Introduction

The IRS in the past year has continued to ramp up its scrutiny partnerships' tax positions, including several pieces of new guidance taking a multiprong approach to partnership "basis shifting" transactions that the agency views as having the potential for abuse. At the same time, IRS is dedicating new funding and resources to examining partnerships.

These developments, along with some new reporting and regulatory changes, mean there are a number of tax areas partnerships should be looking into as they plan for year end and the coming year:

- Evaluate Partnership 'Basis Shifting' Transactions That Are Subject of New IRS Scrutiny
- Plan for Partnership Form 8308 Expanded Reporting and January 31 Deadline
- Review Limited Partner Eligibility for SECA Tax Exemption
- Consider Effect of Proposed Rules on Transactions Between Partnerships and Related Persons
- Double-Check Positions on Inventory Items and Unrealized Receivables Under Section 751(a)
- Keep an Eye on Challenges to IRS Rules, Including Partnership Anti-Abuse Rules, Under *Loper Bright*
- Watch for New Form for Partners to Report Partnership Property Distributions
- Prepare for Partnership Obligations Under Corporate Alternative Minimum Tax Regulations

Evaluate Partnership 'Basis Shifting' Transactions That Are Subject of New IRS Scrutiny

The IRS and Treasury have made clear that they intend to take a harder stance on transactions involving basis shifting between partnerships and related parties. On June 17, 2024, the IRS launched a multiprong approach to curtail inappropriate use of partnership rules to inflate the basis of assets without causing meaningful changes to the economics of a taxpayer's business.

The guidance focuses on complex transactions involving related-party partnerships through which taxpayers "strip" basis from certain assets and shift that basis to other assets where the increased basis is intended to generate tax benefits – through increased cost recovery deductions or reduced gain (or increased loss) on asset sales – in transactions that have little or no economic substance.

To address what it deems the inappropriate use of such transactions to generate tax benefits, the IRS has taken several steps:

1. Notice 2024-54 describes two sets of upcoming proposed regulations addressing the treatment of basis shifting transactions involving partnerships and related parties.
2. Additional proposed regulations (REG-124593-23), issued concurrently with Notice 2024-54, identify certain partnership basis shifting transactions as reportable Transactions of Interest.

3. [Revenue Ruling 2024-14] notifies taxpayers that engage in three variations of these related-party partnership transactions that the IRS will apply the codified economic substance doctrine to challenge inappropriate basis adjustments and other aspects of these transactions.

The IRS stated that the types of related-party partnership basis shifting transactions described in the current guidance cut across a wide variety of industries and individuals. It stated that Treasury estimates the transactions could potentially cost taxpayers more than $50 billion over a 10-year period. The IRS added that it currently has "tens of billions of dollars of deductions claimed in these transactions under audit."

Basis Shifting Transactions Under IRS Scrutiny

An IRS Fact Sheet released concurrently with the basis shifting guidance states that there are generally three categories of basis shifting transactions that are the focus of the new guidance. It describes these three categories of transactions as:

1. ***Transfer of partnership interest to related party:*** A partner with a low share of the partnership's inside tax basis and a high outside tax basis transfers the interest in a tax- free transaction to a related person or to a person who is related to other partners in the partnership. This related-party transfer generates a tax-free basis increase to the transferee partner's share of inside basis.
2. ***Distribution of property to a related party:*** A partnership with related partners distributes a high-basis asset to one of the related partners that has a low outside basis. The distributee partner then reduces the basis of the distributed asset, and the partnership increases the basis of its remaining assets. The related partners arrange this transaction so that the reduced tax basis of the distributed asset will not adversely impact the related partners, while the basis increase to the partnership's retained assets can produce tax savings for the related parties.
3. ***Liquidation of related partnership or partner:*** A partnership with related partners liquidates and distributes (1) a low-basis asset that is subject to accelerated cost recovery or for which the parties intend to sell to a partner with a high outside basis and (2) a high- basis property that is subject to longer cost recovery (or no cost recovery at all) or for which the parties intend to hold to a partner with a low outside basis. Under the partnership liquidation rules, the first related partner increases the basis of the property with a shorter life or which is held for sale, while the second related partner decreases the basis of the long-lived or non-depreciable property. The result is that the related parties generate or accelerate tax benefits.

Notice 2024-54: Forthcoming Proposed Rules Governing Covered Transactions

Notice 2024-54 describes two sets of proposed regulations that the IRS plans to issue addressing certain partnership basis-shifting transactions (covered transactions):

- ***Proposed Related-Party Basis Adjustment Regulations.*** Proposed regulations under Sections 732, 734, 743, and 755 would provide special rules for the cost recovery of positive basis adjustments or the ability to take positive basis adjustments into account in computing gain or loss on the disposition of basis adjusted property following certain transactions.

