March 28, 2019

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

Re: Comments on Proposed Guidance under Section 168(k) Regarding Consolidated Return Issues

Dear Commissioner Rettig:

Enclosed please find comments on the proposed guidance under Section 168(k) of the Internal Revenue Code with respect to consolidated return issues. These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Eric Solomon
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
Krishna P. Vallabhaneni, Acting Tax Legislative Counsel, Department of the Treasury
Hannah Hawkins, Deputy Tax Legislative Counsel, Department of the Treasury
Colin Campbell, Attorney-Advisor, Department of the Treasury
Hon. Michael Desmond, Chief Counsel, Internal Revenue Service
Robert Wellen, Associate Chief Counsel (Corporate), Internal Revenue Service
Lisa Fuller, Deputy Associate Chief Counsel (Corporate), Internal Revenue Service
Mark Weiss, Chief, Branch 2, Office of the Associate Chief Counsel (Corporate), Internal Revenue Service
Ken Cohen, Senior Technician Reviewer, Office of the Associate Chief Counsel (Corporate), Internal Revenue Service
Kevin Jacobs, Senior Technician Reviewer, Office of the Associate Chief Counsel (Corporate), Internal Revenue Service
Sam Trammell, Attorney, Branch 2, Office of the Associate Chief Counsel (Corporate), Internal Revenue Service
Comments on Proposed Guidance under Section 168(k) Regarding Consolidated Return Issues

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these comments was exercised by Bryan Collins, Steve Fattman, and Lulu Ma. Significant contributions were made by Bill Alexander, Larry Axelrod, Don Bakke, James Coss, Jack Cummings, Andy Dubroff, Greg Fairbanks, Nicole Field, Larry Garrett, Milt Hyman, Mark Hoffenberg, Mike Schler, Mark Silverman, David Strong, and Tom Wessel. The Comments have been reviewed by David Wheat, Council Director for the Corporate Tax and Affiliated & Related Corporations Committees, and Lisa Zarlenaga of the Section’s Committee on Government Submissions.

Although members of the Section may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: March 28, 2019
I. **EXECUTIVE SUMMARY**

These Comments are in response to Proposed Regulations issued on August 3, 2018 with respect to changes made by Public Law 115-97 (the “Act”). The Act made substantial changes in the tax rules applicable to the business activities of taxpayers, generally effective as of the 2018 tax year. We commend the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) for their commitment to provide expedited guidance, and we ask that Treasury and the Service consider the following recommendations in the finalization of the Proposed Regulations under section 168(k) (“Proposed Regulations”).

Section 168(k) provides an additional allowance for depreciation with respect to the adjusted basis of qualified property. Before amendment by the Act, section 168(k)(2)(A)(ii) provided that qualified property means property the original use of which commenced with the taxpayer (“Original Use Requirement”).

The Act expanded the type of property subject to section 168(k). Specifically, section 168(k)(2)(A)(ii), as amended by the Act, provides that qualified property means property meeting the Original Use Requirement or property the acquisition of which by the taxpayer meets the requirements of section 168(k)(2)(E)(ii) (i.e., “used property”).

As part of this expansion of section 168(k), the Act placed restrictions on and added requirements regarding what acquisitions of used property can qualify for the additional allowance for depreciation under section 168(k). Section 168(k)(2)(E)(ii), as amended by the Act, provides that an acquisition of property meets these requirements if – (I) such property was not used by the taxpayer at any time prior to such acquisition (the “No Prior Use Requirement”), and (II) the acquisition of such property meets the requirements of paragraphs (2)(A), (2)(B), (2)(C), and (3) of section 179(d) (the “Unrelated Purchase Requirement”).

The Proposed Regulations address a number of issues raised by sections 168(k) and 179(d). As discussed in detail below, we believe that clarification or revision of the Proposed Regulations would further assist taxpayers applying these provisions. Specifically, we respectfully request that Treasury and the Service provide additional guidance under section 168(k) to address the following important issues:

1. We recommend that final Regulations (or other guidance) provide a safe harbor with respect to the number of years a consolidated group must look back to determine if the consolidated group previously had a depreciable interest in the acquired property and therefore the acquisition violated the No

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2. Unless otherwise indicated, all “section” references are to the Internal Revenue Code of 1986, as amended (the “Code”), and all “Reg.” references are to the Treasury regulations promulgated under the Code, all as in effect on the date of these Comments.

Prior Use Requirement. We would recommend that the look back period not exceed 36 months.

2. We recommend that final Regulations provide a definition of “predecessor” in Proposed Regulation section 1.168(k)-2(b)(3)(iii)(A)(1), which in the case of a corporation limits the scope of such term to transactions described in section 381.\(^4\)

3. We recommend that Treasury and the Service consider deleting Proposed Regulation section 1.168(k)-2(b)(3)(iii)(B)(3)(iii) given that it appears to be subsumed within the more general provision in Proposed Regulation section 1.168(k)-2(b)(3)(iii)(C). If retained, we recommend that final Regulations clarify whether the three references in Regulation section 1.168(k)-2(b)(3)(iii)(B)(3)(iii) to “a consolidated group” refer to the same consolidated group or include any consolidated group.

4. We recommend that final Regulations clarify the treatment of a member that departs a consolidated group (the “departing member”) where another member of that group has a direct depreciable interest in property. Specifically, we recommend that final Regulations clarify that such departing member is no longer treated as having a depreciable interest in such property once it is no longer a member of that consolidated group.

5. We recommend that final Regulations clarify the references to “the consolidated group” in Proposed Regulation section 1.168(k)-2(b)(3)(iii)(B)(3)(i). In particular, we recommend that the final Regulations confirm that the group no longer has a depreciable interest in property if the consolidated group terminates, including as a result of all of its members joining another consolidated group (e.g., an acquisition of the stock or assets of the common parent by another corporation) or as a result of a reverse acquisition as defined in Regulation section 1.1502-75(d)(3).

6. We recommend that Example 21 of the Proposed Regulations be expanded to explain the amount, timing, and location of the deduction under section 168(k).

   a. In general, we recommend that final Regulations clarify in Example 21 that Proposed Regulation section 1.168(k)-2(b)(3)(iii)(C) (and Proposed Regulation section 1.168(k)-2(b)(3)(iii)(B)(3)(iii) if it is retained) apply for purposes of the No Prior Use Requirement and the Unrelated Purchase Requirement. In addition, we recommend that the section 168(k) deduction in Example 21 be required to be taken on the buying member’s

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\(^4\) As discussed in the recommendations below, we believe that a broader definition of “predecessor,” for example to include carryover basis transactions such as tax-free transfers under section 351, should not be adopted.
separate return after it leaves the selling consolidated group and that such deduction not be limited by section 168(i)(7)(B)(ii). In other words, we recommend that F Corporation’s acquisition of property from G Corporation not be treated as an intercompany transaction.

b. In addition, we recommend that Treasury and the Service issue new proposed regulations that provide guidance regarding how such deduction (and related items) are allocated to the buying member’s separate return, particularly if the buying member does not leave the group immediately upon acquiring the qualified property from the selling member.

