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Final Regulations Issued for Certain Partnership Related Party Basis Adjustment Transactions

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Introduction

On January 10, 2025, the Treasury Department and the U.S. Internal Revenue Service (the “IRS”) released final regulations (the “regulations”) classifying certain partnership related party basis adjustment transactions and substantially similar transactions as transactions of interest, a type of reportable transaction, which requires disclosure for the taxpayer and its material advisors. The regulations finalize proposed regulations issued in June 2024.

These regulations were issued to require disclosure of transactions that the IRS viewed as objectionable from a policy matter. These transactions often involve distributions of appreciated property from a partnership among related partners under circumstances where the partnership would get a stepped-up basis in its remaining property without any tax cost to the distributee partner or the distributee partner has a step up in basis without cost to the remaining related party partners. However, the regulations also apply to transactions that do not present the same tax policy issues. Although the regulations generally will not apply to funds (which generally do not make section 754 elections and generally avoid having a substantial basis reduction), they could apply to continuation funds, restructuring of funds and fund investments (including as a result of distributions in-kind) and liquidations of splitters owned by blockers and transfers among related parties of interests in funds. The regulations can in certain cases apply retroactively for six years (generally covering transactions occurring on or after January 1, 2019 for partnerships and partners with the calendar year as its tax year).

The regulations apply only to transactions where the total stepped-up basis increases from all transactions engaged in by the same partner or partnership during the taxable year (generally without netting for any basis adjustment that results in a basis decrease in the same transaction or another transaction), reduced by the gain recognized, if any, on which income tax is imposed, equal or exceed **$10 million** for transactions occurring after the "six-year lookback period" (as discussed below), and **$25 million** for transactions that occurred during the "six-year lookback period".

Penalties may be up to $50,000/transaction/participant. Because the penalties are severe and the regulations apply retroactively for six years (and memories may be fuzzy), we expect that many taxpayers and material advisors will "protectively" report many past transactions that in fact are not covered by the regulations.

The regulations largely adopt the proposed regulations but include an increased threshold for basis increases, the limited six-year retroactive lookback window, additional time for reporting, certain exclusions for publicly traded partnerships, and a narrowed scope of reporting for transfers between related transferors and transferees. As described above, the threshold amount is $25 million for transactions occurring within the six-year lookback period (discussed below) and $10 million for transactions occurring after the six-year lookback period.

This blog explains the transactions that the regulations target, the common and innocuous transactions they also seem to cover, and the consequences if a taxpayer enters (or has entered into) one of the transactions.

Background

Under section 734(b)(1),[1] if (i) a partnership has a section 754 election in place, (ii) the partnership distributes property to a partner, and (iii) the adjusted basis of the distributed property immediately before the distribution exceeds the partner's adjusted basis in its partnership interest, the partnership must increase its basis in its remaining assets. In this situation, because the redeemed partnership has "lost basis" in the distributed asset (and the redeemed partner has not increased its basis), the partnership is permitted to increase its basis in its remaining assets to avoid "double gain".

Under section 732(b), if a partner receives appreciated assets in complete liquidation of the partner's interest in a partnership, the partner's basis in the assets is generally equal to the adjusted basis of the partner's interest in the partnership, reduced by any money distributed in that same transaction.[2] Thus, if the partnership's basis in the asset is less than the partner's outside basis, the partner will receive the asset with a basis that is "stepped up" to the partnership's outside basis. This basis step-up also avoids double gain.

Under section 732(d), if a partnership does not have a section 754 election in place, a partner acquires an interest in the partnership, and the partner receives a distribution of property within two years after the partner acquired the partnership interest, the partner can elect to adjust the basis in the distributed property to what it would have been had the section 754 election been in place.

Under section 743, if a partnership has a section 754 election in place, and a partnership interest is transferred, the partnership adjusts the basis of its assets so that it is equal to the transferee's basis in its partnership interest.

Each of these adjustments are designed to avoid possible "double gain." However, where the partners are related and a distributee partner will not be subject to tax with respect to the distributed property, or a transferor of a partnership interest will not be subject to tax on the transfer, these sections can be used to create tax basis for the remaining partners (or the transferee).

