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The Use and Misuse of Antiabuse Rules: Lessons from the Partnership Antiabuse Regulations

*Alan Gunn**

CONGRESS enacted the first version of subchapter K in 1954 with the goal of achieving simplicity and flexibility in taxing partners.[1] Judge Raum once famously observed that the attempt at simplicity "has resulted in utter failure,"[2] but no one doubts that subchapter K has achieved flexibility. In an attempt to limit this flexibility somewhat, the regulations under subchapter K abound with (or, as one commentator has put it, "are littered with"[3]) "antiabuse rules." Section 1.701-2 of the regulations contains two general antiabuse rules, one aimed at insuring that the rules of subchapter K are applied consistently with the "intent" of those rules,[4] the other allowing the Commissioner to treat a partnership as an aggregate of its partners in applying any Internal Revenue Code provision.[5] In addition to these general rules, several sections of the regulations contain antiabuse rules dealing with narrow matters.

The regulations' antiabuse rules—particularly the general antiabuse rules of the regulations under § 701—have received harsh criticism,[6] much of it sound. The regulations are badly written; so badly written that it is hard to imagine that they can actually be applied to many cases. Furthermore, they attempt to make the concept of abuse do too much work. Nevertheless, the new regulations have given us a potentially useful addition to the law of "tax avoidance."

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1. H.R. Rep. No. 1337, 83d Cong., 2d Sess. at 65 (1954).

2. Foxman v. Comm'r, 41 T.C. 535, 551 (1964), *aff'd*, 352 F.2d 466 (3d Cir. 1965).

3. Sheldon I. Banoff, *Anatomy of an Antiabuse Rule: What's Really Wrong with Reg. Section 1.701-2*, 66 Tax Notes 1859 (1995).

4. Treas. Reg. § 1.701-2(b) (2000).

5. Treas. Reg. § 1.701-2(e).

6. *E.g.*, Banoff, *supra* note 3, criticizing the rules as vague, ambiguous, overbroad, attempting to serve too many purposes, inconsistent with the fundamental principles of subchapter K, and badly drafted. For a defense of the antiabuse regulations, see Samuel C. Thompson, Jr., *Ex-Government Officials Challenge Partnership Antiabuse Reg.: An Analysis*, 69 Tax Notes 1395 (1995). Terrill A. Hyde, *Anti-Antiabuse Rhetoric Is Full of Holes*, 67 Tax Notes 299 (1995) (letter to the editor), cites a number of defenses of the antiabuse regulations and questions the assertions made by the regulations' critics.

For most of our tax history, attempts by taxpayers to exploit the wording of particular Code provisions have been struck down on various grounds: substance over form, lack of business purpose, lack of non-tax substance, and the ubiquitous if obscure "step-transaction doctrine." To these, the § 701 regulations add the concept of "abuse." A transaction can be abusive without running afoul of any of the traditional anti-avoidance doctrines; that is, it can have a business purpose and substance, its substance and form can coincide, and yet it yields a tax result that no sensible legislator would have approved of if the transaction had been called to the legislator's attention when the statute was drafted. Flawed though they may be, the § 701 regulations give us a useful concept of "abuse," distinct from other anti-avoidance doctrines.

This article attempts to distinguish those portions of the new regulations that are truly "antiabuse" rules from the balance. My goal is less to endorse or criticize particular applications than to encourage clarity of thought. "Prevention of abuse" can be a useful concept, and we should be glad that the new regulations have introduced it. Unfortunately, defects in the regulations—their use of "factors" (including unstated factors) as their basic approach, their failure to distinguish prevention of abuse from other matters, and their insistence that general principles are not to be drawn from their examples—seem likely to mean that the regulations—and the concept of abuse—will not be taken as seriously as they should be.

I. THE IDEA OF "ABUSE"

A simple non-tax illustration of an "abusive transaction" may serve to introduce the notion of abuse. Suppose that a state statute establishing a speed limit provides that "this limit does not apply to an ambulance transporting an injured person to a hospital." An exception like this makes lots of sense because, in many cases, the needs of a seriously injured accident victim outweigh any small increased risk of traffic accidents caused by high speed, especially if the speeding vehicle uses a siren and flashing lights to warn other drivers of its presence. Now imagine a young ambulance driver returning to the fire station with an EMT in the passenger seat. While rearranging his equipment, the EMT cuts his finger accidentally. The injury is not at all serious, but the EMT suggests to the driver that they stop by the hospital emergency room on the way back so that the EMT can get a tetanus booster shot, and the driver agrees. At this point, the ambulance is "transporting an injured person to a hospital." So does the driver have a license to "find out just how fast this baby can go" without fear of legal consequences? The short answer is, "I don't know." It depends on whether the courts (and, as a practical matter, the police) of the jurisdiction are wedded to a "plain-meaning" approach to statutory interpretation, as opposed to an approach that takes statutes' evident purposes into account in applying them. One can imagine courts going either way. What one cannot imagine is that anyone would seri-

ously deny that the driver's proceeding to the hospital at ninety miles an hour would constitute an abuse of the statutory exclusion for ambulances. What, if anything, should be done to prevent this kind of abuse is a different matter, on which people are likely to disagree, some favoring specific statutory amendments,[7] others favoring narrowly drafted "antiabuse" rules,[8] still others opting for broad antiabuse rules.[9]

Let us now turn to an example of an abuse involving taxation. This particular example is drawn from subchapter S, which has no general antiabuse rules.

