THE I.R.S.'S MULTIFACETED SCRUTINY OF PARTNERSHIP BASIS-SHIFTING TRANSACTIONS

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INTRODUCTION

Over the past several years, the I.R.S. has targeted tax-free partnership transactions designed to shift tax basis to property that will yield tax savings for the partner, the partnership, or both. While it withdrew its initial set of regulations after widespread criticism, it has separately declared that these transactions lack economic substance.

The goal of these transactions is to use the interplay of rules governing inside and outside basis to shift tax basis from assets where it is less beneficial for income tax purposes to assets where a higher basis provides greater benefits, *i.e.*, because the asset offers greater cost-recovery deductions or will be sold.

BACKGROUND

Partnerships combine elements of tax opacity and tax transparency. In some respects, a partnership is viewed as a standalone entity. In other respects, a partnership is viewed as an aggregate of its partners. Thus, partnership tax law contains two concepts of basis: inside basis and outside basis. Inside basis represents a partnership's basis in its assets. Outside basis represents the partners' basis in their interests in the partnership. The two concepts do not always neatly align. Consequently, transfers of partnership interests or distributions of partnership property sometimes require adjustments to basis in distributed property, property held by the partnership, or both.

The general rule is that if a partner transfers its interest, the transferee partner takes over the transferor's share of inside basis.[1] This is in contrast to outside basis, where the transferee partner takes a new cost basis when the interest is transferred by sale or exchange. Similarly, on a distribution of property, the distributee partner takes a carryover basis in the property.[2]

These general rules are subject to modifications. For transfers, the Code §754 election is used to resolve discrepancies between the transferee partner's outside basis and share of inside basis. If the election is in place at the time of the transfer, Code §743(b) increases or decreases the transferee partner's inside basis to match the partner's outside basis. An increase to inside basis under Code §743(b) is also mandatory if the partnership has a substantial built-in loss. A substantial built-in loss exists if either (i) the fair market value of the partnership's assets exceeds its inside basis by more than $250,000 or (ii) the transferee partner would be allocated

1 Code §743(a).

2 Code §732(a)(1); see Code §734(a).

a loss of more than $250,000 if the partnership sold all its assets immediately after the transfer.[3]

With respect to distributions, Code §732(a)(2) provides that a distributee partner's basis in the distributed property cannot exceed the partner's outside basis reduced by any cash received in the distribution. Additionally, Code §732(b) provides that if the distribution is part of a liquidation of the partnership, the partner instead takes a basis in the property equal to its outside basis reduced by any cash received. If multiple properties are distributed to which either of these provisions apply, Code §732(c) provides rules for allocating basis among the properties. Finally, Code §732(d) allows for a partner who became a partner without a §754 election in place and who receives an asset in distribution within two years of becoming a partner to step up its basis in a distributed asset to what the basis would have been had the election been in effect. The basis increase is mandatory (including outside the two-year window) in certain circumstances involving appreciated property.[4]

Distributions are also affected by a Code §754 election. If an election is in place and the distributee partner (i) recognizes gain or loss on the distribution or (ii) otherwise takes a basis in the property different from the partnership's basis prior to the distribution, then the partnership must adjust the basis in its remaining property under Code §734(b). A partner recognizes gain if it is distributed money in excess of its outside basis.[5] A partner recognizes loss only if it receives money, unrealized receivables, or inventory property.[6] In such an event, the partner recognizes loss in an amount equal to the excess of its outside basis over the sum of the bases in the distributed properties.

As applicable, a partnership must increase its basis in its remaining property by the amount of gain recognized by the distributee partner and/or the difference between the partnership's basis in the distributed property and the partner's basis, if the partner was required to take a reduced basis under Code §732(a)(2) (which limits carryover basis to outside basis less cash) or Code §732(b) (which requires partners in a liquidating distribution to take basis equal to outside basis less cash).[7] In parallel, a partnership must decrease its basis in remaining property by the amount of loss recognized by the distributee partner and/or the difference between the partner's basis and the partnership's basis, if the partner took an increased basis in a liquidation.[8]

Finally, even if no Code §754 election is in place, the partnership must still reduce its basis in its property under the rules described above if a distribution results in a "substantial basis reduction." A substantial basis reduction occurs if the sum of a loss recognized by a distributee partner and any increase in basis taken by the partner in distributed property exceeds $250,000.[9]

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3 Code §743(d)(1).

