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Monte A. Jackel practices tax law at Jackel Tax Law (jackeltaxlaw.com) and is an adjunct professor of law at the Catholic University of America Columbus School of Law.

In this article, Jackel reviews a recently released chief counsel advice memorandum regarding special basis adjustments stemming from intercompany tax-free transactions between consolidated group members.

Introduction

The IRS recently issued ILM 202240017 to supplement an earlier chief counsel advice memorandum, ILM 201726012, concerning a putative section 743(b) adjustment created by an intercompany tax-free section 332(a) or section 368(a)(1)(A) and (D) transaction between consolidated group members.[1] Section 743(b) authorizes a special basis adjustment if a section 754 election is made for a sale or exchange of a partnership interest (or there is a substantial built-in loss) and the transferee partner's outside basis in the partner's partnership interest is more or less than that partner's share of partnership inside tax basis.

From what has been revealed publicly in the internal legal memoranda, the IRS has not challenged the bona fides of the section 743(b) adjustment. Rather, apparently assuming a valid section 743(b) adjustment, the IRS[2] has asserted its position in the supplemental memorandum — over the taxpayer's objections — that in effect, a "one-sided intercompany transaction" can occur under reg. section 1.1502-13(c) because a section 743(b) special basis adjustment would otherwise arise in the hands of the transferee (buyer) as a corresponding adjustment without offsetting income to the transferor (seller) as an intercompany item.[3] That would then create a net loss to the consolidated group as a whole. That is not the stated purpose of the intercompany transaction regulations.[4]

The supplemental memorandum concluded that to achieve the goal of the intercompany transaction regulations (single entity treatment),[5] the section 743(b) adjustment attaching to the buyer's property needed to be treated as a nondeductible, noncapital expenditure under section 705(a)(2)(B) rather than as special tax basis to be used either to create or enhance tax depreciation to the partner with the special basis adjustment, or to increase loss on the sale of the asset to which the adjustment attached or to decrease or eliminate gain on the sale of the asset.[6] That adjustment was necessary to account for the elimination of the special basis under section 743(b).

[1] ILM 201726012 (original memorandum); ILM 202240017 (supplemental memorandum); reg. section 1.1502-13.

[2] Apparently as part of a so-called 30-day letter given the reference to a protest in the supplemental memorandum.

[3] A so-called one-sided intercompany transaction means a transaction between consolidated group members in which there is not both an intercompany item and a corresponding item.

[4] Reg. section 1.1502-13(a)(1) states that the purpose of those regulations is "to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability)." And reg. section 1.1502-13(b)(1) states that "an intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction."

[5] Reg. section 1.1502-13(a)(2).

[6] Reg. section 1.743-1(j); section 755.

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The supplemental memorandum also stated that in future consolidated return years, there was regulatory authority under reg. section 1.1502-13 to treat what would have been taxable income from the property in the hands of the buyer as if that gross (taxable) income were never included or realized under section 61.[7] That was necessary, it was argued, to avoid the overtaxation that would arguably occur from the intercompany transaction at issue in the group's future years. The supplemental memorandum rejected the taxpayer's argument that because this one-sided intercompany transaction isn't mentioned in reg. section 1.1502-13(c), it couldn't exist. The memorandum concludes that such a result (the lack of an intercompany item preventing the single entity matching rule from applying[8]) would frustrate the purpose of the intercompany transaction regulations.

Instead of conceding the bona fides of the special basis adjustment under section 743(b), as the IRS has apparently done, the adjustment should have been challenged as an anticipatory assignment of income or an equivalent type of item or, alternatively, as a transfer of no net equity if the facts would justify that result.[9]

The Section 743(b) Adjustment

The structure in the original memorandum was complex, but the gist was that in year 1, various members of a consolidated group formed a partnership solely among group members. Later, in year 6, property (actually stock) was distributed to two group member partners.[10] The original memorandum states that this distribution created a section 734(b) basis adjustment for all the partners. That fact makes clear that basis was stripped off the distributed stock and given to other partnership property under sections 734(b)(1)(B) and 732(a)(2). This distribution created reverse section 704(c) gain because of the revaluation of partnership property in that year.[11]

