

Update - SECA & Related Party Basis Adjustments

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SECA Litigation Update

The term “net earnings from self-employment” means the [net] income derived by an individual from any trade or business...plus his distributive share...of [partnership] income or loss

IRC 1402(a) – Net earnings from self-employment

There shall be **excluded the distributive share** of any item of income or loss **of a limited partner, as such**, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services

EXCEPTION:

IRC 1402(a)(13)

1997 Proposed Regulations – the “Stealth Tax”

“Limited Partner” excludes any member who:

- 1) Is liable for partnership debts,
- 2) Can contract on partnership’s behalf, OR
- 3) Participates >500 hours in partnership trade or business.

What did Congress intend in creating the 1402 limited partner exception?

What might Congress have referenced in crafting a limited partner exception?

1916 Uniform Limited Partnership Act

A limited partner did not become liable as a general partner unless “he takes part in the control of the business.”

1976 Revised Uniform Limited Partnership Act

Acknowledged uncertainty whether LP activities constituted “control” of the partnership’s business.

A “limited partner does not participate in the control of the business...solely by...being a contractor for or an agent or employee of the limited partnership or of a general partner...”

Who is (not) a limited partner for purposes of 1402(a)(13)?

Renkemeyer v. Comm'r (2011)

Limited Liability Partnership (LLP)
limited partners are not 1402(a)(13)
limited partners.

Renkemeyer court applied functional test
to see whether LLP partners were
passive investors or were **actively
involved** in the LLP business.

Possibly aggressive overall posture:

Argued that no part of their law firm income was
subject to employment or self-employment taxes;

Previously treated all income as exempt from income
tax (because the firm was owned by an S corp ESOP).

Who is (not) a limited partner for purposes of 1402(a)(13)?

***Riether v. U.S.* (2012) ***

Limited Liability Company (LLC) members are not 1402(a)(13) limited partners.

Taxpayers were **not members of a limited partnership** and did not resemble limited partners (unlimited liability and sole LLC owners).

***Castigliola v. U.S.* (2017)**

Professional Limited Liability Company (PLLC) members are not 1402(a)(13) limited partners.

Law firm partners were **not members of a limited partnership** and had full control of business.

* See also *Howell v. Comm'r*; *Hardy v. Comm'r*.

What about LPs in state law limited partnerships?

*Since 2023, US Tax Court has held in 3 cases that **state law LPs are not 1402(a)(13) limited partners** if they are active in the partnership trade or business.*

