How large businesses use partnerships to create tax deductions out of thin air: An explainer on related party basis shifting

Treasury and the IRS recently issued guidance regarding tax-motivated related party basis shifting transactions, which Treasury estimates could raise more than $50 billion in revenue over 10 years compared to allowing these transactions to continue unchecked. While the transactions are complex, this resource is intended to walk through them at a simplified level so that audiences beyond tax lawyers can understand the issues at play and what drives the need for guidance in this area. For a more technical resource, please see our comment letter.

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Give me the drastically simplified version.

Imagine a large business that controls several entities trades assets among them to generate tax savings, taking advantage of specific quirks of partnership tax law. There are tax savings for the owner as a result of these transactions despite the fact that no real economic transaction has taken place: the assets are still under the same ownership at the beginning and the end of the transaction.

What are the basic features of these transactions?

Favored by large businesses but impractical for nearly anyone else, these transactions often **involve groups of entities working in cahoots to generate tax reductions – without any true economic cost to the filer – for no other reason than making their income disappear from their tax bill.** In some cases, a series of transactions could lead to the same taxpayer claiming tax deductions for the "cost" of the same piece of property several times over.

These transactions mostly take place in the realm of large, complex businesses sharing common ownership and with large amounts of assets. More specifically, the businesses typically engaging in these transactions have:

- **Common ownership of multiple entities that include at least one partnership.** One party effectively "gives" tax benefits to a party under the same ownership without gaining anything in return—an uneven transaction that unrelated parties would never see a business reason to do but offers tax benefits in this case where the parties are related.
- **Large amounts of assets with different tax treatment**, which is often the case for large businesses.
- **Appetite and resources for extraordinarily complex, multi-year tax planning.** The structures and transactions are so technical that they often require extensive billable work from accountants and tax attorneys—up to millions of dollars—an expenditure that makes sense only for wealthy businesses. It also requires complex tax maneuvers over multiple years, which unsophisticated filers are unlikely to pursue.

These transactions are aggressive. Even if a rigid application of mechanical rules could produce the desired result, tax advisors must navigate murky legal territory given various anti-abuse regimes in order to generate tax savings. Some advisors have told their clients that the transactions are permissible under existing tax rules and actively assisted clients in implementing them. But other tax professionals have viewed them as more suspect. That's because they involve related parties manufacturing tax benefits without real economic cost—something the Code generally seeks to prevent and does not otherwise permit in bona fide business transactions.

<u>OK, tell me more—what are the tax concepts behind these transactions?</u>

The transactions targeted by this guidance generate tax benefits by increasing tax "basis" in certain assets.

In general, basis is how the tax system keeps track of the cost of an asset. Basis corresponds broadly to the value paid for the asset (generally, its purchase price), less any "cost recovery" deductions allowed over time (such as depreciation, which theoretically reflects declining value over time due to wear and tear), plus additional costs capitalized into an asset (such as certain spending incurred to improve the asset). Tax practitioners typically refer to an increase in an asset's basis as a "step-up" and a decrease as a "step-down."

The difference between an asset's tax basis and its value determines the gain or loss inherent in the asset. When a taxpayer holds an asset with a value that exceeds its tax basis, the asset has an inherent gain that has not yet been taxed—i.e., a "built-in gain." Similarly, a tax basis that exceeds value gives an asset an inherent, or built-in, loss. When the taxpayer ultimately sells the asset, the built-in gain (or loss) is triggered and taxed—the taxpayer either pays tax on the excess of the sale price over the asset's basis (the gain) or has a tax loss to the extent basis exceeds the sale price. A taxpayer who sells an asset with a built-in loss may be able to use the tax loss to reduce its other taxable income (subject to various rules and limitations).

