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Report No. 1484
December 4, 2023

The Honorable Lily Batchelder
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Daniel I. Werfel
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William M. Paul
Principal Deputy Chief Counsel
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(Technical)
Internal Revenue Service
1111 Constitution Avenue, NW
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Re: Notice 2023-63

Dear Ms. Batchelder and Messrs. Werfel and Paul:

This letter[1] of the New York State Bar Association Tax Section responds to Notice 2023-63, in which the Department of the Treasury ("**Treasury**") and the Internal Revenue Service ("**IRS**") described the terms of proposed regulations intended to be issued under Section 174[2], as amended by Public Law 115-97, commonly known as the "Tax Cuts and Jobs Act" (the "**TCJA**") and requested comments on a variety of issues.

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1 This letter may be cited as New York State Bar Association Tax Section Report No. 1484, "Notice 2023-63" (December 4, 2023). The principal drafter of this letter was Elliot Pisem with helpful comments from Andrew H. Braiterman, Peter J. Connors, Lawrence M. Garrett, Kevin Jacobs, Jiyeon Lee-Lim, John T. Lutz, Michael T. Mollerus, Richard M. Nugent, Deborah L. Paul, Yaron Z. Reich, Stuart Rosow, Jason Sacks, Michael L. Schler, Karen Gilbreath Sowell, Philip Wagman and Gordon E. Warnke. This letter reflects solely the views of the Tax Section of the New York State Bar Association ("**NYSBA**") and not those of NYSBA's Executive Committee or its House of Delegates.

2 Except where otherwise indicated, references in this letter to "**Sections**" are to sections of the Internal Revenue Code of 1986, as amended (the "**Code**").

Part 1 of this letter provides background and describes the 2017 amendment to the statute. Part 2 addresses questions raised in the Notice about the application of Sections 59(e), 56(b)(2)(A) and 280C(c)(1)(B). Part 3 discusses issues under Section 174 that relate to Section 351 transactions, which are addressed in Section 7 of the Notice. Finally, Part 4 suggests rules for the treatment of research and experimental expenditures incurred by partnerships, in response to questions in Sections 11.02(1) and (2) of the Notice.

*1. **Background***

Section 174 governs the income tax treatment of research and experimental expenditures incurred in connection with the taxpayer's trade or business. Prior to enactment in 2017 of the TCJA, Section 174 and the regulations thereunder provided alternative methods of accounting that could be used by taxpayers, at their election, for such expenditures:

- The default rule was that such expenditures were charged to capital account (Treas. Reg. Section 1.174-1), and, if they had a determinable useful life, were amortized or depreciated over that life (Treas. Reg. Section 1.174-4(a)(2)).
- The expenditures could be treated as expenses not chargeable to capital account and allowed as a deduction in the year paid or incurred (former Section 174(a)).
- The expenditures could, if they lacked a determinable useful life, be treated as deferred expenses and amortized over any period chosen by the taxpayer, provided that such period had to be not less than 60 consecutive months and had to begin with the month in which the taxpayer first realized benefits from the expenditures (former Section 174(b)(1) and Treas. Reg. Section 1.174-4(a)(3)).[3]

Many taxpayers elected current deduction treatment under former Section 174(a).

The TCJA amended Section 174 to require that specified research and experimentation expenditures ("**SRE expenditures**") paid or incurred in taxable years beginning after December 31, 2021, be charged to capital account and amortized ratably over a five-year period (15 years in the case of research expenditures attributable to foreign research), beginning with the midpoint of the taxable year in which the expenditures are paid or incurred (Section 174(a)).[4]

The TCJA also added a rule relating to disposition, retirement, or abandonment of property with respect to which such expenditures have been paid or incurred. Section 174(d) provides: "If any property with respect to which specified research or experimental expenditures are paid or

[3] Special rules were provided for situations in which expenditures resulted in property that became depreciable at a later time (Treas. Reg. Section 1.174-4(a)(4)).

[4] The definition of this type of expenditures is the same as the type of expenditures that were subject to the prior version of the statute, i.e., research and experimental expenditures incurred in connection with the taxpayer's trade or business. *Compare* post-TCJA Section 174(b) (defining SRE expenditures) with pre-TCJA Sections 174(a)(1) and (b)(1)(A).

incurred is disposed, retired, or abandoned during the period during which such expenditures are allowed as an amortization deduction under this section, no deduction shall be allowed with respect to such expenditures on account of such disposition, retirement, or abandonment and such amortization deduction shall continue with respect to such expenditures."[5]