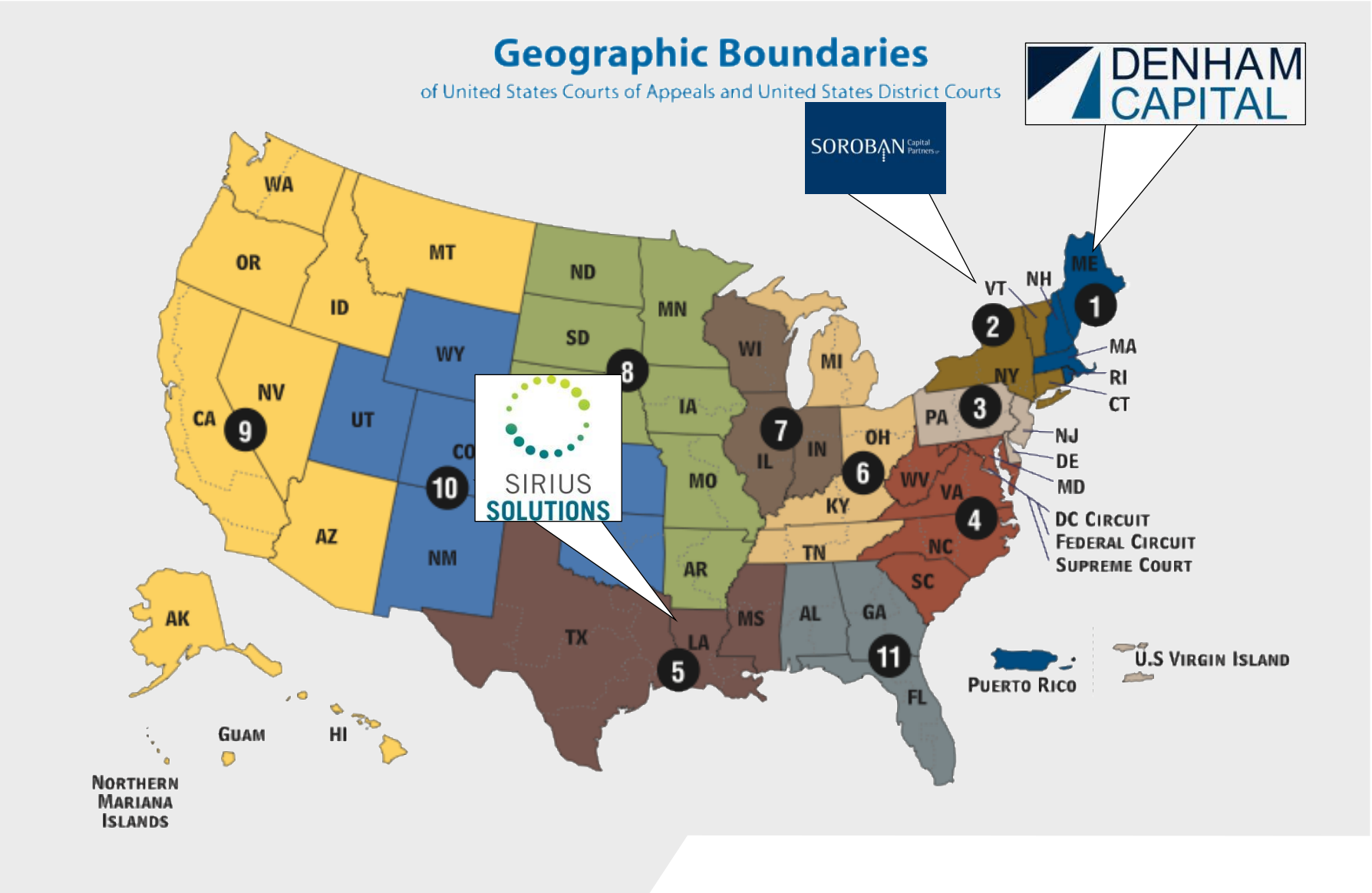


Soroban v. Comm’r (2023)

- Tax Court keys on “as such” language to indicate substance rather than literal meaning.
- Applies “functional analysis test” to test whether partner is a passive investor.

There shall be excluded the distributive share of any item of income or loss of a **limited partner, as such**, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services

The developing situation...



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Related Party Basis Adjustment Update

Basis Adjustments – Background

- **Basis Rules**

- In general, carryover basis for property transferred to or from a partnership. §§ 723, 732(a)
- In liquidation, distributed property takes the partner's outside basis. § 732(b)
- Taxable transfers of a partnership interest result in a cost basis to the transferee in the partnership interest. § 742
- The basis of partnership assets are not adjusted upon the transfer of a partnership interest. § 743(a)

- **Section 754 Election**

- A section 754 election permits a partnership to adjust its basis in partnership assets upon the transfer of a partnership interest or distribution of an asset. §§ 754, 755
- Transfer of an interest: the basis of partnership property is increased with respect to the transferee partner by the difference between outside and inside basis. § 743(b)
- Distribution of an asset: the inside basis in partnership assets is increased by the difference between partnership's basis in the asset distributed and distributee partner's outside basis. § 734(b)

Example 1

Partnership C has a valid § 754 election in place
All parties are related under § 267 or § 707(b)

