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# Bonus Questions on the New Bonus Depreciation Rules

by Richard M. Nugent, Sean E. Jackowitz, and
L. Matthew Waterhouse

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# Bonus Questions on the New Bonus Depreciation Rules

by Richard M. Nugent, Sean E. Jackowitz, and L. Matthew Waterhouse

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In this report, the authors discuss the history of the U.S. depreciation rules and explain the changes made by the Tax Cuts and Jobs Act, including the section 168(k) amendments that enact immediate expensing. They also identify potential interpretative issues under section 168(k) in the corporate and partnership areas that may benefit from IRS and Treasury guidance.

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As this report went to press, the government's initial guidance on section 168(k) was expected shortly.

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## I. Introduction

Enacted in December 2017, the Tax Cuts and Jobs Act (P.L. 115-97) is the most comprehensive



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tax reform legislation adopted in the United States in a generation.[1] In addition to lowering corporate and individual tax rates, permitting some small businesses to reduce their tax rate through a passthrough income deduction, significantly changing the international aspects of the U.S. federal income tax system, and making various revisions to fundamental provisions of the code, the TCJA introduced immediate expensing for some business assets. That expensing concept, which is in section 168(k) and mirrored in a somewhat similar provision in section 179, is the focus of this report.

The TCJA generally allows full immediate expensing (that is, a first-year deduction equal to 100 percent of cost)[2] for qualified property (generally, tangible depreciable property with a recovery period of 20 years or less and some other types of property) acquired and placed in service after September 27, 2017, and before January 1, 2023.[3] Prior law allowed full expensing only in limited instances and, for much of the property now eligible for full expensing, normally required taxpayers to recover their costs over the property's legally mandated recovery period or its useful life. Significantly, the new law permits expensing of used property and thus does not require that the taxpayer be the original user of the property.

Immediate expensing generally should reduce the cost of capital investments to taxpayers through accelerated tax savings, though these savings are likely reduced because of the TCJA's reduction in business tax rates. Also, the new law's application to used property (rather than just property for which taxpayers are making an "original use") may encourage transaction structures that are treated as asset purchases for U.S. tax purposes, including a deemed purchase under section 338(h)(10), given the potential for immediate expensing. Noncorporate purchasers may find the new immediate expensing rules especially desirable given that those purchasers generally are now subject to higher U.S. tax rates than corporations.[4]

This report discusses the history of depreciation generally and immediate expensing in U.S. tax law, including the latter's origins in the movement toward accelerated depreciation deductions. It explains the TCJA's changes to the depreciation rules, most important those to section 168(k) that enact immediate expensing. Finally, the report also describes several interpretative issues and interesting transactions that may arise under the new section 168(k) in both the corporate and partnership contexts and that may benefit from IRS and Treasury guidance.[5]

## II. Tax Depreciation Background

This section briefly discusses the development of tax depreciation rules leading to the enactment of sections 179 and 168(k).[6]

### A. Brief History of U.S. Tax Depreciation

Depreciation — or the concept of recovering the cost of an asset through multiple deductions over a period of years, approximating the asset's decline in value — did not gain broad acceptance

[1] The House bill and Senate amendment that preceded the final version of P.L. 115-97 used the short title "Tax Cuts and Jobs Act," but the final version of the bill did not. Nevertheless, the title "Tax Cuts and Jobs Act" continues to be widely used in referring to the new law, including by the White House. *See*, *e.g.*, White House, "Remarks by President Trump at Signing of H.R. 1, Tax Cuts and Jobs Bill Act, and H.R. 1370" (Dec. 22, 2017). Accordingly, this report refers to P.L. 115-97 by its unofficial title.

[2] The concept of allowing taxpayers a full or larger depreciation deduction in the first year of an asset's service has used several names, including "immediate expensing," "additional first-year depreciation," and "bonus depreciation." Each of those terms has its advantages and disadvantages. This report generally uses the terms "bonus depreciation" and "expensing" interchangeably.

[3] *See* TCJA section 13201. Unless extended, the new expensing system will phase out over several years beginning in 2023. *See* TCJA section 13201(a)(1)(B); and section 168(k)(6). The business community appears generally supportive of an extension. *See*, *e.g.*, Lydia O'Neal, "Business Owners Praise 100 Percent Expensing, Want It Permanent," *DTR*, May 24, 2018.

[4] Some have praised the TCJA's changes to section 168(k) as giving the United States a competitive advantage over other jurisdictions in the area of cost recovery. *See*, *e.g.*, Tax Foundation, "Capital Cost Recovery Across the OECD, 2018," at 2 and 4 (May 24, 2018) (the OECD average deduction for machinery is 83.5 percent, excluding the United States).

[5] For a more detailed discussion of the history of depreciation and the issues discussed in this report, see Richard M. Nugent, "Section 168(k): Bonus Questions on the New Depreciation Rules," Tax Forum No. 690 (May 11, 2018) (on file with the authors).

[6] Some important aspects of the law of depreciation are beyond the scope of this report, including concepts such as group accounts, the general and bonus depreciation recapture rules, and most of the accounting aspects of depreciation.



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as an accounting concept in the United States until the early 20th century.[7] Critics of depreciation deductions often described depreciation as speculative and insufficiently connected to the incurrence of actual costs[8] or rejected its underlying theory of valuation.[9]

The government initially came to accept the use of depreciation deductions for accounting purposes, at least among some classes of businesses.[10] In many cases, the government moved to standardize depreciation in regulated industries, including railroads, which had begun using depreciation for their own accounting purposes.[11] U.S. tax law first explicitly permitted deductions for depreciation in 1909, when Congress enacted a new corporate income tax that measured corporate net income by permitting a deduction for losses, "including a reasonable allowance for depreciation of property."[12]

In that early stage, the boundaries of the concept of tax depreciation — when to allow taxpayers to take deductions for depreciation, in what amounts, and for which items of property — were not firmly set. Moreover, because of the relative paucity of guidance, taxpayers had significant leeway in structuring depreciation deductions. For instance, taxpayers selected comparatively short useful lives in many cases and thus recovered the cost of depreciable assets relatively quickly.[13]

Requirements about the timing of depreciation deductions grew more formalized over time, which generally led to a lengthening of asset lives and increased conflicts between taxpayers and the government. Guidance issued by the Bureau of Internal Revenue in 1931 and 1942 provided the first set of depreciation schedules, and more vigorous government enforcement efforts followed.[14] Also, T.D. 4422[15] in 1934 firmly placed the burden of proving the correctness of depreciation schedules on taxpayers, making it easier for the government to win disputes with taxpayers. The move toward stricter enforcement was at least in part deliberate: In a 1934 letter, the Treasury secretary promised the House Ways and Means Committee that the government would raise additional revenue through this and other administrative changes that would reduce the benefits of the depreciation rules for taxpayers.[16]

Partially in response to the government's increasing enforcement and the formalization of the depreciation rules, pressure developed to

[7]*See, e.g.*, Income Tax Law of 1894, section 28 (barring taxpayers from taking any deduction against income, for purposes of the short-lived 1894 income tax, for estimated depreciation concerning real estate). For a thorough review of the history of tax depreciation in the United States, see David W. Brazell, Lowell Dworin, and Michael Walsh, "A History of Federal Tax Depreciation Policy," Office of Tax Analysis Working Paper No. 64 (1989) (1989 OTA paper).

[8]*See, e.g.*, *United States v. Kansas Pacific Railway Co.*, 99 U.S. 455, 459 (1878) ("This is explained to be the amount necessary to put the road in proper repair, but which was not actually expended for that purpose. We are clearly of [the] opinion that it is not a proper charge. Only such expenditures as are actually made can with any propriety be claimed as a deduction from earnings.").

[9]*See, e.g.*, George N. Webster, *Theoretical Depreciation: A Menace to the Public and the Investor* 6 (1920) ("The professional depreciator refers to the plant and equipment as second-hand and disingenuously inquires if second-hand plant and equipment is worth as much as new plant and equipment. The answer is decidedly yes. Divorced from its earning capacity, a new plant would be only a heap of junk. Coupled with an earning capacity based upon the recognition of sound economics, justice and common sense, the second-hand plant and equipment, in operation, is worth substantially more than a corresponding amount of new plant and equipment.").

[10]During this time, taxpayers generally computed their depreciation deductions using the straight-line or unit of production methods. *See* 1989 OTA paper, *supra* note 7, at 7. The unit of production method generally measures an asset's useful life by the number of units it produces rather than by the asset's length of service. *See* Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates & Gifts*, at para. 23.7.5 (2018). For example, under the unit of production method, an asset with a useful life that generally ceases after producing 10,000 units of inventory would, in a year in which it produced 5,000 units of inventory, produce a depreciation deduction equal to 50 percent of its recoverable cost.

[11]The asset-heavy manufacturing enterprises that developed in the late 19th and early 20th centuries recognized the benefit of smoothing their income by taking deductions over a period of years. *See* Edward W. Higgins, *Depreciation in Federal Income Taxation* 14-16 (1944).

[12]*See* Tariff of 1909, Section 38 (calculating net income by allowing a deduction for losses, including "a reasonable allowance for depreciation of property"); *see also* Tariff of 1913, Section II(G)(b) (similar).

[13]In the early days of depreciation, the government focused on preventing taxpayers from deducting amounts above their actual costs and generally did not challenge the use of depreciation schedules commonly adopted in particular industries. *See* 1989 OTA paper, *supra* note 7, at 6 and 8.

[14]*See* Bureau of Internal Revenue, "Depreciation Studies: Preliminary Report of the Bureau of Internal Revenue" (1931); and Bureau of Internal Revenue, "Bulletin 'F': Income Tax Depreciation and Obsolescence, Estimated Useful Lives and Depreciation Rates" (1942) (1942 Bulletin F).

[15]XIII-1 C.B. 58 (1934) (removing regulatory language providing that taxpayer depreciation deductions "will not be disallowed unless shown by clear and convincing evidence to be unreasonable").

[16]*See* letter from Henry Morgenthau Jr., Treasury secretary, to Robert L. Doughton, Ways and Means Committee Chair (Jan. 26, 1934), *published in*, H.R. Rep. No. 73-704, pt. 1, at 8-9 (1934).



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liberalize the depreciation system in the 1940s and thereafter.[17] Advocates cited various rationales, including countering competition from foreign economies with looser depreciation rules,[18] supporting the U.S. economy more generally,[19] reducing conflicts between taxpayers and the government,[20] and servicing a backlog of worn-down, undermaintained, and obsolescent equipment during and after World War II.[21] As U.S. tax depreciation rules grew more developed over time, the complexity of the rules and their tendency to trigger legal disputes also came up for criticism and unflattering comparison to the rules of other countries.[22]

Those criticisms led to an initial series of changes that permitted taxpayers to take depreciation deductions more rapidly. Legislation enacted in 1940 and repeatedly reenacted permitted taxpayers to amortize the costs of some defense-related manufacturing facilities over five years (as opposed to 15 or 20 years).[23] In the mid-1940s, Treasury began allowing taxpayers to enter into advance agreements blessing the adoption of a 150 percent declining balance method for depreciation.[24] The 1954 code also reflected many of these criticisms, allowing taxpayers to use a variety of depreciation methods, including an accelerated declining balance method.[25] A 1962 revenue procedure laid out a system through which taxpayers could categorize their assets into broad groups and use a few set useful lives for those groups, which in turn allowed many taxpayers to switch to shorter useful lives in many cases.[26]

Despite those developments, as U.S. tax depreciation rules developed in the 1960s and thereafter, taxpayers continued to push for greater liberalization of the depreciation rules and for simplification of a system that was growing increasingly complex. Those criticisms eventually led to the modified accelerated cost recovery system and accelerated cost recovery system regimes discussed below.

### B. Development of MACRS & ACRS

Most of the tax depreciation rules in place before the 1980s used similar analyses in measuring taxpayers' depreciation deductions.[27] Simplifying greatly, a taxpayer would take depreciation equal to the difference between the taxpayer's cost basis in an asset and the asset's salvage value,[28] over the asset's useful life, using an appropriate depreciation method. Because those factors — salvage value, useful life, and

[17] Notably, Treasury (rather than Congress) effected many of the developments in the early history of U.S. tax depreciation. On one level, this allocation of responsibility made sense; Treasury employed many experts and was much closer to the subject matter. On the other hand, Treasury, as an administrative agency, was more insulated from the views of taxpayers, a disconnect that appears to have made itself felt in an increasing hostility toward the agency's policies, at least in the area of depreciation. *See generally* Mark L. Perlis, "Tax Depreciation — From the Origins of the Income Tax to the Tax Reform Act of 1986," Proceedings of the 27th Regulatory Conference, May 17-19, 1988, at Iowa State University in Ames, Iowa.

[18] *See, e.g.*, Dan Throop Smith, *Federal Tax Reform* 156 (1962) ("The depreciation allowances on machinery and equipment authorized for tax deductions in this country by law and by publications of the Internal Revenue Service are probably the most limited in the world. The industrial countries of western Europe and Canada are much more liberal, as are the countries seeking to start industrial development.").

[19] *See, e.g.*, Sumner H. Slichter, "Postwar Boom or Collapse," 21 *Harv. Bus. Rev.* 5, 29 (1942) ("Very shortly after the conclusion of hostilities, therefore, some reform in tax laws will be necessary in order to assist the speedy shift to peacetime production. These modifications might include reductions in the corporate income tax on that part of profits reinvested in the business, an extension of the loss carry-over provision from three years to six, and more liberal treatment of depreciation.").

[20] *See* George Terborgh, *Realistic Depreciation Policy* 15-16 (1954).

[21] *See, e.g.*, N.R. Caine, "Depreciation," 20 *Taxes* 716, 717 (1942) ("Because of the extraordinary conditions engendered by the present emergency, many assets are now being subjected to a far greater rate of wear and tear than would ordinarily be expected under normal conditions. . . . The depreciation rate schedules in such cases should be drastically revised else both the profits and the tax liability of the taxpayer will be overstated."); *see also* Slichter, *supra* note 19, at 8 (forecasting a large increase in deferred maintenance during World War II).

[22] *See* J. Timothy Philipps, "Depreciation and the Reserve Ratio Test," 69 *W.Va. L. Rev.* 1 (1966) (criticizing complexity of 1960s depreciation rules).

[23] *See* Second Revenue Act of 1940, P.L. 76-801, section 302.

[24] *See* Gerhard J. Mayer, "Declining Balance Depreciation," 25 *Taxes* 162 (1947); and Paul D. Seghers, "Accelerated Depreciation," 25 *Taxes* 645 (1947).

[25] *See* former section 167(b) (1954) (permitting the use of a declining balance method whose rate does not exceed twice the rate of the straight-line method, as well as any other reasonable method whose rate does not exceed the allowable declining balance method rate during the first two-thirds of the asset's useful life).

[26] *See* Rev. Proc. 62-21, 1962-2 C.B. 418. For a description of the practical effect of Rev. Proc. 62-21, see 1989 OTA paper, *supra* note 7, at 14-17; or Philipps, *supra* note 22.

[27] Indeed, for assets not subject to section 168 or other relevant depreciation or amortization provisions, a system similar to the one described below generally remains in place today. *See* section 167; and reg. section 1.167(a)-1.

[28] Salvage value is an asset's value when taken out of service. *See* reg. section 1.167(a)-1(c)(1).



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appropriate depreciation method — determined the amount and pace of depreciation, they naturally became areas of conflict between taxpayers and the government.[29] Taxpayers also expended significant time and resources estimating salvage values and useful lives for their assets.

In 1981 Congress enacted ACRS to address criticisms of prior depreciation rules. It then modified that system in the Tax Reform Act 1986, resulting in MACRS.[30] Generally, MACRS and ACRS, which apply only to tangible property, divide assets into broad specified classes, mandate recovery periods for each class, and calculate the amount of depreciation available by applying the appropriate depreciation method (whether selected by the taxpayer or mandated by the statute) over the applicable recovery period.[31] Taxpayers therefore generally do not need to estimate useful life or salvage value for purposes of MACRS and ACRS.

MACRS provides for two general methods of depreciation. The first is the general depreciation system (GDS), which applies to most property for which depreciation is available under section 168. The second method, which is in section 168(g), is the alternative depreciation system (ADS).[32] Nearly all MACRS property uses the GDS by default; some specified types of property must be depreciated under the ADS, or a taxpayer can also elect to apply the ADS in a particular tax year for a particular class of property.[33]

MACRS assigns property a recovery period based on the property's class life, which generally is specified in Rev. Proc. 87-56.[34] The GDS groups together different types of assets with similar class lives, and all assets end up using one of a small number of recovery periods. For the ADS, a property's recovery period generally is its class life, which results in a much greater diversity of recovery periods. To simplify the system and avoid further complexity, Rev. Proc. 87-56 provides class lives for nearly all types of property,[35] and the government generally cannot update the revenue procedure or issue a new one in its place.[36]

Once a MACRS asset's recovery period is determined, a taxpayer generally can elect from several different depreciation methods.[37] MACRS usually allows taxpayers to use a 200 percent declining balance method, a 150 percent declining balance method, or a straight-line method, although taxpayers may be required to use

[29] Government attempts to provide estimated useful lives illustrated the great diversity of figures applicable to commonly assets. *See*, *e.g.*, 1942 Bulletin F, *supra* note 14 (listing thousands of average useful lives for different asset classes). Also, various statutory and regulatory provisions were available only to assets meeting particular useful-life thresholds. *See*, *e.g.*, former section 167(c) (1954) (limiting the use of depreciation methods other than the straight-line method to assets with a useful life of three years or more); and section 179(d)(1)(C) (1958) (limiting the additional first-year depreciation deduction for small business to assets with a useful life of six years or more).

[30] MACRS generally applies to property placed in service after December 31, 1986, in tax years ending after that date. *See* Tax Reform Act of 1986, P.L. 99-514, section 203(a)(1). Comparisons between MACRS, ACRS, and prior law are difficult because of the differences in asset classification and recovery rates in each regime. Nevertheless, the overall decline in tax burdens on investment appears to have been significant. *See* Charles R. Hulten and Robert A. Klayman, "Investment Incentives in Theory and Practice," in *Uneasy Compromises: Problems of a Hybrid Income-Consumption Tax* 317, 321 (1988) (estimating a decline in effective tax rates on equipment from 63.4 percent in 1952 to 3.5 percent in 1983). In general, ACRS provides for much shorter recovery periods than prior law. MACRS in many cases lengthens the recovery periods offered by ACRS.

[31] In addition to the recovery period and depreciation method, also important under MACRS is an asset's convention, discussed below, which determines how the depreciation deduction is calculated for the year the asset is placed in service and the year of removal from service.

[32] A taxpayer generally cannot take a section 168(k) deduction for a MACRS asset for which the ADS is mandated. *See* section 168(k)(2)(D).

[33] *See* section 168(g).

[34] 1987-2 C.B. 674, *modified by* Rev. Proc. 88-22, 1988-1 C.B. 785. ACRS determines recovery periods based on class life, although guidance on this point is arguably not as clear. *See* Rev. Proc. 83-35, 1983-1 C.B. 745. That is, class life ultimately is determined by reference to the law outside MACRS and ACRS and therefore ACRS may require determining class life under former section 167(m), which in turn was determined by reference to an asset's useful life.

[35] Rev. Proc. 87-56 is not exhaustive. Publication 946, "How to Depreciate Property," contains two appendix tables that, using the information provided in Rev. Proc. 87-56, provide additional guidance for taxpayers whose assets and activities may not fit neatly into the revenue procedure's specified categories. Also, section 168 explicitly specifies recovery periods for some types of assets, which override any recovery periods under Rev. Proc. 87-56. *See*, *e.g.*, section 168(e)(3).

[36] *See* Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647, section 6253 (repealing the portion of former section 168(i) that had permitted the Treasury secretary to specify class lives).

[37] Section 168(b)(5), (2)(c), and (3)(d). ACRS calculates annual depreciation allowances somewhat differently. Taxpayers generally can claim a specified percentage of an asset's unadjusted basis as a deduction in each year, *e.g.*, 25 percent in the first year, 38 percent in the second year, and 37 percent in the third year for three-year property. *See* former section 168(b)(1) (1986). Taxpayers also can elect to use the straight-line method in place of the specified annual allowance. *See* former section 168(b)(3) (1986).



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particular methods for particular classes of assets.[38] The ADS generally requires taxpayers to use the straight-line method.[39] By combining the depreciation method and recovery period,[40] taxpayers can determine the annual depreciation allowance under MACRS. While complex, as the earlier discussion indicates, MACRS is actually somewhat simpler than the procedures in place before the 1980s.

Finally, section 168 contains special rules for MACRS property transferred from one holder to another during a tax year. Generally, the section 168 regulations treat property as placed in service or disposed of at the midpoint of the relevant tax year (the half-year convention).[41] In some circumstances, however, property instead is treated as placed in service or disposed of at the midpoint of the relevant quarter or month.[42] The effect of each convention is to modify the amount of depreciation that can be claimed. For example, the half-year convention generally permits a taxpayer to claim half the deduction otherwise available in a tax year for an item of recovery property.[43] These conventions generally assume that property is transferred only a single time during a tax year; when a taxpayer acquires an asset and disposes of it during the same tax year, the MACRS rules usually do not allow that taxpayer any depreciation deduction.[44]

Section 168(k) generally operates under a separate regime from the MACRS rules described above. When section 168(k) property is acquired in a tax year and all the relevant requirements are met, the acquirer generally can claim a full section 168(k) deduction, and no convention reduces that amount. A taxpayer that acquires section 168(k) property and disposes of it in the same tax year typically is still unable to take any deduction, as under the general MACRS rules.[45] An exception applies when a taxpayer transfers section 168(k) property in a transaction described in section 168(i)(7), in which case the section 168(k) regulations allocate the section 168(k) deduction between the transferor and transferee based on the number of months each held the property.[46] Section 168(i)(7) transactions include transactions described in sections 332, 351, 361, 721, and 731, and any transaction between members of a consolidated group.[47] Although that last item, as written, appears to include old target and new target in a section 338 transaction within a consolidated group, some commentators have assumed that the rule in reg. section 1.338-1(b)(1)(i), which specifically states that old target and new target are unrelated for purposes of section 168, overrides section 168(i)(7)(B).[48] Accordingly, qualifying transfers of newly acquired section 168(k) property within a consolidated group under section 338 generally should not forfeit the section 168(k) deduction.

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[38] *See* section 168(b). Under a declining balance method, a taxpayer applies a specified depreciation rate to the remaining basis in a property each year. This method normally produces a lesser amount of deductions than a straight-line method after the first year, but it is normally paired with an increase in the depreciation rate to end up producing a greater amount of deductions in earlier years.

