Hon. Charles P. Rettig  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20224

Re: Comments on Treatment of Partnerships in Proposed Regulations under Section 168(k)

Dear Commissioner Rettig:

Enclosed please find comments on the treatment of partnerships in the proposed regulations under section 168(k). These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Eric Solomon  
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury  
William M. Paul, Acting Chief Counsel and Deputy Chief Counsel (Technical),  
Internal Revenue Service  
Krishna P. Vallabhaneni, Acting Tax Legislative Counsel, Department of the Treasury  
Hannah Hawkins, Deputy Tax Legislative Counsel, Department of the Treasury  
Audrey W. Ellis, Attorney-Advisor, Department of the Treasury  
Ellen Martin, Tax Policy Advisor, Department of the Treasury  
Bryan A. Rimmke, Attorney-Advisor, Department of the Treasury  
Scott K. Dinwiddie, Associate Chief Counsel (ITA), Internal Revenue Service  
Holly Porter, Associate Chief Counsel (PSI), Internal Revenue Service  
Kathleen Reed, Branch Chief (ITA), Internal Revenue Service
These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Ari Berk and John Franco. Substantial contributions were made by Jennifer Alexander, Jeff Erickson, Jane Rohrs, and Risa Trump.

These Comments have been reviewed by Gary Huffman of the Committee on Government Submissions and Eric Sloan, Vice-Chair for Government Relations for the Tax Section.

Although members of the Section of Taxation may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: February 12, 2019
SUMMARY OF RECOMMENDATIONS

These Comments address the treatment of partnerships under the proposed regulations under section 168(k)\(^1\) published on August 8, 2018 (the “Proposed Regulations”) and certain subchapter K provisions.\(^2\) The Proposed Regulations address in part, the interaction of section 168(k) with sections 743(b), 734(b), 704(b), and 704(c) of the Code and with Revenue Ruling 99-5 Situation 1.\(^3\) Section 168(k) was amended by Public Law 115-97 (the “Act”) on December 22, 2017.\(^4\) The amendments to section 168(k) are generally applicable to property acquired and placed in service after September 27, 2017.\(^5\) The Proposed Regulations are proposed to be effective when finalized, but taxpayers are generally permitted to rely on them before final Regulations are published. Before the issuance of the Proposed Regulations, the Section submitted a letter (“Prior Comments”) concerning the treatment of partnerships under section 168(k).\(^6\)

We commend the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) on thoughtfully addressing partnership-related issues as part of the Proposed Regulations and thank the drafters for carefully considering our Prior Comments. We respectfully submit these Comments and request that final Regulations provide additional guidance and clarification with respect to the following partnership-related issues:

1. We recommend the final Regulations provide that the rule in Proposed Regulation section 1.168(k)-2(f)(3)(iiii), which provides for a monthly proration of the additional first year depreciation deduction under section 168(k) between a transferor and a transferee, also applies to the recovery of section 743(b) adjustments under section 168(k) when there are subsequent transfers of partnership interests in transactions described in section 168(i)(7).

2. We recommend the final Regulations modify the language in Proposed Regulation section 1.168(k)-2(f)(1)(i), which provides that the additional first year depreciation deduction under section 168(k) is not allowed for property that is placed in service and sold in the same taxable year, to permit a transferee of a partnership interest

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\(^1\) Unless otherwise indicated, all “section” references are to the Internal Revenue Code of 1986, as amended (the “Code”), and all “Regulation section” references are to the Treasury regulations promulgated under the Code, all as in effect on the date of these Comments.


\(^4\) An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. No. 115-97, 131 Stat. 2054 (sometimes referred to as the “Tax Cuts and Jobs Act” or “TCJA”).


to deduct the additional first year depreciation deduction attributable to the transferee’s section 743(b) adjustment that increases the basis of qualified property only if the transferee does not subsequently transfer the partnership interest to which the section 743(b) adjustment relates in a taxable exchange that occurs within the same taxable year that the transferee acquired the partnership interest.

3. With respect to transfers of partnership interests, we recommend the final Regulations confirm that the series of related transactions rule in Proposed Regulation section 1.168(k)-2(b)(3)(iii)(C) applies solely to determine whether a deduction under section 168(k) is allowed and does not function to change which taxpayer in a series of related transactions is eligible for a deduction under section 168(k) that is allowed.

4. We recommend the final Regulations provide an example clarifying the application of Proposed Regulation section 1.168(k)-1(f)(1)(iii) to a Revenue Ruling 99-5 Situation 1 transaction when the seller has placed qualified property into service in the same taxable year that the Revenue Ruling 99-5 Situation 1 transaction occurs but before the Revenue Ruling 99-5 Situation 1 transaction.

5. We recommend the final Regulations clearly provide whether a partner who acquires qualified property from a partnership or from another partner who acquired that property from the partnership is considered to have had a previous depreciable interest in the partnership’s qualified property solely by reason of owning an interest in the partnership. If the final Regulations provide that a partner is considered to have a previous depreciable interest in the partnership’s qualified property, we recommend the final Regulations provide that this depreciable interest is determined by reference to the partner’s share of depreciation deductions with respect to the qualified property.

6. If it is intended that increases to the basis of qualified property under section 743(b) that are attributable to a remedial section 704(c) layer are not eligible for the additional first year depreciation deduction under section 168(k), we recommend the final Regulations modify the language in Proposed Regulation section 1.743-1(j)(4)(i)(B)(1) to make this clear.

