

Shifting Sands: Treasury Finalizes Regulations on Partnership Basis Shifting

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A partner's tax basis in his partnership interest (referred to as "outside basis") generally represents his economic investment in a partnership plus his share of the partnership's liabilities. In many cases, a partner's outside basis will correspond to his share of the partnership's tax basis in its assets (referred to as "inside basis"). However, there are situations when the two can differ, and various transactions can result in adjustments to the tax basis of a partnership's property.

If a partnership makes a distribution of property to a partner, the partner generally receives a tax basis in the distributed property equal to the partnership's inside basis in the property. However, if the partnership's inside basis in the property was higher than the partner's outside basis in his partnership interest, the partner's basis in the distributed property is limited to his outside basis. In addition, if a partner receives a liquidating distribution of property from a partnership, the partner's basis in the distributed property will equal his outside basis (reduced by any money received in the same transaction). Therefore, the basis of the distributed property in the hands of the partner may be adjusted to be higher or lower than the partnership's inside basis in the distributed property.

If a partnership distributes property to a partner and the basis of the distributed property is decreased, the partnership's basis in its remaining property is increased if the partnership makes a so-called "section 754 election." This basis increase (referred to as a "section 734 adjustment") is necessary to cause the remaining partners' outside bases in their partnership interests to equal their shares of the partnership's inside basis. If the partnership were to sell its remaining assets, this section 734 adjustment is designed to prevent the partners from recognizing more tax gain than their economic share of the gain.

Another situation where basis adjustments may arise is if a partner transfers an interest in a partnership. If a partner purchases a partnership interest at a value that is higher than the partner's share of the partnership's inside basis in its assets, the partner's outside basis will exceed his share of inside basis. If the partnership has a section 754 election in effect, the partnership will increase its inside basis in its assets (referred to as a "section 743 adjustment") solely with respect to the transferee partner so that the transferee's outside basis matches the partner's share of the partnership's inside basis. In some circumstances, if a partner with a pre-existing disparity between outside basis and share of inside basis transfers his partnership interest in a nontaxable transaction, a section 743 adjustment can also result.

The rules described above have been in the tax code since 1954 and have generally not been controversial, as they are designed to cause a partner's share of inside basis to match the partner's outside basis, which generally reflects the partner's economic investment in the partnership. Nonetheless, the IRS has expressed a concern that partnerships with related partners may use these rules to inappropriately shift basis among related parties.

On January 14, 2025, the Treasury Department issued final regulations designating certain related-party partnership basis shifting transactions as “transactions of interest.” Although this designation does not affect the substantive tax characterization of these transactions, it imposes significant reporting requirements on taxpayers and their advisors. To avoid significant penalties, taxpayers that engage in transactions covered by the regulations must file special disclosure statements with the IRS. In addition, certain material advisors (such as attorneys or accountants) must also file disclosure statements with the IRS. The regulations have significant retroactive effect, and can cover transactions that occurred as long ago as 2019. For prior transactions, taxpayers generally have until July 14, 2025, to make the required disclosures.

The regulations cover several different partnership transactions involving basis adjustments and related parties. First, the regulations may apply if a partnership with two or more partners who are related to one another distributes money or property to one of the related partners, and as a result of that distribution, the partnership increases its basis in its remaining property via a section 734 adjustment.

Second, the regulations may apply if a partnership with two or more related partners distributes property to one of the related partners in liquidation of its partnership interest, and as a result of the distribution, the basis of the distributed property is increased.

Third, the regulations may apply if a partner transfers a partnership interest to a related person in a transaction in which gain or loss is not recognized in whole or in part, and as a result of the transfer, the partnership increases its inside basis with respect to the transferee via a section 743 adjustment.

Finally, a transaction similar to those described above may be covered by the regulations even if no partners are related if the transaction involves a tax-indifferent party.

In any of the above situations, a transaction is covered by the regulations only if the aggregate basis increase exceeds the gain recognized in the transaction by at least \$10 million (or, in the case of certain prior transactions, \$25 million). However, any basis decreases from the transaction are generally not taken into account in determining whether this threshold is met.

These final regulations were first issued in proposed form in June, 2024. The proposed regulations were issued in connection with other guidance indicating that the Treasury Department intended to issue regulations actually disallowing the basis adjustments in situations similar to those described above (rather than just creating reporting obligations). However, those other regulations have not yet been issued.

It is difficult to see why the IRS believes the transactions covered by the final regulations are particularly prone to abuse. Because a partner’s outside basis generally reflects his economic investment in a partnership, the basis adjustments described above are often necessary for a partner’s tax consequences to better reflect his economic profit. Thus, such basis adjustments are usually appropriate, even if related parties are involved, and many transactions to which the regulations will apply are not motivated by tax considerations.

Moreover, the significant retroactive nature of the regulations is especially problematic, and is part of an alarming trend of increasingly retroactive tax rules. Taxpayers and their material advisors may struggle to recall covered transactions in which they were involved over the past six or so years, particularly when the basis adjustments at issue were only an ancillary consequence of a transaction. Nevertheless, given the significant penalties at stake, taxpayers and material advisors must make every effort to comply with the new regulations.

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