The TCJA and Inside-Outside Basis Disparities

Adam M. Cohen
Holland & Hart LLP

Barksdale Penick
EY LLP

Julie M. Marion
KPMG LLP

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Inside and Outside Basis Under TCJA

• “Inside basis” refers to partnership’s basis in its assets
• “Outside basis” refers to the partner’s basis in the partnership
• In the absence of transfers of partnership interests, subchapter K is structured to maintain parity between inside basis and total outside basis
  • Where transfers occur, adjustments under Code § 743 can maintain parity
    • Negative adjustments mandatory
    • Positive adjustments pursuant to Code § 754 election

• Basis Disparity Planning:
  • If inside basis is lower than outside basis, sell outside interests (rather than inside assets)
  • If distributing property in liquidation, property takes outside basis (net of money distribution)
Inside and Outside Basis Under TCJA

• TCJA introduced provisions which cause disparities between inside and outside basis even without transfers of partnership interests
  • Code § 163(j)
  • GILTI (Global Intangible Low Taxed Income) provisions
  • Opportunity Zone provisions
Outside Basis Adjustments
Under Code § 163(j)
Outside Basis Adjustment Rules

• Code § 163(j)(4) generally limits a partnership’s deduction of business interest expense (BIE) to the extent of its business interest income (BII) plus 30% of its adjusted taxable income (ATI).

• Excess business interest expense (EBIE) generally is carried forward at the partner level until “freed up” by excess taxable income (ETI) of the partnership.

  • Partner must reduce her outside basis (but not below zero) for her allocable EBIE even though not currently deductible.

  • Immediately prior to sale of “all or substantially all” of partnership interest, partner increases her outside basis for any EBIE that has not been “freed up” by ETI prior to sale.
    • Potential for gain/loss mismatch issues on partial dispositions.
    • How much is “substantially all”? 


Outside Basis Adjustment Rules

• Code § 704(d) generally “suspends” losses in excess of a partner’s outside basis.
  • Basis limitation is determined annually under Code § 705(a) before reduction for current year losses and after taking into account any current year distributions.
  • Limitation on losses must be apportioned proportionately among different classes of losses (e.g., STCL, LTCL, section 1231 loss, bottom line).

• Any EBIE that would be suspended under Code § 704(d) is treated as “negative section 163(j) expense” at the partner level. Prop. Treas. Reg. § 1.163(j)-6(h)(2).
  • Only converts into EBIE when no longer suspended.
  • While suspended, cannot be “freed up” by ETI or added back to outside basis upon a disposition.

• Deductible BIE, EBIE and negative section 163(j) expense are treated as part of a separate Code § 704(d) loss class for purposes of applying Code § 704(d)(2).
Prop. Treas. Reg. § 1.163(j)-6(o), Example 9

- Illustrates the ordering rule of Prop. Treas. Reg. § 1.163(j)-6(h)(1) and the concept of “negative section 163(j) expense.”

- Outside basis first reduced for deductible BIE, then EBIE, of PRS (but not below zero).

- EBIE suspended at the partner level under Code § 704(d) is treated as negative section 163(j) expense (and not EBIE) until no longer suspended.
Illustrates proportionate rule of Code § 704(d).

Year 1 negative section 163(j) expense is treated as separate Code § 704(d) loss class for purposes of applying Code § 704(d)(2):

- $10 AB \times (15 \text{ non-T/B exps}/20 \text{ total losses}) = \$7.50$
- $10 AB \times (5 \text{ neg. 163(j) exp}/20 \text{ total losses}) = \$2.50 \rightarrow \text{EBIE}$
Assume, instead, X and Y each sell their entire interest in PRS to A at the beginning of year 2 when each has:

- $5 EBIE from PRS from year 1, and
- $5 negative section 163(j) expense from year 1.

Under Rev. Rul. 99-6, partnership interest sale to X and Y. Each increases its AB in PRS by year 1 EBIE, but not its negative section 163(j) expense, for purposes of determining gain on sale.

