Report No. 1405

New York State Bar Association Tax Section

Report on Proposed Regulations Under Section 168(k) Relating to Immediate Expensing of Capital Investments

November 2, 2018

TABLE OF CONTENTS

New York State Bar Association
Tax Section

Report on Proposed Regulations Under Section 168(k) Relating to Immediate Expensing of Capital Investments

This report[1] of the Tax Section of the New York State Bar Association (the "**NYSBA**") provides comments on the proposed regulations (the "**Proposed Regulations**")[2] issued under Section 168(k) of the Internal Revenue Code of 1986, as amended (the "**Code**").[3] Section 168(k), as amended by "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97 (the "**Act**"),[4] generally permits a taxpayer to deduct 100% of the cost of certain "qualified property" placed in service after September 27, 2017 and before January 1, 2023 (and lesser percentages for subsequent years prior to phasing out with respect to most property placed in service on January 1, 2027 or after).[5] The Treasury Department ("**Treasury**") and the Internal Revenue Service (the "**Service**") requested comments on all aspects of the Proposed Regulations, including how many years a taxpayer should be required to look back in determining whether the taxpayer previously held an interest in an item of property.[6]

We commend Treasury and the Service for quickly releasing proposed regulations addressing most taxpayer questions regarding the implementation of Section 168(k) under the Act. This report is intended to highlight areas of the Proposed Regulations that we believe warrant modification or clarification, and to offer specific recommendations where possible. Part I of this report summarizes our comments on the Proposed Regulations. Part II provides a summary of Section 168(k) and the existing regulations thereunder (the "**Prior 168(k)**

---

1 The principal drafters of this report are Richard M. Nugent, Sean E. Jackowitz and L. Matthew Waterhouse, with substantial contributions from William D. Alexander, Phillip J. Gall, Scott H. Rabinowitz and Eric B. Sloan. Helpful comments were received from Andrew H. Braiterman, Timothy J. Devetski, Lucy W. Farr, Lawrence M. Garrett, John C. Hart, Shane J. Kiggen, Stephen B. Land, Steven J. Lorch, Andrew W. Needham, Deborah L. Paul, Michael L. Schler, Michael B. Shulman, Karen Gilbreath Sowell and Sara B. Zablotney. This report reflects solely the views of the Tax Section of the NYSBA and not those of the NYSBA Executive Committee or its House of Delegates.

2 *See* Additional First Year Depreciation Deduction, REG–104397–18, 83 Fed. Reg. 39,292 (Aug. 8, 2018) [hereinafter *Proposed Regulations*].

3 The Proposed Regulations also cite Section 7805 as a source of authority. Unless otherwise indicated, all references herein to "Section" or "§" refer to the Code, and references to the Treasury Regulations are to those in effect as of the date of this Report.

4 *See* 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. 115-97, 131 Stat. 2054 (2017) [hereinafter *Act*].

5 The deduction available under Section 168(k) is sometimes referred to by certain other names, such as "additional first-year depreciation," "immediate expensing" or "bonus depreciation," which this report generally uses interchangeably with "Section 168(k) deduction."

6 *See Proposed Regulations*, *supra* note 2, 83 Fed. Reg. at 39,295, 39,299.

Regulations”),[7] the Act’s 2017 amendments to Section 168(k)[8] and the Proposed Regulations. Part III discusses and explains our comments in greater detail.

I. SUMMARY OF COMMENTS

A. Partnership-Related Comments

1. The final regulations generally should adopt an aggregate approach in evaluating whether basis adjustments to qualified property held by a partnership[9] are “used by the taxpayer” and meet the requirements of Section 179(d)(2)(A), (2)(B), (2)(C) and (3).
2. The final regulations should permit immediate expensing of excess book basis under the remedial allocation method in Treasury Regulations Section 1.704-3(d) and corresponding remedial allocations of income and depreciation.[10]
3. Consistent with the Proposed Regulations, the final regulations should retain the availability of immediate expensing to the extent Section 743(b) basis adjustments are allocable to qualified property.
4. Consistent with the Proposed Regulations, the final regulations should deny immediate expensing to the extent basis adjustments under Section 732(b) and Section 734(b)(1)(B) are allocable to qualified property.
5. The government should consider permitting immediate expensing of basis adjustments under Section 734(b)(1)(A) allocable to qualified property, together with its consideration of the proposed regulations under Section 751(b) and Section 755.
6. Treasury Regulations Section 1.743-1(j)(4)(i)(B)(2) should be modified to permit a partnership to elect to claim immediate expensing with respect to the portion of a Section 743(b) adjustment that is allocable to Section 704(c) built-in gain (including “reverse” Section 704(c) gain).
7. The provisions contained in Proposed Regulations Section 1.168(k)-2(f)(1)(iii) should be revised in the final regulations to provide that a partnership interest is treated as a depreciable interest in the partner’s proportionate share of the underlying qualified property solely for purposes of applying such section.
8. The final regulations should require consistency for elections under Section 168(k)(7) with respect to Section 743(b) adjustments.

---

7 *See* Treas. Reg. § 1.168(k)-1; *see also* NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT # 1045 COMMENTING ON PROPOSED REGULATIONS UNDER INTERNAL REVENUE CODE SECTIONS 168 AND 1400L RELATING TO ADDITIONAL FIRST YEAR DEPRECIATION ALLOWANCES (2004), *reprinted in*, 2004 TNT 5-7 (Jan. 8, 2004) (commenting on early temporary regulations under Section 168(k)).

8 *See Act*, *supra* note 4, at § 13201.

9 For purposes of this report, references to a partnership generally include a limited liability company or other entity or arrangement that is classified as a partnership for U.S. federal income tax (“**U.S. tax**”) purposes.

10 For this purpose, “book” refers to the books of the partnership maintained under Treasury Regulations Section 1.704-1(b)(2)(iv).

9. If the final regulations permit immediate expensing of remedial allocation deductions, the special rule contained in the penultimate sentence of Proposed Regulations Section 1.168(k)-2(f)(1)(iii) should be removed.
10. If the final regulations do not permit immediate expensing of remedial allocation deductions, the special rule contained in the penultimate sentence of Proposed Regulations Section 1.168(k)-2(f)(1)(iii) should be retained, but, as discussed below, the government may wish to revisit certain aspects of the rule.
11. The final regulations should clarify that an asset acquired through a transaction described in Revenue Ruling 99-5[11] (Situation 1) is placed in service by the buyer even though it is treated as being immediately contributed to the relevant partnership in a Section 721(a) transaction.

B. Other Comments

1. The final regulations should include an exemption providing that qualified property previously used by a taxpayer and reacquired in a purchase that otherwise satisfies the requirements of Section 168(k)(2)(E)(ii) is eligible for immediate expensing notwithstanding that the taxpayer previously used the property, unless the taxpayer's reacquisition is part of a plan that includes the prior use or disposition of the qualified property.
2. Any safe harbor or other exemption provided in the final regulations to the requirement in Section 168(k)(2)(E)(ii)(I) that a taxpayer acquiring used qualified property must not have previously used the property should also apply to analogous provisions of the final regulations that require one person to determine if another person previously used an item of property, such as the rules in Proposed Regulations Sections 1.168(k)-2(b)(3)(iii)(B)(3)(i), -2(b)(3)(iii)(B)(3)(ii), and -2(f)(1)(iii).
3. The final regulations should provide a definition of the phrase "depreciable interest."
4. The government should consider defining the term "predecessor" in the final regulations.
5. The government should consider clarifying the application of the phrase "series of related transactions" in Example 22 or more generally.
6. The final regulations should clarify how Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(C) is intended to apply.
7. The final regulations should incorporate an example clarifying that where one consolidated group acquires qualified property and stock of a target corporation from another consolidated group, the acquired qualified property is eligible for immediate expensing, provided the acquired target corporation never directly held such property.
8. The government should issue guidance clarifying the tax treatment of transactions in which a member of a consolidated group sells qualified property to a buyer corporation within the same consolidated group and the buyer corporation is itself purchased by an

[11] 1999-1 C.B. 434.

acquiror (and similar transactions involving an actual or deemed sale within a consolidated group, followed by the buyer corporation's departure from the group pursuant to a distribution described in Section 355 of the Code) and addressing in particular (i) whether any Section 168(k) deduction in the above scenarios can be claimed by the buyer corporation or its consolidated group, or by the selling consolidated group, and (ii) the amount of any Section 168(k) deduction and the tax treatment thereof under the consolidated return rules and Section 168(i)(7).

9. Consistent with the Proposed Regulations, the final regulations should amend Treasury Regulations Section 1.179-4(c)(2) to expressly provide that assets deemed transferred in connection with a Section 336(e) election under Treasury Regulations Section 1.336-2(b)(1) should be treated as acquired through a qualifying "purchase." The government also should consider issuing guidance addressing whether qualified property transferred in a Section 355(d) or 355(e) distribution for which a Section 336(e) election is made is eligible for immediate expensing, notwithstanding the "sale-to-self" model in Treasury Regulations Section 1.336-2(b)(2).

10. The government should consider providing in the final regulations that Section 181 deductions for qualified television productions and qualified live theatrical productions are taken before any Section 168(k) deduction applicable to the same production.

II. BACKGROUND

A. Background on Section 168(k)

Under pre-Act law, Section 168(k) permitted taxpayers to deduct 50% of the adjusted basis of any newly purchased "qualified property" in the year in which the taxpayer placed the qualified property in service.[12] Any such taxpayer would reduce the adjusted basis of its qualified property by the Section 168(k) deduction amount to compute regular depreciation deductions for the year the property was placed in service and the years following.[13] A taxpayer could elect out of Section 168(k) for any taxable year, but only on a class-by-class basis as opposed to a property-by-property basis.[14]

"Qualified property" included (i) property to which Section 168 applied with a recovery period not exceeding 20 years, (ii) computer software depreciable under Section 167(a) (rather than Section 197), (iii) water utility property and (iv) "qualified improvement property,"[15] so

[12] *See* I.R.C. § 168(k)(1) (prior to amendment by the Act).

[13] *See* I.R.C. § 168(k)(1)(B). The percentage of cost allowed as a deduction under Section 168(k) was to be phased down to 40% for qualified property placed in service in 2018 and to 30% for qualified property placed in service in 2019. *See* I.R.C. § 168(k)(6) (prior to amendment by the Act).

[14] *See* I.R.C. § 168(k)(7) (prior to amendment by the Act). Subject to special rules, a corporate taxpayer could elect to accelerate its use of alternative minimum tax credits instead of taking depreciation under Section 168(k). *See* I.R.C. § 168(k)(4) (prior to amendment by the Act).

[15] *See* I.R.C. § 168(k)(2)(A)(i) (prior to amendment by the Act). Qualified improvement property generally is any improvement to an interior portion of a building that is nonresidential real property if such improvement is placed in service after the date the building was first placed in service. *See* I.R.C. § 168(e)(6); I.R.C § 168(k)(3)(A) (prior to amendment by the Act).

long as "original use" of the property began with the taxpayer, and the taxpayer placed the property in service before January 1, 2020.[16] "Original use" generally was "the first use to which the property is put, whether or not that use corresponds to the use of the property by the taxpayer."[17] The deadline for placing property in service was extended to December 31, 2020 for certain property having longer production periods, namely, property that met the definition of "qualified property," was acquired by the taxpayer before January 1, 2020 (or acquired pursuant to a written contract entered into before January 1, 2020), had a recovery period of at least 10 years or was property used in the trade or business of transporting persons or property, and had an estimated production period exceeding one year and a cost exceeding $1 million (collectively, "**LPP property**").[18] Subject to additional rules, certain aircraft also qualified (and continue to qualify) as LPP property.[19]

B. Act Changes to Section 168(k)

The Act made several changes to the above rules. Most significantly, the new law increased the allowable Section 168(k) depreciation amount to 100% for qualified property acquired and placed in service after September 27, 2017 and before January 1, 2023.[20] The 100% Section 168(k) depreciation period for placing qualified LPP property in service extends to December 31, 2023.[21] Under the Act, the applicable Section 168(k) depreciation percentage decreases by 20% each year for qualified property placed in service after December 31, 2022 (or December 31, 2023 for LPP property) until sunsetting for qualified property placed in service after December 31, 2026 (or December 31, 2027 for LPP property).[22] A taxpayer may elect to apply a 50%, rather than 100%, Section 168(k) deduction for qualified property placed in service and acquired during the taxpayer's first taxable year ending after September 27, 2017.[23] For property acquired before September 28, 2017 and placed in service after September 27, 2017, the Act retained the existing 50% depreciation rate and the existing phase down to 40% and 30% that were already in place.[24] In addition, property is not treated as subject to the Act's new provisions if a written binding contract for its acquisition was entered into before September 28, 2017.[25]

Second, the Act expanded the definition of qualified property to include "qualified film or television productions" and "qualified live theatrical productions." A qualified film or

---

16 *See* I.R.C. § 168(k)(2)(A)(ii), (iii) (prior to amendment by the Act).

17 *See* Treas. Reg. § 1.168(k)-1(b)(3)(i).

18 *See* I.R.C. § 168(k)(2)(B) (prior to amendment by the Act). Self-constructed property could qualify if the taxpayer began constructing the property before January 1, 2020.

19 *See* I.R.C. § 168(k)(2)(C).

20 *See* I.R.C. § 168(k)(6)(A)(i).

21 *See* I.R.C. § 168(k)(6)(B). The Act permits a Section 168(k) deduction for specified plants planted or grafted before January 1, 2027. The phasedowns are the same as for qualified property. *See* I.R.C. § 168(k)(6)(C).

22 *See* I.R.C. § 168(k)(6)(A), (B). The applicable percentage for LPP property acquired after September 27, 2017 and placed in service in 2027 is 20%. *See* I.R.C. § 168(k)(6)(B)(v).

23 *See* I.R.C. § 168(k)(10).

24 *See* I.R.C. § 168(k)(8).

25 *See Act*, *supra* note 4, at § 13201(h)(1).

television production, generally and subject to additional specific requirements, is a film or television production, at least 75% of the total compensation incurred in the production of which is for services performed in the United States by actors, directors, producers and other relevant production personnel.[26] A qualified live theatrical production generally is a live staged production of a play, with or without music, which is derived from a written book or script in an applicable venue, so long as it meets the same compensation test.[27]

Third, the Act excludes from Section 168(k) property used in certain of the trades or businesses that are not subject to the limitation on interest expense under Section 163(j).[28] In particular, excluded from the definition of qualified property under the new law is property primarily used in the trade or business of furnishing electrical energy, water or sewage disposal services, gas or steam through a local distribution system, or transportation of gas or steam by pipeline, if any such trade or business is subject to regulation.[29] Also excluded is any property used in a trade or business that has floor plan financing indebtedness if the interest related to such indebtedness is exempt from the new interest limitation rules of Section 163(j) pursuant to Section 163(j)(1)(C).[30]

Fourth, the Act amended the requirement that the original use of property commence with the taxpayer.[31] As amended, Section 168(k) now requires that either (i) the original use of the property in question begin with the taxpayer or (ii) the taxpayer acquire the property in a transaction satisfying the requirements of Section 168(k)(2)(E)(ii). Section 168(k)(2)(E)(ii), in turn, requires that (i) the taxpayer did not use the property at any time prior to its acquisition (as amended by the Proposed Regulations, the "**No Prior Use Test**"),[32] and (ii) the acquisition was a qualifying "purchase" under Section 179(d)(2) and (d)(3) (the requirements of Section 179(d)(2)-(3), collectively, the "**Unrelated Purchase Test**").[33] Section 179(d)(2), in turn, imposes three separate requirements. First, the property must not have been acquired from a person whose relationship with the taxpayer is described in Section 267 or Section 707(b).[34] In the case of two corporations, this rule generally requires that the corporations not be members of the same "controlled group" as defined in Sections 267(f) and 1563(a). Second, the property cannot be acquired by one component member of a controlled group from another component member of

---

26 *See* I.R.C. § 168(k)(2)(A)(i)(IV) (cross-referencing I.R.C. § 181(d)).

27 *See* I.R.C. § 168(k)(2)(A)(i)(V) (cross-referencing I.R.C. § 181(e)).

28 After the Act, Section 163(j) generally limits interest deductions to 30% of a taxpayer's adjusted taxable income. *See* I.R.C. § 163(j)(1). For our report on Section 163(j), see NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT # 1393 ON SECTION 163(J) (2018), *reprinted in*, 2018 TNT 62-1 (Mar. 30, 2018).

29 *See* I.R.C. § 168(k)(9)(A) (cross-referencing I.R.C. § 163(j)(7)(A)).

30 *See* I.R.C. § 168(k)(9)(B). "Floor plan financing indebtedness" is indebtedness used to finance the acquisition of motor vehicles held for sale or lease and secured by the inventory so acquired. *See* I.R.C. § 163(j)(9)(B).

31 *See* I.R.C. § 168(k)(2)(A)(ii).

32 As described in Part III.B.2.b, below, the Proposed Regulations provide that prior use by either the taxpayer *or a predecessor of the taxpayer* prevents the taxpayer from receiving a Section 168(k) deduction; the statute does not mention predecessor.

33 *See* I.R.C. § 168(k)(2)(A)(ii), (E)(ii).

34 *See* I.R.C. § 179(d)(2)(A). For this purpose, Section 179(d)(2)(A) modifies the rules of Section 267 such that the family of an individual includes only his or her spouse, ancestors and lineal descendants. *See id.*

the same controlled group, a technical requirement that overlaps significantly with the first requirement.[35] Third, the basis of the acquired property cannot be determined by reference to the transferor's basis in the property (*i.e.*, the property must be acquired in a taxable transaction).[36] Finally, Section 179(d)(3) provides that the cost of property does not include so much of the basis of such property as is determined by reference to the basis of other property held at any time by the person acquiring such property.[37]

C. Background to Proposed Regulations

Treasury and the Service published the Proposed Regulations in the Federal Register on August 8, 2018. Proposed Regulations Section 1.168(k)-2 generally updates the Prior 168(k) Regulations to reflect the Act's amendments to Section 168(k) and the effective date under Section 13201(h) of the Act. The Proposed Regulations also include conforming changes to certain other existing regulations, including those regarding the rehabilitation tax credit, the determination of earnings and profits, maintenance of capital accounts, contributions of property under Section 704(c) and basis adjustments under Section 743(b).

Proposed Regulations Section 1.168(k)-2(b) lists four requirements for depreciable property to constitute qualified property eligible for a Section 168(k) deduction. First, the property must be of a type described in Section 168(k)(2)(A)(i) or Section 168(k)(5)(B) and not subject to Section 168(k)'s various exclusions.[38] Second, the original use of the depreciable property must commence with the taxpayer or, if the property was previously used, the acquisition of the property must satisfy the No Prior Use Test and Unrelated Purchase Test. Third, the property must have been placed in service (within the meaning of the Proposed Regulations) by the taxpayer after September 27, 2017 and before January 1, 2027 (or, for LPP property and certain aircraft, January 1, 2028). Fourth, the property must be acquired by the taxpayer after September 27, 2017 or pursuant to a written binding contract entered into by the taxpayer after September 27, 2017.

---

35 *See* I.R.C. § 179(d)(2)(B).

36 *See* I.R.C. § 179(d)(2)(C).

37 *See* I.R.C. § 179(d)(3). Thus, upon any like-kind exchange, involuntary conversion or similar carryover basis transaction, Section 168(k) applies only with respect to the portion, if any, of the acquired property's basis produced by the acquiring taxpayer's payment of cash or other taxable transfer of property. *See* Treas. Reg. § 1.179-4(d).

38 For this purpose, qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property may constitute qualified property if acquired and placed in service by the taxpayer after September 27, 2017 and before January 1, 2018. *See* Prop. Reg. § 1.168(k)-2(b)(2)(i)(A). Qualified improvement property, a new statutory term added to Section 168 by the Act to cover these categories of depreciable property but not assigned a recovery period in an apparent drafting error, is not eligible for a Section 168(k) deduction if acquired on or after January 1, 2018. *See* Letter from Members of the Senate Finance Committee to Steven T. Mnuchin, Secretary of the Treasury, and David J. Kautter, Assistant Secretary of the Treasury for Tax Policy and Acting Commissioner of the Internal Revenue Service (Aug. 16, 2018). Some predict that, during the lame duck session following the 2018 elections, Congress will pass an extenders package that will contain technical corrections for the Act, including an amendment to address the above issue. *See*, *e.g.*, Stephen K. Cooper & David Van Den Berg, *Costly Extenders on Lawmakers' Lame Duck Action List*, 2018 TNT 208-5 (Oct. 26, 2018).