Section 59(e) provides that, at the election of the taxpayer, any amount which, but for such an election, would have been allowable as a deduction for the year in which paid or incurred under any of a series of Code provisions, including Section 174(a), shall be allowed as a deduction ratably over the 10-year period beginning with the taxable year in which such expenditure was made. Section 59(e) was not amended by the TCJA.[6]

Section 1016(a)(14) provides that proper adjustment "in respect of the property" shall be made for amounts allowed as deductions under Section 174(b)(1).[7] In addition, Section 1016(a)(20) provides that proper adjustment "in respect of the property" shall be made for amounts allowed as deductions under Section 59(e).[8]

2. ***<u>Application of Sections 59(e), 56(b)(2)(A) and 280C(c)(1)(B)</u>***

As noted above, in Notice 2023-63, Treasury and the IRS requested comments on whether and how Section 59(e) applies to SRE expenditures, in periods for which the TCJA amendments to Section 174 are in effect. In view of the apparent emphasis on removing taxpayer optionality in the post-TCJA version of Section 174 (including mandatory 15-year amortization for SRE expenditures incurred in foreign research), Congress may not have intended that taxpayers continue to be entitled to elect 10-year amortization. Moreover, it does not appear such a conclusion is required by the language of Section 59(e), which refers to "any amount which, but for an election under this subsection, would have been allowable as a deduction…..for the taxable year in which paid or incurred under—…. section 174(a)." Before the TCJA, Section 174(a) expressly provided for a current deduction for an SRE expenditure in the year paid or incurred. As revised, the provision does not permit a current deduction for the expenditure; instead, the expenditure must be capitalized. It is then amortized over five or 15 years. While a relatively

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5 Comments on the policy merits of Section 174(d) are beyond the scope of this letter.

6 In Notice 2023-63, Treasury and the IRS requested comments on whether and how Section 59(e) applies to SRE expenditures, in periods for which the TCJA amendments to Section 174 are in effect. *See* Section 11.02 of the Notice.

7 Section 1016 was not amended by the TCJA, notwithstanding the substantive changes made by the TCJA to Section 174. As described at the beginning of this letter, former Section 174(b) related specifically to the election to treat certain expenditures as amortizable deferred expenses. Current Section 174(b) contains only a definition of SRE expenditures, and the rule requiring amortization of all SRE expenditures is found in current Section 174(a).

The TCJA deleted former Section 174(f), which contained a cross-reference to Section 1016, possibly suggesting Section 1016(a)(14) is no longer intended to have any effect. However, we note that Section 7806(a) prohibits giving legal effect to such cross-references and, presumably, to their deletion.

8 Section 1016(a)(20) was not amended by the TCJA. If the reading of Section 59(e) described below in Part 2 of this letter is adopted, then Section 1016(a)(20) will cease to have application as a practical matter.

small portion of the expenditure would be amortized in the year paid or incurred, the "amount" referenced in Section 59(e) may also reasonably be read to refer to the expenditure as a whole (and not the one-tenth or one-thirtieth of the expenditure that – taking into account commencement of amortization at the midpoint of the relevant year under Section 174(a) – would be amortizable in the year paid or incurred). Under this reading, $0 of the expenditure would be eligible for the election in Section 59(e).

One might also find support for a literal reading under which the "amount" in Section 59(e) is one-tenth or one-thirtieth of an SRE expenditure. However, it is hard to identify a rationale for a system in which, after the mandatory amortization schedule imposed by Section 174 is applied to an SRE expenditure, a small part of that expenditure is then (at the taxpayer's election) subjected to amortization under a different schedule.

In a related vein, the Notice requests comments on the proper interpretation of Sections 56(b)(2)(A) and 280C(c)(1)(B) in periods for which the TCJA amendments to Section 174 are in effect.[9] Section 56(b)(2)(A) provides that for purposes of the alternative minimum tax, the amount otherwise deductible under Section 174(a) must instead be capitalized and amortized over 10 years. However, this rule does not apply where the taxpayer materially participates (within the meaning of Section 469(h)) in the activity in which the deductible amount was incurred; and in the event of certain dispositions, the taxpayer is entitled to accelerate the unamortized portion of the deduction that has been deferred under Section 56(b)(2)(A). For reasons similar to those suggested above, it appears reasonable to us to read the reference in Section 56(b)(2)(A) to "the amount allowable as a deduction under … section 174(a)" as $0. By comparison, Section 280C(c)(1) provides that where a taxpayer claims a credit under Section 41(a) for qualified research expenditures, if the amount of the credit exceeds "the amount allowable as a deduction for such taxable year" under Section 174(a), then the amount chargeable to capital account for such expenses will be reduced by such excess. However, an election can be made to claim a reduced credit instead of reducing the taxpayer's capitalized amount. It would seem that a coordination rule like that in Section 280C(c) continues to be appropriate after the TCJA to prevent a taxpayer from claiming a double benefit for the same dollar of research expense; and, if the quoted wording in the provision is interpreted as $0, that would not prevent the rule from functioning in view of the reference to amounts chargeable to capital account (i.e., the taxpayer's entire SRE expenditure for the year would be treated as an amount chargeable to capital account).

