June 7, 2018

David Kautter
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Request for Subchapter K Guidance with Respect to the Interaction of Section 168(k) as amended by P.L. 115-97 and Certain Provisions of Subchapter K

Dear Acting Commissioner Kautter:

Enclosed please find comments regarding our suggestions for published guidance addressing certain issues arising under Subchapter K with respect to the application of section 168(k), which was amended by tax legislation enacted on December 22, 2017 (the “Comments”). These Comments are submitted on behalf of the American Bar Association 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 will be pleased to discuss the Comments with you or your staff.

Sincerely,

Karen L. Hawkins
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
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    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 (the "Section") 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 Eric Sloan. Additional assistance was provided by Noel Brock, Craig Foxgrover, James Jennings, Ted Mateoc, Mike Scaramella, Amy Sutton, and Ryan Tucker.

These Comments were reviewed by Adam M. Cohen, the Section’s Council Director for the Partnerships and LLCs Committee and the Real Estate Committee, Christian Wood, the Section’s Chair for the Capital Recovery and Leasing Committee, and Jeanne Sullivan and Lisa Zarlenga of the Section’s Committee on Government Submissions.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: June 7, 2018
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SUMMARY OF RECOMMENDATIONS

These Comments address the need for published guidance under Subchapter K regarding 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. Section 168(k) was amended by Public Law 115-97 (the “Act”) on December 22, 2017. The amendments to section 168(k) have an effective date that generally applies to property acquired and placed in service after September 27, 2017.

We respectfully request that the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) issue the following guidance:

1. Amend Regulation section 1.168(k)-1(f)(9) to reflect the elimination of the Original Use Requirement of section 168(k) by the Act.

2. Provide that, for purposes of section 168(k), principles similar to Regulation section 1.197-2(h)(12) apply to section 743(b) adjustments, including section 743(b) adjustments resulting from acquisitions of partnership interests by existing partners. In other words, a transferee partner should be able to benefit from section 168(k) to the extent the transferee’s section 743(b) adjustment increases the basis of qualified property.

3. Clarify whether Regulation section 1.743-1(j)(4)(i)(B)(2) applies with respect to qualified property subject to the remedial allocation method under section 704(c).

4. Provide that the additional allowance for depreciation under section 168(k) with respect to an increase in basis of qualified property under section 743(b) be determined separately and independently from the partnership’s application of section 168(k) to its other property.

5. Provide that, for purposes of section 168(k), either (i) increases to the basis of qualified property under section 734(b) do not qualify for the additional allowance for depreciation under section 168(k), or (ii) principles similar to Regulation section 1.197-2(h)(12)(iv) apply to section 734(b) adjustments.

6. Provide that a partnership may not apply section 168(k) with respect to the section 704(b) book basis of contributed qualified property with zero tax basis.

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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.
3 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”).
7. If a partnership adopts the remedial method with respect to a contribution of built-in gain qualified property or a revaluation of qualified property, provide that with respect to the portion of the section 704(b) book basis in excess of the tax basis of the property either (i) the partnership may not apply section 168(k), or (ii) for purposes of section 168(k), principles similar to Regulation section 1.197-2(h)(12)(vii)(B) apply and any election under section 168(k) with respect to such amounts be determined separately and independently from the partnership’s application of section 168(k) to its other property.

8. Provide guidance clarifying that a transferee may apply section 168(k) to property that is deemed to be purchased and contributed to a partnership under Revenue Ruling 99-5, Situation 1.

9. Provide that taxpayers may rely on guidance, even if the guidance is in proposed form and provide that the government will not challenge any reasonable positions taken by taxpayers prior to the issuance of the guidance.

These issues are discussed in greater detail below.
DISCUSSION

I. Background

A. Expansion of Section 168(k)

Section 168(k) provides an additional allowance for depreciation with respect to the adjusted basis of qualified property. Before amendment by the Act, section 168(k)(2)(A)(ii) provided that qualified property means property the original use of which commenced with the taxpayer (“Original Use Requirement”).

With respect to increases to the basis of partnership property under section 743(b) and section 734(b), Regulation section 1.168(k)-1(f)(9) provides that, in general, any increase in basis of qualified property due to a section 754 election is not eligible for the additional first year depreciation deduction. The preamble to the regulation states that the reason for this rule is that “any such increase in basis of property does not satisfy the original use requirement.”

The Act expanded the type of property subject to section 168(k). Specifically, section 168(k)(2)(A)(ii), as amended by the Act provides that qualified property means property the original use of which begins with the taxpayer or the acquisition of which by the taxpayer meets the requirements of section 168(k)(2)(E)(ii).

As part of this expansion of section 168(k), the Act placed restrictions on and added requirements regarding what acquisitions of used property can qualify for the additional allowance for depreciation under section 168(k). Section 168(k)(2)(E)(ii) as amended by the Act provides that an acquisition of property meets these requirements if—(I) such property was not used by the taxpayer at any time prior to such acquisition (the “No Prior Use Requirement”), and (II) the acquisition of such property meets the requirements of paragraphs (2)(A), (2)(B), (2)(C), and (3) of section 179(d) (the “Unrelated Purchase Requirement”).

