefits and Detriments of an Anti-Abuse Rule

A partnership anti-abuse rule such as the Proposed Regulation has both benefits and detriments. We believe the benefits are clear from the foregoing discussion of the proliferation of abusive partnership transactions and the inability of the Service to stop such transactions. An appropriately drawn anti-abuse rule should prove to be a much more efficient way for the Service to combat such transactions as compared to its historic approach of seeking ad hoc remedies from time to time. As a result, such a rule can be expected to cut back considerably on the volume and nature of abusive partnership transactions. Taxpayers will be far more cautious about engaging in such transactions if it is known to them and to agents that such transactions may be attacked on the basis of such a rule. Moreover, the increased risk of penalties will make it less certain that a taxpayer will always come out ahead by engaging in such a transaction. The result will be not only a fairer distribution of the tax burden but also enhanced respect for the tax system among all taxpayers.

On the other hand, we recognize that there are detriments to a general partnership anti-abuse rule. Even for taxpayers engaging in legitimate transactions, a broad anti-abuse rule creates a “regulatory cost” because of the need to determine whether transactions are valid under still another regulation, and the continuing risk of challenge on audit. It must be kept in mind that legitimate transactions will vastly outnumber the relatively few abusive transactions toward which an anti-abuse rule is targeted.

Finally, if an anti-abuse rule is too broad or unclear, it will discourage taxpayers from entering into legitimate partnership transactions because of a fear that such transactions might be covered by the rule. Such fear, whether or not justified, might itself be sufficient to prevent such transactions from taking place and thus create economic inefficiencies. The result could be that taxpayers are in practice prevented from arranging their affairs so as to minimize their taxes, even if their arrangement is consistent with the purposes of the applicable Code provisions. This risk of discouraging legitimate transactions is especially true for Subchapter K, where (a) a transaction must already comply with a detailed set of rules before one even reaches an anti-abuse rule and (b) there is a stated legislative objective of affording partners flexibility in apportioning the tax burden of partnership transactions among themselves. [10] Of course, a tension arises because such flexibility is what permits abusive partnership transactions to occur under the literal language of Subchapter K in the first place.

E. We Support an Anti-Abuse Rule

Based on the foregoing analysis, we believe an appropriately drawn anti-abuse rule is urgently needed. Moreover, we believe that the advantages of such a rule strongly outweigh the disadvantages, and that the disadvantages can be reduced through a careful drafting of the rule. As a result, we strongly support the adoption of such a rule. Such a rule would have a variety of statutory and regulatory precedents, including Section 269 and Section 337(d), the “device” test under Section 355, the business purpose and continuity rules for tax-free

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[10] See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 65 (1954); and S. Rep. No. 1635, 83d Cong., 2d Sess. 89 (1954).

reorganizations, and a number of regulations in the financial products area. [11/]

We wish to emphasize that we have not considered whether a general anti-abuse rule would be appropriate for transactions not involving partnerships. Any anti-abuse rule (including the Proposed Regulation) has the risk of discouraging legitimate transactions, as discussed above. Moreover, no anti-abuse rule will stop all transactions that might be considered abusive, and it would be hopeless to try to write such a rule. As a result, the relative benefits and detriments of any proposed anti-abuse rule must be considered on its own merits. [12/]

However, for the specific reasons discussed above, we believe that a general anti-abuse rule in the partnership area is needed now and is appropriate. We note that the need for such a rule in the partnership area is particularly great because of the pass-through nature of partnerships, the flexibility in making partnership allocations and otherwise tailoring the terms of a partnership, and the considerable uncertainty regarding entity or aggregate treatment of partnerships.

We recognize that, in the abstract, it might be desirable for the law regarding abusive partnership transactions to develop in the same manner that the common law of corporate reorganizations developed, namely through decades of case law applied to specific transactions. In practice, however, the tax

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11/ See, e.g., Treas. Reg. §§ 1.446-3(1) (notional principal contracts); 1.988-2(f) (foreign currency transactions); 1.1275-2T(g) (original issue discount).

12 / The Tax Section recently supported a proposed anti-abuse rule under the original issue discount rules of the Code. See NYSBA Tax Section, letter dated April 22, 1994, to Hon. Leslie B. Samuels and Hon. Margaret M. Richardson re OID Anti-Abuse Rule, reprinted in Highlights & Documents, April 28, 1994.

system is under a great deal of stress from the proliferation of abusive partnership transactions, and the Treasury has reasonably concluded that it is necessary to make a strongly affirmative statement against the abusive use of the partnership rules. We believe that an anti-abuse rule is an appropriate exercise of the Treasury's authority, will be taken seriously in the great majority of cases, and if properly applied will in the long run significantly enhance tax fairness as well as taxpayer respect for the tax system.

IV. Evaluation of the Proposed Regulation

A. We Generally Support the Proposed Regulation

Based on the foregoing discussion, we generally support the Proposed Regulation. However, we believe it is important that the modifications discussed below be made. We believe that the suggested modifications are fully consistent with the purpose, spirit and intended scope of the Proposed Regulation, and that the modifications would not adversely affect the Service’s ability to attack abusive partnership transactions.

The proper scope of an anti-abuse rule requires a balancing. On the one hand, an anti-abuse rule must by its very nature be written in general terms, or else taxpayers will likely be able to avoid it. On the other hand, the more general the rule, the greater the regulatory cost resulting from the uncertainty that will necessarily be shifted to taxpayers, and the greater the risk of discouraging legitimate transactions. Thus, an anti-abuse rule should be written as clearly and narrowly as possible while still providing the Treasury the protection it reasonably needs.

Some would agree and some would disagree that the existing Proposed Regulation creates a significant amount of uncertainty concerning legitimate partnership transactions or a significant "regulatory cost". In particular, the Proposed Regulation has been read by some as calling into question a number of well-established planning techniques and transactions, and the Treasury has responded to these concerns through informal and issue-specific statements.

We do not share all the concerns being expressed. Nevertheless, we believe it is important to achieve the balance described in the preceding paragraphs by narrowing the text of the regulations in a number of specific respects and adding more examples. This will reduce the possibility that over the years unintended Interpretations of the regulations will develop that could lead to unjustified problems in field audits and the unwarranted impairment of legitimate partnership transactions.

We begin our discussion of the Proposed Regulation with a suggestion for a preamble to the final regulation. We then discuss separately the features of the Proposed Regulation that we support (in some cases with technical clarification) and the features that we believe should be modified. The Appendix to this Report contains a revised text of the Proposed Regulation that reflects our comments.

B. Expanded Preamble to the Regulation

We believe taxpayer understanding of the Proposed Regulation, and perhaps even a court's willingness to enforce the Proposed Regulation, would be enhanced by an appropriate statement in the preamble to the final regulation (or even in the final regulation itself). Such a statement would clarify the purpose of the regulation and put it in the context of common law doctrines concerning abusive transactions. We note that existing Treas. Reg. § 1.269-2(b) contains a statement similar to what we have in mind, characterizing Section 269 as simply one of a number of common law and statutory provisions aimed at transactions that are shams or are inconsistent with Congressional purpose.

We would propose something along the following lines as the preamble or actual introductory text for the Proposed Regulation:

> Partnerships, like other business arrangements, are subject to a number of legal principles designed to assure that their tax consequences are governed by their substantive realities and not merely their form. These legal principles include the "substance over form", "step transaction", "business purpose" and "sham transaction" doctrines.
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> There are, however, certain special considerations in applying these legal principles to partnership transactions. Problems of application arise principally from the combination of (1) the flexibility of partnership arrangements, which can take myriad forms that are often of substantial complexity, and (2) the tax rules for partnerships, which involve substantial complexity and, in many cases, emphasize accounting for transactions according to prescribed rules. A mistakenly mechanistic application of these partnership rules to complex business arrangements can lead to tax results that are contrary to the principles regarding economic substance referred to above.
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> For those reasons, the regulations set forth a minimum standard for testing partnership transactions to assure that the partnership provisions of the Code are not used to achieve inappropriate tax results. The regulations also provide rules for applying the minimum standard, examples of its application, and a discussion of the consequences of failure to meet this standard. A partnership transaction that meets this minimum standard remains subject to the above-mentioned legal principles.

We turn now to the text of the Proposed Regulation and describe the specific provisions we support or believe should be modified.

C. Features of the Proposed Regulation That We Support

1. The Test of "A" Principal Purpose. We support the concept in the Proposed Regulation that the anti-abuse rule should apply to a transaction entered into with "a" principal purpose of tax avoidance. [13] We believe this test is appropriate as a tax policy matter, since even if "a" principal purpose of the taxpayer is to save taxes, the Proposed Regulation (with the modifications suggested below) allows recharacterization of the transaction only if the tax result is inconsistent with the economic arrangement of the parties or the substance of the transaction. Taxpayers whose tax result reflects their economic arrangement have nothing to fear from this test.

We have considered whether the anti-abuse rule should apply only when "the" principal purpose of the transaction is tax avoidance. The latter test would provide additional assurance to taxpayers engaging in legitimate transactions that the transactions would not be challenged by a Revenue Agent. However, we believe this benefit to taxpayers is clearly outweighed by the fact that adoption of the latter test would substantially undermine the effectiveness of the Proposed Regulation in reducing the level of abusive transactions.