3. ***<u>Section 351 Exchanges</u>***

Section 7.02 of Notice 2023-63 states that the Treasury Department and the IRS intend to propose rules in forthcoming proposed regulations to the effect that:

- If any property with respect to which SRE expenditures are paid or incurred is disposed of during the applicable Section 174 amortization period, no recovery is allowed with respect to the unamortized SRE expenditures on account of such disposition; and

[9] Section 11.02(4) of Notice 2023-63.

- The taxpayer that disposed of such property continues to amortize such expenditures under Section 174 over the remainder of the applicable Section 174 amortization period.

The Notice provides two exceptions to this rule. First, if a corporation ceases to exist in a transaction governed by Section 381(a),[10] the acquiring corporation steps into the shoes of the transferor or distributing corporation and continues to deduct the unamortized SRE expenditures over the remainder of the Section 174 amortization period.[11] Second, if a corporation ceases to exist in transactions to which Section 381 does not apply, the corporation is entitled to deduct all of its unamortized SRE expenditures in the year of the liquidation.[12] However, if the transaction in which the corporation ceases to exist occurs for a principal purpose of accelerating a deduction under Section 174, such acceleration does not apply.[13]

In Example 1(c), the Notice concludes that amortization of SRE expenditures is not accelerated regardless of whether the taxpayer's disposition of property to which the expenditures relate occurs as part of an "applicable asset acquisition" within the meaning of Section 1060 involving the transfer of an entire trade or business.

Example 1(d) in Section 7.05 of the Notice applies these principles to the transfer of property at a gain in an exchange described in Section 351 and holds that the transferee in such an exchange does not amortize any portion of the SRE expenditures originally paid or incurred by the transferor.

Whether there are circumstances, particularly those involving the transfer of an entire trade or business in a Section 351 exchange, in which the rules set out in Section 7 of the Notice may fail to reach the correct result turns, in large part, on how one views a taxpayer's balance of unamortized SRE expenditures. The view adopted by the Notice appears to be that such a balance is a tax attribute personal to a particular taxpayer, generally the taxpayer that would have been entitled under Section 174(a), prior to its amendment by the TCJA, to an immediate deduction for the SRE expenditures (the "**attribute approach**"). The attribute approach has the cardinal virtue of computational and administrative simplicity: the location and timing of Section 174 amortization deductions for the applicable SRE expenditures remains the same, regardless of whether the expenditures relate to an identifiable asset and, if so, what happens to that asset. Essentially, the only difference from the result under the pre-2017 version of Section 174(a), is that most of the taxpayer's deduction is deferred to future years.

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10 Section 381(a) applies to reorganizations under Sections 368(a)(1)(A), (C), (D) or (G) (provided in the latter two cases that one corporation acquires substantially all the assets of the transferor corporation and that certain distribution requirements are met) and to liquidations under Section 332.

11 Notice 2023-63, Section 7.04(1).

12 *Id.* Section 7.04(2)(a).

13 *Id.* Section 7.04(2)(b). It is unclear what happens to the unamortized SRE expenditures if this anti-abuse rule applies (i.e., whether these SRE expenditures are eliminated and, if not, which taxpayer can claim the relevant deductions).

In many cases, this approach appears to us to reach correct results. For example, in the case of a taxable sale, whether or not an applicable asset acquisition, the attribute approach seems clearly to comport with the mandate of Section 174(d) regarding the treatment of the transferor. More broadly, it also fits with the fact that Section 174 no longer allows optionality for the taxpayer, but mandates amortization over a set period. Although the taxpayer's amount realized on the sale will include the expected present value of the income that will be realized from property to which the SRE expenditures relate, and while there will thus not be a correspondence between the year in which the taxpayer's income is realized and the years when the expenditures are amortized, that might well have been true if the taxpayer had continued to own the property. In addition, Section 197 provides an appropriate mechanism for the transferee to recover its costs properly attributable to the property to which the SRE expenditures relate.

