Preventing **A**busive **R**outine **T**ax **N**onsense **E**nabled by **R**ip-offs **S**helters and **H**avens and **I**nstead **P**romoting **S**implicity **A**ct (the PARTNERSHIPS Act) and the Basis Shifting is a Rip-off Act

Section-by-Section Summary

In General

This bill proposes changes to the rules applicable to pass-through entities, primarily in the rules governing partnerships in Subchapter K of the Internal Revenue Code (IRC). The bill is a follow up to and updated revision of the discussion draft issued by Wyden on September 10, 2021.[1]

The bill eliminates unnecessary optionality and closes tax loopholes that allow investors and corporations to pick and choose when they pay tax.

Complex partnership tax rules make it difficult for well-meaning taxpayers to comply and allows aggressive taxpayers with sophisticated advisors to subvert the partnership tax rules with little-to-no fear of detection.[2] This is concerning as the number of partnerships has exploded over the past three decades while IRS audit rates remain at essentially zero (less than 0.05%).[3] Partnership income is highly concentrated among the wealthiest households.[4] In addition, more than 50 percent of all partnership income accrues to other partnerships and corporations.[5] The increase in the use of partnerships and other pass- through entities has severely depleted corporate revenues and has resulted in a more regressive tax system.

The provisions of the bill, in removing ambiguity and closing loopholes, improve administrability for well-meaning and small business taxpayers, allows the IRS to audit the most aggressive taxpayers, and progressively raises revenue.[6]

The bill also includes changes that remove existing areas of uncertainty and align the language and policy of existing IRC provisions. Subchapter K has remained largely untouched for decades, with well-known

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[1] See "Wyden Unveils Proposal To Close Loopholes Allowing Wealthy Investors, Mega-Corporations To Use Partnerships To Avoid Paying Tax", Sept. 10, 2021.

[2] See the combined collection of partnership tax reform articles available at SSRN, reprinted with the permission of *Tax Notes*, Tax Analysts, Fairfax, VA, by Monte A. Jackel, "Combined Partnership Tax Reform Articles," SSRN (Aug. 5, 2024). See, specifically, Jackel, *Is It (Finally) Time? Reforming Subchapter K*, 170 Tax Notes Federal 2031 (Mar. 29, 2021) ("Meanwhile, the published regulations in the partnership area are mostly addressed to an audience that is largely made up of the most sophisticated partnership practitioners and large corporate CFOs, leaving the average CPA, business tax lawyer, and corporate tax company adviser to flounder around trying to understand and comply with the rules. How much more of this can a tax system that relies on self-assessment and efficient tax audits stand? Time is running out. Subchapter K should be reformed and simplified now. The more time that elapses without reform, the more the treasury is drained of financial resources to fund the government."); Andrea Monroe, *Making Tax Law Work: Improvisation and Forgotten Taxpayers in Partnership Tax*, 55 U. MICH. J. L. REFORM 549 (2022) ("There is a growing awareness that federal tax law caters to a small number of wealthy and well-advised taxpayers without regard for the rest of the taxpaying public, and partnership tax is a prime example. This article explains how complexity and indeterminacy have transformed partnership tax, harming millions of forgotten taxpayers who struggle to comply with their annual filing obligations. A root cause of this phenomenon is the professional culture of elite practitioners, policymakers, and scholars at the heart of the partnership tax.").

[3] Internal Revenue Service Data Book, 2024, Pub. 55-B, at 36 (2023) (Table 17), https://www.irs.gov/pub/irs-pdf/p55b.pdf These extremely low audit rates are *after* implementation of the centralized partnership audit procedures meant to simplify auditing procedures for the IRS.

[4] Michael Cooper et al., *Business in the United States: Who Owns It and How Much Tax Do They Pay?*, National Bureau Of Economic Research, Working Paper 21651, at 36 (Oct. 2015) (Figure 6A), https://www.nber.org/papers/w21651.pdf.

[5] *Id.,* at 33, Figure 3B.

