NEW YORK STATE BAR ASSOCIATION

One Elk Street, Albany, New York 12207 PH 518.463.3200 www.nysba.org

Report No. 1428
November 25, 2019

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1428 – Report on New Final and Proposed Regulations Under Section 168(k) Relating to Immediate Expensing of Capital Investments*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1428 commenting on new final regulations and proposed regulations issued under Section 168(k) of the Internal Revenue Code. We commented in a prior Report on a 2018 notice of proposed rulemaking under Section 168(k). Our enclosed Report, accordingly, highlights remaining issues that we believe warrant modification or clarification and offers specific recommendations. We commend the Department of the Treasury and the Internal Revenue Service on the new final regulations and proposed regulations.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Deborah L. Paul
Chair

Enclosure

Cc:

Krishna Vallabhaneni
Tax Legislative Counsel
Department of the Treasury

John Cross
Associate Tax Legislative Counsel
Department of the Treasury

Michael Novey
Associate Tax Legislative Counsel
Department of the Treasury

John Moriarty
Associate Chief Counsel (Income Tax & Accounting)
Internal Revenue Service

Holly Porter
Associate Chief Counsel (Passthroughs and Special Industries)
Internal Revenue Service

Robert Wellen
Associate Chief Counsel (Corporate)
Internal Revenue Service

Charlotte Chyr
Acting Deputy Associate Chief Counsel (Income Tax & Accounting)
Internal Revenue Service

Lisa Fuller
Deputy Associate Chief Counsel (Corporate)
Internal Revenue Service

Thomas Moffitt
Deputy Associate Chief Counsel (Passthroughs and Special Industries)
Internal Revenue Service

Kathleen Reed
Branch Chief, Branch 7
Internal Revenue Service

Mark Weiss
Branch Chief, Branch 2
Internal Revenue Service

Christopher Kelley
Special Counsel, Office of Associate Chief Counsel (Passthroughs and Special Industries)
Internal Revenue Service

Amy Pfalzgraf
Special Counsel, Office of Associate Chief Counsel (Income Tax and Accounting)
Internal Revenue Service

Kenneth Cohen
Senior Technician Reviewer, Branch 3
Internal Revenue Service

Joy Spies
Senior Technician Reviewer, Branch 1
Internal Revenue Service

Elizabeth Binder
Attorney, Branch 7
Internal Revenue Service

Report No. 1428

New York State Bar Association

Tax Section

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

November 25, 2019

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New York State Bar Association

Tax Section

Report on New Final and 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**") comments on new final regulations (the "**Final Regulations**")[2] and proposed regulations (the "**Proposed Regulations**" and, together with the Final Regulations, the "**New Regulations**")[3] issued under Section 168(k) of the Internal Revenue Code of 1986, as amended (the "**Code**").[4]

The New Regulations partially finalize, and partially withdraw and amend, a 2018 notice of proposed rulemaking under Section 168(k) (the "**Prior Proposed Regulations**"),[5] which was the subject of a prior Report by the Tax Section.[6] Section 168(k), as amended by the 2017 tax reform legislation (the "**Act**"),[7] 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 or after January 1, 2027).[8]

We generally agree with the approach taken by the Department of the Treasury ("**Treasury**") and the Internal Revenue Service (the "**Service**") in the New Regulations, in particular in the Final Regulations. This report highlights remaining issues, primarily but not

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[1] The principal drafters of this Report are Richard M. Nugent, Sean E. Jackowitz and L. Matthew Waterhouse. Substantial contributions were provided by William Alexander, Phillip J. Gall and Eric B. Sloan. Helpful comments were received from Andrew H. Braiterman, Robert Cassanos, Peter J. Connors, Meyer H. Fedida, Lawrence M. Garrett, Shane J. Kiggen, Brian Krause, Deborah L. Paul, Scott H. Rabinowitz, Michael L. Schler, Eric Solomon, Karen Gilbreath Sowell, Dana L. Trier, Gordon E. Warnke and Libin Zhang. 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, T.D. 9874, 84 Fed. Reg. 50,108 (Sept. 24, 2019) [hereinafter *Final Regulations*].

[3] *See* Additional First Year Depreciation Deduction, REG-106808-19, 84 Fed. Reg. 50,152 (proposed Sept. 24, 2019) [hereinafter *Proposed Regulations*].

[4] The New Regulations also cite Sections 1502 and 7805 as sources 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.

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

[6] See NEW YORK STATE BAR ASS'N TAX SECTION, REPORT NO. 1405 ON PROPOSED REGULATIONS UNDER SECTION 168(k) RELATING TO IMMEDIATE EXPENSING OF CAPITAL INVESTMENTS (2018), *reprinted in*, 2018 TNT 214-11 (Nov. 2, 2018) [hereinafter PRIOR REPORT].

[7] *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*].

[8] This Report uses terms such as "bonus depreciation," "additional first-year depreciation," or "immediate expensing" interchangeably with "Section 168(k) deduction."

exclusively in the Proposed Regulations, that we believe warrant modification or clarification, and offers specific recommendations. Part I of this Report summarizes our principal recommendations. Part II summarizes Section 168(k) and the New Regulations. Part III discusses and explains our recommendations in greater detail.

I. SUMMARY OF PRINCIPAL RECOMMENDATIONS

A. Partnership-Related Recommendations

1. We recommend that Treasury and the Service withdraw Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(B)(5) (the "**Partnership Lookthrough Rule**"), and instead adopt a rule whereby (a) a taxpayer would be treated as having a prior depreciable interest in an item of property if the taxpayer was a controlling partner in a partnership at any time the partnership owned the property (subject to the applicable lookback period), and (b) in such case, the taxpayer would be treated as the prior user of all of the property represented by the partnership's interest therein. For this purpose, a taxpayer would be a "controlling partner" if the taxpayer, together with any related persons under the rules of Section 267(b) and Section 707(b), owns, directly or indirectly, more than 50% of the capital interest, or the profits interest, in the partnership.
2. If Treasury and the Service retain the Partnership Lookthrough Rule, then:
    a. We recommend that the Partnership Lookthrough Rule not apply when a taxpayer's depreciable interest in an item of partnership property is below a de minimis threshold.
    b. We recommend that Treasury and the Service provide additional guidance for applying the Partnership Lookthrough Rule in transactions that are treated partially as sales and partially as distributions for U.S. federal income tax purposes, such as disguised sales and transactions governed by Revenue Ruling 99-6.
    c. We recommend that Treasury and the Service amend or clarify the last two sentences of the Partnership Lookthrough Rule in order to (i) clarify which year is the "partnership's current year" and which years are the "five calendar years" referenced, in each case, in the Partnership Lookthrough Rule (and, to the extent possible, harmonizing the Partnership Lookthrough Rule and the 5-Year Safe Harbor), and (ii) provide a reasonable method for determining a partner's depreciable interest in partnership property based on the allocation of depreciation deductions. In particular, new final regulations could measure depreciation deductions across taxable years rather than calendar years for purposes of the Partnership Lookthrough Rule.
    d. We recommend that Treasury and the Service clarify whether the Partnership Lookthrough Rule is relevant only to the provisions cross-referenced therein or to all references to "depreciable interest" in the Section 168(k) regulations.

3. We recommend that Treasury and the Service clarify the intended operation of the bonus depreciation rules with respect to Section 743(b) adjustments after transfers of partnership interests in Section 168(i)(7) transactions.
    a. Treasury and the Service should clarify the timing of the resulting bonus depreciation deduction, which is relevant for determining the transferee partner's outside basis in its partnership interest.
    b. Treasury and the Service should clarify the manner in which the transferee partner gives effect to the resulting bonus depreciation deduction for purposes of determining and allocating such partner's own Section 743(b) adjustment.

B. Definitional, Consolidated Group & Other Miscellaneous Recommendations

1. We recommend changes to the 5-year lookback rule in Treasury Regulations Section 1.168(k)-2(b)(3)(iii)(B)(1) for determining if the taxpayer or a predecessor previously held a "depreciable interest" in an asset.
    a. Treasury and the Service should amend Treasury Regulations Section 1.168(k)-2(b)(3)(iii)(B)(1) to clarify to which years the rule applies.
    b. Treasury and the Service should amend Treasury Regulations Section 1.168(k)-2(b)(3)(iii)(B)(1) to clarify that the taxpayer and each predecessor is subject to a separate 5-year lookback period that begins no earlier than the date such person came into existence.
    c. Treasury and the Service should expand the rule to apply to all determinations of whether any person currently has, or has ever held, a depreciable interest in an asset for Section 168(k) purposes.
2. We recommend changes or potential changes to Proposed Regulations Section 1.168(k)-2(b)(3)(v)(C) and (D) (the "**Intercompany Transfer Rules**"), which recharacterize a transaction in which an initial intercompany transfer is followed within 90 days by the transferee's departure from the group.
    a. The Intercompany Transfer Rules should apply only to property described in Section 168(k)(2)(A)-(C) (excluding, in each case, Section 168(k)(2)(A)(ii)) or Section 168(k)(5)(B), to the extent applicable ("**Bonus-Eligible Property**").
    b. Treasury and the Service should remove the 90-day time limit in the Intercompany Transfer Rules, as the existing requirement in the Proposed Regulations that the relevant transfer and the departure from the group occur pursuant to a series of related transactions should suffice. If Treasury and the Service believe that a specific timeframe is necessary, we recommend a lengthier time period, such as one year. If Treasury and the Service retain the 90-day time limit, the apparently additional requirement that the relevant transfer and departure occur pursuant to the same "series of related transactions" should be removed.
    c. Treasury and the Service should consider further changes to address implementation issues. In particular, we recommend the Delayed Bonus Approach (as defined below), which would not recharacterize the relevant

transactions for most U.S. federal income tax purposes and would still allow the buyer corporation (or its new consolidated group) to claim, after the buyer's departure from the selling consolidated group, most of the bonus depreciation deduction the buyer would otherwise have received under the Intercompany Transfer Rules.

3. We recommend that Treasury and the Service clarify or amend the definition of the term "predecessor" in Treasury Regulations Section 1.168(k)-2(a)(2)(iv) in two respects:

    a. A person that contributes assets in a carryover basis transaction to a corporation or a partnership should be treated as a predecessor to that corporation or partnership if and only if the assets contributed comprised a large portion of the contributing person's total assets at the time of the contribution.

    b. A partner transferring property to a partnership in a transaction treated partially as a sale and partially as a contribution should be eligible for bonus depreciation with respect to the sale.

4. We recommend that Treasury and the Service amend Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(C) (the "**Series Transfer Rule**"), which alters the relatedness requirements of Section 168(k)(2)(E)(ii)(II) for certain transfers of depreciable property occurring as part of a series of related transactions.

    a. The Series Transfer Rule should require each transferee to test for relatedness generally in the same manner as Treasury Regulations Section 1.197-2(h)(6)(ii)(B), *i.e.*, before the first step in the series and after the last step in the series.

    b. Treasury and the Service should consider ways to simplify the Series Transfer Rule and reduce the amount of information needed to follow or administer the rule.

5. We recommend that Treasury and the Service clarify or amend the penultimate sentence of Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(B)(4) (the "**De Minimis Use Rule**") to address certain questions regarding its application: (i) whether the rule applies when the taxpayer received bonus depreciation with respect to the prior period of ownership and use; (ii) whether the rule allows bonus depreciation when a taxpayer places an asset in service in a particular taxable year and then disposes of the asset and reacquires it in the same year, seeking bonus depreciation for the reacquisition (we recommend allowing bonus depreciation in this case); and (iii) whether the rule applies where a taxpayer has previously used an asset for more than 90 days in the aggregate, over multiple periods of ownership and use, none of which individually exceeds 90 days.

6. We recommend that Treasury and the Service remove the sentence in Treasury Regulations Section 1.168(k)-2(g)(1)(i) stating that property placed in service and disposed of during the same taxable year and then reacquired and placed in service in a subsequent taxable year is not eligible for bonus depreciation, as this sentence conflicts with other portions of the New Regulations.

II. BACKGROUND

A. Background of Section 168(k)

Section 168(k), as amended by the Act, is a "special allowance" that overrides the general Modified Accelerated Cost Recovery System ("**MACRS**") rules of Section 168 and generally permits taxpayers to deduct 100% of the cost of certain business assets. Specifically, Section 168(k) grants a deduction equal to "the applicable percentage" of the "unadjusted depreciable basis" of certain "qualified property" acquired in a qualifying transaction and placed in service on or after September 28, 2017 and before 2027.[9] The "applicable percentage" is 100% for property placed in service on or after September 28, 2017 and before 2023; thereafter, the applicable percentage generally declines by 20% in each subsequent year, with Section 168(k) currently scheduled to phase out entirely in 2027.[10] "Unadjusted depreciable basis" generally is the cost of property as determined under Section 1011, without adjustment under Section 1016(a)(2) and (3), after adjustment pursuant to Sections 179, 179C, 181, and other similar provisions.[11] Thus, where it applies, Section 168(k) permits an immediate recovery of cost for taxpayers. The legislative history indicates that Congress intended to provide economic stimulus by encouraging capital investment.[12]

The property to which Section 168(k) applies generally is (i) property to which Section 168 applies with a recovery period not exceeding 20 years, (ii) computer software depreciable under Section 167(a) (rather than Section 197), (iii) water utility property, (iv) certain qualified film, television and theatrical productions, and (v) certain aircraft and other longer-production period property.[13] Certain types of property are not eligible for bonus depreciation, such as certain property subject to the alternative depreciation system (including tangible property used predominantly outside the United States) and certain property used in businesses not subject to the Section 163(j) interest limitation (*i.e.*, certain public utility businesses and businesses with floor plan financing indebtedness).[14] A taxpayer can also elect not to apply Section 168(k) to a particular class of property, as defined in Section 168(e), for a particular taxable year.[15]

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9 Certain longer-production period property, including some aircraft, are eligible for bonus depreciation if placed in service before 2028. *See* I.R.C. § 168(k)(6)(B).

10 *See* I.R.C. § 168(k)(6)(A). Longer-production period property follows the same schedule with a 1-year delay, so 100% depreciation is still available for such property in 2023. *See* I.R.C. § 168(k)(6)(B). A separate set of percentages, generally following pre-Act law, applies to property acquired before September 28, 2017, but placed in service on or after that date. *See* I.R.C. § 168(k)(8).

11 *See* Treas. Reg. §§ 1.168(k)-2(e)(1)(ii) and 1.168(b)-1(a)(3).

12 *See* H.R. REP. NO. 107-251, at 20 (2001) ("The Committee believes that allowing additional first-year depreciation will accelerate purchases of equipment, promote capital investment, modernization, and growth, and will help to spur an economic recovery.").

13 *See* I.R.C. § 168(k)(2)(A)-(C). A similar 100% depreciation deduction also applies to certain specified plants. *See* I.R.C. § 168(k)(5).

14 *See* I.R.C. §§ 168(k)(2)(D), (k)(9).

15 *See* I.R.C. § 168(k)(7); Treas. Reg. § 1.168(k)-2(f)(1)(ii). Taxpayers can elect to take 50% bonus depreciation for qualified property placed in service in a taxpayer's first taxable year ending on or after September 28, 2017. *See* I.R.C. § 168(k)(10).

Only property acquired in transactions meeting the requirements of Section 168(k)(2)(A)(ii) is eligible for bonus depreciation.[16] That section requires that either (i) the "original use" of the relevant property begin with the taxpayer (the "**Original Use Requirement**") or (ii) the acquisition satisfy the requirements of Section 168(k)(2)(E)(ii). In turn, Section 168(k)(2)(E)(ii) requires that (i) the taxpayer cannot have previously used the relevant property (the "**No Prior Use Test**") and (ii) the acquisition must meet the requirements of Section 179(d)(2) and (d)(3) (the "**Unrelated Purchase Test**"). Section 179(d)(2) imposes three separate requirements. First, the acquired property must not have been acquired from a person whose relationship with the taxpayer is described in Section 267 or Section 707(b).[17] 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)(1) and 1563(a)). Second, the acquired property cannot be acquired by one component member of a controlled group from another component member of the same controlled group (as defined in Sections 179(d)(7) and 1563(a)), a technical requirement that overlaps significantly with the first requirement.[18] Third, the basis of the acquired property cannot be determined by reference to the transferor's basis in the property.[19] Finally, Section 179(d)(3) generally disqualifies an acquisition to the extent the basis of the acquired property is determined by reference to the basis of other property held at any time by the person acquiring such property.[20]

B. Prior Proposed Regulations & New Regulations

Treasury and the Service published the Prior Proposed Regulations in the Federal Register on August 8, 2018. The Final Regulations, published in the Federal Register on September 24, 2019, finalize most of the Prior Proposed Regulations and are described briefly below.[21] In a few areas, also described below, the Proposed Regulations, published on the same day, withdrew portions of the Prior Proposed Regulations and offered certain changes upon which this Report will comment.[22] The New Regulations, like the Prior Proposed Regulations and existing Treasury Regulations Section 1.168(k)-1, generally apply to "depreciable property,"

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16 *See* I.R.C. § 168(k)(2)(A)(ii), (B)(i)(I), (C)(i).

17 *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.*

18 *See* I.R.C. § 179(d)(2)(B).

19 *See* I.R.C. § 179(d)(2)(C). In addition, the basis of the acquired property cannot be determined under Section 1014. *See id.*

20 *See* I.R.C. § 179(d)(3).

21 The Final Regulations generally apply to qualified property placed in service in any taxable year that includes September 24, 2019 or any subsequent taxable year. Treas. Reg. § 1.168(k)-2(h)(1). Taxpayers also generally can elect to apply the Final Regulations in their entirety to property acquired on or after September 28, 2017, and placed in service in taxable years ending on or after September 28, 2017. Treas. Reg. § 1.168(k)-2(h)(2).

22 The Proposed Regulations generally would apply to qualified property placed in service in any taxable year that includes the date on which regulations finalizing the Proposed Regulations were published in the Federal Register or any subsequent taxable year. Prop. Reg. § 1.168(k)-2(h)(4)(i). Taxpayers also generally can elect to apply the Proposed Regulations, in their entirety, to property acquired on or after September 28, 2017, and placed in service in taxable years ending on or after September 28, 2017. Prop. Reg. § 1.168(k)-2(h)(4)(ii).

as that term is defined in Treasury Regulations Section 1.168(b)-1(a)(1).[23] Depreciable property that satisfies the requirements of Treasury Regulations Section 1.168(k)-2(b) is eligible for bonus depreciation under Section 168(k).[24]

1. No Prior Use Test

The Final Regulations, following the Prior Proposed Regulations, expand the No Prior Use Test to apply both to a taxpayer seeking bonus depreciation and to that taxpayer's predecessors – neither can have previously used an acquired asset if the taxpayer is to claim bonus depreciation for that asset.[25] The Final Regulations further include a non-exclusive definition of "predecessor" for Section 168(k) purposes: a predecessor includes (i) a transferor of an asset to a transferee in a transaction to which Section 381(a) applies, (ii) a transferor of an asset to a transferee in a transaction in which the transferee's basis in the asset is determined, in whole or in part, by reference to the basis of the asset in the transferor's hands, (iii) a partnership that is considered as continuing under Section 708(b)(2) and Treasury Regulations Section 1.708-1, (iv) the decedent in the case of an asset acquired by the estate, and (v) a transferor of an asset to a trust.[26]

The Final Regulations consider a taxpayer to have previously used an asset if the taxpayer has ever had a "depreciable interest" in the asset.[27] While the Final Regulations do not define this phrase,[28] the preamble to the Final Regulations indicates that it has "same meaning as that term is used for purposes of section 167," that a taxpayer has a depreciable interest only if it uses property in the taxpayer's trade or business for the production of income pursuant to Section 167(a), that legal title to property is not determinative, and that the person who makes a capital investment generally should be treated as having the depreciable interest.[29]

The Final Regulations helpfully provide a safe harbor that limits the number of years that a taxpayer must "look back" in determining if the taxpayer or a predecessor previously held a depreciable interest in an acquired asset for purposes of Section 168(k) (the "**5 Year Safe Harbor**"). Where the 5 Year Safe Harbor applies, "only the five calendar years immediately

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[23] Treasury Regulations Section 1.168(b)-1(a)(1), in turn, defines depreciable property as "property that is of a character subject to the allowance for depreciation as determined under section 167 and the regulations under section 167."

[24] Treasury Regulations Section 1.168(k)-2(b)(2) explicitly references only the categories of property listed in Section 168(k)(2)(A)(i), and not the categories listed in Sections 168(k)(2)(B) and (k)(2)(C). Nevertheless, because the New Regulations primarily reference "depreciable property," which includes property described in Section 168(k)(2)(B) or (k)(2)(C), we generally interpret the rules in the New Regulations to apply to Section 168(k)(2)(B) or (k)(2)(C) property in most respects, including for purposes of the used property acquisition rules in Treasury Regulations Section 1.168(k)-2(b)(3).

[25] *See* Treas. Reg. § 1.168(k)-2(b)(3)(iii)(A)(1).

[26] *See* Treas. Reg. § 1.168(k)-2(a)(2)(iv).

[27] *See* Treas. Reg. § 1.168(k)-2(b)(3)(iii)(A)(1). This Report generally refers to "prior use" and "depreciable interest" interchangeably.

[28] *See Final Regulations*, *supra* note 2, 84 Fed. Reg. at 50,112.

[29] *See Final Regulations*, *supra* note 2, 84 Fed. Reg. at 50,112-13; *see also* PRIOR REPORT, *supra* note 6, at 39-40 (discussing authorities).

prior to the taxpayer's current placed-in-service year of the property [are] taken into account."[30] The Proposed Regulations also include a new De Minimis Use Rule that disregards a prior period of use if the taxpayer places property in service and then disposes of the property within 90 days.[31] However, the De Minimis Use Rule "does not apply if the taxpayer reacquires and again places in service the property during the same taxable year the taxpayer disposed of the property."[32]

The Final Regulations, like the Prior Proposed Regulations, deny depreciation for certain types of transactions. Where a taxpayer places an item of property in service and then disposes of the item, all within a single taxable year, the taxpayer generally cannot claim bonus depreciation for the item (the "**Same-Year Transfer Rule**").[33] However, the Same-Year Transfer Rule generally does not apply if an acquiror's transfer of acquired property occurs pursuant to a transaction described in Section 168(i)(7)[34] (a "**Section 168(i)(7) Transaction**") in the same taxable year that the transferor placed the property in service. In this case, the transferor and transferee generally share the bonus depreciation deduction, which is allocated between them on a monthly basis.[35]

The Final Regulations, moreover, go beyond the Prior Proposed Regulations and provide parallel rules for Section 743(b) adjustments arising from a partnership interest acquired and disposed of in the same taxable year.[36] The Same-Year Transfer Rule applies to such Section 743(b) adjustments, and, if a partnership interest is purchased and transferred to a transferee in a Section 168(i)(7) Transaction in the same taxable year, any Section 743(b) adjustment allocable to Bonus-Eligible Property arising from the initial purchase of the partnership interest is eligible for bonus depreciation (the "**Partnership Interest Transfer Rule**"), assuming all other applicable requirements are met.[37] The resulting deduction must be allocated between the transferor and the transferee on a monthly basis.