The attribute approach also seems to be properly applied when property resulting from SRE expenditures, but less than an entire trade or business, is transferred in a Section 351 exchange. As in the case of a taxable sale, this approach is consistent with the basic approach taken in the revised statute of removing taxpayer optionality. In addition, it eliminates the need to tease out the precise amount of the transferor's aggregate balance of unamortized SRE expenditures that is connected to the transferred property. If such expenditures could be transferred in a Section 351 transaction, such transfers would potentially be subject to abuse. For example, suppose a taxpayer with substantial net operating losses incurs SRE expenditures related to an item of property; it might be advantageous to the taxpayer to be able to transfer those expenditures and the property in a Section 351 transaction, to a transferee corporation that has profits from assets unrelated to the transferred property. As a variation on this example, suppose the transferor does not have net operating losses, and the property transferred in the Section 351 transaction has a low fair market value relative to the amount of SRE expenditures transferred to the transferee corporation. In such a case, the transferor might, subject to Section 362(e), be able to include the SRE expenditures in its stock basis, while the transferee amortized the expenditures under Section 174.[14] It does not appear that Section 269 or other existing rules would reliably police such transactions. In view of the advantaged results that could be obtained, there would be significant pressure on the determination of the appropriate part of the transferor's total unamortized SRE expenditures to treat as having been transferred.

Finally, although it could be argued that, in a Section 351 transaction, there is a mismatch caused by the transferee's recognition of income from the transferred property without offset for the amortization or other cost recovery deduction, the statute already expressly tolerates other mismatches, at least as to timing, as noted above.[15] Moreover, significant computational

[14] In some cases, the transferor might not derive much advantage from including these amounts in stock basis. For example, if the transaction is part of a divisive "D" reorganization, this stock basis will disappear when the transferor distributes the transferee stock pursuant to Section 355. However, we note that in such a reorganization, the transferor may be able to utilize a higher stock basis to increase the amount of cash that it can receive tax-free under Section 361(b)(3).

[15] Prior law also generally resulted in a mismatch, where there was a Section 351 transfer of property created with research and experimental expenditures that had been deducted in full by the transferor under former Section 174(a). Congress eliminated the current deduction in the TCJA; but it may not have done so out of a desire to

complexities would arise from any other approach when a transferor receives not only stock of the transferee, but also "boot," in such an exchange, as discussed further below.

Nevertheless, it is possible to take an alternative view of an unamortized balance of SRE expenditures, that it reflects, in effect, the remaining tax basis of property resulting from those expenditures that would have been capitalized, under former Section 174, in the absence of an election under former Section 174(a) (the "**property approach**"). In particular, where an entire trade or business is transferred in a nontaxable transaction, so that issues of allocation of the unamortized balance of SRE expenditures between retained and transferred property are reduced or eliminated, the property approach can more properly match income to be earned with respect to transferred property with recovery of that property's costs.[16] Some sources of authority suggest that this is a material consideration in transactions of this kind.

First, Private Letter Rulings 200812005 and 201033014 both dealt with Section 351 transactions in which intellectual property the cost of which the transferring taxpayer was amortizing under Section 59(e) was transferred. The 2008 ruling states that "[p]ursuant to Treas. Reg. § 1.59-1(b)(2) and § 1016(a)(20), Taxpayer's basis in the assets that generated the research and experimental expenditures reflects the expenditures deferred under § 59(e) and is reduced by the expenditures that were deducted in prior taxable years. Furthermore, [the transferee]'s basis in the assets is determined by Taxpayer's basis immediately prior to the transfer". Having thus assimilated amounts being amortized under Section 59(e) to asset basis, the ruling holds that the unamortized remaining account balance of taxpayer's Section 59(e) amount carried over to the transferee and would continue to be amortized by the transferee in the same manner and over the remaining period that such balance would have been amortized by the taxpayer. The 2010 ruling reaches the same result, based on similarly worded reasoning.

Both rulings acknowledged that there was no specific authority under Section 59(e) on this point, but noted that a similar result had been reached in a case involving unamortized mine development costs under Section 616(b), *Philadelphia & Reading Corp. v. United States*, 602 F.2d

address timing mismatches. Rather, the change to Section 174 may have been prompted, at least to a significant extent, by the material revenue that such change was expected to raise, which helped meet the revenue targets required by the reconciliation procedure under which the TCJA was enacted. *See* Joint Committee on Taxation, Estimated Budget Effects of the Conference Agreement for H.R. 1, JCX-67-17, at page 3 (Dec. 18, 2017).

16 This is especially true when all or substantially all of the transferor's businesses are transferred to a single transferee in a transaction not governed by Section 381. Where one of multiple trades or businesses is transferred, there might still be questions of allocation of the unamortized balance of the transferor's SRE expenditures among those trades or businesses. (We note, however, that other issues also exist under Section 174 concerning proper allocation of expenditures among different activities; and Treasury has adopted a framework in Notice 2023-63 for resolving those issues. *See* Sections 4.03(3) and (4) of Notice 2023-63.)