All else equal, a higher tax basis in an asset therefore typically translates into tax savings through:

- <u>Increased cost recovery deductions</u>. Tax law allows cost recovery deductions in the form of depreciation, amortization, or depletion for certain assets (e.g., tangible assets such as buildings and equipment, as well as certain intangible assets such as computer software, patents, and business goodwill) but not others. For example, inventories, corporate stock, and land are all non-depreciable. If the asset is a type that can be depreciated or amortized, the cost recovery deduction allowed in any given year reduces the asset's remaining tax basis—i.e., the basis is "recovered" through tax deductions over time and a higher starting tax basis generally means more deductions. These deductions generally offset business income and thus reduce total tax owed.

- <u>Lower taxable gain when an asset is sold</u>. As discussed above, the higher an asset's tax basis the lower the asset's built-in gain (or the higher the asset's built-in loss). Thus, tax basis also reduces total tax owed by reducing taxable gain (or creating a tax loss) on the sale of the asset. This is the primary way that tax basis in non-depreciable assets is recovered.

The most problematic basis shifting transactions attempt to exploit mechanical rules to engineer increases in the basis of certain assets in a manner that is inconsistent with real world economics. They involve the shuffling of assets (either business assets owned by a partnership itself or equity interests in a partnership) among related taxpayers with common economic interests (e.g., entities with the same owner). These transactions can be grouped into two general categories:

- Shifting basis from one asset to another. The idea here is to move tax basis from one asset over to another (or to multiple other assets) where it can generate a larger tax benefit for the relevant organization.

  One approach is to shift tax basis from a non-depreciable asset (such as corporate stock or land) to a depreciable asset (machinery). This generates (and accelerates) tax savings because it creates cost recovery deductions where none previously existed. A similar approach is to shift basis from one depreciable asset to another depreciable asset with a shorter depreciation schedule (e.g., from an asset that generates deductions spread over 15 years to an asset that generates deductions spread over 5 years). This accelerates tax benefits by allowing depreciation deductions to be claimed sooner than they otherwise would have. Of course, the reduction in tax basis of one asset creates a larger built-in gain and thus the potential for increased tax later, but the relatedness of the parties ensures this is not a real trade-off. Often, these transactions will cause built-in gain in assets not intended to be sold (and the increased built-in gain is therefore not taxed).

  It can also be beneficial to shift basis to a non-depreciable asset. For example, basis may be shifted from an asset that is not expected to be sold anytime soon to a non-depreciable asset that will be sold imminently. The basis step-up reduces taxable gain on the sale in exchange for increased (but again, untaxed) built-in gain on the asset that is not sold—a good trade for any taxpayer.