The Proposed Regulations contain several provisions clarifying and interpreting the No Prior Use Test and Unrelated Purchase Test. Under the Proposed Regulations, the acquired property cannot have been used by the taxpayer or a predecessor at any time prior to its acquisition.[39] For this purpose, property is treated as used by the taxpayer or a predecessor prior to its acquisition if the taxpayer or the predecessor had a depreciable interest in the property, whether or not the taxpayer or the predecessor claimed depreciation deductions for the property.[40] The Proposed Regulations also contain rules for applying the No Prior Use Test and Unrelated Purchase Test in special situations. In the case of a "series of related transactions," for purposes of applying the No Prior Use Test and Unrelated Purchase Test, property is treated as directly transferred from the original transferor to the ultimate transferee, and the relation between the original transferor and the ultimate transferee is tested immediately after the last transaction in the series (the "**Direct Transfer Recast Rule**").[41]

Several additional rules apply the No Prior Use Test and Unrelated Purchase Test within consolidated groups. As a general rule, the Proposed Regulations indicate that consolidated corporations are treated as separate taxpayers.[42] However, Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(B)(3)(i) provides that, where a member of a consolidated group uses or previously used an asset while a member of the consolidated group, the group is treated as having previously used the asset for purposes of the used property acquisition requirements of Section 168(k)(2)(E)(ii)(I), and, accordingly, the acquisition of the same asset by any other member of the consolidated group will not produce a Section 168(k) deduction (the "**Group Prior Use Test**"). In addition, the Proposed Regulations deny a Section 168(k) deduction where, as part of a "series of related transactions," a member of a consolidated group acquires qualified property and a corporation that previously used that property becomes a member of the consolidated group (the "**Stock/Asset Acquisition Rule**").[43] Finally, for purposes of the Group Prior Use Test and the Stock/Asset Acquisition Rule, where as part of a "series of related transactions" a member of a consolidated group both acquires property and the transferee ceases to be a member of the consolidated group, the taxpayer's membership in the consolidated group is tested immediately after the last transaction in the series.[44]

For partnerships, whether certain basis adjustments satisfy the No Prior Use Test and Unrelated Purchase Test depends on the Code section at issue. A basis adjustment under Section 743(b) that is attributable to qualified property is eligible for immediate expensing so long as the transferee partner (or its predecessors) did not have any depreciable interest in the portion of the property to which the Section 743(b) adjustment is allocated, and the acquisition of the partnership interest meets the requirements of the Unrelated Purchase Test by testing relatedness at the partner level.[45] Moreover, the preamble explains that this treatment is appropriate

---

39 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(1).

40 *See id.*

41 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(C).

42 *Proposed Regulations*, 83 Fed. Reg. at 39,295.

43 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(3)(ii).

44 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(3)(iii). We assume that, notwithstanding the use of three different nouns, the "member," the "transferee" and the "taxpayer" are all the same entity, which acquires property while a member of a consolidated group and then leaves the group.

45 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iv)(D).

notwithstanding that the transferee partner may have an existing interest in the underlying partnership property, because the transferee's existing interest is "distinct" from the interest transferred.[46] The Proposed Regulations exclude all basis adjustments under Section 732 and Section 734(b) and remedial allocations under Section 704(c).[47]

The Proposed Regulations also contain rules for applying the requirement found in Section 13201(h) of the Act that property must be acquired after September 27, 2017. The Proposed Regulations provide that qualified property does not include property acquired pursuant to a written binding contract entered into before September 28, 2017. The definition of a "binding contract" is consistent with the current one in Treasury Regulations 1.168(k)-1(b)(4)(ii). Self-constructed property may be qualified property if the taxpayer begins manufacturing, constructing or producing the property after September 27, 2017, unless the taxpayer has engaged another person to perform such manufacturing, construction or production pursuant to a written binding contract entered into before September 28, 2017.[48]

Proposed Regulations Section 1.168(k)-2(e) provides guidance on various elections available under Section 168(k). The rules for electing out of Section 168(k) are largely consistent with current Treasury Regulations Section 1.168(k)-1(e). In addition, the Proposed Regulations provide that a Section 743(b) adjustment attributable to a class of qualified property is eligible for immediate expensing without regard to whether the partnership elects out of immediate expensing under Section 168(k)(7) ("a **Section 168(k)(7) Election**") for all other qualified property in the same class of property and placed in service in the same taxable year.[49] Similarly, a partnership may make a Section 168(k)(7) Election for a Section 743(b) adjustment in a class of qualified property, and this election will not bind the partnership to such election for all other qualified property of the partnership in the same class of property and placed in service in the same taxable year.[50]

Finally, the Proposed Regulations contain special rules for qualified property placed in service and disposed of in the same taxable year, redeterminations of basis, depreciation recapture and other situations.

The Proposed Regulations generally will be effective when finalized, but a taxpayer may rely on the Proposed Regulations for qualified property acquired and placed in service after September 27, 2017, during taxable years ending after September 27, 2017, and ending before the taxpayer's taxable year that includes the date on which the Proposed Regulations are adopted.

III. COMMENTS

We appreciate the government's efforts to issue regulatory guidance on the Act's changes to Section 168(k) both promptly and in sufficient detail to address most taxpayer questions. Our comments below address a number of specific items in the Proposed Regulations and are, like

---

46 *Proposed Regulations*, 83 Fed. Reg. at 39,296-97.

47 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iv)(A) – (C).

48 *See* Prop. Reg. § 1.168(k)-2(b)(5)(iv)(A).

49 *See* Prop. Reg. § 1.743-1(j)(4)(i)(B)(1).

50 *See* Prop. Reg. § 1.168(k)-2(e)(1).

the Proposed Regulations themselves, highly varied. Broadly speaking, our comments fall into two categories: (i) partnership issues and (ii) definitional, consolidated group and other miscellaneous issues.

At the outset, we note that a fairly large number of our comments relate to the No Prior Use Test described above. Accordingly, it will be helpful to explain our understanding of that provision's purpose. The legislative history evinces a concern that taxpayers could abuse the used property acquisition option in Section 168(k)(2)(A)(ii).[51] We view the No Prior Use Test as a form of anti-abuse rule that is not aimed at a particular contemplated abuse[52] but rather at a class of transactions (acquisitions of used qualified property by previous users) that is likely to contain a higher percentage of abusive transactions than acquisitions of used qualified property generally. We agree with this determination and appreciate that Section 168(k)(2)(E)(ii)(I) requires no prior use without any qualifications. At the same time, however, we agree with the government's decision, in seeking comments on a possible safe harbor, to effectively exempt certain transactions in this suspect class where the risk of abuse is low. Unlike some other areas of the tax law in which anti-churning rules apply, such as Section 197, Section 168(k) applies to a broad range of assets that are relatively fungible and tradable in secondary market transactions. Given the volume of sales of qualified property that occur in the marketplace and the breadth of the definition of qualified property, it seems to us that it is inevitable that taxpayers on occasion will repurchase previously used qualified property. In our view, where a taxpayer that has previously used qualified property reacquires the property and seeks to obtain a Section 168(k) deduction, the reacquisition warrants additional scrutiny, but not always automatic disqualification, especially if the disposition of the property and the reacquisition do not occur pursuant to a plan or are separated by a significant period of time.[53]

A. Partnership Issues

The Proposed Regulations generally limit eligibility for immediate expensing to basis adjustments resulting from Section 743(b) adjustments and thus deny immediate expensing in the case of adjustments under Section 732(c) or Section 734(b) as well as with respect to notional depreciation deductions available in the case of partnerships that utilize the remedial allocation method under Treasury Regulations Section 1.704-3(d). According to the preamble, remedial allocations cannot satisfy the (i) No Prior Use Test because the partnership already has a depreciable interest in the contributed property at the time the remedial allocation is made, or (ii)

51 *See* H.R. REP. NO. 115-466, at 353 (2017) (Conf. Rep.) ("The provision removes the requirement that the original use of qualified property must commence with the taxpayer. Thus, the provision applies to purchases of used as well as new items. To prevent abuses, the additional first-year depreciation deduction applies only to property purchased in an arm's-length transaction.").

52 Neither the legislative history of the Act nor the Proposed Regulations appear to identify specific abuses relating to the No Prior Use Test.

53 *See* Treas. Reg. § 1.197-2(h)(5)(ii) (acquisition of intangible asset that was amortizable in seller's hands is exempt from the "anti-churning" rules in Section 197, provided that such transaction is not part of a series of related transactions that included the seller's prior acquisition).

the Unrelated Purchase Test because the partnership's basis in the contributed property is determined by reference to the contributing partner's basis in the property.[54]

In the preamble, the government explained that a Section 734(b) basis adjustment is ineligible for immediate expensing because the adjustment is made to the common basis of partnership property (*i.e.*, non-partner-specific basis) and the partnership used the property prior to the partnership distribution giving rise to the basis adjustment.[55] Therefore, the government concluded that a Section 734(b) basis adjustment fails both the original use requirement in Section 168(k)(2)(A)(ii) and the No Prior Use Test.[56] These rationales indicate that, outside of Section 743(b) adjustments, the government generally adopted an entity view of partnerships when assessing the eligibility of basis adjustments under Subchapter K for immediate expensing.[57]

Subchapter K treats a partnership as an aggregate of its partners for some purposes and as a separate entity for others.[58] As discussed in detail below, we believe that the aggregate theory of partnership taxation is the appropriate analytical approach for evaluating the transactions underlying the various basis adjustments (*i.e.*, the transactions should, for this purpose, be analyzed as transfers of qualified property between the applicable partners). That approach, which is effectively the approach the government adopted in the Proposed Regulations for Section 743(b) adjustments, is, we believe, the appropriate one in which to apply the No Prior Use Test and Unrelated Purchase Test for purposes of remedial allocations and Section 734(b) adjustments. Moreover, such an approach would largely parallel the approach adopted in the "anti-churning" rules for intangible property under Section 197.[59]

Adopting an aggregate approach to evaluating these Subchapter K issues does not, however, fully answer the question of whether immediate expensing is available. The question then becomes whether the transactions, as conceptualized under that approach, satisfy the requirements for immediate expensing. The government has already concluded that immediate expensing may be available in the case of some Section 743(b) adjustments. As the preamble indicates, in determining whether a Section 743(b) basis adjustment satisfies the No Prior Use Test, each partner is treated as having owned and used the partner's proportionate share of partnership property. Therefore, in the case of a transfer of a partnership interest, this test will be

---

54 *See Proposed Regulations, supra* note 2, 83 Fed. Reg. at 39,295-96.

55 *See id.* at 39,295-96.

56 *See id.*

57 The Proposed Regulations also would modify current Treasury Regulations Section 1.704-1(b)(2)(iv)(g)(3), which provides that, in the case of zero basis property, book depreciation, for purposes of maintaining partners' capital accounts, may be determined under any reasonable method selected by the partnership. The Proposed Regulations deem immediate expensing not to be a reasonable method, s*ee* Prop. Reg. § 1.704-1(b)(2)(iv)(g)(3), and the preamble explains that the government's approach results from the potential for shifting built-in gain among partners. *See Proposed Regulations* 83 Fed. Reg. at 39,296.

58 *See, e.g.*, Andrew W. Needham, *Bonus Depreciation: Basis Adjustments Under Subchapter K*, 160 TAX NOTES 41, 44-45 (July 2, 2018).

59 *See also* AMERICAN BAR ASSOCIATION TAX SECTION, COMMENTS ON SECTION 168(K) AS AMENDED BY P.L. 115-97 ON DECEMBER 22, 2017 (2018), *reprinted in*, 2018 TNT 111-17 (June 8, 2018) (suggesting that government adopt principles similar to those of Treasury Regulations Section 1.197-2(h)(12) with respect to treatment of Subchapter K basis adjustments for purposes of Section 168(k)).

satisfied if the partner acquiring the interest (or a predecessor of such partner) has not used the portion of the partnership property to which the Section 743(b) adjustment relates at any time prior to the acquisition, notwithstanding the fact that the partnership itself has previously used the property. Similarly, the Unrelated Purchase Test will be satisfied if the partner acquiring a partnership interest is not related to the partner who is transferring the partnership interest.

As discussed below, we believe that application of the aggregate approach in the remedial allocation method context should permit immediate expensing in many cases. By contrast, we do not believe that Section 734(b) basis adjustments should qualify for immediate expensing. While the transactions underlying those adjustments often bear meaningful economic resemblance to other adjustments that qualify (or that we think should qualify) for immediate expensing, we think that those adjustments raise additional issues and concerns because of the nature and allocation of Section 734(b) basis adjustments. Therefore, we cannot recommend unconditionally that the final regulations permit immediate expensing of those adjustments.

In addition, we propose that the government make several clarifications in the final regulations. Although we agree with the government's decision to evaluate Section 743(b) adjustments under an aggregate approach, the Proposed Regulations raise several issues regarding the proper application of the immediate expensing rules to those adjustments. We also recommend clarification of certain aspects of elections under Section 168(k)(7) as applied to partnership basis adjustments.

Finally, under the penultimate sentence of Proposed Regulations Section 1.168(k)-2(f)(1)(iii) (the "**Transferor Allocation Rule**"), if qualified property is transferred in a Section 721(a) contribution to a partnership that has as a partner a person (other than the transferor) who previously used the qualified property in the same taxable year that it is placed in service by the transferor, the Section 168(k) deduction is allocated entirely to the transferor, as opposed to having the partnership and the transferor share the deduction in accordance with Section 168(i)(7). While the Transferor Allocation Rule has advantages and disadvantages, we think that, on balance, permitting immediate expensing of remedial allocation deductions would largely obviate the need for the Transferor Allocation Rule. If the government does not permit immediate expensing of remedial allocations, we recommend certain changes to the approach in the Proposed Regulations.

Each of these topics is addressed in detail below.

1. Basis Adjustments Under Subchapter K

a. Section 743

There generally is no adjustment to the basis of partnership property when a partner transfers its interest in a partnership to another person.[60] However, if a partnership has properly made a Section 754 election (or there is a substantial built in loss), the partnership must adjust the basis of partnership assets upon a partner's sale or exchange of a partnership interest to provide the transferee with the equivalent of cost basis in its allocable share of the partnership's

[60] *See* I.R.C. § 743(a).

assets, just as though the transferee acquired a direct, undivided interest in the partnership assets. If the Section 754 election is in effect, the adjustment equals the difference between the transferee's basis in its partnership interest and the transferee's share of the adjusted basis of the partnership's assets.[61] The basis adjustment is an adjustment to the basis of the partnership's assets with respect to the transferee partner only and does not impact the partnership's computation of items of income, deduction, gain or loss at the partnership level or on other partners.[62] The basis adjustment generally is allocated first to property ("**ordinary income property**") other than capital assets and Section 1231(b) property (capital assets and Section 1231(b) property, collectively, "**capital gain property**")[63] to the extent of the income, gain or loss that would be allocated to the transferee in a deemed sale of the ordinary income assets for cash equal to their fair market value.[64] Any remaining basis adjustment generally is allocated to capital gain property.[65]

When a positive basis adjustment is allocated to depreciable property, the increase in basis is treated "as if it were newly-purchased recovery property placed in service when the transfer occurs."[66] Any applicable recovery period and method are used to determine the allowable depreciation deduction, and no change is made to the common basis in such property.[67]

b. Section 734

Another default rule under Subchapter K is that no adjustment occurs to the basis of partnership property upon a partnership's distribution to a partner.[68] If a Section 754 election is in effect, however, the partnership must adjust the basis of partnership property upon making a distribution in order to address discrepancies between inside and outside basis arising as a result of the distribution. Specifically, the Section 734(b) adjustment applies to a partnership with a Section 754 election in effect if (i) the distributee partner recognizes gain or loss on a distribution (a "**734(b)(1)(A) Adjustment**") or (ii) the distributee partner takes a basis in distributed property greater or less than the partnership's adjusted basis in the property immediately before the distribution (a "**734(b)(1)(B) Adjustment**"). The Section 734(b) adjustment increases the partnership's basis by the amount of any gain that the distributee partner recognizes in the case of a 734(b)(1)(A) Adjustment or by an amount equal to the excess of the partnership's adjusted basis in the distributed property over the distributee partner's basis in the property in the case of

---

61 *See* I.R.C. § 743(b).

62 *See* Treas. Reg. § 1.743-1(j)(1).

63 The portion of gain in Section 1231 property that is attributable to depreciation recapture generally is treated as a separate asset that is ordinary income property. *See* Treas. Reg. § 1.755-1(a)(1).

64 *See* Treas. Reg. § 1.755-1(b)(2)(i).

65 *See* Treas. Reg. § 1.755-1(b)(2)(i). The basis adjustment is further allocated to each item within the two classes in accordance with the income, gain or loss that would be allocated to the transferee from the sale of the item in the hypothetical cash transaction. *See* Treas. Reg. § 1.755-1(b)(3)(i)(A), (ii)(A).

66 *See* Treas. Reg. § 1.743-1(j)(4)(i)(B)(1).

67 *See id*. As discussed below, special rules apply where the partnership uses the remedial allocation method.

68 *See* I.R.C. § 734(a).

a 734(b)(1)(B) Adjustment.[69] Unlike adjustments under Section 743(b), the adjustment applies to the common basis of the partnership.[70]

Any basis increase under Section 734(b) must be allocated to partnership property in the same class (*i.e.*, capital gain property or ordinary income property) as the distributed property.[71] The increase is further allocated to any properties within the applicable class that have unrealized appreciation in proportion to the amount of such appreciation, with the remainder allocated to property within the class in proportion to fair market value.[72] If a cash distribution to a partner results in gain under Section 731(a)(1) and a corresponding 734(b)(1)(A) Adjustment, such adjustment may only be allocated to capital gain property, including the portion of Section 1231(b) property treated as capital gain property.[73]

The Section 734 regulations provide that an increase in the basis of depreciable property "must be taken into account as if it were newly-purchased recovery property placed in service when the distribution occurs."[74] Any applicable recovery period and method are used to determine the allowable depreciation deduction, and no change is made to the remainder of the property's basis.[75]

c. Remedial Allocations Under Section 704(c)

Section 704(c)(1)(A) requires the allocation for tax purposes of any income, gain, loss or deduction with respect to property contributed to a partnership with built-in gain or loss ("**Section 704(c) property**") "among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution."[76] The regulations require a "reasonable method" for allocating such items and offers the traditional method, the traditional method with curative allocations and the remedial allocation method as three methods that are "generally reasonable."[77]

Under the traditional method, the partnership allocates income, gain, loss or deduction to the Section 704(c) property "to avoid shifting the tax consequences of the built-in gain or loss."[78] However, the "ceiling rule" caps the amount of income, gain, loss or deduction that the partnership may allocate for any taxable year to the amount it actually recognizes.[79]

---

69 *See* I.R.C. § 734(b)(1); Treas. Reg. § 1.734-1(b)(1).
70 *See* Treas. Reg. § 1.734-1(d) (requiring only that the partnership attach a statement to the partnership return setting forth the computation of the Section 734(b) adjustment and the allocation thereof).
71 *See* Treas. Reg. § 1.755-1(c)(1)(i).
72 *See* Treas. Reg. § 1.755-1(c)(2)(i).
73 *See* Treas. Reg. § 1.755-1(c)(1)(ii).
74 *See* Treas. Reg. § 1.734-1(e)(1).
75 *See id.*
76 *See* I.R.C. § 704(c)(1)(A). Section 704(c)(1)(A), enacted in 2004, provides additional rules with respect to contributed built-in loss property.
77 *See* Treas. Reg. § 1.704-3(a)(1).
78 *See* Treas. Reg. § 1.704-3(b)(1).
79 *See* Treas. Reg. § 1.704-3(b)(1).