It could also be asked whether SRE expenditures incurred, for example, in a project that has been abandoned should ever be treated under the property approach as transferred in a Section 351 transaction. One might conclude that such expenditures do not relate to any ongoing trade or business and thus should not be viewed as transferred when a trade or business is transferred in a Section 351 transaction. However, at least in some cases, it may be reasonable to view such SRE expenditures as enhancing the goodwill associated with a trade or business of the taxpayer, and as being transferred along with that goodwill (as discussed in note 19 *infra*).

338 (Ct. Cl. 1979). In that case, the court found that a "transferee described in sections 351 or 368" is unlike a purchaser in a taxable sale; the court noted that "[b]oth sections 351 and 368 are the result of statutory recognition of the mere change in form of legal ownership without a substantial change in the substance of the transferor's investment," and it concluded the transferee stepped in the shoes of the transferor for purposes of claiming future deductions for the development costs.[17] The rulings and the case did not address specifically the impact of the transfer on the transferor's basis in the stock of the transferee corporation. While Section 59(e)(2)(B) may have limited continuing vitality, as noted above, the conceptual analysis in the rulings and in the case they cite remains relevant.

Private Letter Rulings 200812005 and 201033014 and *Philadelphia & Reading Corp.* each involved Section 351 transactions in which an entire business was transferred. That may well have made it easier for the transferee to be viewed as a successor to the transferor, notwithstanding the non-applicability of Section 381. In such cases, reasons to focus on matching deductions with associated income appear particularly strong. There is also less reason to expect difficulty in reliably determining whether property resulting from SRE expenditures has been transferred, and the portion of the taxpayer's total SRE expenditures related to transferred property. The approach adopted in these rulings and the case can be seen as conceptually consistent with other authorities involving a Section 351 transaction in which an entire business is transferred, which place similar emphasis on allowing the transferee corporation to claim future deductions associated with the business and transferred assets.[18]

Taken together, these authorities can be seen as indicating the significance that could be placed on allowing amortization deductions under Section 174 to the taxpayer that is enjoying the economic benefit of the property created thereby and the related income in a case involving a transfer of a business. Section 174(d) can be read as permitting such matching of deductions and income, as it requires that the timing of deductions for unamortized SRE expenditures not be

[17] 602 F.2d at 341, 343-344. *Cf*. General Counsel Memorandum 38966 (1983) (discussing *Philadelphia & Reading Corp*. and other authorities that address whether and in what circumstances an attribute will be treated as transferred in a tax-free corporate transaction, in cases where Section 381 does not provide for such transfer).

[18] *See* Rev. Rul. 95-74, 1995-2 C.B. 36; Rev. Rul. 80-198, 1980-2 C.B. 122; *cf*. Revenue Procedure 2017-52, 2017-41 I.R.B. 283 (requiring that the following representation be made in connection with seeking a Private Letter Ruling regarding a divisive D reorganization transaction governed by Section 355: "The transaction does not involve and will not result in a situation in which one party recognizes income but another party recognizes the deductions associated with such income or a situation in which one party owns property but another party recognizes the income associated with such property.").

In Revenue Rulings 95-74 and 80-198, the transferee corporation became entitled to future deductions at the cost of incurring the expenditures associated with those deductions. By comparison, if the transferee inherits unamortized SRE expenditures, the transferee's future deductions would come without any associated economic cost, a fact arguably indicating the transferee should not be entitled to claim the deduction. However, a transferee of depreciable or amortizable property in a Section 351 transaction is entitled to depreciation or amortization deductions, even though it has not incurred the expenditures that gave rise to the property's basis.

accelerated on a disposition of the related property, but does not state that the same taxpayer must continue to claim those deductions following the disposition.[19]

Also supporting application of the property approach is the statutory text in Section 1016. The pre-TCJA version of Section 174(b)(1) expressly stated that if a taxpayer elected to amortize SRE expenditures over a 5-year period, "[s]uch deferred expenses are expenditures properly chargeable to capital account for purposes of Section 1016(a)(1)." Section 1016(a)(14) in turn, as noted above, provides that amortization deductions under Section 174(b)(1) are treated as adjustments to the basis of property. Although Section 59(e)(2)(B) does not contain a sentence parallel to the one found in former Section 174(b)(1), the fact that Section 1016(a)(20), also noted above, contains a similar provision treating amortization deductions for SRE expenditures under Section 59(e) as adjustments to basis implies that unamortized expenses deferred under Section 59(e) are included in asset basis. The fact that Congress did not amend Section 1016(a)(14) in the TCJA arguably indicates that, although Congress decided to make capitalization of SRE expenditures mandatory, it did not intend to change the treatment of such expenditures as being added to basis. The legislative history of the TCJA contains language suggesting Congress amended the statute because it viewed SRE expenditures as giving rise to something of value lasting beyond the taxable year.[20]

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[19] By comparison, use of the attribute approach, rather than the property approach, whether in a divisive reorganization (or in a Section 351 transaction outside of the reorganization context, where the transferor conducts multiple businesses and transfers only some of those businesses to the transferee corporation) would cause the transferor to retain the amortization deductions regardless of whether the transferor retained the trade or business in which the expenditures were incurred and transferred another business to the transferee or *vice versa*. Such rigidity could work either to the benefit or the detriment of the fisc.

