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Treasury and IRS release new guidance on partnership related-party transactions

Tax Alert

Overview

On June 17, 2024, Treasury and the IRS issued a Notice of Proposed Rulemaking under section 6011 (the "Proposed TOI Regulations"), a Revenue Ruling (the "Ruling"), and a Notice announcing an intent to publish proposed regulations, all addressing certain "basis-shifting" transactions involving partnerships and related parties. In Fact Sheet 2024-21, the IRS described the guidance as focusing on "the inappropriate use of partnership rules to inflate the basis of the underlying assets without causing any meaningful change to the economics of their business." According to the IRS press release, a "new dedicated group in the Office of Chief Counsel specifically focused on developing guidance on partnerships" will be formed. In addition, the new group "will work closely with a new passthrough work group being established in the IRS Large Business and International division that will be formally established this fall."

Proposed Regulations under Section 6011

Transactions of Interest

The Proposed TOI Regulations (REG-124593-23) identify certain related-party "basis shifting" transactions by partnerships and their partners as reportable "transactions of interest" (TOI).

> ***Observation:*** TOIs would generally include any basis increases under sections 734(b), 732(b), 732(d), and 743(b) where related persons are parties to the transaction and/or are partners in the partnership, regardless of intent to achieve a tax benefit.

Specifically, TOIs generally would include the following types of transactions:

Section 734(b) Transaction: A partnership distribution (current or liquidating) to a partner that is related to one or more other partners, and the partnership increases the basis of remaining partnership property under section 734(b).

Section 732(b) Transaction: A liquidating distribution from a partnership to a partner that is related to one or more other partners, and the basis of the distributed property is increased under section 732(b).

Section 732(d) Transaction: A partnership distribution to a partner that is related to one or more other partners and section 732(d) applies.

Section 743(b) Transaction: A partner transfers a partnership interest in a nonrecognition transaction (1) to a related person or (2) to a person that is related to other partners, and the basis of one or more partnership properties is increased under section 743(b) as a result of the transfer. (See "substantially similar" discussion for transfers in a recognition transaction.)

A TOI would also include a transaction that is "substantially similar" to the transactions described above and also specifically includes transactions (1) involving a tax-indifferent partner instead of related party partners to facilitate an increase in basis of property, and (2) transferring an interest in a partnership to a related partner in a recognition transaction if the $5 million threshold described below is met.

> ***Observation:*** TOIs covered by the Proposed TOI Regulations appear to capture common, unrelated third-party acquisitions of partnership interests that are followed by common internal transfers of the purchased interests resulting in recomputed basis increases to partnership assets under section 743(b) or the collapsing of a purchased partnership post-acquisition, resulting in additional basis increases to partnership assets under section 732(b).

Relatedness

In general, under the Proposed TOI Regulations, partners and other persons would be considered related if they have a relationship described in section 267(b) (without regard to section 267(c)(3)) or section 707(b)(1). "Related partners" is defined in more detail for each of the four transactions described below.

$5 Million Threshold

TOIs are reportable if the sum of all gross basis increases resulting from all such transactions of a partnership or partner during the taxable year (without netting for any basis decreases in the same transaction or another transaction) exceeds the gain recognized from such transactions, if any, by at least $5 million.

Reporting Requirements for Participating Parties

The Proposed TOI Regulations are proposed to be effective as of the date final regulations are published in the Federal Register. Once the Proposed TOI Regulations are finalized, the disclosure for a TOI must be attached to the taxpayer's tax return for each taxable year in which a taxpayer participates in a TOI. A copy of the disclosure statement must also be sent to the IRS's Office of Tax Shelter Analysis (OTSA) when the disclosure statement is first filed by the taxpayer pertaining to a particular reportable transaction.

