The IRS Throws Down the Gauntlet to Certain Large Partnership Basis-Shifting Transactions

by Robert S. Horwitz and Michel R. Stein

Consistent with its efforts to restore fairness in tax compliance by shifting more attention onto high-income earners, partnerships, and large corporations, on June 17, 2024, the IRS unveiled a series of documents taking aim at basis shifting transactions by related-party partnerships. These documents are:

- IRS Fact Sheet FS 2024-21, which announces the new IRS program;
- Revenue Ruling 2024-14, identifying transactions the IRS claims lack economic substance;
- Notice 2024-54, previewing planned regulations; and
- Proposed regulations that identify certain types of basis-shifting transactions as transactions of interest, which are a form of reportable transaction (REG-124593-23).

This announcement comes two years after a June 22, 2022, statement of an IRS Chief Counsel attorney that the IRS was looking at basis-shifting transactions between related parties.

What Are Basis-Shifting Transactions

A partnership has two types of basis: "outside basis," which is each partner's basis in the partnership, and "inside basis," which is the partnership's basis in each of its assets. In the best of all possible worlds, a partner's outside basis should equal its pro rata share of the partnership's inside basis. Often, however, disparities occur between a partner's outside basis and its share of the partnership's inside basis. IRC §§ 732(b), 734(b), and 743(b) were designed to reduce disparities between inside and outside basis that would otherwise result from a distribution of property or a transfer of a partnership interest. These sections allow the basis of partnership assets to be increased in order to adjust for such disparities. The increased basis allows for increased depreciation or amortization of the asset or for reduced gain when the asset is sold. To make an adjustment to basis of partnership assets, the partnership must make a written election under IRC § 754. An excellent summary of the partnership basis rules is contained in Notice 2024-54.

Where partners in a partnership are not related parties, there is less opportunity for shenanigans that will create disparities between inside and outside basis. Where the partners in a partnership are "related parties" as defined in IRC §§ 267 and 707, the

partners can purposefully create disparities between inside and outside basis in order to increase the basis in assets.

What Types of Transactions Are Targeted?

Three types of basis-shifting transactions are in the IRS's crosshairs. According to the IRS, in all three types of transactions, the partnership engages in transactions to create disparities between inside and outside basis to increase depreciation deductions and/or reduce gain on the sale of an asset. In each of the transactions identified, a parent corporation owns two subsidiaries that are the only partners of one or more partnerships. In each scenario, the partnership has a valid § 754 election in effect. Normally, partnerships who engage in these transactions claim a non-tax business purpose for engaging in the transaction.

In one scenario, a subsidiary/partner transfers its interest in a partnership to a related party, resulting in a claimed increase in basis of the partnership's assets under IRC § 743(b). In a second scenario, a partnership makes a non-liquidating distribution of an asset to a subsidiary/partner that has an artificially low outside basis and then claims an increased inside basis in its non-cash assets under IRC § 734(b). In a third scenario, the partnership liquidates and distributes its assets to the subsidiaries/partners. A subsidiary/partner with a high outside basis is distributed assets in which the partnership had a basis substantially below fair market value and less than the distributee partner's outside basis. The partner claims a basis in the asset that is distributed to it equal to its outside basis in the partnership. These three types of transactions will be referred to below as "covered transactions."

The IRS's New Rulings and Proposed Regulations on Related-Party Partnership Basis-Shifting Transactions

Revenue Ruling 2024-14 will have the most immediate impact on taxpayers and their advisors. It asks the question "Does the economic substance doctrine apply to disallow tax benefits associated with" the covered transactions described above? The Revenue Ruling answers "Yes," under the economic substance doctrine, codified as IRC § 7701(o), these types of transactions lack economic substance. Therefore, the resulting basis adjustments will be disallowed. Taxpayers and partnerships that engaged in these types of covered transactions could be subjected to 20% accuracy related penalties under IRC § 6662(b) and 40% nondisclosed noneconomic substance transaction penalties under IRC § 6662(i). This is the position the IRS will take in any audit where it discovers one of the covered transactions.

The proposed regulation proposes to add Treas. Reg. § 1.6011-18, which designates these covered transactions as "transactions of interest" for purposes of IRC § 6011-4. A "transaction of interest" is a form of reportable transaction. A taxpayer who participates in one of these types of covered transactions must file a disclosure statement, Form 8886, with the IRS. The Form 8886 is attached to the taxpayer's return for each year in which a taxpayer engages in a reportable transaction. Additionally, after a transaction becomes a "transaction of interest" or a "listed transaction" the taxpayer must file a Form 8886 for any year in which it engaged in this type of transaction if the statute of limitations for assessment has not expired. A taxpayer who fails to file Form 8886 is subject to penalties under IRC § 6707A.