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[13] By coincidence, a very recent case discusses the requirement of "a principal purpose". In Santa Fe Pacific Corp. v Central States, Southeast and Southwest Areas Pension Fund, 7th Cir., April 22, 1994 (reprinted in the April 29, 1994 Highlights & Documents), the court interpreted an ERISA provision stating that a parent company selling a subsidiary is not liable for the subsidiary's withdrawal liability from a multiemployer plan unless "a principal purpose" of the sale was to avoid such liability. In finding liability, the court stated that the prohibited purpose "needn't be the only purpose; it need only have been one of the factors that weighed heavily in the seller's thinking". It stated that the employer would not be liable if avoiding liability "was a minor, subordinate purpose, as distinct from a major purpose".

If a transaction were subject to attack only if “the” principal purpose were tax avoidance, the result would be a substantially increased willingness on the part of taxpayers to engage in aggressive transactions. In our experience, a taxpayer usually is able to assert some nontax purpose for a transaction, even if that purpose is on its face borderline. Any such claim would have to satisfy a much lower threshold of “believability” if the test were whether “the” principal purpose of the transaction is tax avoidance. Such a lower threshold would give taxpayers a greater ability to avoid penalties and more comfort that they would be able to negotiate a favorable settlement with the Service. Since roost settlements concerning the transactions in question would put a taxpayer in a better position than if it had not engaged in the transaction in the first place, taxpayers would have a significantly greater incentive to engage in transactions and hope for the best. The result would also be a greatly increased litigation burden for the Service.

The history of Section 269, the corporate anti-abuse rule that applies only when “the” principal purpose of a transaction is tax avoidance, demonstrates the weakness of such a test. The Service has been unable to successfully apply Section 269 with any regularity, as indicated by the dearth of judicial decisions under that sections as well as our experience that agents in the field rarely attempt to apply the section. We believe those results may be attributable to Section 269's requirement that “the” principal purpose of a transaction be tax avoidance, which often allows the taxpayer to prevail by asserting a relatively weak business purpose.

Moreover, under Section 269 a loss of tax benefits is automatically triggered if the principal purpose of a specified type of transaction is “evasion or avoidance” of tax by securing a tax benefit not otherwise available. On the other hand, under the Proposed Regulation (as we propose to revise it), a loss of tax benefits can arise only if the intended tax results are inconsistent with the economic arrangement of the parties or the substance of the transaction. The former test is much harder for a taxpayer to avoid, aside from the purpose requirement. [14/] As a result, we believe “a” principal purpose is the appropriate test in the Proposed Regulation even if “the” principal purpose is considered appropriate in Section 269.

Finally, the changes to the Proposed Regulation that are recommended below should adequately protect taxpayers from unnecessary concern about legitimate partnership transactions, even if “a” principal purpose is the standard. However, if the changes recommended below are not made (particularly the addition of clarifying examples), the resulting generality of the anti abuse rule might justify further consideration of changing the test to “the” principal purpose.

2. Tax Avoidance Purpose. We also support the provision of the Proposed Regulation that tests whether there is a principal purpose “of substantially reducing the present value of the partners' aggregate federal tax liability”. If an allocation

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[14/] Compare Example 1 of the Proposed Regulation (permissible to use partnership form to avoid entity-level tax) with Coastal Oil Storage Co. v Comm'r, 242 F.2d 396 (4th Cir. 1957) (newly formed subsidiary not allowed corporate surtax exemption because alleged business purpose of transfer of assets to subsidiary could have been achieved by entries on books of parent corporation).

On the other hand, even Section 269 has been interpreted not to prevent the receipt of tax benefits specifically contemplated by Congress, such as Subchapter S. Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 14.41[2][c] (6th ed. 1994). This is similar to our suggested exemption from the Proposed Regulation for transactions specifically contemplated by the Code.

is intended to artificially increase one partner's tax liability but decrease another partner's liability by the same amount, we see no need for the fisc to be able to attack the transaction solely on that basis. This language in the Proposed Regulation will have the salutary effect of eliminating potential wasteful challenges to ordinary transactions where the affected partners are in substantially the same tax position, which is a common occurrence.

We note, however, that a taxpayer's purpose is difficult to determine subjectively. While we have not included language to this effect in our proposed draft of the regulation, consideration should be given to a statement in the regulation that an actual reduction in aggregate tax liability of the parties to a transaction would be evidence of their purpose to reduce taxes.

3. Inconsistency with Subchapter K. We support the concept in subsection (b) of the Proposed Regulation that the anti-abuse rule applies if a partnership is formed or availed of “in a manner that is inconsistent with the intent of subchapter K”. Since the intent of Subchapter K is somewhat amorphous, it is important that the Proposed Regulation provide a reasonably clear and concise definition. We assume that the definition in subsection (a) of the Proposed Regulation (which is discussed below) was meant to serve that purpose.

However, the reference to the intent of Subchapter K in the second sentence of subsection (b) can be read as being broader and more amorphous, since that sentence does not expressly incorporate by reference the definition of intent in subsection (a). To avoid any ambiguity, we would suggest that there be an express cross-reference in the second sentence of subsection (b). That clarification would be helpful both to taxpayers (who then would not need to be concerned that a Revenue Agent might attack a transaction on the ground of some newly discovered “intent of Subchapter K”, based, for example, on some piece of legislative history taken out of context) and the Service (which would then not need to be concerned that taxpayers would defend their transactions on the basis of some similar discovery concerning the intent of Subchapter K).

We turn now to the definition of the intent of Subchapter K in subsection (a). The first part of the definition provides that Subchapter K is intended

> “to permit taxpayers to conduct business for joint economic profit through a flexible arrangement that accurately reflects the partners' economic arrangement”,

but not

> “to permit taxpayers ... to structure transactions using partnerships to achieve tax results that are inconsistent with the underlying economic arrangement of the parties or the substance of the transaction....”

We believe that this portion of the definition is narrowly focused and should achieve the desired purpose. We support in particular its emphasis on achieving tax results consistent with the economic substance of the transaction, which adds an important element of objectivity in analyzing whether a transaction comports with the intent of Subchapter K. We have not been able to devise a narrower definition of the intent of Subchapter K that would achieve the desired purpose. Too narrow a definition obviously would create opportunities for taxpayers to devise abusive partnership transactions that are arguably outside the literal scope of the definition.

However, as discussed in more detail below, we recommend that the remainder of the definition of the intent of Subchapter K contained in subsection (a) ("to use the existence of the partnerships to avoid the purposes of other provisions of the Internal Revenue Code") be removed from the Proposed Regulation, and be revised and adopted as a separate Section 702 regulation. If that is done, the remaining portion of the definition of the intent of Subchapter K would still allow references to concepts outside of Subchapter K to determine the substance of the transaction.

4. Discretion Granted to the Service. We support the broad discretion granted to the Service to recast transactions if the substantive requirements of the regulation are satisfied (assuming the scope of the "purpose of subchapter K" is narrowed as discussed below). The Proposed Regulation provides for a recasting "as appropriate". While the Proposed Regulation lists five specific ways that a transaction might be recast, it goes on to provide broadly that the Service also may determine that "the intended tax treatment should otherwise be precluded". Thus, once the anti-abuse rule becomes applicable, there is no express limitation on the Service's ability to recast the transaction.

Given the wide variety of transactions to which the anti-abuse rule potentially could apply, it is not possible to specify exactly how transactions might be recast. However, we recommend that two refinements be added to the language of the Proposed Regulation regarding remedies.

First, the regulation should expressly state what is now implicit, namely that any such recasting must achieve tax results that more clearly reflect the economic substance of the transaction than do the purported tax consequences of the transaction prior to the recasting. As a corollary of that statement, we would expect that the Service would choose the recasting that it determined would cause the tax consequences to most clearly reflect the economic substance of the transaction. Moreover, we would expect that the Service would generally disregard a partnership with real economic substance only to the extent that no alternative recasting would achieve tax results in accordance with the substance of the transaction.

Second, the Service should be required to recharacterize a transaction as to all partners on a consistent basis, rather than simply asserting a deficiency against those partners that would owe more tax under the chosen recasting of the transaction.[15/]

5. Effective Date. We support the provision stating that the anti-abuse rule applies as to "all transactions relating to a partnership occurring on and after May 12, 1994". We understand that under this language the anti-abuse rule could affect preexisting transactions where a partnership has already been formed and assets contributed, but where the parties have not yet "disengaged" from the partnership. This effective date provision

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[15/] Of course, such a consistency requirement would raise procedural issues. For example, to avoid whipsaw, the Service should not be required to offer refunds to some taxpayers before the Service's recharacterization had been upheld against taxpayers that would owe a deficiency under the recharacterization. Such a conclusion is intended to be consistent with our proposed regulatory requirement of "consistent treatment" of the parties.