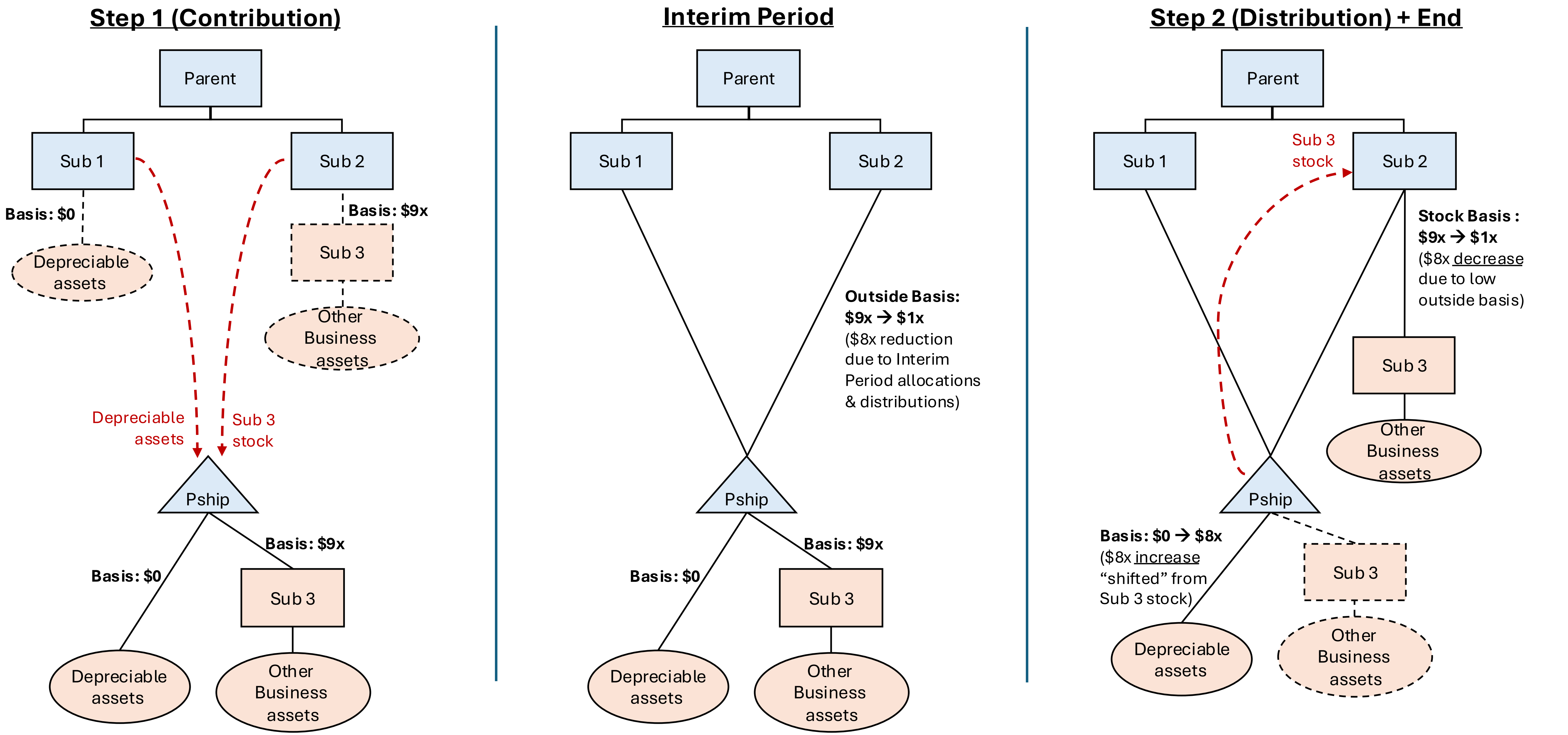
- Shifting basis between partners and manufacturing a "step up". Recall the general discussion of "built-in gain" and "built-in loss" above. A partnership, like any other taxpayer, owns its assets with inherent built-in gains or built-in losses—i.e., the partnership's assets each have their own value and tax basis. Accordingly, each partner holding an interest in the partnership has (indirectly through the partnership) a share of the partnership's tax basis and thus a share of the built-in gains or losses in the partnership's assets. If one partner agrees to take a larger share of the partnership's built-in gains by effectively shifting it away from other partners—something partners acting at arms'-length would avoid doing—then the partner taking on the larger share of built-in gain can use that shifting of gains to generate an artificial step-up in tax basis.

  Put another way, by giving some or all of its share of the partnership's tax basis to related partners (including by taking a "negative" tax basis in partnership assets), resulting in no net change in economics, a partner can obtain a fresh step-up in its own share of the partnership’s tax basis. The fresh step-up replenishes the basis shifted to the related partners and then produces the same tax benefits discussed above—i.e., increased or accelerated cost recovery deductions or reduced gain on the partnership’s future sale of assets. At the end of the day, these shifts should wash out in some manner—for example, duplicated gain or loss should generally be canceled out upon the eventual liquidation of the partnership (or the partnership’s future sale of relevant assets), but those events are either unlikely or will not occur for a very long time.

Thus, with some significant planning, taxpayers can use the above strategies to replenish tax basis in an asset that has already been fully depreciated without ever triggering tax on the asset’s built-in gains—a tax result that the tax law generally does not otherwise permit (other than at death). To illustrate with an extreme (albeit simplified) example, a taxpayer could thus potentially depreciate $1 million of tax basis (i.e., taking $1 million of tax deductions that reduce taxable income over time) and then replenish the asset’s basis by another $1 million, generating another $1 million of tax deductions over time, without ever triggering tax on any gains. In arm’s-length business arrangements, however, “cost” as an economic concept does not simply jump from one asset to another or materialize in this manner (i.e., without tax and without a substantive business transaction).