[39] *See* section 168(g)(2)(A).

[40] Changes to these items, or to the depreciation convention described below, generally will be changes in methods of accounting. *See* reg. section 1.446-1(e)(2)(ii)(d)(2)(i).

[41] *See* section 168(d)(1). Thus, if a taxpayer using the calendar year as its accounting period placed an asset in service on September 1, the asset generally would be treated as placed in service for depreciation purposes at the midpoint of the year, *i.e.*, July 1. *See* reg. section 1.168(d)-1(b)(5)(iii), Example 1. Similarly, property disposed of on September 1 (or March 1) would be treated as disposed of for depreciation purposes on July 1, as well.

[42] The mid-quarter convention applies when the aggregate bases of section 168 property placed in service during the last three months of a tax year exceed 40 percent of the aggregate bases of section 168 property placed in service during the year. *See* section 168(d)(3). The mid-month convention applies to specified real property and other qualifying property. *See* section 168(d)(2).

[43] The mid-quarter convention looks to the quarter in which the property was acquired or disposed of, and it allows a portion of a tax year's deduction based on the asset's deemed disposition date. The mid-month convention operates similarly, except for a month rather than a quarter. Each convention reduces the amount of depreciation available from the amount that could be claimed for a full tax year, and, if the tax year in question is not a full 12-month period, the amount of depreciation for that year may be further reduced.

[44] *See* reg. section 1.168(d)-1(b)(3)(ii) ("No depreciation deduction is allowed for property placed in service and disposed of during the same taxable year."); Publication 946, *supra* note 35, at 6 ("You cannot depreciate the following property: Property placed in service and disposed of in the same year.").

[45] *See* reg. section 1.168(k)-1(f)(1)(i).

[46] *See* reg. section 1.168(k)-1(f)(1)(iii).

[47] *See* section 168(i)(7)(B).

[48] *See*, *e.g.*, James T. Chudy and Harsha Reddy, "Stock Purchases Treated as Asset Acquisitions — Section 338," 788-3rd T.M., at section IX.A.2.a ("In addition, new target should not be considered related to old target for purposes of the 'churning' or carryover depreciation election rules of section 168(f)(5) and section 168(i)(7).").



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## C. Enactment of Bonus Depreciation

### 1. Section 179.

In 1958 Congress enacted an additional first-year depreciation allowance for small businesses.[49] The legislative history indicates that Congress intended section 179 to encourage economic expansion and investment in small businesses.[50]

Although the section 179 deduction was specifically targeted at small business, some still criticized it as insufficiently economically stimulative given its relatively low cap on the amount deductible.[51] Congress eventually eliminated the requirement that taxpayers comply with the requirements of section 167 to receive a section 179 deduction, and it expanded section 179 expensing to cover 100 percent of the cost of an asset rather than the initial 20 percent.[52] However, the overall limitation amount remained low for many years.[53] In 2003, to keep up with the much less limited deduction enacted in section 168(k) in 2002 (discussed later), Congress significantly increased the maximum amount deductible under section 179 from $25,000 to $100,000.[54] Since 2003 Congress has repeatedly increased that amount, most notably from $500,000 to $1 million in the TCJA.[55]

Unlike section 168(k), section 179 has never contained an original use requirement; taxpayers have always been able to take section 179 deductions for used property. Because of the relative similarity of sections 179 and 168(k), one might expect that many of the interpretative issues concerning section 168(k) and the elimination of the original use requirement in the TCJA have already been addressed in the section 179 context. Unfortunately, however, only a limited range of authorities address the treatment of section 179 deductions in connection with transactions such as those described in this report.[56] Nevertheless, section 168(k) cross-references several provisions of section 179, which this report explores as necessary.

### 2. Section 168(k).

Following the September 11 terrorist attacks, and after many years of pressure to create some additional first-year depreciation benefit, Congress enacted section 168(k). As with section 179, the stated purpose of the section 168(k) deduction was to encourage investment in equipment and provide an economic stimulus: A House report predicted that the provision "will accelerate purchases of equipment, promote capital investment, modernization, and growth, and will help to spur an economic recovery."[57]

In its initial form, section 168(k) provided an additional depreciation allowance for some property acquired after September 10, 2001, and

[49] *See* Technical Amendments Act of 1958, P.L. 85-866, section 204. For a paper discussing the history and scholarship of bonus depreciation, see John Kitchen and Matthew Knittel, "Business Use of Section 179 Expensing and Bonus Depreciation, 2002-2014," Treasury Office of Tax Analysis Working Paper No. 110 (Oct. 1, 2016).

[50] *See* H.R. Rep. No. 85-2198, at 5 (1958) ("A writeoff of one-fifth of the total cost of an asset in the year of its acquisition, in addition to regular depreciation on the balance, will in the opinion of your committee make it possible for small business to use depreciation reserves for expansion. In addition, this will make less critical the determination of the useful lives of assets in the hands of the taxpayer and the estimation of salvage value. This also should encourage additional investment in small business since it provides for a faster recovery of capital before the taxing of earnings.").

[51] *See*, *e.g.*, Smith, *supra* note 18, at 162 ("The allowance in 1958 . . . was a very small step in the direction of substantial first-year deductions; it is no more than a gesture compared with the British allowances where there are, of course, no ceilings imposed."); *see also* Joel Barlow, "Depreciation," in Ways and Means Committee, "Tax Revision Compendium: Compendium of Papers on Broadening the Tax Base," at 827 and 834 (1959) ("The enactment by the last Congress of the 20 percent initial allowance was a recognition of the inadequacy of our depreciation system. The difficulty is that the ceiling prevents it from being a really effective corrective.").

[52] *See* Economic Recovery Tax Act of 1981, P.L. 97-34, section 202.

[53] *See*, *e.g.*, former section 179 (2000) (allowing a maximum deduction of $20,000 and phasing out the deduction once $200,000 of qualifying property was placed in service). Given significant inflation between 1958 and 2000, this deduction was actually smaller in overall terms than the $10,000 deduction allowed in 1958.

[54] *See* Jobs and Growth Tax Relief Reconciliation Act of 2003, P.L. 108-27, section 202.

[55] *See* TCJA section 13101. The TCJA also made several other changes in addition to those mentioned above, including increasing the phaseout limitation amount from $2 million to $2.5 million and permitting a section 179 deduction for some types of real property. Some of those changes are described in Section III.B, *infra*.

[56] For instance, reg. section 1.179-4(c)(2) states that a deemed asset transfer under a section 338 election qualifies as a purchase for section 179(d)(2) purposes, which is relevant to some of the corporate transactions discussed in Section V. The lack of authorities may reflect that until 2003, section 179 deductions generally were available to only very small businesses in light of the limitations.

[57] *See* H.R. Rep. No. 107-251, at 20 (2001).



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before September 11, 2004, and placed in service before January 1, 2005,[58] equal to 30 percent of the property's adjusted basis.[59] Congress may have based the form of this deduction on a deduction that was proposed and passed by Congress in 1992 but vetoed by the president.[60] The section 168(k) deduction, as originally enacted in 2002, applied only to (1) MACRS property with a recovery period of 20 years or less, (2) specified kinds of computer software depreciable under section 167(a), (3) some water and sewer utility property, and (4) specified leasehold improvements. Because the initial version of section 168(k) allowed only a portion of an asset's cost to be immediately expensed, taxpayers then had to calculate their remaining basis in the asset and depreciate that remaining basis under the asset's otherwise applicable recovery period.[61]

In addition to the above requirements, section 168(k) initially required that the original use of the asset in question begin with the taxpayer (or taxpayers[62]). In other words, subject to limited exceptions,[63] taxpayers could not take a deduction under section 168(k) for property that had been used previously by the taxpayer or another person.[64] The legislative history of the Job Creation and Worker Assistance Act of 2002 does not appear to elaborate on the purpose of the original use requirement, but the requirement clearly serves to encourage investment in newly purchased property and to limit the situations in which the deduction is available, as well as the overall cost of the deduction. In many cases, the original use requirement also conveniently avoided difficult questions regarding how section 168(k) interacted with other provisions of the code.[65]

After the initial enactment of section 168(k) in 2002, Congress repeatedly amended the provision, culminating in the TCJA changes. An initial change in 2003 raised the percentage of asset cost that could be expensed from 30 percent to 50 percent.[66] Section 168(k) subsequently lapsed from approximately 2005-2006 through 2007,[67] then returned at 50 percent in 2008.[68] In 2010 the percentage of asset cost that could be expensed increased to 100 percent through 2011, then returned to 50 percent thereafter.[69]

## III. Tax Reform & Accelerated Depreciation

The TCJA (1) amended section 168(k) to provide for 100 percent bonus depreciation for

[58] Some assets with lengthy production periods also qualified for the 2002 section 168(k) deduction if placed in service before January 1, 2006.

[59] Job Creation and Worker Assistance Act of 2002 (P.L. 107-147), section 101 (2002 act). In the same bill, Congress enacted other changes to the depreciation rules related to the September 11 attacks, such as a five-year recovery period for some qualifying depreciable property located in Lower Manhattan. *See* 2002 act, section 301.

[60] *See* H.R. 4287, 102d Cong., section 2602 (1992).

[61] For instance, if an asset with a five-year recovery period had a cost of $1 million and was eligible for a 30 percent deduction under section 168(k), the taxpayer would first take a $300,000 deduction ($1 million x 30 percent) and then would calculate its remaining depreciation deductions normally using the remaining basis of $700,000 ($140,000 per year, assuming the straight-line method applied). Thus, the deduction for the first year would be $440,000 total ($300,000 in additional first-year depreciation and $140,000 in regular section 168 depreciation). *See* reg. section 1.168(k)-1(d)(3), Example 1.

[62] The section 168(k) regulations contain a provision permitting multiple taxpayers acquiring fractional interests in an asset to share the asset's section 168(k) deduction. *See* reg. section 1.168(k)-1(b)(3)(iv). This rule also contains a special exception that permits a buyer acquiring a fractional interest in an asset to treat its use its interest in the asset as an original use even if the seller, while holding the asset for sale, also made a use of the asset.

[63] A buyer could also take a section 168(k) deduction for property used by the seller for three months or less then purchased by the buyer and leased back to the seller. This rule remains in effect under current section 168(k). *See* section 168(k)(2)(E)(iii).

[64] Nevertheless, taxpayers could take a deduction under section 168(k) for the cost of reconditioning or rebuilding property. *See* Joint Committee on Taxation, "Technical Explanation of the 'Job Creation and Worker Assistance Act of 2002,'" JCX-12-02, at 3 n.5 (Mar. 6, 2002).

[65] For example, 2003 regulations issued under section 168(k) took the position that increases in the basis of qualified property occurring as a result of a section 754 election were ineligible for a deduction under section 168(k) because the original use requirement was not satisfied. *See* "Special Depreciation Allowance," 68 F.R. 52968, 52990 (Sept. 8, 2003).

[66] *See* JGTRRA, section 201.

[67] Under JGTRRA, most property placed in service on January 1, 2005, or later, and all property placed in service on January 1, 2006, or later, was not eligible for a deduction under the then-existing version of section 168(k).

[68] *See* Economic Stimulus Act of 2008, P.L. 110-185, section 103; *see also* American Recovery and Reinvestment Act of 2009, P.L. 111-5, section 1201 (extending 50 percent deduction through 2009); and Small Business Jobs Act of 2010, P.L. 111-240, section 2022 (extending 50 percent deduction through 2010).

[69] *See* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312, section 401 (2010); *see also* American Taxpayer Relief Act of 2012, P.L. 112-240, section 331 (2013) (extending 50 percent deduction through 2013); Tax Increase Prevention Act of 2014, P.L. 113-295, section 125 (2014) (extending 50 percent deduction through 2014); Consolidated Appropriations Act of 2016, P.L. 114-113, section 143 (2015) (extending 50 percent deduction through 2017, with later phase-out).



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property placed in service after September 27, 2017, and before January 1, 2023 (which percentage phases down each year until it sunsets for property placed in service on or after January 1, 2027); (2) made various changes to the MACRS and ADS depreciation rules; and (3) expanded the limit and phaseout under section 179 to $1 million and $2.5 million, respectively. Those changes are discussed in more detail below.

### A. 100 Percent Bonus Depreciation

#### 1. Prior law.

Under pre-TCJA law, taxpayers could deduct 50 percent of the adjusted basis of any qualified property in the year in which it was placed in service.[70] The taxpayer reduced the adjusted basis of qualified property by the bonus depreciation amount to compute regular depreciation deductions for the year the property was placed in service and the years following.[71] In other words, under pre-TCJA law, total first-year depreciation deductions could exceed 50 percent. The amount of bonus depreciation allowed was to be phased down to 40 percent for qualified property placed in service in 2018 and to 30 percent for qualified property placed in service in 2019. A taxpayer could elect out of bonus depreciation for any tax year, but only on a class-by-class basis as opposed to a property-by-property basis. Subject to special rules, a corporate taxpayer could elect to accelerate its use of alternative minimum tax credits instead of taking bonus depreciation.

Qualified property included property to which section 168 applied with a recovery period not exceeding 20 years, computer software depreciable under section 167(a) (rather than section 197), water utility property, and qualified improvement property,[72] as long as its original use began with the taxpayer and the property was placed in service by the taxpayer before January 1, 2020.[73] Original use generally was "the first use to which the property is put, whether or not that use corresponds to the use of the property by the taxpayer."[74]

The deadline for placing property in service was extended to January 1, 2021, for some property having longer production periods (LPP property) — namely, property that (1) met the definition of qualified property, (2) was acquired by the taxpayer before January 1, 2020 (or acquired under a written contract entered into before January 1, 2020), (3) had a recovery period of at least 10 years or was tangible personal property used in the trade or business of transporting persons or property, and (4) had an estimated production period exceeding one year and a cost exceeding $1 million.[75] Self-constructed property could qualify if the taxpayer began constructing it before January 1, 2020. Property subject to ADS was ineligible for bonus depreciation.[76]

#### 2. TCJA section 168(k) changes.

The TCJA made several changes to the above rules. Most prominently, the new law increased the allowable bonus depreciation amount to 100 percent for qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023.[77] The 100 percent bonus depreciation period for placing qualified LPP property in service extends to before January 1, 2024.[78] The applicable bonus depreciation percentage decreases by 20 percent each year for

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[70] *See* former section 168(k)(1) (before amendment by the TCJA).

[71] *See* former section 168(k)(1)(B). The bonus depreciation amount is computed after allowing for any section 179 deduction. *See* reg. section 1.168(k)-1(d)(3), Example 2.

[72] *See* former section 168(k)(2)(A)(i). Qualified improvement property was any improvement to an interior portion of a building that is nonresidential real property if that improvement is placed in service after the date the building was first placed in service. *See* former section 168(k)(3)(A).

[73] *See* former section 168(k)(2)(A)(ii) and (iii).

[74] *See* reg. section 1.168(k)-1(b)(3)(i). For example, expenditures incurred to recondition or rebuild property acquired or owned by the taxpayer satisfied the original use requirement, but the cost of property that has been reconditioned or rebuilt did not. *See id.* Property converted from personal use to business or income-producing use could satisfy the original use requirement, but not if the taxpayer acquired the property from another person who was using it for his personal use. *See* reg. section 1.168(k)-1(b)(3)(ii)(A). Likewise, property that went from being held as inventory to being held for business or income-producing use could satisfy the original use requirement. *See* reg. section 1.168(k)-1(b)(3)(ii)(B).

[75] *See* former section 168(k)(2)(B).

[76] *See* former section 168(k)(2)(D).

[77] *See* section 168(k)(6)(A). The TCJA also extended the availability of the $8,000 increase to the section 280F limit for passenger automobiles. *See* section 168(k)(2)(F)(iii).

[78] *See* section 168(k)(6)(B). The TCJA provides bonus depreciation for specified plants planted or grafted before January 1, 2027. The phasedowns are the same as for qualified property. *See* section 168(k)(6)(C).



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qualified property placed in service after December 31, 2022 (or December 31, 2023, for LPP property), until it sunsets for qualified property placed in service after December 31, 2026 (or December 31, 2027, for LPP property).[79] A taxpayer may elect to apply 50 percent rather than 100 percent bonus depreciation for qualified property placed in service and acquired during the taxpayer's first tax year ending after September 27, 2017.[80] To be eligible for 100 percent bonus depreciation, property must be acquired and placed in service after September 27, 2017.[81] For this purpose, property is not treated as subject to the TCJA's new provisions if a written binding contract for its acquisition was entered into on or before September 27, 2017.[82]

Second, the TCJA expanded the definition of qualified property to include qualified film or television production and qualified live theatrical production. A qualified film or television production generally is a film or television production, at least 75 percent of the total compensation incurred in the production of which must be for services performed in the United States by actors, directors, producers, and other relevant production personnel.[83] A qualified live theatrical production generally is a live staged production of a play, with or without music, that is derived from a written book in an applicable venue, if it meets the same compensation test.[84] While section 181 permits expensing of qualified film or television productions and qualified live theatrical productions, it generally limits the amount of the deduction to $15 million per production.[85] Thus, treating qualified film or television productions and qualified live theatrical productions as qualified property may allow taxpayers to take a larger deduction under section 168(k).[86]

Third, the TCJA excludes from bonus depreciation property used in some of the trades or businesses that are not subject to the limitation on interest expense under section 163(j).[87] Excluded from the definition of qualified property under the new law is property primarily used in the trade or business of furnishing electrical energy, water or sewage disposal services, gas or steam through a local distribution system, or transportation of gas or steam by pipeline, if that trade or business is subject to regulation.[88] Also excluded is any property used in a trade or business that has floor plan financing indebtedness if the interest related to that indebtedness is exempt from the new interest limitation rules of section 163(j) under section 163(j)(1)(C).[89] Floor plan financing indebtedness is indebtedness used to finance the acquisition of motor vehicles held for sale or lease and secured by the inventory so acquired.[90]

Fourth, the TCJA amended the requirement that the original use of property commence with the taxpayer.[91] As amended, section 168(k) now requires that either the original use of the property begin with the taxpayer or the taxpayer acquire the property in a transaction satisfying the requirements of section 168(k)(2)(E)(ii). The legislative history of the TCJA does not appear to explain why the bill allowed taxpayers to expense qualifying used property. Doing so seems consistent with the original goal of section 168(k)

[79] The applicable percentage for LPP property acquired after September 27, 2017, and placed in service in 2027 is 20 percent. *See* section 168(k)(6)(B)(v). The conference report indicates that this percentage applies only to the adjusted basis attributable to manufacture, construction, or production before January 1, 2027. The remaining adjusted basis does not qualify for bonus depreciation. *See* H.R. Rep. No. 115-466, at 357 n.502 (2017) (Conf. Rep.).

[80] *See* section 168(k)(10). It appears that this election is applicable to all qualified property so acquired, and not on a property-by-property or even a class-by-class basis.

[81] For property acquired before September 28, 2017, but placed in service after September 27, 2017, the TCJA retained the 50 percent deduction percentage (and subsequent phasedowns) already in place before the TCJA. *See* section 168(k)(8).

[82] *See* TCJA, section 13201(h)(1).

[83] *See* section 168(k)(2)(A)(i)(IV) (cross-referencing section 181(d)). Only the first 44 episodes of a television series may qualify. *See* section 181(d)(2)(B)(ii).

[84] *See* section 168(k)(2)(A)(i)(IV) (cross-referencing section 181(e)).

[85] *See* section 181(a)(2)(A).

[86] A qualified film or television production is considered placed in service at the time of initial release or broadcast. *See* section 168(k)(2)(H)(i). A qualified live theatrical production is considered placed in service at the time of the initial live staged performance. *See* section 168(k)(2)(H)(ii).

[87] After the TCJA, section 163(j) generally limits interest deductions to 30 percent of a taxpayer's adjusted taxable income. *See* section 163(j)(1).

[88] *See* section 168(k)(9)(A) (cross-referencing section 163(j)(7)(A)(iv)).

[89] *See* section 168(k)(9)(B).

[90] *See* section 163(j)(9)(B).

[91] *See* section 168(k)(2)(A)(ii). The TCJA also repealed the exception to the original use requirement for sale-leasebacks under former section 168(k)(2)(E)(ii), presumably because the exception is no longer necessary. *See* H.R. 1, section 13201(c)(2).



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to encourage investment and thereby spur the economy and create jobs. Allowing a deduction for used property directly encourages investment in used property and may indirectly encourage investment in new property that will, because of the loosening of the original use requirement, be more valuable to its owner in the future in the case of a sale. Allowing a section 168(k) deduction for used property also eliminates an arguably unnecessary distortion caused by the previously disparate tax treatment of new and used property under section 168(k).

Section 168(k)(2)(E)(ii) requires that the taxpayer did not use the property at any time before its acquisition and that the acquisition was a qualifying purchase under section 179(d)(2) and (3).[92] Section 179(d)(2) in turn imposes three separate requirements. First, the property must not have been acquired from a person whose relationship with the taxpayer is described in section 267 or section 707(b).[93] In the case of two corporations, this rule generally requires that they not be members of the same controlled group as defined in sections 267(f) and 1563(a).[94] Second, the property cannot be acquired by one component member of a controlled group from another component member of the same controlled group — a technical requirement that overlaps significantly with the first requirement. Third, the basis of the acquired property cannot be determined by reference to the transferor's basis in the property (that is, the property must be acquired in a taxable transaction). Finally, section 179(d)(3) provides that for any trade-in, like-kind exchange, or involuntary conversion, bonus depreciation applies only to any money paid in addition to the traded-in property or in excess of the adjusted basis of the replaced property.[95]

[92] *See* section 168(k)(2)(A)(ii) and (E)(ii).

[93] *See* section 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.*

[94] There are several different types of controlled groups under section 1563(a): a parent-subsidiary controlled group, a brother-sister controlled group, and a combined group, which is a combination of the first two varieties.

[95] *See* section 179(d)(3); *see also* H.R. Rep. No. 115-466, *supra* note 79, at 353.

