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INSIGHT: Pass-Through Deduction Regulations and Partnership Basis Adjustments—Further Revisions Needed

BY DAVID SHERWOOD AND KEVIN HALL

As Yogi Berra would say, "It's déjà vu all over again."

It is not unusual for the Internal Revenue Service and Treasury to issue corrected versions of regulations in order to rectify inadvertent mistakes. Sometimes these mistakes are obvious clerical errors, but sometimes they are subtle.

A relatively recent example of the latter type of error involves the so-called "May Company" regulation, which can require gain recognition when a partnership owns or disposes of "stock of a corporate partner." In defining that term, the government's intention was to include stock of a corporation related to the partner, such as a parent corporation, but not stock of a corporation that is a subsidiary of the partner or in a brother-sister relationship. Thus, the original June 2015 version of the temporary regulations invoked tax code Section 304(c) "control" in defining "stock of a corporate partner." Unfortunately, Section 304(c) incorporates the full attribution rules under Section 318, which, in many cases, could result in the stock of subsidiary or sister corporations being treated as "stock of a corporate partner," which in turn could result in gain recognition where it is not appropriate.

To its credit, the government acted quickly in addressing this error, issuing corrected regulations in July 2015 that limit the applicability of Section 318 attribution in defining "stock of a corporate partner." With the benefit of time, the government has realized that its quick fix may not have been ideal. Several weeks ago, the IRS and Treasury issued proposed regulations that would further refine the definition of "stock of a corporate partner" to address potentially abusive situations while maintaining the concept that the stock of subsidiary and sister corporations are not included.

Also this year, the IRS and Treasury once again acted quickly to fix an error involving a technical partnership provision, this time involving the Section 199A "pass-through" deduction and Section 743(b) adjustments. In this case, the correction was made only two weeks later, even before the final Section 199A regulations were published in the Federal Register ("thanks" to the government shutdown). As we discuss below, however, the corrected version still has problems, and unlike with the "May Company" regulation, the need for a second fix is more urgent. Without a timely fix, taxpayers could be deprived of the full Section 199A deduction to which they should be entitled.

Background—Section 199A, UBIA, and Partnerships

Starting with the 2018 tax year, Section 199A allows individuals and certain other non-corporate taxpayers to deduct 20 percent of their qualified business income (**QBI**). However, for taxpayers with taxable income above a threshold amount, the Section 199A deduction is limited to the greater of (a) 50 percent of the W-2 wages paid with respect to the qualified trade or business (**W-2 Wages**), or (b) the sum of (i) 25 percent of W-2 Wages and (ii) 2.5 percent of the unadjusted basis immediately after acquisition of qualified property used in the trade or business (**UBIA**). Qualified property generally is depreciable tangible property held by the qualified trade or business at the close of the tax year and used in such trade or business at any point during the year.

However, qualified property does not include property for which the "depreciable period" has ended before the close of the taxable year (where "depreciable period" means the greater of the applicable Section 168 recovery period and 10 years). Take, for example, a truck used in a delivery business that was purchased for $50,000 and has a five-year depreciation period. As the basis of the truck is depreciated, the UBIA remains at $50,000, until the truck is 10 years old and no longer counts as qualified property. So long as property is considered qualified property, its UBIA represents the value of the original investment. This concept is reinforced in the regulations by the provision requiring that capitalized repairs of property are treated as separate items of property with their own UBIA.

The Section 199A deduction is available to eligible partners of partnerships with QBI. The amount of the deduction is calculated at the partner level, with partners being allocated their share of the partnership's QBI, W-2 Wages, and UBIA.

Background—Partnerships and Section 743(b) Adjustments

In general, the buyer of a partnership interest from an existing partner "steps into the shoes" of the seller, inheriting the seller's capital account, responsibility for pre-contribution gain under Section 704(c), and other items. The major departure from "step in the shoes" treatment is the buyer's basis in the partnership interest, which is determined by how much the buyer pays (as well as the buyer's share of partnership liabilities). In addition, if the partnership makes a Section 754 election, or if the partnership has a "substantial built-in loss" with respect to the transfer of the interest, the basis of the partnership's assets will be adjusted under Section 743(b) to account for the difference between what the buyer pays for the interest and what the buyer's share of the basis of the partnership's assets would otherwise be. A Section 743(b) adjustment is personal to the buyer, and will affect the buyer's share of depreciation deductions, as well as gain or loss on the sale of partnership assets. For purposes of depreciation, a Section 743(b) adjustment generally is treated as a separate item of property that is placed in service at the time of the transfer of the partnership interest.

Section 743(b) adjustments can be contrasted with Section 734(b) adjustments, which result from certain distributions of property by a partnership and affect the basis of partnership property for all partners. Section 734(b) adjustments occur when partnership property is distributed and the recipient takes such property with a non-carryover basis, or when the distributee partner recognizes gain or loss on the distribution under Section 731. As with Section 743(b) adjustments, the partnership must have made a Section 754 election, or the negative Section 734(b) adjustment must be "substantial", in order for the adjustment to take place. Also, a Section 734(b) adjustment generally is treated as a separate item of property that is placed in service at the time of the partnership distribution.