7. We recommend the final Regulations provide that a partnership that did not claim a deduction under section 168(k) for the amount of a section 743(b) adjustment that would otherwise be eligible for the section 168(k) deduction should be deemed to have made a valid election within the meaning of Proposed Regulation section 1.743-1(j)(4)(i)(B)(1) and Proposed Regulation section 1.168(k)-2(e)(1), and that Proposed Regulation section 1.168(k)-2(e)(1)(iv) does not apply to these section 743(b) adjustments. If this recommendation is not adopted, we recommend the final Regulations provide partnerships procedural relief to file a late election under section 168(k)(7) in cases in which a partnership tax return has been filed before or within a certain period of time after the issuance of the Proposed Regulations (for example, within 90 days may be an appropriate period of time, or these taxpayers could be allowed to include the election on their next tax return).
These issues are discussed in greater detail below.

DISCUSSION

I. **Background**

On August 8, 2018, Proposed Regulations regarding the additional first year depreciation deduction under section 168(k) were published in the Federal Register. The Proposed Regulations address several open issues with respect to the interaction of section 168(k) and partnerships.

The Proposed Regulations provide that the recovery of section 704(b) book amounts and adjustments to basis under either section 732(b) or 734(b) do not satisfy the requirements of section 168(k). The Proposed Regulations provide that a new or existing partner’s basis adjustment under section 743(b), however, may satisfy the requirements of section 168(k) provided that the used property acquisition requirements of section 168(k) are met. In addition, the Proposed Regulations permit a partnership to make an election under section 168(k)(7) to not deduct the additional first year depreciation for an increase in the basis of qualified property under section 743(b) even if the partnership does not make such an election with respect to the partnership’s other qualified property in the same class placed in service in the same taxable year, and vice versa. Finally, the proposed regulations provide a special rule that, while not limited in its application to transactions described by Revenue Ruling 99-5 Situation 1, addresses those transactions (the “Special Section 168(i)(7) Rule”). This special rule provides that if qualified property is transferred in a section 721(a) transaction to a partnership that has as a partner a person, other than the transferor, who previously had a depreciable interest in the qualified property, in the same taxable year that the qualified property is placed in service by the transferor, the allowable additional first year depreciation deduction is allocated entirely to the transferor, before the section 721(a) transaction, and not to the partnership.

Although the Proposed Regulations are proposed to be effective when finalized, taxpayers are generally permitted to rely on them before final Regulations are published.

We generally agree with the approach the Proposed Regulations take with respect to the application of section 168(k) as amended by the Act to partnerships and their partners. However, we believe certain partnership issues require additional consideration.

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and/or clarification. These issues include the application of the Proposed Regulations to (i) multiple transfers of the same partnership interest in the same taxable year, (ii) the seller in certain Revenue Ruling 99-5 Situation 1 transactions, (iii) determining a partner’s previous depreciable interest in partnership property, (iv) the remedial section 704(c) recovery rule for section 743(b) adjustments, and (v) partnership elections with respect to section 743(b) adjustments under section 168(k)(7). As noted above in “Summary of Recommendations,” these issues are discussed in detail below.

II. Multiple Transfers of Partnership Interests

A. Purchase and Nonrecognition Transfer in Same Taxable Year

Except as provided in the Special Section 168(i)(7) Rule, if qualified property is both placed in service and transferred in a section 168(i)(7) transaction in the same taxable year, Proposed Regulation section 1.168(k)-2(f)(1)(iii) provides that the additional first year depreciation deduction under section 168(k) is allowable for the qualified property, and that the deduction is allocated between the transferor and the transferee on a monthly basis in accordance with Regulation section 1.168(d)-1(b)(7)(ii).

This rule does not appear to apply to a situation in which a partnership interest is purchased and transferred in a section 168(i)(7) transaction in the same year. Stated differently, this rule does not appear to apply to the additional first year depreciation deduction under section 168(k) with respect to a section 743(b) adjustment that increases the basis of qualified property with respect to a purchased partnership interest where that partnership interest is transferred in a section 168(i)(7) transaction during the year of purchase.

Under the Proposed Regulations, the section 743(b) basis adjustment itself—not the partnership interest—is the property that is eligible for the additional first year depreciation deduction, and that section 743(b) adjustment is not transferred in a section 168(i)(7) transaction. That is, the transferee of an interest in a section 168(i)(7) transaction will not succeed to the section 743(b) adjustment of the transferor; rather under Treas. Reg. § 1.743-1(f), the transferee will have its own section 743(b) basis adjustment. 13

Additionally, if the transferee in the section 168(i)(7) transaction has a section

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12 I.R.C. § 168(i)(7)(A) provides that in the case of any property transferred in a transaction described in I.R.C. § 168(i)(7)(B), the transferee is treated as the transferor for purposes of computing the depreciation deduction determined under I.R.C. § 168 with respect to so much of the basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor. I.R.C. § 168(i)(7)(B) includes (i) any transaction described in I.R.C. §§ 332, 351, 361, 721, or 731, and (ii) any transaction between members of the same affiliated group during any taxable year for which a consolidated return is made by such group.

13 We note that Prop. Reg. § 1.743-1(f)(2), 79 Fed. Reg. 3,063 (2014) provides that a transferee in a substituted basis transaction may succeed to a transferor’s section 743(b) basis adjustment in certain circumstances. We do not believe that Prop. Reg. § 1.743-1(f)(2) provides for a transfer of a section 743(b) adjustment from a transferor to a transferee. Accordingly, we do not believe that Prop. Reg. § 1.743-1(f)(2) provides regulatory precedent to treat a section 743(b) adjustment as a transferrable property.
743(b) adjustment that increases the basis of qualified property, this new section 743(b) adjustment does not meet the requirements of section 168(k) because the partnership interest is transferred in either a carryover or a substituted basis transaction, so the transfer does not appear to meet the used property acquisition requirements of section 168(k) and the Proposed Regulations. Also, because the transferee does not succeed to the section 743 adjustment, Proposed Regulation section 1.168(k)-2(f)(1)(iii) does not apply to permit the transferee to nevertheless claim a portion of the additional first year depreciation deduction.

