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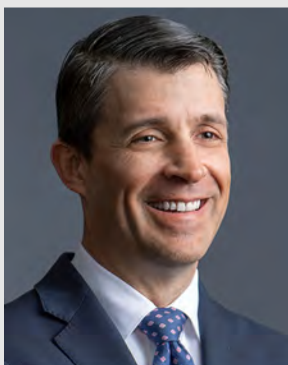
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In this article, the authors argue that because the regulations proposed in Notice 2024-54 and Rev. Rul. 2024-14 are substantively flawed, it is highly uncertain whether a court would uphold their validity or would see the revenue ruling as a helpful tool in addressing IRS challenges made before the regulations are issued.

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On June 17 the IRS issued FS-2024-21, announcing a special initiative by the Office of Chief Counsel to develop rules concerning partnership basis-shifting transactions. The transactions targeted by the IRS initiative involve distributions of property from partnerships or transfers of partnership interests as a result of which one or more partners may be entitled to claim additional depreciation for property held or distributed by a partnership or reduced gain in connection with a sale of that property.[1] The initiative includes the following guidance:

- Notice 2024-54, 2024-28 IRB 24 (the notice), previewing proposed regulations that would suspend basis adjustments in connection with certain specified partnership basis-shifting transactions;
- REG-124593-23, (the proposed regulations) proposing to treat certain partnership transactions as "transactions of interest," which would require the partnership, affected partners, and material advisers to report those transactions to the IRS; and
- Rev. Rul. 2024-14, 2024-28 IRB 18 (the revenue ruling), applying the economic substance doctrine to three scenarios concerning the related-partner basis-shifting transactions.

[1] FS-2024-21.



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## I. Background

In the guidance package, the IRS and Treasury articulated a concern about perceived abuse resulting from basis shifting in partnerships by related or unrelated but tax-indifferent parties (defined below in Section IV).[2] The perceived abuse the IRS is focused on generally involves tax-free transactions in which the tax basis of assets (usually depreciable assets or those intended for sale) is increased and corresponding adjustments are made to decrease the basis of other assets (typically nondepreciable assets). The guidance generally would suspend basis recovery on basis adjustments resulting from certain basis-shifting transactions involving related parties or unrelated but tax-indifferent parties. The guidance also would require partnerships, partners, and their material advisers to report transactions of interest that meet a certain threshold.

Although ostensibly targeting highly structured abusive transactions, the scope of these proposed rules appears much broader than the transactions of concern. In both the notice and the proposed regulations, the rules apply mechanically and do not consider the motivation of the taxpayers engaging in the relevant transactions. As a result, these proposed rules may apply to many routine and nonabusive partnership transactions having valid business purposes in which the tax consequences are clearly consistent with the intention of the IRC. Moreover, these proposed rules would apply retroactively to transactions engaged in years before their enactment if a taxpayer were to claim a benefit associated with the transaction in a tax period after the applicable effective dates of the rules. This approach would create extraordinary compliance challenges for taxpayers, requiring them to review prior transactions in open tax years to determine if the transactions could potentially be captured by these proposed rules and then determine whether to file amended returns to follow the proposed rules or stay the course and fight the rules upon a later challenge. If a basis-shifting transaction occurred today or in the past, taxpayers would be required to track disparities between the tax basis of property under the general rules of the code and the required adjustments made by the proposed rules and make adjustments if subsequent transactions occur to allow the suspended basis adjustment to be applied or eliminated.

An additional and noteworthy feature of the guidance package is its breadth. The guidance takes a tripartite approach in providing the IRS with tools to address the perceived abuses of partnership basis-shifting transactions, with the notice announcing future regulations to eliminate the tax benefits associated with the transactions, the proposed regulations requiring reporting of the transactions, and the revenue ruling purporting to provide the IRS with the authority to challenge the transactions. In addition to the immense compliance burden imposed on taxpayers by the proposed regulations, both the forthcoming proposed regulations contemplated by the notice and the revenue ruling are significantly flawed on substantive grounds. As discussed below in sections VI and VII, it is highly uncertain whether a court would uphold the validity of the regulations contemplated in the notice or would see the revenue ruling as a helpful tool in addressing IRS challenges made before the regulations are issued.