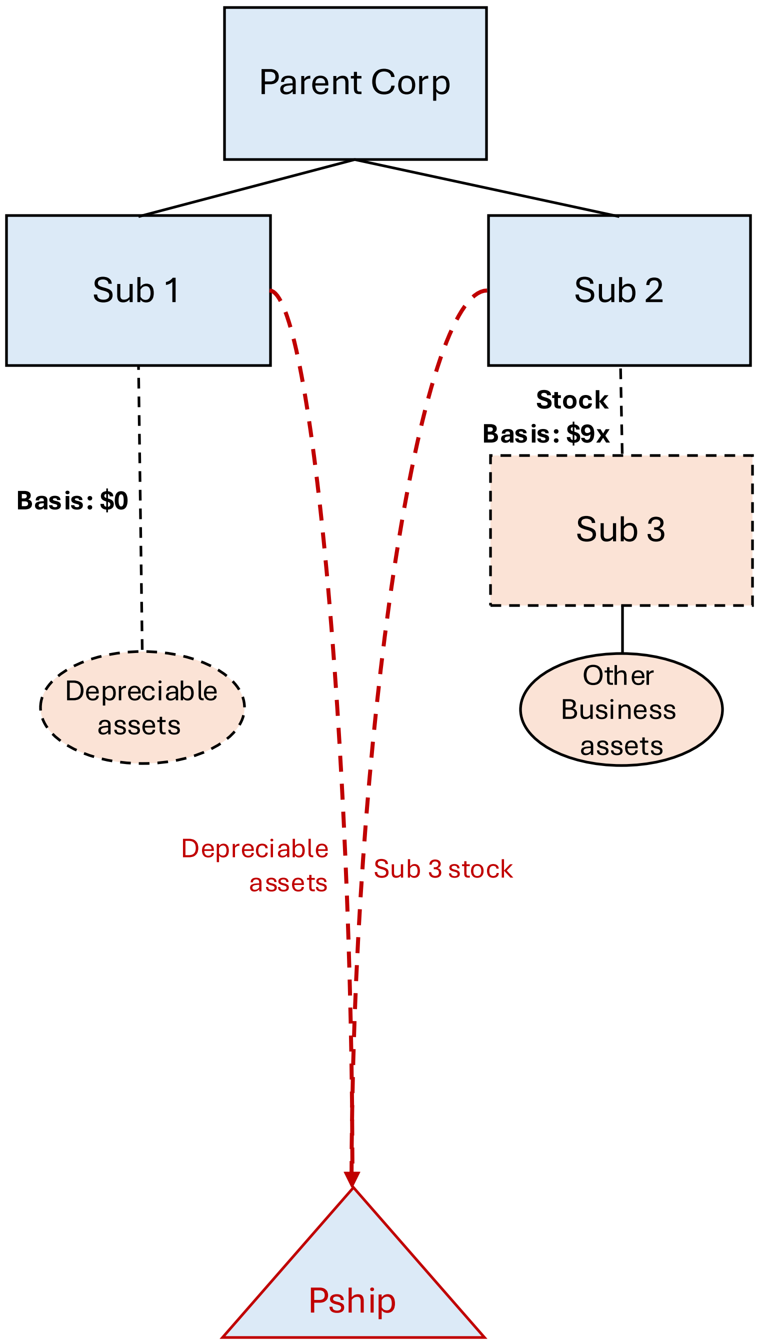
<u>See diagrams showing how one of these transactions works in the following pages.</u>

SUMMARY GRAPHIC: SEE THE WHOLE TRANSACTION FROM START TO FINISH



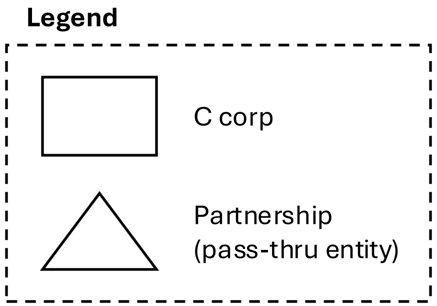
All assets and income remain wholly owned by Parent Corp—economic ownership of the enterprise has not changed or been affected and no taxable transactions have occurred.