The remedial allocation method offers a way to eliminate the distortions caused by the ceiling rule.[80] Under this allocation method, if the ceiling rule would prevent a tax allocation from matching a book allocation, the partnership creates a remedial item to make up the difference, while simultaneously creating an offsetting remedial item in an identical amount allocated to the contributing partner.[81] Remedial allocations have the same attributes as the tax item limited by the ceiling rule.[82] Remedial allocations address ceiling rule shortfalls by replacing the unavailable tax depreciation with a notional deduction and thus generally convey the equivalent of a full step-up to the noncontributing partners.[83]

The remedial allocation regulations establish a separate framework for calculating depreciation deductions for depreciable property. This framework bifurcates the book value of the depreciable property as though it were two assets.[84] The first deemed asset has a book value equal to the adjusted tax basis of the asset, and the partnership recovers that book basis in the same manner and with the same recovery period as the adjusted tax basis.[85] The second deemed asset (the "**excess book basis asset**") equals the excess of the fair market value of the property over its adjusted tax basis. The partnership depreciates the excess book asset for book purposes using any recovery period and depreciation method available for newly purchased property.[86] The partnership then combines the book depreciation arising from the first asset with the book depreciation arising from the second asset and allocates the book depreciation to the partners under the partnership agreement (subject to Section 704(b)). The partnership allocates the tax depreciation to the noncontributing partner to the extent book depreciation was allocated to that partner and makes remedial allocations to the noncontributing partners to the extent that the book depreciation deductions exceed the tax depreciation deductions available under the ceiling rule.[87] In addition, the partnership must make remedial allocations of income to the contributing partner to offset the remedial allocations of depreciation.

Section 704(c) principles apply equally to property with a book value that differs from its basis arising from a "revaluation."[88] The Section 704(b) regulations permit revaluations immediately before certain events, including a contribution of money or other property by a new partner.[89] In a revaluation, the partnership adjusts the book value of its properties by adjusting them to fair market value and further reflecting the book gain or loss in the partners' capital accounts consistent with the economic agreement that would govern a sale of the properties for

---

80 *See id*. The Section 704(c) traditional method with curative allocations addresses the impact of the ceiling rule by reallocating partnership items of income, gain, loss and deduction. *See* Treas. Reg. § 1.704-3(c).

81 *See* Treas. Reg. § 1.704-3(c).

82 *See* Treas. Reg. § 1.704-3(d)(3).

83 *See* Needham, *supra* note 58, at 46.

84 *See* Treas. Reg. § 1.704-3(d)(2).

85 *Id.* Typically, the taxpayer must determine book depreciation at the same rate as tax depreciation. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(g)(3).

86 *See* Treas. Reg. § 1.704-3(d)(2).

87 *See* Treas. Reg. § 1.704-3(d)(7), Ex. 1.

88 *See* Treas. Reg. § 1.704-3(a)(6).

89 *See* Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)(i). The Section 704(b) regulations require that revaluations made in connection with the exercise of noncompensatory options be made immediately after the exercise. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(s)(1).

book value. The partnership then allocates future taxable income, gain, loss and deduction among the partners under the applicable Section 704(c) method.[90]

2. Adopt Aggregate Approach for Evaluating Basis Adjustments

We acknowledge that whether the basis adjustments contemplated by Section 734(b) (and Section 743(b)) and the notional depreciation deductions under the remedial allocation method satisfy the various components of the No Prior Use Test or the Unrelated Purchase Test depends on the analytical approach employed. For example, in the case of a 734(b)(1)(A) Adjustment resulting from a partnership's redemption for cash of a partner's outstanding interest, immediate expensing might appear to be unavailable because the partnership used the relevant qualified property before the acquisition. Similarly, in the case of a partnership that uses the remedial allocation method following the contribution of qualified property with Section 704(c) gain, immediate expensing might appear to be unavailable because the partnership acquired the qualified property in a carryover-basis exchange pursuant to Section 721. The purpose of the basis adjustments and remedial depreciation deductions, however, is to deliver to the "acquiring" partner the same amount of tax depreciation as such partner would have claimed in the event of an actual purchase of the relevant qualified property from the other partner(s).[91]

Section 197, which generally permits amortization deductions for acquired intangible property, including goodwill and going concern value, acquired from third parties ratably over a 15-year recovery period, is a useful analogy. Because the law generally did not permit taxpayers to amortize goodwill or going concern value before Section 197, Congress included a set of anti-churning rules to ensure that taxpayers did not purchase goodwill from a related party and claim amortization deductions. Under Section 197(f)(9), taxpayers may not amortize goodwill, going concern value or other intangibles not amortizable under prior law ("**Section 197(f)(9) intangibles**"), unless they are transferred after the effective date of the statute in a transaction giving rise to a significant change in ownership or use.[92]

The Section 197 regulations address the treatment of partnership-related basis adjustments under the anti-churning rules.[93] These rules generally deem a partner acquiring a partnership interest to acquire an undivided, proportionate share of all of the partnership's assets, including all of the Section 197(f)(9) intangibles.[94] Again, solely for purposes of the anti-churning rules, the regulations deem transactions involving the partnership to occur at the partner level by and among the applicable partners. In the case of Section 743(b) adjustments, these

---

[90] *See* Treas. Reg. § 1.704-3(a)(6).

[91] *See* Needham, *supra* note 58, at 43.

[92] *See* I.R.C. § 197(f)(9)(A). In general, a Section 197(f)(9) intangible is not amortizable if the taxpayer (or a related person) held the intangible before Section 197's enactment, or if the taxpayer has allowed any person that owned or used the intangible before enactment (or a person related to such person) to use the intangible.

[93] *See* Treas. Reg. § 1.197-2(h)(12)(i).

[94] *See id.* ("[E]ach partner is treated as having owned and used the partner's proportionate share of partnership property.").

rules deem a partner that transfers a partnership interest to transfer the partner's share of partnership property, including the Section 197(f)(9) intangible, to the transferee.[95]

Similarly, in the case of Section 734(b) adjustments, the anti-churning rules characterize (solely for this purpose) the continuing partners as acquiring from the distributee partner interests in the Section 197(f)(9) intangibles that remain in the partnership.[96] The anti-churning rules do not apply to the continuing partner's share of the basis adjustment to the intangible, so long as the continuing partner is not the distributee partner or related to the distributee partner.[97] The regulations compute each continuing partner's share of the basis adjustment allocable to a Section 197(f)(9) intangible in proportion to the continuing partners' capital accounts, as determined immediately after the distribution.[98]

The Section 197 regulations also provide rules to determine whether remedial allocations under Section 704(c) are deductible under the anti-churning rules. If a Section 197(f)(9) intangible was not amortizable in the hands of the contributing partner, the partnership generally may not amortize the intangible.[99] Nevertheless, a non-contributing partner may receive remedial allocations of amortization deductions if such partner is not related to the partner that contributed the intangible.[100] Similar rules apply for reverse Section 704(c) allocations arising from a Section 197(f)(9) intangible's revaluation.[101] A partnership may make remedial allocations of amortization with respect to a Section 197(f)(9) intangible if the partners receiving those allocations are not related to the partner receiving the remedial allocations of income.[102]

The Section 197 anti-churning rules address issues similar to those raised by Section 168(k). In determining whether a taxpayer used applicable intangible property before Section 197's effective date, Congress specifically mandated an aggregate theory of partnerships.[103] Treasury Regulations Section 1.197-2(h)(12) (the "**Section 197(f)(9) partnership regulations**") thus treats, for purposes of applying the anti-churning rules, (i) each partner as owning its allocable share of common partnership basis and (ii) any basis adjustment as a transfer of property between the relevant partners.

---

95 *See* Applying Section 197 to Partnerships, REG-100163-00, 65 Fed. Reg. 3903, 3903 (Jan. 25, 2000) [hereinafter *Proposed 197 Regulations*].

96 *See id*. at 3904.

97 More specifically, the regulations ask whether the continuing partner is an "eligible partner." *See* Treas. Reg. § 1.197-2(h)(12)(iv)(A). A continuing partner is an eligible partner if it is not the distributee partner or a person related to the distributee partner. Treas. Reg. § 1.197-2(h)(12)(iv)(B)(1). For this purpose, any continuing partner that makes a contribution to the partnership as part of the same series of related transactions that includes the distribution is deemed related to the distributee. Treas. Reg. § 1.197-2(h)(12)(iv)(B)(2).

98 *See* Treas. Reg. § 1.197-2(h)(12)(iv)(D)(1).

99 *See* Treas. Reg. § 1.197-2(h)(12)(vii)(B).

100 *See id.*

101 *See* Rev. Rul. 2004-49, 2004-1 C.B. 939.

102 *See id.*

103 *See* I.R.C. § 197(f)(9)(E) ("With respect to any increase in the basis of partnership property under section 732, 734, or 743, 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."); *see also* H. R. REP. NO. 103-213, at 692 (1993) (Conf. Rep.) (similar).

Several considerations would support applying those principles generally, and the principles of the Section 197(f)(9) partnership regulations in particular, to Section 168(k). First, Section 168(k)(2)(E)(ii)(I) and Section 197(f)(9) serve similar purposes. That is, both provisions deny taxpayers tax benefits stemming from the ownership of property based on a concept of prior "use" and employ similar language to achieve that end.[104] In addition, Congress was silent as to the interaction between Section 168(k) and Subchapter K, and the legislative history is silent as well. Accordingly, we believe that an appropriate framework is necessary for a proper evaluation of the underlying issues, and Section 197 supplies that framework.

The government, in our view, has the authority to treat a partnership as an aggregate of its partners in order to carry out the purposes of any provision of the Code, unless the provision in question clearly mandates entity treatment.[105] Aggregate treatment is inherent in the nature of the applicable basis adjustments and in remedial allocation deductions.[106] In addition, the Section 704(c) regulations expressly provide that the excess book basis created under the remedial allocation rules is depreciated under any method available to the partnership for newly purchased property of the same type.[107] Moreover, the regulations under Section 734(b) and 743(b) expressly provide that these basis adjustments constitute newly-purchased property that electing partnerships may depreciate pursuant to Section 168 over the "applicable recovery period."[108]

---

[104] *Compare* I.R.C. § 168(k)(2)(E) (property disqualified if "*used* by the taxpayer at any time prior to . . . acquisition" (emphasis added)), *with* I.R.C. § 197(f)(9)(A)(i) (property disqualified if "*held or used* at any time . . . on or before [the] date of enactment by the taxpayer or a related person . . . ." (emphasis added)). The concept of amortization historically has been considered similar to depreciation, and the Code specifically treats amortizable Section 197 intangibles as depreciable assets for Section 167 purposes. *See* I.R.C. § 197(f)(7); *see also*, *e.g.*, Treasury Regulations No. 94, Relating to the Income Tax under the Revenue Act of 1936, Art. 23(l)-3 (1936) ("Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses, and franchises.").

[105] *See* H.R. Rep. No. 83-2543, at 59 (1954) (Conf. Rep.) ("No inference is intended . . . that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions."). When interpreting the Code, courts have stated that the "proper inquiry" is whether "it is more appropriate to treat the partnership as an aggregate or collection of individuals than as a separate entity." *Holiday Vill. Shopping Ctr. v. United States*, 773 F.2d 276, 279 (Fed. Cir. 1985) (internal quotation marks omitted); *see also Casel v. Comm'r*, 79 T.C. 424, 433 (1982).

[106] *See* Needham, *supra* note 58, at 52.

[107] *See* Treas. Reg. § 1.704-3(d)(2).

[108] *See* Treas. Reg. § 1.734-1(e)(1); Treas. Reg. § 1.743-1(j)(4)(i)(B)(1). In 1984, the government issued proposed regulations under the ACRS anti-churning rules that were never finalized. These regulations did address the treatment of Section 734(b) and Section 743(b) transactions for purposes of ACRS, and would have denied a partnership the use of ACRS depreciation for any adjustment to the basis of property that did not itself qualify for ACRS under the anti-churning rules, *i.e.*, because the property was acquired by the partnership but owned or used prior to the enactment of ACRS by the partnership or a related person. *See* Prop. Reg. § 1.168-4(d)(8). We note that these proposed regulations were issued before the government provided that basis adjustments under Section 734(b) and Section 743(b) were to be treated as newly-purchased property for Section 168 purposes. *See* T.D. 8847, 64 Fed. Reg. 69903 (Dec. 15, 1999) (enacting Treas. Reg. § 1.743-1(j)(4)(i)(B) and Treas. Reg. § 1.734-1(e)(1)). Nor was the remedial

We endorse the determination in the Proposed Regulations to allow immediate expensing with respect to certain Section 743(b) basis adjustments. In addition, we respectfully recommend that the government generally adopt an aggregate approach in evaluating whether a particular transfer of qualified property satisfies the No Prior Use Test and the Unrelated Purchase Test. These determinations, therefore, would be made at the partner level.

a. Remedial Allocation Deductions

Applying an aggregate approach in determining Section 168(k) eligibility in the case of a partnership that uses the remedial allocation method, (i) to the extent of the "forward" Section 704(c) layer attributable to a contribution of qualified property to the partnership, the noncontributing partners would be treated as having purchased the qualified property directly from the contributing partner, and (ii) to the extent of the "reverse" Section 704(c) layer attributable to a permissible revaluation by the partnership, similar principles would apply to treat the deemed noncontributing partners as having purchased the qualified property directly from the deemed contributing partners. In each case, compliance with the No Prior Use Test and Unrelated Purchase Test would be tested at the partner level, and the partnership's status as a "prior user" of the property and potential related party would be disregarded.

We think that the government has ample authority under Section 704(c) to permit immediate expensing in the case of partnerships that use the remedial allocation method. Permitting immediate expensing in this context, in our view, would be fully consistent with the treatment of the excess book basis asset as newly purchased property under the Section 704(c) regulations and would further the congressional intent underlying the amendment to Section 168(k) in the Act, namely, to promote investment in qualified property. We believe that the decision whether to have the partnership elect the remedial allocation method is an appropriate matter for negotiation among the partners. The extension of immediate expensing to remedial allocations generally would not affect the fisc, so long as all the parties are in the same tax bracket. Although the Section 704(c) regulations already contain an anti-abuse rule,[109] if the government thought it were necessary, it could consider an anti-abuse rule in the Section 168(k) regulations to police situations in which there were potential rate differentials among the partners, *e.g.*, a corporation contributes qualified property to a partnership in which an individual is a partner, and the remedial income allocations are taxed at 21% while the remedial allocation deductions reduce income otherwise taxable at 37%.

We note that the initial proposed Section 197 anti-churning regulations did not allow remedial allocations of amortization of Section 197(f)(9) intangibles that were not amortizable in the hands of the contributing partner.[110] In permitting such deductions in the final regulations, the government explained that, "under section 704(c), remedial allocations treat the amortizable portion of contributed property like newly purchased property."[111] The government also noted

---

allocation method available yet. It only applies to contributions or revaluations of property after December 20, 1993. *See* Treas. Reg. § 1.704-3(f).

109 *See* Treas. Reg. § 1.704-3(a)(10).

110 *See* Former Prop. Reg. § 1.197-2(h)(5)(ii), 62 Fed. Reg. 2336, 2350 (Jan. 16, 1997).

111 T.D. 8865, 65 Fed. Reg. 3820, 3823 (Jan. 25, 2000).

the similarity between remedial allocations and "basis increases under section 743."[112] In our view, these same considerations strongly support the availability in the final regulations under Section 168(k) of immediate expensing for remedial allocation deductions.

b. Section 734(b) Adjustments

Applying the aggregate approach recommended above, a Section 734(b) basis adjustment attributable to qualified property arising from a partnership distribution to a distributee partner would be treated for Section 168(k) eligibility purposes as if the continuing partners purchased the qualified property directly from the withdrawing partner. Adoption of the aggregate approach alone, however, does not answer whether Section 734(b) adjustments attributable to qualified property should be eligible for immediate expensing.

There are policy arguments in support of permitting a Section 168(k) deduction with respect to a basis adjustment under Section 734(b). A Section 734(b) transaction resembles some of the transactions for which the government has decided to allow a Section 168(k) deduction (*e.g.*, a Section 743(b) transaction) or for which we have suggested a Section 168(k) deduction should be permitted (remedial allocation deductions). In addition, regulations provide that, like a basis adjustment under Section 743(b), a Section 734(b) basis adjustment is treated as newly purchased property, suggesting that both basis adjustments should come to the same result for most U.S. tax issues.[113]

We evaluate 734(b)(1)(A) Adjustments and 734(b)(1)(B) Adjustments separately below. Although we do not recommend at this time that immediate expensing should be available for either adjustment, we think that 734(b)(1)(A) Adjustments present a strong case for eligibility, and we suggest that the government consider this question in connection with its evaluation of the proposed regulations under Section 751(b) and Section 755.

i. <u>Section 734(b)(1)(A) Adjustments</u>

As stated above, a 734(b)(1)(A) Adjustment increases the partnership's basis by the amount of gain recognized by a distributee partner upon a partnership distribution. The triggering event is a taxable transaction in which the distributee partner recognizes gain that is considered gain from the sale or exchange of its partnership interest. For the reasons discussed above, we think it would be appropriate to view this transaction, for purposes of determining compliance with the No Prior Use Test, under aggregate principles as a transfer of the qualified property from the withdrawing partner to the continuing partners. Viewed this way, a 734(b)(1)(A) Adjustment may be analyzed as though the continuing partners purchased, for cash, the withdrawing partner's interest in any remaining qualified property. In addition, the Section 734 regulations already suggest the purchase-like nature of the basis adjustment allocable to depreciable property, providing that such increase is "taken into account as if it were newly-purchased recovery property placed in service when the distribution occurs."[114] In these respects, we think that 734(b)(1)(A) Adjustments can be viewed similarly to Section 743(b)

---

[112] *Id.*

[113] *See* Treas. Reg. § 1.734-1(e)(1).

[114] *See id.*

adjustments, which under the Proposed Regulations generally can qualify for immediate expensing.

In the preamble to the Proposed Regulations, the government denied immediate expensing for Section 734(b) adjustments allocable to qualified property on the grounds that the partnership is necessarily a previous user of the property. [115] However, our recommendation of an aggregate approach for evaluating eligibility for immediate expensing, if adopted, would necessarily address this concern and align the evaluation of 734(b)(1)(A) Adjustments and Section 743(b) adjustments, which the Proposed Regulations view through an aggregate approach.

Notwithstanding the strong arguments in support of extending immediate expensing to 734(b)(1)(A) Adjustments, we believe such adjustments raise several technical concerns under the proposed regulations to Section 751(b). Generally, Section 751(b) overrides the usual nonrecognition rules of Section 731 in the case of certain partnership distributions that alter a partner's interest in "unrealized receivables" and substantially appreciated "inventory items" (collectively, "**hot assets**"). For this purpose, qualified property is a hot asset to the extent of any gain that would be treated as ordinary income under Section 1245 if sold at fair market value.[116] Under the existing regulations, if a distribution results in an exchange of all or a portion of the distributee partner's interest in one class of assets for assets in the other class, the distributee partner is deemed to receive a distribution of the relinquished assets (immediately prior to the actual distribution) and then exchange the relinquished assets with the partnership for the acquired assets (the "**asset exchange approach**").[117] Partnerships with depreciated qualified property may be subject to these rules because a portion of any built-in gain is likely potential ordinary income under the Section 1245 depreciation recapture rules.

In November 2014, the government published proposed regulations that would make substantial revisions to the existing regulations under Section 751(b), Section 755 and related provisions (collectively, the "**Proposed 751 Regulations**").[118] In relevant part, the Proposed 751 Regulations provide that, once it is determined that a distribution is a Section 751(b) distribution, the partnership must use a "reasonable approach" consistent with the purpose of Section 751(b) under which, immediately prior to the Section 751(b) distribution, each partner with a Section 751(b) amount recognizes ordinary income (or eliminates a basis adjustment) equal to its respective Section 751(b) amount.[119]

---

[115] *See Proposed Regulations*, *supra* note 2, 83 Fed. Reg. at 39,296.

[116] *See* I.R.C. § 751(c).

[117] *See* Treas. Reg. § 1.751-1(b)(2).

[118] 79 Fed. Reg. 65,151 (Nov. 3, 2014), *as amended by* 80 Fed. Reg. 3926 (Jan. 26, 2015). For our report on these proposed regulations, see NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT # 1329 ON PROPOSED REGULATIONS UNDER SECTION 751(B) (2015), *reprinted in*, 2015 TNT 175-21 (Sept. 10, 2015) [hereinafter *2015 Report*]. We note that the Proposed 751 Regulations generally provide that a partnership may rely on the proposed rules in determining a partner's interest in hot assets on or after the date of publication of the proposed rules. Specifically, the Proposed 751 Regulations permit reliance only on Proposed Treasury Regulation Section 1.751-1(a)(2) (relating to the clarification of the amount of ordinary income that can be recognized under Section 751(a)), -1(b)(2) (relating to the determination of the Section 751(b) amount), and -1(b)(4) (relating to the anti-abuse rule).