7. We recommend that final Regulations address the amount, timing, and location of deductions under section 168(k) for a fact pattern involving a taxable stock transfer within a consolidated group that is treated as a qualified stock purchase (“QSP”) and a section 338(h)(10) election is made for such QSP, including where such transaction is followed by the separation of the target corporation from the group in a section 355 spin-off. In general, we recommend that final Regulations provide that the new target take the full section 168(k) deduction on its separate return.

8. We recommend that final Regulations address the amount, timing, and location of deductions under section 168(k) for fact patterns involving a qualified stock disposition (“QSD”) where a section 336(e) election is made, which results from either a section 301 distribution of the stock of a group member or a distribution of the stock of a group member to which section 355(d) or (e) applies. In general, we recommend that final Regulations provide that the distributed corporation take the full section 168(k) deduction on its separate return.
II. DISCUSSION

A. Background

As described above, pursuant to section 168(k)(2)(A)(ii) and 168(k)(2)(E)(ii), the acquisition of used property is eligible for the additional first year depreciation deduction only if such acquisition meets the No Prior Use Requirement and the Unrelated Purchase Requirement.5

The No Prior Use Requirement does not refer to any other Code section, but regarding the Unrelated Purchase Requirement, section 179(d)(2) and section 179(d)(3) provide additional requirements with respect to an acquisition of property. Section 179(d)(2) contains the following three requirements – (A) the property is not acquired from a person whose relationship to the person acquiring it would result in the disallowance of losses under sections 267 or 707(b),6 (B) the property is not acquired by one component member of a controlled group from another component member of the same controlled group, and (C) the basis of the property in the hands of the person acquiring it is not determined (i) in whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired (e.g., pursuant to section 351), or (ii) under section 1014(a) (relating to property acquired from a decedent). Finally, section 179(d)(3) provides that the basis of such property is not determined by reference to the basis of other property held at any time by the person acquiring such property (e.g., pursuant to section 1031).7

Special considerations are relevant to the application of these requirements where the acquirer is a corporation that is a member of a consolidated group. Additional provisions in the Proposed Regulations are discussed below where relevant to specific recommendations.

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5 Additional criteria for property to be treated as qualified property for purposes of section 168(k) are listed in section 168(k)(2)(A)(i) and (iii). In particular, section 168(k)(2)(A)(i) provides that the term “qualified property” includes: (I) property that has a recovery period of 20 years or less, (II) computer software (as defined in section 167(f)(1)(B)) for which a deduction is allowable under section 167(a) without regard to section 168(k), (III) water utility property, or (IV) qualified improvement property. Section 168(k)(2)(A)(iii) provides that the property must be placed in service by the taxpayer before January 1, 2027 (January 1, 2020 prior to amendment by the Act) to be qualified property.

6 In applying section 267(b) and (c) for purposes of section 179, paragraph (4) of section 267(c) shall be treated as providing that the family of an individual include only his spouse, ancestors, and lineal descendants.

7 Property acquired by the “new target” as a result of a section 338 election with respect to the acquisition of the target qualifies as acquired by purchase under section 172(d)(2) and (3). Reg. § 1.179-4(c)(2); see also Prop. Reg. § 1.179-4(c)(2) (also providing that property acquired by a new target as a result of a §336(e) election is acquired by purchase).
B. Comments


a. Background

The Proposed Regulations would provide that otherwise eligible property is treated as previously used by the taxpayer (i.e., the acquisition does not meet the No Prior Use Requirement) if the taxpayer or its “predecessor” had a depreciable interest in the property at any time before the acquisition, whether or not the taxpayer or a predecessor claimed depreciation deductions with respect to the property. The Proposed Regulations do not provide a definition of “predecessor” for this purpose.

With respect to the application of the No Prior Use Requirement to a consolidated group, Proposed Regulation section 1.168(k)-2(b)(3)(iii)(B)(3)(i) would provide that if a member of a consolidated group acquires depreciable property in which the consolidated group had a depreciable interest at any time prior to the member’s acquisition of the property, the member will be treated as having a depreciable interest in the property prior to the acquisition and, therefore, the acquisition would not be eligible for additional first year depreciation under section 168(k). Furthermore, for this purpose, the Proposed Regulations would provide that a consolidated group will be treated as having a depreciable interest in property during the time any current or previous member of the group had a depreciable interest in the property while a member of the group.

Example 20. In Example 20, the following facts are provided:

Parent owns all of the stock of D Corporation and E Corporation. Parent, D Corporation, and E Corporation are all members of the Parent consolidated group. D Corporation has a depreciable interest in Equipment #2. No other members of the Parent consolidated group ever had a depreciable interest in Equipment #2. During 2018, D Corporation sells Equipment #2 to BA, a person not related, within the meaning of section 179(d)(2)(A) or (B) and Regulation section 1.179-4(c), to any member of the Parent consolidated group. In an unrelated transaction during 2019, E Corporation acquires Equipment #2 from BA or another person not related to any member of the Parent consolidated group within the meaning of section 179(d)(2)(A) or (B) and Regulation section 1.179-4(c).

10 This is a somewhat curious statement given that pursuant to Proposed Regulation section 1.168(k)-2(b)(3)(iii)(B)(3)(i) (second sentence), all members of a consolidated group appear to be treated as having a depreciable interest in property that is owned by any other member of the consolidated group and the example later concludes to the contrary when it concludes that E Corporation’s acquisition of Equipment #2 fails the No Prior Use Requirement.
In this situation, the Proposed Regulations conclude that E Corporation is treated as previously having a depreciable interest in Equipment #2 because E Corporation is a member of the Parent consolidated group, and D Corporation, while a member of the Parent consolidated group, had a depreciable interest in Equipment #2. As a result, E Corporation’s acquisition of Equipment #2 would not satisfy the No Prior Use Requirement and therefore would not be eligible for additional first year depreciation. This would be the case no matter when any member of the consolidated group had the prior depreciable interest in the acquired property (e.g., 5, 10, or 20 years prior to the acquisition in question). Importantly, the Proposed Regulations would also conclude that the results would be the same if D Corporation had ceased to be a member of the Parent consolidated group prior to E Corporation’s acquisition of Equipment #2.12

Example 23. In Example 23, the following facts are provided:

J Corporation, K Corporation, and L Corporation are unrelated parties within the meaning of section 179(d)(2)(A) or (B) and § 1.179-4(c). None of J Corporation, K Corporation, and L Corporation is a member of a consolidated group. J Corporation has a depreciable interest in Equipment #5. During 2018, J Corporation sells Equipment #5 to K Corporation. During 2020, J Corporation merges into L Corporation in a transaction described in section 368(a)(1)(A). In 2021, L Corporation acquires Equipment #5 from K Corporation.13

The example concludes that, because J Corporation is the predecessor of L Corporation and J Corporation previously had a depreciable interest in Equipment #5, L Corporation’s acquisition of Equipment #5 does not qualify for additional first year depreciation.14