## II. Brief Overview of the Current Law

Subchapter K of the IRC contains rules that determine the tax basis of property when partners:

- contribute property to partnerships on a tax-free basis;
- receive distributions of property from partnerships on a tax-free basis; and
- purchase interests in partnerships in a manner that permits (and in some cases requires) the purchaser's share of the partnership's tax basis in its assets to reflect the purchase price.

Each of these activities may permit or require corresponding basis adjustments to the partnership's current or distributed property to preserve continuity in the tax basis of the partnership's current and distributed assets as well as in the applicable partner's tax basis in its partnership interest. The applicable statutory rules contain antiabuse provisions that are

[2] The IRS said the special initiative is to address "inappropriate use of partnership rules to inflate the basis of the underlying assets without causing any meaningful change to the economics of their business."



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intended to address specific abuses that Congress identified, while otherwise allowing partners flexibility to structure their economic arrangements to address commercial considerations without imposing tax constraints. A summary of certain code provisions relevant to the guidance on partnership basis-shifting transactions follows.

As a starting point, each partner has a tax basis in its partnership interest, commonly referred to as outside basis, and the partnership has a tax basis in its assets, which is commonly referred to as inside basis. In general, subchapter K tries to harmonize a partnership's inside basis with each partner's outside basis upon the occurrence of certain events.

When a partner purchases a partnership interest from another partner, the purchasing partner's outside basis is equal to the amount paid for the interest, which may differ from the purchasing partner's share of the partnership's inside basis. This disparity may create certain unfavorable results. For example, when the purchasing partner's outside basis is higher than that partner's share of the inside basis of the partnership's assets, the purchasing partner will be allocated a share of the built-in gain that is recognized when the partnership sells assets, notwithstanding the built-in gain reflected in the price the purchasing partner paid to acquire its partnership interest. If the partnership were to later liquidate, that partner would recognize a capital loss (or reduced capital gain), but that loss may be recognized in a different tax year and consequently be unusable or may be of a different character than the gain previously recognized. Further, to the extent that a partnership has depreciable assets, the purchasing partner would be unable to depreciate the portion of the purchasing partner's outside basis that exceeds the purchasing partner's share of the inside basis.

Subchapter K provides special rules to ameliorate the potential inequities when there is built-in gain in the partnership assets and address potential abuses when the partnership has property with built-in losses. Under section 743(b), a partnership must adjust a partner's share of its inside basis (1) to eliminate the applicable partner's share of the built-in gain or built-in loss if the partnership has an election under section 754 in effect or (2) when the partnership has a substantial built-in loss.[3] For built-in gain, this increase in a partner's share of the inside basis reduces any preexisting built-in gain that the partnership would otherwise allocate to it, and the partner can also depreciate the basis adjustment to the extent that the underlying partnership assets are depreciable.

When partnership property is distributed, adjustments may be made to both the property being distributed and the partnership's remaining property. In the case of a nonliquidating distribution, a distributee partner receives a tax basis in the distributed property equal to the lesser of (1) the partnership's inside basis in the property or (2) that partner's outside basis, and in either case there is a corresponding reduction in the distributee partner's outside basis. In contrast, in connection with a liquidating distribution of partnership property, the distributee partner receives a tax basis in the distributed property equal to that partner's outside basis, without regard to the partner's share of inside basis under section 732(b). As part of the symmetry of subchapter K, section 734(b) requires the partnership to adjust the basis of its remaining assets by any discrepancy between the partnership's inside basis in the distributed property and the basis of that property in the hands of the distributee partner if (1) an election under section 754 is in effect or (2) there is a substantial basis reduction[4] regarding the distributed property.

