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IRS and Treasury Issue Guidance on Related-Party Basis Adjustments

This alert describes the IRS's recent focus on partnerships, provides background on basis adjustments under subchapter K, and discusses the Related-Party Basis Adjustment Guidance issued earlier today.

Earlier today, the IRS and Treasury issued a notice of proposed rulemaking, a notice of intent to publish future regulations, and a revenue ruling (collectively, the "Related-Party Basis Adjustment Guidance") aimed at preventing taxpayers from benefiting from partnership basis adjustments in situations that the government views as inappropriate.[1]

As described in more detail below, the rules included in the Related-Party Basis Adjustment Guidance have three main elements.

1. **Proposed Reporting Regime for Past and Future Basis Adjustments**. These proposed regulations identify certain "covered transactions" as "transactions of interest" and require taxpayers (and material advisors) to report all such covered transactions to the IRS. These covered transactions would become transactions of interest on the date the proposed regulations are finalized. Once the proposed regulations are finalized, taxpayers and material advisors would have 90 days to disclose any existing covered transactions. Importantly, the rules require the reporting not just of transactions that were executed within taxable periods for which the assessment limitation period has not expired but also for transactions the effects of which are reflected on any tax return for such a period, regardless of how long ago the transaction was executed. It seems likely

that many taxpayers would have considerable difficulty complying with the proposed reporting requirements if finalized in their current form.

2. **Forthcoming Proposed Regulations Governing Future Basis Adjustments**. Notice 2024-54 describes proposed regulations that the IRS and Treasury intend to issue under sections 732, 734, 743, and 1502 that would "mechanically" reduce or eliminate the benefit of related-party basis adjustment transactions.[2] As with the reporting regime described above, the forthcoming proposed regulations effectively would be retroactive in that they would apply to basis adjustments that arose in transactions that occurred in the past.

3. **Explanation of IRS's Economic Substance Doctrine Argument**. Rev. Rul. 2024-14 sets out the IRS's position that the economic substance doctrine, as codified in section 7701(o), applies to certain related-party transactions that give rise to basis adjustments.

If finalized, these rules will be relevant to any person who owns—or has at any time in living memory owned—an interest in a partnership in which a related person was also a partner. In addition, taxpayers should consider whether any of the proposed rules would apply to planned transactions.

This alert describes the IRS's recent focus on partnerships, provides background on basis adjustments under subchapter K, and discusses the Related-Party Basis Adjustment Guidance.

I. Recent IRS Focus on Partnerships

In 2021, the IRS launched a "large partnership compliance" program focusing on partnership audit issues. In July 2023, the U.S. Government Accountability Office (the "GAO") published a report on partnership audits, highlighting what it viewed as some shortcomings in the IRS's approach to partnership audits.[3] In particular, the GAO pointed to the relatively low audit rate for large partnerships and the relatively high "no change" rate (that is, the rate at which partnership audits do not result in a change to tax liability).[4]

In response to the GAO report, on September 8, 2023, the IRS announced that it was expanding partnership audits.[5] Senior government officials have repeatedly expressed the IRS's intent to issue guidance regarding the application of the basis adjustment rules (discussed in part II, below) to certain related-party transactions.[6]

II. Background on Basis Adjustments

Subchapter K (which houses the Code's rules applicable to partnership taxation) includes several provisions that govern the interaction of a partner's basis in its partnership interest with the partnership's basis in its assets. In particular:

- Section 732(a) provides that, when a partnership distributes property (other than money) to a partner in a non-liquidating distribution, the partner's basis in the property is the lesser of (i) the partnership's basis in the property and (ii) the partner's basis in its interest before the distribution. Section 732(b) provides that, when a partnership makes a liquidating distribution, the partner's basis in the distributed property is the partner's basis in its interest before the distribution. Section 732(d) provides special rules with respect to property distributed to a partner that acquired its interest in the partnership when the partnership did not have a section 754 election in effect.