In the Preamble to the Proposed Regulations, Treasury and the Service requested comments on whether a safe harbor should be provided on how many taxable years a taxpayer, its predecessor, or a consolidated group must look back to determine if the taxpayer, its predecessor, or the consolidated group previously had a depreciable interest in the property.15

b. Recommendation 1

We recommend that final guidance under section 168(k), whether by revenue procedure or otherwise, provide a safe harbor with respect to the number of years a consolidated group must look back to determine if the consolidated group previously had a depreciable interest in the property. Without such a safe harbor, the obligation to look back into the entire history of the consolidated group would impose an extraordinary burden on consolidated groups, which would be disproportionate to the policy restricting eligibility for additional first year depreciation to property acquired by a taxpayer that did not have a prior depreciable interest in the property. This would be particularly

12 Id.
14 Id.
burdensome with respect to former members of the consolidated group, since such information would be unlikely to continue to be available to the consolidated group following its departure from the group. Furthermore, given the size and complexity of consolidated groups and the frequency of members joining and leaving, this burden would be significantly higher for consolidated groups than many other taxpayers. Finally, the ownership of certain types of fungible property (e.g., computers, desks, equipment) are not readily traceable, making an unlimited look-back period particularly burdensome, if not impossible, to apply.\textsuperscript{16}

With respect to the specific time frame for this recommended safe harbor, while we acknowledge the strong policy reasons to limit the look-back period to include only prior transactions that are part of the same plan with the acquisition in question,\textsuperscript{17} to the extent that administrability concerns dictate the use of a specific period of time, we suggest a maximum required look-back period of 36 months as an appropriate bright line period that balances the statutory prohibition on prior use and the need for an administrable rule. This time period is analogous to the 3-year testing period under section 382 with respect to the determination of whether a loss corporation has undergone an ownership change and, in our view, is an appropriate length of time to sufficiently protect the No Prior Use Requirement without imposing an undue administrative burden on taxpayers.\textsuperscript{18}

c. \underline{Recommendation 2}

We recommend that the final Regulations include a definition of the term “predecessor” in Proposed Regulation section 1.168(k)-2(b)(3)(iii)(A)(1). With respect to a corporation, we recommend that the definition of a predecessor be limited to transactions that are described in section 381 (e.g., section 332 liquidations and section 368 reorganizations). We note that this is consistent with the conclusion in Example 23 in the Proposed Regulations.

While it may be appropriate to define “predecessor/successor” more broadly to include the transferor and the transferee in carryover basis transfers (e.g., section 351 transactions), we believe that the rules of the Proposed Regulations with respect to consolidated groups provide sufficient protection for the No Prior Use Requirement such

\textsuperscript{16} The ownership of other types of property (e.g., airplanes, railroad cars, buildings, vehicles) are readily traceable, but would still require recordkeeping, which as mentioned, may be particularly burdensome with respect to former members of the group.

\textsuperscript{17} See comments of the New York State Bar Association, Report No. 1405 (Nov. 2, 2018).

\textsuperscript{18} At most, we would recommend a 60-month period, analogous to Regulation section 1.1502-96(a)(2)(ii). That regulation provides that if a loss corporation with a net unrealized loss in its assets (“NUBIL”) joins a consolidated group in a transaction that does not result in an ownership change under section 382(g), the consolidated group is required to separately track such member’s NUBIL for 60 months to determine whether there is a change of ownership under section 382(g) with respect to such NUBIL. Following this 60-month period, the consolidated group is permitted under this provision to cease the separate tracking of such member’s NUBIL, effectively folding its NUBIL into the consolidated group’s determination of its group-wide net unrealized built-in gain or loss for section 382(h) purposes. This “end of separate tracking” provision essentially acknowledges that the administrative burden of separately tracking the joining member’s NUBIL for more than 60 months outweighs the relevant policies implicit in section 382(h).
that a broader definition of predecessor/successor beyond the traditional section 381 definition is unnecessary.

2. **Interaction of Proposed Regulation section 1.168(k)-2(b)(3)(iii)(B)(3)(i), (ii), and (iii) and (b)(3)(iii)(C) – Treatment of Series of Related Transactions by Members of a Consolidated Group**

   a. **Background**

   The Proposed Regulations would provide special rules that affect the treatment of a consolidated group with respect to an acquisition of property that is part of a “series of related transactions.” One of these special rules would have general application (i.e., would be applicable to all taxpayers) for purposes of both the No Prior Use Requirement and the Unrelated Purchase Requirement, while the other of would be specific to consolidated groups and apply only for purposes of the No Prior Use Requirement.

   Proposed Regulation section 1.168(k)-2(b)(3)(iii)(C) would provide that for all taxpayers and for purposes of both the No Prior Use Requirement and the Unrelated Purchase Requirement, in the case of a series of related transactions, the transferred property will be treated as directly transferred from the original transferor to the ultimate transferee, and the relation between the original transferor and the ultimate transferee would be tested immediately after the last transaction in the series.

   Proposed Regulation section 1.168(k)-2(b)(3)(iii)(B)(3)(ii) would provide that in determining whether property meets the requirements of Proposed Regulation section 1.168(k)-2(b)(3)(iii)(A)(1) (i.e., the No Prior Use Requirement), if a series of related transactions that includes one or more transactions in which property is acquired by a member of a consolidated group and one or more transactions in which a corporation that had a depreciable interest in the property becomes a member of that group, the member that acquires the property will be treated as having a depreciable interest in the property prior to the time of its acquisition (i.e., the acquisition will have violated the No Prior Use Requirement).

   In addition, Proposed Regulation section 1.168(k)-2(b)(3)(iii)(B)(3)(iii) would provide that, in the event the acquisition of otherwise eligible property is part of a series of related transactions and such series involves a member of a consolidated group acquiring the otherwise eligible property and also ceasing to be a member of a consolidated group, then whether the acquirer is treated as having a prior depreciable interest in the acquired property would be tested immediately after the last transaction in the series (i.e., the acquisition will satisfy the No Prior Use Requirement).

   In this respect, the Preamble includes the statement that Treasury and the Service believe that the additional first year depreciation deduction should not be allowed when, as part of a series of related transactions, one or more members of a consolidated group acquire both the stock of a corporation that previously had a depreciable interest in the property and the property itself. To illustrate this concern, the Preamble describes an example in which a corporation (the selling corporation) has a direct depreciable interest in property, sells it to an unrelated party, and as part of a series of related transactions, a
member of a consolidated group, unrelated to the selling corporation, acquires the property and the stock of the selling corporation. The stated rationale for this view is that, in substance, the series of transactions is the same as if the selling corporation reacquired the property and then transferred it to another member of its consolidated group, in which case the acquisition would not qualify for additional first year depreciation. Furthermore, the Preamble states that Treasury and the Service believe that the ordering of steps or the use of an unrelated intermediary in a series of related transactions should not control regardless of whether such transactions involve consolidated groups. Thus, the Proposed Regulations would provide that in the case of a series of related transactions, the transferred property will be treated as directly transferred from the original transferor to the ultimate transferee, and the relation between the original transferor and the ultimate transferee would be tested immediately after the last transaction in the series.