## III. Reporting Transactions of Interest

The proposed regulations generally would treat the following transactions as reportable transactions of interest under section 6011: (1) a partnership distribution in which there are two or more directly or indirectly related partners that results in a related partner or the partnership

[3]For this purpose, a substantial built-in loss exists if (1) the partnership's adjusted basis in its property exceeds by more than $250,000 the fair market value of the partnership property or (2) the transferee partner would be allocated a loss of more than $250,000 if the partnership assets were sold for cash equal to their FMV immediately after that transfer. Section 743(d)(1), amended by the 2017 Tax Cuts and Jobs Act, section 13502, effective for transfers of partnership interests occurring after Dec. 31, 2017.

[4]For this purpose, a substantial basis reduction exists if the amount of the basis reduction would exceed $250,000.



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receiving an increase in basis of at least $5 million and (2) a partner transferring a partnership interest to a transferee partner when the transferee is related to the transferor or another partner and when the transferee partner is entitled to an increase in the basis of its share of the underlying partnership's assets of at least $5 million. The proposed regulations refer to four different variations of these transactions as partnership related-party basis adjustment transactions. Related partners are defined in sections 267(b) and 707(b)(1). These rules apply irrespective of whether the transactions were tax- or business-motivated.

The proposed regulations also require that "substantially similar" transactions be reported. Substantially similar transactions include those involving unrelated but tax-indifferent partners or transfers of partnership interests to related transferees in a gain recognition transaction that results in at least a $5 million increase in asset basis. A tax-indifferent party would be defined as a person that is exempt from federal income tax or for which gain would not result in a tax liability for the year in which it is recognized.

The proposed regulations would become effective on the date Treasury and the IRS publish final regulations in the *Federal Register*. The partnership and the related partners, as well as material advisers,[5] would be required to comply with heightened reporting and recordkeeping requirements. Taxpayers and material advisers would have 90 days to disclose any existing applicable transactions, which notably would include transactions entered in prior tax years. Again, the application of these rules to transactions entered into before the effective date of the proposed regulations would impose significant administrative burdens on taxpayers and in many cases would likely make full compliance impossible.

## IV. Partnership Related-Party Basis Adjustment Transactions

The proposed regulations include several examples of partnership related-party basis adjustment transactions that would be treated as reportable transactions of interest. What follows describes three of those examples and how taxpayers have been treating them under current law.

### A. Example 1: Distribution of Property to a Related Partner

In transactions involving current distributions by a partnership to a related partner, a partnership distributes a high-basis asset to a related partner that has a low outside basis. In connection with the distribution, the distributee partner reduces the basis of the distributed asset, and the partnership increases the basis of its remaining assets. The related partners can arrange this transaction so that the reduced tax basis of the distributed asset will not adversely affect the related partners as a group, while the basis increase to the partnership's retained assets can produce tax savings for the related partners as a group.[6]

This is illustrated by an example in the proposed regulations that involves a nonliquidating distribution. In XY partnership, owned equally by related partners X and Y, X has an outside basis of $10 million, while Y's outside basis is $1 million. The partnership owns two properties: Property 1, which is depreciable and has a zero basis, and Property 2, which is nondepreciable and has a $10 million basis. XY partnership has a section 754 election in effect. The partnership distributes Property 2 to Y in a current distribution. Y's basis in the distributed Property 2 is limited to Y's outside basis of $1 million under section 732(a)(2), despite the property's $10 million basis. This results in a significant basis reduction for Property 2. Under section 734(b), XY partnership increases the basis of its remaining property to account for this basis reduction. The amount of the basis increase is $9 million, which is the difference between Property 2's original basis ($10 million) and Y's basis in the distributed property ($1 million). Sections 734(c) and 755 require that XY partnership allocate this entire $9 million basis increase to Property 1. As a result, XY partnership can now claim depreciation

[5] A material adviser includes any individual or entity that provided material advice or assistance regarding a reportable transaction and received fees exceeding a threshold amount.

