

income to Y. All other items of partnership income and loss are allocated equally between X and Y. The allocations under the partnership agreement have substantial economic effect within the meaning of § 1.704-1(b)(2). In addition to avoiding an entity-level tax, a principal purpose for the formation of the partnership was to invest in the Z common stock and to allocate the dividend income from the stock to provide X with a floating-rate return based on LIBOR, while permitting X and Y to claim the dividends received deduction under section 243 on the dividends allocated to each of them.

(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 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. Section 704(b) and § 1.704-1(b)(2) permit income realized by the partnership to be allocated validly to the partners separate from the partners' respective ownership of the capital to which the allocations relate, provided that the allocations satisfy both the literal requirements of the statute and regulations and the purpose of those provisions (see paragraph (c)(5) of this section). Section 704(e)(2) is not applicable to the facts of this example (otherwise, the allocations would be required to be proportionate to the partners' ownership of contributed capital). The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 8. Special allocations; nonrecourse financing; low-income housing credit; use of partnership consistent with the intent of subchapter K. (i) A and B, high-bracket taxpayers, and X, a corporation with net operating loss carryforwards, form general partnership PRS to own and operate a building that qualifies for the low-income housing credit provided by section 42. The project is financed with both cash contributions from the partners and nonrecourse indebtedness. The partnership agreement provides for special allocations of income and deductions, including the allocation of all depreciation deductions attributable to the building to A and B equally in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the building. The section 42 credits are allocated to A and B in accordance with the allocation of depreciation deductions. PRS's allocations comply with all applicable regulations, including the requirements of §§ 1.704-1(b)(2)(ii) (pertaining to economic effect) and 1.704-2(e) (requirements for allocations of nonrecourse deductions). The nonrecourse indebtedness is validly allocated to the partners under the rules of § 1.752-3, thereby increasing the basis of the partners' respective partnership interests. The basis increase created by the nonrecourse indebtedness enables A and B to deduct their distributive share of losses from the partnership (subject to all other applicable

limitations under the Internal Revenue Code) against their nonpartnership income and to apply the credits against their tax liability.

(ii) At a time when the depreciation deductions attributable to the building are not treated as nonrecourse deductions under § 1.704-2(c) (because there is no net increase in partnership minimum gain during the year), the special allocation of depreciation deductions to A and B has substantial economic effect because of the value-equals-basis safe harbor contained in § 1.704-1(b)(2)(iii)(c) and the fact that A and B would bear the economic burden of any decline in the value of the building (to the extent of the partnership's investment in the building), notwithstanding that A and B believe it is unlikely that the building will decline in value (and, accordingly, they anticipate significant timing benefits through the special allocation). Moreover, in later years, when the depreciation deductions attributable to the building are treated as nonrecourse deductions under § 1.704-2(c), the special allocation of depreciation deductions to A and B is considered to be consistent with the partners' interests in the partnership under § 1.704-2(e).

(iii) 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 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. Section 704(b), § 1.704-1(b)(2), and § 1.704-2(e) allow partnership items of income, gain, loss, deduction, and credit to be allocated validly to the partners separate from the partners' respective ownership of the capital to which the allocations relate, provided that the allocations satisfy both the literal requirements of the statute and regulations and the purpose of those provisions (see paragraph (c)(5) of this section). Moreover, the application of the value-equals-basis safe harbor and the provisions of § 1.704-2(e) with respect to the allocations to A and B, and the tax results of the application of those provisions, taking into account all the facts and circumstances, are clearly contemplated. Accordingly, even if the allocations would not otherwise be considered to satisfy the proper reflection of income standard in paragraph (a)(3) of this section, that requirement will be treated as satisfied under these facts. Thus, even though the partners' aggregate federal tax liability may be substantially less than had the partners owned the partnership's assets directly (due to X's inability to use its allocable share of the partnership's losses and credits) (see paragraph (c)(1) of this section), the transaction is not inconsistent with the intent of subchapter K. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

Example 9. Partner with nominal interest; temporary partner; use of partnership not consistent with the intent of subchapter K. (i) Pursuant to a plan a principal purpose of which is to generate artificial losses and thereby shelter from federal taxation a

substantial amount of income, X (a foreign corporation), Y (a domestic corporation), and Z (a promoter) form partnership PRS by contributing \$9,000, \$990, and \$10, respectively, for proportionate interests (90.0%, 9.9%, and 0.1%, respectively) in the capital and profits of PRS. PRS purchases offshore equipment for \$10,000 and validly leases the equipment offshore for a term representing most of its projected useful life. Shortly thereafter, PRS sells its rights to receive income under the lease to a third party for \$9,000, and allocates the resulting \$9,000 of income \$8,100 to X, \$891 to Y, and \$9 to Z. PRS thereafter makes a distribution of \$9,000 to X in complete liquidation of its interest. Under § 1.704-1(b)(2)(iv)(f), PRS restates the partners' capital accounts immediately before making the liquidating distribution to X to reflect its assets consisting of the offshore equipment worth \$1,000 and \$9,000 in cash. Thus, because the capital accounts immediately before the distribution reflect assets of \$19,000 (that is, the initial capital contributions of \$10,000 plus the \$9,000 of income realized from the sale of the lease), PRS allocates a \$9,000 book loss among the partners (for capital account purposes only), resulting in restated capital accounts for X, Y, and Z of \$9,000, \$990, and \$10, respectively. Thereafter, PRS purchases real property by borrowing the \$8,000 purchase price on a recourse basis, which increases Y's and Z's bases in their respective partnership interests from \$1,881 and \$19, to \$9,801 and \$99, respectively (reflecting Y's and Z's adjusted interests in the partnership of 99% and 1%, respectively). PRS subsequently sells the offshore equipment, subject to the lease, for \$1,000 and allocates the \$9,000 tax loss \$8,910 to Y and \$90 to Z. Y's and Z's bases in their partnership interests are therefore reduced to \$891 and \$9, respectively.

(ii) On these facts, any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transaction were respected for federal tax purposes (see paragraph (c) of this section). Accordingly, the transaction lacks a substantial business purpose (see paragraph (a)(1) of this section). In addition, factors (1), (2), (3), and (5) of paragraph (c) of this section indicate that PRS was used with a principal purpose to reduce substantially the partners' tax liability in a manner inconsistent with the intent of subchapter K. On these facts, PRS is not bona fide (see paragraph (a)(1) of this section), and the transaction is not respected under applicable substance over form principles (see paragraph (a)(2) of this section) and does not properly reflect the income of Y (see paragraph (a)(3) of this section). Thus, PRS has been formed and availed of with a principal purpose of reducing substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under judicial principles or the validity of the allocations under § 1.704-1(b)(2) (see paragraph (h) of this section)), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.