- ***Proposed Consolidated Return Regulations.*** Proposed regulations under Section 1502 would provide rules to clearly reflect the taxable income and tax liability of a consolidated group whose members own interests in a partnership.

Generally, for purposes of the notice and planned proposed rules, covered transactions:

1. Involve partners in a partnership and their related parties,
2. Result in increases to the basis of property under Section 732, Section 734(b), or Section 743(b), and
3. Generate increased cost recovery allowances or reduced gain (or increased loss) upon the sale or other disposition of the basis-adjusted property.

The IRS intends to propose that the Proposed Related-Party Basis Adjustment Regulations, when adopted as final regulations, would apply to tax years ending on or after June 17, 2024.

The IRS states that the proposed applicability date for the Proposed Consolidated Return Regulations will be set forth in the proposed regulations once issued.

Proposed Rules Identifying Basis Shifting as Transaction of Interest

The proposed regulations issued concurrently with Notice 2024-54 identify related-partnership basis adjustment transactions and substantially similar transactions as reportable Transactions of Interest.

Under the proposed rules, disclosure requirements for these transactions would apply to taxpayers and material advisers with respect to partnerships participating in the identified transactions, including by receiving a distribution of partnership property, transferring a partnership interest, or receiving a partnership interest.

Generally, the identified Transactions of Interest would involve positive basis adjustments of $5 million or more under subchapter K of the Internal Revenue Code in excess of the gain recognized from such transactions, if any, on which tax imposed under subtitle A is required to be paid by any of the related partners (or tax-indifferent party) to such transactions – specifically, Section 732(b) or (d), Section 734(b), or Section 743(b) – for which no corresponding tax is paid.

Notification that IRS Will Challenge Basis Stripping

In Revenue Ruling 2024-14, the IRS notifies taxpayers and advisors that the IRS will apply the codified economic substance doctrine to challenge basis adjustments and other aspects of certain transactions between related-party partnerships. The IRS will raise the economic substance doctrine with respect to transactions in which related parties:

1. Create inside/outside basis disparities through various methods, including the use of partnership contributions and distributions and allocation of items under Section 704(b) and (c),
2. Capitalize on the disparity by either transferring a partnership interest in a nonrecognition transaction or making a current or liquidating distribution of partnership property to a partner, and
3. Claim a basis adjustment under Sections 732(b), 734(b), or 743(b) resulting from the nonrecognition transaction or distribution.

Planning Considerations

The IRS guidance package highlights a ramping up of IRS scrutiny of the described partnership basis shifting transactions, but there are still questions with respect to how specifically the final rules will aim to address these transactions. Additional detail should become available when the IRS issues the proposed regulations described in Notice 2024-54. In drafting those rules, the IRS will have the opportunity to take into account comments submitted on the Notice.

Moreover, particularly in light of the Supreme Court's recent decision to overturn Chevron deference in *Loper Bright Enterprises. v. Raimondo*, taxpayers are likely to challenge the IRS's authority to issue the planned regulations.

Nonetheless, taxpayers that have structured partnership basis shifting transactions or transactions that merely fall under the mechanical rules like those described in the guidance should evaluate the effects of the anticipated rules on their transactions and consider next steps for compliance.

Plan for Partnership Form 8308 Expanded Reporting and January 31 Deadline

The IRS in October 2023 released a revised Form 8308, "Report of a Sale or Exchange of Certain Partnership Interests" seeking additional information on partnership interest transfers. The revised form was initially required for transfers occurring on or after January 1, 2023, affecting 2024 filings. However, the IRS in January 2024 provided some penalty relief with respect to 2023 transfers, provided certain action was taken by January 31, 2024. It is unclear if the IRS will provide such relief again in 2025 with respect to 2024 transfers.

The IRS relief provided in the past year responded to concerns, which are still relevant, that partnerships will not have the information necessary to complete the new Part IV of Form 8308 in time to meet the January 31 deadline for furnishing information to the transferor and transferee.

Expanded Form 8308 Reporting

Partnerships file Form 8308 to report the sale or exchange by a partner of all or part of a partnership interest where any money or other property received in exchange for the interest is attributable to unrealized receivables or inventory items (that is, where there has been a Section 751(a) exchange).