The No Prior Use Requirement does not refer to any other Code section, but regarding the Unrelated Purchase Requirement, section 179(d)(2) and section 179(d)(3) provide additional requirements with respect to an acquisition of property. Section 179(d)(2) contains the following three requirements—(A) the property is not acquired from a person whose relationship to the person acquiring it would result in the

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5 The additional criteria for property to be treated as qualified property for purposes of I.R.C. §168(k) are listed in I.R.C. §168(k)(2)(A)(i) and (iii). I.R.C. §168(k)(2)(A) provides that the term “qualified property” for purposes of I.R.C. §168(k) includes property (i) (I) to which this section applies which has a recovery period of 20 years or less, (II) which is computer software (as defined in I.R.C. §167(f)(1)(B)) for which a deduction is allowable under I.R.C. §167(a) without regard to this subsection, (III) which is water utility property, or (IV) which is qualified improvement property, (ii) the original use of which begins with the taxpayer or the acquisition of which by the taxpayer meets the No Prior Use Requirement and Unrelated Purchase Requirement (both defined below) and (iii) which is placed in service by the taxpayer before January 1, 2027 (January 1, 2020 prior to amendment by the Act).
disallowance of losses under sections 267 or 707(b),\(^7\) (B) the property is not acquired by one component member of a controlled group from another component member of the same controlled group, and (C) the basis of the property in the hands of the person acquiring it is not determined (i) in whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired, or (ii) under section 1014(a) (relating to property acquired from a decedent). Section 179(d)(3) provides that the basis of such property is not determined by reference to the basis of other property held at any time by the person acquiring such property.\(^8\)

B. **Section 197(f)(9)**

The No Prior Use Requirement and Unrelated Purchase Requirement in the partnership context raise issues as to what is the “property” and who is the “taxpayer” for purposes of section 168(k). Stated differently, is the property the underlying property of the partnership or is it, for example, the section 743, 734, or 732 adjustment? Also, is the relevant taxpayer the partners or the partnership? As is described further below, we believe the principles of section 197(f)(9) and the regulations thereunder (the anti-churning rules) provide a useful framework to be adopted for purposes of section 168(k) because section 197(f)(9) contains use and relationship restrictions similar to section 168(k).

Section 197(f)(9)(A) provides that, in general, amortizable section 197 intangibles do not include any goodwill or going concern value if such intangibles were (i) held or used any time after July 25, 1991, and before August 10, 1993, by the taxpayer or a related person, (ii) acquired from a person who held such intangible at any time on or after July 25, 1991, and on or before August 10, 1993, and, as part of the transaction, the user of such intangible does not change, or (iii) the taxpayer grants the right to use such intangible to a person (or a person related to such person) who held or used such intangible at any time on or after July 25, 1991, and on or before August 10, 1993.

Section 197(f)(9)(E) provides further that with respect to any increase in the basis of partnership property under section 732, 734, or 743, anti-churning determinations shall be made at the partner level and each partner shall be treated as having owned and used such partner’s proportionate share of the partnership assets. The regulations under section 197(f)(9) implement this rule.


\(^{7}\) In applying I.R.C. §267(b) and (c) for purposes of I.R.C. §179, paragraph (4) of I.R.C. §267(c) shall be treated as providing that the family of an individual shall include only his spouse, ancestors, and lineal descendants.

\(^{8}\) Reg. §1.179-4(d) provides an example that illustrates the application of I.R.C. §179(d)(3). X Corporation purchases a new drill press costing $10,000 in November 1984 that qualifies as section 179 property, and is granted a trade-in allowance of $2,000 on its old drill press. The old drill press had a basis of $1,200. Under the provisions of I.R.C. §§1012 and 1031(d), the basis of the new drill press is $9,200 ($1,200 basis of oil drill press plus cash expended of $8,000). However, only $8,000 of the basis of the new drill press qualifies as cost for purposes of the I.R.C. §179 expense deduction; the remaining $1,200 is not part of the cost because it is determined by reference to the basis of the old drill press.
As described in the relevant sections below, the anti-churning regulations have detailed rules with respect to partnership transactions that aim to ensure the use and relationship requirements are satisfied. We believe those rules can provide a framework for achieving the policy objectives of section 168(k) in an administrable way.

II. Increases to the Basis of Qualified Property Under Section 743(b)

A. Section 743(b)

Section 743(b) provides that, in the case of a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, a partnership with respect to which the election provided in section 754 is in effect or which has a substantial built-in loss immediately after such transfer shall—

(1) increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property, or

(2) decrease the adjusted basis of the partnership property by the excess of the transferee partner’s proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership.