[6] We use the term "related partners" here as a simplifying convention.



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deductions on Property 1 based on its new $9 million basis, despite its original zero basis.

### B. Example 2: Transfer of Partnership Interest to Related Partner

In a transaction involving the transfer of a partnership interest to a related partner, a partner with a low inside basis and high outside basis transfers its partnership interest in a tax-free transaction to a person who is related to other partners in the partnership. This related-partner transfer generates a tax-free increase in the transferee partner's share of inside basis of the partnership's assets.

The proposed regulations provide the following example. A owns 95 percent of the capital and profits interests in AB partnership and is allocated 95 percent of all losses, while B owns 5 percent of the capital and profits and is allocated 5 percent of all losses. A's outside basis is $6 million, and A's share of inside basis is $1 million. AB partnership owns depreciable property used in its trade or business. In a year with a section 754 election in effect, A contributes its entire interest to C, a related person, in a nonrecognition transaction.[7] Because of the section 754 election, under section 743(b)(1), AB partnership increases the basis of partnership property by $5 million for C because C is treated as a transferee with a $6 million outside basis but only a $1 million share of inside basis for purposes of these rules. Assuming this increase is allocated to depreciable property under sections 743(c) and 755, C may be allocated depreciation deductions over the applicable recovery periods equal to the $5 million basis increase.

### C. Example 3: Liquidation of Related Partner

In a transaction involving a liquidating distribution by a partnership to a related partner, a partnership with related partners (1) makes a liquidating distribution of a low-basis asset that is subject to accelerated cost recovery[8] to a partner with a high outside basis and (2) allocates the resulting basis reduction to high-basis partnership property that is subject to longer cost recovery (or no cost recovery at all) and that the partnership intends to hold indefinitely. Under the partnership liquidation rules, the distributee partner increases the basis of the distributed property (which may have a shorter depreciable recovery period or which may be held for sale) while the partnership decreases the basis of the retained partnership property (which may have a longer recovery period or may be nondepreciable property), with the result that the related parties generate or accelerate tax benefits.

In an example in the proposed regulations, DEF partnership is owned by related partners D, E, and F. D's outside basis is $7 million. E and F each have an outside basis of $1 million. DEF partnership owns Property 1 and Property 2. Property 1 is depreciable property, and Property 2 is nondepreciable property. DEF partnership has an inside basis in Property 1 of zero and an inside basis in Property 2 of $9 million. DEF partnership distributes Property 1 to D in liquidation of D's interest in DEF partnership. Under section 732(b), D's basis in distributed Property 1 is increased from zero to $7 million. As a result, D can now claim depreciation deductions on Property 1 based on its $7 million basis. DEF partnership must reduce its basis in Property 2 (which is nondepreciable) by $7 million.

## V. Notice 2024-54

Notice 2024-54 announces forthcoming proposed regulations that will address certain basis-shifting transactions involving partnerships and related partners, known as covered transactions. A covered transaction involves an increase in the basis of a partner that corresponds with a decrease in the basis of its related partner. Whether partners are related is determined by reference to section 267(b) (without regard to section 267(c)(3)) or section 707(b)(1) immediately before or after a transaction, such as members of a family or a person who owns 50 percent or more of a corporation or partnership, among many others.

Notice 2024-54 outlines forthcoming regulations in two key areas:

- restricting partnerships and partners from deriving unwarranted tax benefits through

[7]"Nonrecognition transaction" means any disposition of property in a transaction in which gain or loss is not recognized in whole or in part for purposes of subtitle A, as defined in section 7701(a)(45).

[8]"Cost recovery" is defined as an allowance for depreciation, amortization, or depletion.

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basis adjustments arising from covered transactions under sections 732, 734(b), or 743(b); and
- applying a single-entity approach to partnerships involving members of consolidated groups of corporations so that covered transactions cannot shift basis among group members and distort group income.

