Part I

Section 7701(o).--Clarification of economic substance doctrine
(Also §§ 732, 734, 743, 754, 755)

Rev. Rul. 2024-14

ISSUE

Does the economic substance doctrine apply to disallow tax benefits associated with a series of transactions involving a related-party partnership, through which the parties first generate a disparity between inside basis and outside basis and then trigger a basis adjustment to property under § 732(b), § 734(b), or § 743(b),[1] which generates increased cost recovery deductions with respect to the property or reduced gain (or increased loss) upon a sale of the property?

FACTS

[1] Unless otherwise specified, all "Section" or "§" references are to sections of the Code or the Income Tax Regulations (26 CFR part 1).

C is a domestic corporation engaged in operating a trade or business, including through several subsidiary entities commonly managed by C or in which C directly or indirectly holds controlling financial interests (C Subsidiaries) such that C is related to each of the C Subsidiaries under § 267(b) or § 707(b)(1). The C Subsidiaries include, among other entities, Sub 1, Sub 2, Sub 3, Partnership A, Partnership B, Partnership C, and Partnership D, each of which is indirectly owned by C through one or more C Subsidiaries. The C Subsidiaries own various depreciable or amortizable assets used in, and have incurred various liabilities as part of, the conduct of C's trade or business. C issues financial statements for its trade or business that report these assets and liabilities of the C Subsidiaries (C Financial Statements).

Situation 1. C indirectly owns more than 50 percent of the stock of each of Sub 1, Sub 2, and Sub 3, all domestic corporations. Sub 1 and Sub 2 are the only partners in Partnership A with each holding a 50 percent interest in the capital, profits, and losses of Partnership A. Sub 1 and Sub 3 are the only partners in Partnership B with each holding a 50 percent interest in the capital, profits, and losses of Partnership B.

Prior to Date 1, Partnership A had a valid election in place under § 754. Also prior to Date 1, Sub 1's share of the adjusted tax basis of Partnership A's property (that is, Sub 1's share of Partnership A's inside basis) was equal to $20x and the adjusted tax basis of Sub 1's interest in Partnership A (that is, Sub 1's outside basis) was $100x. This $80x disparity between Sub 1's share of Partnership A's inside basis and Sub 1's outside basis in Partnership A prior to Date 1 resulted from Sub 1 and Sub 2 making contributions to Partnership A, and Partnership A making distributions to Sub 1 and

Sub 2, of property with specific Federal income tax attributes, and the allocation of Federal income tax items in accordance with § 704(b) and (c). Such contributions, distributions, and allocations were undertaken with a view to creating a disparity between Sub 1's share of Partnership A's inside basis and Sub 1's outside basis in Partnership A.

On Date 1, Sub 1 transfers its interest in Partnership A to Partnership B in a contribution that qualifies for nonrecognition of gain or loss under § 721(a) (Sub 1 Contribution). The stated business purpose for the Sub 1 Contribution is to achieve cost savings for C and the C Subsidiaries by cleaning up intercompany accounts, reducing administrative complexity, and achieving other administrative efficiencies.

Immediately after the Sub 1 Contribution, Partnership B's outside basis in its interest in Partnership A is $100x under § 723 while its share of Partnership A's inside basis is $20x (without regard to § 743(b)). Under § 743(b), Partnership A increases the adjusted basis of its property by $80x (the excess of Partnership B's $100x outside basis over its $20x proportionate share of inside basis) with respect to Partnership B only.[2] Partnership A allocates substantially all of this $80x basis increase to its depreciable or amortizable property (Basis-Adjusted Property) under § 755 and § 1.755-1(b)(5). The Sub 1 Contribution on Date 1 was undertaken with a view to exploiting the disparity between Sub 1's share of Partnership A's inside basis and Sub 1's outside basis in Partnership A created before Date 1 and increasing Partnership B's share of

[2] This section shows a mechanical application of the rules of subchapter K of chapter 1 of the Code (subchapter K). The tax effect will be disregarded if the economic substance doctrine applies. Later sections of this revenue ruling address whether the economic substance doctrine applies.