We believe the transferor and transferee of a partnership interest in a section 168(i)(7) transaction should be treated in a similar manner as the transfer of the underlying qualified property in a section 168(i)(7) transaction. Thus, we recommend that the final Regulations provide that the rule in Proposed Regulation section 1.168(k)-2(f)(3)(iii), which provides for a monthly proration of the additional first year depreciation deduction under section 168(k) between a transferor and a transferee, also applies to section 743(b) adjustments when there are subsequent transfers of partnership interests in transactions described in section 168(i)(7). Under this approach, the transferor in the section 168(i)(7) transaction may deduct the portion of the additional first year depreciation deduction with respect to the transferor’s section 743(b) adjustment that meets the requirements of section 168(k) and the Proposed Regulations, and the transferee in the section 168(i)(7) transaction would deduct the remaining additional first year depreciation deduction.

For example, assume that a calendar year taxpayer X purchases a partnership interest on April 1, 2018 in a transaction that meets the used property acquisition requirements of section 168(k) and the Proposed Regulations, and X’s section 743(b) adjustment increases the basis of the partnership’s qualified property by $100. Absent a subsequent transfer, section 168(k) would generally result in a deduction of $100 with respect to X’s section 743(b) adjustment. If on July 1, 2018, X transfers its partnership interest to a subsidiary under section 351(a) (a transaction included in section 168(i)(7)), under the Proposed Regulations the subsidiary would not be entitled to claim any deduction under section 168(k), and it is not clear what amount X is entitled to deduct under section 168(k). Our recommendation to apply the principles of section 168(i)(7) and Proposed Regulation section 1.168(k)-2(f)(1)(iii) in this instance, however, would result in X deducting $33 and the subsidiary of X deducting $67 of the $100 section 743(b) adjustment of X that is eligible for the additional first year depreciation deduction. Additionally, because a portion of the section 168(k) deduction related to X’s section 168(i)(7) transaction should be treated in a similar manner as the transfer of the underlying qualified property in a section 168(i)(7) transaction. Thus, we recommend that the final Regulations provide that the rule in Proposed Regulation section 1.168(k)-2(f)(3)(iii), which provides for a monthly proration of the additional first year depreciation deduction under section 168(k) between a transferor and a transferee, also applies to section 743(b) adjustments when there are subsequent transfers of partnership interests in transactions described in section 168(i)(7). Under this approach, the transferor in the section 168(i)(7) transaction may deduct the portion of the additional first year depreciation deduction with respect to the transferor’s section 743(b) adjustment that meets the requirements of section 168(k) and the Proposed Regulations, and the transferee in the section 168(i)(7) transaction would deduct the remaining additional first year depreciation deduction.

Our recommendation to apply the principles of section 168(i)(7) and Proposed Regulation section 1.168(k)-2(f)(1)(iii) in this instance, however, would result in X deducting $33 and the subsidiary of X deducting $67 of the $100 section 743(b) adjustment of X that is eligible for the additional first year depreciation deduction. Additionally, because a portion of the section 168(k) deduction related to X’s section 168(i)(7) transaction should be treated in a similar manner as the transfer of the underlying qualified property in a section 168(i)(7) transaction. Thus, we recommend that the final Regulations provide that the rule in Proposed Regulation section 1.168(k)-2(f)(3)(iii), which provides for a monthly proration of the additional first year depreciation deduction under section 168(k) with respect to the section 743(b) adjustment.

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15 The section 743(b) adjustment with respect to the second transferee arises in connection with a transaction described in section 168(i)(7), so the second transferee’s section 743(b) adjustment would not be eligible for the additional first year depreciation deduction (the acquisition of the partnership interest by the second transferee would not satisfy the used property acquisition requirements of section 168(k) and the Proposed Regulations). Therefore, providing that the first transferee may not claim all of the additional first year depreciation deduction in favor of permitting the second transferee to claim all or a portion of such deduction could result in no party to the transaction being eligible to claim the additional first year depreciation deduction under section 168(k) with respect to the section 743(b) adjustment.
743(b) adjustment is allocated to X’s subsidiary, the outside basis of the subsidiary’s interest in the partnership (and, accordingly, their section 743(b) adjustment) should be reduced to avoid duplication.16

B. **Purchase and Taxable Sale in Same Taxable Year**

If qualified property is both placed in service and sold in the same taxable year (or otherwise disposed of in a transaction not described in section 168(i)(7)), Proposed Regulation section 1.168(k)-2(f)(1)(i) provides that the additional first year depreciation deduction under section 168(k) is not allowed to the taxpayer who placed the property in service and then subsequently sold the property. Similar to the rule addressing transactions under section 168(i)(7), this rule does not by its terms apply to section 743(b) adjustments resulting from multiple taxable sales of a partnership interest in the same taxable year. As noted above, we believe the transfer of a partnership interest should be treated in a similar manner as a transfer of the underlying qualified property.