Under regulations prescribed by the Secretary, such increase or decrease shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only. A partner’s proportionate share of the adjusted basis of partnership property shall be determined in accordance with his interest in partnership capital and, in the case of property contributed to the partnership by a partner, section 704(c) (relating to contributed property) shall apply in determining such share. In the case of an adjustment under this subsection to the basis of partnership property subject to depletion, any depletion allowable shall be determined separately for the transferee partner with respect to his interest in such property.

Section 743(b) was originally enacted as part of the Internal Revenue Code of 1954, and, since enactment has provided, as stated above, that, with respect to the adjustment to basis of partnership property in the case of a transfer of an interest in a partnership by sale or exchange, “such increase or decrease shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only.” The legislative history describes the objective of section 743(b) as follows: “[b]y making adjustments to the basis of partnership assets, the same effect is achieved as though the partnership had dissolved and been reformed, with the transferee of the interest as a

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9 The American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 833(b)(2), 118 Stat. 1418, amended section 743(b) by providing for an adjustment to the basis of partnership property in the case of a transfer of an interest in a partnership which has a substantial built-in loss immediately after such transfer.
member of the partnership.”

Under Regulation section 1.743-1(j)(4)(i)(B)(1), except as provided in Regulation section 1.743-1(j)(4)(i)(B)(2), for purposes of section 168, if the basis of a partnership’s recovery property is increased as a result of the transfer of a partnership interest, then the increased portion of the basis is taken into account as if it were newly-purchased recovery property placed in service when the transfer occurs. Consequently, any applicable recovery period and method may be used to determine the recovery allowance with respect to the increased portion of the basis. However, no change is made for purposes of determining the recovery allowance under section 168 for the portion of the basis for which there is no increase (i.e., the partnership’s “common basis” in the property).

Under Regulation section 1.743-1(j)(4)(i)(B)(2), however, if a partnership elects to use the remedial allocation method described in Regulation section 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 Regulation section 1.704-3(d)(2). Any remaining portion of the basis increase is recovered under Regulation section 1.743-1(j)(4)(i)(B)(1).

B. Application and Recommendations

Current Regulation section 1.168(k)-1(f)(9) provides that in general, for purposes of section 168(k), any increase in basis of qualified property or 50-percent bonus depreciation property due to a section 754 election is not eligible for the additional first year depreciation deduction. However, if qualified property or 50-percent bonus depreciation property is placed in service by a partnership in the taxable year the partnership terminates under section 708(b)(1)(B), any increase in basis of the qualified property or the 50-percent bonus depreciation property due to a section 754 election is eligible for the additional first year depreciation deduction.

Regulation section 1.168(k)-1(f)(9) was finalized in 2003, more than 14 years before section 168(k) was amended by the Act. When the regulation was promulgated, section 168(k)(2)(A)(ii) provided that, for property to be treated as qualified property for purposes of section 168(k), it had to be property “the original use of which commenced with the taxpayer.” Indeed, as noted earlier, the preamble to the regulation specifically states that: “any increase in basis of qualified property, 50-percent bonus depreciation property, or Liberty Zone property due to a section 754 election generally is not eligible for the additional first year depreciation deduction because any such increase in basis of property does not satisfy the original use requirement.”

With the change to section 168(k) under the Act providing for the additional allowance for depreciation for qualified property that either meets the Original Use Requirement or meets both the No Prior Use Requirement and the Unrelated Purchase

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Requirement, Regulation section 1.168(k)-1(f)(9) appears to be out of date, particularly in light of the language in the preamble to the regulation. Given the change in law to allow for expensing under section 168(k) for used property where the No Prior Use Requirement and Unrelated Purchase Requirement are met, we believe that adjustments to the basis of qualified property as a result of a section 754 election should instead be evaluated under the No Prior Use Requirement and Unrelated Purchase Requirement for purposes of section 168(k). Therefore, we recommend that Regulation section 1.168(k)-1(f)(9) be revised to provide that, as provided in the preamble to the current final regulation, any increase in basis of qualified property of a partnership due to a section 754 election does not satisfy the Original Use Requirement, but that those basis adjustments nevertheless may be eligible for the additional allowance for depreciation under section 168(k).12

As described in greater detail below, to evaluate whether an increase to the basis of qualified property under section 743(b) meets the No Prior Use Requirement and Unrelated Purchase Requirement and is eligible for the additional allowance for depreciation under section 168(k), we recommend adopting principles similar to Regulation section 1.197-2(h)(12).

1. The “Property” and the “Taxpayer”

Section 197(f)(9)(E) provides that with respect to any increase in the basis of partnership property under section 732, 734, or 743, anti-churning determinations are made at the partner level, and each partner is treated as having owned and used that partner’s proportionate share of the partnership’s assets. Regulation section 1.197-2(g)(3) provides that any increase in the adjusted basis of a section 197 intangible under section 743(b) is treated as a separate section 197 intangible. Regulation section 1.197-2(h)(12)(i) further provides that in determining whether the section 197 anti-churning rules apply to any increase in the adjusted basis of a section 197(f)(9) intangible under section 743(b), the determinations are made at the partner level and each partner is treated as having owned and used the partner’s proportionate share of partnership property. Finally, Regulation section 1.197-2(h)(12)(v) provides that the section 197 anti-churning rules do not apply to an increase in basis of a section 197 intangible under section 743(b) if the person acquiring the partnership interest is not related to the person transferring the partnership interest, and the partnership interest was acquired after August 10, 1993.