Suppose that *I*, a successful investor, owns some IBM stock, purchased very long ago, which has a basis of $10,000 and a value of $500,000. *I* would like to dispose of this stock and use the proceeds to buy a ranch in Montana. Doing this in the obvious way by selling the stock and using the proceeds to buy the ranch would trigger a tax liability of $98,000. There is no non-recognition provision applicable to the replacement of stock with ranch property, so most tax advisers would probably advise *I* that his goal can be accomplished only by paying this tax. *I*'s tax adviser, however, is one of my former students, who remembers a classroom hypothetical involving these very facts. *I* proceeds as follows: First, he buys all the stock of Essco, a nearly defunct S corporation, from its sole shareholder, *S* (for "seller," or, in some variations of this hypothetical, "sap"[10]), for $10,000. The purchase takes place late in the year, say on December 21. Immediately after buying Essco stock, *I* transfers all the IBM stock to Essco in exchange for more Essco stock. This transfer is tax free under § 351,[11] and Essco takes the IBM stock with *I*'s $10,000 basis. Shortly thereafter—and before the end of the year—Essco sells the IBM stock for $500,000, recognizing a long-term capital gain of $490,000. It then buys the Montana ranch. To whom is Essco's $490,000 gain taxed? According to § 1377(a)(1) (the "per-share, per-day" rule, which applies unless Essco, *I*, and *S* all elect otherwise), the gain is allocated between *S* and *I* according to the number of days during which each of them was Essco's sole shareholder: 355 days for *S* and 10 days for *I*. Therefore, if the statute is read literally, $476,575 of the gain is *S*'s income[12] and only

7. For instance, the ambulance exception to the speed limit could be rewritten to include a requirement of serious injury and genuine need for prompt medical care.

8. Something similar to § 706(d)(1), authorizing the Commissioner to adjust partners' incomes to reflect ownership changes, would be an example. Section 706(d)(1) will be examined below.

9. Like Treas. Reg. § 1.701-2(a), the intent-of-subchapter-K antiabuse rule.

10. *See infra* note 12.

11. Although the assets transferred to Essco are investment properties, the transfer would not be taxable under § 351(e)(1) because it does not diversify the transferor's holdings. Treas. Reg. § 1.351-1(c)(1).

12. The allocation to S of $476,575 of capital gain will not hurt *S* because *S*'s basis for the Essco stock sold to *I* will be increased by that gain under § 1367(a). This will give *S* a capital loss. To illustrate, suppose that *S*'s basis for the Essco stock (before considering any post-sale transactions) was $10,000. If Essco had recognized no income before the end of the year, *S* would have recognized no gain or loss on the sale. Allocating a $476,575 capital gain to *S* gives *S* $476,575 of long-term capital gain, but it also increases *S*'s basis for the stock that was sold to $486,575. *S* will therefore recognize a long-term capital loss of

$13,425 is *I*'s.[13] At a 20-percent rate, *I*'s tax on the gain is $2,695. *I* has achieved his goal of unloading the IBM stock and replacing it with a Montana ranch at the cost of only $12,695.

It is clear enough that any court faced with the scheme described above would try very hard to find a way to tax all of the $490,000 of capital gain on the sale of the IBM stock to *I*.[14] It is just as clear that doctrines having to do with "form," "substance," "shams," and the like will not do the job. This is not a case in which the taxpayer tried to mis-characterize a transaction—by calling a dividend "compensation," for example,[15] or by pretending that a dividend was a reorganization.[16] Every step of the transaction was "real," and had real-world consequences: it can matter that the stock, or the ranch, was owned by a corporation rather than by *I* directly. To be sure, the whole transaction was designed to reduce *I*'s tax burden, but this is true of practically any transaction involving corporations: who would use an S corporation for anything were it not for tax considerations? Furthermore, the result the Commissioner would seek in this case—taxation to *I* of all of the gain on the sale of the IBM stock—is simply the result that would have been reached under § 1377(a)(2) if the parties had agreed to have that section apply. In response to the Commissioner's complaint that the per-share, per-day rule of § 1377(a)(1) causes income to disappear from the tax base, *I* would point out that this happens whenever the per-share, per-day rule allocates capital gain recognized after the sale of an interest in an S corporation to the pre-sale period, yet the statute, in language as clear as English can be, allows this. If the per-share, per-day rule gives the "wrong answer" here, that is because it gives the wrong answer in many other cases as well, and Congress has legislated that wrong answer unless the parties agree otherwise.[17]

So what is it about this transaction that is "abusive"? Principally this: it involves a very large transaction, filtered through an S corporation only to take advantage of a rule that mis-measures income. Whoever drafted

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$476,575 on the sale. *S* must report a $476,575 long-term capital gain and a $476,575 long-term capital loss. Unless *S* cares what her gross income is (very unlikely), this is a wash.

If the property transferred to Essco had been ordinary-income property, *S* would be in very bad shape indeed, as a $476,575 ordinary gain and a $476,575 capital loss would not offset each other. That's why *S* can stand for "sap." Those who sell all their stock of an S corporation should routinely obtain the buyer's agreement to terminate the corporation's taxable year under § 1377(a)(2) to prevent this kind of disaster.

13. *I*'s basis for the stock of Essco is only $23,425. But if *I* holds the Essco stock until his death, this low basis will not matter.

14. Compare Judge Goffe's concurring opinion in *Carriage Square, Inc. v. Commissioner*, 69 T.C. 119, 130 (1977), observing that "[a]ll the members of the Court recognize that the tax avoidance scheme . . . cannot be allowed to stand."

15. As in the "reasonable compensation" cases under § 162(a)(1).

16. As in *Gregory v. Helvering*, 293 U.S. 465 (1935).

17. It may be worth noting that this problem should not arise under subchapter K because § 706(d)(1) authorizes regulations that will provide for calculating a partner's distributive share by taking ownership changes during the year into account. Subchapter S lacks a comparable provision.

§ 1377(a)(l) must have known[18] that that section distorts income; but in many cases this distortion is an acceptable price to pay for simplicity. The IBM stock case is abusive not because it calls for a bad interpretation of the relevant Code section (it does not), but because it seeks to use a Code section for a purpose its drafters could not plausibly be thought to have contemplated. If those drafters thought about problems like this at all, they thought of incidental distortions occurring when shares of S corporations changed hands, not about transactions designed specifically to take advantage of the distorting effects of the provision.