The above relief for Section 168(i)(7) Transactions, however, is subject to an exception: where a transferor places qualified property in service and then transfers the property to a partnership in a Section 721 contribution in the transferor's same taxable year, the transferor retains the entire bonus depreciation deduction, rather than splitting the deduction with the partnership, but only if any other partner in the partnership has previously had a depreciable interest in the contributed property (the "**Transferor Allocation Rule**").[38]

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

31 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(4).

32 *Id.*

33 *See* Treas. Reg. § 1.168(k)-2(g)(1)(i).

34 Section 168(i)(7) Transactions are transfers described in Section 332, 351, 361, 721 or 731, and transfers between members of a consolidated group.

35 *See* Treas. Reg. § 1.168(k)-2(g)(1)(iii).

36 *See id.*

37 Thus, as discussed below, the depreciation deduction received by the ultimate transferee of the partnership interest is determined by reference to the Section 743(b) adjustment of the transferor, overriding the rule in Treasury Regulations Section 1.743-1(f) that a transferee's basis adjustment is determined without regard to any prior transferee's basis adjustment. *See* Treas. Reg. § 1.168(k)-2(g)(1)(iii).

38 *See* Treas. Reg. § 1.168(k)-2(g)(1)(iii). Among other scenarios, the Transferor Allocation Rule would apply to the type of transaction described in Situation 1 of Revenue Ruling 99-5, and would treat the

2. Partnerships

Following the Prior Proposed Regulations, the Final Regulations generally permit bonus depreciation with respect to basis adjustments arising from acquisitions of partnership interests described in Section 743(b).[39] For this purpose, each partner in the partnership is treated as having a depreciable interest in the partner's proportionate share of partnership property and the person acquiring the partnership interest is treated as acquiring a proportionate part of the partnership's property.[40] Bonus depreciation is available to the extent the Section 743(b) basis adjustment applies to Bonus-Eligible Property, neither the person acquiring the partnership interest nor their predecessor has had a depreciable interest in the property deemed acquired, and the transfer of the partnership interest satisfies the requirements of Section 179(d)(2) and (d)(3).[41] By contrast, the Final Regulations deny bonus depreciation with respect to (i) remedial allocations under Section 704(c), (ii) the basis of property distributed by a partnership that is determined under Section 732, or (iii) basis adjustments arising from distributions described in Section 734(b).[42] Explaining the general approach to partnership issues in the Final Regulations, the preamble to those regulations states that Treasury and the Service did not consider an overall aggregate approach appropriate given the lack of a statutory provision applying aggregate principles; instead, the preamble indicates that the Final Regulations take a "case-by-case" approach.[43]

The Proposed Regulations also contain a new rule that would treat every partner in a partnership as having a depreciable interest in a portion of the partnership's property for purposes of the No Prior Use Test (the "**Partnership Lookthrough Rule**").[44] The Partnership Lookthrough Rule would apply, with respect to a particular person, to the property held by the partnership while such person was a partner. The portion of any such item of property in which the person is treated as having a depreciable interest would be "the total share of depreciation deductions with respect to the property allocated to the partner as a percentage of the total depreciation deductions with respect to that property allocated to all partners during the current calendar year and five calendar years immediately prior to the partnership's current year."[45] Only the time period during which such person was a partner and the partnership held the property would be considered.

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acquiror in such a transaction as receiving the entire bonus depreciation deduction for the property deemed acquired by the acquiror and contributed to the new partnership. 1999-1 C.B. 434; *see also Final Regulations*, *supra* note 2, 84 Fed. Reg. at 50,118.

39 *See* Treas. Reg. § 1.168(k)-2(b)(3)(iv)(D).

40 *See* Treas. Reg. § 1.168(k)-2(b)(3)(iv)(D)(1).

41 *See* Treas. Reg. § 1.168(k)-2(b)(3)(iv)(D)(1)(i), (D)(1)(ii), (D)(2).

42 *See* Treas. Reg. § 1.168(k)-2(b)(3)(iv)(A)-(C).

43 *See Final Regulations*, *supra* note 2, 84 Fed. Reg. at 50,114.

44 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(5).

45 Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(5). The initial version of the Proposed Regulations, which preceded publication in the Federal Register, referred to "the current calendar year and five calendar years immediately prior to the partnership's current placed-in-service year of the property."

3. Consolidated Groups

With respect to consolidated groups, the Proposed Regulations re-propose a rule from the Prior Proposed Regulations that treats a member of a consolidated group as holding a depreciable interest in an asset if any other member of the consolidated group previously held a depreciable interest in the asset while a member of the group.[46] The Proposed Regulations also retain a rule that would treat a member of a consolidated group acquiring an asset as having a prior depreciable interest in that asset if, as part of the same series of related transactions, a new corporation that previously had a depreciable interest in the asset joins the group.[47] The Proposed Regulations helpfully clarify that the rule in Proposed Regulations § 1.168(k)-2(b)(3)(v)(A) does not apply in determining if the new corporation previously had a depreciable interest in the asset. Thus, where an acquiring consolidated group purchases both Bonus-Eligible Property and the stock of target corporations from a selling consolidated group, bonus depreciation should be available for the acquired assets unless the target corporations directly held and used the acquired assets while members of the selling consolidated group.

The Proposed Regulations contain two similar rules that recharacterize an intercompany transfer after which the transferee ceases to be a member of the consolidated group within 90 days: one rule applies to intercompany transfers of depreciable property (the "**Intercompany Asset Transfer Rule**"),[48] the other to intercompany transfers of stock of a corporation that holds depreciable property where an election is made under Section 338 or Section 336(e) to treat such stock transfer as an asset transfer for U.S. federal income tax purposes and the deemed asset transfer is eligible for bonus depreciation (the "**Intercompany Deemed Asset Transfer Rule**" and, together with the Intercompany Asset Transfer Rule, the "**Intercompany Transfer Rules**").[49] In each case, the relevant transfer would be recharacterized, "for all Federal income tax purposes," as occurring one day after the transferee leaves the consolidated group. Neither of the Intercompany Transfer Rules would apply if the relevant acquiror (the buyer in an intercompany transfer, or new target in a deemed asset transfer under Section 338 or Section 336(e)) disposes of the depreciable property pursuant to the same series of related transactions.[50]

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46 *See* Prop. Reg. § 1.168(k)-2(b)(3)(v)(A).

47 *See* Prop. Reg. § 1.168(k)-2(b)(3)(v)(B).

48 *See* Prop. Reg. § 1.168(k)-2(b)(3)(v)(C).

49 *See* Prop. Reg. § 1.168(k)-2(b)(3)(v)(D). We note that, as currently drafted, Proposed Regulations Section 1.168(k)-2(b)(3)(v)(D) contains a reference to "paragraph (b)(2)(v)(A) of this section." There is no section -2(b)(2)(v)(A) in the Proposed Regulations or Final Regulations; we assume that this reference should be to "paragraph (b)(**3**)(v)(A) of this section."

50 *See* Prop. Reg. § 1.168(k)-2(b)(3)(v)(E). The Final Regulations also provide that a deemed transfer of property that occurs pursuant to a Section 336(e) election made in connection with a distribution to which Section 355(d) or (e) applies does not constitute a "purchase" under Section 179(d)(2) and thus is ineligible for bonus depreciation. *See* Treas. Reg. § 1.179-4(c)(2); *Final Regulations*, *supra* note 2, 84 Fed. Reg. at 50,113-14. The preamble to the Final Regulations explains that the Section 336(e) regulations recharacterize such distributions as a sale and reacquisition by the same entity that fails to satisfy the No Prior Use Test. *See id.* at 50,114.

4. Other Rules

In a change from the Prior Proposed Regulations, a rule that appeared to recharacterize all of the consequences of transfers of certain property in a "series of related transactions" now would only adjust the testing of relatedness under the Unrelated Purchase Test in such a series (the "**Series Transfer Rule**").[51] Under the Series Transfer Rule, for most purposes, a transferee receiving Bonus-Eligible Property in a series of related transactions would need to test its relatedness to the immediate transferor of the Bonus-Eligible Property and, if the transferee is the "ultimate transferee" in the series, to the original transferor that started the series.[52] Any transferee (other than the ultimate transferee) that either disposes of the Bonus-Eligible Property in the same taxable year as the year received or never places the Bonus-Eligible Property in service would be treated as a "disregarded party," and the transferee of such disregarded party would test its relatedness not to the disregarded party but to the person that transferred the Bonus-Eligible Property to such disregarded party.[53] If the transferee is the "ultimate transferee," the transferee also tests its relatedness to the original transferor.[54] If there are multiple disregarded parties, the transferee tests its relatedness to the most recent transferor that was not a disregarded party.[55]

In addition, if one or more, but less than all, of the transfers in the series of related transactions is a Section 168(i)(7) Transaction, the Series Transfer Rule deems each such transfer a "disregarded step" and requires the transferee in the next transfer after the disregarded step to test its relatedness to both the transferor in the disregarded step and the transferee in the disregarded step.[56] Where a series of related transactions involves consecutive disregarded steps, the transferee in the first transfer after the last disregarded step tests its relatedness to the transferor in the first disregarded step and to the transferee in the final disregarded step.[57] The Series Transfer Rule would not apply to any series of related transactions all the steps of which are transfers described in Section 168(i)(7), or to syndication transactions.[58]

III. COMMENTS

Broadly speaking, our comments on the New Regulations fall into two categories and are so divided below: (i) partnership issues and (ii) definitional, consolidated group and other miscellaneous issues.

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

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

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

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

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

56 *See id*.

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

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

A. Partnership Issues

1. Partnership Lookthrough Rule for Determining Prior Depreciable Interest

Under the Partnership Lookthrough Rule, a person generally is treated as having a depreciable interest in a portion of property prior to the person's acquisition of the property if the person was a partner in a partnership at any time the partnership owned the property.[59] The Partnership Lookthrough Rule conceives of partnerships as aggregates of their members (as opposed to separate entities) for purposes of the No Prior Use Test.[60] We welcome the efforts by Treasury and the Service to clarify the No Prior Use Test in the context of partnership transactions. However, we question whether an aggregate view of partnerships is generally appropriate for determining whether a taxpayer previously held a depreciable interest in Bonus-Eligible Property.

A purely aggregate approach conflicts with the text and structure of the statute, which expressly adopts an entity approach for purposes of the Unrelated Purchase Test. The statute achieves this by incorporating Section 179(d)(2)(A), which tests for relatedness between a buyer and seller of property by asking if the relationship would result in the disallowance of losses under Section 267 and Section 707(b).[61] The citation to Section 707(b) — including the rule in Section 707(b)(1)(A) disallowing losses in transactions between a partnership and a person owning, directly or indirectly, more than 50% of the capital interest or the profits interest of the partnership — clearly reflects an entity view of partnerships.[62]

We doubt that Congress would have intended an entity approach for one Section 168(k) requirement (the Unrelated Purchase Test) and an aggregate approach for another (the No Prior Use Test). Moreover, an aggregate approach gives rise to complications in several common forms of partnership transactions, such as disguised sales and transactions governed by Revenue Ruling 99-6, as discussed below.[63]

In light of these concerns, we believe that Treasury and the Service should adopt an entity approach for determining imputation of prior use of partnership property by a partnership to a partner. Under our proposal (the "**Controlled Partnership Proposal**"), a taxpayer would be treated as having a prior depreciable interest in an item of property if the taxpayer was a controlling partner in a partnership at any time the partnership owned the property (subject to the applicable lookback period), and, in such case, the taxpayer would be treated as the prior user of all of the property represented by the partnership's interest therein. For this purpose, a taxpayer would be a "controlling partner" if the taxpayer, together with any related persons under the rules

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[59] *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(5).

[60] For a discussion of the aggregate and entity theories of partnership taxation, see our prior Report on the Prior Proposed Regulations. PRIOR REPORT, *supra* note 6, at 15-18.

[61] *See* I.R.C. § 168(k)(2)(E)(ii)(II).

[62] *See* H.R. REP. NO. 83-2543, at 59 (1954) (Conf. Rep.) (Section 707(b)(1) "provide[s] for the use of the 'entity' approach in the treatment of the transactions between a partner and a partnership . . . ."); *see also* Annie H. Jeong, *Can a Regulation Survive Statutory Amendments?*, 149 TAX NOTES 555 (Oct. 26, 2015) (With Section 707(b)(1), "Congress clearly intended partnerships to be respected as entities.").

[63] 1999-1 C.B. 432.

of Section 267(b) and Section 707(b), owns, directly or indirectly, more than 50% of the capital interest, or the profits interest, in the partnership (the "**controlled partnership**"). The Controlled Partnership Proposal is discussed in more detail in Part III.A.1.a, below.

In addition, we respectfully submit comments regarding the Partnership Lookthrough Rule should Treasury and the Service decline to adopt the Controlled Partnership Proposal and adopt the Partnership Lookthrough Rule instead. First, we suggest that the Partnership Lookthrough Rule not apply when a taxpayer's depreciable interest in an item of partnership property is less than a de minimis amount. Practically speaking, a taxpayer that has less than a de minimis depreciable interest in partnership property will generally be unable to determine whether it has a depreciable interest in Bonus-Eligible Property under the Partnership Lookthrough Rule. Second, we believe that Treasury and the Service should clarify how the Partnership Lookthrough Rule applies when a partner acquires a portion of partnership property by distribution and another portion in a related sale. By analogy to Treasury Regulations Section 1.168(k)-2(b)(3)(iii)(B)(2) (the "**Additional Depreciable Interest Rule**"), we would expect that the portion previously used by the taxpayer should be treated as the portion acquired by sale. Third, we recommend that Treasury and the Service clarify the intended period for measuring allocations of depreciation deductions to a partnership's partners. Finally, we recommend that Treasury and the Service clarify the scope of the Partnership Lookthrough Rule.

a. Imputation of Prior Use by Controlled Partnerships to Controlling Partners

As indicated above, we respectfully recommend that Treasury and the Service withdraw the Partnership Lookthrough Rule in favor of the Controlled Partnership Proposal. The Controlled Partnership Proposal imputes a controlled partnership's ownership of property to a controlling partner for purposes of the No Prior Use Test, no matter what the controlling partner's proportionate interest in the property is. For example, if a partnership owns 100% of a certain asset, even a 51% partner would be treated as having a prior depreciable interest in (that is, having previously used) 100% of the asset. We think it would be appropriate (and simpler) to impute the partnership's entire ownership interest to the controlling partner, rather than only a pro rata portion of such property. By contrast, a taxpayer that is not a controlling partner of a partnership would not be considered to have a depreciable interest in any item owned by the partnership.

Several considerations support the Controlled Partnership Proposal. As discussed below, the Controlled Partnership Proposal appears to be more in line with Congressional intent than the Partnership Lookthrough Rule. We also believe that the Controlled Partnership Proposal would be relatively simple to apply.

The Partnership Lookthrough Rule is in tension with the relatedness test under Section 179(d)(2)(A), which, by reference to Section 707(b)(1), generally treats a person as related to a partnership only if that person owns more than 50% of the partnership or if there is more than 50% common ownership.[64] We submit that, by opting for such a relatively high barrier in

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[64] *See also* H.R. REP. NO. 115-466, at 353 (2017) (Conf. Rep.) (Section 168(k) "does not apply . . .to property acquired from a member of the taxpayer's family, including a spouse, ancestors, and lineal

defining relatedness, Congress implied, if not mandated, that some acquisitions of partnership property by current or former partners are eligible for bonus depreciation. We doubt that Congress would have announced an explicit bright-line test for relatedness while intending that the No Prior Use Test disallow bonus depreciation deductions in transactions in which a relationship outside the scope of that bright-line test exists.

Consider the following examples:

> *Example 1.* A is a 33% partner in partnership ABC, which allocates all items to its partners proportionately. D, a person unrelated to A and ABC, acquires equipment that is Bonus-Eligible Property from ABC in exchange for cash. In an unrelated transaction, but within the applicable lookback period, A acquires the equipment from D in a transaction that satisfies the Unrelated Purchase Test. Under the Partnership Lookthrough Rule, A is treated as having a 33% depreciable interest in the equipment. Accordingly, A's acquisition of the equipment is eligible for bonus depreciation only to the extent of 67% of A's cost of the equipment.[65]
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> *Example 2.* The facts are the same as Example 1, except that ABC is a corporation for tax purposes at all relevant times and A is a 33% shareholder. A is not deemed to have a depreciable interest in the equipment acquired from D because there is no corporate counterpart to the Partnership Lookthrough Rule. Accordingly, A's acquisition of the equipment is eligible for bonus depreciation for its total cost of the equipment.

A obtains a better result in Example 2 than Example 1 simply because of the choice of underlying entity. This result, however, does not follow from the statute, which contains no relatedness test relevant to minority partners and does not distinguish between corporations and partnerships in testing prior use.

We include many examples in this Report in order to explain the issues presented by the New Regulations as well as our recommendations for addressing them. Transactions between partners and partnerships or shareholders and corporations serve as a helpful benchmark in analyzing other transactions discussed in this Report. For example, consider Example 1 and Example 2 if A instead were to acquire the equipment directly from ABC. Assuming the acquisition were respected as a purchase for U.S. federal income tax purposes, A would satisfy the Unrelated Purchase Test because A and ABC are not related under Section 267 or Section 707(b), A's basis in the equipment would not be determined by reference to ABC's basis in the equipment, and A's basis in the equipment would not be determined by reference to the basis of any other property held by A.[66] The same would be the case in Example 2 where ABC is a corporation and A is a shareholder, if A purchased the equipment directly from ABC. Of course,

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descendants, or from another related entity as defined in section 267, nor to property acquired from a person who controls, is controlled by, or is under common control with, the taxpayer.").

65 In this and all subsequent examples, unless otherwise specified, (i) all persons in the example are calendar-year U.S. taxpayers, (ii) no persons in the example have made the election described in Section 168(k)(7) for any class of property, (iii) all persons in the example have elected to apply the New Regulations to their 2017, 2018 and 2019 taxable years, (iv) each person in the example is unrelated to every other person in the example for purposes of Sections 168(k)(2)(E)(ii)(II) and Section 179(d)(2), and (v) all transactions in the example are separate and do not occur pursuant to a series of related transactions.

66 *See* I.R.C. §§ 168(k)(2)(E)(ii)(II), 179(d)(2)-(3).

whether A would satisfy the No Prior Use Test in these examples is a separate question. In Example 1, under the Partnership Lookthrough Rule, A would satisfy the No Prior Use Test with respect to 67% of the cost of the equipment, but, under the Controlled Partnership Proposal, A would satisfy the No Prior Use Test in full. In Example 2, A would satisfy the No Prior Use Test in full.

We acknowledge that Treasury and the Service have an interest in preventing abuses in which the same taxpayer obtains duplicative bonus depreciation deductions with respect to the same property, but, so long as the Unrelated Purchase Test is met, the statute allows a taxpayer to take bonus depreciation on Bonus-Eligible Property acquired from a partnership in which the taxpayer is a partner, even if the partnership previously allocated depreciation deductions to that taxpayer.

In our view, the Partnership Lookthrough Rule would introduce a regime similar to the proportionate loss disallowance rule under Treasury Regulations Section 1.267(b)-1(b)(1), which disallows deductions with respect to transactions between a partnership and any non-partner person to the extent that any partner in the partnership is related to such other person. While Congress could have invoked the proportionate loss disallowance rule (or crafted something like it) to deny bonus depreciation to the extent of a common relationship between two parties, it opted instead to test relatedness for bonus depreciation purposes under Section 179(d)(2)(A), which applies Section 707(b)(1), an entity rule, for testing relatedness between partners and partnerships. We also note that Treasury Regulations Section 1.267(b)-1(b)(1) itself has been the subject of criticism (including by the Tax Section) on the grounds that it is not in line with Congressional intent.[67]

The Partnership Lookthrough Rule would also add complexity to the analysis of commonplace transactions. In any transaction in which a taxpayer acquires Bonus-Eligible Property from a partnership in which it is a partner, the taxpayer would have to determine its percentage interest in the partnership for <u>two</u> purposes. First, for purposes of the Unrelated Purchase Test (and as expressly required by the statute), the taxpayer must determine its percentage capital or profits interest in the partnership. Second, under the Partnership Lookthrough Rule, the taxpayer would have the <u>additional</u> task of determining its percentage interest in historical allocations of depreciation. It is unclear why taxpayers must contend with two percentage interest tests when the statute requires only one.

There are other complexities as well. What happens when a partner is considered to acquire property from a partnership in part by distribution and in part by sale? How is the taxpayer's prior depreciable interest allocated between the portion of the property acquired by distribution and the portion acquired by sale? As discussed in Part III.A.1.b.ii, below, this treatment may arise in disguised sale transactions as well as transactions governed by Revenue Rule 99-6.

The Controlled Partnership Proposal addresses these concerns. It would not interfere with Congress's intent, as reflected in the incorporation in Section 168(k) of Section

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[67] *See, e.g.*, NEW YORK STATE BAR ASS'N TAX SECTION, REPORT NO. 1271 ON THE APPLICATION OF TREAS. REG. § 1.267(B)-1(B) TO RELATED PARTY LOSS TRANSACTIONS (2012), *reprinted in*, 2012 TNT 169-7; Douglas A. Schaaf & Thomas S. Wisialowski, *Disallowance of Losses and Deferral of Deductions in Partnership Transactions*, 9 J. PARTNERSHIP TAX'N 191 (1992).

179(d)(2)(A), to allow taxpayers to immediately expense the cost of Bonus-Eligible Property acquired from partnerships in which they own a non-controlling interest. Furthermore, it avoids the complexity of the Partnership Lookthrough Rule. Consider the following examples:

> *Example 3.* E is a 50% partner in partnership EF, which allocates all items to its partners proportionately. G, a person unrelated to E and EF, acquires equipment that is Bonus-Eligible Property from EF in exchange for cash. Three years later, in an unrelated transaction, E acquires the equipment from G in a transaction that satisfies the Unrelated Purchase Test.
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> *Example 4.* The facts are the same as Example 3, except that, at all relevant times, E is a 75% partner in EF.

In Example 3, under the Partnership Lookthrough Rule, E would be allowed a bonus depreciation deduction for only 50% of its cost of acquiring the equipment. However, nothing in Section 168(k) itself (as distinguished from the regulations) would prohibit E from claiming bonus depreciation, even if the equipment was acquired directly from EF, because E's interest falls below the greater-than-50% threshold set out in the statute. We believe it would be inappropriate for a rule not found in the statute to deny E bonus depreciation, even if only in part, when E falls below the relevant statutory threshold. Under the Controlled Partnership Proposal, E would be allowed to immediately expense the full cost of the equipment because E was not a controlling partner at the time EF owned the equipment. By contrast, in Example 4, E would not be allowed any bonus depreciation because E is a controlling partner of EF.[68]

If Treasury and the Service adopt the Controlled Partnership Proposal, we suggest it consider three secondary issues. First, we believe that the Controlled Partnership Proposal should be aligned with the 5-Year Safe Harbor, discussed in Part III.B.1. We suggest that only property owned by the partnership during the applicable lookback period be taken into account. At any time during the lookback period, application of the Controlled Partnership Proposal would depend on whether the taxpayer was a controlling partner at the time that the partnership owned the property.

