NEW YORK STATE BAR ASSOCIATION
One Elk Street, Albany, New York 12207 PH 518.463.3200 www.nysba.org

Report No. 1498
August 16, 2024

The Honorable Aviva Aron-Dine
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Daniel I. Werfel
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Marjorie A. Rollinson
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20224

Re: NYSBA Tax Section Report No. 1498 - Report on Proposed Regulation Regarding Partnership Basis Adjustments and Application of Notice 2024-54 to Previously Effected Transactions

Dear Mses. Aron-Dine and Rollinson, and Mr. Werfel:

Please see attached Report No. 1498 of the Tax Section of the New York State Bar Association, which discusses proposed regulation regarding partnership related-party basis adjustment transactions as reportable transactions of interest and the application of Notice 2024 to previously effected transactions.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Jiyeon Lee-Lim
Chair

Enclosure

cc:

Shelley de Alth Leonard
Acting Deputy Assistant Secretary (Tax Policy)
Department of the Treasury

Krishna Vallabhaneni
Tax Legislative Counsel
Department of the Treasury

Sarah Haradon
Attorney Advisor (Office of the Tax Legislative Counsel)
Department of Treasury

William M. Paul
Principal Deputy Chief Counsel and Deputy Chief Counsel (Technical)
Internal Revenue Service

Holly A. Porter
Associate Chief Counsel (Passthroughs & Special Industries)
Internal Revenue Service

Report No. 1498

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED REGULATION REGARDING PARTNERSHIP BASIS ADJUSTMENTS AND APPLICATION OF NOTICE 2024-54 TO PREVIOUSLY EFFECTED TRANSACTIONS

August 16, 2024

New York State Bar Association Tax Section

Report on Proposed Regulation Regarding Partnership Basis Adjustments and Application of Notice 2024-54 to Previously Effected Transactions [1]

This Report comments on the proposed Treasury Regulation (the "Proposed Regulation" or "Proposed TOI Regulation")[2] released June 17, 2024, under which certain partnership "basis adjustment" transactions would be identified as reportable "transactions of interest" under section 6011 of the Internal Revenue Code of 1986, as amended (the "Code").[3] At the same time, the Department of Treasury ("Treasury") and the Internal Revenue Service ("IRS") issued Notice 2024-54 ("Notice") to preview proposed Treasury Regulations that may provide new substantive rules for such transactions and Revenue Ruling 2024-14 ("Revenue Ruling") that concludes that certain such transactions are susceptible to challenge under "economic substance" or other doctrines of present law.[4] The Proposed Regulation, the Notice, and the Revenue Ruling are part of ongoing compliance efforts by Treasury and the IRS that target large, complex partnerships, which might have been prompted by concerns by members of Congress.[5]

Each of the Notice and the Revenue Ruling raises significant issues; however, this Report focuses on the disclosure obligations under the Proposed TOI Regulation and, in the case of the Notice, solely on the retroactive impact of the rules previewed there. (In this context, we use the term "retroactive" to mean that recovery of basis in 2024 and subsequent years, attributable to basis adjustments that occurred in pre-2024 years, would be affected by the new rules.) If and when the proposed substantive rules under the Notice are published, we anticipate authoring a separate report on those rules.[6] Nevertheless, we believe it is important to raise the issue of the

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1 The principal author of this report (the "Report") was Elliot Pisem. Significant contributions were made by Jennifer Alexander, Kimberly Blanchard, Melissa Byun, Peter Connors, Rafael Kariyev, Jiyeon Lee-Lim, Yaron Reich, Stuart Rosow, Michael Schler, Isaac Wheeler, and Libin Zhang. This Report reflects solely the views of the Tax Section of the New York State Bar Association (the "NYSBATS") and not those of the New York State Bar Association's Executive Committee or its House of Delegates.

2 REG-124593-23, 89 FR 51476 (proposing to add Treas. Reg. § 1.6011-18(a)).

3 Unless otherwise indicated, all references in this Report to a "section" refer to a particular section of the Code or Treasury Regulations, as applicable. The Code is also sometimes referred to in this Report as the "IRC."

4 See Notice 2024-54, 2024-28 IRB 1, and Rev. Rul. 2024-14, 2024-28 IRB 1.

5 Treasury and the IRS's work in this area has been extensive. See, e.g., IRS, Press Release, IR-2023-176, "IRS to establish special pass-through organization to help with high-income compliance efforts; new workgroup to blend current employees and new hires to focus on complex partnerships, other key areas" (Sept. 20, 2023) (newly created pass-through work group in the IRS Large Business and International (LB&I) division and the hiring and training of thousands of new agents); IRS, Press Release, IR-2024-166, "New IRS teams being established; new guidance designed to stop partnerships from using sophisticated tax-free transactions that lack economic substance" (June 17, 2024). A case now pending in the Tax Court challenges $867 million of Code section 743(b) adjustments made by a family-held real estate development partnership. Otay Project LP v. Comm'r, Dkt. No. 6819-20. See U.S. Senate Committee on Finance, "Wyden Unveils Proposal to Close Loopholes Allowing Wealthy Investors, Megacorporations to Use Partnerships to Avoid Paying Tax", (September 10, 2021), with a link to the press release. https://www.finance.senate.gov/chairmans-news/wyden-unveils-proposal-to-close-loopholes-allowing-wealthy-investors-mega-corporations-to-use-partnerships-to-avoid-paying-tax

6 The Notice has been the subject of substantial commentary, see, e.g., Sullivan & Cromwell LLP, Commentary, "Forthcoming Proposed Related-Party Basis Adjustment Regulations, as Announced in Notice 2024-54" (July 17, 2024); NYU Tax Clinic, Commentary re "Notice 2024-54 and Forthcoming Guidance

Notice's retroactive impact now, as taxpayers need to know, for planning and reporting purposes, what rules cover basis recovery with respect to properties that they owned on the date of issuance of the Notice, during periods prior to promulgation of the Regulations.[7] We recommend eliminating the Notice's retroactive application to basis adjustments attributable to transactions before its publication on June 17, 2024; to the extent this recommendation is not accepted, the Notice's retroactivity should be limited, as outlined below.

