

use of partnership consistent with the intent of subchapter K. (i) X, a domestic corporation, and Y, a foreign corporation, form partnership PRS under the laws of foreign Country A to conduct a bona fide joint business. X and Y each owns a 50% interest in PRS. PRS is properly classified as a partnership under §§ 301.7701-2 and 301.7701-3. PRS pays income taxes to Country A. X and Y chose partnership form to enable X to qualify for a direct foreign tax credit under section 901, with look-through treatment under § 1.904-5(h)(1). Conversely, if PRS were a foreign corporation for U.S. tax purposes, X would be entitled only to indirect foreign tax credits under section 902 with respect to dividend distributions from PRS. The look-through rules, however, would not apply, and pursuant to section 904(d)(1)(E) and § 1.904-4(g), the dividends and associated taxes would be subject to a separate foreign tax credit limitation for dividends from PRS, a noncontrolled section 902 corporation.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS in order to take advantage of the look-through rules for foreign tax credit purposes, thereby maximizing X's use of its proper share of foreign taxes paid by PRS, is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 4. Choice of entity; avoidance of gain recognition under sections 351(e) and 357(c); use of partnership consistent with the intent of subchapter K. (i) X, ABC, and DEF form limited partnership PRS to conduct a bona fide real estate management business. PRS is properly classified as a partnership under §§ 301.7701-2 and 301.7701-3. X, the general partner, is a newly formed corporation that elects to be treated as a real estate investment trust as defined in section 856. X offers its stock to the public and contributes substantially all of the proceeds from the public offering to PRS. ABC and DEF, the limited partners, are existing partnerships with substantial real estate holdings. ABC and DEF contribute all of their real property assets to PRS, subject to liabilities that exceed their respective aggregate bases in the real property contributed, and terminate under section 708(b)(1)(A). In addition, some of the former partners of ABC and DEF each have the right, beginning two years after the formation of PRS, to require the redemption of their limited partnership interests in PRS in exchange for cash or X stock (at X's option) equal to the fair market value of their respective interests in PRS at the time of the redemption. These partners are not compelled, as a legal or practical matter, to exercise their exchange rights at any time. X, ABC, and DEF chose to form a partnership rather than have ABC and DEF invest directly in X to allow ABC and DEF to avoid recognition of gain under sections 351(e) and

357(c). Because PRS would not be treated as an investment company within the meaning of section 351(e) if PRS were incorporated (so long as it did not elect under section 856), section 721(a) applies to the contribution of the real property to PRS. See section 721(b).

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS, thereby avoiding the tax consequences that would have resulted from contributing the existing partnerships' real estate assets to X (by applying the rules of sections 721, 731, and 752 in lieu of the rules of sections 351(e) and 357(c)), is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. Although it may be argued that the form of the transaction should not be respected because it does not reflect its substance (inasmuch as the present value of the partners' aggregate federal tax liability is substantially less than would be the case if the transaction were integrated and treated as a contribution of the encumbered assets by ABC and DEF directly to X, see paragraph (c)(2) of this section), the facts indicate otherwise. For example, the right of some of the former ABC and DEF partners after two years to exchange their PRS interests for cash or X stock (at X's option) equal to the fair market value of their PRS interest at that time would not require that right to be considered as exercised prior to its actual exercise. Moreover, X may make other real estate investments and other business decisions, including the decision to raise additional capital for those purposes. Thus, although it may be likely that some or all of the partners with the right to do so will, at some point, exercise their exchange rights, and thereby receive either cash or X stock, the form of the transaction as a separate partnership and real estate investment trust is respected under substance over form principles (see paragraph (a)(2) of this section). The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 5. Family partnership to conduct joint business activities; valuation discount; use of partnership consistent with the intent of subchapter K. (i) H and W, husband and wife, form limited partnership PRS by contributing their interests in actively managed, income-producing real property that PRS will own and operate. H holds a general partnership interest, and W holds a limited partnership interest. At a later date, W makes a gift of a portion of her limited partnership interest to each of H and W's two children, S and D. Appropriate discounts, consistent with the taxpayers' treatment of the arrangement as a partnership, were applied in determining the value of W's gifts to the children.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. Although PRS is owned entirely by related parties (see paragraph (c)(4) of this section), the decision

to organize and conduct business through PRS under these circumstances is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. Therefore, absent other facts (such as the creation of the partnership immediately before the gifts by W), the Commissioner cannot invoke paragraph (b) of this section to recast the transaction. But see sections 2701 through 2704 for special valuation rules applicable to family arrangements for estate and gift tax purposes. See also sections 2036 through 2039.

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

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

(ii) PRS is not bona fide and there is no substantial business purpose for the purported activities of PRS. In addition, by using a partnership (if respected), H and W's aggregate federal tax liability would be substantially less than had they owned the partnership's assets directly (see paragraph (c)(1) of this section). On these facts, PRS has been formed and availed of with a principal purpose to reduce H's and W's aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under applicable judicial principles, such as the substance over form doctrine, see paragraph (h) of this section), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

Example 7. Special allocations; dividends received deductions; use of partnership consistent with the intent of subchapter K. (i) Corporations X and Y contribute equal amounts to PRS, a bona fide partnership formed to make joint investments. PRS pays \$100 for a share of common stock of Z, an unrelated corporation, which has historically paid an annual dividend of \$6. PRS specially allocates the dividend income on the Z stock to X to the extent of the London Inter-Bank Offered Rate (LIBOR) on the record date, applied to X's contribution of \$50, and allocates the remainder of the dividend