The approach described in the notice to address the purported unwarranted tax benefits associated with basis-shifting transactions under sections 732, 734(b), 743(b), and 755 is structured to effectively match the increased asset basis to the corresponding downward basis adjustment to other assets and, to the extent related partners are on both sides of that adjustment, the increased asset basis takes on the characteristics of the corresponding asset for purposes of depreciation and amortization (that is, the cost recovery method and remaining recovery period). If the corresponding asset were nondepreciable, the basis increase of the stepped-up asset would not be depreciable. When the corresponding reduced-basis asset is sold to an unrelated third party in a taxable transaction, any remaining increased basis in the other asset is released from that taint. If the stepped-up basis asset is sold first, the increased basis would not be taken into account in determining gain or loss. That basis increase generally shifts to other partnership assets. If the asset with the stepped-up basis is distributed to any partner, the taint carries over to the distributee.

The application of the forthcoming proposed regulations described in the notice is best illustrated through the examples of partnership related-party basis adjustment transactions in the proposed regulations, as described above.

## A. Example 1

In this situation, the related partner basis adjustment would arise under section 734(b) as the partnership has a valid section 754 election and the related partner threshold exists among two or more partners. Because Y's basis in Property 2 is stepped down, related partner X's portion of the corresponding increase to the basis of Property 1 is tainted and would be depreciated in the same manner and with the same timing as the distributed asset (Property 2). Therefore, because Property 2 was nondepreciable, X's portion of the increased basis in Property 1 would also not be depreciable. In a qualifying disposition of Property 1 before Property 2, gain or loss allocated to X would be determined without regard to this tainted basis (that is, the amount of gain recognized would not be reduced by the tainted basis increase), and the increased basis would instead move over to X's share of other partnership assets, although it would be subject to the same taint that applied to Property 1. In a qualifying disposition of Property 2 by Y to an unrelated third party in a taxable transaction, the taint is removed and the basis increase would apply to Property 1.

The mechanical application of the proposed regulations described in the notice, regardless of taxpayer intent, potential abuse, or lack of economic substance, will require partnerships and partners to specifically track special basis adjustment limitations for a partnership's assets to identify what portion of the asset is not subject to the rules (for example, the share of the basis that is attributable to those partners who are unrelated and those partners who are related to the transferee) and also to identify when the distributed asset is sold by the former partner. The potential complexity of the mechanical application of these rules is daunting, particularly when taking into account the effective date rules described below.

## B. Example 2

Here a section 743(b) basis adjustment arises following a transfer of an interest in a partnership with a section 754 election in effect or a substantial built-in loss to a related party in a nonrecognition transaction. C's $5 million step-up in C's share of the AB partnership's assets would be suspended in determining cost recovery allocations to C or gain and loss allocation to C from the sale of assets of the AB partnership until C is no longer related to A or any other partner. After the suspension is lifted, the basis increase to the AB partnership assets is viewed as newly acquired for cost recovery purposes and will be used to determine gain and loss allocation to C. In a qualifying disposition of partnership assets with the suspended basis, the basis is added to other



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partnership assets of similar character (or held until the AB partnership has those assets) and remains subject to suspension until A and all other partners are no longer related to C.

### C. Example 3

To the extent that any increase in the basis of distributed property under section 732(b) corresponds to a decrease in basis of a related partner's share of the inside basis of partnership assets, the upward basis adjustment is tainted and recovered using the cost recovery method and remaining recovery period, if any, of the corresponding property. Moreover, the tainted portion of increased basis is not taken into account in any sale or disposition of the distributed property (that is, the amount of gain recognized would not be reduced by the tainted basis increase). Following a qualifying disposition of the corresponding property to an unrelated person in an arm's-length taxable transaction, these rules no longer apply to the distributed property.

The notice suggests that if the distributed property itself is sold before the corresponding property, the increased basis is lost. This seems to be an inappropriate result, particularly when the parties are not specifically structuring a transaction to artificially generate a tax basis increase for tax benefits.