For example, if W purchases a partnership interest in PRS from X in a transaction that meets the requirements of Proposed Regulation section 1.168(k)-2(b)(3)(iv)(D), the additional first year depreciation deduction under section 168(k) applies to W’s section 743(b) adjustment to the extent the adjustment, with respect to W, increases the basis of qualified property held by PRS. If W subsequently sells its interest in PRS to Z in the same taxable year in a transaction that also meets the requirements of Proposed Regulation section 1.168(k)-2(b)(3)(iv)(D), under the Proposed Regulations the additional first year depreciation deduction attributable to W’s section 743(b) adjustment is allowed.17

We do not believe this treatment with respect to W is the correct result because it would allow a purchase and subsequent sale of a partnership interest to obtain a different result than a purchase and subsequent sale of assets. Therefore, we recommend that final Regulations modify the language in Proposed Regulation section 1.168(k)-1(f)(1)(i), which provides that the additional first year depreciation deduction under section 168(k) is not allowed for property that is placed in service and sold in the same taxable year, to provide that a transferee of a partnership interest is eligible to claim the additional first year depreciation deduction attributable to a section 743(b) adjustment arising in connection with the transferee’s acquisition of the partnership interest only if the transferee does not subsequently transfer the partnership interest in a transaction not described in section 168(i)(7) (i.e., a taxable exchange) in the same taxable year that the partnership interest was acquired by the transferee. For example, if B purchases a

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16 Although an approach that results in all of the section 168(k) deduction related to the section 743(b) adjustment being attributable to X’s subsidiary may make the determination of the transferee’s outside basis easier, we believe that this type of approach is less consistent with the principles of section 168(i)(7) and Proposed Regulation section 1.168(k)-1(f)(1)(i).

17 Z’s section 743(b) adjustment also, arguably, is eligible for the additional first year depreciation deduction under section 168(k) to the extent the adjustment increases the basis of qualified property held by PRS with respect to Z. We believe this is an appropriate result provided that Z does not subsequently sell its partnership interest in the same taxable year as Z’s purchase.
partnership interest from A, but in an unrelated transaction B sells the same partnership interest to C in the same taxable year as the purchase from A, B would not be eligible to claim the additional first year depreciation deduction attributable to any section 743(b) adjustment arising in connection with B’s purchase of the partnership interest from A. However, C may be eligible to claim the additional first year depreciation deduction under section 168(k) with respect to any section 743(b) adjustment arising in connection with the purchase by C from B of the partnership interest, provided C does not subsequently transfer the partnership interest purchased from B in the same taxable year as the purchase from B and the used property acquisition requirements of section 168(k) and the Proposed Regulations are otherwise satisfied with respect to C’s acquisition of its partnership interest. Such a rule results in multiple taxable transfers of partnership interests being treated in the same manner as if the underlying assets were purchased by the taxpayer, placed into service, and then subsequently sold in the same taxable year.

C. Series of Related Transactions

Proposed Regulation section 1.168(k)-2(b)(3)(iii)(C) provides that, solely for purposes of the used property acquisition requirements of section 168(k), in the case of a series of related transactions (for example, a series of related transactions including the transfer of a partnership interest, the transfer of partnership assets, or the disposition of property and the disposition, directly or indirectly, of the transferor or transferee of the property)—

(1) The property is treated as directly transferred from the original transferor to the ultimate transferee; and

(2) The relation between the original transferor and the ultimate transferee is tested immediately after the last transaction in the series.

The portion of the preamble to the Proposed Regulations discussing this rule states that Treasury and the Service believe that the ordering of steps, or the use of an unrelated intermediary, in a series of related transactions should not control the determination of whether the used property acquisition requirements of section 168(k) and the Proposed Regulations are satisfied. The preamble and examples in the Proposed Regulations describe the application of this rule to a series of related transactions involving a father, his daughter, and an unrelated party. In the example, instead of the father selling depreciable property to his daughter (a transaction that would not meet the used property acquisition requirements of section 168(k) and the Proposed Regulations), the father sells the depreciable property to an unrelated party, followed by the unrelated party selling the depreciable property to the daughter (a transaction that would otherwise meet the used property acquisition requirements of section 168(k) and

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18 This result assumes that the parties to the transactions are unrelated. If C were related to B under section 267 (as modified for purposes of section 179(d)(2)(A)), neither B’s nor C’s section 743(b) adjustment would be eligible for the additional first year depreciation deduction under section 168(k).


the Proposed Regulations). In that case, the special rule for a series of related transactions treats the property as being transferred from the father directly to his daughter for purposes of the used property acquisition requirements of section 168(k) and the Proposed Regulations. Because the father and daughter are related within the meaning of section 267 (as modified for purposes of section 179(d)(2)(A)), the transfer does not meet the used property acquisition requirements of section 168(k) and the Proposed Regulations. Because the rule references a series of related transactions including the transfer of a partnership interest, the series of related transactions rule appears to apply to a section 743(b) adjustment that increases the basis of qualified property if the father was instead a partner in a partnership, and the father sold his partnership interest to an unrelated party, followed by the unrelated party selling the partnership interest to the daughter.

The preamble also describes this rule broadly and states that “in a case of a series of related transactions, the transfer of the property will be treated as directly transferred from the original transferor to the ultimate transferee, and the relation between the original transferor and the ultimate transferee is tested immediately after the last transaction in the series.” However, the series of related transactions rule itself specifies that the rule is “solely for purposes of section 168(k)(2)(E)(ii) and paragraph (b)(3)(iii)(A) of this section” (relating to the section 168(k) used property acquisition requirements).

We accordingly read this rule as relevant in determining whether or not a transaction meets the used property acquisition requirements of section 168(k) and the Proposed Regulations, but we do not read the rule to apply in a manner that changes which taxpayer deducts an amount under section 168(k). In other words, we do not believe the ultimate transferee would be assigned a deduction under section 168(k) in a series of related transactions where the original transferor and ultimate transferee are unrelated.

