Treasury Regulations in the Wake of Mayo Foundation *and A Possible Attack on Publicly Traded Partnerships*

by
Erica L. Weiss

Submitted in partial fulfillment of the requirements of the
King Scholar Program
Michigan State University College of Law
under the direction of
Professor Emily L. Cauble
Spring, 2012

TREASURY REGULATIONS IN THE WAKE OF *MAYO FOUNDATION* AND A POSSIBLE ATTACK ON PUBLICLY TRADED PARTNERSHIPS

Erica L. Weiss[1]

CONTENTS

Introduction 2

I. Background 3

A. *National Muffler* Standard 4

B. The *Mayo Foundation* Decision 5

II. Application of *Mayo Foundation* in the Courts 9

A. Case law Upholding Treasury Regulation Section 301.6501(e)-1 9

B. Case law Refusing to Defer to Treasury Regulation Section 301.6501(e)-1 15

III. A Possible Tax Issue to Flow from the more Certain Application of a Higher Deferential Standard 18

A. Background on Publicly Traded Partnerships 18

1. Economic Effect Test 19

2. Substantiality 21

B. Background on the Blackstone IPO and Entity Structure 24

1. Application of Section 704(b) Regulations Where Partners are Unrelated 27

2. Application of Section 704(b) Regulations Where Partners are Related 33

C. How the IRS Could Use Partnership Anti-Abuse Regulations to Recast the Blackstone Structure 40

1. Background on the Partnership Anti-Abuse Regulations 40

2. How the Partnership Anti-Abuse Regulations Would work to Prevent more Blackstones 42

3. Force of the Partnership Anti-Abuse Regulations After Mayo Foundation 44

Conclusion 46

INTRODUCTION

In *Mayo Foundation for Medical Education and Research v. U.S.*,[2] the Court clarified that *Chevron*[3] deference applies to certain Treasury regulations. The reasoning in *Mayo Founda-*

[1] A special thank you to Professor Emily L. Cauble, who helped me a great deal in preparing and understanding the substantive tax law issues discussed in this paper, in addition to reviewing my work throughout the writing process. My paper significantly benefited from her guidance and expertise in tax law.

tion presents many issues. This paper focuses on two. First, because many Treasury regulations are not promulgated rigorously following the Administrative Procedures Act, language in *Mayo Foundation* could lead to some Treasury regulations not being upheld even under *Chevron*. Second, controversial Treasury regulations might be used with greater force in the future because of the higher deference accorded.

Part I of this paper presents background information regarding *National Muffler Dealers Ass'n, v. U.S.*,[4] which is a pre-*Chevron* case, and the *Mayo Foundation* decision. Prior to *Mayo Foundation*, it was unclear whether courts were to analyze Treasury regulations under *National Muffler* or *Chevron*. Part II examines case law post-*Mayo Foundation* and challenges to Treasury regulations under the more certain standard of review, focusing on a circuit split regarding Treasury regulations promulgated under Section 6501(e)(1)(A). Part III analyzes a partnership tax transaction and suggests that it may be ripe for a recast by the Commissioner under the partnership tax anti-abuse regulations now that that Treasury knows that it will be accorded what appears to be a higher level of deference by the courts.

I. Background

The Court, in *Mayo Foundation*, admitted that it had cited to both *National Muffler* and *Chevron* in reviewing Treasury regulations.[5] In *Mayo Foundation*, the Court explained the different treatment under each standard for ambiguous statutes and clarified that "[t]he principles underlying *Chevron* apply with full force in the tax context."[6] Up until *Mayo Foundation* it was unclear which standard a court was to apply in reviewing Treasury regulations. Part I of this paper describes the *National Muffler* standard and the *Mayo Foundation* decision.

---

[2] 131 S. Ct. 704 (2011).
[3] Referring to *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).
[4] 440 U.S. 472 (1979).
[5] *Mayo Found. for Med. Educ. and Research*, 131 S. Ct. at 712.
[6] *Id* at 712-13.

A. *National Muffler* Standard

National Muffler, is viewed as a less deferential review of an agency's interpretation, in which the courts will take a more skeptical look at the agency's regulation.[7] Under *National Muffler*, the Court enumerated factors to determine whether a regulation carried out Congress's mandate properly. A factor cutting in favor of upholding the regulation was if it was issued contemporaneously with the statute's enactment.[8] Other factors courts were to analyze under *National Muffler* included: the way in which the regulation, if older, evolved; how long the regulation has been in effect; the amount of reliance on the regulation; the Treasury's consistency in its interpretation; and Congress's actions in re-enacting the statute post regulation.[9] In *National Muffler*, the Court upheld the Treasury Regulation where it found that the Regulation coincided with the statute's purpose; the Regulation was enacted fifty years earlier; and the Treasury, although sparingly, consistently interpreted the Regulation.[10] The Treasury's view was accorded deference. *National Muffler* is viewed as "applying a more limited standard of reasonableness to a [T]reasury regulation."[11]

In addition to *National Muffler*, there were also cases that formulated a distinction in treatment for regulations enacted pursuant to the Treasury's general authority,[12] and regulations enacted under a specific authority. These cases indicated that Treasury regulations are to be accorded less deference if the regulations are issued under the Treasury's general authority than regulations issued under specific authority.[13]

---

[7] *Id*. at 721.
[8] *National Muffler*, 440 U.S. at 477.
[9] *Id.*
[10] *Id.* at 484.
[11] Burks v. U.S., 633 F.3d 347, 360 (2011).
[12] I.R.C. § 7805(a) (2006).
[13] *Mayo Found. for Med. Educ. and Research*, 131 S. Ct. at 713 (citing *Rowan Companies, Inc. v. U.S.*, 452 U.S. 247, 253 (1981) and *U.S. v. Vogel Fertilizer Co.*, 455 U.S. 16, 24 (1982)).

B. The *Mayo Foundation* Decision

Mayo Foundation concerned an exception to the requirement that employees' wages be taxed under FICA, which funds Social Security.[14] Congress chose to exclude from the tax, "service performed in the employ of . . . a school, college, or university . . . if such service is performed by a student who is enrolled and regularly attending classes at such school, college, or university."[15] The Treasury Regulation, which was in effect since 1951, clarified that the student exception applied to students who work for their schools "as an incident to and for the purpose of pursuing a course of study."[16] In 2004, the Treasury amended the Regulation to state that "an employee's service is 'incident' to his studies only when '[t]he educational aspect of the relationship between the employer and the employee, as compared to the service aspect of the relation, [is] predominant.'"[17] Furthermore, the Regulation also states that a full-time employee includes an employee who is scheduled to work 40 hours or more per week. Thus, such an employee does not qualify for the student exception as the employment is "not incident to and for the purpose of pursuing a course of study."[18]

The plaintiffs (referred to as "Mayo") offer medical residency programs that provide stipends to residents who, in turn, care for patients between 50 to 80 hours per week in addition to taking exams, attending lectures, and reading textbooks and articles.[19] Mayo sued to obtain a refund on withheld money from the students' stipend after the amended Treasury Regulation was

[14] 131 S. Ct. at 709.
[15] *Id.* (quoting I.R.C. § 3121(b)(10) (2006)).
[16] *Mayo Found. for Med. Educ. and Research*, 131 S. Ct. at 709 (quoting 16 Fed. Reg. 12474).
[17] *Mayo Found. for Med. Educ. and Research*, 131 S. Ct. at 710 (quoting 69 Fed. Reg. 76408).
[18] *Mayo Found. for Med. Educ. and Research*, 131 S. Ct. at 710 (quoting 69 Fed. Reg. 76409).
[19] *Mayo Found. for Med. Educ. and Research*, 131 S. Ct. at 708.

in force.[20] Mayo argued that the residents fall into the exemption under Section 3121(b)(10), and further, that the Treasury Regulation was invalid.[21]

Evidencing the confusion existing before the Court's decision in *Mayo Foundation*, the district court held the Treasury Regulation invalid under the *National Muffler* standard and granted summary judgment in favor of Mayo.[22] However, the Eighth Circuit Court of Appeals applied *Chevron* deference to the Treasury Regulation, and it held that the Regulation was valid.[23]

The Court applied *Chevron* deference to the Treasury Regulation. The first step in *Chevron* is to ask whether Congress "directly addressed the precise question at issue."[24] The second step in *Chevron* deference analysis asks whether the regulation is "arbitrary or capricious in substance, or manifestly contrary to the statute,"[25] or more directly, "whether the agency's answer is based on a permissible construction of the statute."[26]

Regarding the first step, the Court indicated that the statute does not define what constitutes a "student" and does not address the treatment for medical residents.[27] Before applying *Chevron's* second step, the Court admits to citing both *National Muffler* and *Chevron*, but not distinguishing between the two, although they call for different treatment of a deemed ambiguous statute.[28] The Court explained that *National Muffler* provides a standard under which the courts may examine the agency's interpretation with more skepticism if that interpretation was inconsistent over time, promulgated much later than the passage of the statute, or not issued in

[20] *Id.* at 710.
[21] *Id.*
[22] *Id.*
[23] *Id.*
[24] *Id.* at 711.
[25] *Mayo Found. for Med. Educ. and Research*, 131 S. Ct. at 711 (quoting *U.S. v. Mead Corp.*, 533 U.S. 218, 227 (2001)).
[26] *Chevron*, 467 U.S. at 843.
[27] *Mayo Found. for Med. Educ. and Research*, 131 S. Ct. at 711.
[28] *Id.* at 712.

the proper manner.[29] However, *Chevron* deference does not depend on consistency, and, under *Chevron*, whether the regulation was spurred by litigation is irrelevant.[30]

The Court explicitly refused to "carve out an approach to administrative review good for tax law only," and further, it emphasized the importance of a uniform approach to reviewing administrative agency action.[31]

> The principles underlying our decision in *Chevron* apply with full force in the tax context. *Chevron* recognized that '[t]he power of an administrative agency to administer a congressionally created . . . program necessarily requires the formulation of policy and the making of rules to fill any gap left, implicitly or explicitly, by Congress.'[32] . . . It acknowledged that the formulation of that policy might require 'more than ordinary knowledge respecting the matters subjected to agency regulations.'[33] . . . Filling gaps in the Internal Revenue Code plainly requires the Treasury Department to make interpretive choices for statutory implementation at least as complex as the ones other agencies must make in administering their statutes.[34]

Finally, the Court examined the past precedent indicating that courts owe less deference to Treasury regulations enacted under its general authority, rather than specific authority, namely the *Rowan* and *Vogel* decisions. The Court clarified that since *Rowan* and *Vogel*, the Court has evolved in its treatment for administrative law. In particular, since *Mead*, *Chevron* deference is appropriate "when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority."[35] The Court, in effect, has seemed to throw away the general versus specific inquiry.[36] Here, the Treasury Regulation was enacted under the Treas-

