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IRS Targets Related-Party Basis Shifting

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In many simple cases, a partner's tax basis in his partnership interest (so-called "outside basis") will equal his pro rata share of the partnership's tax basis in its assets (so-called "inside basis"). However, there are various transactions that may cause a disparity between inside basis and outside basis to occur.

For example, if a person purchases a partnership interest at a valuation that is higher than the partnership's inside basis, the purchaser's outside basis will be greater than his share of the partnership's inside basis. In such a situation, if the partnership sells an asset and allocates the gain pro rata to its partners, the purchaser would be allocated too much tax gain compared to his economic profit. To ameliorate this result, the tax code allows a partnership to make an election (a so-called "section 754 election") to increase the tax basis of its assets with respect to the purchaser in an amount equal to the difference between the purchaser's outside basis in the partnership and his share of the partnership's inside basis in its assets (a so-called "section 743 adjustment").

A similar situation may arise with respect to partnership distributions. If a partnership distributes property to a partner, the partner generally receives a carryover tax basis in the property equal to the partnership's inside basis in the property, but the partner's basis in the property is limited to his outside basis in the partnership. In addition, if a partner receives a distribution of property in liquidation of his partnership interest, he will generally receive a tax basis in the property equal to his outside basis in the partnership. If a partner receives a distribution of property and takes a lower tax basis in the property than the partnership had, the partnership's tax basis in its remaining assets will be too low. This could cause the remaining partners to recognize too much gain if another partnership asset is sold. To remedy this, the tax code allows a partnership that makes a section 754 election to increase the basis of its remaining assets by the amount of the basis reduction in the distributed property (a so-called "section 734 adjustment").

The basis rules described above are designed to reconcile a partnership's inside basis in its assets to the partners' outside bases in their partnership interests. Since a partner's outside basis generally reflects his economic investment in the partnership (plus his share of the partnership's liabilities), these rules largely operate to produce the "right" result, whereby on a sale of partnership assets, a partner is generally only taxed on his economic profit from the sale. Until recently, these rules were relatively uncontroversial.

On June 17, 2024, the IRS released Notice 2024-54, which states that the IRS and the Treasury Department intend to issue proposed regulations relating to partnership basis adjustments resulting from transactions between related parties. The IRS also released other related guidance.

The proposed regulations would address three specific scenarios. First, the proposed regulations would apply if a partnership has two or more partners who are related to each other, and the partnership makes a distribution of property to one of the related partners that would normally result in a basis increase to the remainder of the partnership's assets. In such a case, the proposed regulations would provide that, with respect to the related party, the partnership's basis increase is effectively suspended until the distributed property is sold.

Second, the proposed regulations would apply to a partner who transfers his partnership interest to a related partner in a tax-free transaction, if the partner's outside basis in his partnership interest exceeds his share of the partnership's inside basis. If the partnership has a section 754 election in effect, the partnership would normally have a basis step-up in its assets with respect to the transferee partner. The proposed regulations would effectively suspend the basis increase unless and until the transferee becomes unrelated to the transferor and to all other partners.

Third, the proposed regulations would apply if a partner receives a liquidating distribution of property from a partnership and would normally receive a higher tax basis in the property than the partnership had, if there is a corresponding basis decrease in property held by a related partner. This could occur, for example, if the partnership simultaneously distributes other property to a related partner who receives a basis decrease in such property. The proposed regulations would provide that the basis increase in the distributed property is effectively suspended until the corresponding property with a basis decrease is sold.

If adopted, the proposed regulations would apply to limit the availability of basis adjustments starting in 2024, even with respect to related-party partnership transactions that occurred before 2024. Thus, they would have significant retroactive effect.

The IRS notice argues that these proposed regulations are necessary because related persons have been using partnership transactions to inappropriately shift tax basis to property with shorter depreciation periods, thus resulting in inappropriate federal income tax benefits. However, the rules would apply mechanically to all partnership transactions involving related parties, regardless of whether there is an abusive intent. The basis adjustment rules are generally designed to cause a partner's share of a partnership's inside basis to equal his outside basis in the partnership. As a partner's outside basis generally reflects his actual economic investment in the partnership, it is difficult to see how most such transactions could be abusive, even when related parties are involved. Thus, the proposed regulations would disallow basis adjustments in many non-abusive scenarios where those basis adjustments are necessary to achieve tax results that correspond to economic reality.

Moreover, the proposed regulations would introduce massive additional complexity to an area of the tax law that is already complicated. Many commentators have also questioned whether the IRS has the statutory authority to enact the proposed regulations.

If the proposed regulations are ultimately issued and finalized, taxpayers will need to pay special attention to related-party partnership transactions, even those that are not motivated by tax concerns.

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