Partnership A's inside basis in the depreciable or amortizable property.

The cost savings resulting from the Sub 1 Contribution are insubstantial in relation to the reduction in the aggregate Federal income tax liability of the C Subsidiaries resulting from the $80x increase in Partnership A's basis in the Basis-Adjusted Property, which results in Partnership B being allocated increased amounts of deductions for depreciation or amortization or reduced amounts of gain (or increased amounts of loss) upon the sale of the Basis-Adjusted Property. C reports the relatively small cost savings in the C Financial Statements.

Situation 2. C indirectly owns more than 50 percent of the stock of Sub 1 and Sub 2, both domestic corporations. Sub 1 and Sub 2 are the only partners in Partnership C with each having a 50 percent interest in the capital, profits, and losses of Partnership C. Partnership C owns 100 percent of the stock of Sub 3, a domestic corporation, a depreciable asset, and $100x of money deposited in a bank account.

Prior to Date 2, Partnership had a valid election in place under § 754. Also prior to Date 2, Partnership C held the Sub 3 stock with an adjusted basis of $90x and fair market value of $100x and held the depreciable asset with an adjusted basis of $10x and fair market value of $100x. Also, Sub 1's outside basis in Partnership C was $100x and Sub 2's outside basis in Partnership C was $10x as a result of Sub 1 and Sub 2 making contributions to Partnership C, and Partnership C making distributions to Sub 1 and Sub 2, of property with specific Federal income tax attributes, and the allocation of Federal income tax items in accordance with § 704(b) and (c). Such contributions, distributions, and allocations were undertaken with a view to creating a disparity

between Sub 2's outside basis and Partnership C's inside basis in the Sub 3 stock.

On Date 2, Partnership C distributes all of the Sub 3 stock to Sub 2 other than in liquidation of Sub 2's interest in Partnership C (Sub 3 Stock Distribution). The stated business purpose for the Sub 3 Stock Distribution is to achieve costs savings for C and the C Subsidiaries by cleaning up intercompany accounts, reducing administrative complexity, and achieving other administrative efficiencies.

Immediately after the Sub 3 Stock Distribution, Sub 2's adjusted basis in the Sub 3 stock is $10x under § 732(a)(2), the same as Sub 2's outside basis in Partnership C prior to the Sub 3 Stock Distribution. In addition, the Sub 3 Stock Distribution reduces Sub 2's outside basis in Partnership C from $10x to zero under § 733(2). Following the Sub 3 Stock Distribution, Partnership C increases the inside basis of its assets by $80x under § 734(b)(1)(B). Under § 755 and § 1.755-1(c)(2)(i), Partnership C increases the adjusted basis of its remaining depreciable asset from $10x to $90x.[3] The Sub 3 stock Distribution on Date 2 was undertaken with a view to exploiting the disparity between Sub 2's outside basis in Partnership C and Partnership C's inside basis in the Sub 3 stock created before Date 2 and transferring basis from nondepreciable Sub 3 stock to Partnership C's remaining depreciable asset.

The cost savings resulting from the Sub 3 Stock Distribution are insubstantial in

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[3] The distribution of Sub 3 stock (controlled corporation) to Sub 2 (corporate partner) meets the requirements of § 732(f) because Partnership C's adjusted basis in the Sub 3 stock prior to the Sub 3 Stock Distribution exceeds the adjusted basis of the stock in the hands of the corporate partner (Sub 2). Under § 732(f), the aggregate adjusted bases of Sub 3's property must be reduced by $80x, subject to the limitations in § 732(f)(3). Additionally, this revenue ruling does not address the application of § 751(b) to the facts of Situations 2 and 3.

relation to the reduction in the aggregate Federal income tax liability of the C Subsidiaries resulting from the $80x increase in Partnership C's inside basis in the remaining depreciable asset, which results in Sub 1 and Sub 2 being allocated increased amounts of deductions for depreciation or reduced amounts of gain (or increased amounts of loss) upon the sale of Partnership C's remaining depreciable asset. C reports the relatively small cost savings in the C Financial Statements.