---

[29] *Id.*
[30] *Id.*
[31] *Id.* at 713.
[32] *Chevron*, 467 U.S. at 843.
[33] *Id.* at 844.
[34] *Mayo Found. for Med. Educ. and Research*, 131 S. Ct. at 713.
[35] *Mead Corp.*, 533 U.S. at 226-27.
[36] *See Mayo Found. for Med. Educ. and Research*, 131 S. Ct. at 713-14.

ury's general authority,[37] to "prescribe all needful rules and regulations for the enforcement" of the Code.[38]

The Court concluded that *Chevron*, and not *National Muffler*, provided the correct framework to review the Treasury Regulation.[39] The Court emphasized that express Congressional authority to engage in rulemaking is a good indicator of according *Chevron* deference, and further, that the Regulation here was adopted after notice and comment procedure, which is a "'significant' sign that a rule merits *Chevron* deference."[40]

Determining that *Chevron* deference applied as the proper standard, the Court held that the Treasury Regulation at issue satisfied step two as a reasonable interpretation of the statute.[41] Precisely, the Court mentioned that taxing medical residents furthered the purposes of the Social Security Act and that the Treasury was not irrational in concluding that medical residents are the type of employees Congress intended to supply funds to Social Security through taxes.[42] The Court, in concluding (1) that "students" was an ambiguous term under the statute and (2) that the Regulation was reasonable, upheld the Regulation.[43]

In other words, the Court clarified what factors should be taken into account in determining whether *Chevron* deference applies to a Treasury regulation. First, express congressional authority to engage in rulemaking is a good indicator in favor of applying *Chevron* deference. Second, the fact that a regulation is adopted after notice and comment procedures is a strong indication that *Chevron* deference is appropriate. In addition, the Court eliminated the considerations that prior cases took into account in determining whether *Chevron* deference applies. For

---

[37] I.R.C. § 7805(a).
[38] *Mayo Found. for Med. Educ. and Research*, 131 S. Ct. at 713-14 (quoting I.R.C. § 7805(a)).
[39] *Id.* at 714.
[40] *Id.* (quoting *Mead Corp.*, 533 U.S. at 230-31).
[41] *Mayo Found. for Med. Educ. and Research*, 131 S. Ct. at 714.
[42] *Id.* at 715.
[43] *Id.* at 716.

example, the agency's consistency and whether a regulation was issued in response to litigation do not determine whether *Chevron* applies. Also, whether a regulation is enacted under general or specific authority does not impact the correct deference to accord.

II. APPLICATION OF *MAYO FOUNDATION* IN THE COURTS

Since *Mayo Foundation*, a circuit split has occurred regarding the Treasury Regulations under Section 6501(e) and when *Chevron* deference applies. While the statute of limitations for collecting taxes is generally three years from the date that a return is filed, Section 6501(e) extends the limitations period to six years if a taxpayer omits a substantial amount from gross income reported. If a taxpayer sells property, the gain (or loss) reported will generally be the difference between the amount realized by the taxpayer on the sale and the taxpayer's basis in the property. The Regulation examined by the case law discussed below provides that overstating basis can be considered an omission from gross income. The recent case law discussed below also concerns *Colony, Inc. v. Commissioner*[44] and Section 257(c), which was the predecessor to Section 6501(e). In *Colony*, the Court held that "the overstatement of basis was not an omission from gross income that triggered the longer statute of limitations."[45] So a major issue in these cases that is external to the purposes of this paper, but necessary to understand the following cases is whether or not *Colony* applies so that "an overstatement of basis can be an omission from gross income."[46]

A. Case law Upholding Treasury Regulation Section 301.6501(e)-1

After *Mayo Foundation*, the D.C. Circuit Court of Appeals, Federal Circuit Court of Appeals, and the Tenth Circuit Court of Appeals each addressed and upheld through *Chevron* deference Treasury Regulation Section 301.6501(e)-1. All three cases involved plaintiffs accused of

---

[44] 357 U.S. 28 (1958).
[45] Beard v. Comm'r, 633 F.3d 616, 619 (7th Cir. 2011) (citing *Colony*, 357 U.S. at 33).
[46] *Beard*, 633 F.3d at 619.

using a "Son of BOSS tax shelter" to avoid taxes.[47] A "Son of Boss tax shelter" is a transaction that involves sheltering income by creating an artificially high basis in a partnership interest and then selling that interest to recognize an artificially high loss. Also similar to all three cases, during some point in the pendency of the appeals, the Treasury issued Temporary and Final Regulations that reinterpreted Section 6501(e)(1)(A) to state that "omits from gross income" includes an overstatement in basis.[48] The cases differed slightly in their reasoning and application of the *Chevron* analysis, as described below.

For example, in *Intermountain Insurance Service of Vail LLC*, the issue was whether overstating basis in property that is sold, is understating gross income, and thus, triggering the six-year statute of limitation period.[49] The Tax Court had granted summary judgment for the plaintiff finding that *Colony* applied to Sections 6501(e)(1)(A) and 6229(c)(2), concluding that overstatements of basis were not "omissions from income."[50] The Treasury then promulgated Regulations to interpret "omits from gross income" to include overstatements of basis.[51] The Commissioner asked the Tax Court to reconsider the case, and the Tax Court concluded that the Temporary Regulations did not apply to the plaintiff because the three-year statute of limitations had expired before the Temporary Regulations were applicable, and further, *Colony* prevented the Treasury's interpretation.[52]

---

[47] Intermountain Ins. Serv. of Vail LLC v. Comm'r, 650 F.3d 691, 695 (D.C. Cir. 2011); Grapevine Imports Ltd. v. U.S., 636 F.3d 1368, 1372 (Fed. Cir. 2011); Salmon Ranch Ltd. v. Comm'r, 647 F.3d 929, 932 (10th Cir. 2011).

[48] *Intermountain Ins. Serv. of Vail, LLC*, 650 F.3d at 695-96; *Grapevine Imports Ltd.*, 636 F.3d at 1371-72; *Salmon Ranch Ltd.*, 647 F.3d at 93. The temporary regulations were 26 C.F.R. §§ 301.6501(e)-1T and 301.6229(c)(2)-1T (2010).

[49] *Intermountain Ins. Serv. of Vail, LLC*, 650 F.3d at 694.

[50] *Id.* at 695 (citing *Intermountain Ins. Serv. of Vail, LLC v. Comm'r*, 98 T.C.M. (CCH) 144 (2009)).

[51] *Intermountain Ins. Serv. of Vail, LLC*, 650 F.3d at 695-96. The regulations were 26 C.F.R. §§ 301.6501(e)-1T and 301.6229(c)(2)-1T (2010).

[52] *Intermountain Ins. Serv. of Vail, LLC*, 650 F.3d at 696.

On appeal, the D.C. Circuit cited to *Mayo Foundation*, in stating that courts assessing Treasury regulations interpreting the tax code "must apply the two-step framework of *Chevron.*"[53] The court summarized the steps to be taken under *Chevron* as (1) "'whether Congress has unambiguously foreclosed the agency's statutory interpretation.' . . . [And if not, then (2)] 'whether the [Commissioner's] rule is a 'reasonable interpretation' of the enacted text.'"[54] Under step one, the court concluded that *Colony* did not interpret the current Section 6501(e)(1)(A) and that the phrase "omits from gross income" in the statute is ambiguous.[55] In addition, because the statute's plain text and legislative history do not make the provision unambiguous, the Commissioner was free to interpret "'omissions from gross income' as including basis overstatements."[56] The plaintiff attempted to argue that the Treasury is not entitled to any *Chevron* deference because of the manner in which the regulations were promulgated, specifically that they were enacted in response to the plaintiff's litigation.[57] The court rejected the plaintiff's argument, stating that it does not matter that litigation spurred the agency's regulation for purposes of addressing whether *Chevron* deference applies.[58] Under step two, the court stated that nothing was unreasonable regarding the Treasury's Regulations.[59] The court held that the "Commissioner's regulations were validly promulgated, apply to this case, qualify for *Chevron* deference, and pass muster under the traditional *Chevron* two-step framework."[60]

Also, *Grapevine Imports Ltd.* held that the Treasury Regulations were entitled to deference.[61] The plaintiffs were accused of overstating their basis in capital assets, and as a result,

---

[53] *Mayo Found. for Med. Educ. and Research*, 131 S. Ct. at 714.
[54] *Intermountain Ins. Serv of Vail, LLC*, 650 F.3d at 701 (internal citations omitted).
[55] *Id.* at 705.
[56] *Id.* at 706.
[57] *Id*.
[58] *Id.* at 706-07.
[59] *Intermountain Ins. Service of Vail, LLC*, 650 F.3d at 707.
[60] *Id.* at 710.
[61] 636 F.3d at 1371.

understating their income on the sale of those assets.[62] The Commissioner contended that overstatement of basis constituted an "omission from gross income" and triggered the six-year limitation period.[63] The Court of Federal Claims held that *Colony* applied, meaning that overstatement of basis did not constitute an omission from gross income, and therefore, the court held for the plaintiffs.[64] By the time the case was on appeal, the Treasury had issued its Regulations stating that *Colony* did not absolutely resolve the statute and that the statute of limitations period could be six years for the Treasury to bring claims where a taxpayer overstated basis as an omission from gross income.[65] The court emphasized that the Treasury is mandated to interpret ambiguities within the Internal Revenue Code, and under *Mayo Foundation*, Treasury regulations "are to be interpreted under the standards set forth in *Chevron*. . . . [thus, the court must] determine the deference, if any owed to the Treasury Department . . . undertak[ing] *Chevron* review of the new Treasury regulations. If the Treasury regulations are entitled to *Chevron* deference then they are intervening authority . . . ."[66] The court articulated the *Chevron* analysis in stating that it "[f]irst must determine if there is an ambiguity in the statute such that an agency has room to interpret. Second, we must determine whether the agency's action is a reasonable interpretation of Congress's intent."[67]

In applying the first step, the court found the text of Sections 6501 and 6229 to be ambiguous in terms of taxpayers' overstatement of basis.[68] The court went so far as to hold that *Colony* did not prevent a finding that the text of the statute was ambiguous.[69] Under step two in the

[62] *Id.* at 1370.
[63] *Id.*
[64] *Id.* at 1371.
[65] *Id.* at 1371, 1374. Treas. Reg. §§ 301.6229(c)(2)-1T, 74 Fed. Ref. 49,321 (Sept. 28, 2009). The final regulations: Treas. Reg. §§ 301.6229(c)(2)-1, .6501(e)-1, 75 Fed. Reg. 78,879 (Dec. 17, 2010).
[66] *Grapevine Imports Ltd.*, 636 F.3d at 1376.
[67] *Id.* at 1376 (citing *Chevron*, 467 U.S. at 842-43).
[68] *Grapevine Imports Ltd.*, 636 F.3d at 1378, 1379.
[69] *Id.* at 1378.