Notice 2024-54 identifies two additional sets of regulations that will apply to these types of covered transactions. The first set of regulations (called "Related Party Basis Adjustment Regulations") will be under IRC §§ 732, 734(b), 743(b), and 755 and will provide:

1. The required method of recording adjustments to basis of property arising from a covered transaction (a) held by a partnership, (b) distributed by a partnership, or (c) both.
2. The required method governing the determination of gain or loss on the disposition of such basis-adjusted property.
3. Rules for similar transactions involving a tax indifferent party, such as a tax-exempt organization, rather than a related party.

The second proposed regulation will be under IRC § 1502, concerning consolidated returns. The IRS is concerned that members of a consolidated group that have interests in partnerships engage in covered transactions to improperly reduce their tax liability. This proposed regulation will be to ensure that consolidated groups whose members own interests in a partnership file consolidated returns that clearly reflect income and tax liability. The IRS says that it anticipates that the regulation would treat all members of a consolidated group who are partners in a partnership as a single entity so that there will be no basis shifts.

Note: The draft 2023 Form 1120, *Corporate Income Tax Return*, has a new question 31 on Schedule K. It requires consolidated groups with gross receipts or sales of over $1 billion to report certain subchapter K basis adjustments. This new question is to alert the IRS to potential related-party partnership basis adjustment transactions.

Will the Courts Uphold the IRS's Position?

The issues raised by the revenue ruling have not been the subject of litigation and there are no judicial opinions concerning whether these types of transactions will be respected for tax purposes. Internal Revenue Manual Exhibit 4.46.4-4, "Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties," lists 16 factors that may indicate that a transaction lacks economic substance and advises examiners, their manager, and IRS Counsel "to consider all the relevant facts and circumstances of the case in determining the best and most appropriate legal arguments to make."

For each of the three scenarios Rev. Rul. 2024-14 says that the stated business purpose of the transaction is for the corporate group to achieve cost savings "by cleaning up intercompany accounts, reducing administrative complexity, and achieving other administrative efficiencies." These costs savings are "insubstantial in relation to the reduction in the aggregate Federal income tax liability of" the corporate group. The Revenue Ruling does not indicate what it means by insubstantial. It does not quantify the cost savings. It does not state whether the cost savings are one time savings or will occur annually.

The codified economic substance doctrine of IRC §7701(o) does not mandate the invalidation of a transaction because the non-tax economic benefits are "insubstantial" in relation to tax savings. Instead, it treats a transaction as having economic substance if:

> (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
>
> (B)the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

This determination in any specific case can only be made from "a detailed consideration of its unique facts." *Grove v Commissioner*, 490 F.2d 241 (2nd Cir. 1973). That tax planning and foresight played a role in the decision to engage in a transaction "do not transform a non-taxable event into one that is taxable." *Id.*

Conclusion

The IRS is becoming more aggressive in its approach to high-net-worth taxpayers, corporations, and large partnerships. Taxpayers who were partners in related party partnerships that engaged in basis-shifting transactions can expect a rough ride ahead. They should consult with competent tax professionals to consider their options.

Robert S. Horwitz *is a Principal at Hochman Salkin Toscher Perez P.C., former Chair of the Taxation Section, California Lawyers' Association, a Fellow of the American College of Tax Counsel, a former Assistant United States Attorney and a former Trial Attorney, United States Department of Justice Tax Division. He represents clients throughout the United States and elsewhere involving federal and state administrative civil tax disputes and tax litigation as well as defending clients in criminal tax investigations and prosecutions. He was the 2022 Joanne M. Garvey Award for lifetime achievement in and contribution to the field of tax law by the Taxation Section of the California Lawyers' Association.*

Michel R. Stein *is a principal at Hochman Salkin Toscher Perez, specializing in tax controversies, as well as tax planning for individuals, businesses and corporations. For more than 25 years, he has represented individuals with sensitive issue civil and criminal tax matters where substantial penalty issues may arise, and extensively advised individuals on foreign and domestic voluntary disclosures regarding foreign account and asset compliance tax matters. Mr. Stein is a frequent lecturer at national and regional conferences on topics, including Global High Wealth examinations, cryptocurrency, sensitive tax compliance matters, IRS examinations, International tax issues and state and federal residency and worker classification matters.*

Additional information on the firm is available at http://www.taxlitigator.com.