As discussed under the Background section of this Report, the stated aim of the Proposed TOI Regulation is to help the IRS gather additional information about certain types of "basis shifting" transactions, in order to "better assess the scale and characteristics of the abuse and help direct IRS enforcement resources," and thereby to reduce the number of abusive basis adjustment transactions. We concur with these goals, and we do not object to identification of certain basis shifting transactions as reportable transactions of interest. However, we propose in this Report some ways in which the Proposed TOI Regulation should be narrowed, so as to make it more likely that truly abusive transactions, and not garden-variety partnership restructurings, are drawn to the IRS's attention, and so as to reduce the compliance burden on taxpayers and their advisors, particularly in the context of transactions completed prior to release of the Proposed TOI Regulation.

I. SUMMARY OF RECOMMENDATIONS

A. Notice 2024-54

We recommend that the substantive related-party basis adjustment rules previewed under the Notice apply only prospectively to transactions effected on or after its publication date, June 17, 2024. To the extent that this recommendation is not accepted, we recommend that retroactivity be limited to transactions exhibiting specified characteristics of the sort described in the Revenue Ruling. If and when the proposed rules outlined in the Notice are issued, we anticipate writing a separate report on them.

B. Proposed TOI Regulation

We recommend that the Proposed TOI Regulation be revised to narrow its scope and retroactive application, in the following ways:

1. Restrict application to transactions occurring on or after January 1, 2023;

2. Increase and bifurcate the dollar threshold amounts to (i) $10 million, prospectively, and (ii) $50 million, retroactively;

3. Clarify the rules for determining the dollar threshold;

Regarding Partnership Related-Party Basis Shifting Transactions (July 17, 2024). This Report does not express a view as to the authority of the Treasury and IRS to issue the rules previewed in the Notice.

[7] Indeed, the Notice would change present law even for properties of which a taxpayer disposed between January 1, 2024, and June 17, 2024.

4. Modify the definition of "related," particularly in the case of certain partnerships and corporations and siblings, and make certain technical corrections; and

5. Provide exceptions for material advisors, including an "actual knowledge" qualifier.

II. BACKGROUND

In recent years, the IRS has become increasingly aware of, and may consider abusive, certain basis adjustment transactions, often involving sophisticated partnership structures, related parties, and millions of dollars in tax savings.[8] In such transactions, related parties may "shift" the tax basis of one asset to another, in order to claim increased depreciation deductions or minimize gain realized when an asset is sold, even though such transactions may effect little or no economic change when viewed together at the related party level. In some cases, however, the IRS has not been able to identify, and therefore to challenge, such basis shifting transactions from the face of tax returns.[9]

The Proposed TOI Regulation identifies four types of "Partnership Related-Party Basis Adjustment Transactions" as transactions of interest ("TOIs"):

1. Certain transactions involving transfers of partnership interests between "related partners";[10]

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[8] The preamble to the Proposed TOI Regulation ("Supplementary Information") states that "[t]his awareness results from the IRS's review of various partnership transactions involving related parties in which basis adjustments were created to artificially generate or regenerate Federal income tax benefits that resulted in significant tax savings without a corresponding economic outlay. These transactions were carefully structured to exploit the mechanical basis adjustment provisions of subchapter K to produce significant tax benefits with little or no economic impact on the related parties, and in a manner that would not be a likely arrangement between partners negotiating at arm's-length."

[9] See Supplementary Information, 89 FR 51476.

[10] An example of such a transaction is provided in the Supplementary Information to the Proposed TOI Regulation:

> AB Partnership is owned by partners A and B. A owns 95 percent of the capital and profits interests in AB Partnership and is allocated 95 percent of all losses. B owns 5 percent of the capital and profits interests in AB Partnership and is allocated 5 percent of all losses. A's outside basis is $6 million and share of inside basis is $1 million. AB Partnership owns depreciable property it uses in a trade or business.
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> In a taxable year in which AB Partnership has a section 754 election in effect, A transfers its entire partnership interest to C, a person related to A within the meaning of proposed §1.6011-18(b)(8) and (b)(9)(ii), in a nonrecognition transaction in which no gain was recognized. Because AB Partnership has a section 754 election in effect for the taxable year of the transfer, under section 743(b)(1), AB Partnership increases the basis of the partnership property with respect to C by $5 million.
>
> Assume that under sections 743(c) and 755 and the regulations thereunder, the basis increase with respect to C of $5 million is allocated to partnership property that is depreciable. As a result, C may be allocated depreciation deductions over the recovery periods of the partnership properties equal to the amount of the basis increase under section 743(b)(1).

2. Certain transactions involving partnership distributions to persons that are "related partners";[11]

3. Transactions that would be described above, except that the partners are *not* related, but one or more partners is tax-indifferent and thereby facilitates, by receiving a distribution of property from the partnership or otherwise, an increase in the basis of partnership property or an increase in the basis of property held by another partner in the partnership; and

4. Certain recognition transactions in which a partner transfers an interest in a partnership to a related partner.

The TOIs generally involve positive basis adjustments of $5 million or more (by reason of certain partnership tax rules (specifically sections 732(b) or (d), 734(b), or 743(b))) corresponding to which no tax is paid. The Notice outlines proposals to reduce or eliminate tax benefits of related-party basis-shifting transactions, including matching the timing of the depreciation and amortization of an upward basis adjustment with the timing of inclusion of associated income or gain, and treating as a single entity all members of a consolidated group that are partners in a partnership.

The Proposed TOI Regulation and the forthcoming rules under the Notice would impact partners, partnerships, and material advisors. Failure to comply with the reportable TOI rules can result in significant penalties and toll the statute of limitations on assessment.

