REPORT# 535

TAX SECTION

New York State Bar Association

Comments on Modifications to the Accelerated Cost Recovery System

July 15, 1986

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Attached letter date 7/15/86 enclosing Report on the Depreciation and Investment Credit committee regarding technical comments on H.R. 3838 as passed by the U.S. Senate 6/24/86 sent to the following:

The Honorable Dan Rostenkowski
cc: The Honorable. John J. Duncan
Robert J. Leonard, Esq.

The Honorable Bob Packwood
Chairman
Senate Finance Committee
cc: The Honorable. Russell B. Long
John Colvin, Esq.

The Honorable J. Roger Mentz
Assistant Secretary (Tax Policy)
Department of the Treasury

The Honorable David H. Brockway
Chief of Staff
Joint Committee on Taxation

LaBrenda G. Stodghill, Esq.
Legislation Attorney
Joint Committee on Taxation

REPORT # 544-1

TAX SECTION

New York State Bar Association

July 15, 1986

The Honorable Dan Rostenkowski
2232 Rayburn Building
Washington, DC 20515

Dear Representative Rostenkowski:

I enclose a report prepared by the Committee on Depreciation and Investment Credit of the Tax Section of the New York State Bar Association. The report, which discusses Title II of H.R. 3838 as passed by the Senate on June 24, 1986, comments on modifications to the Accelerated Cost Recovery System, the repeal of the investment credit and the related effective dates and transition rules.

Because of time constraints resulting from the imminent start of Conference Committee meetings, the report has not been considered by the Executive Committee of the Tax Section and thus represents the views only of the Committee on Depreciation and Investment Credit.

I hope the report proves useful to you.

Sincerely,

Richard G. Cohen
Chairman

Enclosure
cc: The Honorable John J. Duncan
Robert J. Leonard, Esq.

REPORT #535

NEW YORK STATE BAR ASSOCIATION
COMMITTEE ON DEPRECIATION AND INVESTMENT CREDIT

Technical Comments on H.R. 3838
as Passed by the Senate on June 24, 1986

This report*/ sets forth certain technical comments on Title II of H.R. 3838, as passed by the Senate on June 24, 1986 (the “Bill”)**/, relating to depreciation deductions and the repeal of the investment credit. References will be made to the report of the Committee on Finance of the United State Senate, Senate Report No. 99-313 (May 29, 1986) (the “Senate Report”), to H.R. 3838 as passed by the House of Representatives on December 17, 1985 (the “House Bill”) and to the Report of the Committee on Ways & Means of the House of Representatives, House Report No. 99-426 (December 7, 1985) (the “House Report”).

Modifications to ACRS--Section 201 of the Bill

Section 201(a) of the Bill restates section 168 of the Internal Revenue Code, which currently contains

*/ Richard J. Bronstein, Victor Zonana, Patricia M. Geoghegan, Stephen B. Land and Kathy A. Ryan participated in the preparation of this report.

**/ Page references to the Bill are to the legislation as reported by the Senate Finance Committee.

rules relating to the Accelerated Cost Recovery System ("ACRS"). Although the depreciation system set forth in proposed section 168 is similar in many respects to ACRS under current law, there are various modifications to the rules governing allowable depreciation deductions. The following technical comments are generally organized by reference to proposed section 168 as contained in Section 201(a) of the Bill.

First-Year Convention, proposed section 168(d)(3). Depreciation deductions under proposed section 168 are generally computed in accordance with a half-year convention, under which all property placed in service or disposed of during a taxable year is treated as being placed in service or disposed of at the midpoint of such year. As a result, a depreciation deduction equal to one-half of a full year's depreciation is allowed for the year in which property is placed in service, and a half-year of depreciation is allowed for the year in which property is disposed of or retired from service, regardless of when the property is actually placed in service or disposed of or retired during the year. Proposed section 168(d)(3) (page 1433), however, provides a special rule under which the first-year depreciation deduction is computed in accordance with a mid-month convention, except as provided in regulations, if more than 40% of the aggregate bases of all property placed in service by a taxpayer during a taxable year is placed in service during the last three months of such taxable year. (For purposes of this test, certain section 1250 property is not taken into account.) Under the mid-month convention, the first-year depreciation deduction is based on the number of months that the property is in service during the year, and property placed in service at any time during a month is treated as having been placed in service in the middle of the month.