Example 21. In Example 21, the following facts are provided:

Parent owns all of the stock of F Corporation and G Corporation. Parent, F Corporation, and G Corporation are all members of the Parent consolidated group. G Corporation has a depreciable interest in Equipment #3. No other members of the Parent consolidated group ever had a depreciable interest in Equipment #3. X Corporation is the common parent of a consolidated group and is not related, within the meaning of section 179(d)(2)(A) or (B) and Regulation section 1.179-4(c), to any member of the Parent consolidated group. No member of the X consolidated group ever had a depreciable interest in Equipment #3. In a series of related transactions, G Corporation sells Equipment #3 to F Corporation, and Parent sells all of the stock of F Corporation to X Corporation.

In this situation, notwithstanding that the Proposed Regulations would appear to provide that F Corporation is treated as having a prior depreciable interest in Equipment #3 since it was a member of the Parent consolidated group along with G Corporation at the time it acquired Equipment #3 from G Corporation, F Corporation is eligible for additional first year depreciation with respect to Equipment #3. This is the case because, pursuant to Proposed Regulation section 1.168(k)-2(b)(3)(iii)(B)(3)(i), the series of related transactions includes the acquisition of Equipment #3 and a transaction in which F Corporation, the transferee of the property, leaves the Parent consolidated group and joins the X consolidated group. Accordingly, the above-referenced provision would provide

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20 Id.
21 Id.
22 Prop. Reg. §1.168(k)-2(b)(3)(iii)(C). As discussed below, we believe that final Regulations should clarify that this recast applies not only for purposes of section 168(k) but also for other provisions applying to the same transaction.
23 See supra footnote 10.
that the time to test whether F Corporation had a prior depreciable interest in the acquired property is immediately after the last transaction in the series (i.e., after the sale of the F Corporation stock to X Corporation). At such time, F Corporation is not a member of the Parent consolidated group and, therefore, after the last transaction of the series, it appears that F Corporation is not treated as previously having a depreciable interest in Equipment #3 by virtue of G Corporation’s depreciable interest in Equipment #3.\textsuperscript{25}

In addition, while not referenced in the example, Proposed Regulation section 1.168(k)-2(b)(3)(iii)(C), which applies to all taxpayers, would appear to provide for the same result, but also provide that for purposes of the Unrelated Purchase Requirement, the relation between the original transferor and the ultimate transferee is tested immediately after the last transaction in the series.\textsuperscript{26}

\textbf{b. Recommendation 3}

We recommend that Treasury and the Service consider removing paragraph (iii) from Proposed Regulation section 1.168(k)-2(b)(3)(iii)(B)(3) as it is duplicative of the more generally applicable “series of related transactions” rule in Proposed Regulation section 1.168(k)-2(b)(3)(iii)(C). As described above, the general provision in subparagraph (C) applies to all taxpayers and applies for purposes of the No Prior Use Requirement and the Unrelated Purchase Requirement. Furthermore, the two provisions appear to have a similar scope and effect – testing the relationship of the parties after the series of related transactions.

If the consolidated return specific provision is retained, we recommend clarification of the references to “a consolidated group” in Proposed Regulation section 1.168(k)-2(b)(3)(iii)(B)(3)(iii). In particular, there are three references to “a consolidated group” in that paragraph and it is ambiguous whether such references refer to the same consolidated group or include references to any consolidated group. For example, it is unclear whether the provision applies if, in a series of transactions, a member ceases to be a member of the selling consolidated group but becomes a member of a different consolidated group since the member continues to be a member of “a consolidated group.”

As discussed above, the Preamble suggests that Proposed Regulation section 1.168(k)-2(b)(3)(iii)(B)(3)(ii) and (iii) require a reordering of the series of steps to determine whether a member had a prior depreciable interest in a series of related

\textsuperscript{25} \textit{Id.}

\textsuperscript{26} Section (iv) of Example 21 would conclude that “because relatedness is tested after F Corporation leaves the Parent consolidated group, F Corporation and G Corporation are not related with the meaning of section 179(d)(2)(A) or (B) and Regulation section 1.179-4(c).” It is not clear why this paragraph does not conclude that the requirement of Proposed Regulation section 1.168(k)-2(b)(3)(iii)(A)(2) is satisfied, particularly since paragraph (iv) starts by stating that F Corporation and G Corporation are not related for purposes of section 179(d)(2)(A) or (B) or Regulation section 1.179-4(c). Section 179 is only relevant to Proposed Regulation section 1.168(k)-2(b)(3)(iii)(A)(2) and (A)(3). Section 179 is not relevant to the No Prior Use Requirement. \textit{Compare Examples 7, 12, and 18}, all of which cite section 179 in support of conclusions regarding the satisfaction or not of “the used property acquisition requirements of paragraph (b)(3)(iii) of this section.” The issue of relatedness and Example 21 is addressed more fully below.
transactions involving a transfer of an asset and the stock of a member. Presumably, this is solely for the purpose of applying the No Prior Use Requirement. We recommend clarifying that such a reordering does not apply more broadly.

3. **Proposed Regulation Section 1.168(k)-2(b)(3)(iii)(B)(3)(i) and (ii) – Treatment of Members of a Consolidated Group**

   a. **Background**

   Proposed Regulation section 1.168(k)-2(b)(3)(iii)(B)(3)(i) provides that: “Solely for purposes of applying paragraph (b)(3)(iii)(A)(1) of this section [relating to the No Prior Use Requirement], if a consolidated group, as defined in §1.1502-1(h), acquires depreciable property in which the consolidated group had a depreciable interest at any time prior to the member’s acquisition of the property, the member will be treated as having a depreciable interest in the property prior to the acquisition.” In addition, that paragraph further provides that, for this purpose, a “consolidated group” will be treated as having a depreciable interest in property during the time any current or previous member of “the group” had a depreciable interest in such property while a member of “the group.”

   **Example 22.** In Example 22, the following facts are provided:

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

   The example concludes that Equipment #4 is not eligible for additional first year depreciation because in a series of related transactions, H Corporation became a member of the Parent consolidated group, and I Corporation, also a member of the Parent consolidated group, acquired Equipment #4. In other words, because H Corporation previously had a depreciable interest in Equipment #4 and joined the consolidated group of which I Corporation was a member as part of the series of transactions, I Corporation is treated as having a prior depreciable interest in Equipment #4. As a result, I Corporation’s acquisition of Equipment #4 is not eligible for the additional first year depreciation deduction.

   The reference in this provision to “a corporation that had a [prior] depreciable interest in the property” is ambiguous with respect to its application to a prior member of

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

28 *Id.*
a selling consolidated group that was treated as having a prior depreciable interest in the subject property solely by virtue of being a member of the selling consolidated group. While the facts in Example 22 involve a member that had the direct depreciable interest in the property joining the acquiring group, there is no suggestion in the operative rules or in Example 22 that there is a distinction between a member of a consolidated group with a direct depreciable interest in property rather than a “deemed” interest in the property. In addition, pursuant to Proposed Regulation section 1.168(k)-2(b)(3)(iii)(B)(3)(ii) and (iii), one must look at the relationships of the corporations and the acquired asset immediately after the last transaction of the series, which would appear to result in the conclusion that the acquired property and the purchased member are both owned by the buying group after the series of transactions and the Proposed Regulations may be interpreted to treat the purchased member as having a prior depreciable interest in the acquired property.29 As a result, it appears that these two provisions together might be interpreted to lead to the result that the acquired property would not be eligible for additional first year depreciation in this situation.