> *Example 5.* At all relevant times, A owns an 80% interest in partnership ABC. In 2005, ABC acquired equipment that is Bonus-Eligible Property. On January 1, 2010, ABC sold the equipment to D, which is unrelated to A and ABC. On January 1, 2020, A acquired the equipment from D.
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> *Example 6.* MN is a partnership in which M and N are partners. MN acquired equipment that is Bonus-Eligible Property in 2016 and sold the equipment to O, which is unrelated to M and MN, in 2017. On January 1, 2020, in an unrelated transaction, M acquired the equipment from O. In 2016 and 2017, M owned a 35% interest in MN and on January 1, 2020, M owned a 65% interest in MN.
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> *Example 7.* The facts are the same as Example 6, except that in 2016 and 2017, M owned a 65% interest in MN, and, on January 1, 2020, M owned a 35% interest in MN.

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68 Under the Partnership Lookthrough Rule as proposed, E would be allowed to expense 25% of the cost of the equipment in Example 4.

In Example 5, A is a controlling partner of partnership ABC, including at the time that A acquires the equipment from D. However, at the time of A's acquisition, it has been more than five years since ABC owned the property (ABC has not owned the property for 10 years), and, as such, neither ABC nor, under the Controlled Partnership Proposal, A would be considered to have a prior depreciable interest in the equipment. In Example 6, M is not a controlling partner in MN at any time that MN owns the equipment, whereas in Example 7, M is a controlling partner when MN owns the equipment. Accordingly, it would be appropriate to treat M as having previously owned the equipment in Example 7, but not in Example 6.

Second, we also recommend that Treasury and the Service determine whether, for purposes of the Controlled Partnership Proposal, a partner's interest exceeds 50% of the capital or profits interest of the partnership by also taking into account the interest of persons related to such partner under Section 179(d)(2)(A), which generally applies in determining relatedness for purposes of the Unrelated Purchase Test. Thus, a particular partner generally would exceed our proposed greater-than-50% threshold if such partner, together with persons related under Section 267(b) and Section 707(b), owned more than 50% of the capital or profits interest of the partnership. The following example illustrates this rule:

> *Example 8.* X1 owns a 40% interest and X2 owns a 20% interest in partnership XY, which allocates all items to its partners proportionately. X1 and X2 are related under Section 267(b). X2 is not a predecessor of X1 within the meaning of Treasury Regulations Section 1.168(k)-2(a)(2)(iv). Z, an unrelated party, purchases the equipment from XY. In a subsequent unrelated transaction, X1 acquires the equipment from Z in exchange for $100 cash.

X1 has only a 40% interest in XY. However, because X2, which is related to X1, has a 20% interest in XY, the interests of X1 and X2 would be combined in testing whether X1's interest exceeds our proposed 50% threshold. This is appropriate because, if X1 were to acquire the equipment directly from XY, the transaction would fail the Unrelated Purchase Test. Thus, there is no risk of undermining Congressional intent to allow bonus depreciation in transactions between partnerships and their noncontrolling partners.[69] Accordingly, under the Controlled Partnership Proposal, X1 would be deemed to have a prior depreciable interest in the equipment and would not be eligible for bonus depreciation.

Finally, we suggest that Treasury and the Service consider the implications of the Controlled Partnership Proposal in determining the eligibility of Section 743(b) adjustments for bonus depreciation. Consistent with the recommendation in our Prior Report, the Final Regulations generally permit bonus depreciation with respect to basis adjustments arising from acquisitions of partnership interests described in Section 743(b) and, for this purpose, treat each partner as having a depreciable interest in the partner's proportionate share of partnership property.[70] Consider the following example:

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[69] *See* I.R.C. § 179(d)(2)(A). X1 would be treated as constructively holding X2's interests in XY, so long as X1 and X2 have a relationship described in Section 267(c) (other than Section 267(c)(3)). *See* I.R.C. § 707(b)(3).

[70] *See* Treas. Reg. § 1.168(k)-2(b)(3)(iv)(D).

> *Example 9.* R owns a 60% interest in the partnership RST, which owns an item of Bonus-Eligible Property. R purchases an additional 20% interest in RST from S for cash. R and S are unrelated. The purchase results in a Section 743(b) adjustment allocable to the item of Bonus-Eligible Property.

Under the Final Regulations, R may be entitled to bonus depreciation to the extent that the Section 743(b) adjustment is allocable to the Bonus-Eligible Property. In addition, as the example below illustrates, the Final Regulations permit bonus depreciation with respect to a Section 743(b) adjustment arising from the acquisition of a partnership interest by a person related to a controlling partner:

> *Example 10.* The facts are the same as Example 9, except that R-Sub, a wholly owned corporate subsidiary of R, purchases the 20% interest in RST from S.

Under the Final Regulations, as in Example 9, R-Sub may be entitled to bonus depreciation to the extent that the Section 743(b) adjustment is allocable to the Bonus-Eligible Property. An entity approach to the question of prior use could preclude bonus depreciation in these examples. Under such an approach, R (in Example 9) and R-Sub (in Example 10) could be considered to have previously used all of the partnership's property by virtue of R's controlling interest in RST. Accordingly, such an approach would not be consistent with the treatment of Section 743(b) adjustments in the Final Regulations. If Treasury and the Service adopt the Controlled Partnership Proposal and wish to maintain the treatment of Section 743(b) adjustments set forth in the Final Regulations, they may wish to consider clarifying that, for purposes of determining whether Section 743(b) adjustments qualify for bonus depreciation, each partner is treated as having a depreciable interest in the partner's proportionate share of partnership property, even if the partner is a controlling partner and would be imputed all of the partnership's prior depreciable interest in partnership property for other purposes.

b. *Recommendations Regarding the Partnership Lookthrough Rule*

If Treasury and the Service decline to adopt the Controlled Partnership Proposal in favor of the Partnership Lookthrough Rule, we still respectfully urge them to consider several recommendations regarding the Partnership Lookthrough Rule. These recommendations are discussed in this Part III.A.1.b. For purposes of this Part, we assume that Treasury and the Service will adopt the Partnership Lookthrough Rule in some form in the final regulations.

i. <u>Exclusion from the Partnership Lookthrough Rule for Partners with De Minimis Depreciable Interests</u>

Under Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(B)(5), a taxpayer generally is treated as having a depreciable interest in any partnership property to the extent of the taxpayer's share of depreciation deductions with respect to the property as compared to the total depreciation deductions with respect to that property allocated to all partners. As a result, under the Partnership Lookthrough Rule, a taxpayer that owns only a small partnership interest (and is allocated only a small portion of the partnership's depreciation deductions) would be deemed to have previously owned a small share of the partnership's depreciable property. We question whether a taxpayer in this situation should be tainted as a prior user of partnership property, even if only in part.

In our view, the Partnership Lookthrough Rule would unduly burden these types of partners, especially those that hold interests as investments and do not participate in the management of the partnership's business. These taxpayers may not know whether the partnerships in which they are (or have been) partners ever owned any particular item of Bonus-Eligible Property. Management might not share with rank-and-file partners the exact identity of equipment and other types of Bonus-Eligible Property used in a partnership's trade or business in all but exceptional circumstances. Moreover, the partnership agreement may not provide such partners with the contractual rights necessary to investigate what Bonus-Eligible Property the partnership owned, especially in situations involving tiered partnerships. A former partner may have no commercially reasonable means for requesting the relevant records, assuming that the relevant partnership is still in existence at the time the issue becomes relevant. Nor is this the kind of information that reliably may be obtained from <u>sellers</u> of Bonus-Eligible Property. Even if records are available that show historic ownership, the records may not disclose information about beneficial ownership.

In light of these practical concerns, we see little policy justification for subjecting taxpayers that have only a de minimis depreciable interest in partnership property to the Partnership Lookthrough Rule. Any detriment from a taxpayer claiming a deduction twice with respect to the same property is slight, yet the burden on taxpayers would be considerable. As such, we recommend that the Partnership Lookthrough Rule not apply when a taxpayer's depreciable interest in an item of partnership property is less than a de minimis amount. Potential de minimis thresholds could be ownership interests ranging between 10% and 25%, which would be similar to other thresholds relating to partnerships.[71]

ii. <u>Transactions Involving Sales and Distributions of Partnership Property</u>

The application of the Partnership Lookthrough Rule is unclear in cases in which a partner acquires partnership property partially by sale and partially by distribution for U.S.

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71 *See, e.g.*, I.R.C. § 954(c)(4)(B) (for purposes of determining foreign personal holding company income, lookthrough treatment does not apply to sales of partnership interests by a controlled foreign corporation if the corporation's interest in the partnership is less than 25%); Treas. Reg. § 1.731-2(e)(4) (for purposes of "investment partnership" exception to Section 731(c), lookthrough treatment generally does not apply if the upper-tier partnership does not actively and substantially participate in the management of the lower-tier partnership and the upper-tier partnership's interest in the lower-tier partnership is below 20%); Treas. Reg. § 1.861-9T(e)(4) (for purposes of apportioning the interest expense of a partnership by a partner, lookthrough treatment generally does not apply to limited partners (or corporate general partners) whose interests in the partnership are below 10%); Treas. Reg. § 1.1374-4(i)(5) (for purposes of determining recognized built-in gain or loss under Section 1374, lookthrough treatment generally does not apply if the S corporation's partnership interest is less than 10% (and worth less than $100,000)); *cf. also* I.R.C. § 1297(c) (in the case of a foreign corporation that is potentially a passive foreign investment company, for purposes of determining whether a foreign corporation's gross income and assets are passive, lookthrough treatment does not apply to any subsidiary in which the foreign corporation owns less than 25% of the stock).

federal income tax purposes. The issue arises in disguised sales of property by a partnership to a partner as well as transactions governed by Revenue Ruling 99-6.

Under Treasury Regulations Section 1.707-6(a), the distribution of property by a partnership to a partner in connection with the transfer of money or other consideration by the partner to the partnership may be recharacterized as a sale of property, in whole or in part, to the partner. To the extent the transaction is recharacterized as a sale, it is treated as a sale for all purposes of the Code.[72] To the extent not treated as a sale, the transfer is generally treated as a distribution by the partnership to the partner.[73] Transfers made within two years of each other are rebuttably presumed to be sales.[74]

Revenue Ruling 99-6 applies when either an existing partner or an unrelated purchaser acquires all of the partnership interests in the relevant partnership.[75] Under Situation 1 of the Ruling, A and B are equal partners in AB (an LLC taxable as a partnership), and A sells his entire interest to B for $10,000. In determining the tax treatment of B, the Ruling deems the AB partnership to make a liquidating distribution of all of its assets to A and B, following which B is treated as acquiring the assets deemed to have been distributed to A in liquidation of A's partnership interest. Under Situation 2 in the ruling, C and D sell their interests in CD (an LLC taxable as a partnership) to E for $10,000 each. After the sale, the business is continued by the LLC, which is owned solely by E. In determining E's tax treatment, the Ruling deems the CD partnership to make a liquidating distribution of all of its assets to C and D, following which E is treated as acquiring such assets by purchase from C and D directly.[76]

In transactions like these that are taxed as part sales and part distributions, the Partnership Lookthrough Rule is difficult to apply because there is no mechanism for determining which portion of the partnership property is deemed transferred by distribution and which portion of the partnership property is deemed transferred by sale. To the extent that the portion of the partnership property considered sold is the portion in which the partner has a prior depreciable interest, the sale would be ineligible for bonus depreciation. Accordingly, these transactions give rise to the question of how a taxpayer should allocate a prior depreciable interest in newly acquired property when the tax law treats a portion of the property as acquired by purchase and a portion as acquired by distribution.

As a theoretical matter, the prior depreciable interest could be allocated (i) first to whatever portion a partner acquires by distribution, (ii) first to whatever portion a partner acquires by purchase, or (iii) pro rata in accordance with relative values. Consider the following example:

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72 Treas. Reg. § 1.707-3(a)(2). The transfer of property by the partnership to a partner constitutes a sale, in whole or in part, if based on all the facts and circumstances, the transfer of money or other consideration would not have been made but for the transfer of property. Treas. Reg. § 1.707-3(b)(1)(i).

73 *See, e.g.*, Treas. Reg. § 1.707-6(d), Ex. 2.

74 Treas. Reg. § 1.707-3(c)(1).

75 1999-1 C.B. 432.

76 For our Report on Revenue Ruling 99-6, see NEW YORK STATE BAR ASS'N TAX SECTION, REPORT NO. 1240 ON REVENUE RULING 99-6 (2011), *reprinted in*, 2011 TNT 114-19 (June 13, 2011).

> *Example 11.* J owns 75% and K owns 25% of the interests in partnership JK. J and K are unrelated. JK owns equipment that is Bonus-Eligible Property with a fair market value of $100 and basis of $0. In the applicable lookback period, JK has allocated depreciation deductions in the equipment proportionately to J and K. J buys all of K's interests for $25. Under Revenue Ruling 99-6, Situation 1, from J's perspective, the transaction is treated as though JK made a liquidating distribution of the equipment to J and K, and, following this distribution, J acquires K's portion of the equipment for $25.

One possibility is that the portion of the equipment that J acquires by purchase from K is the portion in which J does not have a prior depreciable interest. Another possibility is that J acquires by purchase from K the portion of the equipment in which he has a prior depreciable interest, in which case J would not be entitled to any bonus depreciation deduction. That is, the 75% of the equipment that J acquires by distribution from JK would fail the Unrelated Purchase Test, and the 25% of the equipment that J acquires by purchase from K would fail the No Prior Use Test. Finally, J could be treated as having a prior depreciable interest in 75% of the portion of the property acquired by distribution and 75% of the portion of the property acquired by purchase. In that case, however, J would be treated as having had a depreciable interest in 75% of the $25 of equipment acquired from K and would be eligible for a bonus depreciation deduction of only $6.25.

We believe the final regulations should expressly adopt the first method for allocating prior depreciable interests above. Accordingly, we recommend that the final regulations provide that, for purposes of the No Prior Use Test, (i) if a taxpayer has a prior depreciable interest in property, (ii) if the taxpayer (or a person related to the taxpayer) acquires a portion of such property in a distribution from a partnership in which the taxpayer (or such related person) is a partner, and (iii) if the taxpayer acquires an additional portion of the same property in a related sale, then the taxpayer's prior depreciable interest should be allocated first to the portion that the taxpayer (or such related person) acquires by distribution that is not eligible for bonus depreciation. To the extent that a taxpayer's prior depreciable interest exceeds the portion of the property received by distribution from the partnership, it would be appropriate to allocate the excess to any other portion distributed and then to the portion acquired by sale.

We acknowledge that this alternative is the most taxpayer friendly of the three possible alternatives identified above. However, we believe that such a method of allocation is consistent with comparable rules found elsewhere in Subchapter K. Specifically, when property is distributed to a partner, the partnership taxation rules typically allocate interests in that property using an ordering rule that is favorable for the distributee partner.[77] In addition, this allocation rule would be consistent with the Additional Depreciable Interest Rule, which treats a taxpayer that holds a portion of an asset and acquires an additional portion of the same asset as acquiring an additional unused portion, unless the taxpayer or a predecessor previously had a depreciable

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77 *See, e.g.*, Treas. Reg. § 1.704-4(c)(6) (Section 704(c)(1)(B) gain recognition does not apply to a distribution of an undivided interest in property to a partner to the extent that such undivided interest does not exceed any undivided interest contributed by the distributee partner in the same property); Treas. Reg. § 1.737-2(d)(4) (same rule for Section 737 gain recognition purposes); Prop. Reg. § 1.751-1(b)(5)(v) (2014) (same rule for Section 751(b)(2) ordinary income recognition).

interest in the subsequently acquired portion.[78] The analogy to the Additional Depreciable Interest Rule is appropriate because the Partnership Lookthrough Rule effectively treats partners as holding partnership property directly. Under the aggregate view of partnerships implied by the Partnership Lookthrough Rule, a transaction in which a partner acquires partnership property from the partnership or from other partners may be recharacterized as if the partner retained a portion of such property (*i.e.*, that portion in which such partner is deemed to have a depreciable interest under the Partnership Lookthrough Rule) and acquired an additional portion of such property. As such, a partner in a partnership that acquires an additional interest in the partnership would, under the Additional Depreciable Interest Rule, be treated as acquiring an additional unused portion of partnership property. Similarly, under the Additional Depreciable Interest Rule, it would be appropriate to treat the additional portion as one in which such partner did not have a prior depreciable interest. For example, if, in Example 11, J and K were co-owners of the equipment and J bought out K's interest in the equipment, J would be treated, under the Additional Depreciable Interest Rule, as acquiring a portion of the equipment in which J did not have a prior depreciable interest.

Our proposed rule would apply to other common types of transactions. Consider the following examples:

> *Example 12.* AA is a partner in a partnership that owns equipment that is Bonus-Eligible Property with a value of $100, subject to a nonrecourse liability of $60. AA has received 10% of the depreciation deductions for the equipment. The nonrecourse liability is not a qualified liability within the meaning of Section 1.707-6(b)(2) of the Treasury Regulations.[79] The partnership transfers the equipment to AA subject to the nonrecourse liability. Immediately before the transfer, AA's share of the nonrecourse liability was $10. Assuming no facts to rebut the presumption of disguised sale treatment, AA is treated as purchasing half of the equipment for $50 (the difference between the $60 liability assumed and AA's share of $10) and receiving a distribution of the other half of the equipment.

Under the Partnership Lookthrough Rule as originally drafted, AA has a prior depreciable interest in the equipment of $10. It is unclear, however, whether the prior depreciable interest is allocated to the portion of the equipment transferred by sale or the portion transferred by distribution. Under our recommended approach, AA is treated as acquiring $50 of the equipment in which AA has no prior depreciable interest by purchase, and AA's prior depreciable interest in the equipment of $10 is allocated to the portion of the equipment received in the distribution. The remaining $40 of equipment received in the distribution, therefore, is ineligible for bonus depreciation because such equipment was not acquired by purchase.

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[78] *See* Treas. Reg. § 1.168(k)-2(b)(3)(iii)(B)(2).

[79] A qualified liability is a liability that, under the relevant regulations, is deemed not to have been incurred in anticipation of the transfer of property. *See* Treas. Reg. § 1.707-5(a)(6). A partner receiving a distribution of property subject to a nonqualified liability generally is treated as receiving consideration equal to the amount that the liability assumed by the partner exceeds the partner's share of that liability immediately before the transfer. *See* Treas. Reg. § 1.707-6(b)(1).

> *Example 13.* The facts are the same as Example 12, except that, notwithstanding that AA owns a less-than-50% interest in the partnership, AA has received by special allocation 90% of the depreciation deductions with respect to the equipment at all relevant times. Under Treasury Regulations Section 1.707-5(a)(2)(ii), AA's share of the nonrecourse liability remains 10%. AA is still treated as receiving half of the equipment by purchase for $50 and receiving a distribution of the other half worth $50.

In this example, AA has a prior depreciable interest in 90% of the equipment. Under our recommended approach, AA is treated as receiving a prior depreciable interest in the $50 portion of the equipment received by distribution and a prior depreciable interest of $40 in the $50 portion of the equipment received by purchase. Accordingly, AA would be entitled to a bonus depreciation deduction of only $10.

> *Example 14.* A and B1 are equal partners in partnership AB, which owns equipment that is Bonus-Eligible Property. B2 buys all of A's and B1's partnerships interests for $100. B2 is related to B1, but unrelated to A, and B2 has previously had a depreciable interest in 80% of the equipment. Under Revenue Ruling 99-6, Situation 2, from B2's perspective, the transaction is treated as though AB made a liquidating distribution of the equipment to A and B1, and, following this distribution, B2 acquires the equipment from A and B1 for $100, which is its fair market value.

Under our recommended approach, B2's prior depreciable interest of $80 in the equipment would be allocated first to the $50 portion of the property that B1 is deemed to receive by distribution. The remaining $30 depreciable interest in the property would be allocated to the $50 portion of the property that A is deemed to receive by distribution. This allocation affects the analysis of the deemed sales between B1 and B2 and between A and B2 under Section 168(k). As to the portion of the equipment sold by B1 to B2, no bonus depreciation is permitted because B1 and B2 are related parties. As to the portion of the equipment sold by A to B2, B2 is denied bonus depreciation under the No Prior Use Test on account of B2's prior depreciable interest of $30 in such portion. Thus, B2 is only allowed bonus depreciation for $20, *i.e.*, the portion of the equipment in which B2 did not have a prior depreciable interest.

iii. <u>Portion of Partnership Property in Which Partners Deemed to Hold a Depreciable Interest</u>

As stated above, the Partnership Lookthrough Rule in the Proposed Regulations deems a partner to have a depreciable interest in a portion of the partnership's property "equal to the total share of depreciation deductions with respect to the property allocated to the partner as a percentage of the total depreciation deductions with respect to that property allocated to all partners during the current calendar year and five calendar years immediately prior to the partnership's current year."[80] However, this rule takes into account only those years in the testing period during which both (i) the partner was a partner and (ii) the partnership held the property.[81]

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80 Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(5).

81 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(5).

This language, though brief, raises difficult questions regarding the determination of a partner's depreciable interest in an item of partnership property. For the reasons explained below, we respectfully recommend that Treasury and the Service (i) clarify which years are the relevant "five calendar years" for purposes of this determination or, alternatively, require taxpayers to look back over five taxable years of the partnership, and (ii) assuming that taxpayers must look back over five calendar years, provide a reasonable method for determining how depreciation deductions are allocated over calendar years for this purpose, including in scenarios where the partnership and its partners have differing taxable years or change their taxable years.

(a) Calendar Years, Taxable Years & Alignment with General Depreciable Interest Rule

As an initial matter, it is not entirely clear under the Partnership Lookthrough Rule which year is "the partnership's current year" and, therefore, which five calendar years are tested.[82] On the one hand, the reference to "calendar years immediately prior to" the partnership's current year suggests that the year in question is itself a calendar year. On the other hand, since a partnership's "year" for tax purposes is its taxable year, the phrase "partnership's current year" seems more likely to refer to a taxable year, which, of course, is not always a calendar year.[83]

As described in Part III.B.1.a.i, below, where the New Regulations refer to calendar years "immediately prior to" a year that is (or may be) a taxable year, the time period referenced is open to interpretation. Both the Partnership Lookthrough Rule and the 5-Year Safe Harbor use this language, and we recommend that Treasury and the Service clarify each rule. Drafting those rules to operate in the same manner as each other will make it easier for taxpayers to understand and apply the rules and for the Service to audit taxpayers' compliance therewith.

(b) Allocation of Depreciation Deductions

As described above, the Partnership Lookthrough Rule may require taxpayers to measure the amount of depreciation deductions allocated to different partners in a partnership over a period of calendar years. We are not aware of any existing rule in the tax law that fixes the allocation of a depreciation deduction to a partner on a particular date, which is presumably necessary to determine the allocation of depreciation deductions on a calendar-year basis.[84]

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[82] We assume for purposes of this Part III.A.1.b.iii(a) that Treasury and the Service do not change the existing references to "calendar years" in the Partnership Lookthrough Rule to "taxable years," as suggested in Part III.A.1.b.iii(b), below.