Sub 1

Outside Basis in Partnership C: \$100

Sub 2

Outside Basis in Partnership C: \$10

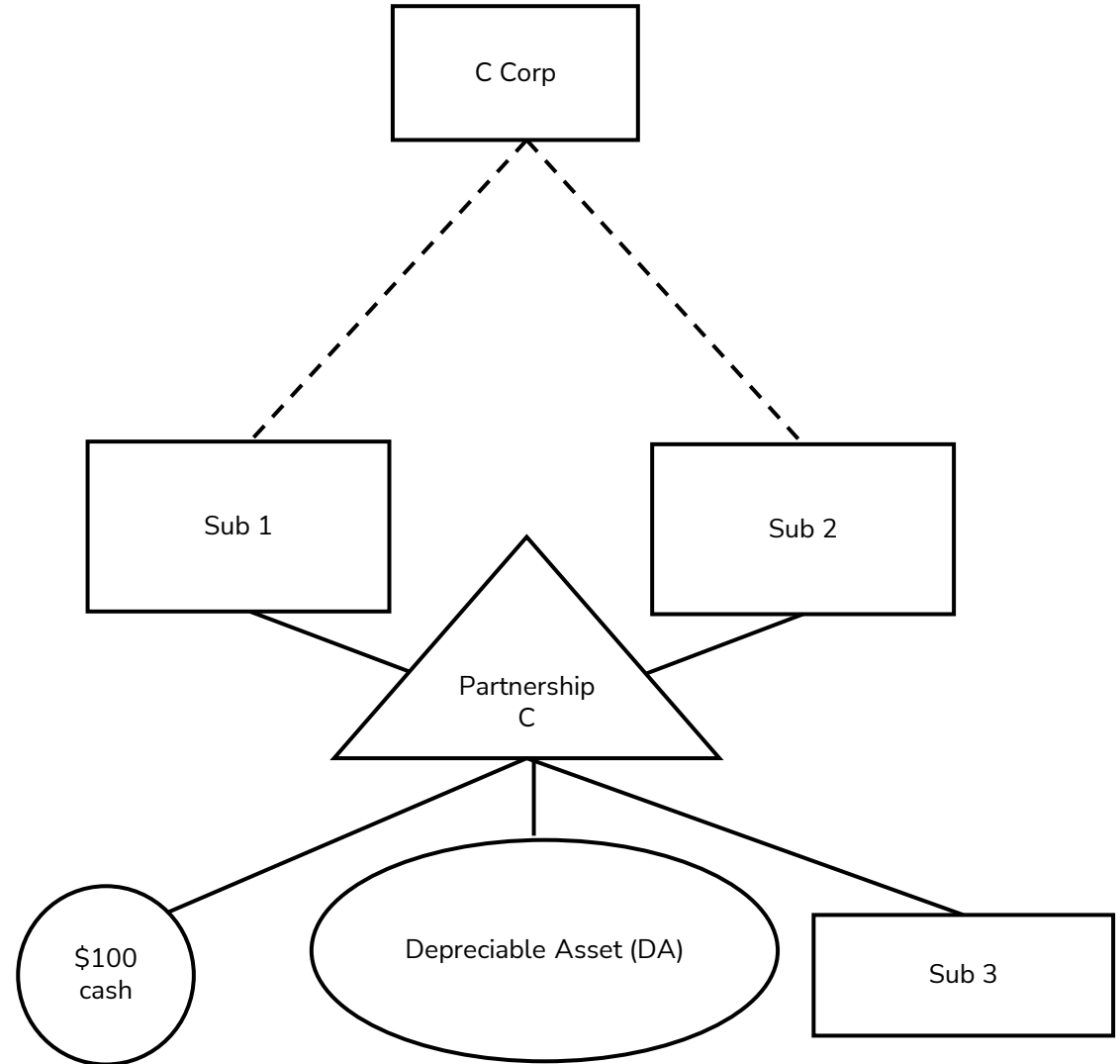
Partnership C

Depreciable Asset (DA)

- Basis: \$10
- FMV: \$100

Sub 3 stock

- Basis: \$90
- FMV: \$100



Example 1

Partnership C distributes Sub 3 stock to Sub 2

Sub 1

Outside Basis in Partnership C: \$100

Sub 2

Adjusted Basis in Sub 3 stock: \$10 (\$80 decrease under § 732(a)(2))

Outside Basis in Partnership C: \$0 (§ 733(2))

Partnership C (No § 754 Election)