Situation 3. C indirectly owns more than 50 percent of the stock of Sub 1 and Sub 2, both domestic corporations. Sub 1 and Sub 2 are the only partners in Partnership D with each having a 50 percent interest in the capital, profits, and losses of Partnership D.

Prior to Date 3, Partnership D owned two assets: a depreciable asset with an adjusted basis of $20x and a fair market value of $100x and nondepreciable land with an adjusted basis of $90x and fair market value of $100x. Also prior to Date 3, Sub 1's outside basis in Partnership D was $100x, and Sub 2's outside basis in Partnership D was $20x as a result of Sub 1 and Sub 2 making contributions to Partnership D, and Partnership D making distributions to Sub 1 and Sub 2, of property with specific Federal income tax attributes, and the allocation of Federal income tax items in accordance with § 704(b) and (c). Such contributions, distributions, and allocations were undertaken with a view to creating a disparity between Partnership D's inside basis in the depreciable asset and Sub 1's outside basis in Partnership D.

On Date 3, Partnership D liquidates by distributing the depreciable asset to Sub 1 and the nondepreciable land to Sub 2 (Partnership D Liquidation). The stated business

purpose for the Partnership D Liquidation is to achieve cost savings for C and the C Subsidiaries by cleaning up intercompany accounts, reducing administrative complexity, and achieving other administrative efficiencies.

Immediately after the Partnership D Liquidation, Sub 1's adjusted basis in the depreciable asset is $100x under § 732(b), the same as Sub 1's outside basis in Partnership D prior to the Partnership D Liquidation, reflecting an increase of $80x to the adjusted basis of the depreciable asset in the hands of Sub 1. Also immediately after the Partnership D Liquidation, Sub 2's adjusted basis in the nondepreciable land is $20x under § 732(b), the same as Sub 2's outside basis in Partnership D prior to the Partnership D Liquidation, reflecting a decrease of $70x to the adjusted basis of the nondepreciable land in the hands of Sub 2. The distribution of the depreciable asset to Sub 1 as part of the Partnership D Liquidation on Date 3 was undertaken with a view to exploiting the disparity between Partnership D's inside basis in the depreciable asset and Sub 1's outside basis in Partnership D created before Date 3 and transferring basis from nondepreciable land distributed to Sub 2 to the depreciable asset distributed to Sub 1.

The cost savings resulting from the Partnership D Liquidation are insubstantial in relation to the reduction in the aggregate Federal income tax liability of the C Subsidiaries resulting from the $80x increase in Sub 1's adjusted basis in the depreciable asset, which results in increased deductions for depreciation or reduced amounts of gain (or increased amounts of loss) upon the sale of the depreciable asset for Sub 1. C reports the relatively small cost savings in the C Financial Statements.

LAW

Section 267(a) generally disallows deductions in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of § 267(b), other than any loss of a distributing corporation (or the distributee) in the case of a distribution in complete liquidation. Section 267(b)(3) provides that two corporations that are members of the same controlled group (as defined in § 267(f)) have a relationship referred to in § 267(a). Section 267(f)(1) provides that a controlled group has the meaning given by § 1563(a), except that "more than 50 percent" is substituted for "at least 80 percent" each place it appears in § 1563(a), and the determination is made without regard to § 1563(a)(4) and (e)(3)(C). In addition, § 267(b)(10) provides that a corporation and a partnership owned by the same persons have a relationship referred to in § 267(a) if the same persons own more than 50 percent of both the value of the outstanding stock of the corporation and the capital interest, or the profits interest, in the partnership.

Section 707(b)(1)(A) disallows any deduction for losses from sales or exchanges of property (other than an interest in the partnership) directly or indirectly, between a partnership and a partner owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership. Section 707(b)(1)(B) disallows any deduction for losses from sales or exchanges of property (other than an interest in the partnership) directly or indirectly, between two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or

profits interests.