Consistency would often be achieved under the partnership audit rules of Section 6221 et seq. However, it is not clear those rules would always be applicable because of the Service's power under the Proposed Regulation to disregard a partnership or treat purported partners as not being partners. In any event, those rules should be clarified to indicate whether all or only specified recastings under the Proposed Regulation are subject thereto.

is similar to the effective date provision of the proposed Section 337(d) regulations. [16/]

In general, we believe taxpayers should have advance notice of rules that will be applicable to their transactions. However, the Proposed Regulation (with our suggested modification) only applies when the tax consequences of a transaction are inconsistent with the economic arrangement of the parties or the substance of the transaction. We do not believe taxpayers can legitimately claim surprise at this principle. Thus, assuming our suggestion is accepted, we believe the proposed effective date is appropriate.

In light of the proposed effective date, it is particularly important that the Proposed Regulation be finalized (in its current or modified form) as promptly as possible. Even though the regulations are intended to affect only abusive transactions, to the greatest extent possible taxpayers should be able to engage in transactions with knowledge of the actual regulations applying to those transactions. If any delay is expected in the finalization of the regulation, because of the uncertainty expressed by some taxpayers about the effect of the Proposed Regulation on legitimate transactions, we would urge that interim guidance be provided in the form of examples of transactions not covered by the regulation.

[16/] The Section 337(d) regulations are proposed to be effective for any partnership (including a preexisting partnership) where a distribution or other relevant transaction occurs after March 9, 1989. That was the date of Notice 89-37, 1989-1 C.B. 679, announcing the Service's intention to issue such regulations. See Prop. Treas. Reg. § 1.337(d)-3(g).

D. Features of the Proposed Regulation That We Recommend Be Changed

1. Add Exceptions for Specifically Contemplated Results. As we recently suggested in our report on the anti-abuse rule contained in the original issue discount regulations, [17/] the final regulation should contain an express statement that it will not apply where the intended tax results are specifically contemplated by the Code and/or regulations. Taxpayers should not have to defend such results on the ground that they are consistent with the overall intent of Subchapter K. This concept is similar to a point made in the preamble to the Proposed Regulation, which states that the Proposed Regulation is not intended to modify "specific regulatory *de minimis* rules".

We believe, however, that a broader statement of this principle should be included in the regulation itself. Thus, for example, such a rule would give explicit protection to a special allocation of tax depreciation to a high-bracket partner that satisfies the Section 704(b) "substantiality" test, even though it is expected that the property will not decrease in value in a manner corresponding to the tax depreciation. [18/]

Such a statement should make clear, however, that the Code and regulations must on their face specifically contemplate each step of a series of steps, all the relevant surrounding circumstances, and the ultimate tax result after putting all the steps together. Thus, where a taxpayer, through a series of steps whose individual tax consequences may be specifically contemplated by Subchapter K, manages to achieve an overall

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[17/] *See* Part III.E above.

[18/] *See* Example 4 in the Appendix.

result through the operation of the Subchapter K rules that was not specifically contemplated, the anti-abuse rule should be applicable.

As a related matter, we believe that the Proposed Regulation should not apply to the extent that a type of transaction is dealt with by a specific anti-abuse provision of Subchapter K itself relating to partnerships and any regulations under such a provision, provided that such provision specifically contemplates each step in the transaction and all the relevant surrounding facts and circumstances. A taxpayer that successfully satisfies the requirements of any such more specific provision should not also have to be tested under the Proposed Regulation. We are aware of only four Code sections to which this rule would apply: the specific five-year distribution rules of Sections 704(c)(1)(B) and 737, the disguised sale rule of Section 707(a)(2)(B), and the inventory stuffing rule of Section 751(d)(1)(B).

In other words, unless the transaction in question has relevant elements not specifically contemplated by those provisions (and, in the case of Section 707(a)(2)(B), the regulations thereunder), a taxpayer engaging in a type of transaction governed by these provisions should be immune from attack under the anti-abuse rule. For example, the anti-abuse rule should not apply to a taxpayer merely because it intentionally waits more than five years to make a distribution described in Section 704(c)(1)(B) or Section 737. [19/] Similarly, a taxpayer should be entitled to the two-year presumption under the Section 707(a)(2)(B) regulations. [20/] Failure of the Proposed

[19/] See Example 1 in the Appendix.
[20/] Treas. Reg. § 1.707-3(d). We note that the regulations under Section 707(a)(2)(B) do not themselves contain a general anti-abuse rule.

Regulation to exempt these types of transactions, to the extent such transactions are expressly contemplated by the Code itself, might raise questions of authority. [21] However, to prevent taxpayer claims that this exemption is broader than was intended, the Proposed Regulation should list each specific Code section to which the exemption applies.

In addition, we believe the Proposed Regulation should not apply where a provision of Subchapter K itself is very general (rather than a specific anti-abuse provision), but the regulations under that section themselves contain a comprehensive anti-abuse rule. We see no need for the Proposed Regulation to apply if the only issue raised is whether the transaction is within the potential scope of the comprehensive anti-abuse rule under a particular section. The only example of this situation of which we are aware is Section 704(c)(1)(A). [22] We would not apply this exception to the Proposed Regulation for transactions involving Section 704(b) allocations, since Section 704(b) is a general provision rather than an anti-abuse provision, and the Section 704(b) regulations do not have a comprehensive anti-abuse rule (notwithstanding their attempts to stop abusive transactions). [23]

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[21] See the discussion of Stephenson Trust, below. On the other hand, we believe a question of authority would not arise to the extent that the Proposed Regulation reaches a result that could have been required, for example, under the Section 707(a)(2)(B) regulations.

[22] See Treas. Reg. § 1.704-3(a)(10).

[23] Of course, under our proposal a taxpayer could still claim that a transaction involving Section 704(b) was eligible for the separate exemption from the Proposed Regulation we suggest above for transactions specifically contemplated by regulations (including the Section 704(b) regulations).

Again, we believe the Proposed Regulation should specifically identify any regulation to which this exemption applies. [24/]

2. Delete and Move Reference to Other Provisions of the Code. As noted earlier, we believe the last portion of the description of the “intent of subchapter K” in Proposed Regulation § 1.701-2(a), which refers to using “the existence of the partnerships to avoid the purposes of other provisions of the Internal Revenue Code”, should be deleted from the existing Proposed Regulation and rewritten as a new Section 702 regulation. We believe it should be removed from the basic anti-abuse rule for the following reasons.

First, this phrase is not necessary to adequately deal with transactions that involve manipulation of the provisions of Subchapter K itself or that use Subchapter K to reach results inconsistent with the substance of the transaction. Those transactions are dealt with by the remaining portion of the Proposed Regulation.

Second, this portion of the Proposed Regulation is too broad, since it refers to the mere “existence of the partnership” to avoid the purposes of any other section of the Code. In some cases, it is perfectly legitimate to use a partnership to avoid the purposes of other Code sections, as is indicated by the later statement in the Proposed Regulation that the mere reduction in tax liability through the use of a partnership does not establish a violation of the “intent of subchapter K” test. It appears to

[24/] Another issue is raised by specific rather than comprehensive anti-abuse rules in regulations under a particular Code section. See, for example, Treas. Reg. § 1.752-2(j), relating to certain arrangements to avoid the rules for recourse and nonrecourse debt. We do not suggest an exemption from the Proposed Regulation for transactions within the scope of this type of anti-abuse regulation, to avoid the need to determine where the exclusive scope of such a regulation would end.

be unduly restrictive if every use of a partnership that resulted in a tax reduction were to be potentially subject to this second hurdle of the anti-abuse rule even after the first hurdle (no tax results inconsistent with the economic arrangement of the parties or economic substance of the transaction) had been successfully overcome. Examples 3, 6, 8 and 9 in the Appendix illustrate this point.

Third, as we understand it, this portion of the Proposed Regulation raises pure entity/aggregate issues, which involve the theoretical interrelationship between Subchapter K and other provisions of the Code. That subject is conceptually distinct from the question of whether the application of the mechanical rules of Subchapter K produces tax results that are inconsistent with the economic arrangement of the parties or the substance of the transaction.

Fourth, the Proposed Regulation as written permits a broad range of remedies to the Service from a violation of the intent of Subchapter K, including this portion of the test. Because we believe only entity/aggregate issues are implicated by this portion of the test, we believe the only appropriate remedy on the part of the Service is to apply aggregate principles. That more focused result appropriately belongs in Section 702.

Fifth, under the Proposed Regulation entity/aggregate principles can only be applied if the parties had a principal purpose of reducing taxes. We believe entity/aggregate principles should not depend upon the intent of the parties or on whether a tax savings results from either approach. Thus, we believe this portion of the regulation belongs under Section 702.

Sixth, under the Proposed Regulation the Commissioner alone has the authority to apply entity or aggregate principles on the basis of the purpose of a particular Code section outside of Subchapter K. It is not clear that this is the appropriate result, and this issue is more appropriately dealt with under Section 702.

If the suggested deletion from the Section 701 regulations is made, we believe it is important that a new regulation be added under Section 702 as we suggest below. Many abusive partnership transactions involve the interrelationship between Subchapter K and other provisions of the Code, and reach results inconsistent with the purposes of those other Code provisions. Absent either the existing language under Section 701 (which we suggest deleting) or an expanded regulation under Section 702, these transactions might "fall through the cracks", which would largely defeat the purpose of the Proposed Regulation. For the reasons stated above, we believe that Section 702 is the proper location for this type of provision.