Chevron analysis, the court concluded that the Treasury Regulations were reasonable even though they departed from prior judicial interpretation.[70] In response to the plaintiff's argument that the Treasury Regulations should not receive *Chevron* deference, the court emphasized that there is "little doubt that final regulations of the Treasury [ ] are entitled to *Chevron* review and, where appropriate, deference."[71] The Treasury issued the Regulations after the lower court had found for the plaintiffs but before the appellate decision was rendered, and the plaintiffs argued that the regulations should not apply in their case because the Treasury was "chang[ing] the rules in the middle of the game."[72] In response, the court stated that the timing of the Treasury's interpretation does not "diminish the Department's authority, nor its right to have its interpretations, when promulgated, respected by the judiciary—so long as they are reasonable."[73]

Likewise, in *Salmon Ranch Ltd.*, the court emphasized "any agency's construction of a statute it administers is generally owed judicial deference when 'the statute is silent or ambiguous' on the precise issue in question and the agency's reading represents a 'permissible construction of the statute,'" specifically mentioning that *Chevron* applies in tax law.[74] The court concluded that Section 6501(e)(1)(A) is ambiguous regarding Congress's intent.[75] Under the second step, the court stated that *Colony* does not prevent the Treasury's interpretation of Section 6501(e)(1)(A).[76] The court also mentioned that the Treasury's interpretation is reasonable in light of the fact that it interprets "gross income" under Section 6501(e)(1)(A) consistently with Sections 61(a) and 1001(a), in which gross income equals amount realized minus adjusted basis. Thus, it was reasonable for the Treasury to conclude that overstating basis results in an omission

---

[70] *Id.* at 1380.
[71] *Id.* at 1380 (citing *Mayo Found. for Med. Educ. and Research*, 131 S. Ct. at 714).
[72] *Grapevine Imports Ltd.*, 636 at 1383.
[73] *Id.*
[74] *Salmon Ranch Ltd.*, 647 F.3d at 937 (quoting *Chevron,* 467 U.S. at 843).
[75] *Salmon Ranch Ltd.*, 647 F.3d at 939.
[76] *Id.*

from the taxpayer's gross income.[77] Again, the court dismissed the fact that the Regulations were spurred by litigation and that the Temporary Regulations did not go through notice and comment.[78] The court held that "[t]here can be little doubt that the final regulations . . . are entitled to *Chevron* review and, where appropriate, deference."[79] The court concluded that the Treasury Regulations were permissible under *Chevron*, and thus, upheld the Regulations.[80]

Lastly, in *Beard v. Commissioner*,[81] without citing to *Mayo Foundation*, the court concluded that *Colony* did "not control and that an overstatement of basis can be treated as an omission from gross income." The court found that under Section 6501(e)(1)(A), an inflation of basis is included as an omission of gross income to allow the six-year statute of limitations.[82] In dicta, the court mentioned that although the court found *Colony* to not be controlling, the court would have granted the Temporary Treasury Regulation Section 301.6501(e)-1T(a)(1)(iii) *Chevron* deference.[83] The court noted that it has given deference to Treasury regulations issued with notice and comment and that the Supreme Court has held that the absence of notice and comment procedures is not "dispositive to the finding of *Chevron* deference."[84]

In other words, the courts upholding the Treasury Regulation Section 301.6501(e)(1), do so under *Chevron* deference. Specifically, under step one, the courts concluded that *Colony* (1) did not interpret the present Section 6051(e)(1)(A), (2) did not prevent the Treasury's interpretation, or (3) did not prevent a finding that the statute was ambiguous. Under step two of *Chevron*, all three courts found the Regulations to be reasonable. The courts rejected the argument, raised

---

[77] *Id.* at 940.

[78] *Id.*

[79] *Id.* (quoting *Grapevine Imports Ltd.*, 636 F.3d at 1380, citing *Mayo Found. for Med. Educ. and Research*, 131 S. Ct. at 714).

[80] *Salmon Ranch Ltd.*, 647 F.3d at 940.

[81] 633 F.3d 616, 620 (7th Cir. 2011).

[82] *Id.* at 621-23.

[83] *Id.* at 623.

[84] *Id.* at 623.

by plaintiffs in all three cases, that either the Treasury Regulations should not be applied to them or that the Regulations should be accorded less deference because the Regulations were spurred by litigation. Finally *Salmon Ranch Ltd.* and *Beard*, through dicta, dismissed the plaintiffs' argument that the Temporary Regulations should not be accorded *Chevron* deference because they did not go through notice and comment.

B. Case law Refusing to Defer to Treasury Regulation Section 301.6501(e)-1

On the other hand, the Fourth Circuit, Fifth Circuit, and Tax Court, have heard similar cases regarding Treasury Regulation Section 301.6501(e)-1 and have refused to accord it deference. For example, in *Home Concrete & Supply, LLC v. U.S.*,[85] the court held that *Colony* applied so that it would not defer to the Treasury Regulations. The plaintiffs engaged in short sales, which affected the basis in Home Concrete, and thus, reported less gain on the sale accordingly.[86] The court held that *Colony* construed "omits from gross income."[87] Therefore, *Colony* prevented the Treasury's arguments that Home Concrete's overstated basis was an "omission from gross income."[88] The court refused to apply the Treasury Regulations in this case.[89] In analyzing under step one of *Chevron*, the court concluded that Section 6501(e)(1)(A) was unambiguous because *Colony* interpreted the statute to be unambiguous, so the Treasury Regulations were not entitled to deference.[90] Therefore, the court held that the Regulations failed at step one under *Chevron*.

Also, in *Burks v. U.S.*,[91] the court found that the Treasury Regulations did not apply to the taxpayers. Here, the taxpayers were accused of using "the 'Son of BOSS' tax shelter."[92] The

---

[85] 634 F.3d 249, 251 (4th Cir. 2011).
[86] *Id.* at 251-52.
[87] *Id.* at 255.
[88] *Id.*
[89] *Id.* at 256.
[90] *Id.* at 257.
[91] 633 F.3d 347, 349 (5th Cir. 2011).

court's ultimate holding was that *Colony* still applies regarding "omits from gross income," so an overstatement of basis is not included within the definition.[93] The Treasury argued that the Treasury Regulations clarified that "omits from gross income" includes an overstatement of basis.[94] The taxpayers argued, under *National Muffler*, that the statute was unambiguous and that the Regulations' interpretations were unreasonable. However, because the court held that the statutory section was unambiguous and that *Colony* controlled the meaning, it did not decide what level of deference to apply to the Treasury Regulations.[95] The court did note that even if the statute was ambiguous and *Colony* did not control, that it did not necessarily mean that the Treasury Regulations would be accorded *Chevron* deference.[96] The court distinguished the present case from *Mayo Foundation*, in that here, the Treasury promulgated the Regulations during appeals in response to judicial decisions against the Treasury.[97] In addition, the court emphasized that *Mayo Foundation* credited the fact that the regulations in that case underwent notice and comment, but that here, the Treasury issued the Temporary Regulations without notice and comment, and the Treasury only completed notice and comment after the final regulations were issued.[98]

Finally, *Carpenter Family Investments, LLC v. Commissioner*,[99] involved taxpayers also engaging in a Son of BOSS tax shelter. The Tax Court concluded that *Colony* controls section 6501(e)(1)(A), but that conclusion did not prevent, necessarily, *Chevron* deference, but that it

---

[92] *Id.*
[93] *Id.* at 355.
[94] *Id.* at 359.
[95] *Id.* at 360.
[96] *Id.* at 360 n.9 (citing *Mayo Found. for Med. Educ. and Research*, 131 S. Ct. at 711).
[97] *Burks*, 633 F.3d at 360 n.9.
[98] *Id.*
[99] 136 T.C. 373, 375 (2011).

had to apply the *Brand X* version of the *Chevron* analysis.[100] The Tax Court noted that *Mayo Foundation* indicates that during *Chevron* step one, the courts should look just at the text of the statute to determine Congress's intent and suggests not using legislative history during step one.[101] Regarding gap-filling, the Commissioner can interpret the meaning where Congress has left gaps, as long as the interpretation is reasonable and does not counter clear congressional intent.[102] The court concluded that because the Ninth Circuit held that *Colony* controls the statute's meaning of "omits from gross income" and that the Supreme Court held that "omits from gross income" does not include situations where taxpayers overstated their basis, that the six-year extended limitation did not apply.[103]

In other words, the courts concluding that the Treasury Regulations did not apply to the taxpayers did so by concluding that *Colony*, a Supreme Court prior judicial determination, interpreted the statute to be unambiguous, and therefore, the Treasury Regulations failed at step one under *Chevron* analysis. Typical of most decisions on administrative law, if a regulation fails under *Chevron* analysis, it will most likely do so under step one. In addition, *Burks* also distinguished itself from *Mayo Foundation*, in emphasizing that the Treasury Regulations concerned in *Burks* were spurred by adverse litigation decisions against the Treasury, whereas that fact was absent in *Mayo Foundation*. Also, *Burks* raised the issue that the Temporary Regulations concerned in *Burks* did not go through the notice and comment process, but only after the final regulations were issued, as opposed to *Mayo Foundation*, in which the Treasury Regulations went through proper notice and comment procedure.

---

[100] *Carpenter Family Investments, LLC*, 136 T.C. at 386-87 (citing Nat'l Cable & Telecomm. Ass'n. v. Brand X Internet Services, 545 U.S. 967, 984 (2005), concluding that a court's interpretation of a statute may overcome an agency's interpretation if the court had held the statute to be unambiguous).

[101] *Carpenter Family Investments, LLC*, 136 T.C. at 389.

[102] *Id.* at 390.

[103] *Id.* at 397.

Looking at the circuit split in light of the guidance of *Mayo Foundation*, it appears that the D.C. Circuit, Federal Circuit, and the Tenth Circuit have the correct position. The Supreme Court accepted certiorari in *Home Concrete* and will presumably resolve the circuit split just identified. Based on the Court's opinion in *Mayo Foundation*, the Court will likely agree with the reasoning established by *Intermountain*, *Grapevine Imports Ltd.*, and *Salmon Ranch Ltd.*, so long as the Court finds that Section 6501(e)(1)(A) is ambiguous as to the meaning of "omits from gross income." Provided that the regulation passes under step one of *Chevron* analysis and Section 6501(e)(1)(A) is found to be ambiguous, then the Treasury Regulations will likely be upheld as being reasonable because the tax code accounts for gain recognized equal to amount realized minus adjusted basis, so it is, therefore, reasonable for the Treasury to interpret that overstating basis in a sold asset will result in an "omi[ssion] from gross income."[104]

III. A POSSIBLE TAX ISSUE TO FLOW FROM THE MORE CERTAIN APPLICATION OF A HIGHER DEFERENTIAL STANDARD

Now that the Treasury knows that a *Chevron* analysis (which is viewed as more agency-deferential than the *National Muffler* standard) applies to tax law, the Treasury might now use this to its advantage in furthering some of its more controversial regulations. In particular, the Treasury might rely more on the partnership tax anti-abuse regulations. As discussed below, these regulations are more likely to receive deference after *Mayo Foundation*.