In addition, the attribute approach would place a premium – in a potentially arbitrary manner – on whether a taxpayer conducted businesses in which SRE expenditures were incurred through separate corporate subsidiaries, or directly through branches (or disregarded entities). In the former case, a transfer by the taxpayer of its subsidiaries which had incurred the expenditures to a new holding corporation that would conduct the relevant business, would result in a transfer of the SRE expenditures to the corporate group headed by the new holding corporation. In the latter case, the SRE expenditures would not transfer.

The potentially arbitrary results described above, however, apply to other types of attributes in these types of transactions, suggesting such results may generally be acceptable. For example, similar results are obtained under Section 163(j) where a member of a consolidated group has carryforwards of interest disallowed under Section 163(j) and the shares of that member (as opposed to the assets of the member) are transferred out of the group. *See* Treas. Reg. Section 1.163(j)-5(b)(3).

[20] "The Committee recognizes that research and experimentation expenditures have a useful life beyond the tax year in which the expenditures are incurred, and that the tangible and intangible property created through research and experimentation activities provide value to a business beyond a single tax year. … For these reasons, the Committee believes research expenses, including software development costs, should be amortized over a period beyond the current year." H.R. Rep. 115-409, at 282 (2017).

Even if SRE expenditures cannot be tied to a specific resulting piece of property, it nonetheless is conceivable, at least in some cases, that such expenditures have created overall value for the taxpayer's business – essentially, adding to the residual value generally associated with goodwill and going concern value under Sections 1060 and 197.

On the other hand, Congress clearly opted to treat such expenditures in a manner different than asset basis in Section 174(d), at least in regard to taxable asset transfers. There is not evidence that Congress intended a different characterization of such expenditures in Section 351 transactions than in asset sales. And, since Section 1016(a)(14) refers only to deductions under Section 174(b)(1), which after the TCJA no longer provides for any deductions, it is possible to read the provision as simply a dead letter without continuing application.

Moreover, while a "property" approach has some conceptual and precedential support in the context of a Section 351 transaction transferring an entire trade or business, it could, in the case of many such transactions, involve significantly more complexity than the Notice's attribute approach. First, it would be difficult to draw a clear and principled line between the broad class of cases in which it should clearly apply and the narrower class where the property approach might be an acceptable alternative: it may not always be clear whether a trade or business has been transferred; and in cases where such a trade or business is transferred, it may be carved out from a larger, integrated trade or business of the transferor, thus potentially raising complicated factual questions about the portion of the taxpayer's total SRE expenditures related to the larger trade or business that should be attributed to the transferred activities. This factual complexity may raise some of the same concerns about potential abuse as noted above for other types of transactions.

Moreover, application of the property approach in the Section 351 context can lead to significant computational complexities and, arguably, to abuse.[21] For example, assume that Corporation X incurs 100 of SRE expenditures, and amortizes 10 of them, in Year 1, and then, at the beginning of Year 2, contributes all of its assets, consisting solely of intellectual property developed with the SRE expenditures, such that the intellectual property is the sole asset of its sole trade or business, to newly-formed Corporation Y, in exchange for 10 of Y stock and 80 of cash in a Section 351 transaction; other contributors put in cash and other assets for additional Y stock. At the time of the contribution, the assets contributed by X are worth 90.

Under the property approach, X could get the 80 of cash tax-free, because, if X is treated as having 90 of "basis" in assets, X hasn't realized any gain.[22] This result is more favorable to X than that of a sale of the assets to a third party for cash of 90, in which case X would immediately recognize 90 of gain, to be offset only over time by amortization deductions under Section 174. Arguably, this difference in treatment is unjustified, particularly given X's receipt of stock representing only a small part of the consideration for the assets transferred.[23] While one could

[21] Of course, it is possible to imagine that abuses, including attribute trafficking and other inappropriate tax planning techniques, could arise under the attribute approach as well, for example, if an entire business is transferred to a corporation that has net operating losses available to shelter its income, while the transferor retains Section 174 amortization deductions to offset against unrelated investment income.