Section 721(a) provides that no gain or loss is recognized to a partnership or to any of its partners on the contribution of property to the partnership in exchange for an interest in the partnership. Section 723 provides that the basis of property contributed to a partnership by a partner is the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount of gain (if any) recognized under § 721(b) to the contributing partner at such time.

Section 731(b) provides that no gain or loss is recognized to a partnership on the distribution to a partner of property, including money. Section 732(a)(1) generally provides that the basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner's interest is its adjusted basis to the partnership immediately before the distribution. However, § 732(a)(2) limits the basis to the distributee partner to the adjusted basis of that partner's interest in the partnership reduced by any money distributed in the same transaction. Section 732(b) provides that the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest equals the adjusted basis of the partner's interest in the partnership reduced by any money distributed in the same transaction. Section 732(c) provides rules for the allocation of basis among properties received in a distribution to which § 732(a)(2) or § 732(b) applies.

Section 733 provides that the adjusted basis of a distributee partner's interest in a partnership following a non-liquidating distribution is reduced (but not below zero) by (1) the amount of any money distributed to the partner, and (2) the adjusted basis of

distributed property (other than money), as determined under § 732.

Section 734(a) provides that the basis of partnership property is not adjusted as the result of a distribution of property to a partner unless an election provided in § 754 is in effect or there is a substantial basis reduction (as defined in § 734(d)) with respect to such distribution. Section 734(b) provides that a partnership, with respect to which an election provided in § 754 is in effect or with respect to which there is a substantial basis reduction, increases or decreases the adjusted basis of partnership property to take into account the gain or loss recognized by a distributee partner under § 731(a) or changes in the basis of distributed property under § 732. Under § 734(b)(1)(B), in the case of distributed property to which § 732(a)(2) applies, the amount of increase includes the excess of the adjusted basis of the distributed property immediately before the distribution over the basis of the distributed property to the distributee. If § 734(b) is applicable, § 734(c) provides that the allocation of basis among partnership properties is made in accordance with the rules provided in § 755. Section 734(d) provides that there is a substantial basis reduction with respect to a distribution if, had an election provided in § 754 been in effect, there would be a negative net basis adjustment to partnership property of more than $250,000.

Section 743(a) provides that the basis of partnership property is not adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner unless an election provided in § 754 is in effect or there is a substantial built-in loss (as defined in § 743(d)) immediately after such transfer. Section 743(b) provides that, in the case of a transfer of an interest in a partnership by sale or exchange or upon

the death of a partner, a partnership with respect to which an election provided in § 754 is in effect or a partnership that has a substantial built-in loss immediately after such transfer, increases the adjusted basis of the partnership property by the excess of the basis to the transferee partner of the transferee partner's interest in the partnership over such partner's proportionate share of the adjusted basis of the partnership property, or decreases the adjusted basis of the partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of such partner's interest in the partnership. Section 743(b) further provides that, under regulations prescribed by the Secretary of the Treasury or her delegate (Secretary), such increase or decrease constitutes an adjustment to the basis of partnership property with respect to the transferee partner only. If § 743(b) is applicable, § 743(c) provides that the allocation of basis among partnership properties is made in accordance with the rules provided in § 755.

Section 754 provides, in part, that if a partnership files an election, in accordance with the regulations prescribed by the Secretary, the basis of partnership property is adjusted, in the case of a distribution of property, in the manner provided in § 734, and, in the case of a transfer of a partnership interest, in the manner provided in § 743. A § 754 election applies with respect to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year with respect to which the election was filed and all subsequent taxable years.