## B. Section 179 Expensing

### 1. Prior law.

Before the TCJA, the maximum amount a taxpayer could elect to expense under section 179 for property placed in service in any given tax year was $500,000 in the aggregate.[96] The $500,000 cap was reduced by the amount by which the cost of all qualifying property placed in service during the tax year exceeded $2 million.[97] No deduction for a sport-utility vehicle in any tax year was permitted in excess of $25,000.[98] The overall limitation and the phaseout amounts were indexed to inflation, but the cap on expensing SUVs was not.[99] Qualifying property included specified tangible property and off-the-shelf computer software purchased for use in the active conduct of a trade or business.[100]

### 2. TCJA section 179 changes.

The TCJA permanently increased the limitation on section 179 expensing to $1 million and the phaseout to $2.5 million.[101] The inflation index was adjusted to cover the limitation on expensing the costs of SUVs exceeding $25,000.[102]

## C. Additional Depreciation-Related Changes

The TCJA made various other changes to cost recovery rules. For instance, the code used to provide for a 15-year recovery period, depreciable under the straight-line method, for three kinds of real property improvements: qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.[103] The TCJA eliminated those distinctions in favor of the concept of "qualified improvement property," as previously defined under section 168(k)(3).[104] However, as discussed in Section IV, contrary to congressional intent, the

[96] *See* former section 179(b)(1) and (2) (before amendment by the TCJA).

[97] *See* former section 179(b)(2).

[98] *See* former section 179(b)(5).

[99] *See* former section 179(b)(6).

[100] *See* former section 179(d)(1).

[101] *See* section 179(b)(1).

[102] *See* section 179(b)(6).

[103] *See* former section 168(b)(3), (e)(3)(E), (e)(6), (e)(7), and (e)(8) (before amendment by the TCJA).

[104] *See* section 168(e)(6).



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TCJA, as finally enacted, does not by its terms provide that qualified improvement property would have a 15-year recovery period, thus arguably leaving the recovery period applicable to qualified improvement property at the 39 years applicable to nonresidential real property.[105] The TCJA also reduced the ADS recovery period for residential rental property from 40 years to 30 years, applicable for property placed in service after December 31, 2017.[106]

The TCJA's international provisions place new emphasis on the ADS rules. Significantly, the TCJA created a new tax on each U.S. shareholder of a controlled foreign corporation equal to the corporation's global intangible low-taxed income.[107] Similarly, the new legislation established a new deduction designed to encourage U.S. multinationals to keep their intellectual property in the United States, equal to 37.5 percent of the taxpayer's foreign-derived intangible income (FDII).[108] Both the GILTI tax and the FDII deduction require taxpayers to compute a deemed amount of intangible income by backing out of applicable income a deemed tangible income return.[109] Generally, the deemed tangible income return for any tax year is 10 percent of the applicable corporation's qualified business asset investment (QBAI).[110] QBAI in turn captures the depreciable tangible property of the corporation used in its trade or business.[111] The amount of the QBAI is determined by reference to the adjusted basis of the tangible property, which for these purposes must be recomputed using the ADS.[112] Accordingly, U.S. multinationals must focus on ADS recovery lives, which, all other things being equal, will result in lower GILTI inclusions and lower FDII deductions than computing depreciation for these purposes under MACRS.

Further, taxpayers in a real property or farming trade or business that elect under section 163(j)(7)(B) out of the TCJA's interest expense limitations must pay special attention to the ADS rules. Under section 168(g)(1)(F), taxpayers must depreciate specified property used in such trades or businesses under the ADS rules.[113]

Finally, the TCJA enacted several new changes to the treatment of net operating losses. With some exceptions, most taxpayers can no longer carry back NOLs to prior years (but can carry NOLs forward indefinitely) and can no longer take a deduction for NOL carryforwards in any particular year exceeding 80 percent of taxable income (computed without regard to the carryforwards).[114] Solely from a tax perspective, these changes may have some effect on taxpayer behavior regarding section 168(k) deductions: Taxpayers may wish to consider whether there is any benefit to timing their section 168(k) deductions to limit the possibility that the deductions generate an NOL that cannot be fully used for several years.

## IV. Technical Issues Under New Section 168(k)

The principal issues presented by the TCJA relate to the elimination of the original use requirement for bonus depreciation eligibility. Sections V and VI address some of the corporate and partnership issues presented by that change.

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[105] It appears indisputable that the intent was to provide for a 15-year recovery period, as was the case under prior law. *See* H.R. Rep. No. 115-466, *supra* note 79, at 367 ("The conference agreement provides a general 15-year MACRS recovery period for qualified improvement property.").

[106] *See* section 168(g)(2)(C)(iii).

[107] *See* section 951A.

[108] *See* section 250(a)(1).

[109] *See* sections 250(b)(2)(A) and 951A(b)(1).

[110] *See* sections 250(b)(2)(B) and 951A(b)(2)(A).

[111] *See* section 951A(d)(1).

[112] *See* section 951A(d) (first (3) paragraph). Also, the TCJA enacts a new minimum tax determined by reference to a taxpayer's modified taxable income, which generally is taxable income with base erosion payments made to related foreign persons (plus a percentage of NOL deductions attributable to those payments) added back. *See* section 59A. A base erosion payment generally includes depreciation attributable to property acquired from a related foreign person in tax years beginning after December 31, 2017. Thus, taxpayers subject to the base erosion and antiabuse tax must track property acquired from related foreign persons, though that property is unlikely to have been eligible for bonus depreciation because of the exclusion from section 168(k) for tangible assets used primarily outside the United States. *See* reg. section 1.168(k)-1(b)(2)(ii)(A)(2).

[113] The switch to the ADS rules for those taxpayers has been called a quid pro quo. *See* Laura Davison, "Real Estate Faced With Depreciation, Interest Tax Trade-Off," *Tax Mgmt. Wkly. Rep.*, May 7, 2018.

[114] *See* section 172.



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The TCJA also raises several interpretative questions about how the new rules should work in practice, especially in light of some gaps and glitches in the statute. The discussion in this Section IV addresses the meaning of the binding contract rule, the scope of the no prior use rule, the availability of bonus depreciation for qualified improvement property, the interaction between the bonus depreciation rules and the new section 163(j) limitations on interest deductibility, the availability of bonus depreciation for qualified improvement property used in a real property trade or business that elects out of the section 163(j) limitations, and the treatment of lease syndication transactions under the TCJA.[115]

### A. Binding Contract Rule

As discussed earlier, the TCJA's changes to section 168(k) apply only to property acquired and placed in service after September 27, 2017. For this purpose, property is not treated as acquired after the date on which a written binding contract is entered into for the acquisition.[116] Section 168 itself does not define the term "written binding contract." It is necessary, therefore, to consider the types of commercial arrangements that may be sufficiently binding to disqualify a taxpayer from bonus depreciation under the TCJA.

The concept of a binding contract is a common one in the tax law. For instance, in corporate reorganizations, rules generally value the consideration exchanged for a proprietary interest in a target corporation on the last day before the parties enter into a binding contract requiring the delivery of fixed consideration.[117] For that purpose, a binding contract is an instrument enforceable under applicable law against the parties to the instrument.[118] The government also invokes the concept of a binding contract in transition rules for new statutes or regulations.[119] In some cases, the intent of those transition rules is to avoid unfairly disadvantaging taxpayers who relied on preexisting law.[120] In others, the intent may be to prevent taxpayers from reaping a windfall from newly available tax benefits they did not anticipate.[121]

The binding contract rule in section 168(k) is of the latter sort: The enactment of bonus depreciation could not give taxpayers an incentive to acquire property if they already had a legal obligation to do so. Indeed, when Congress first enacted bonus depreciation, it excluded from the definition of qualified property any property acquired after September 10, 2001, for which a "written binding contract for the acquisition was in effect before September 11, 2001."[122] Similarly, when Congress increased the bonus depreciation levels to 50 percent, it excluded from qualified property any property acquired after May 5, 2003, for which a written binding contract for the acquisition was in effect before May 6, 2003.[123] The government promulgated detailed regulations describing when a contract is considered binding for bonus depreciation purposes.[124] Like in the corporate reorganization context, a contract is binding only if it is "enforceable under State law against the taxpayer or a predecessor."[125] However, the section 168(k) regulations go further still. Under the regulations, a contract is

[115] For a discussion of the technical issues presented by the TCJA's amendments to section 168(k) and related depreciation rules, see PwC, "Tax Reform Legislation Makes Significant Changes to Depreciation Provisions" (Feb. 2018).

[116] *See* TCJA section 13201(h)(1).

[117] *See* reg. section 1.368-1(e)(2)(i).

[118] *See* reg. section 1.368-1(e)(2)(ii)(A).

[119] *See, e.g.*, section 162(m)(4)(B) (limitations on excessive employee remuneration not applicable to remuneration payable under a written binding contract in effect on February 17, 1993).

[120] *See, e.g.*, *DreamWorks Animation SKG Inc. v. United States*, 128 Fed. Cl. 624, 631 (2016) ("Congress's decision to apply different rules to . . . binding contracts that pre-dated the repeal of the extraterritorial income tax exemption . . . is logical because pre-repeal . . . binding contracts might have been negotiated on the basis of the tax exemption, whereas post-repeal transactions were made with full knowledge of the changed tax consequences.").

[121] *See, e.g.*, ILM 200529007 (applying exclusion of export sales from income to transactions entered into before the effective date of the enacting legislation would have constituted a windfall for taxpayers that did not anticipate the availability of the exclusion).

[122] *See* 2002 act, section 101.

[123] *See* JGTRRA section 201(a). Section 168(k) has also used the concept of a written binding contract to grandfather in acquisitions of property that were committed to before a relevant expiration date but effected thereafter.

[124] *See* T.D. 9091, 68 F.R. 52986; and T.D. 9283, 71 F.R. 51727.

[125] *See* reg. section 1.168(k)-1(b)(4)(ii)(A).



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binding notwithstanding a condition to performance, so long as the condition is not within the control of either party, but the contract is not binding if it "limit[s] damages to a specified amount (for example, by use of a liquidated damages provision)."[126] A contract that limits damages to at least 5 percent of the total contract price is not treated as limiting damages to a specified amount.[127] An option to acquire or sell property is not a binding contract,[128] nor are supply agreements and similar contracts if the amount and design specifications of the property to be purchased have not been specified.[129]

Principles of statutory construction generally presume Congress to be aware of existing law, including regulations, relevant to enacted legislation.[130] Therefore, one may assume the same of the regulatory interpretation of the term "written binding contract" used in construing the same language in a similar context. Accordingly, one might expect that in the absence of any contrary guidance, taxpayers can rely on reg. section 1.168(k)-1(b)(4)(ii) to determine whether property was acquired under a written binding contract in effect on or before September 27, 2017, in which case bonus depreciation for that property is determined under pre-TCJA law.

Less clear is the treatment of self-constructed property. The regulations, consistently with the prior statutory text, treat self-constructed property as acquired when the taxpayer (or a third party under a written binding contract) begins manufacturing, constructing, or producing the property.[131] However, the TCJA struck the relevant language without inserting a new effective date for self-constructed property. Any argument that the TCJA incorporated the rule in the regulations thus lacks a statutory foundation. Accordingly, the application of the written binding contract rule to self-constructed property is an appropriate candidate for guidance.

### B. Prior Use by Lessees

As noted earlier, the TCJA expanded the scope of qualified property to cover both new and used property otherwise eligible for bonus depreciation. However, even under the new law, the taxpayer cannot have previously used the relevant property.[132] The TCJA does not define what counts as use for these purposes, thus raising the question whether a taxpayer who *leases* property before acquiring it can claim bonus depreciation.

A lessee typically is considered to have the right to use the leased property.[133] In the federal income tax context, the issue of use notably arises when taxpayers claim benefits (such as depreciation deductions or tax credits) for property "used" by tax-exempt entities.[134] For example, section 168 contains a special rule for tax-exempt use property — that is, the portion of any tangible property (other than nonresidential real property) leased to a tax-exempt entity.[135] The statute denies the owner of tax-exempt use property the benefit of depreciating it under MACRS and instead restricts depreciation to that permitted under the ADS.[136] Similarly, section 50(b) generally deems property used by a tax-

[126] *See* reg. section 1.168(k)-1(b)(4)(ii)(A) and (B).

[127] *See* reg. section 1.168(k)-1(b)(4)(ii)(A).

[128] *See* reg. section 1.168(k)-1(b)(4)(ii)(C).

[129] *See* reg. section 1.168(k)-1(b)(4)(ii)(D).

[130] *See Grove City College v. Bell*, 465 U.S. 555, 588 (1984) ("existing administrative regulations" are a "principal indicator of the accepted interpretation" of new legislation); and *Minneapolis & St. Louis Railway. Co. v. United States*, 361 U.S. 173, 187 (1959) (Congress is presumed to be aware of existing regulation).

[131] *See* reg. section 1.168(k)-1(b)(4)(iii)(A). The determination of when manufacture, construction, or production begins depends on when physical work of a significant nature begins, which is a question of facts and circumstances. *See* reg. section 1.168(k)-1(b)(4)(iii)(B)(1). However, the regulations contain a safe harbor that treats physical work of a significant nature as beginning when the taxpayer incurs more than 10 percent of the total cost of the property. *See* reg. section 1.168(k)-1(b)(4)(iii)(B)(2).

[132] *See* section 168(k)(2)(E)(ii)(I).

[133] *See Black's Law Dictionary* (8th ed. 2004) (defining lease as a "contract by which a rightful possessor of real property conveys the right to *use and occupy* the property in exchange for consideration" (emphasis added)); and 52 C.J.S. *Landlord & Tenant* section 335 (2018) ("The purpose of a lease is to transfer for consideration certain rights in property, generally use and possession.").

[134] *See* section 168(h). The concern is that tax-exempt entities would indirectly benefit even though they generally are not taxpayers. *See* S. Rep. No. 98-169, pt. 1, at 123 (1984) ("When tax-exempt entities use property under [leases or similar arrangements], they pay reduced rents that reflect a pass-through of investment tax incentives from the owner of the property. Tax-exempt entities thereby benefit from investment incentives for which they do not qualify directly.").

[135] *See* section 168(h)(1)(A). A lease includes "any grant of a right to use property." Section 168(h)(7). Nonresidential real property constitutes tax-exempt use property only if it is subject to specified kinds of disqualified leases, such as a lease with a term exceeding 20 years or a lease with a fixed or determinable purchase price or sale option. *See* section 168(h)(1)(B).

[136] *See* section 168(g)(1)(B).



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exempt organization or a federal or state governmental entity to be ineligible for section 46 investment credits, such as the rehabilitation credit and the energy credit.[137] The applicable regulations consider such an entity to be using the property if the entity leases the property.[138]

Section 197, which permits amortization deductions for some intangible assets acquired from third parties, contains an anti-churning rule that appears to serve similar purposes to the no prior use rule in section 168(k). Under section 197(f)(9), a taxpayer may not take amortization deductions for goodwill or going concern value (or any other intangible not amortizable before section 197's enactment) unless those assets are transferred after the applicable effective date of the statute in a transaction giving rise to a significant change in ownership or use.[139] Thus, for example, a taxpayer generally cannot take amortization deductions if it acquired goodwill or going concern value that the taxpayer (or a related person) owned *or used* during the period beginning July 25, 1991, and ending August 10, 1993.[140] While neither section 197 nor its regulations delineate what counts as use, an example in the regulations indicates that a license of intangible property constitutes use.[141]

The foregoing authorities suggest that "use" includes use under a lease or license, and, therefore, section 168(k) likely does not allow a deduction for property purchased by a person that has previously leased the same property.[142] To be sure, that rule, if adopted, may seem harsh in some circumstances, such as when a lessee exercises an option to acquire, at fair market value, equipment used in its trade or business at the end of a lease term — that is, should it matter for bonus depreciation purposes whether the lessee exercises the option or buys comparable equipment to replace it? Accordingly, clarification on the treatment of prior lessees for section 168(k) purposes would be an appropriate topic for future guidance.[143]

## C. Qualified Improvement Property

As mentioned earlier, section 168(k) formerly included "qualified improvement property" on the list of qualified property eligible for bonus depreciation and provided a definition of the term.[144] The TCJA moved the definition of qualified improvement property from section 168(k) to section 168(e)(6) and removed the cross-reference to qualified improvement property from the list of qualified property. While the intention almost certainly was to give qualified improvement property a 15-year recovery period, which would have made it automatically eligible for bonus depreciation under section 168(k)(2)(A)(i)(I), the TCJA actually failed to designate qualified improvement property as 15-year property. As such, qualified improvement property would appear to have a 39-year recovery period applicable to nonresidential real property, and nothing in section 168(k) would make

[137] There are exceptions to the extent property leased to a tax-exempt organization is used predominantly in an unrelated trade or business whose income is subject to tax under section 511 or for property leases to a governmental entity with a term of less than six months. *See* section 50(b)(3) and (4)(B).

[138] *See* reg. section 1.48-1(k); *see also* reg. section 1.48-1(j) ("Thus, for example, a data processing or copying machine which is leased to an organization exempt from tax would be considered as property used by such organization.").

[139] *See* reg. section 1.197-2(h)(1)(ii).

[140] *See* section 197(f)(9)(A)(i); and reg. section 1.197-2(h)(2)(i). Nor can the taxpayer take section 197 amortization deductions if the taxpayer acquired that intangible from a person who held it at any time during that period and the user of the intangible does not change as part of the acquisition or if the taxpayer grants the right to use the intangible to a person who held or used the intangible during that period. *See* section 197(f)(9)(A)(ii) and (iii); and reg. section 1.197-2(h)(2)(ii) and (iii).

[141] *See* reg. section 1.197-2(k), Example 27; *see also* Philip F. Postlewaite, David L. Cameron, and Thomas Kittle-Kamp, *Federal Income Taxation of Intellectual Properties and Intangible Assets*, para. 1.04[4][a] (2018) ("The word 'use' would appear to include the exercise of any right under [an exclusive or nonexclusive] license.").

[142] *See, e.g.*, *Gustafson v. Alloyd Co.*, 513 U.S. 561, 562 (1995) (referring to the "normal rule of statutory construction that identical words used in different parts of the same Act are intended to have the same meaning").

[143] If taxpayer B acquires qualified property from A (an unrelated party) and leases the property back to A, can B claim bonus depreciation for the property? B would not be a prior user of the property, and we know of no authority for imputing A's prior use to B. *See also* reg. section 1.168(k)-1(b)(3)(iii)(A) (if new property is originally placed in service by a person and is sold to a taxpayer and leased back to that person within three months after placement in service, the taxpayer is considered the original user of the property).

[144] As discussed earlier, qualified improvement property includes any improvement to an interior portion of a building that is nonresidential real property if the improvement is placed in service after the date the building was first placed in service, but not any improvement for which the expenditure is attributable to enlargement of the building, any elevator or escalator, or the internal structural framework of the building. Section 168(e)(6). The TCJA did not change this definition in any respect.



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qualified improvement property eligible for bonus depreciation.

The conference agreement to the TCJA suggests that this exclusion was unintentional. Indeed, the conference agreement expressly provides that the drafters intended to subject qualified improvement property to the 15-year MACRS recovery period and the 20-year ADS recovery period.[145] Moreover, the government has recognized this error, and the Senate Finance Committee has identified correcting the omission as a priority.[146]

The rectification of the unintentional exclusion of qualified improvement property from the 15-year recovery period, however, may be difficult to accomplish administratively because of the statutory nature of this mistake.[147] Section 168 expressly lists property that is eligible for the 15-year recovery period and omits qualified improvement property from this list. Therefore, any regulation allowing a section 168(k) deduction for that property might be considered to conflict with the statutory text, thereby raising a question about the regulation's validity.[148]

Consistent with the conclusion that regulatory guidance would be insufficient to fix the error, the government has taken the position that this mistake is most appropriately addressed through a corrections bill.[149] Technical corrections historically have been used to fix similar errors.[150] To date, however, Republicans in Congress have been unable to pass the necessary legislation. Further, although the Consolidated Appropriations Act of 2018 (P.L. 115-141) did correct some technical errors with the TCJA, the exclusion of qualified improvement property from the 15-year recovery period was not one of them. As of yet, Democrats are unwilling to cooperate with a technical corrections process given their exclusion from input on the initial tax reform legislation.[151] It remains to be seen whether (or when) this mistake will be rectified.

### D. Mismatch of Effective Dates

Under section 168(k)(9), the definition of qualified property excludes property used in specified trades or businesses exempt from the TCJA's interest limitations under section 163(j). The section 163(j) exemptions include property primarily used in the trade or business of furnishing electrical energy, water or sewage disposal services, gas or steam through a local distribution system, or transportation of gas or steam by pipeline, if that trade or business is subject to regulation.[152] Similarly, qualified property does not include any property used in a trade or business that has floor plan financing indebtedness if section 163(j)'s interest limitations do not apply to the interest related to that indebtedness.[153] The problem, however, is that the effective date of the TCJA's changes to section 168(k) precedes the effective date of the section 163(j) changes, which apply to tax years beginning after December 31, 2017. As such, it is unclear whether property eligible for bonus depreciation but for its use in an excluded trade or business is so eligible if the taxpayer acquired the

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[145] *See* H.R. Rep. No. 115-466, *supra* note 79, at 366-367.

[146] *See* Lydia O'Neal, "Restaurants, Retailers Don't Benefit From New Depreciation Rules," *DTR*, Feb. 6, 2018. Industry groups have urged Congress to amend the qualified improvement property provisions of the code. *See* letter from the National Retail Federation to Finance Committee Chair Orrin G. Hatch, R-Utah (June 5, 2018).

[147] *See, e.g.*, Richman, "Qualified Improvement Property Ripe for Technical Correction Fix," *Tax Notes*, May 21, 2018, p. 1236 (quoting Natalie Tucker, JCT legislation tax accountant, as stating, "We all agree this is definitely a technical correction that should be fixed in the statute."). Nevertheless, some have suggested that taxpayers may be able to take the position that qualified improvement property has a 15-year recovery period, despite the statutory glitch. *See* letter from Tom McGee, International Council of Shopping Centers (ICSC), to David Kautter, Treasury assistant secretary for tax policy and William M. Paul, acting chief counsel (Apr. 9, 2018) ("While we understand that the expectation is for a statutory technical correction to fix this drafting error, in the meantime, ICSC and its members request confirmation that they can rely on the clear legislative history showing qualified improvement property as 15-year (20-year ADS) property for tax reporting until the technical correction is adopted.").

[148] *See, e.g.*, *Manhattan General Equipment Co. v. Commissioner*, 297 U.S. 129, 134 (1936) ("A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity"); and *Koshland v. Helvering*, 298 U.S. 441, 447 (1936) (Where "the provisions of the act are unambiguous, and its directions specific, there is no power to amend it by regulation.").

[149] *See* O'Neal, *supra* note 146.

[150] *See* Marc J. Gerson, "Technically Speaking: The Art of Tax Technical Corrections," *Tax Notes*, Mar. 5, 2007, p. 927.