A. Background on Publicly Traded Partnerships

Under Subchapter K, the part of the Internal Revenue Code that governs partnerships, partnerships are not subject to entity level tax, and the partners of the partnership are, instead,

[104] For example, if A has property that they paid $100 for and then A sold that property for $200, assuming that they took the cost basis of $100, A's recognized gain on the sale = $200 (amount realized on the sale) - $100 (cost basis) = $100 gain to be added to A's gross income. However, if through some tax manipulation, A overstated the basis in the property as $150, then A's recognized gain on the sale = $200 (amount realized on the sale) - $150 (overstated basis) = $50 gain, to be added to A's gross income. As the example demonstrates, A will be reporting less income on the sale of the property where A overstates the basis in the property, which, reasonably, could be considered an omission of gross income.

taxed on an individual basis.[105] Partners are allowed to enter into a partnership agreement, detailing how the partnership's taxable gains and losses will be allocated among the partners, unless an exception applies.[106] However, Section 704(b) provides that

> a partner's distributive share of income, gain, loss, deduction, or credit . . . shall be determined in accordance with the partner's interest in the partnership [PIP] (determined by taking into account all facts and circumstances), if—. . . (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit . . . does not have *substantial economic effect*.[107]

To determine whether an allocation has "substantial economic effect" the Treasury promulgated detailed regulations under Section 704(b). Under these Regulations, in order for an allocation to have substantial economic effect, "the allocation [1] must have economic effect . . . [and 2] the economic effect of the allocation must be substantial."[108] Thus, substantial economic effect includes two requirements: (1) economic effect and (2) substantiality.

Also, Section 7704 provides the treatment for publicly-traded partnerships. If a partnership is publicly-traded within the meaning of Section 7704(b), then unless the partnership is earning primarily passive-type income, the entity will be deemed a corporation for tax purposes and subject to corporate taxes.[109]

1. *Economic Effect Test*

There are three tests to determine whether a given allocation has economic effect: (1) the basic test for economic effect, (2) the alternate test for economic effect, and (3) the economic effect equivalence test.[110] If an allocation complies with any of the three tests, the allocation will

[105] I.R.C. § 701 (2006).
[106] I.R.C. § 704(a) (2006).
[107] I.R.C. § 704(b) (2006) (emphasis added).
[108] Treas. Reg. § 1.704-1(b)(2).
[109] I.R.C. § 7704(a), (c), (d) (2006); *see infra* Part III.B.
[110] LAURA E. CUNNINGHAM & NOEL B. CUNNINGHAM, THE LOGIC OF SUBCHAPTER K: A CONCEPTUAL GUIDE TO THE TAXATION OF PARTNERSHIPS 52 (2011).

meet the first requirement for having substantial economic effect, namely, the economic effect requirement.

The most common economic effect test used is the alternate test for economic effect, and this test consists of three requirements. First, the partnership must maintain a capital account for each partner in accordance with the Treasury Regulations such that each partners' capital account equals (1) the cash contributed by that partner + (2) the fair market value of other property contributed by that partner + (3) the tax gain (or income) allocated to that partner – (4) the cash distributed to that partner – (5) the fair market value of other property distributed to that partner – (6) the tax loss (or deduction) allocated to that partner.[111]

Second, the alternate test for economic effect requires that when the partnership liquidates, the partnership must distribute cash pro rata to the partners based on each partner's positive capital account balance.[112] Finally, to meet the alternate test for economic effect, the partnership must take various steps that are designed to ensure that no partner will have a negative capital account balance that exceeds the partner's deficit restoration obligation ("DRO") prior to liquidation of the partnership.[113]

---

[111] *See* Treas. Reg. § 1.704-1(b)(2)(ii)(d).

[112] *See Id.*

[113] *See Id.* A DRO is an obligation to contribute cash to the partnership upon liquidation if a partner has a negative capital account balance. If a partner has no DRO, the partner will not have to contribute any cash on liquidation. To ensure that any allocations to the partner will have economic effect, therefore, the partner should not be allocated a tax loss, for example, that would cause the partner's capital account to be negative. This can be illustrated with a numerical example. A, taxable entity, and B, a tax-exempt entity, formed a partnership ("P") and each contributed $1,000. Initially, A and B's capital account balances equal their original contributions at $1,000 each. Assume in Year 1, P earns a taxable loss of $1,200. For example, P bought property for $2,000 and then sold it for $800, recognizing a loss equal to (1) the amount realized minus (2) P's basis ($800 - $1200 = $1,200 loss). P allocated the entire taxable loss to A, which allows A to take advantage of the tax loss that B would have no use for since it is a tax exempt entity. The resulting capital accounts would be:

A	B
$1,000 (original contribution)	$1,000 (original contribution)
-	-
($1,200) taxable loss	$0
($200) negative balance	$1,000

Overall, the purpose of the economic effect requirements is to guarantee that net tax items allocated to a partner over the life of a partnership correspond to the economic gain or loss recognized by that partner over the life of the partnership. In particular, because capital accounts are increased by allocations of tax gain (or income), if a partner is allocated more tax gain, that partner will have a higher capital account balance. If that partner has a higher capital account balance, then, because the partnership must liquidate based on capital account balances, that partner will receive more cash on liquidation of the partnership, if not before. Therefore, a partner can only be allocated more tax gain if that partner realizes more economic gain. Likewise, capital accounts are decreased by allocations of tax loss, so if a partner is allocated more tax loss, that partner will have a lower capital account balance. If that partner has a lower capital account balance, then, because at liquidation the partnership must distribute cash on a pro rata basis to the partners based on their positive capital account balances, the partner who received more tax loss will receive less cash on liquidation of the partnership. Therefore, a partner can only be allocated more tax losses if that partner realizes more economic losses.

2. *Substantiality*

In order for an allocation to have "substantiality" and, therefore, be respected under the substantial economic effects test, the allocation must pass four tests under the regulations.[114] The

---

Assume P then liquidates, to meet the second requirement of the alternate test for economic effect, P must distribute cash pro rata to A and B in relation to their positive capital account balances. At liquidation, P would have $800 in cash to distribute pro rata to A and B in relation to their positive account balances. If A had a DRO, then A would be obligated to pay $200 out-of-pocket to P to ensure that A does not have a negative account balance. However, if A does not have a DRO, then A would not be obligated to pay the $200; thus, a negative capital account balance would persist and P would fail the alternate test for economic effect. At liquidation, A would not receive any cash, and B would receive the $800. As a result, A's tax losses, which equaled $1,200, exceeded A's economic loss, which equaled $1,000.

[114] Treas. Reg. § 1.704-1(b)(2)(iii).

four tests the allocation must satisfy are (A) the dollar effect test, (B) the shifting allocation test, (C) the transitory allocations test,[115] and (D) the overall tax effect test.[116]

Under the dollar effect test, there must be "a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences."[117] In other words, at the time the allocation becomes part of the partnership agreement, there must be a reasonable possibility that the amount of cash received by the partners (pre-tax) will be substantially different as a result of the allocation compared to what would occur if the partnership agreement instead allocated all items based on the "partners' interests in the partnership." "Partners' interest in the partnership" is a concept that describes the economic contributions of each partner in relation to the economic sharing of each partner. More specifically, the IRS describes the test to determine the "partners' interest in the partnership" as a "subjective facts and circumstances test" in order "to determine the true economic sharing arrangement of the partners."[118]

If the allocation passes the dollar effect test, the next test to apply to see if the allocation has substantiality is the shifting allocation test. An allocation is a shifting allocation and, therefore, fails to be substantial if

> [T]here is a strong likelihood that—
> (1) The net increases and decreases that will be recorded to the partners' respective capital accounts for such taxable year will not differ substantial-

[115] I will not address this test within this paper, but instead, assume that the hypothetical transactions meet the test so as to not fail substantiality under the transitory allocation test.

[116] Treas. Reg. § 1.704-1(b)(2)(iii).

[117] Treas. Reg. § 1.704-1(b)(2)(iii)(a).

[118] IRS, Partnership – Audit Technique Guide – Chapter 6 – Partnership Allocations (Revised 12-2007), http://www.irs.gov/businesses/partnerships/article/0,,id=134695,00.html (last visited Apr. 5, 2012). The Treasury regulations consider relevant: "a) the partners' relative contributions to the partnership, b) the interests of the partners in economic profits and losses, c) the interests of the partners in cash flow and other non-liquidating distributions, and d) the rights of the partners to distributions of capital upon liquidation." *Id.* (citing Treas. Reg. § 1.704-1(b)(3)). Some tax practitioners contend that "partners' interest in the partnership" is ambiguous. *See* Bradley T. Borden, *Allocations Made in Accordance with Partners' Interests in the Partnership* (Nov. 2009), *available at* http://works.bepress.com/brad_borden/30.

> ly from the net increases and decreases that would be recorded in such partners respective capital accounts for such year if the allocations were not contained in the partnership agreement, and
> (2) The total tax liability of the partners . . . will be less than if the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership)[119]

In other words, an allocation is a shifting allocation if, at the time the allocation becomes part of the partnership agreement, there is a strong likelihood that: (1) the allocation will not affect the amount of cash received by the partners (pre-tax) compared to what they would have received if the partnership agreement instead allocated all items based on the "partners' interests in the partnership" and (2) the total tax liability of the partners will be less than what it would have been if the partnership agreement instead allocated all items based on the "partners' interests in the partnership." While the tests under (1) and (2) refer to what was true at the time the allocations became part of the partnership agreement, the regulations provide that, if (1) and (2) turn out to be true based on the actual results in any tax year, then there is a rebuttable presumption that, at the time the allocations became part of the partnership agreement, there was a strong likelihood that (1) and (2) would be true.[120]

Finally, the fourth test for substantiality is the overall tax effect test, which states that

> The economic effect of an allocation (or allocations) is not substantial if, at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, by substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. In determining the after-tax economic benefit or detriment to a partner, tax consequences that result from the interaction of the allocation with such partner's tax attributes that are unrelated to the partnership will be taken into account.[121]

[119] Treas. Reg. § 1.704-1(b)(2)(iii)(b).
[120] *Id.*
[121] Treas. Reg. § 1.704-1(b)(2)(iii)(a).