- Section 734(b) provides that, when a partnership distributes property to a partner and either (i) the distributee partner recognizes gain or loss on the distribution or (ii) the basis of the distributed property in the distributee partner's hands differs from the partnership's adjusted basis in the distributed property immediately before the distribution, the partnership is required to adjust the basis of its remaining partnership property. A section 734(b) adjustment is made only if the partnership has a section 754 election in effect or the distribution results in a "substantial" reduction in basis under section 734(d).
- Section 743(b) provides that, when there is a "sale or exchange" of a partnership interest, the partnership adjusts its basis in partnership property solely with respect to the transferee. Very generally, the amount of the adjustment is the amount necessary to ensure that, if the partnership were to sell all of its assets for their fair market values immediately after the transfer, the transferee partner would not recognize any gain or loss. As with a section 734(b) adjustment, a section 743(b) adjustment is made only if the partnership has a section 754 election in effect or the partnership has a "substantial built-in loss" with respect to the transfer of the partnership interest.

These basis adjustments arise in both taxable and tax-deferred transactions.[7]

In recent years, the IRS has expressed discomfort with basis adjustments that arise in nonrecognition transactions between related persons.[8] The IRS has, however, been unable to point to any law or regulation that prohibits taxpayers from undertaking such transactions (except in certain limited cases, such as transactions among members of a consolidated group that fall within the scope of Treas. Reg. § 1.1502-13 or transactions with respect to which Treas. Reg. § 1.701-2 may be applicable).[9]

III. **Related-Party Basis Adjustment Guidance**

A. **Reporting Regime: Transactions of Interest**

In the proposed regulations, the IRS and Treasury identify four types of transactions involving related parties that would be designated "transactions of interest." (The proposed regulations would also apply in the absence of related parties if there are unrelated parties that are "tax-indifferent.") This designation would make the transactions reportable transactions under the section 6011(b) regime. As a result, taxpayers that have engaged, or that later engage, in these transactions would be required to file disclosures with the IRS. (Material advisors on the transaction also would be required to make filings.)

Importantly, the proposed regulations would require reporting with respect to past transactions. Specifically, if, during any taxable year for which the assessment limitations period has not expired, a taxpayer either (i) engaged in a covered transaction or (ii) filed a tax return that reflected the results of a covered transaction (e.g., depreciation or amortization), the taxpayer would have only 90 days from the finalization of the proposed regulations to report the transaction to the IRS.

Complying with these rules would require taxpayers to review decades of transactions to determine whether any transaction is, or is substantially similar to, one of the transactions described in the proposed regulations and if so, determine whether the "results" of that transaction are reflected on an open-year return. Thus, for example, if a taxpayer entered into a transaction in 1979 that gave rise to a basis adjustment that attached to 39-year property, the final year in which that adjustment would have been depreciated would have been 2018 (or possibly 2019). If the 2018 return is still open, the transaction that occurred in 1979 would be reportable. (If the use of a net operating losses attributable to a basis adjustment is included, it is possible that transactions occurring during the Eisenhower administration would be picked up.)

The proposed regulations would also apply to transactions in which partners are not related but one partner is a "tax-indifferent party" that facilitates the transaction (for example, a partner that is tax-exempt or non-U.S.). As a result, there will be a considerable compliance burden for many taxpayers.

The four transactions described in Prop. Treas. Reg. § 1.6011-18 are:

> (1) A partnership distributes property to a person who is a related partner in a current or liquidating distribution and the partnership increases the basis of one or more of its remaining properties under section 734(b).
>
> (2) A partnership distributes property to a person who is a related partner in liquidation of the person's partnership interest (or in complete liquidation of the partnership) and the basis of one or more distributed properties is increased under section 732(b).
>
> (3) A partnership distributes property to a person who is a related partner, the basis of one or more distributed properties is increased under section 732(d), and the related partner acquired all or a part of its interest in the partnership in a transaction that would have been a transaction described in paragraph (4), below, if the partnership had a section 754 election in effect for the year of transfer.
>
> (4) A partner transfers an interest in a partnership to a related partner in a recognition or nonrecognition transaction and the basis of one or more partnership properties is increased under section 743(b).