The original memorandum states that in year 9, the two corporate members who received the distribution in year 6 were merged or liquidated under section 332(a) or section 368(a)(1)(A) and (D). These transfers were properly treated as sales or exchanges for purposes of section 743(b).[12]

The transferee corporation in these types of nonrecognition transactions would take a carryover basis from the basis of the property held by the partially redeemed corporate members under section 362. If inside and outside partnership tax basis were the same, there would be no section 743(b) adjustment.[13] However, the distribution three years earlier in year 6 caused a reduction in the book capital accounts of the distributee-corporate member partners and created a substantial amount of reverse section 704(c) gain — that is, gain that is realized and recognized for book purposes only, not for tax purposes.

When the reverse section 704(c) gain (a large number) is subtracted from what the partners would receive in the liquidation (a substantially smaller number because it reflects the post-distribution book capital account), the share of inside tax basis is negative. At that point, the outside carryover tax basis will be substantially greater than the negative inside basis because it is a positive amount. This creates substantial positive section 743(b) special basis upon the in-form nonrecognition sale or exchange. This is so even though the fair market value of the transferred partnership interests in the original memorandum were undoubtedly substantially

[7] Section 1502 authorizes the issuance of consolidated return regulations and states that "the Secretary may prescribe rules that are different from the provisions of chapter 1 [federal income tax] that would apply if such corporations filed separate returns." *See also* reg. section 1.1502-80.

[8] Reg. section 1.1502-13(c).

[9] The failure to challenge the bona fides of the section 743(b) adjustment could simply have resulted from the failure to coordinate between the corporate division of Chief Counsel, which issued the supplemental memorandum, and passthroughs and special industries, which issued the original memorandum, but that is unknown at this time.

[10] Any potential issues under sections 732(f), the May Company regulations under reg. section 1.337(d)-3, or section 755(c) will not be addressed here.

[11] Reg. section 1.704-1(b)(2)(iv)(f) and (g), -1(b)(4)(i).

[12] Rev. Rul. 81-38, 1981-1 C.B. 386 (section 351 transfer); Rev. Rul. 87-110, 1987-2 C.B. 259 (section 361 transfer).

[13] Reg. section 1.743-1(d) measures inside basis as essentially the book capital account less gain that will be recognized in the future on the sale of the property to which the adjustment attaches. This amount, under the regulations, can be a negative amount.

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less than the reverse section 704(c) gain that traveled with those interests.[14]

Assignment of Income Principles Should Apply

The transfer of a partnership interest to either a controlled corporation or another partnership is ordinarily tax-free to both the transferor and the transferee under either section 351(a) or section 721(a).[15] However, in Rev. Rul. 84-115, a partner was due payment for prior services rendered to the partnership and thereafter transferred that partnership interest to another partnership for what the ruling states were valid business reasons. The IRS ruled that the assignment of income doctrine didn't apply, but the ruling was premised on there being a nontax business purpose for the transfer. The business purpose was not specified in the ruling. Without that business purpose, the transfer in the ruling would have been an anticipatory assignment of income.

It is an open question whether section 351 or section 721 would apply when no net value is transferred to the transferee corporation or partnership.[16] At a minimum, even without any added tax benefit, such as section 743(b), the otherwise tax-free transfer of property with no net equity would be risky and somewhat questionable.[17]

In a previous article, I stated:

> Case law supports the proposition that the literal statutory and regulatory language of the IRC and its underlying regulations can in effect be overridden by the common law economic substance doctrine. In one key and representative case, the Third Circuit stated:
>
>> While ACM's transactions, at least in form, satisfied each requirement of the contingent installment sale provisions and ratable basis recovery rule, ACM acknowledges that even when the "form of the taxpayer's activities indisputably satisfie[s] the literal requirements" of the relevant statutory language, the courts must examine "whether the substance of those transactions was consistent with their form," because a transaction that is "devoid of economic substance . . . simply is not recognized for federal taxation purposes."
>
> Should the same principle apply in the case of basis strips and basis shifting among related-party partners, especially when the tax benefits are obtained in a nonrecognition provision under the IRC? It would seem so. Approving transactions that would violate section 482 by its own terms if challenged when the related-party transaction literally meets the requirements of sections 732 and 734

[14] If the partnership interest that is transferred would constitute a built-in loss asset within the meaning of section 362(e), that statute could prevent the importation of the built-in loss by limiting the basis of the transferred partnership interest to its FMV (inclusive of the share of partnership liabilities attributable to the interest transferred). But the application of section 362(e) would not negate the ability to create a section 743(b) amount in the cases at issue here; only the amount of the adjustment may be affected. After all, the transfer of a partnership interest with a zero tax basis but negative inside basis would still generate a positive section 743(b) adjustment in otherwise nonrecognition transfers.