[6] Id., at 23-24.

oversights unaddressed and long-standing questions unanswered. More recent changes to the taxation of partnerships have given rise to new questions. Legislative changes to remove uncertainty and better effectuate policy ends, at the cost of some optionality, will assist both taxpayers and the IRS in administering and applying the IRC.

Section 2: Determination of Distributive Shares– IRC Section 704(b)

The partnership tax rules afford tremendous flexibility in the allocation of partnership items among partners. The IRC and regulations provide two sets of rules circumscribing the allocation of partnership items – the "partners interest in the partnership" (PIP) standard and the "substantial economic effect" (SEE) safe harbor. Both are based on the general principle of economic substance, and both are intended to align tax allocations with the underlying economic arrangement. However, the flexibility of current law has resulted in gaming for wealthy taxpayers.

Current law section 704(b) and the regulations thereunder provide that the allocations in a partnership agreement will be respected if the allocations have substantial economic effect. Otherwise, the allocations may be recast in accordance with the partners' interests in the partnership. Much has been written about the deficiencies of this standard to police aggressive partnership allocations.[7]

Under the bill, in general, the existing rules for allocations with SEE and PIP have been maintained. This bill differs from the original 2021 Wyden draft which required allocations in accordance only with PIP.

When partners are not independent and do not have sufficient competing interests, it is not appropriate to rely solely on the purported economic arrangement between them for the purpose of determining tax allocations (under the present-law allocation rules) because, in substance, those partners often act in unity as a single economic person.[8]

The provision creates a specific rule requiring allocations consistent with contributed capital, which applies only for certain related-party partnerships. In such instances, relative contributed capital is a better indicator of their economic interests in the partnership.

Under the bill, if partners are members of a controlled group (within the meaning of section 267(f)) and together own 50 percent or more of partnership capital or profits,[9] the provision would require the partnership to consistently allocate all items based on partner net contributed capital.[10] The Secretary is granted authority to require the use of the consistent percentage method by other partnerships to prevent abuse.[11]

Because the IRC cannot compel taxpayers to agree to only certain economic arrangements, the consistent percentage method contains a provision which applies when the partners do not provide

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[7] See Jackel, "Is It (Finally) Time? Reforming Subchapter K," *Tax Notes Federal*, Mar. 29, 2021, p. 2031, and commentaries and articles cited therein.
[8] Gregg D. Polsky & Emily Cauble, *The Problem of Abusive Related-Partner Allocations*, 16 FLA. TAX. REV. 479, 479 (2014), https://digitalcommons.law.uga.edu/fac_artchop/1086 ("Because the section 704(b) regulations are premised on the assumption that partners deal with each other at arm's length, they are ill-suited to deal with related-partner allocations. As a result, these regulations can easily be abused by related partners").
[9] Treas. reg. sec. 1.706-1(b)(4)(ii) and (iv).
[10] Essentially, these partnerships would be subject to a single class of partnership interest allocation scheme, similar to S corporation allocation rules.
[11] The Secretary has authority to require use of the consistent percentage method by other ownership structures designed to avoid the purpose of these rules including, for example, through the use of other related-party arrangements, ownership by tax-indifferent parties, or through the use of intermediaries.

distributions on a pro rata basis (i.e., not proportionate to net contributed capital). The rule is intended to discourage non-proportional allocations and distributions among related parties.

Any distribution or right to partnership property not proportional to partner net contributed capital would be treated as a transaction directly between the partners. The partner receiving such distribution or right would, in substance, be treated as receiving an interest in the partnership from one or more other partners represented by undivided interests in each partnership asset. The receiving partner would recognize gross income and any expense would be nondeductible and non-capitalizable by the other partner(s) who may also realize gain or loss on the deemed transfer of partnership assets in extinguishment of the capital interest obligation.

The Secretary is authorized to provide exceptions to the general rule (such as for required regulatory allocations, such as for qualified income offsets and minimum gain).