Section 755(a) provides that a basis adjustment under § 734(b) or § 743(b) is allocated among partnership properties in a manner that reduces the difference

between the fair market values and adjusted bases of those properties or in any other manner permitted by the regulations prescribed by the Secretary. Section 755(b) provides that in applying the allocation rules of § 755(a), increases or decreases in the adjusted basis of partnership property arising from a distribution of, or a transfer of an interest attributable to, capital assets and property described in § 1231(b), or any other property of the partnership, are allocated to partnership property of like character. The allocation of basis adjustments under §§ 743(b) and 734(b) among partnership property is provided in § 1.755-1(b) and (c), respectively.

Section 7701(o)(1) provides that, in the case of any transaction to which the economic substance doctrine is relevant, the transaction is treated as having economic substance only if (i) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (ii) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction. For this purpose, achieving a financial accounting benefit is not taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax. Section 7701(o)(4).

Section 7701(o)(5)(A) provides that the "economic substance doctrine" means the common law doctrine under which tax benefits under subtitle A of the Code with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

Section 7701(o)(5)(C) provides that the determination of whether the economic substance doctrine is relevant to a transaction is made in the same manner as if

§ 7701(o) had never been enacted.

Section 7701(o)(5)(D) provides that the term "transaction" includes a series of transactions.

Section 7701(o)(2)(A) provides that if a taxpayer relies on profit potential to help prove that a transaction has economic substance, profit potential will only be taken into account if the present value of the reasonably-expected pretax profit of that transaction is substantial in relation to the present value of the expected net tax benefits of the transaction that would be allowed if the Federal income tax effects of the transaction were not disregarded.

Section 6662(b)(6) provides that a 20 percent penalty applies to an underpayment attributable to a transaction lacking economic substance under § 7701(o) or failing to meet the requirements of any similar rule of law. Under § 6662(i), the penalty is increased to 40 percent or any portion of an underpayment that is attributable to one or more nondisclosed noneconomic substance transactions. Under § 6664(c)(2), there is no reasonable cause exception to the penalties described in § 6662(b)(6) or (i).

ANALYSIS

The basis adjustment rules under §§ 732(b), 734(b), and 743(b) are intended to reduce disparities between inside and outside basis that would otherwise result from a distribution of property or transfer of a partnership interest. In each of Situations 1-3, however, the parties engaged in a concerted effort to create disparities between inside and outside basis through various methods, such as the contribution or distribution of

property with specific Federal income tax attributes or the allocation of Federal income tax items in accordance with § 704(b) and (c). They then exploited the created disparities by engaging in transfers resulting in basis adjustments under the mechanical rules of § 732(b), 734(b), or 743(b) to inappropriately reduce taxable income through increased deductions or reduced gain (or increased loss).

In Situation 1, the actions of the parties creating a disparity between Sub 1's outside basis and share of Partnership A's inside basis, the transfer of Sub 1's interest in Partnership A to Partnership B in the Sub 1 Contribution, and the resulting positive basis adjustment to Partnership B's share of inside basis of Partnership A's property under § 743(b) were undertaken with a view to increasing Partnership B's share of Partnership A's inside basis in depreciable or amortizable property by $80x while avoiding recognition of gain or loss under § 721(a) through a nonrecognition transaction. Additionally, the $80x basis increase was relatively large in amount compared to the cost savings to C and the C Subsidiaries.

In Situation 2, the actions of the parties creating a disparity between Sub 2's outside basis and Partnership C's inside basis in the Sub 3 stock, the distribution of Sub 3 stock (a high-inside basis asset) to Sub 2 (a partner with a low outside basis in its partnership interest) and the resulting adjustment to the inside basis of Partnership C's remaining property were undertaken with a view to transferring $80x of basis from nondepreciable Sub 3 stock to Partnership C's remaining depreciable asset while avoiding recognition of gain or loss under § 731 through a nonrecognition distribution. Additionally, the $80x basis increase was relatively large in amount compared to the cost savings.