In each case, a transaction is reportable only if the sum of all basis increases resulting from all such transactions of a partnership or partner during the taxable year (without reduction for any basis adjustment in the same transaction or another transaction that reduces basis) exceeds by at least $5 million the gain recognized from such transactions, if any, on which U.S. federal income tax imposed is required to be paid by any of the related partners.

B. Forthcoming Proposed Regulations under Sections 732, 734, 743, and 1502

In addition to subjecting past and future transactions to the reporting requirements in section 6011, the IRS and Treasury announced an intention to issue two sets of proposed regulations that would reduce or eliminate the benefit of transactions involving partnerships and related parties (or tax-indifferent parties).

As with the reporting regime described above, these rules effectively would be retroactive because they would apply to taxable years ending on or after June 17, 2024 but would apply to basis adjustments that arise before the finalization of the regulations.

Proposed Related-Party Basis Adjustment Regulations

The first set of proposed regulations, which would be issued under sections 732, 734(b), 743(b), and 755, would apply to a wide range of ordinary course transactions and would (very generally) include rules intended to match the timing of the depreciation and amortization of the basis adjustment with the timing of the inclusion of the associated income or gain. The exact manner in which the rules accomplish this would depend on the type of basis adjustment.

- *Section 732(b) or (d) Adjustments*. To the extent a positive section 732 basis adjustment corresponds to a basis decrease to a related partner (or the basis decrease the related partner would have had if the partnership had a section 754 election in effect), the basis adjustment would be recovered using the cost recovery method and remaining recovery period, if any, of the property the basis of which was decreased. Thus, for example, if a transaction results in an increase in the basis of distributed 5-year property and a decrease in the basis of retained 15-year property, the basis increase would be recovered over 15 years rather than 5. This rule would cease to apply when the corresponding property (i.e., the property the basis of which was decreased) is sold to an unrelated person in an arm's-length transaction in which taxable gain or loss is fully recognized.

- *Section 734(b) Adjustments*. Any positive section 734(b) adjustment arising from a related-party basis adjustment transaction would be recovered using the cost recovery method and remaining recovery period, if any, of the distributed property that gave rise to the section 734(b) adjustment. Thus, for example, if a partnership distributes 15-year property to a related partner and there is a section 734(b) adjustment that increases the partnership's basis in its remaining property (all of which is 5-year property), the basis increase would be recovered over 15 years rather than 5. This rule would cease to apply when the property is sold to an unrelated person in an arm's-length transaction in which taxable gain or loss is fully recognized.

- *Section 743(b) Adjustments*. Any positive section 743(b) adjustment arising in a transfer between related parties would be non-depreciable and non-amortizable until the transferee partner becomes unrelated to the transferor and all other existing partners.

In each case, the proposed regulations would prohibit the use of any “suspended” basis adjustment to increase loss or decrease gain until the occurrence of applicable triggering events.

Proposed Consolidated Return Regulations

The second set of proposed regulations, which would be issued under section 1502, “would apply a single-entity approach with respect to interests in a partnership held by members of a consolidated group.”[10] Although the exact meaning of “single-entity approach” in this context is unclear, the intent is to “prevent distortions of a consolidated group’s income” and “avoid many of the anomalous results that arise” from transactions between members of a consolidated group.

The description of both sets of regulations in Notice 2024-54 is general and quite high level; there are many nuances and unanswered questions that the IRS and Treasury will need to consider and address in drafting the proposed regulations. One thing that is clear is that the proposed regulations will affect a large number of ordinary course transactions and impose considerable additional burdens on taxpayers.

C. **Revenue Ruling on Economic Substance Doctrine**

Rev. Rul. 2024-14 sets out the IRS’s position that certain related-party basis adjustment transactions may be covered by the economic substance doctrine as codified in section 7701(o). The ruling is unsurprising and, given that any revenue ruling effectively reflects the IRS’s litigating position and is not binding on taxpayers or the courts, is unlikely to be given much weight.

There are, however, a handful of interesting points worth noting.

- The ruling appears to “mix and match” concepts from unrelated anti-abuse rules in a way that is not supported by existing law. In particular, the ruling introduces to the economic substance doctrine the concept of activities being undertaken “with a view” to a particular outcome. This “with a view” concept has its origins in the collapsable corporation rules of former section 341 and is found today in Treas. Reg. § 1.704-3(a)(10) but has never been relevant for the economic substance doctrine (as codified in section 7701(o)).