Neither proposed section 168 nor the relevant legislative history indicates whether, in the case of a corporation that is a member of an affiliated group filing consolidated Federal income tax returns, the 40-percent test is applied separately to each member of the affiliated group or, instead, is applied with respect to all property placed in service by the members of the affiliated group. It would be helpful for Congress to indicate whether the 40-percent test will be applied on a separate company basis or on a group basis to enable taxpayers to operate with some degree of certainty in advance of regulations being issued. In this regard, we note that the ACRS rules (as well as the predecessor ADR system) are generally applied on a separate company basis; on the other hand, a separate company rule could be disadvantageous to taxpayers that form special purpose corporations for nontax reasons (e.g., limited liability) near the end of a taxable year.

More generally, the requirement of using the mid-month convention in certain circumstances is apparently intended to prevent taxpayers from realizing a disproportionate benefit from the half-year convention as a result of placing in service a large portion of its property in the last quarter of a taxable year. But, because the 40-percent test is determined with reference to the basis of property placed in service and not to the amount of the first-year depreciation deduction allowable under the half-year convention, this rule operates in a somewhat indirect fashion. For example, property that would be depreciated under the alternative depreciation system in proposed section 168(g) – such as property used outside the United States, tax-exempt use property and tax-exempt bond financed property -- would be included for purposes of the 40-percent test, unless such property constitutes real property. As a result, if at the end of a year a taxpayer placed in service an expensive item of property that is subject to proposed section 168(g), then, even if such item of property had a long applicable recovery period and there were only a small benefit from the half-year convention with respect to such property, the taxpayer might be required to use the mid-month convention for all of its property placed in service during the year. It is not clear why all of the taxpayer's property should be subject to the mid-month convention (including property that is not subject to proposed section 168(g)), since this taxpayer would receive only a small benefit from the application of the half-year convention to this expensive item of property. If this circumstance is not addressed directly in proposed section 168, we would recommend that consideration be given to excluding situations of this type in the regulations that are authorized by the Bill.

Neither the Bill nor the Senate Report address the effect in computing the 40-percent test of changes in tax basis after property is placed in service (e.g., due to a redetermination, see Prop. Reg. $1.168-2 (d)(3)). Presumably, the application of the 40-percent test would not be affected by events occurring in subsequent taxable years, but this matter should be clearly covered in the Bill or its legislative history.

More importantly, we are concerned about the significant complexity created by the 40-percent test-and the resulting application of the mid-month convention. A substantial attraction of ACRS is its simplicity, and this attraction is clearly diluted by creating a different method of depreciation for certain years and not others. As a result, it is not clear to US that the benefits of this test justify the resulting complexity.

In any event, a more finely-tuned rule might be to apply the mid-month convention if more than 40% of a taxpayer’s first-year depreciation deductions (computed in accordance with the half-year convention) are attributable to property placed in service during the last quarter of the taxpayer's taxable year. Such a rule would more directly address the purpose that proposed section 168(d)(3) is apparently intended to serve, and it might also avoid the need to provide regulatory exceptions to proposed section 168(d)(3) as it is currently drafted. On the other hand, such a rule could lead to greater uncertainty in circumstances in which the applicable depreciation method for some of the taxpayer's property is not clear.

Certain Elections, proposed section 168 (b)(5). Proposed section 168(b)(5) (page 1433) allows taxpayers to elect to use the straight-line method to compute depreciation deductions. In addition, under proposed section 168(g)(7) (page 1444), a taxpayer is permitted to elect to use an alternative depreciation system based on ADR mid-point lives rather than the recovery classes generally provided under proposed section 168. As in the case of section 168(d)(3), however, it is not clear whether these elections are to be made on a separate company basis or, instead, on a group basis in the case of an affiliated group of corporations filing consolidated Federal income tax returns. Guidance on this question prior to the issuance of regulations would be helpful, and we suggest that this question ought to be resolved in the same manner as (i.e, on a separate company basis) as is generally applicable under the ACRS rules.

R & D Property, proposed section 168(e)(2)(D). Proposed section 168(e)(2)(D) (page 1437) includes property that is used in connection with research and experimentation in the 5-year property class if the property is placed in service during 1987, 1988 or 1989, and in the 3-year property class if it is placed in service after 1989. Presumably, this provision represents a political compromise, but it also creates substantial complexity. One example of this complexity is that such property is subject to anti-churning rules with respect to three different points in time (i.e. January 1, 1981, January 1, 1987, and January 1, 1990).