[15] Reg. section 1.704-3(a)(7) (transfer of partnership interests (and 1.704-3(a)(9)) relating to tiered partnerships) arguably implies that transfers of most partnership interests in otherwise nonrecognition transfers are tax-free, but of course, those rules never say that the transferor can move a large amount of deferred gain to the transferee on an otherwise tax-free transaction with a small value partnership interest.

[16] Monte A. Jackel and Nadine A. Holovach, "Contributions to No Net Equity Partnerships," *Tax Notes*, Jan. 30, 2012, p. 569. That article references former proposed section 351 no net equity regulations (REG-163314-03) ("The IRS and the Treasury Department recognize that the principles in the proposed rules under section 351 may be applied by analogy to . . . section 721, dealing with the contribution of property to a partnership in exchange for a partnership interest."). Those regulations were withdrawn in July 2017. REG-139633-08, 2017-31 IRB 175 (stating that current law would apply — whatever that is: "The Treasury Department and the IRS are of the view that current law is sufficient to ensure that the reorganization provisions and section 351 are used to accomplish readjustments of continuing interests in property held in modified corporate form."). Why was that true?

[17] *See* Emily L. Foster, "Treasury Report Adds to Confusion Over No Net Value Transactions," *Tax Notes*, May 28, 2018, p. 1365. The regulations proposed in 2005 stated a rationale for the net value requirement: "transactions that fail the requirement, that is, transfers of property in exchange for the assumption of liabilities or in satisfaction of liabilities [when no net value is transferred or received], resemble sales and should not receive nonrecognition treatment." Soon after withdrawal of the proposed regulations, Treasury issued a report stating that "removal of the proposed regulations provides certainty to corporate taxpayers that an exchange of net value is not required for many corporate transactions to be eligible for tax-free treatment." *See* Treasury, "Regulatory Reform Accomplishments Under President Trump's Executive Orders" (Apr. 24, 2018). It's unclear whether this is an authoritative Treasury statement that taxpayers can rely on.

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doesn't seem like something that Congress would endorse.[18]

When property that has a FMV substantially less than the deferred reverse section 704(c) future gain is transferred with the partnership interest to a related party of the taxpayer in an otherwise in-form nonrecognition transaction, it seems that this should be treated no differently from when actual debt or other contractual obligations exceed the value transferred with the partnership interest in such cases. In fact, some practitioners view the "small book capital account but large reverse section 704(c) amount" case as somewhat analogous to encumbered property, the transfer of which (subject to liabilities in excess of tax basis) is not an assignment of income or an otherwise taxable transaction.

Reg. section 1.752-7 treats transfers of property with contingent obligations (such as environmental potential obligations) attached thereto to partnerships as if the contingent obligation were built-in loss property with a basis of zero and a FMV of a negative amount equal to what someone would demand to receive in order to assume that obligation.[19] However, that transfer is not treated as an actual sale to the partnership at the time of transfer.

Similarly, results from a revaluation — the actual tax gain and liability that will match up with that book gain arising upon the book-up — have not yet arisen or accrued in the same manner as the classic assignment of income or "income in respect of a decedent" case. So the transfer of that property in an otherwise nonrecognition transaction isn't technically the same as the assignment of income cases in the classic sense.

On the other hand, the amount of potential tax gain allocable to those partners who received the book-up is fixed based on the valuations at that point in time. That gain will be realized and recognized in the future as the property is depreciated or is actually sold. In that sense, the liability for future tax gain is fixed subject to future valuation changes (that are presumably unknown at that time).

