Case Western Reserve Law Review

Volume 60 | Issue 2 Article 6

2010

What's in a Name: Can the Partnership Anti-Abuse Rule Really Stop Partnership Tax Abuse ?

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WHAT'S IN A NAME: CAN THE PARTNERSHIP ANTI-ABUSE RULE REALLY STOP PARTNERSHIP TAX ABUSE?

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INTRODUCTION

Partnership taxation is a disaster. Subchapter K, which contains the rules governing the taxation of partners and partnerships,[1] suffers from flaws that have wrought havoc on the government's ability to tax one of our most rapidly increasing categories of business and investment entities.[2] Subchapter K's most longstanding affliction is its commitment to flexibility. Since subchapter K's enactment in 1954,[3] Congress has been steadfast in its desire that partnership tax be flexible, enabling partners to structure their ventures in whatever manner seems most sensible.[4]

But this grant of latitude in structuring partnerships is not without cost. Congress has struggled to reconcile this flexibility with subchapter K's other goals, such as equity. Subchapter K's flexibility has also led to abuse.[5] Taken together, these problems have triggered

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[1] *See* I.R.C. §§ 701–761 (2006). These rules govern all unincorporated entities with two or more members, including limited liability companies ("LLCs"), that elect to be treated as partnerships for federal income tax purposes. *See also* Treas. Reg. § 301.7701-3 (as amended in 2006).

[2] *See* Tim Wheeler & Nina Shumofsky, *Partnership Returns, 2005*, SOI BULL., Fall 2007, at 69, 70 fig.B, *available at* http://www.irs.gov/pub/irs-soi/05partnr.pdf. The number of partnerships grew by 8.5% in 2005, the most recent year for which partnership return information is available. *Id.* at 69. Indeed, the number of partnerships increased at an average annual rate of 5.7% between 1995 and 2005. *Id.* This increase was due in large measure to the explosive growth of LLCs. *See id.* at 75. For four consecutive years starting in 2002, LLCs grew more than all other entity types, increasing by 15.4% in 2005. *Id.* Indeed, since 1995, the number of LLCs has grown by more than 1100%. *Id.* (noting that 118,559 returns were filed by LLCs in 1995 versus 1,465,223 returns filed by LLCs in 2005); STAFF OF THE JOINT COMM. ON TAXATION, PUB. NO. JCX-48-08, TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF ENTITY 11 (2008), *available at* http://www.jct.gov/x-48-08.pdf.

[3] Internal Revenue Code of 1954, Pub. L. No. 83-591, 68 Stat. 730, 68A Stat. 3.

[4] *See* Jerome Kurtz, *The Limited Liability Company and the Future of Business Taxation: A Comment on Professor Berger's Plan*, 47 TAX L. REV. 815, 821–22 (1992) ("A partnership possesses the capacity to allow implementation, in rational ways, of the infinite imagination that entrepreneurs demonstrate in arranging their economic affairs.").

[5] *See* Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1, 1 (1990) ("The flexibility of subchapter K, one of its most celebrated features, has given partners license to shift income and loss among themselves and dispose of assets while deferring

another of subchapter K's afflictions—complexity. Over the years, Congress and the Treasury have added myriad technical provisions to subchapter K in an attempt to prevent abuse or promote equity. As a consequence, subchapter K requires taxpayers who wish to do business in the partnership form to navigate a grueling array of technical provisions.[6] And as the years pass, the level of complexity continues to worsen.

Subchapter K nonetheless remains appealing to many taxpayers because the enforcement resources dedicated to partnership taxation have been woefully insufficient.[7] Audit rates in subchapter K remain low, and the temptation to play the audit lottery remains high.[8] Thus,

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recognition of gain in ways that are not otherwise possible under the income tax." (footnote omitted)); *see also* Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 FLA. TAX REV. 249, 250 (1999) [hereinafter Lokken, *Future Without Subchapter K*] ("The flexibility of the original conduit model facilitated devices to shift income, deductions, and other tax attributes from partner to partner and from property to property in ways that Congress found unacceptable.").

6 *See* Foxman v. Comm'r, 41 T.C. 535, 551 n.9 (1964) ("The distressingly complex and confusing nature of the provisions of subchapter K present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field."); *see also* Lokken, *Future Without Subchapter K*, *supra* note 5, at 251 ("The cumulative result of all of this legislative and administrative activity is a system of such complexity that full compliance is only theoretically possible.").

7 *See* INTERNAL REVENUE SERV., FISCAL YEAR 2007 ENFORCEMENT AND SERVICE STATISTICS 4 (2008), http://www.irs.gov/pub/irs-news/2008_enforcement.pdf. In 2008, the Internal Revenue Service ("Service") examined 0.42% of all partnership returns (13,203 partnership returns examined out of 3,146,994 filed for the 2007 calendar year). *Id.* Since 1998, the Service has examined an average of 0.34% of all partnership returns annually. *Id.* In addition, with few exceptions, the percentage of partnership returns examined each year since 1998 has been lower than the percentage of any other type of income tax return. *See id.* The only exception was S corporation returns for the 2003 through 2005 fiscal years, but the difference was never larger than 0.07%. *See id.* (demonstrating that for 2003 through 2005, the Service examined 0.35%, 0.26% and 0.33%, respectively, of all partnership returns, and it examined 0.30%, 0.19% and 0.30%, respectively, of all S corporation returns); *see also* Lokken, *Future Without Subchapter K*, *supra* note 5, at 252 ("[M]any tax practitioners believe that very few IRS auditors of partnership returns understand enough of subchapter K to challenge partnership accounting for items subject to the more complicated aspects of subchapter K . . . . This perception diminishes taxpayers' incentives to try their best to comply in any but the largest of transactions."); David M. Schizer, *Enlisting the Tax Bar*, 59 TAX L. REV. 331, 335–36 (2006).

8 *See, e.g.*, Noël B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1, 26 n.123 (2004) ("[T]he audit lottery heavily favors taxpayers investing in tax shelters organized as partnerships because there is a low audit rate for partnerships. Many practitioners we spoke to in Boston and New York have *never* had a tax shelter partnership client audited by the Service other than family limited partnerships used in estate planning."); James S. Eustice, *Abusive Corporate Tax Shelters: Old "Brine" in New Bottles*, 55 TAX L. REV. 135, 161 (2002) ("The Service's shockingly low audit coverage makes the audit lottery an irresistible attraction; it is not even a lottery, but rather a virtually sure thing." (footnote omitted)); Lokken, *Future Without Subchapter K*, *supra* note 5, at 252; *see also* George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141, 174–201 (1999).

for taxpayers with enough sophistication or financial resources to exploit subchapter K's complexity, partnerships offer plentiful opportunities to engage in strategic behavior. Indeed, many taxpayers consider partnerships the perfect vehicle for tax shelter activity: the rules are flexible, but also technical, and the entity is less likely to be audited than its transactional counterparts.[9]

Thus, it is no surprise that partnerships played a central role in the most recent generation of tax shelters.[10] Enron, General Electric, Colgate-Palmolive, and many other corporations all used partnerships to structure abusive transactions during the last decade.[11] Although the government ultimately eliminated many of these specific abuses,[12]

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[9] This Article adopts the following definition of a tax shelter: an abusive transaction "is a transaction which is designed to technically comply with the letter of the law, but which produces tax savings that are inappropriate to the underlying purposes of the statutory scheme and inconsistent with the economic reality of the transaction." Cunningham & Repetti, *supra* note 8, at 20; Alan Gunn, *The Use and Misuse of Antiabuse Rules: Lessons from the Partnership Antiabuse Regulations*, 54 SMU L. REV. 159, 164 (2001). However, there is much disagreement in the literature regarding the definition of a tax shelter. "Corporate tax shelters 'appear in the guises of Proteus,' taking many different forms and utilizing many different structures. For this reason, a single, comprehensive definition of corporate tax shelters is difficult to formulate." DEP'T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS 11–12 (July 1999), http://www.ustreas.gov/offices/tax-policy/library/ctswhite.pdf (footnote omitted); *see also* Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775, 1776–77 (1999) [hereinafter Bankman, *New Market in Corporate Tax Shelters*]; Peter C. Canellos, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47, 52–55 (2001); Eustice, *supra* note 8, at 158–60; David P. Hariton, Essay, *Kafka and the Tax Shelter*, 57 TAX L. REV. 1 (2003); Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325, 328–32 (2002).

[10] *See* IRS.gov, Partnership – Audit Technique Guide – Chapter 9 – Tax Shelters – The Disclosure Regime, http://www.irs.gov/businesses/partnerships/article/0,,id=134698,00.html (last visited Mar. 8, 2010) ("In recent years, there has been a continuous growth of the use of partnerships in tax shelters."); *see also* Cunningham & Repetti, *supra* note 8, at 57–58 ("[S]ubchapter K was the vehicle of choice for abusive transactions that the Treasury was unable to address by adopting more rules.").

[11] *See, e.g.*, TIFD III-E, Inc. v. United States, 459 F.3d 220 (2d Cir. 2006) (General Electric); ACM P'ship v. Comm'r, 157 F.3d 231 (3d Cir. 1998) (Colgate-Palmolive); STAFF OF THE JOINT COMM. ON TAXATION, PUB. NO. JCS-3-03, REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS: VOLUME 1: REPORT 100–403 (2003), *available at* http://www.jct.gov/s-3-03-vol1.pdf (Enron); David Cay Johnston, *Tax Moves by Enron Said to Mystify the I.R.S.*, N.Y. TIMES, Feb. 13, 2003, at C1 (Enron). *See generally* DEP'T OF THE TREASURY, *supra* note 9, at 25–33; Janet Novack & Laura Saunders, *The Hustling of X Rated Shelters*, FORBES, Dec. 14, 1998, at 198.

[12] *See, e.g.*, Calvin H. Johnson & Lawrence Zelenak, *Codification of General Disallowance of Artificial Losses*, 122 TAX NOTES 1389 (2009); Pamela F. Olson, *Now That You've Caught the Bus, What Are You Going to Do With It? Observations from the Frontlines, the Sidelines, and Between the Lines, So To Speak*, 60 TAX LAW. 567, 567 (2007) [hereinafter Olson, *Observations from the Frontlines*]; Jeremiah Coder, *Korb Reflects on Long Tenure, Cites Recruiting and Litigation Successes*, TAX NOTES TODAY, Dec. 22, 2008, 2008 TNT 246-3 (LEXIS) (recounting the view of Donald Korb, outgoing I.R.S. Chief Counsel, that the Treasury has turned the corner on corporate tax shelters).

tax shelters remain a perennial problem of the federal income tax system, ebbing and flowing over the years with devastating effect.[13] Most immediately, the cost of tax shelters is borne by the public at large, with some estimates suggesting that corporations avoided paying federal income taxes of roughly $10 billion in 1999, and that such numbers grew dramatically thereafter.[14] The non-monetary costs of tax shelters are also destructive. Tax shelters create a perception that the federal income tax system rewards the wealthy, the well advised, and taxpayers who are sufficiently lucky or skilled to discover new tax-saving techniques.[15] In so doing, tax shelters undermine the foundational notion that similarly situated taxpayers should be treated similarly. And when the federal tax system's integrity is compromised, taxpayers are less likely to comply with its rules and are more likely to enter into abusive transactions.[16]

There exists a growing modern literature analyzing tax shelters and how to prevent future generations of abusive transactions. One strand focuses on enforcement and disclosure regimes.[17] Another examines

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[13] *See* Eustice, *supra* note 8, at 136 ("What has become increasingly clear to me, however, is that while aggressive corporate tax planning may be a serious problem, it is not a new one . . . .").

[14] *See, e.g.*, DEP'T OF THE TREASURY, *supra* note 9, at 31; Cunningham & Repetti, *supra* note 8, at 3; Novack & Saunders, *supra* note 11. The Government Accountability Office estimates that in 1998, the monetary loss from tax shelters was between $13.6 and $17.3 billion. *See* JANE G. GRAVELLE, ANTI-TAX-SHELTER AND OTHER REVENUE-RAISING TAX PROPOSALS CONSIDERED IN THE 108TH CONGRESS, CONGRESSIONAL RESEARCH SERVICE REPORT FOR CONGRESS 8 (2005), *available at* http://digital.library.unt.edu/govdocs/crs/permalink/meta-crs-6773. The same study estimates cumulative losses from tax shelters between 1989 and 2003 to be $85 billion. *Id.* Nonetheless, the true cost of tax shelters is difficult to quantify. *See, e.g.*, DEP'T OF THE TREASURY, *supra* note 9, at 31; Bankman, *New Market in Corporate Tax Shelters*, *supra* note 9, at 1776; Canellos, *supra* note 9, at 48; Cunningham & Repetti, *supra* note 8, at 3.

[15] *See* DEP'T OF THE TREASURY, *supra* note 9, at 3 ("Corporate tax shelters breed disrespect for the tax system—both by the people who participate in the tax shelter market and by others who perceive unfairness. A view that well-advised corporations can and do avoid their legal tax liabilities by engaging in these tax-engineered transactions may cause a 'race to the bottom.'"); Sheldon I. Banoff, *The Use and Misuse of Anti-Abuse Rules*, 48 TAX LAW. 827, 828–30 (1995) [hereinafter Banoff, *Use and Misuse of Anti-Abuse Rules*].

[16] *See* Margaret Milner Richardson, Comm'r, Internal Revenue Serv., Remarks at the ABA Tax Section Annual Meeting, *reprinted in Full Text: Richardson's Speech to ABA Tax Section Annual Meeting*, TAX NOTES TODAY, Aug. 6, 1994, 94 TNT 157–67 (LEXIS) [hereinafter Richardson Remarks] ("I am concerned that voluntary compliance with the tax law can be severely damaged by the perception that taxpayers with sophisticated advisors are able to creatively use the tax laws to their undue advantage. If some taxpayers can find ways to circumvent the law, then compliance will be seriously jeopardized."); Letter from Daniel Halperin, Georgetown Univ. Law Ctr., to Leslie B. Samuels, Assistant Sec'y (Tax Pol'y), Dep't of the Treasury (July 26, 1994), *reprinted in Halperin Expresses Support For Partnership Antiabuse Reg.*, TAX NOTES TODAY, July 26, 1994, 94 TNT 152-36 (LEXIS) [hereinafter Halperin Comments].

[17] *See, e.g.*, Joshua D. Blank, *Overcoming Overdisclosure: Toward Tax Shelter Detection*, 56 UCLA L. REV. 1629 (2009); Canellos, *supra* note 9; Ronald A. Pearlman, *Demystifying Disclosure: First Steps*, 55 TAX L. REV. 289 (2002); Alex Raskolnikov, *Revealing Choices:*

substantive law, particularly the various judicial doctrines applied in challenging tax shelter transactions.[18] Absent from the literature, however, is much discussion of subchapter K itself. Considering its unique standing as the preeminent breeding ground for tax shelters, one would expect a more spirited dialogue among scholars and practitioners about the relationship between subchapter K and tax shelters.

Perhaps the reason for this omission is a grim perception that subchapter K is beyond repair. From this viewpoint, there is only one question that really matters—should Congress kill subchapter K? Commentators have occasionally addressed this question,[19] but Congress is not yet prepared to consider subchapter K's fate. Thus, fundamental reform of partnership taxation is unlikely to happen anytime soon.

With the most pressing question about subchapter K indefinitely tabled, we must consider second-best alternatives that might prevent the tax shelters that have become endemic to partnership taxation. This Article suggests that Treasury regulation section 1.701-2, commonly referred to as the partnership anti-abuse rule ("PAAR"),[20] may provide subchapter K with the support it so desperately requires. The PAAR, in basic terms, authorizes the Internal Revenue Service ("Service") to recast a partnership transaction if the transaction has a principal purpose of substantially reducing the partners' federal income tax liability in a manner inconsistent with the intent of subchapter K.[21] The PAAR's goal is simple—to remind taxpayers that the literal language of subchapter K cannot be manipulated to generate results contrary to the legislative intent underlying

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Using Taxpayer Choice to Target Tax Enforcement, 109 COLUM. L. REV. 689 (2009); David A. Weisbach, *The Failure of Disclosure as an Approach to Shelters*, 54 SMU L. REV. 73 (2001) [hereinafter Weisbach, *Failure of Disclosure*].

18 *See, e.g.*, Marvin A. Chirelstein & Lawrence A. Zelenak, Essay, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939 (2005) [hereinafter Chirelstein & Zelenak, *Search for a Silver Bullet*]; Johnson & Zelenak, *supra* note 12; Leandra Lederman, *W(h)ither Economic Substance?*, 95 IOWA L. REV. (forthcoming 2010).

19 *See* GEORGE K. YIN & DAVID J. SHAKOW, AM. LAW INST., FEDERAL INCOME TAX PROJECT: TAXATION OF PRIVATE BUSINESS ENTERPRISES REPORTERS' STUDY 73–76, 80 (Am. Law Inst. Draft 1999) [hereinafter, ALI, 1999 REPORTERS' STUDY]; *see also* Curtis J. Berger, *W(h)ither Partnership Taxation?*, 47 TAX L. REV. 105, 108 (1991); Gunn, *supra* note 9, at 174; Jeffrey L. Kwall, *Taxing Private Enterprise in the New Millennium*, 51 TAX LAW. 229, 238 (1998); Lokken, *Future Without Subchapter K*, *supra* note 5, at 285; Philip F. Postlewaite, *I Come to Bury Subchapter K, Not to Praise It*, 54 TAX LAW. 451, 462 (2001); Yin, *supra* note 8, at 165.

20 Treas. Reg. § 1.701-2 (as amended in 1995).

21 *Id.* § 1.701-2(b). The PAAR also includes a second anti-abuse rule, referred to as the "abuse of entity rule." *See id.* § 1.701-2(e). For discussion of the abuse of entity rule, see *infra* note 113.

subchapter K. To many observers, the PAAR seemed self-evident, but the Treasury feared that subchapter K's unique combination of flexibility, complexity, and low enforcement caused some taxpayers to believe that partnerships were special and, thus, not subject to the tax system's first principles.[22]

The PAAR's short history is as colorful and intriguing as any soap opera.[23] The Treasury proposed the PAAR in 1994,[24] and practitioners responded venomously, displaying a level of anger and outrage rarely seen in the tax world.[25] In response, the Treasury significantly reworked the PAAR before its final issuance six months later.[26]

To this day, the PAAR remains controversial, drawing visceral reactions from scholars and practitioners alike.[27] But the passion stirred by the PAAR is remarkably puzzling because the regulation has had virtually no impact on subchapter K. Indeed, the PAAR is a complete failure. Practitioners, the Service, and the courts regularly disregard the regulation when structuring and analyzing transactions. And despite the PAAR's prohibitions, a new generation of tax shelters has proliferated at exorbitant public cost.[28]

The PAAR might thus seem like an improbable candidate to sustain subchapter K until Congress considers fundamental reform of the partnership tax rules. Yet that is precisely what this Article suggests. Specifically, the Treasury should revise the PAAR and return the regulation to its roots as a broad anti-abuse rule. In doing so, the Treasury would finally free the regulation to combat the abusive partnership transactions that justified its issuance sixteen

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22 *See* Prop. Treas. Reg. § 1.701-2, 59 Fed. Reg. 25,581, 25,582 (May 17, 1994). In her inimitable style, Lee Sheppard described this form of "partnership tax exceptionalism" as follows: "A partnership is a magic circle. Anything that is dropped into it becomes exempt from taxation. Forever .... Adherents to this view of subchapter K understand the word 'flexible' to mean that you can do absolutely anything you want without incurring tax." Lee A. Sheppard, *Partnerships, Consolidated Returns and Cognitive Dissonance*, 63 TAX NOTES 936, 936 (1994) [hereinafter Sheppard, *Cognitive Dissonance*].

23 *Cf.* Lawrence Lokken, *As the World of Partnership Taxation Turns*, 56 SMU L. REV. 365, 365–66 (2003) [hereinafter Lokken, *As the Partnership World Turns*].

24 Prop. Treas. Reg. § 1.701-2, 59 Fed. Reg. 25,581.

25 *See infra* Part I.B.2.

26 *See infra* Part I.C.

27 *See, e.g.*, Shop Talk, *Misuse of the Partnership Anti-Abuse Rule: New ILM Lacks Reasoned Analysis*, 104 J. TAX'N 376 (2006) [hereinafter Shop Talk, *Misuse of Partnership Anti-Abuse Rule*] (discussing the IRS's increasingly liberal application of the final PAAR); Shop Talk, *Partnership Anti-Abuse Rules: Agents Will Apply, Courts May Deny*, 106 J. TAX'N 314 (2007) [hereinafter Shop Talk, *Agents Will Apply, Courts May Deny*] (noting the uncertainty surrounding the final PAAR's validity); Lee A. Sheppard, *Government Officials Discuss Partnership, Shelter Issues*, TAX NOTES TODAY, June 4, 2007, 2007 TNT 107-1 (LEXIS) (analyzing the final PAAR's structural defects and practitioners' dissatisfaction with the regulation).

28 *See infra* Part I.E.

years ago. Likewise, there is little downside to revitalizing the PAAR. At a minimum, revising the regulation would send an important signal regarding the Treasury's and the Service's continued commitment to preventing abuse in subchapter K.

Part I provides a uniquely comprehensive history of the PAAR, tracing its journey from proposed regulation to final regulation to failed regulation. The dynamic relationship between the Treasury and practitioners shaped the PAAR's story, and this part highlights the interplay of these two oppositional forces. Part II explores the causes of the PAAR's distinctive failure and what lessons may be learned. Although numerous factors contributed to the PAAR's failure, the period between the regulation's proposal and finalization was transformative, corrupting the PAAR beyond repair. Correcting the mistakes of that six-month period is the subject of Part III, which sketches the path to a better PAAR and, in turn, a better subchapter K. Part III suggests that the Treasury streamline the PAAR, thus liberating the regulation to effectively challenge abusive partnership transactions. Part III concludes by examining several objections to revising the PAAR, ultimately finding that such objections are premature and factually uncertain. What is certain, however, is subchapter K's pressing crisis and the final PAAR's inability to prevent the proliferation of tax shelters. It seems very possible, if not likely, that revising the PAAR could be part of the solution.

I. HISTORY OF THE PARTNERSHIP ANTI-ABUSE RULE

The PAAR is unique in the federal income tax system, confounding its proponents and opponents alike. The Treasury proposed the regulation in hopes of halting the proliferation of abusive partnership transactions.[29] Practitioners responded with unprecedented venom, and argued that the Treasury should withdraw the regulation.[30] But they failed in this campaign against the PAAR; the Treasury issued the final regulation six months later.[31] Still, these practitioners set in motion a chain of events that ultimately led to the PAAR's demise. Most importantly, the firestorm surrounding the PAAR's proposal led the Treasury to make numerous changes to the regulation that are reflected in its final form. These changes were not for the better, shackling the PAAR and severely limiting its efficacy. The PAAR failed, as the regulation has had very little impact on subchapter K or the spread of tax shelters.

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[29] *See* Prop. Treas. Reg. § 1.701-2, 59 Fed. Reg. 25,581.

[30] *See infra* Part I.B.2.

[31] T.D. 8588, 1995-1 C.B. 109.

A. The Problem

Tax shelters are an obvious and serious problem for the federal income tax system. So long as the law requires taxpayers to share their annual income with the federal government, taxpayers will look for means to reduce this obligation. Because of subchapter K's unique dysfunction, it is a fertile ground for tax shelter transactions. Subchapter K prizes flexibility,[32] and its provisions offer taxpayers great latitude in structuring their ventures to achieve various goals, including tax reduction. Coupled with such flexibility is complexity. Subchapter K includes a formidable patchwork of technical provisions responding to abuses and inequities caused by the regime's commitment to flexibility. To make matters worse, the enforcement resources dedicated to subchapter K are insufficient.[33] Audit rates are low and detection rates are even lower due to complexity, layering, and taxpayer concealment strategies.[34] Taken together, these flaws create a playground for those who engage in transactions that comply with subchapter K's literal language, yet result in tax consequences that Congress did not contemplate.[35]

By the early 1990s, it was evident that the Treasury's traditional arsenal of anti-tax shelter weapons—judicial doctrines, administrative guidance, regulations, and statutory provisions—had not stemmed the tide of abusive partnership transactions.[36] For example, the Service often challenged abusive transactions based on various judicial doctrines, which serve as overlays to the literal language of the Code and regulations. These doctrines require, inter alia, that transactions have economic substance[37] and a business purpose apart from tax savings.[38]

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32 *See supra* notes 4–5 and accompanying text.

33 *See supra* note 7 and accompanying text; *see also* N.Y. State Bar Ass'n Tax Section, Report on the Proposed Partnership Anti-Abuse Rule, *reprinted in NYBSA Submits Report on Partnership Anti-Abuse Regulation*, TAX NOTES TODAY, July 1, 1994, 94 TNT 130-34 (LEXIS) [hereinafter NYSBA Report].

34 *See* NYSBA Report, *supra* note 33 ("There is a low audit rate in the partnership area, and agents often are inexperienced in sophisticated partnership tax matters."); *see also* Cunningham & Repetti, *supra* note 8, at 26 n.123; Lokken, *Future Without Subchapter K*, *supra* note 5, at 252.