In other words, an allocation will not be substantial if, at the time the allocation becomes part of the partnership agreement: (1) the allocation may make at least one partner better off on an after-tax basis compared to what would have occurred if the partnership agreement instead allocated all items based on the "partners' interests in the partnership" and (2) there is a strong likelihood that no partner will be worse off compared to what would have resulted if the partnership agreement instead allocated all items based on the "partners' interests in the partnership."

B. Background on the Blackstone IPO and Entity Structure

Blackstone Group LP is a publicly traded partnership that became publicly traded in 2007.[122] Blackstone Group LP was structured with the use of a Lower-Tier Partnership whose partners include a U.S. corporate entity, various partnership entities, and a foreign corporation.[123] The complicated structure was likely designed precisely to literally comply with the Section 7704(c) passive-type income exception that allows publicly-traded partnerships to escape treatment as corporations. Furthermore, the partnership agreement for the Lower-Tier Partnership likely was geared to satisfy the requirements in Section 704 and Treasury Regulation Section 1.704-1 for economic effect and substantiality.

The ingenuity of the Blackstone Group LP organization structure results in the publicly-traded partnership, Blackstone Group LP, maintaining its partnership tax status through strategic entity structuring and, therefore, securing significant tax advantages that otherwise would not be possible.

[122] Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89 (Winter 2008) (citing The Blackstone Group L.P. Registration Statement (Form S-1) (Mar. 22, 2007), *available at* http://www.sec.gov/Archives/edgar/data/1393818/000104746907002068/a2176832zs-1.htm).

[123] See Blackstone Group L.P. Prospectus (Form 424B) 16 (June 25, 2007). (showing the organizational structure of Blackstone Group L.P.) For purposes of this paper I will be using a simplified version of the Blackstone Group L.P. structure, which should serve to demonstrate the tax advantages flowing from such a structure and the need for the partnership anti-abuse regulations in situations where the partners are related.

The Blackstone Group LP structure was supposed to work and has effectively worked as follows. Blackstone Group LP had an initial public offering of 133,333,334 common units of limited partner interests.[124] Blackstone Group LP is traded on the New York Stock Exchange ("NYSE"), an established securities market, under the symbol "BX."[125] If the Blackstone Group LP did not use the structure described below, then Blackstone Group LP would be treated as a corporation, and thus, subject to corporate entity tax under the default rule for publicly-traded partnerships, Section 7704(a). Blackstone Group LP meets the statutory definition of a publicly-traded partnership because the common units "are traded on an established securities market," namely here, the NYSE. Thus, in order for the Blackstone Group LP to not be treated as a corporation, it needs to meet the requirements of the Section 7704(c) exception to the rule that a publicly-traded partnership is to be treated as a corporation. The statutory exception allows a publicly-traded partnership to avoid being treated as a corporation for a taxable year if ninety percent or more of its gross income consists of "qualifying income" for that taxable year and all preceding years after the first year since 1987 during which it was publicly-traded.[126] "Qualifying income" includes, but is not limited to, "(A) interest, (B) dividends, (C) real property rents, [and] (D) gain from the sale or other disposition of real property."[127] If it were not for the Lower-Tier Partnership's specific allocations, Blackstone Group LP would have enough active-type income that it would be treated as a corporation.

The organizational structure of Blackstone Group LP is designed so that the U.S. corporation is allocated all of the active-type income and corporate level taxes are paid on that income,

---

[124] Blackstone Group L.P. Prospectus at 20.

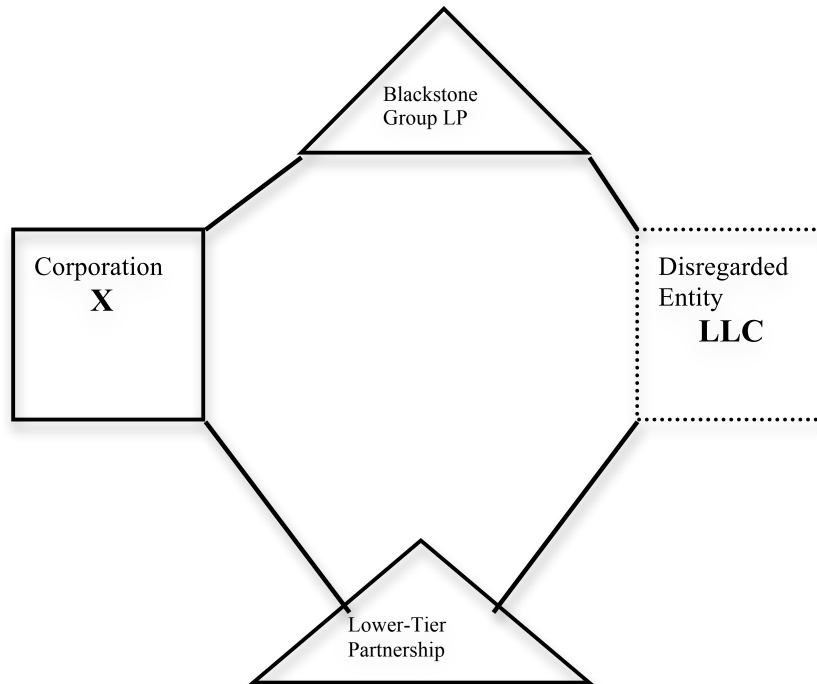
[125] Blackstone Group L.P. Prospectus at 25.

[126] I.R.C. § 7704(c). "Qualifying income" is also referred generally as "passive-type" income, *see id.*, which generally means investment type income and not active business earning income, such as earnings from the actual operation of the business.

[127] I.R.C. § 7704(d)(1) (listing other types of "qualifying income").

which is then distributed through a dividend, and it is, then, “qualifying income,” to the publicly-traded partnership, Blackstone Group LP. Another lower-tier entity is treated as a disregarded entity (“DRE”) of Blackstone Group LP and all of the passive-type income, such as interest, dividends, and rental income, is allocated to the DRE, and therefore, constitutes additional “qualifying income” to Blackstone Group LP.[128] If the active and passive-type income was not allocated through separate entities, Blackstone Group LP would not meet the ninety percent qualifying income requirement. In particular, if Blackstone Group LP earned all the underlying income directly, Blackstone Group LP would earn too much active income and, thus, run afoul of the Section 7704(c) exception for publicly-traded partnerships. The Lower-Tier Partnership is the entity that allocates the active-type income to the U.S. corporation and the passive-type income to the DRE, and the Lower-Tier Partnership’s allocations are the focus of this paper. While the allocations likely comply literally with the Section 704(b)(2) “substantial economic effect” requirement, the Treasury could challenge the allocations under the partnership anti-abuse regulations.

[128] As mentioned *supra* note 123, this paper describes a simplified version of the Blackstone Group LP structure, and thus, the foreign entity and the income allocated through the foreign entity is not discussed within this paper.



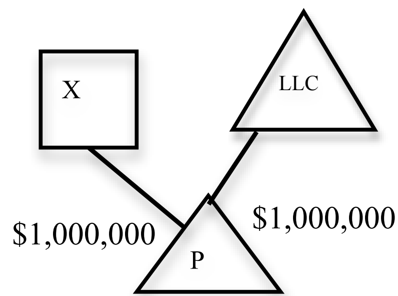
To illustrate the point that the Blackstone Group LP structure could be challenged under the partnership anti-abuse regulations, this paper will demonstrate in subsection (1) a hypothetical situation where partners are unrelated to one another, and here the allocations should be respected and are likely business-motivated and not tax motivated. Then, subsection (2) will demonstrate through a simplified version of the Blackstone Group LP structure, where the partners are related, that the substantiality tests are not sufficient to prevent tax-motivated allocations. Therefore, the allocations under Blackstone Group LP could be challenged with the partnership anti-abuse regulations discussed later.

1. *Application of Section 704(b) Regulations Where Partners are Unrelated*

If the partners in a Lower-Tier Partnership were not related to each other, then a Lower-Tier Partnership likely would only allocate all passive income to the one partner and all active income to the other partner if there were business reasons, rather than tax reasons, for doing so. The following hypothetical will prove this point using a simplified structure that resembles the

Blackstone structure, with one principle difference being that the partners are not related to one another.

The basic facts are as follows: U.S. Corporation "X" and U.S. Partnership "LLC" are the sole partners of Lower-Tier Partnership "P." The partnership agreement provides that each partner will initially contribute $1,000,000, and there is no DRO. The partnership agreement states that X will be allocated all active-type income and LLC will be allocated all passive-type of income.



For the first year of operation, P earns $700 in active income and $300 in dividends from investments. Under the partnership agreement, X is allocated the $700 of active income and LLC is allocated the $300 in dividends.

Under the facts given, the partnership agreement does not provide that the partners share income in accordance with the "partners' interest in the partnership" because each partner contributed fifty percent.[129] Depending on the amount and type of income that P earns each year, each partner will receive a share of P's income, but the share received likely will be different than fifty percent of the total amount of income earned. To make sure that the IRS will respect the partnership agreement, the allocations must have "substantial economic effect."[130]

[129] So that, at least arguably, the partners' interests in the partnership are 50% each. "Partners' interest in the partnership" is a facts and circumstances analysis, and capital contribution is only one factor, but at least arguably the "partners' interest in the partnership" is 50% each.

[130] I.R.C. § 704(b).

As mentioned earlier, substantial economic effect requires allocations to have substantiality and economic effect.[131] Looking at whether the allocation has economic effect, the most common test to apply is the alternate test for economic effect. The alternate test for economic effect requires (1) a capital account must be maintained for each partner, (2) upon liquidation, the liquidating distributions must be made according to the positive capital account balances of each partner, and (3) the partnership must take various steps that are designed to ensure that no partner will have a negative capital account balance that exceeds the partner's DRO prior to liquidation of the partnership.[132] Applying the first requirement of maintaining a capital account for each partner in accordance with the relevant Treasury Regulation, each partner's capital account would be as follows:

Table 1[133]

X	LLC
$1,000,000 (original contribution)	$1,000,000 (original contribution)
+	+
$700 (active income)	$300 (dividend income)
$1,000,700	$1,000,300

If the allocations were, instead, made according to the "partners' interest in the partnership," the capital accounts would be as follows:

Table 2[134]

X	LLC
$1,000,000 (original contribution)	$1,000,000 original contribution
+	+
$700 * 50% = $350 (active income)	$700 * 50% = $350 (active income)
$300 * 50% = $150 (dividend income)	$300 * 50% = $150 (dividend income)
$1,000,500	$1,000,500

---

[131] See discussion *supra* Part III.A.

[132] Treas. Reg. 1.704-1(b)(2)(ii)(d).

[133] Under Table 1, based on the partnership agreement, X's capital balance equals $1,000,700 and the LLC's capital balance equals $1,000,300.

[134] Under Table 2, based on the "partners' interest in the partnership," X's capital balance would equal $1,000,500, and the LLC's capital balance would equal $1,000,500 as well.