12 We believe it is necessary for guidance to provide explicitly that any increase in basis of qualified property of a partnership due to an I.R.C. §754 election does not satisfy the Original Use Requirement because that language would prevent unintended results if, as recommended below, the “property” is the I.R.C. §743(b) adjustment itself. As noted previously, Reg. §1.743-1(j)(4)(i)(B)(1) provides the general rule that, for purposes of I.R.C. §168, an I.R.C. §743(b) adjustment is taken into account as if it were newly purchased property by the partnership, presumably purchased from an unrelated person. A possible interpretation of that language may be that any increase to the basis of qualified property under I.R.C. §743(b) may be eligible for the additional allowance for depreciation under I.R.C. §168(k) because, if the “property” is the I.R.C. §743(b) adjustment, neither the partnership nor the partners have used the I.R.C. §743(b) adjustment previously, as it did not exist and therefore would meet the Original Use Requirement.
As described above, the Unrelated Purchase Requirement under section 179(d)(2) and section 179(d)(3) provide that property is ineligible for the additional allowance for depreciation under section 168(k) if it is acquired from a person whose relationship to the person acquiring it would result in the disallowance of losses under section 267 or 707(b),\textsuperscript{13} is acquired by one component member of a controlled group from another component member of the same controlled group,\textsuperscript{14} or has a basis determined (i) in whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired, or (ii) under section 1014(a) (relating to property acquired from a decedent),\textsuperscript{15} or has basis in the property that is determined by reference to the basis of other property held at any time by the person acquiring such property.\textsuperscript{16}

The Unrelated Purchase Requirement’s reference to the above section 179 requirements indicates that Congress was focused on preventing the application of section 168(k) to used property purchased from a related person or acquired in a nonrecognition transaction with carryover or substituted basis, and that Congress was focused on allowing the application of section 168(k) in the case of a taxable purchase of used property (that would otherwise be qualified property for purposes of section 168(k)) between unrelated parties. We believe that an approach to the application of section 168(k) that is similar to the partner-level approach in the section 197(f)(9)(E) rules for section 743(b) adjustments would provide results consistent with the expansion of section 168(k).

Although section 168(k) does not contain a statutory partner-level application rule similar to the partner-level application rule in section 197(f)(9)(E), the legislative history of section 743(b) and the approach of the section 743(b) regulations support using a partner-level approach for purposes of section 168(k) as applied to section 743(b) adjustments. Further, the operation of section 743(b) ensures that an increase to the basis of qualified property under section 743(b) constitutes an adjustment to the basis of partnership property only with respect to the transferee partner. Therefore, we believe that guidance coordinating section 743(b) with section 168(k) should adopt principles similar to Regulation section 1.197-2(h)(12)(i) and treat each partner as having owned and used that partner’s proportionate share of the partnership’s property.

If guidance provides that the “taxpayer” is the transferee partner for purposes of the No Prior Use Requirement and Unrelated Purchase Requirement of section 168(k), then a fully taxable purchase of an interest in the partnership by a new partner (who is not related to the selling partner under section 267 or 707(b)) that results in an increase to the basis of qualified property under section 743(b) should be an acquisition that meets both of the No Prior Use Requirement and Unrelated Purchase Requirement,\textsuperscript{17} because the transferee partner has not previously used any of the partnership’s property, is not related

\textsuperscript{13} I.R.C. §179(d)(2)(A).
\textsuperscript{14} I.R.C. §179(d)(2)(B).
\textsuperscript{15} I.R.C. §179(d)(2)(C).
\textsuperscript{16} I.R.C. §179(d)(3).
\textsuperscript{17} Although Reg. §1.743-1(d)(2) uses a hypothetical disposition by the partnership of all of the partnership’s property to compute the I.R.C. §743(b) adjustment, this hypothetical disposition should not be considered an actual sale of the partnership’s qualified property for purposes of I.R.C. §168(k).
to the seller of the partnership interest under section 267 or 707(b), and has a basis in its partnership interest that is a purchased cost basis determined under section 1012.¹⁸

This approach would also address the situation of an existing partner who buys an interest from another partner as long as the “taxpayer” for purposes of section 168(k) is each partner solely with respect to that partner’s proportionate share of partnership property, rather than with respect to all of the partnership’s property. That is, if the “taxpayer” is an existing partner acquiring an additional interest in the partnership and the existing partner is treated as previously using all of the partnership’s property for purposes of section 168(k), then the existing partner would never meet the No Prior Use Requirement with respect to the partnership’s property if guidance does not treat the section 743(b) adjustment as separate property. Under this approach, for a section 743(b) transferee to meet the No Prior Use Requirement with respect to a partnership’s qualified property, the section 743(b) transferee would always need to be a new partner and not an existing partner in the partnership. That said, an existing partner that acquires an additional interest in the partnership and benefits from a new section 743(b) adjustment has acquired an additional interest in previously used partnership property in which that partner did not previously have any interest. Thus, it appears appropriate for purposes of section 168(k) to treat that partner as acquiring additional partnership property that the partner did not previously use.

