

respected under substance over form principles, and (3) the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must, subject to certain exceptions, accurately reflect the partners' economic agreement and clearly reflect the partner's income (*proper reflection of income*). However, certain provisions of subchapter K that were adopted to promote administrative convenience or other policy objectives may, under certain circumstances, produce tax results that do not properly reflect income. To reflect the conscious choice in these instances to favor administrative convenience or such other objectives over the accurate measurement of income, the final regulation provides that proper reflection of income will be treated as satisfied with respect to the tax consequences of a partnership transaction that satisfies paragraphs (a) (1) and (2) of the final regulation to the extent the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision. Examples of such provisions include section 732, the elective feature of section 754, and the value-equals-basis rule in § 1.704-1(b)(2)(iii)(c), as well as regulatory de minimis rules such as those reflected in §§ 1.704-3(e)(1) and 1.752-2(e)(4). A number of examples in the final regulation demonstrate the proper application of these rules.

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

This clause was principally intended to address aggregate/entity issues that exist under current law. The final regulation clarifies this aspect of the regulation by removing the clause from paragraph (a) and adding a new paragraph (e) to address inappropriate treatment of a partnership as an entity.

Paragraph (e) confirms the Commissioner's authority to treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Code or the regulations thereunder. As stated in some comments, as well as under current law, the Commissioner's authority to treat a partnership as an aggregate of its partners is not dependent on the taxpayer's intent in structuring the transaction. However, the Commissioner may not treat the partnership as an aggregate of its partners under paragraph (e) to the extent that a provision of the Code or the regulations thereunder prescribes the treatment of a partnership as an entity, in whole or in part, and that treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision. Underlying the promulgation of paragraph (e) is the belief that significant potential for abuse exists in the inappropriate treatment of a partnership as an entity in applying rules outside of subchapter K to transactions involving partnerships. Examples in new paragraph (f) illustrate the application of paragraph (e).

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

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

2. A Principal Purpose

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

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

By contrast, as noted above, the entity/aggregate determination under paragraph (e) of the final regulation does not require the taxpayer to have a principal purpose of substantially reducing taxes through misapplication of that principle. In this context, the IRS and Treasury agree with those