35 Prop. Treas. Reg. § 1.701-2, 59 Fed. Reg. at 25,582; *see also* Cunningham & Repetti, *supra* note 8, at 2; Lokken, *As the Partnership World Turns*, *supra* note 23, at 366.

36 Indeed, at the ABA Tax Section Annual Meeting in August 1994, Margaret Milner Richardson, then Commissioner of the Service, made the following observation: "Wall Street bankers regularly market partnership tax plays, rumors of clever transactions abound, and entire seminar presentations focus on strategies for 'running amok' in the area. Apparently for some, partnerships have become the tax shelters of the '90s." Richardson Remarks, *supra* note 16.

37 *See* Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935); *see also* Frank Lyon Co. v. United States, 435 U.S. 561 (1978). In basic terms, the economic substance doctrine provides that a transaction will not be respected if it fails to result in a

The Service's application of these general tax doctrines to contexts involving subchapter K, however, was problematic. Each judicial doctrine required intensive analysis of a transaction's facts and circumstances, and there was scant authority applying these doctrines to partnership transactions.[39] From the Service's perspective, litigating a partnership transaction involved the risk that a court would be unwilling to extend the relevant judicial doctrine into a context as technical and complex as partnership taxation, particularly when the transaction was structured in literal compliance with subchapter K. Under such circumstances, the Service was overly hesitant to litigate partnership tax shelters, opting instead for the greater certainty of a settlement.[40] But the failure to develop

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meaningful change in the taxpayer's economic position apart from federal income tax consequences. *See* Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 21 (2000); David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235, 235 (1999). Different courts have interpreted the economic substance doctrine differently. *Compare, e.g.*, United Parcel Serv. of America, Inc. v. Comm'r, 254 F.3d 1014, 1018 (11th Cir. 2001) ("This economic substance doctrine, also called the sham-transaction doctrine, provides that a transaction ceases to merit tax respect when it has 'no economic effects other than the creation of tax benefits.' Even if the transaction has economic effects, it must be disregarded if it has no business purposes and its motive is tax avoidance." (footnote omitted)), *with* ACM P'ship v. Comm'r, 157 F.3d 231, 247 (3d Cir. 1998) ("[T]hese distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes."), *and* Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 91 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists."). For a more detailed discussion of the economic substance doctrine, see BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 4.3.4A (3d ed. 1999 & Supp. III 2004) [hereinafter BITTKER & LOKKEN, FEDERAL INCOME TAXATION].

[38] The business purpose doctrine requires that, to be respected, a transaction have a business purpose other than tax avoidance. *See Gregory*, 69 F.2d at 810–11. For a more detailed discussion of the business purpose doctrine, see BITTKER & LOKKEN, FEDERAL INCOME TAXATION, *supra* note 37, at ¶ 4.3.4.

[39] *See* NYSBA Report, *supra* note 33 ("The common law authority is very general in nature, and there is little case law involving the application of such doctrines in the partnership context. As a result, a taxpayer may have a respectable argument that the common law doctrines do not apply to a particular transaction that literally complies with Subchapter K, and an agent may tend to be reluctant to respond with common law authority that does not directly involve partnerships.").

[40] *See id.* As the New York State Bar Association Tax Section observed:

> Taxpayers engaging in these transactions . . . often have the perception that the Service tends to settle on a basis favorable to taxpayers rather than litigate. Likewise, taxpayers know that penalties are unlikely because of their literal compliance with the statute and regulations, and as a result believe (often with considerable justification) that even with an unfavorable settlement they will generally end up better off than if they had not engaged in the abusive transaction.

Id.; *see also* Cunningham & Repetti, *supra* note 8, at 28.

precedent applying the judicial doctrines to subchapter K diminished their utility as effective weapons against abusive partnership transactions.

Administrative responses, such as rulings and regulations, were similarly inadequate to stop abusive partnership transactions. The Treasury can only challenge an abusive transaction once it has been noticed and, thus, significant time lags hampered the Treasury's ability to respond to tax shelters. Years often passed between the introduction of a new sheltering technique and the Treasury's discovery of it.[41] Developing a viable regulatory response and ensuring that it was procedurally proper also required a significant time investment.[42] As a result, the Treasury remained years behind the market.[43] And by the time the Treasury could react, the market had moved on to the next tax shelter, leaving the Treasury back where it started—hopelessly behind the market.

Time lags, however, were not the only factor working against the Treasury. The Treasury's ad hoc responses were typically prospective, only applying to transactions entered into after the effective date of the applicable regulation or ruling.[44] These effective date provisions sent several counterproductive signals to taxpayers, thereby contributing to the growth of partnership tax shelters. First, they created an incentive for taxpayers to complete as many transactions as possible, as early as possible.[45] Second, prospective application led taxpayers to believe that any transaction completed prior to the ruling or regulation's effective date would ultimately be respected if litigated.[46]

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[41] *See* NYSBA Report, *supra* note 33 ("[T]hese attempts are inevitably slow in coming, thereby allowing abusive transactions to occur on a large scale before the door is shut. The delay occurs because the Service often does not become aware of a new form of transaction until some time after it is created . . . ."); Halperin Comments, *supra* note 16 ("[T]he Treasury and the IRS are frequently unaware of abusive transactions until they have been carried out for some time. Practitioners do their best to conceal their plans.").

[42] *See* Halperin Comments, *supra* note 16; NYSBA REPORT, *supra* note 33; Letter from Peter L. Faber, Kaye, Scholer, Fierman, Hays & Handler, to Margaret Milner Richardson, Comm'r, Internal Revenue Serv. (Aug. 12, 1994), *reprinted in Faber Offers Views on Partnership Antiabuse Reg.*, TAX NOTES TODAY, Aug. 25, 1994, 94 TNT 167-9 (LEXIS) [hereinafter Faber Comments].

[43] As Michael Thomson, Acting Deputy Tax Legislative Counsel, noted, "[t]his Treasury has decided we are no longer going to play the catch-up game . . . ." Lee A. Sheppard, *Partnership Antiabuse Rule: Dirty Minds Meet Mrs. Gregory*, 64 TAX NOTES 295, 295 (1994) [hereinafter Sheppard, *Dirty Minds*].

[44] *See* Halperin Comments, *supra* note 16; NYSBA Report, *supra* note 33.

[45] NYSBA Report, *supra* note 33 (noting that prospective effective date provisions "appear[ed] to put a premium on being the first to market a 'secret' new transaction and to close as many transactions of the same type as possible before the Service discover[ed] and act[ed] on the form of transaction").

[46] *See id.* (arguing that prospective effective date provisions "may confer an aura of

Further, the Treasury's responses typically targeted one abuse at a time. They followed subchapter K's traditional rulemaking model, resulting in additional layers of complex, technical rules. Thus, the Treasury's ad hoc responses tended to replicate, rather than resolve, many of subchapter K's most troublesome traits.[47]

Congressional efforts to combat abusive transactions were plagued by similar difficulties.[48] The time between the initial marketing of a sheltering technique and Congress's enactment of a specific anti-abuse provision could be significant.[49] Like the Treasury, Congress also followed an ad hoc process that typically resulted in narrowly targeted, highly technical statutory provisions.

Even worse, Congress's and the Treasury's responses contributed to subchapter K's downward spiral. Each response added yet another layer of complexity to subchapter K.[50] This complexity, in turn, created opportunities for strategic behavior, providing a roadmap for the next abusive transaction.[51] And when Congress or the Treasury would respond to this new tax shelter, the cycle would simply begin anew.

Nowhere was the vulnerability of the Treasury's arsenal more apparent than in the critical link between the law and the tax shelter—tax opinions. Participants in abusive partnership transactions typically required a tax opinion, and the Treasury believed that many of the practitioners writing such opinions increasingly focused on the technical provisions of subchapter K and the resulting loopholes, rather than on the foundational principles of the federal income tax system.[52] As a result, practitioners structuring partnership transactions

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validity on transactions completed before the Service's response").

[47] *See* Halperin Comments, *supra* note 16; NYSBA Report, *supra* note 33.

[48] *See* Letter from Joseph Bankman, Professor, Stanford Law Sch., to Internal Revenue Serv. (July 1, 1994), *reprinted in Stanford Professor Rebuts Criticisms of Partnership Antiabuse Reg.*, TAX NOTES TODAY, July 20, 1994, 94 TNT 140-33 (LEXIS) [hereinafter Bankman Comments]; Eustice, *supra* note 8, at 141.

[49] *See* Bankman Comments, *supra* note 48 ("One obvious disadvantage to the legislative approach is that it gives taxpayers a multi-year window in which to 'cash in' on even the most egregious tax-driven transactions, so long as those transactions are supported by the literal language of one or more statutes.").

[50] *See* sources cited *supra* note 47.

[51] *See* Richardson Remarks, *supra* note 16 ("As all of you know from experience, precise, mechanical rules cannot possibly cover all conceivable situations. Moreover, such rules tend to be the oil fields into which the perennial loophole seekers punch holes looking for a gusher.").

[52] *See Official Expresses IRS' Resolve to Finalize Anti-Abuse Rule, Attacks Comments on Rules*, Daily Tax Report (BNA), at D11 (Oct. 14, 1994). ("Explaining why IRS and Treasury proposed the regulations, [IRS Deputy Associate Chief Counsel Monte] Jackel said there has been 'a failure on the part of some' practitioners to ask themselves certain basic and fundamental questions about the intent of the tax law when undertaking certain transactions."); Sheppard, *Dirty Minds*, *supra* note 43, at 296.

lost sight of the line separating legitimate tax planning from impermissible tax sheltering. This problem was best articulated by Margaret Milner Richardson, then Commissioner of the Service: "At times, the tax law has become so complex that mechanical rules have caused some tax lawyers to lose sight of the fact that their stock-in-trade as lawyers should be sound judgment, not an ability to recall an obscure subparagraph and manipulate its language to derive unintended tax benefits."[53]

In the Treasury's view, if the tax consequences of a partnership transaction were too good to be true, then they were precisely that—too good to be true.[54] But the Treasury lacked any legal tool that could reliably cause taxpayers to forgo a partnership transaction when its results, although in compliance with subchapter K's literal language, were too good to be true. Thus, the Treasury needed a new tool to combat the proliferation of abusive transactions within subchapter K. It had to be nimble enough to challenge partnership transactions in a constantly evolving market, broad enough to counterbalance subchapter K's overly technical rules, and strong enough to compel the magicians practicing within subchapter K to keep a safe distance from abusive transactions.

The Treasury's choice was the PAAR, a general anti-abuse rule that would govern all partnership transactions. The PAAR's goal was simple—to remind taxpayers that literal compliance with subchapter K was necessary but not sufficient. Partnership transactions also had to satisfy the foundational principals that overlay the entire federal income tax system, including subchapter K.[55]

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53 Richardson Remarks, *supra* note 16.

54 *See* Sheppard, *Cognitive Dissonance*, *supra* note 22, at 943 ("[Tax Legislative Counsel Glen] Kohl joked that he wished to write a rule saying 'if it's too good to be true, it isn't.' The new style of drafting should, he ventured, allow lawyers to be lawyers again—to be paid for using their judgment and ability to see the big picture, rather than for being technicians. The era of the technician, he hoped, will end."); Lee A. Sheppard, *Partnership Antiabuse Rule Produces Anticlimactic Hearing*, 3 TAX. PRAC. & CONTROVERSIES 333, 335 (1994) [hereinafter Sheppard, *Anticlimactic Hearing*] ("The regulation is simply a reminder that transactions that everyone knows are too good to be true *are* too good to be true." (quoting Michael Schler, chairman of the New York State Bar Association Tax Section)); *see also* Faber Comments, *supra* note 42 ("[I]t is appropriate to place a general anti-abuse rule in the regulation. Such a regulatory provision reminds practitioners and taxpayers that technical rules must be applied with judgement [sic] and that results that look as if they are too good to be true are likely not to come about.").

55 *See* Sheppard, *Dirty Minds*, *supra* note 43, at 296; *see also* Cunningham & Repetti, *supra* note 8, at 33; Richardson Remarks, *supra* note 16 ("These anti-abuse provisions are designed to inform taxpayers and practitioners that a literal application of a rule to achieve a result that is inconsistent with the applicable statute or regulatory principle will not be respected. Taxpayers should then be able to resolve tax issues by determining the proper result based on general principles, rather than by parsing through detailed rules to derive a mechanical result based on a literal reading of the regulation.").

B. The Proposed Partnership Anti-Abuse Rule

1. The Proposed Regulation

On May 17, 1994, the Treasury proposed the PAAR.[56] The proposed regulation set forth the following anti-abuse rule:

> [I]f a partnership is formed or availed of in connection with a transaction or series of related transactions . . . with a principal purpose of substantially reducing the present value of partners' aggregate federal tax liability in a manner that is inconsistent with the intent subchapter K, the Commissioner can disregard the form of the transaction.[57]

The Treasury defined the intent of subchapter K as permitting "taxpayers to conduct business for joint economic profit through a flexible arrangement that accurately reflects the partners' economic agreement without incurring an entity-level tax."[58] But the proposed PAAR placed an explicit limit on this flexibility. Subchapter K was not intended to allow partnerships to structure transactions that were inconsistent with the partners' underlying economic arrangement or that avoided the purposes of other Code provisions.[59]

The Treasury, however, provided little guidance about determining whether a transaction violated the proposed PAAR. The regulation provided that a substantial reduction in the partners' federal income tax liability, standing alone, would not trigger application of the regulation.[60] The Service could only recast a transaction if the substantial reduction in tax liability was also contrary to the intent of subchapter K.[61] Otherwise, the proposed PAAR was silent, simply stating that the Service should take account of all relevant facts and circumstances in determining whether a transaction violated the regulation.[62]

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[56] Prop. Treas. Reg. § 1.701-2, 59 Fed. Reg. 25,581 (May 17, 1994).

[57] *Id.* § 1.701-2(b), 59 Fed. Reg. at 25,583. If a transaction violated the proposed PAAR, the Service was authorized to take any of the following remedial measures: (1) disregard the purported partnership in whole or part; (2) decline to treat one of the purported partners as a partner; (3) treat the partners as owning their respective shares of partnership assets directly; (4) adjust the methods of accounting employed by the partnership or a partner; (5) reallocate or disregard items of income, gain loss, deduction or credit; or (6) otherwise preclude any intended tax treatment. *Id.* § 1.701-2(b)(1)–(6), 59 Fed. Reg. at 25,583.

[58] *Id.* § 1.701-2(a), 59 Fed. Reg. at 25,583.

[59] *Id.*

[60] *Id.* § 1.701-2(c), 59 Fed. Reg. at 25,583.

[61] *Id.* § 1.701-2(b), 59 Fed. Reg. at 25,583.

[62] *Id.* § 1.701-2(c), 59 Fed. Reg. at 25,583.

The proposed PAAR applied for all purposes of the Code, and it did not supersede any of the judicial doctrines otherwise applicable to a transaction.[63] To illustrate its operation, the Treasury included four examples in the proposed regulation—three involving transactions complying with the regulation and one violating it.[64]

Perhaps anticipating the tax community's opposition, the Treasury specifically delineated the proposed regulation's intended scope.[65] According to the Treasury, the PAAR "primarily will affect a relatively small number of abusive large partnership transactions and reflects [the] Treasury's and the IRS's commitment to preventing those abuses from undermining the intent of subchapter K."[66]

2. *The Reaction—The Fury of the Tax Practitioners*

"I'm gonna have a heart attack. You can print that."[67] This was a common practitioner reaction to the proposed PAAR. It would be hard to exaggerate the vitriol generated by the regulation's proposal.[68] One practitioner described the proposed PAAR as the "greatest derogation of executive authority since Watergate."[69] Another posited that the proposed regulation would cause "nuclear winter [to] descend upon the joint venture profit-oriented partnership."[70] In written comments, practitioners described the proposed PAAR in myriad

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63 *Id.* § 1.701-2, 59 Fed. Reg. at 25,582.

64 *Id.* § 1.701-2(e), 59 Fed. Reg. at 25,583–84.

65 *See infra* Part I.B.2.

66 Prop. Treas. Reg. 1.701-2, 59 Fed. Reg. at 25,582. Government officials expressed this sentiment on numerous occasions. For instance, in remarks prepared for the ABA Tax Section Annual Meeting in August 1994, Commissioner Richardson stated that "[w]e also made it very clear in the regulation's preamble, and in subsequent discussions, that the regulation is not intended to interfere with the use of partnerships in ordinary business ventures, but is instead designed to curb the activities of a relatively small number of abusive partnerships." Richardson Remarks, *supra* note 16.

67 Sheppard, *Cognitive Dissonance*, *supra* note 22, at 936 (quoting Sanford C. Presant, chairman of the ABA Tax Section Partnerships Committee, describing his reaction to the issuance of the proposed PAAR).

68 Interestingly, practitioners' fierce response to the proposed PAAR made a strong impression on several influential members of Congress—Representative Bill Archer, the incoming chair of the House Ways and Means Committee, and Senator Bob Packwood, the incoming chair of the Senate Finance Committee. Representative Archer and Senator Packwood sent a sharply worded letter to Treasury Secretary Lloyd Bentsen regarding the wisdom of the proposed PAAR. *See* Letter from Rep. Bill Archer & Sen. Bob Packwood to Lloyd Bentsen, Sec'y of the Treasury (Dec. 16, 1994), *reprinted in Archer, Packwood Caution Treasury on Partnership Antiabuse Rule*, TAX NOTES TODAY, Dec. 21, 1994, 94 TNT 249-6 (LEXIS).

69 Robert J. Wells et al., *ABA Tax Section Meeting: Subchapter K Antiabuse Reg. Sparks Heated Reactions*, 63 TAX NOTES 933, 934 (1994).

70 *Unofficial Transcript of IRS Hearings on Partnerships*, TAX NOTES TODAY, July 29, 1994, 94 TNT 147-18 (LEXIS) [hereinafter *Partnership Hearing*] (testimony of Michael Lux of Deloitte & Touche).

colorful ways, likening it to a meat cleaver,[71] an atomic bomb,[72] and a generally blunderbuss approach to rulemaking.[73]

Although practitioners claimed to support the Treasury's efforts to combat tax shelters,[74] they identified a seemingly endless number of problems with the proposed PAAR. Almost unanimously, practitioners called for the Treasury to withdraw the regulation.[75]

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71 Letter from Michael E. Schaff & Jerome Busch, Orange County Bar Ass'n Tax'n Section, to Internal Revenue Serv. (June 30, 1994), *reprinted in Orange County Bar Association Criticizes Partnership Antiabuse Reg.*, TAX NOTES TODAY, June 30, 1994, 94 TNT 142-40 (LEXIS) [hereinafter Orange County Bar Ass'n Comments] ("We recommend use of an administrative scalpel, and only when necessary. We protest the meat cleaver that the Service is attempting to use in the form of the Proposed Regulation.").

72 Florida Bar Section of Tax'n, Comments Concerning Proposed Treas. Reg. Section 1.701-2 Pertaining to the Recharacterization of Certain Partnership Transactions, *reprinted in Florida Bar Committee Call for Antiabuse Rule's Overhaul*, TAX NOTES TODAY, June 22, 1994, 1994 TNT 142-41 (LEXIS) [hereinafter Florida Bar Ass'n Comments] ("The adoption of proposed regulation section 1.701-2 to attack perceived abuses involving a 'small number of large partnership transactions' is akin to using an atomic bomb to perform delicate brain surgery.").

73 *See* Letter from Kenneth Zuckerbrot, Ross & Hardies, to Internal Revenue Serv. (May 17, 1994), *reprinted in Attorney Criticizes 'Blunderbluss Approach' of Partnership Antiabuse Reg.*, TAX NOTES TODAY, May 17, 1994, 94 TNT 111-25 (LEXIS).

74 *See, e.g.*, ABA Section of Tax'n, Comments Concerning Proposed Regulation Under Section 701 of the Internal Revenue Code of 1986, *reprinted in ABA Tax Section Members Say Antiabuse Rule is Not a Valid Exercise of IRS Authority*, TAX NOTES TODAY, July 1, 1994, 94 TNT 146-50 (LEXIS) [hereinafter ABA Comments] ("The authors are supportive of the purpose of this regulation project, which is to curb abusive tax avoidance transactions."); Federal Tax'n Comm. of the Chicago Bar Ass'n, Comments on Proposed Regulation Section 1.701-2 Subchapter K Anti-Abuse Rule, *reprinted in Chicago Bar Calls Partnership Antiabuse Rule Invalid, Urges Withdrawal*, TAX NOTES TODAY, June 30, 1994, 94 TNT 139-61 (LEXIS) [hereinafter Chicago Bar Ass'n Comments] ("Although the Federal Taxation Committee of the Chicago Bar Association . . . strongly supports the proposition that abusive partnership transactions must be prevented, the Committee believes . . . that the Proposed Regulation should be withdrawn."); Tax'n Section, Los Angeles County Bar Ass'n, Comments Concerning Proposed Treasury Regulation Section 1.701-2, *reprinted in Los Angeles County Bar Urges Withdrawal of Antiabuse Reg.*, TAX NOTES TODAY, July 22, 1994, 94 TNT 151-40 (LEXIS) [hereinafter Los Angeles Bar Ass'n Comments] ("We understand that Treasury and the Internal Revenue Service are legitimately concerned about certain partnership transactions without economic substance that have been promoted as vehicles for tax reduction . . . . [But] we believe that there are sufficient statutory and judicial authorities already available."); Letter from Sheldon I. Fink et al., Sonnenschein Nath & Rosenthal, to Internal Revenue Serv. (June 7, 1994), *reprinted in Partnership Antiabuse Reg. Will Have 'Chilling Effect' on Legitimate Transactions, Attorneys Say*, TAX NOTES TODAY, June 15, 1994, 94 TNT 115-16 (LEXIS) [hereinafter Sonnenschein Nath & Rosenthal Comments] ("These criticisms notwithstanding, we are sympathetic to the IRS' stated concern of limiting 'abusive' transactions which are based on Subchapter K of the Code . . . .").

75 Although a distinct minority, several commentators supported the Treasury's issuance of the proposed PAAR. Most notably, the Tax Section of the New York State Bar Association submitted a generally favorable report on the regulation. *See* NYSBA Report, *supra* note 33. Additionally, a very small number of practitioners and academics submitted comments in support of the proposed PAAR. *See* Bankman Comments, *supra* note 48; Letter from N. Jerold Cohen, Sutherland, Asbill & Brennan, to Leslie B. Samuels, Assistant Sec'y (Tax Pol'y), Dep't of the Treasury (July 1, 1994), *reprinted in Cohen Supports Partnership Antiabuse Regulation*, TAX NOTES TODAY, July 1, 1994, 94 TNT 135-35 (LEXIS); Faber Comments, *supra* note 42; Halperin Comments, *supra* note 16; Letter from Rebecca S. Rudnick, Professor, Boston Univ.

a. Validity

Many practitioners believed the Treasury exceeded its rulemaking authority when it proposed the PAAR. The Treasury did not issue the proposed PAAR pursuant to any specific statutory authorization in subchapter K; rather, it issued the PAAR pursuant to the general authorization of Section 7805(a),[76] which allows the Treasury to "prescribe all needful rules and regulations for the enforcement" of the Code.[77] For objecting practitioners, nothing in the history of subchapter K evinced Congress's intent to supplement the literal language of the Code with a broad anti-abuse rule like the proposed PAAR.[78]

Sch. of Law, to Internal Revenue Serv. (June 29, 1994), *reprinted in Boston University Professor Praises Antiabuse Reg.*, TAX NOTES TODAY, June 29, 1994, 94 TNT 139-69 (LEXIS).

76 Prop. Treas. Reg. § 1.701-2, 59 Fed. Reg. 25,581 (May 17, 1994).

77 I.R.C. § 7805(a) (2006). Regulations issued under Section 7805(a) are referred to as interpretive regulations. *See* BITTKER & LOKKEN, FEDERAL INCOME TAXATION, *supra* note 37, at ¶ 110.4.2. In contrast, regulations issued pursuant to a specific statutory authorization are referred to as legislative regulations. For a useful discussion of both interpretive and legislative regulations, see MICHAEL I. SALTZMAN, IRS PRACTICE AND PROCEDURE ¶ 3.02[3][a]–[b] (rev. 2d ed. 2002 & Supp. I 2009).

