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Tax Basis Shifting Transactions

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Introduction

The IRS and Treasury issued guidance addressing the perceived "inappropriate" use of basis shifting transactions by related parties through partnerships. This set of guidance includes (1) Notice 2024-54 (the "Notice"), describing forthcoming proposed regulations that would suspend basis utilization on a related-party basis adjustment ("RPBA") as a result of a "covered transaction" (discussed below), (2) proposed regulations (the "Proposed Reporting Regulations"), which would treat certain RPBA transactions as transactions of interest and therefore would require the partnership, affected partners and material advisors to report such transactions to the IRS and (3) Revenue Ruling 2024-14, setting out the IRS's position that certain related-party basis adjustment transactions may be subject to the economic substance doctrine.

A covered transaction typically involves an increase in basis that would generate tax benefits to a partner, often matched by a corresponding decrease in basis with respect to a related partner while there is no real economic impact. The Notice and Proposed Reporting Regulations would apply to all covered transactions without regard to the partners' intent or whether the transaction is abusive or lacking in economic substance. It is also worth noting that for purposes of these rules, a taxable partner and a tax-indifferent partner can be treated as related partners.

Under the Notice, final regulations will apply to taxable years ending on or after June 17, 2024 and apply to past transactions to the extent the tax benefits from the RPBA remain. If finalized in their current form, the Proposed Reporting Regulations would also apply to past transactions (even if no tax benefits from the RPBA remain) to the extent the statute of limitations remains open as of the date the regulations are finalized—taxpayers will have only 90 days to report prior transactions.

Comment: The retroactive scope of the Notice and Proposed Reporting Regulations and lack of an intent or abuse element are sure to be significant challenges for taxpayers, and we expect taxpayers to push back against the IRS and Treasury on the retroactive scope

to mitigate some of the taxpayer hardship under the current proposals. For example, under the Notice, if a partnership distributed a non-depreciable asset 50 years ago to a partner that resulted in a step-up in the distributed asset, the partner receiving the partnership property (the "Distributee Partner") could be subject to these rules if it holds the asset on June 17, 2024 because the basis is still relevant—the Distributee Partner will need to determine whether there was a related partner 50 years ago and whether intervening events would have removed the suspension. Similarly, under the Proposed Reporting Regulations, partnerships, partners and their material advisors will need to investigate their files to determine whether they were ever involved in or advised on a transaction with a RPBA, however innocuous. Material advisors will only be required to look back six years from the date the Proposed Reporting Regulations become final.

Step-Up Rules Implicated

The abuse the IRS is targeting with this guidance is the scenario where the basis of assets (usually depreciable assets or those intended for sale) increases through a nontaxable transaction, with any corresponding adjustments generally involving a decrease in the basis of other assets. When related parties are involved, they may structure their transactions such that the benefits of an increased asset basis outweigh any disadvantages from corresponding reductions in basis, for instance by increasing basis in assets that are subject to speedy depreciation and reducing basis in non-depreciable assets. However, neither the Notice nor the Proposed Reporting Regulations require any anti-abuse intent. They are mechanical rules that apply without regard to intent.

Under Subchapter K of the Internal Revenue Code (the "Code"), each partner has a basis in its partnership interest ("Outside Basis"), and the partnership has basis in its assets ("Inside Basis"). When partnership property is distributed, both the partnership and the Distributee Partner take into account any disparity between the Distributee Partner's Inside Basis and Outside Basis, as described below.

In the case of a non-liquidating distribution, a Distributee Partner's basis in distributed property equals the partnership's Inside Basis in the property, up to the amount of the Distributee Partner's Outside Basis. In a non-liquidating distribution, the Distributee Partner cannot take a basis in an asset that is higher than the partnership's Inside Basis but can take a basis in an asset that is lower than the partnership's Inside Basis. Under section 732(b), however, if the partnership distribution was in liquidation of the Distributee Partner's interest in the partnership, the Distributee Partner's basis in the distributed property is equal to the Distributee Partner's Outside Basis. In a liquidating

distribution, the Distributee Partner's basis in the asset may be higher or lower than the partnership's Inside Basis. Where a Distributee Partner's basis in an asset is different than the partnership's Inside Basis, section 734(b) requires the partnership to adjust the basis of its remaining assets by such discrepancy if (1) a section 754 election is in effect or (2) there is a substantial basis reduction.