In Situation 3, the actions of the parties creating a disparity between Sub 1's outside basis and Partnership D's adjusted basis in the depreciable asset, the liquidating distribution of the depreciable asset (a low-inside basis asset) to Sub 1 (a partner with a high outside basis in its partnership interest) in the Partnership D Liquidation and the resulting adjustment to the adjusted basis of the depreciable asset to Sub 1 under § 732(b) were undertaken with a view to transferring basis from nondepreciable land distributed to Sub 2 to the depreciable asset distributed to Sub 1 while avoiding recognition of gain or loss under § 731 through a nonrecognition distribution. Additionally, the $80x basis increase was relatively large in amount compared to the cost savings to C and the C Subsidiaries.

Situations 1-3 all involve persons related to each other under § 267(b) or § 707(b)(1). A transaction among related parties to avoid Federal income tax by generating inflated basis adjustments falls outside the plain intent of §§ 732(b), 734(b), 743(b), and 754. While the differing economic interests of unrelated parties generally make it less likely that unrelated partners will engage in transactions such as those in Situations 1-3, partnerships composed of related partners have no such disincentive.[4]

Congress intended that the provisions of subchapter K apply to transactions between partnerships and their partners to preserve parity between inside and outside basis "so as to prevent any unintended tax benefit or detriment to the partners." H.R. Rep. No. 1337, 83d Cong., 2d Sess. A225 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 384

[4] This revenue ruling does not address the application of § 7701(o) to transactions among unrelated partners. Depending on the specific facts, § 7701(o) may apply to transactions among unrelated partners.

(1954). Congress also expressed its desire to prevent related parties from exploiting the rules of subchapter K to avoid tax "through the realization of fictitious losses or increasing the basis of property for purposes of depreciation." H.R. Rep. No. 1337, at A226; S. Rep. No. 1622, at 386-87.

Congress did not intend that taxpayers be able to *avoid or indefinitely defer taxation* altogether by creating basis disparities through contributions or distributions of property or through allocations of tax items by reason of a § 743(b) basis adjustment after a nonrecognition transaction, such as the Sub 1 Contribution in Situation 1; by reason of a § 734(b) basis adjustment after distribution of property, such as the Sub 3 Stock Distribution in Situation 2; or by reason of a § 732(b) basis adjustment after a liquidating distribution of property, such as the Partnership D Liquidation in Situation 3. The shared economic interests of related parties make them more likely than unrelated parties to attempt to generate such tax benefits in a manner not intended by Congress by entering into transactions with no meaningful economic change.

Unless a "meaning plainly appears" that Congress intended a provision to grant a tax benefit to transactions without economic substance or business purpose, such an intent "will not [be] attribute[d] to Congress." Knetsch v. United States, 364 U.S. 361, 367-69 (1960). The economic substance doctrine is intended to apply "despite literal compliance with the statute." Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1354 (Fed. Cir. 2006); see Gregory v. Helvering, 293 U.S. 465, 470 (1935). The economic substance doctrine was developed to address transactions such as these, which follow the literal words of the Code but lie outside of Congress's plain intent. Gregory, 293

U.S. at 469-470.

Each series of transactions described in Situations 1-3 lacks economic substance. In each of those situations, the economic substance doctrine is applied to basis adjustments generated by the following series of connected transactions involving related parties, which may occur over the course of several taxable years: (i) the parties generate basis disparities through various methods, such as contributions of property with specific Federal income tax attributes to the partnership, the allocation of Federal income tax items in accordance with § 704(b) and (c), or distributions of property with specific attributes to the partners, and (ii) either (1) a partner transfers its partnership interest in a nonrecognition transaction while there exists an inside/outside basis disparity, or (2) the partnership distributes property with specific Federal income tax attributes (for example, high inside basis) to one or more partners with specific Federal income tax attributes (for example, low outside basis) in a current or liquidating distribution. The resulting basis adjustments, if allowed, would permit the parties to shift basis in a manner that enables the parties to claim increased cost recovery deductions or reduced gain (or increased loss) upon the sale of the basis-adjusted property.