For example, assume Z purchases an interest in PRS from X in a transaction that meets the used property acquisition requirements of section 168(k) and the Proposed Regulations, and the basis of the qualified property of PRS is increased with respect to Z under section 743(b). Pursuant to a post-acquisition restructuring plan, in the subsequent taxable year Z transfers its interest in PRS to a wholly owned corporate subsidiary of Z. This is not an abusive fact pattern and, if the series of related transactions rule in Proposed Regulation section 1.168(k)-2(b)(3)(iii)(C) applied to treat the transfer as occurring directly between X and the wholly owned subsidiary of Z for purposes of the used property acquisition requirements of section 168(k) and the Proposed Regulations, X and the wholly owned subsidiary of Z are unrelated, so the purchase of the interest in

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21 Id.
22 Id.
23 Id.
PRS by Z would meet the used property acquisition requirements of section 168(k) and the Proposed Regulations, and Z would be eligible for the additional first year depreciation deduction under section 168(k) with respect to Z’s section 743(b) adjustment. We do not interpret this rule to apply in a manner that causes Z’s wholly owned subsidiary to be eligible for a deduction under section 168(k) as if the transfer of the interest in PRS occurred between X and the wholly owned subsidiary of Z.

Therefore, with respect to transfers of partnership interests, we recommend that the final Regulations confirm that the series of related transactions rule in Proposed Regulation section 1.168(k)-2(b)(3)(iii)(C) applies solely to determine whether a deduction under section 168(k) is allowed and does not function to change which taxpayer in a series of related transactions is eligible for a deduction under section 168(k) that is allowed.25

III. Revenue Ruling 99-5 Situation 1 Transaction-Seller Treatment

A. In General

Proposed Regulation section 1.168(k)-2(f)(1)(iii) provides a special exception to the general monthly proration rule discussed above (with respect to property that is both placed in service and transferred in a section 168(i)(7) transaction in the same taxable year). Under the Special Section 168(i)(7) Rule, if qualified property is transferred in a section 721(a) transaction to a partnership that has as a partner a person, other than the transferor of the property to the partnership, who previously had a depreciable interest in the qualified property, in the same taxable year that the qualified property is placed in service by the transferor, the allowable additional first year depreciation deduction is allocated entirely to the transferor, and not to the partnership.

Under this rule, if A owns qualified property through a disregarded LLC and B (who is unrelated to A under section 267 (as modified for purposes of section 179(d)(2)(A)) and section 707(b)) purchases an interest in the LLC from A causing a partnership to form in accordance with Revenue Ruling 99-5 Situation 1,26 the additional first year depreciation deduction under section 168(k) applicable to the qualified property that B is deemed to purchase from A and then subsequently contribute to LLC in a transaction qualifying under section 721(a) is allocated entirely to B under the Special Section 168(i)(7) Rule. That is, all of the additional first year depreciation deduction under section 168(k) is allocated to B, instead of being allocated between B and the LLC on a monthly basis. We believe that this is an appropriate solution to the issues that arise in a partnership formation under Revenue Ruling 99-5 Situation 1 in light of the fact that

25 Although our recommendation is limited to transfers of partnership interests, we see no reason why it should be so limited. For example, if Z instead purchased qualified property from X and then subsequently transferred the qualified property to a wholly owned subsidiary of Z, the same issue would arise.

26 Rev. Rul. 1999-5, 1999-1 C.B. 434. In Rev. Rul. 99-5, Situation 1, the owner of a disregarded entity (A) sells an interest in the disregarded entity to another taxpayer (B). Under the ruling, the following are deemed to occur: (i) B purchases an undivided interest in each of the disregarded entity’s assets and, immediately thereafter, (ii) A and B are treated as contributing their respective interests in those assets to the partnership in exchange for ownership interests in the partnership.
remedial section 704(c) allocations are not eligible for the additional first year depreciation deduction under section 168(k) because it ensures that B receives the entire benefit of the additional first year depreciation deduction under section 168(k).27

**B. Seller Places Qualified Property into Service in Same Taxable Year**

The example above assumes that the qualified property owned by A through A’s interest in LLC has been placed into service in a taxable year before the taxable year in which B purchases an interest in LLC from A. If the qualified property is instead placed in service by LLC (while LLC is disregarded as separate from A) in the same taxable year that B purchases an interest in LLC from A (in other words, in the same taxable year that the Revenue Ruling 99-5 Situation 1 formation of LLC as a partnership occurs), it appears that both the general section 168(i)(7) monthly proration rule and the Special Section 168(i)(7) Rule apply to the transaction.

For example, assume that LLC places qualified property in service with a basis of $100 on April 1, 2018, and B purchases 50 percent of LLC from A for $60 on July 1, 2018, when the fair market value of the LLC has increased to $120.

B is eligible for an additional first year depreciation deduction of $60 under the Special Section 168(i)(7) Rule.28 A is not eligible for the additional first year depreciation deduction under section 168(k) with respect to the portion of qualified property that is deemed to be sold to B in the same taxable year it is placed into service (i.e., $50, half of A’s cost basis).29 With respect to the portion of the qualified property that is deemed to be contributed to LLC by A, this property is both placed in service and transferred in a section 168(i)(7) transaction in the same taxable year in which A held the property for three months (while LLC was a disregarded entity owned by A) and LLC (as a partnership) held the property for six months. Therefore, the additional first year depreciation deduction under section 168(k) with respect to this portion of the qualified property is allocated $17 to A (1/3 of $50) and $33 to LLC (2/3 of $50), regardless of which section 704(c) method is used with respect to A’s contributed property.30

With respect to the LLC, A is deemed to contribute qualified property with a fair