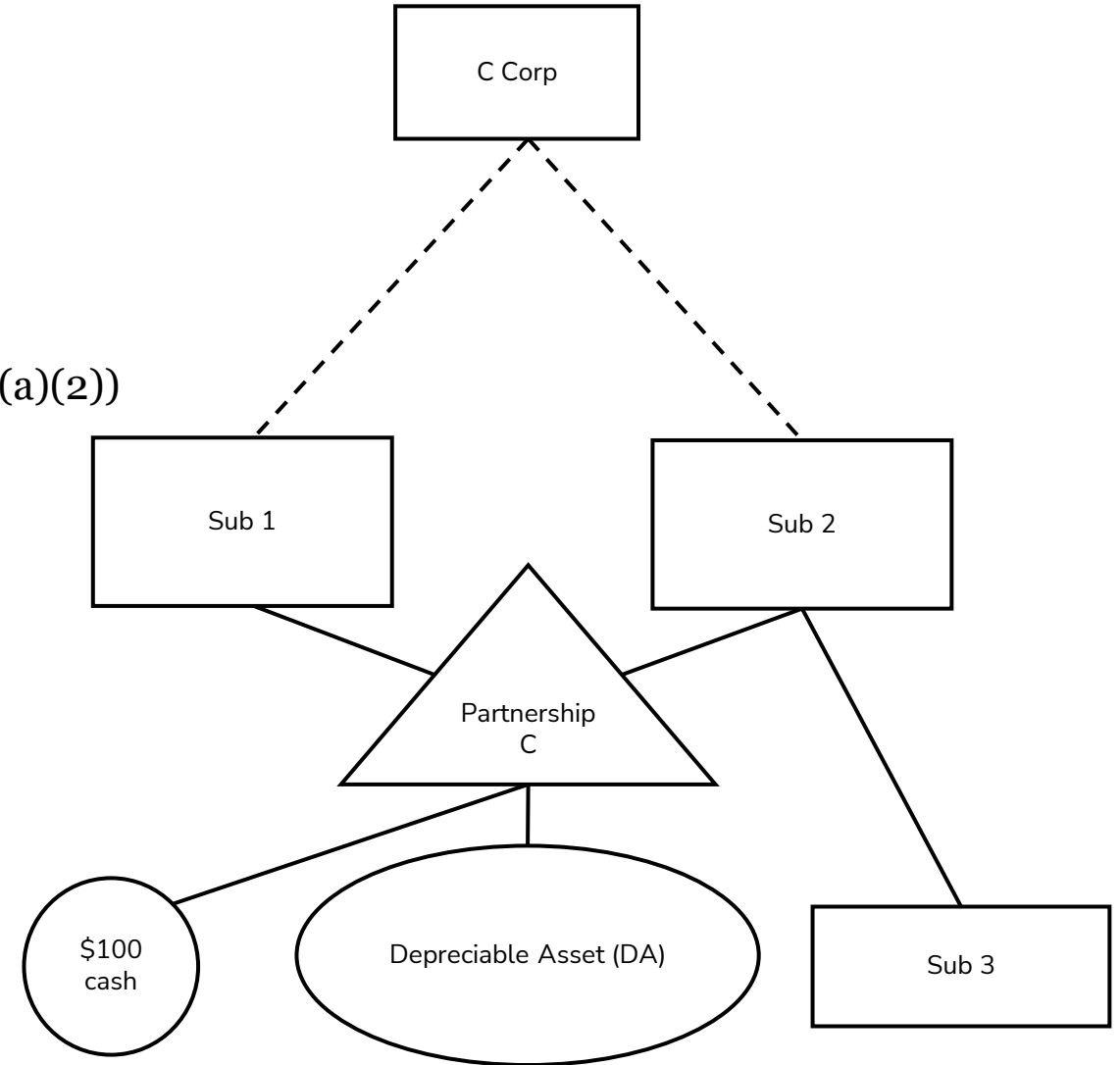
Depreciable Asset (DA)

- Basis: \$10
- FMV: \$100

Partnership C (§ 754 Election)

Depreciable Asset (DA)

- Basis: \$90 (\$80 increase under § 734(b)(1)(B))
- FMV: \$100



Excess basis from distribution of Sub 3 stock is allocated to Depreciable Asset under § 755

Example 2

All parties are related under § 267 or § 707(b)