[119] *See* Prop. Treas. Reg. § 1.751-1(b)(3)(i).

The Proposed 751 Regulations do not mandate a specific method, but suggest that the "hot asset sale approach" and the "deemed gain approach" generally would be considered reasonable. Very generally, under the hot asset sale approach, a partnership is deemed to distribute Section 751 property to the partner whose interest in the partnership's Section 751 property is reduced, and then the partner is deemed to sell the Section 751 property back to the partnership immediately before the actual distribution.[120] By contrast, the deemed gain approach would require that (i) a partnership recognize gain in its hot assets equal to the aggregate reduction in the partners' share of hot-asset gain, (ii) the gain be allocated to the partner(s) whose share of hot asset gain would otherwise be reduced, and (iii) appropriate basis adjustments be made to the partnership's assets to reflect the recognition of the hot asset gain.[121]

It is not clear the extent to which these basis adjustments would be eligible for immediate expensing or would be treated as failing the No Prior Use Test.[122] Accordingly, while strong arguments can be made in support of extending immediate expensing to 734(b)(1)(A) Adjustments, we think that, on balance, it would be appropriate for the government to consider this issue in connection with its consideration of its course of action on the Proposed 751 Regulations (including the proposed regulations under Section 755).[123]

In this regard, we note that the government previously observed, in connection with the finalization of the Prior 168(k) Regulations, that 734(b)(1)(A) Adjustments "allocable to qualified property under section 755 would have no correlation to the taxpayer's cost of the property."[124] We respectfully disagree and believe that there generally is a correlation between 734(b)(1)(A) Adjustments and the cost of qualified property. Within the class of capital gain property, a 734(b)(1)(A) Adjustment is allocated initially in accordance with relative appreciation in the assets and then in accordance with relative fair market values. Admittedly, the correlation is not perfect. These allocation rules create some distortion from what the allocation of a 734(b)(1)(A) Adjustment would be if the adjustment were based solely on fair market value.[125] First, no part of a 734(b)(1)(A) Adjustment is allocated to ordinary income property. Thus, a 734(b)(1)(A) Adjustment will increase the partnership's basis in capital gain property even if, economically, the adjustment is attributable to appreciation in a partnership's ordinary income property. Second, an allocation of the 734(b)(1)(A) Adjustment may cause the partnership's basis in particular assets to exceed their fair market value.

---

120 *See* Notice 2006-14, 2006-1 C.B. 498 (Feb. 2, 2006). For our report on the Notice, see NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT # 1122 RESPONDING TO NOTICE 2006-14 RELATING TO THE TREATMENT OF PARTNERSHIP DISTRIBUTIONS UNDER SECTION 751(B) (2006), *reprinted in*, 2006 TNT 230-8 (Nov. 30, 2006) [hereinafter *2006 Report*].

121 *See 2006 Report*. The Proposed 751 Regulations also clarify that a Section 734(b) adjustment allocable to depreciable property is not taken into account in determining the recomputed or adjusted basis in depreciable property for purposes of Section 1245(a)(1). *See* Prop. Reg. § 1.755-1(c)(2)(iii).

122 Our prior reports have noted the potential anti-churning issues raised by the deemed transactions occurring under the hot asset sale approach. *See 2015 Report*, *supra* note 118, at 12 n.16; *2006 Report*, *supra* note 120, at 51.

123 We note our recommendation in the 2015 Report encouraging Congress and Treasury to reevaluate the purposes of, and stakes involved with, Section 751(b) and consider whether the statute should be amended to make Section 751(b) operate far more narrowly as an anti-abuse rule.

124 *See* T.D. 9283, 71 Fed. Reg. 51,727, 51,736 (Aug. 31, 2006).

125 *See* Treas. Reg. § 1.755-1(c)(1)(ii).

Because of these distortions, we recommend that, if the government concludes that 734(b)(1)(A) Adjustments are eligible for immediate expensing, the amount of basis eligible for immediate expensing should be limited to the portion of the adjustment that does not cause the basis of the qualified property to exceed its fair market value at the time the adjustment arises.[126] In addition, as stated above, the portion of gain in Section 1231 property that is attributable to depreciation recapture generally is treated as a separate asset that is ordinary income property.[127] Accordingly, while we are mindful of the resulting complexity, we note that the government may wish to consider whether to impose a further limitation, such that a 734(b)(1)(A) Adjustment would be eligible for immediate expensing only to the extent that the adjustment would have been made to the asset if the adjustment were allocated among all partnership property (and not only capital gain property).

ii. Section 734(b)(1)(B) Adjustments

In addition to the reasons stated above, we believe immediate expensing of 734(b)(1)(B) Adjustments is inappropriate because, unlike the other adjustments discussed in this report, such an adjustment does not arise from the recognition of gain and, therefore, does not resemble a new investment attributable to a true, arm's length purchase. Stated differently, a 734(b)(1)(B) Adjustment is no more than a reallocation of basis from a distributed asset to remaining partnership property, the effect of which is to preserve aggregate unrealized gain or loss with respect to distributed and retained partnership assets. Permitting immediate expensing of these adjustments would thus result in an immediate deduction for the continuing partners, but gain deferral for the partner receiving the distribution.[128] Accordingly, we do not think that the final regulations should permit immediate expensing of 734(b)(1)(B) Adjustments attributable to qualified property.[129]

3. Proposed Modifications Relating to Section 743(b) Adjustments

a. Treasury Regulations Section 1.743-1(j)(4)(i)(B)(2)

Treasury Regulations Section 1.743-1(j)(4)(i)(B)(2) requires that a partnership using the remedial allocation method to recover the portion of any Section 743(b) increase allocable to

---

126 Thus, for example, if a partnership owns qualified property with a basis of $30 and a fair market value of $100, and a 734(b)(1)(A) Adjustment of $80 attached to the property, only $70 of the adjustment would be eligible for immediate expensing, and then only to the extent attributable to continuing partners unrelated to the distributee partner. We note that the Section 355(d) regulations contain a similar concept, limiting the extent to which a Section 734(b) adjustment to stock basis is treated as "purchased" for Section 355(d) purposes to the fair market value of the stock at the time of the adjustment. *See* Treas. Reg. § 1.355-6(d)(2)(v)(B).

127 *See* Treas. Reg. § 1.755-1(a)(1).

128 We recognize that Treasury Regulations Section 1.197-2 adopts a more taxpayer-friendly approach, but, for the reasons discussed above, we do not favor importing that treatment in the case of 734(b)(1)(B) Adjustments to Section 168(k).

129 We also agree with the determination in the Proposed Regulations that Section 732 basis adjustments attributable to qualified property should not qualify for immediate expensing. *See Proposed Regulations*, *supra* note 2, 83 Fed. Reg. at 39,296.

Section 704(c) built-in gain over the remaining recovery period for the partnership's excess book basis in the property, "as determined in the final sentence of Treasury Regulations Section 1.704-3(d)(2)."[130] Thus, while Section 743(b) generally treats the adjustment as new property with a new placed-in-service date, the regulations change this treatment to the extent of the remaining Section 704(c) gain inherited by the transferee partner. Instead, the recovery period is the useful life of the related Section 704(c) layer.

Although the purpose of this rule is to align the recovery period governing the adjustment with the remaining recovery period governing the remedial income to the transferee, it has the effect of precluding a Section 168(k) deduction. By contrast, if the partnership had used a different Section 704(c) method (such as the traditional method) with regard to the property, the related Section 743(b) adjustment would have been eligible for immediate expensing given that Treasury Regulations Section 1.743-1(j)(4)(i)(B)(2), by its terms, applies solely in the remedial allocation context. It generally is understood that the government favors the remedial allocation method because it eliminates ceiling rule distortions and that the special rule in Treasury Regulations Section 1.743-1(j)(4)(i)(B)(2) was intended to incentivize partnerships to use that method (and foster "fungibility" of interests in publicly traded partnerships). In addition, this special rule presumably was intended to benefit taxpayers by permitting cost recovery for a Section 743(b) adjustment over the shorter recovery period applicable to the remedial income for the related recovery property, rather than a longer, newly-created recovery period. The interaction of this special rule with Section 168(k), however, essentially reverses the effect of the special rule, which now discourages use of the remedial method and requires cost recovery with respect to Section 743(b) adjustments over a longer period of time. By effectively limiting the availability of a Section 168(k) deduction for acquirors of partnership interests that have made a cognizable capital investment in qualified property, this special rule, as applied in situations where immediate expensing is otherwise available, also arguably runs counter to Congress's intent in expanding the immediate expensing rules in the Act.

Based on the foregoing, a majority of the Executive Committee recommends that the government modify Treasury Regulations Section 1.743-1(j)(4)(i)(B)(2). Specifically, the government should permit a partnership to elect immediate expensing with respect to the portion of the Section 743(b) adjustment that is attributable to Section 704(c) built-in gain, even if the partnership is using the remedial allocation method with regard to that Section 704(c) gain.

On the other hand, for the reasons discussed below, a minority of the Executive Committee would recommend that the government make no change to Treasury Regulations Section 1.743-1(j)(4)(i)(B)(2). As currently written, the provision has the effect of aligning the period over which a purchasing partner may recover its Section 743(b) adjustment attributable to the Section 704(c) built-in gain with the period over which the corresponding remedial allocations of income are made. Immediate expensing of the Section 743(b) adjustment attributable to the Section 704(c) built-in gain would disadvantage the government from a timing

---

130 In general, Subchapter K does not require symmetry between the amortization by a purchaser of a partnership interest of its Section 743(b) basis adjustment and any related recognition of income or gain with respect to Section 704(c) property. *See generally* Gregory J. Marich & William S. McKee, *Sections 704(c) and 743(b): The Shortcomings of the Existing Regulations and the Problem of Publicly Traded Partnerships*, 41 TAX L. REV. 627 (1986).

perspective: deductions would be accelerated, while the corresponding remedial allocations of income would not.

b. Successive Transfers of Partnership Interests

Under Proposed Regulations Section 1.168(k)-2(b)(3)(iv), for purposes of applying the No Prior Use Test and Unrelated Purchase Test, the transfer of a partnership interest is treated as the transfer, by the transferor to the transferee, of a depreciable interest in the transferor's proportionate share of the underlying partnership property. If the partnership has a Section 754 election in place (or there is a substantial built in loss), any increase in basis of depreciable property under Section 743(b) may be eligible for immediate expensing, so long as the No Prior Use Test and Unrelated Purchase Test are met as between the transferor partner and the transferee partner. However, this rule's application is unclear where the transferee ("**T1**") disposes of the partnership interest in a Section 168(i)(7) transaction to a transferee ("**T2**") in the same taxable year in which T1 acquires the partnership interest. Ordinarily, under Proposed Regulations Section 1.168(k)-2(f)(1)(iii), the adjustment would be entitled to immediate expensing, notwithstanding the disposition, with the only consequence that T1 would share the deduction with T2 based on the number of months during the taxable year that T1 and T2, respectively, held the property. However, Proposed Regulations Section 1.168(k)-2(f)(1)(iii) applies, by its terms, solely to dispositions of qualified property. It does not apply to transfers of any other assets, including partnership interests, even if those interests correspond to Section 743(b) basis adjustments in qualified property.[131]

The uncertainty stems, in part, from the state of the law regarding Section 743(b) adjustments and transfers of partnership interests. Under Treasury Regulations Section 1.743-1(f), where there has been more than one transfer of a partnership interest, a transferee's basis adjustment is determined without regard to any prior transferee's basis adjustment. Under regulations proposed in 2014, however, if a partnership interest is transferred in a "substituted basis transaction" within the meaning of Treasury Regulations Section 1.755-1(b)(5), the transferee succeeds to any Section 743(b) basis adjustment of the transferor.[132] Under the approach of these proposed regulations, while T2 may succeed to T1's basis adjustment, T2's acquisition of the adjustment would not appear to satisfy the Unrelated Purchase Test. Instead, the acquisition appears to violate Section 179(d)(2)(C) (because the adjustment is inherited from T1) and possibly Section 179(d)(2)(A) (to the extent T1 and T2 are more than 50 percent related).[133]

We believe that the treatment of partnership interests should be aligned with the treatment of proportionate shares of qualified property. To this end, we recommend that the final

---

131 The rule in Proposed Regulations Section 1.168(k)-2(b)(3)(iv) that the transfer of a partnership interest is treated as the transfer of the underlying partnership property only applies for a limited purpose (determining compliance with the No Prior Use Test) and does not appear to recast the partnership interest, in whole or in part, as qualified property for purposes of Proposed Regulations Section 1.168(k)-2(f)(1)(iii).

132 *See* Prop. Reg. 1.743-1(f), 79 Fed. Reg. 3042 (Jan. 16, 2014).

133 We note that "self-help" may be available to the extent that T1 can close its taxable year before the transfer of the partnership interest to T2. *See* I.R.C. § 706(c)(2).

regulations provide that, for purposes of the rule currently in Proposed Regulations Section 1.168(k)-2(f)(1)(iii), a partnership interest is treated as a depreciable interest in the partner's proportionate share of the underlying partnership property.

4. Section 168(k)(7) Elections for Partnership Basis Adjustments

The Proposed Regulations flexibly interpret the Section 168(k)(7) Election rules with respect to partnership adjustments. Specifically, as we read the Proposed Regulations, they would permit the following: (i) if a partnership has made a Section 168(k)(7) Election with respect to a class of qualified property that the partnership owns, the partnership can immediately expense Section 743(b) adjustments allocable to property of the same class, (ii) a partnership may make a Section 168(k)(7) Election with respect to Section 743(b) adjustments allocable to qualified property of a certain class, even if the partnership does not make a Section 168(k)(7) Election for all of its qualified property in such class, (iii) a partner can immediately expense Section 743(b) adjustments allocable to qualified property held by the partnership, even if such adjustments are allocable to qualified property with respect to which the partner itself has made a Section 168(k)(7) Election, and (iv) a partnership can make inconsistent Section 168(k)(7) Elections with respect to different Section 743(b) adjustments.[134]

While we appreciate the above flexibility, we nonetheless recommend that the government require consistency in the final regulations. For instance, one approach, which would be simplest to administer, would provide that any election out of immediate expensing by a partnership with respect to its qualified property would apply equally to the partnership's common basis as well as any Section 743(b) basis adjustments. In addition, the partnership could not separately elect out of immediate expensing with respect to any Section 743(b) basis adjustments available to its partners.

Alternatively, the government might require that any Section 168(k)(7) Election with respect to partnership basis adjustments would have to be consistent with the relevant partner's treatment of qualified property in the same class. Under this alternative, a partnership could not elect out of immediate expensing for Section 743(b) adjustments with respect to a particular class of qualified property unless the applicable partner also elected out of immediate expensing for qualified property in the same class. This alternative arguably would harmonize with the general approach of the Proposed Regulations to analyze Section 743(b) adjustments at the partner (rather than the partnership) level.[135] However, in contrast to the first approach, the partnership's Section 168(k)(7) Elections with respect to partnership basis adjustments would not have to be consistent with the partnership's own treatment of qualified property. In addition, under this alternative, the partnership could make inconsistent Section 168(k)(7) Elections with respect to Section 743(b) adjustments among different partners.

Finally, if the government adopts our recommendation to permit immediate expensing with respect to remedial allocation deductions, we recommend that any Section 168(k)(7) Election with respect to such remedial allocations be treated consistently with the other Section 168(k)(7) Elections for partnership basis adjustments. For instance, if the government were to

---

[134] *See* Prop. Reg. § 1.168(k)-2(e)(1); Prop. Reg. § 1.743-1(j)(4)(i)(B)(1).

[135] *See Proposed Regulations*, *supra* note 2, 83 Fed. Reg. at 39296.

adopt our first suggested approach for imposing consistency with respect to Section 168(k)(7) Elections, then an applicable partnership would make any Section 168(k)(7) Elections with respect to remedial allocation deductions at the partnership level.

5. Transferor Allocation Rule

a. Introduction

Proposed Regulations Section 1.168(k)-2(f)(1)(i) preserves the rule under the current regulations that qualified property placed in service and disposed of during the same taxable year generally is not eligible for immediate expensing.[136] Both the current regulations and the Proposed Regulations contain an exception to this general rule that allows Section 168(k) deductions for qualified property despite a later disposition of the qualified property in the same taxable year if the acquiror effects the later disposition through a Section 168(i)(7) transaction (generally, a transfer in which basis carries over to the transferee).[137] As is the case in the current regulations, the transferor and transferee must share the deduction, with the deduction allocated between the transferor and transferee based on the number of months each holds the qualified property within the taxable year.[138] However, the Proposed Regulations would carve out an exception to Section 168(i)(7) for certain partnership contributions. Specifically, under the penultimate sentence of Proposed Regulations Section 1.168(k)-2(f)(1)(iii) (the "**Transferor Allocation Rule**"), if the qualified property is transferred in a Section 721(a) contribution to a partnership that has as a partner a person (other than the transferor) who previously used the qualified property in the same taxable year that it is placed in service by the transferor, the Section 168(k) deduction is allocated entirely to the transferor.

The Transferor Allocation Rule appears to have been crafted with transactions like Situation 1 of Revenue Ruling 99-5[139] (a "**Situation 1 Transaction**") in mind, although, as described below, this rule would cut considerably more broadly.[140] Consider the facts of Situation 1 with the following modifications. LLC owns qualified property with a basis of zero and a fair market value of $100. A owns all of the outstanding interests in LLC, which is disregarded as separate from A for U.S. tax purposes, and sells a 60-percent interest in LLC to an unrelated purchaser, B, for $60. The transaction is characterized for U.S. tax purposes as B's acquisition of a 60-percent interest in the qualified property, followed immediately by the contribution by A and B of their respective interests in the qualified property to a partnership in exchange for partnership interests in a Section 721(a) transaction. As a result of this characterization, A recognizes $60 of gain under Section 1001(a) on the sale of the 60-percent interest in the qualified property, and B takes a Section 1012(a) cost basis of $60 in its share of the qualified property. B's acquisition thus qualifies as a "purchase" under Section 179, and, if B is treated as placing the qualified property in service prior to B's deemed contribution to the

---

136 *See* Treas. Reg. § 1.168(k)-1(f)(1)(i).

137 *See* Treas. Reg. § 1.168(k)-1(f)(1)(iii); Prop. Reg. § 1.168(k)-2(f)(1)(iii).

138 The allocation is made in accordance with the rules in Treasury Regulations Section 1.168(d)-1(b)(7)(ii).

139 1999-1 C.B. 434.

140 *See Proposed Regulations*, *supra* note 2, 83 Fed. Reg. at 39,299 (describing a Situation 1 Transaction "as an example of . . . a fact pattern" to which the Transferor Allocation Rule would apply).

partnership, B is entitled to a Section 168(k) deduction of $60. B's deemed contribution under Section 721(a) of its interest in the qualified property to the newly formed partnership does not disqualify B from a Section 168(k) deduction under Proposed Regulations Section 1.168(k)-2(f)(1)(i) because a Section 721(a) contribution is a Section 168(i)(7) transaction. Without the Transferor Allocation Rule, B and the partnership must share in the resulting deduction, with the effect that A could be allocated $24 of the deduction (*i.e.*, 40 percent of $60) by virtue of its interest in the partnership. The Transferor Allocation Rule, however, allocates the entire deduction to B, precluding A from receiving any Section 168(k) benefit.

The proper treatment of Situation 1 Transactions and other partnership contribution transactions is difficult, and the government's approach embodied in the Transferor Allocation Rule offers both advantages and disadvantages. On balance, we believe that the Transferor Allocation Rule would be unnecessary for addressing Situation 1 Transactions and other partnership contribution transactions, and the complications the rule creates could be avoided, if the government adopts our recommendations regarding immediate expensing of remedial allocations. Alternatively, if the government does not permit immediate expensing of remedial allocations, we believe that certain changes to the Transferor Allocation Rule would be appropriate. We discuss below the advantages and disadvantages of the Transferor Allocation Rule before turning to the details of our recommendations.

i. Proposed Regulations' Approach

Initially, we acknowledge that the Transferor Allocation Rule has merit. It offers a straightforward, easily administrable rule for Situation 1 Transactions, which are common in everyday practice. The Transferor Allocation Rule also aligns the treatment of Situation 1 Transactions with the Proposed Regulations' treatment of Section 743(b) adjustments. Just as the Proposed Regulations consider the purchaser of a partnership interest as acquiring a proportionate share of the partnership's qualified property, so do the Proposed Regulations consider the purchaser in a Situation 1 Transaction as purchasing a proportionate share of the underlying qualified property. The Proposed Regulations reward both purchasers with all of the bonus depreciation.