For example, assume that elderly parents own 50% of a real estate partnership and their children own the other 50%. The partners have a zero basis in their partnership interest, and the partnership has a zero basis in its property, but the property has high fair market value. The partnership has a section 754 election in place. The partnership borrows funds, uses those funds to purchase an asset and distributes the asset to the parents in redemption of the parents' interest in the partnership. The parents will have a zero basis in the asset and, were the parents to sell the asset, they would have gain.[3] However, the parents will hold the asset and receive a stepped-up basis on their death. Under section 734(b)(1), the partnership will get a stepped-up basis in its real estate equal to the fair market value of the distributed asset over the parents' outside basis (zero), which the partnership could depreciate or use to offset gain on the sale of the property.

While this transaction complies with the relevant tax rules, the IRS views the result as objectionable as a tax policy matter because the children will get a stepped-up basis but the parents will not pay tax (by reason of the stepped-up basis at death).

Transactions of Interest

The following transactions are discussed in the regulations as transactions of interest:

- **Situation 1 (Section 734(b)):** A partnership distributes property to a person who is a related partner in a current or liquidating distribution, the partnership increases the basis of one or more of its remaining properties under section 734(b) and (c) and the $10 million or $25 million threshold is met. A related party in this situation means two or more direct partners of a partnership that are related (within the meaning of section 267(b) (without regard to section 267(c)(3)) or section 707(b)(1), generally a 50% test) immediately before or immediately after the relevant transaction.
- **Situation 2 (Section 732(b)):** A partnership distributes property to a person who is a related partner in liquidation of the person's partnership interest (or in complete liquidation of the partnership), the basis of one or more distributed properties in increased under section 732(b) and (c) and the $10 million or $25 million threshold is met. A related party in this situation means two or more direct partners of a partnership that are related (within the meaning of section 267(b) (without regard to section 267(c)(3)) or section 707(b)(1)) immediately before or immediately after the relevant transaction.
- **Situation 3 (Section 732(d)):** A partnership distributes property to a person who is a related partner, the basis of one or more distributed properties is increased under section 732(d), the related partner acquired all or a portion of its interest in the partnership in a transaction that would be a transaction described in Situation 4 if the partnership had a section 754 election in effect for the year of the transfer and the $10 million or $25 million threshold is met. A related partner in this situation means two or more direct partners of a partnership that are related (within the meaning of section 267(b) (without regard to section 267(c)(3)) or section 707(b)(1)) immediately before or immediately after the relevant transaction.
- **Situation 4 (Section 743):** A partner transfers an interest in a partnership to a related partner in a nonrecognition transaction, the basis of one or more partnership properties is increased under section 743(b)(1) or (c) of the Code and a predetermined threshold is met. A transferor and transferee of a partnership interest are related for purposes of this situation if they are related (within the meaning of section 267(b) (without regard to section 267(c)(3)) or section 707(b)(1)) to each other immediately before or immediately after the relevant transaction.

Substantially Similar Transactions

The Final Regulations also cover “substantially similar transactions.” These transactions include any transaction that is the same or substantially similar to one of the types of transactions described above. Transactions are generally “substantially similar” if they are expected to obtain the same or similar types of tax consequences or are factually similar. The regulations specifically provide that a transaction is substantially similar if the partners are not related, but one or more partners are “tax-indifferent parties” that facilitate an increase in the basis of partnership property by receiving a distribution of property from the partnership or having a share of a corresponding decrease to the basis of partnership property, and the $10 million or $25 million threshold is satisfied. The transfer of a partnership interest in a partnership with a section 754 election by a tax-indifferent party is not specifically listed as substantially similar. A tax-indifferent party is, in general, a person that is either not liable for federal income tax by reason of the person’s tax-exempt status or foreign status, or to which any gain that would have resulted from a transaction (that is described in Situation 1 or Situation 2 except that the partners are not related and one or more of the partners is a tax-indifferent party) if the property subject to the basis decrease in such transaction were sold immediately after such transaction would not result in federal income tax liability, and whose status as a tax-indifferent party is known or should be known to any other person that participates in the transaction or to a partner in a partnership that participates in such a transaction. As a result, a transaction would be substantially similar if it is described in Situations 1 and 2 above, except it involves a tax-indifferent party (instead of related partners) and that status was known or should have been known.