Sub 1

Outside Basis in Partnership D: \$100

Sub 2

Outside Basis in Partnership D: \$20

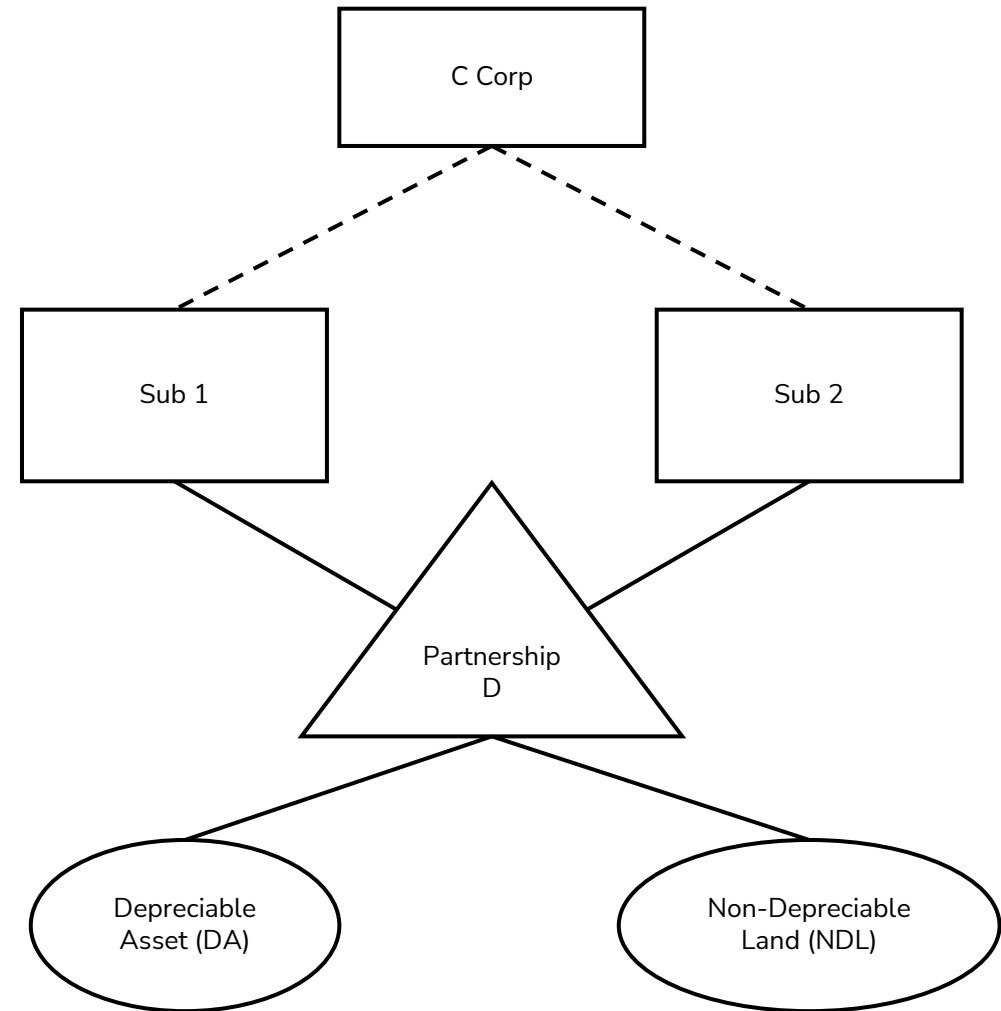
Partnership D

Depreciable Asset (DA)