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[11] In such transactions, basis adjustments may be made under Code sections 732(b) and (c), 732(d), and 734. The Supplementary Information to the Proposed TOI Regulations gives an example of each, of which we reproduce here the section 734 example:

> XY Partnership is owned by partners X and Y. The partners are related to each other within the meaning of proposed §1.6011-18(b)(8) and (b)(9)(i). Each partner directly owns 50 percent of the capital and profits interests in XY Partnership and shares losses equally. X has an outside basis of $10 million, and Y has an outside basis of $1 million. XY Partnership owns property it uses in its trade or business, including Property 1 and Property 2. For Federal income tax purposes, Property 1 is depreciable property and Property 2 is nondepreciable property. XY Partnership has an adjusted basis in Property 1 of zero, and an adjusted basis in Property 2 of $10 million.
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> XY Partnership has a section 754 election in effect for the taxable year and makes a current distribution of Property 2 to Y. Under section 732(a)(2), Y's basis in distributed Property 2 is limited to Y's adjusted basis in its partnership interest of $1 million. As a result of the distribution to Y, Property 2's adjusted basis is decreased from $10 million immediately before the distribution to $1 million in Y's hands. Under section 734(b), XY Partnership must increase the basis of its remaining property. The amount of the basis increase is equal to the excess of XY Partnership's basis in Property 2 immediately before the distribution of $10 million over Y's adjusted basis in Property 2 after the distribution of $1 million, which results in an increase to the basis of XY Partnership's remaining property of $9 million.
>
> Under sections 734(c) and 755 and the regulations thereunder, XY Partnership allocates the basis increase of $9 million to Property 1. As a result, XY Partnership claims depreciation deductions based on an increased basis in Property 1.

Although this example involves a basis increase to depreciable property, the Proposed TOI Regulation may apply to transactions that increase the basis of nondepreciable property and give rise to an offsetting decrease to the basis of depreciable property.

III. Retroactivity of Notice 2024-54

A. Summary

The Notice states that the basis shifting rules to be proposed would apply, in tax years that end on or after June 17, 2024, with respect to the recovery of basis adjustments resulting from a "covered transaction,"[12] regardless of (i) when the "covered transaction" took place and (ii) whether the transaction was motivated by non-tax business purposes.[13] Specifically, the "Proposed Applicability Date" provides:

> The Treasury Department and the IRS intend to propose that the Treasury decision that adopts the Proposed Related-Party Basis Adjustment Regulations described in section 4 of this notice as final regulations would apply to taxable years ending on or after June 17, 2024. That is, once finalized, the regulations would govern the availability and amount of cost recovery deductions and gain or loss calculations for taxable years ending on or after June 17, 2024 even if the relevant covered transaction was completed in a prior taxable year.

B. Discussion

Under present law, some transactions that have a basis-shifting effect may be subject to challenge under various judicial doctrines, including (but not limited to) economic substance. It also may be appropriate to apply new substantive Regulations, if and when proposed and promulgated, to transactions implemented on or after the date of the Notice.

However, we oppose the application of such rules to basis increases arising before the date of publication of the Notice, because such application would change the tax consequences of previously consummated, non-abusive, commercial transactions that were done in complete accord with existing law. As the proposed retroactive effect specifically negates any inquiry into the *bona fides* of a transaction, many transactions to which the new rules could apply would involve the well-settled application, in the years in which the transactions were effected, of longstanding provisions of subchapter K of the Code. We offer these examples of such transactions:

Example 1. Third-party purchase, followed by a nonrecognition transaction involving the purchaser (*e.g.*, a merger or liquidation of the purchasing partner into a corporate affiliate, or contribution of an acquired partnership interest to a corporation or partnership). In 2000, two unrelated corporations create a partnership to operate a business with

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[12] Section 3.10 of the Notice states, "Generally, in a covered transaction, partnership property is distributed to a partner who is related to one or more other partners, and that distribution results in a person related to the distributee partner, the distributee partner, or both, receiving all or a share of basis increase in the distributed property or remaining partnership property under § 732 or § 734(b) (as applicable); alternatively, a partnership interest is transferred between related persons or to a transferee partner who is related to an existing partner in the partnership, and that transfer results in an increase to the inside basis in partnership property with respect to the transferee partner under § 743(b)."

[13] See sec. 6 of the Notice ("Proposed Applicability Dates").

assets contributed by both partners. In 2015, when a 754 election is in place, the partners agree to part ways, and a subsidiary of one partner buys the interest of the other partner. An upward section 743(b) adjustment is made to the assets of the partnership with respect to the purchaser. In 2020, the subsidiary merges into a corporate affiliate in a transaction described in Code section 368. In 2024, the partnership sells the business (or some of its assets). Under the Notice, the acquiror in the merger would need to calculate gain by ignoring the section 743(b) basis step-up from the 2015 acquisition, because the nonrecognition transaction resulted in a re-application of 743(b).[14]

Example 2. Continuation fund. In 2022, a private equity fund (Fund 1) was reaching the end of its life, but the time was not ripe for selling certain investments. One of those investments was a controlling interest in an operating partnership (Portco) that Fund 1 had purchased in 2020, and Fund 1's basis in its interest in Portco exceeded its share of Portco's basis in its assets. The sponsor organized a new fund (Fund 2), and Fund 1 contributed some of its investments, including its Portco interest, to Fund 2, in exchange for Fund 2 partnership interests, and distributed the Fund 2 partnership interests to its partners. Some partners exit and sell their Fund 2 interests to new investors. Each of Fund 1, Fund 2, and Portco had a section 754 election in place in 2022 (at the time of the continuation transaction), but not in prior years, and, at the time of the continuation transaction, Fund 1, Fund 2, and Portco were related persons. Under the Notice, in 2024 and subsequent years, Portco would need to ignore at least the portion of the 743(b) basis adjustment attributable to those Fund 1 partners that continue to hold Fund 2 interests.

Example 3. Family partnership redemption. A partnership of three brothers has owned and operated several businesses for many years. Due to differences of strategic vision regarding the operation of the businesses, one brother's partnership interest is liquidated in 2022 through a distribution of one of the businesses (which he had been managing). The basis and fair market value of that business are greater than the distributee's basis in his partnership interest. Under sections 734(b) and 755, such excess basis amount increased the basis of the partnership's remaining assets. Under the Notice, any basis recovery in 2024 or subsequent years would need to be determined by reference to computations that take into account the depreciation deductions of the now distributed business.[15]

Example 4. Pro rata liquidating distribution. Partnership is a longstanding 50/50 partnership between related partners A (whose outside basis is $10,000,000) and B (whose outside basis is $40,000,000). Partnership's only asset are shares in Corporation X that have a basis of $50,000,000 in the hands of Partnership. In liquidation, Partnership distributes 50% of the shares to A and 50% of the shares to B. Under the Notice, the amount of basis that B may recover upon sale of any of the shares, no matter how long after the liquidating distribution, would

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[14] Similarly, if the partnership did not have a section 754 election in effect until 2020, the Notice would require the corporation to calculate its gain on the 2024 sale by ignoring the section 743(b) basis increase from the 2020 merger, even though the underlying inside-outside basis disparity arose from the third-party purchase in 2015.