3. Add More Examples. We believe it is essential that the Proposed Regulation provide more examples of transactions that are consistent with the intent of Subchapter K, as well as the reasons that those examples represent permissible transactions. This will significantly reduce any uncertainty arising from the statement of general principles in the Proposed Regulation, and will provide both taxpayers and field agents with a better grasp of the intended scope and effect of the Proposed Regulation.

There are numerous commonly-occurring transactions that the drafters of the Proposed Regulation presumably did not intend to be covered by the regulation, as indicated by the statement in the preamble that the anti-abuse rule was only intended to catch a few large transactions. However, many taxpayers have expressed significant concern that Revenue Agents might challenge legitimate partnership transactions that are consistent with the purposes of Subchapter K. Such concern could discourage taxpayers from entering into legitimate transactions, as well as create the risk of increased future litigation involving taxpayers needlessly required to defend such transactions. Other taxpayers question whether such concern is justified, on the grounds that legitimate partnership transactions do not raise the issues addressed in the Proposed Regulation. In any event, the best way to minimize these concerns, while at the same time protecting the interests of the government, is for the regulation to provide more examples of types of transactions that are consistent with the intent of Subchapter K.

We recognize the difficulty of this effort. The government must be careful not to provide examples that could be exploited by taxpayers in unexpected ways. That problem can be minimized by including an express statement in the introduction to the examples that a context for a transaction that is not contemplated by the example might make the example inapplicable. The government must also be careful to avoid the possibility that Revenue Agents will consider such an expanded list of permissible transactions to be exclusive. Thus, the Proposed Regulation should make clear that the examples are illustrative only and provide clear rationales for the results reached that could be applied to other transactions.

It is also essential that additional examples be given of transactions intended to violate the anti-abuse rule, since the Proposed Regulation contains only one example of a “bad” transaction (Example 3). If this is done, taxpayers and Revenue Agents alike would get a feel for the types of transactions intended to be covered.

In that connection, we note that the facts of Example 3 are unclear. As a result, the example does not provide any meaningful insight as to where the line is being drawn. Part of the uncertainty arises because the concept of “phantom income” in the example is not well defined. We assume the example is intended to illustrate that an allocation literally having substantial economic effect under Section 704 may fail the anti-abuse rule because of surrounding circumstances. In any event, the example should be clarified.

As part of the Appendix to this Report (our proposed revision to the Proposed Regulation), we have suggested a number of examples for inclusion in the final version of the regulation.

V. Entity/Aggregate Issues

There are significant, difficult questions involved in determining the proper interface of Subchapter K with various other provisions of the Code. These questions usually reduce to “entity/aggregate” issues and are properly dealt with under Section 702 rather than through the basic anti-abuse rule. Many of the issues that arise are not adequately dealt with under the existing Section 702 regulations. Those regulations now require a partner to “take into account its distributive share” of partnership tax items, and provide that the character of any items are determined “as if such item were realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership.” [25]

[25] Treas. Reg. §§ 1.702-l(a), (b).

The regulations do not, however, treat assets, liabilities, or activities of a partnership as if for all purposes they were owned, owed, or carried on by the partners, respectively.

As a result, we believe a provision should be added to the Section 702 regulations stating that, to the extent appropriate to carry out the purposes of any provision of the Code, (a) any item of income, gain, loss, deduction, or credit of a partnership shall be treated as if such tax items were directly earned by the partners of the partnership, and (b) any or all of the assets, liabilities, and activities of a partnership shall be treated as if such assets were owned, liabilities were owed, and activities were carried on, by the partners of the partnership.

A provision of this type is particularly important if our suggested deletion from the "intent of Subchapter K" under the Section 701 regulation is adopted. Many abusive partnership transactions may be perfectly consistent with Subchapter K but nevertheless involve the use of a partnership to avoid the application of other Code sections in a manner not intended by Congress. An amendment to the Section 702 regulations would be needed to make clear that these transactions do not work.

We believe a regulation under Section 702 of the type we suggest would in fact be a codification of the current common law, based upon the original legislative history of the Internal Revenue Code of 1954. [26]/ Case law has supported this

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[26]/ The Conference Report to the 1954 Code states that "[b]oth the House provisions and the Senate Amendment provide for the use of the 'entity' approach in the treatment of the transactions between a partner and a partnership which are described above. No inference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions. An illustration of such a provision is section 543(a)(6), which treats income from the rental of property to shareholders as personal holding

interpretation, although by no means uniformly. [27]/ The Service also routinely applies this principle in published rulings. Explicitly stating the principle in the Section 702 regulations would make clear to taxpayers that the concept exists and that the government intends to enforce it.

However, this approach would raise certain additional issues. First, at a minimum, we believe any such regulation should provide that a partnership will be treated as an entity where entity treatment under the particular circumstances in question is specifically contemplated by the Code or regulations. This rule is designed to preserve entity treatment in the case of "plain vanilla" Section 721 contributions to a partnership and Section 731 distributions from a partnership, which under pure aggregate principles would be deemed to be sales or exchanges between the partners. The rule would also preserve entity treatment in transactions not involving unusual circumstances that involve any of the numerous provisions of the Code and regulations outside of Subchapter K that specifically refer to partnerships as entities.[28]/

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company income under certain circumstances." H. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954).

[27]/ See, e.g., Holiday Village Shopping Center v. U.S., 773 F.2d 276 (CAFC 1985) (aggregate theory applies to treat corporate partner's liquidating distribution of partnership interest as distribution of underlying assets, for purposes of recapture rules, for year prior to statutory codification of this result in Section 386; court looked at 1954 legislative history and purpose of recapture rules); Casel v Comm'r, 79 T.C. 424 (1982) (upholding a regulation applying aggregate principles to Section 267, on the basis of the 1954 legislative history and the purpose of Section 267). Compare Petroleum Corporation of Texas v U.S., 939 F.2d 1165 (5th Cir. 1991) (entity theory applies and recapture does not result on facts similar to Holiday Village).

[28]/ See, e.g., (i) provisions such as Section 108(e)(4) that determine whether parties are related under the rules of Section 707(b)(1), which in turn applies entity concepts, and (ii) Section 514(c)(9), which has special rules for partnerships holding real property and incurring acquisition indebtedness.

Second, as indicated above, the concept being discussed is analytically distinct from the basic anti-abuse rule. In particular, any such regulation should make clear that the entity/aggregate determination is to be based entirely or largely upon the theoretically correct approach in view of the purpose of the Code provision in question. It should not vary from case to case based upon the subjective purpose of the parties in structuring the transaction, or upon whether entity or aggregate treatment achieves a higher tax result in the particular case.

Third, consideration should be given to whether the Service is to have the sole power to apply aggregate principles to a partnership, or whether a taxpayer is also to be permitted to have that power. The legislative history cited above does not indicate that this power belongs exclusively to the Service. Moreover, in many cases aggregate treatmentwould be favorable to taxpayers.[29/]

Fourth, if this approach is taken, the regulation should illustrate the application of entity or aggregate principles in a variety of situations. For example, the regulation might explicitly address the issue of how Subpart F should apply where a controlled foreign corporation conducts its operations through a subsidiary partnership. That issue was recently considered in Brown Group Inc., et al. v. Comm'r, [30/] where the Tax Court

[29/] See, e.g., Babin v Comm'r, 94-1 U.S.T.C. 1150,224 (6th Cir. May 6, 1994), where a partner relied on the insolvency exception to avoid COD income from the cancellation of partnership debt, but the court held that the exempt income did not increase the partner's basis in the partnership, with the result that the partner was taxed on the deemed distribution from the partnership resulting from the cancellation. The court considered irrelevant the taxpayer's argument that he was in a worse position than if he had engaged in the underlying business directly, and stated that he was bound by his form.

[30/] 30/ 102 T.C. No. 24 (1994).

concluded that income earned through a partnership could not be Subpart F income on the ground that the applicable statutory provisions expressly refer only to income earned by a corporation. This result was directly contrary to Rev. Rul. 89-72 [31]/ and, in our experience, unexpected.

Likewise, the regulation could address the proper application of entity or aggregate principles to circumstances such as:

> (1) the application of Section 163(e)(5) (which limits interest deductions on certain debt obligations “issued by a corporation”) to debt issued by a partnership with corporate partners;
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> 2) the application of Section 162(m) (which limits compensation deductions of “any publicly traded corporation”)to compensation paid by a partnership one or more partners of which are publicly traded corporations;
>
> (3) the application of Section 246(c)(4) (which reduces a corporate shareholder's holding period in stock, for purposes of determining eligibility for the dividends received deduction, for periods that the holder diminished its risk of loss in certain respects) where the stock is held in a partnership and the corporate partner entitled to the dividend has diminished its risk of loss through the economic terms of the partnership; and
>
> (4) the application of Section 1059(a) (which applies when “any corporation receives any extraordinary dividend” and reduces the corporation's basis in the stock of the paying corporation) to an extraordinary dividend received by a partnership with corporate partners.[32]/

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[31]/ 1989-1 C.B. 257.

