

# The \$714 Million Phantom: Why the Tax Court Just Plowed Under Basis Shifting

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## Overview

For decades, the tax code has been a tool for savvy farmers and ranchers to preserve capital, transition operations to the next generation, and manage the razor-thin margins of American agriculture. We use partnerships—specifically those governed by Subchapter K—because they offer flexibility. But there is a fine line between "aggressive tax planning" and a "facade."

A recent landmark decision,<sup>1</sup> just drew that line in permanent ink. The case involves a staggering \$714 million tax adjustment, a complex web of offshore entities, and a clear warning: if your tax strategy lacks a real-world business purpose, the IRS is now equipped with the AI tools to find it and the legal precedent to dismantle it.

Whether you are managing a few hundred acres or a multi-state cattle operation, the lessons from the Otay Project are vital for anyone using tiered partnerships or Section 754 elections.

## Importing" Basis

To understand the case, we have to look at how "basis shifting" works in a tiered partnership. In simple terms, basis is your investment in an asset for tax purposes. When you sell an asset, you only pay tax on the gain *above* that basis. The petitioners in the Otay Project held high-value real estate in California. They wanted to sell or develop it, but they faced a massive tax bill. To avoid this, they engaged in a sophisticated maneuver to "step up" the basis of the land without actually spending a dime on improvements.

**The step-by-step strategy.** Otay Project created a tiered partnership structure involving shell companies and offshore interests. They introduced assets into the partnership, purportedly intellectual property or foreign securities, that carried a high tax basis but had very low actual market value. Using a sequence of redemptions and transfers, they triggered I.R.C. §754 and §734/743 elections. This allowed them to "strip" the high basis from the junk assets and "shift" it onto the California land. Suddenly, the land had a \$714 million higher basis on paper. When the land was later developed or sold, the partnership reported a massive loss instead of a taxable gain.

The taxpayers argued they followed every "mechanical rule" in the book. The IRS, however, saw it differently. They called it a "pre-planned tax play."

## The Tax Court's Rationale

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<sup>1</sup> Otay Project, LP v. Comm'r., T.C. Memo. 2026-21.



The Tax Court's ruling against the *Otay* Project didn't just focus on the math; it focused on the intent. Even if you follow the literal words of the tax code, you can still lose if the transaction lacks "economic substance."

The Court applied I.R.C. §7701(o), known as the Codified Economic Substance Doctrine. Because the series of transfers happened in such rapid succession, the Court ruled they lacked "independent significance." In other words, if step A, B, and C only exist to get to step D (the tax break), the IRS can collapse them all into one taxable event.

The Court found that the "new" partners brought into the deal weren't actually business partners - they were facilitators. They had no objective profit potential and no meaningful change in their economic relationship. In the eyes of the law, a partnership must be an association of people joining together to make a profit, not just to manufacture a deduction.

The taxpayers used "internal" or "aggressive" estimates to value the assets used to import the basis. The Court noted these values were unsubstantiated and didn't reflect "arm's-length reality." When you deal with related parties or offshore shells, the IRS expects (and the law requires) third-party, independent appraisals.

### The New Reality - AI and Automated Audits

Perhaps the most chilling part of the *Otay* case for modern taxpayers is how the IRS caught them. We are no longer in the era of an auditor manually flipping through paper ledgers. The IRS now uses Advanced AI Analytics to run multi-year reconciliations of partnership balance sheets. In the *Otay* case, several "red flags" triggered an automated mismatch alert:

- **Schedule L Disparities:** The AI flags sudden, massive gaps between the "inside" basis (what the partnership owns) and the "outside" basis (what the partners own) that don't correspond to a capital injection.
- **High-Risk Circular Flow:** The IRS's new visualization tools can "see through" tiered structures. If the same money or asset moves through three or more layers of entities in a single cycle, it's a "Transaction of Interest."
- **Negative Basis Signals:** The partnership tried to defer income while simultaneously claiming a Section 743(b) deduction. To the IRS's new algorithms, this is a "classic" signal for an audit.

Starting in late 2025 and 2026, the IRS officially designated certain basis shifts as "Transactions of Interest." This means that if you engage in these specific maneuvers, you are legally required to disclose them or face stiff penalties.

### Protecting Your Operation

If you are a farmer or rancher working with a CPA on partnership restructuring, how do you stay out of the crosshairs? Here are five "rules of the road" based on the *Otay* ruling:

**Document the "business purpose."** Technical compliance is no longer a safe harbor. You must have a non-tax reason for your structure. Are you trying to consolidate management? Are you preparing for a succession plan for



your kids? And write things down. Contemporaneous memos created *at the time of the transaction* carry much more weight than an explanation cooked up during an audit three years later.

**Avoid "compressed" timelines.** If you move land into an LLC on Monday, bring in a new partner on Wednesday, and shift basis on Friday, you are begging for a "Step Transaction" challenge. Transactions should ideally have "resting time" (often 24 months or more) to show they have independent economic significance.

**Synergistic assets only.** If you are trying to "step up" the basis of your farm using intellectual property from a tech startup or foreign currency, expect a fight. Contributed assets should have a clear operational or investment synergy with your core business.

**Independent appraisals are mandatory.** Do not rely on your own estimates or the "projections" provided by a company selling a tax strategy. Get a qualified, independent appraisal at the time of contribution. This is your best defense against I.R.C. §6662 accuracy-related penalties, which can add 20 percent to 40 percent to your tax bill.

**Verify the advice.** The taxpayers in *Otay* tried to blame their tax advisors. The Court rejected this, stating the advice was based on "unreasonable" assumptions provided by the taxpayer. You cannot give your CPA "aggressive" numbers and then claim you were just following their lead. You (and your practitioner) must verify the underlying facts.

## Conclusion

The *Otay Project* case represents a shift in how the government views tax law. They are looking past the "paper barriers" of shell companies and technical elections to find the economic truth.

For the American producer, partnerships remain a powerful and necessary tool. But as the IRS turns on its AI-powered "visualization tools," the era of manufacturing deductions "out of thin air" is over. If you're planning a major shift in your partnership basis, make sure it's rooted in the reality of your business, not just the mechanics of a spreadsheet.

Have you reviewed your partnership's Schedule L lately? If you have tiered entities or recent I.R.C. §754 elections, now is the time to ensure your "Business Purpose" memos are in order before the IRS's AI comes knocking.

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