Whether *I*'s transaction is vulnerable to attack under current law is unclear. The government's best chance of success would be to invoke § 269, which authorizes the Commissioner to "disallow . . . [any] deduction, credit or other allowance" if any person has acquired control of a corporation with the principal purpose of "evasion or avoidance of Federal income tax by securing the benefit of [that] deduction, credit, or other allowance." This statutory language does not fit very closely with *I*'s transaction, which does not entail *I*'s taking any deduction or credit (and the phrase "other allowance" seems meaningless). Section 269, drafted long before the notion of "abuse" was current, is phrased as a "tax avoidance" measure, not an antiabuse rule. This feature makes § 269 almost hopelessly vague, as no sensible person ever decides to acquire and use a corporation unless doing so will lead to more-favorable tax consequences than if a corporation had not been used. What is called for here is an antiabuse rule: either a narrow one like § 706(d)(1)[19] or something more general, such as the intent-of-subchapter-K antiabuse regulations, to which we now turn.

II. THE INTENT-OF-SUBCHAPTER-K ANTIABUSE REGULATIONS

The regulations' most general and most elaborate antiabuse provision asserts that subchapter K and the regulations under that subchapter "must be applied in a manner that is consistent with the intent of subchapter K."[20] This "intent"[21] is said to be "to permit taxpayers to conduct joint business (including investment) activities through a flexible eco-

18. I do not mean "actually knew." It seems reasonably likely that those who drafted § 1377(a)(1) forgot that any capital gain allocated to the selling shareholder would not actually be taxed to that shareholder (or to anyone else) because of the basis increase that results from the allocation. My students often overlook this, and the people who draft tax legislation are no smarter than my students. I am following the convention of assuming that the drafters of legislation knew what the results of that legislation would be except for cases in which the results are so absurd that no reasonable legislator could have intended them. Section 1377(a)(1) is not one of those "no reasonable legislator could have meant this" provisions, as a certain amount of imprecision in exchange for simplicity is a routine legislative tradeoff.

19. Described in note 17, *supra*.

20. Treas. Reg. § 1.701-2(b).

21. "Purpose" would probably have been a better word. No one doubts that statutes are enacted to achieve some purpose, while references to "intent" may invite speculations about the mental states of legislators, almost none of whom have even read the legislation

nomic arrangement without incurring an entity-level tax."[22] These intent-of-subchapter-K rules provide several pages of general principles, including a list of factors to be applied in deciding whether a particular transaction constitutes an abuse of subchapter K, followed by eleven examples.

A. The Intent of Subchapter K: General Principles

In one important respect, the intent-of-subchapter-K antiabuse regulations get it right: a transaction that tries to use a statutory (or regulatory) provision to achieve a goal that no sensible legislator would have approved of is abusive. If the notion of "abuse" means anything, it is this. Unfortunately, the regulations follow this perfectly sensible, if vague, observation with a string of cliches about "business purpose,"[23] "substance over form,"[24] and "clear reflection of income."[25] As noted earlier, "abuse" is a notion quite distinct from matters like business purpose and clear reflection of income. By invoking the latter concepts, the regulations can cause readers[26] to miss their main point.

Determining whether a transaction is abusive depends on "all of the facts and circumstances," according to the regulations.[27] "All facts and

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they have enacted, let alone thought enough about it to have formed an "intent" about how particular cases should be resolved.

22. Treas. Reg. § 1.701-2(a).

23. Treas. Reg. § 1.701-2(a)(1) ("The partnership must be bona fide and each partnership transaction or series of related transactions . . . must be entered into for a substantial business purpose").

24. Treas. Reg. § 1.701-2(a)(2) ("The form of each partnership transaction must be respected under substance over form principles").

25. Treas. Reg. § 1.701-2(a)(3) ("[T]he tax consequences to each partner . . . must accurately reflect the . . . partner's income"). The accurate-reflection-of-income requirement is followed by the useful observation that accurate reflection of income is not always required when a rule is adopted for administrative convenience, despite the distortion that inevitably accompanies simplification for the sake of convenience.

26. Including me. *See* Alan Gunn, Partnership Income Taxation 12 (3d ed. 1999) (observing that the antiabuse regulations "serve as reminders of basic tax principles [such as] . . . substance over form").

27. Treas. Reg. § 1.701-2(c). Rather than simply saying that the "facts and circumstances" test is used to determine whether a transaction is abusive, this provision says it is to be used to determine "[w]hether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K." This, it seems to me, amounts to much the same thing, stated more awkwardly and at greater length. It hardly seems necessary to point out that "abusive" transactions must reduce taxes substantially. The requirement that an abusive transaction have been entered into for a tax-reduction purpose is unwise; as commentators have noted, a bad result that a taxpayer stumbles into accidentally is just as undesirable as one that the taxpayer tried to achieve. *See* George K. Yin & David J. Shakow, American Law Institute, Federal Income Tax Project: Taxation of Business Enterprises, Reporters' Study 91 (1999) ("If the partnership tax rules somehow permit outcomes that the Treasury considers inappropriate, the solution should be to fix the rule rather than simply to prejudice those taxpayers who take advantage of the rule with the wrong mind-set"). Furthermore, defining abusive transactions as those entered into for tax avoidance creates a risk that a taxpayer's invocation of a non-tax purpose for a deal may shield undesirable outcomes from challenge: any competent tax adviser can think of a non-tax purpose for just about anything. (In the notorious *Brown Group* case, which was just the sort of thing that a sensible antiabuse rule would target, the Tax Court found a business purpose for the critical steps in the transaction. Brown Group,

circumstances" tests cannot be taken seriously: surely, for instance, the "fact" that a party to the transaction was born in April, or July, or was tall, short, fat, thin, or a football fan, would seldom be useful in assessing the transaction's tax consequences. After stating the "facts and circumstances" test, the regulations list seven factors that "may be indicative" of abuse. Tests based on lists of factors give little useful guidance, as in any real-world case, some factors will be present and others will be absent. In this case, the list of factors seems even less useful than those lists normally are, as the regulations tell us that the weight to be given any factor "depends on all the facts and circumstances" and that other, unstated, factors may also be taken into account: the listed factors are "illustrative only."[28] This kind of drafting comes perilously close to creating a "rule" that says nothing at all.