However, the Transferor Allocation Rule has several flaws. First, it is unclear why the newly formed partnership in a Situation 1 Transaction should *never* be allocated bonus depreciation deductions. As the preamble to the Proposed Regulations makes clear, the Transferor Allocation Rule keeps bonus depreciation deductions away from the newly formed partnership out of a concern that the partnership could allocate the deductions to the seller.[141] The statute, however, generally allows a partnership to take bonus depreciation deductions on qualified property purchased from other than a majority partner. Section 179(d)(2)(A), as incorporated by Section 168(k)(2)(E)(ii)(I), excludes qualified property only if acquired from a person whose relationship to the acquiror would result in the disallowance of losses under Section 267 or Section 707(b). For a partnership acquiring qualified property from a partner, this means that the only acquisitions that are disqualifying under Section 179(d)(2)(A) are those from partners owning, directly or indirectly, more than 50 percent of the capital interests or the profits

[141] *See Proposed Regulations*, *supra* note 2, 83 Fed. Reg. at 39,299.

interests in the partnership. A partnership, therefore, could satisfy Section 179(d)(2)(A) and, assuming all other applicable requirements are met, immediately expense the cost of qualified property that it acquires from a 50-percent-or-less partner. The Transferor Allocation Rule, nonetheless, presupposes that a partnership should not immediately expense the cost of qualified property held by *any* partner. Indeed, the preamble to the Proposed Regulations appears to say as much.[142] We believe that presupposition is incorrect.

Second, the Transferor Allocation Rule creates discrepancies in the treatment of immediate expensing across different kinds of partnership formation transactions. For example, the Transferor Allocation Rule produces a result for Situation 1 Transactions that is much different from the result under the statute for the set of facts sometimes referred to as the "Missing Situation 3" of Revenue Ruling 99-5 ("**Situation 3 Transactions**"). Like in the Situation 1 Transaction described above, assume that A owns all of the outstanding interests in LLC, except that B contributes $60 cash to LLC in exchange for a 60-percent ownership interest, and LLC distributes $60 to A. Under Treasury Regulations Section 1.707-3(b)(1), the cash distribution is treated as a partial sale by A to the newly formed partnership, and A would recognize $60 of gain. However, B would be allocated only $36 (*i.e.*, 60% of $60) of the partnership's Section 168(k) deduction. It is unclear why different treatment of Situation 1 Transactions and Situation 3 Transactions is appropriate.[143]

The Transferor Allocation Rule's treatment of Situation 1 Transactions also contrasts with the treatment of transactions like Situation 2 of Revenue Ruling 99-5 ("**Situation 2 Transactions**"). Assume that B contributes $60 cash to the LLC in exchange for a 60-percent interest in LLC, which uses the contributed cash in its business. For U.S. tax purposes, A is treated as contributing the qualified property to the newly formed partnership in exchange for a 40-percent interest, while B is treated as contributing $60 in exchange for the 60-percent interest. Under the Proposed Regulations, because B is not considered to acquire any qualified property, B is not eligible for immediate expensing. The newly formed partnership is also ineligible for immediate expensing, because its basis in the qualified property is determined under Section 723 by reference to the basis of the qualified property in A's hands, which the Unrelated Purchase Test precludes. The reason, though, for treating Situation 1 Transactions differently is unclear: in both cases, B parted with $60, but only in Situation 1 is B eligible to claim immediate expensing.

Third, as noted earlier, the Transferor Allocation Rule sweeps more broadly than Situation 1 Transactions. Indeed, this special rule, by its terms, applies whenever qualified property is contributed in a Section 721(a) transaction to a partnership that has as a partner a

---

142 *See id.* ("The Treasury Department and the IRS believe that allocating any portion of the deduction to a partner who previously had a depreciable interest in the property would be inconsistent with section 168(k)(2)(E)(ii)(I).").

143 By way of comparison, we note that the Section 197 anti-churning rules align the treatment of Situation 1 Transactions and Situation 3 Transactions. *See* Treas. Reg. § 1.197-2(k), Exs. 17, 18. In the Situation 3 Transaction, this is because of the relationship between the contributing partner and the partnership (tested at a more-than-20-percent threshold). *See* Treas. Reg. § 1.197-2(h)(6). In the Situation 1 Transaction, this is because of a special rule in the Section 197 anti-churning regulations that tests whether the transferee in a nonrecognition transaction is related to a prior disqualifying user, even if the transferor is unrelated. *See* Treas. Reg. § 1.197-2(h)(10).

person (other than the transferor) who previously had a depreciable interest in the qualified property, provided that the contribution occurs in the same taxable year in which the qualified property is placed in service.[144] Thus, for example, assume that B purchases from A qualified property in a transaction otherwise eligible for immediate expensing, B immediately contributes the qualified property to a partnership for a 45-percent interest, A contributes cash for a 5-percent interest, and an unrelated party C contributes cash to the partnership for a 50-percent interest. In such case, the Transferor Allocation Rule would allocate all of the bonus depreciations deductions to B. Since A is a partner in the partnership, the partnership would be entitled to none of the deductions, and, thus, C would obtain no Section 168(k) benefit from its investment in the partnership. The rationale for applying the Transferor Allocation Rule in this context is unclear, especially because C, a third party that never held a depreciable interest in the qualified property, joins the partnership in a transaction tantamount to a purchase transaction, *i.e.*, the type of activity Congress sought to encourage in the Act.

Finally, the Transferor Allocation Rule, as with any bright-line rule, appears susceptible to manipulation. For example, assume that a taxpayer acquires and places in service qualified property in a transaction that is otherwise eligible for immediate expensing, and, in the same taxable year, the taxpayer contributes the qualified property to a partnership in a Section 721(a) transaction. Ordinarily, under Proposed Regulations Section 1.168(k)-2(f)(1)(iii), the taxpayer would surrender a portion of its bonus depreciation deductions to the partnership. However, the taxpayer might seek to enlist the seller of the qualified property to join the partnership, perhaps by assigning the seller only a 1-percent interest, in which case the Transferor Allocation Rule would apply to prevent any allocation of bonus depreciation deductions to the partnership. The Transferor Allocation Rule asks solely whether the seller is a partner in the partnership to which the qualified property is contributed. In this way, the Transferor Allocation Rule is easy to plan into, as all the parties need to do is issue a small partnership interest to the seller. If the Transferor Allocation Rule can easily be planned into, then the general rule of Proposed Regulations Section 1.168(k)-2(f)(1)(iii) can just as easily be avoided.

ii. Remedial Allocation Approach

Immediate expensing of remedial allocations, which we generally endorse above, would largely obviate the need for the Transferor Allocation Rule and generally avoid the problems identified above. Consider the Situation 1 Transaction described above, but without the Transferor Allocation Rule and assuming that remedial allocations can be immediately expensed. Under the fiction of Revenue Ruling 99-5, B is deemed to acquire a 60-percent interest in the qualified property for $60 and, so long as B is treated as placing the qualified property in service prior to B’s deemed contributed to the partnership, B receives a Section 168(k) deduction of $60. However, under Proposed Regulations Section 1.168(k)-2(f)(1)(i) and without the Transferor Allocation Rule, all $60 of the Section 168(k) deduction would be claimed by the newly formed partnership. Because B is a partner in the newly formed partnership, B does not lose the deduction entirely, but rather must share the deduction with A under the terms of the partnership agreement, $24 (*i.e.*, 40 percent) to A and $36 (*i.e.*, 60 percent) to B. Furthermore, if the newly formed partnership elects the remedial allocation method, A’s contributed property would be

[144] *See* Prop. Reg. § 1.168(k)-2(f)(1)(iii).

Section 704(c) Property (with a basis of zero and fair market value of $40) and B would be entitled to a remedial deduction of an additional $24 (*i.e.*, 40 percent of $60). For its part, A would receive a remedial allocation of income of $24. B has a total deduction of $60, and A receives no net benefit — precisely the same answer for the same transaction under the Transferor Allocation Rule.

In addition, allowing immediate expensing of remedial allocations generally would align the treatment of Situation 1 Transactions and Situation 2 Transactions under the Proposed Regulations. Under the facts of the Situation 2 Transaction described above, B would be entitled to a remedial allocation of $60 arising from the contribution of qualified property with built-in gain of $100. B ends up with the same benefit as it would in economically similar circumstances. Moreover, immediate expensing of remedial allocations would align both Situation 1 Transactions and Situation 2 Transactions with the purchase by B of a partnership interest where B would be entitled to expense its Section 743(b) adjustment.

Immediate expensing of remedial allocations also would bring Situation 1 Transactions and Situation 3 Transactions into closer alignment. In the Situation 3 Transaction described above, B would be entitled to a remedial allocation of $24 (*i.e.*, 60 percent of $40) arising from the portion of A's transfer of the qualified property to the partnership treated as a contribution under Treasury Regulations Section 1.707-3(b)(1), in addition to the $36 deduction resulting from the deemed purchase.[145]

Admittedly, reliance on immediate expensing of remedial allocations to address Situation 1 Transactions may create oddities of its own. Assume that LLC, which is again disregarded as separate from A, owns qualified property with a basis and a fair market value of $100, and A sells a 50-percent ownership interest in LLC to B for $50. For U.S. tax purposes, the transaction is treated as a purchase by B for $50 of a 50-percent interest in the qualified property, followed by the contribution by A and B of their respective interests in the qualified property to a newly formed partnership. Under Proposed Regulations Section 1.168(k)-2(f)(1)(iii), the $50 deduction that B receives from the purchase must be allocated entirely to the partnership, which in turn allocates it $25 to A and $25 to B. Because the portion of the qualified property that A contributes to the partnership has no built-in gain, it is not Section 704(c) Property, and no remedial allocations are available. A receives a benefit even though A previously held the property, and B receives less of a benefit (on a present value basis) than it would receive under the Transferor Allocation Rule.

Moreover, immediate expensing of remedial allocations will not precisely replicate the Transferor Allocation Rule in all cases, especially outside of Situation 1 Transactions. Assume

---

[145] We note that the Direct Transfer Recast Rule requires that the relationship between the original holder and the final transferee be tested after a series of related transactions, though, as discussed in Part III.B.3, below, it is unclear whether the Direct Transfer Recast Rule is meant to apply to Situation 1 Transactions. The Direct Transfer Recast Rule appears to contemplate that the ultimate transferee would ordinarily claim immediate expensing and, moreover, would deny the intermediate transferee any such deduction. *See* Prop. Reg. § 1.168(k)-2(b)(3)(vi), Ex. 18. However, the Proposed Regulations preclude the ultimate transferee in a Situation 1 Transaction (*i.e.*, the partnership) from claiming a Section 168(k) deduction, and instead the intermediate transferee receives the entire amount of the deduction. Accordingly, regardless of whether our recommendations regarding remedial allocations are adopted, the government may wish to clarify the possible application of the Direct Transfer Recast Rule in Situation 1 Transactions.

that, instead of owning qualified property through LLC, A directly owns qualified property, with a basis and a fair market value of $100, B buys the qualified property from A and contributes it to a partnership in which A is a 50-percent owner, and the partnership holds zero-basis goodwill contributed by A as the partnership's only other asset. As a result, the partnership will have a bonus depreciation deduction of up to $100, allocated up to $50 to A and up to $50 to B, and A's offsetting remedial income allocation from the amortization of the goodwill will likely be spread out over 15 years. This result, however, appears consistent with the statute because the partnership is not related to A or B.

While our recommended approach may not yield a perfect economic answer in every conceivable circumstance, we believe that, on balance, it is preferable to the Transferor Allocation Rule.

iii. <u>Modifications to Proposed Regulations' Approach</u>

If the final regulations do not permit immediate expensing of remedial allocations, we recommend that the Transferor Allocation Rule be retained, but note that the government may wish to revisit certain aspects of the rule.

First, the Transferor Allocation Rule does not contemplate transactions in which a person related to the prior user of the qualified property is a partner in the partnership. Assume that S1, a subsidiary of A, owns qualified property, and B purchases the qualified property from S1. In the same taxable year, B contributes the property to a partnership in which A is a partner. It appears that the Transferor Allocation Rule is not triggered in these circumstances, because S1 is not a partner in the partnership. The government may wish to consider expanding the Transferor Allocation Rule to cover situations like this by including a related party rule.

Second, the government may wish to consider limiting the Transferor Allocation Rule to situations in which the partnership is related to the prior user of the qualified property. While the preamble to the Proposed Regulations expresses concern that a prior user may receive any benefit, the statute itself denies immediate expensing only when the partnership and prior user are related. Narrowing the application of the Transferor Allocation Rule in this way would be consistent with the statute and with congressional intent.

Finally, to the extent that the government wishes to align the treatment of Section 743(b) adjustments and Situation 1 Transactions, it may consider whether a special rule is necessary for Section 168(k)(7) Elections with respect to Situation 1 Transactions. Under the Proposed Regulations and subject to the government's evaluation of our recommendation for consistency in Part III.A.4 above, the relevant partnership makes any Section 168(k)(7) Elections with respect to Section 743(b) adjustments, and this election does not appear to affect a partner's ability to claim immediate expensing with respect to qualified property of the same class that the partner owns directly. In the case of qualified property purchased pursuant to a Situation 1 Transaction, however, the partnership would not be the party to make a Section 168(k)(7) Election because the resulting deduction is at the partner level. This, in turn, means that whether or not a Situation 1 Transaction results in a Section 168(k) deduction depends on the relevant partner's applicable Section 168(k)(7) Elections for the taxable year. The Proposed Regulations do not provide purchasers in Situation 1 Transactions with the same flexibility in terms of Section 168(k)(7) Elections as partnerships currently enjoy with respect to such elections in the Proposed Regulations.

b. Clarification of Placement in Service

As discussed above, Proposed Regulations Section 1.168(k)-2(f)(1)(iii) applies when a transferor transfers qualified property in a Section 168(i)(7) transaction in the same taxable year that the transferor places the qualified property in service. The preamble to the Proposed Regulations implies that this rule is intended to capture Situation 1 Transactions,[146] but, as a technical matter, it is unclear whether the buyer in a paradigmatic Situation 1 Transaction would qualify. That is, by its terms, this rule requires that the transferor place the qualified property in service prior to the relevant nonrecognition transaction. In a traditional Situation 1 Transaction, however, the contributing partner would be deemed to hold the contributed property for only an instant. Property generally is considered to be placed in service when it is placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity or in a personal activity.[147] Because the buyer in a Situation 1 Transaction is only deemed to hold the contributed property for a moment, the buyer arguably would not meet this standard.[148]

At the same time, we note that there may be scenarios in which the purchaser in a Situation 1 Transaction arguably ought to be treated as placing the acquired assets in service, or otherwise arguably ought to be eligible for immediate expensing. For instance, assume that LLC operates a business and currently employs an asset in that business, and then B acquires an interest in LLC. Under the deemed transactions outlined in Revenue Ruling 99-5, the asset in question was actually in service (as that phrase is commonly understood) in the business at all relevant times: prior to B's purchase, during the brief period in which B was deemed to hold its interest in the asset directly and then after B's contribution to LLC as well.

Based on the foregoing, the government may wish to issue guidance clarifying that an asset acquired through a Situation 1 Transaction meets the "placed in service" requirement in the depreciation rules.

B. Other Issues

1. Safe Harbor for Prior Use

As described above, the Proposed Regulations request comments regarding whether a safe harbor should be created with respect to Section 168(k)(2)(E)(ii)(I) and Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(B)(1), disregarding certain prior "uses" that occur outside a specified lookback period.[149] We appreciate the government's recognition that an unlimited lookback period may impose a significant burden on taxpayers, and we endorse the adoption of an appropriate safe harbor, which we think would be a prudent exercise of the government's regulatory authority in this area.

---

[146] *See Proposed Regulations*, *supra* note 2, 83 Fed. Reg. at 39,299.

[147] *See* Treas. Reg. §§ 1.46-3(d)(1), 1.167(a)-11(e)(1)(i).

[148] *Cf. Acro Mfg. Co. v. Comm'r*, 334 F.2d 40, 43-44 (6th Cir. 1964) ("[T]he ownership of these assets for such a minimal, transitory period of only a few hours at the most was insufficient to establish use of the assets in the taxpayer's business or to place the taxpayer in the [applicable business] . . . .").

[149] *See Proposed Regulations*, *supra* note 2, 83 Fed. Reg. at 39,295.

a. Plan-Based Exemption

As an initial matter, while the preamble to the Proposed Regulations requests comments on a safe harbor with a lookback period consisting of a set number of years, we respectfully recommend that the final regulations instead incorporate a plan-based exemption for the No Prior Use Test. This exemption would treat an asset as previously used only if the prior use or disposition of the asset occurred pursuant to a plan that included the taxpayer's reacquisition of the asset.[150] Whether a plan, in fact, exists would be determined on the basis of all the facts and circumstances.

Because we view the No Prior Use Test as identifying a broad class of potentially abusive transactions for which additional scrutiny is appropriate, we think that the rule's efficacy would be increased by focusing on taxpayer intentions. Presumably, most abusive reacquisitions of qualified property will occur pursuant to a plan that includes the original use or disposition of such property. We believe that a plan-based exemption would disallow a Section a 168(k) deduction, and focus limited government resources, where the risk of abuse is highest and allow a Section 168(k) deduction where the risk of abuse is least. By contrast, a safe harbor that exempts reacquisitions based solely on the amount of time between a prior use or disposition and a reacquisition will permit some abusive transactions that fall within the safe harbor, while disallowing Section 168(k) deductions for other non-abusive transactions. As an example, a taxpayer might acquire qualified property and receive a Section 168(k) deduction, sell the property in the next taxable year (with the new owner receiving a Section 168(k) deduction) and lease the property back from its new owner, and then reacquire the property again once any applicable lookback period expired, receiving another Section 168(k) deduction. While each Section 168(k) deduction in this example arises out of an accompanying capital investment, it appears that the taxpayer in the example never intended to cease using the property in question, and the plan-based exemption we propose should, assuming the facts demonstrate as much, exclude the taxpayer's reacquisition as part of a plan with the taxpayer's earlier use and disposition of the property.

We also note that our recommended plan-based exemption may limit recordkeeping burdens. Taxpayers that do not repurchase assets pursuant to a plan with an earlier use or disposition could, in theory, undertake no additional recordkeeping with respect to the No Prior

[150] As noted below, if a plan-based exemption applied to situations in the Proposed Regulations in which one person is required to determine whether a second person previously used an asset (such as a consolidated group's need, under the Stock/Asset Acquisition Rule, to determine if corporations entering the group previously used assets that are being acquired as part of the same series of related transactions), the transaction should be exempt unless the second person's prior use or disposition of the asset occurred pursuant to a plan that included the transaction(s) prompting the prior use inquiry (e.g., in the case of the Stock/Asset Acquisition Rule, the series of related transactions that include an acquisition of qualified property and the admission to the relevant consolidated group of a corporation that previously used such qualified property).

Use Test, while additional recordkeeping burdens appear probable under any time-based safe harbor.[151]

On the other hand, we appreciate that a plan-based test could be difficult to police, and that taxpayer intentions can be difficult to discern or prove, both for the government and for taxpayers. Similar standards, however, operate in other provisions of the tax law, including in Section 355(e) and, to some degree, the Section 197 regulations[152] and the consolidated return rules. [153] We expect that a functioning plan-based exemption could be established with respect to the No Prior Use Test as well.

In addition, the tax law in some cases buttresses plan-based tests with time-based rules and presumptions.[154] We considered whether it would be viable or appropriate for a plan-based exemption from the No Prior Use Test to incorporate a rebuttable presumption that a plan existed until a certain number of years after the relevant prior use, with the opposite presumption applying thereafter. However, we note that any such time-based presumption would likely produce arbitrary results depending on when the relevant transactions occur, presuming some transactions occurring pursuant to an abusive plan to be within the safe harbor and presuming others not occurring pursuant to an abusive plan to fail to qualify for a Section 168(k) deduction. After considering the options listed above, on balance, we favor a pure plan-based exemption from the No Prior Use Test and do not recommend that the government adopt any time-based presumption or other time-based rules if it incorporates a plan-based exemption to the No Prior Use Test in the final regulations.

b. Other Alternative Potential Exemptions

i. <u>Exemption for Prior Use Absent Knowledge</u>

The government could also consider treating a person as previously using an asset for purposes of the No Prior Use Test only if the person possesses actual or constructive knowledge of the prior use. The broad exemption provided by such a rule might be appropriate given that it will be difficult for taxpayers to track the prior use and ownership of less valuable assets, especially when acquired in the used property market. In addition, such an exemption would be in line with other provisions of the tax law that apply a presumption regarding ownership in the

---

151 We appreciate that some taxpayers might still undertake additional recordkeeping on account of the No Prior Use Test even if a plan-based exemption existed in order to be able to demonstrate through contemporaneous documentation that a subsequent reacquisitions did not, in fact, occur as part of a plan.

