

1995

Meeting with IRS Regarding Partnership Issues in Developing Section 1017 Regulations

Blake D. Rubin

Repository Citation

Rubin, Blake D., "Meeting with IRS Regarding Partnership Issues in Developing Section 1017 Regulations" (1995). *William & Mary Annual Tax Conference*. 299.
<https://scholarship.law.wm.edu/tax/299>

STEPTOE & JOHNSON LLP

ATTORNEYS AT LAW

1330 CONNECTICUT AVENUE, N.W.
WASHINGTON, D.C. 20036-1795

STEPTOE & JOHNSON INTERNATIONAL
AFFILIATE IN MOSCOW, RUSSIA

PHOENIX, ARIZONA
TWO RENAISSANCE SQUARE

TELEPHONE: (602) 257-5200
FACSIMILE: (602) 257-5299

(202) 429-3000
FACSIMILE: (202) 429-3902
TELEX: 89-2503

TELEPHONE: (011-7-501) 258-5250
FACSIMILE: (011-7-501) 258-5251

BLAKE D. RUBIN
(202) 429-6211

AGENDA

MEETING WITH IRS REGARDING PARTNERSHIP ISSUES IN DEVELOPING SECTION 1017 REGULATIONS

September 21, 1994

I. Treatment of Partnership Interest as Depreciable Property

- A. Section 1017(b)(3)(C), as added by the Bankruptcy Tax Act of 1980, states:

For purposes of this section, any interest of a partner in a partnership shall be treated as depreciable property to the extent of such partner's proportionate interest in the depreciable property held by such partnership. The preceding sentence shall apply only if there is a corresponding reduction in the partnership's basis in depreciable property with respect to such partner.

- B. Section 1017(b)(3)(F), as added by the 1993 Act, states:

In the case of any amount which under section 108(c)(1) is to be applied to reduce basis --

(i) depreciable property shall include only depreciable real property for purposes of subparagraph (A) and (C). . . .

- C. The legislative history of section 1017(b)(3)(C) indicates that the "inside" basis adjustment is similar to the adjustment under section 743(b) that applies when there is a transfer of a partnership interest and a section 754 election is in effect. The House version of the Bankruptcy Tax Act of 1980 would have mandated the treatment of a partnership interest as depreciable property with a corresponding "inside" basis

adjustment; the Senate (and Conference) rejected this in favor of an elective approach.

II. Determination of Partner's "Proportionate Interest" in Depreciable Property: The Section 743(b) Regulations

- A. The only guidance on the determination of a partner's "proportionate interest" in depreciable property is contained in regulations under section 743(b), which provide guidance on the determination of a partner's "proportionate share" of adjusted basis.
- B. Treas. Reg. § 1.743-1(b)(1) states:
- A partner's share of the adjusted basis of partnership property is equal to the sum of his interest as a partner in partnership capital and surplus, plus his share of partnership liabilities. Where an agreement with respect to contributed property is in effect under section 704(c)(2), such agreement shall be taken into account in determining a partner's share of the adjusted basis of partnership property. Generally, if a partner's interest in partnership capital and profits is one-third, his share of the adjusted basis of partnership property will be one-third.
- C. The determination of a partner's proportionate share of partnership depreciable property can be extremely problematic. For example, assume that a partner has a one-third interest in capital and a one-third share of liabilities, but all depreciation deductions are validly specially allocated to other partners. Is the partner's share of depreciable basis really one-third, as implied by the section 743(b) regulations?
- D. Also, a partner's share of depreciable basis may change over time. For example, a partner's share of depreciation deductions may currently be one-third, but may be expected to "flip" to zero in the future. In addition, a partner's share of liabilities may change as the result of the lapse or creation of guarantees, or the admission or withdrawal of a partner. Under the section 743(b) regulations a shift in liabilities apparently results in a shift in share of inside basis.

III. Policy Considerations

In the context of an inside basis adjustment resulting under sections 108(c) and 1017(b)(3)(C), two policy goals should be paramount:

- A. The inside basis reduction should result in the electing partner receiving, over a period of years,

reduced depreciation deductions and greater gain on sale in an amount equal to the excluded COD.

- B. The inside basis reduction should not, under any circumstances, result in other partners receiving reduced depreciation deductions, greater gain on sale, or any other adverse (or beneficial) tax consequence.

IV. Possible Regime to Achieve Policy Goals

One possible regime that would achieve the above policy goals would be as follows:

- A. A partner's share of inside basis in depreciable real estate would be determined by computing the amount of depreciation deductions from qualifying real property then owned by the partnership that will be allocated to the partner, assuming the partnership continues to own the depreciable real estate until it is fully depreciated.
- B. An amount of COD up to the amount of total depreciation deductions, as computed above, could be excluded by the partner.
- C. Each year, the partner would amortize into income an amount equal to his share of qualifying basis, as computed above, multiplied by the recovery percentage applicable to the qualifying real property. If, in a future year, the partner's actual depreciation deductions are reduced below this amortization amount, the partner would recognize positive income equal to the excess.
- D. Upon a taxable disposition of the partnership's depreciable real property, the partner would be required to take the remaining amortization amount into income.

V. Other Issues

- A. If partnership indebtedness that was used to purchase real property is cancelled and the partnership consents to the downward basis reduction, under the section 1017 ordering rules, the basis reduction presumably should be made first with respect to the partnership property that was purchased with the cancelled debt (and the partner's interest in the partnership).
- B. If a partnership consents to the basis reduction with respect to one partner, it should not thereby be required to consent to the basis reduction with respect

to other partners, particularly if the COD arises from the cancellation of non-partnership debt.

- C. Under section 1017(d), a partner's reduction in outside basis should not give rise to section 1245 recapture. Rather, disposition of the real property by the partnership should give rise to section 1250 recapture, and disposition of the partnership interest by the partner should give rise to ordinary income under sections 751 and 1250.