78 Much like subchapter K, judicial deference to interpretive regulations is a muddled area of the tax law. *See* N.Y. State Bar Ass'n Tax Section, Report on Legislative Grants of Regulatory Authority, *reprinted in NYSBA Tax Section Comments on Legislative Grants of Regulatory Authority*, TAX NOTES TODAY, Nov. 3, 2006, 2006 TNT 215-22 (LEXIS) (discussing the substantial uncertainty surrounding judicial deference to interpretive regulations); Kristin E. Hickman, *The Need for* Mead*: Rejecting Tax Exceptionalism in Judicial Deference*, 90 MINN. L. REV. 1537, 1556–63 (2006). Although a detailed discussion of the proper level of deference that should be afforded to interpretive regulations is beyond the scope of this Article, a brief summary of the two primary approaches might be useful. Under the standard enunciated by the Supreme Court in *Chevron U.S.A. Inc. v. Natural Resources Defense Council*, the validity of a regulation is determined by applying a two-part analysis. 467 U.S. 837, 842–43 (1984). First, a court must consider whether Congress has directly spoken to the precise question at issue. *Id.* at 842. If it has, then the courts and the Treasury must give effect to Congress's unambiguously expressed intent. *Id.* at 842–43. On the contrary, if the statute is silent or ambiguous with respect to the question at issue, then the court must determine whether the regulation is a permissible construction of the statute. *Id.* at 843. For examples of the PAAR's analysis under the *Chevron* standard, see Cunningham & Repetti, *supra* note 8, at 50–55 (concluding that the final PAAR is valid) and WILLIAM S. MCKEE ET AL., FEDERAL INCOME TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 1.05[5] (4th ed. 2007) [hereinafter MCKEE ET AL., TAXATION OF PARTNERSHIPS AND PARTNERS] (concluding that the final PAAR is invalid). The alternative deference standard, which derives from *National Muffler Dealer's Association, Inc. v. United States*, provides that a regulation will be upheld if found to implement a congressional mandate in some reasonable manner. 440 U.S. 472, 476–77 (1979). That is, the regulation must harmonize the statute's origin, purpose, and plain language. *Id.* at 477. Additionally,

> [a] regulation may have particular force if it is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent. If the regulation dates from a later period, the manner in which it evolved merits inquiry. Other relevant considerations are the length of time the regulation has

The Treasury issued the proposed PAAR under Section 701, but many practitioners argued that, read literally, the regulation failed to interpret or clarify this section. Indeed, these practitioners believed that the regulation had little direct connection with Section 701,[79] which provides that partners, rather than partnerships, are subject to tax in their individual capacities for the entity's income.[80] In the view of many practitioners, the connection between Section 701 and the proposed PAAR was tenuous at best and, therefore, the proposed PAAR simply could not be understood as a proper interpretation of Section 701.

Additionally, many practitioners maintained that the proposed PAAR, with its unprecedented breadth, impermissibly overrode subchapter K's literal language.[81] Specifically, the proposed

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> been in effect, the reliance placed on it, the consistency of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent re-enactments of the statute.

Id. For an example of the PAAR's analysis under the *National Muffler* standard, see ABA Comments, *supra* note 74.

[79] *See* Letter from Sheldon I. Banoff, Katten Muchin & Zavis, to Internal Revenue Serv. (May 19, 1994), *reprinted in Partnership Antiabuse Regs Should Be Rescinded, Banoff Asserts*, TAX NOTES TODAY, May 19, 1994, 94 TNT 106-24 (LEXIS) [hereinafter Banoff Comments: Part 1]. In describing a discussion of the proposed regulation at the May 1994 ABA meeting, Banoff notes that:

> The IRS representative's statement . . . that "we issued this regulation under Section 701 to make sure it was up front in Subchapter K, so everyone would see it" might be true. It may be equally true that it was issued under Section 701 because there is no authority in any section of Subchapter K for this regulation, and since it preempts statutory compliance with the rest of Subchapter K, it needs to be placed first.

Id.; *see also* ABA Comments, *supra* note 74; James A. Gouwar, *The Proposed Partnership Anti-Abuse Regulation: Treasury Oversteps Its Authority*, 11 J. PARTNERSHIP TAX'N 287, 291 (1995) (noting that "[e]xactly how the [Proposed] Regulation relates to Section 701 is unclear"); Letter from Barbara C. Spudis & James H. Barrett, Baker & McKenzie, to Comm'r of Internal Revenue, Internal Revenue Serv. (July 25, 1994), *reprinted in Commentators Say Partnership Antiabuse Rule Should Be Withdrawn*, TAX NOTES TODAY, July 25, 1994, 94 TNT 152-37 (LEXIS) [hereinafter Baker & McKenzie Comments].

[80] I.R.C. § 701 (2006).

[81] *See, e.g.*, ABA Comments, *supra* note 74 ("The Proposed Regulation's operative provisions, by design, produce a result contrary to the literal language of subchapter K or other provisions of the Code."); Richard M. Lipton, *Controversial Partnership Anti-Abuse Prop. Regs. Raise Many Questions*, 81 J. TAX'N 68, 74 (1994) [hereinafter Lipton, *Controversial Prop. Regs.*] ("Indeed, the Proposed Regulations expressly *override* the Code in transactions deemed inconsistent with the intent of Subchapter K."); Philadelphia Bar Ass'n Tax Section, Comments to Proposed Regulations section 1.701-2, *reprinted in Philadelphia Bar Tax Section Calls for Partnership Rule's Withdrawal*, TAX NOTES TODAY, June 30, 1994, 94 TNT 140-31 (LEXIS) [hereinafter Philadelphia Bar Ass'n Comments] ("The proposed rule constitutes a significant change in existing law, which is not authorized by any existing statutory provision in subchapter K . . . ."); Letter from Ernst & Young to Internal Revenue Serv. (July 1, 1994), *reprinted in Ernst & Young Criticizes Partnership Antiabuse Reg.*, TAX NOTES TODAY, June 27, 1994, 94 TNT 141-32 (LEXIS) ("The regulation is so broad as to defy meaningful

regulation permitted the Service to disregard the form of a partnership transaction, even if it fully complied with the literal language of subchapter K.[82] In doing so, the proposed PAAR inappropriately trumped Congress's intent, as expressed in the carefully crafted, highly technical provisions of subchapter K.[83] And it did so without any specific congressional authorization.[84]

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interpretation."); Letter from Michael Lux, Deloitte & Touche, to Internal Revenue Serv. (July 1, 1994), *reprinted in Deloitte & Touche Says Reg Exceeds IRS's Authority*, TAX NOTES TODAY, July 1, 1994, 94 TNT 139-68 (LEXIS) [hereinafter Deloitte Comments] ("In essence, if adopted, Treasury and IRS would be issuing a regulation for a statute that does not exist. We believe that would exceed IRS' and Treasury's regulatory authority.").

[82] *See* Lipton, *Controversial Prop. Regs.*, *supra* note 81, at 74; Baker & McKenzie Comments, *supra* note 79; Sonnenschein Nath & Rosenthal Comments, *supra* note 74.

[83] *See, e.g.*, Philadelphia Bar Ass'n Comments, *supra* note 81 ("We know of no expression of Congressional will that suggests that a partnership transaction motivated by legitimate business reasons may be denied the application of the provisions of subchapter K with which it literally complies."); *see also* Chicago Bar Ass'n Comments, *supra* note 74; Florida Bar Ass'n Comments, *supra* note 72; Los Angeles Bar Ass'n Comments, *supra* note 74; Gouwar, *supra* note 79, at 287–89.

[84] Some practitioners went a step further, asserting that the proposed PAAR contravened congressional intent, as reflected in past amendments to subchapter K's allocation provisions. *See* ABA Comments, *supra* note 74 ("Congress has considered anti-avoidance language of the type in the Proposed Regulation and has rejected it."); Chicago Bar Ass'n Comments, *supra* note 74 ("Congress has previously considered and rejected broad anti-tax avoidance language for the administration of subchapter K."). When Congress amended the partnership allocation rules set forth in Section 704 in 1976, it considered a provision prohibiting a partnership from making an allocation if such allocation lacked a business purpose or would result in a significant avoidance or evasion of tax. *See* Tax Reform Bill of 1975, H.R. 101612, 94th Cong., 1st Sess. (1975). The Senate rejected this provision because of concern over its "significant avoidance or evasion of any tax" language. S. REP. No. 94-938, at 100 & 100 n.11 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3439, 3536. Specifically, the Senate was concerned that such language might result in the disallowance of an allocation having both a business purpose and economic substance. *Id.* at 100 n.11. Rather than the "significant avoidance or evasion of tax" threshold, Congress enacted the substantial economic effect rules, which remain the governing standard for partnership allocations today. *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 709(d), 90 Stat. 1520, 1548 (1976). Even though almost twenty years had passed, the proposed PAAR's opponents believed that the history of the partnership allocation rules represented an express congressional rejection of any rule including a tax avoidance component. As the Chicago Bar Association noted:

> Congress has already rejected the standard of 'significant avoidance or evasion of any tax' to guide administration of provisions which are significant to the operation of subchapter K. Treasury cannot now issue an interpretative regulation that attempts to implement an even broader anti-abuse rule than [what] Congress has not adopted.

Chicago Bar Ass'n Comments, *supra* note 74; *see also* ABA Comments, *supra* note 74 ("In our view, Congress . . . expressly rejected the concept of 'significant tax avoidance or evasion of any tax' as a standard to guide the administration of subchapter K."); Am. Inst. of Certified Pub. Accountants, Comments on Proposed Regulation Section 1.701-2 Regarding Anti-Abuse Rule for Subchapter K, *reprinted in AICPA Calls For Changes in Partnership Antiabuse Reg.*, TAX NOTES TODAY, July 13, 1994, 94 TNT 139-64 (LEXIS) [hereinafter AICPA Comments] ("The use of an 'intent to avoid tax' standard in so far as it applies to the application of Code section 704(b) is contrary to the express intent of Congress."); Gouwar, *supra* note 79, at 292.

b. Uncertainty

Practitioners also believed that the proposed PAAR created an impossible level of uncertainty within subchapter K. They claimed that the proposed regulation was both vague and overbroad, and created novel challenges in structuring partnership transactions. Specifically, they charged that the uncertainty surrounding the proposed PAAR's application would increase the cost and risk of entering into partnership transactions. And this, practitioners posited, would lead to the scenario they feared most—paralysis of the market for partnership transactions.

This apocalyptic vision began with the proposed PAAR's vagueness, which practitioners believed rendered the regulation unworkable. To them, the Treasury failed to provide taxpayers with sufficient guidance regarding the types of transactions it considered abusive and, therefore, in violation of the proposed PAAR.[85] Absent such guidance, no one could predict what techniques might trouble the Treasury. Further exacerbating the problem, the proposed PAAR contained only four explanatory examples,[86] and only one violated the

[85] *See, e.g.*, Tax Executives Inst., Inc., Comments of Tax Executives Institute, Inc., on Proposed Regulations Under Section 701 of the Internal Revenue Code, *reprinted in TEI Urges Withdrawal of Partnership Antiabuse Rule*, TAX NEWS TODAY, July 18, 1994, 1994 TNT 140-21 (LEXIS) ("Indeed, the Treasury and IRS appear to be attempting to limit debate on the proper scope of tax planning—or precisely defining what is or is not an 'abuse'—by invoking the shibboleth of 'anti-abuse' rules. By providing little or no useful information on the 'bad' transactions to be avoided, however, the Treasury and IRS prevent taxpayers from knowing, BEFORE THE FACT, what the proper tax planning standard is to be."); *see also* Lipton, *Controversial Prop. Regs.*, *supra* note 81, at 70 ("The most significant problem with the Proposed Regulations is that they are so broadly and vaguely worded, and the examples are so limited, that it is almost impossible to determine what transactions will be covered."); Baker & McKenzie Comments, *supra* note 79 ("If the government cannot be more specific as to the situations it is targeting, how can it expect practitioners to understand and interpret the regulation?"); Banoff Comments: Part 1, *supra* note 79; Letter from Elizabeth A. Case, Price Waterhouse, to Internal Revenue Serv. (June 30, 1994), *reprinted in Price Waterhouse Says Existing Law Is Sufficient to Curb Abusive Partnership Transactions*, TAX NOTES TODAY, June 30, 1994, 94 TNT 141-33 (LEXIS); Letter from Jere W. Glover, Chief Counsel for Advocacy, Small Bus. Admin., to Margaret Richardson, Comm'r, Internal Revenue Serv. (Aug. 26, 1994), *reprinted in SBA Criticizes Partnership Antiabuse Rule*, TAX NOTES TODAY, Aug. 26, 1994, 94 TNT 228-27 (LEXIS) ("[I]t is one thing to expect tax practitioners to judge the tax ramifications of business transactions based on an [sic] reasonably ascertainable standard elucidated by the Service. It is quite another to require these practitioners to render an opinion based on a standard which the Service itself has not yet adequately articulated in its regulations."); Letter from Michael S. Wolff, Nat'l Dir. of Tax Servs., Grant Thornton, to Internal Revenue Serv. (June 29, 1994), *reprinted in Grant Thornton Calls Antiabuse Rule an Invitation to Unfairness*, TAX NOTES TODAY July 21, 1994, 94 TNT 141-34 (LEXIS) [hereinafter Grant Thornton Comments] ("[The proposed PAAR] does not provide adequate guidance as to the difference between legitimate tax planning (which every taxpayer has a right to do) and the use of a partnership in a transaction that exploits or misuses the provisions of subchapter K.").

[86] *See* Prop. Treas. Reg. § 1.701-2(e), 59 Fed. Reg. 25,581, 25,583–84 (May 17, 1994).

regulation.[87] Practitioners considered this wholly inadequate, concluding that the proposed PAAR was devoid of any useful guidance about abusive transactions.[88]

Particularly problematic to practitioners was the intent of subchapter K standard.[89] They objected to the Treasury's decision to reduce the intent of the entire partnership tax regime into a single sentence.[90] To these practitioners, the intent of subchapter K must encompass the intent of each individual partnership provision, as well as the overarching intent of all the provisions taken together. And they believed it was impossible to do this in one sentence.[91]

Even if the Treasury could reduce the intent of subchapter K to one sentence, significant questions remained. How should taxpayers reconcile the proposed PAAR's intent of subchapter K standard with the intent of individual partnership provisions?[92] Likewise, how should they reconcile this standard with provisions outside subchapter K and with the judicial doctrines?[93] Practitioners wanted guidance, but the proposed PAAR left these questions unanswered.

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[87] *See, e.g.*, ABA Comments, *supra* note 74 (recommending a new version of the Proposed Regulation that would "provide numerous examples"); Baker & McKenzie Comments, *supra* note 79; Sonnenschein Nath & Rosenthal Comments, *supra* note 74 ("Additional examples should be provided which illustrate the limited types of transactions which can be recharacterized."); *see also* NYSBA Report, *supra* note 33; Gouwar, *supra* note 79, at 288; Lipton, *Controversial Prop. Regs.*, *supra* note 81, at 70.

[88] *See, e.g.*, Baker & McKenzie Comments, *supra* note 79 ("[I]t appears that both government representatives and members of the partnership tax bar are having marked difficulty in producing examples of the abuse targeted."); Banoff Comments: Part 1, *supra* note 79 ("Are there not specific examples of transactions of which the IRS has knowledge that could be illustrated? Are there really no abuses currently in mind, after all?").

[89] *See* Prop. Treas. Reg. § 1.701-2(a), 59 Fed. Reg. at 25,583.

[90] *See* Sonnenschein Nath & Rosenthal Comments, *supra* note 74 ("The Proposed Regulation attempts to distill numerous provisions of the Code and regulations into a single sentence; this general statement does not provide meaningful guidance and leads to significant confusion and uncertainty."); *see also* Chicago Bar Ass'n Comments, *supra* note 74.

[91] *See* Sonnenschein Nath & Rosenthal Comments, *supra* note 74. The comments asserted:

> The 'intent' of subchapter K is reflected in numerous provisions which address the specific way in which a partnership interrelates with its partners. All of these provisions, taken individually and together, set forth the intent of subchapter K; the intent of an entire subchapter of the Code is not accurately reflected in one sentence.

Id.

[92] *See* NYSBA Report, *supra* note 33 (recommending that "the final regulation should contain an express statement that it will not apply where the intended tax results are specifically contemplated by the Code and/or regulations. Taxpayers should not have to defend such results on the ground that they are consistent with the overall intent of Subchapter K."); Sonnenschein Nath & Rosenthal Comments, *supra* note 74 (noting the difficultly of reconciling the individual intent of various provisions of subchapter K and the overall intent of subchapter K standard set forth in the proposed PAAR).

[93] *See, e.g.*, Lipton, *Controversial Prop. Regs.*, *supra* note 81, at 70; Orange County Bar Ass'n Comments, *supra* note 71; Sonnenschein Nath & Rosenthal Comments, *supra* note 74.

The proposed regulation's vagueness raised the additional concern of overbreadth. Despite the Treasury's repeated statements that the proposed PAAR was only intended to apply to a small number of abusive large partnership transactions,[94] the regulation's broad language indicated otherwise.[95] Indeed, practitioners believed the proposed PAAR's language was so expansive that it could apply to virtually any partnership transaction.[96] Because a taxpayer's decision to use the partnership form almost invariably involved a desire to reap the benefits of pass-through taxation, one of the proposed PAAR's two standards—a principal purpose of tax reduction—would exist in most partnership transactions.[97] If a transaction were also inconsistent with the intent of subchapter K, it would violate the proposed PAAR. Thus, virtually every partnership transaction would require careful analysis to determine whether it complied with the intent of subchapter K.[98]

Herein lay the problem. Practitioners maintained that the proposed PAAR's uncertainty made it impossible to predict what transactions the Service might consider contrary to the intent of subchapter K.[99]

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[94] *See* Prop. Treas. Reg. § 1.701-2, 59 Fed. Reg. at 25,582; *see also supra* note 66 and accompanying text.

[95] *See* Banoff Comments: Part 1, *supra* note 79 (noting that, despite repeated statements from persons at the Treasury and the Service to the contrary, the proposed PAAR could potentially apply to any "partnership transactions which generate tax savings").

[96] *See* Philadelphia Bar Ass'n Comments, *supra* note 81. The Philadelphia Bar Association commented that:

> We understand that individual members of the Department of Treasury have publicly stated that certain legitimate business transactions would not be affected by this regulation . . . . It strains credulity to believe that a regulation that plainly can be read to apply to legitimate transactions somehow does not apply merely because certain Treasury officials say it was not intended to apply to those types of transactions.

Id.; *see also* Chicago Bar Ass'n Comments, *supra* note 74; Florida Bar Ass'n Comments, *supra* note 70; Baker & McKenzie Comments, *supra* note 79; Letter from Coopers & Lybrand to Margaret Millner Richardson, Comm'r, Internal Revenue Serv. (July 5, 1994), *reprinted in Coopers & Lybrand Urges Withdrawal Partnership Antiabuse Rule*, TAX NOTES TODAY, July 7, 1994, 94 TNT 172-25 (LEXIS) [hereinafter Coopers & Lybrand Comments]; Lipton, *Controversial Prop. Regs.*, *supra* note 81, at 70; Sonnenschein Nath & Rosenthal Comments, *supra* note 74.

[97] *See* Philadelphia Bar Ass'n Comments, *supra* note 81 ("[T]he Tax Reduction Test of the anti-abuse rule will catch virtually every business transaction where taxation is a consideration; rational business people will ALWAYS arrange their legitimate affairs so as to minimize taxation.").

[98] *See* Coopers & Lybrand Comments, *supra* note 96 (identifying twenty-six common transactions that could be subject to the proposed regulation); Lipton, *Controversial Prop. Regs.*, *supra* note 81, at 71–72 (identifying five common transactions that could be subject to the proposed regulation); Los Angeles Bar Ass'n Comments, *supra* note 74 (identifying eleven common transactions that could be subject to the proposed regulations).

[99] *See, e.g.*, Lipton, *Controversial Prop. Regs.*, *supra* note 81, at 70 ("The most significant problem with the Proposed Regulations is that they are so broadly and vaguely worded, and the examples are so limited, that it is almost impossible to determine what transactions will be

Because of the regulation's vagueness and overbreadth, a practitioner could reasonably conclude that any transaction violated the proposed PAAR.[100] Indeed, practitioners believed that it would be impossible to advise a client that the Service would not challenge her transaction under the proposed PAAR.[101] Likewise, it would be impossible to advise a client on how the Service would recharacterize a transaction that violated the proposed PAAR.[102] Thus, tax planning would become more conservative, more qualified, and more expensive.[103]

And this, perhaps more than anything, concerned practitioners. They feared that the proposed PAAR's uncertainty would make the use of subchapter K both cost and risk prohibitive, thereby impairing the market for partnership transactions.[104] To this end, these practitioners made a very simple argument against the proposed

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covered.").

[100] *See* Lawrence M. Stone, *Proposed Antiabuse Reg Will Create Uncertainty but Accomplish Little Else*, TAX NOTES TODAY, July 4, 1994, 94 TNT 131-45 (LEXIS) ("Because they provide no guidance, the proposed regulations may unfortunately accomplish little good. That in itself would not be troublesome if they did not have the mischievous characteristic of creating great uncertainty for what I believe are permitted uses."); Grant Thornton Comments, *supra* note 85 ("Prudent businessmen and their tax advisors will now have to consider the impact of the Proposed Regulation in all but the simplest situations. The uncertainty and complexity in applying the intent standard will be yet another seemingly incomprehensible tax risk for the common businessman to consider and will have a dampening affect on legitimate business transactions. It is exactly this type of uncertainty and complexity that undermines the middle market businessman's confidence in the U.S. tax system."); *see also* Sonnenschein Nath & Rosenthal Comments, *supra* note 74.

[101] *See* Lipton, *Controversial Prop. Regs.*, *supra* note 81, at 72.

[102] *See id.*

[103] Indeed, many commentators believed that legitimate partnership transactions would suffer more than abusive transactions under the proposed PAAR. These commentators posited that most abusive transactions already receive a heightened degree of analysis under existing judicial doctrines. Thus, the PAAR's introduction would likely have little effect on the legal advice given in connection with abusive partnership transactions. *See, e.g.*, *id.* at 73 ("While it is doubtless true that some transactions would be outside of the Service's authority under existing case law (and would require a statutory change), these solutions are relatively limited. Thus, the IRS might have limited the controversy surrounding the Proposed Regulations by not attempting to 'boldly regulate' where no one had gone before."); Grant Thornton Comments, *supra* note 85 ("The aggressive tax advisors and taxpayers involved in large abusive partnerships already deal with risk of this type and will not be deterred by the Proposed Regulation. It is the cautious and conservative businessman who will struggle with these rules and, in some cases, in an effort to reduce risk choose less desirable operating structures or abandon legitimate business opportunities altogether.").

[104] *See, e.g.*, Los Angeles Bar Ass'n Comments, *supra* note 74 ("[T]he proposed regulation can be expected to inhibit legitimate business transactions involving partnerships."); Lipton, *Controversial Prop. Regs.*, *supra* note 81, at 73 (discussing the "chilling effect" the Proposed Regulations could have on non-abusive partnership transactions); Baker & McKenzie Comments, *supra* note 79 ("The approach chosen has the unfortunate effect of not being specific enough to assist in interpreting those transaction and yet being so broad as to have a chilling effect on bona fide transactions."); Coopers & Lybrand Comments, *supra* note 96 (discussing the potential chilling effect of the Proposed Regulation on the development of new partnership transactions).

PAAR: the proposed PAAR increased the uncertainty of partnership transactions. Because the market does not like uncertainty, they claimed, the proposed PAAR was bad and, therefore, should be withdrawn immediately.[105]

c. Unpredictable IRS Application

Practitioners also claimed that the proposed PAAR presented insurmountable enforcement challenges for the Service. Specifically, these practitioners feared that the Service would be incapable of applying the proposed PAAR in a consistent and objective manner.[106] One practitioner described the "rogue" agent problem in the following colorful manner:

> The regulation casts a dark and ominous cloud over partnership entities throughout the land in spite of its limited objective . . . . Once cast, no one would be able to effectively control its reach. No one today can reasonably predict how such a vague regulation could be interpreted by future officials at the IRS and Treasury.[107]

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[105] Lee Sheppard may have described this argument best when she reported that "Wall Street lawyers who represent investment bankers are arguing to Senate Finance Committee Chairman Daniel Patrick Moynihan, D-N.Y., that the future of capitalism depends on investment bankers' ability to sell tax shelters to corporate chief financial officers." Sheppard, *Cognitive Dissonance*, *supra* note 22, at 942. Ms. Sheppard proceeded with commentary that is particularly apt today:

> Now, investment bankers perform a socially and economically valuable function in moving capital from investors to businesses; this is called underwriting, and investment bankers make a lot of money from it. Merchant bankers, of which there are few in America, even invest in businesses. The economy has an interest in seeing these functions efficiently carried out. Investment bankers also make huge profits from other activities for which there does not appear to be a compelling social or economic need, like trading for their own accounts, playing games with government securities, and designing exotic products to be sold to unwitting retail investors and young mutual fund managers. *No one would seriously argue that a Merrill Lynch or a Kidder Peabody should be rescued by the government for, say, losses incurred in proprietary trading.*"

Id. (emphasis added). What a difference sixteen years has made!

[106] *See, e.g.*, Florida Bar Ass'n Comments, *supra* note 74; Lipton, *Controversial Prop. Regs.*, *supra* note 81, at 72; Banoff Comments: Part 1, *supra* note 79 ("If several hundred of the top tax attorneys and accountants in America attending the ABA (and other) meetings in the past week cannot figure out where the line is drawn or why, the test cannot possibly be applied uniformly and administratively by IRS field agents . . . ." (emphasis omitted)).

[107] Deloitte Comments, *supra* note 81. Lee Sheppard offered this description of the problem:

> Much complaining about the partnership antiabuse rule has been that while the lawyers in Washington know what they are doing, 'rogue' IRS agents will come roaring up to a taxpayer's premises in an old Ford Torino with fake mag

Practitioners posited that examiners could misapply the proposed PAAR in two equally problematic manners—excessive application and strategic application. First, because of the regulation's uncertainty, an examiner could raise it in all instances out of an abundance of caution.[108] Likewise, an overzealous examiner might indiscriminately find abuse in all instances where the partners' aggregate federal income tax liability was reduced.[109] Second, a strategic examiner could apply the proposed PAAR in order to exert settlement pressure on a taxpayer.[110] In either scenario, the Service's application of the proposed PAAR would be inconsistent and unpredictable, thereby exacerbating its debilitating uncertainty.