[151] For example, Finance Committee member Sherrod Brown, D-Ohio, recently remarked, "We're not just going to sit down and fix the things they did badly because they did it in the dead of night with lobbyists at the table." Jim Tankersley and Alan Rapperport, "G.O.P. Rushed to Pass Tax Overhaul. Now It May Need to Be Altered," *The New York Times*, Mar. 11, 2018.

[152] *See* section 168(k)(9)(A) (cross-referencing section 163(j)(7)(A)(iv)).

[153] *See* section 168(k)(9)(B) (cross-referencing section 163(j)(9)).



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property after September 27, 2017, and placed that property in service before January 1, 2018. It similarly is unclear whether otherwise qualifying property leased to an excluded trade or business remains eligible for bonus depreciation. The government presumably will release clarifying guidance on these issues.

### E. Property Used in Excluded Trade or Business

An electing real property trade or business, as defined under section 163(j)(7)(B), is not subject to the interest limitation rules of section 163(j). However, the cost for a real property trade or business to make that election is that it must depreciate any nonresidential real property, residential property, and qualified improvement property under the ADS, which imposes longer recovery periods.[154] Moreover, given the ADS property designation, any qualified improvement property that the real property trade or business owns would remain ineligible for bonus depreciation even if qualified improvement property generally is otherwise so eligible because of the enactment of a technical correction or the issuance of valid clarifying administrative guidance.[155] The statute does not address, and the government presumably will issue guidance clarifying, whether property placed in service in a tax year before a real property trade or business elects out of section 163(j) may continue to be depreciated under MACRS.[156]

### F. Lease Syndication Transactions

While pre-TCJA section 168(k) contained an original use requirement, there was a special rule for lease syndication transactions in which an underwriter or syndicator typically arranges an equipment lease between the lessee that intends to use the equipment and investors that will take beneficial ownership of the equipment as lessors. For practical reasons, the underwriter or syndicator often acquires the equipment and enters into the lease before assigning the lease to investors.[157] Under the special rule in section 168(k)(2)(E)(iii), an investor generally could satisfy the original use requirement (and claim bonus depreciation) if the underwriter or syndicator originally placed the property in service, the investor acquired the property within three months after the property was originally placed in service, and the user of the property remained the same as when the property was placed in service.

The TCJA retained that special rule for lease syndication transactions, but its meaning is unclear now given the amendment of the original use requirement and the eligibility of used equipment for bonus depreciation.[158] Arguably, there is an implication that lease syndication transactions must still satisfy the requirements of section 168(k)(2)(E)(iii) if only because of the general rule that presumes that every provision of a statute has independent effect.[159] Indeed, some commentators have expressed concern that section 168(k)(2)(E)(iii) now effectively imposes a three-month limit on completing lease syndicating transactions even though those transactions otherwise would seem to meet the requirements of section 168(k).[160]

## V. Section 168(k) Corporate Issues

The TCJA's elimination of the original use requirement and other changes to section 168(k) raise a variety of interesting issues under the corporate provisions of the code. Because it generally is clear that a section 168(k) deduction is available in a plain vanilla sale between unrelated corporate counterparties, most of this section will examine more complex scenarios, including transactions between parties that are technically

[154] *See* section 168(g)(7) and (8). Because the ADS requirement does not apply to any property of such trade or business other than real property, subject to compliance with section 168(k), bonus deprecation should be available for that other property (assuming compliance with all other applicable requirements).

[155] *See* section 168(k)(2)(D).

[156] One possibility, for example, is the government could seek to treat that election as a change in use under reg. section 1.168(i)-4.

[157] *See* letter from J. Roger Mentz of White & Case to Pamela F. Olson, Treasury acting assistant secretary for tax policy (June 25, 2002).

[158] Curiously, the TCJA repealed a similar rule regarding sale-leaseback transactions. *See* TCJA, section 13201(c)(2) (amending section 168(k)(2)(E)(ii)).

[159] *See, e.g.*, *Lowe v. SEC*, 472 U.S. 181, 207 n.53 (1985) ("We must give effect to every word that Congress use[s] in the statute.").

[160] *See* letter from Ralph A. Petta of the Equipment Leasing and Finance Industry Association to Kautter (Apr. 27, 2018) (requesting that Treasury and the IRS "issue a statement or clarifying guidance indicating that when determining whether bonus depreciation applies, the portions of the Code that provide for bonus depreciation for used equipment are still applicable after three months").



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related at the time of the transaction (but later become unrelated) and the application of section 168(k) in the context of special corporate tax law regimes (section 382(h) and the consolidated return rules). In the two examples discussed in this Section V, the report presents the facts and then seeks to determine if a section 168(k) deduction is (or should be) available and analyzes other collateral tax issues. The tax consequences in these scenarios, of course, are not clear, and the analysis may change as the government issues guidance and practitioners bring additional focus to bear on some of the new potential applications of section 168(k).

### A. Sections 168(k) & 338

Before discussing the examples, it is necessary to consider as a threshold matter how section 168(k) should apply to a transfer of stock for which an election under section 338 is made, especially if the transaction occurs within a corporate group.[161] Either a section 338(h)(10) election or a section 338(g) election could raise most of the issues discussed below, and this report generally will use the generic term "section 338 election." Nevertheless, section 168(k) should be relevant most often for section 338(h)(10) elections since taxpayers generally make section 338(g) elections upon the acquisition of non-U.S. target corporations, and section 168(k) generally is not available upon the purchase of most non-U.S. assets.[162] Because some of the structures discussed below involve transfers within a corporate group, a variety of exceptions potentially may apply under general U.S. tax principles to prevent the transferor and transferee from achieving certain beneficial tax results, such as the denial of certain losses[163] or depreciation deductions. Making a section 338 election in connection with a stock transfer avoids at least some of these requirements.[164] In addition, as described below, a section 338 transaction arguably escapes the restrictions on related-party transfers in section 168(k) as well.

Under pre-TCJA law, a section 168(k) deduction was not available for assets deemed transferred in a section 338 transaction because of the original use requirement. In a section 338 transaction, the target corporation holds and uses its assets before the transaction, the "old" target is deemed to transfer the assets, the "new" target is deemed to acquire them, and the target corporation then continues to hold and use the same assets.[165]

However, assets can now qualify under section 168(k) if the transfer satisfies the acquisition requirements of section 168(k)(2)(E)(ii) rather than the original use requirement. Section 168(k)(2)(E)(ii) imposes two requirements: (1) The acquisition of the property must satisfy section 179(d)(2) (generally, the transferee and transferor must not be related, and the transfer must be a taxable transaction) and section 179(d)(3); and (2) the taxpayer cannot have used the property at any time before the acquisition. Therefore, although the original use requirement remains in section 168(k), it is now only one of two alternatives for taxpayers to claim bonus depreciation.

For the first requirement, the section 179 regulations explicitly provide that section 179(d)(2) is satisfied for property deemed transferred under a section 338 election.[166] Section 179(d)(3) generally should not be relevant to qualified stock purchases under section 338. Accordingly, a deemed acquisition of tangible property in a section 338 transaction generally should satisfy section 179(d)(2) and (3) for purposes of assessing section 168(k)'s applicability.

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[161] *See* reg. section 1.168(k)-1(b)(2)(ii)(A)(2) (providing that property required to be depreciated under section 168(g) in accordance with section 168(g)(1)(A) is not eligible for the additional first-year depreciation deduction); and section 168(g)(1)(A) (applying ADS to tangible property used predominantly outside the United States during the tax year).

[162] The discussion below generally assumes that the section 338 election in question is a section 338(h)(10) election.

[163] *See* section 267 (preventing a taxpayer from recognizing a loss as a result of a transfer to specified related persons).

[164] *See* reg. section 1.338-1(b)(1)(i) (providing that the new target and the old target in a section 338 transaction are not considered related for purposes of section 168).

[165] *See* reg. sections 1.338-1(a)(1) and 1.338(h)(10)-1(d).

[166] *See* reg. section 1.179-4(c)(2). The relevant preamble does not discuss the interaction of sections 179 and 338.



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For the second requirement, the analysis is more complicated. When a section 338 transaction occurs between unrelated parties, it seems appropriate to conclude that the new target has not previously used the assets in question because it is treated as a newly formed entity for U.S. tax purposes. However, for an intragroup section 338 transaction (like the one described in Example 1, below), there is some suggestion in the legislative history of the TCJA that Congress may not have had that transaction in mind when expanding section 168(k).

Section 168(k)(2)(E)(ii) originated in the tax bill originally passed by the House in November 2017. The conference report for the TCJA describes section 168(k)(2)(E)(ii) as passed in that bill and states that "to prevent abuses, the additional first-year depreciation deduction applies only to property purchased in an arm's-length transaction."[167] The report further states that section 168(k)(2)(E)(ii) prevents section 168(k) from applying when "one member of an affiliated group of corporations purchases property from another member."[168] Obviously, these statements, if interpreted as new rules imposed under the no prior use requirement of section 168(k)(2)(E)(ii)(I), could pose a problem for a section 338 transaction initially occurring between related parties within an affiliated group.

However, neither of those statements in the conference report contains a citation, and the paragraph in question cites solely to section 179. It therefore seems likely that this paragraph is merely describing in general terms the effect of the section 179 requirements incorporated through section 168(k)(2)(E)(ii)(II), and not the no prior use requirement in section 168(k)(2)(E)(ii)(I). As described earlier, the section 179 regulations generally deem section 179(d)(2) to be satisfied for a section 338 transaction, and the requirements of section 179(d)(3) should be irrelevant.[169] Accordingly, there is a good argument that the statements in the legislative history of section 168(k) should not be taken to disqualify intragroup section 338 transactions.

Even taking the conference report statements at face value, an arm's-length transaction between unrelated parties is precisely what is deemed to occur in a section 338 transaction. Although the same legal entity may continue to use the assets in a section 338 transaction, it seems equally clear that U.S. tax law generally treats the new target as newly formed and unrelated to the old target, even if both are members of the same corporate group. For U.S. tax purposes, therefore, a new target corporation in a section 338 transaction should not be treated as previously using its assets for section 168(k) purposes.

In short, there is a strong argument that a section 168(k) deduction is available for assets deemed transferred in a section 338 transaction, whether occurring within or outside a corporate group. This report generally assumes, in the discussion that follows, that the deduction is available.

### B. Intragroup Stock Transfer & Disposition

One structure that has attracted attention recently is a taxable sale, exchange, or distribution within a corporate group of a target company holding significant tangible depreciable property (or other qualified property under section 168(k)), followed by a transfer of either the target company or its buyer or seller outside the corporate group and the making of a section 338(h)(10) election or a section 336(e) election for the taxable sale, exchange, or distribution.

Some taxpayers may use a similar structure to increase asset basis, recognize built-in losses in assets, or avoid triple taxation of corporate income, in each case within a corporate group. Sometimes referred to as "sell the seller" transactions,[170] in these deals one member of a corporate group transfers a corporate subsidiary's stock to another group member in a taxable transaction (often a so-called busted 351), and the stock transferor and stock transferee make a section 338(h)(10) election for the transfer. The section 338 regulations endorse the use of a

[167] *See* H.R. Rep. No. 115-466, *supra* note 79, at 353.

[168] *See id.*

[169] *See* reg. section 1.179-4(c)(2).

[170] As described below, many of the relevant private letter rulings involve a parent entity's transfer of a target company to the parent's subsidiary, and then the subsidiary's transfer along with the target company outside the affiliated group. Thus, despite the use of the term "sell the seller," either the stock buyer or stock seller may be transferred outside the group in this type of transaction.



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contribution to capital in exchange for stock, paired with a binding commitment to transfer the stock received, to create a busted 351 that is treated as occurring between unrelated parties.[171]

There are two relatedness concerns in a sell-the-seller transaction or other intragroup transaction attempting to qualify under section 338. First, the stock seller and the stock buyer cannot be related for section 338(h)(3)(A)(iii) purposes, or the stock transfer will not constitute a qualified stock purchase and the section 338 election will be unavailable. Second, assuming that a successful qualified stock purchase occurs, the relatedness (or not) of the old target and the new target must be tested for the deemed asset sale. Several private letter rulings confirm that this type of transaction can produce a qualified stock purchase for section 338(d)(3) purposes, even though the transaction occurs within an affiliated group, if the stock seller and stock buyer cease to be in the same corporate group as part of the same series of related transactions.[172]

Of course, the relatedness test in section 338(h)(3)(A)(iii), which arises from similar language in former section 334(b)(3) of the 1954 code and the rule in reg. section 1.338-3(b)(3)(ii)(C) for applying the relatedness test after a series of transactions, was not designed to address the applicability of section 168(k), which entered the code in 2002 and presumably was inapplicable to a transaction like Example 1 below before the TCJA's enactment. Nevertheless, the motivation for the original section 334(b)(3) relatedness test appears to have been a general concern that permitting related parties to elect between a carryover basis and an FMV basis in intragroup sales would permit abuses.[173] That the government, with this concern in mind, still chose to turn off the relatedness test when a related party became unrelated as part of a series of transactions, may suggest that the government has concluded that there is limited potential for abuse in these cases, at least under section 338 itself.[174]

There are at least two variations of this structure, described below.[175] Although each structure is different, the availability of bonus depreciation in either example is not entirely clear.

**Example 1:** *Intragroup section 338(h)(10) transaction with spinoff.* A publicly traded corporation (Distributing) transfers the stock of one of its subsidiaries holding substantial qualified property (Target) to another subsidiary (Intermediary) in exchange for common and nonvoting preferred stock of Intermediary. At the time of the transfer, Distributing is under a binding commitment to sell the preferred stock to a third party for cash. The intent of this prearranged sale is to prevent Distributing from holding Intermediary stock representing section 368(c) control immediately after the transfer, which generally should prevent section 351 from applying.

After the transfer, Distributing contributes all the common stock of Intermediary to a new corporation, Controlled, in exchange for Controlled stock in a transaction intended to qualify as a section 368(a)(1)(D) reorganization. Distributing then distributes the stock of Controlled to its shareholders in a distribution intended to qualify as tax-free under section 355. Intermediary and Distributing elect to treat the transfer of Target's stock as a section 338(h)(10) transaction.

[171] *See* reg. section 1.338-3(b)(3)(iv), Example 1.

[172] *See* LTR 201228011 (steps vii and viii and rulings 1 and 2); LTR 201220020 (steps i and ii and rulings 1 and 2); LTR 201203004 (steps vi, vii, and rulings 2 and 3); LTR 201145007 (steps vii and viii and rulings 1-3); LTR 201126003 (step viii and rulings 16 and 17); and LTR 200427011 (steps ii-vi and rulings 1-3). Of course, these authorities do not themselves decide whether a section 168(k) deduction is available.

[173] *See, e.g.*, H.R. Rep. No. 89-2273, at 2 (1966) (purpose of relatedness test is "to prevent manipulation"); GCM 35590 (Dec. 10, 1973) ("This requirement was enacted in order to limit the possibilities of manipulation in dealings between related corporations.").

[174] *See* LTR 9747001 (section 338 relatedness test is intended "to prevent a first corporation from realizing the benefits of a section 338 election by a second corporation *while the first corporation controls the second*" (emphasis added)).

[175] Variations of these structures have been discussed in several forums, including a D.C. Bar Communities event in Washington on January 30, 2018, and the PLI Consolidated Tax Return Regulations Conference in New York City on February 20-21, 2018.



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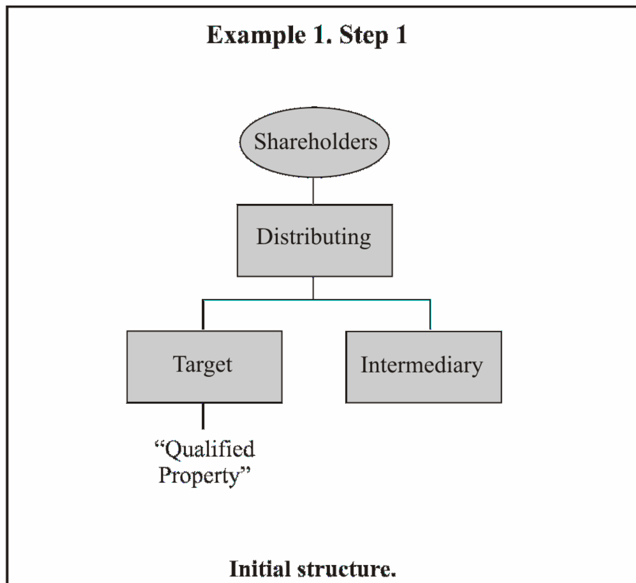
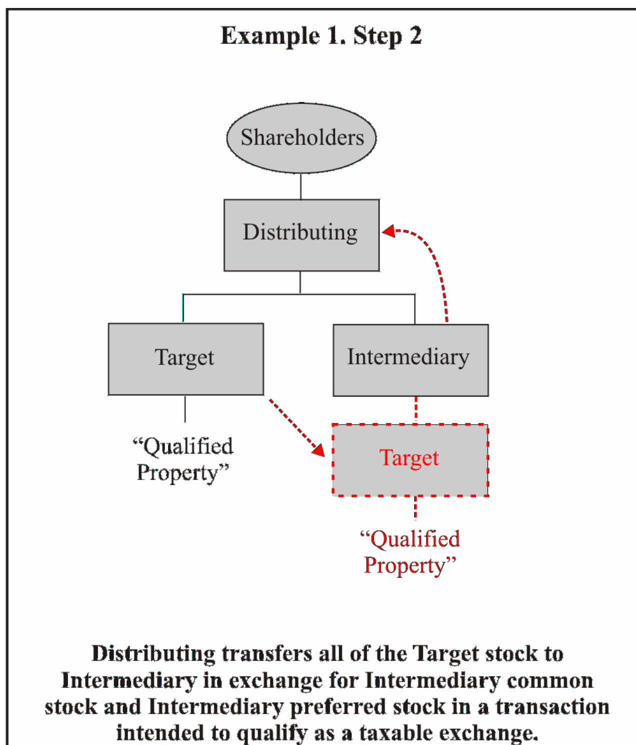
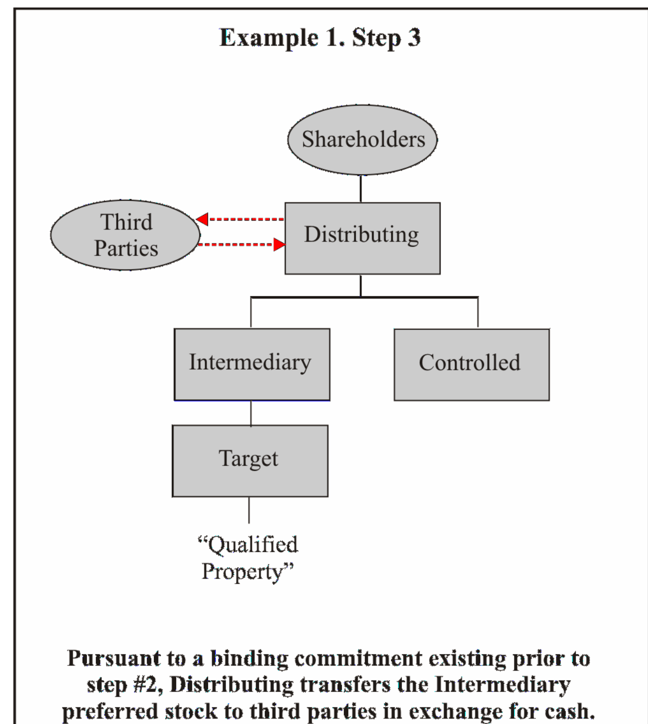



As described earlier, it generally should be possible to make a section 338 election for a transfer within this structure, even though the transfer takes place within an affiliated group: A section 338(h)(10) election is available in Example 1 because the stock buyer (Intermediary) and the stock seller (Distributing) are members of separate corporate groups after the spinoff and therefore are not related within the meaning of section 338(h)(3)(A)(iii). The section 338 regulations explicitly provide that for a "series of transactions effected pursuant to an integrated plan," relatedness is measured after the end of all transactions occurring together as part of the plan.

Is a section 168(k) deduction available for Target's assets in Example 1? As described earlier, to receive a section 168(k) deduction, the transaction must satisfy section 168(k)(2)(A)(ii). The transaction cannot satisfy the original use requirement, so it instead must satisfy section 168(k)(2)(E)(ii)(II), which incorporates the requirements of section 179(d)(2). The deemed asset transfer is a taxable transaction, which should satisfy section 179(d)(2)(C), but old Target and new Target arguably are related under sections 179(d)(2)(A) and (B). In fact, several private letter rulings on sell-the-seller transactions also appear to treat the old target corporation and the new target corporation as related at the time of the deemed asset transfer, suggesting that the same is true of old Target and new Target in Example 1.[176]




[176] *See, e.g.*, LTR 201203004 (ruling 6); and LTR 201145007 (ruling 5). Each of these rulings treats an intercompany section 338(h)(10) transaction as subject to section 267, which generally defers losses on transactions between controlled group members until the transferred property leaves the group.



