

deduction control the attributes of M1's intercompany income. Accordingly, M1's income is treated as ordinary income. Paragraph (g)(3) of this section also provides that, immediately after section 475 would apply, a new contract is treated as reissued with an upfront payment of \$100. Under § 1.446-3(f), the deemed \$100 payment by M2 to M1 is taken into account over the term of the new contract in a manner reflecting the economic substance of the contract (for example, allocating the payment in accordance with the forward rates of a series of cash-settled forward contracts that reflect the specified index and the \$1,000 notional principal amount). (The timing of taking items into account is the same if M1, rather than M2, is the dealer subject to the mark-to-market requirement of section 475 at year-end. However in this case, because the attributes of the corresponding deduction control the attributes of the intercompany income, M1's income from the deemed termination payment might be ordinary or capital.)

(h) *Anti-avoidance rules*—(1) *In general.* If a transaction is engaged in or structured with a principal purpose to avoid the purposes of this section (including, for example, by avoiding treatment as an intercompany transaction), adjustments must be made to carry out the purposes of this section.

(2) *Examples.* The anti-avoidance rules of this paragraph (h) are illustrated by the following examples. The examples set forth below do not address common law doctrines or other authorities that might apply to recast a transaction or to otherwise affect the tax treatment of a transaction. Thus, in addition to adjustments under this paragraph (h), the Commissioner can, for example, apply the rules of section 269 or § 1.701-2 to disallow a deduction or to recast a transaction.

Example 1. Sale of a partnership interest.

(a) *Facts.* S owns land with a \$10 basis and \$100 value. B has net operating losses from separate return limitation years (SRLYs) subject to limitation under § 1.1502-21(c). Pursuant to a plan to absorb the losses without limitation by the SRLY rules, S transfers the land to an unrelated, calendar-year partnership in exchange for a 10% interest in the capital and profits of the partnership in a transaction to which section 721 applies. The partnership does not have a section 754 election in effect. S later sells its partnership interest to B for \$100. In the following year, the partnership sells the land to X for \$100. Because the partnership does not have a section 754 election in effect, its \$10 basis in the land does not reflect B's \$100 basis in the partnership interest. Under section 704(c), the partnership's \$90 built-in gain is allocated to B, and B's basis in the partnership interest increases to \$190 under section 705. In a later year, B sells the partnership interest to a nonmember for \$100.

(b) *Adjustments.* Under § 1.1502-21(c), the partnership's \$90 built-in gain allocated to B

ordinarily increases the amount of B's SRLY limitation, and B's \$90 loss from its sale of the partnership interest ordinarily is not subject to limitation under the SRLY rules. Because the contribution of property to the partnership and the sale of the partnership interest were part of a plan a principal purpose of which was to achieve a reduction in consolidated tax liability by creating offsetting gain and loss for B while deferring S's intercompany gain, B's allocable share of the partnership's gain from its sale of the land is treated under paragraph (h)(1) of this section as not increasing the amount of B's SRLY limitation.

Example 2. Transitory status as an intercompany obligation. (a) *Facts.* P historically has owned 70% of X's stock and the remaining 30% is owned by unrelated shareholders. On January 1 of Year 1, S borrows \$100 from X in return for S's note requiring \$10 of interest annually at the end of each year, and repayment of \$100 at the end of Year 20. As of January 1 of Year 3, the P group has substantial net operating loss carryovers, and the fair market value of S's note falls to \$70 due to an increase in prevailing market interest rates. X is not permitted under section 166(a)(2) to take into account a \$30 loss with respect to the note. Pursuant to a plan to permit X to take into account its \$30 loss without disposing of the note, P acquires an additional 10% of X's stock, causing X to become a member, and P subsequently resells the 10% interest. X's \$30 loss with respect to the note is a net unrealized built-in loss within the meaning of § 1.1502-15.