When a partner (the "Transferee Partner") purchases a partnership interest from another partner, the Transferee Partner's Outside Basis is equal to the amount paid for the interest, which may differ from its share of the partnership's Inside Basis. Where the Transferee Partner's Outside Basis is higher (meaning the Inside Basis is lower than fair market value and reflects inherent built-in gain), the Transferee Partner will recognize the built-in gain when the partnership sells assets. Additionally, it will not be able to amortize or depreciate the excess basis.

However, if the partnership has a section 754 election in effect as of the date of the transfer, section 743(b) provides that the partnership adjusts its Inside Basis to eliminate the built-in gain. This incremental Inside Basis is personal to the Transferee Partner and may be used by the Transferee Partner to offset any built-in gain allocated to it. The Transferee Partner may also amortize or depreciate this Inside Basis if the asset is of a type that is amortizable or depreciable. If no election is in effect on the date of purchase, a later section 754 election will not ameliorate the Transferee Partner's unhappy circumstance. Prior to this guidance, a Transferee Partner in this circumstance could transfer its interest to a related partner in a non-recognition transaction and, because the related partner would succeed to the Transferee Partner's Outside Basis, the related partner would be able to step up its share of Inside Basis because of the section 754 election in effect at the time of the later transaction.

Examples

The Proposed Reporting Regulations provide a few examples of transactions that the IRS is targeting. We describe three of them below and how the Notice and Proposed Reporting Regulations would apply to them.

Example 1: Step-Up on a Non-Liquidating Distribution (Section 734(b) Step-Up)

Example 1 describes XY Partnership, co-owned by related partners X and Y, who each own 50% of XY Partnership's capital and profits and equally share losses. XY Partnership makes a non-liquidating distribution to Y. X's Outside Basis in the partnership is $10 million, while Y's is $1 million. The partnership owns two properties: Property 1, which is depreciable (e.g., a building, vehicle, intangible asset, etc.) with an adjusted basis of

zero, and Property 2, which is non-depreciable (e.g., land or stock) with an adjusted basis of $10 million. A section 754 election is in place, allowing for basis adjustments upon distributions of property.

When Property 2 is distributed to Y, Y's basis in the property is limited to its Outside Basis in its partnership interest ($1 million), reducing Property 2's basis from $10 million to $1 million. Consequently, XY Partnership increases the basis of its remaining assets (i.e., Property 1) by $9 million, the difference between Property 2's basis before and after the distribution. This increase will allow the partnership to claim depreciation deductions on the newly adjusted basis of Property 1.

Example 2: Step-Up on a Liquidating Distribution (Section 732(b) Step-Up)

In Example 2, a partnership with multiple related partners makes a liquidating distribution of depreciable property to one of the partners. Immediately before the distribution, the partnership's Inside Basis in the distributed property was relatively low and the Transferee Partner had a relatively high Outside Basis. Under section 732(b), the distributed property's basis is increased by an amount equal to the excess of the Transferee Partner's Outside Basis over the partnership's basis in the distributed property. As a result, the Distributee Partner receives increased cost recovery allowances and can take advantage of this tax benefit directly (as opposed to the indirect benefit covered in Example 1).

The partnership is likely to be required to decrease the basis of its remaining property because of the basis adjustment on the distributed property. However, the example posits that the partnership only holds non-depreciable property after the distribution, causing this reduction in basis to not have an immediate adverse tax effect on the related parties.