The issue raised in Example 1, regarding a prior basis adjustment under section 743(b) from a transaction with an unrelated party, can arise as well under the Proposed TOI Regulation. We believe that any subsequent related party transfer should not negate the effect of such prior adjustment resulting from a transaction with an unrelated party, and we recommend that the language of the Proposed TOI Regulation be modified (or clarified) to reach this result.

[15] The same sort of odd result would follow if a partnership distributed equally valuable parcels of vacant land to various partners, unless the basis of each of the parcels also happened, fortuitously, to be equal.

depend on whether A had already disposed of any of the shares distributed to A. (Indeed, the Notice fails even to specify when, if at all, B would recover any disallowed basis, if B sold all of the shares distributed to B before A sold the shares distributed to A.)

None of the foregoing transactions has features identified in the Notice as warranting new rules – these transactions were not "carefully structured" to "inappropriately exploit the basis-adjustment provisions of subchapter K" and thereby "artificially generate" tax benefits "with little or no economic impact on the related parties, and in a manner that would not be a likely arrangement between partners negotiating at arm's-length." Similarly, these transactions bear no resemblance to the situations that the Revenue Ruling found offensive, where "the parties engaged in a concerted effort to create disparities between inside and outside basis through various methods" "undertaken with a view to creating a disparity" [and] "then exploited the created disparities by engaging in transfers resulting in basis adjustments under the mechanical rules of § 732(b), 734(b), or 743(b) to inappropriately reduce taxable income through increased deductions or reduced gain (or increased loss)."

Moreover, taxpayers have prevailed in litigation when similar transactions were challenged by the IRS, even when transactions were planned with an eye toward the existing rules of the Code and Regulations,[16] and it is inappropriate to change adversely the tax consequences that taxpayers expect from completed transactions that conform to the Code and Regulations and to such case law.

We also note that retroactivity of the sort proposed by the Notice would impose significant administrative burdens on taxpayers by requiring them to review the history of every asset acquired in, or tracing its basis to, any partnership distribution or partnership interest transfer, no matter how long ago, to determine whether the new rules applied and, if so, how to do the necessary computations to limit basis recovery.

In contrast to the approach of the Notice, Congress, Treasury, and the IRS have regularly applied purely prospective effective dates when changing partnership tax rules, even in arguably abusive situations. Perhaps the most striking example of this is Treasury Regulation section 1.701-2, the general anti-abuse rule applicable throughout subchapter K, which was issued on December 29, 1994, effective only for transactions occurring on are after the date of its proposal in May 1994 or, with respect to a portion of the rule, only for transactions occurring on or after the date of issuance. Other examples include:

- Code sections 704(c)(1)(B) and 737, each of which applies only to built-in gain on property contributed to a partnership after a date proximate to its enactment.[17]

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[16] See, e.g., Countryside Limited Partners v. Comm'r, TC Memo 2008-3; MCA Inc. v. U.S., 50 AFTR 2d 82-5782, 685 F.2d 1099 (9th Cir. 1982).

[17] When these sections were amended to extend the five-year holding period thereunder to seven years, the amendments similarly applied only to property contributed after a date proximate to enactment of the amendment.

- The 2004 amendments to Code sections 734 and 743, in the case of "substantial basis reductions" and "substantial built-in losses apply only to distributions and transfers after the date of their enactment.

- Regulatory amendments concerning application of sections 704(c)(1)(B) and 737 to distributions of property after assets-over mergers became effective only for distributions made after issuance of a Notice announcing proposed Regulations. The IRS also withdrew a related revenue ruling due to retroactivity concerns.[18]

- Clarification of the economic substance doctrine in Code section 7701(*o*) was made effective only for transactions entered into after the date of its enactment, March 30, 2010.

C. Recommendation

In light of the foregoing, we recommend that the rules previewed in the Notice, if and when issued, apply only to transactions effected on or after the date of publication of the Notice. To the extent that this recommendation is not accepted, retroactivity should be limited, in the words of the Revenue Ruling, to "concerted effort[s] to create disparities between inside and outside basis through various methods," such as "contributions, distributions, and allocations … undertaken with a view to creating a basis disparity," that "demonstrat[e] a lack a meaningful change in economic position" and also "demonstrate a lack of substantial purpose (apart from Federal income tax effects)," followed by "exploit[ing] the created disparities by engaging in transfers resulting in basis adjustments under the mechanical rules of § 732(b), 734(b), or 743(b) to inappropriately reduce taxable income through increased deductions or reduced gain (or increased loss)."[19]

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[18] 72 FR 46932 ("Some commentators argued that Rev. Rul. 2004-43 was not consistent with the existing regulations under sections 704(c)(1)(B) and 737, and that the conclusions contained in the ruling should not be applied retroactively. In response to these comments, the Treasury Department and the IRS issued Notice 2005-15, 2005-7 IRB 527, (see § 601.601(d)(2) of this chapter) indicating their intent to issue regulations under sections 704(c)(1)(B) and 737 implementing the principles of the ruling, and issued Rev. Rul. 2005-10, 2005-7 IRB 492 (see § 601.601(d)(2) of this chapter) officially revoking Rev. Rul. 2004-43. The Notice provided that any such regulations would be effective for distributions made after January 19, 2005").

[19] An example of such a transaction might involve a partnership composed initially of two corporations that are members of a single consolidated group. Corp. A contributes Asset A with a basis and value of $1,500 to the partnership; Corp. B contributes Asset B with a basis of $1,200 and a value of $1,500. Three years after the partnership's formation, when the values of the assets have remained the same, Corp. C, also a member of the consolidated group, invests $3,000 for a 1/2 interest in the partnership. The cash is used to purchase a non-depreciable capital asset. Five years later (eight years after the partnership's formation), and in preparation for a sale of Asset B, Asset B is distributed by the partnership to Corp. A in liquidation of Corp. A's interest in the partnership. As Corp. A takes a basis in Asset B of $1,500, its basis for its interest in the partnership, section 734 may require a $300 step down in basis for the partnership's remaining assets. However, if Corp. C now transfers its interest in the partnership to Corp. D, also a related party, at a time that the partnership has a section 754 election in effect, Corp. D will be entitled to a basis increase with respect to the partnership's assets. The net result of the transaction is that Asset B is sold at no gain, but a substantial portion of the downward basis adjustment is nullified.