With respect to TOIs that occurred in past years (including on an amended return or administrative adjustment request), participating partnerships, partners, and related subsequent transferees have 90 days from the finalization of the Proposed TOI Regulations to report to the OTSA on Form 8886, *Reportable Transaction Disclosure Statement*, if the participating party (1) engaged in a TOI during a year for which a return has been filed and for which the period of limitations for assessment has not expired, or (2) filed a tax return for which the period of limitations for assessment has not expired that

reflected the US federal income tax consequences of a basis increase resulting from a TOI (for example, depreciation or amortization deductions).

> ***Observation:*** Although the Proposed TOI Regulations are not effective until finalized, if finalized in their proposed form, a taxpayer would be required to disclose if its tax return reflects the recovery (for example, amortization, depreciation, disposition of the assets) of the basis increase from a TOI even though the TOI giving rising to the basis increases happened before the regulations become finalized and the TOI itself was not required to be reported.

Reporting Requirements for Material Advisors

If finalized, material advisors of affected partnerships or partners must disclose transactions on Form 8918, *Material Advisor Disclosure Statement*. Under the current material advisor rules, a person may become a material advisor with respect to a transaction that is later identified as a TOI. In some circumstances, material advisors would be required to disclose transactions occurring in prior years. Specifically, material advisors would be required to disclose transactions that occurred in prior years only if they have made a tax statement on or after six years before the date of the Treasury decision adopting the Proposed TOI Regulations as final.

Notice 2024-54

In Notice 2024-54, Treasury and the IRS announced two sets of forthcoming proposed regulations: proposed regulations under sections 732, 734(b), 743(b), and 755 (the "Proposed Related-Party Basis Adjustment Regulations") and proposed regulations under section 1502 (the "Proposed Consolidated Return Regulations"). Once proposed, both sets of proposed regulations would apply to basis adjustments arising from a "covered transaction," which are defined to be similar to the TOI described above.

Covered Transactions

The Notice identifies certain related-party "basis shifting" transactions by partnerships and their partners as "covered transactions."

> ***Observation:*** Covered transactions would generally include any basis increases under sections 734(b), 732(b), 732(d), and 743(b) where related persons are parties to the transaction and/or are partners in the partnership, regardless of intent to achieve a tax benefit.

Specifically, covered transactions generally would include the following types of transactions:

Section 734(b) Covered Transactions – A partnership with a section 754 election in effect and two or more partners that are related to each other makes a distribution of property to one or more of the related partners, resulting in a basis increase among remaining partnership properties under section 734(b).

Section 743(b) Covered Transactions – (1) A partner transfers an interest in a partnership that has a section 754 election in effect or a substantial built-in loss immediately after the transfer (2) to a related transferee or a transferee that is related to one or more of the partners (3) in a nonrecognition transaction or a partial recognition transaction, resulting in the increase(s) in the basis of partnership property with respect to the transferee partner under sections 743(b) and 755.

> ***Observation:*** Because section 7701(a)(45) defines a "nonrecognition transaction" as any disposition of property in a transaction in which gain or

loss is not recognized in whole or in part, a part sale, part contribution could result in the entire basis adjustment, including the portion corresponding to the sold partnership interest, being a related-party basis adjustment (RPBA, as described below).

Section 732 Covered Transactions – A partner receives a liquidating distribution of property resulting in a basis increase in the distributed property, and either—

1. The partnership liquidates and distributes its other property to one or more parties related to the distributee partner resulting in a basis decrease in that property under section 732(b) and (c), or
2. The partnership continues and a partner related to the distributee partner has a share of the resulting basis decrease under section 734(b) or (d) (or would have had a share if the partnership had a section 754 election in effect).

Observation: Unlike the Proposed TOI Regulations, which provide for a $5 million threshold, the Notice does not describe any exception for de minimis related-party basis adjustments.

Relatedness

Like the Proposed TOI Regulations, in general, partners and other persons would be considered as related if they have a relationship described in section 267(b) (without regard to section 267(c)(3)) or section 707(b)(1) – i.e., common ownership of more than 50 percent – immediately before or immediately after a transaction.