### D. Consolidated Return Regulations

The notice indicates that the forthcoming consolidated return regulations would apply a single-entity approach to interests in a partnership held by consolidated group members to prevent basis shifting among members of a consolidated group. This approach is intended to "prevent direct or indirect basis shifts among the members of the group" resulting from the covered transactions described above. While a single-entity approach is generally understood by consolidated return experts, it is unclear what this approach would accomplish that is not already covered in the prospective partnership regulations for related partners.

### E. Observations

The notice states that the proposed regulations are intended to be applied to all covered transactions regardless of taxpayer intent, potential abuse, or lack of economic substance. The final regulations would apply to years ending on or after June 17, 2024. The regulations would govern the availability and amount of cost recovery deductions and gain or loss calculations for tax years ending on or after June 17, 2024, even if the relevant covered transaction was completed many years before the enactment of the ultimate Treasury regulations. For example, if a property were distributed to a former partner that was related to a current partner in a partnership in 1995 in a transaction in which the partnership increased its tax basis in its property under section 734(b) and the partnership sold that property in 2025, these rules would be applicable. Similarly, if the property is not fully depreciated, the transaction would still be subject to these rules. This retroactive scope of the rules and lack of intent or abuse element creates significant uncertainty and administrative challenges for taxpayers.

The notice indicates that the forthcoming proposed regulations also will address other provisions, such as tiered partnership structures, and transactions involving tax-indifferent parties (that is, tax-exempt organizations or non-U.S. persons or partners with meaningful net operating losses). There are countless partnerships between taxable taxpayers and tax-indifferent parties when there are property contributions and distributions. If these rules were to apply to those transactions, given the absence of a requirement for abusive intent, ordinary course transactions would be unwittingly captured by these rules. For example, assume a real estate joint venture owns a parcel of high-basis land that it has held for 30 years and some low-basis real estate. It distributes the parcel of land to a tax-exempt partner (for example, a university) in redemption of the partner's low-basis interest in the venture under pre-negotiated exit rights because of the strategic value of the land to the university. Because the venture's other assets experience a basis increase under section 734(b), these rules would be applicable. Further, certain taxpayers may not be able to control

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whether partnerships in which they invest make or revoke section 754 elections, and therefore they may not be able to control whether they are subject to these rules, given that section 754 elections apply to all property distributions and transfers of partnership interests taking place in the taxable year for which the election is made and in all subsequent taxable years.

Many of the transactions that would be covered by the proposed regulations described in the notice are customarily engaged in by partnerships with related partners. In the context of real estate or private equity funds, for example, routine rebalancing of feeder fund interests and fund structuring transactions, such as forming continuation funds or management company restructurings, could be subject to these rules. The regulations could also implicate corporate restructurings involving tax-free transfers within a consolidated tax group for partnership interests undertaken for reasons unrelated to tax (for example, regulatory requirements). The breadth of the application of these rules appears to be well beyond the scope of the abusive transactions that Treasury and the IRS were targeting.

## VI. Rev. Rul. 2024-14

The revenue ruling claims the economic substance doctrine under section 7701(o) will be invoked in related-party basis-shifting transactions when disparities between inside and outside basis are created and capitalized on through partnership allocations and distributions. The scenarios all involve related parties that engage in the following series of events:

- the parties engage in a concerted effort over a period of time to create disparities between inside basis and outside basis through various methods, including contributions of property to the partnership, distributions of property from the partnership, and allocations of federal income tax items in accordance with sections 704(b) and (c);
- the parties then allegedly exploit the created disparities by engaging in transfers resulting in basis adjustments under sections 732(b), 734(b), or 743(b), such as nonrecognition transactions or distributions; and
- according to the revenue ruling, the parties inappropriately reduce taxable income through increased deductions or reduced gain (or increased loss).