Renewal Options, proposed section 168(i)(3)(B). Proposed section 168(i)(3) (page 1466) provides a definition of “lease term” for various purposes under proposed section 168. For example, there are exceptions from rules relating to the treatment of tax-exempt use property if the property is leased only pursuant to a short-term lease, and the recovery period for tax-exempt use property that is subject to a lease is not less than 125% of the lease term. Under subparagraph (A) of proposed section 168(i)(3), the lease term is treated as including all periods for which there is an option to renew the lease. Under subparagraph (B), however, options to renew at fair market value (determined at the time of renewal) are not taken into account in the case of real property. Although it might be easier to administer a rule that takes into account all options to renew, there is no conceptual justification for a rule that takes into account options to renew at fair market value, and there is no justification for treating real property and personal property differently. Accordingly, we suggest that subparagraph (B) should apply to all property.

Partnership Terminations, proposed section 168(i)(7)(B). Proposed section l68(i)(7) (page 1468) generally provides special rules that are substantially the same as section 168(f)(10) of the Code relating to the computation of depreciation deductions after the transfer of property in certain specified transactions. The effect of these special rules with respect to certain transfers is that the transferee of property “steps into the shoes” of the transferor to the extent that the property’s basis is not increased as a result of the transaction.

Under the second sentence of proposed section 168(i)(7)(B), however, these rules would not apply to the distribution and recontribution that is deemed to occur for property of a partnership that is terminated under section 708(b)(1)(B) of the Code as a result of a 50-percent change of ownership. In the case of a partnership termination under current law, the depreciation deductions with respect to the partnership's property would be allowable after the termination at the same rate and in the same amounts that the deductions would have been allowable if there had not been any change of ownership of the partnership. Such a rule avoids reducing the depreciation deductions available to continuing partners after a termination of the partnership, and this result seems appropriate. On the other hand, the new partners are, in effect, permitted to claim depreciation deductions over a period that is shorter than the generally applicable recovery period; presumably, the exclusion of partnership terminations from the application of proposed section 168(i)(7) was intended to prevent this benefit from being realized by entering partners. We recommend that, in the case of a partnership termination under section 708 of the Code, consideration be given to providing separate rules for continuing partners and for entering partners, so that the depreciation deductions allowable to the continuing partners with respect to the remaining basis of property are not reduced as a result of the termination of the partnership.

Effective Dates and Transition Rules--Section 202 of the Bill

Section 202 of the Bill contains various effective dates and transition rules relating to Section

201 of the Bill. The Tax Section of the New York State Bar Association has previously filed general comments concerning various considerations involved in determining the applicable effective dates and transition rules, and we will not attempt to repeat or summarize these comments here. We have, however, certain specific comments with respect to the transition rules in Section 202 of the Bill.

Binding Contracts, Section 202(b)(1)(A) of the Bill. Under Section 202(b)(1)(A) of the Bill (page 1491), proposed section 168 does not apply to property that is constructed, reconstructed or acquired pursuant to a written contract that was binding on March 1, 1986. If a taxpayer were to acquire property pursuant to a written contract that was binding on March 1, 1986, this provision, read literally, would exempt such property from proposed section 168 for its entire useful life, even in the hands of a transferee of such taxpayer. It appears that such a result was not intended. Instead, the Senate Report (at page 108) indicates that, if a taxpayer transfers his rights under a binding contract, proposed section 168 would not apply to the property that is the subject of the contract in the hands of the transferee, “as long as the property was not placed in service before the transfer by the transferor.” We believe that this aspect of the binding contract rule is significant, and we recommend that consideration be given to including it clearly in the statute, and not merely in the legislative history. We also note that this aspect of the rule might be viewed as being consistent with Section 202(b)(3) of the Bill (i.e., the sale-leaseback window, discussed below). In other words, proposed section 168 would not apply to property that is the subject of a binding contract on March 1, 1986 if (a) right s under the contract are transferred before the property is placed in service or (b) the property is transferred after it is placed in service in a manner that satisfies the "window" provision of Section 202(b)(3) of the Bill.

Finally, we believe that the binding contract rule is intended to apply whether or not the original use of the property commences with the taxpayer (i.e., the binding contract rule is available both for new and for used property). For example, we interpret the phrase quoted above to mean "as long as the property was not placed in service by the transferor before the transfer." It would be helpful if this point were clarified in either the statute or the legislative history.