[32]/ A number of unusual situations requiring guidance arise in the foreign area because, under Section 7701(a)(30), a U.S. partnership is a U.S. person and a foreign partnership is not a U.S. person, regardless of the identity of the partners. For example, consider a foreign corporation that has some U.S. stockholders but is not a controlled foreign corporation (CFC) because the CFC ownership tests are not satisfied. If all the stockholders transfer their stock to a U.S. partnership, the corporation will literally become a CFC (because the partnership, as a “U.S. person”, is a “U.S. shareholder” under Section 951(b)). If the corporation qualifies as a CFC, the U.S. owners (now partners) will receive certain benefits (such as more liberal Section 904 foreign tax credit rules).

We note that these issues could alternatively be addressed under specific Code sections. This approach would in fact be preferable in cases where a Code section specifically authorizes regulations dealing with pass-through entities, [33] since that authorization would seem to extend to entities such as S corporations and trusts as well as partnerships.

In this Report we do not make specific recommendations as to the situations in which entity or aggregate principles should be applied to a partnership. That matter raises difficult issues and has been analyzed elsewhere. [34]

VI. Additional Suggestions

A. Administration of the Proposed Regulation

Of course, the effectiveness and fairness of the Proposed Regulation will ultimately depend upon the manner in which it is enforced. The regulation cannot be effective unless the Service increases the training of Revenue Agents in partnership issues and makes clear that it will make a serious

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Moreover, consider a U.S. issuer paying interest on registered debt to a foreign partnership. Under Sections 871(h)(1) and 871(h)(2)(B)(ii), the interest is exempt from tax as portfolio interest only if the payor receives a statement from the beneficial owner of the interest stating that the owner is not a "U.S. person". As a literal matter, a foreign partnership could provide this statement even if all its partners were U.S. persons. A similar issue arises under Section 163(f)(2)(B)(1), which disallows an interest deduction on bearer debt unless it is intended to be sold only to persons that are not U.S. persons.

[33] See, e.g., Section 1059(g)(l).

[34] For an extensive discussion of entity/aggregate issues, see American Law Institute, Proposals on the Taxation of Partners 452-532 (1984). See also Youngwood, Partners and Partnerships -- Aggregate vs. Entity Outside of Subchapter K, Tax Forum Paper No. 493 (June 6, 1994), arguing that aggregate treatment of partnerships is generally appropriate, at least as to general partners; Shakow, How Now Brown K, Tax Notes, June 27, 1994 (discussing authorities and concluding that they generally support aggregate treatment, contrary to Brown).

effort to increase the level of audit coverage of major partnership transactions.

In connection with the fairness issue, we applaud the issuance of Announcement 94-87, providing that a Revenue Agent must coordinate issues arising under the Proposed Regulation with the National Office. We believe this will lessen the concerns of taxpayers that individual agents will take extreme positions under the regulations and challenge transactions generally accepted as legitimate.

We urge that a number of further steps along the same line be taken. First, it should be made clear that issues raised under the Proposed Regulation will receive the attention of high level officials in the National Office, to give assurance to taxpayers that the regulation will be administered as fairly and consistently as possible. Second, it would be extremely helpful if the Service would periodically release summaries of issues under the regulation brought to the attention of the National Office and the National Office resolution of those issues. It should be possible to do this without identifying the particular taxpayers involved. [35]/

B. Possible Simplification of Subchapter K Regulations

As described above, the complexity of Subchapter K and the regulations thereunder is due in part to attempts to stop abusive partnership transactions. We would hope that after the anti-abuse regulation is adopted, the Treasury would consider the

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[35]/ If there is concern about identifying taxpayers, the procedure for disclosing information concerning Advance Pricing Agreements under Section 482 could be used. General disclosure is made concerning the issues arising for groups of taxpayers in the same industry and the resolution of those issues. See, e.g., Notice 94-40, April 11, 1994, relating to global trading operations for financial products.

possibility of reducing such complexity. For example, it might be possible to simplify the Section 704(b) regulations in a manner similar to the recent simplification of the Section 752 regulations.

Such simplification would be one of the major benefits of the anti-abuse regulation to the average taxpayer. We would be happy to work with the Treasury and the Service to consider whether such simplification would in fact be possible.

VII. Authority for the Proposed Regulation

We believe that the Treasury has the legal authority to issue the Proposed Regulation, at least in the more focused form we recommend above. [36]/ It must be observed that a general anti-abuse rule covering an entire subchapter of the Code issued under the authority of Section 7805(a) is unusual and could, in other circumstances, raise questions of validity. [37]/ There is presently, however, a demonstrable need for an anti-abuse rule under Subchapter K and we believe that the Proposed Regulation, with the recommendations made herein, is a reasonable interpretation of Subchapter K supported by its legislative history.

In many cases, there is clearly no question of the validity of the Proposed Regulation. Section 7805(a) authorizes the Secretary to issue "all needful rules and regulations for the enforcement of this title . . . ." A large portion of the results

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[36]/ This section discusses the validity of our proposed revised Section 701 regulation. We believe our proposed Section 702 regulation is valid on the basis of the legislative history to the 1954 Code, as discussed in Part V above.

[37]/ We note that in Stephenson Trust v. Commissioner, 81 T.C. 283 (1983), the court found invalid a regulation which disregarded the separate taxable status of multiple trusts if formed for a tax avoidance motive.

that the Proposed Regulation will achieve in specific cases could have been achieved piecemeal through regulations under each specific section of Subchapter K. We have no doubt that the Treasury has the power to concentrate its aggregate regulatory authority under Subchapter K into a single Section 701 regulation. Our revised draft of the Proposed Regulation makes the exercise of this power explicit. Moreover, since the ultimate purpose of the Proposed Regulation is to require taxpayers to report income from their partnership transactions in accordance with the economic substance of the transactions, many specific applications of the Proposed Regulation will be justifiable on the basis of the Service's authority under Section 446 to require taxpayers to report income under a method of accounting that clearly reflects income. Finally, in many cases the result achieved under the Proposed Regulation could also be achieved under the common law authority relating to abusive transactions. [38]/

The Proposed Regulation (as we suggest it be modified) would apply to some situations not described in the preceding paragraph. We believe even in those circumstances it would be an appropriate and valid exercise of the Treasury's regulatory authority under Section 7805. Although interpretive regulations such as the Proposed Regulation are accorded less weight than legislative regulations, they will be upheld if they implement the Congressional mandate “in some reasonable manner”. [39]/ The general standard of review is whether the regulation is “unreasonable and plainly inconsistent with the revenue statute”

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[38]/ See Section III.B, supra, and the accompanying text.

[39]/ United States v. Vogel Fertilizer Co., 455 U.S. 16, 24 (1982). See also, e.g., Rowan Co. v. United States, 452 U.S. 247 (1981). The question of validity turns on whether the Service's implementation of the statute is reasonable, not whether it is the best of all possible interpretations. Earl A. Brown, Jr. v. United States, 890 F.2d 1529 (5th Cir. 1989).

in light of the specific statutory provisions being interpreted and the legislative intent underlying such provisions. [40]/ The Supreme Court has also noted that the manner in which a tax regulation evolved is an appropriate factor to be taken into consideration in determining its validity. [41]/

The threshold question of validity is whether the regulation is plainly inconsistent with the statute. As noted above, we recommend that the Proposed Regulation be revised to make clear that it cannot be used to upset a result that is specifically contemplated by the Code. Although we believe that such a change is desirable from a policy perspective, we also believe that such change increases the likelihood that this threshold condition for validity will be considered to be satisfied.

If the Proposed Regulation is consistent with the language of the statute (as we believe it would be if narrowed as we suggest), the validity of the Proposed Regulation turns on whether it is a “reasonable” interpretation of Subchapter K. We believe it is entirely reasonable for the Treasury to conclude that the Proposed Regulation furthers a Congressional intent that the tax consequences of partnership transactions conform to their economic substance. While the legislative history of the 1954 Code stressed the flexibility that Subchapter K was intended to provide, and the 1954 Code permitted certain disparities between tax and economic substance Regulation turns on whether it is a “reasonable” interpretation of Subchapter K. We believe it is

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[40]/ Commissioner v. South Texas Lumber Co., 333 U.S. 496, 501 (1948); Brooks v. United States, 473 F.2d 829 (6th Cir. 1976); Sohio Transp. Co. v. U.S., 756 F.2d 499 (Fed. Cir. 1985) (where the language of the statute is unclear, it is appropriate to look to statements of legislative intent).