On the other hand, in Example 21 of the Proposed Regulations described above, F Corporation is not treated as having a prior depreciable interest in Equipment #3 notwithstanding that, pursuant to Proposed Regulation section 1.168(k)-2(b)(3)(iii)(B)(3)(i), it was a member of the Parent group while another member of such group, G Corporation, had a depreciable interest in Equipment #3. One might infer from this example that F Corporation’s deemed depreciable interest in Equipment #3 while it was a member of the Parent group does not apply to F Corporation once it departs the Parent group as a result of the application of Proposed Regulation section 1.168(k)-2(b)(3)(iii)(B)(3)(iii) (assuming one is adopted in final guidance as recommended in Recommendation 1).

b. Recommendation 4

We recommend that final Regulations clarify the treatment of a member of a consolidated group (the “departing member”) that does not have a direct depreciable interest in the group’s depreciable property once the departing member is no longer a member of that consolidated group. In other words, we recommend a clarification that such departing member is no longer treated as having a depreciable interest in such property once it is no longer a member of that consolidated group. In particular, we submit that otherwise eligible assets acquired in a transaction in which an unrelated corporation or consolidated group acquires both assets of some members of an unrelated selling consolidated group and stock of other members of such selling consolidated group should be eligible for additional first year depreciation, as long as the acquired members did not have a direct depreciable interest in the acquired assets at any point during the look-back period.30

29 This result also would appear to be the case pursuant to Proposed Regulation section 1.168(k)-2(b)(3)(iii)(C), which applies to all taxpayers.

30 See Prop. Reg. § 1.168(k)-2(b)(3)(vi), Ex. (22) (concluding that the acquiring consolidated group was not eligible for additional first year depreciation where the acquired member had a direct depreciable interest).
c. **Recommendation 5**

We recommend that final Regulations clarify the references to “the consolidated group” in Proposed Regulation section 1.168(k)-2(b)(3)(iii)(B)(3)(i). In particular, we recommend that the final Regulations address situations in which a consolidated group terminates as a result of all of its members joining another consolidated group (e.g., an acquisition of the stock or assets of the common parent by another corporation), including as a result of a reverse acquisition as defined in Regulation section 1.1502-75(d)(3). The provision of the Proposed Regulations that treats a consolidated group as having a depreciable interest in property during the time any current or previous member of “the group” had a depreciable interest in the property while a member of “the group” suggests that if “the group” terminates, including in a transaction in which all of its members join another consolidated group, such treatment would no longer be applicable. We believe this is the way the rule should operate and recommend that the final Regulations confirm this conclusion. If Treasury and the Service believe that the group should continue for purposes of section 168(k), we suggest that the final Regulations clarify the scope of this provision in situations where the consolidated group terminates as a result of its members joining another consolidated group.

4. **Related-Party Transactions and Example 21**

a. **Background**

Although Example 21 of the Proposed Regulations helpfully answers the question of whether a sale to a member of a consolidated group satisfies the No Prior Use requirement when the buying member leaves the group as part of the series of related transactions, it does not cite or illustrate the application of Proposed Regulation section 1.168(k)-2(b)(3)(iii)(A)(2) or -2(b)(3)(iii)(C) as fully as it should. In addition, Example 21 leaves a number of questions unanswered. For example, what is the appropriate amount of the section 168(k) deduction? What is the appropriate timing and location of the section 168(k) deduction?

As noted above, the Unrelated Purchase Requirement prevents taxpayers from qualifying for full expensing under section 168(k) if the acquisition of the property consists of a transfer between persons related under section 267 or section 707(b) or component members of the same controlled group or if the transfer is a transferred basis transaction. The Proposed Regulations generally provide that, for purposes of the No Prior Use Requirement and the Unrelated Purchase Requirement, a series of related transactions will be tested immediately after the last transaction in the series.

Regulation section 1.1502-13 governs the treatment of intercompany transactions within a consolidated group. For this purpose, an intercompany transaction is defined as “a transaction between corporations that are members of the same consolidated group

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31 See Reg. § 1.1502-13(ji)(5).

immediately after the transaction.\textsuperscript{33} The intercompany transaction is treated as actually occurring, but under the matching rule, the selling member’s intercompany items are taken into account to reflect the difference between the buying member’s corresponding item taken into account under its method of accounting and the recomputed corresponding item that would be taken into account if the selling and buying member were divisions of a single corporation.\textsuperscript{34} Under the acceleration rule, the selling member’s intercompany items and the buying member’s corresponding items are taken into account to the extent they cannot be taken into account to produce the effect of treating the selling and buying member as divisions of a single corporation (\textit{e.g.}, the buying member leaves the group).\textsuperscript{35}

Section 168(i)(7) provides that, if property is transferred between members of the same consolidated group, the transferee shall be treated as the transferor for purposes of computing the depreciation deduction determined under section 168 with respect to so much of the basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor. In other words, the transferee “steps into the shoes of the transferor” for section 168 purposes with respect to the carryover portion of the transferee’s basis in the property, and depreciates its additional basis as new property.

Importantly, neither the operative rules in the Proposed Regulations nor Example 21 directly address the application of the definition of component member of a controlled group or the application of Regulation section 1.1502-13 or section 168(i)(7) to a series of related transactions similar to Example 21. The Preamble and operative rules in the Proposed Regulations suggest that Treasury and the Service believe that depreciable property acquired by a member of a consolidated group in a transaction in which the acquiring member ceases to be a member of the group would be eligible for additional first year depreciation.\textsuperscript{36} Although Example 21 illustrates that sales between members of a group will not necessarily be treated as sales between related parties for purposes of Proposed Regulation 1.168(k)-2(b)(3), if the Proposed Regulations were finalized without modification, the sale from G Corporation to F Corporation in Example 21 would generally constitute an intercompany transaction to which section 168(i)(7) would apply.\textsuperscript{37} As a result, F Corporation’s purchased depreciable assets generally would be bifurcated into a portion in which there is a carryover of basis from the transferor and a portion in which there is a purchased basis.\textsuperscript{38} In addition, the intercompany gain and the section 168(k) deduction would be on the Parent group’s return.