<u>Self-constructed Property, Section 202(b)(1)(B) of the Bill</u>. Under Section 202 (b)(1)(B) of the Bill (page 1491), proposed section 168 does not apply to property t h a t is constructed or reconstructed by the taxpayer if the taxpayer incurs or commits to spend the lesser of $1,000,000 or 5% of the cost of the property

not later than March 1,1986, so long as the construction or reconstruction of the property begins by March 1, 1986. The Bill appears to treat self-constructed property that is transferred before it is placed in service in a manner that is different from property that is acquired pursuant to a binding contract; in the hands of the transferee, property would not have been “constructed or reconstructed by the taxpayer.” We are not aware of any policy that would justify such different treatment, and we suspect that this difference was not intended. For example, if a taxpayer began construction of property prior to March 1, 1986 in a manner that would satisfy the terms of Section 202(b)(l)(B) of the Bill, and if the taxpayer then transfers the property before it is placed in service (perhaps in connection with a sale of substantially all of the taxpayer’s assets or as a result of bankruptcy or other financial problems), section 202(b)(l)(B) of the Bill should apply to such property. Moreover, as a general matter, to the extent that distinction s between the effective date rules for binding contracts and for self-constructed property can be eliminated, both taxpayers and the Internal Revenue Service would avoid the need to make the difficult factual distinction between property that is acquired and property that is constructed by or for the taxpayer. On the other hand, a rule that would include in Section 202(b)(1)(B) of the Bill all self-constructed property that is transferred before it is placed in service by the transferor is probably too broad. For example, if a taxpayer is constructing or manufacturing property that will be included in its inventory and held for sale to customers in the ordinary course of business such property should probably not be within Section 202(b)(1)(B) of the Bill.

Equipped buildings, Section 202(b)(1)(C) of the Bill. Under Section 202(b)(1)(C) of the Bill (page l49l), where construction of an equipped building began on or before March 1, 1986 pursuant to a written specific plan and more than one-half of the cost of the equipped building was incurred or committed on or before March 1, 1986, proposed section 168 does not apply to the entire equipped building. On the other hand, if the costs incurred or committed on or before March 1, 1986 are less than one-half of such costs, each item of machinery and equipment is treated separately for purposes of determining whether proposed section 168 applies to such item. The foregoing comments concerning the binding contract and self-constructed property effective date provisions also apply to the provisions dealing with equipped buildings, and any modifications or clarifications that are made in Sections 202(b)(1)(A) and (B) of the Bill should also be made in Section 202(b)(1)(C) of the Bill.

Sale-leaseback “window”, Section 202(b)(3) of the Bill. Under Section 202(b)(3) of the Bill (page

1492), proposed section 168 does not apply to property if it meets the following requirements:

(1) the property must be placed in service by a taxpayer who acquired the property from a person in whose hands the property would not have been subject to proposed section 168 under another transition rule or general effective date provision,

(2) the property must be leased back by the taxpayer to such person, and

(3) the leaseback must occur within 90 days after the property was originally placed in service by such person or, if earlier, the applicable date specified in Section 202(b)(2) of the Bill.

Although the difference is not significant, the applicable period should be three months rather than 90 days, to be consistent with the three-month period specified in section 48(b)(2) of the Code. (Similarly, a three-month rule is provided in section l68(j)(3)(B)(v) of the Code.) Under Section 202(b)(3) of the Bill as now drafted, there is a possibility that property would be eligible for investment credit under the three-month window of section 48(b)(2) and fail to qualify as transition property for depreciation purposes (or vice versa). This difference in the length of the window period is a totally unnecessary complexity in the transition rules.

As discussed above, we believe that the binding contract rule of Section 202(b)(1)(A) of the Bill is intended to apply both to new and used property. The use of the term “originally placed in service” at the end of Section 202(b)(3), however, could be construed to limit the availability of the sale-leaseback window to new property; the terns “original use” and “originally placed in service” are generally used in the Code to distinguish between new and used property. (See, e.g., section 48(b) of the Code.) Accordingly, to make it clear that the sale-leaseback window is available with respect to used property, we recommend the deletion of the words “originally placed in service” at the end of Section 202(b)(3) and the substitution of the phrase “placed in service by the transferor.”