[83] In either case, "the partnership's current year" presumably is the year that includes the date on which the determination under the Partnership Lookthrough Rule is made. The change in the regulatory text to "the partnership's current year" from "the partnership's current placed-in-service year of the property," described in footnote 45, above, supports this interpretation. Measuring the partnership's depreciation deductions in years prior to "the partnership's current year" is logical since the partnership likely owned, and computed depreciation deductions with respect to, the relevant asset in such years.

[84] We note that Section 706(a) prescribes a rule for determining how tax items of a partnership with a particular taxable year flow through to the tax return of a partner with a different taxable year (though the Code and Treasury Regulations also attempt to minimize these discrepancies). Such a partner generally includes items from taxable years of the partnership that end within the partner's taxable year. *See* I.R.C. § 706(a); Treas. Reg. § 1.706-1. While this rule may be relevant authority in determining how to allocate

Accordingly, a particular methodology is necessary for determining which allocations of partnership depreciation deductions are inside (and outside) the relevant testing period.

Under the Partnership Lookthrough Rule as proposed, we could foresee at least four possible approaches. These approaches can produce significantly different results in some cases. First, the depreciation deductions could be treated as allocated to partners on the last day of the partnership's taxable year. This would follow the approach of Section 706(a) to the effect that partners include tax items from partnership taxable years that end within their taxable years (the "**Partnership Year-End Approach**"). Second, the depreciation deductions attributable to an asset held by a partnership could be allocated to the partnership's partners ratably on each day of the U.S. federal income tax recovery period for the asset (the "**Tax Recovery Period Approach**"). Because it follows the tax recovery period for an asset rather than the period of actual ownership and use, in taxable years in which an asset is acquired or disposed of, this method would allocate depreciation deductions to the days on which the asset was deemed to be in service under the relevant convention, rather than the days on which the asset was actually held by the partnership. Third, the depreciation deductions attributable to an asset held by a partnership could be allocated to the partnership's partners ratably on each day the asset is actually held by the partnership (the "**Ownership Period Approach**"). This approach has the virtue of arguably following the Partnership Lookthrough Rule's focus on periods in which the partnership held the asset. Fourth, each partner could be treated as allocated, daily throughout its taxable year, any depreciation deductions that the partner includes on its tax return for the year (the "**Partner Year Approach**").[85] Other approaches are also possible.[86]

If the partnership and all partners are calendar-year taxpayers and the allocation of depreciation deductions does not change, the exact date on which the allocation is deemed to occur may not matter, and these different approaches may yield similar results. Thus, it may be relatively straightforward to determine the allocation of depreciation deductions in such a case. However, the different approaches will begin to yield different results in cases where the partnership and its partners have differing taxable years.[87] Consider the following example:

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depreciation deductions for purposes of the Partnership Lookthrough Rule, it does not appear to answer every question regarding how these allocations work, for instance because the Partnership Lookthrough Rule counts depreciation deductions allocated within a calendar year, while Section 706(a), as stated above, governs the flow of tax items between two persons' taxable years.

85 We note that any approach based on the taxable years of the partners, such as the Partner Year Approach, permits greater variation in the calendar years to which deductions are allocated and also requires any partner seeking to apply the Partnership Lookthrough Rule to know the taxable years of all other partners. Accordingly, such an approach will be more difficult to apply and, as demonstrated below, will produce greater distortions than the other approaches.

86 For instance, a partner could be treated as being allocated depreciation deductions on a particular date relevant to the partner, such as the first or last day of the partner's taxable year.

87 For purposes of Example 15 and Example 16 in this Part III.A.1.b.iii(b), assume that the relevant testing period for whether A held a depreciable interest in the asset through partnership C is the years 2017-2021 (as well as the assumed current calendar year, 2022), and, therefore, any depreciation deductions allocated to 2016 (the shaded lines in the tables below) would not be considered.

Example 15. Partnership C has several partners, among which are corporation A and corporation B. A's taxable year begins on July 1 and ends on June 30, B's taxable year begins on February 1 and ends on January 31, and C's taxable year begins on April 1 and ends on March 31. At all times, C allocates all depreciation deductions equally between A and B (and allocates none of such deductions to its other partners). On July 1, 2016, C purchases and places in service an asset that is Bonus-Eligible Property (under post-Act law), but elects not to take bonus depreciation with respect to assets of this class and instead takes $20 of depreciation, using the half-year convention for its first taxable year holding the asset. On September 1, 2017, C disposes of the asset to an unrelated third party, but the half-year convention treats C as disposing of the asset halfway through the year, and C receives $16 of depreciation for the asset for its second taxable year holding the asset. On January 1, 2022, A acquires the asset from the unrelated third party.

Calculations (all numbers approximate)

	Partnership Year-End Approach			**Tax Recovery Period Approach**		
Year	**A Deductions**	**B Deductions**	**A's %**	**A Deductions**	**B Deductions**	**A's %**
2016	$0	$0	N/A	$5	$5	50%
2017	$10	$10	50%	$13	$13	50%
2018	$8	$8	50%	$0	$0	N/A
2019	$0	$0	N/A	$0	$0	N/A
Total	$18	$18	50%	$13	$13	50%
	Ownership Period Approach			**Partner Year Approach**		
Year	**A Deductions**	**B Deductions**	**A's %**	**A Deductions**	**B Deductions**	**A's %**
2016	$6.67	$6.67	50%	$5	$0	100%
2017	$11.33	$11.33	50%	$9	$9.17	49.5%
2018	$0	$0	N/A	$4	$8.16	32.9%
2019	$0	$0	N/A	$0	$0.67	0%
Total	$11.33	$11.33	50%	$13	$18	41.9%

Though their calculations differ significantly, the Partnership Year-End Approach, the Tax Recovery Period Approach and the Ownership Period Approach all yield the same percentage share of depreciation deductions for A. The Partner Year Approach, however, deviates significantly from the other approaches because deductions are allocated to A's and B's taxable years, which extend beyond the calendar year in which C's taxable year ends.

The different approaches will yield even greater differences if the allocation of depreciation deductions changes over time.

Example 16. The facts are the same as Example 15, except that partnership C specially allocates to A 100% of the deductions for C's first taxable year holding the asset.

Calculations (all numbers approximate)

	Partnership Year-End Approach			**Tax Recovery Period Approach**		
Year	**A Deductions**	**B Deductions**	**A's %**	**A Deductions**	**B Deductions**	**A's %**
2016	$0	$0	N/A	$10	$0	100%
2017	$20	$0	100%	$18	$8	69.2%
2018	$8	$8	50%	$0	$0	N/A
2019	N/A	$0	N/A	$0	$0	N/A
Total	$28	$8	77.7%	$18	$8	69.2%
	Ownership Period Approach			**Partner Year Approach**		
Year	**A Deductions**	**B Deductions**	**A's %**	**A Deductions**	**B Deductions**	**A's %**
2016	$13.34	$0	100%	$10	$0	100%
2017	$14.66	$8	64.6%	$14	$0	100%
2018	$0	$0	N/A	$4	$7.33	35.3%
2019	$0	$0	N/A	$0	$0.67	0%
Total	$14.66	$8	64.6%	$18	$8	69.2%

In Example 16, the Partnership Year-End Approach allocates the $20 deduction for C's first taxable year holding the asset to A on the last day of C's taxable year (March 31, 2017). A and B split the remaining deductions on the last day of C's next taxable year (March 31, 2018).

Under the Tax Recovery Period Approach, one-half of the $20 deduction for C's first taxable year holding the asset is allocated to A starting halfway through C's taxable year, in accordance with the half-year convention, and A therefore is allocated $10 from October 1, 2016 to December 31, 2016, and $10 from January 1, 2017 to March 31, 2017. Each of A and B is allocated the entire $8 depreciation deduction from April 1, 2017 to September 30, 2017, because the half-year convention treats the asset as disposed of halfway through C's second taxable year holding the asset. Under the Ownership Period Approach, the $20 deduction for A is allocated two-thirds ($13.34) to the 6 months in 2016 in which C actually holds the asset, and one-third ($6.66) to the 3 months in 2017 that C actually holds the asset. Each of A and B is also allocated the $8 depreciation deduction from April 1, 2017 to September 1, 2017. Finally, under the Partner Year Approach, A allocates one-half of the $20 depreciation deduction arising from C on March 31, 2017 to 2017 and one-half to the prior year, and takes the same approach with the $8 deduction arising from C on March 31, 2018. Similarly, B allocates eleven-twelfths of the $8 deduction arising from C on March 31, 2018 to the 11 months of B's taxable year in 2018, and one-twelfth to the one month of B's taxable year in 2019.

As the complexity of the analysis in Example 16 illustrates, allocating depreciation deductions on a calendar-year basis is difficult where different taxable years are involved. Even more complexity could arise if the partnership or a partner changes its taxable year during the relevant testing period, or a partner leaves the partnership before or during a calendar year in which the partner was allocated depreciation deductions.

Accordingly, we respectfully recommend that Treasury and the Service specify a reasonable method for determining a partner's depreciable interest in partnership property based on the allocation of depreciation deductions. In particular, if the Partnership Lookthrough Rule instead were amended to test the allocation of depreciation deductions in the five <u>taxable</u> years of the partnership prior to its current <u>taxable</u> year, the determination of a partner's prior depreciable interest would be simpler (at least in scenarios like Example 15 and Example 16), and generally would eliminate the need to consider the approaches discussed above. Regardless of how Treasury and the Service ultimately decide to respond, we recommend that final regulations include multiple examples illustrating the adopted approach.

iv. <u>Scope of Partnership Lookthrough Rule</u>

The Partnership Lookthrough Rule, by its terms, would apply "[s]olely for purposes of applying paragraphs (b)(3)(iii)(A)(1) and (b)(3)(iii)(B)(1) and (2)." It is unclear whether this language means that the Partnership Lookthrough Rule, if adopted, would not apply elsewhere in the New Regulations where the concept of depreciable interest is similarly relevant. Indeed, the phrase "depreciable interest" can be found throughout the regulations. For instance, as explained above, the rule permitting bonus depreciation with respect to Section 743(b) adjustments in Treasury Regulations Section 1.168(k)-2(b)(3)(iv)(D) requires testing the transferee partner (and any predecessor) in determining whether it has had any depreciable interest in the portion of the property deemed acquired. The term is also used in the operative provisions of the Final Regulations and the Proposed Regulations regarding substantial renovations of property,[88]

[88] Treas. Reg. § 1.168(k)-2(b)(3)(iii)(B)(3) ("If a taxpayer acquires and places in service substantially renovated property and the taxpayer or a predecessor previously had a <u>depreciable interest</u> in the property before it was substantially renovated . . . ." (emphasis added)).

syndication transactions,[89] de minimis uses of property,[90] and consolidated groups.[91] However, because of the "solely" language in the Partnership Lookthrough Rule, it is unclear whether the Partnership Lookthrough Rule applies in any of these contexts. We believe the Partnership Lookthrough Rule is intended to apply generally throughout the regulations, wherever the concept of "depreciable interest" is relevant, rather than "solely" for a limited purpose. Accordingly, we recommend clarifying the intended scope of the Partnership Lookthrough Rule in the final regulations.

Additionally, we suggest that Treasury and the Service consider whether the Partnership Lookthrough Rule may be unduly restrictive insofar as it would measure depreciation deductions arising from partnership property but disregard depreciation recapture. If a partner is allocated both depreciation deductions with respect to an item of partnership property and depreciation recapture upon the partnership's sale of the property, little risk exists that the partner would enjoy a double benefit upon a subsequent purchase of the item. Accordingly, it may be appropriate to measure a partner's depreciable interest in partnership property by reference to the partner's share of net depreciation deductions (*i.e.*, allocations of depreciation deductions less allocation of recapture gain). Put differently, even if Treasury and the Service decide as a general matter to impute to a partner prior use on the basis of a benefit obtained from the underlying partnership, it is questionable whether this result should still obtain if the partner realizes no net benefit on account of depreciation recapture. We make no recommendation on this point, other than to suggest that Treasury and the Service consider further the possibility of taking depreciation recapture into account in determining prior use under the Partnership Lookthrough Rule.

2. Successive Transfers of Partnership Interests

Under the Partnership Interest Transfer Rule, if a partnership interest is purchased by a taxpayer (the "**Purchasing Partner**") and transferred to a transferee (the "**Successor Partner**") in a Section 168(i)(7) Transaction in the same taxable year, any Section 743(b) adjustment allocable to Bonus-Eligible Property arising from the initial purchase of the partnership interest is eligible for bonus depreciation, assuming all other requirements are met.[92] However, the resulting deduction must be "allocated between the transferor and the transferee on a monthly basis" — that is, the depreciation deduction is shared between the Purchasing Partner and the

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89 Treas. Reg. § 1.168(k)-2(b)(3)(vi) ("[I]f used property is acquired and placed in service by a lessor and the lessor or a predecessor did not previously have a <u>depreciable interest</u> in the used property . . . ." (emphasis added)).

90 *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(4) ("If . . . the taxpayer or a predecessor did not previously have a <u>depreciable interest</u> in the property . . . ." (emphasis added)).

91 *See* Prop. Reg. § 1.168(k)-2(b)(3)(v)(A) ("[A] consolidated group is treated as having a depreciable interest in property during the time any current or previous member of the group had a <u>depreciable interest</u> in the property while a member of the group." (emphasis added)).

92 *See* Treas. Reg. 1.168(k)-2(g)(1)(iii). For purposes of allocating the depreciation deduction between the transferor and transferee, the transferor takes into account the month in which the property was placed in service but not the month in which the property was transferred. *See* Treas. Reg. § 1.168(d)-1(b)(7)(ii); *see also* Treas. Reg. § 1.168(k)-2(g)(1)(iv)(B), Ex. 2.

Successor Partner depending on the number of months out of the calendar year each held the partnership interest.

The Final Regulations include a separate rule for partnership basis adjustments occurring with respect to Section 168(i)(7) Transactions because Section 743(b) adjustments in Bonus-Eligible Property are not themselves Bonus-Eligible Property. The preamble to the Final Regulations states that the Partnership Interest Transfer Rule is meant to "parallel" the rules for actual transfers of property in Section 168(i)(7) Transactions.[93] We commend Treasury and the Service for recognizing that Section 743(b) adjustments in Bonus-Eligible Property should be afforded the same treatment as Bonus-Eligible Property in these respects. Moreover, we interpret the Final Regulations to provide that it is the basis adjustment of the Purchasing Partner (and not the Successor Partner) that determines the amount of the bonus depreciation deduction. This corresponds to the treatment of Section 743(b) adjustments as if the adjustments themselves were Bonus-Eligible Property.[94]

Nevertheless, we discuss below two principal concerns regarding the Partnership Interest Transfer Rule. First, it is unclear when the resulting deduction arises under the Partnership Interest Transfer Rule. The timing is important because the deduction may reduce a partner's outside basis in the partnership, which is key in determining the transferee's amount of a Section 743(b) adjustment. Second, it is unclear how the sharing of a bonus depreciation deduction under the Partnership Interest Transfer Rule affects the determination of the Successor Partner's Section 743(b) adjustment and the allocation of the adjustment among items of partnership property.

The following examples illustrate the need for guidance on these points. Example 17 reviews the tax consequences of a transfer of qualified property in a Section 168(i)(7) Transaction, and Example 18 considers similar facts but involving the transfer of a partnership interest.

> *Example 17.* On January 1, 2020, A purchases equipment that is Bonus-Eligible Property from an unrelated person for $100 and immediately places it in service. On July 1, 2020, A transfers the equipment to A-Sub, a wholly owned subsidiary corporation, in a Section 351(a) transaction. Neither A nor A-Sub has previously used the equipment. A and A-Sub are calendar year taxpayers. Because A transfers the equipment to A-Sub in a Section 168(i)(7) Transaction, the bonus depreciation deduction of $100 is allocated between A and A-Sub based on the number of months the equipment is held by A and A-Sub (*i.e.,* $50 each because each held the equipment for six months out of the year).

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93 *See Final Regulations*, *supra* note 2, 84 Fed. Reg. at 50,118.

94 The Final Regulations reference the basis adjustment that arises "from the initial acquisition," *i.e.,* the acquisition by the Purchasing Partner. They also provide that the deduction is allocated between the Purchasing Partner and the Successor Partner "notwithstanding that under § 1.743-1(f) a transferee's section 743(b) adjustment is determined without regard to a transferor's section 743(b) adjustment, " implying that the Successor Partner's deduction is based on the Purchasing Partner's basis adjustment.

Example 18. On January 1, 2020, M purchases an interest in partnership P from an unrelated person for $100. P has a Section 754 election in effect. P's only assets are equipment that is Bonus-Eligible Property and unimproved land (Blackacre). Immediately after the sale, M's share of the adjusted basis to P of P's property, as determined under Treasury Regulations Section 1.743-1(c), is $100, resulting in a net Section 743(b) adjustment of $0. Further, in a hypothetical sale of P's assets, M's share of the resulting gain with respect to the equipment would be $100 and M's share of the resulting loss with respect to Blackacre would be $100. As a result, even though M's net Section 743(b) adjustment is $0, under the allocation rules of Section 755, M has a positive Section 743(b) adjustment in the equipment of $100 and a negative Section 743(b) adjustment in Blackacre of $100. On July 1, 2020, M transfers its partnership interest in P to M-Sub, a wholly owned subsidiary corporation, in a transaction described in Section 351(a). Neither M nor M-Sub has previously used the equipment. M and M-Sub are calendar year taxpayers. If the transfer of the partnership interest by M to M-Sub is to be treated the same as the transfer of equipment by A to A-Sub in Example 17 above, M and M-Sub should each have a bonus depreciation deduction of $50 because each held the partnership interest for six months out of the year.

The Partnership Interest Transfer Rule appears to provide M and M-Sub with respect to the partnership interest transfer in Example 18 the same result as A and A-Sub with respect to the actual sale of Bonus-Eligible Property in Example 17. However, the Partnership Interest Transfer Rule, as currently drafted, may not necessarily achieve the intended symmetry between Bonus-Eligible Property and basis adjustments in Bonus-Eligible Property because the Final Regulations do not address several critical questions. Does M reduce its basis in the P interest by $100 (the full amount of the deduction) or only $50 (its share of the deduction)? What is the outside basis of the partnership interest for purposes of determining M-Sub's Section 743(b) adjustment? And how is that adjustment allocated among P's assets? We discuss the possible complications in Part III.A.2.b.i and Part III.A.2.b.ii below. Before addressing these issues, we briefly review the state of the law for determining basis adjustments in substituted basis transactions.

a. Treatment of Section 743(b) Adjustments in Substituted Basis Transactions

In general, a taxable acquisition of a partnership interest gives rise to a "two-way" Section 743(b) adjustment. That is, the Section 743(b) adjustment from a taxable acquisition of a partnership interest is a <u>net</u> adjustment that may be allocated between the partnership's two classes of property (ordinary income property and capital gain property) and can result in both positive adjustments (increases to basis) and negative adjustments (decreases to basis).[95] The Section 743(b) adjustment generally is allocated first to ordinary income property, *i.e.*, the class of partnership property that consists of all partnership assets other than capital assets and Section 1231(b) property, to the extent of the income, gain or loss that would be allocated to the Purchasing Partner in a hypothetical sale of the ordinary income assets for cash equal to their fair

[95] Treasury and the Service adopted the "two-way" adjustment rule for taxable acquisitions of partnership interests effective December 15, 1999. *See* T.D. 8847, 64 Fed. Reg. 69,903 (Dec. 15, 1999); *see also* Treas. Reg. § 1.755-1(e)(1).

market value.[96] The amount of the Section 743(b) adjustment allocated to capital gain property — *i.e.*, capital assets and Section 1231(b) property of the partnership — is the difference between the total Section 743(b) adjustment and the amount of the basis adjustment allocated to ordinary income property.[97] Thus, the amount allocated to ordinary income property may be a positive adjustment while the amount allocated to capital gain property may be a negative adjustment.[98] Within each class, the amount allocated to an item may be a positive adjustment while the amount allocated to another item may be a negative adjustment.[99]

Different rules apply when a transferee (the "**Substituted Basis Partner**") acquires a partnership interest in a transaction in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in that interest (a "**Substituted Basis Transaction**"). Under current law, the Substituted Basis Partner does not inherit any Section 743(b) adjustment from the Purchasing Partner. The Substituted Basis Partner instead determines its basis adjustment without regard to any prior transferee's basis adjustment.[100] Further, Treasury Regulations Section 1.755-1(b)(5) (the "**Substituted Basis Allocation Regulations**") provides for only "one-way" basis adjustments. This means that a Substituted Basis Partner's basis adjustment is allocated among partnership property in a different manner than the "two-way" basis adjustments for a Purchasing Partner. Depending on whether the partnership has net unrealized built-in gain or loss, the Substituted Basis Allocation Regulations may shift allocations of basis adjustments toward or away from Bonus-Eligible Property.

The "one-way" adjustments mandated by the Substituted Basis Allocation Regulations operate as follows: if an aggregate basis adjustment with respect to a Substituted Basis Partner is zero, no adjustment may be made to the basis of partnership property.[101] If the aggregate basis adjustment is positive, the basis adjustment resulting from the Substituted Basis Transaction may be allocated to ordinary income property or capital gain property only if the hypothetical sale of all partnership property in that class would result in net gain or net income to the Substituted Basis Partner.[102] If the aggregate basis adjustment is negative, the basis adjustment may be allocated to ordinary income property or capital gain property only if the hypothetical sale of all partnership property in that class would result in net loss to the Substituted Basis Partner.[103]

The following example, which does not involve depreciable property or bonus depreciation, illustrates the basic application of the Substituted Basis Allocation Regulations:

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

97 *See id.*

98 *See* Adjustments Following Sales of Partnership Interests, 63 Fed. Reg. 4408, 4412 (proposed Jan. 29, 1998).

99 *See* Treas. Reg. § 1.755-1(b)(3)(i), (ii).

100 *See* Treas. Reg. § 1.743-1(f).

101 *See* Treas. Reg. § 1.755-1(b)(5)(ii).

102 *See id*.

103 *See id*.

> *Example 19.* X, Y, and Z are equal partners in the partnership XYZ, and Z sells its interest to W for $200. XYZ owns three assets: two items of ordinary income property and one item of capital gain property. Immediately after the sale, W's share of the adjusted basis to XYZ of XYZ's property, as determined under Treasury Regulations Section 1.743-1(c), is $200, resulting in a net Section 743(b) adjustment of $0. Further, in a hypothetical sale of XYZ's assets, W's share of the gain with respect to the first item of ordinary income property (receivables) is $100, its share of the gain with respect to the second item of ordinary income property (inventory) is $0 and its share of the loss with respect to the single item of capital gain property (Blackacre) is $100. Accordingly, W receives a positive adjustment of $100 in the ordinary income property (allocated entirely to the receivables) and a negative adjustment of $100 in the only item of capital gain property (Blackacre). In a later year, W transfers the partnership interest to W-Sub in a Section 351 transaction in which $50 of gain is recognized (*e.g.*, because W receives boot) at a time when the built-in loss in Blackacre with respect to W has declined to $50.