This approach to existing partners is also consistent with the principles of Regulation section 1.168(k)-1(b)(3)(iv), which provides that if, in the ordinary course of its business, a taxpayer sells fractional interests in property to third parties unrelated to the taxpayer under section 267(b) or 707(b), each first fractional owner of the property is considered as the original user of its proportionate share of the property.¹⁹ Although this rule addresses the Original Use Requirement and is limited to sales of fractional interests in the ordinary course of business, we believe that the principles of this rule apply equally to the acquisition of an additional undivided interest in used property under amended

¹⁸ It may be possible that none of the consideration paid by the acquiring partner for the partnership interest resulting in the I.R.C. §743(b) adjustment would be treated as a “cost” within the meaning of I.R.C. §179(d)(3) if the cost of the property to which the I.R.C. §743(b) adjustment attaches (or, even if the I.R.C. §743(b) adjustment is itself a separate property by analogy to Reg. §1.197-2(g)(3)) were treated as being determined by reference to the basis of the purchasing partner’s interest in the partnership (rather than the partnership’s property). Although this is a potential interpretation of the statutory provisions, we do not believe it would further the purpose of the legislation, and it would be inconsistent with other provisions of the Code and regulations discussed in the text. The apparent purpose of I.R.C. §179(d)(3) is to prevent an I.R.C. §179 deduction on the portion of a property’s basis that is not purchased basis (see example in Reg. §1.179-4(d), which excludes the portion of basis in property determined under I.R.C. §1031(d) but includes the portion of the property’s basis determined under I.R.C. §1012). We think that this purpose is not violated with respect to an I.R.C. §743(b) adjustment on a fully taxable purchase of a partnership interest, as the transferee’s basis in the partnership interest is determined under I.R.C. §1012. We note that an I.R.C. §743(b) adjustment resulting from a transfer of a partnership interest on death does not appear to meet the Unrelated Purchase Requirement, because it in part requires that the basis of the property is not determined under I.R.C. §1014(a) (relating to property acquired from a decedent). See I.R.C. §179(d)(2)(C)(ii).

¹⁹ Reg. §1.168(k)-1(b)(3)(v), Ex. (4), describes the application of this rule in the context of a taxpayer selling fractional interests in its aircraft to unrelated parties in the ordinary course of the taxpayer’s business.
section 168(k), and supports treating each partner in a partnership as having previously used only that partner’s proportionate share of partnership property for purposes of the No Prior Use Requirement.

If the Unrelated Purchase Requirement is not met, because, for example, the transferee partner is related to the transferor of the partnership interest under section 267 or 707(b), or if the partnership interest is transferred in an exchange where the basis of the partnership interest to the transferee partner is determined in whole or in part by reference to the basis of the partnership interest in the hands of the transferor, or is determined under section 1014(a) (relating to property acquired from a decedent), guidance should clarify that the related increase to the basis of qualified property under section 743(b) should not be eligible for the additional allowance for depreciation under section 168(k).

We believe that the above recommendations are consistent with the legislative policy goal of section 168(k) as amended by the Act to treat certain used property as qualified property for purposes of section 168(k). Because section 743(b) functions to treat the acquirer of a partnership interest in a similar manner as if the acquirer had instead acquired undivided interests in the partnership assets, section 743(b) should produce a result consistent with the policy change to section 168(k) as part of the Act. Guidance coordinating section 168(k) as amended by the Act with section 743(b) in a manner that treats the buyer’s positive section 743(b) adjustment in a similar manner to a buyer of partnership assets for purposes of section 168(k) should achieve these results and allow a transferee partner to benefit from section 168(k) to the extent the transferee’s section 743(b) adjustment increases the basis of qualified property.

2. **Impact of Remedial Section 704(c) Allocations**

It is relevant to note that in any case where a partnership elects the remedial allocation method with respect to section 704(c) layers associated with its qualified property, to the extent that a section 743(b) adjustment increases the basis of qualified property with an associated remedial section 704(c) layer, under Regulation section 1.743-1(j)(4)(i)(B)(2), the portion of the increase 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 Regulation section 1.704-3(d)(2).

We recommend that guidance clarify whether this portion of an increase to the basis of qualified property is eligible for the additional allowance for depreciation under section 168(k) or must instead be recovered over the remaining recovery period for the partnership’s excess book basis in the property under Regulation section 1.743-1(j)(4)(i)(B)(2).