The Proposed Related-Party Basis Adjustment Regulations

The Proposed Related-Party Basis Adjustment Regulations would provide that a basis increase allocated to property retained or distributed by a partnership following a covered transaction (a "related-party basis adjustment," or an "RPBA") would be subject to specific rules providing the required method of recovering the basis adjustment and the treatment of the basis adjustment upon the disposition of the property to which the adjustment applies. The Proposed Related-Party Basis Adjustment Regulations would apply only if, and to the extent that, property has been allocated a basis increase. If, and to the extent that, property has been allocated a basis decrease, the proposed rules would not apply.

Adjustments Resulting from Section 734(b) Covered Transactions

A section 734(b) RPBA would be recovered using the cost recovery method and remaining recovery period, if any, of the corresponding distributed property that gave rise to the section 734(b) RPBAs. For example, if a partnership distributes non-depreciable property resulting in a section 734(b) covered transaction and the basis adjustment is allocated to 5-year depreciable property, the resulting RPBA could not be recovered over five years despite being allocated to 5-year depreciable property.

In addition, generally the partnership would not be eligible to take the section 734(b) RPBA into account in calculating the amount of gain or loss recognized upon the sale or other disposition of partnership property to which a section 734(b) RPBA applies, until a disposition of the corresponding distributed property to an unrelated person in an arm's-length transaction in which taxable gain or loss is fully recognized (a "qualifying disposition").

If a basis adjustment ceases to be a section 734(b) RPBA because of a qualifying disposition, (1) the remaining basis attributable to the former RPBA would be treated as giving rise to a newly placed in service property that is subject to the cost recovery period and method of the property to which it was allocated, and

(2) the basis adjustment would be taken into account in computing gain or loss upon the sale or other disposition of the property.

> ***Observation:*** Immediately following the discussion of a basis adjustment that ceases to be a section 734(b) RPBA, the Notice states that "[t]hese rules would not apply to the share of any [section] 734(b) basis adjustment of a partner that is unrelated to the distributee partner." It is not clear how broadly the term "these rules" applies.

Notice 2024-54 also describes rules to address distributions of property with respect to which there is a section 734(b) RPBA and rules to address dispositions of property to which a section 734(b) RPBA applies whether by a partnership or a partner. The general effect of these rules would be to determine the extent to which the distributee partner becomes subject to the section 734(b) RPBA or the section 734(b) RPBA is reallocated to remaining partnership property.

Adjustments Resulting from Section 743(b) Covered Transactions

A section 743(b) RPBA would be ineligible for cost recovery until the transferee partner becomes unrelated to both the transferor partner and to all existing partners, at which point the basis adjustment ceases to be a section 743(b) RPBA. In addition, generally the transferee partner would not be eligible to take the section 743(b) RPBA into account upon the sale or other disposition of partnership property to which a section 743(b) RPBA applies until the basis adjustment ceases to be a section 743(b) RPBA.

Generally, if a basis adjustment ceases to be a section 743(b) RPBA, the basis attributable to the former RPBA would be treated as giving rise to newly placed in service property that is subject to the cost recovery period and method of the property to which it was allocated.

Notice 2024-54 also describes rules to address distributions of property with respect to which there is a section 743(b) RPBA and rules to address dispositions of property to which a section 743(b) RPBA applies whether by a partnership or a partner. The general effect of these rules would be to determine the extent to which the distributee partner would take the section 743(b) RPBA into account or whether the section 743(b) RPBA would be reallocated to remaining partnership property.

Adjustments Resulting from Section 732 Covered Transactions

A section 732 basis increase to distributed property would be treated as a section 732 RPBA to the extent the increase corresponds to a basis decrease of a related partner (or the basis decrease a related partner would have had if the partnership had a section 754 election in effect). The cost recovery rules for section 732 RPBAs vary depending on whether the partnership liquidated or continued in the relevant section 732 covered transaction.

In both cases, the distributee partner would not be eligible to take the section 732 RPBA into account upon the sale or other disposition of the property to which the section 732 RPBA applies unless the corresponding property giving rising to the section 732 RPBA is disposed of to an unrelated person in a fully taxable, arm's-length transaction.