In each situation, the various contributions, distributions, and allocations over a period are done "with a view to exploiting the disparity" between outside basis and inside basis. In each situation the disparity is exploited by a transaction (that is, partnership distribution, transfer of partnership interest, or partnership liquidation) that achieves the business purpose of "cost savings for [the related parties] by cleaning up intercompany accounts, reducing administrative complexity, and achieving other administrative efficiencies."

The revenue ruling first concludes that the entire series of transactions, meaning the contributions, distributions, and allocations made over a period of time, as well as the transaction that actually shifted basis, failed the objective prong in section 7701(o)(1)(A) (the codified economic substance doctrine). Because the partners were related, moving property or allocating income items among and between the separate legal entities did not have an appreciable economic effect. Further, the cost savings achieved by the basis-shifting transaction were insubstantial in comparison to the federal income tax benefits from the basis-shifting transaction.

The revenue ruling further concludes that the entire series of transactions failed the subjective prong in section 7701(o)(1)(B) for the same reason: The cost savings achieved by the basis-shifting transactions were "not substantial compared to the Federal income tax purposes the transactions were designed to carry out."

Finally, the revenue ruling threatens to impose a "strict liability" 20 percent penalty under section 6662(b)(6) and increase the penalty to 40 percent under section 6662(i) if the taxpayer fails to disclose the transactions. It also claims that the "series of transactions" may be subject to the partnership antiabuse rule in reg. section 1.701-2, the antiabuse rule in reg. section 1.704-3(a)(10), and substance-over-form and step transaction doctrines but offers no guidance on how those

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authorities would be applied to the facts in the revenue ruling.

Courts may give some respect to a revenue ruling under *Skidmore*,[9] which asks whether the government's interpretation of the law is thoroughly considered, well-reasoned, and consistent with prior and subsequent positions. However, the revenue ruling would not be given respect under the *Skidmore* standard and likely would be completely rejected by a court. Essentially, the revenue ruling is a woefully inadequate explanation of the applicable principles under section 7701(o) and is flatly incorrect on several points.

Among other things, the revenue ruling concludes that a series of transactions over several years lacks economic substance but never explains, as it must do under the case law, which of the transactions — whether one, several, or all — is actually disregarded. The ruling leaps to the conclusion that the federal income tax effects "must be disregarded," but the courts are clear that tax benefits are disregarded only after the transaction or transactions giving rise to those benefits are identified and disregarded.[10]

Further, in determining whether the cost savings change the taxpayer's economic position in a meaningful way under the objective prong, the revenue ruling states that the cost savings do not change the taxpayer's economic position by purporting to compare the cost savings to the tax benefits (and finding the cost savings are insubstantial by comparison). Similarly, in analyzing the second prong of section 7701(o), the revenue ruling concedes that the taxpayers in the revenue ruling have a "legitimate nontax economic purpose" but states that the transactions fail the test because that business purpose was "not substantial compared to the Federal income tax purposes." Nothing in section 7701(o) authorizes the IRS to make these comparisons, which are permitted under section 7701(o)(2)(A) only when a taxpayer relies on profit potential, which was not the case in the revenue ruling. The case cited in support of this comparison — *Reddam*[11] — involved a transaction in which the taxpayer had relied on profit potential. Thus, the *Reddam* case does not actually support the broad application of that comparison.

## VII. Effect of *Loper Bright* on the Guidance

The recent decision of the Supreme Court in *Loper Bright*[12] to overrule *Chevron*[13] should have a profound effect on the government's ability to sustain the proposed regulations described in the notice. Under the *Chevron* doctrine, the government could contend that either ambiguity or silence within the rules of subchapter K provided an implicit delegation of authority to the IRS and Treasury to write regulations that restrict the ability of related parties to take advantage of certain subchapter K rules. The goal of that contention would be to move the judicial review to *Chevron* Part Two, in which courts defer to the federal agency so long as the regulation is a reasonable construction of the statutory language.