The IRS significantly expanded the Form 8308 reporting requirements in the revised form released in October. For transfers occurring on or after January 1, 2023, the revised Form 8308 includes expanded Parts I and II and new Parts III and IV. New Part IV is used to report specific types of partner gain or loss when there is a Section 751(a) exchange, including the partnership's and the transferor partner's share of Section 751 gain and loss, collectibles gain under Section 1(h)(5), and unrecaptured Section 1250 gain under Section 1(h)(6).

Furnishing Information to Transferors and Transferees

Partnerships with unrealized receivables or inventory items described in Section 751(a) (Section 751 property or "hot assets") are also required to provide information to each transferor and transferee that are parties to a Section 751(a) exchange.

Under the regulations, each partnership that is required to file a Form 8308 must furnish a statement to the transferor and transferee by the later of (1) January 31 of the year following the calendar year in which the Section 751(a) exchange occurred or (2) 30 days after the partnership has received notice of the exchange.

Generally, partnerships must use the completed Form 8308 as the required statement, unless the form covers more than one Section 751 exchange. If the partnership is not providing the Form 8308 as the required statement, then it must furnish a statement with the information required to be shown on the form with respect to the Section 751(a) exchange to which the person is a party.

A penalty applies under Section 6722 for failure to furnish statements to transferors and transferees on or before the required date, or for failing to include all the required information or including incorrect information.

Penalty Relief with Respect to 2023 Transfers

The IRS issued guidance (Notice 2024-19) providing penalty relief for partnerships with unrealized receivables or inventory items that would fail to furnish Form 8308 by January 31, 2024, to the transferor and transferee in certain partnership interest transfers that occurred in 2023. To qualify for the relief, among other requirements, partnerships generally still had to furnish to the transferor and transferee Parts I–III of Form 8308 by the January 31, 2024, deadline.

Notice 2024-19 stated that, with respect to Section 751(a) exchanges during calendar year 2023, the IRS would not impose penalties under Section 6722 for failure to furnish Form 8308 with a completed Part IV by the regulatory due date (i.e., generally, January 31, 2024).

To qualify for last year's relief, the partnership was required to:

- Timely and correctly furnish to the transferor and transferee a copy of Parts I, II, and III of Form 8308, or a statement that includes the same information, by the later of January 31, 2024, or 30 days after the partnership is notified of the Section 751(a) exchange, and
- Furnish to the transferor and transferee a copy of the complete Form 8308, including Part IV, or a statement that includes the same information and any additional information required under the regulations, by the later of the due date of the partnership's Form 1065 (including extensions) or 30 days after the partnership is notified of the Section 751(a) exchange.

Planning Considerations

While the requirement of furnishing Form 8308 statements is not new, the inclusion of actual "hot asset" (i.e., unrealized receivables or inventory items) information within Form 8308 for transfers in 2023 and later has created difficulties.

Prior to 2023, this requirement could be satisfied by providing a taxpayer with a Form 8308 that merely notifies the transferor that they will have some amount of hot asset recharacterization. With the new form, partnerships are now required to provide actual recharacterization amounts.

The penalty relief for furnishing information in 2024 on 2023 transfers was welcome. However, it is unclear if the IRS will extend the relief for an additional year or otherwise address concerns about the availability of the information necessary to timely meet the requirement.

Review Limited Partner Eligibility for SECA Tax Exemption

There is some additional clarity in the ongoing dispute between the IRS and some partnerships over whether an active "limited partner" is eligible for the statutory exemption from self-employment (SECA) tax.

The U.S. Tax Court on November 28, 2023, responding to a Motion for Summary Judgment, held that nominally being a "limited partner" in a state law limited partnership is insufficient to qualify for the statutory exemption from SECA tax for limited partners (*Soroban Capital Partners v. Commissioner*, 161 T.C. No. 12). The court agreed with the government that the statutory exemption requires a functional analysis of whether a partner was, in fact, active in the business of the partnership and a "limited partner" in name only.

SECA Tax Exemption for Limited Partners

Under Internal Revenue Code Section 1402(a)(13), the distributive share of partnership income allocable to a limited partner is generally not subject to SECA tax, other than for guaranteed payments for services rendered. However, the statute does not define "limited partner," and proposed regulations issued in 1997 that attempted to clarify the rules around the limited partner exclusion have never been finalized.

In recent years, courts have held – in favor of the IRS – that members in limited liability companies (LLCs) and partners in limited liability partnerships (LLPs) that are active in the entity's trade or business are ineligible for the SECA tax exemption.