152 C*f.* Treas. Reg. § 1.197-2(h)(5)(ii) (using "series of related transactions" standard).

153 *Cf., e.g.*, Treas. Reg. § 1.1502-13(j)(4) (grouping intercompany transactions that are "part of the same plan or arrangement" for purposes of adjusting tax results to achieve single company treatment).

154 *See, e.g.*, I.R.C. § 355(e)(2)(B) (presuming for purposes of Section 355(e) that an acquisition of a 50-percent or greater interest in the distributing or controlled corporation that occurs within 2 years of the relevant distribution occurs pursuant to a plan with the distribution); *cf.* I.R.C. § 338(d)(3) (purchases within 12-month acquisition aggregated in determining if qualified stock purchase occurs); Treas. Reg. §§ 1.1502-35(d)(4)(ii)(A) (similar rule), 1.385-3(b)(3)(iii)(A) (covered debt instrument treated as funding any covered distribution and or acquisition occurring within 36 months of instrument's issuance).

absence of actual knowledge to the contrary.[155] Because taxpayers will have greater ability to track the prior use and ownership of certain types of items, this rule could provide that a taxpayer has constructive knowledge of the prior use of an asset with a fair market value exceeding a particular threshold, or of the prior use of certain kinds of assets with researchable chains of title, such as aircraft or other vehicles.

ii. Recovery Period-Based Safe Harbor

Another possible alternative would be a lookback period measured by reference to the recovery period for an applicable item of property, such as the lesser of the property's recovery period or a set number of years.[156] Such a rule would presumably address most potential abusive transactions as it would not permit immediate expensing for reacquired property until the property had lost at least a significant portion of its value.[157] While such a rule seems harsh, we note that an asset's actual useful life likely exceeds its recovery period under Section 168 in many cases (given accelerated depreciation), meaning that assets subject to this rule would likely have at least some useful economic life remaining at the time they became subject to reacquisition in transactions for which immediate expensing was available. In addition, imposing a limit on the number of years in the lookback period could lead, of course, to disparate treatment of different types of assets. For instance, with a lookback period consisting of the lesser of 10 years and the asset's recovery period, a 5-year asset with an actual useful life of 6 years could be repurchased in a transaction eligible for immediate expensing during a 1-year period (or for approximately 17% of the asset's useful life), while a 20-year asset with an actual useful life of 24 years could be repurchased in a transaction eligible for immediate expensing during a 14-year period (or for approximately 58% of the asset's useful life). Finally, the great variability of lookback periods would presumably limit the administrability benefits at which any proposed safe harbor presumably would be aimed.

c. Options for Temporal Safe Harbor / Lookback Period of Set Number of Years

If the government does not incorporate a plan-based exemption to the No Prior Use Test in the final regulations, and instead incorporates a safe harbor with a lookback period consisting

[155] *See, e.g.*, Temp. Reg. § 1.382-2T(k)(1)(i) (presumption that certain 5% shareholders may be identified through Schedule 13D and 13G filings in absence of actual knowledge to contrary under Section 382); Treas. Reg. § 1.367(a)-3(c)(5)(iii) (similar rule in definition of five-percent target shareholder for purposes of Section 367(a) rules on transfers of stock and securities by U.S. person to foreign corporation); Treas. Reg. § 1.355-7(h)(8) (similar rule in definition of five-percent shareholder for purposes of Section 355(e) rules). Similar presumptions that operate in the absence of knowledge to the contrary also exist with respect to non-ownership rules in the Code. *See, e.g.*, Treas. Reg. § 1.1441-1 (permitting withholding agents to make various assumptions regarding payee or beneficial owner tax status absent actual knowledge or reason to know of actual tax status).

[156] *See* Capitol Tax Partners, LLP, Comment Letter on Proposed Section 168(k) Regulations, *reprinted in* 2018 TNT 193-19 (Oct. 4, 2018).

[157] Because of the lower value, the reacquiring taxpayer would pay a reduced amount for the property, and the amount of the Section 168(k) deduction would likewise be reduced, along with the risk that taxpayers might plan into such a transaction for abusive reasons.

of a set number of years, the government will have numerous options for selecting the appropriate number of years. There is precedent in the tax law for lookback periods (or similar provisions) that apply a 12-month period,[158] a 2-year period,[159] a 3-year period,[160] a 5-year period,[161] or a 10-year period,[162] among other timeframes.[163]

We do not take a position as to the appropriate lookback period if Treasury and the Service decide to establish this type of safe harbor to the No Prior Use Test, but we do offer

---

158 *See, e.g.*, I.R.C. §§ 338(d)(3) (12-month aggregation period for a "qualified stock purchase"), 382(h)(8) (aggregation of "a series of related transactions during any 12-month period"); Treas. Reg. §§ 1.336-1(b)(6)(i) (12-month aggregation period for a "qualified stock disposition"), 1.368-2(c) (aggregation of stock acquisitions occurring over "a relatively short period of time such as 12 months" for Section 368(a)(1)(B) purposes), 1.1503-2(g)(2)(iii)(A)(4), (5), (7) (references to acquisitions in "a series of transactions" within "a twelve-month period" in dual consolidated loss regulations).

159 *See, e.g.*, I.R.C. §§ 355(e)(2)(B) (2-year period before or after a distribution during which actions are presumed to occur pursuant to a plan for purposes of Section 355(e)), 7874(c)(3) (foreign corporation's acquisition of substantially all properties of domestic corporation or partnership within 2 years before or after satisfying ownership requirements for surrogate foreign corporation status treated as part of plan for purposes of Section 7874), 336(d)(2)(B)(ii) (acquisition of property within 2 years prior to liquidation treated as part of plan to recognize loss for purposes of Section 336(d)(2)(B)(i)(II)); *see also* Treas. Reg. § 301.6532-1(a) (2-year period to file suit for recovery of tax after mailing of notice of disallowance of claim).

160 *See, e.g.*, I.R.C. §§ 382(i)(1) (3-year testing period for Section 382 ownership change), 332(b)(3) (complete liquidation can occur through distributions over 3-year period); Treas. Reg. §§ 1.7874-8(g)(4)(i) (3-year lookback period for prior domestic entity acquisitions under the Section 7874 serial inverter rule), 1.385-3(b)(3)(iii)(A) (3-year lookback period and 3-year look-forward period for covered acquisitions and distributions under the "per se" funding rule in the debt-equity regulations), 1.305-3(b)(4) (distribution or series of distributions of stock more than 3 years before or after receipt of cash or property by some shareholders not pursuant to the same plan presumed not to be a disproportionate distribution for purposes of Section 305); *see also* I.R.C. § 6511(a) (3-year period from time of return filing for filing of refund claim).

161 *See, e.g.*, I.R.C. §§ 1374(d)(7) (5-year recognition period for built-in C corporation gain of S corporations), 355(a)(3)(B) (stock acquired in taxable transaction within 5 years of distribution treated as boot under Section 355), 355(b)(2)(B) (trade or business relied upon for tax-free distribution under Section 355 must be actively conducted for 5 years before distribution), 382(h)(7)(A) (5-year recognition period after ownership change under Section 382); *see also* I.R.C. §§ 1362(g) (5-year waiting period to elect S corporation status after taxable year of termination of election), 1504(a)(3) (5-year waiting period to reconsolidate corporation), 871(d)(2) (5-year waiting period to elect to treat income from U.S. real property as effectively connected after revoking such election).

162 *See, e.g.*, I.R.C. §§ 302(c)(2) (10-year testing period for termination of interest in redeeming corporation), 864(c)(7) (income and gain attributable to disposition of property that was used in U.S. trade or business within prior 10-year period treated as arising from disposition occurring while property was still used in U.S. trade or business), 514(b)(3) (land acquired for use exempt use within 10 years may avoid classification as debt-financed property); Temp. Reg. § 1.337(d)-7T(f)(1)(i) (10-year lookback period for purposes of temporary REIT spinoff regulations); *see also* I.R.C. § 877(a)(1) (expatriation tax applicable to persons that lost U.S. citizenship in 10-year period preceding close of current taxable year).

163 Other timeframes certainly occur in the tax law, though more rarely than those listed above. *See, e.g.*, I.R.C. § 965(h) (election permitting taxpayers to elect to pay transition tax amount over 8-year period); Treas. Reg. § 1.702-3T (permitting partners to include income from multiple partnership taxable years over 4 taxable years where the inclusion of income from multiple taxable years occurred due to changes to the rules for partnership taxable years in the Tax Reform Act of 1986).

some observations that the government may wish to consider. As a general matter, we note that a lengthy lookback period could deny access to a safe harbor for many shorter-lived types of assets, because their useful lives generally will expire before any taxpayer has a chance to reacquire them in a qualifying transaction. A longer lookback period also may create significant recordkeeping burdens for taxpayers, as it will be difficult to track the comings and goings of individual assets, some of which may never be identified by a serial number in business records.[164] The relatively broad reach of the No Prior Use Test, coupled with the lack of any specific abuse identified in the legislative history, might militate in favor of a shorter lookback period.

On the other hand, we recognize that an extremely short lookback period could sap the No Prior Use Test of any independent vitality, especially given that multiple acquisitions of an item of qualified property within a single taxable year generally would already disallow immediate expensing under existing rules.[165] The No Prior Use Test is a statutory rule, adopted by Congress as an integral component of its expansion of the immediate expensing rules in the Act. Accordingly, choosing a safe harbor with a lookback period consisting of a set number of years will require the government to appropriately balance the taxpayer burdens and other factors weighing in favor of a shorter lookback period with the need to retain an effective No Prior Use Test that implements congressional intent.

d. Recommendation that Safe Harbor Extend to Analogous Provisions

Additionally, we note that the preamble to the Proposed Regulations mentions the possibility of a safe harbor and lookback period only with respect to the No Prior Use Test. We recommend, however, that any safe harbor or other exemption incorporated in the final regulations apply not only for purposes of assessing compliance with the No Prior Use Test, but also to certain analogous provisions of the Proposed Regulations that similarly require taxpayers to locate prior uses of acquired property.[166] For instance, if the final regulations adopt the plan-based safe harbor recommended in Part III.B.1.a above, this safe harbor also would apply in the determination (i) by one member of a consolidated group as to whether any other current or former member of such group has previously used acquired assets for purposes of the Group Prior Use Test,[167] (ii) by a member of a consolidated group, for purposes of the Stock/Asset Acquisition Rule, whether any corporation that becomes part of the same consolidated group in a series of related transactions has previously used assets acquired as part of the same series of related transactions,[168] and (iii) by a partnership, for purposes of Proposed Regulations Section 1.168(k)-2(f)(1)(iii), whether any partner in the partnership previously used assets contributed to the partnership by a contributing partner that has received a Section 168(k) deduction for such

---

164 *See* I.R.C. § 168(k)(2) (defining "qualified property").

165 *See* Treas. Reg. § 1.168(k)-1(f)(1)(i); Prop. Reg. § 1.168(k)-2(f)(1)(i).

166 Alternatively, if the government adopted a presumption against prior use for low-value assets or adopted a lookback period for assets based on recovery periods, either of those safe harbors simply would change the length of time a taxpayer must verify another person's prior use of assets or change the types of assets for which prior use must be verified.

167 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(3)(i).

168 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(3)(ii).

assets. Similarly, if the government selected a solely temporal safe harbor in the final regulations, then we believe that it should apply in making these determinations as well.[169]

This additional change, in our view, would promote the administrability and consistency of the final regulations by avoiding the burdens and confusion that would attend multiple conflicting lookback analyses in a single regulatory package. In addition, we believe that such a change is appropriate because these analogous provisions generally would be even more difficult than the No Prior Use Test for taxpayers to comply with if required to look back over an unlimited period of time, because each provision requires the taxpayer to gather information about the prior uses of property by other persons who may not be incentivized to share such information, may be entirely unwilling to do so or in some cases may even be legally or contractually barred from doing so.

2. Definitional Issues

a. "Depreciable Interest"

As described above, the Proposed Regulations implement the No Prior Use Test for acquisitions of used property by treating a taxpayer as having previously used an asset if the taxpayer or a predecessor previously held a "depreciable interest" in the asset, whether or not the taxpayer or a predecessor previously claimed depreciation deductions for the asset.[170] We do not take a position on the suitability of measuring "use" in terms of holding a depreciable interest, but note the possibility that the Proposed Regulations may consider a taxpayer not to have "used" an asset for purposes of the No Prior Use Test notwithstanding actual use (as that term is commonly understood). For instance, where a taxpayer leases a business asset and then employs the asset in its business, the taxpayer clearly "uses" the asset under the dictionary definition of the term. However, because the lessee taxpayer generally could not depreciate its interest in the leased asset,[171] the Proposed Regulations indicate that the taxpayer did not hold a depreciable interest in the asset and, upon acquiring a fee interest in the asset in an otherwise-qualifying acquisition, the taxpayer could qualify for immediate expensing with respect to the amount paid.[172] We note that this deviation from the plain meaning of "use" is obviously favorable to taxpayers.

i. <u>Clarity of Definition</u>

The Proposed Regulations do not define the phrase "depreciable interest," and the phrase is not used in either the statute or the Prior 168(k) Regulations. The phrase is used in several

---

169 *See* Prop. Reg. § 1.168(k)-2(f)(1)(iii).

170 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(1).

171 The taxpayer, of course, could depreciate its interest in any leasehold improvements made upon the leased asset, and therefore likely holds a depreciable interest in such leasehold improvements. *See* Prop. Reg. § 1.168(k)-2(b)(3)(vi), Ex. 8. The Proposed Regulations provide that, in such a case, if the taxpayer later acquires the leased property (including the leasehold improvements), immediate expensing is available solely with respect to the portion of the property's basis not attributable to the leasehold improvements. *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(1).

172 *See* Prop. Reg. § 1.168(k)-2(b)(3)(vi), Ex. 6.

examples in the Proposed Regulations that indicate a depreciable interest exists where a taxpayer holds an asset and is eligible for depreciation deductions with respect to that asset, but does not exist where a taxpayer holds an asset and is not so eligible.[173] This phrase appears to arise from Section 167 and case law and other authority interpreting the requirements to take a depreciation deduction (not all of which use the phrase "depreciable interest"). These authorities generally have likened a depreciable interest to a fee interest in, or "tax ownership" of, an asset.[174]

In the absence of a definition, it is unclear whether the phrase "depreciable interest" in the Proposed Regulations is intended to have the same meaning as that phrase has in the Section 167 authorities. Alternatively, the Proposed Regulations may intend that a "depreciable interest" exist only where a taxpayer has tax ownership of an asset *and* has placed the asset in service in its business, or only where a taxpayer has tax ownership, has placed the relevant asset in service in its business *and* could qualify for a depreciation deduction but foregoes the deduction.[175] Numerous other more specific questions could also arise.[176]

In many cases, taxpayers' general understanding of the meaning of the phrase "depreciable interest" may suffice. On the other hand, we note that, under the Proposed Regulations as drafted, "depreciable interest" is the key phrase in Section 168(k)'s expansion to acquisitions of used property, and its meaning, therefore, will be key for many taxpayers. It presumably would be relatively straightforward to add language to the final regulations directing taxpayers to Section 167 for the meaning of "depreciable interest" or otherwise defining the phrase in accordance with its apparent meaning.

For these reasons, we recommend that the government clarify the definition of "depreciable interest" in the final regulations.

---

173 *See, e.g.*, Prop. Reg. § 1.168(k)-2(b)(3)(vi), Ex. 6-8.

174 *See, e.g.*, LAFA 2004-23-03F (June 4, 2004) (citing authorities on meaning of "depreciable interest"). Several authorities appear to have defined a depreciable interest as consisting solely of an ownership interest in an asset, separate from any requirement to place the asset in service. *See, e.g.*, Rev. Proc. 2007-48, § 3(4), 2007-2 C.B. 110 (Revenue Procedure for treating rotable spare parts as depreciable assets applies only when the taxpayer "has a depreciable interest in the rotable spare parts and [also] has placed in service the rotable spare parts after 1986"); Rev. Rul. 79-255, 1979-2 C.B. 17 ("in order to obtain the investment credit with respect to a qualified film, a taxpayer must have an ownership interest in at least a part of the film. That is, the taxpayer must have a depreciable interest in at least a part of the film.").

175 With respect to the placement in service requirement, as stated in Part III.A.5.b above, existing law generally considers property to be placed in service when it is placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity or in a personal activity. *See* Treas. Reg. §§ 1.46-3(d)(1), 1.167(a)-11(e)(1)(i).

176 For example, what if a taxpayer is able to take a deduction with respect to an asset's cost, but the deduction is not clearly "depreciation"? Is an interest in a live theatrical production, the cost of which is eligible for expensing under Section 181 or Section 168(k), a depreciable interest? Arguably, any interest for which immediate expensing is available must be a depreciable interest, as defined in the Proposed Regulations, or else taxpayers could "churn" property back and forth without the restrictions of Section 168(k)(2)(E)(ii)(I).

ii. <u>Situations Where Statute or Prior 168(k) Regulations Disregard Prior Use</u>

As described above, portions of Section 168(k) and the Prior 168(k) Regulations continue to allow immediate expensing for acquired property the original use of which commences with the taxpayer. Under these authorities, however, certain instances of transitory ownership of an asset prior to its acquisition by the relevant taxpayer may be disregarded in determining whether the taxpayer makes an original use of the asset. Specifically, among certain other exceptions,[177] the statute or the Prior 168(k) Regulations disregard for purposes of the original use requirement: (i) a person's use of an asset for 3 months or less if the person then sells the property to the taxpayer and the taxpayer leases the property back to the original user (the "**Sale-Leaseback Exception**"),[178] (ii) a syndicator-lessor's use of an asset for a 3-month period (or longer under certain circumstances[179]) so long as the syndicator-lessor sells the asset within that period and the lessee that is the end user of the asset remains the same (the "**Syndication Exception**"),[180] and (iii) certain temporary uses of an asset by a seller whose business includes the sale of fractional interests in such assets, so long as the fractional interests in the asset remain held primarily for sale to customers during the course of the temporary use (the "**Fractional Interest Exception**" and together with the Sale-Leaseback Exception and the Syndication Exception, the "**Transitory Use Exceptions**").[181]

Does the original transitory user in each of these situations hold a depreciable interest in the asset in question for purposes of the No Prior Use Test? Each original transitory user appears to hold a fee interest and to be the "tax owner" of the asset for a brief period of time. The Proposed Regulations also appear to provide that a lessor such as that in the Syndication Exception is the one that holds the depreciable interest in a leased asset, not the lessee.[182] Some of the Transitory Use Exceptions, moreover, clearly contemplate that the original transitory user places the relevant assets in service in its business, making "depreciable interest" treatment even more likely.[183] Even if many of these transitory users do not so employ the relevant assets, such

[177] For instance, the Prior 168(k) Regulations also disregard prior ownership that is followed by both a sale-leaseback and a syndication. *See* Treas. Reg. §§ 1.168(k)-1(b)(3)(iii)(C), (b)(5)(ii)(C).

[178] *See* Treas. Reg. § 1.168(k)-1(b)(3)(iii)(A), (b)(5)(ii)(A). The Act removed the exception for sale-leaseback transactions, which is now present only in the Prior 168(k) Regulations, from Section 168(k) itself. *See Act*, *supra* note 4, at § 13201(c)(2); I.R.C. § 168(k)(2)(E)(ii) (prior to amendment by the Act).

[179] Specifically, where multiple items of property are subject to a single lease, to preserve original use status for the later purchaser, the syndicator-lessor must sell each item within 3 months after the date the final unit is placed in service (which may be up to 12 months after the first unit is placed in service). *See* I.R.C. § 168(k)(2)(E)(iii)(II); Treas. Reg. §§ 1.168(k)-1(b)(3)(iii)(B), (b)(5)(ii)(B); *see also* Prop. Reg. §§ 1.168(k)-2(b)(3)(v), (b)(4)(iv).