\textsuperscript{33} Reg. § 1.1502-13(b)(1)(i).
\textsuperscript{34} Reg. § 1.1502-13(b)(4), (c)(2).
\textsuperscript{35} Reg. § 1.1502-13(d).
\textsuperscript{37} As discussed below, this is true even in the context of deemed asset transfers under section 338(h)(10). \textit{See}, \textit{e.g.}, P.L.R. 201702035 (Feb. 1, 2016); P.L.R. 201047016 (Aug. 19, 2010). While the PLRs involve the initial deferral of the gain/loss recognized on the intercompany transaction, typically such gain/loss is immediately accelerated on the departure of the acquiring member from the consolidated group. Reg. § 1.1502-13(d).
\textsuperscript{38} \textit{Cf.} Reg. § 1.1502-13(c)(7)(ii), Ex. (4) (applying section 168(i)(7) to an intercompany sale).
To illustrate the consequences under the Proposed Regulations and the existing rules governing consolidated groups, it is helpful to add some facts to Example 21. Assume that the Parent consolidated group uses a calendar year. G purchased Equipment #3 for $100, has an adjusted basis of $80 in Equipment #3, and sells Equipment #3 to F for $130 on January 1 of Year 3 of Equipment #3’s 10-year recovery period. The acquisition of F stock by unrelated X (the “External Sale”) occurs on April 1 of Year 3.

Under these facts, pursuant to Regulation section 1.1502-76(b), F’s tax year ends for all Federal income tax purposes at the end of the day on April 1 (i.e., the day on which it ceases to be a member of the Parent consolidated group). Pursuant to section 1563 and Regulation section 1.1563-1(b), a corporation is, with respect to its taxable year, a component member of a controlled group of corporations for the group’s testing date (generally December 31) if it was a member of such group for one-half (or more) of the number of days in its testing period. The member’s testing period, in turn, begins on the first day of a member’s tax year and generally ends on the December 31 (regardless of whether the member is a calendar year or fiscal year taxpayer). However, if a member has a short tax year that does not include a December 31, the last day of the testing period becomes the last day of that member’s short tax year.

By virtue of the application of Proposed Regulation section 1.168(k)-2(b)(3)(iii)(C), for purposes of determining whether F Corporation and G Corporation are component members of the same controlled group under section 179(d)(2)(B), F is treated as acquiring the depreciable property immediately after the series of transactions. Thus, for such purpose, F is treated as acquiring the property on April 2 of Year 3, because F left the group at the end of the day on April 1 of such year. Consequently, F Corporation should be a component member of the X controlled group for its tax year April 2 - December 31 of Year 3 because it was a member of the X controlled group for 100% of the days in the relevant testing period.

Because neither Proposed Regulation section 1.168-2(k)(3)(b)(iii)(C) nor any of the other consolidated group operating rules in the Proposed Regulations applies for

39 However, under the “next day rule,” if, on the same day as such deconsolidation event, a transaction occurs that is “properly allocable” to the portion of S’s day after the deconsolidation event, then S must treat the transaction as occurring at the beginning of the following day. Reg. § 1.1502-76(b)(1)(ii)(B). A determination as to whether a transaction is properly allocable to the portion of S’s day after the event will be respected if it is reasonable (based on factors in the regulations) and consistently applied by all affected persons. However, proposed regulations, REG-100400-14 (Mar. 5, 2015) (the “Proposed next day rule”), would change the next day rule to: (1) require mandatory application of the next day rule to an extraordinary item resulting from a transaction that occurs on the same day as S’s change in status but after the deconsolidating event, and (2) make the proposed rule inapplicable to items that arise simultaneously with the deconsolidating event. Prop. Reg. § 1.1502-76(b)(1)(ii)(A)(2).

40 Reg. § 1.1563-1(b)(1)(iii)(B).

41 Note that a second argument has been raised to avoid, to an extent, the component member limitation. It is possible that if an election were made to ratably allocate items under Regulation section 1.1502-76(b)(2)(ii)(D), the section 168(k) deduction might be prorated between the selling group’s return and the Buyer’s separate return. See Jerred Blanchard, Bonus Depreciation and Consolidated Returns, 162 Tax Notes 641 (Feb. 11, 2019) (referring to a “colorable argument” that making the election has the effect of making F Corporation in Example 21 a member of the X controlled group, rather than the P/S controlled group, depending on when F Corporation leaves the P controlled group.
purposes of Regulation section 1.1502-13 or section 168(i)(7), the sale is an intercompany transaction under Regulation section 1.1502-13 and section 168(i)(7) would apply.\textsuperscript{42} Thus, the intercompany sale creates a deferred intercompany gain of $50 that is taken into account under Regulation section 1.1502-13. Under section 168(i)(7), F’s new $130 basis would be bifurcated: F would step into the shoes of G for depreciation purposes with respect to G’s $80 adjusted basis at the time of the intercompany sale (i.e., depreciating it $10 per year), and be eligible to deduct its additional basis ($50) under section 168(k).\textsuperscript{43} This deduction would be taken into account for F’s short year ending April 1 of Year 3 and thus would be included in the Parent group’s consolidated return.\textsuperscript{44} G’s $50 gain would be taken into account to reflect the difference between F’s depreciation taken into account (i.e., $60) and the amount of depreciation that would be taken into account if F and G were divisions of a single corporation (i.e., $10). Thus, G’s $50 gain would be offset by F’s $50 section 168(k) deduction.

b. Recommendation 6

We believe that in Example 21, F Corporation (the buyer) should take the full deduction under section 168(k) on its separate return. Allowing the deduction to X group in Example 21 is more consistent with the policy underlying section 168(k). In Example 21, it is X, the unrelated acquirer of F, that makes the critical economic outlay.\textsuperscript{45} Absent the acquisition by X, it is clear that the deduction under section 168(k) would not even be considered. Similarly, had the steps been reversed such that X acquired the stock of F before F purchased the property from G, the seller, it is clear that the full deduction by F would be immediately available. In addition, to the extent that the deduction in Example 21 is on the selling group’s return, the gain recognized by the selling member will offset the benefit of the deduction on the selling group’s return. In many instances, the selling group will suffer the additional detriment of recognizing a greater amount of gain upon the sale of the F stock because of the investment adjustment to the F stock that results from the deduction. Moreover, leaving the deduction on the return of the selling consolidated group raises questions because it has the effect of dividing the assets of the

\textsuperscript{42} There similarly is no other operating rule in the Proposed Regulations that would affect the timing of when the depreciable property is acquired and placed in service.

\textsuperscript{43} See Reg. § 1.1502-13(c)(7)(ii), Ex. (4).

\textsuperscript{44} As discussed below, we believe this result is inconsistent with the policy objectives of section 168(k) and recommend modifications to the Regulations to achieve the conclusion reached in Example 21, which we believe reflects the correct policy result. We note, however, that if the gain and the section 168(k) deduction are reported on the same consolidated return, the application of 168(i)(7) is necessary to achieve the purposes of Regulation section 1.1502-13, which is to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability). Reg. § 1.1502-13(a) (“Clear Reflection Policy”). In contrast, if section 168(i)(7) did not apply, and if the deduction remained with the selling Parent consolidated group, such group would obtain an immediate net $50 deduction. This impact on timing may be contrary to Clear Reflection Policy.

