Final Partnership Antiabuse Regulations Issued, Slightly Softened

by Robert W. Wood • San Francisco

Given the number of joint ventures that some corporate taxpayers employ, at least some readers of this newsletter were doubtless aware of the significant controversy surrounding the release of proposed regulations last May governing so-called abusive partnership transactions. Particularly after the repeal of the *General Utilities* doctrine, partnerships have surfaced not merely as strategic vehicles, but also in many cases as tax-favored entities. The proposed regulations issued in May 1994 gave the Service broad authority to disregard or modify transactions—authority that went beyond the traditional step-transaction doctrine, sham transaction doctrine, and principle of substance-over-form. (For discussion, *see* Laffie, "Are Partnerships Still Valid After Antiabuse Prop. Regs.?" 2 *M&A Tax Report* 12, (July 1994), p. 4).

The reaction to the proposed regulations issued last May was predictable: strong and negative. Now, in final regulations issued in January 1995 (T.D. 8588), the IRS has softened the rules. As in the case of the proposed rules, the final regulations authorize the Service to recast transactions that attempt to use partnerships in a manner inconsistent with the intent of Subchapter K. The recasting can

Continued on Page 4

 Continued from Page 3

be in any manner that is appropriate to achieve tax results that are consistent (in the Service's view) with the intent of Subchapter K, taking into account all the facts and circumstances.

Furthermore, the final regulations provide that the Service can treat a partnership as an aggregate of its partners, in whole or in part, as appropriate to carry out the purposes of any provision of the Code or regulations. However, this aggregate treatment does not apply to the extent that both: (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.

The final regulations make significant revisions to the proposed rules, mostly in response to the plethora of comments that came in from practitioners and academics. There were three principal revisions. First, the scope of the regulations was clarified as respects the supposed "intent of Subchapter K." The final regulations now specifically require that:

- The partnership must be *bona fide* and each partnership transaction or series of related transactions must be entered into for a substantial business purpose;
- The form of each partnership must be respected under substance-over-form principles; and
- The tax consequences under Subchapter K to each partner of partnership operations and of transactions between the partnership must, subject to certain exceptions, accurately reflect the partners' economic agreement and clearly reflect the partners' income.

Finally, this "intent of Subchapter K" section of the final regulations differs from the proposed rules in that it no longer provides that the provisions of Subchapter K are not intended to permit taxpayers to use the existence of partnerships to avoid the purposes of other Code provisions. Rather than this global prioritization rule that was contained in the proposed regs (in effect, making specific Code provisions of a higher priority than partnership rules), the final regulations add a new paragraph 1.701-2(e) to address inappropriate treatment of a partnership as an entity. This provision now confirms the IRS' authority to 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 and Regs.

Whose Purpose and How?

The second main revision which the final regulations reflect over the proposed ones deals with the all-important (and clearly confusing) question of intent. The proposed regulations had said that the purposes for structuring a transaction involving a partnership would be determined based upon all of the facts and circumstances. Various comments to these proposed rules requested guidance on the factors that would indicate that the taxpayers had a principal purpose to substantially reduce their aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. Paragraph (c) of the final regulations now lists several of those factors. They include:

- The present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly;
- The present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. For example, this analysis may indicate that it was contemplated that a partner who was necessary to achieve the intended tax results and whose interest in the partnership was liquidated or disposed of (in whole or in part) would be a partner only temporarily in order to provide the claimed tax benefits to the remaining partners;
- One or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities (through distribution preferences, indemnity or loss guaranty agreements, or other arrangements), or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;

Continued on Page 5

FINAL PARTNERSHIP

Continued from Page 4

- Substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another; (5) Partnership items are allocated in compliance with the literal language of Sections 1.704-1 and 1.704-2 but with results that are inconsistent with the purpose of Section 704(b) and those regulations. In this regard, particular scrutiny will be paid to partnerships in which income or gain is specially allocated to one or more partners that may be legally or effectively exempt from federal taxation (for example, a foreign person, an exempt organization, an insolvent taxpayer, or a taxpayer with unused federal tax attributes such as net operating losses, capital losses, or foreign tax credits);
- The benefits and burdens of ownership of property nominally contributed by the partnership are in substantial part retained (directly or indirectly) by the contributing partner (or a related party); or
- The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed to the distributee partner (or a related party).

Examples Galore

The third main change in the final regulations concerns explanatory and exemplary guidance. Various commentators noted that the examples in the proposed regulations did not provide adequate guidance on the application of the regulations. Comments also suggested additional examples to clarify the scope of the regulations. The final regulations contain numerous examples that illustrate the application of the rules to specifically describe transactions, including the weight to be given to relevant factors listed in paragraph (c) (the items noted above) in the particular situations involved. Both good and bad transactions are described, that is to say, transactions that are deemed consistent with the intent of subchapter K, as well as transactions that are deemed inconsistent with it.

Effective Dates

Yet another subject of dispute in the proposed regulations concerned effective dates. The proposed regulations were meant to be effective for all transactions relating to a partnership occurring on or after May 12, 1994. The final regulations generally follow this effective date. However, could the new rules apply when a partner who received an asset from a partnership before the effective date of the regulations dispose of the asset after that effective date?

Answering this question in the negative, the final regulations clarify that they apply only to transactions involving a partnership after the effective date. Furthermore, paragraphs 1.701-2(e) and 1.701-2(f) of the final regulations are effective for all transactions involving a partnership on or after December 29, 1994. Section 1.701-2(e) gives the Commissioner power to treat a partnership as an aggregate of its partners to carry out the purpose of any Code provision or regulation. Section 1.701-2(f) provides examples of the operation of subparagraph (e), giving circumstances (explicitly a non-exclusive list) in which the Service's "abuse of entity treatment" provision should be invoked.

To foreclose the possibility that transactions could be viewed as protected by virtue of not being subject to the new final regulations, the preamble to the final regulations states that no inference is intended as to the treatment of partnership transactions before the applicable effective date of these new rules.

Cause for Concern?

Probably no one can resolve the question how extensively the final regulations will be applied in the partnership arena. Although there was a great hue and cry when the proposed regulations were released, and it is true that the Service tried to give itself (in the proposed regulations, and indeed, in the final ones too) great latitude, no one really knows how aggressively the Service will pursue partnership transactions. At the least, this new rule will give practitioners yet another area in which to constantly be looking over their respective shoulders. With all the other problems that we have, that is not a good thing. ■