[22] Even if the value of the intellectual property transferred by Corporation X, were greater than 10, such that Corporation X realized gain, application of the property approach would enable a greater amount of Corporation X's liabilities to be assumed by Corporation Y before Corporation X recognized gain under Section 357(c).

[23] By comparison, where the stock X receives represents all or a large part of the consideration, it could be argued the difference in treatment between the Section 351 transaction and a taxable sale, is a function of the substantive

create additional basis recovery rules to deal with situations like this example, the complexity of such a regime would proliferate rapidly.[24]

4. ***SRE Expenditures In the Partnership Context – Selected Issues***

Treasury and the IRS requested comments in Section 11.02 of Notice 2023-63 on partnership issues:

> (1) Under what circumstances should unamortized SRE expenditures continue to be amortized or accelerated with respect to property that is contributed to, distributed from, or transferred from a partnership?
>
> (2) Under what circumstances should unamortized SRE expenditures continue to be amortized or accelerated with respect to property of a partnership that is a party to a merger, consolidation, division, or liquidation, or that otherwise terminates under § 708 and the regulations thereunder? Is there potential for abuse as a result of allowing a deduction for unamortized SRE expenditures in the final year of a partnership that liquidates or otherwise terminates? If so, what rules are appropriate to address such abuse?[25]

As a general observation, the basic treatment of a partnership as a pass-through whose items are allocated to its partners appears to fit logically with the approach taken in the Notice of treating SRE expenditures as a non-transferable attribute of a particular taxpayer. Subchapter K contains a series of provisions that are designed to ensure that items of expense or loss economically attributable to a particular partner remain with that partner, instead of being transferred by means of the partnership to other partners: Sections 704(b), 704(c) (and the related rules dealing with "reverse Section 704(c)" allocations), 706(d), 734(d) and 743(d), and Treas. Reg. Section 1.752-7 are all broadly designed to prevent shifting and duplication of such items. Thus, for example, it appears appropriate that if a partner transfers property to a partnership in a transaction governed by Section 721, then whether or not that property constitutes a trade or business, only the transferring partner should be entitled to Section 174 deductions for SRE expenditures related to such property that the transferring partner incurred prior to such transaction.[26]

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differences between the two transactions: in the Section 351 transaction, X continues to have a material indirect interest in the transferred property.

24 As noted in text above, we do not believe that Section 174(d) precludes adoption of the property approach in the case of a Section 351 exchange, as no loss would be claimed by any party, and as the amortization deduction provided by Section 174 would continue to be claimed, albeit by a different party.

25 Notice 2023, Sections 11.02(1) and (2).

26 Even if a "property approach" to Section 174(d) were adopted in such a case like the one described above in the discussion of Section 351 transactions, the results would arguably be the same as under an attribute approach. The partnership would inherit unamortized SRE expenditures of the transferring partner in such a case; but, under the principles of Section 704(c), it would seem reasonable to view those expenditures as a separate item of property with a fair market value of $0 and a "basis" equal to the amount of such expenditures, with the result that the entire amount of the partnership's future Section 174 deductions on account of those expenditures would

When a partnership pays or incurs SRE expenditures, the amortization deductions arising from those expenditures will be allocated to the partners and ultimately deducted by them over the five- (or 15-) year amortization period pursuant to Section 174. If the partnership-level amortization deduction is accounted for and allocated separately during each year of the amortization period, and if there are changes in the ownership of partnership interests during that period, by reason of contributions or distributions, sales of partnership interests, amendments to the partnership agreement, or other causes, the benefit of the deduction may be realized by a partner who did not, through the partnership, incur the associated cost. Moreover, in some cases, a partner's transfer of a partnership interest during the amortization period could result in that partner's accelerating an indirect recovery of costs (through the partner's use of its outside basis, unreduced by the portion of SRE expenditures that the partnership has not yet deducted, to offset against the partner's amount realized on a taxable disposition of the partnership interest), in violation of the principles of Section 174(d).

In order to mitigate these concerns and give effect to the objectives of Section 174(d), we recommend that one of the following approaches be adopted.