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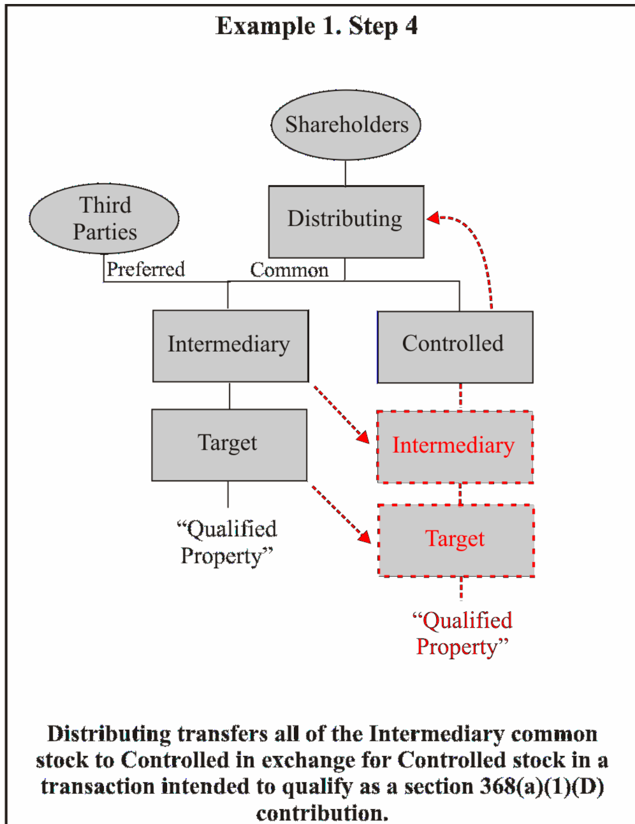
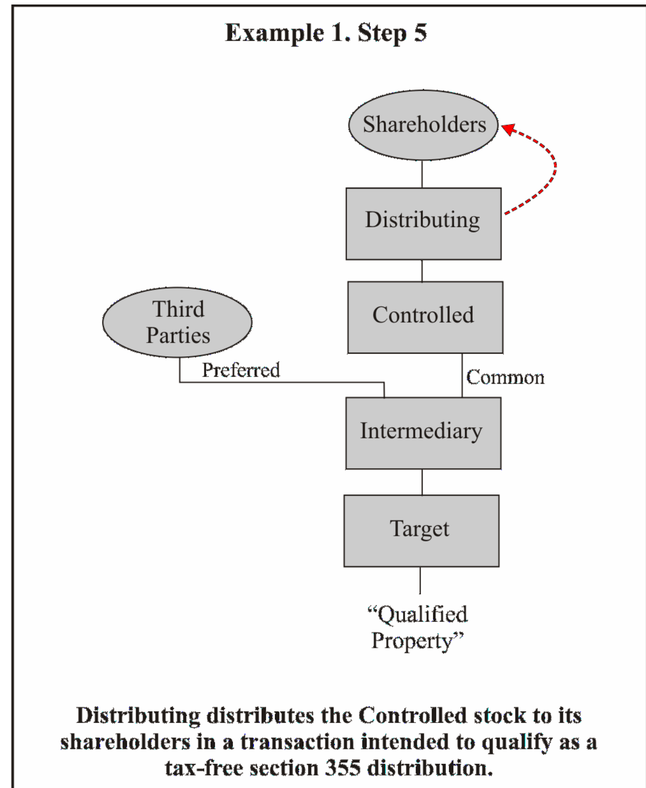
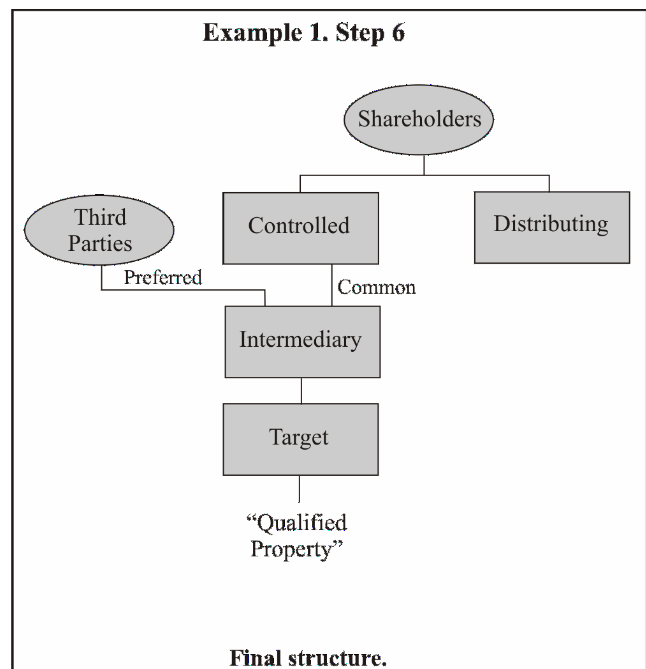



Reg. section 1.179-4(c)(2) may address the relatedness problem, however, given its explicit statement that property deemed acquired by a new target corporation as a result of a section 338 election is treated as acquired in a purchase (and therefore satisfies the requirements of section 179(d)(2)). The section 338 regulations also state that the old target and the new target generally are not considered related "for purposes of Subtitle A of the Internal Revenue Code," which includes sections 168, 179, 267, and 1563. Finally, a reinterpretation of section 179(d)(2), which is cross-referenced in many sections of the code, might have unforeseen consequences.[177] Therefore, several arguments exist that a transaction like Example 1 should be able to create a section 168(k) deduction, at least from a technical perspective.




It is also worth considering the availability of a section 168(k) deduction in Example 1 from a policy perspective. If section 168(k) is intended to spur new investment, it might be argued that, viewing the Distributing group as a whole

[177] Two other provisions in section 168 also cross-reference section 179(d)(2). *See* section 168(l) (deduction for second-generation biofuel plant property) and 168(m) (deduction for certain reuse and recycling property). However, each of those provisions, unlike section 168(k), still contains an original use requirement, which might limit the effect of reinterpreting section 179(d)(2) to not apply in an intercompany transaction like Example 1.



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immediately before and after the deemed transfer of assets under section 338, Example 1 does not produce any real additional investment. If this is the case, does allowing a section 168(k) deduction in Example 1 further the purposes of the statute? It also seems likely that Congress did not have such a complex transaction in mind in enacting changes to section 168(k) in the TCJA. The lack of direct congressional consideration of this type of transaction might suggest that an administrative agency like the IRS should have more leeway in prescribing, by regulation or other guidance, whether section 168(k) applies.

On the first policy point, even if Example 1 did not produce additional investment, it is unclear why that fact should lead to denial of the section 168(k) deduction. Section 168(k) should not be interpreted to require the unquestioned achievement of its every conceivable policy objective every time it applies. Further, the same arguments against applying section 168(k) to Example 1 would apply equally to section 179, which Congress enacted with a similar purpose to section 168(k), yet section 179 appears to have been available in sell-the-seller transactions for many years.

At the same time, one could also argue that Example 1 does in fact produce additional investment. For instance, after the completion of all related transactions, a new corporate group, separate from Distributing, holds Target's stock and, indirectly, Target's qualified property, each of which was actually (or deemed) acquired in exchange for cash or other consideration.[178] Thus, as much as is ever the case in a section 338 transaction, the deemed transferred assets have a new owner, and the deemed transfer represents a new investment. Moreover, allowing a section 168(k) deduction in Example 1 might serve section 168(k)'s purposes, and produce additional investment indirectly, by increasing the value of qualified property (that is, by giving investors in qualified property an additional ability to engage in transactions such as Example 1 when beneficial and thereby marginally increasing taxpayers' incentive to make those investments).

Note that the availability of the section 168(k) deduction in Example 1 arguably is not the core policy concern at issue. If a section 338 transaction such as the one described in Example 1 should not entitle the new target corporation to a section 168(k) deduction because the old target and the new target are so obviously related, why are section 179 deductions allowed under the same set of facts? Why are sell-the-seller rulings appropriate? The underlying policy issue arguably is the treatment of the new target and the old target as unrelated for all code purposes, which is a widely supported decision made by the government in the section 338 regulations. Ultimately, it is not clear that Example 1 deviates unacceptably from the policies of section 338 (or section 168(k)), although there are certainly arguments on either side.[179]

It is also worth considering a collateral question: Assuming a section 168(k) deduction were available, would Example 1 be beneficial for taxpayers? In at least some cases, the answer appears to be yes. Although Example 1 does not create an additional deduction that would otherwise escape realization, it may significantly accelerate deductions that would otherwise be realized only gradually through annual depreciation or through a reduced gain upon a taxable disposition of the asset in question. Because a dollar now is worth more than a dollar many years hence, this benefit appears significant. Therefore, a section 168(k) deduction should always produce a net benefit when taken for an asset that would otherwise be depreciated over multiple years, even if the overall deductions are the same in both scenarios.

If all the members of the Distributing group file separate tax returns, the benefit in Example 1 is fairly clear. After the spinoff, Target can take a section 168(k) deduction against its income that would otherwise be unavailable. Because old

[178] Comparing the facts before the section 338 transaction and after the final related transaction is especially appropriate because the section 338 regulations generally require this frame of analysis, and the same comparative approach generally appears to underlie the government's position in the sell the seller rulings in which a later transfer of the seller permits a section 338(h)(10) election.

[179] Concern over this non-relatedness principle arguably is not well addressed by adding regulatory exceptions for the numerous implementations of the principle. *See* Executive Order 13789 (Apr. 21, 2017) ("The Federal tax system should be simple, fair, efficient, and pro-growth. The purposes of tax regulations should be to bring clarity to the already complex Internal Revenue Code . . . and to provide useful guidance to taxpayers.").



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Target will only recognize gain equal to the built-in gain in its assets before the qualified stock purchase, while new Target will receive an immediate section 168(k) deduction equal to the FMV of those assets (which is likely to be higher), Target will probably receive an overall net tax benefit in both the first year and overall (taking into account the time value of money, which should make acceleration of a deduction valuable even if the overall size of the deduction does not increase).

If the members of the Distributing group file a consolidated return, and the Distributing and Controlled groups will each file consolidated returns after the spinoff (as generally would be the case), Example 1's tax consequences are much more complicated. A section 338(h)(10) transaction generally would still cause old Target to recognize gain or loss, though that gain or loss would be deferred until new Target left the Distributing consolidated group. However, whether the Distributing group or the Controlled group would receive the section 168(k) deduction, and the calculation of the deduction, are not entirely clear.

While part of Distributing's consolidated group, old Target and new Target will use Distributing's tax year, but new Target's tax year generally will end on the day on which it ceases to be a member of Distributing's group (that is, the day of Controlled's spinoff).[180] New Target's tax items for the portion of the year not included in Distributing's consolidated return must be reported on new Target's (that is, Target's) separate return or the consolidated return of the Controlled group.[181]

In the consolidated group context, the section 338 regulations generally treat the old target as selling its assets and liquidating in intercompany transactions that occur while the old target is still a member of the seller's consolidated group.[182] Because new Target appears to acquire the section 168(k) property in question while it is still a member of Distributing's consolidated group, Distributing seems to be eligible to take the section 168(k) deduction on its consolidated return.

Also, if the section 338 transaction is treated wholly as an intercompany transaction, old Target's gain from the sale of its assets is treated as an intercompany item, and new Target's section 168(k) deduction is treated as a corresponding item, then the transaction potentially is subject to recharacterization under the matching rule of reg. section 1.1502-13(c). If old Target and new Target were divisions of a single corporation, transferring property between the divisions would produce no net tax result. Therefore, the argument would be, the Distributing group should recognize matching amounts of gain and deduction in Example 1 to similarly produce no net tax result upon the deemed transfer of property within the consolidated group. In that case, the excess of new Target's section 168(k) deduction over the amount of gain recognized by old Target could be recharacterized as a noncapital, nondeductible amount (that is, there would be no section 168(k) deduction for this amount).[183] Although it is not entirely clear, it would seem logical that new Target would retain a basis in its acquired assets equal to the amount of the disallowed deduction. That is, section 168(k) provides both for a deduction equal to 100 percent of adjusted basis and a reduction in the relevant asset's adjusted basis by the amount of the deduction allowed; if the consolidated return

[180] *See* reg. section 1.1502-76(a) and (b)(1)(ii)(A)(1).

[181] *See* reg. section 1.1502-76(b)(1). If the section 338 election in Example 1 is a section 338(g) election rather than a section 338(h)(10) election, the regulations generally appear to require old Target to include its gain from the section 338 transaction on a one-day return separate from the Distributing group's consolidated return. *See* section 338(h)(9) and reg. section 1.338-10.

[182] *See* reg. section 1.338(h)(10)-1(d)(4). This section of the regulations appears to assume that the buyer is not a member of the selling consolidated group, but sell-the-seller rulings apply parts of the regulations and appear to confirm that the regulations apply even when the asset buyer and asset seller are members of the same consolidated group.

[183] The consolidated return regulations do not provide rules for this exact scenario. It is possible to imagine other ways to treat the transaction, such as allowing the Controlled group to take the remainder of the deduction denied to the Distributing group. Splitting the deduction is not unthinkable: The section 168(k) regulations already provide for a sharing of the deduction in cases in which one person acquires section 168(k) property and then transfers the property in particular nonrecognition transactions. *See* reg. section 1.168(k)-1(f)(1)(iii).



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regulations limit the deduction under section 168(k), presumably they or section 168(k) would also limit the matching reduction in asset basis.

On the other hand, new Target receives the section 168(k) property only for a brief moment before new Target leaves Distributing's consolidated group. New Target's holding period for the property appears likely to start on the day after the acquisition, when new Target is a member of a different consolidated group.[184] Has this property truly been placed in service as required by section 168(k) while new Target is part of Distributing's consolidated group?[185] Also, new Target's receipt of the section 168(k) property and its departure from Distributing's consolidated group are in fact part of a prearranged plan. Further, it is notable that if the section 168(k) deduction remained with the Distributing group, the person receiving the deduction would be the person that previously used the property and not the person that for U.S. tax purposes made an investment to acquire the property. This result seems difficult to square with Congress's apparent intent to use section 168(k) to reward persons making capital investments.

Could the Controlled group receive the section 168(k) deduction instead of the Distributing group? The consolidated return rules contain a provision that treats a transaction occurring on the same day as a member's departure from the group as occurring at the beginning of the next day if the transaction is "properly allocable" to the post-departure period.[186] It is not entirely clear how Example 1 would be recast if this "next day" rule applied, but presumably Target's stock would be treated as transferred on the day after the spinoff, and the deemed asset transfer would occur between two unrelated groups. In that case, it seems that the Controlled group, as the acquirer in the section 338 transaction, would be entitled to the section 168(k) deduction, and that the deduction would not be limited in amount. The Distributing group would still be left with the gain recognized on old Target's deemed disposition of its assets.

Whether the Distributing group or the Controlled group is entitled to the deduction, the two groups, considered together, should receive a deduction that at least equals any gain recognized. If the amount of the deduction exceeds the gain recognized, the value of accelerating into the current year cost recovery deductions that otherwise are available only in future years should make the transaction beneficial. If not, the transaction in Example 1 may not be beneficial.

**Example 2:** *Intragroup section 336(e) election with sale of seller.* In another variation of this structure, a corporation in a group (Distributing) distributes the stock of its subsidiary (Controlled) to the group parent (Parent) in a transaction intended to be taxable for U.S. tax purposes.[187] Then, and as part of the same plan, Parent sells Distributing's stock to a third party, and Distributing ceases to be a member of the same corporate group as Parent and Distributing. Distributing and Parent jointly make a section 336(e) election for the transfer of Controlled's stock.[188]

[184] *See, e.g.*, Rev. Rul. 66-7, 1966-1 C.B. 188 ("It is concluded that the holding period of a capital asset begins to run on the day following the date of acquisition of the asset involved.").

[185] Because old Target was previously using the section 168(k) property, it might be argued that new Target, while still a member of the Distributing consolidated group, would satisfy the requirements for placing the property in service as required by sections 167 and 168. *See* reg. section 1.167(a)-11(e)(1)(i).

[186] *See* reg. section 1.1502-76(b)(1)(ii)(B)(4) (factors used in making this determination include "whether other facts exist, such as a prearranged transaction"). Admittedly, proposed regulations issued in 2015 but not yet finalized would amend the next day rule so that it would not apply to events (like the section 338 transaction in Example 1) occurring before or simultaneously with an event that causes a consolidated group member's change in status. *See* REG-100400-14.

[187] Because section 355 is not elective, Distributing must take steps to ensure that the distribution does not satisfy section 355(a). For instance, similar to the approach in Example 1, Distributing might seek to arrange for Controlled to issue a class of nonvoting preferred stock, and then sell or fail to distribute that stock; Distributing, therefore, would fail to distribute section 368(c) control of Controlled. *See* section 355(a)(1)(A) and (D). Alternatively, Distributing might arrange to fail another of section 355's requirements, such as the active trade or business test in section 355(b).

[188] If the distribution also qualified under section 338, the section 338 rules would take precedence. *See* reg. section 1.336-1(b)(6)(ii)(A). Whether a distribution such as the one in Example 2 can constitute a qualified stock purchase described in section 338(d)(3) is not entirely clear, but some authorities suggest that it cannot because a distribution is not a purchase, as required by section 338(d)(3). *Cf.* T.D. 9619, 78 F.R. 28467, 28473 (May 15, 2013) ("The proposed [section 336(e)] regulations expanded the section 338(h)(10) model to include fully taxable distributions and section 355(d)(2) and (e)(2) distributions.").



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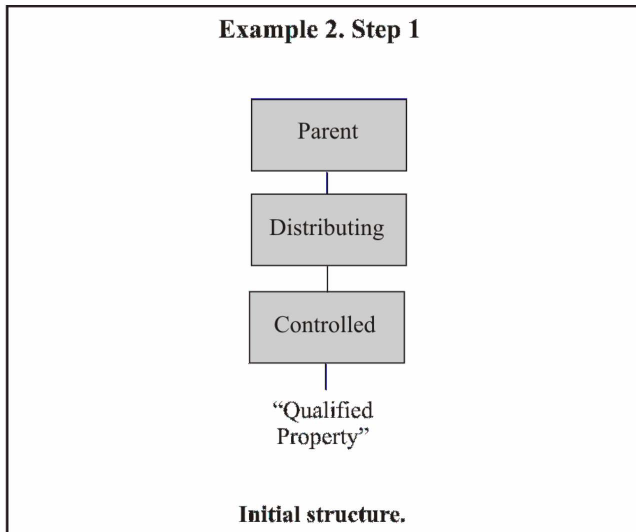
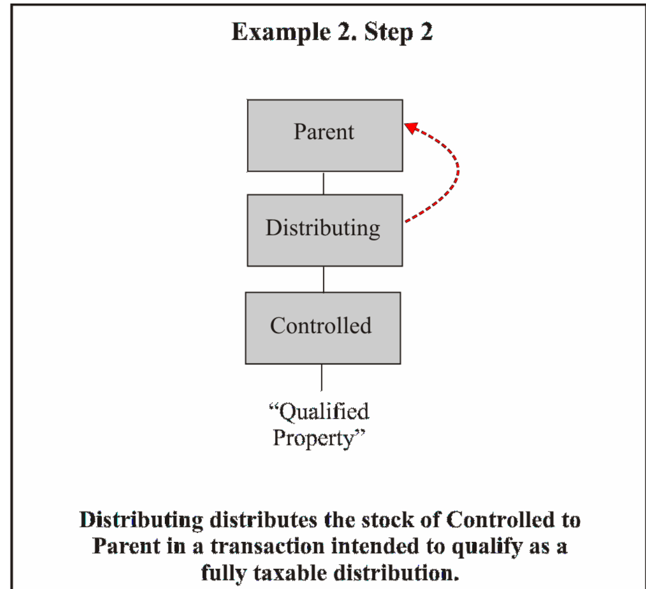
To qualify for a section 336(e) election, Distributing must not distribute Controlled's stock to a related person. However, section 336(e) incorporates the relatedness rules of section 338.[189] Therefore, for a series of transactions carried out under an integrated plan to dispose of target corporation stock, relatedness should not be tested until after completion of the final transaction — that is, in Example 2, the sale of Distributing's stock to a third party. After this sale, Distributing is no longer related to Parent under section 338(h)(3)(A)(iii) and section 318. Accordingly, the relatedness requirement is satisfied, and the distribution should be able to qualify for a section 336(e) election.

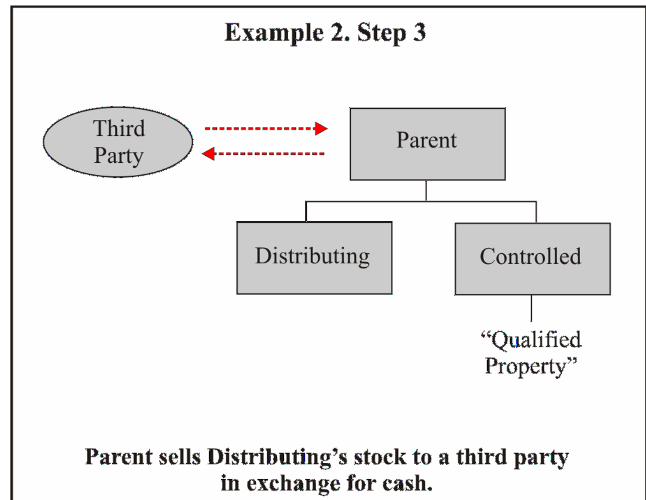


Initial structure.

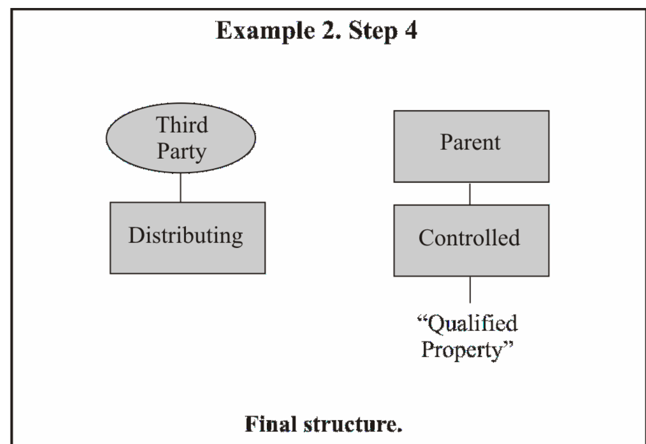
Assuming that the distribution in Example 2 is a fully taxable distribution and that Parent and Distributing can make a section 336(e) election for the distribution, mechanics similar to those in section 338 should apply. That is, old Controlled should be treated as selling its assets to an unrelated person in a deemed transfer in exchange for a deemed disposition price and then ceasing to exist; new Controlled should be treated as acquiring those assets from an unrelated person for a deemed price; and Distributing should be treated as acquiring new Controlled's stock from an unrelated person and distributing the stock in a transaction in which no gain or loss is recognized.



Distributing distributes the stock of Controlled to Parent in a transaction intended to qualify as a fully taxable distribution.



Parent sells Distributing's stock to a third party in exchange for cash.



Final structure.

Again, the first question is whether this transaction, and specifically the deemed asset

[189] *See* reg. section 1.336-1(b)(5)(iii).



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transfer between old Controlled and new Controlled, can qualify for a section 168(k) deduction. As explained below, the answer is unclear, and Example 2 may be somewhat less likely to produce a section 168(k) deduction than Example 1. The section 336(e) regulations generally provide that except to the extent inconsistent with section 336(e), a section 336(e) election should produce the same results as a section 338(h)(10) election. Therefore, old Controlled and new Controlled presumably should be treated as unrelated for purposes of subtitle A of the code, including for section 168 purposes.