Evolution of the Treatment of Section 743(b) Adjustments in the Section 199A Regulations

The statutory language of Section 199A is silent on the treatment of Section 743(b) and Section 734(b) adjustments. On the one hand, if such adjustments are treated as newly-placed-in-service separate items of property, it would make sense to treat such adjustments as UBIA. On the other hand, doing so would, in many cases, lead to a duplication of UBIA that does not make sense. For example, if any of the partnership's assets are depreciable, a positive Section 743(b) adjustment represents, at least to some extent, the adding back of depreciation deductions taken by the selling partner, and, as discussed above, UBIA is not decreased as a result of those depreciation deductions. In the case of Section 734(b) adjustments, the case for increasing UBIA is even weaker, because the remaining partners benefiting from the Section 734(b) adjustment have not made any cash outlay or additional investment in the partnership.

Consequently, the proposed regulations under Section 199A explicitly stated that Section 743(b) and Section 734(b) adjustments are not qualified property, and so do not increase UBIA. However, with respect to Section 743(b) adjustments, the government reversed course in the final regulations. Several comments to the proposed regulations argued that a Section 743(b) adjustment should be allowed for purposes of computing UBIA, at least to the extent that the fair market value of property immediately before the adjustment exceeded the partner's share of the partnership's UBIA computed without regard to a Section 743(b) adjustment. The preamble to the final regulations acknowledged the comment letters and stated that the Treasury and the IRS agree that Section 743(b) adjustments should be treated as qualified property for purposes of computing QBIA, but only to the extent that the basis adjustment "reflects an increase in the fair market value of the underlying qualified property." (the IRS and Treasury declined to make a similar reversal with respect to Section 734(b) adjustments, because they did not view such adjustments as resulting from an "acquisition.")

Accordingly, the final regulations provide that a taxpayer can include in its share of the UBIA of partnership qualified property the "**excess section 743(b) adjustment**" with respect to such qualified property. The key building block in determining the "excess section 743(b) adjustment" is an alternative calculation of the Section 743(b) adjustment, taking into account the rules in the regulations under Sections 743 and 755, but replacing the adjusted basis of all partnership property with the UBIA of such property (while there is no defined term in the regulations, we'll call this amount the "**UBIA 743(b) Adjustment**").

When the UBIA 743(b) Adjustment is positive in amount, it represents exactly the portion of a standard Section 743(b) adjustment that reflects any increase in the fair market value of the partnership's property over its UBIA. Unfortunately, the original version of the final regulations defined "excess section 743(b) adjustment" not as the UBIA 743(b) Adjustment, but instead as the excess of the standard Section 743(b) adjustment over the UBIA 743(b) Adjustment, an amount without a policy justification. We believe that this was an error and that it may not have been caught prior to initial publication of the regulations because the numerical example in the regulations involved a situation where the "excess section 743(b) adjustment" and the UBIA 743(b) Adjustment were equal in amount (so that the answer in the example was correct, but for the wrong reasons).

The current version of the final regulations instead defines ''excess section 743(b) adjustment'' as equal to the UBIA 743(b) Adjustment, with the further limitation that the absolute value of the ''excess section 743(b) adjustment'' cannot be larger than the absolute value of the standard Section 743(b) adjustment (we'll call this the ''**Absolute Value Limitation**'').

The preamble to the final regulations does not explain the purpose of the Absolute Value Limitation. Our best guess is that the purpose is to prevent taxpayers from being required to take into account a negative excess Section 743(b) adjustment to the extent that such negative adjustment is attributable to a decrease in an asset's value in excess of the allowable depreciation. Just as a positive UBIA 743(b) Adjustment represents increases in value beyond adding back depreciation, a negative standard Section 743(b) adjustment represents decreases in value over and above depreciation. Therefore, bringing a negative UBIA 743(b) Adjustment in line with a more modest negative standard Section 743(b) adjustment would prevent tax depreciation from negatively impacting UBIA.

While the definition of ''excess section 743(b) adjustment'' with this Absolute Value Limitation formulation comes closer to serving the policy of Section 199A than the government's original formulation, it still has significant flaws. Two of the flaws have been pointed out in the New York State Bar Association's (**NYSBA's**) report on the final Section 199A regulations.