4 Treas. Reg. §1.732-1(d)(4).

5 Code §731(a)(1).

6 Code §731(a)(2).

7 Code §734(b)(1).

8 Code §734(b)(2).

9 Code §734(d)(1).

THE REGULATIONS

The I.R.S. announced it was taking aim at basis-shifting transactions in June 2024. It specified that it would scrutinize three broad groups of transactions:[10]

- A transfer of a partnership interest by a partner with low inside basis and high outside basis to a related person (or person who is related to another partner), in a way that would increase the transferee's inside basis tax-free.
  - A transferee partner who takes a high outside basis can increase its share of inside basis if a Code §754 election is in effect. If inside basis was initially low, the resulting increase in basis can be significant.
- A distribution of a high-basis asset to a related[11] partner with low outside basis, creating a reduction in the basis of the distributed asset and a corresponding increase in the basis of the partnership's remaining assets, with no adverse consequence to the other related partners.
  - A distribution to a partner with a low outside basis means that, if the partnership had a higher basis in the distributed property, the partner must reduce its would-be carryover basis under Code §732(a)(2). If a Code §754 election is in effect, the partnership correspondingly increases its basis in its remaining properties by the same amount.
- The liquidation of a partnership having related partners where (i) a low-basis asset that is either subject to accelerated cost recovery or intended to be sold is distributed to a partner with high outside basis and (ii) a high-basis asset that is either subject to longer or no cost recovery or intended to be held is distributed to a partner with low outside basis.
  - In a liquidating distribution, the carryover rule is generally overridden by Code §732(b), and the distributee partners instead take a basis equal to their outside basis. Thus, a partner with a high outside basis can increase its basis in distributed low-basis property, generating smaller gains or greater depreciation deductions. Property that is intended to be held or that does not provide as much depreciation potential can be distributed to low-basis partners, mitigating the disadvantages of a low basis in the property.

Concurrent with this announcement, the I.R.S. issued proposed regulations which were finalized and made effective January 14, 2025, as Treas. Reg. §1.6011-18. Nonetheless, the regulations imposed a six-year lookback period.[12]

Definitions

The I.R.S. outlined four transactions as "transactions of interest" ("T.O.I.'s"), divided into one "transfer T.O.I." and three "distribution T.O.I.'s."

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[10] FS-2024-21.

[11] *I.e.*, to one or more other partners in the partnership.

[12] Treas. Reg. §1.6011-18(b)(11).

The sole transfer T.O.I. was the §743(b) T.O.I., defined as a transaction in which[13]

- a partner transfers all or a portion of a partnership interest to a related partner in a nonrecognition transaction,
- the transferee partner's share of inside basis increases under Code §743(b), and
- the applicable threshold for the year is satisfied.

The three types of distribution T.O.I.'s were Code §734(b) T.O.I.'s, Code §732(b) T.O.I.'s, and Code §732(d) T.O.I.'s.

A Code §734(b) T.O.I. was defined as a transaction in which

- a partnership distributes property to a related partner in a current or liquidating distribution,
- the partnership increases its basis in one or more remaining properties under Code §§734(b) and 734(c), and
- the applicable threshold is satisfied.[14]

A Code §732(b) T.O.I. was defined as a transaction in which

- a partnership distributes property to a related partner in liquidation of the partner's partnership interest,
- the basis of one or more distributed properties is increased under Code §§732(b) and 732(c), and
- the applicable threshold is satisfied.[15]

Finally, a Code §732(d) T.O.I. was defined as a transaction in which

- a partnership distributes property to a related partner,
- the basis of one or more distributed properties is increased under Code §732(d),
- the partner acquired all or part of its interest in a transaction that would have been a Code §743 T.O.I. if a Code §754 election had been in effect, and
- the applicable threshold is satisfied.[16]

T.O.I.'s also included substantially similar transactions, including transactions that would not fit the above definitions because the partners were unrelated, but where a similar tax benefit would be achieved because one or more of the partners were

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[13] Treas. Reg. §1.6011-18(c)(2).