The requirements in section 168(k)(2)(E)(ii), described earlier in relation to Example 1, may also be satisfied. Because new Controlled is treated as a new entity, unrelated to old Controlled, new Controlled arguably has not used old Controlled's property before acquiring it in the deemed asset transfer, thereby apparently satisfying section 168(k)(2)(E)(ii)(I). It is more difficult to say whether section 168(k)(2)(E)(ii)(II) (which requires that the transaction qualify under section 179(d)(2) and (3)) is satisfied. In providing that a section 338 transaction is a qualifying purchase, the section 179 regulations do not explicitly say the same about a section 336(e) transaction. Those regulations initially were issued before section 336(e)'s enactment in 1986, but they have been updated since without mentioning section 336. However, because the section 336(e) election is clearly modeled on the section 338(h)(10) election and shares the same purposes, it is perhaps the better view that a section 336(e) transaction should also qualify as a purchase for section 179(d)(2) purposes. If the section 179 regulations did not deem this transaction to be a qualifying purchase, old Controlled and new Controlled would likely be related for bonus depreciation purposes, and the transaction would probably fail to produce a section 168(k) deduction because of section 168(k)(2)(E)(ii)(II).

From a policy perspective, an obvious problem with allowing a section 168(k) deduction under these facts is that in Example 2, unlike in Example 1, the section 168(k) property does not leave an affiliated group. Parent indirectly holds the section 168(k) property before the initial step and also indirectly holds the section 168(k) property after the final step. This might invite an argument that there has been no additional investment in section 168(k) property and that a section 168(k) deduction is therefore inappropriate.[190] Moreover, Example 2 does not involve a transfer in exchange for legal consideration. Although examples 1 and 2 both involve deemed asset transfers for deemed cash consideration, for legal purposes, Example 2 involves a distribution of Controlled stock for no consideration, which might suggest that it is less appropriate to allow a section 168(k) deduction in Example 2 than in Example 1.

On the other hand, unlike in Example 1, the stock seller (Distributing) and the stock buyer (Parent) end up owned by different ultimate shareholders in Example 2, which might suggest that the sale in Example 2, and Parent's resulting lack of relatedness to Distributing, should be respected to a greater degree than the spinoff of Controlled's stock in Example 1 and Distributing's lack of relatedness to Controlled in that example. More important, it is unclear how Example 2 presents any policy concern not already presented, and resolved in the taxpayer's favor, by the government in the sell-the-seller rulings. In short, there are policy arguments for and against allowing a section 168(k) deduction in Example 2.

Further, as in Example 1, if a section 168(k) deduction is available in Example 2, the taxpayers may achieve an overall benefit. Old Controlled should recognize gain on its deemed asset transfer, which would be reported on Parent's consolidated return if Parent and Controlled were part of a consolidated group. If Parent and Controlled do not file a consolidated return, new Controlled would receive a section 168(k) deduction equal to or greater than the gain recognized by old Controlled, which in most cases should produce an overall benefit to the Parent group in the first year after the transaction, especially after taking the time value of money into account.

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[190] Indeed, a similar argument could be made for Example 1 in that Distributing's shareholders retained indirect ownership of the section 168(k) property both before and after the transactions; nevertheless, the section 168(k) property did not remain within the same corporate group in Example 1.



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If Parent and Controlled file a consolidated return, the treatment of the transaction is again not entirely clear, but a beneficial result may be less likely than in Example 1. The treatment of Example 2 under the consolidated return rules should resemble the treatment of Example 1, except that the Parent group is more likely to receive the benefit of the section 168(k) deduction, because old Controlled is a member of the Parent consolidated group at the time of the distribution and the section 168(k) property remains in the Parent consolidated group after the sale of Distributing's stock. Given these factors, it may also be more likely that the consolidated return rules limit the transaction to approximate the results as if old Controlled and new Controlled were divisions of a single corporation — that is, by denying the section 168(k) deduction to the extent that it exceeds old Controlled's gain from the sale. It will be difficult to argue that the departing entity (Distributing or its consolidated group) should receive the excess deduction in Example 2 since Distributing ceases to hold the section 168(k) property (directly or indirectly) following its distribution of Controlled stock.

### C. Section 168(k) Under Notice 2003-65

Notice 2003-65[191] provides guidance in calculating some tax items for section 382(h) purposes. Some of the calculation methods in Notice 2003-65 explicitly rely on depreciation deductions, raising the question whether a 100 percent section 168(k) deduction should also be included in the calculations. On May 8, 2018, the government released Notice 2018-30,[192] which excludes section 168(k) from Notice 2003-65's calculations.

By way of background, after a corporation undergoes an ownership change, section 382 significantly limits that corporation's use of pre-change NOLs. The goal, of course, is to limit acquisitions of loss corporations by acquirers seeking to use those tax losses. Section 382(h) provides an exception to the extent that a loss corporation, at the time of its ownership change, has net unrealized built-in gains (NUBIG) that are recognized post-change.[193] Pre-change NUBIG, when recognized post-change, increases a loss corporation's limitation on using pre-change NOLs, while pre-change net unrealized built-in losses (NUBIL) reduce the same limitation. In both cases, section 382(h) applies only for approximately five years after the ownership change.[194]

Notice 2003-65 gives taxpayers two methods for calculating pre-change NUBIG and NUBIL, as well as the amount of recognized built-in gain (RBIG) and recognized built-in loss (RBIL) after a change in control: the 338 approach and the 1374 approach.[195] The 338 approach hypothesizes an acquisition of the loss corporation on the date of its change in control, for which a section 338 election is made. For each asset that had a built-in gain on the date of the change in control, the 338 approach treats as RBIG the excess of the cost recovery deduction that would have been allowed for the asset had it been acquired in a deemed transfer under a section 338 election, over the asset's actual cost recovery deduction. For an asset with a built-in loss on the change date, the 338 approach also treats the excess of the actual cost recovery deduction generated by the asset, over the cost recovery deduction that would have been generated had the asset been acquired in a deemed transfer under a section 338 election, as RBIL.

Separately, the 1374 approach generally incorporates the rules for calculation of built-in gains and losses in section 1374, but with an exception for depreciation, amortization, and depletion deductions for built-in loss assets. Any

[191] 2003-2 C.B. 747.

[192] 2018-21 IRB 610.

[193] *See* section 382(h)(1)(A). The justification for this provision is that, before experiencing an ownership change, the loss corporation could have triggered its NUBIG and reduced its overall amount of NOLs; section 382(h) simply allows the loss corporation to do after the ownership change what it could have done before.

[194] *See* section 382(h)(7).

[195] By its terms, Notice 2003-65 applies only to the determination of NUBIG, NUBIL, RBIG, and RBIL under section 382(h) and does not address section 384 except insofar as requesting comments regarding the potential application of the notice's principles to section 384. Under section 382, a loss corporation seeks to maximize its NUBIG and RBIG to increase the limitation on the amount of pre-change losses that can be offset against current income. By contrast, under section 384, it is in a gain corporation's interest to minimize its NUBIG and RBIG to limit the amount of gain that cannot be offset by pre-acquisition losses. *See generally* Deanna W. Harris and Mark Hoffenberg, "Code Sections Interact: Is Section 382's Treasure Section 384's Trash?" 36 *Corp. Tax'n* 17 (Feb.-Mar. 2009) (thorough discussion of the interaction of sections 382 and 384).



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such deduction, even if accrued before the change date, generally constitutes RBIL except to the extent that the taxpayer can prove that the deduction is not attributable to an asset's built-in loss on the change date. In turn, an asset's actual depreciation deduction can be treated as not attributable to built-in loss on the change date, and therefore not as RBIL, to the extent of the hypothetical depreciation deduction available if the asset were purchased for FMV on the change date. Before the TCJA, section 168(k) deductions generally were unavailable in the hypothetical transactions described in Notice 2003-65 because the acquirer would not have made an original use of the acquired assets. The TCJA's changes to section 168(k) raised the question of the availability of a section 168(k) deduction, and some commentators believed that a deduction was available in some cases under Notice 2003-65.[196]

In Notice 2018-30, however, the government modified Notice 2003-65 and excluded section 168(k) deductions in calculating RBIG and RBIL under the 338 approach or for demonstrating that an asset's deductions are not attributable to built-in loss on the change date under the 1374 approach. As described by Notice 2018-30, if a section 168(k) deduction were available for the hypothetical section 338 transaction used by the 338 approach, a loss corporation generally could take a deduction equal to 100 percent of the basis of its section 168(k) property, and the excess of that amount over the amount actually depreciated for the property would be RBIG in the loss corporation's first year after the change in control. The notice explained that allowing a loss corporation to use section 168(k) under the 338 approach likely would significantly increase the loss corporation's first-year RBIG and, because of the five-year limitation applicable to NUBIG, might cause the loss corporation to recognize RBIG that would otherwise have gone unrecognized. The notice describes this result as "not appropriate."[197]

Further, Notice 2018-30 indicates that the deduction available under section 168(k) is inconsistent with the description of the 338 approach in Notice 2003-65 — namely, that approach's assumption that an asset generates income equal to its cost recovery deduction available as a result of the hypothetical deemed section 338 transaction. This is not the case for a section 168(k) deduction, which generates a large deduction in the first year and no deduction thereafter.[198] Although Notice 2018-30 does not specifically state its objection to using section 168(k) to prove that depreciation deductions are not RBIL under the 1374 approach, it highlights the similarity of this calculation to the RBIG calculation under the 338 approach and concludes that section 168(k) cannot be used to produce a "reasonable estimate" of RBIL for purposes of the aforementioned exception in the 1374 approach.

## VI. Section 168(k) Partnership Issues

Before the TCJA, section 168(k) required that the original use of any property for which a taxpayer claimed bonus depreciation commence with the taxpayer. The implication for partnership transactions that result in basis adjustments to depreciable property was a matter for debate. As discussed below, if a partnership makes an election under section 754, basis adjustments to depreciable property may result when a partner acquires a partnership interest (under section 743(b)) or when the partnership distributes property to a partner (under section 734(b)).

The government decided that these basis adjustments were ineligible for pre-TCJA bonus depreciation. First, the government stated that any such increase would "not satisfy the original use requirement."[199] The government concluded that for section 168(k) purposes, the entity theory (rather than the aggregate theory) of partnerships

[196] *See, e.g.*, EY, "Tax News Update" (Nov. 6, 2017).

[197] Notice 2018-30, 2018-21 IRB at 611.

[198] It might be noted that Notice 2003-65 has never truly followed an economic approach to cost recovery deductions. Rather, taxpayers have used the cost recovery deductions available under U.S. tax law, nearly all of which are accelerated deductions enacted by Congress since the 1980s, which reduce basis more quickly than an asset actually depreciates in value. Moreover, taxpayers presumably have included full 100 percent deductions under section 179 in Notice 2003-65 calculations for many years.

[199] T.D. 9091, 68 F.R. 52986, 52990. The government's reasoning in this area may be somewhat imprecise. For instance, it later rejected a comment that basis adjustments made to qualified property before placement in service should be taken into account under section 168(k) even though such an adjustment would not seem to raise an original use issue. *See* T.D. 9283, 71 F.R. 51727, 51736.



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should apply to determine original use. Thus, in the government's view, partners claiming the benefit of a basis adjustment were no different than a secondary user of the property that acquired it from the partnership. Second, the government argued that these basis increases have "no correlation to the taxpayer's cost of the property."[200] Only the cost of property, the government reasoned, is depreciable, and section 734(b) allocates basis adjustments in particular in ways that do not reflect cost.[201] Accordingly, the government promulgated reg. section 1.168(k)-1(f)(9), generally denying bonus depreciation to any increase in the basis of qualified property as the result of a section 754 election.

We believe that the TCJA has superseded reg. section 1.168(k)-1(f)(9). By repealing the original use requirement, the TCJA rendered obsolete much of the government's original justification for the rule against bonus depreciation for section 754 elections. Although the government also posited that basis adjustments do not reflect cost, that position seems to be at odds with the treatment of basis adjustments under section 743(b) and, possibly, section 734(b) to the extent allocable to depreciable property, which as described below generally is regarded as newly purchased and placed-in-service property.

Further, bonus depreciation of basis adjustments under sections 743(b) and 734(b) accords with the other requirements of section 168(k) — namely, that the property acquired "was not used by the taxpayer at any time prior to such acquisition" and that the acquisition is a valid purchase under section 179(d).[202] Although there is not yet guidance on the no prior use rule, the government has already worked through a similar set of no prior use issues in crafting the special partnership provisions of the section 197 anti-churning regulations. If applied by analogy, those provisions generally would treat basis adjustments as acquisitions of property from other partners, not the partnership itself.

The discussion below summarizes the mechanics of basis adjustments resulting from section 754 elections under section 743(b) (for purchases of partnership interests) and section 734(b) (for distributions of specified partnership property), as well as the remedial allocation method under the section 704(c) regulations, which raises a similar set of issues. It also considers the partnership anti-churning rules of section 197 and their possible applicability to section 168(k). Finally, it analyzes whether bonus depreciation should be available for section 743(b) and section 734(b) adjustments, as well as for acquisitions of interests in disregarded entities, and required for section 704(c) remedial allocations.[203]

## A. Basis Adjustments Under Subchapter K

### 1. Section 743.

By default, there generally is no adjustment to the basis of partnership property when a partner transfers its interest in a partnership to another person.[204] However, if a partnership has filed a section 754 election, the partnership must adjust the basis of partnership assets upon a partner's sale or exchange of a partnership interest in order to give the transferee the equivalent of cost basis in its allocable share of the partnership's assets, just as though the transferee acquired a direct, undivided interest in the partnership assets.[205] If the section 754 election is in effect, the adjustment equals the difference between the transferee's basis in its partnership interest and the transferee's share of the adjusted basis of the partnership's assets.[206] The basis adjustment is an

[200] *See* T.D. 9283, 71 F.R. at 51736.

[201] The government argued that there would be no correlation to the taxpayer's cost of the property as a result of a section 734(b) adjustment when the partnership distributes property at a gain to the distributee. *Id.* Section 755 generally allocates section 734(b) adjustments in accordance with the character of the distributed property, as opposed to unrealized gain. *See* reg. section 1.755-1(c)(1)(i).

[202] *See* section 168(k)(2)(E)(ii)(I) and (II).

[203] Variations of these transactions have been discussed in some forums, including a D.C. Bar Communities conference in Washington, hosted by Jones Day, on January 25, 2018. For a discussion of subchapter K issues presented by new section 168(k), see Andrew W. Needham, "Bonus Depreciation: Basis Adjustments Under Subchapter K," *Tax Notes*, July 2, 2018, p. 41; and American Bar Association Section of Taxation, "Comments on Section 168(k) as Amended by P.L. 115-907 on December 22, 2017" (June 7, 2018) (ABA report).

[204] *See* section 743(a).

[205] *See* William S. McKee, William F. Nelson, and Robert L. Whitmire, *Federal Taxation of Partnerships & Partners*, at para. 24.02[1] n.24 (4th ed. 2007 and Supp. 2018) (citing H.R. Rep. No. 83-1337 (1954) and S. Rep. No. 83-1622 (1954)).

[206] *See* section 743(b).



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adjustment to the basis of the partnership's assets for the transferee partner only and does not affect the partnership's computation of items of income, deduction, gain, or loss at the partnership level or on other partners.[207]

The basis adjustment generally is allocated first to property (ordinary income property) other than capital assets and section 1231(b) property (capital gain property) to the extent of the income, gain, or loss that would be allocated to the transferee in a deemed sale of the ordinary income assets for cash equal to their FMV.[208] Any remaining basis adjustment generally is allocated to capital gain property.[209] The basis adjustment is further allocated to each item within the two classes in accordance with the income, gain, or loss that would be allocated to the transferee from the sale of the item in the hypothetical cash transaction, subject to specified adjustments.[210]

When a positive basis adjustment is allocated to depreciable property, the increase in basis is treated "as if it were newly-purchased recovery property placed in service when the transfer occurs."[211] Any applicable recovery period and method are used to determine the allowable depreciation deduction, and no change is made to the common basis in that property.[212]

#### 2. Section 734.

Another default rule under subchapter K is that no adjustment occurs to the basis of partnership property upon a partnership's distribution to a partner.[213] If a section 754 election is in effect, however, the partnership must adjust the basis of partnership property upon making a distribution in order to address discrepancies between inside and outside basis arising as a result of the distribution.[214] Absent that adjustment, distortions may occur concerning the amount and timing of income received by the other partners.[215]

Specifically, the section 734(b) adjustment applies to a partnership with a section 754 election in effect if the distributee partner recognizes gain or loss on a distribution or the distributee partner takes a basis in distributed property greater or less than the partnership's adjusted basis in the property immediately before the distribution. The section 734(b) adjustment increases the partnership's basis by the amount of any gain that the distributee partner recognizes and also by the amount of any "disappearing" basis (that is, the excess of the partnership's adjusted basis in the distributed property over the distributee partner's basis in the property).[216] Unlike adjustments under section 743(b), the adjustment applies to the common basis of the partnership and need not be tracked at the partner level.[217]

Any basis increase under section 743(b) must be allocated to partnership property in the same class (that is, capital gain property or ordinary income property) as the distributed property.[218] The increase is further allocated to any properties within the applicable class that have unrealized appreciation in proportion to the amount of that appreciation, with the remainder allocated to property within the class in proportion to FMV.[219]

The section 734 regulations contain a special rule for depreciating property under section 168. An increase in the basis of depreciable property "must be taken into account as if it were newly-

[207] *See* reg. section 1.743-1(j)(1).

[208] *See* reg. section 1.755-1(b)(2)(i).

[209] *See id*. However, any portion of the adjustment allocable to property placed in service before 1981 could be depreciated under the pre-ACRS rules. *See* prop. reg. section 1.168-4(d)(8), 49 F.R. 5940, 5958 (Feb. 16, 1984). That adjustment likely would be depreciated on a straight-line basis over the property's remaining useful life. *See* reg. section 1.167(c)-1(a)(6).

[210] *See* reg. section 1.755-1(b)(3)(i)(A) and (ii)(A).

[211] *See* reg. section 1.743-1(j)(4)(i)(B).

[212] *Id*. Special rules applicable to the remedial allocation method are discussed in Section VI.A.3, below.

[213] *See* section 734(a).

[214] *See, e.g.*, McKee, Nelson, and Whitmire, *supra* note 205, at para. 25.01[2] n.7 ("The effect of section 734(b) is to preserve the aggregate unrealized gain or loss with respect to distributed and retained partnership assets.").

[215] *See id.* at para. 25.01[1].

[216] *See* section 734(b)(1); and reg. section 1.734-1(b)(1).

[217] *See* reg. section 1.734-1(d) (requiring only that the partnership attach a statement to the partnership return setting forth the computation of the section 734 adjustment and the allocation thereof).

[218] *See* reg. section 1.755-1(c)(1)(i).

[219] *See* reg. section 1.755-1(c)(2)(i). If a distribution of cash results in gain under section 731(a)(1) and a corresponding basis adjustment to undistributed property under section 734(b)(1)(A), the adjustment may be allocated only to capital gain property. *See* reg. section 1.755-1(c)(1)(ii).



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purchased recovery property placed in service when the distribution occurs."[220] Any applicable recovery period and method are used to determine the allowable depreciation deduction, and no change is made to the remainder of the property's basis.[221]

#### 3. Remedial allocations under section 704(c).

Section 704(c) requires the allocation for tax purposes of any income, gain, loss, or deduction for property contributed to a partnership with built-in gain or loss (section 704(c) property) "among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution."[222] The regulations do not prescribe a method for carrying out this statutory command, but rather require a "reasonable method" for allocating those items and offer three methods that are "generally reasonable."[223] Those methods are the traditional method, the traditional method with curative allocations, and the remedial allocation method.[224]

Under the traditional method, the partnership allocates income, gain, loss, or deduction attributable to the section 704(c) property "to avoid shifting the tax consequences of the built-in gain or loss."[225] However, the "ceiling rule" caps the amount of income, gain, loss, or deduction that the partnership may allocate for any tax year to the amount it actually recognizes.[226]

The remedial allocation method is an alternative method permitted by the regulations that offers a way to eliminate the distortions caused by the ceiling rule.[227] Under this allocation method, if the ceiling rule would prevent a tax allocation from matching a book allocation, the partnership creates a remedial item to make up the difference, while simultaneously creating an offsetting remedial item in an identical amount allocated to the contributing partner.[228] Remedial allocations have the same attributes as the tax item limited by the ceiling rule.[229]

The remedial allocation regulations establish a separate framework for calculating depreciation deductions for depreciable property. This framework bifurcates the book value of the depreciable property as though it were two assets.[230] The first deemed asset has a book value equal to adjusted tax basis, and the taxpayer recovers the book basis in the same manner and with the same recovery period as the adjusted tax basis.[231] The second (the excess book basis asset) consists of the excess book value. Although the excess book basis asset has no tax basis, the taxpayer depreciates it for book purposes using any recovery period and depreciation method available for newly purchased property.[232] When the partnership depreciates the book value of the excess book basis asset, it must make remedial allocations to the noncontributing partners to the extent that the book depreciation deductions exceed the tax depreciation deductions available under the ceiling rule.[233] Also, the partnership must make remedial allocations of income to the contributing partner to offset the remedial depreciation allocations.

## B. Section 197 Anti-Churning Rules

Although the TCJA repealed the original use requirement, section 168(k) requires a determination whether the taxpayer previously used the property in question. Under the entity theory of partnerships, one might ask whether basis adjustments are analogous to repurchases of the property by the partnership and thus fail the "no prior use" requirement. By contrast, under

[220] *See* reg. section 1.734-1(e)(1).

[221] *See id.*

[222] *See* section 704(c)(1)(A).

[223] *See* reg. section 1.704-3(a)(1).

[224] *See* reg. section 1.704-3(b), (c), and (d).

[225] *See* reg. section 1.704-3(b)(1). Thus, for example, if the partnership sells section 704(c) property, it must allocate the gain or loss to the contributing partner to the extent of the built-in gain or loss at the time of contribution. *Id.*

[226] *See id.*

[227] *See* reg. section 1.704-3(d)(1).

[228] *See id.*

[229] *See* reg. section 1.704-3(d)(3).

[230] *See* reg. section 1.704-3(d)(2).

[231] *See id.* Typically, the taxpayer must determine book depreciation at the same rate as tax depreciation. *See* reg. section 1.704-1(b)(2)(iv)(g)(3).

[232] *See* reg. section 1.704-3(d)(2).

[233] *See* reg. section 1.704-3(d)(7), Example 1.



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the aggregate theory of partnerships, one might conclude that basis adjustments reflect purchases of property among the partners.

The section 197 anti-churning rules address a similar issue. In determining whether a taxpayer used applicable intangible property before section 197's effective date, Congress specifically instructed that the rules apply an aggregate theory of partnerships.[234] Reg. section 1.197-2(h)(12) (the section 197(f)(9) partnership regulations) thus treats each partner as owning its allocable share of common partnership basis and treats any basis adjustment as a transfer of property between the partners. By analogy to those regulations, if the transfer of property from one partner to another would meet the section 168(k) requirements, the basis adjustment generally would be eligible for bonus depreciation.