W-Sub's basis adjustment must be determined without regard to W's basis adjustment. The amount of W-Sub's net basis adjustment is $50 (outside basis of $250 over W-Sub's share of inside basis of $200). Because the net basis adjustment is positive, no basis adjustment may be allocated to any class of property that, if sold, would result in net loss to W-Sub. Thus, the capital gain property (Blackacre), in which W-Sub's share of the loss is $50, is not eligible for any basis adjustment, and the $50 basis adjustment must be allocated entirely to the ordinary income assets, which are held at a net gain. Further, the entire $50 is allocated to the receivables because the Substituted Basis Allocation Regulations prioritize assets with unrealized appreciation when allocating positive basis adjustments within a class of partnership property. In sum, the basis adjustment for W-Sub (only a $50 positive basis adjustment with respect to the receivables) looks very different from the basis adjustments for W ($100 positive basis adjustment with respect to the receivables and $100 negative adjustment with respect to Blackacre).

Proposed regulations published in 2014 would help eliminate shifts in basis adjustments by requiring that the Substituted Basis Partner step into the basis adjustments of the Purchasing Partner.[104] Under Section 1.743-1(f)(2) of those proposed regulations (the "**Proposed Substituted Basis Transaction Regulations**"), when a Purchasing Partner has a Section 743(b) adjustment attributable to a partnership interest that is subsequently transferred in a Substituted Basis Transaction, the Substituted Basis Partner succeeds to that portion of the Purchasing Partner's basis adjustment attributable to the transferred partnership interest.[105] The basis

[104] *See* Modification of Basis Allocation Rules for Substituted Basis Transactions, 79 Fed. Reg. 3041 (Jan. 16, 2014). For our Report on these proposed regulations, see NEW YORK STATE BAR ASS'N TAX SECTION, REPORT NO. 1314 ON THE PROPOSED REGULATIONS ON PARTNERSHIP BUILT-IN LOSSES (2014), *reprinted in*, 2015 TNT 175-21 (Sept. 9, 2015).

[105] The Proposed Substituted Basis Transaction Rule will be effective only for transfers of partnership interests occurring on or after the date the Proposed Substituted Basis Transaction Rule is adopted as final. *See* Prop. Reg. § 1.743-1(p) (2014).

adjustments to which the Substituted Basis Partner succeeds are taken into account in determining the allocation of the basis adjustments under Section 755.[106]

In Example 19, assuming the Proposed Substituted Basis Transaction Regulations applied, W-Sub succeeds to W's positive basis adjustment of $100 with respect to the receivables and W's negative basis adjustment of $100 with respect to Blackacre. These adjustments are taken into account in determining W-Sub's share of the adjusted basis of XYZ property. Accordingly, W-Sub has an additional basis adjustment of $50 (because W-Sub has an outside basis of $250 and W-Sub's share of the inside basis is $200, after giving effect to the inherited adjustments). The $50 adjustment is not allocated to any ordinary income property because, taking into account W's adjustments to which W-Sub succeeded, there is no built-in gain in the ordinary income property. After giving effect to those adjustments, the capital gain property (*i.e.*, Blackacre) has a built-in gain of $50. Therefore, the entire $50 adjustment is allocated to the capital gain property.

By way of summary, the table below summarizes the allocation of the aggregate $50 positive Section 743(b) adjustment by W-Sub (the Successor Partner) in Example 19.

	Treatment of W-Sub under Current Law	Treatment of W-Sub under Proposed Substituted Basis Regulations
Receivables	Allocated adjustment of $50 because ordinary income assets are held at a net gain and there is unrealized appreciation in receivables.	Succeeds to W's $100 positive adjustment. No allocation of additional adjustment because there is no built-in gain in ordinary income property.
Inventory	No allocation of adjustment because there is no unrealized appreciation in inventory.	No allocation of additional adjustment because there is no built-in gain in ordinary income property.
Blackacre	No allocation of adjustment because adjustment is positive and capital gain property is held at loss.	Succeeds to W's $100 negative adjustment. Allocated all $50 positive adjustment because Blackacre is held at a gain (after giving effect to $100 negative adjustment).

b. Suggested Changes to the Partnership Interest Transfer Rule

We respectfully recommend that the Partnership Interest Transfer Rule be clarified in two respects: (i) whether a bonus depreciation deduction should be considered as arising before or after the Section 168(i)(7) Transaction (or partly before and partly after), and (ii) how the Partnership Interest Transfer Rule interacts with the Substituted Basis Allocation Regulations. We discuss each of these issues below.

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[106] *See* Prop. Reg. § 1.743-1(f)(2) (2014). The 2014 proposed regulations also proposed changes to the regulations under Section 755 applicable to Substituted Basis Transactions. Under the proposed regulations, as under the current regulations, no adjustment to items of partnership property may be made if the aggregate basis adjustment is zero. *See* Prop. Reg. § 1.755-1(b)(5)(ii)(A) (2014). However, the proposed regulations would allocate a positive or negative adjustment, as applicable, to ordinary income property or capital gain property in proportion to, and to the extent of, gross gain or gross loss (as opposed to net gain and net loss under the current regulations). *See* Prop. Reg. § 1.755-1(b)(5)(ii)(B), (C) (2014).

i. Timing of Resulting Bonus Depreciation Deduction

The Partnership Interest Transfer Rule provides that, if a partnership interest is purchased and transferred in a Section 168(i)(7) Transaction in the same taxable year and all other requirements are satisfied, the bonus depreciation "deduction is allowable for any Section 743(b) adjustment that arises from the initial acquisition with respect to Bonus-Eligible Property held by the partnership." However, the deduction must be "allocated between the transferor and the transferee on a monthly basis."[107] It is not clear under this rule when the deduction, in fact, becomes "allowable." The answer to this timing question is critically important because, under Section 705, the deduction generally will reduce a partner's outside basis which is key in determining the amount of a Section 743(b) adjustment.[108]

One interpretation is that, because the deduction "arises from the initial acquisition," the deduction is taken in full by the Purchasing Partner before the transfer of the partnership interest in the Section 168(i)(7) Transaction only to be shared with the Successor Partner after the transfer. Under this interpretation, it is unclear exactly how the Successor Partner would claim its share of the bonus depreciation deduction. It is also unclear what impact the deduction would have on the parties' basis amounts, but possibly the Purchasing Partner's outside basis would be reduced by the full amount of the deduction, such that the Successor Partner generally would take a carryover basis in the partnership interest equal to the Purchasing Partner's cost basis, reduced by the full amount of the allowable depreciation deduction.

Another possible interpretation is that, because the deduction is "allocated between the transferor and the transferee," the deduction is treated as a partnership item that the partnership allocates between the Purchasing Partner and the Successor Partner. Under this interpretation, the Purchasing Partner would reduce its basis in the partnership interest only by the amount of the allocated deduction. The Successor Partner would then take a carryover basis, in most cases equal to the Purchasing Partner's cost basis, reduced only by the Purchasing Partner's portion of the deduction.

A third approach conceivably would be to treat the deduction as arising after the transfer of the partnership interest by the Purchasing Partner to the Successor Partner. In that case, the Purchasing Partner would not reduce its outside basis in the partnership. The Successor Partner would take a carryover basis in the partnership interest presumably equal to the Purchasing Partner's cost basis and would reduce outside basis only after it obtains the deduction.

We believe that Treasury and the Service should adopt the second approach and include examples illustrating the rule's application. The chief advantage of the second approach is that it provides a mechanism for allocating the deduction between the Purchasing Partner and the

107 Treas. Reg. § 1.168(k)-2(g)(1)(iii).

108 The partnership's taxable year ends with respect to a partner that disposes of its entire partnership interest. *See* I.R.C. § 706(c)(2)(A). The departing partner's share of income or loss for the period ending on the date of disposition is determined and included in that partner's return that includes such date. *See* Treas. Reg. § 1.705-1(a)(1). In the event the partner disposes of less than the entire interest, the partnership's taxable year does not end with respect to that partner, but outside basis adjustments for partnership operations through the date of disposition may be appropriate. *See* Treas. Reg. § 1.705-1(a)(1) ("[W]here there has been a sale or exchange of all or a part of a partnership interest . . . the adjusted basis of the partner's interest should be determined as of the date of sale or exchange . . ." (emphasis added)).

Successor Partner, which is lacking in the other approaches. The second approach is also consistent with the treatment of qualified property placed in service and transferred in a Section 168(i)(7) Transaction in the same taxable year.[109] Further, if the relevant Section 168(i)(7) Transaction is a contribution to a corporation or partnership, the second approach will ensure that the Purchasing Partner takes basis in the stock or partnership interests received in the Section 168(i)(7) Transaction that reflects the deduction that the Purchasing Partner actually obtained.

ii. Interaction with the Substituted Basis Allocation Regulations

The Partnership Interest Transfer Rule and the Substituted Basis Allocation Regulations are in tension with one another. That is, as explained above, the Partnership Interest Transfer Rule grants a deduction to a Successor Partner by reference to another taxpayer's basis adjustment (*i.e.*, that of the Purchasing Partner), but the Substituted Basis Allocation Regulations, by their terms, require that the determination and allocation of the Successor Partner's Section 743(b) adjustment be made without regard to any prior transferee's basis adjustments. This means that the Successor Partner's basis adjustment may not appropriately reflect the consequences of the deduction that the Successor Partner obtains under the Partnership Interest Transfer Rule insofar as the Successor Partner is a Substituted Basis Partner, as will often be the case.

Consider the facts of Example 18. Under our interpretation of the Partnership Interest Transfer Rule, M and M-Sub are each allocated a bonus depreciation deduction of $50 upon M's contribution of the P interest to M-Sub. Further, M-Sub takes a carryover basis in the partnership interest of $50 from M (*i.e.*, M's initial basis of $100, reduced by the $50 bonus depreciation deduction, and carried over to M-Sub under Section 362(a)).

As indicated above, under current law, M-Sub must nevertheless determine its own Section 743(b) adjustment without regard to M's basis adjustment. M-Sub's Section 743(b) adjustment is equal to the difference between M-Sub's outside basis and M-Sub's share of P's inside basis. However, it is unclear exactly what M-Sub's outside basis would be for this purpose. Perhaps the outside basis would be $50, reflecting the carryover basis from M's transfer. Or perhaps the outside basis would be zero, reflecting the deduction received on account of the Section 168(k) deduction. The answer under current law is unclear.

If we assume that M-Sub's outside basis is $50, M-Sub would have a negative Section 743(b) adjustment of $50 (*i.e.*, outside basis of $50, over M-Sub's share of P's inside basis of $100). Under the "one-way" adjustment rules of the Substituted Basis Allocation Regulations, the adjustment must be allocated entirely to Blackacre. The adjustment, however, would not be sufficient to eliminate the loss that would be allocated to M-Sub upon the sale of Blackacre. Thus, after the contribution of the P interest to M-Sub, P would have a built-in gain of $100 in the equipment and a built-in loss of $50 as to M-Sub. This result is not intuitive. The effect of the Partnership Interest Transfer Rule is that M-Sub, after giving effect to the adjustments, could

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[109] *See* Treas. Reg. § 1.168(k)-2(g)(1)(iv), Ex. 2. In this example, XX purchases qualified property and contributes it to partnership BC in the same taxable year with the result that each receives a portion of the allowable deduction. Nothing in the example suggests that XX or partnership BC receives the entire deduction only to surrender it to the other party.

claim a loss upon P's disposition of Blackacre, even though M, which actually purchased the partnership interest, could not.

The Proposed Substituted Basis Transaction Regulations would alleviate the complications in Example 18 and likely in many other situations as well. In Example 18, under the proposed rule, M-Sub would succeed to M's remaining Section 743(b) adjustments: a positive $50 adjustment in P's equipment and a negative $100 adjustment in Blackacre. With these adjustments taken into account, M-Sub's outside basis ($50) would equal its share of the partnership's inside basis ($50), and no further allocations of the Section 743(b) adjustment could be made. The $50 deduction allocated to M-Sub under the Partnership Interest Transfer Rule would reduce the $50 adjustment that M-Sub inherited in P's equipment. Indeed, the end result is similar to the treatment of an actual transfer of Bonus-Eligible Property in Example 17. However, while the Proposed Substituted Basis Transaction Regulations may reach a more sensible result, those proposed regulations, as discussed above, have not yet been finalized.

Therefore, until finalization of the Proposed Substituted Basis Transaction Regulations, we recommend that Treasury and the Service permit taxpayers to use any reasonable method to account for the deduction allowed to a Successor Partner under the Partnership Interest Transfer Rule in determining the Successor Partner's Section 743(b) adjustments and the appropriate allocations thereof. We believe that one appropriate method for doing so would be as follows (collectively, the "**Reasonable Allocation Method**"): (1) solely to determine the Successor Partner's Section 743(b) adjustment, the Successor Partner's basis in its partnership interest should be reduced by the amount of the deduction allowed to the Successor Partner under the Partnership Interest Transfer Rule, and (2) the Section 743(b) adjustment should be determined and allocated under the Substituted Basis Allocation Regulations by disregarding the partnership's Bonus-Eligible Property to which the deduction is attributable.

Consider Example 18 under the Reasonable Allocation Method. If M-Sub's outside basis in the P interest is deemed to be zero, M-Sub would have a negative Section 743(b) adjustment of $100 (M-Sub's outside basis of zero over M-Sub's share of inside basis of $100). The negative adjustment, in turn, would be allocated entirely to Blackacre, which has a built-in loss of $100 as to M-Sub. Accordingly, the Reasonable Allocation Method produces the exact same result in Example 18 as the Proposed Substituted Basis Transaction Regulations.

Two additional examples further illustrate the Reasonable Allocation Method's application:

> *Example 20.* On January 1, 2020, O purchases an interest in partnership R from an unrelated person for $100. R partnership has a Section 754 election in effect. Immediately after the sale, O's share of the adjusted basis of R's property is $30, resulting in a positive Section 743(b) adjustment of $70. R's only assets are equipment that is Bonus-Eligible Property (of which O's share of the gain in a hypothetical sale would be $40), Blackacre (of which O's share of the gain in a hypothetical would be $50), and Whiteacre (of which O's share of the loss in a hypothetical sale would be $20). Accordingly, the $70 adjustment is allocated with a $40 positive adjustment to the equipment, a $50 positive adjustment to Blackacre, and a $20 negative adjustment to Whiteacre. On July 1, 2020, O transfers its partnership interest in R to O-Sub, a wholly owned subsidiary corporation, in a Section 351(a) transaction and recognizes no gain. The values do not change between O's initial acquisition and the contribution to O-Sub.

Under the Partnership Interest Transfer Rule, O is entitled to a bonus depreciation deduction of $20. O-Sub takes carryover basis of $80 in the R interest. Under the Reasonable Allocation Method, O-Sub determines its Section 743(b) adjustment by treating its outside basis as if it were $60, resulting in a positive Section 743(b) adjustment of $30 ($60 over O-Sub's share of inside basis of $30). Because the basis adjustment is positive, the basis adjustment may be allocated only to Blackacre, the only asset with unrealized appreciation (other than the equipment, which would be disregarded under the Reasonable Allocation Method). Accordingly, N-Sub has a basis adjustment of $30 in Blackacre and no basis adjustment in Whiteacre.[110]

> *Example 21.* On January 1, 2020, N purchases an interest in partnership Q from an unrelated person for $100. Q has a Section 754 election in effect. Immediately after the sale, N's share of the adjusted basis of Q's property is $0, resulting in a positive Section 743(b) adjustment of $100. The Q partnership's only assets are equipment that is Bonus-Eligible Property (of which N's share of the gain from a hypothetical sale would be $40), Blackacre (of which N's share of the gain from a hypothetical sale would be $10), and Whiteacre (of which N's share of the gain would be $50). Accordingly, the $100 adjustment is allocated with a positive adjustment of $40 in the equipment, a positive adjustment in Blackacre of $10, and a positive adjustment in Whiteacre of $50. On July 1, 2020, N transfers its partnership interest in Q to N-Sub, a wholly owned subsidiary corporation, in a Section 351(a) transaction and recognizes no gain. At the time of the transfer, N's share of the gain from a hypothetical sale of Blackacre has increased to $20 and N's share of the gain from a hypothetical sale of Whiteacre has decreased to $30. Neither N nor N-Sub has previously used the equipment. N and N-Sub are calendar year taxpayers.

Under the Partnership Interest Transfer Rule, N is entitled to a bonus depreciation deduction of $20. N-Sub takes a carryover basis of $80 in the Q interest. Under the Reasonable Allocation Method, N-Sub determines its Section 743(b) adjustment by treating its outside basis as if it were $60, resulting in a positive Section 743(b) adjustment of $60 ($60 over N-Sub's share of inside basis of zero, ignoring the equipment). The adjustment is allocated to Blackacre and Whiteacre in accordance with unrealized appreciation, and then in proportion to the hypothetical amount realized.[111] That results in an adjustment of $24 in Blackacre and $36 in Whiteacre (*i.e.*, $20 of the unrealized appreciation in Blackacre and $30 of the unrealized appreciation in Whiteacre, with the remaining $10 of the adjustment allocated proportionately).[112]

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110 In Example 20, the application of the Proposed Substituted Basis Transaction Regulations would result in different adjustments to Blackacre and Whiteacre with respect to O-Sub. In particular, O-Sub would inherit O's positive basis adjustment in Blackacre of $50 and negative basis adjustment in Whiteacre of $20. No further allocation would be permissible because the total Section 743(b) adjustment would be zero. *See* Prop. Reg. § 1.755-1(b)(5)(ii)(A) (2014).

111 *See* Treas. Reg. § 1.755-1(b)(5)(iii).

112 In Example 21, under the Proposed Substituted Basis Transaction Regulations, N-Sub would inherit a basis adjustment of $20 in the equipment, $10 in Blackacre, and $50 in Whiteacre. Its Section 743(b) adjustment would be zero, the difference between its outside basis ($80) and its share of inside basis, taking into account the basis adjustments inherited from N ($80). Because N-Sub's total basis adjustment would be zero, no further allocations would be permitted. *See* Prop. Reg. § 1.755-1(b)(5)(ii)(A) (2014).

B. Definitional, Consolidated Group & Other Miscellaneous Recommendations

1. 5-Year Lookback Rule for Depreciable Interests

a. Recommended Technical Changes

i. <u>"Five Calendar Years"</u>

As currently drafted, the 5 Year Safe Harbor in Treasury Regulations Section 1.168(k)-2(b)(3)(iii)(B)(1) states that, in determining if the taxpayer or a predecessor previously had a depreciable interest in property "only the five calendar years immediately prior to the taxpayer's current placed-in-service year of the property [are] taken into account." The New Regulations do not define the phrase "placed-in-service year," but the phrase appears to refer to the <u>taxable</u> year in which an item of property is placed in service. Certain portions of the New Regulations also suggest that the "placed-in-service year" is a taxable year. For instance, Section 168(k) itself refers in several places to the "taxable year in which such property is placed in service," and the New Regulations sometimes use the phrase "placed-in-service year" in what appear to be related portions of the New Regulations.[113] Treasury Regulations Section 1.168(k)-2(f)(1)(iv) refers to a determination of depreciation "for the placed-in-service year and for all subsequent taxable years." Furthermore, it seems more likely that the "placed-in-service year" would be a taxable year, as placement in service is itself a legal concept arising from the Code and Treasury Regulations.[114]

Given that a "placed-in-service year" appears to refer to a taxable year, as the example below illustrates, it is not clear how to determine which years are the "five calendar years immediately prior to the taxpayer's current placed-in-service year." Since a taxable year, of course, can begin on a date other than January 1, there is not necessarily a particular calendar year that is "immediately prior" to such taxable year. This issue matters because it affects how far back in time a taxpayer must look to determine whether there is a prohibited prior use.

For example, assume that a taxpayer has a short taxable year that begins on July 15, 2019, and that the taxpayer acquires Bonus-Eligible Property and places it in service on that day.

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[113] *Compare, e.g., Final Regulations*, *supra* note 2, 84. Fed. Reg. at 50,108 ("Section 168(k) allows an additional first year depreciation deduction in the placed-in-service year of qualified property."), *with* I.R.C. § 168(k)(1)(A) ("[T]he depreciation deduction provided by section 167(a) for the taxable year in which such property is placed in service shall include an allowance equal to the applicable percentage of the adjusted basis of the qualified property").

[114] We do note that other portions of the New Regulations arguably suggest that the "placed-in-service year" could be a calendar year (or portions thereof). The reference to a calendar year "immediately prior to" the placed-in-service year suggests that the placed-in-service year is a calendar year that must start on January 1. In addition, Proposed Regulations Section 1.168(k)-2(c)(5) refers to "the phase-down percentage in section 168(k)(8) applicable to the placed-in-service year of the larger self-constructed property." The phase-down percentages in Section 168(k)(8), other than the zero-percent rate in Section 168(k)(8)(D), generally apply to calendar years (or portions thereof). In addition, if a "placed-in-service year" is a taxable year, it could have <u>two different</u> phasedown percentages if the taxable year did not begin on January 1, a possibility not addressed by the Proposed Regulations, which refer to "<u>the</u> phase-down percentage . . . applicable to the placed-in-service year."

Assuming that the "placed-in-service" year is the taxpayer's short taxable year, there are at least two possible interpretations of the "five calendar years" referenced in the Final Regulations.

- The five calendar years could be the years 2014, 2015, 2016, 2017 and 2018 (and the "stub" portion of 2019 covering the period up to the beginning of the taxpayer's current taxable year). If so, we recommend that Treasury Regulations Section 1.168(k)-2(b)(3)(iii)(B)(1) be amended to clarify that any depreciable interest held in the "stub" portion of the current calendar year (2019, in this example) is also within the 5 Year Safe Harbor, and to refer more specifically to the years in question, perhaps using the language "the preceding portion of the taxpayer's current placed-in-service year for the property, the five calendar years ending prior to the taxpayer's current placed-in-service year for the property, and the portion of any calendar year beginning before and ending on the first day of the taxpayer's current placed-in-service year for the property."
- The five calendar years could be the years 2015, 2016, 2017 and 2018 (and the "stub" portion of 2019 covering the period up to the beginning of the taxpayer's current taxable year). If so, we recommend that Treasury Regulations Section 1.168(k)-2(b)(3)(iii)(B)(1) be amended to provide that any depreciable interest held in the "stub" portion of the current calendar year (2019, in this example) is also within the 5 Year Safe Harbor, and to refer more specifically to the years in question, perhaps using the language "the preceding portion of the taxpayer's current placed-in-service year for the property, the four calendar years ending prior to the taxpayer's current placed-in-service year for the property, and the portion of any calendar year beginning before and ending on the first day of the taxpayer's current placed-in-service year for the property."