Despite their shortcomings, principles set out in the intent-of-subchapter-K regulations do give some useful hints about problems that should be dealt with (though in some cases by distinguishing "form" from "substance" rather than by calling them "abusive" in the sense that they could not be consistent with any purpose sensibly attributable to subchapter K). Perhaps someday a revision of these regulations will give us something sufficiently rule-like to be applied in a principled, consistent way. Consider, for instance, the regulations' sixth factor:

> The benefits and burdens of ownership of property nominally contributed to a partnership are in substantial part retained (directly or indirectly) by the contributing partner (or a related party).[29]

This factor recognizes that a formal transfer of ownership of property to a partnership may not necessarily be the same thing as a genuine transfer of the property. If the transferor remains the property's owner for all practical purposes, by continuing to enjoy that property's benefits and remaining subject to the risks that accompany its ownership, it makes sense to allow the government to treat the case as if the property had never been transferred. A rule to that effect would be quite desirable. What is objectionable about this particular "factor" is not its content, but its being part of a list of stated and unstated "factors" to be considered as relevant "facts and circumstances." Had the regulations presented this "factor" as a rule, no cogent objection to that rule could have been raised, and the rule might have been applied from time to time. But it is not a rule; it is only a "factor." So if, in some actual case, a partner seeks a tax benefit by purporting to transfer property to a partnership while retaining the substance of ownership, an attempt by the government to invoke the antiabuse regulations can be resisted by citing other factors (listed or oth-

Inc. v. Comm'r, 104 T.C. 105 (1995), *vacated*, 77 F.3d 217 (8th Cir. 1996)). Fortunately, the regulations' tax-avoidance-motive requirement is likely to do little harm, as tax avoidance need be only "a" principal purpose for the transaction, not "the" principal purpose. As no one ever engages in a high-stakes deal without structuring it to keep taxes as low as possible, "a" tax-reduction motive should be present in any case worth worrying about.

28. Treas. Reg. § 1.701-2(c).

29. Treas. Reg. § 1.701-2(c)(6).

erwise) not present in the case. Similar criticisms apply to several of the regulations' other factors.[30]

Only three of the regulations' seven listed factors aim directly at abuse, as distinct from "substance over form" or mere suspicion.[31] The first and probably most important factor calls for a comparison of the tax results under subchapter K with those that would have obtained had the partners owned the partnership's assets and conducted its activities directly.[32] An American Law Institute study once observed that, subject to the needs of administrative convenience, "the ideal mode for taxing partnership earnings is to tax each partner as though he were directly conducting his proportionate share of partnership business."[33] While there will be cases in which practical considerations make it impossible to achieve this goal, an interpretation of subchapter K that allows parties much more favorable tax results than they could have obtained as individuals should be avoided unless compelled by the language and purposes of the particular Code section in question. The regulations' fifth factor essentially repeats the first in the particular context of allocations of partnership income.[34] Finally, the second factor deals with those who become partners only temporarily and whose tax status enables the parties to achieve a particular tax benefit: subchapter K was meant to allow people to do business together without an entity-level tax, not to allow people to pretend to do business together so that one of them could benefit from the other's special tax status.[35]

Putting aside those portions of the intent-of-subchapter-K principles that deal with form and substance leaves us with very little: the regulations empower the Commissioner to restructure "abusive" transactions[36]

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30. The regulations' seventh factor resembles the sixth except that it deals with property coming out of a partnership rather than going in. It observes that the benefits and burdens of ownership of a partnership asset may be shifted to a distributee before an actual distribution occurs. As with the sixth factor, this should have generated a rule, not just a factor. The third factor, if expressed as a rule, would say that a person with no real interest in the partnership's activities, or with no interest other than the kind that a lender would have, need not be treated as a partner. Treas. Reg. §§ 1.701-2(c)(7); (3).

31. Treas. Reg. § 1.701-2(c)(4) makes substantially all of the partners' being related to each other a "factor." This is more an expression of a customary suspicion than a real aid in distinguishing abusive from non-abusive transactions. It is no doubt true that related parties will often be more willing than unrelated parties to make side deals that will cancel out the non-tax effects of a partnership transaction. Still, non-abusive arrangements among related taxpayers do not become abusive just because of the relationship, and abusive transactions among unrelated taxpayers are abusive despite the absence of a special relationship.

32. Treas. Reg. § 1.701-2(c)(1).

33. American Law Institute, Federal Income Tax Project, Subchapter K 5 (1984).

34. Treas. Reg. § 1.701-2(c)(5) ("Partnership items are allocated in compliance with the literal language of §§ 1.704-1 and 1.704-2 but with results that are inconsistent with the purpose of section 704(b) and those regulations"). Allocations of income to tax-exempt or foreign partners are particularly suspect.

35. Treas. Reg. § 1.701-2(c)(2).

36. Treas. Reg. § 1.701-2(b) allows the Commissioner to do anything to change the tax treatment of an abusive transaction. This section of the regulations begins by listing a number of specific measures the Commissioner may take: disregarding the partnership, treat-

and define abusive transactions in a general sort of way. This is better than nothing,[37] and perhaps it is as much as one could expect of general rules. Let us now turn to the regulations' eleven examples to see how the regulations are to be applied in practice.

B. The Intent of Subchapter K: Examples

The standard and quite widespread objection to the antiabuse regulations maintains that those regulations are "subjective," "arbitrary," and "inconsistent," and that they generate excessive "uncertainty," making tax planning difficult and undermining "the ability to make personal and business decisions knowing the tax effect of those decisions."[38] A survey of the intent-of-subchapter-K regulations' eleven examples casts great doubt on the validity of this concern. Eight of the examples conclude that the transaction in question is not abusive; these eight examples include several in which taxpayers structure transactions in order to obtain significant tax benefits, without good business reasons for doing so. Persons doing business together may use partnerships to avoid the entity-level tax that would apply to their incomes if they incorporated,[39] to avoid the limit that subchapter S imposes upon the number of shareholders,[40] to qualify for the direct foreign tax credit, rather than the indirect credit,[41] and to avoid the recognition of gain that would occur under § 351(e) or § 357(c) if property had been transferred to a corporation.[42] They may use a partnership to allocate a portion of dividend income to a corporate partner while maintaining that income's character as a dividend, qualifying for the corporate dividends-received deduction,[43] and they may allocate depreciation deductions and the low-income housing credit to high-bracket partners.[44] In structuring a liquidating distribution, a partnership may choose assets so as to take advantage of the fact that it has not made a § 754 election, increasing the basis of the distributed as-

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ing partnership assets or activities as being owned or carried on by persons who are not partners, and so on. It then concludes by saying, "[t]he claimed tax treatment [may] otherwise be adjusted or modified." This last provision seems to make irrelevant the Commissioner's ability or inability to achieve a correct result under any of the methods that are specifically described. Compare Treas. Reg. § 1.702-1(a)(8)(ii), which requires separate statement of any item of partnership income or deduction if separate statement matters. This provision follows a list of items that must be separately stated, and it makes the list irrelevant.