Assume that P then liquidates. P has $2,001,000 in cash total. To meet requirement (2) for the alternate test for economic effect, P must distribute cash pro rata to X and LLC in relation to their capital account balances. Therefore, P, under the partnership agreement, would distribute $1,000,700 to X and $1,000,300 to LLC as a result of allocations contained in the agreement.[135]

Tax and Economic Effects Based on the Partnership Agreement:

Table 3[136] Tax Consequences for X:

Pre-tax cash received by X	$1,000,700
Tax liability of X	$245 (assuming X is in the 35% tax bracket)
After tax cash received by X	$1,000,455

Table 4[137] Tax Consequences for LLC

Pre-tax cash received by LLC	$1,000,300
Tax liability of LLC[138]	$0
After tax cash received by LLC	$1,000,300

Tax and Economic Effects based on Partner's Interest in the Partnership:

Table 5[139] Tax Consequences for X

Pre-tax cash received by X	$1,000,500
Tax liability of X	$175 ($500 * 35%)
After tax cash received by X	$1,000,325

Table 6[140] Tax Consequences for LLC

Pre-tax cash received by LLC	$1,000,500
Tax liability of LLC	$0
After tax cash received by LLC	$1,000,500

[135] Neither partner has a negative capital account balance, so there is no concern over whether the partnership agreement meets the third requirement for the alternate test for economic effect.

[136] Based on the capital accounts shown in Table 1. Under the partnership agreement, X will pay $245 in tax liability on the $700 of active income that it was allocated, and this results in X's receiving $1,000,455 after tax.

[137] Based on the capital accounts shown in Table 1. Under the partnership agreement, the LLC will not incur tax liability on the $300 it was allocated, and the LLC receives $1,000,300 after tax.

[138] The LLC is a flow-through entity, and thus, not subject to entity-level tax.

[139] Based on the capital accounts shown in Table 2. Under the "partners' interest in the partnership," X incurs tax liability equal to $175, and thus receives $1,000,325 after tax.

[140] Based on the capital accounts in Table 2. Under the "partners' interest in the partnership," LLC will not incur tax liability on the $500 it was allocated, and the LLC receives $1,000,500 after tax.

In an arms-length transaction where X and LLC are not related to one another, it is unlikely that LLC would be willing to agree to a partnership agreement where it will receive significantly less than its partner and undertake a transaction to benefit another partner absent a compelling business reason. For example, if LLC was responsible for picking stocks that generate dividend income while X was responsible for picking investments that generate active income, the parties might agree to allocate all dividend income to LLC and all active income to X as a way of incentivizing each partner to pick profitable investments. Moreover, given that the partners are unrelated, the fact that LLC is made worse off (compared to what LLC would have received if everything was allocated 50% to each partner) suggests that the partners had such a business reason for agreeing to the allocations. For this reason, if unrelated partners agreed to these allocations, the allocations would and should be respected under substantial economic effect. Regarding economic effect, the allocations can comply with the alternate test for economic effect assuming the three requirements discussed above are met (in particular, maintaining capital accounts, liquidating based on capital account balances, and ensuring that partners' capital accounts do not become negative in excess of any DRO).

The other part of meeting the Section 704(b) requirement for substantial economic effect is that the transaction must have substantiality. To meet the substantiality requirement, the allocation must meet the (1) dollar effect test, (2) shifting allocation test, (3) transitory allocation test,[141] and (4) overall tax effect test.[142] The dollar effect tests asks whether at the time the partnership agreement was entered into, was there a reasonable possibility that what each partner receives on a pre-tax basis as a result of the allocations of the agreement would be substantially different than what each partner would get pre-tax if everything was allocated based on the

[141] For simplicity, this paper assumes that the allocation meets the transitory allocation test, and therefore, will not address that test.

[142] *See* Treas. Reg. § 1.704-1(b)(2)(iii).

"partner's interest in the partnership."[143] Here, on a pre-tax basis in the agreement, X gets $700 more than what X contributed, which is substantially different than what X would get on a pre-tax basis under X's interest in the partnership, which would be $500 more than what X contributed. Also, on a pre-tax basis in the agreement, the LLC would get $300 more that what the LLC contributed, which is substantially different than what the LLC would get under LLC's interest in the partnership, which would be $500 more than what the LLC contributed. Therefore, the hypothetical example meets the requirements of the dollar effects test.

The next test is the shifting allocation test. An allocation will lack substantiality if it is a shifting allocation.[144] An allocation is a shifting allocation if, when the allocation becomes part of the partnership agreement, there is a strong likelihood that the net increases and decreases to the partners' capital accounts will not differ substantially from the net increases or decreases that would have occurred if the items were allocated based on the "partners' interest in the partnership," and the tax liability of the partners will be less than if the items had been allocated based on the "partners' interest in the partnership."[145]

Here, the tax liability of the partners will be less under the "partners' interest in the partnership" compared to what would result if items were allocated according to the partnership agreement." The tax liability under the partnership agreement is $245, and the tax liability according to the "partners' interest in the partnership" is $175. The net increases to the partners' capital accounts will differ substantially from the net increases that would have occurred if the items were allocated based on the "partners' interest in the partnership." X's capital account under the partnership agreement is $1,000,700 and X's capital account according to X's interest in P would be $1,000,500. Also, LLC's capital account under the partnership agreement is

[143] Treas. Reg. § 1.704-1(b)(2)(iii)(a).
[144] Treas. Reg. § 1.704-1(b)(2)(iii)(b).
[145] *Id.*

$1,000,300, and LLC's capital account according to LLC's interest in P would be $1,000,500. Therefore, the allocation will not be a shifting allocation.

The last test to discuss for whether the transaction meets the substantiality requirement is the overall tax effect test.[146] An allocation fails this test if, at the time the allocation becomes part of the partnership agreement, the after tax consequences of one partner may be enhanced compared to allocations based on the "partners' interest in the partnership" and there is a strong likelihood that the after tax consequences of no partner will be substantially diminished compared to allocations based on the "partners' interest in the partnership."

After tax, X receives more under the agreement compared to what X would have received according to its interest in the partnership because X received a profit of $455 after tax under the partnership agreement and only $325 according to its interest in the partnership. However, after tax, LLC receives less compared to what it would have received according to its interest in the partnership. LLC would receive an after tax profit of $300 under the partnership agreement, but according to its interest in the partnership, LLC would have received an after tax profit of $500. Because at least one partner is made worse off by the allocations, the allocations satisfy the overall tax effect test, meeting the last requirement to be deemed to have substantial economic effect. Thus, under Section 704(b), the IRS would respect the partnership agreement and tax treatment because it has substantial economic effect.

2. *Application of Section 704(b) Regulations Where Partners are Related*

To demonstrate the tax benefits that are obtained by a hypothetical transaction based on a simplified version of Blackstone Group LP, this hypothetical will assume the same basic facts assumed under subsection (1), with the additional facts that X Corporation is a wholly owned corporation of Blackstone Group LP, that the other partner is a disregarded entity of Blackstone

[146] Treas. Reg. § 1.704-1(b)(2)(iii)(a).

Group LP, and that Blackstone Group LP is a publicly-traded partnership. While looking at the after tax consequences under the partnership agreement compared to those following from allocations based on the "partners' interest in the partnership agreement," it is important to remember the general rule that publicly-traded partnerships are treated as corporations for tax purposes.[147] The exception to the general rule applies if a publicly-traded partnership meets certain gross income requirements for any taxable year after the first year since 1987 during which the partnership existed and was publicly-traded.[148] If the partnership meets this requirement, the partnership does not have to be treated as a corporation for tax purposes.[149] To meet the gross income requirement, ninety percent or more of the gross income of the partnership for any relevant year must consist of qualifying income.[150] "Qualifying income" includes passive types of income, such as interest, dividends, and real property rents, but does not include active income from operating the partnership.[151]

In applying the alternate test for economic effect to the partnership agreement, the first requirement of maintaining a capital account for each partner in accordance with the Regulations would be calculated as follows:

Table 7[152]

X	Blackstone Group LP[153]
$1,000,000 (original contribution)	$1,000,000 (original contribution)
+	+
$700 (active income)	$300 (dividend income)
$1,000,700	$1,000,300

[147] I.R.C. § 7704(a).
[148] I.R.C. § 7704(c)(1).
[149] I.R.C. § 7704(c).
[150] I.R.C. § 7704(c)(2).
[151] I.R.C. § 7704(d).
[152] Under the partnership agreement, X's capital account balance equals $1,000,700, and Blackstone Group LP's capital account balance equals $1,000,300.
[153] In Table 7 through Table 12 I referenced the partners as X (U.S. corporation) and Blackstone Group LP. I used Blackstone Group LP as the partner, rather than the DRE, because the DRE is disregarded as separate from Blackstone Group LP for tax purposes.

If the distributions were according to the "partners' interest in the partnership," the capital accounts would be as follows:

Table 8[154]

X	Blackstone Group LP
$1,000,000 (original contribution)	$1,000,000 original contribution
+	+
$700 * 50% = $350 (active income)	$700 * 50% = $350 (active income)
$300 * 50% = $150 (dividend income)	$300 * 50% = $150 (dividend income)
$1,000,500	$1,000,500

To meet the alternate test for economic effect, at the Lower-Tier Partnership's liquidation, the partnership must distribute cash pro rata based on the partners' positive account balances in their capital accounts, so X would receive $1,000,700 and Blackstone Group LP would receive $1,000,300 at liquidation according to the partnership agreement if the Lower-Tier Partnership liquidates at the end of the first year. Again, to meet the alternate test for economic effect, if there was a negative balance, a partner would need to restore the balance to $0 at the time of liquidation, but because there is no DRO, it is likely that the Lower-Tier Partnership will not be able to make either partner have a negative capital account. Therefore, assuming that the Lower-Tier Partnership agreement meets the requirements for economic effect, the real question will lie with whether the partnership agreement has "substantiality."

Tax and Economic Effects Based on the Partnership Agreement:

Table 9[155] Tax Consequences for X:

Pre-tax cash received by X	$1,000,700
Tax liability of X	$245 (assuming X is in the 35% tax bracket)
After tax cash received by X	$1,000,455

Table 10[156] Tax Consequences for Blackstone Group LP

[154] Under the "partners' interest in the partnership," X's capital account balance equals $1,000,500, and Blackstone Group LP's capital account balance also equals $1,000,500.

[155] Based on the capital accounts shown in Table 7. Under the partnership agreement, X incurs $245 in tax liability and receives $1,000,455 after tax.