A rule similar to Section 202(b)(3) of the Bill was also included in the House Bill. In the House Report (at page 164) the following statement appears:

> “For purposes of this rule, a leaseback to a taxpayer’s wholly-owned subsidiary included in the same affiliated group is to be treated as a leaseback to the taxpayer.”

It is not clear why this rule was not included in the Senate Report (page 111). Moreover, the report of the Conference Committee should clearly indicate whether or not such a rule exists; one cannot determine whether this rule applies simply by examining the House Bill, the

Senate Bill and the final legislation (unless the final legislation deals with the issue expressly).

We believe that much a rule is totally appropriate and, indeed, it should be expanded. First, there is no apparent reason to limit a leaseback to a “wholly-owned subsidiary”, and we would recommend instead that a corporation should be allowed to enter into a leaseback to any corporation in the same affiliated group filing a consolidated Federal income tax return. Moreover, a leaseback to a parent or sister corporation should also be permitted. It is not unusual for a corporation to establish a subsidiary to own property during construction, perhaps because of restrictions on borrowing contained in a parent corporation’s loan agreements. After the property is completed, however, if the subsidiary sells the property to a third party (within the 90-day or three-month window), it is also not unusual for the parties to desire to have the property leased to the parent corporation, rather than a subsidiary. For example, the subsidiary might be a special purpose corporation that does not have the capability of operating the property itself, and in these circumstances the subsidiary might be required either to sublease the property to the parent or to enter into a management arrangement with the parent, in which case the Internal Revenue Service might question whether the leaseback is to the subsidiary or to the parent. To avoid these uncertainties, we recommend adopting a rule that would permit the property to be leased to the parent corporation, particularly since we do not perceive any abuse potential in such arrangements.

Moreover, the foregoing reasoning also suggests that section 48(b)(2) of the Code should be amended to permit leasebacks to affiliates. Accordingly, consideration should be given to adding such a rule to section 48(b)(2) of the Code by adding a provision in Section 1809(d) of the Bill (page 2543), which contains other technical corrections to section 48(b)(2).

Other Transition Rules, Section 202(d) of the Bill. Under Section 202(d) of the Bill (beginning on page 1496), proposed section 168 does not apply to various categories of property. Neither the Bill nor the Senate Report expressly deals with the application of proposed section 168 to such property if such property is transferred, except that the sale-leaseback window provisions in Section 202(b)(3) of the Bill do apply. Consideration should be given to clarifying this aspect of Section 202(d) as discussed above in connection with Sections 202(b)(1)(A) and (B) of the Bill. For example, a number of provisions in Section 202(d) would exempt property from proposed section 168 for its entire useful life.

Investment Credit Repeal Section 211 of the Bill

Section 211 of the Bill provides rules relating to the repeal of the investment credit. The approach in the Senate Bill (proposed section 49(b), page 1527) of reducing by 30% (when fully effective) the investment credit with respect to transition property (as well as investment credit carryovers) is clearly preferable to the approach taken in the House Bill, which would have provided for spreading investment credits on transition property over a five-year period. It is both easier to understand and less susceptible to various complexities. For example, under the House Bill approach, rules must be provided for short taxable years, acquisitions, dispositions, reorganizations and other transactions.

It is also appropriate to tie the phase-in of the reduction in available investment credits to the phase-in of the reduction in the marginal income tax rate for corporations, since this relationship dilutes the incentive to accelerate income to maximize the value of investment credit carryovers. For example, if a calendar-year taxpayer with large investment credit carryovers were to accelerate $100 of income from 1988 to 1986, that taxpayer would use up (ignoring certain limitations on the utilization of investment credits) $46 of its carryover. Alternatively, if the income were recognized in 1988, the applicable tax before credits would be $33, and the amount of the original carryover (before the 30% reduction) that would be used up is approximately $47.

As a technical matter, proposed section 49(d)(2) (page 1528), which defines the term “transition property,” has been corrected by a Senate floor amendment. Nevertheless, as an alternative drafting approach, we suggest that the relevant provisions of Section 202 of the Bill be included (with appropriate modifications) in proposed section 49(d)(2), rather than incorporated by reference. As proposed section 49(d)(2) is currently drafted, its meaning can be determined only by referring to Section 202 of the Bill, which will not be included in the Internal Revenue Code. It would be helpful, however, if the significance of proposed section 49(d)(2) could be determined by referring code.