- Basis: \$20
- FMV: \$100

Non-Depreciable Land

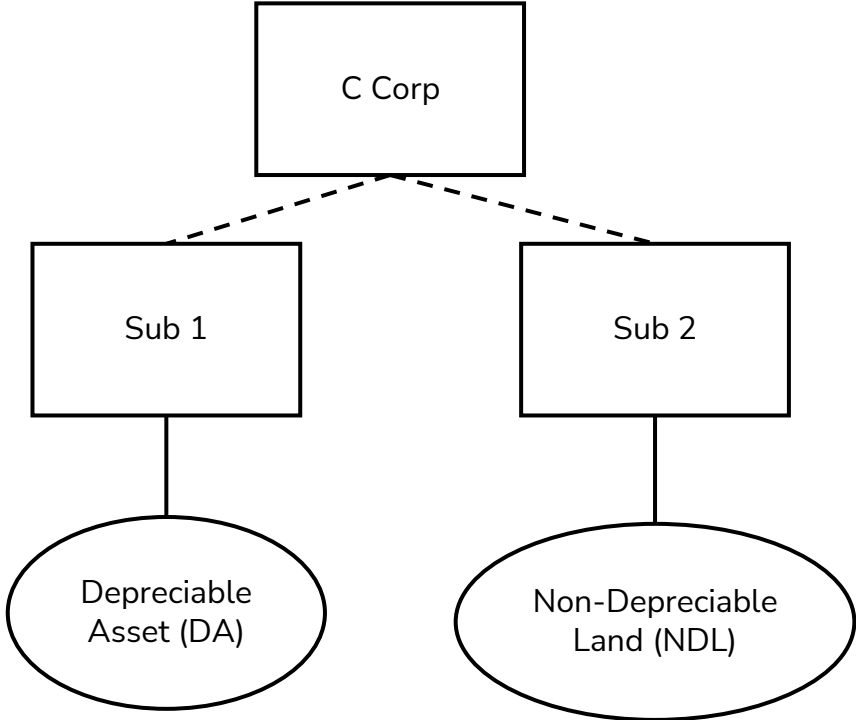
- Basis: \$90
- FMV: \$100



Example 2

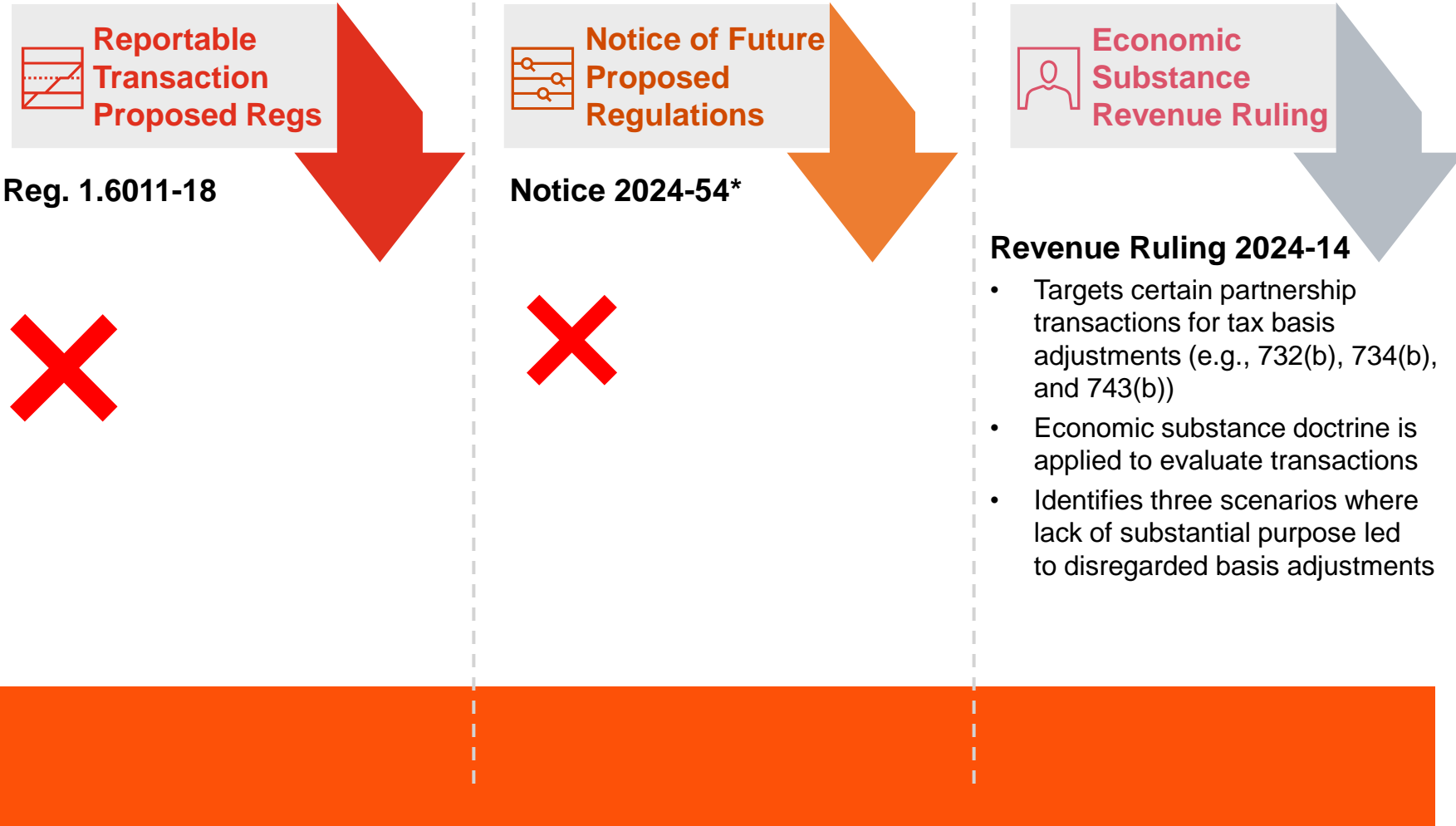
Partnership D liquidates by distributing the Depreciable Asset to Sub 1 and the Non-Depreciable Land to Sub 2