C. The Final Partnership Anti-Abuse Rule

Despite this remarkable turmoil, the Treasury remained intent on finalizing the PAAR,[111] and it issued final regulations on December

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> wheelcovers, jump out with guns drawn, yell 'freeze!' and assert the partnership anti-abuse rule.

Lee A. Sheppard, *News Analysis: Final Partnership Antiabuse Rule—Grudging Acceptance*, TAX NOTES TODAY, Feb. 10, 1995, 95 TNT 28-5 (LEXIS) [hereinafter Sheppard, *Grudging Acceptance*].

[108] *See* Sheldon I. Banoff, *Proposed Antiabuse Reg is 'Fatally Flawed,'* TAX NOTES TODAY, July 4, 1994, 94 TNT 131-44 (LEXIS) [hereinafter Banoff Comments: Part 2]; *see also* Florida Bar Ass'n Comments, *supra* note 74 (arguing that the broad language of the proposed PAAR will likely discourage legitimate partnership transactions).

[109] *See* Banoff Comments: Part 2, *supra* note 108. With his usual flair, Mr. Banoff described the excessive application problem in this way:

> [W]hoever is interpreting the proposed reg[ulation] (as written in its current form) will effectively be the all-powerful, omnipotent "Subchapter K King," because the proposed reg[ulation] is so broad and vague that large numbers of transactions will fall into the gray area of its scope and thus be subject to unpredictability and administrative discretion. The Subchapter K King will be able to exercise his (or her) "divine authority" to exercise discretion in whatever manner is then felt appropriate. . . . Will the Subchapter K King instruct his tax collectors (IRS field agents) to bring forward all types of partnership transactions involving aggressive (in the eyes of the IRS) tax planning for determination as to potential abusive status? Will the tax collectors view any transaction that generates tax savings as being "abusive," i.e., having a principal purpose of reducing taxes "in a manner that is inconsistent with the intent of Subchapter K"?

Id.; *see also* AICPA Comments, *supra* note 84 ("One of the significant concerns of both taxpayers and their advisors is that this proposed regulation will be used by field agents to arbitrarily recast a transaction simply because it provides a result favorable to the taxpayer, even when there are valid business reasons for the particular form . . . .").

[110] *See* Lipton, *Controversial Prop. Regs.*, *supra* note 81, at 72 ("[T]he vague standard set forth in these provisions could be used by an IRS agent to gain leverage in the course of an audit."); Coopers & Lybrand Comments, *supra* note 96 ("[A]gents may be tempted to use the regulation to bring settlement pressures to bear on otherwise legitimate transactions.").

[111] *See* Juliann Avakian Martin, *Officials Address Partnership Antiabuse, Passive Activity Loss Reg Projects*, TAX NOTES TODAY, Nov. 1, 1994, 94 TNT 214-1 (LEXIS); Lee A.

29, 1994.[112] In doing so, the Treasury preserved the PAAR's core provision[113]—a two-pronged anti-abuse rule prohibiting the formation or use of a partnership "in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K."[114] Like the proposed PAAR, the final PAAR also provides that the intent of subchapter K is to "permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax."[115]

Nonetheless, the Treasury did revise the PAAR, presumably to mollify the regulation's critics. Most importantly, the Treasury clarified the final PAAR's scope. To this end, the Treasury more fully articulated the intent of subchapter K standard by providing three requirements that are implicit in such intent. First, a partnership must be bona fide, and any transaction or series of transactions entered into by the partnership must have a substantial business purpose.[116] Second, the form of any partnership transaction must be respected under substance over form principles.[117] Third, the tax consequences of any transaction must accurately reflect the partners' economic agreement and properly reflect each partner's income.[118]

Sheppard, *Partnership Antiabuse Rule is Here to Stay, Officials Say*, TAX NOTES TODAY, July 12, 1994, 94 TNT 134-1 (LEXIS).

112 T.D. 8588, 1995-1 C.B. 109. Within weeks of the final PAAR's issuance, the Treasury provided notice that the regulation would be amended. *See* I.R.S. Announcement 95-8, 1995-7 I.R.B. 56. Specifically, the Treasury intended to amend the regulation to provide that it would apply only with respect to federal income taxes. *Id.* at 56–57. As a result, Treasury intended to delete two of the final PAAR's examples—Examples 5 and 6. *Id.* at 57. These changes were ultimately published in the Federal Register on April 13, 1995. *See* Subchapter K Anti-Abuse Rule, 60 Fed. Reg. 18,741 (Apr. 13, 1995); T.D. 8592, 1995-1 C.B. 119. For purposes of this Article, all discussion of the PAAR, as finalized, takes the 1995 amendments into account.

113 In addition, the final PAAR includes a separate provision addressing abuses related to the entity treatment of partnerships. *See* Treas. Reg. § 1.701-2(e) (as amended in 1995). Specifically, the abuse of entity rule permits the Service to treat a partnership as an aggregate of its partners, rather than a separate entity, if necessary to fulfill the purpose of any provision of the Code. *Id.* § 1.701-2(e)(1). The rule will not apply, however, if the applicable Code provision explicitly provides for the partnership to be treated as an entity, and the ultimate tax consequences of entity treatment are clearly contemplated by such provision. *Id.* § 1.701-2(e)(2). This Article focuses on the PAAR's abuse of subchapter K rule rather than its abuse of entity rule. For a more detailed discussion of the PAAR's abuse of entity rule, see MCKEE ET AL., TAXATION OF PARTNERSHIPS AND PARTNERS, *supra* note 78, at ¶ 1.05[6] and Cunningham & Repetti, *supra* note 8, at 38.

114 Treas. Reg. § 1.701-2(b).

115 *Id.* § 1.701-2(a).

116 *Id.* § 1.701-2(a)(1).

117 *Id.* § 1.701-2(a)(2).

118 *Id.* § 1.701-2(a)(3).

Unlike the first two requirements, the proper reflection of income requirement presents difficulties. In drafting some of subchapter K's provisions, Congress found it impossible to reconcile its goal that a transaction's tax consequences properly reflect income with competing goals, such as administrability and simplicity.[119] Thus, by design, certain provisions of subchapter K produce tax consequences that do not properly reflect income.[120] Cognizant of this congressional tradeoff, the Treasury provided that a transaction will satisfy the proper reflection of income requirement to the extent that the application of a particular provision of subchapter K and the resulting tax consequences are each clearly contemplated by such provision.[121]

The Treasury also provided additional guidance for determining whether a partnership has a principal purpose of substantially reducing the federal income tax liability of its partners in a manner inconsistent with the intent of subchapter K. Like the proposed regulation, the final PAAR notes that the Service shall determine whether a transaction violates the regulation by considering all relevant facts and circumstances.[122] This time, however, the Treasury enumerated seven non-exclusive factors to be considered in making this determination.[123] For instance, the Service may consider whether the present value of the partners' aggregate federal income tax liability is substantially less than if the partners had owned the partnership's assets directly or if purportedly separate transactions are treated as one integrated transaction.[124] Further, the Service may consider whether a partner has a temporary or nominal interest in the partnership.[125] In addition, and of particular importance, the final

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[119] *See id.*

[120] *Id.* The final PAAR lists the following examples of partnership provisions that may result in tax consequences that do not clearly reflect income: Treas. Reg. § 1.704-1(b)(2)(iii)(c) (value equals basis assumption in partnership allocations); I.R.C. § 754 (election to adjust basis in partnership property following certain distributions and sales of partnership interests); Treas. Reg. § 1.704-3(e)(1) (de minimis rule regarding partnership allocations attributable to contributed property); Treas. Reg. § 1.752-2(e)(4) (de minimis rule regarding the allocation of recourse liabilities).

[121] Treas. Reg. § 1.701-2(a)(3). In addition, this special rule for transactions generating tax consequences that do not clearly reflect income will only apply if the final PAAR's first two requirements are satisfied. *Id.*

[122] *Id.* § 1.701-2(c).

[123] *Id.*

[124] *Id.* § 1.701-2(c)(1)–(2).

[125] *Id.* § 1.701-2(c)(3). Additional factors that the Service may consider include: (1) whether substantially all of the partners are related to one another; (2) whether the benefits and burdens of ownership of property nominally contributed to the partnership are retained by the contributing partner; and (3) whether the benefits and burdens of ownership of partnership property are substantially shifted to a distributee partner before or after the property is actually distributed to such partner. *Id.* § 1.701-2(c)(4), (6)–(7). In addition, if a partnership allocates items in a manner consistent with section 704's literal language but the results are inconsistent

PAAR includes a "super-factor," permitting the Service to compare the stated business purpose for a transaction with the tax benefits arising from such transaction.[126] In evaluating these transactions, however, the weight afforded to any particular factor depends entirely on the facts and circumstances of the transaction.[127]

To better illustrate the final PAAR's application, the Treasury expanded the examples of acceptable and unacceptable transactions.[128] The final PAAR includes eleven examples, as compared to the proposed regulation's four, and a more thorough analysis of each specified transaction.[129] Although most examples involve transactions complying with the regulation, the final PAAR includes three examples of transactions violating the regulation.[130] Like the examples set forth in the proposed PAAR, however, the Treasury explicitly limits the examples' applicability to the facts and circumstances set forth in each specific example.[131]

In conjunction with the final PAAR's issuance, the Service instituted a special enforcement procedure designed to promote the uniform and objective application of the regulation.[132] Specifically, the Service now requires its examiners to obtain prior approval from the IRS National Office before challenging a transaction based on the final PAAR.[133] Thus, the IRS National Office maintains primary

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with its purpose, then the Service may consider such factor in determining whether the final PAAR is violated, particularly when the partnership specially allocates income or gain to a partner that is actually or effectively exempt from tax. *Id.* § 1.701-2(c)(5).

[126] *Id.* § 1.701-2(c).

[127] *Id.*

[128] *Id.* § 1.701-2(d).

[129] *Id.* Initially, the final PAAR contained thirteen examples, but the Treasury amended the regulation and deleted two of its examples. *Compare* T.D. 8588, 1995-1 C.B. 109, 114 (initial rule with 13 examples), *with* T.D. 8592, 1995-1 C.B. 119, 120 (final rule eliminating examples 5 and 6).

[130] *See* Treas. Reg. § 1.701-2(d), exs. 7, 9, 11.

[131] *See id.* § 1.701-2(d) ("[T]he addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example."). For a more thorough discussion of the final PAAR's examples, see MCKEE ET AL., *supra* note 78, at ¶ 1.05[3]. *See also* Herman J. Marino, *The Final Partnership Anti-Abuse Regulation: The Treasury Redefines the "Intent of Subchapter K,"* 73 TAXES 171, 176 (1995).

[132] *See* I.R.S. Announcement 94-87, 1994-27 I.R.B. 124 (June 13, 1994).

[133] *See id.*; *see also* I.R.S. Coordinated Issue Paper, *Subchapter K Anti-Abuse Rule Regulation Section 1.701-2* (June 26, 1995), TAX NOTES TODAY, June 26, 1995, 95 TNT 124-10 (LEXIS) (directing examiners to contact the partnership industry or issue specialist when considering an issue under section 1.701–2); Memorandum from L.E. Carlow, Assistant Comm'r of Examinations, Internal Revenue Serv., to Regional Chief Compliance Officers (Oct. 17, 1995), *reprinted in Examiners Directed Not to Raise Antiabuse Issue Without Permission*, TAX NOTES TODAY, Oct. 17, 1995, 95 TNT 207-10 (LEXIS) (requiring examiners to contact the Partnership Issue Specialist or Partnership Industry Specialist to obtain clearance before raising the final PAAR with a taxpayer).

responsibility for coordinating the final PAAR's application throughout the country.[134]

D. The Post-Issuance World: 1995 to Present

Sixteen years have passed since the Treasury issued the final PAAR. Thus, sufficient time has elapsed to assess the PAAR's impact on the federal income tax system. Were practitioners' virtually unanimous doomsday predictions accurate? Did the regulation bring about the demise of commercial partnership transactions? Did the Service indiscriminately apply the final PAAR to any and every transaction that it did not like or understand?

The answer to all these questions is no. For a regulation earnestly compared to a weapon of mass destruction,[135] the final PAAR has had a surprisingly modest impact on subchapter K. The Service has relied on the final PAAR in few published materials, and no court has decided a case based on the regulation.[136] Even practitioners, who responded furiously to the proposed PAAR, have adopted a muted approach to the regulation.[137] This Section tracks the PAAR's application from its finalization to the present, illustrating its nominal presence in the world of partnership taxation.

1. Administrative Guidance

Almost five years passed before the publication of any administrative material—whether intended as public guidance to taxpayers or internal guidance to examiners—in which the Service challenged a transaction based on the final PAAR.[138] Similar to the

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[134] The Service has, however, given examiners blanket approval to raise the final PAAR without the prior consent of the IRS National Office in seven designated areas: (1) transactions involving a sale of state tax credits; (2) Son-of-BOSS transactions; (3) partnership straddle transactions; (4) S corporation transactions involving excess losses; (5) transactions involving the sale of compensatory options to related parties; (6) transactions involving foreign corporations and the creation of deductions; and (7) Redemption BOB transactions. Shop Talk, *Agents Will Apply, Courts May Deny*, *supra* note 27, at 314; *see also* Sheryl Stratton, *IRS Gives Agents Blanket Authority to Apply Partnership Antiabuse Reg*, TAX NOTES TODAY, Mar. 15, 2007, 2007 TNT 51-5 (LEXIS) [hereinafter Stratton, *Blanket Authority*].

[135] *See* Orange County Bar Ass'n Comments, *supra* note 71 (equating section 1.701-2 to using an atomic bomb to perform delicate brain surgery).

[136] *See infra* Part I.D.1.

[137] *See, e.g.*, Richard M. Lipton, *The Partnership Anti-Abuse Regs. Revisited: Is There Calm After the Storm?*, 83 J. TAX'N 68, 68 (1995) [hereinafter Lipton, *Calm After the Storm?*] ("While the validity of the Regulations continues to be questionable, practitioners should take a practical approach in planning transactions."); Lee A. Sheppard, *Final Partnership Antiabuse Rule: Not So Bad, Apparently*, 66 TAX NOTES 465, 465 (1995) [hereinafter Sheppard, *Not So Bad, Apparently*].

[138] Although the Service did not apply the final PAAR in any published guidance for approximately five years, it did mention the regulation in various authorities, generally noting

tax climate at the time of the PAAR's proposal, partnership tax shelters were proliferating, and the Service was struggling to devise an effective strategy to combat them.[139] Thus, the Service turned to the final PAAR. In most instances, the Service raised the regulation together with a judicial doctrine like the economic substance doctrine.[140] To date, the Service has relied on the final PAAR as the

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that it did not apply. *See* Field. Serv. Adv. 1999-230 (March 26, 1999), TAX NOTES TODAY, March 26, 1999, 99 TNT 165-71 (LEXIS); Field Serv. Adv. 1999-36-011, 1999 FSA LEXIS 166 (June 3, 1999) (PAAR not applicable to determination of whether payment by an LLC to a member is treated as a section 707 sale or exchange); Field Serv. Adv. 1999 FSA LEXIS 386 (Mar. 26, 1999) (PAAR not applicable to determination of whether taxpayer is a partner); Field Serv. Adv. 1998 FSA LEXIS 315 (Sept. 23, 1998) (transaction completed prior to effective date of PAAR); Field Serv. Adv. 1998 FSA LEXIS 356 (June 5, 1998) (transaction completed prior to effective date of PAAR); Field Serv. Adv. 1998 FSA LEXIS 337 (Apr. 15, 1998) (transaction completed prior to effective date of PAAR); Field Serv. Adv. 1997 FSA LEXIS 208 (Aug. 14, 1997) (transaction completed prior to effective date of PAAR); I.R.S. Priv. Ltr. Rul. 96-45-015 (Aug. 9, 1996) (expressing no opinion on whether the PAAR applies to the transaction); Field Serv. Adv. 1996 FSA LEXIS 177 (June 6, 1996) (transaction completed prior to effective date of PAAR); Field Serv. Adv. 1995 FSA LEXIS 192, (Nov. 20, 1995) (transaction completed prior to effective date of PAAR).

There is, however, one 1998 Field Service Advice Memorandum that notes the existence of the final PAAR and advises the examiner to contact either the Partnership Industry Specialist or the IRS National Office to seek authorization to apply the regulation. Field Serv. Adv. 1998 FSA LEXIS 276 (Apr. 13, 1998). But again, the Service did not apply the final PAAR in this memorandum. *Id.*

[139] *See* Compaq Computer Corp. v. Comm'r, 277 F.3d 778 (5th Cir. 2001); United Parcel Serv. of Am., Inc. v. Comm'r, 254 F.3d 1014 (11th Cir. 2001); IES Indus., Inc. v. United States 253 F.3d 350 (8th Cir. 2001); Boca Investerings P'ship v. United States, 167 F. Supp. 2d 298 (D.D.C. 2001), *rev'd*, 314 F.3d 625 (D.C. Cir. 2003); Salina P'ship L.P. v. Comm'r, 80 T.C.M. (CCH) 686 (2000); Saba P'ship v. Comm'r, 78 T.C.M. (CCH) 684 (1999), *vacated*, 273 F.3d 1138 (D.C. Cir. 2001).

[140] *See, e.g.*, I.R.S. Tech. Adv. Mem. 2008-07-015 (Nov. 7, 2007) (foreign tax credit generator transaction); I.R.S. Coordinated Issue Paper, *Distressed Asset/Debt Tax Shelters* (Apr. 18, 2007), TAX NOTES TODAY, Apr. 18, 2007, 2007 TNT 79-11 (LEXIS) (distressed asset/debt transaction); Chief Couns. Adv. 2007-002 (Jan. 11, 2007), TAX NOTES TODAY, Jan. 11, 2007, 2007 TNT 19-23 (LEXIS) (state income tax credit generator transaction); Chief Couns. Adv. 2007-04-030 (Oct. 6, 2006), TAX NOTES TODAY, Oct. 6, 2006, 2007 TNT 19-21 (LEXIS) (state income tax credit generator transaction); Chief Couns. Adv. 2007-002 (Jan. 11, 2007), TAX NOTES TODAY, Jan. 11, 2007, 2007 TNT 19-23 (LEXIS) (state income tax credit generator transaction); Chief Couns. Adv. 2007-04-028, (Oct. 6, 2006), TAX NOTES TODAY, Oct. 6, 2006, 2007 TNT 19-20 (LEXIS) (state income tax credit generator transaction); I.R.S. Coordinated Issue Paper, *Redemption Bogus Optional Basis Tax Shelter* (Jan. 31, 2006), TAX NOTES TODAY, Jan. 31, 2006, 2006 TNT 25-38 (LEXIS) (Redemption BOB transaction); Chief Couns. Adv. 2004-50-001 (Apr. 4, 2003), TAX NOTES TODAY, Apr. 4, 2003, 2004 TNT 239-75 (LEXIS) (transaction artificially increasing the basis of partnership assets under sections 732(c) and 708(b)(1)(B)); I.R.S. Coordinated Issue Paper, *Transfer or Sale of Compensatory Options or Restricted Stock to Related Persons* (Oct. 15, 2004), TAX NOTES TODAY, Oct. 15, 2004, 2004 TNT 204-14 (LEXIS) (transfer or sale of stock to related persons); I.R.S. Notice 2004-31, 2004-1 C.B. 830 (earnings stripping transaction); I.R.S. Notice 2004-19, 2004-1 C.B. 606 (foreign tax credit generator transaction); Chief Couns. Notice CC-2003-030 (Sept. 10, 2003), TAX NOTES Today, Sept. 10, 2003, 2003 TNT 217-21 (LEXIS) (Son-of-BOSS transaction); I.R.S. Notice 2003-55, 2003-2 C.B. 395 (lease stripping transaction); Chief Couns. Notice CC-2003-020 (June 25, 2003), TAX NOTES TODAY, June 25, 2003, 2003 TNT 124-18 (LEXIS) (Son-of-BOSS transaction); Field Serv. Adv. 2002-46-016 (Aug. 14, 2002), TAX NOTES

sole grounds for challenging a transaction in only four written determinations.[141]

Although the level of analysis varies, these administrative materials generally contain little guidance about the final PAAR's application. In many cases, the Service simply notes that it may challenge the transaction under the final PAAR.[142] More recent administrative materials contain more robust discussions of the factors relevant to determining whether the transaction violates the regulation.[143] Yet practitioners continue to criticize the Service for

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TODAY, Aug. 14, 2002, 2002 TNT 222-46 (LEXIS) (leveraged partnership transaction); Chief Couns. Adv. 2002-46-014 (Aug. 8, 2002), TAX NOTES TODAY, Aug. 8, 2002, 2002 TNT 222-46 (LEXIS) (leveraged partnership transaction); I.R.S. Notice 2002-65, 2002-2 C.B. 690 (pass-through entity straddle tax shelter); I.R.S. Notice 2002-50, 2002-2 C.B. 98 (partnership straddle tax shelter); I.R.S. Coordinated Issue Paper, *Losses Reported from Inflated Basis Assets from Lease Stripping Transactions* (Dec. 3, 2001), TAX NOTES TODAY, Dec. 3, 2001, 2001 TNT 235-18 (LEXIS) (lease stripping transaction); Field Serv. Adv. 2001-34-002 (Mar. 23, 2001), TAX NOTES TODAY, Mar. 23, 2001, 2001 TNT 166-17 (LEXIS) (lease stripping transaction); Chief Couns. Adv. 2001-18-005, TAX NOTES TODAY, Jan. 8, 2001, 2001 TNT 88-71 (LEXIS) (Son-of-BOSS transaction); I.R.S. Notice 2000-44, 2000-2 C.B. 255 (Son-of-BOSS transaction).

Additionally, in several instances, the Service raised the PAAR as an alternative second-level means of challenging a transaction. *See, e.g.*, Chief Couns. Adv. 2006-50-014 (Sept. 7, 2006), TAX NOTES TODAY, Sept. 7, 2006, 2006 TNT 242-17 (LEXIS); Field Serv. Adv. 2002-19-008 (Jan. 30, 2002), TAX NOTES TODAY, Jan. 30, 2002, 2002 TNT 92-55 (LEXIS); Field Serv. Adv. 2000-15-005 (Dec. 30, 1999), TAX NOTES TODAY, Dec. 30, 1999, 2000 TNT 74-57 (LEXIS).

[141] *See* Chief Couns. Adv. 2006-13-031 (Nov. 1, 2005), TAX NOTES TODAY, Nov. 1, 2005, 2006 TNT 64-8 (LEXIS) (relying solely on the PAAR to invalidate a series of transactions); Chief Couns. Adv. 2005-13-022 (Nov. 15, 2004), TAX NOTES TODAY, Nov. 15, 2004, 2005 TNT 63-36 (LEXIS) (using the PAAR to invalidate a building transfer); Field Serv. Adv. 2002-42-004 (July 19, 2002), TAX NOTES TODAY, July 19, 2002, 2002 TNT 204-45 (LEXIS) (using the PAAR to prevent loss recognition on the sale of a loss property to a third party); Chief Couns. Adv. 2001-28-053 (May 22, 2001), TAX NOTES TODAY, May 22, 2001, 2001 TNT 136-75 (LEXIS) (invoking the PAAR to recast a transaction abusing Section 732).

[142] *See, e.g.*, I.R.S. Notice 2003-55, 2003-2 C.B. 395; I.R.S. Notice 2002-50, 2002-2 C.B. 98; Chief Couns. Adv. 2001-28-053 (May 22, 2001), TAX NOTES TODAY, May 22, 2001, 2001 TNT 136-75 (LEXIS); Chief Couns. Adv. 2001-18-005 (Jan. 8, 2001), TAX NOTES TODAY, Jan. 8, 2001, 2001 TNT 88-71 (LEXIS); I.R.S. Notice 2000-44, 2000-2 C.B. 255; *see also* Shop Talk, *Partnership Anti-Abuse Rules: Postpone the Funeral*, 95 J. TAX'N 123, 123 (2001) ("Application of the Regulation to date has been virtually nonexistent, and in the few reported situations where it has been raised by a field agent, the National Office has ruled it not to be applicable to the transaction at hand . . . or to be an alternative or additional argument in connection with the Service's multiple attacks on an allegedly abusive tax shelter.").