*Loper Bright*'s decision overruling *Chevron* effectively means that courts may no longer defer to a federal agency's regulation under a *Chevron* Part Two analysis after finding that the key statutory language is ambiguous or the statute is otherwise silent. Rather, regardless of whether the language in question is ambiguous or silent, courts are required to exercise their independent judgment in deciding if an agency has acted within its statutory authority, as courts did before *Chevron* was decided in 1984.

In cases in which federal agencies have been given specific grants of rulemaking authority, they may be given deference if they operate within their statutory and constitutional bounds. However, the proposed regulations described in the notice are supported only by the general rulemaking authority of section 7805(a) and thus will not be entitled to deference.

[9] *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944).

[10] *See, e.g.*, *Coltec Industries Inc. v. United States*, 454 F.3d 1340, 1360 (Fed. Cir. 2006) ("We conclude that . . . the transaction that created the high basis in the stock lacked economic substance and therefore must be disregarded for tax purposes."), and *Liberty Global Inc. v. United States*, No. 1:20-cv-03501 (D. Colo. 2023) (on appeal in the Tenth Circuit) (The court "considers whether Steps 1, 2 and 3 together should be recognized for tax purposes (affording LGI the claimed deduction) or disregarded for lack of economic substance.").

[11] *Reddam v. Commissioner*, 755 F.3d 1051 (9th Cir. 2014).

[12] *Loper Bright Enterprises v. Raimondo*, 144 S. Ct. 2244 (2024).

[13] *Chevron U.S.A. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984).



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As a result of *Loper Bright*, the proposed regulations contemplated in the notice will be analyzed by a court under a statutory construction analysis, in which the court determines whether the regulation follows the plain meaning of the statutory words and context and, if the words and context are ambiguous, whether the regulation follows Congress's intent as expressed in the legislative history. When interpreting statutes, or regulations that purport to interpret statutes, courts rarely go beyond the statute and legislative history to consider whether the regulation achieves policies or purposes that are not clearly expressed in the legislative history regarding the statute in question.

Even before *Loper Bright*, the proposed regulations contemplated in the notice would likely be invalidated at the *Chevron* Part One stage, in which the court uses statutory construction principles — without any deference to the agency — to determine whether the regulation correctly interprets the statute. Over 20 years ago, in *The Limited*,[14] the Sixth Circuit held that the government was prohibited from finding an implied related-party prohibition in section 956(b)(2)(A). There was a related-party prohibition in other provisions within section 956 but not one in the provision at issue. The Sixth Circuit applied the plain meaning rule and reasoned that "Congress could have easily made that prohibition more general or applied it beyond solely those [other] subsections."[15]

History is now repeating itself, with the government trying to take the same approach with the proposed regulations contemplated by the notice, that is, by reading an implied related-party prohibition into the basis adjustment provisions in subchapter K when no such prohibition exists in the statute. As a result of *Loper Bright*, the government can no longer attempt an escape to *Chevron* Part Two to validate its regulations. Rather, the entire inquiry will begin and end with a statutory construction analysis conducted by a court with the benefit of precedent like the holding in *The Limited* and will likely result in a similar conclusion.

## VIII. Conclusion

In light of the breadth and scope of the guidance and the notable lack of statutory authorization, we expect significant challenges to these regulations, particularly in light of the Supreme Court's ruling in *Loper Bright*. However, if proposed regulations are enacted as now proposed and regulations are issued in a manner that is consistent with the notice, unless and until that challenge is successful, partnerships and partners will need to scrutinize prior transactions between the partners and partnerships and evaluate the degree to which those transactions (most of which are routine and undertaken for nontax avoidance purposes) must be reported and track and make basis adjustments following the principles outlined in the notice, a process we expect to be burdensome for many taxpayers. ■

[14] *The Limited Inc. v. Commissioner*, 286 F.3d 324 (6th Cir. 2002).

[15] *Id.* at 336.



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