For certain related partners, the provision will remove some unnecessary optionality of current law, better prevent the shifting of tax attributes between partners, simplify the rules governing partnership allocations, and allow the IRS to better focus audit and enforcement efforts.

The provision is effective for allocations made in taxable years beginning after the date of enactment.

Section 3: Allocation of Built-In Gains With Respect to Contributed Property – IRC Section 704(c)(1)(A)

In general, property can move into and out of partnerships tax free under sections 721 and 731. Current law section 704(c) attempts to prevent the shifting of gain or loss between partners by requiring that the tax items of contributed or revalued property be shared between the partners so as to take into account the built-in gain or loss at the time of contribution or revaluation (i.e., the variation between the value and basis at the time of contribution or revaluation). However, current rules provide significant flexibility for partnerships in choosing how to take into account that variation. The regulations provide for three nonexclusive methods generally deemed reasonable: the traditional method, the curative method and the remedial method. [12]

Only one of these methods – the "remedial method" – fully prevents shifting of built-in gain between partners in all cases.[13] While Subchapter K has attempted to allow for partners to deal with this issue flexibly, it is no longer sustainable.

Under the proposal, all partnerships must use the remedial method for section 704(c) allocations (as described in Treas. Reg. sec. 1.704-3(d)) for both forward and reverse section 704(c) allocations. In applying the remedial method, additions and reductions of partnership capital shall be taken into account. This would cure the "ceiling rule" problem encountered under the other section 704(c) methods in all instances.

The provision is effective for contributions to a partnership after date of enactment.

Section 4: Treatment of Revalued Property – New IRC Section 704(f)

An opportunity to shift built-in gain and loss arises in connection with a change in a partner's interest in a partnership (e.g., as a result of a contribution of money or other property to a partnership in exchange for an interest in the partnership). To minimize shifting of gain, the regulations generally allow, but do not

[12] Treas. reg. sec. 1.704-3(a)-(d).
[13] Leigh Osofsky, *Unwinding the Ceiling Rule*, 34 VA. TAX REV. 63 (2014).

require, a partnership to revalue the partnership assets for section 704(b) purposes prior[21] to such transactions (commonly referred to as "book-ups").

Revaluations are meant to prevent the shifting of partnership built-in gain and loss away from the partners who accrued such economic gain or loss. However, the optionality allows partnerships to shift gains and losses between partners by selectively planning when and if to make such optional revaluations.

The bill requires any partnership that is not a small business to revalue its property upon a revaluation event. In the case of an upper tier partnership that owns more than 50% of the capital or profits interests in a lower tier partnership, the lower tier partnership must also revalue its properties for revaluation events occurring at the level of the upper tier partnership. If 50% or less is owned, the lower tier partnership may but is not required to revalue its property upon a revaluation at the upper tier.

Small businesses eligible for the exception for partnerships that satisfy the gross receipts test of section 448(c) (i.e., $25 million adjusted for inflation) are not subject to this mandatory revaluation rule of the bill. Unless regulations provide to the contrary, tax shelters under section 448(d)(3) are eligible for this safe harbor.

The provision is effective for revaluation events occurring after date of enactment.

Section 5: Repeal of Time Limitation on Taxing Pre-contribution Gain-IRC Sections 704(c)(1)(B) and 737

Generally, when a partner contributes property with a built-in gain, the partner must recognize gain if such property is subsequently distributed to any other partner within seven years of the original contribution. Similarly, if other property is distributed to the contributing partner within seven years of the original contribution the contributing partner generally recognizes gain. These "mixing bowl" rules attempt to prevent taxpayers from engaging in tax-free transactions involving contributions and related distributions that are not otherwise recharacterized as sales or exchanges. However, partnerships are able to avoid these rules due to the limited time period of application (currently seven years).

The provision would repeal the seven-year time period for the application of the mixing bowl rules. The revised mixing bowl rules would apply to contributed property regardless of the time since contribution. The provision would apply to property contributed to a partnership after the date of enactment.