1. The full amount of the partnership's SRE expenditures could be allocated among the partners in the year incurred, under the rules of Section 704(b) and the Regulations thereunder.

   a. Those expenditures would reduce the partners' respective bases in their partnership interests under Section 705(a)(2)(B) at that time (and would similarly reduce the partners' respective "book" capital account balances under the Section 704(b) Regulations).

   b. The amortization deduction would be allowed to the partners individually, as a deduction of the same character as it would have had at the partnership level, over the statutory period.

   c. For purposes of applying the passive loss rules of Section 469 at the partner level, the deduction would be characterized as it would have been if allowed to the partner in the year paid or incurred by the partnership. In some cases, a partner who materially participates in an activity of the partnership during a taxable year in which SRE expenditures are incurred may no longer do so

be allocated to the transferring partner. *Cf.* Treas. Reg. Section 1.704-3(a)(12); *see generally* New York State Bar Association Tax Section, Report No. 1274, Report on the Allocation of Basis Adjustments under Section 743(b) to Contingent Liabilities (October 9, 2012). In such a case, any contributed property created by means of the transferor's incurrence of SRE expenditures would be treated as a separate zero basis asset that itself had to be accounted for under Section 704(c). On the other hand, applying a "property approach" might lead one to conclude that where an asset to which unamortized SRE expenditures relate is transferred to a partnership, those expenditures are akin to basis in such transferred asset; and in that case, Section 704(c) principles would not prevent other partners from being allocated a share of the partnership's Section 174 deductions after the contribution.

during the years in which Section 174 amortization deductions are allowed with respect to those expenditures. This is particularly likely to be the case where the partnership has disposed of the business in which the SRE expenditures were incurred or the partner has disposed of some or all of the partner's interest in the partnership. However, even if the partner has disposed of the partner's entire interest in the partnership in a manner that invokes the loss allowance rule of Section 469(g)(1), that rule may not apply to allow losses attributable to amortization deductions allowed in subsequent years. Accordingly, the recommended special rule is needed to insure that the appropriate year's participation is taken into account in determining whether the amortization deductions are passive activity deductions.[27]

2. Alternatively, one could treat the partnership-level deduction in each year of the amortization period as though it were a realization of a built-in loss on property contributed by the partners to the partnership. This would invoke the mechanism of Section 704(c)(1)(C) to preclude shifting of the benefit of the deduction to other partners.

Under the first approach, SRE expenditures incurred by the partnership would become a partner-level attribute once allocated, and subsequent changes in the partner's interest in the partnership would have no effect on that attribute; nor would a later disposition by the partnership of property created as a result of the SRE expenditures (whether or not as part of a transfer of the entire applicable trade or business conducted by the partnership). An immediate reduction of the partner's outside basis by the full amount of the expenditure allocated to that partrner would help to eliminate the possibility of a double benefit. In addition, an immediate reduction of the partner's capital account would reflect the economic detriment of the partnership's cash expenditure. No further adjustments to the partner's outside basis or capital account would be made in subsequent periods, when the partner amortized the allocated SRE expenditure under Section 174. These results would generally parallel those the partner would have had, if they had directly conducted the relevant partnership activities and incurred the SRE expenditures. We believe this approach would be the most logical way to implement the principles of Section 174(d).

There are some analogies for this type of approach. For instance, under Section 163(j) a partnership's excess business interest expense is generally allocated to its partners, with such expense then becoming a partner-level attribute that can potentially be used by that partner in future years. In addition, certain creditable expenditures of a partnership are allocated to the partners, with each partner then separately determining whether to claim a credit for their allocable share of the expense. Under such an approach, the partnership would need to inform the partners of their allocable shares of SRE expenditures incurred during the partnership's taxable year, and each partner would then bear the burden of tracking the allocated share of SRE expenditures and claiming deductions under Section 174 on that partner's returns.

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[27] Indeed, a similar issue can arise, and the same rule should be applied, when SRE expenditures are incurred directly by an individual or by a C corporation subject to Section 469.

This approach would be built on top of, and function largely independently of, the existing Subchapter K regime. By comparison, the second alternative mentioned above would adapt an existing partnership rule, Section 704(c)(1)(C), to apply to SRE expenditures. Such alternative might thus be somewhat simpler to implement in guidance. However, if a partner disposed of its entire interest in the partnership during the amortization period, the Section 704(c)(1)(C) approach might not prevent that partner from recovering its basis attributable to the unamortized expenditures in computing the partner's gain or loss on the disposition. It thus may not completely accomplish the objectives of Section 174(d).

For completeness, we note that another conceivable alternative would be to treat each partner's allocable share of the partnership SRE expenditure, as determined in the year the expenditure was incurred, as a Treas. Reg. Section 1.752-7 liability. Such treatment could eliminate the possibility of a double benefit, and also might generally ensure that only the partner to which the expenditure was allocated would get the benefit of the Section 174 deductions corresponding to that expenditure. However, Treas. Reg. Section 1.752-7 was not designed with this type of tax attribute in mind; and it appears to us that, as a result, the existing rules would need to be modified significantly in order to adapt them to fit SRE expenditures. We thus do not recommend pursuing this option, as opposed to adopting rules more specifically tailored to Section 174.

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We appreciate your consideration of this letter. 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,

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