IV. Proposed TOI Regulation

A. Retroactivity

1. Summary

The proposed effective date of the new disclosure requirements is "the date the regulations are published as final regulations in the Federal Register."[20] Neither the Proposed Regulation nor the Supplementary Information accompanying it addresses explicitly whether the disclosure requirements would apply to transactions implemented before the proposed effective date, but that result in basis adjustments recovered by depreciation or amortization or by reduced gain on the disposition of property after that date. However, the conclusion that the disclosure requirements do apply to such transactions, and perhaps even more broadly, may be drawn by combining:

- the proposed rule stating that a party may "participate" in a TOI in any taxable year in which its tax return reflects the tax consequences of a basis increase resulting from a TOI;[21] and

- the rule that, if a transaction becomes a TOI even after filing of a taxpayer's tax return reflecting the taxpayer's "participation" in the TOI and before the end of the period of limitations for assessing tax for the year of such participation, a disclosure statement must be filed within 90 days after the date on which the transaction becomes a TOI.[22]

The Supplementary Information explicitly states that material advisors would be required to disclose only if they have made a relevant "tax statement" within six years prior to the date on which final Regulations are published,[23] thereby implying that statements within that prior six-year period may trigger a reporting obligation.

2. Discussion

The retroactivity issues under the Proposed TOI Regulation are similar to those under the Notice, in that they each presents serious difficulties in identifying transactions and benefits that may be covered. They differ, however, in that the Proposed TOI Regulation simply imposes reporting requirements regarding transactions of which Treasury and the IRS have an

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20 Prop. Treas. Reg. § 1.6011-18(h) ("This section's identification of transactions that are the same as or substantially similar (within the meaning of § 1.6011-4(c)(4)) to the transactions described in paragraph (c) of this section as transactions of interest for purposes of § 1.6011-4(b)(6) and sections 6111 and 6112 of the Code is effective on the date the regulations are published as final regulations in the Federal Register.")

21 Prop. Treas. Reg. § 1.6011-18(e)(5).

22 Prop. Treas. Reg. § 1.6011-18(e)(5). 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).

23 See Supplementary Information (p. 35) ("[n]otwithstanding § 301.6111-3(b)(4)(i) and (iii), material advisors would be required to disclose only if they have made a tax statement on or after six years before the date of the Treasury decision adopting these regulations as final regulations is published in the Federal Register").

appropriate and reasonable interest in becoming apprised of so that they may be challenged. As such, we support some retroactive application of the new disclosure rules.

However, exactly as noted with respect to the Notice, many transactions that would become TOIs under the proposed retroactive application of the Proposed TOI Regulation relied on the well-settled application, in the years in which the transactions were effected, of longstanding provisions of subchapter K of the Code. Taxpayers have prevailed in litigation when these transactions were challenged by the IRS, even when transactions were planned with an eye toward the existing rules of the Code and Regulations.[24] Moreover, such transactions are often planned by taxpayers' regular tax advisors—not syndicated or marketed—and they affect real world restructurings, with real economic effects of existing *bona fide* business entities. Thus, they are quite different from the typically "one off" transactions that predominate on the rosters of listed transactions and transactions of interest.[25]

Identifying those basis adjustment transactions that arise from a TOI will entail a fact-intensive inquiry of transactions from the last many years, and taxpayers and, even more so, their advisors[26] often will have no ready way of now recalling or identifying transactions that may fit within the Proposed TOI Regulation's definition but happened years ago. This will be particularly so where advisors have died or retired, firms have dissolved or merged, and so on. For example, if a transaction that resulted in a positive basis adjustment to commercial or industrial real property occurred 30 or more years ago, a participant might have to attach a Form 8886 to its tax return for any taxable years for which the period of limitations is still open when and if the Proposed TOI Regulation are finalized in the mid-2020s.

3. Recommendation

In order to mitigate these concerns, we believe that identification of TOIs affected by the Proposed Regulation should apply with extremely limited retroactivity (such as to transactions effected on or after January 1, 2023, and then only with the further modifications described below). This will reduce the number of taxpayers and advisors who are unfairly surprised to learn that transactions they effected years ago, and may no longer remember, have suddenly become reportable and the burden that would otherwise be imposed on them to analyze many years of prior transactions.

If and when information garnered from reporting that is made under the Proposed TOI Regulation, when finalized, and from appropriate audits of partnership transaction identifying

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24 See note 16, above.

25 As of the date of this Report, there are six types of TOIs. See, e.g., Notice 2015-74 (basket contracts); Notice 2017-8 (section 831(b) micro-captive insurance transactions); Notice 2007-72 (contribution of successor member interest).

26 We acknowledge the self-interest that members of the Tax Section have in limiting the reporting burden imposed on material advisors. On the other hand, it is our personal experience in advising on transactions of this (or similar) kind that makes it possible for us to state with assurance that it is worse than impractical to expect many professionals to construct a list of transactions that occurred even three years ago that may come within the scope of a retroactive reporting requirement. Even were records to be readily available and the relevant transactions easy to identify, changed client relationships, considerations of privilege and conflict of interest, and similar circumstances may stand in the way of obtaining needed information.

particular circumstances that tend to make transactions actually abusive, rather than merely "of interest," additional reporting requirements can be considered.[27]

B. $5 Million Threshold Requirement

1. Summary

Reporting under the Proposed TOI Regulation is generally not required unless a "$5 million threshold is met." The proposed rules define the $5 million threshold:

> For the purpose of determining whether a transaction is described in paragraph (c)(1), (c)(2), (d)(1), or (d)(2) of this section, the $5 million threshold is met for a taxable year if the sum of all basis increases resulting from all such transactions of a partnership or partner during the taxable year (without netting for any basis adjustment in the same transaction or another transaction that reduces basis) exceeds by at least $5 million the gain recognized from such transactions, if any, on which tax imposed under subtitle A is required to be paid by any of the related partners (or tax-indifferent party, in the case of a transaction described in paragraphs (d)(1) and (2) of this section) to such transactions.[28]

The explanation in the Supplementary Information states that "[a] threshold of $5 million of basis increases in a taxable year to which no corresponding tax is paid should be sufficiently large to capture the situations that use the provisions of subchapter K to produce significant tax benefits with little to no economic impact."[29]

2. Discussion

The $5 million threshold requirement, as written, sweeps too broadly in several ways.