[41]/ See National Muffler Dealers Ass'n v. United States, 440 U.S. 472, 477 (1979).

entirely reasonable for the Treasury to conclude that the Proposed Regulation furthers a Congressional intent that the tax consequences of partnership transactions conform to their economic substance. While the legislative history of the 1954 Code stressed the flexibility that Subchapter K was intended to provide, and the 1954 Code permitted certain disparities between tax and economic substance in the interests of simplicity, [42]/ the broad outline of Subchapter K evidences a Congressional intent that the tax consequences of partnership transactions conform to their economic substance. The amendments and additions made to Subchapter K over the years have provided more specific evidence of that intent. [43]/

For example, in 1976 Section 704(b) was amended to codify the substantial economic effect requirement. The more recent amendments to Section 704(c) and Section 707(a) and the enactment of Section 737 also evidence an unambiguous legislative intent that partnerships not be used to achieve tax results inconsistent with the economic arrangements of the parties.

We believe that the manner in which the Proposed Regulation has evolved provides further support for its validity. [44]/ As noted above, Subchapter K has in recent years been the basis for many abusive transactions. The Service has repeatedly had to play catch-up, issuing ad hoc pronouncements when abusive transactions have come to light. A consistent theme of these

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[42]/ See, for example the original Section 704(c) as adopted in 1954.

[43]/ See Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 238 (1984), describing new Section 386, which requires recapture on a corporate distribution of a partnership interest, as follows: “Congress believed that in this case, as elsewhere, the use of a partnership form should not result in greater tax benefits than would be available in the case of direct ownership.” (emphasis added)

[44]/ See National Muffler Dealers Ass’n, supra.

pronouncements is that Subchapter K cannot be used to achieve tax results inconsistent with the economic arrangements of the parties. Given the inherent inadequacy of after-the-fact responses to abusive transactions and the recent history of abuse of Subchapter K, the Proposed Regulation is a reasonable regulatory response.

Our conclusion that the Proposed Regulation is consistent with the language and legislative history of Subchapter K is itself consistent with the decision in Stephenson Trust v. Commissioner, 81 T.C. 283 (1983), in which the Tax Court held invalid an anti-abuse regulation. At issue in Stephenson Trust was a regulation that purported to consolidate multiple trusts if the principal purpose of such trusts was the avoidance or mitigation of the progressive tax rates or the minimum tax. The Tax Court concluded that Congress had previously addressed the specific “abuse” to which the regulation was directed and had, in eliminating some of the benefits of using multiple trusts to reduce tax liability, “sanctioned the use of multiple trusts to obtain certain tax benefits.” [45]/ Because the regulation sought to achieve a result that was expressly contrary to the legislative intent behind the relevant statute, the court concluded that the regulation was invalid. [46]/

While Congress has specifically addressed a number of partnership abuses, numerous other abuses have not been addressed and are not implicitly sanctioned. Unlike the situation in Stephenson Trust, the Proposed Regulation (with our recommended exception for specifically contemplated results) will not overturn any result explicitly considered and sanctioned by

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[45]/ Stephenson Trust, 81 T.C. at 297.

[46]/ Id.

Congress. Accordingly, we do not believe that Stephenson Trust is inconsistent with our analysis of the validity of the Proposed Regulation.

Moreover, we are not aware of any other authority stating that a regulation may not validly require that a transaction not specifically contemplated by the Code result in tax consequences that reflect the economic arrangement of the parties or the substance of the transaction. In particular, we do not believe that the Proposed Regulation (as we suggest it be modified) is Inconsistent with the Culbertson case [47/] or with the so-called “family partnership” rules of Section 704(e)(1). [48/] Those authorities state that an owner of a capital interest in a partnership will be respected as a partner as long as the partnership interest has real economic substance, regardless of how the interest was acquired. They do not support treating a person as a partner if the partnership interest is not bona fide, or permitting tax results that are inconsistent with the economic arrangement of the parties or the substance of the transaction.

APPENDIX

1. Text of Revised Proposed Section 701 Regulation [49/]

$ 1.701-2 Anti-Abuse rule.

[47/] Comm'r v Culbertson, 337 U.S. 733 (1949) (valid partnership is created among father and four sons as long as there is bona fide and good faith intent for partners to join together in conduct of business, even if sons were not the original source of partnership capital).

[48/] That section, originally enacted in 1951, provides as follows: “A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.” See also Treas. Reg. S 1.704-1(e).

[49/] New material (except examples) is underlined; deleted material is bracketed. For text of existing Proposed Regulation, include bracketed material but disregard underlined material.

(a) Intent of subchapter K. The intent of the partnership provisions in subchapter K is to permit taxpayers to conduct business for joint economic profit through a flexible arrangement that produces tax consequences that accurately reflect[s] the partners' economic agreement without incurring an entity-level tax. These provisions are not intended, however, to permit taxpayers to structure transactions using partnerships to achieve tax results that are inconsistent with the underlying economic arrangements of the parties or the substance of the transactions[, or to use the existence of the partnerships to avoid the purposes of other provisions of the Internal Revenue Code].

(b) Application of subchapter K rules. The provisions of subchapter K and the regulations thereunder must be applied in a manner consistent with their intent as set forth in paragraph (a) of this section. Accordingly, if a partnership is formed or availed of in connection with a transaction or series of related transactions (individually or collectively, the transaction) with a principal purpose of substantially reducing the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K as set forth in paragraph (a) of this section, the Commissioner can disregard the form of the transaction. In such a case, even if the taxpayer complies with the literal language of one or more of the provisions of the Internal Revenue Code or the regulations thereunder, the Commissioner can recast the transaction for federal tax purposes as appropriate. For example, the Commissioner can determine that--

(1) The purported partnership should be disregarded in whole or in part in determining the tax effects of the transaction;

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

(3) The partnership and its partners should be respected but the partners should be treated as owning their respective shares of partnership assets directly (applying the aggregate concept of partnership taxation);

(4) 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;

(5) The allocations of the partnership's items of income, gain, loss, deduction, or credit should be disregarded and reallocated; or

(6) The intended tax treatment should otherwise be precluded.

Any such recasting shall cause the tax treatment of the parties to the transaction to more accurately reflect the economic substance of the transaction, and to the extent possible shall result in consistent treatment of the transaction as to all parties.

(c) Facts and circumstances test. The purposes for structuring a transaction involving a partnership will be determined based on all of the facts and circumstances. A reduction in the present value of the partners' aggregate federal tax liability through the use of a partnership does not by itself establish inconsistency with the intent of subchapter K.

(d) Inapplicability of Paragraphs (a) and (b). Paragraphs (a) and (b) shall not apply in the following circumstances:

(1) where each step in the transaction, all the relevant surrounding facts and circumstances, and the ultimate tax results of those steps, are specifically contemplated by the Code or regulations;

(2) where (i) the only issue raised by the Commissioner is whether a "disguised sale" has occurred, and (11) each step in the transaction and the surrounding facts and circumstances are specifically contemplated by Section 704(c)(1)(B), Section 707(a)(2)(B), or Section 737, or the regulations thereunder; or

(3) where the only issue raised is the proper application of Section 704(c)(1)(A) or Section 751(d)(1)(B).

(e) Application of judicial principles and authorities. The Commissioner can continue to assert and to rely upon applicable judicial principles and authorities (for example, the substance over form, step transaction, and sham transaction doctrines) as well as other statutory authority (such as clear reflection of Income) to challenge abusive transactions. This regulation does not limit the applicability of those principles and authorities.

(f) Relationship to other regulations. This regulation shall be deemed to be a portion of the regulations under each section of this Title that may be relevant to a particular transaction, and (except for paragraph (d)) shall supersede any Inconsistent regulation under any such section, including regulations promulgated after the issuance of this regulation.

(g) Examples. The following examples are illustrative only. The fact that a transaction is not included herein as a permissible type of transaction does not create any inference that it is impermissible. Likewise, the fact that a transaction is not included herein as an impermissible type of transaction does not create any inference that it is permissible. Moreover, any facts and circumstances surrounding an actual transaction that are not specifically contemplated by an otherwise applicable example may make the example inapplicable to an actual transaction. All parties are unrelated to each other unless otherwise indicated.

(1) Examples of Permitted Transactions. [50/]

[50/] These examples are intended to supplement existing examples 1, 2, and 4, which we assume will be retained.

Example 1. D and E each contributes appreciated property to a 50/50 partnership, with the expectation that the partnership will hold and operate such properties indefinitely. However, after four years and eleven months the parties unexpectedly decide to cause the partnership to distribute to E property that had originally been contributed by D. If the property were distributed at that time, E would be required to recognize its precontribution gain under Section 737 (and D would be required to recognize its precontribution gain under Section 704(c)(1)(B)). Consequently, the parties decide to wait until five years and one month have elapsed before causing the partnership to make the distribution. Because the distribution occurs after the five-year period established in Section 737 (and Section 704(c)(1)(B)), E does not recognize its precontribution gain under Section 737 (and D does not recognize its precontribution gain under Section 704(c)(1)(B)). This transaction raises only "disguised sale" issues, and each step is specifically contemplated by Section 737 (and Section 704(c)(1)(B)). Therefore, it is not subject to the anti-abuse rule solely because of the decision to delay the distribution.

The result would be the same if D and E had initially intended to make the distribution after five years, although in that case Section 707(a)(2)(B) would be potentially applicable.

