

appropriately by Revenue Agents. As stated in Announcement 94-87, 1994-27 I.R.B. 124, when an issue that may be affected by the regulation is considered on examination, any application of the regulation must be coordinated with *both* the Issue Specialist on the Partnership Industry Specialization Program team and the IRS National Office. The IRS and Treasury believe that this coordination, together with the many clarifying changes made in the final regulation, will result in fair and consistent treatment of taxpayers in the application of the final regulation to partnership transactions.

3. Special Analyses and the Secretary's Authority

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

4. De Minimis Rule

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

The requirement in the regulation that the present value of the partners' aggregate federal tax reduction must be substantial assures that the regulation will not be applied where the amounts involved are not significant. In addition, the IRS and Treasury believe that the clarifications made in the final regulation provide sufficient safeguards for bona fide joint business arrangements involving partnerships. For example, the exception from the

proper reflection of income standard set forth in paragraph (a)(3) for transactions that are clearly contemplated by a particular provision of subchapter K provides appropriate safeguards for these business arrangements. Finally, the final regulation explicitly recognizes the application of specific statutory and regulatory de minimis rules in subchapter K. In light of these safeguards, the IRS and Treasury believe no additional specific safe harbor rules are needed.

Special Analyses

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

Authority: 26 U.S.C. 7805 * * *
Section 1.701-2 also issued under 26 U.S.C. 701 through 761 * * *

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

§ 1.701-2 Anti-abuse rule.

(a) *Intent of subchapter K.* Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements—

(1) The partnership must be bona fide and each partnership transaction or series of related transactions

(individually or collectively, the transaction) must be entered into for a substantial business purpose.

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

(3) Except as otherwise provided in this paragraph (a)(3), the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, *proper reflection of income*). However, certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. Thus, the proper reflection of income requirement of this paragraph (a)(3) is treated as satisfied with respect to a transaction that satisfies paragraphs (a)(1) and (2) of this section to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision. See, for example, paragraph (d) *Example 8* of this section (relating to the value-equals-basis rule in § 1.704-1(b)(2)(iii)(c)), paragraph (d) *Example 11* of this section (relating to the election under section 754 to adjust basis in partnership property), and paragraph (d) *Examples 12 and 13* of this section (relating to the basis in property distributed by a partnership under section 732). See also, for example, §§ 1.704-3(e)(1) and 1.752-2(e)(4) (providing certain de minimis exceptions).

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