[143] *See* I.R.S. Tech. Adv. Mem. 2008-07-015 (Nov. 7, 2007); Chief Couns. Adv. 2007-04-030 (Oct. 6, 2006), TAX NOTES TODAY, Oct. 6, 2007, 2007 TNT 19-21 (LEXIS); Chief Couns. Adv. 2007-04-028 (Oct. 6, 2006), TAX NOTES TODAY, Oct. 6, 2007, 2007 TNT 19-20 (LEXIS); Chief Couns. Adv. 2006-13-031, 2005 IRS CCA LEXIS 99 (Nov. 1, 2005); Field Serv. Adv. 2002-42-004, 2002 FSA LEXIS 75 (July 19, 2002); Field Serv. Adv. 2001-34-002 (Mar. 23, 2001), TAX NOTES TODAY, Mar. 23, 2001, 2001 TNT 166-17 (LEXIS). Although the level of analysis contained in these authorities is greater than prior authorities, I do not suggest that all practitioners considered this level of analysis adequate. See *infra* note 144 for an example of a practitioner response to the heightened analysis set forth in these authorities.

failing to provide them with the guidance necessary to apply the final PAAR.[144]

There is also a growing perception among practitioners that the Service's application of the final PAAR has become increasingly aggressive.[145] But, like much of the lore surrounding the PAAR, the known facts belie this concern. Although the Service does appear to be relying on the final PAAR somewhat more often, the regulation remains a rarely used tool in the fight against abusive partnership transactions. In the past sixteen years, the Service has applied the final PAAR in less than thirty published rulings and written determinations.[146] Of these, only six qualify as guidance that a taxpayer may rely on when structuring a transaction.[147]

One might argue that these statistics are incomplete. Although providing some evidence of the Service's limited reliance on the final PAAR, such numbers fail to consider the Service's application of the final PAAR in audits and withdrawn private letter ruling requests.[148]

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[144] *See, e.g.*, Shop Talk, *Misuse of Partnership Anti-Abuse Rule*, *supra* note 27, at 378. The article maintains that

> [i]t is possible that, with fuller explanation and analysis, the IRS could have reasonably concluded that the transaction described in ILM 200613031 was inconsistent with the intent of Subchapter K . . . . The paucity of analysis, however, makes it impossible to reach this conclusion . . . . Your editors find this 'analysis,' such as it is, indefensible. If the IRS wants to assert that the partnership anti-abuse Regulation applies to a given transaction, the IRS needs to better define the reason for its application.

Id.

[145] *See id.* at 377 ("[W]ith the passage of time, the IRS has become much more 'liberal' in determining the situations in which it will attempt to apply the partnership anti-abuse Regulation."). The Service has relaxed its enforcement restrictions with respect to the final PAAR in one important respect. As of 2007, the Service has granted examiners blanket approval to apply the regulation without prior approval from the IRS National Office in seven contexts, many of which relate to listed transactions. *See supra* note 134. All other transactions remain subject to the procedures set forth in Announcement 94-87. *See supra* notes 132–33 and accompanying text. That is, an examiner cannot apply the final PAAR to a transaction without the prior approval of the Partnership Industry Specialist or the IRS National Office.

[146] *See supra* notes 140–41.

[147] *See* I.R.S. Notice 2004-31, 2004-1 C.B. 830; I.R.S. Notice 2004-19, 2004-1 C.B. 606; I.R.S. Notice 2003-55, 2003-2 C.B. 395; I.R.S. Notice 2002-65, 2002-2 C.B. 690; I.R.S. Notice 2002-50, 2002-2 C.B. 98; I.R.S. Notice 2000-44, 2000-2 C.B. 255. The remaining authorities, discussed *supra* notes 140–41 are primarily internal agency advice that taxpayers cannot rely on as precedent.

[148] *See* Shop Talk, *Partnership Anti-Abuse Rules: The Service's Clandestine Activities*, 95 J. TAX'N 318, 318 (2001) ("Word now comes that [the] IRS is applying Reg. 1.701-2 in a seemingly clandestine fashion . . . . Shop Talk subsequently spoke with Paul Kugler, IRS Associate Chief Counsel, Pass-Throughs and Special Industries, who informed us that the IRS indeed has applied Reg. 1.701-2 on numerous occasions. Although it occasionally arises in the context of a letter ruling request, it more frequently arises in the context of audits . . . ."); *see also* Brant Goldwyn, *IRS Chief Counsel Office Grappling with Partnership Guidance Projects*, Daily Tax Rep. (BNA), at G-6 (Oct. 19, 2001) ("IRS application of the [final PAAR] often is not visible to the public because it involves letter ruling requests that are withdrawn before [the]

Again, however, the available data do not support this concern. Between 2003 and 2007, examiners submitted a mere 154 requests to the IRS National Office for prior approval to challenge a transaction under audit based on the final PAAR.[149] Of these requests, the IRS National Office granted 128.[150] During this same period, an average of approximately 2,693,755 partnerships filed federal income tax returns annually.[151] Thus, the number of times the IRS National Office authorized an examiner to raise the final PAAR during an audit is miniscule in comparison to the average number of annual returns filed.

2. *Judicial Decisions*

The final PAAR has had a similarly modest impact on judicial decisions.[152] To date, there are approximately twenty reported cases in which the Service initially challenged a transaction under the final PAAR.[153] Like most of the administrative materials discussed above,

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IRS issues a ruling . . . .").

149 Lee A. Sheppard, *Government Officials Discuss Partnership, Shelter Issues*, TAX NOTES TODAY, June 4, 2007, 2007 TNT 107-1 (LEXIS); Shop Talk, *Agents Will Apply, Courts May Deny*, *supra* note 27, at 315.

150 *See* Shop Talk, *Agents Will Apply, Courts May Deny*, *supra* note 27, at 315.

151 JOINT COMM. ON TAX'N, *supra* note 2, at 8 tbl.1 (providing reported number of partnership returns filed between 2003 and 2005); Taukir Hussain *Internal Revenue Service Projections of Federal Tax Return Filings: Calendar Years 2005–2012*, SOI BULL., Winter 2005–2006, at 147, 155 tbl.1, *available at* http://www.irs.gov/pub/irs-soi/12proj.pdf (providing projected number of partnership returns expected to be filed in 2006 and 2007).

152 In discussing some of these litigated cases, one commentator made the following observation:

> Where is the partnership antiabuse rule in these cases? Wasn't it supposed to make things easier for the government when a partnership was formed for no other purpose than to obtain tax benefits that would otherwise not be obtainable? . . . The government has been arguing reg. section 1.701-2 in son-of-BOSS cases, but courts have been looking for easier ways to dispose of them.

Lee A. Sheppard, *Scorched Earth in Son-of-BOSS Cases*, 120 TAX NOTES 9, 14 (2008) [hereinafter Sheppard, *Scorched Earth*].

153 *See* Klamath Strategic Inv. Fund v. United States, 568 F.3d 537 (5th Cir. 2009); Kornman & Assocs., Inc. v. United States, 527 F.3d 443 (5th Cir. 2008); Cemco Investors, L.L.C. v. United States, 515 F.3d 749 (7th Cir. 2008); RJT Invs. X v. Comm'r, 491 F.3d 732 (8th Cir. 2007); Murfam Farm, L.L.C. v. United States, 88 Fed. Cl. 516 (2009); Alpha I, L.P. *ex rel.* Sands v. United States, 84 Fed. Cl. 622 (2008); Jade Trading, L.L.C. v. United States, 80 Fed. Cl. 11 (2007), *aff'd in part, vacated in part, and rev'd in part sub nom.* Jade Trading, L.L.C. *ex rel.* Ervin v. United States, No. 2008-5045, 2010 WL 1049876 (Fed. Cir. Mar. 23, 2010); Salman Ranch Ltd. v. United States, 79 Fed. Cl. 189 (2007), *rev'd*, 573 F.3d 1362 (Fed. Cir. 2009); Fid. Int'l Currency Advisor A Fund, L.L.C. v. United States, Nos. 05-40151-FDS, 06-40130-FDS, 06-40243-FDS, 06-40244-FDS, 2008 U.S. Dist. LEXIS 94237 (D. Mass. Apr. 18, 2008); Belford Strategic Inv. Fund, L.L.C. v. United States, No. C-04-4309 VRW, 2005 U.S. Dist. LEXIS 45219 (N.D. Cal. Nov. 7, 2005); Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004), *aff'd*, 150 F. App'x 40 (2d Cir. 2005); Tigers Eye

the Service applied the final PAAR together with one of the longstanding judicial doctrines, generally the economic substance doctrine.[154] In deciding these cases, the courts based their holdings on the judicial doctrines rather than the final PAAR.[155] With one exception, no reported case devoted more than a sentence to the final PAAR.[156]

The exception, *Countryside Limited Partnership v. Commissioner*, dedicated just two paragraphs to the final PAAR.[157] *Countryside* involved a highly structured series of transactions spanning a number of years.[158] In basic terms, Countryside owned appreciated real property that the partnership intended to sell. Two of Countryside's partners wanted to avoid recognizing gain on the sale; therefore, the partnership agreed to liquidate their partnership interests.[159] To this end, Countryside distributed recently purchased notes to the partners in complete liquidation of their interests, and neither partner

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Trading, L.L.C. v. Comm'r, 97 T.C.M. (CCH) 1622 (2009); Napoliello v. Comm'r, 97 T.C.M. (CCH) 1536 (2009); New Millennium Trading, L.L.C. v. Comm'r, [2008 Transfer Binder] 131 T.C. No. 18 (2008), *aff'd*, 591 F.3d 649 (D.C. Cir. 2010); Petaluma FX Partners, L.L.C. v. Comm'r, [2008 Transfer Binder] 131 T.C. No. 9 (2008); Countryside L.P. v. Comm'r, 95 T.C.M. (CCH) 1006 (2008); Nussdorf v. Comm'r, 129 T.C. 30 (2007); Domulewicz v. Comm'r, 129 T.C. 11 (2007), *aff'd sub nom.* Desmet v. Comm'r, 581 F.3d 297 (6th Cir. 2009); Goldberg v. Comm'r, 93 T.C.M. (CCH) 1081 (2007); Santa Monica Pictures, L.L.C. v. Comm'r, 89 T.C.M. (CCH) 1157 (2005).

Additionally, in several litigated cases involving transactions entered into prior to the effective date of the final PAAR, the courts took note of the regulation but did not consider its application. *See, e.g.*, ACM P'ship v. Comm'r, 157 F.3d 231, 246 n.29 (3d Cir. 1998); Brown Group, Inc. v. Comm'r, 77 F.3d 217, 222 (8th Cir. 1996).

[154] *See* cases cited *supra* note 153.

[155] *See, e.g.*, *Klamath*, 568 F.3d at 543; *Cemco*, 515 F.3d at 752; *Jade Trading*, 80 Fed. Cl. at 52; *Tigers Eye Trading*, 97 T.C.M. (CCH) at 1638; *Countryside*, 95 T.C.M. (CCH) at 1016–19; *Jade Trading*, 80 Fed. Cl. at 52; *Santa Monica Pictures*, 89 T.C.M. (CCH) at 1204.

Interestingly, several of the cases involved challenges to the final PAAR's validity. In particular, practitioners' hopes ran high that the United States Court of Federal Claims would address the regulation's validity in *Jade Trading*, 80 Fed. Cl. 11 (2007). *See, e.g.*, Shop Talk, *Will the Court of Federal Claims Invalidate the Partnership Anti-Abuse Rule?*, 102 J. TAX'N 379, 379 (2005) (discussing the possible implications of *Jade Trading* on the validity and applicability of the final PAAR). But such hopes were dashed due to intervening developments concerning the economic substance doctrine. Specifically, the United States Court of Appeals for the Federal Circuit decided *Coltec Industries, Inc. v. United States*, thereby establishing the governing standard for economic substance controversies arising within the circuit. 454 F.3d 1340, 1355–57 (Fed. Cir. 2006). As a result, the Court of Federal Claims relied on *Coltec*, holding that the transactions at issue in *Jade Trading* lacked economic substance. *Jade Trading*, 80 Fed. Cl. at 52. Thus, there was no need for the court to address the final PAAR's validity.

[156] *See Santa Monica Pictures*, 89 T.C.M. (CCH) at 1190 n.84.

[157] *Countryside*, 95 T.C.M. (CCH) at 1010–11.

[158] *See id.* at 1006, 1008–09. For a more detailed discussion of the *Countryside* case, see Karen C. Burke, *Tax Avoidance as a Legitimate Business Purpose*, 118 TAX NOTES 1393 (2008); Martin J. McMahon, Jr. et al., *Recent Developments in Federal Income Taxation: The Year 2008*, 9 FLA. TAX REV. 275, 406 (2009).

[159] *Countryside*, 95 T.C.M. (CCH) at 1008.

recognized any gain on the transaction.[160] Thereafter, in separate transactions, the partnership sold the real property, and the liquidated partners redeemed their notes.[161]

The issue in *Countryside* was whether the liquidated partners should recognize gain on the distribution of the notes.[162] Relying on the economic substance doctrine and the final PAAR, the Service recharacterized the distribution as a cash distribution, which would have triggered gain recognition for the liquidated partners.[163] The Service argued that the series of transactions—including the liquidating distribution, the real property sale, and the note redemption—resulted in the liquidated partners controlling the proceeds of the real property sale, yet impermissibly avoiding the related tax liability.[164]

Focusing exclusively on the liquidating distribution, the Tax Court disagreed and held that the distribution of the notes had economic substance.[165] Both Countryside and its partners had legitimate business reasons for engaging in the liquidating distribution, and that transaction affected the economic position of the parties.[166] Although tax-advantaged, the court was unwilling to disregard a transaction with economic substance.

The Tax Court then proceeded to do something that no federal court had done before—analyze the transaction under the final PAAR.[167] Although cursorily, the court walked through each element of the regulation, ultimately finding that the liquidating distribution complied with the final PAAR.[168] Specifically, the court determined that the transaction was consistent with the intent of subchapter K. Countryside was a bona fide partnership, the liquidating distribution was supported by substantial business purposes, the distribution did not violate substance over form principles, and the partners' nonrecognition of gain clearly reflected income.[169]

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160 *Id.*

161 *Id.*

162 *Id.* at 1009.

163 *Id.* at 1016.

164 *Id.* at 1012.

165 *Id.* at 1018–19.

166 *Id.*

167 *See id.* at 1021–22.

168 *See id.*

169 *Id.* In a footnote, however, the court noted that if the entire series of transactions, including the liquidating distribution, the real property sale and the redemption of the note, were taken together, the overall transaction might not clearly reflect income. *Id.* at 1022 n.29. Thus, the transactions might violate the final PAAR. *Id.* Since these transactions were not in dispute in *Countryside*, the court declined to address them. *Id.* Rather, such issues will await decision when the three remaining Countryside cases are heard by the Tax Court and the Court of Federal Claims. *Countryside L.P. v. Comm'r*, No. 22023-05 (T.C., filed June 8, 2009),

3. Practitioner Advice

Most surprisingly, the final PAAR has only nominally impacted professional tax advice.[170] Because practitioners have come to view the final PAAR as toothless, they simply ignore it.[171]

Practitioners' view of the final PAAR was shaped, in large part, by the same concerns raised when the regulation was proposed in 1994. First, practitioners claim that the final PAAR is so vague that they do not know how to apply it.[172] Thus, practitioners continue to do what they have always done—ensure that a transaction has a business purpose and otherwise complies with the various judicial doctrines.[173] The only new twist is that the client now has to be advised of this curious, but impotent, regulation.[174] Second, practitioners continue to believe that the final PAAR is invalid, and would not survive a judicial challenge.[175] As a consequence, they do not feel compelled to take account of the final PAAR when structuring transactions.[176]

Manchester Promisee, L.L.C. v. United States, No. 1:05-cv-00011-MCW (Fed. Cl., filed Jan. 5, 2005), and CLP Promisee, L.L.C. v. United States, No. 1:05-cv-00012-MCW (Fed. Cl., filed Jan. 5, 2005).

170 *See, e.g.*, Cunningham & Repetti, *supra* note 8, at 58–59; Gunn, *supra* note 9, at 173.

171 *See* Gunn, *supra* note 9, at 159; Burke, *supra* note 158, at 1393; Shop Talk, *Agents Will Apply, Courts May Deny*, *supra* note 27, at 314; Lee A. Sheppard, *Partnership Shelter Guidance Coming*, TAX NOTES TODAY, June 12, 2002, 2002 TNT 113-3 (LEXIS) ("The partnership antiabuse rule, reg. section 1.701-2, is reputed to be toothless. It is widely viewed as ineffectual and meaningless by the partnership bar.").

172 *See* Banoff, *Use and Misuse of Anti-Abuse Rules*, *supra* note 15, at 835 (noting that overly broad and vague rules provide no guidance in individual situations); Frank V. Battle, Jr., *The Appropriateness of Anti-Abuse Rules in the U.S. Income Tax System*, 48 TAX LAW. 801, 806 (1995) (questioning the "wisdom and effectiveness of an anti-abuse rule that spawns more and more rules, examples, and explanations"); Lipton, *Calm After the Storm?*, *supra* note 137, at 70 ("Significant ambiguities in the anti-abuse Regulations make it difficult to determine whether the rules apply to a particular transaction.").

173 *See* Lipton, *Calm After the Storm?*, *supra* note 137, at 73–74; Sheppard, *Not So Bad, Apparently*, *supra* note 137, at 465.

174 *See* Lipton, *Calm After the Storm?*, *supra* note 137, at 74.

175 *See, e.g.*, *id.* ("[T]he broadly worded anti-abuse Regulations may not survive judicial scrutiny."); William F. Nelson, *The Limits of Literalism: The Effect of Substance Over Form, Clear Reflection and Business Purpose Considerations On the Proper Interpretation of Subchapter K*, 73 TAXES 641, 642 (1995) ("I believe it goes without saying that any interpretive approach that proposes to overlook the plain meaning of statutory language that has survived the constitutional process of bicameralism and presentment ought to raise eyebrows."); Sheldon I. Banoff, *Anatomy of an Antiabuse Rule: What's Really Wrong with Reg. Section 1.701-2*, TAX NOTES TODAY, Mar. 20, 1995, 1995 TNT 56-84 (LEXIS) [hereinafter Banoff, *What's Really Wrong with 1.701-2*] ("The antiabuse rule appears to extend existing law and go beyond congressional principles."); *see also* Shop Talk, *Ninth Circuit Invalidates Anti-Abuse Rule; Is Reg. 1.701-2 Similarly Flawed?*, 83 J. TAX'N 380, 380–81 (1995) (sharing the thoughts of attorney William H. Caudill of Fulbright & Jaworski concerning the final PAAR).

The final PAAR's intent of subchapter K standard is particularly problematic to practitioners. They believe it applies the traditional judicial doctrines in an unprecedented and impermissible manner. *See* Lipton, *Calm After the Storm?*, *supra* note 137, at 73–74; Nelson,

E. The Failure of the Partnership Anti-Abuse Rule

Sixteen years of experience with the final PAAR lead to one conclusion: the regulation failed. And it failed in the most distinctive and unexpected way, especially in light of the controversy the regulation generated; the final PAAR is irrelevant. In an era marked by prolific tax abuse, there is scant evidence of the final PAAR's existence, let alone its application.[177] The Service rarely raises it, the courts rarely apply it, and practitioners rarely consider it.[178]

Two important developments, each occurring after the Treasury issued the final PAAR, illustrate the regulation's failure. First, partnership tax shelters flooded the market with devastating effect.[179] The Treasury had hoped that the final PAAR would discourage taxpayers from entering into abusive partnership transactions, but the regulation had no such impact. On the contrary, taxpayers paid little heed to the regulation.

Even worse, many partnership tax shelters marketed after the Treasury finalized the PAAR strongly resembled the very examples of abusive transactions set forth in the regulation. For instance, Example 7 of the regulation describes a rent-stripping transaction that would violate the final PAAR.[180] Yet rent-stripping transactions were common in the years following the Treasury's issuance of the final PAAR, and the Service was ultimately forced to issue a separate

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supra, at 658. For excellent discussions of the final PAAR's validity, compare Cunningham & Repetti, *supra* note 8, at 50–55 (concluding that the final PAAR is valid), with MCKEE ET AL., TAXATION OF PARTNERSHIPS AND PARTNERS, *supra* note 78, ¶ 1.05[5] (concluding that the final PAAR is invalid).

176 *See* Cunningham & Repetti, *supra* note 8, at 34.

177 *See supra* Part I.D.

178 The one notable exception is Lee Sheppard. Over the past decade, Sheppard has written a plethora of articles addressing abusive partnership transactions. In many of these articles, she repeatedly wonders about the PAAR's whereabouts. *See, e.g.*, Lee A. Sheppard, *Erroneous Application of the Economic Substance Doctrine*, 118 TAX NOTES 259; Lee A. Sheppard, *The Fairies, the Magic Circle, and Partnership Options*, 90 TAX NOTES 721 (2001); Lee A. Sheppard, *Government Officials Discuss Partnership, Shelter Issues*, TAX NOTES TODAY, June 1, 2007, 2007 TNT 107-1 (LEXIS); Lee A. Sheppard, *Treasury Begins to Shut Down Bond Premium Games*, TAX NOTES TODAY, Mar. 21, 1995, 95 TNT 55-13 (LEXIS); Sheppard, *Scorched Earth*, *supra* note 152, at 14.

179 *See supra* notes 10–14 and accompanying text.

180 Treas. Reg. § 1.701-2(d), ex. 7 (as amended in 1995). While a detailed discussion of rent-stripping transactions is beyond the scope of this Article, a general definition of such transactions might be useful. Rent stripping transactions are "multiple-party transactions intended to allow one party to realize rental or other income from property or service contracts and to allow another party to report deductions related to that income (for example, depreciation or rental expenses)." I.R.S. Notice 95-53, 1995-2 C.B. 334.

notice proscribing such transactions.[181] The final PAAR itself did nothing.

Similarly, Example 8 addresses a transaction involving the improper duplication of tax losses through a partnership distribution.[182] Despite this example, loss-duplicating transactions proliferated following the PAAR's finalization. Again, the Service had to take separate remedial action, issuing a specific notice prohibiting these transactions.[183]

Second, Congress and the Treasury continued to issue targeted anti-abuse provisions. Most notably, Congress enacted a series of provisions specifically addressing the abusive partnership transactions included in the final PAAR's examples. For instance, in 2004 Congress enacted a narrowly tailored anti-abuse rule intended to prevent the transactions addressed in Example 8 of the final regulation.[184] Thus, partnerships are now required to make adjustments to their basis in property following certain distributions in order to prevent the improper duplication of losses.[185] Had the final PAAR more effectively addressed this abusive transaction, congressional action might not have been necessary.[186]

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[181] *See* I.R.S. Notice 2003-55, 2003-34 C.B. 395.

[182] Treas. Reg. § 1.701-2(d), ex. 8 (as amended in 1995). In this example, Taxpayer A owns a loss asset that he would like to sell to a third party. As part of this transaction, Taxpayer A also would like to duplicate the asset's loss. Thus, Taxpayer A forms a partnership with his brother and his brother's spouse, and Taxpayer A contributes the loss asset, which is thereafter leased to a third party for three years, to the partnership. Several years later, the partnership liquidates Taxpayer A's interest, distributing investment property to him. The partnership does not make a Section 754 election and, thus, it makes no basis adjustments following the distribution. Taxpayer A then sells such investment property, and recognizes a loss equal to the built in loss in the property he originally contributed to the partnership. Since the partnership did not make a Section 754 election, the partnership also recognizes a loss, which is shared by A's brother and his spouse, when the leased property is sold to the third party. *Id.*

If the partnership had made an election under Section 754, then it would have adjusted the basis of its property following the distribution to Taxpayer A. *See* I.R.C. §§ 734(b), 754 (2006). For a more detailed discussion of the elective-basis adjustment, see MCKEE ET AL., TAXATION OF PARTNERSHIPS AND PARTNERS, *supra* note 78, at ¶¶ 25.01–.07.

[183] *See* I.R.S. Notice 2002-65, 2002-2 C.B. 690; I.R.S. Notice 2000-44, 2000-2 C.B. 255.

[184] American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 833, 118 Stat. 1418, 1589–91 (2004) (codified at I.R.C. § 734(b), (d)).

[185] I.R.C. § 734(b), (d) (2006). A partnership must reduce its basis in its assets if there is a distribution of property to a partner with respect to which there is a substantial basis reduction. *Id.* § 732(b). A distribution triggers a substantial basis reduction if: (1) the distributee partner recognizes a loss in excess of $250,000 with respect to the distribution; or (2) the basis of the distributed property to the distributee partner exceeds the partnership's basis in such property immediately before the distribution by more than $250,000. *Id.* § 734(b)(2), (d)(1).

[186] Additionally, Congress enacted a provision eliminating the abusive transaction illustrated by Example 11 of the final PAAR. Treas. Reg. § 1.701-2(d), ex. 11 (as amended in 1995). Still, in 1997, Congress amended Section 732, providing a more equitable, less abuse-prone means of allocating basis among distributed property. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1061, 111 Stat. 788, 945–46 (codified at I.R.C. § 732(c)). For a more detailed discussion of Section 732 and basis allocations following a liquidating distribution, see

More generally, if confidence in the final PAAR had been higher, neither Congress nor the Treasury would likely have felt it necessary to promulgate targeted anti-abuse provisions proscribing abusive transactions that were seemingly within the regulation's domain. If the many anti-abuse rules added to subchapter K since the final PAAR's issuance serves as any evidence, confidence in the regulation was not high. Nor should it have been; the final PAAR was a remarkable failure.

II. WHY THE PARTNERSHIP ANTI-ABUSE RULE FAILED

There is no one reason why the final PAAR failed. Yet the dynamic relationship between the Treasury and practitioners, particularly during the PAAR's first six months, had a unique and indelible impact on the regulation. Practitioners' venomous response to the PAAR, which continued long after the Treasury finalized the PAAR, was devastating. Even worse, the practitioner reaction triggered other factors that ultimately contributed to the PAAR's demise—the Service's hesitance to apply the regulation and the Treasury's decision to make significant changes to the regulation. But the mystery remains. How could a regulation that generated such intense emotions from the government and practitioners alike founder so terribly and so quickly?