Example 4: Step-Up in a Nonrecognition Transaction (Section 743(b) Step-Up)

Example 4 examines a related-party basis adjustment upon a transfer of a partnership interest. In the example, A and B own AB Partnership ("AB"), 95% and 5%, respectively. A's Outside Basis is $6 million and A's share of the Inside Basis is $1 million. This disparity may have arisen because a section 754 election was not in effect when A purchased its interest in AB. AB itself owns depreciable property used in a trade or business. During a taxable year when AB has a 754 election in effect, A transfers its entire interest to C, who is a related party in a nonrecognition transaction where C's Outside Basis is equal to $6 million, causing AB to increase the basis of its property with respect to C by $5 million.

Application of Guidance

The Proposed Reporting Regulations would treat as reportable (1) a distribution by any partnership with two or more directly or indirectly related partners to a related partner that results in a related partner or the partnership getting a step-up of at least $5 million and (2) a transfer by any partner of a partnership interest to a Transferee Partner who is related to the transferor or related to another partner and where the Transferee Partner gets a section 743 step-up of at least $5 million. In measuring the $5 million threshold, any step-up is reduced by any gain recognized in the transaction by a related partner. For these purposes, two partners are related if the same group of persons directly or indirectly owns more than 50% of each. The Proposed Reporting Regulations would also apply to transactions where the partners are not related but one partner is a tax-indifferent partner (e.g., a state pension plan not subject to UBTI or a taxable partner with NOLs) that facilitates the transaction. All of the examples described above would be reportable under the Proposed Reporting Regulations.

The Notice describes a novel approach that the forthcoming proposed regulations on basis shifting will adopt to address this perceived abuse. The basic framework under the Notice is that the increased asset basis is matched to the corresponding downward basis adjustment to other assets and, to the extent related parties are on both sides of that adjustment, the increased asset basis takes on the tainted characteristics of the corresponding asset for purposes of depreciation and amortization. If the corresponding asset was non-depreciable, the basis shifting transaction would not achieve increased depreciation in the stepped-up asset. When the corresponding asset is sold to an unrelated third party in a taxable transaction, any remaining increased basis is released from that taint. If the stepped-up asset is sold first, the tainted basis would not be taken into account in determining gain or loss—instead, that basis generally shifts to other assets. If the stepped-up asset is distributed to any partner, seemingly including an unrelated partner, the taint carries over to the Distributee Partner.

Comment: While the Proposed Reporting Regulations define the transaction of interest on a partnership transfer in the context of a nonrecognition transaction with an Inside/Outside Basis disparity of more than $5 million, the Proposed Reporting Regulations treat a taxable transfer with a pre-transfer Inside/Outside Basis disparity of more than $5 million as a similar transaction also requiring reporting. The Notice would similarly apply to any taxable transfer of a partnership interest with any pre-transfer Inside/Outside Basis disparity—the suspension would apply to this spread. Moreover, it is worth noting that any section 743 step-up is personal to the specific partner—a transferee partner does not succeed to a transferor's section 743 step-up but instead has its own step-up. Therefore, a transfer by a partner to a related partner where there is no

pre-transfer Inside/Outside Basis disparity on account of the transferor's prior section 743 step-up may nevertheless be caught in these rules.

Comment: The Proposed Reporting Regulations and Notice would also apply to a transfer between unrelated persons where the transferee is related to another partner in the partnership. No explanation is provided as to what abuse the IRS was concerned about here. Peculiarly, it appears that a transfer to an unrelated partner is not covered, but a transfer to a person related to that partner is covered.

The Notice also discusses forthcoming proposed regulations meant to address basis shifting in related-party partnership transactions where the parties to the transaction are part of the same consolidated group. Not much detail is offered on what these regulations will provide—they will apparently prevent direct or indirect basis shifts among the members of a consolidated group resulting from a covered transaction. The Notice reserves on the effective date of these regulations.

