

# The IRS Takes Aim at Basis Adjustments in Partnership Transactions

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On June 17, 2024, the IRS issued three pieces of guidance addressing certain “basis-shifting” transactions in the context of related-party partnerships:

- In new proposed regulations, the IRS identified several transactions as “transactions of interest,” which would require taxpayers and material advisors to report such transactions to the IRS.<sup>1</sup>
- Notice 2024-54 describes two sets of forthcoming proposed regulations that would have the effect of (i) suspending the basis-adjustment benefits of certain transactions in the related-party partnership setting and (ii) disallowing basis-adjustment benefits where related partners are members of the same consolidated group.
- Revenue Ruling 2024-14 applies the economic substance doctrine to three specific transactions in the related-party partnership setting, concluding that each transaction lacks economic substance, disallowing the intended tax benefit and imposing penalties.

Certain aspects of the guidance, if finalized, could apply to disallow deductions this year, even if the related-party partnership transaction occurred in prior years, and would apply without regard to a taxpayer’s intent. These and other key provisions and takeaways are described below.

In a press release accompanying the guidance, the IRS announced the formation of a new group within the Office of Chief Counsel that will handle issues surrounding partnerships and other pass-through entities, with a focus on “closing loopholes.”<sup>2</sup> Regarding the transactions addressed in the proposed guidance, the press release provides that “[c]urrently, the IRS has tens of billions of dollars of deductions claimed in these transactions under audit.” As previously reported,<sup>3</sup> the IRS has significantly ramped up enforcement activity in the partnership and pass-throughs area. This guidance shows that basis-shifting transactions are an early priority of this new group.

## Transactions of Interest – Proposed Regulations Under Section 6011

Proposed Treasury Regulations Section 1.6011-18(c) describes four “basis-shifting” transactions in the related-party partnership setting identified as transactions of interest (requiring reporting by taxpayers and material advisors). The first three transactions involve current or liquidating distributions by a partnership to a “related partner” that result in a basis increase to property distributed to the partner or retained by the partnership under IRC section 732 or 734.<sup>4</sup> The fourth transaction involves a transfer of a partnership interest to a related partner in a nonrecognition transaction that results in a basis increase to partnership property under IRC section 743.<sup>5</sup> Finally, “substantially similar” transactions — *e.g.*, transactions that involve tax-indifferent (rather than related) partners or transfers of partnership interests to related transferees in recognition transactions that exceed the \$5,000,000 threshold — would also be reportable transactions.<sup>6</sup>

<sup>1</sup> REG-124593-23.

<sup>2</sup> IR-2024-166, June 17, 2024.

<sup>3</sup> See Armando Gomez, Kathleen (Kat) Saunders Gregor, Emily Lam, “The Informed Board: The IRS Is Coming for Partnerships and High Net Wealth Individuals,” Skadden Publications, Fall 2023

<sup>4</sup> Prop. Treas. Reg. § 1.6011-18(c)(1)(i)-(iii).

<sup>5</sup> Prop. Treas. Reg. § 1.6011-18(c)(2).

<sup>6</sup> Prop. Treas. Reg. § 1.6011-18(d).

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The comment period for the proposed regulations ends on August 19, 2024, and a public hearing has been scheduled for September 17, 2024.

## Key Points

- Although the proposed regulations are not yet effective (and will be effective only after finalization), reporting by participating partners, partnerships and material advisors may nevertheless be required for transactions occurring before that date. This is because a partner or partnership is treated as “participating” in a transaction of interest both in the taxable year in which the basis-adjusting transaction occurs and in any taxable year in which the tax return of the partner or partnership, as applicable, reflects the tax consequences of the basis increase.<sup>7</sup>
- Increased audit scrutiny of these and similar transactions involving partnerships has already begun, meaning the IRS is likely developing theories for challenging tax benefits arising from existing (*i.e.*, already completed) transactions that might be reportable at a later date — partnerships and partners might benefit from a risk assessment of existing transactions now, particularly in light of the reasoning set forth in Revenue Ruling 2024-14, discussed below.