In applying the conjunctive test of § 7701(o)(1), each of two prongs must be met for the transactions described in Situations 1-3 to have economic substance. First, under § 7701(o)(1)(A), the transaction must change in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position. Second, under § 7701(o)(1)(B), the taxpayer must have had a substantial purpose (apart from Federal income tax effects) for entering into the transaction.

With respect to the first prong under § 7701(o)(1)(A), the transactions in Situations 1-3 have a negligible effect on C's economic position because the transactions shift ownership of property among commonly controlled entities without "effect[ing] any real change in the 'flow of economic benefits,' or provid[ing] any real 'opportunity to make a profit' . . . ." Coltec, 454 F.3d at 1360; see Reddam v. Commissioner, 755 F.3d 1051, 1060-62 (9th Cir. 2014). The transactions fail to "*appreciably* affect the [taxpayer's] beneficial interest except to reduce . . . tax"; that is, the transactions do not appreciably affect C's beneficial interests in the C Subsidiaries or their assets, except to reduce the aggregate Federal income tax liability of the related persons involved. Knetsch, 364 U.S. at 366 (quoting Gilbert v. Commissioner, 248 F.2d 399, 411 (2d Cir. 1957) (Learned Hand, J., dissenting)) (emphasis added). The only potential economic gains are derived from purported cost savings from cleaning up intercompany accounts between the C Subsidiaries, reducing administrative complexity, and achieving administrative efficiencies. However, any such cost savings do not change C and the C Subsidiaries' economic position in a meaningful way because any economic benefits attributable to purported cost savings (apart from the Federal income tax effects) are insubstantial compared to the $80x in Federal income tax benefits from the basis adjustments attributable to these transactions. The basis increases of $80x resulting from the transactions in Situations 1-3 can be used to reduce taxable income of the C Subsidiaries through depreciation, amortization, or other deductions or reduce gain recognized upon the sale of the property. The transactions were "designed to generate" basis increases, and those basis increases "would always . . . have overshadowed" the

economic gain, including gain derived from cost savings. Reddam, 755 F.3d at 1061-62. Even if there had been "some prospect of profit" from transferring a partnership interest or partnership property among related parties, the calculable Federal income tax benefits would have "far exceeded any independent potential for economic return." Bank of New York Mellon Corp. v. Commissioner, 801 F.3d 104, 117-18, 120 (2d Cir. 2015); Salem Fin., Inc. v. United States, 786 F.3d 932, 949 (Fed. Cir. 2015) (citing Knetsch, 364 U.S. at 365-66). Thus, any change in economic position (apart from the Federal income tax effects) in the transactions described in Situations 1-3 is not meaningful within the meaning of § 7701(o)(1)(A).

With respect to the second prong of the conjunctive test under § 7701(o)(1)(B), the transactions described in Situations 1-3 demonstrate a lack of any substantial purpose (apart from Federal income tax effects) to enter into these transactions. The stated business purpose of achieving cost savings from cleaning up intercompany accounts between the C Subsidiaries, reducing administrative complexity, and achieving administrative efficiencies may be a legitimate nontax economic purpose. However, any such business purpose is not substantial compared to the Federal income tax purposes the transactions were designed to carry out. See Reddam, 755 F.3d at 1061. Many of the facts in these transactions demonstrating a lack of meaningful change in economic position (apart from Federal income tax effects) also demonstrate a lack of substantial purpose (apart from Federal income tax effects) for these related parties to enter into these transactions. Reasonable inferences into a taxpayer's purpose for entering a transaction can be drawn from the facts and circumstances surrounding such

transaction, including results from a transaction that the taxpayer could have reasonably anticipated as well as results from a transaction that were by design. The fact that the cost savings were insubstantial compared to relatively large basis increases of $80x, that there was no appreciable effect on the parties' economic ownership of the property allocated the basis increases, and that the transactions were structured to guarantee basis increases of $80x to depreciable or amortizable property while carrying a *de minimis* risk of economic loss compared to the designed Federal income tax benefit, Altria Grp., 658 F.3d at 290-91, "indicate[] that the taxpayer's true motivation for the transaction is tax avoidance." See Bank of New York Mellon Corp. v. United States, 140 T.C. 15, 38 (2013). Therefore, C lacked a substantial purpose (apart from Federal income tax effects) for causing its subsidiaries to enter into the transactions described in Situations 1-3 within the meaning of § 7701(o)(1)(B).