Asset	Partnership D's Asset Basis (Before Liquidation)	Distributee Partner's Basis in Partnership Interest	Asset Basis (After liquidation)
Depreciable Asset	20	100 (Sub 1)	100 (for Sub 1)
Non-Depreciable Land	90	20 (Sub 2)	20 (for Sub 2)



Guidance on Related Party Basis Adjustments

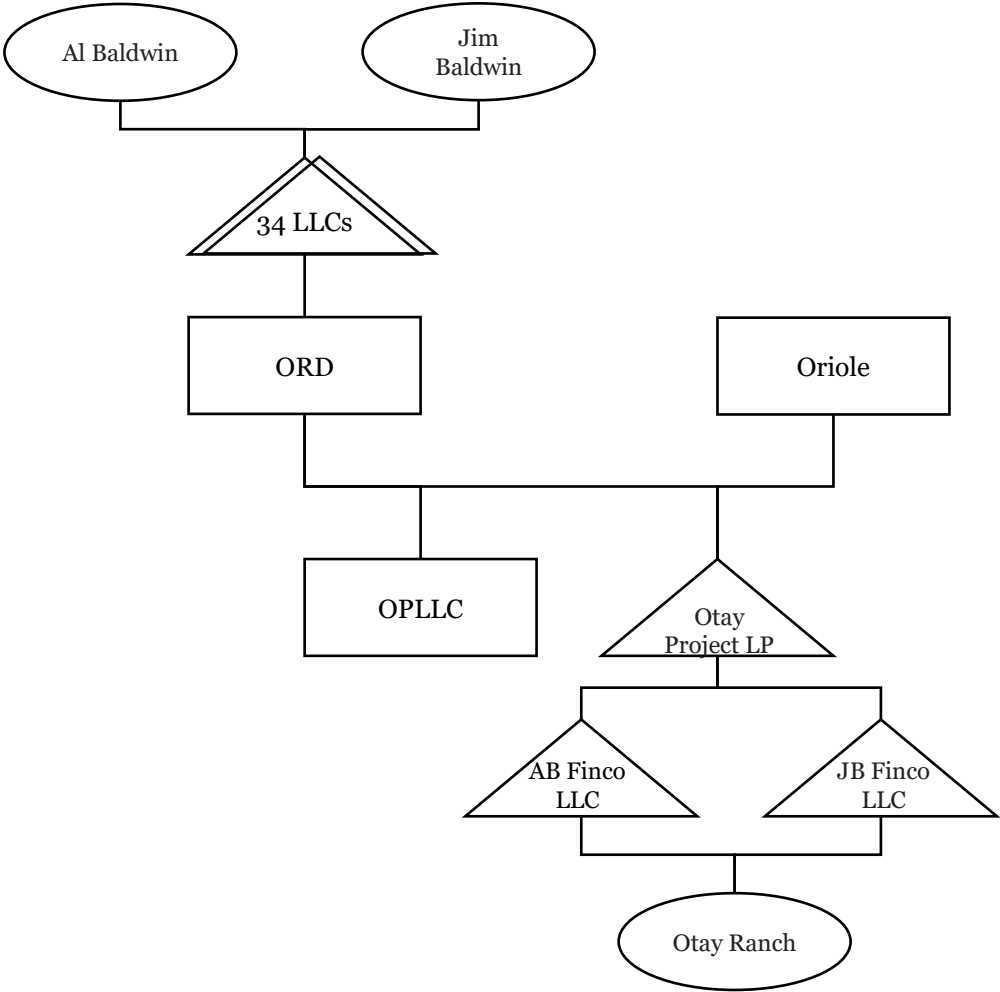
On June 17, 2024, The Treasury Department and the IRS issued three guidance items addressing basis-shifting transactions involving partnerships and related parties:



Otay Project L.P. v. Comm’r, T.C. Dkt. No. 6819-20

- Related-Party basis shifting, the partnership anti-abuse rules, and the codified economic substance doctrine will be tested in a case in which a family-held real estate development partnership is challenging the agency’s denial of an \$867 million basis adjustment arising under section 743(b).
 - The adjustment resulted from the non-recognition transfer of the right to deferred income from long-term contracts held by 34 lower-tier partnerships.
 - The taxpayer claims the restructuring was necessitated by deep family animosity.
- IRS denied the basis adjustment under a variety of theories, including:
 - That the partnership incurred additional liabilities under section 752.
 - That the partnership retained the right to receive payment from the contracts.
 - The application of the partnership anti-abuse rules, the step-transaction doctrine, the common law economic substance doctrine, the codified economic substance doctrine, and the substance over form doctrine.
 - The IRS contends that “OPLP has used sham negative inside basis to eliminate gain altogether by way of an adjustment under section 743(b), a statute that was intended to prevent the duplication of gain.”
 - Otay counters that the tax consequences of a transaction are mandated by the application of the plain text of a Code provision that admits of no other interpretation (*i.e.*, section 743(b)).
- Pretrial memorandums filed September 24, 2024; Trial in October 2024; Briefing completed as of March 2025.

Otay Project L.P. v. Comm’r, T.C. Dkt. No. 6819-20— Organizational Structure



Otay Project L.P. v. Comm’r, T.C. Dkt. No. 6819-20

Partnership Anti-Abuse Regulations:

- The IRS argued that the anti-abuse rule is applicable because the transactions altered the timing and character of the income through the use of partnerships, generating section 743(b) adjustments to offset gain in a manner not intended by Congress in enacting the elective basis adjustment regime.
- The taxpayer argued that the government’s interpretation of the anti-abuse rule, if correct, would likely make the regulation invalid because it would exceed the authority delegated to Treasury by Congress.

Codified Economic Substance Doctrine:

- Does COES apply to mechanical basis adjustment provisions?
 - IRS Pretrial Memorandum:
 - Section 743(b) was intended to prevent unfair duplication of gain or loss.
 - The transactions had no practical economic effect other than indefinite tax deferral.
 - The tax benefits of the transactions significantly outweighed the economic impact of the transactions.
 - The transactions had no realistic expectations of profit other than tax benefits.
 - Taxpayer’s Pretrial Memorandum:
 - IRS cannot use COES to overwrite section 743(b) as the doctrine does not apply if the tax consequences are mandated by that application of the plain text of a statutory provision.
 - The transfer of a partnership interest by sale or exchange inherently has economic substance.

Note: Rev. Rul. 2024-14 provides that three related-party partnership transactions (including a simpler version of the transaction at issue in Otay) involving partnership basis shifting lack economic substance under COES. The IRS press release (IR-2024-166) states that the ruling was issued to provide support for the IRS’s position in audits and litigation that these transactions violate the codified economic substance doctrine.