Despite these IRS successes, some – including the taxpayer in the *Soroban* case – continued to claim that state law controls in defining "limited partner" in the case of a state law limited partnership. This specific issue – i.e., the application of the exemption in the case of a state law limited partnership – had not previously been addressed by the courts.

Soroban Capital Partners' Position and IRS Challenge

The Soroban Capital Partners litigation filed with the Tax Court involved a New York hedge fund management company formed as a Delaware limited partnership. The taxpayers challenged the IRS's characterization of partnership net income as net earnings from self-employment subject to SECA tax. According to the facts presented, each of the three individual limited partners spent between 2,300 and 2,500 hours working for Soroban, its general partner and various affiliates – suggesting that the limited partners were “active participants” in the partnership’s business. For the years at issue, Soroban was subject to the TEFRA audit and litigation procedures.

The government contended that the term “limited partner” is a federal tax concept that is determined based on the actions of the partners – not the type of state law entity. Citing previous cases, the government asserted that the determination of limited partner status is a “facts and circumstances inquiry” that requires a “functional analysis.” The taxpayers in *Soroban*, on the other hand, argued that such a functional analysis does not apply in the case of a state law limited partnership and that, in the case of these partnerships, limited partner status is determined by state law.

Under the functional analysis adopted by the Tax Court in previous cases (not involving state law limited partnerships), to determine who is a limited partner, the court looks at the relationship of the owner to the entity’s business and the factual nature of services the owner provides to the entity’s operations.

Tax Court’s Analysis

To answer the question of whether Soroban’s net earnings from self-employment should include its limited partners’ distributive shares of ordinary business income, the court turned first to two preliminary questions:

1. What is the scope of the Section 1402(a)(13) SECA tax exemption for “a limited partner, as such”?
2. If the exemption requires looking through to the limited partner’s role in the partnership, does that inquiry concern a partnership item to be resolved in a TEFRA partnership-level proceeding?

With respect to the scope of the exemption – noting that neither the statute nor regulations define “limited partner” – the court highlighted that the statute expressly applies the exemption to “a limited partner, as such”. In interpreting statutes, the court explained that it looks at the ordinary meaning of the terms and that it must avoid rendering any words or clauses to be meaningless. Thus, the court interpreted the addition of the words “as such” to signify that Congress intended the exemption to apply to something more specific than a “limited partner” in name only.

Having concluded that a functional analysis is necessary to determine limited partner status for purposes of the exemption, the court turned to whether this inquiry concerned a “partnership item” under the applicable TEFRA procedures. The court explained that partnership items are those that (1) are required to be taken into account for the partnership tax year under subtitle A of the Internal Revenue Code and (2) are more properly determined at the partnership level.

The court stated the first prong is easily resolved – subtitle A generally requires partnerships to state the amounts of income that would be net earnings from self-employment in the hands of the recipients. The court further determined the second prong was satisfied, stating that a functional analysis of the partners’ activities involves factual determinations that are necessary to determine Soroban’s aggregate amount of net earnings from self-employment.

Accordingly, the court held that a functional analysis applies to determine whether a partner in a state law limited partnership is a “limited partner” for SECA tax exemption purposes, and, for a TEFRA partnership, that inquiry concerns a partnership item subject to a TEFRA proceeding.

Planning Considerations

This *Soroban* case appeared to be a big win for the government. By denying Soroban's Motion for Summary Judgment and granting the government's Motion for Partial Summary Judgment, the Tax Court cleared the way for this case to continue. Once the court proceeds with a functional analysis based on the facts, it can rule on whether the government's Final Partnership Administrative Adjustments for tax years 2016 and 2017 should be upheld.

Based on prior court cases, the functional analysis will likely center around the roles and activities of the individual partners. If they are merely passive investors, then the analysis likely results in them being classified as limited partners under the SECA statute. However, if they are active in the business and/or are able to contractually bind the business under state law, the court is likely to reach the opposite conclusion.

The *Soroban* case involves a partnership subject to TEFRA. Although self-employment tax is not covered under the centralized partnership audit regime enacted by the Bipartisan Budget Act of 2015 (BBA), it's unclear how the IRS will attempt to address this treatment in audits of partnerships subject to the BBA rules instead of TEFRA.

Consider Effect of Proposed Rules on Transactions Between Partnerships and Related Persons

The Department of the Treasury and IRS in November 2023 issued proposed regulations (REG-131756-11) relating to the tax treatment of transactions between partnerships and related persons. The proposed amendments to the regulations under Sections 267 and 707 relate to the disallowance or deferral of deductions for losses and expenses in certain transactions with partnerships and related persons.