\textsuperscript{45} The legislative history of the amendment to section 168(k) indicates that Congress intended to stimulate economic growth by promoting capital investment. H.R. Rep. No. 115-409, at 232 (2017); S. Prt. No. 115-20, at 140 (2017).
selling member by moving an asset from the selling member to the buying member with an adjusted basis that, in the end, is the same in the hands of the buyer as it was in the hands of the selling member. Finally, to the extent that final Regulations locate the deduction in Example 21 on the buyer’s separate return, it would no longer make sense to treat the acquisition as an intercompany transaction under Regulation section 1.1502-13 that is subject to section 168(i)(7), as described below.

(1) Component Members of a Controlled Group

We recommend that the final Regulations clarify that Proposed Regulation section 1.168(k)-2(b)(iii)(C) applies for purposes of applying the definition of component member of a controlled group. Specifically, final Regulations should confirm that F Corporation is a component member of the X group during the relevant testing period and, therefore, the component member limitation does not prevent the transaction in Example 21 from being eligible for the section 168(k) deduction.

(2) Intercompany Transactions

As noted, Example 21 implies that the time for testing whether two parties are related within the meaning of section 179 is immediately after the last transaction in a series of related transactions. If Example 21 is read more broadly to recharacterize the nature of the potential intercompany sale (instead of for the limited purpose of determining whether section 168(k) applies), then the sale by G to F might no longer be treated as occurring between members of a consolidated group and, thus, Regulation section 1.1502-13 and section 168(i)(7) would not apply. As a result, the section 168(k) deduction would not be triggered on the Parent group’s return, and the full amount of the deduction would be allowed to F Corporation while a member of the X group. We recommend that final Regulations provide that Proposed Regulation section 1.168(k)-2(b)(3)(iii)(B)(3)(iii) and (b)(3)(iii)(C) also apply for purposes of Regulation section 1.1502-13 and section 168(i)(7)(B)(ii).

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46 This result raises more of a concern if the buying member leaves the group in a nonrecognition transaction, rather than a transaction such as Example 21 in which investment adjustments with respect to the stock of the buying member, reflecting the section 168(k) deduction, mitigate such concern.

47 See supra note 26.

48 We believe this recommendation is well within Treasury and the Service’s broad regulatory authority under section 1502:

The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability. In carrying out the preceding sentence, the Secretary may prescribe rules that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns.
Note, however, that amending the regulations to require that the section 168(k) deduction be taken on the buyer’s separate return in Example 21 raises a number of complexities. For example, if F does not leave the consolidated group immediately after the intercompany transaction, how closely related must its departure from the group be to the intercompany transaction in order for the requirement to apply? In addition, how would F’s items that arise during the period between the intercompany sale and F’s departure be treated? Would they be suspended? What if the intercompany sale and F’s departure straddle a tax year end? How would one decide which items would be treated similarly to the section 168(k) deduction (e.g., associated income items) in order to clearly reflect income? Notwithstanding these complexities, we believe that allowing F Corporation in Example 21 to take the full deduction while a member of the X group is the soundest result. We recommend that Treasury and the Service issue new proposed Regulations to provide guidance regarding how such deduction is allocated to the buying member’s separate return, particularly if the buying member does not leave the group immediately upon acquiring the qualified property from the selling member.

5. **Guidance Regarding the Application of 168(k) to Internal Section 338(h)(10) Transactions that are Followed by Spin-offs and to Section 336(e) Dispositions**

a. **Background**

Issues similar to those raised by Example 21 relating to the amount, timing, and location of a deduction under 168(k) arise in the context of intra-group QSPs under section 338(h)(10) that are followed by a spin-off and in the context of QSDs under section 336(e).

In the section 338(h)(10) context, Regulation section 1.179-4(c)(2), which is incorporated by reference in Proposed Regulation section 1.168(k)-2(b)(3)(iii)(A)(2), provides that property deemed acquired by a new target corporation as a result of a section 338 election is deemed acquired by purchase (i.e., for purposes of section 179(d)(2), including the component member limitation). Regulation section 1.338-1(a) indicates that new target is treated as acquiring its assets from (and old target is treated as transferring its assets to) an unrelated person. Regulation section 1.338-1(b)(1) provides that the new target is treated as a new corporation that is unrelated to old target for purposes of subtitle A of the Code, and thus is “not considered related to old target for purposes of section 168.”

The Service has issued a number of private letter rulings indicating that the section 338(h)(10) deemed asset sale is an intercompany transaction.49 Note however, if

49 See P.L.R. 201702035 (Feb. 1, 2016); P.L.R. 201333007 (May 20, 2013). These rulings are consistent with the examples in Regulation section 1.338(h)(10)-1(e), which indicate that in the deemed fiction under section 338, the new target acquires its assets from old target. See Reg. § 1.338(h)(10)-1(e), Ex. (2) (“[u]nder section 338(a), the assets present in T at the close of the acquisition date are deemed sold by old T to new T”); Ex. (3) (same). See also Reg. § 1.338-1(a)(2) (referring to “the transaction between old target and new target”). The rulings could also be explained as an application of the anti-avoidance rule of Regulation section 1.1502-13(h). See Reg. § 1.1502-13(h), Ex. (4) (treating the transfer of property out of
the deemed asset sale and the external sale occur on the same day, there is authority to
suggest that, applying the end of the day rule, new target would not be treated as a
member of the Parent consolidated group if it is formed and acquires its assets in a non-
transferred basis transaction (e.g., a busted section 351 transaction), and leaves the group
on the same day. In that case, the deemed asset sale would not be treated as
intercompany transaction warranting the application of section 168(i)(7).

b. Recommendation 7

We recommend that final Regulations add an example addressing a fact pattern
involving a busted section 351 transaction that is treated as a QSP of a target corporation,
followed by the separation of the target corporation from its consolidated group in a
section 355 spin-off, where the taxpayer makes a section 338(h)(10) election. For the
reasons discussed above, we believe Recommendation 6 above applies equally to the
section 338(h)(10) election context, and the results should be the same as those described
above with respect to Example 21.

Section 338(h)(10) Example

Parent, the widely held common parent of a consolidated group, owns 100% of
Target, a member of the Parent consolidated group. Target has a $15 basis in its
assets, which constitute qualifying property for purposes of section 168(k), and
the Target assets have a fair market value of $100. Parent contributes 100% of its
Target stock to newly-formed Sub in exchange for 100% of Sub’s stock,
consisting of voting common stock and non-voting preferred stock (the “Target
Contribution”). Sub is also a member of the Parent consolidated group. Pursuant
to a prior binding commitment, Parent sells the non-voting preferred stock to an
unrelated third party for cash. Parent and Sub make an election under section
338(h)(10) with respect to the stock of Target. Two days later, and as part of the
same overall plan, Parent contributes the Sub voting common stock to a newly
formed Spinco and distributes the stock of Spinco to the Parent shareholders in a
section 355 distribution (the “External Distribution”).