Example 2. G and H form the GH partnership, with G contributing cash and H contributing appreciated property. Subsequently H receives a cash distribution from GH. The sole question raised is whether the organization of GH coupled with the distribution of cash to H is more properly characterized as a sale of property by H to GH. Since each step in the transaction is specifically contemplated by Section 707(a)(2)(B) and the regulations thereunder, the proper characterization of the transaction will be determined entirely under Section 707(a)(2)(B). The anti-abuse rule will not be applicable.

Example 3. F owns real property encumbered by a mortgage the principal amount of which exceeds F's basis in the property. C is a corporation newly formed for cash contributions and qualifying as a REIT under Section 856. F and C form a partnership P, with F contributing the property subject to the mortgage and C contributing cash. F has the option of exchanging its interest in P for economically equivalent shares of C. All of the transactions are at arm's-length.

Applying the rules of Sections 721, 731 and 752, and disregarding the direct tax consequences of the issuance of the option, F does not recognize any gain or loss on the transfer of the property to P. F could not have contributed its property to C on a tax-free basis under Section 351 because C is an investment company under Section 351(e) and, in any event, Section 357(c) would have been applicable. Thus, recognition of the existence of P and respecting the form of the transaction as a contribution to P is necessary for F's transfer of property to P to be tax-free under Section 721.

The economic consequences to F and C are consistent with the underlying economic arrangements of the parties. Accordingly, the anti-abuse rule is not applicable.

Example 4. K, a high bracket taxpayer, and L, a corporation with net operating loss carryforwards, form partnership KL, with each contributing cash. KL purchases an operating business the assets of which include a significant amount of depreciable equipment. The partnership agreement provides that all of the depreciation deductions attributable to the equipment will be specially allocated to K and that these special allocations will be reversed through a chargeback of gain, if any, upon disposition of the equipment. K does not believe the equipment will decline in value and, accordingly, anticipates significant timing benefits as a result of the special allocation of depreciation coupled with the income chargeback. A principal purpose of K in entering into the transaction is to take advantage of this benefit. If the equipment does in fact decline in value, K will bear the economic burden of the decline. Capital accounts and all allocations comply with Section 704(b) and the regulations thereunder.

Each step in the foregoing transaction, and the ultimate result of those steps, is specifically contemplated by the Section 704(b) regulations, and in particular the “value equals basis” rule of Treasury Regulation S 1.704- 1(b)(2)(iii)(c). Accordingly, the validity of the allocations in this example will be determined entirely under the Section 704(b) regulations. The anti-abuse rule will not apply.

Example 5. SP is a securities investment partnership that does not make an election under Section 754. It is formed by its partners with cash for a good business purpose and without a principal purpose to avoid tax.

R, an SP partner, wishes to withdraw from SP. Under the terms of the SP partnership agreement R is entitled to be paid the balance in its capital account in cash or readily marketable securities. The amount of cash and the mixture of securities to be paid to R is, under the SP partnership agreement, to be determined by the general partner of SP.

The general partner of SP elects to distribute securities to R, the aggregate basis of which in the hands of SP is substantially less than R’s basis in its partnership interest in SP. In selecting these securities, the general partner had a principal purpose to take advantage of the fact that (i) SP's basis in the securities is not relevant to R since R's basis in the securities will be determined pursuant to Section 732(b), and (ii) the remaining partners of SP will likely enjoy a federal income tax timing advantage since the distribution of the highly appreciated securities to R removes unrealized gain from the partnership.

The timing benefit to the remaining partners of SP is a result of SP not having made an election under Section 754. (If a Section 754 election had been made, Section 734 would have required SP to reduce the basis of its remaining assets by the excess of R's basis in its partnership interest over SP's basis in the securities distributed to R.) The failure to make an election under Section 754 in some cases can result in significant temporary tax timing advantages, but those advantages in this situation are consistent with the intent of Subchapter K. The anti-abuse rule will not apply.

Example 6. Corporation A and Corporation B decide to combine their businesses by forming a joint venture. Each contributes its business to a newly formed general partnership, with A receiving a 70% interest and B receiving a 30% interest. The partnership is expected to generate tax losses for its first three years of operations (due to substantial research and development expenses), which losses will be specially allocated 100% to A in a manner that has substantial economic effect under Treas. Reg. S 1.704-l(b). The partnership form of organization was chosen over the corporate form to enable the tax losses to be so allocated, which would not have been possible had the corporate form of organization been used, since the entity would not have qualified for inclusion in A's consolidated return given A's 70% ownership interest.

The anti-abuse rule is not applicable, since Subchapter K expressly contemplates that partnerships may be formed between corporate partners and special allocations of tax losses may be made to one of the partners.

<u>Example 7.</u> G and H form the GH partnership, with G contributing $99 and H contributing appreciated property with a value of $201. Capital accounts are established and maintained in accordance with Section 704(b) and the regulations thereunder. H's capital account is subdivided into two components--a “preferred” component of $200 and a “common” component of $1. G’s capital account consists entirely of a common component of $99. With respect to the preferred component of H's capital account, H receives an 8% annual guaranteed payment from the partnership.

H is entitled to a mandatory distribution of its preferred capital account of $50 in each of years 7, 8, 9 and 10 following the organization of the partnership. The general profits and losses of the partnership are allocated 99% to G and 1% to H.

H intends to treat the contribution of property to GH as qualifying for nonrecognition treatment under Section 721, the guaranteed payment as such, and the mandatory distributions in years 7 through 10 as distributions under Section 731.

This transaction might potentially be characterized as an actual sale of the property by H to the partnership under Section 1001 (which would arise if H's interest in the partnership were considered debt rather than equity). The debt/equity determination is made under general principles of tax law, rather than on the basis of the Proposed Regulation. If the partnership interest is properly characterized as debt, there would be no need for the further application of the Proposed Regulation. If the partnership interest is properly characterized as equity, the only further issue raised by the transaction is whether there has been a disguised sale under Section 707(a)(2)(B). Since all the circumstances surrounding the transaction are contemplated by the regulations under that section, the Proposed Regulation is not applicable.

Example 8. X, an S corporation, engages in business B. Y, a C corporation, wishes to invest in business B. The owners of X are unwilling to permit Y to invest directly in X since such investment would disqualify X from being an S corporation. X and Y agree to organize the XY partnership with X contributing the B business and Y contributing cash. The partnership form is chosen to facilitate Y's investment in the B business in a manner that permits X to continue to qualify as an S corporation.

The tax consequences to X and Y are not inconsistent with the underlying economic arrangements of the parties. [51]/ Accordingly, the anti-abuse rule is not applicable.

Example 9. A, an Individual professional money manager, and B, an individual, organize partnership AB. A contributes $10,000 in exchange for a general partnership interest, and B

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[51]/ This arrangement is apparently also consistent with the status of X as an S corporation. See Rev. Rul. 94-43, 1994-27 I.R.B. (June 17, 1994), stating that the purpose of the numerical shareholder limitation on S corporations is administrative simplicity at the corporate level, so that a partnership among multiple S corporations is permissible even though the principal purpose for the partnership is to avoid that shareholder limitation.

contributes $990,000 in exchange for a limited partnership interest. The purpose of AB is to invest in securities.

In general, AB profits are allocated 20% to A and 80% to B; losses are allocated 1% to A and 99% to B. In choosing to structure their arrangement as a partnership rather than, for example, as a fee-for-service management arrangement, A and B had a principal purpose to reduce their aggregate tax liability by virtue of the facts that (i) allocations of income to A would be capital gain rather than ordinary income, and (ii) payments made by B to A under a management arrangement would be miscellaneous itemized deductions subject to Section 67.

In Rev. Proc. 93-27, 1993-24 I.R.B. 63, the Service announced that it would not generally treat as a taxable event to the partnership or partner the receipt of a partnership profits interest in exchange for services to be provided to the partnership. Implicit in that announcement is the fact that the partnership profits interest can result in an allocation of income other than ordinary income to the service providing partner, and that an allocation pursuant to the profits interest will not automatically be recharacterized on an ongoing basis as compensation payable by the partnership to the partner. Thus, subject to the application of Section 707(a), [52]/ the tax results to A and B will be considered consistent with the underlying economic arrangement of the parties. Accordingly, the anti-abuse rule is not applicable.

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[52]/ Section 707(a) in some circumstances treats partnership income allocated to a service partner as compensation income. That provision would not apply to the facts of the example because A's partnership interest is not transitory and payments to A are subject to an appreciable risk as to amount. See Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 226-31 (1984).

Example 10. Corporation A and Corporation B each contributes $50 to a partnership P, which pays $100 for a share of preferred stock paying an annual dividend of $6. P is a 50/50 partnership, except that the dividend income is allocated (and cash paid) to A to the extent of current LIBOR interest rates on A's contribution of $50, with the remainder of the dividend being allocated and paid to B. For example, if LIBOR is 10%, $5 of the current dividend (10% of $50) will be allocated and paid to A, and $1 will be paid to B. A and B enter into this transaction with a principal purpose of receiving the dividends received deduction on all dividends allocated to either of them, knowing that alternative methods of achieving the same economic result (such as buying $50 of preferred stock outright and entering into an interest rate swap) would not have achieved the desired tax result. Moreover, the arrangement could not have been structured as a fixed investment trust because it would have had multiple classes of ownership interests not permitted by Treas. Reg. $ 1.7701-4(c).