A similar situation arises in the case of the mid-contract change in taxpayer rules of reg. section 1.460-4(k) when a long-term contract is transferred by the taxpayer in an otherwise nonrecognition transaction. Under the principles of reg. section 1.460-4(k)(3), transfers of long-term contracts in some otherwise nonrecognition transactions (such as under sections 351 and 721) do not trigger the deferred revenue from the long-term contract not yet taken into income. However, this "step-in-the-shoes" treatment depends on the transfer qualifying under the designated nonrecognition transaction, which may not be the case if either the assignment of income or the no net value rules apply.[20]

If the future tax liability attributable to the reverse section 704(c) amount is treated as an actual debt or other contractual obligation, it would seem that the no net value issue would be present. However, the usual case would seem to be that the reverse section 704(c) amount would be deferred for as long as possible, perhaps even to the time of complete liquidation, whereas the section 743(b) amount would be available immediately to offset what would otherwise be taxable income. When the present value of the tax benefit created by the section 743(b) special basis adjustment is weighed against the future cost of the deferred tax detriment caused by the reverse section 704(c) amounts, there may be net positive value in the transfer. Most likely, given unrelated parties, that will be the case. But related-party transfers are much more prone to abuse because of the single economic aggregate interest in the transaction in those related-party cases.

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[18] Jackel, "Partnership Basis Shifting: A Desperate Need for Immediate Reform," *Tax Notes Federal*, Feb. 14, 2022, p. 961.

[19] *See also* reg. section 1.358-7. Proposed regulations under section 751(b) condone some transfers in which the reverse section 704(c) amount exceeds the remaining section 704(b) book capital account. REG-151416-06 (Nov. 3, 2014, corrected Jan. 26, 2015), prop. reg. section 1.751-1(b)(4)(i)(A)(1) (respecting a reverse section 704(c) amount that is no greater than four times the remaining book capital account).

[20] See Jackel, *supra* note 18 (discussing a case involving the transfer of specific long-term contracts and that the creation of a large reverse section 704(c) amount and a large section 743(b) adjustment was described as at issue at that time before the Tax Court). *See Otay Project LP v. Commissioner*, No. 6819-20 (T.C. 2021). Examples 11 and 12 of reg. section 1.460-4(k)(5) are most analogous to the transfer of a partnership interest with deferred income (even though the actual contract was transferred); in those regulation examples, the long-term contract that was transferred with its related rights and obligations had a positive net FMV in excess of the tax basis of the contract.

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Conclusion

How is a deferred reverse section 704(c) amount any different from the previously accrued income in the common law assignment of income cases?[21] Undoubtedly, the taxpayer will be able to set forth several nontax business reasons for the transfers in years 6 and 9 in the original memorandum.[22] But without regard to the tax benefits of the year 9 transfer in the memoranda, the obligation to pay the deferred reverse section 704(c) amount is moving the taxation obligation from one related-party partner to another.

Much like transfers of accounts receivable by a cash-method taxpayer in a putative section 351 transfer, a substantial nonfederal income tax business purpose may indeed be a prerequisite for a tax-free transaction.[23] Even the mid-contract change of taxpayer step-in-the-shoes rules[24] don't expressly authorize or condone an otherwise step-in-the-shoes transfer of a long-term contract when the tax liability transferred to the transferee of the long-term contract exceeds the FMV of that transferred contract.

That type of transfer seems to be the paradigm assignment of income transaction or a transaction similar or analogous to it, such as a transfer of no net equity. It should be expressly treated in the same manner and not be afforded tax-free nonrecognition treatment.[25] ■

[21] *Schneer v. Commissioner*, 97 T.C. 643 (1991).

[22] Rev. Rul. 80-198, 1980-2 C.B. 113 (transfer of accounts receivable by a cash-method taxpayer to a corporation in a putative section 351 transfer had a bona fide business purpose and was valid).

[23] *Id.*

[24] Reg. section 1.460-4(k)(3).

[25] This article doesn't address the application of the various statutory, regulatory, and common law anti-abuse rules or doctrines that could apply here. *See* section 7701(o) (codified economic substance doctrine); reg. section 1.701-2 (the partnership anti-abuse rule); and the common law doctrines of economic substance, substance over form, step transaction, sham, and business purpose.

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