## Suspension of Benefits and Implications for Consolidated Groups – Notice 2024-54

Notice 2024-54 outlines two sets of forthcoming proposed regulations intended to address the basis-shifting transactions described above in the related-party partnership setting (defined in the notice as “covered transactions”):

- Proposed regulations under IRC sections 732, 734(b), 743(b) and 755 (the “Proposed Related-Party Basis Adjustment Regulations”) are intended to disallow the benefit of the basis adjustment in covered transactions. The proposed regulations would generally disallow recovery of the basis increase through depreciation or amortization, and would also prohibit taking such basis increase into account upon a future disposition of the property.
- Proposed regulations under section 1502 (the “Proposed Consolidated Return Regulations”) would address the interplay between the consolidated return rules and the rules of subchapter K. Short on any specific details, Notice 2024-54 provides that the forthcoming proposed regulations would “apply a single-entity approach with respect to interests in a partnership

<sup>7</sup> Prop. Treas. Reg. § 1.6011-18(e)(5). In addition, taxpayers and material advisors may also be required to disclose a transaction of interest occurring in any taxable year for which the period of limitations remains open. See Treas. Reg. § 1.6011-4(e)(2)(i).

held by members of a consolidated group” and that such an approach is intended to “prevent direct or indirect basis shifts among the members of the group” resulting from the covered transactions described above.<sup>8</sup>

Treasury and the IRS have requested comments regarding the approaches to addressing distortions of income from related-party partnership basis shifting transactions by July 17, 2024.

## Key Points

- The Proposed Related-Party Basis Adjustment Regulations explicitly recognize that they could cover a host of transactions that are neither abusive nor lacking in economic substance as they are meant to apply mechanically regardless of taxpayer intent.<sup>9</sup> In addition, the rules would apply to suspend positive basis adjustments only, even if the related-party transaction also had the effect of reducing basis in other depreciable property.
- Similar to the proposed reportable transaction regulations described above, the Proposed Related-Party Basis Adjustment Regulations could apply retroactively to transactions that occurred before June 17, 2024, as long as the basis increase from such transactions is reflected on a tax return after the effective date.<sup>10</sup>
- Although Notice 2024-54 describes the Proposed Consolidated Return Regulations as intended to prevent direct or indirect basis shifts among consolidated group members, the implications of this guidance are potentially much broader. If, as the notice suggests, a true “single-entity approach” were applied with respect to partnership interests held by consolidated group members, this could severely restrict the use of partnerships wholly-owned within consolidated groups. The applicability date for the Proposed Consolidated Return Regulations will be contained in future guidance.

## Economic Substance Analysis – Revenue Ruling 2024-14

Revenue Ruling 2024-14 sets forth three situations involving basis-adjustment transactions in the related-party partnership setting and analyzes these transactions under the economic substance doctrine. In each situation, through the use of partnership distributions and/or related-party transfers of partnership interests, members of a controlled group shift basis from partnership property that is not depreciable or amortizable to depreciable or amortizable property held by the partnership

<sup>8</sup> Notice 2024-54 § 5.01.

<sup>9</sup> Notice 2024-54 § 4.01.

<sup>10</sup> Notice 2024-54 § 6.01.

# The IRS Takes Aim at Basis Adjustments in Partnership Transactions

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or by a related partner, resulting in increased deductions or reduced amounts of gain (or increased loss). In each situation, (i) partnership contributions, distributions and allocations had been previously undertaken “with a view to creating a disparity” between inside and outside basis, (ii) the stated business purpose of the transactions at issue involved “cleaning up intercompany accounts, reducing administrative complexity and achieving other administrative efficiencies” and certain cost savings, and (iii) the cost savings resulting from the transaction were insubstantial relative to the reduction in aggregate federal income tax liability.

After discussing the relevant code provisions, Revenue Ruling 2024-14 concludes that, in each situation, the transactions at issue failed both the objective and subjective prongs of the economic substance doctrine as codified at IRC section 7701(o), *i.e.*, the transactions neither changed in a meaningful way (apart from federal income tax effects) the taxpayer’s economic position nor was there a substantial nontax business purpose for entering into the transactions. As a result, the ruling concludes that any resulting

basis increases must be disregarded, and that the taxpayers are subject to a 20% penalty on any underpayment resulting from such a basis increase (increased to 40% for nondisclosure).

## Key Points

- While the first two pieces of guidance describe new rules, Revenue Ruling 2024-14 states the IRS’s current position with respect to certain basis-shifting transactions in the related-party partnership context.
- Notably, the IRS relies on IRC section 7701(o) and not Treasury Regulation section 1.701-2, the partnership anti-abuse rules. This reflects a broader and questionable trend by the IRS to expand the application of IRC section 7701(o) in contexts not traditionally considered to be subject to the economic substance doctrine or where another anti-abuse provision or doctrine already exists. Additionally, Revenue Ruling 2024-14 applies the economic substance doctrine without any consideration of its relevancy to the transactions at issue.

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