PLUNKETT COONEY

IRS Issues Guidance to Close Partnership Basis Shifting Transactions Loopholes

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As part of its continuing efforts to close loopholes related to abusive partnership transactions, the IRS recently released three new sets of guidance in the form of a notice, a revenue ruling and proposed regulations.

This guidance specifically addresses transactions between partnerships and related members who own them to use inappropriate basis adjustments to avoid taxes. Taken as a group, this guidance could significantly impact the flexibility that related party partnerships currently have to determine how basis adjustments are applied to assets transferred between related members.

The New Guidance and Proposed Regulations

Notice 2024-54

This notice states that the U.S. Department of Treasury and the IRS will publish proposed regulations relating to related party basis adjustment transactions and taxable income and tax liability for a consolidated group whose members own interest in a partnership. The IRS describes these proposed regulations as follows:

- The first set of regulations would require partnerships to treat basis adjustments arising from covered transactions in a way that would restrict them from deriving inappropriate tax benefits from the basis adjustments.
- The second set of regulations would provide rules to ensure clear reflection of the taxable income and tax liability of a consolidated group of corporations when members of the group own interests in partnerships. The notice further announces that that the covered transactions governed by these regulations would involve basis adjustments under Internal Revenue Code sections 732, 734(b) and/or 743(b).

Revenue Ruling 2024-14

Under Revenue Ruling 2024-14, the IRS announces that the economic substance doctrine will be raised in cases where related parties:

1. create inside/outside basis disparities through various methods, including the use of certain partnership allocations and distributions,
2. capitalize on the disparity by either transferring a partnership interest in a nonrecognition transaction or making a current or liquidating distribution of partnership property to a partner, and
3. claim a basis adjustment under Internal Revenue Code sections 732(b), 734(b), or 743(b) resulting from the nonrecognition transaction or distribution.

Proposed Regulations

The proposed regulations would identify basis shifting transactions that fall into one of the three categories below as reportable Transactions of Interest (TOI). These transactions as classified as positive basis adjustments of $5 million or more under subchapter K of the Internal Revenue Code. Currently, there is no reporting requirement for these types of basis shifting transactions.

Why is This new Guidance and Proposed Regulations Important?

The IRS announced in 2023 that it would seek to modernize the tax system to address loopholes that were used by high-income individuals, partnerships, corporations and promoters to abuse current tax rules using funding it received from the Inflation Reduction Act. This new guidance on partnership basis shifting reform marks the first major announcement in 2024 as part of this new initiative.

The guidance and proposed regulations describe related-party basis adjustment transactions that related members of a partnership utilize to take additional cost-recovery deductions, decrease overall taxable gain or increase taxable gain without any corresponding economic impact.

To accomplish this, a partnership completes a series of transactions between related members that include contributions or distributions of property to other related-party or tax-neutral partners in such a way that results in a tax-free increase in basis under the partnership tax basis adjustment provisions. By generating a tax-free step up in basis, the partnership can blunt the effect of any future capital gains tax if the asset is sold in the future or increase the depreciation deduction available to offset future income. These transactions also create disparities between the outside basis of the individual members and their respective shares of the inside basis of the property held by the partnership.

With these new guidelines and proposed regulations, the IRS would create new reporting requirements by identifying certain basis shifting transactions as reportable TOI. The treatment of these transactions for tax purposes will also be restricted to prevent the realization of inappropriate tax benefits.

The guidance and proposed regulations issued by the IRS are designed to specifically target the following three groups of transactions:

- **Transfer of partnership interest to related party:** In this transaction, a partner with a low share of the partnership's "inside" tax basis and a high "outside" tax basis transfers the interest in a tax-free transaction to a related person or to a person who is related to other partners in the partnership. This related-party transfer generates a tax-free basis increase to the transferee partner's share of "inside" basis.
- **Distribution of property to a related party:** In this transaction, a partnership with related partners distributes a high-basis asset to one of the related partners that has a low outside basis. After this, the distributee partner reduces the basis of the distributed asset, and the partnership increases the basis of its remaining assets. The related partners can arrange this transaction so that the reduced tax basis of the distributed asset will not adversely impact the related partners, while the basis increase to the partnership's retained assets can produce tax savings for the related parties.
- **Liquidation of related partnership or partner:** In this transaction, a partnership with related partners liquidates and distributes (1) a low-basis asset that is subject to accelerated cost recovery or for which the parties intend to sell to a partner with a high outside basis and (2) a high-basis property that is subject to longer cost recovery (or no cost recovery at all) or for which the parties intend to hold to a partner with a low outside basis. Under the partnership liquidation rules, the first related partner increases the basis of the property with a shorter life, or which is held for sale while the second related partner decreases the basis of the long-lived or non-depreciable property, with the result that the related parties generate or accelerate tax benefits.

The guidance generally will only impact partnerships where partners are related parties as described in Section 267(b) or where a party is tax-exempt, foreign or has a tax attribute that limits or eliminates the recognition of gain. The proposed regulations would apply to tax years ending on or after June 17, 2024.

Taxpayers should consult with their tax advisors to determine the impact of this new guidance on future and completed transactions that are like those described above.

Plunkett Cooney's Tax Practice Group is continuing to analyze the new guidance and proposed regulations. Another report will be issued in the future to provide additional insight on this announcement.