First, the threshold amount is set too low, especially in the context of past transactions. The dollar amounts involved in real estate development and ownership, securities investment, and many other industries commonly conducted in partnership form are often much larger than $5 million, and the potentially distortive effect of ignoring negative basis adjustments highlights the need for a threshold that will sweep in only transactions worthy of potential scrutiny. Moreover, as a matter of tax administration, we question whether it is worthwhile to treat every transaction accompanied by a gross basis increase of $5 million or more as reportable, since the volume of paperwork generated likely would be staggering—even more so, for transactions completed in years past—and the instances of tax abuse could be few to the extent it is detected.

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[27] Additional sources of information are questions recently added to the 2023 versions of Forms 1065 and 1120 regarding basis adjustments and recently issued draft Form 7217 (Distributions From a Partnership of Property With Partner Basis Adjustments), and these might be expanded, albeit carefully, to ask about basis recovery attributable to pre-2024 transactions.

[28] Prop. Treas. Reg. § 1.6011-18(c)(3).

[29] See REG-124593-23, 89 FR 51476.

The setting of a dollar threshold is necessarily arbitrary, and a wide range of amounts, some as large as $1 billion, and some significantly smaller, is used to distinguish "large" transactions and taxpayers from others throughout the Code. Weighing competing considerations of administrability, fairness, expectations of inflation, and the need to collect information to combat tax abuse, we recommend that the threshold amount be increased to $10 million in the case of future transactions; however, in the case of past transactions, where the burden of identifying transactions and evaluating whether they are reportable is much greater, we recommend a threshold of $50 million.[30]

Second, as written, the threshold seems to encompass all basis increases, including those enjoyed by unrelated persons. Specifically, the phrase "the sum of all basis increases from all such transactions of *a* partnership or partner" contains the indefinite article "a" in modifying the partnership or partner. On the other hand, and quite logically, only gain recognized "by any of the related partners" is taken into account in determining the extent to which basis increases exceed the gain recognized. We believe that the basis increases taken into account should be similarly limited to those the burden of basis decrease corresponding to which is borne by related parties, which are the only ones offering a potential for abuse in this context.[31] These principles are illustrated in this example.[32]

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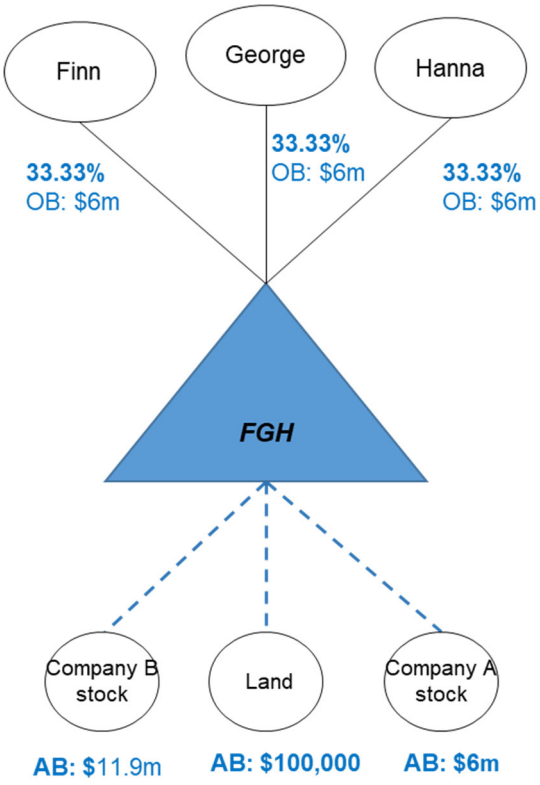
30 The dollar thresholds for reportable "loss transactions" under Treas. Reg. § 1.6011-4(b)(5) are set below this level, but those thresholds are more than 20 years old and have never been adjusted for inflation.

31 The Supplementary Information hones in on related parties, the "net tax benefit to the related parties" and the "related party group as a whole" that enjoy the tax benefits. REG-124593-23, 89 FR 51476 (pp. 16-17) ("Whether the tax benefits are received directly or indirectly, the resulting decrease in taxable income or gain (or increase in taxable loss) benefits the related-party group as a whole. Further, because the partners are related, the distributions or transfers may have little or no effect on the overall economic ownership of the property yet produce significant tax benefits shared by the related partners. . . . [F]or related parties, basis can be manipulated to provide a material net tax benefit to the related parties"). Moreover, the proposed substantive rules regarding basis increases outlined in the Notice would generally apply only to the extent of basis decreases to related parties, and not to the extent of basis decreases to unrelated (not-tax-indifferent) parties.

32 Moreover, the suggested clarification (in addition to the suggestion to the "related" party definition below) would ensure that a partner that is a partner in multiple unrelated partnerships would not have to aggregate all of the basis increases unrelated to any one particular partnership.

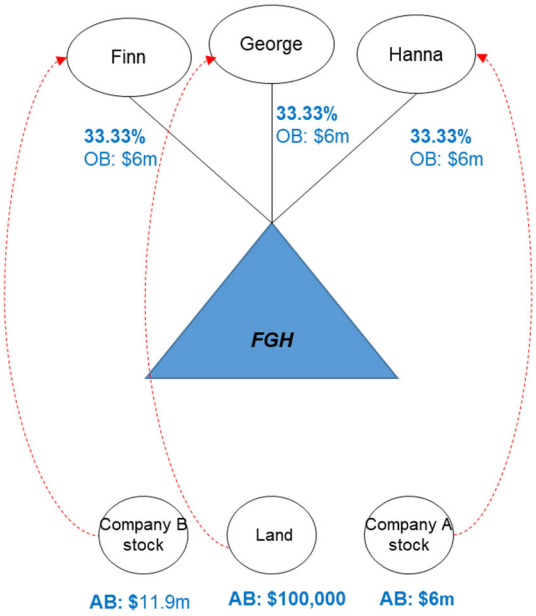


FGH Partnership ("FGH") is owned by three individual partners Finn, George, and Hanna, each of whom contributed $6 million in cash and owns a one-third capital and profits interest in FGH. George and Hanna are siblings and thus "related partners"; Finn is not related to either George or Hanna.