Section 6: Repeal of Rules Relating to Certain Liquidating Distributions-IRC Section 736 and 761

A partner's distributive share of partnership income can serve as compensation for the partner's services on the partnership's behalf as well as for the use of the partner's capital. However, a partner can receive a payment from the partnership in addition to its distributive share.

Payments to Retiring and Successor-in-Interest Partners

Partnerships may structure payments to withdrawing or retiring partners in a variety of ways. Instead of following one consistent regime, some partnerships selectively choose the rules that will apply in order to minimize their tax liability.[14] Section 736(a) provides in pertinent part that payments made in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in section 736(b), be considered either as a distributive share of partnership income if the amount thereof is determined with regard to the income of the partnership, or as a

[14] Howard E. Abrams, Wherefore Code Sec. 736?, 96 Taxes 119 (2018).

guaranteed payment under section 707(c) if the amount is determined without regard to the income of the partnership. Section 736(b) in turn provides that payments made in liquidation of the interest of a retiring partner or a deceased partner shall be determined to be made in exchange for the interest of such partner in partnership property and shall be considered as a distribution by the partnership and not as a distributive share or guaranteed payment under section 736(a). This code section, it has been argued, has outlived its usefulness and should be repealed.[15]

Because the IRC has subsequently been amended to eliminate the need for the special rules of section 736, the provision repeals[16] section 736 to align payments to retirees and successor-in-interest partners with the general rules of subchapter K specifically and the IRC generally (such as, for example, section 409A). Section 761 is also proposed to be amended to provide that a retiring or successor-in-interest partner remains a partner until complete liquidation of the partnership interest.

The provision is effective for successors-in- interests and partners retiring after the date of enactment. The bill differs from the 2021 Wyden draft and does not repeal guaranteed payments under section 702(c).

Sections 7 and 8: Application of Rules Relating to Payments to Partners for Property or Services; Elimination of Pre-formation Expenditures Exception to Partnership Transfer Rules – IRC Section 707(a)(2)

Partners are generally permitted to contribute property to, and receive distributions from, a partnership without recognition of gain. However, a number of provisions exist to prevent taxpayers from using partnerships to exchange one type of property for another type, or even for cash, without recognition of gain. In addition to sections 704(c)(1)(B) and 737 discussed above, section 707(a)(2)(B) was enacted to prevent such abuses by directing the Secretary to identify circumstances under which a contribution and related distribution should be characterized as a sale of property or a partnership interest. The following provisions correct two asserted ambiguities that may limit the effectiveness of the "disguised sale" rules.

Make Self-executing Disguised Sale of Partnership Interest Rules

Section 707(a)(2) addresses sales of partnership interests that take the form of a contribution by one partner and a related distribution to another partner. However, some taxpayers have taken the position that such transactions are not considered sales of a partnership interests because the Secretary has not yet issued regulations.[28] The provision would clarify that the disguised sale rules are self-executing.

Remove Capital Expenditure Exception to Disguised Sale Treatment

Regulations under section 707(a)(2) provide an exception from disguised sale treatment as sale proceeds for certain reimbursements from the partnership to a partner for capital expenditures.[29] The provision would override this exception, treating proceeds for reimbursement of capital expenditures as disguised sale proceeds.

The provisions are effective for services performed or property transferred after the date of the enactment.

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[15] See, e.g., Philip F. Postlewaite and Adam H. Rosenweig, "Anachronisms in Subchapter K of the Internal Revenue Code: Is It Time to Part With Section 736", 100 N.W. U.L. Rev. 379 (2006) (Postlewaite). See, also, JCS-1-14, pp. 357 and 358.

[16] Commentators have long called for the repeal of section 736. *See e.g.*, John A. Lynch, Jr., *Taxation of the Disposition of Partnership Interests: Time to Repeal I.R.C. Section 736*, 65 NEB. L. REV. 450 (1986), https://core.ac.uk/download/pdf/33140306.pdf; See, also, Postlewaite, id.

Section 9: Partnership Terminations – IRC Section 708

Under current law, a partnership is considered as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. Some view section 708(a) to incorporate a historic continuity of partner requirement.