Tax Treatment of Transactions with Related Parties Under Current Regulations

In general, Section 267(a)(1) provides that a taxpayer may not deduct a loss on the sale or exchange of property with a related person as defined in Section 267(b). Section 267(a)(2) sets forth a "matching rule" that provides that if because of a payee's method of accounting, an amount is not (unless paid) includible in the payee's gross income, the taxpayer (payor) may not deduct the otherwise deductible amount until the payee includes the amount in gross income if the taxpayer and payee are related persons within the meaning of Section 267(b) on the last day of the taxpayer's taxable year in which the amount otherwise would have been deductible.

As part of enacting the Internal Revenue Code of 1954, Congress added Section 707(b)(1) to the Code to address the sale or exchange of property between a partnership and a partner owning, directly or indirectly, more than 50% of the capital or profit interest in the partnership. Given a lack of statutory and regulatory guidance addressing transactions between a partnership and a related person who was not a partner, the Treasury Department and the IRS issued Reg. §1.267(b)-1(b) in 1958.

Reg. §1.267(b)-1(b) applies an aggregate theory of partnerships to provide that any transaction described in Section 267(a) between a partnership and a person other than a partner is considered as occurring between the other person and the members of the partnership separately. Specifically, Reg. §1.267(b)-1(b) provides that if the other person and a partner are within any of the relationships specified in Section 267(b), no deductions with respect to the transaction between the other person and the partnership will be allowed: (i) to the related partner to the extent of the related partner's distributive share of partnership deductions for losses or unpaid expenses or interest resulting from the transactions, and (ii) to the other person to the extent the related partner acquires an interest in any property sold to or exchanged with the partnership by the other person at a loss, or to the extent of the related partner's distributive share of the unpaid expenses or interest payable to the partnership by the other person as a result of the transaction.

Conflict with Statute and Proposed Amendments

Although the U.S. Tax Court upheld the validity of Reg. §1.267(b)-1(b) and its use of the aggregate theory, subsequent statutory changes to Sections 267 and 707(b) have made Reg. §1.267(b)-1(b) inconsistent with the statute. The statutory changes to Sections 267 and 707(b) enacted since 1982 indicate that Congress intended for a partnership to be viewed as an entity, rather than as an aggregate of its partners, in applying the rules of Sections 267 and 707(b). Therefore, the loss disallowance rules of Sections 267(a)(1) and 707(b)(1), the gain recharacterization rules of Section 707(b)(2), and the matching rule of Section 267(a)(2) similarly should be applied at the partnership level and not the partner level.

Accordingly, the IRS proposed changes to the regulations under Section 267, including removing Reg. §1.267(b)-1(b), to conform the regulations with the current statute.

Application of Proposed Regulations

Once the proposed regulations are finalized, Reg. §1.267(b)-1(b) will be stricken. This means that transactions described in Section 267(a) between a partnership and a person other than a partner will no longer be considered as occurring between the other person and each partner separately.

Consider the following example from the current Reg. §1.267(b)-1(b):

> *Example (1). A, an equal partner in the ABC partnership, personally owns all the stock of M Corporation. B and C are not related to A. The partnership and all the partners use an accrual method of accounting, and are on a calendar year. M Corporation uses the cash receipts and disbursements method of accounting and is also on a calendar year. During 1956 the partnership borrowed money from M Corporation and also sold property to M Corporation, sustaining a loss on the sale. On December 31, 1956, the partnership accrued its interest liability to the M Corporation and on April 1, 1957 (more than 2½ months after the close of its taxable year), it paid the M Corporation the amount of such accrued interest. Applying the rules of this paragraph, the transactions are considered as occurring between M Corporation and the partners separately. The sale and interest transactions considered as occurring between A and the M Corporation fall within the scope of section 267(a) and (b), but the transactions considered as occurring between partners B and C and the M Corporation do not. The latter two partners may, therefore, deduct their distributive shares of partnership deductions for the loss and the accrued interest. However, no deduction shall be allowed to A for his distributive shares of these partnership deductions. Furthermore, A's adjusted basis for his partnership interest must be decreased by the amount of his distributive share of such deductions. See section 705(a)(2).*

Once the proposed regulation is finalized, the transactions would be treated as occurring between the ABC Partnership (as an entity) and M Corporation. Under Section 267(b)(10), a corporation and a partnership are related if the same persons own (A) more than 50% in value of the outstanding stock of the corporation, and (B) more than 50% of the capital interest, or the profits interest, in the partnership. In this case, A owns 100% of M Corporation and only 33-1/3% of ABC Partnership. Accordingly, since the partnership and corporation are unrelated, the partners can deduct the accrued interest liability to M corporation, and the partners can also deduct the loss on sale of property to M Corporation.