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27 The rationale stated in the preamble suggests that the Special Section 168(i)(7) Rule is necessary to prevent any of B’s section 168(k) deduction from being apportioned to the partnership and then allocated by the partnership to A, a partner who has a previous depreciable interest in the property. 83 Fed. Reg. 39,299 (2018). However, because A is also treated as contributing to the partnership the portion of the property that is not deemed to be sold to B (with section 704(c) built-in gain assuming that A has fully depreciated the property), A would not be allocated a net deduction as a result of the application of section 168(k) if remedial section 704(c) allocations were eligible for section 168(k) in this situation. In this regard, if Treasury and the Service were to permit remedial section 704(c) allocations to be eligible for the additional first year depreciation deduction, the Special Section 168(i)(7) Rule might not be necessary, especially in cases where the allocations of section 704(b) book depreciation with respect to qualified property are in proportion to the interest in the LLC purchased.


market value of $60 and an adjusted basis of $33 ($50 - $17 deduction under section 168(k) attributable to A), with a forward section 704(c) layer of $27.\textsuperscript{31} B is deemed to contribute qualified property with a fair market value of $60 and an adjusted basis of zero (the $60 section 168(k) deduction attributable to the qualified property that B is deemed to purchase is allocated entirely to B before B’s contribution to the partnership), with a forward section 704(c) layer of $60.

LLC has a section 168(k) deduction of $60 for section 704(b) book purposes and $33 for tax purposes with respect to A’s contributed property.\textsuperscript{32} A and B are each allocated $30 of section 704(b) book depreciation. Regardless of what section 704(c) method the LLC uses, B is allocated $30 of tax depreciation because B is the non-contributing partner with respect to the qualified property that is deemed to be contributed by A, and A is allocated $3 of tax depreciation from LLC as a result of section 168(k).\textsuperscript{33}

This means that, in the current year, B has $90 of total deductions under section 168(k),\textsuperscript{34} and A has total deductions under section 168(k) of $20. If the section 704(b) book basis of the property contributed by B is recovered over a 5-year depreciable life with $30 of section 704(b) book depreciation allocated to A and LLC uses the remedial allocation method, B will be allocated $30 of remedial income and A will be allocated $30 of remedial deductions over the 5-year depreciable life of the property contributed by B. It should be noted that at the end of the depreciable life of the property contributed by B, B would have a net $60 of tax deductions, and A would have a net $50 of tax deductions, reaching the appropriate result. The issue this example presents is the benefit B receives by being able to take advantage of a timing benefit of the Special Section 168(i)(7) Rule, while A cannot.

If this is the intended result of the application of the Proposed Regulations to this

\textsuperscript{31} We believe that because Prop. Reg. § 1.168(k)-2(f)(1)(iii) applies to apportion A’s deduction under section 168(k) between A and the LLC, the application of this rule and the amount of the section 168(k) deduction apportioned to A accordingly determines the adjusted basis of the property that A is deemed to contribute to the LLC. We are assuming that the effect of Prop. Reg. § 1.168(k)-2(f)(1)(iii) on this transaction is that A is deemed to contribute qualified property to the LLC with an adjusted basis of $33, instead of A being deemed to contribute qualified property with an adjusted basis of $0 as would appear to be the case if this rule solely functioned to apportion the deduction that A otherwise would be entitled to under section 168(k) (that is, without any effect on the adjusted basis of the property A is deemed to contribute to the LLC).

\textsuperscript{32} The section 704(b) book basis of A’s contributed property is recovered over the same time period as the tax basis of A’s contributed property is recovered. Reg. § 1.704-1(b)(2)(iv)(g)(3). The section 704(b) book basis of B’s contributed property with zero tax basis, however, may not be recovered under section 168(k). Prop. Reg. § 1.704-1(b)(2)(iv)(g)(3).

\textsuperscript{33} There is no ceiling rule limitation with respect to the property that is contributed by A. Therefore, the same result would occur with respect to the property that is contributed by A regardless of what section 704(c) method is applied.

\textsuperscript{34} Assuming that LLC has no other items, B would have a $30 suspended loss under I.R.C. § 704(d) in this example that would carry forward, so not all $90 of B’s deductions as a result of section 168(k) are immediately deductible by B.
fact pattern, we recommend that the final Regulations provide an example confirming that this is the intended result. Alternatively, the final Regulations could instead apply the Special Section 168(i)(7) Rule to both B and A. In that case, both A and B would be treated as contributing zero basis qualified property to the partnership, and B would not receive more deductions under section 168(k) than B’s purchase price for its interest in LLC that is attributable to qualified property.  

IV. Partner Previous Depreciable Interest

The used property acquisition requirements of section 168(k) and the Proposed Regulations are not met with respect to an acquisition of used property if the property was “used by the taxpayer” at any time before such acquisition by the taxpayer. Under the Proposed Regulations, property is treated as previously used by the taxpayer “if the taxpayer or the predecessor had a depreciable interest in the property at any time prior to such acquisition, whether or not the taxpayer or the predecessor claimed depreciation deductions for the property.” The Proposed Regulations do not provide any guidance regarding whether, or to what extent, a partner will be treated as having a “depreciable interest” in property of a partnership. We recommend that the final Regulations provide clear guidance on these issues.

For example, assume A and B are 49- and 51-percent members, respectively, of LLC, which acquires qualified property and places it into service. A later purchase of the qualified property from the LLC by B does not meet the requirements of section 168(k) and the Proposed Regulations because B and the LLC are related under section 707(b). A and the LLC are not related under section 707(b), however. If A purchases qualified property from the LLC, because A is unrelated to the LLC, A is eligible to claim additional depreciation under section 168(k) except to the extent, if any, A is treated as having a depreciable interest in the qualified property owned by the LLC. The question, therefore, becomes whether A had a depreciable interest in the qualified property of the LLC and, if so, how A determines its depreciable interest in the property.