Common Transactions

While these regulations are focused on the transactions described above, given their broad scope, the regulations may apply to many basic transactions and impose significant compliance burdens. Certain common transactions that may be covered by the regulations include the following:

- **Liquidations of “splitter” partnerships:** Assume a fund sets up a “splitter” partnership for non-U.S. investors. The partners of the partnership are a U.S. corporation and a non-U.S. corporation owned by the non-U.S. feeder. At the end of the fund, the partnership liquidates and distributes assets to the U.S. corporation. The U.S. corporation’s basis in the partnership exceeds the partnership’s basis in its assets by more than $10 million. In this case, the U.S. corporation will receive a stepped-up basis by more than the $10 million threshold, and the two corporate partners are related to each other because they are owned by the same investors. The distribution is a transaction of interest under the regulations.
- **Certain continuation fund transactions:** An existing fund (“Fund 1”) is at the end of its life and one of its remaining assets is an interest in a partnership (the “Investment”). Fund 1’s basis in its interest in Investment exceeds its share of Investment’s basis in its assets. Investment has section 754 elections in place. Fund 1 contributes Investment to a new fund (“Fund 2”) in exchange for interests in Fund 2 and Fund 1 distributes Fund 2 interests to Fund 1’s partners in liquidation of Fund 1. Assume that more than 50% of the partners in Fund 1 “rollover” to Fund 2. This is a “Situation 2 (Section 732(b)) transaction”: Fund 1’s investors will receive a stepped-up basis, and they are “related” to Fund 2’s investors. If the basis step up exceeds to $10/$25 million threshold, the distribution will be a transaction of interest.
- **Liquidation of a partnership AIV in connection with a blocker sale:** A fund forms a partnership AIV to purchase a partnership portfolio company. The AIV is owned more than 50% by a blocker corporation and the balance is owned by the fund. The AIV and the portfolio company make section 754 elections. Subsequently, a buyer agrees to purchase the blocker

and the AIV's interest in the portfolio company but does not wish to acquire the AIV. Therefore, the AIV distributes the portfolio company to the fund and the blocker in liquidation, and the buyer purchases the blocker and the remaining interests in the portfolio company. The AIV's basis in the portfolio company with respect to the blocker is more than $10 million greater than the blocker's basis in the AIV. Because the blocker owns more than 50% of the AIV, they are related parties. Therefore, the distribution is a transaction of interest.
- **Distribution by a partnership owned by consolidated group members**: Assume two members of a consolidated group set up a partnership. The partnership distributes assets to one of the members. The recipient partner's basis in the partnership exceeds the partnership's basis in its assets by more than $10 million. In this case, the recipient partner will receive a stepped-up basis by more than the $10 million threshold, and the two corporate partners are related to each other because they are members of a consolidated group. The distribution is a transaction of interest under the regulations.
- **Distribution by an Up-REIT partnership to its REIT:** Assume a REIT distributes an asset to its REIT member. Assume that the asset is a capital gain asset, and the REIT's basis in the partnership exceeds the partnership's basis in its assets by more than $10 million. Although not entirely clear, the REIT may be a tax-indifferent party (because a tax-indifferent party is a person that is not liable for federal income tax and a REIT that designates a distribution as a capital gain dividend is not subject to tax on the capital gains). If so, the distribution would be a transaction of interest under the regulations.

Lookback Rule

The regulations require a taxpayer to report a transaction that was entered into prior to the publication of guidance identifying a transaction as transaction of interest. Many transactions that could be covered by the new rules would cause completed, non-abusive transactions that were done in accordance with law existing at such time to be treated as transactions of interest. Under the regulations, a participant of a transaction of interest must provide the information described in the regulations if the transaction of interest occurred within a six-year lookback period. This lookback period means the seventy-two months immediately preceding the first month of the taxpayer's most recent taxable year that began before the date of publication of the regulations in the Federal Register. Taxpayers have 180 days from the publication of the regulations to file disclosure statements for transactions of interest in open tax years for which a tax return has already been filed and that fall within the six-year lookback period. Material advisors have an additional 90 days beyond the regular reporting deadline (which is generally the last day of the month that follows the end of the calendar quarter in which the advisor became a material advisor with respect to the transaction) to file the disclosure statements for transactions made prior to the publication of the regulations.

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[1] All references to section numbers are to the U.S. Internal Revenue Code of 1986, as amended.

[2] "Marketable securities" are generally treated as cash for these purposes unless the partnership is an "investment partnership" and the partner is an "eligible partner". See sections 731(a), 731(b), and 731(c)(3)(A)(iii).

[3] Under section 752(a), the parents' basis in the partnership would increase by their share of the borrowing and then decrease when they are relieved of it, so the liability would have no effect on them.

Rita N. Halabi & Maggie Livingstone also contributed to this article.

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