DETAILED GRAPHIC

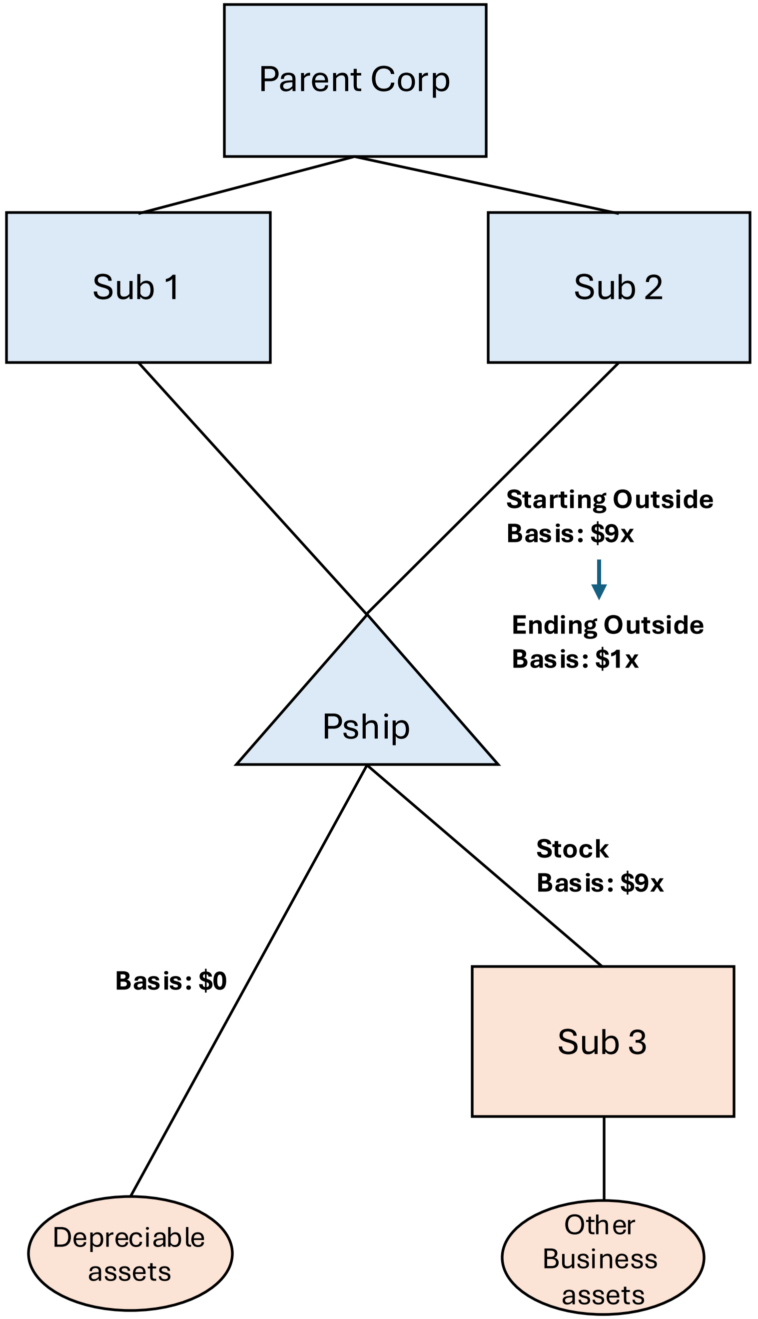


Step 1: Contribution

- Parent Corp is the sole owner of two subsidiary corporations (Sub 1 and Sub 2).
- Sub 2 is the sole owner of another subsidiary corporation (Sub 3).
- Parent Corp, Sub 1, Sub 2, and Sub 3 make up a corporate consolidated group (the "**P Group**") that is treated as a single taxpaying entity and files a single consolidated income tax return.
- Sub 1 owns depreciable assets with a tax basis of $0. They were fully depreciated previously, which generated prior tax deductions to Sub 1 (and thus to the P Group).
- Sub 2 owns Sub 3 stock, a non-depreciable asset, with a tax basis of $9x.
- Sub 1 and Sub 2 form a new partnership ("**Pship**"). Sub 1 contributes its depreciable assets to Pship in exchange for equity of Pship; Sub 2 contributes all of the stock of Sub 3 to Pship in exchange for equity of Pship.