FGH uses the $18 million in cash proceeds to acquire three assets: Land for $100,000, Stock in Company A for $6 million, and Stock in Company B for $11.9 million. None of the assets is depreciable, nor is any an unrealized receivable or an inventory item. FGH has a cost basis in each asset.

The Land appreciates to $6.1 million, the Company A Stock appreciates to $6.1 million, and the Company B Stock depreciates to $6.1 million. There has been a net increase of $300,000 in total value of the FGH's assets. (*i.e.*, they are collectively worth $18.3 million)

In liquidation of the partnership, FGH distributes the Land to George, the Company A Stock to Hanna, and the Company B Stock to Finn.



The basis in the Land is stepped up from $100,000 to $6 million in George's hands (a positive basis adjustment of $5.9 million), while the basis of the Company A Stock remains unchanged at $6 million in Hanna's hands. The basis of the Company B Stock is stepped down from $11.9 million to $6 million in Finn's hands (a negative basis adjustment of $5.9 million). This downward adjustment seems to be ignored for purposes of the Proposed TOI Regulation. Given Hanna and George's status as "related partners" and the basis step up in the Land of $5.9 million, the distributions to them seem to constitute reportable TOIs under the Proposed Regulation, even though there is a basis decrease to an unrelated party with whom there would presumably be arm's length bargaining—a result that we consider inappropriate.

3. Recommendations

We recommend increasing the threshold to $10 million prospectively and to an amount in the range of $50 million to $100 million retroactively and clarifying that only basis increases the burden of the basis decreases corresponding to which are borne by related parties are taken into account. We also suggest that where only a small portion (perhaps 10%) of an overall basis decrease impacts parties related to those enjoying basis increases, or, conversely, only a small portion of an overall basis increase is enjoyed by parties related to those bearing a basis decrease, the new rules should not apply. For example, if partners, related one to the other, own interests aggregating 10% or less in a partnership without special allocations, section 704(c) differences, and similar items, a distribution to one of the related partners ought not to be a TOI.

We do not object to the Proposed TOI Regulation's aggregating of multiple transactions during a taxable year and ignoring of offsetting negative basis adjustments in determining whether a transaction meets the threshold. Moreover, if multiple partnerships that are "related" under the standards discussed below engage in transactions during a single taxable year giving rise to upward basis adjustments, those adjustments should be aggregated for purposes of the threshold.

C. Definition of "Relatedness"

1. Summary

The Proposed TOI Regulation defines "related" as "having a relationship described in section 267(b) of the Code (without regard to section 267(c)(3)) or section 707(b)(1) of the Code."[33] The relatedness requirement may be met either immediately before or immediately after a basis shifting transaction.

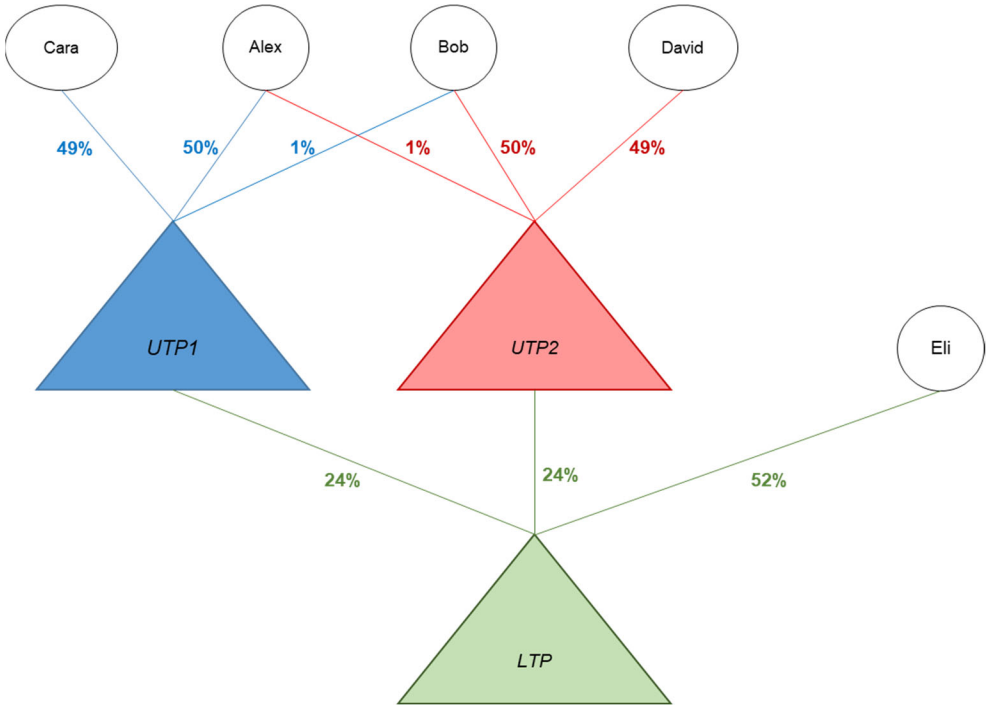
The relationship described in section 707(b)(1)(B) is between "two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests." Similar language is used in section 267(b)(10), (11), and (12) to describe the relationship between a corporation and a partnership, an S corporation and another S corporation, and an S corporation and a C corporation, respectively. The constructive ownership rules of section 267(c) apply for these purposes, except that section 267(c)(3) does not apply for purposes of section 707(b)(1)(B). The constructive ownership rules treat an individual as being related to that individual's brothers and sisters, spouse, ancestors, and lineal descendants.

Because section 707(b)(1)(B) and sections 267(b)(10), (11), and (12) focus on aggregate ownership of all common owners of the two entities, those provisions may create relationships when there is, in reality, almost no commonality of interest.

2. Discussion

We believe that this definition of relatedness, without further modification, is too broad to be appropriately applied for purposes of the disclosure requirements. Consider this example.

[33] Prop. Reg. § 1.6011-18(b)(8).