Planning Considerations

Given the fact that Treasury and IRS have stated in the Notice of Proposed Rulemaking that statutory changes in the 1980s indicate that Congress intended for a partnership to be viewed as an entity, rather than as an aggregate of its partners, there may be reasonable basis to take such a position even before the proposed regulations are issued in final form, as long as a disclosure is made. Taxpayers should consult with their BDO tax advisers if considering relying on the proposed regulations.

Double-Check Positions on Inventory Items and Unrealized Receivables Under Section 751(a)

On appeal from the Tax Court, the U.S. Court of Appeals for the D.C. Circuit has clarified the application of the recharacterization provision under Section 751(a).

Reversing the Tax Court, the circuit court held that gain attributable to inventory (Section 751(a) property) in the sale of a partnership interest by a nonresident alien is still the sale of a partnership interest under Section 751(a) and not taxable as U.S. source income under the law applicable in the year at issue (*Rawat v. Commissioner*, July 23, 2024).

Taxation of Gain on Partnership Dispositions by Nonresident Aliens

Gain or loss on the sale of partnership interests is generally taxed as a capital gain or loss under Section 741. However, to the extent the gain or loss is attributable to inventory and unrealized receivables – "Section 751(a) property" – the gain or loss is recharacterized as ordinary.

Specifically, Section 751(a) states that an amount realized on the sale of a partnership interest that is attributable to inventory items of the partnership "shall be considered as an amount realized from the sale or exchange of property other than a capital asset."

Section 864(c)(8), enacted by the Tax Cuts and Jobs of 2017 (TCJA), treats a nonresident alien's gain or loss from the sale of an interest in a U.S. partnership as taxable U.S.-source income. However, before the enactment of the TCJA, personal property law controlled, and a nonresident alien's gain or loss from the sale of personal property was generally treated as foreign-source but could be treated as U.S.-source under certain exceptions, including for inventory. A U.S. partnership interest is personal property for purposes of this rule.

Is Gain from Section 751(a) Property Treated as Gain from Selling Inventory?

Rawat, a nonresident alien, sold her interest in a U.S. partnership in 2008 for $438 million, with $6.5 million of her gain attributable to the sale of the company's inventory. The IRS asserted that the gain attributable to inventory was U.S.-source and taxable. Therefore, Rawat owed $2.3 million in taxes on it. Rawat argued that the inventory-attributed gain was foreign-source and nontaxable. The Tax Court agreed with the government.

The dispute centered on the interpretation of Section 751(a): whether it causes gain from a partnership interest sale that is attributable to inventory merely to be taxed as ordinary income or actually to be treated as the sale of inventory and therefore potentially U.S. source in the hands of a nonresident alien.

There was no dispute that the statute required gain attributable to Section 751(a) property to be taxed as ordinary income if it was taxable to Rawat as U.S.-source income.

D.C. Circuit Finds Narrow Interpretation of Section 751(a)

The D.C. Circuit Court found relevant that the definition of "ordinary income" in Section 64 parallels the language in Section 751(a), with both Code sections referring to gain from the sale or exchange of property that is not a capital asset. It follows, the court reasoned, that the language of Section 751(a) that states that gain (or an amount realized) attributable to inventory "shall be considered as an amount realized from the sale or exchange of property other than a capital asset" may be read more plainly to mean "shall be considered as ordinary income."

The court stated that this interpretation is further supported by the fact that Section 751(a) operates as a carveout to the general rule in Section 741 that gain on the sale of a partnership interest is treated as capital gain. The court further pointed to legislative history indicating Section 751(a) was enacted to end efforts to evade taxation as ordinary income.

On the contrary, the government argued that, under the statute, gain on the sale of a partnership interest from inventory or Section 751(a) property is not just taxed as ordinary income but is taxed as a sale of inventory rather than as of a partnership interest. The result being that the gain could be U.S.-source income to a nonresident alien under the pre-TCJA law.

However, the D.C. Circuit rejected the argument put forth by the government and previously accepted by the Tax Court. The D.C. Circuit noted that Section 751(a) states that the applicable gain is to be treated as ordinary income, nothing more, and that Congress would have stated more if it meant more. The broader reading of Section 751(a) is not supported by other sections of the Code using similar language or the legislative history, the court concluded.