The allocations to A and B are consistent with the underlying economic arrangement between the parties. Moreover, the regulations under Section 704(b) specifically contemplate that items of partnership income with varying tax consequences to the partners may be specially allocated among the partners as long as the allocations have true substantial economic effect. As a result, the anti-abuse rule will not apply.

(2) Examples of Abusive Transactions.

Example 11. A is a corporate partner in partnership P. A has a $0 basis in its partnership interest. P agrees to redeem A's interest for its value of $100. With a principal purpose to permit A to avoid taxable gain on the redemption, P contributes the cash to a newly formed subsidiary and distributes the stock of the subsidiary to A. Under a literal reading of Sections 731 and 732, A has no taxable gain and a $0 basis in the stock of the subsidiary. A can subsequently liquidate the subsidiary under Section 332 and receive the cash at no tax cost.

The substance of the transaction is a redemption of A for cash. As a result, the anti-abuse rule applies and A will be taxable on $100 of gain. Section 269 is also potentially applicable to this transaction.

Example 12. H and W, husband and wife, each owns 50% of the stock of corporation S. The stock held by each has a basis and value of $100. S has earnings and profits of $100. H and W could sell their stock at no gain or loss, or take out an aggregate $100 dividend (taxable as ordinary income) and sell their stock for an aggregate of $100 (creating a capital loss of $100).

Instead, with a principal purpose to reduce their aggregate tax liability, H and W form a partnership, H contributing nominal cash for a nominal interest and W contributing her 50% stock interest in S for most of the interests. W has a tax basis of $100 in her partnership interest. S then redeems, for $100 in cash, all the stock held by the partnership.

Under Section 302, the $100 redemption price is treated as a dividend to the partnership and is allocated entirely to W (disregarding H's nominal interest). Moreover, under Treas. Reg. S 1.302-2(c), the partnership's basis of $100 in half the S stock is shifted to H's stock in S, increasing H's basis in his stock from $100 to $200.

W has $100 of ordinary income on the dividend. The dividend income to the partnership increases W's basis in the partnership from $100 to $200. No provision of Subchapter K appears to literally cause a reduction in W's basis in the partnership to reflect the fact that the redemption caused a shifting of basis in the S stock. Thus, since the only asset of the partnership is then $100 in cash, W can sell her partnership interest for a capital loss of $100. In addition, H now has a basis of $200 in S stock worth $100, and S can sell his stock for a capital loss of $100. The net effect is that H and W together have ordinary income of $100 and a capital loss of $200.

The above-described transaction violates the anti-abuse rule. The partnership had as one of its principal purposes the reduction of the tax liabilities of the partners and was employed to generate a tax benefit as a result of basis shifting that does not reflect the economic position of the partners. The correct economic result would be a reduction in W's basis in the partnership to reflect the basis of the S stock held by the partnership that “disappears” from the partnership as a result of the redemption of the S stock. On the other hand, H's increased basis in his S stock is permissible and would have arisen even if S had redeemed all its stock held by W absent the formation of the partnership. Accordingly, the Service may disallow W's capital loss of $100.

Example 13. A and B form a partnership to which A contributes $1 and B contributes $99. With a principal purpose to reduce the tax liability of present and future partners, the partnership (1) purchases $100 of mortgage obligations issued by individuals, (2) borrows U.S. government bonds with a fair market value of $1,000, becoming obligated to return identical securities at some date in the future, together with an additional amount to compensate the lender, (3) sells the government bonds for $1,000 and (4) uses the proceeds of the sale to buy similar government securities. At that point the partnership holds $1100 of assets and has an obligation to deliver a $1000 bond in the future.

Then C, an unrelated corporation, purchases B's interest in the partnership for $99. The sale of B's interest causes a constructive termination of the partnership under Section 708(b)(1)(B). As a result, on the deemed distribution of assets, the aggregate basis of the assets in the hands of A and c is equal to the aggregate basis of A and C in their partnership interests, and such aggregate basis is allocated among the assets in proportion to the respective adjusted basis of each asset in the hands of the partnership. This asset basis then carries over to the partnership on the deemed recontribution.

As an economic matter the partnership has incurred an obligation to deliver $1,000 of government bonds, which if treated as a “liability” would increase the partners aggregate basis in their partnership interests to $1100 and cause the assets deemed distributed and recontributed to retain their initial basis. However, the parties intend to take the position that the obligation to deliver securities pursuant to the borrowing does not constitute a liability for purposes of Section 752 [53]/ and, therefore, that A and C have an aggregate basis of $100 in their partnership interests.If this is correct, the partnership assets having an aggregate basis of $1100 would have their aggregate basis reduced to $100, of which the government

[53]/ The regulations under Section 752 do not define “liability”. The obligation is arguably not a “liability”, and in any event is literally contingent because the cost of purchasing the Treasury obligation to be delivered in the future is not fixed. Under Long v Comm'r, 71 T.C. 1 (1978) and LaRue v Comm'r, 90 T.C. 465 (1988), contingent liabilities are not liabilities under Section 752. See also the immediately following footnote.

securities would have a basis of $91 and the mortgage obligations would have a basis of $9.

The partnership then sells the government securities for $1,000, recognizing a capital gain of $909, 99% of which (or $900) is allocated to C under Section 704(c), increasing C's basis in its interest in the partnership to $999. The partnership takes the proceeds of the sale of the government securities and purchases $1,000 of government securities, which it uses to cover its obligation to return the bonds that had been originally borrowed.

Later, the partnership is liquidated. The individual mortgage obligations distributed to C, which have a fair market value of $99, take a basis of $999 under Section 732(b). When the mortgages are subsequently paid, C reports a loss of $900 which is ordinary under Section 1271.

C's offsetting capital gain and ordinary loss of $900 are inconsistent with the underlying economic arrangements. Because the partnership has been formed or availed of for a principal purpose of substantially reducing the present value of aggregate Federal tax liability of A, B and C in a manner that is inconsistent with the economic arrangements of the parties, the transaction is subject to recharacterization under the anti-abuse rule. C's gain and loss are disregarded.

The result would be the same if the partnership, instead of engaging in transactions in government bonds, issued to a third party for $1000 an option to buy specified securities at a fixed price, used the proceeds to buy a similar option from an unrelated party, and treated the obligation under the former option as not a “liability” [54] but treated the latter option as an asset.

Example 14. A, B, and C are corporations with the same sole shareholder. A has an asset with a basis of $0 and value of $100 that it expects to sell in the future. With a principal purpose of reducing their aggregate tax liability, the parties form a partnership, with A contributing the asset, B contributing $100 in cash, and C contributing nominal cash. All allocations are pro rata. After five years, at a time when the asset is still worth $100, the partnership redeems out B's interest with the asset. If the parties were unrelated, the regulations under Section 707(a)(2)(B) would not create a disguised sale under the facts and circumstances, because B literally had an “entrepreneurial risk of partnership operations” under Treas. Reg. S 1.707—3(b)(1).

B's basis in the asset is $100. B sells the asset to an unrelated party for $100 and has no gain or loss.

The anti-abuse rule applies to this transaction. Because A, B and C have the same shareholder, that shareholder in reality bears the ultimate risk of loss on the asset regardless of which corporation owns the asset. As a result, the entrepreneurial risk test in the regulations is not an appropriate test for a disguised sale in this situation. Moreover, a relevant circumstance surrounding the transaction, namely that the entire

[54] See Helmer v Comm'r, T.C. Memo. No. 1975-160 (accepting the Commissioner's contention that a partnership's receipt of an option premium does not create a liability that increases the partners’ basis in the partnership, with the result that the partnership's distribution of the premium was taxable to the partners). See also Rev. Rul. 73-301, 1973-2 C.B. 215 (partnership liabilities do not include cash progress payment unconditionally received by partnership using completed contract method of accounting, so that partners receive no “outside” basis increase despite increased basis of partnership assets from cash received).

risk is borne by a common owner, was not specifically contemplated by the Section 707(a)(2)(B) regulations. The transaction may be recast to cause A to have taxable gain of $100.

(g) Effective date. Paragraphs (a), (b), (c), (d) and [e] (f) of this section are effective for all transactions relating to a partnership occurring on or after May 12, 1994.

2. Text of New Proposed Section 702 Regulation [55]/

$ 1.702-1(c) Entity/aggregate principles, (1) In general. The Commissioner may treat any Item of income, gain, loss, deduction, or credit of a partnership, and/or any or all of the assets, liabilities or activities of a partnership, as if such tax items were directly earned by the partners of the partnership and such assets, liabilities or activities were directly owned, owed or carried on by the partners of the partnership, to the extent such treatment is appropriate to carry out the purposes of any provision of this Title.

(2) Exception. Paragraph (a) shall not apply for purposes of any provision of this Title to the extent that the status of the partnership as an entity under all the relevant surrounding facts and circumstances is specifically contemplated by such provision.

(3) Examples.

[55]/ Existing Treas. Reg. S 1.702-1(c) through (f) should be renumbered as-1(d) through (g), respectively.