Gain from partnership interest sale included in partner ATI. Prop. Treas. Reg. § 1.163(j)-6(e)(3).

Negative section 163(j) expense does not carryover to X, Y or A.
Sale of Partnership Assets

- Assume, instead, PRS sells all of its assets to A at the beginning of year 2 and liquidates.
- Sale gain creates ETI, which frees up year 1 EBIE. However, because outside basis is reduced for distributions before losses, no basis is available to convert year 1 negative section 163(j) expense to EBIE.
- Difference in tax liability of partner Y is attributable to the partner level Code § 163(j) limitation vs. full $5 gain offset in partnership interest sale.
Sale of Partnership Interest – Code § 743 Adjustment

• Assume, instead, Y sells her entire interest in PRS to A at the beginning of year 2 when PRS has a Code § 754 election in effect. Later in year 2, PRS sells its assets to B.

• Because outside basis is reduced for distributions before losses, none of PRS’s deductible BIE is deductible to X or A.

• A’s Code § 743(b) adjustment with respect to PRS is taken into account at the partner level as a reduction to ATI, reducing A’s partner level Code § 163(j) limitation.
Inside/Outside Basis Differences Arising Under GILTI Provisions
General Application of Transition Tax and GILTI

- **Transition Tax - Code § 965**
  - All deferred offshore E&P ("Accumulated deferred foreign income") taxed in 2017 (at lower rate)
  - Treated as subpart F income and included by U.S. shareholder

- **GILTI - Code § 951A**
  - A U.S. shareholder of a CFC includes in gross income its GILTI for the current tax year
    - Taxed at lower rate than domestic income
    - Broad income tax base

- Both income inclusions built on subpart F rules, but with wider application
  - Subpart F applied to limited categories of "passive" type income
  - Definition of a CFC expanded
Treatment of CFCs Owned by Partnerships under Subpart F

- A **domestic partnership** was treated as a US shareholder under subpart F (entity approach)
  - As a result, subpart F inclusions for a domestic partnership occurred at the partnership level and were then allocated to partners.
  - Partners increased their outside basis in the partnership to reflect their allocable shares of subpart F income

- A **foreign partnership** was treated as an aggregate, with subpart F inclusions for US shareholders occurring at the partner level
  - Under Code § 961(a), partners would increase their outside basis in the partnership to reflect their shares of subpart F income
  - The partnership did not recognize subpart F income and there was no mechanism to increase the partnership’s inside basis in CFC stock
Foreign Partnerships under Subpart F

- Assume CFC generates 600 of subpart F income, of which X Co.’s share is 300
- X Co. recognizes 300 of subpart F income
  - X Co.’s outside basis increases by 300
  - No apparent mechanism to increase the partnership’s basis in the CFC
- If CFC pays a dividend of 600, the partnership recognizes 600 of income, 300 allocated to X Co.
  - X Co. is permitted to exclude the 300 as PTI (previously taxed income)
- If X Co. were to sell its partnership interest, its basis would include the GILTI amount of 300.
- However, if the foreign partnership were to sell the CFC stock, there is no comparable exclusion for X Co.’s share of the gain
Partnerships under Code § 965 (Transition Tax)

- Code § 965 generally followed subpart F principles with respect to partnerships
  - Domestic partnerships were treated as entities under Code § 965
  - Foreign partnerships were treated as aggregates

- Final regulations allowed an inside basis adjustment to a foreign partnership for partner level inclusions
  - “Specified basis adjustment”
  - Regulations are brief and do not elaborate on how this basis adjustment will operate and whether it is intended to be comparable to, or different from, a Code § 743 basis adjustment

- This provision avoids creating an inside/outside basis disparity for stock held through foreign partnerships
Foreign Partnerships: Code § 965 Example