[180] *See* I.R.C. § 168(k)(2)(E)(iii); Treas. Reg. §§ 1.168(k)-1(b)(3)(iii)(B), (b)(5)(ii)(B); *see also* Prop. Reg. §§ 1.168(k)-2(b)(3)(v), (b)(4)(iv).

[181] *See* Treas. Reg. §§ 1.168(k)-1(b)(3)(iv); *see also* Prop. Reg. § 1.168(k)-2(b)(3)(ii)(C).

[182] *See, e.g.*, Prop. Reg. § 1.168(k)-2(b)(3)(vi), Ex. 6.

[183] *See, e.g.*, I.R.C. § 168(k)(2)(E)(iii)(II) (referring to asset subject to the Syndication Exception as "placed in service" by originally transitory user).

a fact may be of no avail if, as described in Part I.A.1.a.i above, a holder does not need to place an asset in service in its business in order to be treated as holding a "depreciable interest."[184]

The potential treatment of these original transitory uses as prior holders of depreciable interests disqualified by the No Prior Use Test raises a consistency issue. Assuming that an original transitory user held a depreciable interest, absent an exception, such a user cannot claim immediate expensing in the event of an otherwise-qualifying subsequent acquisition in the used property market.[185] However, if these original transitory uses of the relevant qualified property were so insubstantial as to be disregarded under the original use acquisition rules, why should they be both regarded and disqualifying under the No Prior Use Test?

An additional effect of treating these instances of transitory ownership as prior uses for purposes of the No Prior Use Test is to create more prior users who must be tracked under other provisions of the Proposed Regulations. Each original transitory user could also be a person whose membership in, or entry into, a consolidated group could prevent the group from claiming immediate expensing for acquired qualified property.[186] In addition, assuming that the final regulations retain the Transferor Allocation Rule, if an original transitory user of qualified property holds an interest in a partnership, any other partner that contributes the same qualified property to the partnership after purchasing the property in the same taxable year will need to determine whether the original transitory user previously used the property for a brief period of time and, upon making the determination, wholly claim the qualified property's Section 168(k) deduction and ensure that the partnership does not claim any portion of the deduction.[187] It is not clear that these results are appropriate or that the administrative burden taxpayers will need to undertake to avoid them is necessary.

Moreover, the apparent intent of the No Prior Use Test is to prevent situations that might be perceived as abusive, such as permitting a taxpayer to claim immediate expensing multiple times for the same asset. However, the No Prior Use Test, by its terms, will apply even if an original transitory user has never claimed immediate expensing for the asset. In such a case, absent some other indication of abuse, a prior transitory use that may already be disregarded for purposes of the original use requirement seems a fair candidate for an exception to the No Prior Use Test as well. Accordingly, we recommend that the government consider adding an exception in the final regulations to the definition of prior use as holding a depreciable interest (as currently located in Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(B)(1)) so as to

---

184 We note that the scope of the definition of "depreciable interest" may limit this dilemma. For instance, if a "depreciable interest" existed only where a taxpayer held tax ownership of an asset, placed the asset in service in its business and was permitted to depreciate the asset, many original transitory users presumably would not be treated as holding depreciable interests in the assets in question, either because they did not place the relevant assets in service, or because placing an asset in service and disposing of it in the same taxable year generally precludes the taxpayer from taking a depreciation deduction with respect to such asset. *See* Treas. Reg. § 1.168(d)-1(b)(3)(ii) ("No depreciation deduction is allowed for property placed in service and disposed of during the same taxable year."). Presumably, such a taxpayer might still be treated as holding a depreciable interest if the placement in service and disposition occurred in separate taxable years, which is possible under the terms of the Transitory Use Exceptions.

185 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(A)(1).

186 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(3)(ii).

187 *See* Prop. Reg. § 1.168(k)-2(f)(1)(iii).

disregard uses eligible for one of the Transitory Use Exceptions, provided that the original transitory user did not claim immediate expensing with respect to that original transitory use. Such an exception would mirror the Transitory Use Exceptions and essentially disregard the original transitory use – the original transitory use would not itself generate a Section 168(k) deduction, but also would not prevent any subsequent acquirors of the relevant qualified property from claiming the deduction assuming they are otherwise eligible to do so.

b. "Predecessor"

In several sections, the Proposed Regulations provide that a particular rule applies to a taxpayer and its "predecessor."[188] Most notably, for the cost of used property to be eligible for immediate expensing under the Proposed Regulations,[189] the property must not have been "used by the taxpayer or a predecessor at any time prior to" its acquisition by the taxpayer.[190] The Proposed Regulations do not define the term "predecessor," nor does the statute or the Prior 168(k) Regulations.[191]

There are several other authorities in the tax law that define the meaning of "predecessor" or "successor" at greater or lesser length. Presumably, in the absence of a specific definition, taxpayers should refer to such analogous authority, which frequently defines a predecessor by reference to a transfer described in Section 381. As we have noted in other reports on other areas of the tax law, it may also be appropriate to treat other similar transactions not described in Section 381, such as Section 351 exchanges, as causing a transferor to be treated as a predecessor.[192] Accordingly, the government may wish to address these issues in the final

---

188 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(A)(1), (b)(3)(iii)(B)(1), (b)(3)(iii)(B)(2), (b)(3)(iv)(D)(1)(i), (b)(3)(v), (b)(3)(vi), (b)(4)(iv), (b)(5)(iii)(A), (b)(5)(iii)(B), (b)(5)(vii).

189 We note that Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(A)(1) would prevent a Section 168(k) deduction where a predecessor of the taxpayer has previously used an asset although the equivalent statutory provision, Section 168(k)(2)(E)(ii)(I), does not contain any reference to a "predecessor."

190 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(A)(1).

191 The Prior 168(k) Regulations also use the term "predecessor" without definition. *See* Treas. Reg. § 1.168(k)-1(b)(4)(ii)(A), (B).

192 *See* Guidance Under Section 355(e) Regarding Predecessors, Successors, and Limitation on Gain Recognition; Guidance Under Section 355(f), 81 Fed. Reg. 91,738, 91,746 (Treasury and the Service continue to study whether transferee in Section 351 transaction should be treated as a successor for purposes of Section 355(e)) (Dec. 19, 2016); NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT # 1370 ON TEMPORARY AND PROPOSED REGULATIONS DEALING WITH "PREDECESSORS" AND "SUCCESSORS" UNDER SECTION 355(E) (2017), *reprinted in*, 2017 TNT 105-27 (June 2, 2017). Questions may also arise as to how a "predecessor of a predecessor" should be treated. *See* Guidance Regarding Predecessors and Successors Under Section 355(e); Limitation on Gain Recognition Under Section 355(e), REG-145535-02, 69 Fed. Reg. 67,873, 67,874 (Nov. 22, 2004) ("The IRS and Treasury Department . . . are concerned that treating [transferors to predecessors of Distributing] as predecessors of Distributing would add substantial complexity."); NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT ON FINAL, TEMPORARY AND PROPOSED REGULATIONS UNDER SECTION 337(D) RELATING TO CERTAIN TRANSFERS OF PROPERTY TO REGULATED INVESTMENT COMPANIES AND REAL ESTATE INVESTMENT TRUST 25 n.60 (2017), *reprinted in*, 2017 TNT 195-27 (Oct. 10, 2017); NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT # 1089 ON PROPOSED REGULATIONS DEALING WITH "PREDECESSORS" AND "SUCCESSORS" IN SECTION 355(E) (2005), *reprinted in*, 2005 TNT 123-13 (July 4, 2005).

regulations in the form of a definition of the term "predecessor," or by providing confirmation in the preamble to the final regulations that the term is intended to be defined by reference to Section 381 or other related transactions, or to otherwise have its usual meaning.

c. *"Series of Related Transactions"*

The Proposed Regulations also contain a few rules (including most that apply to consolidated groups) that use the phrase "series of related transactions" without defining it.[193] The phrase is not used in the Prior 168(k) Regulations, and is used twice in Section 168(i)(3)(A), as well as certain related regulations, without definition.[194] The preamble to the Proposed Regulations introduces the phrase through an example, and the Proposed Regulations include a more detailed version of this example as Example 22, reproduced in part below:[195]

> (i) H Corporation, which is not a member of a consolidated group, has a depreciable interest in Equipment #4. Parent owns all the stock of I Corporation, and Parent and I Corporation are members of the Parent consolidated group. No member of the Parent consolidated group ever had a depreciable interest in Equipment #4. Neither Parent nor I Corporation is related to H Corporation within the meaning of section 179(d)(2)(A) or (B) and § 1.179-4(c). During 2018, H Corporation sells Equipment #4 to a person not related to H Corporation, Parent, or I Corporation within the meaning of section 179(d)(2)(A) or (B) and § 1.179-4(c). In a series of related transactions, during 2019, Parent acquires all of the stock of H Corporation, and I Corporation purchases Equipment #4 from an unrelated person.

The remainder of the example provides that the Stock/Asset Acquisition Rule applies to I Corporation's purchase of Equipment #4, and immediate expensing is unavailable.

It is not clear from the facts of the example why Parent's acquisition of H Corporation stock and I Corporation's acquisition of Equipment #4 are part of the same series of related transactions. Example 22 does not explain the relationship between these two transactions, aside from indicating that they occur during the same calendar year. However, the example does not clearly state that temporal proximity alone is sufficient to create a series of related transactions. Example 22 describes only the 2019 transactions as occurring as part of a series of related transactions, and appears to suggest that the 2018 and 2019 transactions are not related for this purpose, notwithstanding that they occur only approximately one year apart. Under the Stock/Asset Acquisition Rule, the 2018 transaction apparently requires no relation to the 2019 acquisitions to achieve the result described in Example 22, further suggesting that the 2018 and 2019 transactions in Example 22 are not part of the same series of related transactions.

Based upon a review of the example and the rules in the Proposed Regulations that it demonstrates, it does not seem that transactions separated by one year, or otherwise close in

---

193 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(3)(ii), -2(b)(3)(iii)(B)(3)(iii), -2(b)(3)(iii)(C).

194 *See* Treas. Reg. § 1.168(i)-2(c); Temp. Reg. § 1.168(j)-1T, A-17(iv). This phrase (or a variant thereof) is also used in certain other sections of the tax law, particularly Treasury Regulations Section 1.197-2, which uses the phrase numerous times without definition, and Treasury Regulations Section 1.355-7, which explains the concept of a "plan (or a series of related transactions)" at length.

195 *See* Prop. Reg. § 1.168(k)-2(b)(3)(vi), Ex. 22.

time, must necessarily be treated as part of the same series of related transactions. We appreciate that cautious taxpayers may be inclined to view any temporally close transactions as part of a series of related transactions, notwithstanding any suggestion to the contrary in Example 22.[196] In the alternative, the phrase might be read to mean that multiple transactions are "related" when they occur as part of a plan decided upon beforehand. Alternatively, the phrase could be interpreted as applying any (or all) of the three main variations of the step transaction doctrine.[197] Many of these interpretations may overlap in practice. On balance, we believe that it is appropriate to interpret a "series of related transactions" as applying to transactions that are part of the same taxpayer plan.

In addition, the rules that would adopt a "series of related transactions" standard are consequential and heighten the importance for taxpayers to apply the standard correctly. Taxpayers undertaking various business transactions over time, that wish to preserve immediate expensing, presumably will want to know what steps they can take to ensure that unrelated transactions are not unintentionally characterized as part of a "series of related transactions."

For all these reasons, the government may wish to consider clarifying the use of the phrase in Example 22 and/or providing guidance on the phrase's general meaning. We do not ultimately conclude, however, that the adoption of a definition of "series of related transactions" is essential for the final regulations.

3. Prop. Reg. § 1.168(k)-2(b)(3)(iii)(C)

The Direct Transfer Recast Rule set forth in Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(C) recharacterizes a series of related transactions involving multiple transfers of property as a single direct transfer of the property from the original holder to the final transferee, and provides that the relationship between the original holder and the final transferee should be

---

196 *See, e.g.*, DAVID L. CAMERON, THOMAS KITTLE-CAMP & PHILLIP F. POSTLEWAITE, FEDERAL INCOME TAXATION OF INTELLECTUAL PROPERTIES & INTANGIBLE ASSETS § 1.04 (referring to the "temporal or other characteristics" that could cause transactions to be part of a "series of related transactions" for Section 197 purposes).

197 *See, e.g.*, AMERICAN BAR ASSOCIATION SECTION OF TAXATION, COMMENTS ON GUIDANCE NEEDED UNDER 1997 AMENDMENTS TO SECTION 355 AND 358 n.13 (1998), *reprinted in*, 98 TNT 93-22 (May 14, 1998) (generally arguing that "plan" and "series of related transactions" should be defined by reference to the step transaction doctrine for purposes of Section 355(e)). The three alternative forms of the step transaction applied by courts generally are identified as (i) a binding commitment test, which integrates multiple transactions if they occur pursuant to a legally binding agreement, *see, e.g.*, *Comm'r v. Gordon*, 391 U.S. 83, 96 (1968), (ii) a mutual interdependence test, which integrates multiple transactions "so interdependent that the legal relations created by one transaction would be fruitless without the completion of the series," *Am. Bantam Car Co. v. Comm'r*, 11 T.C. 397, 405 (1947), *aff'd*, 177 F.2d 513 (3d Cir. 1949); *see also Penrod v. Comm'r*, 88 T.C. 1415, 1428 (1987), and (iii) an end result test, which integrates multiple transactions when all of the transactions appear to have been intended to achieve the same end result, *see, e.g.*, *King Enters., Inc. v. United States*, 418 F.2d 511, 516 (Ct. Cl. 1969); *True v. United States*, 190 F.3d 1165, 1175 (10th Cir. 1999). For an overview of the issues relating to the application of the step transaction doctrine by the courts, see NEW YORK STATE BAR ASSOCIATION TAX SECTION, REPORT ON THE ROLE OF THE STEP TRANSACTION DOCTRINE IN SECTION 355 STOCK DISTRIBUTIONS: CONTROL REQUIREMENT AND NORTH-SOUTH TRANSACTIONS 4-8 (2013), *reprinted in*, 2013 TNT 215-21 (Nov. 5, 2013).

tested after the last such related transaction, solely for purposes of the used property acquisition requirements in Section 168(k)(2)(E)(ii). An example in the preamble to the Proposed Regulations indicates that this rule would prevent immediate expensing in the case of a qualified property sale from a father to an unrelated third party, followed by the third party's sale of the property to the father's daughter.[198] As discussed below, it is not always clear how to apply the Direct Transfer Recast Rule.

First, the Direct Transfer Recast Rule provides sparse details regarding the transaction that is deemed to occur. For instance, where A transfers property to B in exchange for cash and B transfers the property to C in a nonrecognition transaction in exchange for stock or other property (or for no consideration), it is not entirely clear whether C is deemed to pay cash or to transfer in a nonrecognition transaction, and whether C is receiving a carryover or cost basis in the acquired property. The Proposed Regulations only mention a potential relatedness issue under Section 179(d)(2)(A) between A and C under Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(C).[199] If the Direct Transfer Recast Rule is intended solely to test relatedness under Section 179(d)(2)(A), and cannot disqualify a transaction for any other reason, the final regulations should clearly state as much.[200]

Alternatively, if a transaction deemed to occur under the Direct Transfer Recast Rule must be tested under all of the rules of Section 168(k)(2)(E)(ii), final regulations should provide further clarification regarding how to apply the rule. The form and basis results of, and consideration for, this deemed transaction will be relevant in determining (i) whether C is receiving property the basis of which is determined by reference to the basis of property previously held by C,[201] or (ii) whether C is receiving property the basis of which is determined by reference to the basis of the transferor,[202] each of which would prevent immediate expensing. In general, it seems appropriate to treat the deemed direct transfer between A and C as qualifying under Section 179(d)(2)(C) and 179(d)(3) if any of the indirect transfers disregarded by the Direct Transfer Recast Rule so qualify. In addition, the final regulations should clarify whether B's prior use of the transferred property prevents immediate expensing, notwithstanding that the transfer of property is deemed to occur between A and C without B's involvement. We would assume that B's prior use is not relevant in such a case.

Even where relatedness is the sole issue, it may not be clear how to apply the Direct Transfer Recast Rule in scenarios involving Section 179(d)(2)(B). The Direct Transfer Recast Rule simply states that "the relation between the original transferor and the ultimate transferee is tested immediately after the last transaction in the series," but it is not clear if this approach of

---

198 *See Proposed Regulations*, *supra* note 2, 83 Fed. Reg. at 39,295. Presumably, to clearly rely on this rule, the daughter's subsequent acquisition might need to occur in a subsequent year than the unrelated third party's acquisition since an acquisition in the same year might not qualify for immediate expensing under Proposed Regulations Section 1.168(k)-2(f)(1)(i).

199 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(C), (b)(3)(vi), Ex. 18.

200 This interpretation seems less defensible since the Direct Transfer Recast Rule itself states that the deemed transaction rule applies for purposes of "section 168(k)(2)(E)(ii) and paragraph (b)(3)(iii)(A) of this section," which include Section 179(d)(2)(C) and (d)(3) and Section 168(k)(2)(E)(ii)(I).

201 Such a transfer would fail to qualify (in whole or in part) under Section 168(k)(2)(E)(ii)(II) and Section 179(d)(3).

202 Such a transfer would fail to qualify under Section 168(k)(2)(E)(ii)(II) and Section 179(d)(2)(C).

taking a snapshot of the parties' relationship works with a rule like Section 179(d)(2)(B), which labels persons as related based on the existence of a relationship over a sustained period of time.

In the case of two corporations that become members of the same controlled group pursuant to a series of related transactions that also involves a sale of qualified property between the two, Section 179(d)(2)(B) would require testing whether the two corporations are "component members" of the same controlled group for purposes of Section 1563, a determination that generally is based on membership in the group for one-half of the relevant taxable year.[203] If the corporations both become members of the controlled group pursuant to a series of related transactions ending in the first half of the taxable year,[204] the corporations should be component members for purposes of Section 179(d)(2)(B). By contrast, if a series of related transactions ends in the second half of the taxable year, does the Direct Transfer Recast Rule treat the two corporations as non-members prior to the end of the series of related transactions, in which case the purchaser of the qualified property may be eligible for immediate expensing (setting aside for this discussion the effect of Section 179(d)(2)(A))?[205] Presumably, the Direct Transfer Recast Rule should not operate in this manner.

Finally, we note that the Direct Transfer Recast Rule may overlap with the rule in Proposed Regulations Section 1.168(k)-2(f)(1)(iii). Under the latter rule, a taxable acquisition of qualified property, followed by a contribution of the property to a partnership in a transaction described in Section 721 in the same taxable year, results in the acquiror and the partnership sharing a Section 168(k) deduction, which is allocated between them based on the number of months held. Assuming that the initial acquisition and the transfer to the partnership are part of the same series of related transactions, which seems quite possible as the transfer must occur in the same taxable year, does the Direct Transfer Recast Rule override this rule and treat the transfer as occurring directly between the partnership and the original seller?[206] Because the rule for Section 168(i)(7) transactions in Proposed Regulations Section 1.168(k)-2(f)(1)(iii) is narrower and more specific (and because a similar rule has been present in the Prior 168(k) Regulations for many years), it may be appropriate that the Direct Transfer Recast Rule not apply to a transaction described in Proposed Regulations Section 1.168(k)-2(f)(1)(iii). In any case, we would recommend that the government clarify the application of the Direct Transfer Recast Rule, including in the areas described above.

---

203 *See* Treas. Reg. § 1563-1(b)(3)(iii).

204 The same issues would arise if one corporation were a component member of an existing controlled group and the second corporation became a member of the same controlled group pursuant to a series of related transactions also involving a sale of qualified property between the two.

205 We appreciate that, because of the significant overlap between Section 179(d)(2)(A) and Section 179(d)(2)(B), the former may still apply in many of these cases and cause the transaction to fail Section 168(k)(2)(E)(ii)(II).

206 Presumably, this recharacterization would occur only if the original taxable acquisition was an acquisition of used property seeking to qualify under Section 168(k)(2)(E)(ii) and not qualifying under the original use acquisition requirements. We would not interpret the Direct Transfer Recast Rule as requiring an acquisition of qualified property that satisfies the original use acquisition requirements to be recharacterized and then, in recharacterized form, to also satisfy the used property acquisition requirements. The Proposed Regulations appear to support this conclusion by stating that the Direct Transfer Recast Rule applies "[s]olely for purposes of section 168(k)(2)(E)(ii) and paragraph (b)(3)(iii)(A) of [the Proposed Regulations]". *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(C).