The issue of whether a partner should be treated as having a “depreciable interest” in property of a partnership involves statutory interpretation and policy questions, and arguments can be made to support either outcome. We note, however, that if the final

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35 Alternatively, if Treasury and the Service were to permit remedial section 704(c) allocations to be eligible for the additional first year depreciation deduction under section 168(k), applying section 168(k) to the section 704(b) book basis of B’s contributed property subject to the remedial section 704(c) method could achieve the same result.


39 As a general matter, Subchapter K applies an entity approach to sales of property between a partner and the partnership, and the language of Proposed Regulation section 1.168(k)-2(b)(3)(iii)(B)(1) implies an entity approach to determining whether a taxpayer has a depreciable interest in property. On the other hand, it might be argued that an aggregate approach would be more consistent with the results under Proposed Regulation section 1.168(k)-2(b)(iv)(D)(1) (treating each partner in a partnership as having a
Regulations provide that a partner has a depreciable interest in a qualified property of the partnership, it would be necessary to provide rules to determine the amount of a partner’s depreciable interest in the partnership’s qualified property. We believe that the best approach would be that a partner’s depreciable interest should be proportionate to the tax depreciation deductions the partner has received with respect to the qualified property over the total tax depreciation deductions claimed with respect to the property.

Under this type of approach, if, in the example discussed above, the LLC made a special allocation of all of its depreciation deductions to A, A would have a depreciable interest in 100 percent of the LLC’s qualified property and the purchase of qualified property by A from the LLC would not meet the used property acquisition requirements of section 168(k) and the Proposed Regulations. Alternatively, if instead of contributing cash to LLC, B contributed zero basis qualified property and the LLC adopted the traditional section 704(c) allocation method, A would not receive any tax depreciation allocations with respect to the LLC’s qualified property. Although B would have a previous depreciable interest in all of the property prior to contributing the property to the LLC, A would have none. Additional complexity arises if the partnership capitalizes depreciation on qualified property pursuant to section 263A.

Therefore, we recommend that the final Regulations clearly provide whether a partner who acquires qualified property from a partnership or from another partner who acquired that property from the partnership is considered to have had a previous depreciable interest in the partnership’s qualified property solely by reason of owning an interest in the partnership. If the final Regulations provide that a partner is considered to have a previous depreciable interest in the partnership’s qualified property, we recommend that the final Regulations provide that this depreciable interest is determined by reference to the partner’s share of depreciation deductions with respect to the qualified property.


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40 In addition, if the LLC owns both qualified and non-qualified property and uses the curative section 704(c) allocation method, to the extent tax depreciation from qualified property is used to cure a ceiling rule limitation with respect to non-qualified property or vice versa, the curative allocations could be taken into account in determining the depreciable interests in qualified property of the partners. Similarly, remedial allocations with respect to qualified property might increase the depreciable interest of the partner receiving remedial deductions and decrease the depreciable interest of the partner receiving remedial income.
V. Other Issues

A. Section 743(b) Increases Allocated to Remedial Section 704(c) Layers

In the preamble to the Proposed Regulations, it is stated that a section 743(b) adjustment is eligible for section 168(k) provided that all requirements of section 168(k) are satisfied and assuming that Regulation section 1.743-1(j)(4)(i)(B)(2) does not apply. However, the changes the Proposed Regulations made to Regulation section 1.743-1(j)(4)(i)(B) do not clearly state the rule with respect to the intended non-application of section 168(k) to section 743(b) adjustments that are allocated to remedial section 704(c) layers.

Mechanically, the Proposed Regulations do not remove the existing language of Regulation section 1.743-1(j)(4)(i)(B)(2), which provides that section 743(b) adjustments that increase the basis of property and that are allocated to remedial section 704(c) layers are recovered over the remaining life of the remedial section 704(c) layer, instead of being recovered as newly purchased property as is generally provided under Regulation section 1.743-1(j)(4)(i)(B)(1). Instead, the Proposed Regulations add additional language to what is currently included in Regulation section 1.743-1(j)(4)(i)(B)(1). More specifically, this means that the first sentence of the current rule that begins with “[e]xcept as provided in paragraph (j)(4)(i)(B)(2)” still provides that increases to the basis of qualified property under section 743(b) that are allocated to a remedial section 704(c) layer with respect to a partner must still be recovered over the life of the remedial section 704(c) layer as provided under Regulation section 1.743–1(j)(4)(i)(B)(2), and are not eligible for the additional first year depreciation deduction under section 168(k), consistent with the statement in the preamble noted above.

However, the language that the Proposed Regulations add to Regulation section 1.743–1(j)(4)(i)(B)(1) begins with “[n]otwithstanding the above.” This clause could be read by some taxpayers and practitioners as conflicting with the “[e]xcept as provided as provided in paragraph (j)(4)(i)(B)(2)” clause at the beginning of the rule noted above, possibly leading to uncertainty with respect to this rule.

We believe that the intent of the Proposed Regulations is that the additional first year depreciation deduction under section 168(k) does not apply to increases to the basis of qualified property under section 743(b) to the extent the increase is attributable to a

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41 83 Fed. Reg. 39,327 (2018). Reg. § 1.743-1(j)(4)(i)(B)(2) provides that if a partnership elects to use the remedial allocation method described in Reg. §1.704-3(d) with respect to an item of the partnership’s recovery property, then the portion of any increase in the basis of the item of the partnership’s recovery property under section 743(b) that is attributable to section 704(c) built-in gain is recovered over the remaining recovery period for the partnership’s excess book basis in the property as determined in the final sentence of § 1.704-3(d)(2). Any remaining portion of the basis increase is recovered under Reg. § 1.743–1(j)(4)(i)(B)(1), which provides that a section 743(b) increase to the basis of a partnership’s recovery property is generally taken into account as if it were newly-purchased recovery property placed in service when the transfer that gives rise to the section 743(b) adjustment occurs.