A. The Practitioners' Role

Although practitioners failed to convince the Treasury to withdraw the proposed PAAR, they did succeed in their ultimate goal of eviscerating the regulation. As previously discussed, practitioners waged a bitter campaign against the proposed PAAR.[187] And that campaign did not end when the Treasury finalized the regulation.

Most importantly, a respected cadre of former tax officials commenced an unprecedented letter writing campaign, expressing to the Treasury their displeasure with the final PAAR.[188] Specifically,

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MCKEE ET AL., TAXATION OF PARTNERSHIPS AND PARTNERS, *supra* note 78, at ¶ 19.01[2].

[187] *See supra* Part I.B.2.

[188] *See* Letter from Donald C. Alexander et al. to Leslie B. Samuels, Assistant Sec'y (Tax Pol'y), Dep't of the Treasury (Aug. 18, 1995), *reprinted in Commentators Say Partnership Antiabuse Rule Doesn't Satisfy Fundamental Principles for a Workable Tax System*, TAX NOTES TODAY, Aug. 18, 1995, 95 TNT 175-28 (LEXIS) [hereinafter Alexander Group Comments]; Letter from Lawrence B. Gibbs & John S. Nolan, Miller & Chevalier, to Leslie B. Samuels, Assistant Sec'y (Tax Pol'y), Dep't of the Treasury (Aug. 23, 1995), *reprinted in Partnership Antiabuse Rule Is Broader Than Necessary, Say Miller & Chevalier Attorneys*, TAX NOTES TODAY, Aug. 23, 1995, 95 TNT 175-27 (LEXIS) [hereinafter Gibbs & Nolan Comments]; Letter from Kenneth W. Gideon, Wilmer, Cutler & Pickering, to Leslie B. Samuels, Assistant Sec'y

these former judges and administrative officials believed that a broad freestanding anti-abuse rule like the final PAAR could not be applied objectively or predictably.[189] They argued that this uncertainty, in turn, would trigger larger, more systemic problems, including a reduction in market activity and an erosion of the tax system's integrity.[190] To them, the final PAAR was a dangerous regulation and an even more dangerous precedent for agency rulemaking.[191]

These extraordinary letters raise a fascinating question. Why would such an esteemed group of former tax officials send these coordinated letters almost one year after the Treasury finalized the regulation? Although most of the letters called for the Treasury to withdraw the final PAAR,[192] it is inconceivable that these lawyers believed withdrawal was a realistic possibility, especially considering the Treasury's well-documented commitment to the regulation.[193] It is more likely that these lawyers were trying to manage the future of the final PAAR, as well as the future of broad anti-abuse rules in general.[194]

(Tax Pol'y), Dep't of the Treasury (Aug. 29, 1995), *reprinted in Wilmer, Cutler & Pickering Attorney Says Partnership Antiabuse Rule Encourages 'Standardless Challenges' by IRS Agents*, TAX NOTES TODAY, Aug. 29, 1995, 95 TNT 175-26 (LEXIS) [hereinafter Gideon Letter]; *see also* Samuel Thompson Jr., *Ex-Government Officials Challenge Partnership Anti-Abuse Reg: An Analysis*, TAX NOTES TODAY, Dec. 11, 1995, 95 TNT 242-47 (LEXIS).

189 *See* Alexander Group Comments, *supra* note 188; Gibbs & Nolan Comments, *supra* note 188; Gideon Letter, *supra* note 188.

190 *See, e.g.*, Alexander Group Comments, *supra* note 188.

191 *See, e.g.*, *id.*

192 *See* Alexander Group Comments, *supra* note 188; Gibbs & Nolan Comments, *supra* note 188.

193 *But see* Letter from David H. Brockway to Leslie B. Samuels, Assistant Sec'y (Tax Pol'y), Dep't of the Treasury (Sept. 18, 1995), *reprinted in Brockway Sees Necessity for Partnership Anti-Abuse Rule*, TAX NOTES TODAY, Sept. 18, 1995, 1995 TNT 190-24 (LEXIS) [hereinafter Brockway Comments]. Mr. Brockway, a former chief of staff of the Joint Committee on Taxation, wrote a letter to the Treasury expressing his support for the final PAAR in response to the aforementioned letters of opposition:

> I am writing not because I think that there is any realistic chance that the case made in the correspondence would cause Treasury to reverse field and withdraw the regulations (nor, I suspect, did you [sic] correspondents write with that objective) but because I am concerned that their intended audience might be lulled into believing that their expressed views represent a consensus among former government officials.

Id.

194 *See* Alexander Group Comments, *supra* note 188 ("We do not believe that the best interests of either the Government or the taxpayers will be served by this regulation or similar broad anti-abuse rules not grounded in or authorized by statutory provisions in the Code."); Gibbs & Nolan Comments, *supra* note 188 ("Our real concern is wider than these particular regulations. They represent a type of policy approach to solving tax avoidance problems that is far broader then [sic] we think is necessary and that, by its nature, creates uncertainties as to the application of broad areas of the tax law that are vital to planning business transactions."); Gideon Letter, *supra* note 188 ("I hope that the Treasury Department and the Internal Revenue

B. The Service's Role

The actions of the Service reflected a deep ambivalence toward the final PAAR. Although publicly proclaiming its steadfast commitment to the regulation,[195] the Service's conduct was less convincing. The Service, together with the Treasury, fought a bruising battle over the proposed PAAR, and its finalization failed to quell the controversy. In the PAAR's first year alone, the incoming chairmen of both congressional tax-writing committees,[196] a host of former government officials,[197] and myriad tax practitioners challenged the decision to finalize the regulation.[198] In light of such uniform and passionate disapproval, the Service might have begun to doubt the wisdom of the final PAAR.

Once finalized, the Service neglected the final PAAR, rarely challenging a transaction under the regulation.[199] Perhaps the Service wanted to avoid drawing further ire from the final PAAR's powerful opponents. Or perhaps the Service was concerned about the regulation's validity and feared that litigation might lead to a successful challenge.[200]

Service will not in the future issue similar 'free standing' anti-abuse rules."); *see also* Sheryl Stratton, *They're Back . . . Washington Lawyers Attack Anti-Abuse Rules*, 68 TAX NOTES 1263, 1263 (1995) ("The letter-writing campaign seems to be a concerted cage-rattling effort to get guidance that limits the regulation's application and to deter Treasury from ever trying anything like this again."). Former government officials, however, were not unanimous in their opposition to the final PAAR and broad anti-abuse rules, more broadly. *See* Brockway Comments, *supra* note 193 ("[O]n balance, the regulations are an important and necessary step to protect the fairness of the tax system and the rights of the vast majority of taxpayers that do not engage in the types of tax driven and artificial transactions that are the targets of the regulations."); Letter from Terrill A. Hyde, Wilmer, Cutler & Pickering, to Editor, Tax Notes Today (Mar. 30, 1995), *reprinted in Anti-Abuse Rule Rhetoric Is Full of Holes*, TAX NOTES TODAY, Apr. 13, 1995, 95 TNT 72-49 (LEXIS) [hereinafter Hyde Letter].

195 *See* Juliann Avakian Martin, *Government Aims to Finalize Partnership Antiabuse Rules by Year's End*, 94 TAX NOTES INT'L 200-1 (1994); F.R. Nagle, *Officials Stress Partnership Antiabuse Rules Open to Revisions*, 94 TAX NOTES INT'L 153-1 (1994); Sheppard, *Partnership Antiabuse Rule is Here to Stay*, *supra* note 111.

196 *See supra* note 68.

197 *See* sources cited *supra* note 188.

198 *See supra* Part I.B.2.

199 *See supra* Part I.D.1.

200 These concerns were well founded. In the few litigated cases involving the final PAAR, taxpayers did challenge the regulation's validity. *See, e.g.*, Plaintiff's First Motion for Partial Summary Judgment (Relating to Invalidity of Treas. Reg. § 1.701-2) at 2, Jade Trading, L.L.C. v. United States, 60 Fed. Cl. 558 (2004) (No. 03-2164T), 2003 WL 25656589 (noting severe criticism by leading members of the federal tax bar and alleging unconstitutional vagueness); Plaintiff's Memorandum in Support of First Motion for Partial Summary Judgment (Relating to Invalidity of Treas. Reg. § 1.701-2) at 5, Jade Trading, L.L.C. v. United States, 60 Fed. Cl. 558 (2004) (No. 03-2164T), 2003 WL 25626574 (describing the final PAAR as the "single most criticized regulation in the past 20 years"); Original Brief for Petitioners at 216–26, Santa Monica Pictures, L.L.C. v. Comm'r, 89 T.C.M. (CCH) 1157 (2005) (Nos. 6163-03, 6164-03),

The final PAAR's limited use may also have stemmed from a very different group within the Service—field examiners. These examiners, whose caseloads are notoriously high,[201] may have chosen not to challenge transactions under the final PAAR because the regulation's use required prior approval from the IRS National Office.[202] Thus, it might have seemed easier and less time-consuming to challenge transactions on grounds other than the final PAAR.

In addition to these possibilities, one might also posit that the Service was simply being judicious in applying the regulation. The final PAAR was intended to be a measure of last resort, only to be applied in those rare instances where a transaction complies with the literal language of subchapter K but violates its underlying principles.[203] To the extent that the Service could challenge a partnership transaction on narrower grounds, sound tax policy might dictate that it do so.[204]

Ultimately, the reason why the Service failed to apply the final PAAR more robustly remains a mystery.[205] Regardless of the reason, the final PAAR's disuse was a major blow to its effectiveness. Practitioners believed that the Service failed to challenge more transactions under the final PAAR because of its internal ambivalence towards the regulation. And this perception had a crippling effect on

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2005 WL 1328520 (alleging that the final PAAR lacks statutory foundation, violates separation of powers, and is unconstitutionally vague). The arguments raised by taxpayers when challenging the final PAAR's validity typically mirrored those raised by practitioners who opposed the PAAR. *See supra* Part I.B.2.a. For instance, in *Jade Trading*, the taxpayer asserted that the final PAAR overrules decades of precedent regarding the business purpose doctrine, overrides the literal language of the Code, and is unconstitutionally vague. *See* Plaintiff's Memorandum in Support of First Motion for Partial Summary Judgment (Relating to Invalidity of Treas. Reg. § 1.701-2), *supra*, at 7–8.

201 In 2002, the last year in which data is available from the Service, field service examiners reviewed 171,576 returns, 4,693 of which involved partnerships. INTERNAL REVENUE SERV., FIELD EXAMINATION VOLUMES BY EXAMINATION CLASS, INCLUDING EITC, FISCAL YEARS 1996–2002 (2002), *available at* http://www.irs.gov/pub/irs-soi/rtctab5c.xls.

202 *See* Banoff, *Use and Misuse of Anti-Abuse Rules*, *supra* note 15, at 841 ("National Office involvement may act as a disincentive. To the extent that assertion of anti-abuse rules requires clearance from the National Office as a condition precedent, agents are less likely to go that route in the first place.").

203 T.D. 8588, 1995-1 C.B. 109, 110 ("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.").

204 *See* Kenneth W. Gideon, *Use, Abuse, and Anti-Abuse: Policy Considerations Affecting the Nature of Regulatory Guidance*, 73 TAXES 637, 639 (1995) [hereinafter Gideon, *Regulatory Guidance*] (discussing policy drawbacks of anti-abuse rules).

205 Indeed, it is likely that this mystery could only be solved through an elaborate research project well beyond the scope of this Article. Nonetheless, the roots of the mystery probably lie within the unique dynamics of the Service, including the revolving door between public service and private practice, and the role of practitioners in shaping tax law and policy.

the final PAAR's legitimacy in the eyes of an already skeptical tax community. If the Service itself had doubts about the final PAAR, then taxpayers had no incentive to comply with it.

C. The Treasury's Role

The Treasury also played a leading role in the final PAAR's demise. Although extreme in much of their commentary, the regulation's opponents were correct in one important respect—the final PAAR is deeply flawed. In its proposed form, the PAAR was a broad anti-abuse rule, reminding taxpayers to behave well in an area teeming with temptations to behave badly.[206] But the Treasury strayed from its original design in the final PAAR, suffocating the regulation with details.[207] The final PAAR is narrower, more technical, and more complex than the proposed version. Ironically, the final regulation bears a striking resemblance to the troublesome provisions of subchapter K that the Treasury had hoped the PAAR would counterbalance.[208]

To mollify the regulation's detractors, the Treasury made several changes to the PAAR after its proposal. But these changes rendered the final regulation structurally unsound. First, the Treasury added a list of seven non-exhaustive factors plus the "super-factor" to the final PAAR.[209] The Treasury hoped these factors would give taxpayers additional guidance when determining whether a transaction violated the regulation. Nonetheless, the Treasury provided them for illustrative purposes only.[210] The Service is authorized to consider other unstated factors in its analysis of a transaction. Likewise, the weight afforded to any particular factor is fluid, depending entirely on the partnership transaction under review.[211]

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[206] *See, e.g.*, Richardson Remarks, *supra* note 16 ("One possible answer [for the strong opposition to the final PAAR] may be that the regulation is simple and to-the-point and reminds taxpayers and their representatives that they have a responsibility for determining whether their transactions are abuses of the tax system.").

[207] *See* George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. REV. 209, 224 n.87 (2001) (noting that the proposed PAAR had "some real bite," but the Treasury severely watered down the final version).

[208] *See* AM. LAW INST., FEDERAL INCOME TAX PROJECT: TAXATION OF PASS-THROUGH ENTITIES, MEMORANDUM NO. 1, at 6–7 (1995) [hereinafter ALI MEMORANDUM NO. 1]; *see also* Gunn, *supra* note 9, at 175 (describing the historical evolution of the regulations and their increasing technicality); Banoff, *What's Really Wrong with 1.701-2*, *supra* note 175 ("Ironically, the partnership antiabuse rule itself runs counter to the policy of encouraging simplicity, flexibility, and equity.").

[209] Treas. Reg. § 1.701-2(c) (as amended in 1995); *see also supra* notes 122–27 and accompanying text.

[210] Treas. Reg. § 1.701-2(c).

[211] *Id.*

If considered separately, each stated factor legitimately signals a suspect transaction.[212] Thus, a factor's inclusion in a list indicative of tax abuse is hardly controversial. Yet the Treasury's decision to include these factors, including the "super-factor," in the final PAAR creates unnecessary confusion for taxpayers.[213] For instance, the regulation fails to provide any guidance about the relative weight to be placed on the presence or absence of any of the stated factors.[214] Likewise, some factors require comparative benchmarks, but the final PAAR is silent on how to apply these factors.[215]

Second, the Treasury added numerous examples to the final PAAR. By design, these examples are incredibly narrow, expressly limited to their facts and circumstances. Indeed, any change in an example could affect the Treasury's conclusion regarding the final PAAR's applicability.[216] Further, the Treasury did not intend the examples to delineate the boundary between permissible and impermissible transactions.[217] Like the factors, the Treasury included the examples for illustrative purposes only.

The examples' narrow design feature, however, only exacerbates the confusion surrounding application of the final PAAR.[218] Again, the relative weight the Treasury affords to an example's particular facts or circumstances is uncertain. Similarly, it is unclear what facts or circumstances, or combination thereof, would affect the outcome of a given example.

Even worse, the final PAAR's examples are internally inconsistent, creating a perception that the key factor in determining whether a transaction violates the regulation is the Treasury's view of the transaction's social or political value.[219] To illustrate, the final PAAR includes one example, Example 8, where a partnership is used

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[212] *See* Gunn, *supra* note 9, at 165.

[213] *See, e.g.*, Battle, *supra* note 172, at 806; Gunn, *supra* note 9, at 165.

[214] *See* Gunn, *supra* note 9, at 165–66.

[215] AM. LAW INST., FEDERAL INCOME TAX PROJECT: TAXATION OF PASS-THROUGH ENTITIES, MEMORANDUM NO. 2, at 61–62 (1996); Yin, *supra* note 207, at 163.

[216] *See* Treas. Reg. § 1.701-2(d) (as amended in 1995).

[217] *Id.*

[218] *See* Lipton, *Calm After the Storm?*, *supra* note 137, at 69 (arguing that the limited examples provide only minimal guidance); Richard M. Lipton, *IRS Improves Partnership Anti-Abuse Regs., but Major Problems Remain*, 82 J. TAX'N 132, 134–35 (1995) [hereinafter Lipton, *Major Problems Remain*].

[219] *See* MCKEE ET AL., TAXATION OF PARTNERSHIPS AND PARTNERS, *supra* note 78, at ¶ 1.05[3]; Banoff, *What's Really Wrong With 1.701-2*, *supra* note 175; Sheryl Stratton, *Revised Partnership Antiabuse Reg Still Subject to Debate, Revision*, 66 TAX NOTES 647, 648 (1995) [hereinafter Stratton, *Subject to Debate*]; Lee A. Sheppard, *Partnership Shelter Guidance Coming*, TAX NOTES TODAY, June 11, 2002, 2002 TNT 113-3 (LEXIS) [hereinafter Sheppard, *Partnership Shelter Guidance Coming*]; ("Practitioners complain about the regulation's internal contradictions and obviously [sic] political blessing of certain transactions that would otherwise be considered offensive.").

to improperly duplicate a loss.[220] Although the transaction has some modicum of business purpose,[221] it violates the final PAAR. The example seems to establish a stringent business purpose requirement, finding that no business purpose would be significant when compared to the transaction's tax benefits.[222] Yet the final PAAR also includes examples involving partnership transactions that generate significant tax benefits but lack much business purpose.[223] Taken together, these examples are difficult to reconcile.[224] The determinative factor appears to be the Treasury's subjective valuation of the underlying transaction. Partnership transactions that the Treasury considers inoffensive or congressionally sanctioned comply with the final PAAR; others violate it. And this struck another blow to the final PAAR, severely damaging both its credibility and its coherence.

The Treasury would likely respond that it included the factors and examples in the final PAAR to provide taxpayers with as much guidance as possible without sacrificing the regulation's flexibility. Taxpayers are continually developing novel partnership tax shelters and, hence, it would be impossible for the Treasury to provide more definitive guidance. Although laudable, the Treasury's attempt to

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220 Treas. Reg. § 1.701-2(d), ex. 8 (as amended in 1995). For a discussion of Example 8, see *supra* note 182.

221 In this example, the partnership's three-year lease of the property involves real economic risk and return. For instance, the value of the loss asset could change during the lease term, thereby eliminating the desired loss duplication. *See* MCKEE ET AL., TAXATION OF PARTNERSHIPS AND PARTNERS, *supra* note 78, at ¶ 1.05[3]; Battle, *supra* note 172, at 806 n.18 (discussing Example 10, which following the Treasury's amendment of the PAAR in 1995, became the current Example 8); Lipton, *Calm After the Storm?*, *supra* note 137, at 69; Lipton, *Major Problems Remain*, *supra* note 218, at 135; Stratton, *Subject to Debate*, *supra* note 219, at 648.

222 Treas. Reg. § 1.701-2(d), ex. 8.

223 *Id.* § 1.701-2(d), exs. 2, 4, 6 (as amended in 1995). For example, consider Example 6. This example involves a partnership formed by two high bracket taxpayers and a corporation with net operating loss carry-forwards in order to own a building eligible for the low-income housing tax credit. Because the corporate partner cannot use any of the depreciation deductions or tax credits attributable to the building, these tax benefits are allocated entirely to the high-bracket taxpayers, thus allowing them to shelter other, unrelated income. *Id.* § 1.701-2(d), ex. 6. Yet the Treasury blessed this transaction, despite its significant tax benefits and insignificant business purpose apart from tax savings. *Id.*; *see also* MCKEE ET AL., TAXATION OF PARTNERSHIPS AND PARTNERS, *supra* note 78, at ¶ 1.05[3]; Lipton, *Calm After the Storm?*, *supra* note 137, at 69 ("The criticism of the examples in the Regulations has not been limited to those with 'unfavorable' results; some of the examples in which the anti-abuse rules do not apply are equally mystifying and unclear."); Sheppard, *Grudging Acceptance*, *supra* note 107 (reporting one attorney's view of Example 4 as "intellectually dishonest" because of the high level of tax avoidance inherent in the transaction).

224 One might argue that these examples are not inconsistent because partnership transactions involving low-income housing tax credits are congressionally sanctioned. However, even transactions involving congressionally sanctioned tax benefits can be abusive. *See, e.g.*, Rev. Proc. 2007-65, 2007-45 I.R.B. 967, *modified by* I.R.S. Announcement 2009-69, 2009-40 I.R.B. 1175 (wind energy production tax credits); I.R.S. Notice 2005-13, 2005-1 C.B. 630 (sale-in, lease-out transactions).

balance taxpayers' desire for additional guidance and its need for flexibility backfired. Indeed, no guidance would have been preferable to the incomplete guidance set forth in the final PAAR. The factors and examples added to the regulation have muddled it to the point of incoherence.

The result is a worst-of-all-worlds scenario. Taxpayers trying to apply the final PAAR to legitimate partnership transactions are plagued by confusion. They understand that the regulation is not intended to interfere with legitimate partnership transactions. They also understand that there are facts and circumstances—some known, some unknown—that will determine whether their transaction violates the final PAAR. What they do not understand, however, is how all these facts, circumstances, factors, super-factors, and examples work together. After accounting for all of the final PAAR's limitations, qualifications, and variables, whatever conceptual understanding these taxpayers initially had likely disappears.[225] Thus, they do what many well-meaning taxpayers do when navigating subchapter K's complexities—give up. Simply put, these taxpayers stop trying to comply with the final PAAR.[226]

The confusion of those entering into legitimate partnership transactions has had another, more nefarious, consequence. It has allowed taxpayers engaging in abusive partnership transactions to camouflage their true objections to the final PAAR. Since its proposal, the PAAR has presented only one problem to these taxpayers: it might work, thereby disabling the very lucrative market for partnership tax shelters. For obvious reasons, these taxpayers could not criticize the regulation on the grounds that it was likely to succeed. But they could take up the cause of the taxpayers engaging in legitimate partnership transactions. Thus, under the guise of complexity and market concerns, taxpayers engaging in abusive partnership transactions were able to viciously attack the PAAR without disclosing their true agenda. And they succeeded. Partnership

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225 See Lokken, *Future Without Subchapter K*, *supra* note 5, at 251; *see also* Sheppard, *Partnership Shelter Guidance Coming*, *supra* note 219.

226 *See* Lokken, *Future Without Subchapter K*, *supra* note 5, at 252. Lokken writes:

> A large number of partnerships thus seem to be governed by what might be called an 'intuitive subchapter K.' Taxpayers and tax advisers who want to comply account for partnership transactions in ways that are consistent with their conceptions of the basic aims of subchapter K; others account as adventurously as they believe the IRS is likely to tolerate. IRS auditors challenge partnership accounting only if it seems to be seriously out of whack. No one has the ability, resources, and incentive to figure out exactly what the rules require.

Id.

tax shelters continue to thrive and the final PAAR has been unable to do anything about it.

III. BUILDING A BETTER PARTNERSHIP ANTI-ABUSE RULE

The PAAR's tragic fate was likely sealed before the Treasury even finalized the regulation. The actions and reactions of the Treasury, the Service, and practitioners in the months following the PAAR's proposal disabled the regulation, denying it any chance of accretive legal development. But the final PAAR's failure does not discredit the notion that a broad anti-abuse rule could effectively combat abusive partnership transactions. Given the changes that the Treasury made to the final PAAR, it can hardly be described as a broad anti-abuse rule. Thus, it remains possible, perhaps even likely, that a broad anti-abuse rule could work in subchapter K.

To this end, this Part suggests that the Treasury revise the PAAR, unwinding the damage of those fateful six months that culminated in the final PAAR's issuance. In doing so, the Treasury would return the PAAR to its origins as a broad anti-abuse rule and finally give the regulation a legitimate chance to fight the tax shelters endemic to subchapter K. Although a revised PAAR would not solve subchapter K's deepest structural problems—nothing but fundamental reform could do that—a revised PAAR would help support subchapter K, while presenting little downside risk.

A. Back to Basics: The Partnership Anti-Abuse Rule Version 2.0

A revised PAAR should be short, simple, and broad. Thus, I propose the following streamlined general anti-abuse rule for subchapter K: if a partnership is formed or availed of in connection with a transaction that substantially reduces the present value of the partners' aggregate federal income tax liability in a manner that is inconsistent with the intent of subchapter K, the Service may recast the transaction for federal income tax purposes, as appropriate, to achieve tax results that are consistent with the intent of subchapter K.

Like current law, a revised PAAR would include guidance regarding the intent of subchapter K. I propose using the final PAAR's definition—the intent of subchapter K is to permit taxpayers to conduct joint business or investment activities in a manner that affords them flexibility in structuring their economic arrangements but does not trigger an entity-level tax.[227] Implicit in this intent are several familiar foundational principles. The partnership must be bona

[227] *See* Treas. Reg. § 1.701-2(a).

fide and the transaction must have a substantial business purpose, comply with substance over form principles, and clearly reflect income.[228]

A revised PAAR would also preserve the final PAAR's scope, only applying to the small number of abusive partnership transactions that cannot be challenged under the specific provisions of subchapter K. The regulation would not serve as the primary method of challenging a partnership transaction. On the contrary, a revised PAAR would be a provision of last resort.