50 See P.L.R. 201644018 (Oct. 28, 2016) (ruling 15).
51 Note, however, that the Proposed next day rule would revise the rules under Reg. § 1.1502-76(b) in
several respects. One of the revisions would delink the status of a corporation as a member from the
determination of the return on which it reports income or loss. In finalizing the Proposed next day rule,
Treasury and the Service should consider the impact of such rules on section 168(k).
52 If no changes were made to the Proposed Regulations, the deduction would be on the selling group’s
return and, depending on one’s view of the effect of Regulation section 1.338-1(b), limited by section
168(i)(7).
53 Alternatively, assume that the External Distribution fails to meet the requirements of section 355 and is
instead treated as a taxable distribution under section 301. We believe that the failure of the External
Distribution to qualify under section 355 does not warrant any difference in the treatment of the deemed
asset sale for purposes of section 168(k). Thus, our recommendations with respect to section 338(h)(10)
As result of the section 338(h)(10) election, old Target is treated as selling all of its assets to an unrelated person at fair market value (the “deemed asset sale”) and liquidating into Parent immediately thereafter, and new Target is treated as purchasing the assets from an unrelated person.\textsuperscript{54} Old Target is treated as selling the assets at the close of the date of the Target Contribution (\textit{i.e.,} while it is owned by Parent), while new Target is treated as purchasing the assets as of the beginning of the day after the Target Contribution.\textsuperscript{55} Thus, old Target recognizes $85 of gain from the deemed asset sale, which is recognized by the Parent group, while new target takes a $100 fair market basis in the assets. As noted above, we believe that the analysis of the section 168(k) deduction is largely the same as the analysis described above with respect to Example 21, except for the applicability of Reg. section 1.179-4(c)(2). Consistent with Recommendation 6 above, we recommend that the final regulations require Target to take the full deduction on its separate return, without limitation by section 168(i)(7).\textsuperscript{56}

c. \textbf{Recommendation 8}

We recommend that final Regulations add an example addressing a fact pattern involving a corporation whose stock is distributed in a section 301 distribution, or a distribution to which section 355(d) or (e) applies, that is a QSD for which a section 336(e) election is made. For the reasons discussed above, we believe Recommendation 6 above applies equally to the section 336(e) election context.

\textbf{Section 336(e) Example #1}

Parent, the widely held common parent of a consolidated group, owns 100\% of Target, a member of the Parent consolidated group. Target has a $15 basis in its assets, which are qualifying property for purposes of section 168(k), and the Target assets have a fair market value of $100. Parent distributes the stock of Target to its shareholders in a section 301 distribution (the QSD), and Parent and Target make a section 336(e) election with respect to the QSD.

As result of the section 336(e) election, old Target is treated as selling its assets to an unrelated person in a single transaction at the close of the date of the QSD (the deemed asset sale), and recognizes any gain on the deemed asset sale before the close of the disposition date, while it is still owned by Parent.\textsuperscript{57} New Target is treated as acquiring the Target assets from an unrelated person at the close of the disposition date.\textsuperscript{58}

\textsuperscript{54} Reg. § 1.338-1(a)(1). Old Target and new Target are generally treated as two separate corporations for purposes of subtitle A of the Code. Reg. § 1.338-1(b)(1).

\textsuperscript{55} I.R.C. § 338(a)(1).

\textsuperscript{56} Although outside the scope of the Proposed Regulations, it would be helpful for Treasury and the IRS to clarify in published guidance that the deemed fictions under section 338 do not cause the target’s business to have been acquired for purposes of section 355(b).

\textsuperscript{57} Reg. § 1.336-2(b)(1)(i).

\textsuperscript{58} Reg. § 1.336-2(b)(1)(ii).
and immediately thereafter, old Target is deemed to liquidate. Thus, as in section 338(h)(10) example, old Target recognizes $85 of gain from the deemed asset sale, which is recognized by the Parent group, while new Target takes a $100 fair market basis in the assets, which qualifies for a section 168(k) deduction, which new Target is entitled to take on its separate return. Finally, Parent is deemed to purchase from an unrelated person, on the disposition date, immediately after the deemed liquidation of old Target, the amount of stock distributed in the QSD (i.e., new Target stock) and to have distributed such new Target stock to its shareholders.

**Section 336(e) Example #2**

Assume the same facts as Section 336(e) Example #1, except that Parent distributes the stock of Target to its shareholders in a section 355 distribution that violates section 355(d) or (e).

Here, as in Section 336(e) Example #1, as result of the section 336(e) election, old Target is treated as selling its assets to an unrelated person in a single transaction at the close of the date of the QSD, and recognizes any gain on the deemed asset sale before the close of the disposition date, while it is still owned by Parent. In contrast, however, to Section 336(e) Example #1, old Target is not deemed to liquidate. Rather, under the “sale-to-self” model, old Target (rather than a new Target) is treated as acquiring the Target assets from an unrelated person at the close of the disposition date, and immediately thereafter, Parent is deemed to distribute the stock of old Target (that was actually distributed to its shareholders in the QSD) at no gain or loss. Thus, old Target recognizes $85 of gain from the deemed asset sale, which is recognized by the Parent group, but should also take a $100 fair market basis in the assets.

Regarding the application of section 168(k), the proposed amendment to Regulation section 1.179-4(c)(2) suggests that the section 168(k) deduction was intended to be available in Section 336(e) Example #1 but not in Section 336(e) Example #2 because Regulation section 1.179-4(c)(2) only applies to acquisitions by a “new target.” In addition, there is at least a technical question as to whether the No Prior Use Rule would apply in Section 336(e) Example #2, where the same entity (old Target) is deemed to both sell and purchase the qualifying assets while Target is still owned by Parent. In other words, is Target tainted by its own prior use of the assets?

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60 Reg. § 1.336-2(b)(1)(iv). Presumably, section 382 should not apply to the deemed acquisition of new Target stock by Parent because Target stock is not in fact undergoing an ownership change.


65 Query whether such a distinction was intended.

66 Note that this question would not arise with respect to any subsidiaries of Target for which an election under section 336(e) is also made. See Reg. § 1.336-2(b)(2)(iii)(B) (providing that the treatment of such lower-tier subsidiaries is determined under Reg. § 1.336-2(b)(1)). Thus, the potential No Prior Use Rule...
Government’s stated policy in promulgating the sale-to-self model in Section 336(e) Example #2 was “to preserve the consequences of section 355 distributions”67 (for example, by preserving the E&P of a controlled corporation), rather than to create broader substantive distinctions between distributions that violate section 355(d) or (e) and section 301 distributions, we recommend that the final Regulations clarify that the section 168(k) deduction is available for section 336(e) elections made for QSDs described in section 301 and for QSDs described in sections 355(d)(2) or (e)(2).

In addition, because the deemed asset sale is treated as occurring between unrelated parties (and the QSD is not, and need not be, preceded by an intercompany transaction between Parent and Target), Regulation section 1.1502-13 and section 168(i)(7) should not apply in either example, and accordingly, Target’s section 168(k) deduction should be equal to the full amount of Target’s new $100 basis in the assets.

Finally, for the reasons described above with respect to Example 21 and with respect to section 338(h)(10) transactions, we recommend that the final regulations require that the deduction for the full purchase price of the depreciable property be taken on the Target’s separate return in both of the section 336(e) examples.