If this is the intended result, we recommend that the final Regulations modify this language to make it clear that increases to the basis of qualified property under section 743(b) that are attributable to a remedial section 704(c) layer are not eligible for the additional first year depreciation deduction under section 168(k).

B. **Elections under Section 168(k)(7)**

The Proposed Regulations provide that section 743(b) adjustments that increase the basis of qualified property may be recovered applying the additional first year depreciation deduction under section 168(k) even if the partnership elects out of the additional first year depreciation deduction under section 168(k)(7) with respect to qualified property that the partnership itself acquires and places in service during the same taxable year as the taxable year in which the transfer of partnership interest that gives rise to the section 743(b) adjustment occurs. Conversely, partnerships may also elect out of the additional first year depreciation deduction under section 168(k) with respect to the recovery of a section 743(b) adjustment that increases the basis of qualified property under section 168(k)(7), and the election will not bind the partnership with respect to applying the additional first year depreciation deduction under section 168(k) to qualified property that the partnership itself acquires and places in service in the same taxable year as the transfer of a partnership interest that gives rise to the section 743(b) adjustment occurs. That is, a partnership has flexibility to elect out of the additional first year depreciation deduction under section 168(k) with respect to section 743(b) adjustments while applying the additional first year depreciation deduction under section 168(k) to qualified property that the partnership itself acquires. These elections may be made on a section 743(b) adjustment by section 743(b) adjustment basis and on a qualified property class by class basis.

Proposed Regulation section 1.168(k)-2(e)(1)(iii) provides the time and manner in which a partnership must make elections under section 168(k)(7). The Proposed Regulations provide that if taxpayer does not make the election specified in Proposed Regulation section 1.168(k)-2(e)(1) within the time and in the manner prescribed in

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43 In the preamble to the proposed regulations that introduced the rule addressing the interaction of section 743(b) adjustments and remedial section 704(c) layers, the Service and Treasury noted that matching the timing of the recovery of a section 743(b) adjustment with the recognition of income attributable to a remedial section 704(c) layer to which the section 743(b) adjustment was allocated ensured that partnership interests were “fungible” (that is, the tax consequences of a buyer purchasing a partnership interest do not vary with the identity of the seller and the specific section 704(c) layers attributable to the seller’s interest that the buyer steps into the shoes of) if each partnership interest has identical rights to capital and profits and each item of the partnership’s section 704(c) property is subject to the remedial allocation method. [REG-209682-94], 63 Fed. Reg. 4,411 (1998). Our understanding of the intent of the Proposed Regulations is that this fungibility is maintained, because if section 168(k) could apply to section 743(b) adjustments attributable to remedial section 704(c) layers, certain partnership interests would no longer be fungible.


45 Id.

46 Id.
Proposed Regulation section 1.168(k)-2(e)(1)(iii), the amount of depreciation allowable for that property under section 167(f)(1) or 168, as applicable, must be determined for the placed-in-service year and for all subsequent taxable years by taking into account the additional first year depreciation deduction (i.e., as if the additional first year depreciation deduction had been claimed).\textsuperscript{47}

Some partnerships have filed tax returns before the Proposed Regulations were published and did not apply section 168(k) to section 743(b) increases to the basis of qualified property that otherwise meet the used property acquisition requirements of section 168(k).\textsuperscript{48}

We recommend that the final Regulations provide that a partnership that did not deduct the amount of a section 743(b) adjustment under section 168(k) that would otherwise have been eligible for the section 168(k) deduction under the Proposed Regulations should be deemed to have made a valid election under Proposed Regulation section 1.743-1(j)(4)(i)(B)(1) and Proposed Regulation section 1.168(k)-2(e)(1), and that Proposed Regulation section 1.168(k)-2(e)(1)(iv) does not apply to these section 743(b) adjustments.\textsuperscript{49} If this recommendation is not adopted, we recommend that the final Regulations provide partnerships procedural relief to file a late election under section 168(k)(7) in cases where a partnership tax return has been filed before or within a certain period of time after the issuance of the Proposed Regulations (for example, within 90 days may be an appropriate period of time, or these taxpayers could be allowed to include the election on their next tax return).

V. Conclusion

We believe that the Proposed Regulations effectively address many of the uncertainties regarding the application of section 168(k), as amended by the Act, to partnerships and their partners. We appreciate your consideration of the additional issues and recommendations that we have described in these Comments.

\textsuperscript{47} Prop. Reg. § 1.168(k)-2(e)(1)(iv).

\textsuperscript{48} Some partnerships filed in this manner because they did not think that section 743(b) adjustments could be recovered using the additional first year depreciation deduction under section 168(k). Other partnerships filed in this manner because they thought there was no linkage between elections made with respect to qualified property that the partnership itself acquired and placed into service and section 743(b) adjustments that increased the basis of the partnership’s qualified property.

\textsuperscript{49} This approach would be consistent with the procedural relief previously provided to taxpayers with respect to deemed elections not to deduct the 50-percent additional first year depreciation deduction for classes of property that were qualified property with respect to taxpayers for certain 2009 taxable years and 2010 short-year taxable years. Rev. Proc. 2011-26, 2011-1 C.B. 664, Sec. 5.04(2).