If a transaction or series of transactions lacks economic substance, it may be disregarded for Federal income tax purposes. See Gregory, 293 U.S. 465; Coltec, 454 F.3d at 1352; ACM P'ship v. Commissioner, 157 F.3d 231, 247-48 (3d Cir. 1998). While a transaction might meet the literal requirements of the Code, courts will not recognize a transaction that is not within the intent of the Code. Gregory, 293 U.S. at 469-70. The series of transactions described in Situations 1-3—related-party contributions or distributions of property or allocations of tax items and the subsequent transfer of a partnership interest or distribution of property to generate a basis adjustment to property that is eligible for cost recovery (or is held for future sale)—failed both prongs under § 7701(o)(1) and, therefore, lack economic substance. As a result, their Federal income

tax effects must be disregarded. The transactions did not change in a meaningful way (apart from Federal income tax effects) the economic position of C or the C Subsidiaries within the meaning of § 7701(o)(1)(A), and C lacked a substantial business or other purpose (apart from Federal income tax effects) for causing the C Subsidiaries to enter into these transactions within the meaning of § 7701(o)(1)(B).

In addition, under § 6662(b)(6), the transactions described in Situations 1-3 give rise to a 20 percent penalty applicable to an underpayment attributable to a transaction lacking economic substance under § 7701(o). The penalty is increased to 40 percent on any portion of the underpayment attributable to one or more nondisclosed noneconomic substance transactions. See § 6662(i). Under § 6664(c)(2), a reasonable cause exception to the penalties described in § 6662(b)(6) and (i) may not be asserted.

The series of transactions described in Situations 1-3 may also be subject to the partnership anti-abuse rule under § 1.701-2 or the § 704(c) anti-abuse rule under § 1.704-3(a)(10). Other anti-abuse doctrines including, but not limited to, the substance-over-form doctrine and step-transaction doctrine may apply, depending on the facts and circumstances of a specific transaction or series of transactions.

HOLDING(S)[5]

(1) The series of transactions in Situations 1-3 lack economic substance under

[5] This revenue ruling makes no interpretations regarding which audit procedures (for example, the application of subchapter C of chapter 63 of the Code) might apply to effectuate the substantive interpretations of the Holdings section. Any such interpretations would require facts that are outside the scope of this revenue ruling.

§ 7701(o). The transactions did not change the economic position of C or the C Subsidiaries in a meaningful way (aside from the Federal income tax effects). Additionally, neither C nor the C Subsidiaries had a substantial purpose for entering the transactions (aside from Federal income tax effects).

(2) In Situation 1, the basis adjustment under § 743(b) is disregarded. As a result, Partnership B is not entitled to an increase of $80x in its share of the inside basis of Partnership A's assets, and Partnership B's share of the inside basis of Partnership A's assets remains $20x.

(3) In Situation 2, the basis adjustment under § 734(b) is disregarded. As a result, Partnership C is not entitled to an increase of $80x to the inside basis of the remaining depreciable asset, and the inside basis of the depreciable asset remains $10x.

(4) In Situation 3, the basis adjustment to Sub 1 under § 732(b) is disregarded. As a result, Sub 1 is not entitled to an increase of $80x to the adjusted basis of the depreciable asset, and the adjusted basis of Sub 1's depreciable asset remains $20x.

(5) C and/or the C Subsidiaries, as applicable, are subject to the 20 percent penalty under § 6662(b)(6) or the 40 percent penalty under § 6662(i) for a nondisclosed noneconomic substance transaction, as applicable.

DRAFTING INFORMATION

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