Pre-tax cash received by Blackstone Group L.P.	$1,000,300
Tax liability of Blackstone Group L.P.	$0
After tax cash received by Blackstone Group L.P.	$1,000,300

Tax and Economic Effects based on Partner's Interest in the Partnership (PIP):

Table 11[157] Tax Consequences for X

Pre-tax cash received by X	$1,000,500
Tax liability of X	$175 ($500 * 35%)
After tax cash received by X	$1,000,325

Table 12[158] Tax Consequences for Blackstone Group LP

Pre-tax cash received by Blackstone Group L.P.	$1,000,500
Tax liability of Blackstone Group L.P.[159]	$175 ($500 * 35%)
After tax cash received by Blackstone Group L.P.	$1,000,325

In applying the dollar effects tests, the concern is whether there was a reasonable possibility that what each partner receives on a pre-tax basis from the allocations in the partnership

[156] Based on the capital accounts shown in Table 7. Under the partnership agreement, Blackstone Group LP does not incur tax liability and receives $1,000,300.

[157] Based on the capital accounts shown in Table 8. Under the "partners' interest in the partnership," X incurs $175 in tax liability and receives $1,000,325 after tax.

[158] Based on the capital accounts shown in Table 8. Under the "partners' interest in the partnership" Blackstone Group LP would now incur tax liability because it would no longer qualify for the passive-type income exception under the code, *see* § 7704(c), and thus, Blackstone Group LP would incur $175 of liability and would receive $1,000,325 after tax.

[159] Under the tax and economic effects based on the "partners' interest in the partnership," Blackstone Group LP would now be taxed at thirty-five percent based on the income allocated to it through the DRE because it is getting active-type income through the DRE, which results in Blackstone Group LP no longer satisfying the ninety percent qualifying income requirement under section 7704(c), and this results in Blackstone Group LP being treated as a corporation. Numerically, based on the "partners' interest in the partnership," the income allocated to the U.S. Corporation, X, equaled $350 (active-type income) + $150 (dividend income), resulting in $500 income that X will pay 35% tax on, or $175, and the remaining $325 after taxes will be distributed to Blackstone Group LP in the form of a dividend, constituting $325 of "qualifying income" under section 7704(d). Then, the income allocated to the DRE will constitute $350 (active income) and $150 (dividend income). At this point, testing Blackstone Group LP to see whether it meets the ninety percent "qualifying income" test under section 7704(c), it is apparent that it fails because Blackstone Group LP's total income would constitute (1) $325 (dividend income distributed by X) + $150 (dividend income allocated through DRE to Blackstone Group LP) + (3) $350 (active income allocated through DRE to Blackstone Group LP). Therefore, at this point, Blackstone Group LP would have $825 of income, $350 of which is active income, constituting 42.4% active-type income, failing the ninety percent "qualifying income" test. Because Blackstone Group LP fails the ninety percent qualifying income test under 7704(c), the Code requires that Blackstone Group LP, the publicly traded partnership, be treated as a corporation for tax purposes; thus, the income allocated to the DRE and up to Blackstone Group LP is taxed at the thirty-five percent tax rate, assuming that Blackstone Group LP qualifies for the thirty-five percent income tax bracket.

agreement would be substantially different from what each would get if everything was allocated on the basis of the "partner's interest in the partnership." Under the partnership agreement on a pre-tax basis, X gets $700 more than what X contributed, which is substantially different than what X would be allocated under X's interest in the partnership, which accordingly would only be $500 more than what X had contributed. Under the partnership agreement on a pre-tax basis, Blackstone Group LP, through the DRE, receives $300 more than what it contributed under the agreement; however, under its interest in the partnership, it would have received $500 more on a pre-tax basis than what it contributed. The allocation passes the dollar effects test because when the partners agreed to the allocation there was a reasonable possibility that the pre-tax result of each partner would be substantially different than if the allocations were based on the "partners' interest in the partnership."

Under the shifting allocation test, the net increases to the partners' capital accounts will differ substantially from the net increases that would have occurred if the items were allocated based on "partners' interest in the partnership." For example, X's capital account would have increased by $700 under the agreement, but X's capital account would have only increased by $500 under the "partners' interest in the partnership." Blackstone Group LP's capital account would have only increased by $300 under the agreement, but would have increased by $500 under "partners' interest in the partnership." On the other hand, the total tax liability under the agreement would have been less than if the income was allocated based on the "partners' interest in the partnership" because under the agreement only $245 in tax liability is owed, but under the "partners' interest in the partnership," $350 in tax liability would have been due. However, this cannot be a shifting allocation because it does not meet the first element of the test.

Finally, the allocation also meets the requirements under the overall tax effect test. X is better off under the agreement in receiving $455 more than what X contributed compared to what it would have received based on the "partners' interest in the partnership," which would have been $325 more than what X contributed. However, Blackstone Group LP is worse off under the agreement, receiving $300 more than what Blackstone Group LP contributed, compared to what it would have received under the "partners' interest in the partnership," which would have been $325 more than what it contributed.

The important difference between the transaction under subsection (1) and this subsection, is that here the parties are all related. In subsection (1) it is unlikely that the LLC would agree to contribute an equal amount of capital to a partnership, but receive less than an equal share of profit to the benefit of the other partner, absent a compelling business reason. Therefore, in the unrelated partner context, the transaction likely would not occur, unless for some other significant business purpose.

However, where the entities are related as they are here, and moreover, the overarching entity, Blackstone Group LP, is the controlling parent of the wholly-owned subsidiary corporation and owns 100% of the DRE, there are significant tax savings that Blackstone Group LP is obtaining that it would not be allowed without this structure. The most important effect is that the structure allows Blackstone Group LP to earn primarily qualifying income through stripping types of income and funneling the money through different entities to secure its necessary ninety percent threshold to meet the requirements of Section 7704(c).

The derivative effect of ensuring that ninety percent of Blackstone Group LP's income is qualifying income is the avoidance of paying corporate level taxes on a significant amount of Blackstone Group LP's income, as demonstrated in the following table.

Table 13 End Result Based on the Partnership Agreement Being Upheld:

Total cash Blackstone Group LP receives	$455 (dividend income from X Corporation) + $300 (dividend income allocated through the DRE to Blackstone Group LP) = $755
Tax liability on cash received from Blackstone Group LP	$0 (100% of Blackstone Group LP's income is "qualifying income")
Total taxes paid as a result of respecting the structure	$245 taxes paid by X on the distribution from the Lower-Tier Partnership.

If there were no subsidiaries and Blackstone Group LP directly earned all of the income the tax results would flow as demonstrated in the following table:

Table 14 End Result Based on Blackstone Group LP Directly Earning All Income

Total cash Blackstone Group receives	$700 (active type income) + $300 (dividend income) = $1,000
Tax liability on cash received from Blackstone Group LP[160]	($1,000 * 35%) = $350
Total taxes paid as a result of treating Blackstone Group LP as directly earning all income	$350

There is a stark contrast in the tax results when comparing Tables 13 and 14. Table 13 highlights the tax and economic effects resulting from the IRS respecting the Lower-Tier Partnership agreement. Where the Lower-Tier Partnership agreement is respected, the only tax liability incurred is from the active-type income that was allocated to X. However, if the IRS chose to treat Blackstone Group LP as through it earned all the income directly, then Blackstone Group LP would no longer qualify under the passive-type income exception,[161] and therefore, Blackstone Group LP would be treated as a corporation for tax purposes and subject to entity level tax at thirty-five percent. Thus, if Blackstone Group LP is treated as earning all the income directly,

[160] For simplicity, this calculation ignores any dividends received deduction to which Blackstone Group LP would be entitled if the dividend income were received from U.S. corporations.

[161] *see* § 7704(c).

it would incur $350 in tax liability, which is greater than the $245 incurred if the partnership agreement was respected.

C. How the IRS Could Use Partnership Anti-Abuse Regulations to Recast the Blackstone Structure

After *Mayo Foundation*, the IRS may pursue enforcement under some of its more controversial regulations. One such regulation is the anti-abuse regulations. A transaction that would be ripe for a recast under the anti-abuse regulation is highlighted by the Blackstone IPO transaction.[162] Through looking at the reasoning in *Mayo Foundation*[163] and the guidance of how courts have treated challenged regulations since *Mayo Foundation*,[164] this paper suggests that the IRS could successfully pursue a recast of a Blackstone-type transaction under the anti-abuse regulations as follows.

1. *Background on the Partnership Anti-Abuse Regulations*

The partnership anti-abuse regulations were adopted after notice and comment procedure.[165] The cited authority for the regulations was the Treasury's general authority to regulate.[166] In the proposed and final regulations, the Treasury explains that Subchapter K was not intended to be used to avoid taxes.[167] Congress wanted to "prevent the use of special allocations for tax avoidance purposes, while allowing their use for bona fide business purposes."[168] Therefore, Subchapter K was not supposed to allow taxpayers to engage in transactions with the use of the partnership form to obtain advantageous tax treatment, "inconsistent with the underlying

---

[162] *See supra* Part III.B.

[163] *See supra* Part I.B.

[164] *See supra* Part II.

[165] Subchapter K Anti-Abuse Rule, 59 Fed. Reg. 25,581-01, (May 17, 1994) (to be codified at 26 C.F.R. pt. 1) (proposed rulemaking and notice of public hearing).

[166] Subchapter K Anti-Abuse Rule, 59 Fed. Reg. at 25,582; Subchapter K Anti-Abuse Rule, 60 Fed. Reg. 23, 27 (Jan. 3, 1995) (to be codified at 26 C.F.R. pt. 1) (final regulation). The Treasury's general authority is provided in Section 7805 of the Code.

[167] Subchapter K Anti-Abuse Rule, 59 Fed. Reg. at 25,581.

[168] *Id.*; Subchapter K Anti-Abuse Rule, 60 Fed. Reg. 23-01 (Jan. 3, 1995) (quoting S. Rep. No. 938, 94th Cong., 2d Sess. 100 (1976)).

economic arrangements of the parties or the substance of the transactions, or to use the existence of partnerships to avoid the purposes of other provisions of the Code."[169] The final regulations explained that they were not intended to prevent bona fide business arrangements that use partnerships.[170] The Treasury sets out three requirements that it indicated are implicit from the intent of Subchapter K: (1) "the partnership must be bona fide and each partnership transaction . . . must be entered into for a substantial business purpose," (2) "the form of each partnership transaction must be respected under substance over form principles," and (3) "the tax consequences under subchapter K to each partner of partnership operations and of transaction between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income."[171]

Section 704(b) was specifically mentioned in the Treasury's final regulations as one of the provisions "that may be used inappropriately to reach results that are inconsistent with the intent of subchapter K," and some comments suggested alternative regulation in the form of amending section 704(b) regulations and other efforts instead of issuing the partnership anti-abuse regulations.[172] Therefore, the Treasury intended the anti-abuse regulations to help with its concern about several types of transactions, but in particular, partnership allocations.[173]

The purpose of the partnership anti-abuse regulations was to prevent tax-motivated allocations and other tax-motivated transactions involving partnerships. The partnership anti-abuse regulations allow the Commissioner to recast a partnership transaction "as appropriate to achieve tax results that are consistent with the intent of subchapter K."[174] According to the regulations,

---

[169] Subchapter K Anti-Abuse Rule, 59 Fed. Reg. at 25,581.
[170] Subchapter K Anti-Abuse Rule, 60 Fed. Reg. at 24.
[171] *Id.*, codifying the Treasury's thoughts in Treas. Reg. 1.701-2(a).
[172] Subchapter K Anti-Abuse Rule, 60 Fed. Reg. at 26.
[173] CUNNINGHAM & CUNNINGHAM, *supra* note 110, at 252.
[174] Treas. Reg. § 1.701-2(b).