37. A similar rule for subchapter S would allow the government to tax *I* in the transaction involving the use of an S corporation to avoid tax on the sale of IBM stock described at pages 161-163 above.

38. All quotes are from letters described in Thompson, *supra* note 6, at 1397-98, discussing the opposition to the issuance of the regulations. *See also* 1 William S. McKee, et al., Federal Taxation of Partnerships and Partners ¶ 1.05[a] (3d ed. 1997), arguing that tax planning requires mechanical rules.

39. Treas. Reg. § 1.701-2(d) (ex. 1).

40. Treas. Reg. § 1.701-2(d) (ex. 2).

41. Treas. Reg. § 1.701-2(d) (ex. 3).

42. Treas. Reg. § 1.701-2(d) (ex. 4).

43. Treas. Reg. § 1.701-2(d) (ex. 5).

44. Treas. Reg. § 1.701-2(d) (ex. 6).

sets with no offsetting tax cost to anyone,[45] or to shift basis from non-depreciable to depreciable property under the former version of § 732.[46] These examples make clear that routine tax planning for partnerships that engage in genuine ongoing business transactions is alive and well, even when that tax planning generates very favorable results.[47]

In all three of the examples invalidating a transaction as abusive, one member of the partnership becomes a partner only temporarily. The first example involves a stripping transaction, in which the partnership buys an asset, sells the income stream from that asset, allocates the income from that sale to its foreign partner, who pays no tax on the income, and then liquidates the foreign partner's interest.[48] This leaves the remaining partners with a high-basis asset of little value. The partnership, having in the meantime purchased real estate, then sells the stripped asset, recognizing a loss. The example concludes, quite sensibly, that the transaction is abusive (and, in addition, violates "substance over form" principles). The essence of the deal is the purchase and disposition of an asset by (mostly) the foreign partner, with the asset's basis being used entirely by the domestic partners. The second example concerns a partnership that owns land that a non-partner, X, wants to buy.[49] Instead of simply selling the land to X, the partnership makes X a partner and shortly afterwards liquidates X's interest, distributing the land and another "insignificant" asset. The total basis of the assets X gets is X's basis for his partnership interest, and under the basis-allocation rules of former § 732, this basis was allocated equally between the two distributed assets, as each of them had the same basis in the partnership's hands. This enables X to sell the insignificant asset for its (low) value and recognize a loss. In addition to invalidating the transaction as abusive, the example notes that it would be vulnerable to attack under the disguised-sale rules of § 707.

The regulations' final example of an abuse amounts, in essence, to the sale of a tract of depreciated land by A to B. Instead of simply selling the land, A contributes it to a partnership, the other members of which are related to A. The partnership then leases the land to B with an option to buy, and liquidates A's interest with investment property, which it bought with the money contributed by A's relatives. A takes as his basis for this asset the basis of the land he contributed to the partnership and then sells that asset, recognizing a loss. The partnership, which does not make a § 754 election, still has a high basis for the land, which it sells to B, recognizing a loss. In substance, the high basis for the land that A purportedly contributed to the partnership is used twice: once by A (on the sale of the investment asset) and again by A's relatives, when the partnership

45. Treas. Reg. § 1.701-2(d) (ex. 9).
46. Treas. Reg. § 1.701-2(d) (ex. 10).
47. Examples 9 and 10 note that the transactions in question distort the partners' incomes; they allow the distortions as the inevitable results of provisions adopted for administrative convenience.
48. Treas. Reg. § 1.701-2(d) (ex. 7).
49. Treas. Reg. § 1.701-2(d) (ex. 11).

sells the land. This sort of double use of basis is countenanced by § 734 when the partnership has not made a § 754 election. When it occurs in connection with the disposition of assets that a partnership has actually used in its business, the distortion is accepted as the price to be paid for the administrative convenience of avoiding complex basis-adjustment calculations.[50] In this case, however, the parties have gone out of their way to pass the land through a partnership while it was on its way from A to B, in order to obtain the distortion. If this is not an abuse, nothing is.

The regulations' three examples of abuses present nothing that endangers ordinary tax planning. They involve temporary partners and the temporary holding of property by a partnership. Taxpayers contemplating conducting ordinary business affairs through a partnership have nothing to fear from the intent-of-subchapter-K regulations.

III. THE ABUSE-OF-ENTITY REGULATIONS

As noted earlier, the intent-of-subchapter-K regulations offer a useful concept of "abuse" but confuse the issue by also dealing with substance-over-form, business purpose, and other anti-avoidance principles. Turning to the regulations dealing with abuse of the entity treatment, which partnerships sometimes receive, we find a very different picture. The abuse-of-entity regulations do not really deal with abusive transactions: they cover cases in which a choice must be made between treating a partnership as an entity and treating it as an aggregate. This is not a problem of abuse, it is a problem of selecting the appropriate rule.