Accordingly, we recommend that Treasury and the Service amend the language of Treasury Regulations Section 1.168(k)-2(b)(3)(iii)(B)(1) to clarify which years are covered by the 5 Year Safe Harbor and also recommend that Treasury and the Service add one or more examples illustrating the application of the 5 Year Safe Harbor. Other alternatives to the language listed above are possible. One alternative would be to amend Treasury Regulations Section 1.168(k)-2(b)(3)(iii)(B)(1) and refer to the preceding portion of the <u>current calendar year</u> and the five (or four) calendar years immediately prior to the <u>current calendar year</u>, removing any reference to "placed-in-service year." Another alternative would be to focus on the sixty months ending on the day immediately prior to the taxpayer's current placed-in-service year, and the portion of any month beginning before and ending during or after the taxpayer's current placed-in-service year.

ii. <u>"The Taxpayer and a Predecessor"</u>

Treasury Regulations Section 1.168(k)-2(b)(3)(iii)(B)(1) also provides that, "[i]f the taxpayer and a predecessor have not been in existence for this entire five-year period, only the number of calendar years the taxpayer and the predecessor have been in existence is taken into account." This language arguably suggests that a short-lived predecessor can limit the lookback period for a taxpayer, or vice versa. Consider the following example:

> *Example 22.* Corporation A has been in existence for decades, while corporation B is formed on January 1, 2018. A owned and used asset C, which is Bonus-Eligible Property, in 2016, but disposed of the asset on July 1, 2016. On January 1, 2019, B merges into A in a transaction described in Section 368(a)(1)(A). On January 1, 2020, A reacquires asset C in a transaction otherwise qualifying under Section 168(k)(2)(E)(ii).

A's 2020 acquisition should necessitate looking back to determine if the No Prior Use Test is satisfied. However, A conceivably could argue that "the taxpayer and the predecessor" have been in existence for only 2 years (January 1, 2018 through January 1, 2020), and that, accordingly, only 2 calendar years are taken into account, overlooking A's 2016 ownership of asset C. The same argument could be made with the opposite facts: if A were newly formed but B was a long-standing predecessor that owned asset C in 2016.[115] To address these issues, we recommend that Treasury and the Service amend the previously quoted sentence in Treasury Regulations Section 1.168(k)-2(b)(3)(iii)(B)(1) to clarify that the taxpayer and each of its predecessors is subject to a <u>separate</u> 5-year lookback period that begins no earlier than the date such person came into existence.

b. 5 Year Safe Harbor Should Apply for Other Relevant Purposes

The 5 Year Safe Harbor currently states that "[t]o determine if the taxpayer or a predecessor had a depreciable interest in the property at any time prior to acquisition, only the five calendar years immediately prior to the taxpayer's current placed-in-service year of the property [are] taken into account."[116] This language appears to limit the 5 Year Safe Harbor (i) to the determination of whether <u>the taxpayer or a predecessor</u> previously held a depreciable interest and (ii) to the determination, <u>as of the date of the current acquisition</u>, whether a prior depreciable interest was held during the relevant five-year period preceding the current acquisition. This language, by its terms, does not appear to apply to the determination whether any other person previously held a depreciable interest in an asset. However, as this Report discusses, the prior ownership of Bonus-Eligible Property by persons other than the taxpayer or its predecessor is relevant in certain cases, such as the Transferor Allocation Rule. The following examples illustrate certain such situations:

> *Example 23.* On January 1, 2019, corporation A acquires a used asset that is Bonus-Eligible Property in a transaction otherwise qualifying under Section 168(k)(2)(E)(ii) and places the asset in service. On July 1, 2019, A transfers the asset to partnership BC, which has two existing partners, B and C, in exchange for partnership interests in a Section 721 transaction. Under Treasury Regulations Section 1.168(k)-2(g)(1)(iii), to establish whether A receives the entire bonus depreciation deduction or shares the deduction with BC, A must determine if either B or C previously held a depreciable interest in the asset.

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[115] An extreme interpretation of Treasury Regulations Section 1.168(k)-2(b)(3)(iii)(B)(1) would permit a taxpayer not to look back for a prior depreciable interest at all if the taxpayer did not have a predecessor.

[116] *See* Treas. Reg. § 1.168(k)-2(b)(3)(iii)(B)(1).

> *Example 24.* On January 1, 2019, corporation A, the parent of the A consolidated group, in a transaction otherwise qualifying under Section 168(k)(2)(E)(ii), purchases from corporation B a used asset that is Bonus-Eligible Property, in which A has never had a depreciable interest. Under Proposed Regulations Section 1.168(k)-2(b)(3)(v)(A), to establish whether A receives a bonus depreciation deduction with respect to the asset, A would need to determine if any other member of the A consolidated group previously held a depreciable interest in the asset while a member of the A consolidated group.

> *Example 25.* On January 1, 2019, corporation A, the parent of the A consolidated group enters into a purchase agreement with corporation B, the parent of the B consolidated group. Pursuant to the purchase agreement, in exchange for cash, B transfers to A, in a transaction otherwise qualifying under Section 168(k)(2)(E)(ii), a used asset that is Bonus-Eligible Property and 100% of the stock of corporation C, a subsidiary of B. Under Proposed Regulations Section 1.168(k)-2(b)(3)(v)(B), to establish whether A receives a bonus depreciation deduction with respect to the asset, A would need to determine if C previously held a depreciable interest in the asset.

> *Example 26.* On January 1, 2019, corporation B buys from unrelated corporation C 50% of the partnership interests in partnership A, which holds a single used asset that is Bonus-Eligible Property and has a Section 754 election in effect. B's purchase produces a Section 743(b) adjustment and otherwise qualifies under Section 168(k)(2)(E)(ii) and Treasury Regulations Section 1.168(k)-2(b)(3)(iv)(D). Under Treasury Regulations Section 1.168(k)-2(b)(3)(iv)(D)(1)(i), in order to establish whether the Section 743(b) adjustment is eligible for bonus depreciation, A must determine whether B previously held a depreciable interest in the portion of the property deemed acquired by B.

> *Example 27.* On January 1, 2020, corporation B, a syndicator, acquires a new asset that is Bonus-Eligible Property and places the asset in service on the same date. B leases the asset to corporation C on the same date, but holds the asset for sale and, on April 1, 2020, sells the asset to corporation A. C remains the lessee of the asset at all relevant times. Under Treasury Regulations Sections 1.168(k)-2(b)(3)(vi) and -2(b)(4)(iv), to establish whether A is treated as originally placing the asset in service, A would need to determine if B previously held a depreciable interest in the asset as of January 1, 2020.

In each of these examples, we believe that A should be entitled to apply the 5 Year Safe Harbor and examine only the five previous years of the relevant person's prior ownership. Indeed, these examples arguably are more worthy of the relief provided by the 5 Year Safe Harbor than the cases to which the 5 Year Safe Harbor currently applies under the Final Regulations, because a taxpayer likely has even less access to documents and records from a third party than it does to its own documents and records and, therefore, less ability to determine if a third party previously owned or used an asset than to determine its own prior ownership or use. A third party may have no incentive or be unwilling to share such information or in some cases may be legally or contractually prohibited from doing so.[117] Accordingly, we recommend that Treasury and the Service expand the 5 Year Safe Harbor to permit a taxpayer to rely on it in determining whether

[117] *See* PRIOR REPORT, *supra* note 6, at 39.

any other person has previously had a depreciable interest in an asset for Section 168(k) purposes.

In addition, the language of the 5 Year Safe Harbor ("the five calendar years immediately prior to the taxpayer's current placed-in-service year") does not appear to apply to the determination of whether the taxpayer or a predecessor had a depreciable interest at a point in time other than the present time. However, as this Report discusses, the New Regulations in certain cases require the determination of the prior ownership of Bonus-Eligible Property by the taxpayer or its predecessor at a time in the past. Consider the following examples:

> *Example 28.* On December 1, 2017, corporation A, acquires a used asset that is Bonus-Eligible Property and places the asset in service on the same date. On February 1, 2018, A sells the asset to an unrelated person. On January 1, 2022, A reacquires the asset from a different person in a cash purchase otherwise qualifying under Section 168(k)(2)(E)(ii). Under Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(B)(4), to establish whether A's 62-day ownership and use of the asset in 2017 and 2018 is treated as a cognizable depreciable interest in the asset (which would render the 2022 reacquisition ineligible for bonus depreciation), A would need to determine if A or any predecessor thereof had previously had a depreciable interest in the asset as of December 1, 2017.

> *Example 29.* On January 1, 2020, corporation A, a syndicator, acquires an asset that is Bonus-Eligible Property and places the asset in service on the same date. A leases the asset to corporation C on the same date, but holds the property for sale and, on April 1, 2020 (91 days after placing the asset in service), sells the asset to corporation B. C remains the lessee of the asset at all relevant times. On January 1, 2022, after B has disposed of the asset in the market, A reacquires the asset in a cash purchase otherwise qualifying under Section 168(k)(2)(E)(ii). Under Treasury Regulations Section 1.168(k)-2(b)(3)(vi), to establish whether A's 91-day ownership and use of the asset in 2020 is treated as a cognizable depreciable interest in the asset (which would render the 2022 reacquisition ineligible for bonus depreciation), A would need to determine if A or any predecessor thereof had previously had a depreciable interest in the asset as of January 1, 2020.

In each of these examples, we believe that A should be entitled to apply the 5 Year Safe Harbor, looking back for five years from the earlier determination date (*i.e.*, from December 1, 2017 in Example 28, and from January 1, 2020 in Example 29). Therefore, we recommend that the 5 Year Safe Harbor be amended to provide as much.

2. Intercompany Transfer Rules

We appreciate the revisions Treasury and the Service made to the Prior Proposed Regulations, resulting in the Intercompany Transfer Rules. Nevertheless, we believe that the Intercompany Transfer Rules, as currently drafted, do not provide taxpayers with sufficient flexibility and raise a number of difficult implementation issues. We, therefore, recommend several changes to the Intercompany Transfer Rules below.

a. Limitation to Bonus-Eligible Property

As currently drafted, the Intercompany Asset Transfer Rule would apply to any transfer of depreciable property between members of a consolidated group in a transaction satisfying the Unrelated Purchase Test and No Prior Use Test if the 90-day time limit for the buyer's departure is satisfied as part of the same series of related transactions.[118] The Intercompany Deemed Asset Transfer Rule would apply to a transfer of stock of a corporation that holds depreciable property between members of a consolidated group if the 90-day time limit is satisfied as part of the same series of related transactions and the target corporation would be eligible for bonus depreciation with respect to the depreciable property.[119] Therefore, as drafted, the Intercompany Transfer Rules appear to subject certain transfers of depreciable property to the delayed transfer requirement in the Proposed Regulations regardless of whether such property is Bonus-Eligible Property.

> *Example 30.* On January 1, 2019, corporation B sells to corporation A a single used asset: asset D, which is depreciable real estate that is not Bonus-Eligible Property. Both A and B are 100% owned by corporation X and are members of the X consolidated group. On April 1, 2019 (90 days later), X distributes 100% of the stock of A to its shareholders in a pro rata distribution that qualifies under Section 355(a). A's acquisition appears to be subject to Proposed Regulations Section 1.168(k)-2(b)(3)(v)(C), because asset D is "depreciable property."

> *Example 31.* On January 1, 2019, corporation B sells to corporation A 100% of the stock of corporation C, which holds asset D, depreciable real estate that is not Bonus-Eligible Property, and no other assets. A and B are 100% owned by corporation X, and A, B, and C are members of the X consolidated group. On April 1, 2019 (90 days later), X distributes 100% of the stock of A to its shareholders in a pro rata distribution that qualifies under Section 355(a). X and A make a Section 338(h)(10) election with respect to A's acquisition of the C stock. A's acquisition does not appear to be subject to Proposed Regulations Section 1.168(k)-2(b)(3)(v)(D) because C is not eligible for bonus depreciation with respect to asset D.

> *Example 32.* On January 1, 2019, corporation B sells to corporation A two assets: asset C, which is Bonus-Eligible Property, and asset D, depreciable real estate that is not Bonus-Eligible Property. A and B are 100% owned by corporation X and are members of the X consolidated group. On April 1, 2019 (90 days later), X distributes 100% of the stock of A to its shareholders in a pro rata distribution that qualifies under Section 355(a). A's acquisition of each asset appears to be subject to Proposed Regulations Section 1.168(k)-2(b)(3)(v)(C), because each is "depreciable property."

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[118] *See* Prop. Reg. § 1.168(k)-2(b)(3)(v)(C).

[119] *See* Prop. Reg. § 1.168(k)-2(b)(3)(v)(C), (D).

Example 33. On January 1, 2019, corporation B sells to corporation A 100% of the stock of corporation C, which holds two assets: asset E, which is Bonus-Eligible Property, and asset D, a depreciable real estate asset that is not Bonus-Eligible Property. A and B are 100% owned by corporation X and A, B, and C are members of the X consolidated group. On April 1, 2019 (90 days later), X distributes 100% of the stock of A to its shareholders in a pro rata distribution that qualifies under Section 355(a). X and A make a Section 338(h)(10) election with respect to A's acquisition of the C stock. A's acquisition appears to be subject to Proposed Regulations Section 1.168(k)-2(b)(3)(v)(D) because C is eligible for bonus depreciation with respect to a portion of C's assets (asset E).

The Intercompany Asset Transfer Rule appears to recharacterize the intercompany transfer described in Example 30 even though none of the property involved in that transaction is eligible for bonus depreciation. By contrast, in Example 31, the Intercompany Deemed Asset Transfer Rule appears not to apply to the intercompany transfer, because the Intercompany Deemed Asset Transfer Rule tests whether the target corporation is eligible for bonus depreciation with respect to the target corporation's assets. In Example 32 and Example 33, the Intercompany Asset Transfer Rule and the Intercompany Deemed Asset Transfer Rule, respectively, appear to apply to the entire transaction even though only a portion of the relevant assets are, in each case, Bonus-Eligible Property.

The application of the Intercompany Transfer Rules to all of the transferred assets in Example 30, Example 32 and Example 33 seems to be the wrong result. The stated purpose of the Intercompany Transfer Rules is to permit a bonus depreciation deduction where a buyer makes a capital investment through an intercompany transfer but otherwise could not receive the related bonus depreciation deduction because the transfer occurs shortly before the buyer leaves its consolidated group.[120] Applying the Intercompany Transfer Rules to property other than Bonus-Eligible Property does not serve this purpose. More generally, it is not clear whether regulations under Section 168(k) are the appropriate venue, or have the necessary authority, to affect <u>all</u> U.S. federal income tax consequences of holding an asset not described in Section 168(k). Finally, as noted above, applying the Intercompany Transfer Rules to transfers of property other than Bonus-Eligible Property creates a trap for unwary taxpayers who may not think to consult the regulations under Section 168(k) in planning transfers of property to which Section 168(k) does not, by its terms, apply.

We recognize that, as a strictly technical matter, certain collateral consequences conceivably may arise from bifurcating a transfer of assets, some of which are Bonus-Eligible Property and some of which are not, into one transfer of Bonus-Eligible Property and one transfer of other property. For instance, treating a transfer of intangible assets as occurring separately from the transfer of all of the accompanying business assets conceivably could raise a technical issue as to whether the intangible assets are subject to amortization under Section 197.[121] Similarly, in the case of a stock transfer for which a Section 338(h)(10) election is made, recharacterizing the transfer as a sale of less than all of the target's assets conceivably could

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[120] *See Proposed Regulations*, *supra* note 3, 84 Fed. Reg. at 50,155-57.

[121] *See* I.R.C. § 197(c)(2) (disallowing amortization of certain intangibles under Section 197 to the extent not acquired in connection with a trade or business). Intangibles excluded under Section 197 may still be eligible for cost recovery under Section 167. *See, e.g.*, Treas. Reg. § 1.167(a)-14(c)(4).

affect the application of the Section 338 rules and the calculation of aggregate deemed sale price and adjusted grossed-up basis.[122] Nevertheless, for the reasons mentioned above, we believe that it is important that the Intercompany Transfer Rules apply only to Bonus-Eligible Property. In addition, to the extent Treasury and the Service believe it appropriate to ameliorate any collateral tax consequences of limiting the Intercompany Transfer Rules in this manner, Treasury and the Service could prescribe special rules addressing such consequences, or could, as described in Part III.B.2.d, below, amend the Intercompany Transfer Rules to restrict their application to Section 168(k) (as opposed to recharacterizing transactions for all U.S. federal income tax purposes).

Whether or not Treasury and the Service amend the Intercompany Transfer Rules as described in Parts III.B.2.b–III.B.2.d, below, we believe Treasury and the Service should amend the Intercompany Transfer Rule to provide that (i) in facts like Example 30, the transfer is not recharacterized under Treasury Regulations Section 1.168(k)-2(b)(3)(v)(C), and (ii) in facts like Example 32 and Example 33, the transfer is recharacterized under Treasury Regulations Section 1.168(k)-2(b)(3)(v)(C) or (D), respectively, solely with respect to the Bonus-Eligible Property.

b. 90-Day Time Period

Both of the Intercompany Transfer Rules require that the buyer corporation cease to be a member of its consolidated group (the "**departure**") on a date (the "**departure date**") that is no more than 90 days (the "**90-day limit**") after the date (the "**transfer date**," and the time between the transfer date and the departure date, the "**interim period**") of the relevant intercompany transfer (the "**transfer**"). Both rules also require that the transfer and the departure occur as part of a series of related transactions. We believe that this time limit is unnecessarily limited, lacks a firm foundation, and will be difficult for many taxpayers to satisfy. Accordingly, as described below, we recommend that Treasury and the Service remove the 90-day time limit, while retaining the requirement that the transfer and departure occur pursuant to the same series of related transactions.

To be sure, the Intercompany Transfer Rules raise implementation problems, including problems relating to changes in the characteristics of the transferred assets between the transfer date and the departure date. As the permissible time limit lengthens, these problems presumably are exacerbated. However, these issues will arise with any time limit of significant length and could be at least partially addressed by adopting one of the alternative approaches described below.

The Proposed Regulations explain the 90-day time limit used in several portions of the regulations by noting that the period is "consistent with the period of time specified in section 168(k)(2)(E)(iii)."[123] However, Section 168(k)(2)(E)(iii), which provides the syndication exception to the original use requirement, actually permits a syndicator to hold Bonus-Eligible Property for sale for 3–12 months before the syndicator is regarded as the original user of the

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[122] The calculation of aggregate deemed sale price requires a determination of the target corporation's liabilities and asset basis as of a particular date, and the aggregate deemed sale price is then allocated among the assets purchased in accordance with Section 1060. *See* Treas. Reg. §§ 1.338-4(d)(1), (g), Ex. 1; 1.338-6; 1.338-7.

[123] *See Proposed Regulations*, *supra* note 3, 84 Fed. Reg. at 50,153, 50,156.

property, and does not reference any 90-day period. In addition, we do not believe the syndication exception is necessarily a relevant source of authority for the Intercompany Transfer Rules. The syndication exception in Section 168(k)(2)(E)(iii) applies to leasing transactions, while the Intercompany Transfer Rules apply primarily to M&A transactions. In addition, Section 168(k)(2)(E)(iii) specifies <u>a period of time that ownership of an asset should be disregarded</u>, rather than <u>a period of time that the relationship between transferor and transferee should be disregarded</u>, as the Intercompany Transfer Rules do. We also believe that the citation to Section 168(k)(2)(E)(iii) may mistake the primary authority for disregarding periods of transitory ownership in the Intercompany Transfer Rules and other portions of the Proposed Regulations, which in our view is not Section 168(k) itself, but rather the step transaction doctrine.

Finally, we believe that it may be difficult for some deserving taxpayers to satisfy the proposed 90-day time limit. While 90 days is not an inappropriate period of time within which to undertake a syndication transaction, the types of transactions at which the Intercompany Transfer Rules are targeted may take much longer. An actual intercompany transfer of assets may be considered a preparatory step undertaken well in advance of the departure date, especially if the transaction involves the transfer of legal title to assets, which can be cumbersome and subject to delays. Any unexpected transaction delay after the intercompany transfer could therefore cause the departure date to fall outside the proposed 90-day time limit. Regulatory delays are not uncommon in the types of transactions involving a buyer subsidiary's departure from a consolidated group (*e.g.*, large M&A deals subject to antitrust approval, spin-offs and public offerings subject to SEC scrutiny).

Based on the foregoing, we recommend that Treasury and the Service remove the 90-day time limit from the Intercompany Transfer Rules. Instead, requiring that the relevant transfer and the departure from the group occur pursuant to a series of related transactions, as is already the case under the Proposed Regulations, suffices as the correct standard in our view.[124]

If Treasury and the Service do not accept this recommendation, we have two fallback recommendations. First, if Treasury and the Service believe it is necessary to require that the transfer and departure occur within a specified period of time, we recommend a period longer than 90 days, such as one year.[125] Second, if Treasury and the Service believe it is appropriate to

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[124] *Cf.* The Treatment of Certain Interests in Corporations as Stock or Indebtedness, 84 Fed. Reg. 59,318, 59,319 (proposed Nov. 4, 2019) (Treasury and the Service intend to replace the "per se" funding rule in the Section 385 regulations with a rule linking issuances of debt instruments with distributions based on "a sufficient factual connection" rather than "temporal proximity"). We also note that Treasury and the Service could incorporate a "safe harbor"*; i.e.*, a maximum period of time that could elapse between the transfer and the departure, with taxpayers effecting the departure within the specified period either deemed or presumed to be acting pursuant to a series of related transactions and, therefore, eligible for bonus depreciation on account of the Intercompany Transfer Rules. Taxpayers effecting the departure outside the specified period could, if Treasury and the Service considered it appropriate, be deemed or presumed not to be acting pursuant to a series of related transactions and, therefore, ineligible for bonus depreciation.

[125] *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). We also note that the

retain the current 90-day time limit for the Intercompany Transfer Rules, we recommend removing the requirement in each of the Intercompany Transfer Rules that the transfer and departure occur pursuant to a series of related transactions, as this requirement seems unnecessary if the transfer and departure occur close together in time. In our view, a gap of 90 days or less between two such transactions makes a further demonstration of relatedness unnecessary.[126]

c. Implementation Issues

Because the Intercompany Transfer Rules recharacterize a transaction as occurring on a different date, they raise implementation issues, which we discuss below.

i. <u>General Approach of Intercompany Transfer Rules</u>

We acknowledge that the Intercompany Transfer Rules address certain potential problems that could arise from a rule that grants a bonus depreciation deduction for an intercompany transfer of Bonus-Eligible Property. For instance, deeming the transfer to occur after the buyer's departure should reduce the likelihood that the transfer fails to satisfy the Unrelated Purchase Test and should ensure that the buyer is not attributed the seller's prior use of the asset under Proposed Regulations Section 1.168(k)-2(b)(3)(v)(A). In addition, the post-departure timing of the deemed transfer prevents Section 168(i)(7) from applying.

Nevertheless, the approach has certain shortcomings. Although the Intercompany Transfer Rules would not be the only rules that recharacterize a transaction as occurring on a different date for all U.S. federal income tax purposes,[127] we are not aware of any rule in the tax law that moves a transaction's date for all U.S. federal income tax purposes for such an extended length of time as 90 days.[128] As is discussed in Parts III.B.2.c.ii-III.B.2.c.iv, below, a recharacterization for all U.S. federal income tax purposes, for a significant period of time, creates numerous uncertainties. Also, as a matter of fairness, we note that, if the Intercompany Transfer Rules apply for all U.S. federal income tax purposes, they may become a trap of the

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Intercompany Transfer Rules apply only when the transfer and departure occur pursuant to a series of related transactions, and that examples in the Proposed Regulations indicate that the steps in a series of related transactions can occur over a period as long as 19 months. *See* Prop. Reg. § 1.168(k)-2(b)(3)(vii), Exs. 33 & 34.