[14] Treas. Reg. §1.6011-18(c)(1)(i).

[15] Treas. Reg. §1.6011-18(c)(1)(ii).

[16] Treas. Reg. §1.6011-18(c)(1)(iii).

known to be tax-indifferent.[17] For example, foreign partners would not have a U.S. tax liability arising from these transactions.[18]

Partners were considered related if they were related before or after the transaction under Code §267(b).[19] Examples of related parties include (i) family members, (ii) affiliated corporations, (iii) a greater-than-50% individual shareholder of a corporation and the corporation, and (iv) a grantor and a fiduciary of a trust. Transactions excepted from T.O.I.'s included transfers of partnership interests by death and most transactions involving publicly traded partnerships.[20]

As noted above, a transaction only became a T.O.I. if all transactions in a given year collectively satisfied the applicable threshold. The applicable threshold was met if all increases in basis from the T.O.I. transactions exceeded the gains from the transactions by at least $10 million.[21] For transactions occurring during the six-year lookback period, the threshold was increased to $25 million.

Reporting Requirement

"Participating partners" and "participating partnerships" were required to report the T.O.I.'s on Form 8886 (*Reportable Transaction Disclosure Statement*).[22] Participating partners include the transferor, transferee, and distributee partners in T.O.I.'s. Look-through rules provided that where the participating partner was a disregarded entity ("D.R.E.") or grantor trust, the D.R.E. owner or grantor was considered the participating partner. Form 8886 is generally used to report reportable transactions, or transactions that the I.R.S. has deemed to have high potential for tax abuse.[23]

"As noted above, a transaction only became a T.O.I. if all transactions in a given year collectively satisfied the applicable threshold."

Failure to report a reportable transaction causes a penalty equal to 75% of the decrease in tax resulting from the transaction.[24] This penalty has a minimum of $5,000 for individuals and $10,000 for other taxpayers and a maximum of $10,000 for individuals and $50,000 for other taxpayers. Material advisers to reportable transactions must also report the transactions on Form 8918 (*Material Advisor Disclosure Statement*) maintain a list of advisees.[25] The penalties are $50,000 for failure to file Form 8918 and, if requested by the I.R.S. to furnish the list of advisees, $10,000 per day for each day after the twentieth day following the I.R.S.'s request.[26]

Backlash

Practitioners criticized the new rules for being overly broad. In response, the final regulations, compared to the proposed regulations, narrowed the scope of reporting. Examples include the following:

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17 Treas. Reg. §1.6011-18(d).

18 Treas. Reg. §1.6011-18(b)(12).

19 Treas. Reg. §1.6011-18(b)(8), (9).

20 Treas. Reg. §§1.6011-18(c)(4), -18(b)(3)(iv).

21 Treas. Reg. §1.6011-18(c)(3)(i).

22 Treas. Reg. §1.6011-18(f)(1).

23 Treas. Reg. §1.6011-4.

24 Code §6706A(b)(1).

25 Code §§6111(a), 6112(a).

26 Code §§6707(a), 6708(a)(1).

- The threshold amount was raised from $5 million to $10 million.
- The lookback period was limited to six years instead of an indefinite period, and the deadline for reporting historic transactions was extended from 90 days to 180 days after the effective date.
- "Related partners" were limited to those who are direct partners.
- Tax-indifferent parties caused a transaction to become a T.O.I. only if their tax-indifferent status was known beforehand.
- The exceptions for transfers on death and transfers involving P.T.P.'s were added.