The abuse-of-entity regulations set out their substantive principles in two short sentences.[51] The first says, "[t]he 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 the regulations. . . ." The second provides that a partnership is not to be treated as an aggregate if a Code section or regulation provides for treatment of a partnership as an entity and if the tax results of entity treatment are clearly contemplated by the provision in question. These "rules" come close to saying that a partnership is to be treated as an aggregate of its partners unless entity treatment is better in a particular

50. Treas. Reg. § 1.701-2(d) (ex. 9).

51. Treas. Reg. § 1.701-2(e). The proposed antiabuse regulations dealt with the aggregate/entity problem only by saying, in their list of ways in which the Commissioner can recast abusive transactions, "the Commissioner can determine that . . . [t]he partnership and its partners should be respected but the partners should be treated as owning their respective shares of partnership assets directly (applying the aggregate concept of partnership taxation)." Prop. Treas. Reg. § 1.701-2(a), 59 Fed. Reg. 25581 (1994). The proposed regulations gave no examples applying this provision. The intent-of-subchapter-K portion of the final antiabuse regulations continues to allow the Commissioner to treat partnership assets as owned by a partner or partners, although the reference to "the aggregate concept of partnership taxation" has been deleted. Treas. Reg. §1.701-2(b). Apparently, the reference to partner ownership in the intent-of-subchapter-K rules is meant to cover cases in which a particular asset has not really been contributed to a partnership. *See* Treas. Reg. § 1.701-2(c)(6).

case, a principle that makes perfect sense but which contains no useful information about how one tells whether a particular situation calls for entity or aggregate treatment.[52]

After briefly stating their general rule, the abuse-of-entity regulations provide three examples, none of which should be controversial. (Although the intent-of-subchapter K rules have come in for withering criticism, the abuse-of entity regulations have been ignored by most of the critics.) The first example[53] concerns a partnership with only corporate partners. The partnership issues a high-yield discount obligation, the interest on which would be limited by §163(e)(5) if it had been issued by a corporation. The example finds the interest on the obligation subject to § 163(e)(5), as if it had been issued directly by the corporate partners themselves. In the second example,[54] a partnership which has some corporate partners buys stock and, six months later, receives an extraordinary dividend (in the § 1059(a) sense). Because § 1059(a) was designed to "limit the benefits of the dividends received deduction with respect to extraordinary dividends" by reducing the basis of the stock in question by the untaxed portion of the dividend, each partner is treated as owning a portion of the stock and the stock attributed to the corporate partners will have its basis reduced under § 1059(a). It is hard to imagine anyone seriously challenging the results of either of these examples.

The regulations' third and final example[55] also reaches a defensible result, though its reasoning is not entirely persuasive. The partnership in this example owns all the stock of a foreign corporation. The foreign corporation will be a controlled foreign corporation ("CFC") if the partnership is a "United States shareholder" as defined in § 951(b), which says that a "United States shareholder" is a "United States person" who owns 10 percent or more of a foreign corporation's stock. Sections 957(c) and 7701(a)(30) expressly make a domestic partnership a "United States person" for purposes of determining who is a "United States shareholder," and the example concludes that the foreign corporation is a CFC, enabling the partnership's domestic corporate partner to claim foreign tax credits. Had the example simply cited the relevant statutory language, which calls for entity treatment of a domestic partnership in language as clear as one can imagine, it would hardly be worth mentioning. Unfortunately, after presenting the relevant statutory provisions, the example adds that its "analysis confirms that Congress clearly contemplated that taxpayers could use a bona fide domestic partnership to subject themselves to the CFC regime." No legislative history or policy

52. A literal reading of Treas. Reg. § 1.701-2(e) would mean that the Commissioner may always treat a partnership as an aggregate if no Code provision or regulation says otherwise, as one of the requirements for an exception to aggregate treatment is that a section of the Code or regulations call for entity treatment. It seems likely that this result was not intended.

53. Treas. Reg. § 1.701-2(f) (ex. 1).

54. Treas. Reg. § 1.701-2(f) (ex. 2).

55. Treas. Reg. § 1.701-2(f) (ex. 3).

concern is cited in support of this claim of what Congress "clearly contemplated." The example is sound, but not because it contains an "analysis" that has revealed Congressional thinking: it is sound because it follows the language of the Code to a result that is not absurd.

Regulatory guidance on when a partnership is an entity and when it is an aggregate in applying provisions outside of subchapter K has been needed for a long time, and the abuse-of-entity regulations supply some. Furthermore, the regulations' general approach of treating the partnership as an aggregate except in cases for which entity treatment is better suited has substantial scholarly support: it is the approach taken by the American Law Institute's 1984 study of subchapter K[56] and by commentators.[57] So a certain amount of gratitude to the Treasury for issuing these regulations is in order. But not much gratitude, because by drafting these regulations as antiabuse rules, rather than simply writing regulations to provide guidance on the aggregate/entity question, the Treasury has generated needless uncertainty and has left open questions that would almost certainly have been addressed by more-conventional rulemaking.

By treating the aggregate/entity problem as one of preventing "abuse," the Treasury can be seen as saying that aggregate treatment can apply only when it favors the Government.[58] In the first two examples, for instance, what is gained by saying that the Commissioner "can" treat the partnerships in question as aggregates? Nothing in either of the examples turns on traditional abuse-related considerations. But if the rule really is that the Commissioner "can" treat these partnerships as aggregates, it must follow as a matter of logic that the Commissioner could have chosen to treat them as entities if that would have benefitted the fisc: "can" implies choice. Nothing in the regulations (or anywhere else) justifies allowing the Commissioner this kind of discretion. Indeed, the examples themselves seem to say that they are reaching results that make sense in applying the provisions in question;[59] the problem of discretion arises

56. AMERICAN LAW INSTITUTE STUDY, *supra* note 33, at 523-32. The ALI favored treating the partnership as an aggregate except in cases in which entity treatment is required by a particular Code provision or would be desirable for reasons of administrative convenience, such as avoiding complexity, avoiding unpredictability, or avoiding having to answer unanswerable hypothetical questions (such as what the intention of a partner would have been if that partner had owned a particular asset directly).

57. *E.g.*, David J. Shakow, *How Now* Brown *K?*, 63 TAX NOTES 1761 (1994); Alfred D. Youngwood & Deborah B. Weiss, *Partners and Partnerships, Aggregate vs. Entity Outside of Subchapter K*, 48 TAX LAW. 39 (1994).