"even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K [various remedies, including disregarding the partnership may be warranted.]"[175]

Treasury Regulation Section 1.701-2(c) lists the relevant facts and circumstances to be considered by the IRS in determining whether a remedy is necessary.

2. *How the Partnership Anti-Abuse Regulations Would work to Prevent more Blackstones*

Here, the Blackstone Group LP transaction fits within the literal language of the Treasury Regulations under § 704(b) governing substantial economic effect, but such literal compliance can be ignored and the Commissioner can recast the allocations or the transaction if necessary to "achieve tax results that are consistent with the intent of subchapter K."[176]

Two factors that the IRS could use under the facts and circumstances analysis in its favor are listed in Treasury Regulation Sections 1.701-2(c)(4) ("Factor Four") and (5) ("Factor Five"). Factor Four states that application of the anti-abuse regulations may be warranted when "[s]ubstantially all of the partners . . . are related to one another."[177] Factor Five states that, the anti-abuse regulations may apply when

> [p]artnership items are allocated in compliance with the literal language §§ 1.704-1 and 1.704-2 but with results that are inconsistent with the purpose of section 704(b) and those regulations. In this regard, particular scrutiny will be paid to partnerships in which income or gain is specially allocated to one or more partners that may be legally or effectively exempt from federal taxation . . . .[178]

Factor Four applies aptly under the basic facts from the subsection (2) hypothetical Blackstone Group LP transaction because all of the entities are related and, importantly, the U.S.

[175] *Id.*
[176] *Id.*
[177] Treas. Reg. § 1.701-2(c)(4).
[178] Treas. Reg. § 1.701-2(c)(5).

Corporation, X, is related to its partner in the Lower-Tier Partnership, which is a DRE of Blackstone Group LP.[179] Factor Five is also applicable to the basic facts explained in the hypothetical Blackstone Group LP transaction.[180] As demonstrated in subsection (2) above, the items are allocated to comply with the literal language of Treasury Regulation Section 1.704-1.[181] However, the purpose of Section 704(b) and the underlying Regulations is to prevent tax-motivated partnership allocations. Given the effects of the allocations under Blackstone Group LP (in particular, allowing it to avoid treatment as a corporation for tax purposes), the allocations by the Lower-Tier Partnership seem, fairly clearly, to be tax-motivated. Thus, the allocations are arguably, in the words of Factor Five, "inconsistent with the purpose of Section 704(b) [and the regulations thereunder]."

If the IRS applied the anti-abuse regulations to the Blackstone transaction, the IRS could invoke any number of remedies including disregarding the Lower-Tier Partnership entirely. If the Lower-Tier Partnership were disregarded, the Blackstone Group LP would be deemed to be earning all of the income directly. As shown through Table 14, if Blackstone Group LP earned the income directly, it would result in $1,000 worth of income, $700 of which would be active-type income, which would result in Blackstone Group LP being treated as a corporation under Section 7704(a) because it would no longer meet the ninety percent qualifying income rule to except it out of corporate entity tax treatment.[182] Therefore, Blackstone Group LP, assuming sufficient income to place Blackstone in the thirty-five percent tax bracket, would incur tax liability of $350 on the $1,000 taxable income it earned under the hypothetical in subsection (2).

[179] *See supra* Part III.B.2.
[180] *See supra* Part III.B.2.
[181] *See Id.*
[182] *see* I.R.C. § 7704(a)-(d) (2006).

3. *Force of the Partnership Anti-Abuse Regulations After* Mayo Foundation

The partnership anti-abuse regulations have been criticized as going beyond congressional principles.[183] However, after *Mayo Foundation*, a court would be more likely to give deference to the anti-abuse regulations. Looking at the anti-abuse regulations in light of the *Mayo Foundation* explanation of what is important in considering whether *Chevron* deference is applicable, the anti-abuse regulations appear to fit within the type of regulations that should be upheld under *Chevron* deference. Under *Chevron* step one, Section 701 cannot really be said under the plain text of the statute to be unambiguous, and to the extent it is clear what Section 701 means, the anti-abuse regulations merely fill in gaps in terms of what is considered to be a partnership by allowing the Commissioner to recast a partnership transaction. Under *Chevron* step two, courts are highly deferential to agencies, and given that the anti-abuse regulations seek to prevent tax-motivated allocations and list reasonable and relevant factors to determine if a remedy is necessary, a court would likely find that the Treasury was reasonable in issuing the anti-abuse regulations. The Court, in *Mayo Foundation*, also listed some specific considerations for according *Chevron* deference. First, as mentioned earlier, express Congressional authority to engage in rulemaking is a good indicator of according *Chevron* deference, and here, Section 7805(a) states that the "Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue."[184] While this is the Treasury's general rulemaking authority provision, it is express Congressional authority, and *Mayo Foundation* effectively eliminated the importance of the general versus specific authority distinction so that regulations issued under gen-

---

[183] *See* Sheldon Banoff, *Anatomy of an Antiabuse Rule: What's Really Wrong with Reg. Section 1.701-2*, 95 TAX NOTES TODAY 56-84 (1995).
[184] I.R.C. § 7805(a) (2006).

eral authority, such as the anti-abuse regulations, can be accorded *Chevron* deference.[185] Second, the other emphasized consideration mentioned in *Mayo Foundation* in determining whether *Chevron* deference is appropriate, was whether the regulation was adopted after notice and comment. Here, the anti-abuse regulations were indeed issued under the appropriate notice and comment procedure as indicated in the proposed and final regulations.

Also, in comparison to the case law regarding Section 6501(e)(1)(A) and regulations thereunder,[186] the anti-abuse regulations should more easily be accorded *Chevron* deference because of the fact that the Administrative Procedure Act requirements in terms of notice and comment apparently were more closely followed here than with the Section 6501(e)(1)(A) regulations. Also, while *Mayo Foundation* seemed to limit the importance of whether litigation spurred regulation, at least one court still found the existence of that fact troubling regarding Section 6501(e)(1)(A) cases.[187] However, here, the anti-abuse regulations were promulgated and issued in final form in 1994 and 1995, so a court in examining a challenge to a transaction of Blackstone Group LP's structure formulated in 2007 or a publicly-traded partnership following the form of Blackstone Group LP's structure today, would not find the spurred litigation factor present and would, therefore, more easily accord deference to the anti-abuse regulations. Finally, the circuit split regarding Section 6501(e)(1)(A) and corresponding Treasury Regulations involved a prior Supreme Court case that interpreted a predecessor statute contrary to the Regulations' interpretation. There, some courts concluded that the statute was therefore unambiguous, because of the prior Supreme Court case. However, here, there is no such case, and therefore,

[185] *See supra* notes 35-36 and accompanying text.
[186] *See supra* Part II.
[187] *Burks*, 633 U.S. F.3d at 360, n.9; *see supra* notes 96-97.

courts should not have as much difficulty in applying deference with the anti-abuse regulations as compared to the Regulations under Section 6501(e).[188]

Therefore, it follows that under the guidance of *Mayo Foundation*, the anti-abuse regulations should be and likely would be accorded *Chevron* deference if applied in a recast of a transaction similar to Blackstone Group LP.[189]

CONCLUSION

Mayo Foundation clarified that *Chevron* analysis applies in the tax law context and it appears to be a more deferential standard than *National Muffler*. Given that the Treasury knows that courts will use a *Chevron* analysis to review Treasury regulations, the Treasury may chose to pursue enforcement under some of the controversial Treasury regulations. In the context of publicly-traded partnerships, Blackstone Group LP uses an entity structure that offers the benefits of publicly-traded interests, while maintaining beneficial partnership tax status, and there are other publicly-traded partnerships engaging in similar behavior.[190] The anti-abuse regulations appear to apply to the Blackstone Group LP allocations to enable the Commissioner to pursue a remedy under the anti-abuse regulations. In light of *Mayo Foundation*, the Treasury may attempt to recast similar allocations under the anti-abuse regulations and be successful in defending the anti-

[188] Furthermore, some cases have indicated that the anti-abuse regulations are akin to other judicial doctrines. *See* Santa Monica Pictures v. Comm'r, 89 TCM (CCH) 1157, n.84 (2005); Fidelity Int'l Currency Advisor A Fund LLC v. U.S., 747 F. Supp. 2d 49, 234-35 (D. Mass. 2010).

[189] In researching this issue, I was unable to find a case that has discussed the deference to apply to Treasury Regulation Section 1.701-2. It should be noted that courts have not yet expressly and independently relied on the anti-abuse regulations to adjust or modify a transaction, but instead, courts rely on judicial doctrines, only mentioning the anti-abuse regulations. CUNNINGHAM, *supra* note 110 at 258. For example, in *Santa Monica Pictures*, 89 T.C.M. (CCH) at 1157, n.84, the court indicated that "because we decide these cases utilizing existing judicial doctrines, we need not and do not decide whether the partnership anti-abuse regulation is valid or whether it applies to any of the transactions in these cases;" *see also Fidelity Int'l Currency Advisor A Fund LLC*, 747 F. Supp. 2d at 234-35 (D. Mass. 2010) (stating that Treasury Regulation Section 1.701-2 is complimentary to common law doctrines). Also, other cases concerning Treasury Regulation Section 1.701-2 simply refused to apply Section 1.701-2 given the facts of the case. *See* Countryside Ltd P'ship v. Comm'r, 95 T.C.M. (CCH) 1006 (2008) (refusing to allow the Treasury to adjust the transaction with Treasury Regulation Section 1.701-2(b)(5) under the facts); Historic Boardwalk Hall, LLC v. Comm'r, 136 T.C. 1 (2011) (stating that the decision to re-characterize the transaction was incorrect).

[190] John D. McKinnon, *More Firms Enjoy Tax Free Status*, WALL ST. J., Jan. 10, 2012.

abuse regulations in court because they are regulations that (1) went through notice and comment and (2) were issued under express congressional authority, and the Court cited these two considerations as strong indications that *Chevron* deference applies.[191] Finally, given the apparent tax-motivated purposes of transactions like Blackstone Group LP, such a recast would seem consistent with Subchapter K.

[191] *See supra* Part I.B.