Two principal considerations support applying section 197(f)(9) principles generally, and the section 197(f)(9) partnership regulations in particular, to section 168(k). First, sections 168(k) and 197(f)(9) serve similar purposes. That is, both provisions deny taxpayers tax benefits stemming from the ownership of property based on a concept of prior use and employ similar language to achieve that end.[235] The concept of amortization historically has been considered more or less the same as depreciation, and the code specifically treats amortizable section 197 intangibles as depreciable assets for section 167 purposes.[236] Thus, section 168 and section 197 arguably should be read *in pari materia* and construed as one.[237] Second, except for a few cross-references to section 179 that are inapplicable here, Congress was silent on the interaction between section 168(k) and subchapter K. The legislative history is silent as well. Therefore, unless and until the government provides guidance to the contrary, taxpayers arguably should be able to rely on reasonable, closely analogous regulations to fill the legislative gap.[238]

#### 1. Section 197 and the partnership anti-churning rules.

Section 197 generally permits amortization deductions for acquired intangible property, including goodwill and going concern value, acquired from third parties, ratably over a 15-year recovery period. Because the law generally did not permit taxpayers to amortize goodwill or going concern value before section 197, Congress included a set of anti-churning rules.[239] Under section 197(f)(9), taxpayers may not amortize goodwill, going concern value, or other intangibles not amortizable under prior law (section 197(f)(9) intangibles) unless they are transferred after the effective date of the statute in a transaction giving rise to a significant change in ownership or use.[240] Thus, the transferee and transferor must be tested under the principles of sections 267(b) and 707(b)(1).[241]

[234] *See* section 197(f)(9)(E) ("With respect to any increase in the basis of partnership property under section 732, 734, or 743, determinations . . . shall be made at the partner level and each partner shall be treated as having owned and used such partner's proportionate share of the partnership assets.").

[235] *Compare* section 168(k)(2)(E)(ii)(I) (property disqualified if "*used* by the taxpayer at any time prior to . . . acquisition" (emphasis added)), *with* section 197(f)(9)(A)(i) (property disqualified if "*held or used* at any time . . . on or before [the] date of enactment by the taxpayer or a related person" (emphasis added).).

[236] *See* section 197(f)(7); *see also*, *e.g.*, Treasury Regulations No. 94, "Relating to the Income Tax Under the Revenue Act of 1936," art. 23(l)-3 (1936) ("Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses, and franchises.").

[237] *See*, *e.g.*, *Smith v. City of Jackson*, 544 U.S. 228, 233 (2005) ("When Congress uses the same language in two statutes having similar purposes, . . . it is appropriate to presume that Congress intended that text to have the same meaning in both statutes.").

[238] *Cf. Mayo Foundation for Medical Education and Research v. United States*, 562 U.S. 44, 58 (2011) (holding that Treasury regulations are valid if they are reasonable constructions of ambiguous text in the code).

[239] *See* H.R. Rep. No. 103-213, at 691 (1993) (Conf. Rep.) ("Special rules are provided by the bill to prevent taxpayers from converting existing goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable under present law into amortizable property to which the bill applies.").

[240] *See* section 197(f)(9)(A). Broadly, a section 197(f)(9) intangible is not amortizable if the taxpayer (or a related person) held it before section 197's enactment, or if the taxpayer has allowed any person that owned or used the intangible before enactment (or a person related to that person) to use it.

[241] *See* section 197(f)(9)(C); and reg. section 1.197-2(h)(6)(i).



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The section 197(f)(9) partnership regulations describe the treatment of partnership-related basis adjustments under the anti-churning rules.[242] The general principle deems a partner acquiring a partnership interest to acquire an undivided, proportionate share of all the partnership's assets, including all the section 197(f)(9) intangibles.[243] The regulations deem transactions involving the partnership to occur at the partner level by and among the applicable partners.

In applying the anti-churning rules to section 743(b) adjustments, the section 197 regulations deem a partner that transfers a partnership interest to transfer the partner's share of partnership property, including the section 197(f)(9) intangible, to the transferee.[244] If the transferee is unrelated to the selling partner, the anti-churning rules do not apply to the deemed transfer,[245] because a section 197(f)(9) intangible's transfer to an unrelated person generally would not trigger the anti-churning rules.[246] Accordingly, the section 743(b) basis adjustment would not be subject to the anti-churning rules and may be amortized as permitted under section 197.

For section 734(b) adjustments, the anti-churning rules characterize the continuing partners as acquiring from the distributee partner interests in the section 197(f)(9) intangibles that remain in the partnership.[247] The acquired interests correspond to the section 734(b) basis adjustment allocable to the section 197(f)(9) intangibles. The anti-churning rules do not apply to the continuing partner's share of the basis adjustment to the intangible if the continuing partner is not the distributee partner or related to the distributee partner.[248] The same rationale applicable to section 743(b) adjustments applies: The continuing partner is generally not related to the distributee.[249] The regulations compute each continuing partner's share of the basis adjustment allocable to a section 197(f)(9) intangible in proportion to the continuing partners' capital accounts, as determined immediately after the distribution.[250]

The section 197 regulations also provide rules to determine whether remedial allocations under section 704(c) are deductible under the anti-churning rules. If a section 197(f)(9) intangible was not amortizable in the hands of the contributing partner, the partnership generally may not amortize the intangible.[251] Nevertheless, a noncontributing partner may receive remedial allocations of amortization deductions, unless the partner is related to the partner that contributed the intangible.[252]

#### 2. Applying the section 197(f)(9) partnership regulations by analogy.

The section 197(f)(9) partnership regulations support the view that a basis adjustment under section 743(b) or 734(b) (or a remedial allocation of depreciation deductions under section 704(c)) does not constitute property previously used by the partner. These regulations also suggest that basis adjustments may be analyzed as transfers of interests in partnership property directly by and among partners. In other words, these regulations indicate that the no prior use requirement should

[242] *See* section 197(f)(9)(E) ("With respect to any increase in the basis of partnership property under section 732, 734, or 743, determinations under [the anti-churning rules] shall be made at the partner level and each partner shall be treated as having owned and used such partner's proportionate share of the partnership assets.").

[243] Reg. section 1.197-2(h)(12)(i) ("Each partner is treated as having owned and used the partner's proportionate share of partnership property."); *see also* REG-100163-00, 65 F.R. 3903-3907.

[244] *Id.* at 3903. This treatment is consistent with the section 743 regulations, which treat the basis adjustment allocable to depreciable or amortizable property as newly purchased recovery property placed in service when the transfer occurs. *See* reg. section 1.743-1(j)(4)(i)(B)(1).

[245] *See* reg. section 1.197-2(h)(12)(v)(A).

[246] *See* 65 F.R. at 3903.

[247] *See id*. at 3904.

[248] Technically, the regulations ask whether the continuing partner is an "eligible partner." *See* reg. section 1.197-2(h)(12)(iv)(A). A continuing partner is an eligible partner if it is not the distributee partner or a person related to the distributee partner. Reg. section 1.197-2(h)(12)(iv)(B)(1). For this purpose, a continuing partner that makes a contribution to the partnership as part of the same series of related transactions that includes the distribution generally is deemed related to the distributee. Reg. section 1.197-2(h)(12)(iv)(B)(2).

[249] *See* 65 F.R. at 3904.

[250] *See* reg. section 1.197-2(h)(12)(iv)(D)(1).

[251] *See* reg. section 1.197-2(g)(2)(ii) and (4)(ii).

[252] *See* reg. section 1.197-2(h)(12)(vii)(B). Similar rules apply for reverse section 704(c) allocations arising from a section 197(f)(9) intangible's revaluation. *See* Rev. Rul. 2004-49, 2004-1 C.B. 939. If a revaluation occurs for a section 197(f)(9) intangible, the partnership may make remedial allocations of amortization as long as the section 197(f)(9) intangible is amortizable in the hands of the partnership or the "booked-up" partners are unrelated to the partner receiving the remedial allocation. *See id.*



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be tested at the partnership level. Further, although these regulations relate to specific statutory authority under section 197, none of the legislative history suggests that Congress intended to disavow this approach for section 168(k) purposes. The implications of applying these regulations by analogy under section 168(k) are as follows:

For section 743(b) basis adjustments allocable to depreciable property, section 168(k)(2)(E)(ii) would apply by treating the transferee partner as acquiring the selling partner's share of the property directly. Assuming that transaction meets the applicable requirements of section 179(d), section 168(k)(2)(E)(ii) would appear to be satisfied.

For section 734(b) basis adjustments allocable to depreciable property, section 168(k)(2)(E)(ii) would apply by treating the continuing partners as acquiring interests in the property directly from the distributee partner. If these deemed purchases meet the applicable requirements of section 179(d), section 168(k)(2)(E)(ii) would appear to be satisfied.[253]

As discussed in the next section, it appears that property contributed to a partnership does not qualify for bonus depreciation because a contribution is not a purchase under section 179.[254] Nevertheless, the section 197(f)(9) partnership regulations permit remedial allocations of amortization deductions even when the deductions themselves are not allowed. Under this same reasoning, remedial allocations of bonus depreciation may be appropriate even if contributed property would not itself be subject to bonus depreciation. Nevertheless, allocations of bonus depreciation to partners related to the contributing partner presumably would be disallowed, as is the case under section 197(f)(9).

The discussion above assumes that the transferee partner never used the depreciable property in any capacity other than indirectly as a partner in a partnership that owns the property. If the partner previously used the depreciable property, bonus depreciation may not be available.[255]

## C. Applying Section 168(k) to Basis Adjustments

This section considers the possible application of section 168(k) to different partnership transactions: the purchase of a partnership interest, a distribution of partnership property, the purchase of a disregarded entity, and section 704(c) remedial allocations. We assume in each example below that the form of the transactions will be respected (in Example 5, taking into account Rev. Rul. 99-5[256]) — that is, the step transaction doctrine will not recharacterize the relevant transactions.

**Example 3:** *Section 743 transactions.* On January 1, 2018, A and B form partnership PRS, in which A owns a 40 percent and B owns a 60 percent interest for all purposes. A contributes equipment with a value of $80 and an adjusted basis of $0 to PRS, and B contributes $120 cash to PRS. On February 1, 2018, A sells its entire PRS interest to C, an unrelated person, for $80 cash. PRS has a section 754 election in effect.[257]

It is reasonably clear that PRS may not claim bonus depreciation on the contributed equipment. Under sections 168(k)(2)(E)(ii) and 179(d)(2)(C), property is ineligible for bonus depreciation if the basis of the property in the hands of the acquirer is determined (in whole or in part) by reference to the adjusted basis of the property in the hands of the person from whom it is acquired. The contribution of the equipment by A to PRS would constitute such a transfer.[258]

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[253] For both section 743(b) and 734(b) basis adjustments under the section 197(f)(9) partnership regulations, if an "anti-churning partner" (or a related person other than the partnership) is deemed to transfer its interest in the section 197(f)(9) intangible but becomes (or remains) a direct user of the intangible, no amortization is permitted for the proportionate share of the intangible treated as transferred by that person. *See* reg. section 1.197-2(h)(12)(vi)(A). An anti-churning partner generally is any partner that is itself subject to the anti-churning rules. *See* reg. section 1.197-2(h)(12)(vi)(B). Although section 197 contains a specific statutory prohibition against the use of a section 197(f)(9) intangible by anyone who held or used it before the date of section 197's enactment (see section 197(f)(9)(A)(ii) and (iii)), there does not appear to be a similar requirement under section 168(k).

[254] *See* reg. section 1.179-4(c)(1)(iv) ("Property acquired by a partnership through contribution (section 723)" does not qualify as property acquired by purchase for purposes of section 179(d)(2).).

[255] *See* section 168(k)(2)(E)(ii)(I) (property eligible only if "such property was not *used* by the taxpayer at any time prior to such acquisition" (emphasis added)).

[256] 1999-1 C.B. 434.

[257] This example is based on example 27 of reg. section 1.197-2(k).

[258] *See also* reg. section 1.179-4(c)(1)(iv).



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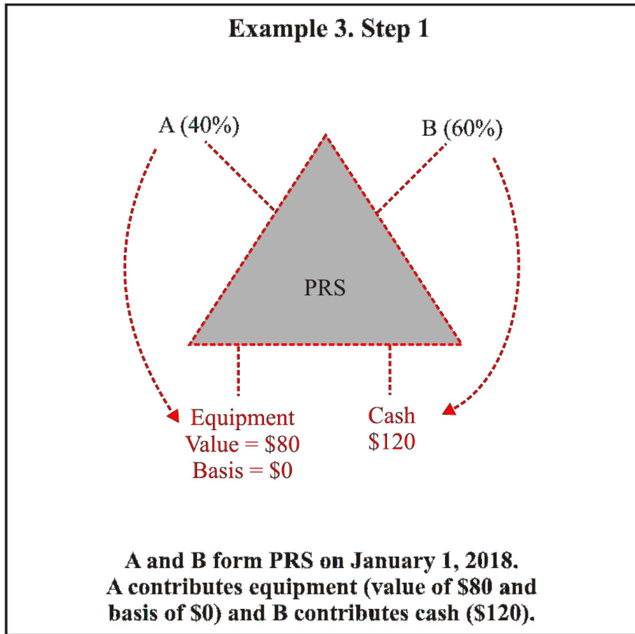


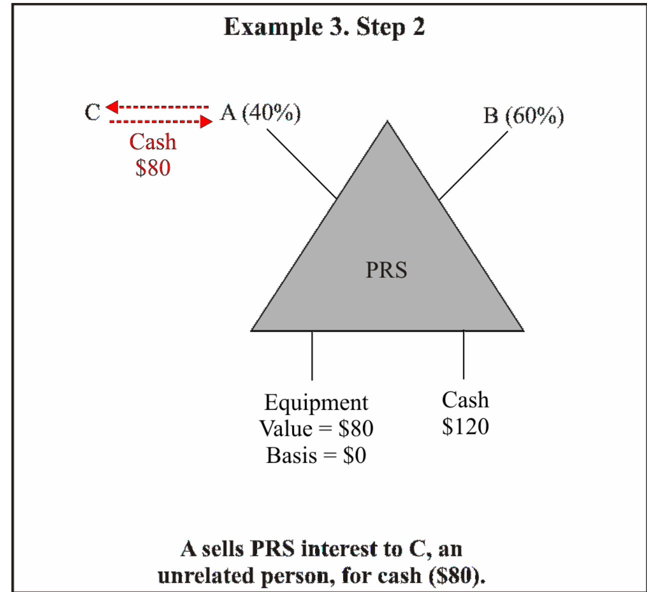


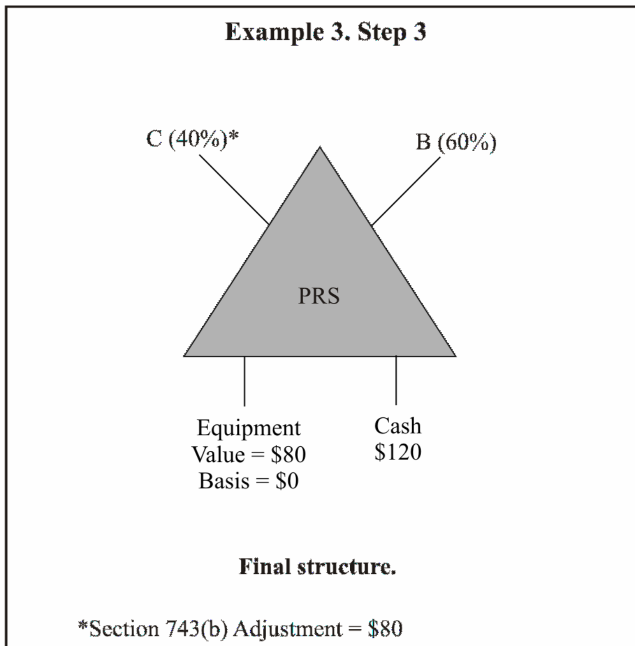


However, when A sells the PRS interest to C, C will have a basis adjustment in the PRS assets under section 743(b) equal to $80, and the entire basis adjustment will be allocated to equipment because the only other asset is cash. Can the basis adjustment qualify for bonus depreciation?

The answer appears to depend on whether reg. section 1.168(k)-1(f)(9) still applies. That regulation provides that any increase in basis as the result of a section 754 election is not eligible for bonus depreciation. As mentioned earlier, the government has offered two different rationales for reg. section 1.168(k)-1(f)(9). First, it has argued that "many basis increases resulting from a section 754 election bear no relation whatsoever to the cost of qualified property."[259] However, the government could not have had section 743(b) basis adjustments in mind. The purpose of a section 743(b) basis adjustment is to give the partner acquiring the partnership interest the equivalent of cost basis in its allocable share of the partnership's assets. Far from having no relation to the cost of qualified property, section 743(b) is meant to ensure that the cost of qualified property is properly accounted for.

Second, the government has stated that any basis adjustment cannot satisfy the original use requirement.[260] However, with the TCJA's repeal of the original use requirement, this rationale should no longer be dispositive. Congress decided to reward investment in used property under section 168(k) just the same as investment in new property, and nothing in the statute

[259] *See* T.D. 9283, 71 F.R. at 51736.

[260] *See* T.D. 9091, 68 F.R. at 52990.



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suggests a different treatment for an indirect investment in used property through a partnership as compared with a direct investment in used property. Accordingly, reg. section 1.168(k)-1(f)(9) presumably should have no continuing effect, at least for basis adjustments under section 743(b).[261]

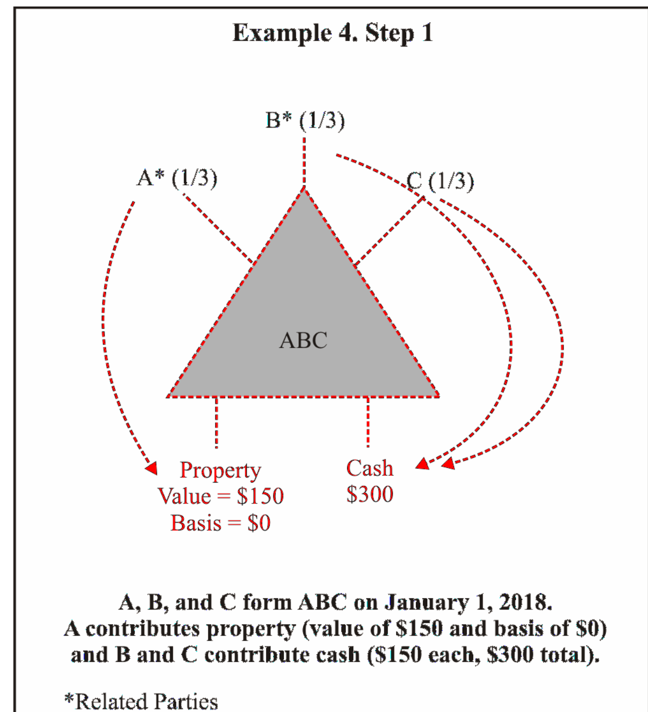
Putting reg. section 1.168(k)-1(f)(9) aside, the section 743 regulations treat the increase in the basis of the equipment "as if it were newly-purchased recovery property placed in service when the transfer occurs."[262] In testing whether the basis adjustment satisfies section 168(k)(2)(E)(ii), the basis adjustment may be viewed as a transfer of an interest in the equipment from A to C. A and C are unrelated to each other, and the adjustment should constitute a deemed purchase, so section 168(k)(2)(E)(ii) generally should be satisfied. Therefore, at least as a policy matter, it generally should be possible for C to depreciate the amount of the section 743(b) adjustment in accordance with section 168(k).[263] Indeed, this result is consistent with the congressional policy behind section 743(b), which, as discussed earlier, is to treat the purchase of a partnership interest (when a section 754 election is in effect or section 743(b) otherwise applies to the interest) as an acquisition of a direct, undivided interest in the partnership's assets. The purchase of a direct, undivided interest in qualified property should be eligible for bonus depreciation if the other relevant requirements are met.[264]

Could the parties have planned into a better result? Because A contributed the equipment, the partnership was unable to expense the equipment under section 168(k). However, if A had contributed cash and PRS purchased comparable equipment from an unrelated party, PRS could have expensed the purchase (and C still could have expensed the basis adjustment upon acquisition of A's partnership interest).

Finally, if C had purchased property and placed the property in service itself (and assuming the requirements of section 168(k) were otherwise met), C could have expensed the entire purchase price. However, by purchasing a partnership interest, C may expense only the basis adjustment.

**Example 4:** *Section 734(b) adjustments.* On January 1, 2018, A, B, and C form partnership ABC in which each partner has an equal interest. A contributes property described in section 168(k)(A)(i) with a value of $150 and an adjusted basis of $0. B and C each contribute $150 cash. A and B are related, but neither A nor B is related to C. By December 1, 2018, the value of the property has increased to $600, and on that date ABC distributes $300 to B in complete redemption of B's interest in the partnership. ABC has a section 754 election in effect. Assume each partner's outside basis remains constant until the distribution.[265]

**Example 4. Step 1**




**A, B, and C form ABC on January 1, 2018. A contributes property (value of $150 and basis of $0) and B and C contribute cash ($150 each, $300 total).**

*Related Parties

Under section 731(a)(1), B recognizes $150 of gain upon the distribution in redemption of its

[261] *See, e.g.*, *K Mart Corp. v. Cartier Inc.*, 486 U.S. 281, 294 (1988) (when a provision of a regulation "is in conflict with the plain language of the statute, that provision cannot stand").

[262] *See* reg. section 1.743-1(j)(4)(i)(B)(1).

[263] C's share of the common basis in the equipment is ineligible for bonus depreciation because that basis is carried over from A and is ineligible for bonus depreciation under section 179(d)(3). *See* section 179(d)(2)(C).

[264] Indeed, the section 168(k) regulations approve the application of bonus depreciation to fractional interests in property. *See* reg. section 1.168(k)-1(b)(3)(v), Example 4.

[265] This example is based on Example 31 of reg. section 1.197-2(k).



