**EFFECTIVE DATES:** This regulation is effective May 12, 1994, except that  $\S 1.701-2$  (e) and (f) are effective December 29, 1994.

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### SUPPLEMENTARY INFORMATION:

#### Introduction

This document adds §1.701–2 to the Income Tax Regulations (26 CFR part 1) under section 701 of the Code.

### Background

Subchapter K was enacted to permit businesses organized for joint profit to be conducted with "simplicity, flexibility, and equity as between the partners." S. Rep. No. 1622, 83d Cong., 2d Sess. 89 (1954); H.R. Rep. No. 1337, 83d Cong., 2d Sess. 65 (1954). It was not intended, however, that the provisions of subchapter K be used for tax avoidance purposes. For example, in enacting subchapter K, Congress indicated that aggregate, rather than entity, concepts should be applied if such concepts are more appropriate in applying other provisions of the Code. H.R. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954). Similarly, in later amending the rules relating to special allocations, Congress sought to "prevent the use of special allocations for tax avoidance purposes, while allowing their use for bona fide business purposes." S. Rep. No. 938, 94th Cong., 2d Sess. 100 (1976).

On May 12, 1994, the IRS and Treasury issued a notice of proposed rulemaking (59 FR 25581) under section 701 of the Code. That document proposed to add an anti-abuse rule under subchapter K. Comments responding to the notice were received, and a public hearing was held on July 25, 1994. After considering the comments that were received in response to the notice of proposed rulemaking and the statements made at the hearing, the IRS and Treasury adopt the proposed regulation as revised by this Treasury decision. The anti-abuse rule in this final regulation applies to the operation and interpretation of any provision of the Code and the regulations thereunder that may be relevant to a particular partnership transaction (including income, estate, gift, generation-skipping, and excise tax). The anti-abuse rule in the final regulation is expected primarily to affect a relatively small number of partnership transactions that make inappropriate use of the rules of subchapter K. The regulation is not intended to interfere with bona fide joint business

arrangements conducted through partnerships.

## **Explanation of Provisions**

# A. Overview of Provisions

As noted above, 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 three requirements. First, the partnership must be bona fide and each partnership transaction (or series of related transactions) must be entered into for a substantial business purpose. Second, the form of each partnership transaction must be respected under substance over form principles. Third, 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 (referred to in the final regulation as proper reflection of income), except to the extent that a provision of subchapter K that is intended to promote administrative convenience or other policy objectives causes tax results that deviate from that requirement. In those cases, if the application of that provision of subchapter K and the ultimate tax results to the partners and the partnership, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision, the transaction is treated as properly reflecting the partners' income. In determining whether a transaction clearly reflects the partners' income, the principles of sections 446(b) and 482 apply.

The provisions of subchapter K must be applied to partnership transactions in a manner consistent with the intent of subchapter K. The final regulation clarifies the authority of the Commissioner to recast transactions that attempt to use partnerships in a manner inconsistent with the intent of subchapter K as appropriate to achieve tax results that are consistent with this intent, taking into account all the facts and circumstances.

In addition, the final regulation provides that the Commissioner can 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 regulations, except to the extent that (1) a provision of the Code or regulations prescribes the treatment of the partnership as an entity, and (2) that treatment and the ultimate tax results, taking into account all of the facts and circumstances, are clearly contemplated by that provision.

### B. Discussion of Comments Relating to Provisions in the Regulation

Comments that relate to the application of the proposed regulation and the responses to them, including an explanation of the revisions made to the final regulation, are summarized below.

#### 1. Scope of the Regulation

Several comments stated that, as drafted, the language in the proposed regulation was too broad and too vague to provide adequate guidance to taxpayers as to which transactions are affected by the regulation. Similarly, some comments suggested that the intent of subchapter K as stated in the proposed regulation (upon which the regulation operates) was overbroad and potentially conflicted with explicit statutory or regulatory provisions. Several comments expressed concern that the regulation, if finalized as proposed, would adversely affect the legitimate use of partnerships. Other comments suggested that additional examples should be added to clarify the scope of the regulation, which would provide the necessary guidance. Some of the comments requested that the regulation be withdrawn, or revised and reproposed.

On the other hand, other comments supported the approach in the proposed regulation, noting that it was well established that the provisions of the Code must be interpreted consistent with their purpose. Some of these comments noted that the regulation would in large part simply be codifying aspects of existing judicial doctrines, such as substance over form and business purpose, as they relate to partnership transactions. Finally, some of these comments suggested that the regulation be modified in various respects, including by adding additional examples of its application.

In response to these comments, the IRS and Treasury have revised the final regulation in three principal respects. First, the scope of the regulation has been clarified substantially by revising the portion captioned Intent of Subchapter K, in paragraph (a) of the proposed regulation. Paragraph (a) of the final regulation now specifically requires that (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