4. Consolidated Group Issues

We consider the Group Prior Use Test, described in Part II.C, above, an appropriate implementation of the No Prior Use Test in the consolidated group context. However, as described below, we suggest that the government consider certain clarifying guidance to prevent possible misinterpretations of this rule and otherwise assist taxpayers.

a. Acquisitions Involving Two Consolidated Groups

Importantly, the Group Prior Use Test disallows immediate expensing only when a corporation that is a member of a consolidated group acquires qualified property in an otherwise-eligible purchase, and applies only to the consolidated group of which the acquiring corporation is a member. This qualification is particularly relevant in certain acquisitions involving two consolidated groups.

Assume that Buyer is a domestic corporation that is a member of a consolidated group (the "**Acquiring Group**"). Holder is a domestic corporation unrelated to Buyer that holds qualified property and that is a member of an unrelated consolidated group (the "**Target Group**"). Target is another domestic corporation that is also a member of the Target Group. Holder is not a direct or indirect subsidiary of Target, and Target has never directly held the qualified property currently held by Holder. As part of a series of related transactions, Buyer acquires qualified property from Holder for cash in a taxable purchase, and Target also becomes a member of the Acquiring Group (*e.g.*, in a taxable stock purchase).

The Group Prior Use Test should not apply to the example. Because Target has never directly held the qualified assets held by Holder and acquired by Buyer, our example does not represent a series of related transactions described in Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(B)(3)(ii) in which a member of a consolidated group acquires assets and a corporation that previously held those assets becomes a member of the same consolidated group. Although Target was a member of the Target Group at a time when another member of the Target Group, Holder, held the assets, the Proposed Regulations do not impute Holder's prior use of the assets to Target under these circumstances. Rather, Holder's prior use would be imputed to Target under the Group Prior Use Test only if Target itself had acquired the assets while a member of the Target Group. This result is appropriate because the same result would obtain in a single corporation context. If Target were a division or disregarded subsidiary of a single corporation, and another division or disregarded subsidiary held qualified property, the Acquiring Group's acquisition of Target and the qualified property would be treated as two asset acquisitions and would not implicate the Stock/Asset Acquisition Rule, absent other facts.

However, we think it is conceivable that a taxpayer might erroneously assume that the Stock/Asset Acquisition Rule applied in a transaction like the one presented in the above example. The Group Prior Use Test treats a consolidated group member as previously using qualified property held by other members only when the first member acquires the property in question while a member of the group, and, as a result, the Group Prior Use Test (along with the Stock/Asset Acquisition Rule) does not prevent immediate expensing in our example. If the Group Prior Use Test instead treated every member of a consolidated group as previously holding a depreciable interest in all assets previously held at any time by any member of the group, arguably immediate expensing would be unavailable in our example because Target would be treated as having previously used the assets on account of its prior membership in the Target Group.[207] To clarify that this latter interpretation is incorrect and conflicts with the preamble's general recognition that consolidated corporations are separate taxpayers, we suggest that the government include an example in the final regulations similar to the one above and explain that immediate expensing is available on these facts.

b. Example 21 & Similar Transactions

In Example 21 in the Proposed Regulations, Parent owns all of the stock of F corporation and G corporation, which are both members of a consolidated group. In a series of related transactions, G corporation sells qualified property to F corporation, and Parent sells F corporation's stock to X corporation, an unrelated third party that is also the parent of a consolidated group. The Proposed Regulations indicate that F is not treated as previously holding a depreciable interest in the qualified property under the Group Prior Use Test because F's membership in the consolidated group is tested at the end of the series of related transactions when F is no longer a member. Accordingly, Example 21 states that, assuming all other relevant requirements are satisfied, immediate expensing is available with respect to the qualified property acquired by F. We generally approve of this result and note that the IRS has previously issued several private letter rulings addressing similar but more complex transactions, many of which involve a "busted" Section 351 exchange (*e.g.*, through the sale of non-voting preferred stock of the transferee corporation to a party that does not contribute property to the transferee) within a consolidated group, followed by the transferee's departure from the group through one or more spin-off transactions (a "**spin-off disposition**").[208]

However, aspects of the U.S. tax treatment of a transaction like that described in Example 21 remain unclear. In particular, which group should receive the Section 168(k) deduction for the qualified property held by F? Alternatively, in the context of a spin-off disposition where the purchasing entity becomes a subsidiary of a controlled corporation that departs the group in a spin-off, should the distributing corporation's consolidated group receive the Section 168(k) deduction, or the controlled corporation's consolidated group? The legislative history of Section 168(k), including the legislative history of the changes thereto in the Act, indicates that Congress intends Section 168(k) to stimulate the economy by incentivizing capital investment.[209] Using Example 21 as the base case, the capital investor there is the X consolidated group, which paid cash to acquire qualified property from the Parent consolidated group. The X consolidated group makes a capital investment both under the tax fiction imposed by the Proposed Regulations, which treats F as leaving (or not being a member of) the Parent consolidated group prior to purchasing qualified property, and in economic reality, because any purchase of qualified property for cash by F while a part of the Parent consolidated group results in the X consolidated group acquiring qualified property when the X consolidated group acquires F (and having the

---

[207] Specifically, in such case, Target would be treated as previously holding a depreciable interest in the assets held by Holder and acquired by Buyer, and the transaction would be subject to the Stock/Asset Acquisition Rule.

[208] *See, e.g.*, Priv. Ltr. Rul. 201203004 (Jan. 20, 2012).

[209] *See* H.R. REP. NO. 107-251, at 20 (2001) (Section 168(k) "will accelerate purchases of equipment, promote capital investment, modernization, and growth, and will help to spur an economic recovery.").

same amount of cash on a group basis as it would have had after an actual purchase).[210] Therefore, on balance, we believe that the consolidated group in which the purchasing entity and the qualified property reside after the completion of the transaction generally should be entitled to the Section 168(k) deduction.

At the same time, we appreciate that a spin-off disposition raises more policy issues than the more simple type of transaction described in Example 21, and it may not be as clear in a spin-off disposition which consolidated group, the distributing corporation's or the controlled corporation's, should receive the Section 168(k) deduction. However, we note that, if the controlled corporation's consolidated group purchased assets from the distributing corporation's consolidated group after the spin-off, the controlled group presumably would receive the full Section 168(k) deduction. Where the same purchase instead takes place a short time before, but as part of the same plan with, the spin-off, it would seem appropriate that the parties receive the same tax results.

Returning to Example 21 in the Proposed Regulations, there appear to be several potential technical obstacles to the X consolidated group's ability to claim a Section 168(k) deduction. Initially, we note that the Proposed Regulations generally eliminate one potential obstacle: F's and G's relatedness, which would otherwise pose an issue under the Unrelated Purchase Test. Under the Proposed Regulations, F and G generally are treated as unrelated persons for purposes of such test.[211] Second, the sale of qualified property clearly occurs first in the series of related transactions in Example 21, prior to F's departure from the group.[212] Therefore, the sale appears to be an intercompany transaction subject to the consolidated return rules. When an intercompany sale of depreciable property occurs within a consolidated group, the group parent generally includes the tax items arising from the sale, including gain or loss and any related deductions, in its consolidated return for that taxable year.[213] The deduction could be included in F's return in some circumstances, for instance if the next day rule altered the date on which the sale was treated as occurring.[214] However, in Example 21, if significant time passes between G's sale to F and F's departure from the Parent consolidated group, it seems likely that the sale would be treated as an intercompany transaction.

The consolidated return rules generally adjust the recognition of tax items in intercompany transactions in order to approximate the result that would attain if the transaction

---

210 In addition, we note that, depending on the form of the acquisition of F, the X consolidated group may be eligible to make an election under Section 338 or Section 336(e) to treat the acquisition as a deemed asset sale.

211 Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(3)(iii), (b)(3)(iii)(C).

212 While the example indicates that the qualified property sale comes first, it does not specify the time period between the sale of qualified property and the sale of F's stock. Depending on the breadth of the "series of related transactions" standard, it presumably is possible that a significant amount of time could elapse between the two sales without changing the tax results described in the example.

213 *See* Treas. Reg. § 1.1502-76(b)(1).

214 *See* Treas. Reg. § 1.1502-76(b)(1)(ii)(B). Alternatively, a newly-formed buyer corporation that receives assets in a taxable transaction (avoiding successor status) and is immediately transferred to an acquiring consolidated group could also be treated as having never been part of the selling consolidated group. *See* Priv. Ltr. Rul. 201644018 (Oct. 28, 2016).

had occurred between divisions of a single corporation.[215] Accordingly, in the case of an intercompany sale of depreciable property, the selling member generally would recognize gain as the purchasing member took depreciation deductions, producing no net tax result (the same as would occur if one division of a single corporation purchased the property from another division).[216] If the purchasing member recognized a depreciation deduction greater than the selling member's total gain on the sale, the matching rule might treat the excess depreciation deduction as a noncapital, nondeductible amount.[217] If the consolidated return rules applied in this manner to the transaction described in Example 21, the Parent consolidated group might be permitted to take a Section 168(k) deduction only in the amount of G corporation's gain on the sale of qualified property, while the X consolidated group might receive no Section 168(k) deduction.

Additionally, whether an intercompany transaction or not, G's sale to F could be subject to Section 168(i)(7), which generally provides that, in a transfer of depreciable property between two members of the same consolidated group, the transferee "steps into the shoes" of the transferor and continues to use the transferor's existing depreciation method with respect to so much of the transferee's basis in the asset as does not exceed the transferor's basis. If Section 168(i)(7) applied and G had a basis and existing depreciation method with respect to the qualified property, the purchaser, F, generally would continue to depreciate an equal amount of basis in the qualified property under G's depreciation method (and could presumably treat any additional basis in the qualified property as newly purchased and subject to Section 168(k), though this is not clear).[218] Section 168(i)(7) might not apply in certain cases, such as if the qualified property were transferred in a transaction for which a Section 338 or Section 336(e) election were made.[219] However, in Example 21, F and G are members of the same consolidated

---

[215] *See* Treas. Reg. § 1.1502-13(c).

[216] *See* Treas. Reg. § 1.1502-13(c)(7)(ii), Ex. 4. Transactions between 3 parties are also subject to the matching rule. *See* Former Reg. § 1.1502-13(c)(7)(ii), Ex. 13 (prior to removal by later regulations for unrelated reasons); *see also* T.D. 9261, 71 Fed. Reg. 26687 (2006).

[217] *See* Treas. Reg. § 1.1502-13(c).

[218] A transfer between members of a consolidated group would also be subject to the Group Prior Use Test, but because one of the group members leaves the group as part of the same series of related transactions that includes the transfer, the departing member's membership in the consolidated group would be tested after the last of the series of related transactions (*i.e.*, after F's departure). *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(3)(iii). Accordingly, F should not be treated as a member of the Parent consolidated group for purposes of the consolidated group rules in the Proposed Regulations, including the Group Prior Use Test.

[219] Some commentators have assumed that the rule in the Section 338 regulations providing that the "old target" and "new target" are treated as unrelated corporations for most U.S. tax purposes prevents Section 168(i)(7) from applying to such a transaction. *See*, *e.g.*, JAMES T. CHUDY & HARSHA REDDY, 788-3RD T.M., STOCK PURCHASES TREATED AS ASSET ACQUISITIONS – SECTION 338 § IX.A.2.a ("In addition, new target should not be considered related to old target for purposes of the 'churning' or carryover depreciation election rules of §168(f)(5) and §168(i)(7)."). The government may wish to consider guidance confirming this point. *See also* Treas. Reg. § 1.197-2(h)(8) (clarifying that new target in a Section 338 deemed acquisition is not treated as holding or using old target's assets for purposes of Section 197). As a general matter, it is not clear why a Section 338 election should produce a different result in a transaction like Example 21 than a direct asset sale. In our view, the government should instead consider whether Section 168(i)(7) should not apply where the purchasing entity leaves the consolidated group.

group at the time of the sale transaction and, therefore, likely would be subject to Section 168(i)(7).[220]

These potential results under the consolidated return regulations and Section 168(i)(7) appear to conflict with Congress's intent as enacted in the statute, both as to the amount of the allowable deduction (*i.e.*, denying any deduction in excess of the seller's gain) and as to which party is permitted to take a deduction (*i.e.*, the selling consolidated group, which has made no new capital investment). Accordingly, we recommend that the government issue regulations or other guidance specifying (i) which party (the X consolidated group or Parent consolidated group in Example 21, or the distributing corporation consolidated group or controlled corporation consolidated group, in the case of the more complex spin-off disposition) can properly claim a Section 168(k) deduction and (ii) the amount of the deduction and the tax treatment thereof under the consolidated return rules and Section 168(i)(7).

5. Section 336(e) Elections

We agree with the Proposed Regulations' decision to expressly amend Treasury Regulations Section 1.179-4(c)(2) to provide that assets deemed transferred in connection with either a Section 338 election or a Section 336(e) election should be treated as acquired through a qualifying "purchase," which also permits the assets to satisfy the used property acquisition requirements and potentially qualify for immediate expensing.[221] However, we note that the regulations under Section 336(e), which deem an asset transfer to occur notwithstanding a transfer of stock, contain two deemed asset transfer models. The first model, described in Treasury Regulations Section 1.336-2(b)(1), is similar to that of Section 338(h)(10).

The second model, sometimes referred to as the "sale-to-self" model, applies to a distribution of stock of a controlled corporation that qualifies under Section 355(a) but becomes subject to Section 355(d) or Section 355(e) and, therefore, is treated as a taxable distribution to the distributing corporation. This model treats the "old target" (usually, the controlled corporation) as selling its assets to an unrelated party and then purchasing the assets back.[222] Except for certain specified purposes, the sale-to-self model does not treat the target corporation as a newly formed entity.[223]

The lack of a deemed "new target" in the sale-to-self model may pose an issue for a Section 355(d) or Section 355(e) distribution's qualification as a "purchase" under Section 179.

---

220 While the Proposed Regulations (and other regulations, such as those issued under Section 338, and certain private letter rulings) do test relatedness and/or membership in a consolidated group after the last of a series of related transactions, no such rule clearly applies for Section 168(i)(7) purposes to treat a pure asset sale between F and G while both are still members of the same consolidated group as a transfer between unrelated persons.

221 The preamble to the Proposed Regulations also indicates that this treatment applied under prior law. *See Proposed Regulations*, *supra* note 2, 83 Fed. Reg. at 39,294.

222 *See* Treas. Reg. § 1.336-2(b)(2)(i)(A), (ii)(A).

223 *See* Treas. Reg. § 1.336-2(b)(2)(ii)(C). Absent a rule treating the deemed acquisition in a Treasury Regulations Section 1.336-2(b)(2) scenario as a qualifying purchase, the deemed acquisition may not satisfy the requirements of Section 179(d)(2)(A) and (B); under the Direct Transfer Recast Rule, a controlled corporation could be treating as selling to itself.

Specifically, the Section 179 regulations grant "purchase" status only to acquisitions of assets "deemed to have been acquired by a new target corporation" as a result of a Section 338 election, and the Proposed Regulations generally would maintain this language.[224] This language, however, may suggest that assets transferred in the sale-to-self model are not transferred in a "purchase" for Section 179 purposes and, therefore, do not qualify for immediate expensing.

In addition, the No Prior Use Test may pose an issue under the sale-to-self model. Assuming that the fiction provided for in the Section 336(e) regulations for a Section 355(d) or (e) distribution is respected, and the Direct Transfer Recast Rule does not apply, the old target (usually, the controlled corporation) sells its assets to an unrelated third party and then reacquires the assets from an unrelated third party. Thus, the controlled corporation arguably has previously used the assets in question, potentially causing an issue under the No Prior Use Test.

In general, whether assets transferred under the sale-to-self model should be eligible for immediate expensing is debatable. There arguably is no additional capital investment to justify a Section 168(k) or Section 179[225] deduction in the case of a taxable distribution under Section 355(d) or Section 355(e), though the same could also be said of a stock purchase under Section 338, which expressly qualifies for a Section 168(k) deduction. On the other hand, the sale-to-self model does not appear to have been designed to impose additional restrictions on the deemed asset transfers involved. Rather, the goal of treating the controlled corporation as the same entity was a taxpayer-friendly one, namely, to cause the controlled corporation to preserve its tax attributes (such as E&P) and the consequences of a Section 355(e) distribution as much as possible.[226] Treating a deemed asset transfer under the sale-to-self model as a "purchase" under Section 179 does not interfere with this goal and is consistent with the general approach of Section 336(e) to deem a taxable asset transfer to have occurred. In addition, we note that, in order to avoid negative tax consequences that would otherwise apply in the sale-to-self model under the Section 197 anti-churning rules and the wash sale rules, the existing Section 336(e) regulations already provide several exceptions that treat the sale-to-self deemed asset transfers as occurring between unrelated parties.[227]

We do not ultimately take a position as to whether a deemed asset transfer under the sale-to-self model should be treated as a "purchase" under Section 179 and, therefore, potentially eligible for a Section 168(k) deduction, but note that the government may wish to clarify this

---

[224] *See* Treas. Reg. § 1.179-4(c)(2).

[225] Like Section 168(k), Congress's motivation in enacting Section 179 appears to have been to spur investment. *See* H.R. REP. NO. 85-2198, at 5 (1958) (Section 179 "will in the opinion of your committee make it possible for small business to use depreciation reserves for expansion. In addition, this will make less critical the determination of the useful lives of assets in the hands of the taxpayer and the estimation of salvage value. This also should encourage additional investment in small business since it provides for a faster recovery of capital before the taxing of earnings.").

[226] *See* Regulations Enabling Elections for Certain Transactions Under Section 336(e), REG-143544-04, 73 Fed. Reg. 49965, 49968 (Aug. 25, 2008) ("The IRS and Treasury Department believe that, except as necessary to carry out the purposes of section 336(e), the section 355 consequences generally should continue to apply in such a transaction. For example, if the controlled corporation were treated as a new corporation, with no earnings and profits, the controlled corporation may be able to distribute its assets to its shareholders without recognizing any dividend consequences under section 301(c)(1). Therefore, to preserve the consequences of section 355 distributions, the proposed regulations provide special rules").

[227] *See* Treas. Reg. § 1.336-2(b)(2)(ii)(C).

issue. To the extent the government believed it appropriate to permit a Section 355(d) or (e) distribution for which a Section 336(e) election was made to qualify for immediate expensing, the easiest way to address both the Section 179 "purchase" issue and the No Prior Use Test would be to provide, either through a regulatory amendment to Treasury Regulations Section 1.336-2(b)(2)(ii)(C) or other applicable guidance, that, for Section 179(d) and Section 168(k) purposes, the old target in its capacity as an acquiror of assets should be treated as a separate and distinct taxpayer unrelated to the old target in its capacity as a seller of assets.

6. Interaction of Section 181 & Section 168(k)

The Act added qualified film or television productions and qualified live theatrical productions to the definition of qualified property under Section 168(k)(2)(A)(i), permitting taxpayers to take Section 168(k) deductions for such an item if acquired and placed in service after September 27, 2017. Section 181, as amended by the Bipartisan Budget Act of 2018,[228] also permits a taxpayer to expense the cost of such a production, subject to a specific dollar limitation on the amount of the deduction and so long as the production is commenced on or prior to December 31, 2017.[229]

It is not clear how these two expensing provisions interact with respect to a production acquired and placed in service after September 27, 2017 and commenced on or prior to December 31, 2017. Section 168(k) does not address this issue: at the time of the Act's enactment, there was no risk of interaction because Section 181 applied solely with respect to productions commenced on or prior to December 31, 2016. One possible model to adopt would be Section 179, which, like Section 181, is subject to a specific dollar limitation. The Prior Section 168(k) Regulations specifically provide that the Section 168(k) deduction applies to the portion of an asset's basis remaining after any Section 179 deduction.[230] The government may wish to consider issuing similar guidance with respect to the interaction of Section 181 and Section 168(k).

---

[228] *See* Pub. L. No. 115-123, § 40308, 132 Stat. 64, 83 (2018).

[229] Because of the differing language of the Section 168(k) "placed in service" and "acquisition date" requirements and the Section 181(g) "commencement" requirement, a production might be treated as "commenced" on a different date than it was "placed in service" or "acquired."

[230] *See* Treas. Reg. § 1.168(k)-1(d)(1)(i), (a)(2)(iii).