



# TaxNewsFlash

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## U.S. Tax Court: Partnership deduction disallowed because section 743(b) basis adjustment incorrectly calculated and related transactions lacked economic substance

The U.S. Tax Court yesterday held that the taxpayer, a partnership engaged in real estate development, was not entitled to a more than \$700 million claimed deduction attributable to a section 743(b) basis adjustment because the basis adjustment was incorrectly calculated and the transactions resulting in the basis adjustment lacked economic substance.

The case is: *Otay Project LP v. Commissioner*, T.C. Memo. 2026-21 (February 23, 2026). Read the Tax Court's [opinion](#)

### Summary

The taxpayer underwent a restructuring in 2012 that resulted in a technical termination of the partnership under section 708(b)(1)(B). Because the partnership had a section 754 election in place, basis adjustments under section 743(b) were made to assets of the partnership as a result of the technical termination. The partnership subsequently claimed a more than \$743 million deduction attributable to the section 743(b) basis adjustments.

The IRS disallowed approximately \$714 million of the claimed deduction on the grounds that the section 743(b) basis adjustment was incorrectly calculated. The IRS specifically argued that the section 743(b) basis adjustment did not take into account all the relevant rights and obligations under the partnership agreement or prior partnership distributions relevant to the calculation. The IRS argued in the alternative that the partnership's restructuring transactions lacked economic substance and may be disregarded under general substance-over-form principles or under Treas. Reg. § 1.701-2. The IRS also asserted accuracy-related penalties for substantial valuation misstatement and negligence under sections 6662(b)(3) and (h) and section 6662(b)(1), respectively.

The Tax Court held that the partnership's calculation of the section 743(b) adjustment was fundamentally flawed. The court noted that the section 743(b) adjustment, absent the deferred gain under the completed contract method of accounting and certain liabilities, was an incomplete calculation, was contrary to the partnership agreement and should not be respected. .

The court also found that the restructuring transactions lacked economic substance because they were principally tax-motivated, involved circular flows of funds, and had no useful nontax business purpose.

However, the court declined to impose the asserted penalties because it found that the partnership and its principals had obtained extensive and detailed advice from reputable tax advisors, and their reliance on this professional advice was reasonable and in good faith.

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