Nonetheless, the core criticism remained unchanged: many non-abusive transactions would be caught up by the new rules largely because some of the partners happened to be related.

The I.R.S. relented. Notice 2025-23 removed the regulations and allowed taxpayers to treat them as though they had never come into effect. It also waived the penalties relating to reporting reportable transactions for participants and material advisers and the obligation of material advisers to maintain lists of advisees.

While the new rules had only required taxpayers to report transaction and distribution T.O.I.'s, the I.R.S. also issued Notice 2024-54, where they announced a plan to issue two sets of proposed regulations that would have required taxpayers to alter their tax computations where the T.O.I.'s were involved. That plan has been scrapped.

WHAT REMAINS: REV. RUL. 2024-14

The new regulations are history, but the I.R.S. indicated it is not done scrutinizing these transactions. While the T.O.I. regulations are gone, Notice 2025-23 did not mention Rev. Rul. 2024-14, which remains in effect. Under Rev. Rul. 2024-14, issued alongside the proposed regulations, the I.R.S. deemed three types of basis-shifting transactions to fail the economic substance doctrine codified in Code §7701(o). This doctrine has two prongs: a transaction lacks economic substance if it (i) fails to meaningfully change a taxpayer's economic position, disregarding tax effects and (ii) lacks a substantial non-tax purpose. A 20% penalty applies to underpayments of tax resulting from transactions lacking economic substance, which increases to 40% if the transaction is not disclosed.[27]

Rev. Rul. 2024-14 features a fact pattern involving U.S. corporation C, which has interests in several subsidiaries and partnerships, which in turn own depreciable and amortizable assets.

In Situation 1, the facts are as follows:

- C is a majority shareholder in Subs 1, 2, and 3.
- Subs 1 and 2 are 50-50 partners in Partnership A, which has a Code §754 election in place, and Subs 1 and 3 are 50-50 partners in Partnership B.

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[27] Code §6662(b)(6), (i).

- Sub 1 has high outside basis and low inside basis.
- Sub 1 contributes its interest in Partnership A to Partnership B, a tax-free transaction under Code §721(a).
- As a result of the §754 election, Partnership A increases Partnership B's portion of inside basis to match Partnership B's outside basis in Partnership A.
- The increase is allocated to depreciable or amortizable property.

In Situation 2, the facts are as follows:

- C is a majority shareholder in Subs 1 and 2, which are partners in Partnership C, which owns 100% of the shares of Sub 3, depreciable property, and cash.
- Partnership C has a Code §754 election in place. It has a small built-in loss in Sub 3 and a big built-in loss in the depreciable property.
- Sub 1 has a high outside basis in Partnership C while Sub 2 has low outside basis.
- Partnership C distributes Sub 3 stock to Sub 2. Sub 2's basis in Sub 3's stock is reduced to the value of Sub 2's outside basis. This triggers a decrease in Sub 2's outside basis under Code §733(2), which happens to fall to zero here.
- Because Sub 2 took a reduced basis in Sub 3 stock, Partnership C increases its basis in its remaining assets by the same amount.
- Under Code §755, all of the increase is allocated to the depreciable asset.

In Situation 3, the facts are as follows:

- Partnership D owns a depreciable asset with a large built-in loss and a non-depreciable asset (land) with a small built-in loss.
- Sub 1 has high outside basis in Partnership D, and Sub 2 has low outside basis.
- Partnership D adopts a plan of liquidation and distributes the depreciable asset to Sub 1 and the land to Sub 2.
- Sub 1 takes an increased basis in the property to match its high outside basis while Sub 2 does the opposite with the land. This allows additional depreciation deductions to be taken from Sub 1's distributed property.

The I.R.S. concluded that all three situations lack economic substance. Corporation C's economic position was unchanged because the transactions shuffled assets between its controlled entities. The transactions had no identifiable non-tax purpose. All three situations mirror the T.O.I.'s described earlier. Thus, even if the basis-shifting regulations have been removed, all indications are that the I.R.S. is not giving up its battle.