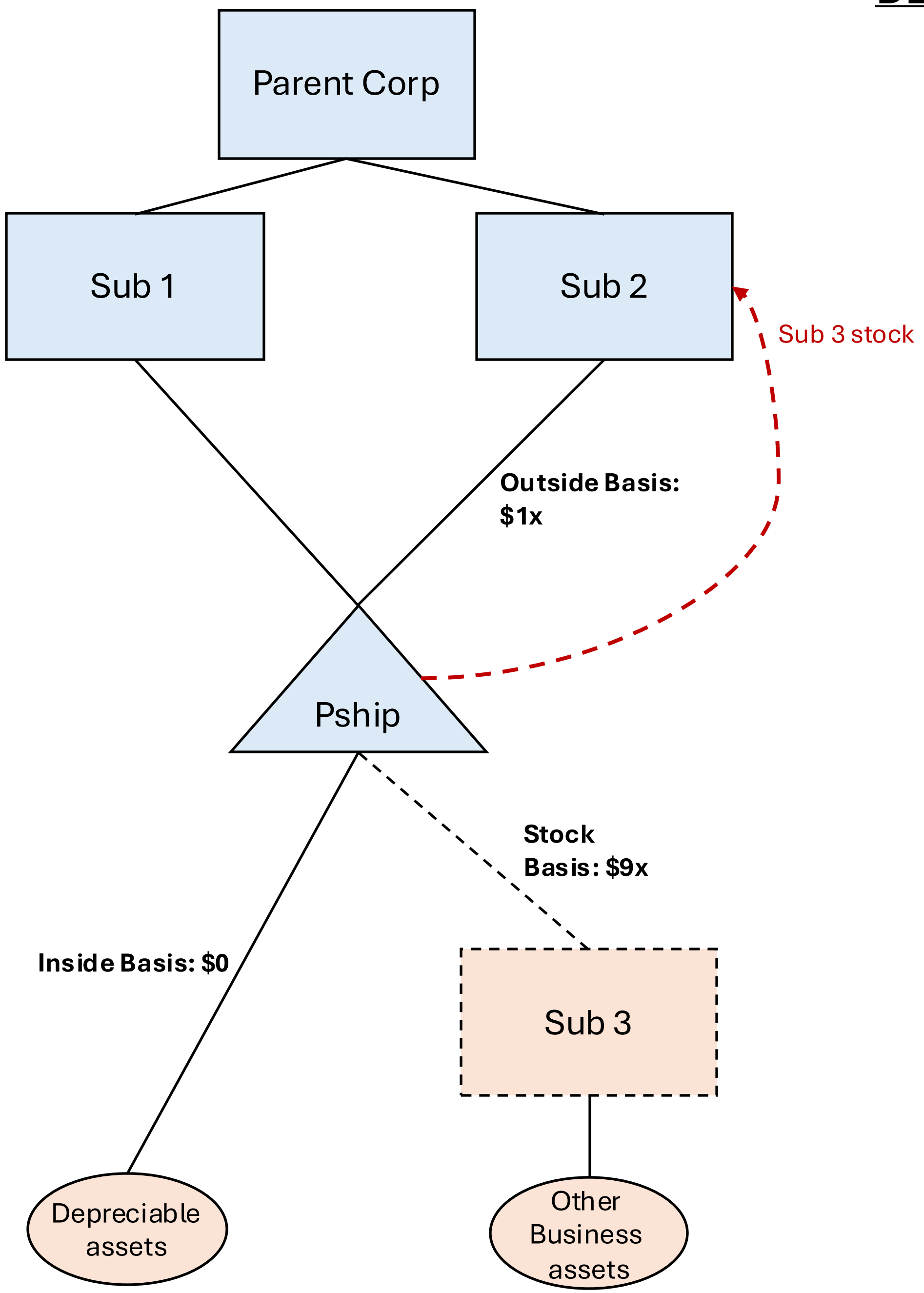
DETAILED GRAPHIC CONTINUED



Interim Period

- Immediately after the Step 1 Contribution, Sub 2 has a starting tax basis in its Pship interest (i.e., starting "outside basis") of $9x. This mirrors the basis of the Sub 3 stock it contributed in the previous Step 1.
  - *Note: **Outside basis** refers to a partner's tax basis in its partnership interest. **Inside basis** refers to the partnership's tax basis in its assets.*
- Over a period of time, which may be several years (the "**Interim Period**"), the P Group desires to create a situation in which Sub 2's outside basis in its Pship interest is low. This will create the circumstances for the later **basis shift**.
- Accordingly, allocations of Pship income and losses, as well as operating cashflow distributions by Pship, are made to its partners (Sub 1 and Sub 2) during the Interim Period in a manner that decreases Sub 2's basis to $1x.
  - *Note: Pship income allocations increase outside basis; Pship loss allocations and cash distributions decrease outside basis.*
- Pship's tax basis in its assets (i.e., "inside basis") does not change over the Interim Period.
  - *Because the Sub 3 stock is non-depreciable and the depreciable assets already had a $0 tax basis, no further adjustments to Pship's inside basis are made.*