Comment: These forthcoming proposed regulations appear unnecessary in light of the broader forthcoming proposed regulations on basis shifting. The IRS may have taken this additional approach with respect to consolidated group members to buttress its position to combat the perceived abuse in the event taxpayers challenge the IRS's authority to issue the basis shifting regulations, especially in light of the recent Supreme Court ruling overturning the "Chevron doctrine".

Application of Notice to Example 1: Step-Up on a Non-Liquidating Distribution (Section 734(b) Step-Up)

In Example 1, because partner Y's basis in Property 2 is stepped down, related partner X's portion of the corresponding increase to the basis of Property 1 is "tainted" and would depreciate in the same manner and with the same timing as the distributed asset. Therefore, because Property 2 was non-depreciable, X's portion of the increased basis in Property 1 would also not be depreciable. If Property 1 is sold first, gain/loss allocated to X would be determined without regard to this tainted basis—that basis would instead move over to X's share of other partnership assets with the same taint. If Y sells Property 2 to an unrelated third party in a taxable transaction, the taint is removed and the basis increase would get freed up in Property 1.

Application of Notice to Example 2: Step-Up on a Liquidating Distribution (Section 732(b) Step-Up)

The Notice generally applies the same rules as discussed above in Example 1 to the distributee partner. Specifically, to the extent any increase in the basis of distributed property under section 732(b) corresponds to a decrease in basis of an asset distributed to a related partner or the related partners share of a decrease in basis of partnership

assets, the upwards basis adjustment is tainted and recovered using the cost recovery method and remaining recovery period, if any, of the corresponding property. In addition, the tainted portion of increased basis is not taken into account in any sale or disposition of the distributed property. Following a disposition of the corresponding property to an unrelated person in an arm's-length, taxable transaction, these rules no longer apply to the distributed property.

Comment: As drafted, the Notice appears to say that if the distributed property itself is sold before the corresponding property, the tainted increased basis is lost and does not move over to other property. This is inconsistent with the Notice's approach in Example 1 (or Example 4), where the amount of any increased basis is reallocated to other property upon such a sale. The Notice does not provide any explanation for this difference in treatment.

Application of Notice to Example 4: Step-Up in a Nonrecognition Transaction (Section 743(b) Step-Up)

In Example 4, partner C's $5 million step-up in AB's assets would essentially be suspended in determining cost recovery allocations to C or gain/loss allocation to C from partnership sales of assets. This suspension would continue until C is not related to former partner A or any other partner. After the suspension is lifted, the basis increase to the partnership assets is viewed as newly acquired for cost recovery purposes and will be used to determine gain/loss allocation to C. If partnership assets with the suspended basis are sold, the basis is added to other partnership assets of similar character (or held until the partnership has such assets) and remains subject to suspension until A and all other partners are no longer related to C.

Implications for Private Equity M&A

While the Notice is generally intended to govern transactions between related parties that produce significant tax benefits via the application of the partnership basis adjustment rules, the forthcoming proposed regulations will apply mechanically to related-party transactions, without regard to taxpayer intent or whether the relevant transaction is abusive. Given the breadth of these rules as described, they might apply to transactions between private equity funds, which are typically structured as partnerships with many of the same investors, even though such transactions are not tax-motivated.

One difficult issue is the prevalence of continuation fund, fund-to-fund and rollover transactions in the private equity space. These transactions typically give rise to meaningful investor overlap among buying and selling partnerships, which creates the

possibility that any basis shifting arising from the tax-free rollover component of these commonplace transactions may have some taint. That analysis is also complicated by the fact that ultimate ownership of private equity funds is not widely disclosed, making it difficult to determine relatedness among the rollover and non-rollover partners. Similarly, if one private equity fund acquires an interest in a partnership from another fund in a transaction generating a large section 743(b) step-up, the buyer may need to determine with the selling fund the extent of the overlap among their investors, or confirm that the Notice and Proposed Reporting Regulations don't apply to the transaction in some other manner, such as establishing that the seller does not have an Inside/Outside Basis disparity or, in the case of reporting, that the Inside/Outside Basis disparity is below the $5 million threshold.

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