The most notable changes to a revised PAAR, however, would be the deletions. First, this proposal eliminates the principal purpose of tax reduction standard and, thus, the regulation's application would no longer depend on the partners' state of mind.[229] Second, this proposal omits the non-exclusive list of factors, including the "super-factor," that is currently applied to determine whether a transaction violates the final PAAR. Third, this proposal does not include examples.

Finally, in connection with the PAAR's revision, I also propose that the Service terminate its current enforcement restrictions. Examiners would no longer be required to seek prior approval before challenging a transaction under the PAAR.

B. Addition by Subtraction: The Benefits of the Revised Partnership Anti-Abuse Rule

A revised PAAR would offer a return to the hopeful days of 1994, and would reverse the missteps of the PAAR's first months. It would be a simple, unencumbered reminder that compliance with subchapter K's complicated and technical rules is not sufficient; compliance with the foundational principles underlying the federal income tax system is also required. This, in turn, would allow tax lawyers to be lawyers, freeing them to exercise judgment in structuring partnership transactions.

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[228] *See id.*

[229] The principal purpose of tax reduction standard, contained in both the proposed and final PAAR, is troublesome. This standard makes the partners' motivations for entering into the transaction determinative. If the partners engaged in the transaction with the goal of substantially reducing their aggregate federal income tax liability, then they run afoul of the final PAAR. If, however, the partners accidentally stumble on a transaction that substantially reduces their aggregate federal income tax liability, then the transaction would survive scrutiny under the regulation. The results of both transactions are improper, yet the Service is only permitted to remedy the abuse when the partners intended to achieve such results. Given the chronic abuse of subchapter K, the Treasury's decision to condition the final PAAR's application on the taxpayer's state of mind is curiously misguided. ALI, 1999 REPORTERS' STUDY, *supra* note 19, at 116; Banoff, *Use and Misuse of Anti-Abuse Rules*, *supra* note 15, at 833–34; Battle, *supra* note 172, at 803.

Indeed, a revised PAAR could be transformative. After sixteen ineffectual years, the Treasury might finally empower the PAAR to combat abusive partnership transactions. If a revised PAAR were to succeed in eliminating some of subchapter K's worst excesses, as seems likely, it would provide structural support to subchapter K, which remains deeply in crisis.

1. Saying What It Means

Revising the PAAR would give the Treasury a second chance to say exactly what it means with respect to subchapter K. Simply put, it could remind taxpayers that subchapter K's unique combination of flexibility, complexity, and low enforcement does not absolve them of the obligation to comply with the federal income tax system's foundational principles. Even in subchapter K, transactions must comply with those ground rules. And a revised PAAR would say this simply and directly.

In doing so, a revised PAAR could reverse a troublesome trend in the practice of partnership taxation. In recent years, practitioners have clamored for an increasing amount of guidance from the Treasury and the Service and, for the most part, the government has acquiesced.[230] This trend toward increased guidance has transformed the profession by reducing the risk associated with providing partnership tax advice. Practitioners are increasingly required to navigate subchapter K's maze of technical rules, and decreasingly required to use independent legal judgment when structuring partnership transactions.[231]

If the Treasury revised the PAAR, the regulation would require practitioners to exercise judgment in structuring complex partnership

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[230] *See* Richard M. Lipton, *"We Have Met the Enemy and He is Us": More Thoughts on Hyperlexis*, 47 TAX LAW. 1, 3–9 (1993) [hereinafter Lipton, *Thoughts on Hyperlexis*]; Olson, *Observations from the Frontlines*, *supra* note 12, at 576.

[231] *See* Joseph Bankman, *The Business Purpose Doctrine and the Sociology of Tax*, 54 SMU L. REV. 149, 151 (2001) [hereinafter Bankman, *Sociology of Tax*]; Pamela Olson, *Some Thoughts on Anti-Abuse Rules*, 48 TAX LAW. 817, 825 (1995). Professor Stanley Surrey described a similar problem arising under the Internal Revenue Code of 1954. His words are apt today:

> Given such a detailed, often mathematically-oriented statute, it becomes impossible to fly by the seat of one's tax pants. Tax intuition and instinct are of no help in the face of myriads of rules turning on eighty percent of this or that, one year from this or that date, this or that being done before this or that date, this or that attribution of stock ownership, and so on. Clearly, such "flyers" are passé under the present Code. While this is not a serious calamity, there is a need to provide working room for the use of tax instinct.

Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 LAW & CONTEMP. PROBS. 673, 699 (1969).

transactions.[232] Practitioners could no longer hide behind subchapter K's complex, technical provisions. On the contrary, they would have to account for fundamental tax principles when applying subchapter K. Most importantly, tax opinions would likely reflect the increased risk associated with providing partnership tax advice, presumably becoming more comprehensive and more qualified. Thus, shifting tax risk back to practitioners could help reduce the demand for tax shelters.

2. Meaning What It Says

By finally saying what it means, a revised PAAR would have its first real chance to fight partnership tax shelters. A revised PAAR, with its combination of flexibility and simplicity, would be uniquely situated to supplement subchapter K. As previously discussed, Congress has been steadfast in its commitment to flexibility in partnership taxation, and this commitment has spawned matchless complexity.[233] These attributes, coupled with insufficient enforcement resources, have turned subchapter K into a virulent breeding ground for tax shelters.

A revised PAAR might offer a partial antidote. It would offset partnership taxation's complexity with simplicity, reminding taxpayers that they need to follow the rules, even in subchapter K. At the same time, a revised PAAR's flexibility would be well matched to subchapter K's flexibility, thus neutralizing the endless manipulations of partnership taxation. If, as some observers believe, subchapter K allows taxpayers to do virtually anything, then subchapter K needs an anti-abuse rule nimble enough to respond to virtually anything.[234]

Again, a revised PAAR is the most promising candidate. It might counterbalance some of subchapter K's most problematic qualities through a simple, yet expansive, directive that taxpayers comply with all of the law, not just its literal language. If successful in fighting

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[232] *See* Cunningham & Repetti, *supra* note 8, at 59–60. As one commentator noted:

> The return to simpler rules and regulations will be difficult for many practitioners who have become accustomed to finding answers to every question. For these practitioners, the loss of the unending stream of guidance will remove a crutch on which they have long relied. It will also require them to exercise judgment as well as to perform research. In the long run, however, this change will benefit both tax practitioners and the tax system. It will restore the intellectual aspect of the practice of tax law, in which imagination and judgment are combined to reach results for clients which are consistent with sound tax policy. It will encourage tax practitioners to think for themselves.

Lipton, *Thoughts on Hyperlexis*, *supra* note 230, at 10–11 (footnote omitted).

[233] *See supra* notes 4–6 and accompanying text.

[234] *See, e.g.*, Sheppard, *Cognitive Dissonance*, *supra* note 22, at 936–37.

abusive partnership transactions, particularly those exploiting still-undiscovered fault lines, a revised PAAR would also simplify subchapter K.[235] Neither Congress nor the Treasury would be required to promulgate additional, targeted anti-abuse rules in response to newly developed tax shelters.[236] A revised PAAR, standing alone, might well suffice.

Even under the worst-case scenario, a revised PAAR remains a worthwhile endeavor with nominal downside. The regulation would still serve as a stronger, clearer signal that transactions are improper if they comply with the literal language of subchapter K but generate tax consequences contrary to its overarching principles.[237] Given subchapter K's deepening crisis, the value of such a simple reminder may be significant.[238]

Before proceeding, let me emphasize one critical point. A revised PAAR is not a panacea. It would not cure subchapter K of its decades of remarkable dysfunction. Only fundamental reform could do that.[239] To illustrate subchapter K's precarious state, consider the following observation made by the American Law Institute after the Treasury finalized the PAAR in 1994:

> [I]t is evident that if one were writing on a clean slate, one would not adopt a set of operating rules that first touts their flexibility, then proceeds to restrict that flexibility with a series of highly complex mechanical and sometimes subjective tests, and then overlays on top of those tests a relatively amorphous supertest authorizing the disregard of the consequences of earlier tests despite plain compliance with them . . . . Something very fundamental must be awry in

[235] *See* NYSBA Report, *supra* note 33; Cunningham & Repetti, *supra* note 8, at 58. *See generally* Surrey, *supra* note 231, at 694–95; David A. Weisbach, *Formalism in the Tax Law*, 66 U. CHI. L. REV. 860, 870–71 (1999) [hereinafter Weisbach, *Formalism in Tax Law*].

[236] *See* Weisbach, *Formalism in Tax Law*, *supra* note 235, at 870–71.

[237] *See* Bankman Comments, *supra* note 48; Halperin Comments, *supra* note 16. *See generally* Ellen P. Aprill, *Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines*, 54 SMU L. REV. 9, 19 (2001); Martin J. McMahon, Jr., *Random Thoughts on Applying Judicial Doctrines to Interpret the Internal Revenue Code*, 54 SMU L. REV. 195, 208 (2001).

[238] Nonetheless, one might assert that there is a more significant cost associated with a revised PAAR: the uncertainty it would create. As will be discussed *infra* Part III.C.1., this argument is factually unproven.

[239] *See* ALI MEMORANDUM NO. 1, *supra* note 208, at 8–9; Gunn, *supra* note 9, at 174 ("The new regulations are an addition to a deeply unsatisfactory statutory and regulatory structure. Antiabuse rules . . . 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 re-writing the statute.").

> the basic structure of the rules for the law to have evolved into this unhappy state.[240]

The ALI's view of subchapter K was incredibly bleak, and the picture has only deteriorated since that time. Thus, to the extent that revising the PAAR might help sustain subchapter K until Congress is prepared to tackle its fundamental reform, the Treasury should be encouraged to act. Indeed, there is every reason to try a revised PAAR and, as will be discussed below, no persuasive reason not to.

Further, there is little downside to the Treasury revising the PAAR. Its revision does not trade off with alternative anti-tax shelter initiatives within subchapter K or the federal income tax system more broadly. Indeed, it is hard to imagine any observer chastising the Treasury for developing too many tools in the fight against tax shelters.

C. Objections to the Better-Built Partnership Anti-Abuse Rule

Revising the PAAR would likely reignite the controversy that has surrounded the PAAR since its proposal sixteen years ago. The regulation's opponents would invariably raise questions about the uncertainty of a revised PAAR. Likewise, these opponents would challenge the need for a special anti-abuse rule in subchapter K, particularly in light of the government's success in fighting the last generation of tax shelters.[241] As this section explains, all of these objections are premature and factually uncertain, with reason to doubt their accuracy. Thus, such objections should not deter the Treasury from revising the PAAR.

1. We Don't Want Uncertain Anti-Abuse Rules

Historically, the primary objection to the PAAR has been that it is too uncertain.[242] Opponents might maintain that a revised PAAR is

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240 ALI MEMORANDUM NO. 1, *supra* note 208, at 8–9; Kwall, *supra* note 19, at 232.

241 *See infra* notes 283–84 and accompanying text.

242 In addition, opponents would likely challenge a revised PAAR's validity, asserting that it would not be a reasonable interpretation of subchapter K. *See* Aprill, *supra* note 237, at 17; Cunningham & Repetti, *supra* note 8, at 39 n.196. Thus, the Treasury would have to be prepared to litigate the validity question. For excellent discussions of the final PAAR's validity, see MCKEE ET AL., TAXATION OF PARTNERSHIPS AND PARTNERS, *supra* note 78, at ¶ 1.05[5]; Cunningham & Repetti, *supra* note 8, at 50–55. If, however, these validity concerns were deemed sufficiently problematic, which is unlikely, Congress might consider codifying a revised PAAR. At a minimum, codification would eliminate any questions about a revised PAAR's validity. Nonetheless, it is unlikely that Congress would codify a revised PAAR, since enacting a broad anti-abuse rule to govern subchapter K would be a time-consuming process and would not likely be considered a high priority by many members of Congress. *See* Schler, *supra* note 9, at 359. Further, Congress may be particularly reluctant to codify a revised PAAR due to current

simultaneously vague and overbroad, making it impossible to determine whether a transaction involves legitimate tax planning or illegitimate tax abuse.[243] Notwithstanding the Treasury's intent that a revised PAAR would apply to only a small number of abusive transactions, its expansive language would lead to the contrary conclusion. This uncertainty, opponents might assert, would lead to a parade of horribles, including the diminution of commerce, the regulation's haphazard enforcement, and the erosion of the federal income tax system's fairness.[244] Further, as empirical evidence of the problems with broad anti-abuse rules, these opponents might point to other nations' experiences with general anti-avoidance rules ("GAARs"), particularly Canada's experience with a GAAR.

To these opponents, this proposal likely represents a particularly nefarious brand of anti-abuse rule. Although most critics of the PAAR's revision likely disfavored the final PAAR, these critics would almost invariably acknowledge that the Treasury at least tried to make substantive changes to reduce the final regulation's

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economic concerns, fearing that it would deter legitimate commercial transactions, just as the regulation's opponents would invariably argue. Ultimately, however, this "location" question is peripheral. What matters most is that the PAAR be reworked and the mistakes of the past be corrected.

[243] *See* Banoff, *Use of Misuse of Anti-Abuse Rules*, *supra* note 15, at 837; Graeme S. Cooper, *International Experience with General Anti-Avoidance Rules*, 54 SMU L. REV. 83, 92–93 (2001) ("This is the standard claim that a GAAR is uncertain. It is a universal claim that 'tax avoidance' cannot be defined in a sufficiently precise verbal formula for it to be used as the basis for the imposition of tax: that there will be too much GAAR fallout creating havoc for unintended targets. This claim is rarely well developed; it is apparently thought sufficient merely to assert it and its truth becomes self-evident, but how uncertain are GAARs?" (footnotes omitted)); Weisbach, *Formalism in Tax Law*, *supra* note 235, at 861 ("A common reaction to anti-abuse rules is horror. Anti-abuse rules seem to eliminate certainty and reliability in the tax law."); Kenneth W. Gideon, Wilmer, Cutler & Pickering, Address at the Laurence Neal Woodworth Memorial Lecture, Ohio Northern Univ. Claude W. Pettit College of Law (Nov. 23, 1998), *in Tax Law Works Best When the Rules are Clear*, TAX NOTES TODAY, Nov. 23, 1998, 1998 TNT 225-71 (LEXIS) [hereinafter Gideon, *Tax Law Works Best*] ("Even more fundamentally, the uncertain application of vague rules has the same uncontrollable consequences of a nuclear weapon: the uncertainty afflicts everyone, not just abusers.")

[244] To many readers, these objections may resemble those raised in the perennial debate between rules and standards in the federal income tax and, more broadly, in the law. Indeed, the Treasury's revision of the PAAR would introduce a standard into the primarily rule-based world of subchapter K. Although the questions raised by the PAAR's revision parallel the questions arising in the rules versus standards debate, a thorough examination of such debate is beyond this Article's scope. For recent, thoughtful discussions of rules and standards in the federal income tax, see generally Aprill, *supra* note 237; Bankman, *Sociology of Tax*, *supra* note 231; Mark P. Gergen, *The Common Knowledge of Tax Abuse*, 54 SMU L. REV. 131 (2001); Edward D. Kleinbard, *Corporate Tax Shelters and Corporate Tax Management*, 51 TAX EXECUTIVE 235 (1999); Weisbach, *Formalism in Tax Law*, *supra* note 235. For equally thoughtful discussions outside the federal income tax, see generally Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992); Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577 (1988).

uncertainty.[245] Moreover, the Service imposed enforcement restrictions on its examiners, requiring them to obtain prior approval before challenging a transaction under the final PAAR.[246] Yet a revised PAAR would include none of these measures.

Before considering these objections, a preliminary comment on uncertainty is warranted. Each objection starts from the premise that uncertainty is bad, hampering subchapter K's administrability, equity, and efficiency.[247] Although a comprehensive analysis of uncertainty's role in partnership taxation is well beyond this Article's scope, I posit that the opposite might be correct. The introduction of greater uncertainty into subchapter K might have a positive effect on partnership taxation.[248]

Subchapter K overflows with complex and technical statutory provisions, regulations, rulings, and other forms of administrative guidance.[249] Although intended, at least in part, to increase the certainty of partnership taxation, these materials have also contributed to subchapter K's deepening crisis. Likewise, the addition of numerous technical, targeted rules has created new fault lines ripe for exploitation by taxpayers at extraordinary public cost.[250] Thus, one might reasonably question the virtue of certainty in subchapter K,

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[245] *See supra* Part I.C.

[246] *See supra* notes 132–34 and accompanying text.

[247] *See, e.g.*, Aprill, *supra* note 237, at 21–22; Gideon, *Tax Law Works Best*, *supra* note 243 ("The basic defect of all antiabuse rules is uncertainty. There is no clear delineation between situations in which the rule applies to deny benefits and those in which it doesn't.").

[248] *See* Weisbach, *Failure of Disclosure*, *supra* note 17, at 81. Professor Weisbach aptly notes that the uncertainty objection

> is usually just left at that, as if it were self-evident that uncertainty is a bad thing that should be avoided at all costs. But this is not the case . . . . There is a lot of literature about the effects of uncertainty in the tax law and in other areas of law. The general thrust is that uncertainty generally does not have uniformly bad or good effects and that we should have no presumption that reducing uncertainty (even for free) is a good thing. None of this literature has been incorporated into the tax shelter debate. While uncertainty may play a role in the debate over anti-shelter doctrines, the assumption that it is a strong argument against these doctrines is false. We cannot say that uncertainty is necessarily bad and cannot say that we should not impose significant uncertainty if it is needed to implement strong anti-shelter doctrines.

Id. (footnote omitted); *see also* Sarah B. Lawsky, *Probably? Understanding Tax Law's Uncertainty*, 157 U. PA. L. REV. 1017, 1072–73 (2009).

[249] *See* sources cited *supra* note 231 and accompanying text.

[250] *See, e.g.*, Schler, *supra* note 9, at 373. One commentator observed:

> [D]etailed technical changes in the Code or regulations are likely to have only a short-term ameliorative effect. The reason is that the tax shelter business attracts very smart people who devote their days and nights to finding holes (in some cases pinholes) in the law. The Service is always behind. Changes in the law designed to stop abuse simply lead to more creative techniques.

Id.

concluding that a decrease in certainty might increase subchapter K's efficacy.

Nonetheless, let us consider the four objections to a revised PAAR based on the regulation's perceived uncertainty. First, there would be nothing uniquely uncertain about a revised PAAR. Indeed, the regulation would be like any new law, regulation, or judicial doctrine.[251] Initially, the application of any change in law is uncertain, yet greater clarity emerges over time through the federal income tax system's elaborative process. And a revised PAAR would develop in this manner too. There is no reason to believe that practitioners, the Service, or the courts would have a singular blind spot with respect to this one regulation.

Second, the parade of horribles that opponents maintain would result from a revised PAAR's uncertainty is factually unproven and unlikely to occur. Although the claim that such uncertainty would lead to a diminution in commercial partnership transactions is a perennial favorite,[252] there is scant evidence that a revised PAAR would hamper real commercial activity.[253] The past sixteen years' experience with the PAAR is illustrative. Although opponents viciously attacked the PAAR, claiming that it would impair commerce,[254] not one legitimate transaction has been publicly identified as failing to close because of the final PAAR's uncertainty.[255] Given the innumerable transactions that practitioners claimed could run afoul of the proposed PAAR,[256] it seems likely that a transaction that was actually aborted because of the final PAAR

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[251] *See* Bankman Comments, *supra* note 48.

[252] *See, e.g.*, Battle, *supra* note 172, at 808; Hal Gann & Roy Strowd, *The Recent Evolution of Antiabuse Rules*, 66 TAX NOTES 1189, 1191 (1995) ("But the tax system has to tolerate some unintended results, and some abuses, because the purity of the tax system is not the most important factor in a healthy economy. Under this holistic approach, when a distortion or abuse gets big enough, tax officials must intercede. But efforts to 'get out in front' of tax planners can cost the economy more than they save the fisc."); Gideon, *Regulatory Guidance*, *supra* note 204, at 639 ("[W]hat seems inevitable is that taxpayers who have partnership and non-partnership options to accomplish the same objective must take into account the prospect of challenge under the rule out of a concern that simply achieving an advantageous tax result in a partnership form may be enough to trigger audit controversy."); Banoff, *What's Really Wrong with 1.701-2*, *supra* note 175 ("Where antiabuse rules potentially apply to Middle America, so that all but the most straightforward transactions are subjected to review and analysis by tax counsel—thereby burdening transactions with additional professional services costs and slowing the process for completing the transactions—it has been suggested that perhaps it is better to tolerate some unintended results or abusive transactions, if that is the only alternative.").

[253] *See* Schler, *supra* note 9, at 381 ("The level of uncertainty created by anti-abuse rules should not be overstated. In reality, normal business transactions are not threatened by anti-abuse rules.").

[254] *See supra* note 104 and accompanying text.

[255] *See* Hyde Letter, *supra* note 194 (noting that no tax practitioner has provided an example of a business transaction that has failed to close as a result of the final PAAR).

[256] *See supra* note 98 and accompanying text.

would have been widely publicized as empirical proof of the regulation's detrimental effect on the market for partnership transactions.

Further, the notion that the cost of partnership transactions would increase because practitioners could not distinguish between the proper and improper use of subchapter K is particularly unpersuasive. Practitioners involved in tax shelter transactions unquestionably have a keen sense of the difference between a legitimate partnership transaction and a tax shelter.[257] Indeed, without such knowledge, these practitioners would be unable to provide the services for which they are so generously compensated—structuring and opining on partnership transactions that shade between legitimate and abusive.[258] Nor should other tax practitioners have difficulty distinguishing between proper tax planning and improper tax sheltering.[259] Practitioners' stock in trade is judgment, and they are trained to apply the law to various factual settings and transaction structures.[260] In this regard, a revised PAAR would be no different than the many judicial doctrines and changes in law that lawyers grapple with daily.

In addition to its adverse effect on commerce, opponents of a revised PAAR might argue that the regulation's uncertainty would lead to inconsistent and subjective enforcement.[261] For skeptical observers, the resulting uneven enforcement would erode taxpayer confidence in the federal income tax system's fairness.[262] And this reduced confidence, in turn, would trigger decreased compliance and increased abuse.[263]

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[257] *See, e.g.*, Canellos, *supra* note 9, at 51–54.

[258] *See, e.g.*, *id.* at 56 ("The hard part is not finding the loophole (there are plenty around and most have been written up). Rather, it is cloaking the shelter in the mantle of a real transaction by incorporating the requisite economic return to satisfy a perceived 'economic substance' minimum threshold.").

[259] *See id.* at 51 ("While defining tax shelters may be difficult and while there are cases on the borderline, experienced tax professionals can usually readily distinguish tax shelters from real transactions."); Daniel Halperin, *Are Anti-Abuse Rules Appropriate?*, 48 TAX LAW. 807, 809 (1995) ("[P]ractitioners are undoubtedly aware when a transaction is structured to achieve a tax result inconsistent with its economic substance.").

[260] *See* McMahon, *supra* note 237, at 200 ("[U]ncertainty is the stuff of tax lawyering."); Schler, *supra* note 9, at 381 ("[T]ax lawyers are familiar with unclear and ambiguous provisions of the Code and regulations. They routinely apply such provisions in giving advice as to whether transactions work . . . . Providing advice concerning the applicability of a broader anti-abuse rule would not be a novel concept to tax lawyers."); Bankman Comments, *supra* note 48 (interpreting the intent of statutes and regulations is an "everyday task of the practicing lawyer").

[261] *See* Aprill, *supra* note 237, at 22; *supra* Part I.B.2.c.

[262] Banoff, *Use and Misuse of Anti-Abuse Rules*, *supra* note 15, at 842–43; Olson, *Observations from the Frontlines*, *supra* note 12, at 574.

[263] Olson, *Observations from the Frontlines*, *supra* note 12, at 574.

Again, there is little factual support for the foregoing assertions. As previously discussed, the federal income tax system is replete with broad rules of uncertain scope, including the judicial doctrines, and examiners routinely apply these rules without internal oversight restrictions.[264] The Service has considerable experience applying novel and uncertain provisions, and this experience belies the notion that the Service would struggle to apply a revised PAAR uniformly and objectively.[265]

Additionally, the enforcement restrictions currently imposed on the final PAAR are particularly problematic.[266] As a preliminary matter, their efficacy is difficult to gauge. The little evidence available suggests that the IRS National Office approves the overwhelming majority of requests from examiners to apply the final PAAR.[267] But this evidence also suggests that examiners make very few requests to apply the regulation.[268] What remains unknown is why examiners make so few requests. Are examiners simply applying the final PAAR judiciously, or does the prior approval requirement deter them from raising the regulation? Absent additional information, any assessment of the impact of these enforcement restrictions on the final PAAR remains speculative.