3. **Consistency**

Section 168(k)(7) provides that if a taxpayer makes an election under section 168(k)(7) with respect to any class of property for any taxable year, the additional
allowance for depreciation under section 168(k)(1) shall not apply to any qualified property in such class placed in service during such taxable year. Although an adjustment to the basis of partnership property under section 743(b) is basis in partnership property, such adjustment is with respect to the transferee partner only. We do not believe it is appropriate that the application of section 168(k)(1), or lack thereof, to an increase in basis of qualified property under section 743(b) should affect the partnership’s ability to apply section 168(k)(1) to other property of the same class placed in service during the taxable year in which the section 743(b) adjustment arises. We therefore recommend flexibility in allowing the additional allowance for depreciation under section 168(k) with respect to an increase in basis of qualified property under section 743(b) to be determined separately and independently from the partnership’s application of section 168(k) to its other property.

For example, guidance could provide that a partnership may either apply, or elect out of (under section 168(k)(7)), the additional allowance for depreciation under section 168(k) with respect to the portion of its section 743(b) adjustment that increases the basis of qualified property without impacting the partnership’s application of section 168(k), or election out under section 168(k)(7), with respect to property that it acquires separately. This approach would be consistent with partner-level application principles for purposes of section 743(b) and section 168(k) described previously.

III. **Increases to the Basis of Qualified Property Under Section 734(b)**

A. **Section 734(b)**

Section 734(b) provides, in part (with respect to increases in the basis of partnership property), that in the case of a distribution of property to a partner by a partnership with respect to which the election provided in section 754 is in effect, the partnership shall

(1) increase the adjusted basis of partnership property by—

(A) the amount of any gain recognized to the distributee partner with respect to such distribution under section 731(a)(1), and

(B) in the case of distributed property to which section 732(a)(2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by section 732(d)) over the basis of the distributed property to the distributee, as determined under section 732.

Regulation section 1.734-1(e)(1) provides that, for purposes of section 168, if the basis of a partnership’s recovery property is increased as a result of the distribution of property to a partner, then the increased portion of the basis must be *taken into account as if it were newly-purchased recovery property placed in service when the distribution*
occurs (emphasis added). Consequently, any applicable recovery period and method may be used to determine the recovery allowance with respect to the increased portion of the basis. However, no change is made for purposes of determining the recovery allowance under section 168 for the portion of the basis for which there is no increase.

For the same reasons discussed above with respect to section 743(b) adjustments, to evaluate whether an increase to the basis of qualified property under section 734(b) meets the No Prior Use Requirement and Unrelated Purchase Requirement and is eligible for the additional allowance for depreciation under section 168(k), we recommend adopting principles similar to Regulation section 1.197-2(h)(12)(iv).

B. Application and Recommendations

The partner-level application principles of the section 197(f)(9) regulations supply a good framework for applying a partner-level approach for section 734(b) purposes as well. Regulation section 1.197-2(g)(3) treats an increase in the basis of a partnership section 197(f)(9) intangible under section 734(b) as a separate, newly acquired section 197 intangible. Regulation section 1.197-2(h)(12)(iv)(A) applies the section 197 anti-churning rules separately to each partner’s share of the increase in basis of partnership section 197(f)(9) intangibles under section 734(b). For reasons similar to those above, a section 168(k) approach similar to the partner-level approach in the section 197(f)(9)(E) rules for section 734(b) adjustments would provide results consistent with the expansion of section 168(k).

Under these principles, each partner would satisfy the No Prior Use Requirement with respect to the proportionate share of partnership property attributable to the other partners of the partnership because, before the distribution giving rise to the basis adjustment under section 734(b), each partner would only have used its proportionate share of partnership property.

Nevertheless, even though each partner would be able to meet the No Prior Use Requirement with respect to a portion of the partnership’s property, generally the Unrelated Purchase Requirement cannot be met with respect to an increase in basis of qualified property under section 734(b) because there is not an acquisition of property by the partnership or its partners that would meet the requirement under section 179(d)(3) that the basis of the property not be determined by reference to the basis of other property held at any time by the person acquiring such property. This is because in the case of a distribution of property to a partner where the adjusted basis of the distributed property to the partnership exceeds the adjusted basis of the distributed property to the distributee partner as determined under section 732, the corresponding increase to the basis of partnership property under section 734(b)(1)(B) is determined in part by reference to the basis of the distributed property and in part by reference to the distributee partner’s basis in its partnership interest. On the other hand, the regulations under Regulation section 1.734-1(e)(1) treat the section 734(b) adjustment as newly purchased property for purposes of section 168, arguably indicating that the “cost” of property benefiting from the section 734(b) adjustment should include the section 734(b) adjustment despite the fact that the amount of the adjustment is determined, in part, by reference to the basis of
other property that was held by the partnership.

