Partnership Basis Adjustments

Cross References

- Notice 2025-23

A partnership's basis in its assets is known as inside basis. In addition to contributions of property, the partnership may acquire property by means of purchase. Generally, the partnership's basis in contributed property is the same as the adjusted basis of the property in the hands of the contributing partner at the time of the contribution. Similarly, the partnership has a holding period in the property which dates back to the contributor's acquisition of the property. The partnership depreciates the contributed property as if the partner still held the property. Thus, the partnership's basis in property contributed by a partner will not be the same as its fair market value (FMV).

Example #1

Sam contributes a machine worth $1,000 to a new partnership in exchange for a 50% ownership interest in the partnership. The other 50% partner contributes $1,000 in cash. Sam's basis in the machine at the time he contributes it equals $400. Thus, the partnership's inside basis in the machine after its contribution equals $400 (Sam's adjusted basis prior to its contribution).

A partner's basis in his or her partnership interest is referred to as outside basis. Upon formation of the partnership, a partner's initial outside basis will generally equal the amount of money and the adjusted basis of property contributed. If the partner purchases his or her partnership interest from another partner, the outside basis will equal the purchase price.

Example #2

Assume the same facts as Example #1. Sam's outside basis in his partnership interest is $400, even though he owns a 50% interest in a partnership worth $2,000. The other partner's outside basis is $1,000, the amount of cash he contributed at the time of the formation of the partnership.

No gain or loss is recognized to a partnership, or to any of its partners, when property is contributed to the partnership in exchange for a partnership interest. (IRC §721)

When the FMV of property at the time it is contributed to the partnership is different from the partner's adjusted basis, the partnership must allocate among the partners any income, deduction, gain, or loss on the property that will account for the difference.

Example #3

Assume the same facts as Example #1. The partnership continues to depreciate the property under the same schedule that Sam used prior to the partnership formation. Since a depreciation deduction each year will be less than if the contributed property had a $1,000 depreciable basis, depreciation must be allocated to the other partner until both partners are equal economically. If the partnership sells the property, gain on its sale must likewise be allocated in a way that makes both partners equal economically.

Under IRC section 754, an election is available that allows a partnership to adjust the basis of partnership property upon distribution of property (IRC §734) or when the transfer of a partnership interest occurs (IRC §743). The election can address inequities that occur when partnership interests are sold or transferred and the FMV of property is different from the adjusted basis.

The IRS is aware of related persons using partnerships to engage in transactions that inappropriately exploit the basis adjustment provisions under the Internal Revenue Code. This awareness results from the IRS's review of various partnership transactions involving related parties in which basis adjustments were created to artificially generate or regenerate federal income tax benefits that resulted in significant tax savings without a corresponding economic outlay. These transactions were carefully structured to exploit the mechanical basis adjustment provisions to produce significant tax benefits with little or no economic impact on the related parties, and in a manner that would not be a likely arrangement between partners negotiating at arm's-length.

Generally, in a Partnership Related-Party Basis Adjustment Transaction, partnership property is distributed to a partner who is related to one or more other partners, and that distribution results in a person related to the distributee partner, the distributee partner, or both, receiving all or a share of a basis increase in the distributed property or remaining partnership property under IRC sections 732 or 734(b) (as applicable); alternatively, a partnership interest is transferred between related persons or to a transferee partner who is related to an existing partner in the partnership, and that transfer results in an increase to the inside basis in partnership property with respect to the transferee partner under IRC section 743(b).

Partnership Related-Party Basis Adjustment Transactions generally are structured so that, under the applicable allocation rules [IRC sections 732(c), 734(c), 743(c), and 755], the basis increase is allocated to property that is eligible for cost recovery allowances (or eligible for a shorter cost recovery period) or that the partnership or the distributee partner disposes of in a taxable sale or exchange. Accordingly, the basis increase results in related partners decreasing their overall taxable income through additional or accelerated cost recovery allowances or decreasing their taxable gain or increasing their taxable loss on the subsequent taxable disposition of the property subject to the basis increase.

The related partners receive these tax benefits directly in the case of a distribution of property in which the basis of the distributed property is increased in the distributee partner's hands under IRC section 732(b) or (d). They receive these benefits indirectly in the case of a transfer of a partnership interest in which the inside basis of partnership property is increased for the transferee partner under IRC section 743(b) or in the case of a distribution of property that results in an increase to the common basis of partnership property under IRC section 734(b). Whether the tax benefits are received directly or indirectly, the resulting decrease in taxable income or gain (or increase in taxable loss) benefits the related-party group as a whole. Further, because the partners are related, the distributions or transfers may have little or no effect on the overall economic ownership of the property yet produce significant tax benefits shared by the related partners.

A related partner's partnership interest must have certain characteristics to create the opportunity for a Partnership Related-Party Basis Adjustment Transaction. In general, these characteristics are (1) a partner's outside basis in its partnership interest that is low compared to the partnership's basis in property it distributes to such partner, (2) a partner's outside basis in its partnership interest that is high compared to such partner's share of the partnership's basis in the partnership property (that is, the partner's share of inside basis), or (3) a partner's outside basis in its partnership interest that is high compared to the partnership's basis in property it distributes to such partner in liquidation of the partner's interest. Partnerships with related parties can create these characteristics through orchestrated contributions and distributions, as well as allocations under IRC section 704(b) and (c). In most commercial transactions involving unrelated parties, the opportunity for abuse is limited because each party has separate, and often competing, economic and tax interests and the parties transact at arm's length. In contrast, for related parties, basis can be manipulated to provide a material net tax benefit to the related parties.

Reportable transactions. IRC section 6011(a) generally provides that, if required by regulations prescribed by the IRS, any person made liable for any tax imposed by the Internal Revenue Code, or with respect to the collection thereof, must make a return or statement according to the forms and regulations prescribed by the IRS. Every person required to make a return or statement must include therein the information required by such forms or regulations.

IRC section 1.6011-4(a) provides that every taxpayer that has participated in a reportable transaction within the meaning of Regulation section 1.6011-4(b) and who is required to file a tax return must file a disclosure statement within the time prescribed in Regulation section 1.6011-4(e). Reportable transactions are identified in Regulation section 1.6011-4 and include listed transactions, confidential transactions, transactions with contractual protection, loss transactions, and transactions of interest.

Certain partnership related-party basis adjustment transactions as transactions of interest. On June 18, 2024, the IRS issued proposed regulations that would make these types of transactions subject to the reportable transaction rules. On January 10, 2025, the IRS issued final regulations based upon the proposed regulations identifying certain partnership related-party "basis shifting" transactions as transactions of interest (TOIs) subject to the rules for reportable transactions.

Executive order. On February 19, 2025, President Trump issued Executive Order 14219, *Ensuring Lawful Governance and Implementing the President's "Department of Government Efficiency" Deregulatory Initiative*. Executive Order 14219 directs agencies to initiate a review process for the identification and removal of certain regulations and other guidance that meet any of the factors set forth in Executive Order 14219. Pursuant to the review directed by Executive Order 14219, the IRS have identified the Basis Shifting TOI Regulations for removal and the Basis Shifting Notice for withdrawal.

Notice 2025-23. As a result, the IRS has issued Notice 2025-23 stating that partnership related-party basis adjustment transactions designed to exploit the mechanical basis adjustment provisions of the Internal Revenue Code to produce significant tax benefits with little or no economic impact on the related parties are not subject to the reportable transaction rules, and taxpayers are not subject to penalties for failure to disclose such transactions to the IRS.