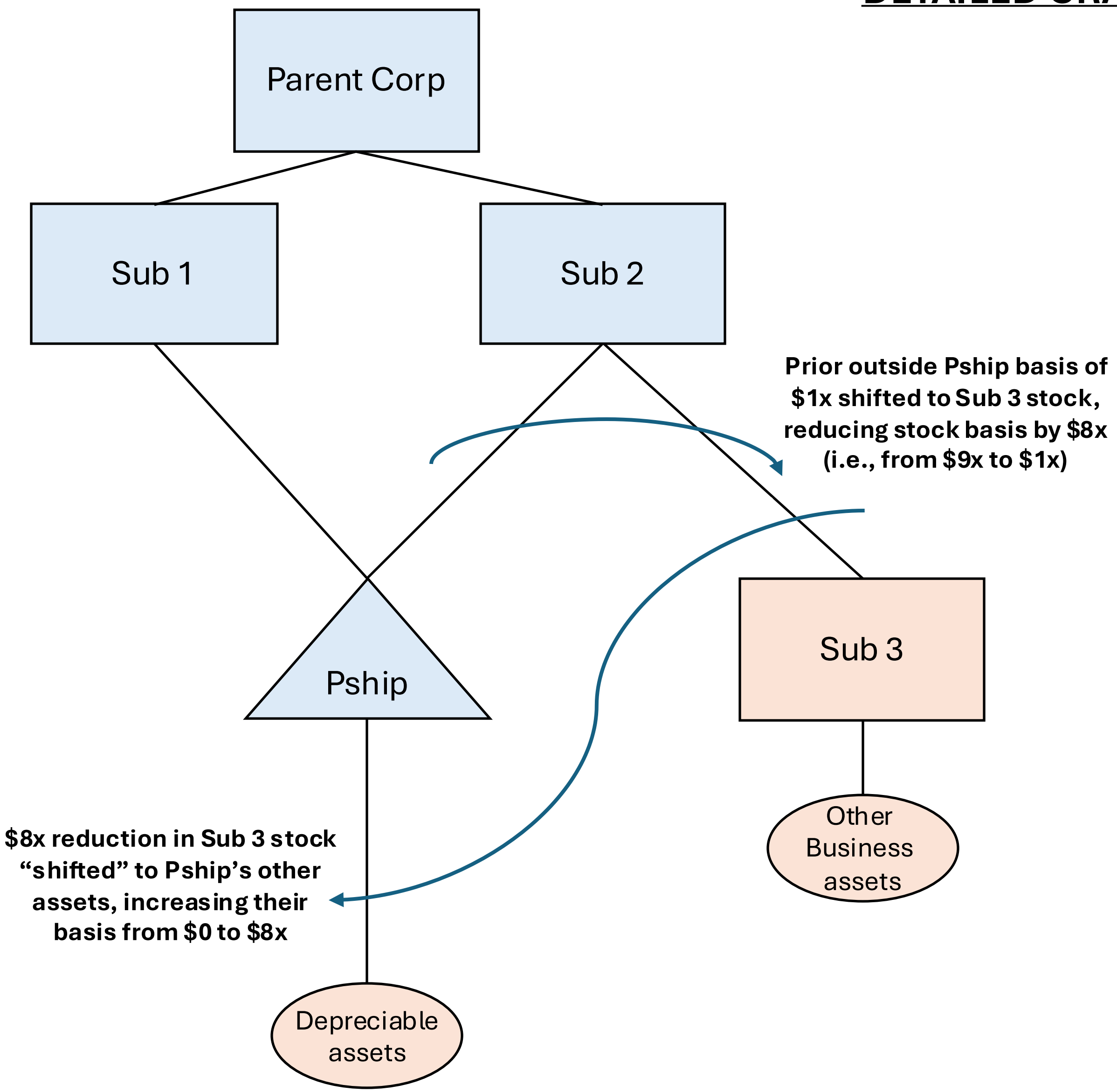
DETAILED GRAPHIC CONTINUED



Step 2: Distribution

- After the Interim Period, Pship transfers all of the Sub 3 stock to Sub 2 as a tax-free partnership distribution.
  - *Note: Under partnership tax rules, a distribution by a partnership is generally tax-free to the recipient partner, subject to specific exceptions. Here, the distribution of Sub 3 stock does not trigger tax for Sub 2. Sufficient time has passed since the Step 1 contribution such that the P Group does not expect the distribution to be disregarded as transitory.*

DETAILED GRAPHIC CONTINUED



Summary: How the basis moves

- Under partnership tax rules, Sub 3's tax basis in the distributed Sub 3 stock is the lesser of (1) Pship's tax basis in the Sub 3 stock ($9x) and (2) Sub 2's outside basis in Pship ($1x).
- Thus, Sub 2's basis in the distributed Sub 3 stock is limited to $1x—its prior outside basis.
  - *This means the basis in the Sub 3 stock is reduced by $8x in the distribution (from $9x to $1x).*
- Pship makes an election that allows it to increase the basis of its remaining assets by the amount of basis that is stripped away in the distribution (i.e., the $8x reduction above).
- As a result, $8x of tax basis that was previously in the Sub 3 stock (and did not generate any depreciation deductions) is "shifted" to Pship's other assets. This $8x of tax basis can now be depreciated, generating $8x of future tax deductions to Pship.
- These additional depreciation deductions are allocated by Pship to its partners (Sub 1 and Sub 2), thus reducing the P Group's overall taxable income.
- At all times, all assets and income are wholly owned by Parent Corp—economic ownership of the enterprise has not changed or been affected and no taxable transactions have occurred.
- And while tax basis in the Sub 3 stock has been reduced (creating more built-in gain in the Sub 3 stock), the P Group has no plan to sell the Sub 3 stock or otherwise trigger those gains.