First, the Absolute Value Limitation does not lead to a policy driven result where both the standard Section 743(b) adjustment and the UBIA 743(b) Adjustment are positive in amount. In general, the UBIA of partnership property will be greater than its adjusted basis. Consequently, in general, the UBIA 743(b) Adjustment will be smaller in amount than the standard Section 743(b) adjustment, and thus the Absolute Value Limitation will not generally come into play when both the standard Section 743(b) adjustment and the UBIA 743(b) Adjustment are positive. However, it is possible for the adjusted basis of property to be greater than its UBIA, if the partnership has experienced a large enough positive Section 734(b) adjustment to its assets, because the Section 734(b) adjustment will affect adjusted basis but not UBIA. In that case, the Absolute Value Limitation would operate to decrease the taxpayer's UBIA. This is an odd result. Why, for example, should partner A's recognizing Section 731 gain upon an earlier partnership distribution have any impact on partner C's UBIA when partner C buys partner B's interest in the partnership? Partner C's original investment in the partnership's property should be determined by what partner C paid, and the Absolute Value Limitation should not change that result here.

Second, the Absolute Value Limitation does not lead to a policy driven result where the standard Section 743(b) adjustment is positive and the UBIA 743(b) Adjustment is negative. It does not make sense for the Absolute Value Limitation to treat a negative $100 UBIA 743(b) Adjustment as negative $50 where the standard Section 743(b) adjustment is negative $50 and where the standard Section 743(b) adjustment is positive $50, but for the UBIA 743(b) Adjustment to remain at negative $100 where the standard Section 743(b) adjustment is positive $150. In line with the NYSBA, we believe that the ''excess section 743(b) adjustment'' should equal $0 whenever the standard Section 743(b) adjustment is positive and the UBIA 743(b) Adjustment is negative.

In fact, we would go further than the NYSBA. In our view, the ''excess section 743(b) adjustment'' should equal $0 whenever the UBIA 743(b) Adjustment is negative. There are a couple of advantages to defining ''excess section 743(b) adjustment'' as the maximum of the UBIA 743(b) Adjustment and $0 over and above its ''relative'' simplicity. First, as we discussed above, the standard Section 743(b) adjustment can be impacted by whether the partnership had prior Section 734(b) adjustments. Thus, using the standard Section 743(b) adjustment as a limitation on the UBIA 734(b) Adjustment introduces an unnecessary element of distortion when the UBIA 734(b) Adjustment is negative (just as it did when the UBIA 734(b) Adjustment is positive).

Second, if the premise for treating a Section 743(b) adjustment as qualified property for UBIA purposes is that it is a separate item of property under Subchapter K, query whether any separate item of property should be treated as having negative UBIA. UBIA represents a taxpayer's original investment in qualified property, and a negative original investment is a hard concept to fathom. A negative UBIA amount would make more sense if Section 743(b) adjustments were treated as part the underlying partnership property under the Section 199A regulations, but the regulations explicitly state that Section 743(b) adjustments are treated as separate items of property.

Furthermore, under the regulations, the UBIA associated with a Section 743(b) adjustment will often outlive the UBIA of the underlying partnership property. While the regulations state that the recovery period of a negative Section 743(b) adjustment is determined under the Section 743 regulations, i.e., it is coterminous with the underlying property, the negative Section 743(b) adjustment is still treated as placed in service at the time of the transfer of the partnership interest. The ''qualified property'' concept is based on an asset's ''depreciable period,'' rather than its ''recovery period.'' As discussed above, depreciable period means the greater of the recovery period or 10 years. Thus, if the underlying property has a remaining depreciable period of less than 10 years, the negative Section 743(b) adjustment will continue to be treated as qualified property until 10 years has passed. Unless this rule is adjusted, allowing negative Section 743(b) adjustments to be treated as negative UBIA will have the impact of reducing the UBIA of unrelated partnership property.

Proposed Correction

For these reasons, we believe that the Section 743(b) rules in the Section 199A regulations need to be corrected once again in order to avoid unintended results. In our view, the preferred approach would be to define ''excess section 743(b) adjustment'' as the maximum of the UBIA 743(b) Adjustment and $0. An alternative approach would be to define ''excess section 743(b) adjustment'' as equal to the UBIA 743(b) Adjustment when the UBIA 743(b) Adjustment is positive, $0 when the UBIA 743(b) Adjustment is negative and the standard Section 743(b) adjustment is positive, and the greater of the UBIA 743(b) Adjustment and the standard Section 743(b) adjustment when they are both negative. However, if the alternative approach is taken, we would further recommend that the ''depreciable period'' of a negative Section 743(b) adjustment be modified so that it is coterminous with the ''depreciable period'' of the underlying property.

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David Sherwood is counsel and Kevin Hall is an associate at the law firm, McDermott Will & Emery.

David Sherwood focuses his practice on a broad range of domestic tax issues affecting corporations, joint ventures and their owners, including the tax treatment of spin-offs and other restructurings, consolidated returns, the availability of deductions on the worthlessness or other disposition of stock, and the formation of investment partnerships, real estate partnerships, corporate joint ventures and multinational group internal partnerships.

Kevin Hall regularly represents private equity funds, multinational corporations, and family offices in connection with a variety of transactional tax matters.