Accordingly, the court held that the sale by Rawat of the partnership interest attributable to inventory was still the sale of a partnership interest, and accordingly, under the law applicable at the time, was foreign-source income and non-taxable.

Planning Considerations

This court case has limited direct applicability after the TCJA enacted Section 864(c)(8). However, the court case is instructive in that it supports the idea that, absent a specific statutory exception, the entity theory of partnerships (rather than the aggregate theory) controls with respect to the sale of a partnership interest. Section 751(a) is merely a recharacterization provision and it does not operate to dictate that a partnership interest sale be deemed to be an actual sale of inventory.

Because the Tax Court's judgment has now been reversed by the circuit court, taxpayers that have relied on a similar theory as that adopted by the Tax Court in *Rawat* should review their positions. Although the reversal of the Tax Court in *Rawat* was a win for the taxpayer in the current case, taxpayers have taken other taxpayer-friendly positions based on a similar interpretation of Section 751(a) as argued by the government and originally accepted by the Tax Court in *Rawat*.

Keep an Eye on Challenges to IRS Rules, Including Partnership Anti-Abuse Rules, Under *Loper Bright*

In its June 2024 decision in *Loper Bright*, the Supreme Court overturned the longstanding *Chevron* doctrine, which gave deference to agency interpretations of silent or ambiguous statutes if the interpretation was reasonable. In overturning this principle, the Supreme Court held that courts must exercise independent judgment.

In light of the *Loper Bright* decision, taxpayers are bringing new challenges to IRS regulations, including in the *Tribune Media* case involving the application of a liability allocation anti-abuse rule under Treas. Reg. §1.752-2(j) and the general partnership anti-abuse rule under Treas. Reg. §1.701-2. For a detailed discussion of the relevant facts and anti-abuse rules, see BDO's Tax Alert, "Government Appeals Tax Court Decision on Leveraged Partnership Transactions, Anti-Abuse Rules."

Generally, in the *Tribune Media* case, the government appeals a Tax Court decision that it views as paving the way for inappropriate income tax planning, potentially enabling taxpayers to follow the roadmap created by the taxpayer in Tribune Media to implement leveraged partnership transactions without triggering taxable gain while avoiding incurring meaningful economic risk.

Loper Bright* Arguments in *Tribune Media

Tribune Media and the government have supplemented their arguments in their pending appeal before the Seventh Circuit on leveraged partnership transactions and the application of partnership anti-abuse rules. Tribune Media has submitted a letter to the court arguing that the U.S. Supreme Court's decision in *Loper Bright* reinforces its argument that the general anti-abuse rule in question is invalid.

In its letter to the Seventh Circuit regarding the effect of *Loper Bright* in its case, Tribune Media challenges the validity of the general anti-abuse rule. It notes that, although the government does not expressly claim *Chevron* deference for the rule, the *Loper Bright* decision instructs the court to scrutinize whether the IRS had the authority to issue the rule, which Tribune Media argues is regulatory overreach as "the agency even contends that it can invalidate a transaction that follows 'the literal words' of a statute that Congress enacted."

In its response, the government contends that the anti-abuse rule does not rely on *Chevron* deference, is based on established case law, and was promulgated within the bounds of authority granted to the IRS by Congress.

Planning Considerations

The decision in *Loper Bright* has opened the door for taxpayers to make fresh challenges to the validity of Treasury regulations. The *Tribune Media* case is an example of the type of challenge that taxpayers are making to the government's authority to promulgate its interpretation of statutes in existing regulations. The issue in this specific case is whether the government can write broad anti-abuse regulations that change the taxation of transactions that follow a strict reading of the statute, but that the IRS and Treasury contend are abusive or argue aren't in line with the intent of the statute.

Watch for New Form for Partners to Report Partnership Property Distributions

The IRS has released a draft of new Form 7217, "Partner's Report of Property Distributed by a Partnership," and related instructions.

The form is to be filed by any partner receiving a distribution of property from a partnership in a non-liquidating or liquidating distribution. However, partners do *not* have to file the form for

- Distributions that consist only of money or marketable securities treated as money,
- Payments to the partner for services other than in their capacity as a partner under Section 707(a)(1), or
- Payments for transfers that are treated as disguised sales under Section 707(a)(2)(B).

The partner uses the form to report the basis of distributed property, including any basis adjustments to the property required by Section 732(a)(2) or (b). The two-page draft Form 7217 is broken into two parts, with Part I used for reporting the aggregate basis of the distributed property on the distribution date and Part II covering the allocation of basis of the distributed property.