UTP1 Partnership ("UTP1") is owned by three individual partners Alex, Bob, and Cara. Alex holds a 50% interest in the capital and profits of UTP1; Bob holds a 1% interest; and Cara holds the remaining 49% interest. None of the partners of UTP1 are related.

Alex and Bob also own interests in another partnership, UTP2, along with a third individual partner, David. Alex holds a 1% interest in the capital and profits of UTP2 Partnership; Bob holds a 50% interest; and David holds the remaining 49% interest.

LTP Partnership ("LTP") is owned by three partners, including the two partnerships, UTP1 and UPT2, as well as an individual partner, Eli. Each of the UTP1 and UTP2 holds a 24% interest in the capital and profits of LTP. Eli holds the remaining 52% LTP interest and manages the LTP. LTP distributes property to UTP1 in liquidation of UTP1's partnership interest in LTP. Assume that such distribution results in a $5 million basis increase to the distributed property in the hands of UTP1 and in a $5 million basis decrease to the remaining property of LTP.

Under section 707(b)(1)(B), two partnerships are "related" if the "same persons" own, directly or indirectly, more than 50 percent of the capital or profits interests. Here, UTP1 and UTP2 are considered "related" because "the same persons"—Alex and Bob—collectively own more than a 50 percent interest in both partnerships, even though the actual common cross-ownership is only 2 percent. Thus, even if a partnership has substantially unrelated partners, transactions that results in a positive basis adjustment could be covered by the Proposed Regulation.[34]

[34] Indeed, one could layer in the "family attribution" rules of section 267(c) in this example and find that the partnerships were related even though they had no actual overlapping ownership at all.

3. Recommendation

The goal of the Proposed TOI Regulation is to alert the IRS to transactions in which what may sometimes be viewed as an improper tax benefit is being enjoyed within a group that does not have adverse interests. Sections 707(b)(1)(B) and 267(b)(10), (11), and (12), because of their failure to take into account the actual amount of overlapping ownership, are inappropriate tools for identifying such transactions.

We recommend that the definitions in those provisions be modified for this purpose to incorporate the concept found in Code section 1563(a)(2) (and incorporated by reference to that section elsewhere in the Code) of "taking into account the stock ownership of each person only to the extent such stock ownership is identical with respect to each such corporation." Thus, for purposes of the Proposed TOI Regulation, section 707(b)(1)(B) would be applied as though it read, "two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests, taking into account ownership of capital interests or profits interests only to the extent such ownership is identical with respect to each such partnership," and corresponding modifications would be made for purposes of applying section 267(b)(10), (11), and (12).

We also recommend that, as is the case under section 1.752-4(b)(1)(ii), a person's family for purposes of the Proposed TOI Regulation should be determined by excluding brothers and sisters. While individuals may frequently view themselves and their descendants as a single economic unit, it is our experience that siblings often have contentious business relations and are far less likely to confer large gratuitous economic or tax benefits one on the other.[35]

D. Material Advisors

1. Summary

[35] We note the existence of a technical oddity in the definition of "related partners" that applies for purposes of the rules governing transfers of partnership interests. That definition reads, "In the case of a transaction described in paragraph (c)(2) of this section, the transferor of a partnership interest is related to the transferee, or the transferee is related to one or more of the partners in the partnership, immediately before or immediately after a transaction described in paragraph (c)(2) of this section." Assume that each of A, B, and C owns a 1/3 interest in Partnership ABC. There is no relationship between any of the partners. If A transfers A's interest in the partnership to C, whether in a nonrecognition transaction or in a recognition transaction, the transaction is not a TOI (so long as the transaction itself does not create a relationship between A and C). However, if A transfer's A's interest in the partnership to D, who is a related party with respect to C, the transaction appears to be a TOI if the dollar threshold is met. We perceive no sound basis for this distinction, and we recommend that A's transfer to D be treated exactly as would have been a transfer to C.
Similarly, section 1.6011-18(b)(9)(i) captioned, “Related Partner,” provides that, for purposes of section 1.6011-18(c)(1), the term includes “partners of a partnership that are related in the following manner: … the partnership has two or more direct or indirect partners that are related immediately before or immediately after [the (c)(1) transaction].” Does this mean that if *any* two partners in the partnership are related before or after a (c)(1) transaction, *all* partners in the partnership are considered “Related Partners”? This could not have been intended, and we recommend that the text of the Proposed TOI Regulation be revised to make this clear.

Each material advisor with respect to any reportable basis shifting TOI is required to file a report and maintain a list with respect to the transaction. Under the current rules, a practitioner becomes a material advisor, by among other requirements, making a tax statement to a taxpayer. *See* Treas. Reg. § 301.6112-1(c)(2)(i). Failure to comply with this requirement may result in imposition of a substantial penalty on the advisor under section 6707A; there is no generally applicable "reasonable cause" exception to application of that penalty.

2. Discussion

The Proposed Regulation imposes filing requirements on a potential material advisor by reference to information that may not be available to that person. For example, an advisor may make a tax statement with respect to a transaction that gives rise to a gross positive basis adjustment of $3,000,000. During the same taxable year, the same taxpayer, working with another advisor (or with no advisor), may engage in another, separate transaction that gives rise to an additional gross positive basis adjustment of $4,000,000. The first advisor lacks the knowledge and capacity to determine if the taxpayer has done other transactions—let alone to ascertain whether or not there is an applicable reporting requirement.[36] Moreover, an advisor, in many cases, may not have full information regarding the magnitude of a basis adjustment.

3. Recommendation

We recommend that the Proposed TOI Regulation add an "actual knowledge" qualifier for material advisors, such that advisors would be required to disclose and list only those transactions that would be reportable transactions to their actual knowledge. We do not object to putting material advisors with actual knowledge of the occurrence of a transaction to the obligation of exercising due diligence to ascertain the magnitude of positive basis adjustments arising from such transactions.

V. CONCLUSION

We commend Treasury for providing the comprehensive guidance package regarding the partnership related-party basis adjustment transactions. However, we respectfully request that Treasury reconsider the retroactive application of the Notice and modify the Proposed Regulation to incorporate the suggestions set forth in this Report.

[36] If our recommendation to increase the dollar thresholds is adopted, the numbers in this example should be correspondingly changed.