We see policy reasons for and against allowing section 734(b) adjustments to benefit from section 168(k). On balance, though, we believe section 734(b) adjustments should not benefit from section 168(k).20 If, however, section 734(b) adjustments do benefit from section 168(k), we believe principles similar to Regulation section 1.197-2(h)(12)(iv) should be adopted.21

IV. Recovery of the Section 704(b) Book Basis of Qualified Property

Under Regulation section 1.704-1(b)(2)(iv)(g)(3), partners’ capital accounts are not considered adjusted in accordance with Regulation section 1.704-1(b)(2)(iv)(g) unless the amount of book depreciation, depletion, or amortization for a period with respect to an item of partnership property is the amount that bears the same relationship to the book value of the property as the depreciation (or cost recovery deduction), depletion, or amortization computed for tax purposes with respect to that property for the period bears to the adjusted tax basis of that property. Thus, generally, the section 704(b) book basis of depreciable property is recovered over the same time period as the adjusted tax basis of the property. In the case of qualified property that has a section 704(b) book basis in excess of tax basis, there is some uncertainty regarding the recovery of the section 704(b) book basis of the qualified property in the case of (i) a contribution of qualified property when the property has no adjusted basis, and (ii) a contribution or revaluation of qualified property when the partnership adopts the remedial method.

A. Contribution of Zero Basis Qualified Property

When a partner contributes built-in gain qualified property, Regulation section 1.704-1(b)(2)(iv)(g)(3) provides that if the contributed property has zero tax basis, the section 704(b) book depreciation, depletion, or amortization may be determined under any reasonable method selected by the partnership. Although the No Prior Use Requirement is not met if the partner’s use of the property is attributed to the partnership, and the Unrelated Purchase Requirement is not met in a section 721 contribution with carryover basis,22 it is possible that applying section 168(k) to the recovery of section

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20 We believe the increase in basis to qualified property under I.R.C. §734(b)(1)(A) as the result of gain recognized by a distributee partner under I.R.C. §731(a)(1) presents a more compelling case for the application of I.R.C. §168(k) than the adjustment under I.R.C. §734(b)(1)(B). In that case, there is a taxable event in which the distributee partner recognizes gain that is considered gain from the sale or exchange of their partnership interest, and the partnership increases its basis in qualified property under I.R.C. §734(b)(1)(A) by the amount of such gain. Guidance providing for the application of I.R.C. §168(k) in this circumstance may be appropriate, particularly because the partner and partnership may not be related under I.R.C. §707(b).

21 The same policy considerations exist for adjustments to basis under I.R.C. §732(b). Section 732(b) provides that the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction. Thus, we similarly recommend that guidance provide that adjustments to basis pursuant to I.R.C. §732(b) should not benefit from I.R.C. §168(k). If, however, adjustments to basis under I.R.C. §732(b) do benefit from I.R.C. §168(k), we believe principles similar to Reg. §1.197-2(h)(12)(ii) should apply.

22 I.R.C. §723.
704(b) book basis in this circumstance is a “reasonable method.” However, because allowing the additional allowance for depreciation under section 168(k) with respect to the 704(b) book basis of property contributed to a partnership with zero tax basis is inconsistent with the policy of section 168(k), we recommend that this section 704(b) book basis be ineligible for the additional allowance for depreciation under section 168(k).

B. **Remedial Section 704(c) Recovery of Section 704(b) Book Basis**

Similar issues arise under the remedial allocation method under Regulation section 1.704-3(d). If the remedial method is selected with respect to a contribution of built-in gain qualified property, the portion of the partnership’s section 704(b) book basis in the property equal to the adjusted tax basis in the property at the time of contribution is recovered in the same manner as the adjusted tax basis in the property is recovered. The amount by which the book basis exceeds the adjusted tax basis, however, is recovered using any recovery period and depreciation (or other cost recovery) method (including first-year conventions) available to the partnership for newly purchased property (of the same type as the contributed property) that is placed in service at the time of contribution. Although one or both of the No Prior Use Requirement and Unrelated Purchase Requirement appear to not be met in a contribution of property as noted previously, as described further below, it is not clear whether section 168(k) may apply with respect to the section 704(b) book basis in excess of the tax basis of the qualified property by reason of Regulation section 1.704-3(d)(2). Similarly, in the case of a revaluation to which the remedial allocation method is applied, the No Prior Use Requirement may not be met regardless of whether the “taxpayer” is the partnership or the partners. In either case, the “taxpayer” would have used the qualified property previously. Moreover, in the case of a revaluation, the Unrelated Purchase Requirement appears to not be met because a revaluation of qualified property does not constitute an actual acquisition of property.