Nonetheless, these restrictions most certainly have a detrimental signaling effect. Requiring examiners to seek approval before raising the final PAAR signals to taxpayers that the Service does not trust its examiners to apply the regulation properly, thereby adding credibility to the urban legend of the "rogue" agent. Likewise, these enforcement restrictions signal that the Service itself believes there is something wrong with the final PAAR, and that only a handful of individuals within the government understand the regulation well enough to apply it. Taken together, these adverse signaling effects outweigh any potential, albeit unproven, benefit that might be derived from the final PAAR's enforcement restrictions.

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[264] *See supra* note 248 and accompanying text. Still, to the extent questions would arise regarding a revised PAAR's application, examiners have internal avenues through which to obtain advice and resolve such issues. *See generally* BITTKER & LOKKEN, FEDERAL INCOME TAXATION, *supra* note 37, at ¶ 110.5; SALTZMAN, *supra* note 77, at ¶ 3.04.

[265] *See* Aprill, *supra* note 237, at 22–33. In her article, Professor Aprill traces the Treasury's application of anti-abuse rules set forth in Sections 482 and 355, and concludes that such application has been cautious and judicious. *See id.* at 33. Indeed, she notes that the history of these rules "demonstrates how, in exercising discretion under such broad standards . . . [the] Treasury and the IRS act in ways to make the justifications more predictable, reliable, and certain." *Id.*

[266] *See* Cunningham & Repetti, *supra* note 8, at 34.

[267] *See supra* notes 149–50 and accompanying text.

[268] *See supra* note 149 and accompanying text.

Most importantly, the assertion that a revised PAAR would adversely affect the fairness of the federal income tax system is incongruous, particularly when considered in context. Partnership tax shelters have devastated subchapter K, costing taxpayers billions of dollars and compromising the federal income tax system's integrity. The Treasury's goal in revising the PAAR would be to eliminate tax sheltering opportunities and, thus, restore fairness to the federal income tax system. The potential loss of fairness caused by the Service's enforcement of the revised PAAR is quite unlikely to exceed the certain loss of fairness caused by tax shelters. Simply put, the proliferation of abusive partnership transactions would invariably cause greater harm to the federal income tax system than the Service's imperfect application of a revised PAAR.[269]

Third, reliance on international experience with GAARs, especially the Canadian GAAR, to conclude that a revised PAAR would fail is problematic.[270] Initially, it is important to note that commentators remain divided about the Canadian GAAR's effectiveness. Some observers consider it to be a failure that has had little effect on the Canadian tax system.[271] But others believe that the Canadian GAAR, although not a universal remedy, has had a positive impact on the nation's tax system.[272] Thus, it seems premature to draw any conclusions regarding the revised PAAR's fate based on the Canadian GAAR.

Even if one assumes that the Canadian GAAR failed, however, transnational comparisons are nonetheless tricky because a GAAR's success depends heavily on variables unique to a nation's tax system.[273] For instance, a GAAR is influenced by a nation's "tax culture"—the views of taxpayers, taxing authorities, and courts

[269] *See* Cunningham & Repetti, *supra* note 8, at 58 ("In our view, however, the net increase in uncertainty is a price worth paying in order to reassert the applicability of the judicial doctrines as a backstop to the abuse of complex rules."); Brockway Comments, *supra* note 193 ("I am convinced the Treasury's efforts to ensure a fair and equitable tax system cannot be left solely to targeted anti-abuse regulations that your correspondents would endorse. The reality is that, no matter how hard the Treasury and the IRS might try, they will only be able to identify, analyze, and respond to a fraction of the arguably abusive transactions that are entered into. Certainly, none of us that advise clients with respect to highly structured, tax-oriented investments has any intention of bringing the structures to your attention.").

[270] *See* DEP'T OF THE TREASURY, *supra* note 9, at 119 ("It is difficult from the experiences of other countries to draw general conclusions about the efficacy of a GAAR, or its appropriateness for the United States, because tax systems and systems of jurisprudence differ from country-to-country."); Cooper, *supra* note 241, at 117–30.

[271] *See, e.g.*, Brian J. Arnold, *The Long, Slow, Steady Demise of the General Anti-Avoidance Rule*, 52 CAN. TAX J. 488 (2004).

[272] *See, e.g.*, Cooper, *supra* note 243, at 127–30.

[273] DEP'T OF THE TREASURY, *supra* note 9, at 119–20.

regarding taxes and tax abuse.[274] Likewise, the judiciary's comfort with and willingness to apply broad anti-avoidance rules plays a role in the fate of a GAAR.[275] Lastly, the rationale underlying a GAAR's adoption and the terms of the GAAR itself may affect its future success.[276]

A cursory review of these variables highlights significant differences between the Canadian GAAR and a revised PAAR, thereby casting doubt on the former's evidentiary value. Prior to the GAAR's adoption, the Canadian tax system had little experience with overarching judicial doctrines.[277] The Canadian Parliament introduced the GAAR in response to the increasing incidence of tax shelters and the judiciary's continued adherence to formalism.[278] Indeed, some observers have posited that the Canadian Parliament had hoped to transform Canada's tax culture through the introduction of the GAAR.[279]

The variables shaping a revised PAAR would be quite different, making Canada's experience with the GAAR inapt. Most importantly, a revised PAAR would not be designed to reshape the United States' tax culture. On the contrary, the regulation would simply seek to better align one rogue regime, subchapter K, with the nation's existing tax culture, which is firmly rooted in notions of substance. Broad anti-abuse principles, such as the judicial doctrines, have a long and rich history in the federal income tax system. Although the judiciary's commitment to these doctrines has varied over the years, few observers would disavow their role in the federal income tax system.

Fourth, the assertion that a revised PAAR would be especially problematic because of the Treasury's decision to eliminate prior palliative measures is overstated. As previously discussed, many of the final PAAR's features that were designed to ameliorate its uncertainty were counterproductive, ultimately contributing to the

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[274] *See* Michael A. Livingston, *Law, Culture, and Anthropology: On the Hopes and Limits of Comparative Tax*, 18 CAN. J.L. & JURISPRUDENCE 119, 121–24 (2005).

[275] DEP'T OF THE TREASURY, *supra* note 9, at 120.

[276] Cooper, *supra* note 243, at 85.

[277] Indeed, in 1984, the Supreme Court of Canada rejected the principle that a transaction must have a business purposes to be respected. *Stubart Invs. Ltd. v. The Queen*, [1984] 1 S.C.R 536, 580 (Can.) ("[W]here the substance of the Act, when the clause in question is contextually construed, is clear and unambiguous and there is no prohibition in the Act which embraces the taxpayer, the taxpayer shall be free to avail himself of the beneficial provision in question."); *see also* Arnold, *supra* note 271, at 488 (noting that the Canadian GAAR was adopted in response to the *Stubart* Court's rejection of the business purpose test).

[278] *See* DEP'T OF THE TREASURY, *supra* note 9, at 122.

[279] *See* Lee A. Sheppard, *China Tries a GAAR*, 123 TAX NOTES 523 (2009).

regulation's failure.[280] In revising the PAAR, the Treasury would seek to correct those mistakes by unshackling the PAAR. The revised PAAR would, for the first time, develop through the common law elaborative process. By releasing the revised PAAR from the Treasury's prior failed efforts to achieve greater certainty, the revised PAAR might paradoxically become more certain. At the very least, the magnitude and effects of any increased uncertainty are themselves quite uncertain.

If, however, the government wanted to address these opponents' uncertainty concerns more proactively, there is a relatively easy and effective way to do this. The Service could initiate an advance ruling procedure designed to address taxpayer issues regarding the application of a revised PAAR.[281] Such a procedure would offer taxpayers an expedited means of determining whether the regulation applied to their transactions without compromising the Service's need for flexibility in combating abusive partnership transactions. To this end, the risk of compliance with a revised PAAR would remain entirely on the taxpayer. Thus, the only taxpayers that would likely take advantage of this procedure are those engaging in legitimate partnership transactions. As previously discussed, taxpayers engaging in abusive partnership transactions are unlikely to want or need additional guidance.[282]

2. *We Don't Need Redundant Anti-Abuse Rules*

If the Treasury were to revise the PAAR, a different objection would likely emerge. The regulation's opponents would likely assert

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[280] *See supra* Part II.C.

[281] *See* Chirelstein & Zelenak, *Search for a Silver Bullet*, *supra* note 18, at 1960. In addition, an advance ruling procedure is not without precedent. Specifically, taxpayers can enter into advance pricing agreements with the Service under Section 482, which authorizes the Service to reallocate tax items among two or more business entities under common ownership or control whenever necessary in order to prevent evasion of taxes or to clearly to reflect income. I.R.C. § 482 (2006). For a more detailed discussion of Section 482 and transfer pricing generally, see BITTKER & LOKKEN, FEDERAL INCOME TAXATION, *supra* note 37, at ¶ 79.1.1. Advance pricing agreements allow the taxpayer and the Service to agree in advance on the best transfer pricing method to be used for transactions specified in the agreement. *See* Rev. Proc. 2006-9, 2006-1 C.B. 278 (revised by Rev. Proc. 2008-31, 2008-23 I.R.B. 1133). In doing so, the advance pricing agreement program aims to resolve taxpayer disputes cooperatively and prospectively rather than through the traditional audit process. *Id.*; *see also* I.R.S. Announcement 2009-28, 2009-15 I.R.B. 760, 766 tbl.1 (IRS Annual Report Concerning Advance Pricing Agreements and APA Program). For a more detailed discussion of advance pricing agreements, see BITTKER & LOKKEN, FEDERAL INCOME TAXATION, *supra* note 37, at ¶ 79.14.

[282] *See* Chirelstein & Zelenak, *Search for a Silver Bullet*, *supra* note 18, at 1960 ("In reality, of course, this approach would call the bluff of those who complain about uncertainty but whose real interest is in being able to play the audit lottery without risk of penalty."); *see also supra* note 257 and accompanying text.

that the Service's current arsenal of anti-tax shelter tools is sufficient to fight abusive partnership transactions and, therefore, a revised PAAR would be redundant.[283] Although tax shelters remain an enduring problem of the federal income tax system, the government ultimately quelled the most recent generation of abusive transactions through the application of a series of tools, including the judicial doctrines[284] and an enhanced disclosure regime.[285] Even Congress experienced a critical shift in thinking about tax shelters, which has resulted in the enactment of numerous anti-abuse provisions[286] and may result in the codification of the economic substance doctrine.[287]

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[283] Some might even go a step further, proclaiming that "[t]he tax shelter war is over. The government won." Olson, *Observations from the Frontlines*, *supra* note 12, at 567. In recent years, this has been an all too common refrain because the government has experienced incredible success in combating the last generation of tax shelters. *See, e.g.*, Coder, *supra* note 12 (recounting the views of Donald Korb, outgoing I.R.S. Chief Counsel, that the Treasury has turned the corner on corporate tax shelters). But the tax shelter war is not over. Although the market for abusive transactions is currently quiet, a lull in the action should not be confused with an end to hostilities. The tax shelter industry suffered a tremendous blow, but it has proven to be a nimble and adaptive adversary. Further, the current economic crisis has assuredly reduced the demand for tax shelters. Taxpayers are suffering incredible losses; there is little need to purchase losses, deductions, and credits in the tax shelter market. Make no mistake, however, bankers and lawyers high atop Wall Street (or deep in the trenches beneath the Chicago loop, as has been suggested by one commentator) are currently developing the next big tax shelter. *See* Lee A. Sheppard, *Corporate Tax Shelters: More Plain Brown Wrappers*, TAX NOTES TODAY, Apr. 17, 2000, 2000 TNT 74-6 (LEXIS). There is simply no reason to believe that, with the passage of time and the improvement of the economy, the tax shelter industry will not return to its innovative and daring ways. *See* Johnson & Zelenak, *supra* note 12, at 1391 ("Shelters may not reemerge as a major problem soon, both because the forces noted above should continue to operate and, regrettably, because there may not be much income needing sheltering for the next few years. It would be a major mistake, however, to assume that the tax shelter dragon has been slain once and for all.").

[284] *See* Olson, *Observations from the Frontlines*, *supra* note 12, at 569 ("[T]he courts backstopped the Service's efforts, not quite universally, but with more than enough frequency for taxpayers to realize the courts were an unreliable refuge.").

[285] *See* Canellos, *supra* note 9, at 70–71; Mark P. Gergen, *The Logic of Deterrence: Corporate Tax Shelters*, 55 TAX. L. REV. 255, 286 (2002); Olson, *Observations from the Frontlines*, *supra* note 12, at 569. Although disagreeing with the conclusion that strong disclosure is sufficient to successfully combat tax shelters, one scholar described the argument for disclosure as follows:

> [T]he economics of the shelter industry rely on the audit lottery rather than on substantive tax law. Taxpayers compare the probability of being caught and the cost of being caught with the potential tax savings. . . . If we believe courts generally can differentiate between permissible, aggressive tax planning and impermissible tax shelters, we can change these odds without changing substantive law. Disclosure increases the chance of being caught and penalties create a cost to being caught. Properly structured disclosure and penalties should be sufficient and a new substantive disallowance rule is not needed.

Weisbach, *Failure of Disclosure*, *supra* note 17, at 73. For a detailed discussion of the current disclosure regime, see SALTZMAN, *supra* note 77, at ¶ 7B.16[3][a]–[b].

[286] *See, e.g.*, American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 833, 188 Stat. 1418, 1589–92 (codified at I.R.C. §§ 704(c)(1)(C), 734(b), (d), 743(b), (d)).

[287] *See* Jeremiah Coder, *Administration Supports Codification of Economic Substance*,

To these opponents, existing anti-tax shelter tools, plus the potential addition of a codified economic substance doctrine, are sufficient to combat future abusive partnership transactions. Hence, revising the PAAR would be unnecessary.

Before addressing the substance of the redundancy objection, readers will notice a tension between this objection and the uncertainty objection previously discussed. The uncertainty objection posits that the PAAR's revision would create chaos in subchapter K, deterring taxpayers from using partnerships and diminishing the fairness of the federal income tax system. That is, this objection predicts that a revised PAAR would have a profoundly negative impact on the federal income tax system. On the contrary, the redundancy objection maintains that revising the PAAR would have little effect because the federal income tax system already accomplishes the goals that the Treasury would set for a revised PAAR. Taken together, these objections are difficult to reconcile and, thus, raise the possibility that revising the PAAR could be just the right remedial measure for subchapter K.

Notwithstanding this contradiction, the redundancy argument is unpersuasive. First, recent congressional efforts to combat partnership tax shelters have been counterproductive. The statutory anti-abuse rules added to subchapter K during the past decade have been technical, narrowly tailored provisions.[288] As a result, the complexity of these provisions has only exacerbated subchapter K's deepening crisis.[289] Because these provisions typically apply to such a narrow range of transactions, their structural costs far outweigh any benefits achieved through the elimination of abuse. Thus, Congress's recent willingness to combat partnership tax shelters through targeted

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Treasury Official Says, TAX NOTES TODAY, June 16, 2009, 2009 TNT 113-4 (LEXIS); Amy S. Elliot, *Debate Is Over on Codification of Economic Substance Doctrine, Treasury Official Says*, TAX NOTES TODAY, Oct. 2, 2009, 2009 TNT 189-2 (LEXIS) ("Joshua Odintz, acting Treasury tax legislative counsel, said that 'the debate is effectively over' about whether there should be codification of the economic substance doctrine and that he imagines Congress will pass codification in the next few years."). For a discussion of the most recent codification proposal, see *infra* note 297 and accompanying text.

288 *See, e.g.*, I.R.C. § 704(c)(1)(C) (2006) (providing a special rule for allocations attributable to property contributing with a built-in loss); § 734(b), (d) (2006) (mandating basis adjustments if there is a substantial basis reduction with respect to a distribution); § 743(b), (d) (2006) (mandating basis adjustments if the partnership has a substantial built-in loss immediately following the transfer of a partnership interest).

289 For a discussion of one such change, Section 704(c)(1)(C), and the confusion it has created, see Andrea Monroe, *Saving Subchapter K: Substance, Shattered Ceilings, and the Problem of Contributed Property*, 74 BROOK. L. REV. 1381 (2009), and Daniel L. Simmons, *Built-in Gain and Built-in Loss Property on Formation of a Partnership: An Exploration of the Grand Elegance of Partnership Capital Accounts*, 9 FLA. TAX REV. 599, 661–86 (2009).

statutory anti-abuse provisions has not rendered a revised PAAR superfluous.[290]

Second, the potential codification of the economic substance doctrine would not eliminate the need for a revised PAAR. As a preliminary matter, Congress has yet to codify the economic substance doctrine and, thus, this argument is premature. Although the likelihood of congressional action has increased,[291] Congress has flirted with codifying economic substance for almost a decade.[292] Yet the doctrine remains uncodified.[293]

Even if Congress were to codify the economic substance doctrine, this should not deter the Treasury from revising the PAAR. Let's assume that Congress ultimately enacts an economic substance provision resembling the proposal currently under consideration.[294] In basic terms, if a court determines that the application of the economic substance doctrine is appropriate, then this proposal would require the

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290 The same can be said of Congress's commitment to combat tax shelters. In recent years, Congress has demonstrated a renewed vigor in the fight against tax shelters. But Congress is fickle, and its desire to combat tax shelters ebbs and flows with the political climate. Indeed, Congress's appetite for combating tax shelters may be waning in light of the current economic crisis. Members of both congressional tax-writing committees recently sent a letter to Douglas Shulman, Commissioner of the Service, requesting relief for small business owners subject to significant penalties for their participation in tax shelters. *See* Letter from Sen. Max Baucus et al. to Douglas H. Schulman, Comm'r, Internal Revenue Serv. (June 12, 2009), *reprinted in Taxwriters Seek To Curb Listed Transaction Penalties on Small Businesses*, TAX NOTES TODAY, June 15, 2009, 2009 TNT 113-25 (LEXIS). In response, the Service announced that it would not seek to collect certain penalties from small businesses that had previously engaged in listed transactions until December 31, 2009. *See* Jeremiah Coder, *IRS Extends Suspension of Listed Transaction Disclosure Penalty*, TAX NOTES TODAY, Sept. 25, 2009, 2009 TNT 184-1 (LEXIS); *see also* Michael Joe, *Shulman Suspends Collection of Some Tax Shelter Penalties as Lawmakers Plan Legislative Fix*, TAX NOTES TODAY, July 8, 2009, 2009 TNT 128-2 (LEXIS).

291 The Obama administration supports codification of the economic substance doctrine. *See* sources cited *supra* note 287. This is in marked contrast to the Bush administration's opposition to codification of the doctrine. *See* OFFICE OF MGT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, STATEMENT OF ADMINISTRATION POLICY, H.R. 2419 – FOOD AND ENERGY SECURITY ACT OF 2007, at 3 (2007) (opposing codification of the economic substance doctrine in the Food and Energy Security Act of 2007).

292 *See* Lee A. Sheppard, *Turning Japanese: Federal Policy Prolongs Bank Crisis*, 123 TAX NOTES 657, 658 (2009) (noting that an economic substance proposal has been "kicking around" for years); Clinton Stretch et al., *Economic Substance and Strict Liability Do Not Mix*, TAX NOTES TODAY, June 16, 2009, 2009 TNT 113-11 (LEXIS) (noting that efforts to codify the economic substance doctrine have intensified over the past seven years).

293 The codification of the economic substance doctrine has generated much controversy over the past decade. *See, e.g.*, Monte A. Jackel, *Farming for Economic Substance: Codification Fails to Bear Fruit*, 119 TAX NOTES 59, 59–60 (2008); Sheryl Stratton & Karla L. Miller, *To Codify Is to Ossify, IRS Official Says on Economic Substance*, TAX NOTES TODAY, June 20, 2003, 2003 TNT 119-6 (LEXIS); *see also* N.Y. State Bar Ass'n Tax Section, Summary Report on the Provisions of Recent Senate Bills That Would Codify the Economic Substance Doctrine, *reprinted in NYBSA Objects to Codification of Economic Substance Provisions*, TAX NOTES TODAY, May 28, 2003, 2003 TNT 102-19 (LEXIS).

294 *See* Affordable Healthcare for America Act, H.R. 3692, 111th Cong. § 562 (2009).

court to use a uniform, statutory definition of economic substance.[295] Under this codified version of economic substance, a court would still have to engage in a fact-intensive analysis of the underlying transaction in order to determine whether the economic substance doctrine is applicable. Yet it is this analysis that has proven so unpredictable in litigating partnership tax shelters.[296] Additional problems emerge if we further assume that a codified economic substance doctrine would exclude various transactions from its application.[297] The codified doctrine would become more complex, and its exceptions would likely provide a roadmap to future abusive transactions.[298]

Third, the recent success of various anti-tax shelter tools does not eliminate the need to revise the PAAR. For instance, the judicial doctrines remain unpredictable, experiencing periods of both robust and limited application by the courts.[299] Different views of judicial role may affect a court's willingness to extend these doctrines into novel contexts where a taxpayer technically complies with subchapter K, but violates its intent.[300] Similarly, disclosure rules are not assured

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295 *See id.* § 562(a). Specifically, a transaction will only be deemed to have economic substance if the following two requirements are satisfied: "(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction." *Id.*

296 *See* Donald Korb, *Codification of the Judicial Economic Substance Doctrine*, *in* 852 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCING, REORGANIZATIONS AND RESTRUCTURINGS 377, 394 (P.L.I. 2008) ("Because the court must still review the transactions 'for what they are': The cheap, easy way out that codification of the economic purpose doctrine might seem to offer is no way out at all.").

297 *See* Farm, Nutrition and Bioenergy Act of 2007, S. 2242, 110th Cong., 1st Sess. § 511 (2007) (proposed Section 7701(p)); *see also* S. REP. NO. 110-206, at 92-3 (2007). The legislative history to this codification proposal provides that "this provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages." S. REP. NO. 110-206, 92 (2007). To illustrate, the report contains a non-exclusive list of basic structuring techniques that should not violate the economic substance doctrine, including: (1) capitalizing an enterprise with debt or equity, (2) making a foreign investment through a foreign corporation or a domestic corporation, (3) entering into a transaction that constitutes a corporate organization or reorganization, and (4) using a related party entity in a transaction, so long as such transaction satisfies Section 482 and other applicable standards. *Id.*, at 92–93. *See generally* Jackel, *supra* note 293.

298 *See, e.g.*, McMahon, *supra* note 237, at 208 ("A complicated comprehensive codification of the anti-abuse rules inevitably would include numerous safe harbors and examples of non-abusive transactions. And most, if not all, of those safe harbors would have the potential to metamorphose into yet another tax shelter transaction.").

299 *See* McMahon, *supra* note 237; Weisbach, *Failure of Disclosure*, *supra* note 17, at 75–77.

300 *See* Cunningham & Repetti, *supra* note 8, at 4; Johnson & Zelenak, *supra* note 12, at 1391 ("Tax shelters could return—perhaps with a vengeance—if the federal judiciary were to become less receptive to the government's invocation of the various common-law antiabuse

to halt the spread of future partnership tax shelters. Taxpayers are likely to adapt to the current disclosure rules, as they have adapted to previous changes in law. For some taxpayers, this may mean becoming more efficient in disclosing transactions, thereby freeing up additional time to focus on tax planning.[301] For others, this may mean developing novel ways to obfuscate suspect transactions.[302] Simply put, past success in the fight against tax shelters may not be predictive of future success.

CONCLUSION

Subchapter K is failing. Its ailments are legendary: the allegiance to flexibility, the matchless complexity, and the limited enforcement resources. And the consequences have been ruinous. Subchapter K has become a breeding ground for some of the most egregious tax shelters, costing the general public billions of dollars and compromising the integrity of the federal income tax system.

Remarkably, the most promising candidate to sustain subchapter K is perhaps its least successful, most controversial provision—the PAAR. Despite the regulation's infamous, much publicized failure, a revised PAAR could more effectively challenge partnership tax shelters and provide subchapter K with much needed structural support. Thus, this Article suggests that the Treasury rework the PAAR, correcting the mistakes made in the months following the regulation's proposal. In doing so, the Treasury would return the PAAR to its roots as a broad anti-abuse rule, reminding taxpayers that partnership transactions, like all transactions, must comply with the foundational principles that undergird the federal income tax system.

While the PAAR's longstanding opponents will invariably question the wisdom of revising the PAAR, these scholars' and practitioners' concerns are speculative and there is reason to doubt their ultimate persuasiveness. What is certain, however, is subchapter K's deepening crisis. And a revised PAAR seems likely to help curb this crisis while risking little downside. Given the disastrous state of

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doctrines.").

301 *See* Olson, *Observations from the Frontlines*, *supra* note 12, at 567.

302 *See* Blank, *supra* note 17, at 1641–42. Equally problematic, disclosure rules are only as effective as the enforcement regime undergirding them and as the judiciary's commitment to eliminating tax shelters. *See* Eustice, *supra* note 8, at 153, 161; Schler, *supra* note 9, at 362–63; Weisbach, *Failure of Disclosure*, *supra* note 17, at 74. As previously discussed, the enforcement resources dedicated to subchapter K are woefully insufficient. *See* sources cited *supra* note 7 and accompanying text. Whether subchapter K's enforcement regime can effectively and reliably use the information obtained through disclosure to fight abusive partnership transactions remains uncertain.

subchapter K and the extraordinary public cost of tax shelters, the time has come for the Treasury to answer one of the most intriguing tax questions never asked: can the partnership anti-abuse rule really stop partnership tax abuse?