

comments that suggested that the entity/aggregate principle is properly applied, as under current law, solely on the basis of carrying out the purpose of the particular provision to be applied.

### 3. Scope of Commissioner's Ability To Recast Transactions

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

### 4. Effective Date of the Regulation

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

prior to the applicable effective date of the regulation.

### 5. Relationship of the Regulation to Established Legal Doctrines

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

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

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

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

#### C. Other Comments

##### 1. Suggested Alternatives to the Regulation

While some comments stated that it is appropriate to include a general anti-abuse rule in the regulations to limit the misuse of the provisions of subchapter K, others claimed that was not necessary. These comments stated that the IRS and Treasury already have sufficient means to challenge abusive partnership transactions and that existing authority should be used to

address specific transactions as they are discovered. These comments suggested using the established legal doctrines, amending the section 704(b) regulations, and increasing partnership audits.

These comments are discussed below.

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

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

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

##### 2. Application by Revenue Agents

Many comments expressed concern that the regulation, if finalized as proposed, will not be applied