- Foreign partnership’s ownership of CFC/DFIC resulted in $300 of Code §§ 951/965 inclusion to X Co.
- Treas. Reg. § 1.965-2(h)(5) provides Foreign partnership with a “specified basis adjustment” with respect to CFC stock.
- This partnership level basis adjustment is a new concept without a specific parallel in subpart F.
- This would offset X Co.’s share of gain on sale by foreign partnership.
- Specified basis adjustment presumably reduced by distributions.
GILTI Final Regulations

- Final regulations provide aggregate treatment for all partnerships

- Proposed regulations included a hybrid approach to ensure each non-US shareholder would include in income its distributive share of the domestic partnership’s GILTI inclusion amount, while permitting a US shareholder partner to determine a single GILTI inclusion. *Prop. Treas. Reg. § 1.951A-5(b)*

- Treasury determined the historic subpart F entity treatment of domestic partnerships was inconsistent with GILTI regime’s dependency on a single GILTI inclusion amount for a US person

- Treasury further noted the proposed regulations caused procedural and computational complexity

- Final regulations treat all partnerships as aggregates
Partnerships: GILTI (Example)

- GILTI inclusion occurs at the partner level, regardless of whether a partnership is foreign or domestic

- X Co. is the U.S. shareholder in CFC

- Code § 961(a) provides that X Co. has PTI basis in its partnership interest for GILTI inclusions with respect to CFC

- However, under Code § 961(a) there is not a specific rule for inside basis adjustments (US LLC basis in CFC stock)

- Government has asked for comments with respect to inside basis adjustments
Partnerships: GILTI (Example)

- X Co.’s ownership of CFC through partnership resulted in $300 of GILTI inclusion
- A has $300 of PTEP ("previously taxed earnings and profits") and Code § 961 basis in US LLC
- There might be an inside outside/basis disparity.
- A dividend by CFC would be income to US LLC but could be excluded by X Co.
- Sale of CFC stock could cause gain to X Co.
- Are capital accounts affected by inclusion?

**Diagram:**

- X Co. (US)
- Y Co. (Foreign)
- US LLC
- CFC
- $600 Tested Income
- Code § 951A $300 GILTI
- Code § 961 $300 Basis
- No inside basis adjustment

**Currency Conversion:**

- USD $600

**Business Entity Flow:**

- X Co. 
  - US
  - Y Co.
  - Foreign
  - US LLC
  - CFC
  - $600 Tested Income
  - Code § 951A $300 GILTI
  - Code § 961 $300 Basis
  - No inside basis adjustment

**Questions:**

- Are capital accounts affected by inclusion?
Partnerships: Code § 743 Adjustments (Example)

- Assume X Co. has $300 of outside basis from a GILTI inclusion
- Assume inside basis is zero
- X Co. contributes its partnership interest to X Sub in a Code § 351 transaction

Outside basis = $300

- $600 Fair Value
- Zero Tax Basis

X Co. US

X Sub US

Y Co. Foreign

US LLC

Assets

CFC

$600 Fair Value

Zero Tax Basis

$600 Fair Value

Zero Tax Basis

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Partnerships: Code § 743 Adjustments (Example)

- X Co. contributes its partnership interest to X Sub

- Code § 743 basis adjustment allocated in part to Assets rather than to CFC stock, even though the CFC stock generated the GILTI inclusions

- Compare if CFC stock had been distributed to Y. Co. before the contribution to X Sub.
  - Entire basis step up would go to the Assets
Inside/Outside Basis Differences in Opportunity Zones
Opportunity Zone Basis Disparities – Initial Disparity

- Code §1400Z-2 uses basis as the mechanism for delivering the intended Opportunity Zone benefits:
  - At initial investment:
    - Outside basis = $0
    - Inside basis = Full basis

*Taxpayer had $100 of gain from sale of capital asset to unrelated party within 180 days of investment*
Opportunity Zone Basis Disparities – 5 Year Benefit