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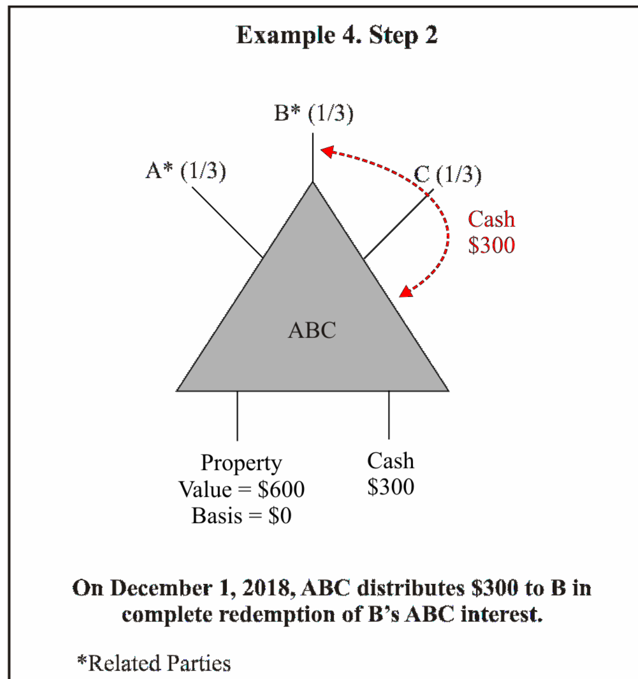
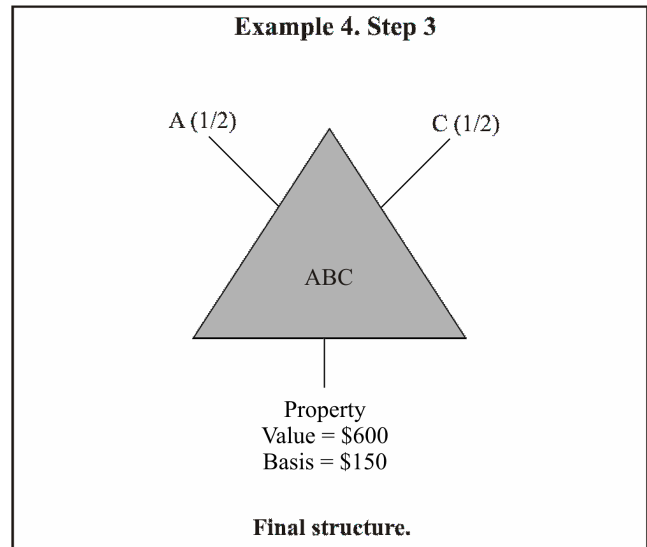
partnership interest. As a result, the adjusted basis of the property held by ABC increases by $150 in accordance with a basis adjustment under section 734(b).[266] Can ABC immediately expense the adjustment?




The section 734 regulations, like the section 743 regulations, treat the increased portion of the basis as a result of a distribution of property to a partner "as if it were newly-purchased recovery property placed in service when the distribution occurs."[267] That language suggests that the placement-in-service requirement and purchase requirements are met. Further, under the section 197(f)(9) partnership regulations, the no prior use requirement generally would be met because the transaction would be recharacterized as a transfer of a separate property interest from B to A and C. However, because A and B are related, only $75 of the adjustment would qualify for bonus depreciation under the section 197(f)(9) regulations, all of which would be allocated to C.[268]




It is unclear whether A could disregard reg. section 1.168(k)-1(f)(9) in the context of a partnership distribution. When the government announced the intent behind reg. section 1.168(k)-1(f)(9), it offered the example of a section 734(b) adjustment as having "no correlation to the taxpayer's cost of the property."[269] Treasury and the IRS cited section 755 for that proposition, suggesting that their concern was the manner in which section 734(b) adjustments are allocated. Although a section 743(b) adjustment is allocated in accordance with gain from a hypothetical sale of the assets,[270] a section 734(b) adjustment is allocated to other property in the same class.[271] Therefore, that allocation admittedly may not reflect the cost of the partners' investment in partnership property.

Some section 734(b) adjustments also arguably run up against the requirement in section 179(d)(3) that the basis of the property acquired not be determined by reference to the basis of other property held at any time by the person acquiring the property. When a section 734(b) adjustment includes any disappearing basis — that is, the excess of the adjusted basis of the distributed property before the distribution over the basis of the distributed property to the

[266] For purposes of this example, we assume that less than all of the built-in gain is attributable to section 1245 recapture, such that some portion of the property can be treated as a capital gain asset. *See* reg. section 1.755-1(c)(1)(ii).

[267] Reg. section 1.734-1(e)(1).

[268] *See* reg. section 1.197-2(k), Example 31(ii).

[269] *See* T.D. 9283, 71 F.R. at 51736.

[270] *See* reg. section 1.755-1(b)(2)(i).

[271] *See* reg. section 1.755-1(c)(1)(i).



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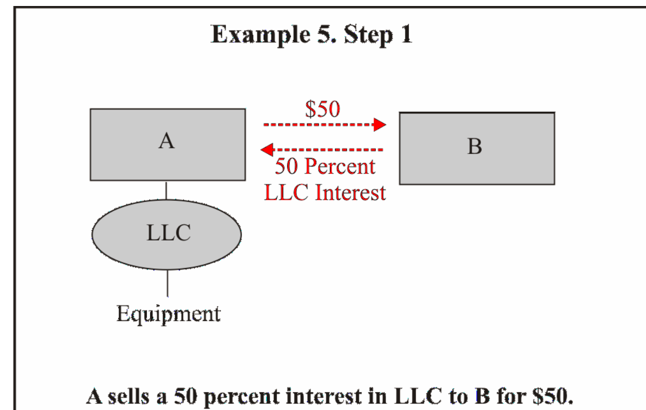
distributee after the distribution — the partnership must indeed refer to the basis of other property (namely, the distributed property) to determine the amount of the adjustment.[272] Although the section 734 regulations treat all section 734(b) basis adjustments as newly purchased recovery property, it is unclear whether this regulatory instruction applies in testing the requirement of section 179(d)(3).[273]

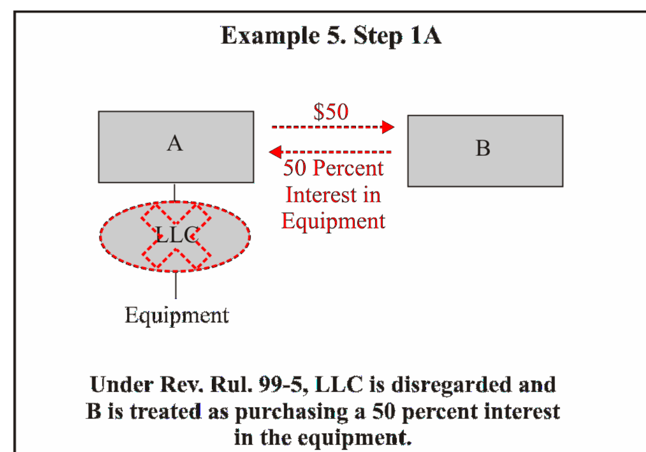
Nevertheless, good arguments exist for revisiting the application of reg. section 1.168(k)-1(f)(9) to section 734(b) adjustments. As the prior discussion indicates, section 197(f)(9), a helpful analogue, generally allows amortization of section 734(b) adjustments for section 197(f)(9) intangibles. Also, a partnership distribution undoubtedly constitutes a form of investment — namely, an investment by the continuing partners in the remaining partnership property. If Congress meant to boost investment broadly, transactions that produce additional basis in tangible property generally should be encouraged even if not strictly correlative with cost.

**Example 5:** *Purchases of interests in disregarded entities.* A owns a disregarded limited liability company with equipment that has an FMV of $100 and a basis of $0. A sells a 50 percent interest in the LLC to B for $50. A and B are not related.

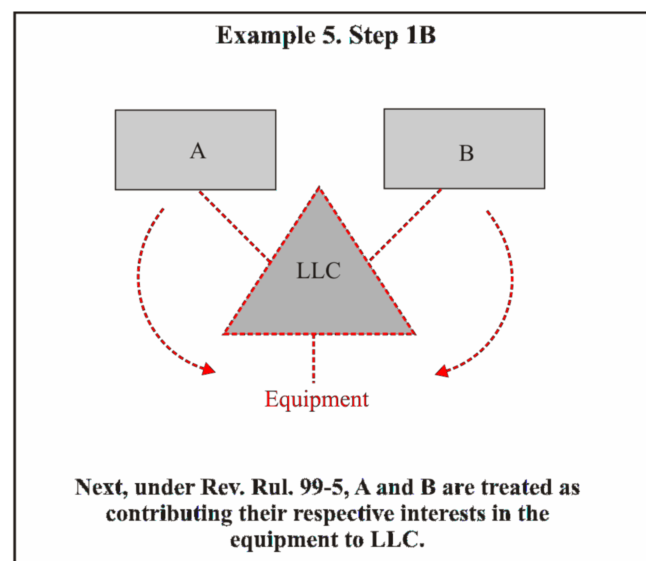
Rev. Rul. 99-5 treats the purchase of a portion of the interests in a disregarded LLC by a person other than its owner as the purchase of a 50 percent interest in each of the LLC's assets, followed immediately thereafter by A and B contributing their respective interests in those assets to a partnership in exchange for ownership in the partnership. Under section 721(a), A and B do not recognize gain or loss as a result of the transaction, and under section 723, the basis of the property treated as contributed is the adjusted basis of that property immediately after the deemed sale to B.



A sells a 50 percent interest in LLC to B for $50.



Under Rev. Rul. 99-5, LLC is disregarded and B is treated as purchasing a 50 percent interest in the equipment.



Next, under Rev. Rul. 99-5, A and B are treated as contributing their respective interests in the equipment to LLC.

[272] *See* section 734(b)(1)(B).

[273] The ABA tax section suggests that a dual-track approach to bonus depreciation of section 734(b) adjustments may be appropriate. On one hand, the group recommends that a section 734(b) basis adjustment should not benefit from section 168(k), at least to the extent determined under section 734(b)(1)(B) (*i.e.*, for disappearing basis). On the other hand, the tax section contends that it may be appropriate to apply section 168(k) to a section 734(b) basis adjustment to the extent determined under section 734(b)(1)(A), *i.e.*, for gain recognized by the distributee partner. *See* ABA report, supra note 203, at 15 n.20. In Example 4 above, the section 734(b) adjustment arises because B recognizes $150 of gain on the distribution, so the partnership may still benefit from section 168(k), even under the tax section's approach.



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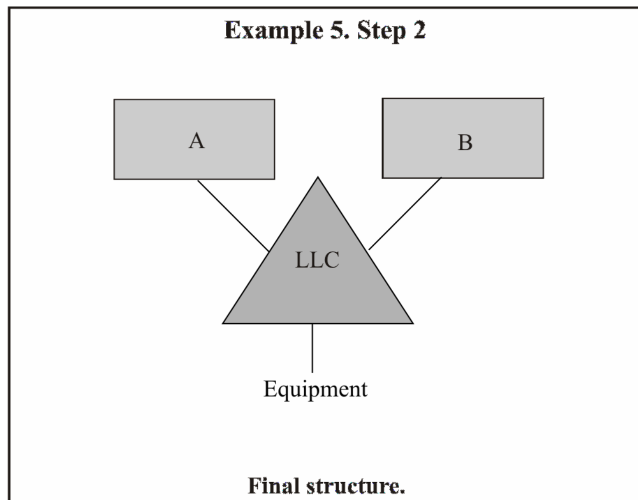


Final structure.

Can the LLC claim bonus depreciation? Because contributions to a partnership do not qualify as a purchase under section 179(d)(3), it does not appear that B's deemed contribution of the equipment to the LLC suffices to obtain bonus depreciation treatment.[274]

Can B claim bonus depreciation? The answer is unclear. Section 168(i)(7) contains the so-called "step into the shoes" rule, which treats a transferee as the transferor for all purposes of section 168 in some nonrecognition transactions, including section 721 contributions. Thus, under section 168(i)(7), it arguably is necessary to test bonus depreciation eligibility by reference to B, and in this light, the LLC would in fact be eligible for bonus depreciation to the extent of B's interest because B is unrelated to A, and B acquired its interest in the LLC by purchase.

While awarding B bonus depreciation is sensible as a policy matter and consistent with Congress's goal of awarding investment in tangible property, the approach may be inconsistent with the current section 168(k) regulations. Those regulations generally deny bonus depreciation when property is placed in service and then disposed of in the same year.[275] Although bonus depreciation may be allowed if the taxpayer disposes of the property in a section 168(i)(7) transaction (allocated between the transferor and transferee monthly), the regulations require that the transferor place the equipment in service before the transfer.[276] Rev. Rul. 99-5 deems the purchaser of an interest in a disregarded entity to acquire the relevant property presumably for the sole purpose of contributing it to the partnership, rather than using the property in the purchaser's trade or business.[277] Thus, it is not clear that B could have placed the equipment into service before contributing it to the LLC and have met the requirements of the current regulations. Accordingly, in furtherance of section 168(k)'s investment-promoting goals, the government may wish to consider updating the section 168(k) regulations to allow purchases and contributions in the same year when the property in question is not technically placed in service by the purchasing partner before contribution.[278]

**Example 6:** *Remedial allocations under section 704(c).* On January 1, 2018, L and M form partnership LM, and each receives a 50 percent interest. The partnership agreement requires section 704(c) allocations to be made using the remedial method. L contributes equipment with an adjusted tax basis of $4,000 and an FMV of $10,000. The equipment is 10-year property (assumed to be depreciable under the straight-line method for the sake of simplicity) and has four years remaining on its recovery period. M contributes $10,000. Except for any depreciation deductions, LM's expenses equal its income in each year.

[274] *See* reg. section 1.179-4(c)(1)(iv).

[275] *See* reg. section 1.168(k)-1(f)(1)(i).

[276] *See* reg. section 1.168(k)-1(f)(1)(iii) and (iv), Example 2; *see also* section 168(i)(7)(B)(i).

[277] *See* reg. section 1.167(a)-11(e)(1)(i) ("Property is first placed in service when first placed in a condition or state of readiness and availability for a specifically assigned function."). The outcome may be different if the purchaser actually purchased equipment and placed it in service before contribution to the partnership in the same year. The purchaser could be entitled to bonus depreciation for the equipment, and under the pre-TCJA bonus depreciation regulations, the partnership is considered to step into the shoes of the purchaser and would receive a portion of the deduction. *See* reg. section 1.168(k)-1(f)(1)(iii).

[278] Even without specific guidance, analogous authority suggests that the section 168(k) regulations would permit the partnership to depreciate basis in the contributed property to the extent gain was recognized on the transfer of the property to the partnership. The step-into-the-shoes rule does not apply to the extent of any gain recognized on the transfer. *See* section 168(i)(7)(A); and S. Rep. No. 99-313, at 105 (1986) (Conf. Rep.) ("To the extent the transferee's basis exceeds the property's basis in the hands of the transferor (*e.g.*, because the transferor recognized gain in the transaction), the transferee depreciates the excess under the bill's general rules."). Similar reasoning may apply to treat property contributed to a partnership as purchased under section 179(d)(2) to the extent the contributing partner recognizes gain.



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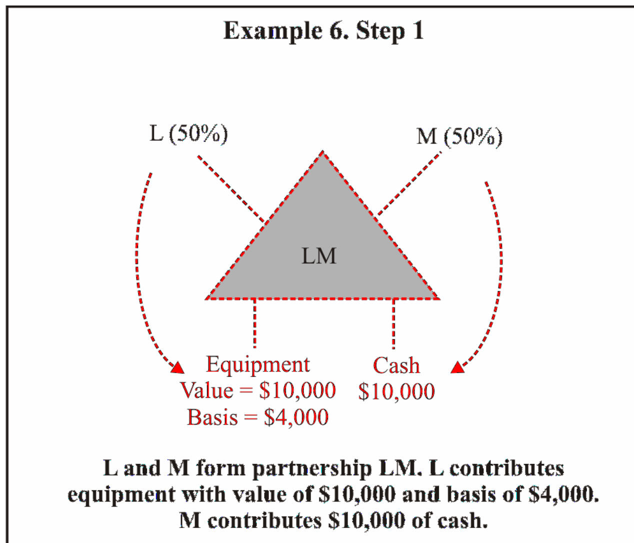
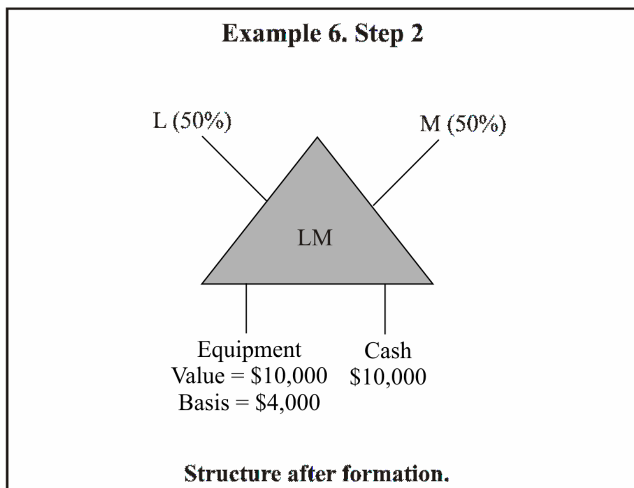



L and M form partnership LM. L contributes equipment with value of $10,000 and basis of $4,000. M contributes $10,000 of cash.




Structure after formation.

In years 1 through 4, LM would compute depreciation as follows: The equipment would be bifurcated into two assets, the first with book value deemed equal to tax basis ($4,000), and the second with book value equal to the remainder ($6,000). Book depreciation for the first deemed asset would be $1,000 per year, consistent with the preexisting depreciation method and recovery period for the equipment for tax purposes.

The treatment of the excess book basis asset is unclear, however. Reg. section 1.704-3(d)(2) provides that the book basis of the excess book basis asset "is recovered using any recovery period and depreciation (or other cost recovery) method (including first-year conventions) available to the partnership for newly purchased property (of the same type as the contributed property) that is placed in service at the time of contribution." Absent an election out of bonus depreciation, bonus depreciation arguably is the only cost recovery method available for newly purchased property.[279] Thus, the excess book basis asset would be depreciated fully in the first year for book purposes, such that total book depreciation for the first year would be $7,000, split $3,500 each. After the first year, the allocations would result in capital accounts as follows, including remedial allocations because of the disparity between book and tax depreciation under the ceiling rule (see table).

The consequence of applying bonus depreciation for book purposes to the excess book basis asset is that the contributing partner (L) is allocated a significant amount of the built-in gain in the first year. Although this rule ensures equitable treatment for the noncontributing partner (M), whose tax deductions match the book allocations of depreciation, the income allocation to L is a hefty price to pay and arguably inconsistent with the policy under section 721(a) of permitting gain deferral upon contributions to partnerships.[280]

To be sure, reg. section 1.704-3(d)(2) only requires recovery of the excess book basis asset for tax purposes using any "recovery period and depreciation (or other cost recovery) method . . . available." As a technical matter, however, it is unclear whether bonus depreciation is a recovery period or depreciation method for purposes of this regulation. Section 168(k) provides for an "allowance" in addition to the depreciation deductions under section 167(a) determined by using the applicable depreciation method and recovery period. Section 167 does not directly

[279] An election out of bonus depreciation for a tax year is made by the partnership. *Cf.* reg. section 1.168(k)-1(e)(3)(ii). It is not entirely clear, however, that an election could avoid the issue. Reg. section 1.704-3(d)(2) asks whether a depreciation method is "available" to the partnership. Technically, bonus depreciation may be available even if a partnership elects out, because it would merely be by virtue of the partnership's election that bonus depreciation does not apply. The government may wish to consider this issue in any guidance it publishes on section 168(k) and related topics.

[280] New regulations that address overriding section 721(a) for transfers to partnerships with related foreign partners contain a procedure for deferring gain (*i.e.*, the gain deferral method), which requires that the partnership elect the remedial allocation method. *See* T.D. 9814. It would be ironic if the remedial allocation method would result in gain deferral under the new regulations but acceleration of income in the bonus depreciation context.



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| | L | | M | |
|---|---|---|---|---|
| Book | Tax | Book | Tax | |
| Initial contribution | $10,000 | $4,000 | $10,000 | $10,000 |
| Depreciation | -$3,500 | | -$3,500 | -$1,000 |
| Remedial allocations | | $2,500 | | -$2,500 |
| | $6,500 | $6,500 | $6,500 | $6,500 |

mention bonus depreciation. The government may wish to consider clarifying this point, such as by making a regulatory statement that bonus depreciation is not a depreciation method for purposes of reg. section 1.704-3(d)(2) or by allowing taxpayers to elect not to apply bonus depreciation when computing remedial allocations.[281]

At the same time, however, something of the opposite issue arises under the section 743 regulations. Reg. section 1.743-1(j)(4)(i)(B)(2) requires recovery of any section 743(b) basis adjustment attributable to section 704(c) built-in gain over the "remaining recovery period for the partnership's excess book basis in the property." Accordingly, if the partnership's excess book basis assets are recovered over longer recovery periods, the purchaser would be denied bonus depreciation simply because of the partnership's choice of section 704(c) allocation method. It may therefore be appropriate for the government to revise reg. section 1.743-1(j)(4)(i)(B)(2) to provide that bonus depreciation is available for a section 743(b) adjustment, despite the recovery of the excess book basis assets over a longer period.[282]

## VII. Conclusion

The TCJA's amendments to sections 168(k) and 179 represent the latest push in decades of movement toward more accelerated depreciation under U.S. tax law. As enacted, these changes stand to benefit taxpayers significantly in the form of simpler and more accelerated cost recovery and are likely to result in a renewed focus on depreciation in many transactions. The degree to which the TCJA's changes to sections 168(k) and 179 will result in a clear incentive to capital investment remains to be seen.

As this report describes, equally interesting for practitioners are the various applications of the new expensing provisions under the tax law. Because of the changes in section 168(k)'s substantive requirements, this statute, in particular, raises a variety of interpretative issues throughout the code, especially the need to reinterpret the statute's interaction with other provisions in light of recent changes. While future guidance hopefully will resolve at least some of these issues, if the government does not provide a clear answer, taxpayers will need to consider carefully section 168(k)'s proper application. ■

[281]What if there was a revaluation of qualified property (*i.e.*, a book-up)? Under section 704(c), the revaluation generally would result in a remedial allocation to the contributing partner and an offsetting allocation of income to the noncontributing partner. Applying section 197(f)(9) principles (see *supra* note 252), the remedial allocation would be immediately deductible, as long as there were no relationship between the contributing and noncontributing partners.

[282]To be sure, this outcome would result in a timing distortion because the purchasing partner would recognize an immediate deduction while the contributing partner would recognize the offsetting income over time. However, any other result could be considered inconsistent with the policies of both section 168(k) (immediate expensing of investment) and section 721 (nonrecognition of partnership contributions).



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