[126] And, by the same token, as drafted, it seems clear that a departure more than 90 days after the transfer is not eligible for the Intercompany Transfer Rules.

[127] *See, e.g.*, Treas. Reg. § 1.1502-76(b)(1)(ii)(B). We also note that Treasury and the Service have expressed concern over the effects of this "next day rule" and have proposed rules limiting the range of transactions to which it could apply. *See* Guidance Regarding Reporting Income and Deductions of a Corporation That Becomes or Ceases To Be a Member of a Consolidated Group, 80 Fed. Reg. 12,097 (proposed Mar. 6, 2015).

[128] Other rules can treat a transaction as occurring on a date more than 90 days after its actual date for <u>particular</u> U.S. federal income tax purposes. *See, e.g.*, I.R.C. § 168(d)(4)(A) (MACRS half-year convention treats applicable property as placed in service on the mid-point of the relevant taxable year regardless of actual date of placement in service).

unwary, as it will not be an obvious step for taxpayers to examine the Section 168(k) regulations for rules on the general treatment of their transactions.

ii. Treatment of Tax Items in Interim Period

As drafted, the Intercompany Transfer Rules do not specify how to treat, during the interim period, any tax items arising from assets transferred to the buyer corporation in the transfer (the "**transferred assets**"), or the consideration transferred to the seller corporation in exchange therefor (the "**seller consideration**").

First, the Intercompany Transfer Rules do not specify whether either the transferred assets or the seller consideration can produce depreciation deductions during the interim period. None of the examples in the Proposed Regulations depict any such depreciation, however, and we generally interpret the Proposed Regulations to disallow any depreciation with respect to the pre-existing basis in the transferred assets prior to the departure.[129] With respect to the seller consideration, the Intercompany Transfer Rules do not appear to consider possible depreciation, and the answer is simply unclear. The seller consideration could, for instance, potentially generate depreciation if the buyer corporation transferred depreciable assets to the seller corporation as consideration for the transferred assets.

Second, the Intercompany Transfer Rules do not appear to address how to treat income, gain, losses or other non-depreciation deductions generated by either the transferred assets or the seller consideration. For instance, the seller consideration could consist of stock or debt instruments that produce dividends or other distributions or interest during the interim period. As described in Part III.B.2.a, above, the Intercompany Transfer Rules may also recharacterize transfers of property other than Bonus-Eligible Property between the seller corporation and the buyer corporation, in which case the transferred assets could also consist of stock and debt instruments that produce dividends and interest. In addition, the transferred assets and seller consideration may be used in the operation of a business during the interim period and contribute to the production of income or losses. In either case, it is not clear where these tax items are allocated during the interim period: (i) to the seller for the seller consideration and to the buyer for the transferred assets, in accordance with the legal form of the transfer, (ii) to the buyer for the seller consideration and to the seller for the transferred assets, on the assumption that the transfer does not occur for tax purposes until after the interim period, or (iii) to no one, with the tax items held in abeyance during the interim period and then treated as arising in accordance with clause (i) after the transfer. In addition, as consolidated group members, the seller and buyer may also have separate return limitation year ("**SRLY**") registers recording certain of their contributions to the group's tax attributes.[130] It is not clear which tax items arising during the interim period should be included on such SRLY registers, and to what extent.

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[129] With respect to the transferred assets, the preamble to the Proposed Regulations indicates that the purpose of the Intercompany Transfer Rules is to "allow the deduction to the appropriate party," suggesting that the entire depreciation deduction will be received by the buyer corporation in the form of bonus depreciation after the departure, and that no amount of depreciation will be recognized by the buyer corporation before that time. *See Proposed Regulations*, *supra* note 3, 84 Fed. Reg. at 50,156.

[130] *See* Treas. Reg. § 1.1502-21(c)(1).

iii. Changes in Asset Characteristics in Interim Period

During the interim period, the characteristics of either the transferred assets or the seller consideration could change. For instance, either could increase or decrease in value. Such changes arguably should affect the buyer's purchase price for the transferred assets after the departure and the amount of the bonus depreciation deduction received by the buyer corporation after the departure. The Intercompany Transfer Rules do not take such changes into account in determining the buyer's purchase price or the amount of the bonus depreciation deduction. Doing so could introduce further complexity.[131]

A change in value would also be relevant to the treatment of the seller consideration. For instance, if the seller disposed of the seller consideration, the seller would need to know its cost and basis therein. The cost of the seller consideration could determine whether or how the OID, market discount or acquisition premium rules apply to any debt instruments in the seller consideration.

Other characteristics of the transferred assets or seller consideration could also change during the interim period, such as their use. As an example, the transferred assets could cease to be described in Section 168(g) or Section 168(k)(9) and therefore become eligible for bonus depreciation, or could cease to be described in Section 168(k) and therefore become ineligible for bonus depreciation. The Intercompany Transfer Rules and the examples relating thereto in the Proposed Regulations do not contain numbers or otherwise address any potential changes in the characteristics of the assets involved, and it, therefore, is not clear how (or whether) the Intercompany Transfer Rules would address these issues.

iv. Departure and Post-Departure Issues

Because the Intercompany Transfer Rules recharacterize the transfer as not occurring until one day after the departure for all U.S. federal income tax purposes, the tax consequences of buyer's departure may change to the extent that the buyer's ownership of the transferred assets is relevant. For instance:

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[131] For instance, if the buyer paid the seller \$100 at the time of the transfer and the fair market value of the transferred assets decreased to \$90 shortly after the departure, the buyer arguably should be deemed to purchase the assets for their fair market value of \$90 shortly after the departure, rather than paying an above-market price of \$100. However, because the buyer actually paid \$100, it could be necessary to characterize the payment of the additional \$10 — whether as a payment in exchange for value deemed to have passed from the seller to the buyer or as a deemed contribution or distribution — in order to explain why the buyer actually holds \$100 less cash (or other consideration). *Cf.* Treas. Reg. § 1.482-1(g)(3) (requiring appropriate adjustments to conform a taxpayer's accounts to reflect allocations under Section 482).

> *Example 34.* On January 1, 2020, corporation B sells to corporation A used business assets that are Bonus-Eligible Property and that comprise an active trade or business within the meaning of Section 355(b). A and B are 100% owned by corporation X, are members of the X consolidated group, and are also members of an affiliated group within the meaning of Treasury Regulations Section 1.355-3(b)(4)(iii). On March 31, 2020 (90 days later), X distributes 100% of the stock of A to its shareholders in a pro rata distribution intended to qualify under Section 355(a). A intends to rely on the assets received from B for purposes of the active trade or business test of Section 355(b).

In Example 34, absent the application of the Proposed Regulations, X's distribution of the stock of A appears to be eligible for Section 355. If the Intercompany Asset Transfer Rule applies, however, A would be treated as receiving the active trade or business assets one day after X's distribution of A. Accordingly, the distribution of A's stock by X may not qualify under Section 355(b) because A may not be respected as conducting an active trade or business immediately after the distribution.

Other tax differences could arise on account of the fact that an intercompany transaction between members of a consolidated group is subject to different tax rules than a transaction between a member of a consolidated group and a nonmember. For instance, if the transferred assets were treated as transferred in an intercompany transaction before the buyer corporation left the consolidated group, the seller corporation's activities would generally continue to affect the transferred assets after the departure, and the buyer would generally tack the seller's holding period for the transferred assets.[132] The Intercompany Transfer Rules instead treat the transfer as occurring after the departure for all U.S. federal income tax purposes, and, therefore, the transferred assets do not appear to be affected by the seller's activities and the buyer appears to begin a new holding period on the day after the departure date.

d. Possible Alternative Approaches

We respectfully urge that Treasury and the Service amend the Intercompany Transfer Rules to address the issues raised herein. We have identified for Treasury's and the Service's consideration at least two potential alternative approaches to the current Intercompany Transfer Rules. On balance, we recommend that Treasury and the Service adopt the Delayed Bonus Approach (as defined below), which would alleviate many of the implementation issues in the current Intercompany Transfer Rules described in Part III.B.2.c, above, while adapting relatively easily to an extended period of time between the transfer and the departure.[133]

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[132] *See* Treas. Reg. § 1.1502-13(d)(2)(i)(B).

[133] As discussed below, if Treasury and the Service adopt one of the approaches described in this Part III.B.2.d, or otherwise change the Intercompany Transfer Rules in a manner that recognizes a transfer of Bonus-Eligible Property as occurring within a consolidated group, it may be necessary to exempt any transaction subject to the Intercompany Transfer Rules, as revised, from the Series Transfer Rule in Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(C).

i. Delayed Bonus Approach

The "**Delayed Bonus Approach**" would treat the transfer between the seller and the buyer as occurring on the transfer date and and being subject to the normally applicable tax rules. During the interim period, the buyer would be treated as holding all of the transferred assets and the seller would be treated as holding the seller consideration.[134] The buyer would recognize depreciation, and the seller would recognize gain or loss, with respect to the transferred assets during the interim period in accordance with Section 168(i)(7) and Treasury Regulations Section 1.1502-13(c)(2). The buyer would not be eligible for bonus depreciation during the interim period. A transfer of assets between members of a consolidated group, none of which leave the group in connection with the transfer, cannot satisfy the requirements of Section 168(k)(2)(E)(ii). On the day after the departure date, the buyer corporation would be treated as disposing of the transferred assets to an unrelated third party in a transaction that generated no gain or loss, and then purchasing identical assets that the buyer has never used[135] from an unrelated third party for an amount equal to the buyer corporation's remaining basis in the transferred assets.[136] The buyer's deemed purchase would produce a bonus depreciation deduction approximately equal to the basis remaining in the transferred assets on the departure date.[137] The seller would also recognize any remaining deferred gain or loss as a result of the buyer's departure.[138]

The Delayed Bonus Approach would alleviate some of the issues discussed in Part III.B.2.c, above, because the transfer would be respected for all U.S. federal income tax purposes and the tax consequences of the transfer during the interim period would be governed by existing law. The Delayed Bonus Approach would not take the extraordinary approach of recharacterizing a transaction for all U.S. federal income tax purposes as occurring on another, possibly much later, date. If, for instance, the buyer corporation transferred stock as consideration for the transferred assets and a distribution were made on the stock during the interim period, the seller corporation would be treated as the owner of the stock and the recipient of the distribution (subject to any applicable holding period requirements). In addition, to the extent that Treasury and the Service accept our recommendation in Part III.B.2.b, above, to permit the Intercompany Transfer Rules to apply even if the buyer corporation departs the group more than 90 days after the transfer, the Delayed Bonus Approach would accommodate an extended interim period more easily than the existing Intercompany Transfer Rules because it does not hold any tax items in abeyance.

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134 For purposes of the explanations in this section, we assume that all transferred assets are Bonus-Eligible Property. As described in Part III.B.2.a, we generally recommend that transfers of assets that are not Bonus-Eligible Property should not be subject to the Intercompany Transfer Rules, and we would make the same recommendation even if Treasury and the Service adopted one of our proposed alternatives.

135 In other words, assets that the buyer corporation has not used before but that are identical to the assets acquired in the transfer while the buyer was still a member of a consolidated group.

136 These deemed transactions would be necessary to cause the buyer to receive a bonus depreciation deduction notwithstanding having previously used the assets in question and having acquired the assets from a related seller.

137 Under Treasury Regulations Section 1.168(k)-2(e)(1)(ii), some portion of the depreciation deduction might arise under other Sections of the Code, such as Section 179.

138 *See* Treas. Reg. § 1.1502-13(d).

On the other hand, the Delayed Bonus Approach does not necessarily address all of the departure-related issues discussed above. For instance, while the buyer corporation in Example 34 would be treated as holding the active trade or business assets "immediately after the distribution," it would be treated as disposing of those assets on the next day. If Treasury and the Service adopt the Delayed Bonus Approach, it would be helpful for the new regulations to confirm that these deemed transactions do not prevent the buyer's departure in a stock distribution from qualifying under Section 355.[139] The Delayed Bonus Approach would address possible changes in the characteristics of the seller consideration, which would simply be subject to existing law, but changes in the characteristics of the transferred assets might still pose issues. For instance, if the transferred assets cease to be Bonus-Eligible Property during the interim period, should the post-departure deemed transfer of the transferred assets and acquisition of identical assets be treated as eligible for bonus depreciation? If the value of the transferred assets increases during the interim period, is it appropriate that the buyer is treated as selling the transferred assets after the departure without recognition of gain, and then buying identical assets for the same price (*i.e.*, both the deemed sale and purchase are treated as occurring at a price lower than fair market value)?

Finally, the Delayed Bonus Approach would in at least some cases allocate some of the cost recovery deductions with respect to the transferred assets to the selling consolidated group after the transfer, notwithstanding that the buyer paid the entire cost for the transferred assets. Such an allocation is arguably contrary to Congress's intent in permitting the buyer of used Bonus-Eligible Property a 100% deduction as compensation for its capital investment.

ii. Frozen Depreciation Approach

If Treasury and the Service do not believe that the Delayed Bonus Approach should be adopted, they could consider another approach that would address some of the implementation issues in the current Intercompany Transfer Rules. The "**Frozen Depreciation Approach**" would treat the transfer between the seller and the buyer as occurring on the transfer date and subject to the normally applicable tax rules, except those relating to depreciation. During the interim period, the buyer would be treated as holding all of the transferred assets and the seller would be treated as holding the seller consideration. However, the buyer (and the seller and the selling consolidated group) would not take any depreciation for the transferred assets during the interim period, and, accordingly, the matching rule would not cause the seller to recognize any gain or loss on the transfer until the departure date.[140] On the day after the departure date, the buyer would engage in the same deemed transactions as under the Delayed Bonus Approach but would receive a full bonus depreciation deduction upon doing so. In addition, the seller would recognize any deferred gain or loss as a result of the buyer's departure.

The Frozen Depreciation Approach would have some of the same benefits as the Delayed Bonus Approach in that it would avoid the recharacterization of the transfer for all U.S. federal income tax purposes and also permit most of the normal tax rules to operate with respect to the transferred assets and the seller consideration during the interim period. However, unlike the

[139] A similar rule already provides that the deemed transactions that occur when a Section 336(e) election is made with respect to a distribution described in Section 355(d)(2) or (e)(2) do not prevent the underlying distribution from qualifying under Section 355. *See* Treas. Reg. § 1.336-2(b)(2)(v).

[140] *See* Treas. Reg. § 1.1502-13(c)(2)(ii).

Delayed Bonus Approach, the Frozen Depreciation Approach would grant the buyer a full bonus depreciation deduction for the transfer, therefore avoiding the arguable conflict with Congressional intent present in the Delayed Bonus Approach.

As with the Delayed Bonus Approach, changes in the characteristics of the transferred assets might still pose issues under the Frozen Depreciation Approach, as would the consequences of the buyer's departure.[141] In addition, because the Frozen Depreciation Approach still holds certain items in abeyance (*i.e.*, depreciation and the seller's gain or loss) during the interim period, this approach is presumably less appropriate if the 90-day time limit for the Intercompany Transfer Rules is extended. The treatment of these items could become a particular issue if, for instance, a consolidated group planned to dispose of the buyer corporation's stock in a series of related transactions, did not recognize depreciation during the presumed interim period, and then ultimately no sale of the buyer occurred. The selling consolidated group likely would need to recognize retroactive depreciation or make other adjustments in such a case.

3. Imputation of Prior Use by Predecessor

The Final Regulations define "predecessor" for purposes of the No Prior Use Test to include a transferor of an asset to a transferee in a transaction in which the transferee's basis in the asset is determined, in whole or in part, by reference to the basis of the asset in the transferor's hands.[142] While we believe that including a definition of "predecessor" in the Final Regulations is helpful to taxpayers, and agree that a carryover basis transaction generally should create a predecessor-successor relationship, we recommend that Treasury and the Service narrow the definition of "predecessor" in two respects.

a. Limitation to Particular Item of Property

We recommend limiting item (B) of the definition of "predecessor" to ensure that a shareholder or partner that transfers property to a corporation or partnership is treated as a predecessor only if the shareholder or partner transfers a large portion of its assets to the corporation or partnership, as the case may be. Without this change, issues could arise whenever a corporation or partnership acquires Bonus-Eligible Property previously used by a person that made a contribution to that corporation or partnership. The definition of predecessor in the Final Regulations could be interpreted to include any taxpayer that has previously contributed property to a corporation or partnership, even if the taxpayer only contributed a de minimis portion of its assets.

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[141] As with the Delayed Bonus Approach, if Treasury and the Service adopt the Frozen Depreciation Approach, we recommend that Treasury and the Service clarify that the deemed transactions occurring as a result of the Frozen Depreciation Approach do not prevent a departure of the buyer from the selling consolidated group in a stock distribution from satisfying the requirements of Section 355. *See supra* note 139.

[142] *See* Treas. Reg. § 1.168(k)-2(a)(2)(iv).

Example 35. In 2000, R, S and T form partnership Q. R and S each contribute cash and receive a 33% partnership interest. T contributes an intangible asset that represents a de minimis portion of T's assets and receives in exchange a 33% partnership interest. T's contribution is treated as a contribution of property under Section 721(a). In 2004, T ceases to be a partner in Q. On January 1, 2022, Q acquires, either from T or from an unrelated party, equipment that is Bonus-Eligible Property that T used in a trade or business within the last 5 years, in a transaction that is treated as a taxable purchase for U.S. federal income tax purposes.

T arguably meets the definition of "predecessor" in the Final Regulations because T previously contributed an asset to the partnership (the intangible) in a carryover basis transaction, even though the contribution occurred more than 20 years earlier and did not involve a large portion of T's assets. If T is treated as a predecessor, then Q may not take a bonus depreciation deduction for the acquisition of the equipment previously used by T. If Q were treated as a corporation instead of a partnership upon formation (such that the contributions by R, S and T would qualify under Section 351), the analysis would not be different. T would still seem to be a "predecessor."[143]

We do not believe that this result is correct. In our view, a corporation or partnership that acquires Bonus-Eligible Property previously used by a person that made a contribution to the corporation or partnership should not be prohibited from taking bonus depreciation deductions with respect to such Bonus-Eligible Property, provided that the acquisition meets the Unrelated Purchase Test and that the prior contribution was not a contribution of a large portion of the contributor's assets.

By relying upon the related party test under Section 179(d)(2), Congress prohibited bonus deductions only for certain related party transactions. For example, bonus depreciation would be disallowed in a transaction where a majority shareholder acquires property from a corporation because the transaction would fail the Unrelated Purchase Test.[144] However, Congress said nothing about transactions between corporations and minority shareholders (or partnerships and minority partners). Those transactions could satisfy the Unrelated Purchase Test, assuming the requirements other than a lack of relatedness were met.[145] It is unlikely that Congress would have intended to disallow bonus depreciation in any acquisition of property previously used by a shareholder or partner that ever contributed property to the taxpayer, while at the same time, for purposes of the Unrelated Purchase Test, adopting a 50% or greater ownership test.[146] The

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143 Indeed, under the definition of "predecessor" as drafted, T could arguably be a predecessor even if T contributed property to Q <u>after</u> Q acquired property from T. Treasury Regulations Section 1.168(k)-2(a)(2)(iv)(B) currently applies to any and all transferors in carryover basis transactions, seemingly without regard to when the transfer occurs.

144 *See also* H.R. REP. NO. 115-466, *supra* note 64, at 353 (Section 168(k) does not apply "if an individual who controls a corporation purchases property from that corporation.").

145 *See supra* note 66 and surrounding text.

146 *See* I.R.C. §§ 168(k)(2)(E)(ii)(II) (incorporating Section 179(d)(2) requirements), 179(d)(2) (testing for relationship under Sections 267, 707 or 1563), 267(b)(2) (testing whether a shareholder has a 50% interest, by value, in a corporation), 707(b)(1) (testing whether a partner has a 50% capital or profits interest in a partnership), 1563(a)(2) (testing whether 5 or fewer persons own 50% of the vote or value in two corporations).

breadth of such an approach to prior contributions could risk rendering the related party test in Section 179(d)(2) redundant.

Such a broad definition of "predecessor," moreover, would create inconsistencies between shareholders or partners who acquire their stock or interests by purchase, on the one hand, and those who acquire their stock or interests by contribution, on the other. It is unclear why the latter should be treated differently than the former where the latter's contribution has no real connection to the acquisition of Bonus-Eligible Property.

In our view, the best way to address this problem is to amend item (B) in the definition of "predecessor" in Treasury Regulations Section 1.168(k)-2(a)(2)(iv) such that it applies only to a transferor that transfers a large portion[147] of its assets to a transferee in a carryover basis transaction. This change would prevent the existence of a predecessor relationship in Example 35, unless T contributed a large portion of its assets to the partnership Q (in which case the result in Example 35 does not appear as objectionable).[148] The change would also more closely align item (B) with the other prongs of the definition of predecessor, such as the asset reorganizations described in Section 381(a) and the partnership continuation transactions described in Section 708(b)(2), in which a transferor generally transfers most of its assets and ceases to exist in connection with the transfer. Accordingly, we recommend that Treasury and the Service implement this change to the Final Regulations.

b. Partnership Part-Sale Part-Contribution Transactions

In the partnership context, the new definition of "predecessor" could also lead to unexpected results in part-sale, part-contribution transactions under Section 707(a).

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[147] We do not take any position as to the percentage of the transferor's assets that should need to be transferred to a single transferee in a carryover basis transaction for the transferor to become a predecessor for these purposes. We do note that some similar provisions in the Code and Treasury Regulations require a transfer of "substantially all" of a transferor's assets (or assets of a certain type) in order to create a predecessor-successor relationship. *See, e.g.*, Treas. Reg. §§ 31.3302(e)-1(a), 1.6050P-2(g), and 1.6043-4T(e). Other similar provisions have not required as high a threshold, or have not specified a threshold. *See, e.g.*, I.R.C. § 41(f)(3)(A)(i) ("a major portion"); Treas. Reg. §§ 1.585-2(e)(4) ("more than 50 percent") and 1.1502-1(f)(4)(ii) (no threshold specified). Presumably, this determination should be made by comparing the fair market value of the transferred assets at the time of the transfer to the fair market value of the transferor's total assets at the same time.

[148] If T contributed a large portion of its assets, T would be a predecessor to Q even if the contribution occurred many years in the past. Q would not need to look back further than 5 years in determining which assets T previously used, because the 5-Year Safe Harbor would limit the lookback period for both Q's prior uses and T's prior uses. *See* Treas. Reg. § 1.168(k)-2(b)(3)(iii)(B)(1). Nevertheless, the burden on Q in terms of identifying all of its existing predecessors and tracking their ownership and use of assets on an ongoing basis could be significant, and Q presumably might acquire new predecessors, in future transactions, as time went on. If Treasury and the Service concluded it appropriate, they could make one of several changes that would reduce or alleviate this burden. For instance, they could amend the definition of predecessor to include only persons who engaged in a transaction with the taxpayer within a particular period of time, such as the last five years (to match the 5-Year Safe Harbor). Alternatively, Treasury and the Service could narrow the types of transactions listed in the definition such that it only included transactions in which the transferor ceased to exist in connection with the transaction.