- The ruling introduces the notion of “connected” transactions that occur over multiple tax years. This concept is not defined, and it is not clear from the ruling when transactions will be considered “connected” to each other.

- The ruling makes the same mistake the district court made in *Liberty Global* in that it ignores the question of whether the economic substance doctrine is, as an initial matter, relevant to the facts at issue, as required under section 7701(o).[11] Because it is well accepted that, except, perhaps, in rare and unusual circumstances, there is no need for (and often there is not) a business purpose for a distribution, the economic substance doctrine likely is not relevant for many of the transactions about which the IRS is concerned.

[1] Notice 2024-54; Notice of Proposed Rulemaking and Public Hearing, Certain Partnership Related-Party Basis Adjustment Transactions as Transactions of Interests Fed. Reg. 2024-12,282 (Jun. 18, 2024); Rev. Rul. 2024-14. As the preamble to the proposed regulations explains, the IRS and Treasury believe that related-party basis adjustment transactions are "carefully structured to exploit the mechanical basis adjustment provisions of subchapter K to produce significant tax benefits with little or no economic impact on the related parties, and in a manner that would not be a likely arrangement between partners negotiating at arm's-length."

[2] Any reference to "section" is a reference to section of the Internal Revenue Code of 1986, as amended (the "Code"), and any reference to Treasury regulations or "Treas. Reg. §" is a reference to sections of the United States Treasury regulations promulgated under the Code.

[3] U.S. Gov. Accountability Office, GAO-23-106020, Tax Enforcement: IRS Audit Processes Can Be Strengthened to Address a Growing Number of Large, Complex Partnerships (2023).

[4] The GAO report concluded that more than 80 percent of large partnership audits resulted in no change, more than double the rate of similarly sized corporate audits. In the GAO's view, this reflects a shortcoming in the IRS's audit strategy or conduct. The GAO does not seem to have considered, however, the possibility that large partnerships are less complex from a tax perspective when compared with similarly sized corporations. For example, a corporation with $1 billion of revenue may have manufacturing activities, international operations, R&D expenses and credits, and significant fixed assets. A partnership with $1 billion of revenue, however, may be a law firm or accounting firm with a comparatively simple business model with only domestic operations.

[5] News Release IR-2023-166 (Sept. 8, 2023).

[6] *See, e.g.*, Kristen A. Parillo, *IRS Cracking Down on Related-Party Basis Shifting*, 175 TAX NOTES FEDERAL 1747 (June 13, 2022)

[7] For purposes of section 743(b), a "sale or exchange" generally includes nonrecognition transactions. *See, e.g.*, section 761(e)(2) (distribution of a partnership interest), Treas. Reg. § 1.755-1(b)(5) (contribution of a partnership interest to a partnership), and CCA 201726012 (a reorganization to which section 368(a)(1)(A) or (D) applies).

[8] CCA 201726012 (discussing related-party basis adjustment transactions in a consolidated group). Congress has twice made changes to the basis adjustment rules to limit what were, at the time, perceived abuses. In 1984, as part of the Deficit Reduction Act of 1984 (P.L. 98-369), Congress added the flush language at the end of section 734(b) to prevent taxpayers from obtaining a benefit from a positive section 734(b) adjustment attributable to a lower-tier partnership interest where the lower-tier partnership did not have a section 754 election in effect. Then, in 1999, as part of the Tax Relief Extension Act of 1999 (P.L. 106-170), Congress enacted section 732(f) in an attempt to achieve the same result with respect to the stock of a corporation.

[9] *See, e.g.*, CCA 201726012; CCA 202240017. It is not clear whether the regulations under Treas. Reg. § 1.701-2 are valid.

[10] Notice 2024-54 (Section 5).

[11] For a discussion of this issue, *see* https://www.taxnotes.com/tax-notes-today-federal/litigation-and-appeals/nam-urges-remand-economic-substance-case-consider-relevance/2024/05/08/7jhkp.

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