The statutory language has created some uncertainty as to whether an original or historic partner must continue as a partner and what quantum of continuing historic ownership, if any, is needed to constitute a continuation.[17] Since the repeal of technical terminations in the 2017 tax legislation, some may still consider current law to allow taxpayers to structure into termination treatment, even if the business is still operating.[18]

The bill would clarify that a partnership is not terminated if any part of the business is carried on by a person or persons who was a "historic partner" in the prior partnership or by a person related to any of those partners. Related parties are defined by reference to section 267 or 707(b).

The provision is effective taxable years beginning after date of enactment.

Section 10: Repeal of Requirement That Inventory Be Substantially Appreciated – IRC Section 751(b)

Current law section 751(b) applies to prevent the shifting of ordinary income between partners of a partnership. If the partnership holds certain ordinary income assets ("hot assets") which include either unrealized receivables, or inventory items which have appreciated substantially in value, a presumed tax-free partnership distribution can instead be treated as a taxable sale or exchange between the distributee partner and the partnership. Inventory items of the partnership are considered to have appreciated substantially in value if their fair market value exceeds 120 percent of the adjusted basis to the partnership of such property. This rule prevents partners from converting what should be ordinary income into lower-taxed capital gain.

The bill would remove the requirement that inventory be substantially appreciated to be treated as ordinary income property.

The provision is effective for distributions after the date of enactment.

Section 11: Treatment of Partnership Debt – IRC Section 752

The current rules for determining whether a partner of a partnership has recourse debt under section 752 and Treas. Reg. secs. 1.752-1 and 1.752-2 assume that the partner will fulfill any obligation, generally regardless of a partner's ability to do so. In practice, a lender typically expects that credit extended to a partnership will be repaid with partnership profits.[19] The flexible recourse debt rules of current law may incentivize aggressive taxpayers to manipulate a partner's basis in the partnership, manipulate the allocations of losses, avoid disguised sale rules, and generate tax-deferred cash distributions. The rules are fairly complex, and difficult to administer, and rife with abuse.

The provision would require that all partnership debt be shared among the partners in accordance with

[17] Ray, id.
[18] *See* Jennifer Ray & Dina Wiesen, *Partnership Continuations After the Tax Cuts and Jobs Act*, 164 Tax Notes Federal 1215 (Aug. 19, 2019), herein "Ray"); New York State Bar Association Tax Section, Rept. No. 1432, *Report on Partnership Terminations Following the Tax Cuts and Jobs Act* (Jan. 17, 2020).
[19] Steven C. Todrys, *Recourse Debt is Usually Nonrecourse: A Comment*, 84 Taxes 251 (2006).

partnership profits.[20] An exception is provided in cases of bona fide indebtedness of the partnership to partner (or a person related to the partner).

The provision is effective for taxable years beginning after December 31, 2025. A transition rule is provided allowing taxpayers to pay any tax liability that arises as a result of the enactment of the provision over six years.

Section 12: Adjustments to Basis of Partnership Property– IRC Sections 734, 743, and 754

Under current law, a partnership can elect to adjust the basis of partnership property for disparities between the partnership's basis in its property and the partners' basis in their partnership interests. The following provisions make these basis adjustments mandatory, limiting opportunities for tax planning through deferral and shifting of tax liability.[21]

Make Mandatory Basis Adjustments Arising from Partnership Distributions

Partnership distributions create disparities between inside and outside basis when (1) a partner recognizes gain or loss on the distribution or (2) a partner takes basis in distributed property that is different than the basis in the hands of the partnership. Current law only requires a partnership to adjust basis in partnership assets to correct such a disparity in the case of substantial basis reductions under sections 734(d) and 743(d). Basis adjustments are otherwise optional, leading to tax planning opportunities.[22]

The provision would make basis adjustments mandatory at the time of a partnership distribution of money or other property. The provision would also revise the calculation of each partner's basis adjustment to preserve each remaining partner's[23] gain or loss that would be recognized if the partnership had sold all partnership property at fair market value (i.e., each partner's pre-distribution built-in gain or loss would equal its post-distribution built-in gain or loss). This provision has the effect of aligning the partners' shares of tax gain or loss with their economic shares of book gain or loss in the partnership.