> *Example 36.* Individual U transfers equipment that is Bonus-Eligible Property to partnership P in exchange for a 25% interest in the partnership worth $100, as well as $300 of cash. At the time of transfer, the equipment has a fair market value of $400 and basis of $100. No facts are available to rebut the presumption that the transfer is a partial sale under Treasury Regulations Section 1.707-3(c)(1). U is treated as having sold 75% of the equipment to P for $300, recognizing gain of $225, and contributing the remaining $100 portion of the equipment.[149]

A part-sale, part-contribution occurs when a partner transfers property other than money to a partnership and the partnership transfers money or other consideration to the partner.[150] The transfer of property to the partnership is treated as a sale, in whole or in part, only if based on all the facts and circumstances the transfer of money would not have been made but for the transfer of property.[151] To the extent the transaction is treated as a sale under the disguised sale rules, sale treatment applies for all purposes of the Code.[152] Indeed, Section 707(a)(1) provides that a deemed sale within its scope is "considered as occurring between the partnership and one who is not a partner."[153] Accordingly, in Example 36, U is treated as selling Bonus-Eligible Property to P. However, because U is also treated as contributing property to P, U is arguably a predecessor for purposes of the No Prior Use Test.

For the reasons discussed above, we believe that treating U as a predecessor is inappropriate. The sale and the contribution are deemed, by function of the Section 707 regulations, to be separate transactions. Accordingly, we recommend that the Final Regulations clarify that the acquisition of Bonus-Eligible Property by a partnership in part by sale and in part by contribution can satisfy the No Prior Use Test.

4. Series Transfer Rule

The Proposed Regulations significantly modify the Series Transfer Rule, as compared to Section 1.168(k)-2(b)(3)(iii)(C) of the Prior Proposed Regulations. We appreciate and generally endorse these changes, especially the restriction of the Series Transfer Rule to the determination of relatedness under Treasury Regulations Section 1.168(k)-2(b)(3)(iii) and Sections 179(d)(2)(A) and (B). While we believe that the modified Series Transfer Rule represents a significant improvement, we think Treasury and the Service should consider certain further changes, which we explain below.

a. Time for Testing Relatedness

As drafted, the Series Transfer Rule states that relatedness is tested in most cases "immediately after" the relevant step in the series. Thus, in a series of related transactions

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149 *Cf*. Treas. Reg. § 1.707-3(f), Ex. 1.

150 Treas. Reg. § 1.707-3(b)(1).

151 *See id*.

152 *See* Treas. Reg. § 1.707-3(a)(2).

153 *See also* Treas. Reg. § 1.707-3(a)(3) (sale for purposes of Treasury Regulations Section 1.707-3 means a sale or exchange of property, in whole or in part, to the partnership by the partner acting in a capacity other than as a member of the partnership).

involving a transfer of an asset from A to B, B to C, and C to D, assuming no exceptions applied, B would test its relatedness to A after the A-B transfer, C would test its relatedness to B after the B-C transfer, and D would test its relatedness to A and to C after the C-D transfer.[154] This timing is questionable given that, by definition, a transferee such as B or C will be testing relatedness in the middle of a series of connected steps, perhaps disregarding significant relationships that existed before the series of related transactions or that emerge as a result of the series.

The Series Transfer Rule, and the examples thereof in the Proposed Regulations, do not address how relatedness should be tested when the relationship between the parties changes over the course of the series of related transactions, or when a party ceases to exist. Consider the following example:

> *Example 37.* On January 1, 2019, pursuant to a series of related transactions, corporation D sells a used asset that is Bonus-Eligible Property to corporation C, and C places the asset in service on the same date. On January 1, 2020, pursuant to the same series, C sells the asset to corporation B in a transaction otherwise qualifying under Section 168(k)(2)(E)(ii). B never places the asset in service, but sells the asset to corporation A on February 1, 2020 pursuant to the same series in a transaction qualifying under Section 168(k)(2)(E)(ii), and A places the asset in service on the same date. A was related to C and to D for many years but, prior to February 1, 2020, A ceased to be related to C, and D ceased to exist. As the ultimate transferee in the series of related transactions, under Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(C)(1), A apparently must test its relatedness to the initial transferor in the series (D) and to A's immediate transferor as of immediately after the B-A transfer. In addition, under Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(C)(2)(i), because B did not place the asset in service, B is a disregarded party and B's transferor (C) is treated as the immediate transferor to A, so A must test its relatedness to C rather than to B.

The result in Example 37 is not entirely clear. Most likely, because A is not related to D (which no longer exists) or to C immediately after the B-A transfer, A is eligible for bonus depreciation under the Series Transfer Rule as currently written, notwithstanding A's longstanding relationships to D and C, and regardless of how those relationships ended (and regardless of whether the relationships were terminated in order to allow A to receive bonus depreciation, *e.g.*, by liquidating D).

Testing for relatedness only after a transferee receives an asset could also undermine the purposes of the Series Transfer Rule by allowing indirect transfers between related persons to produce a bonus depreciation deduction. Consider the following example:

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[154] *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(C)(1). The Proposed Regulations specify this time for testing relatedness in subsection (C)(1), but do not specify whether the time for testing is any different if any of the exceptions apply, such as subsections (C)(2)(i) and (C)(2)(iii). However, examples in the Proposed Regulations appear to prescribe the same timing even if one of the exceptions applies: each transferee tests for relatedness after its transfer. *See* Prop. Reg. § 1.168(k)-2(b)(3)(vii), Ex. 34.

> *Example 38.* On January 1, 2019, individual D owns 100% of the only classes of common stock of each of corporation B and corporation A. On the same date, B sells a used asset that is Bonus-Eligible Property to corporation C, which is unrelated to A, B or D, in a transaction qualifying under Section 168(k)(2)(E)(ii), and C places the asset in service on the same date. On June 1, 2019, pursuant to the same series of related transactions, D sells 55% of the stock of B to an unrelated person. On January 1, 2020, pursuant to the same series of related transactions, C sells the asset to A, and A places the asset in service on the same date. As the ultimate transferee in the series of related transactions, under Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(C)(1), A must test its relatedness to its immediate transferor (C) and to the initial transferor (B) as of immediately after the C-A transfer. A is not related to B or to C at that time, and, therefore, A appears to be eligible for bonus depreciation.

This is arguably the wrong result, as D, B and A were related when the series of related transactions began, and the group has received a bonus depreciation deduction despite making no net economic outlay and despite transferring the asset among parties that are essentially related.

It also seems possible that the Series Transfer Rule may inappropriately disregard relatedness arising after a transfer. Consider the following example:

> *Example 39.* Individual C owns 100% of the only class of common stock of corporation D, while individual B owns 100% of the only class of common stock of corporation A. On December 1, 2019, as part of a series of related transactions, D purchases a used asset that is Bonus-Eligible Property from an unrelated party in a transaction qualifying under Section 168(k)(2)(E)(ii). On December 1, 2020, as part of the same series, D sells the asset to A in a transaction otherwise qualifying under Section 168(k)(2)(E)(ii), and A places the asset in service on the same date. On January 1, 2021, as part of the same series of related transactions, C purchases 100% of the stock of A from B. As the ultimate transferee in the series of related transactions, under Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(C)(1), A must test its relatedness to its immediate transferor (D) and to the initial transferor (the unrelated party) as of immediately after the D-A transfer. A is not related to D or to the unrelated party at that time, and, therefore, A appears to be eligible for bonus depreciation.

This result arguably is inappropriate, as the asset transfer between D and A would have been ineligible for bonus depreciation under Treasury Regulations Section 1.168(k)-2(b)(3)(iii)(A)(2) and Section 179(d)(2) had C controlled both D and A at the time of the transfer only a month earlier. C and B may have been discussing an acquisition of A and decided to try to obtain an extra bonus depreciation deduction, or B might have even formed A for the purpose of engaging in a churning transaction with C and D.

To address situations like the examples above, we recommend that, along the lines of Treasury Regulations Section 1.197-2(h)(6)(ii)(B), relatedness in each step generally should be tested immediately before the first step in the series of related transactions and immediately after the last step in the series. This change would, appropriately in our view, reverse the results in Example 37, Example 38 and Example 39.

We are mindful that such a change could require testing for relatedness a significant period of time after a transaction occurs, and may result in later transactions disallowing bonus depreciation for transactions that occurred earlier, potentially more than a year earlier. However, the same is true of Treasury Regulations Section 1.197-2(h)(6)(ii)(B), and the benefit of this rule appears to outweigh its negative tradeoffs. In addition, we appreciate that this rule would not "catch" certain disqualifying relationships that arise during the course of a series of related transactions, but do not exist as of the commencement or termination of such series, even though such relationships could be "caught" by the Series Transfer Rule in its current form. Nevertheless, it is not as clearly appropriate to deny bonus depreciation in the case of a transitory relationship that ends as part of a series of related transactions as compared with a scenario involving persons related before and/or after the same series, and we assume that transfers subject to the Series Transfer Rule, between transitorily related persons, are relatively rare in any case.[155]

b. Complexity and Knowledge Burden

The Series Transfer Rule is quite complex, consisting of one general rule[156] and separate sub-rules for transfers by persons that do not place an asset in service or place it in service and dispose of it in the same taxable year[157] and transfers in Section 168(i)(7) Transactions,[158] as well as exclusions for syndication transfers[159] and for any series of related transactions that consists entirely of Section 168(i)(7) Transactions.[160] The rule also requires transferees of Bonus-Eligible Property to be aware of numerous details regarding prior transfers, and prior transferors and transferees, in the relevant series of related transactions, which is not necessarily feasible.

Consider the following example:

> *Example 40.* On March 1, 2020, corporation C sells a used asset that is Bonus-Eligible Property to corporation B in a transaction otherwise qualifying under Section 168(k)(2)(E)(ii). B sells the asset to corporation A on February 1, 2021, in a transaction otherwise qualifying under Section 168(k)(2)(E)(ii), and A places the asset in service on the same date. On March 1, 2022, A transfers the asset to another person.

Can A satisfy the Unrelated Purchase Test by testing its relationship to B? It is not clear from these facts that A can do so. First, it is unclear whether these transfers occur pursuant to a series of related transactions. If they do not, then it will be sufficient for A to test its relatedness to B. Second, if the transfers are pursuant to a series of related transactions, both A and the Service will need to know a great deal about B, and perhaps C and others as well. If B's taxable year begins on March 1, 2020 and ends on February 28, 2021, then B could not have placed the asset in service and disposed of the asset within separate taxable years, and B is a disregarded party; in

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155 For instance, we note that all of the disqualifying relationships in the examples in the Proposed Regulations applying the Series Transfer Rule exist both before and after the relevant series of related transactions. *See* Prop. Reg. § 1.168(k)-2(b)(3)(vii), Exs. 31-34.

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

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

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

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

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

that case, A would need to test its relatedness to C rather than B. This issue exists even if A purchases the property more than a year after B acquired the property, because there is always a possibility that B placed the property in service more recently, in the same taxable year as the disposition to A, or did not place the property in service at all. In addition, if A is the ultimate transferee in the series, which is not clear from the facts, A would need to test its relatedness to the initial transferor, which could be C or, if C received the asset as part of the series, another person.

Thus, in most cases, A appears to need to know, and the Service appears to need to know to audit A, (i) whether the transfer from B occurs pursuant to a series of related transactions, (ii) whether the transfer from A to another person occurs pursuant to the same series, (iii) for each previous transferor in the series, the date that such person placed the asset in service and the dates of such person's taxable year, and (iv) whether A is related to each previous transferor.[161] Obtaining this knowledge could be a significant burden on both A and any auditor of A. The example also illustrates the complexity of the Series Transfer Rule.

Of course, the Series Transfer Rule applies only to transfers pursuant to a series of related transactions, and this ameliorates the burden placed on transferees by the rule. In most cases, the parties will presumably be aware of, and plan, the entire series of related transactions, and the determination of which relationships to test will be performed by parties, or their advisors, who will have access to the relevant information. However, it cannot be assumed that taxpayers will always have the necessary information. The term "series of related transactions" is not defined in the New Regulations. The examples suggest that a series can continue over at least 2 years and include transferees that are unrelated to the other parties. Thus, a taxpayer might not have access to the same information as other parties and might even be unaware of other transactions in the series.[162]

Accordingly, we recommend that Treasury and the Service consider simplifying the Series Transfer Rule and alleviating knowledge burdens on transferees such as A in Example 40, as well as on the Service. We do not recommend a particular change but discuss alternative approaches below.

One approach would be to require any transferee in a series of related transactions to test its relatedness to every prior transferor in the series in order to obtain a bonus depreciation deduction (excluding the deduction received by a transferee in a Section 168(i)(7) Transaction). Though this change would make it more difficult for a transferee to obtain a bonus depreciation deduction, it would also make the rule easier to administer by eliminating the need to know when prior transferors placed an asset in service and the dates of those prior transferors' taxable years. The change would also eliminate the distinction between "disregarded parties," transfers from whom are subject to one sub-rule in Proposed Regulations Section 1.168(k)-

[161] If the transaction between C and B were a Section 168(i)(7) Transaction rather than a sale, A might be required to test its relatedness to both C and B under Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(C)(2)(iii), and would need to know that the C-B transfer was a Section 168(i)(7) Transaction. However, this may not be a significant additional burden in many cases, as many Section 168(i)(7) Transactions will occur between related parties, and, therefore, A will often be equally related, or equally unrelated, to both C and B.

[162] *See, e.g.*, Prop. Reg. § 1.168(k)-2(b)(3)(vii), Exs. 33 & 34.

2(b)(3)(iii)(C)(2)(i), and "disregarded transfers" which are subject to a different sub-rule in Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(C)(2)(iii).

Alternatively, a transferee might be permitted to test its relatedness only to its immediate transferor if the transferee demonstrated that it did not know, or have reason to know, that the transfer occurred pursuant to a series of related transactions. The Series Transfer Rules would still apply presumptively, but this exception would permit an unaware participant in a series of related transactions to follow the normal statutory rule and test relatedness solely with its immediate transferor.[163]

5. De Minimis Use Rule

In response to public comment, the Proposed Regulations introduce the De Minimis Use Rule, which provides an exception to the No Prior Use Test by allowing a taxpayer that disposes of property within a 90-day period after placement in service to later reacquire that property and still claim bonus depreciation without the need to satisfy the 5-year lookback period.[164] We commend Treasury and the Service for providing a grace period in which insubstantial uses of property do not count as prior use, consistent with the exception in the statute for syndication transactions.[165] Nevertheless, we recommend certain changes or clarifications with respect to the De Minimis Use Rule.

a. Prior Bonus Depreciation Deductions

As currently drafted, the De Minimis Use Rule appears to disregard a period of prior ownership of 90 days or less regardless of whether the taxpayer received a bonus depreciation deduction with respect to such prior period of ownership.[166] If the 90-day period falls entirely within a single taxable year of a taxpayer, the Same-Year Transfer Rule would prevent the taxpayer from receiving a bonus depreciation deduction. However, if the taxpayer acquired and placed Bonus-Eligible Property in service in one taxable year and then, within 90 days but in a separate taxable year, disposed of the Bonus-Eligible Property, the taxpayer's acquisition would apparently be eligible for bonus depreciation but also disregarded under the De Minimis Use Rule.[167] We question whether Treasury and the Service intended this result, which could permit a taxpayer to receive a bonus depreciation deduction for a single asset several times over the

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[163] In addition, as stated in footnote 133, above, depending upon whether Treasury and the Service make any changes to the Intercompany Transfer Rules, it may be necessary to exempt any transactions subject to such rules from the application of the Series Transfer Rule. Put differently, the Series Transfer Rule should not prevent a transaction that complies with the Intercompany Asset Transfer Rule or the Intercompany Deemed Asset Transfer Rule from producing a bonus depreciation deduction.

[164] *See* Prop. Reg. § 1.168(k)-2(b)(3)(iii)(B)(4).

[165] *See* I.R.C. § 168(k)(2)(E)(iii).

[166] *See* Treas. Reg. § 1.168(k)-2(g)(1)(i).

[167] Other provisions of the New Regulations nevertheless could deny bonus depreciation in these facts. For instance, if the taxpayer's acquisition and reacquisition were considered the first and last steps in a series of related transactions, the reacquisition would fail the Unrelated Purchase Test on account of the Series Transfer Rule.

course of an asset's useful life.[168] We recommend that Treasury and the Service either clarify that this result is permitted or, if this result is not intended, clarify that the rule does not apply to periods of ownership and use with respect to which the taxpayer received a prior bonus depreciation deduction.

b. Disqualifying Reacquisition Rule

We respectfully recommend clarification regarding the penultimate sentence of Proposed Regulations Section 1.168(k)-2(b)(3)(iii)(B)(4), which provides that the De Minimis Use Rule does not apply if a taxpayer "reacquires and again places in service the property during the same taxable year the taxpayer disposed of the property" (the "**Disqualifying Reacquisition Rule**"). We believe that the intent of this language is to ensure that the De Minimis Use Rule does not override the Same-Year Transfer Rule, which provides that a taxpayer that places property in service and disposes of it in the same taxable year is not eligible for bonus depreciation.[169] For instance, consider the following example:

> *Example 41.* On January 1, 2020, A places in service a used asset that is Bonus-Eligible Property. On March 31, 2020 (90 days later), A disposes of the asset to an unrelated party. On November 1, 2020, A reacquires the asset in a transaction otherwise qualifying under Section 168(k)(2)(E)(ii) and places the asset in service on the same date.

The taxpayer's January 1 acquisition should not be eligible for bonus depreciation on account of the Same-Year Transfer Rule. In addition, however, the Disqualifying Reacquisition Rule appears to apply to the November 1 reacquisition and prevent the application of the De Minimis Use Rule, in which case the reacquisition would appear to fail the No Prior Use Test.

We agree that the January 1 acquisition should not be eligible for bonus depreciation. However, it is not clear to us why the November 1 reacquisition should not be so eligible. A's 90-day period of prior ownership would have been disregarded had it occurred only 3 months earlier in a prior taxable year, and we do not perceive any obvious reason for treating the 90-day period differently only because it falls within the same taxable year as A's reacquisition. Accordingly, we recommend that the Disqualifying Reacquisition Rule not apply, and that bonus depreciation be allowed, in the facts of Example 41.

The Disqualifying Reacquisition Rule could also be read to apply to scenarios where an acquiror previously used an asset for more than 90 days <u>in total</u> over multiple periods of ownership and use. Consider the following examples:

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[168] For instance, if a calendar-year taxpayer acquired an asset that is Bonus-Eligible Property and placed the asset in service on December 1, 2019, disposed of the asset on January 1, 2020, and reacquired the asset and placed it back in service on January 1, 2021, the taxpayer apparently could claim bonus depreciation with respect to the December 1, 2019 acquisition and the January 1, 2021 reacquisition. Thus, based upon the De Minimis Use Rule as drafted, the same taxpayer would appear to be able to receive a bonus depreciation deduction with respect to a single asset approximately every two years.

[169] *See* Treas. Reg. § 1.168(k)-2(g)(1)(i).

Example 42. On January 1, 2020, A places in service a used asset that is Bonus-Eligible Property. On March 31, 2020 (90 days later), A disposes of the asset to an unrelated party. On November 1, 2020, A reacquires the asset from another unrelated party and places it in service on the same date, then disposes of the asset again on January 1, 2021 (61 days later) to another unrelated party. Finally, on January 1, 2025, A reacquires the asset from an unrelated party in a transaction otherwise qualifying under Section 168(k)(2)(E)(ii) and places it in service on the same date.

Example 43. On January 1, 2020, A places in service a used asset that is Bonus-Eligible Property. On March 31, 2020 (90 days later), A disposes of the asset to an unrelated party. On January 1, 2021, A reacquires the asset from another unrelated party and places it in service on the same date, then disposes of the asset again on April 1, 2021 (90 days later) to another unrelated party. Finally, on January 1, 2025, A reacquires the asset from an unrelated party in a transaction otherwise qualifying under Section 168(k)(2)(E)(ii) and places it in service on the same date.

We note that Example 42 and Example 43 arguably represent the types of scenarios at which the De Minimis Use Rule is aimed – *i.e.*, A used an asset for relatively short periods of time in the past and subsequently reacquires that asset. On the other hand, in each case, A used the relevant asset for more than 90 days in the aggregate (151 days in Example 42 and 180 days in Example 43).

As written, while the wording of the Disqualifying Reacquisition Rule is arguably a better fit for Example 42,[170] the De Minimis Use Rule appears to deny bonus depreciation for A in both cases. Both Example 42 and Example 43 involve (i) a reacquisition of an asset, (ii) a placement in service of the asset, and (iii) a disposition of the asset in the same taxable year as acts (i) and (ii). Therefore, the Disqualifying Reacquisition Rule arguably applies, turns off the De Minimis Use Rule, and disallows bonus depreciation in 2025. In Example 42, the transactions proceed (iii)-(i)-(ii) (on March 31, November 1, and November 1 of 2020, respectively), while in Example 43 they proceed (i)-(ii)-(iii) (on January 1, January 1, and April 1 of 2021, respectively).

Based on the foregoing, we recommend that the Disqualifying Reacquisition Rule be amended to clarify when it applies. We specifically recommend that the Disqualifying Reacquisition Rule allow bonus depreciation in transactions such as the November 1 reacquisition in Example 41, and that Treasury and the Service should consider whether the Disqualifying Reacquisition Rule should deny bonus depreciation in situations like the 2025 reacquisitions in Example 42 and Example 43.

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[170] "[R]eacquires and again places in service the property during the same taxable year the taxpayer disposed of the property" could be read to apply only when the reacquisition and placement in service occur after, but in the same taxable year as, the disposition of the relevant property. Under this reading, the Disqualifying Reacquisition Rule would apply to Example 42 but not to Example 43.

6. Treasury Regulations Section 1.168(k)-2(g)(1)(i)

The final sentence of Treasury Regulations Section 1.168(k)-2(g)(1)(i) states that, "if qualified property is placed in service and disposed of during the same taxable year and then reacquired and again placed in service in a subsequent taxable year, the additional first year depreciation deduction is not allowable for the property in the subsequent taxable year." This sentence, which mirrors a sentence in the regulations issued under the pre-Act Code,[171] does not appear correct given the New Regulations' addition of several exceptions to the No Prior Use Test, such as the 5-Year Safe Harbor and the De Minimis Use Rule, each of which allows bonus depreciation for Bonus-Eligible Property reacquired after a period of prior use. In addition, an example in the Proposed Regulations confirms that Bonus-Eligible Property previously placed in service and disposed of in a single taxable year is eligible for bonus depreciation upon its reacquisition if the De Minimis Use Rule applies to the prior period of ownership and use.[172]

Accordingly, because the final sentence of Treasury Regulations Section 1.168(k)-2(g)(1)(i) appears to conflict with other portions of the New Regulations, we recommend that Treasury and the Service remove this sentence.

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[171] *See* Treas. Reg. § 1.168(k)-1(f)(1)(i).

[172] *See* Prop. Reg. § 1.168(k)-2(b)(3)(vii), Ex. 25; *cf. also* Treas. Reg. § 1.168(k)-2(b)(3)(vii), Ex. 11 (N, a calendar-year taxpayer, holds a 50% interest in equipment "only during 2011" and receives bonus depreciation upon the reacquisition of this 50% interest in 2018 because of the 5-Year Safe Harbor).