If a basis adjustment ceases to be a section 732 RPBA, the remaining basis attributable to the former RPBA would be treated as giving rise to newly placed in service property that is subject to the cost recovery period and method of the distributed property, and the basis adjustment would be taken into account in computing gain or loss on the sale or other disposition of the property.

In a partnership liquidation, a section 732 RPBA will be recovered using the cost recovery method and remaining recovery period, if any, of the corresponding property the basis of which a related distributee partner reduced. In a partnership continuation, a section 732 RPBA will be recovered using the cost recovery method and remaining recovery period, if any, of the corresponding property the basis of which the partnership reduced under section 734(b), or would have reduced under section 734(b) if the partnership had a section 754 election in effect.

Distributions of Multiple Properties – Each distributed property would have a separate section 732 RPBA with respect to each basis decrease to corresponding property. The amount of a section 732 RPBA would be proportional to the share of the basis decrease to that section 732 RPBA's corresponding property out of the aggregate basis decrease to all corresponding property. A section 732 RPBA would be recovered using the cost recovery method and remaining recovery period, if any, of that section 732 RPBA's corresponding property.

> ***Observation:*** The rules contemplate the possibility of multiple section 732 RPBAs being allocated to a single property, which may be burdensome for taxpayers to track.

Proposed Applicability Date

Treasury and the IRS intend to propose that the Proposed Related-Party Basis Adjustment Regulations apply to taxable years ending on or after June 17, 2024.

> ***Observation:*** The preamble clarifies that the rules may apply to transactions completed in prior taxable years saying that the Proposed Related-Party Basis Adjustment Regulations, "would govern the availability and amount of cost recovery deductions and gain or loss calculations for taxable years ending on or after June 17, 2024, *even if the relevant covered transaction was completed in a prior taxable year*" (emphasis added).

> ***Observation:*** It is unclear how the rules described in the Notice would apply to a tiered partnership structure (for example, whether it is appropriate to "look through" a lower-tier partnership to the underlying property). The Notice states that the forthcoming proposed regulations will describe how these rules would apply to such structures.

The Proposed Consolidated Return Regulations

The Proposed Consolidated Return Regulations would apply a single-entity approach with respect to interests in a partnership held by members of a consolidated group in order to prevent direct or indirect basis adjustments among the members of the consolidated group resulting from covered transactions (as described above and in Section 3 of the Notice).

The Notice does not specify an intended effective date for the Proposed Consolidated Return Regulations; rather the Notice provides that an effective date will be proposed in the forthcoming notice of proposed rulemaking containing the Proposed Consolidated Return Regulations.

Rev. Rul. 2024-14

In Rev. Rul. 2024-14, the IRS analyzed whether the codified economic substance doctrine under section 7701(o) applied to disallow tax benefits associated with a series of transactions involving a related-party partnership, through which the rules governing the transaction create a disparity between inside and outside basis and the rules governing the transaction create a basis adjustment to property under sections 732(b), 734(b), or 743(b). As a result,

the rules applying to the transactions create increased recovery deductions with respect to the property or reduced gain (or increase loss) upon a sale of that property.

Observations:

The Ruling is consistent with the IRS's litigation position in other recent court cases.

Unlike the Proposed TOI Regulations and Notice 2024-54, the Ruling describes the intent of the parties to the transactions described. Questions remain whether the intent of the parties is a necessary condition to disallow tax benefits.

The Ruling arguably expands the current economic substance doctrine by comparing the magnitude of tax benefits to the taxpayer's financial statement benefit. In addition, the Ruling does not carve out "basic business transactions" or discuss whether there is a relevance requirement.

The Ruling references section 7701(o)(5)(D) in saying that a transaction may include a series of transactions, but arguably expands the section by applying the economic substance doctrine to disallow basis adjustments generated in a "series of *connected* transactions" (emphasis added) without defining the scope of connection needed to apply the doctrine.