Make Mandatory Basis Adjustments Arising from Transfers of Partnership Interests

Sales of partnership interests create disparities between inside and outside tax basis of a partner when a transferee partner has basis in its partnership interest that is different than the transferee partner's proportionate share of basis in partnership assets. Current law allows a partnership to elect to adjust basis in partnership assets with respect to the transferee partner. Such basis adjustments are only mandatory in the case of a "substantial" built-in loss with respect to the transfer of an interest.

The provision would make basis adjustments resulting from transfers of partnership interests

[20] It is intended that if a partnership is unable to service a partnership liability and a partner is called upon to make (and makes) a payment to service the liability, the payment be treated a contribution to the capital of the partnership, which would increase the partner's basis in its interest. *See* Eric B. Sloan & Jennifer H. Alexander, *Economic Risk of Loss: The Devil We Think We Know*, 84 Taxes 217 (2006).

[21] William D. Andrews, *Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 Tax Law Review 1 (Fall 1991); Noel B. Cunningham, *Needed Reform: Tending the Sick Rose*, 47 Tax Law Review 1 (Fall 1991).

[22] Cunningham, Laura E. and Cunningham, Noël B., "The Logic of Subchapter K : a Conceptual Guide to the Taxation of Partnerships" (2011). ("Although it may have once seemed unduly burdensome to require partnerships to make the adjustments, today the elective nature of section 734(b) is very difficult to justify.").

[23] Including a partner who is not completely redeemed out of the partnership by the distribution.

mandatory to prevent deferral of tax liabilities.

A small business exception would apply to these provisions. The provisions are effective for distributions and transfers occurring after the date of enactment.

Section 13: – Net Investment Income Tax -- IRC section 1411

The self-employment tax of section 1401 (SECA) is imposed on the net self-employment tax earnings of the taxpayer. However, there is an exception in section 1401 that excepts “limited partners” from SECA. Many partners who are individuals have taken a position that income from the partnership is not subject to SECA because they are “limited partners” in name, despite their level of involvement in the partnership. The net investment income tax (NIIT) of section 1411 operates in tandem with SECA by imposing a tax on net investment income of passive partners. These same taxpayers often take the position that they also are not required to pay the net investment income tax (NIIT) on income from their partnership interest because they are actively involved with the partnership. The result is a loophole that state law limited partners may not be subject to the SECA tax (such cases remain in litigation), and active partners or shareholders of partnerships and S corporations are not subject to the NIIT.

The bill would expand the NIIT for high-income individuals and all estates and trusts to apply to income derived in the ordinary course of any trade or business; i.e., to active income. The bill would exclude income that is already subject to FICA or SECA under current law. Net investment income includes Subpart F, GILTI, and PFIC inclusions.

The provision is effective for taxable years beginning after the date of enactment.

Section 14: Swap Funds -- -- IRC sections 721 and 351

Under the swap fund rule, gain or loss that would otherwise not be recognized upon a contribution to a partnership or corporation is recognized if such property is contributed to a partnership or corporation that is treated as an investment company and such contribution results in diversification (that does not already exist). Currently, taxpayers can use swap funds to get around this rule and diversify their portfolios without paying taxes because swap funds are diversified prior to contribution. Congress has closed down swap fund transactions several times in the past, but each time practitioners come up with more creative workaround to avoid the tax. This provision should close the loophole for good.

This provision eliminates the avoidance technique by expanding the types of asset contributions that would trigger gain under the swap fund rule. The swap fund rule would be expanded to apply to contributions or transfers of any interest in an entity, if the return on the interest is limited and preferred. The swap fund rule would also be expanded to apply to transfers of marketable securities to a registered investment company (or an entity exempt from registration), or to any entity that allows persons with blocks of marketable securities with significant unrealized appreciation to diversify those holdings.