58. See Youngwood & Weiss, *supra* note 57, at 42, noting that the original proposed regulations "[did] not address inappropriate results from entity treatment that are unfavorable to taxpayers," and MCKEE, *supra* note 38, ¶1.05[1][b], observing that the regulations "give[ ] the entity-aggregate choice to the Commissioner, with no indication that this choice must be made consistently in applying a particular provision to different transactions or to different taxpayers."

59. Indeed, Treas. Reg. § 1.701-2(f) (ex. 1) says that its result holds "regardless of whether any party had a tax avoidance purpose in having [the partnership] issue the obligation." Treas. Reg. § 1.701-2(f) (ex. 2) also says that the partner's lack of a tax-avoidance motive does not matter, and it justifies its "aggregate" approach to partnerships in applying

only because the examples follow a "rule" expressed in terms of what the Commissioner can do, rather than of what the right rule should be.

Because they say that the Commissioner "can" sometimes correct an "abuse" by requiring aggregate treatment, the regulations could be read as creating the unhappy impression that the norm for dealing with partnerships under provisions outside of subchapter K is entity treatment. After all, unless there is a background rule prescribing entity treatment, it makes no sense to say that aggregate treatment is needed to prevent abuse: abuse of what? The very notion of "abuse" implies that there is an underlying rule that, if left unchecked, would produce a bad result. In a long series of rulings, the Service has consistently held that a partnership is treated as an aggregate when the character of an income item depends on the taxpayer's status—as a corporation, or as a CFC, for instance[60]—and the commentators agree.[61] Under this approach, the abuse-of-entity regulations' first two examples reach the right results because an aggregate approach makes sense in dealing with the issues in question, not because there is a general rule of entity treatment, which the taxpayers in those examples were abusing.

I do not mean to suggest that those who drafted the abuse-of-entity regulations actually thought that entity treatment was the norm for cases involving the taxpayer's status. The two examples calling for aggregate treatment (as opposed to the "rule") seem simply to reflect the Service's longstanding approach; they find that aggregate treatment provides sensible answers to the problems raised by the examples, not that aggregate treatment is required because the particular taxpayer was behaving badly. Antiabuse notions seem to have played no role in the resolution of any of the questions raised by the examples. But because those examples appear as part of an "antiabuse regulation," some risk arises that they will be read by courts as implying that a partnership is to be treated as an entity except in a few special cases. It would have been far better for the Treasury to have approached the problem of aggregate versus entity treatment by drafting guidance about when aggregate treatment is warranted and when it is not, without invoking the rhetoric of abuse.

Had the Treasury approached the aggregate versus entity issue on the merits, rather than as a problem of taxpayer abuse, it would probably have dealt with the subject more comprehensively than it actually did; one shortcoming of the abuse-of-entity regulations is that they leave unanswered questions that would naturally have been addressed by more-conventional regulations. Consider, for instance, the regulations' first example, involving a partnership that issued a high-yield discount obligation that would have been subject to §163(e)(5) if issued by the corporate

§ 1059(a) by citing the purpose of that section. Compare Rev. Rul. 87-51, 1987-1 C.B. 158, saying that the choice between an aggregate and an entity approach "depends upon which theory is more appropriate" for the Code section in question.

60. *See* Shakow, *supra* note 57, at 1763-64.

61. *See* American Law Institute Study, *supra* note 33; Shakow, *supra* note 57; Youngwood & Weiss, *supra* note 57.

partners themselves.[62] We know, from the example, that the obligation is treated as a corporate obligation under § 163(e)(5) if all of the partnership's partners are corporations. But what if the facts are slightly different? What if only one partner is a corporation, and the others are individuals? Is the obligation a corporate obligation with respect to the corporate partner's share of the interest and a non-corporate obligation with respect to the rest? And what if the partnership's makeup changes after the obligation has been issued: does the interest cease to be subject to § 163(e)(5) if, over a period of years, the corporate partners sell their interests to individuals? And, if so, what happens to the accrued interest that was nondeductible when the partners were corporations: can it now be deducted? It is all but inconceivable that questions like these would have been left unaddressed by regulations (either under § 701 or under § 163(i)(5), which authorizes regulations dealing with, among other things, issuance of high-yield discount obligations by issuers other than C corporations) that had been drafted to give sound substantive answers to aggregate/entity questions rather than to condemn misbehaving taxpayers. Furthermore, a regulations project that set out to address aggregate/entity questions comprehensively would surely have addressed more than three Code sections and would have supplied some general principles for resolving aggregate/entity issues.[63]

In the end, the main shortcoming of the abuse-of-entity regulations is this: they were premature. Before a rule can be abused, it must exist. The intent-of-subchapter-K antiabuse regulations make some sense as antiabuse rules because they deal with cases in which we know what the rules are, and the question is whether there are special cases in which those rules will not apply. The abuse-of-entity regulations are very different: they deal with problems on which the Code and regulations are largely silent. To the extent that there are underlying rules for entity and aggregate treatment—rules found mostly in the Service's rulings and the views of commentators—the regulations call not for departures from those rules but only for their application.

IV. CONCLUSION

The antiabuse regulations seem destined to play no part in the affairs of most partnerships. In an apparent response to the criticism that the regulations have attracted, the Service has established procedures seriously limiting the ability of revenue agents to apply them in audits.[64] Even without these procedural restrictions, the regulations' use of countless and sometimes unspecified "factors"[65] and their insistence that even

62. Treas. Reg. § 1.701-2(f) (ex. 1).
63. The 1984 ALI study, *supra* note 33, deals at length with the principles that should govern the choice between entity and aggregate treatment in specific cases.
64. Announcement 94-86, 1994-27 I.R.B. 124, requires agents who propose to apply the regulations to refer the matter to a specialist for permission to proceed.
65. *See supra* note 27.

their examples are not to control if "any facts or circumstances . . . not specifically set forth" differ from those of the examples[66] almost guarantee that the regulations will not be widely applied. And perhaps this very limited role for the antiabuse regulations was inevitable. The new regulations are an addition to a deeply unsatisfactory statutory and regulatory structure. Antiabuse rules, substance over form, and other "anti-avoidance" doctrines may be useful adjuncts to any statutory scheme, but they cannot be expected to transform the mess that subchapter K has become into a workable, fair, and efficient body of law: doing that will require rewriting the statute.[67] Nevertheless, the antiabuse regulations contain much that is valuable.