We see policy reasons for and against allowing section 704(c) amounts to which the remedial method applies to benefit from section 168(k). While it is very close, on balance, we believe these amounts should not benefit from section 168(k). If, however, forward and reverse section 704(c) amounts to which the remedial method applies do benefit from section 168(k), we recommend principles similar to Regulation section 1.197-2(h)(12)(vii)(B) should be adopted and we recommend that the recovery of remedial section 704(c) layers under Regulation section 1.704-3(d)(2) be determined separately from the partnership’s application of section 168(k) to its qualified property. In other words, if a partnership is able to apply section 168(k) to remedial section 704(c) layers on qualified property, but elects not to do so under section 168(k)(7), this election should not impact whether a partnership applies section 168(k) to the tax basis of

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23 In this case, the zero basis in the property carries over to the partnership under I.R.C. §723, which indicates that the property may not meet the I.R.C. §179(d)(2)(C)(i) prong of the Unrelated Purchase Requirement. This view also appears consistent with Reg. §1.704-1(b)(2)(iv)(q), which provides, in part, that capital account adjustments when guidance is lacking should be “based, wherever practicable, on Federal tax accounting principles.”

24 Reg. §1.704-3(d)(2).
qualified property of the same class that it purchases during the same taxable year. As described above, this should also be true with respect to increases to the basis of qualified property under sections 743(b) and 734(b) that are eligible for the additional allowance for depreciation under section 168(k), in that if a partnership may apply section 168(k) to remedial section 704(c) layers, this application should be independent from the partnership’s application of section 168(k) to increases to the basis of qualified property under sections 743(b) and 734(b).

V. Revenue Ruling 99-5

Revenue Ruling 99-5, Situation 1, presents interesting issues with respect to the application of section 168(k). In Revenue Ruling 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.25

Assuming that the other requirements under section 168(k)(2)(A) are satisfied, the Unrelated Purchase Requirement and the No Prior Use Requirement under section 168(k)(2)(A)(ii) must be satisfied for any of the property that the transferee is deemed to contribute to the partnership to be eligible for full expensing.

Under section 168(i)(7)(A), the partnership is treated as B “for purposes of computing the depreciation deduction determined under [section 168].” This suggests that B is the relevant taxpayer when applying the Unrelated Purchase Requirement and the No Prior Use Requirement. Because the partnership is treated as B, the Unrelated Purchase Requirement is satisfied as long as B is not related to A, and the basis of the portion of each asset purchased by B is not determined “in whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired.” Instead, B has a basis equal to the purchase price under section 1012.

The No Prior Use Requirement is also satisfied because the partnership is treated as B, a taxpayer that has not used the assets at any time prior to the deemed transaction. However, some portion of the depreciation on each asset deemed contributed by B would be allocated to A. We believe that B should benefit from the additional allowance for depreciation under section 168(k) with respect to the portion of the property B is deemed to purchase from A and deemed to contribute to the partnership. However, any depreciation taken by the partnership under section 168(k)(1)(A) and allocated to A may be in conflict with the intent of the No Prior Use Requirement because A itself would not satisfy the No Prior Use Requirement.

Accordingly, we request guidance clarifying that a transferee may apply section 168(k) to property that is deemed to be purchased and contributed to a partnership under Revenue Ruling 99-5, Situation 1.

VI. **Reliance and Reasonable Positions**

As is described above, the law is unclear in many respects regarding the application of section 168(k) in the partnership context, and there is more than one reasonable position for each issue. Because of the frequency with which these issues arise and the need for taxpayers to address these issues currently (as the law became effective September 28, 2017), we respectfully request that any guidance provide that taxpayers may rely on that guidance, even if the guidance is in proposed form. In addition, we respectfully request that any guidance provide that the government will not challenge any reasonable positions taken by taxpayers prior to the issuance of the guidance.\(^{26}\)

VII. **Conclusion**

We believe that the change in section 168(k) by the Act to permit the additional allowance for depreciation with respect to the acquisition of certain used property creates a need to revise the existing guidance under Regulation section 1.168(k)-1(f)(9) with respect to increases to the basis of qualified property under section 743(b) and section 734(b). We also believe there is significant uncertainty regarding the interaction between section 168(k) and other common partnership rules, including those contained in section 704(b), section 704(c), and Revenue Ruling 99-5. Given the fact that this change to section 168(k) applies to acquisitions of property occurring after September 27, 2017, we urge that guidance be issued quickly. Many business transactions use partnership structures, and providing clarity and guidance treating these transactions similar to direct asset acquisition transactions should be done as soon as possible. We appreciate your consideration of our recommendations.

\(^{26}\) In the past, Treasury and the Service have issued regulations providing that the Service would not challenge a reasonable position taken before the issuance of final regulations. For example, Reg. §1.468B-5(a) provided that Reg. §§1.468B-1 through 1.468B-4, relating to the tax treatment of funds, accounts, and trusts used in the settlement of certain controversies, were effective on January 1, 1993. However, Reg. §1.468B-5(b) provided that with respect to a fund, account, or trust established after August 16, 1986, but prior to February 15, 1992, that satisfies (or, if it no longer exists, would have satisfied) the requirements of Reg. §1.468B-1(c), the Service will not challenge a reasonable, consistently applied method of taxation for transfers to the fund, income earned by the fund, and distributions made by the fund after August 16, 1986, but prior to January 1, 1996.