The provision is effective for transfers made after the date of enactment.

Section 15: Modifications to Treatment of Certain Losses - Worthless Partnership Interests and Debt – IRC Section 165

Under current law section 165(g), if a security that is a capital asset becomes worthless, the loss is treated as a loss from the sale or exchange of a capital asset under section 1001. However, under present law it is unclear whether worthlessness of a partnership interest or of partnership debt should be treated as a disposition under section 1001. This lack of clarity in the law for holders of partnership interests and partnership debt allows optionality for taxpayers that has led to disputes and litigation.

The bill would amend section 165 to treat worthless partnership debt as a worthless security, and treat the loss as a loss from the sale or exchange of a capital asset. The bill further provides certainty by adding a rule that if a partnership interest becomes worthless, the resulting loss is treated as loss from the sale or exchange of the partnership interest. The bill provides additional clarity by adding a timing rule that a worthlessness loss occurs at the time of the identifiable event establishing worthlessness.

The provision is effective for claims of worthlessness in taxable years beginning after date of enactment.

Section 16: Codification of Partnership Anti-Abuse Rule – IRC Section 701

Since enactment of the Internal Revenue Code of 1954, wealthy individuals and large corporations have made extensive use of the ambiguities in partnership tax law to greatly reduce, if not eliminate, federal income tax on a transaction with arguable non-tax business purpose. The proliferation of different types of entities that have been granted passthrough tax treatment with limited liability — like limited liability companies — complicate and in some cases prevent the IRS from completing audits of such entities.

This provision adds a new section 701(b) directing the Treasury Secretary to promulgate anti-abuse rules, the function of which is to allow the Secretary to recast, disregard, or otherwise modify any transaction involving a partnership for reasons specified in the statute. Specifically, the reasons are so that tax consequences to each partner and the partnership reflect the economic agreement and clearly reflect income, the form and substance of the transaction are consistent, and so that there is a substantial purpose (apart from Federal income tax effects) for entering into the transaction.

The effective date of the new codified anti-abuse rule is for transactions after the date of enactment with no inference as to the authority of the Treasury Secretary to regulate such transactions absent new section 701(b).

Related-Party Basis Shifting Transactions – IRC Sections 731, 734, and 743

Under current law, aggressive taxpayers plan into structured transactions with related parties to exploit the shifting of basis through a partnership while avoiding tax on built-in gains. These transactions commonly result in an increase in basis (a "step-up") to (i) depreciable property or (ii) property that is intended to be sold shortly after the transaction. The corresponding basis reduction (or "step-down") is then allocated to non-depreciable or non-amortizable property.

When these transactions are done in a related-party context, the result is that taxpayers can manufacture ordinary income deductions through increased depreciable basis and reduction in gain by way of these shifts without any real economic impact to the group.

Basis shifting transactions without gain recognition generally take three forms.

First, a partnership distributes high-basis property to a partner with a relatively low basis in its partnership interest (the "section 734(b) basis shift"). The partner steps down the basis of the distributed property to equal its basis in its partnership interest and, the partnership then steps-up the basis in its retained property by an equal offsetting amount.

Second, a partnership distributes low-basis property to a partner with a relatively high-basis in its partnership interest in a liquidating distribution (the "section 732 basis shift"). The partner steps up the basis of the distributed property equal to its partnership interest and, the partnership steps-down the basis in its retained property by an equal offsetting amount.

Third, certain nonrecognition transfers of partnership interests with a section 754 election in place are tax-free resulting in a step-up to the basis of partnership property (the “section 743(b) basis shift).

This bill closes the basis shifting loophole for certain related-party partnerships. The bill treats the distributions in the first two instances as taxable transactions. The bill also disallows nonrecognition basis adjustments (to the extent of nonrecognition) under section 743(b) basis shifts.

Small businesses, even if they would otherwise be treated as a related-party partnership, are exempt from this provision.

This provision would apply to transfers after the date of introduction.