First, and perhaps most important in the long run, the regulations perform a useful service by setting forth the notion of abuse as something distinct in principle from substance-over-form and business purpose. Although, as I have noted earlier, the regulations tend at times to confuse these matters, they are actually quite distinct. The new regulations provide the first official recognition of "abuse" as something that should and can be prevented: earlier attempts at targeting abuses, such as § 269, have spoken of things like tax-avoidance purpose, making those attempts almost incomprehensible.[68] Defining abuse and identifying abuses in particular cases are far from easy. If they are ever to be done well, they will be done by people trying to do those very things, not by people looking for evil motives.

Furthermore, and notwithstanding the harsh criticism they have received from some practitioners, the antiabuse regulations offer useful guidance about transactions that are not abusive—in some ways, the regulations are quite pro-taxpayer. They remind us, for example, that even very favorable tax results, results that may seem too good to be true, are sometimes required by the language and purposes of particular statutory provisions.[69] In dealing with the effect of form on tax consequences, they display considerably more restraint than do some of the courts applying the "substance-over-form" doctrine:[70] the statute often makes form controlling; when it does, appeals to "substance" are idle.

66. Treas. Reg. § 1.701-2(f). What good is an example if changing "any fact" makes it inapplicable?

67. YIN & SHAKOW, *supra* note 27, offer a comprehensive proposal for reforming the taxation of business enterprises.

68. Legislating against transactions inspired by a desire to reduce taxes leads to absurdity. If taken literally, it would mean that tax planning would never succeed; who would want that? Some tax-motivated transactions are perfectly legitimate, while others are not; a rule purporting to strike down all tax-motivated transactions cannot be taken seriously. *See generally* Alan Gunn, *Tax Avoidance*, 76 MICH. L. REV. 733 (1978).

69. For instance, failure to make a § 754 election before distribution of partnership assets can create serious distortions, and it could hardly be expected that partners would not consider whether the distortions would favor or disfavor them in deciding whether to make the election. Treas. Reg. § 1.701-2(d) (ex. 9) recognizes this and accepts the inevitable conclusion that the distortion must be tolerated.

70. See Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859 (1982), presenting many examples.

Finally, and tentatively, let me suggest that the antiabuse regulations may signal an improvement in the way in which regulations under subchapter K are drafted. The earliest partnership tax regulations were superb examples of how regulations should be written. They clarified statutory uncertainties, spelled out fundamental principles, and presented useful examples, without trying to resolve every possible problem that might arise.[71] This was an impressive achievement, especially as subchapter K was then new, and those who drafted the regulations had no experience of how the statute was working in practice. More recently, however, partnership tax regulations have attempted (without much success) to subject the transactions to which they apply to mechanical rules, designed to provide answers to all possible questions without reference to basic policies. To do this, the regulations have sometimes abandoned inquiries into things that actually matter to the parties and have instead ordered that tax consequences turn on what would have happened if particular imaginary events, quite unlikely to occur, had taken place. So today, according to the regulations, allocations of partnership income can depend on how transactions affect partners' capital accounts, even in cases where it is plain that those capital accounts have little meaning to the partners,[72] and partnership liabilities may be allocated among the partners according to what would happen if all of a partnership's assets (including cash) were to become worthless.[73] These regulations are extremely long and detailed, complex to the point of near incomprehensibility, and yet remarkably spotty, offering virtually no guidance about day-to-day matters. They seem to have been drafted by people who gave very little thought to what the basic principles should be and then devoted

71. The original regulations under § 704(b), for example, created the "substantial economic effect" idea for evaluating the validity of partnership allocations, gave several useful examples, and prudently refrained from trying to answer all questions that could arise. *See* Former Treas. Reg. § 1.704-1(b), T.D. 6175, 1956-1 C.B. 211, 220. The regulations under § 736 do much to make comprehensible a Code section that is almost impossible to read, and they fill a statutory gap by providing that an "unrealized receivable" that has a basis is not to be treated as an unrealized receivable for purposes of § 736. The regulations under § 751(b) make a valiant attempt to apply a statute that is inherently too complex for real-world use.

72. *See* Treas. Reg. § 1.704-1(b). The plainest example of an incorrect allocation required by the regulations' insistence that tax consequences turn on hypothetical transactions may be the allocation of deductions that would reduce to less than zero the capital account balance of a partner not required to pay in a deficit balance on liquidation of the partnership. According to the regulations creating the "alternate test" for substantial economic effect, the deductions must be allocated to the partners who would bear the related economic losses if the partnership were to sell its assets for book value and liquidate immediately—even if, in a particular case, those partners bear virtually no risk of actually bearing those losses. Treas. Reg. §§ 1.704-1(b)(3)(iii), 1.704-1(b)(5) (exs. (1)(iv), (1)(v), (1)(vi), 15(ii), 15(iii)). I have argued elsewhere that these provisions are invalid. *See* GUNN, *supra* note 26, at 63-64.

73. Treas. Reg. § 1.752-2(b). For criticisms, *see* Richard A. Epstein, *The Application of the* Crane *Doctrine to Limited Partnerships*, 45 SO. CAL. L. REV. 100 (1972); Glenn E. Coven, *Limiting Losses Attributable to Nonrecourse Debt: A Defense of the Traditional System Against the At-Risk Concept*, 74 CAL. L. REV. 41(1986); Stephen G. Utz, *Partnership Taxation in Transition: Of Form, Substance, and Economic Risk*, 43 TAX LAW. 693 (1990).

years of effort to spelling out, in appalling detail, the implementation of principles chosen almost by whim. For all of their flaws, the antiabuse regulations do not attempt to subject all transactions to arbitrary, mechanical rules, they do not attempt to deprive decisionmakers of judgment about what makes sense in particular cases, and they are mercifully brief. For that alone we can be grateful.