Partners are to file a separate Form 7217 for each date during the tax year that they actually (not constructively) receive distributed property subject to Section 732 – even if property distributions received on different days were part of the same transaction.

The instructions state that Forms 7217 are to be due when the partner's tax return is due, including extensions. They add that partners should file their Forms 7217 attached to their annual tax return for the tax years in which they actually received distributed property subject to Section 732.

Planning Considerations

The draft form is a continuation of the IRS's recent efforts to expand required disclosures from partnerships. Based on an initial review of the draft version of the form, it appears likely they IRS will need to make some modifications to appropriately capture the information being requested by the form.

Prepare for Partnership Obligations Under Corporate Alternative Minimum Tax Regulations

The IRS on September 12, 2024, issued proposed regulations on the corporate alternative minimum tax (CAMT), enacted by the Inflation Reduction Act, that include significant new provisions for partnerships with corporate partners subject to the CAMT.

For tax years beginning after December 31, 2022, the CAMT imposes a 15% minimum tax on the adjusted financial statement income (AFSI) of large corporations (generally, those with average annual AFSI exceeding $1 billion).

The proposed regulations set out rules for determining and identifying AFSI, including applicable rules for partnerships with CAMT entity partners. For a general discussion of the CAMT proposed regulations, see the Corporate Tax section of this guide.

CAMT Statute, AFSI Adjustments & Partnerships

Generally, the CAMT is imposed on AFSI – as determined under Section 56A – of an applicable corporation. Under Section 56A, AFSI means, with respect to any corporation for any tax year, the net income or loss of the taxpayer set forth on the taxpayer's applicable financial statement for that tax year, adjusted as further provided within that Code section.

Adjustments to AFSI are set out in Section 56A(c). Regarding partnerships, Section 56A(c)(2)(D) states that, except as provided by the Secretary, if the taxpayer is a partner in a partnership, the taxpayer's AFSI with respect to such partnership is adjusted to take into account only the taxpayer's distributive share of such partnership's AFSI. It adds that the AFSI of a partnership is the partnership's net income or loss set forth on that partnership's applicable financial statement, as adjusted under rules similar to the rules set forth in Section 56A.

Proposed Rules on for Partner's Distributive Share of Partnership AFSI

The IRS sets out in Prop. Reg. §1.56A-5 rules under Section 56A(c)(2)(D) regarding a partner's distributive share of partnership AFSI. The IRS explains that it is proposing adopting a "bottom-up" method which it believes is consistent with the statute and is more conducive to taking into account Section 56A adjustments. Under the proposed "bottom-up" method, a partnership would calculate its AFSI and provide this information to its partners. Each partner would then need to determine its "distributive share" of the partnership's AFSI.

The proposed rules generally provide that, if a CAMT entity is a partner in a partnership, its AFSI with respect to its partnership investment is adjusted as required under the applicable regulations to take into account the CAMT entity's distributive share of the partnership's AFSI.

Under the proposed rules, a CAMT entity's distributive share amount is computed for each tax year based on four steps:

1. The CAMT entity determines its distributive share percentage,
2. The partnership determines its modified financial statement income,
3. The CAMT entity multiplies its distributive share percentage by the modified financial statement income of the partnership (as reported by the partnership), and
4. The CAMT entity adjusts the product of the amount determined in step (3) above for certain separately stated Section 56A adjustments.

There are also related reporting and filing requirements in the proposed rules. Because a CAMT entity may require information from the partnership to compute its distributive share of a partnership's AFSI, the proposed regulations would require a partnership to provide the information to the CAMT entity if the CAMT entity cannot determine its distributive share of the partnership's AFSI without the information and the CAMT entity makes a timely request for the information.

Proposed Rules on AFSI Adjustments to Apply Certain Subchapter K Principles

The proposed regulations also include rules to provide for adjustments to carry out the principles of subchapter K regarding partnership contributions, distributions, and interest transfers. The rules, as proposed, would apply to most contributions to or distributions from a partnership, but not with respect to stock of a foreign corporation except in limited circumstances.

For both contributions and distributions of property, the IRS proposes a deferred sale method. Thus, for contributions, the proposed rules generally provide that, if property (other than stock in a foreign corporation) is contributed by a CAMT entity to a partnership in a non-taxable transaction, any gain or loss reflected in the contributor's financial statement income from the property transfer is included in the contributor's AFSI in accordance with the deferred sale approach set forth in the proposed rules.

The proposed regulations also include rules relating to the maintenance of books and records and reporting requirements for a partnership and each CAMT entity that is a partner in the partnership.