

When Hypothetical Liquidations Become “Illogical”: Otay Project LP v. Commissioner

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The Tax Court's recent decision in *Otay Project LP v. Commissioner*, T.C. Memo. 2026-21, is likely to become one of the most discussed partnership cases of the year — not because it announces a new doctrine, but because it quietly rewrites how § 743(b) is expected to operate in large tiered partnerships.

At issue was a familiar structure. A real estate development partnership underwent ownership changes that triggered a technical termination under pre-2018 § 708(b)(1)(B). Because the partnership had a § 754 election in effect, the termination required a basis adjustment under § 743(b). The partnership computed that adjustment using the regulatory hypothetical liquidation framework in Treas. Reg. § 1.743-1(d), which assumes a fully taxable disposition of partnership assets at fair market value. That hypothetical recognition of embedded gain — including large deferred income under long-term contract accounting — produced a substantial negative “previously taxed capital” amount and therefore a large positive § 743(b) adjustment.

The IRS disallowed the deduction, and the court ultimately agreed.

But the court did not reject the adjustment primarily on economic substance grounds. Instead, it concluded the calculation itself was “illogical,” pointing to the resulting balance sheet, which reflected negative partner capital and a basis adjustment far larger than the partnership's book of equity.

That reasoning deserves scrutiny.

The Problem with the Court's Analytical Frame

Section 743(b) is mechanical. When a partnership interest is transferred, and a § 754 election exists, the statute requires the partnership to adjust inside basis so that the transferee partner's share of inside basis matches its outside basis. Congress did not condition the adjustment on accounting symmetry, economic parity, or a positive capital account. The statute simply compares two numbers.

Treasury regulations likewise adopt a mechanical approach. Treas. Reg. § 1.743-1(d) defines a transferee partner's share of partnership basis using a “hypothetical transaction”; an immediate sale of all partnership assets for cash equal to fair market value. The regulation expressly requires gain recognition in that hypothetical liquidation.

In a development partnership using the completed contract method, such a hypothetical sale necessarily accelerates large amounts of deferred income. The resulting negative capital is not anomalous — it is the direct product of the regulatory model. The purpose of § 743(b) is precisely to prevent that phantom gain from being taxed to the transferee partner a second time.

The court, however, treated the result as evidence that the computation must be wrong rather than evidence that the regulation is working as intended.

Negative Capital Is Not a Defect

The opinion implicitly assumes that inside basis cannot produce a negative capital allocation. But neither the statute nor the regulations impose that limitation. To the contrary, § 743(b) adjustments routinely arise when outside basis exceeds a partner's share of inside basis — especially in partnerships holding appreciated property or deferring income.

The regulatory hypothetical liquidation is not a balance-sheet exercise; it is a tax allocation exercise. Its purpose is to determine how much gain would be allocated to the transferee partner if the partnership sold all of its assets immediately after the transfer. If that hypothetical gain exceeds the partner's liquidation proceeds, negative capital necessarily follows.

Calling that result “illogical” effectively replaces the regulation with a net-equity test that does not appear anywhere in subchapter K.

The Liability Expansion Issue

The government also argued that additional liabilities — including construction obligations — should reduce the § 743(b) adjustment. The court appeared receptive to this position.

That approach risks blurring an important doctrinal boundary. Section 752 governs partnership liabilities. It does not treat executory performance obligations as liabilities simply because the partnership must perform under a contract. Real estate developers frequently have future performance obligations, but those obligations do not automatically create recourse liabilities for basis purposes.

If performance obligations are treated as § 752 liabilities in order to neutralize § 743(b), the liability rules cease to be administrable.

A Practical Consequence

The most significant implication of *Otay* is not confined to pre-2018 technical terminations. The reasoning threatens routine partnership transactions:

- family succession transfers
- upper-tier partnership restructurings
- real estate development partnerships using CCM
- any partnership with a large built-in gain and a § 754 election

Under the decision's logic, a § 743(b) adjustment may be disregarded whenever the result is large enough to appear economically disproportionate. That converts a mechanical statute into a facts-and-circumstances inquiry — exactly what subchapter K historically sought to avoid.

What the Case Really Reflects

The opinion appears less concerned with statutory interpretation than with scale. The partnership reported substantial deferred income and an offsetting basis deduction attributable to the prior § 743(b) adjustment. The court viewed the magnitude as incompatible with economic reality.

But subchapter K has never limited tax consequences by magnitude. Congress allowed long-term contract deferral. Congress allowed § 754 elections. Congress required § 743(b) adjustments to maintain parity between inside and outside basis. Large

numbers are sometimes the inevitable consequence of those interacting provisions.

Courts traditionally police abusive transactions through economic substance or anti-abuse doctrines. Here, however, the court did something more consequential, it recast a regulatory computational rule into an equitable limitation.

Why the Decision Matters

The importance of *Otay* lies in its methodological shift. Instead of asking whether the statute and regulations were followed, the court asked whether the result looked sensible on a balance sheet. That is not how subchapter K operates.

Partnership taxation depends on predictability. Taxpayers make structural decisions — § 754 elections in particular — based on mechanical consequences. If courts can override those consequences whenever hypothetical liquidation math produces large disparities, then § 743(b) becomes unreliable as a planning tool.

In short, *Otay Project* does not merely deny a deduction. It introduces uncertainty into one of the most fundamental coordination rules in partnership taxation: the alignment of inside and outside basis.

The case will likely be remembered not for its facts, but for its implication that regulatory mechanics yield to judicial intuition. For partnerships relying on § 754 elections, that is a far more significant development than the adjustment at issue in the case itself.