(b) *Adjustments.* Under paragraph (g)(4) of this section, X ordinarily would take into account its \$30 loss as a result of the note becoming an intercompany obligation, and S would take into account \$30 of discharge of indebtedness income. Under § 1.1502-22(c), X's loss is not combined with items of the other members and the loss would be carried to X's separate return years as a result of X becoming a nonmember. However, the transitory status of S's indebtedness to X as an intercompany obligation is structured with a principal purpose to accelerate the recognition of X's loss. Thus, S's note is treated under paragraph (h)(1) of this section as not becoming an intercompany obligation.

Example 3. Corporate mixing bowl. (a) *Facts.* M1 and M2 are subsidiaries of P. M1 operates a manufacturing business on land it leases from M2. The land is the only asset held by M2. P intends to dispose of the M1 business, including the land owned by M2; P's basis in the M1 stock is equal to the stock's fair market value. M2's land has a value of \$20 and a basis of \$0 and P has a \$0 basis in the stock of M2. In Year 1, with a principal purpose of avoiding gain from the sale of the land (by transferring the land to M1 with a carry-over basis without affecting P's basis in the stock of M1 or M2), M1 and M2 form corporation T; M1 contributes cash in exchange for 80% of the T stock and M2 contributes the land in exchange for 20% of the stock. In Year 3, T liquidates, distributing \$20 cash to M2 and the land (plus \$60 cash) to M1. Under § 1.1502-34, section 332 applies to both M1 and M2. Under section 337, T recognizes no gain or loss from its

liquidating distribution of the land to M1. T has neither gain nor loss on its distribution of cash to M2. In Year 4, P sells all of the stock of M1 to X and liquidates M2.

(b) *Adjustments.* A principal purpose for the formation and liquidation of T was to avoid gain from the sale of M2's land. Thus, under paragraph (h)(1) of this section, M2 must take \$20 of gain into account when the stock of M1 is sold to X.

Example 4. Partnership mixing bowl. (a) *Facts.* M1 owns a self-created intangible asset with a \$0 basis and a fair market value of \$100. M2 owns land with a basis of \$100 and a fair market value of \$100. In Year 1, with a principal purpose of creating basis in the intangible asset (which would be eligible for amortization under section 197), M1 and M2 form partnership PRS; M1 contributes the intangible asset and M2 contributes the land. X, an unrelated person, contributes cash to PRS in exchange for a substantial interest in the partnership. PRS uses the contributed assets in legitimate business activities. Five years and six months later, PRS liquidates, distributing the land to M1, the intangible to M2, and cash to X. The group reports no gain under sections 707(a)(2)(B) and 737(a) and claims that M2's basis in the intangible asset is \$100 under section 732 and that the asset is eligible for amortization under section 197.

(b) *Adjustments.* A principal purpose of the formation and liquidation of PRS was to create additional amortization without an offsetting increase in consolidated taxable income by avoiding treatment as an intercompany transaction. Thus, under paragraph (h)(1) of this section, appropriate adjustments must be made.

Example 5. Sale and leaseback. (a) *Facts.* S operates a factory with a \$70 basis and \$100 value, and has loss carryovers from SRLYs. Pursuant to a plan to take into account the \$30 unrealized gain while continuing to operate the factory, S sells the factory to X for \$100 and leases it back on a long-term basis. In the transaction, a substantial interest in the factory is transferred to X. The sale and leaseback are not recharacterized under general principles of Federal income tax law. As a result of S's sale to X, the \$30 gain is taken into account and increases S's SRLY limitation.

(b) *No adjustments.* Although S's sale was pursuant to a plan to accelerate the \$30 gain, it is not subject to adjustment under paragraph (h)(1) of this section. The sale is not treated as engaged in or structured with a principal purpose to avoid the purposes of this section.

(i) [Reserved]

(j) *Miscellaneous operating rules.* For purposes of this section—

(1) *Successor assets.* Any reference to an asset includes, as the context may require, a reference to any other asset the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis of the first asset.

(2) *Successor persons*—(i) *In general.* Any reference to a person includes, as the context may require, a reference to a predecessor or successor. For this