- Code §1400Z-2 uses basis as the mechanism for delivering the intended Opportunity Zone benefits:
  - At 5-year hold point:
    - Outside basis increases by 10% of the deferred gain
    - Inside basis – no change
Opportunity Zone Basis Disparities – 7 Year Benefit

• Code §1400Z-2 uses basis as the mechanism for delivering the intended Opportunity Zone benefits:
  • At 7-year hold point:
    • Outside basis increases by 5% of the deferred gain
    • Inside basis – no change

![](image-url)
Opportunity Zone Basis Disparities – End of Gain Deferral

- Code §1400Z-2 uses basis as the mechanism for delivering the intended Opportunity Zone benefits:
  - At end of gain deferral:
    - Outside basis increases by amount of gain recognized
      - i.e., excess of
        - i. lesser of deferred gain or FMV over
        - ii. then basis
    - Inside basis – no change
Opportunity Zone Basis Disparities – 10 Year Benefit with Sale of QOF Interest

- Code §1400Z-2 uses basis as the mechanism for delivering the intended Opportunity Zone benefits:
  - Immediately prior to disposition of interest in QOF after 10 years (with election):
    - Outside basis increases to:
      - FMV of the interest, including debt
    - Inside basis – “immediately prior to the sale or exchange, the basis of the QOF partnership assets are also adjusted, such adjustment is calculated in a manner similar to a section 743(b) adjustment had the transferor partner purchased its interest in the QOF partnership for cash equal to fair market value immediately prior to the sale or exchange assuming that a valid section 754 election had been in place.”

![Diagram showing basis calculation](image)
Opportunity Zone Basis Disparities – 10 Year Benefit with Sale of QOF Assets

- Treas. Reg. §1400Z2(c)-1(b)(2)(ii) uses income exclusion as the mechanism for delivering the intended Opportunity Zone benefits:
  - Upon disposition of assets by QOF after 10 years (with election):
    - Exclude CG (incl. net 1231 gain) on K-1 from “qualified opportunity zone property”
    - Excluded gain is income for Code §705(a)(1)
Opportunity Zone Basis Disparities – Depreciable Assets

End of Gain Deferral with Depreciable Assets

1. At end of gain deferral:
   - Outside basis increases by amount of gain recognized
     - i.e., excess of
       - i. lesser of deferred gain or FMV over
       - ii. then basis
   - Inside basis – no change

2. If losses from depreciation?
   - T/b assets could be 5 or 7 year property or eligible for bonus depreciation
   - Assume break-even (other than depreciation)
     - Assume year 1 loss of $100, limited by Code §704(d)
     - At year 5, outside basis increases by $10 and $10 loss is freed up and basis decreases to $0
     - At year 7, outside basis increases by $5 and $5 loss is freed up and basis decreases to $0
     - At end of gain deferral, outside basis increase:
       - Lesser of $100 or $250 over
       - $0 [per Code §1400Z-2(b)(2)(A)(ii)] or
       - $15 [per Prop. Treas. Reg. §1.1400Z2(b)-1(e)(3)(ii)]

Diagram:
- Taxpayer
  - Basis = $100 or $85
- Managing Member
  - Basis = $0
- QOF
  - Basis = $0
- QOZB
  - Basis = $0
  - Depr. t/b assets
    - Basis = $0
    - FMV = $250
Opportunity Zone Basis Disparities – Tiering Up Problem

• Prop. Treas. Reg. §1.1400Z2(b)-1(c)(6)(ii)(B) provides Code §721 transaction may not be inclusion event

• Code §743 generally applies upon Code §721 transaction:
  • If Taxpayer contributes its QOF interest to a new partnership and if QOF has 754 election (or if QOF assets have declined in value sufficiently), the new partnership’s previously tax capital is $100 and basis is $0
  • Interest in QOZB will receive $100 negative Code § 743 adjustment
    • If QOZB has Code § 754 election (or if QOZB assets have decline in value sufficiently), QOZB’s assets will also have negative Code § 743 adjustment