New York State Bar Association Tax Section

Report Commenting on Proposed Regulations Under Internal Revenue Code Sections 168 and 1400L Relating to Additional First Year Depreciation Allowances

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REPORT NO. 1045

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT COMMENTING ON PROPOSED REGULATIONS UNDER INTERNAL REVENUE CODE SECTIONS 168 AND 1400L RELATING TO ADDITIONAL FIRST YEAR DEPRECIATION ALLOWANCES

Introduction

This report comments on proposed regulations (REG-157164-02) under sections 168 and 1400L of the Internal Revenue Code (the "Code"), published in the *Federal Register* on September 8, 2003.[1] The text of temporary regulations issued at that time as Treasury Decision 9091 serves as the text of the proposed regulations. The proposed regulations relate to the additional first year depreciation allowance provided by sections 168(k) and 1400L(b) for certain MACRS property and computer software.

Sections 168(k) and 1400L(b) were added to the Code by sections 101 and 301(a) of the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) (the "2002 Tax Act"), and were modified by section 201 of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27) (the "2003 Tax Act"). Section 168(k)(1) allows a 30-percent additional first year depreciation deduction for qualified property acquired after September 10, 2001, and generally, placed in service before January 1, 2005. Section 168(k)(4) allows a 50-percent additional first year depreciation deduction for qualified property acquired after May 5, 2003, and, generally, placed in service before January 1, 2005. Section 1400L(b) allows a 30-percent additional first year depreciation deduction for qualified New York Liberty Zone property acquired after

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[1] The primary drafters of this report of the Committee on Real Property were David E. Kahen, Elliot Pisem, and David A. Weintraub. Helpful comments were received from Harvey Berenson, Kimberly S. Blanchard, Ronald A. Morris, and Michael Schler.

September 10, 2001, and placed in service before January 1, 2007 (January 1, 2010, in the case of qualifying nonresidential real property and residential rental real property). If property qualifies for additional first year depreciation under section 168(k), it is not eligible for benefits under section 1400L(b); accordingly, except in the case of a taxpayer that has elected for section 168(k) not to be applicable,[2] section 1400L(b) will generally apply to personal property described in section 168(k)(2)(A)(i) only if such property is placed in service on or after January 1, 2005, and before January 1, 2007.[3]

The proposed regulations provide needed guidance regarding the statutory requirements relating to: (1) the types of depreciable property that qualify for bonus depreciation, (2) the circumstances in which the original use of property commences with the taxpayer, (3) the time periods within which the depreciable property must be acquired and placed in service, and (4) New York Liberty Zone property. In addition, the proposed regulations provide special rules regarding: (i) property placed in service and disposed of in the same year, (ii) redetermination of basis, (iii) depreciation recapture under Code sections 1245 and 1250, (iv) coordination of the additional first year depreciation rules with amortization of pollution control facilities under Code section 169, (v) like-kind exchanges and involuntary conversions, (vi) changes in use, (vii) earnings and profits, (viii) limitation of amount of depreciation for certain passenger automobiles, and (ix) Code section 754 elections. The regulations are generally proposed to apply to property acquired after September 10, 2001.

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[2] See Part B(3) below.

[3] Real property described in section 1400L(b)(2)(B) may be subject to section 1400L(b) even if placed in service prior to January 1, 2005, since, except for certain leasehold improvements, real property is not generally described in section 168(k)(2)(A(i).

We are generally in accord with the approach taken in the proposed regulations. However, in a number of specific areas, we believe that the proposed regulations can be made more consistent with the relevant statutory provisions, resulting in greater clarity and reducing unnecessary uncertainty.

Comments Regarding the Regulations

A. ADDITIONAL FIRST YEAR DEPRECIATION DEDUCTION UNDER SECTION 168(K).

1. *Property that is not qualified property and therefore not eligible for additional first year depreciation*. Section 1.168(k)-1T(b)(2)(ii)(A)(2) provides that property not eligible for the additional first year depreciation deduction includes property "[r]equired to be depreciated under the alternative depreciation system of section 168(g) pursuant to section 168(g)(1)(A) through (D) or other provisions of the Internal Revenue Code (for example, property described in section 263A(e)(2)(A) or section 280F(b)(1))." Section 168(k)(2)(C) provides that property to which the alternative depreciation system applies, determined without regard to section 168(g)(7) (relating to the election to have the alternative depreciation system apply), but after application of section 280F(b) (relating to "listed property" with limited business use), is not "qualified property" eligible for additional first year depreciation.

It might be argued that the statute is less than entirely clear as to whether property required to be depreciated under the alternative depreciation system pursuant to provisions other than sections 168(g)(1)(A)-(D) or section 280F(b)(1) is intended to be excluded from eligibility for the additional first year depreciation deduction. Assuming that the above-quoted interpretation of section 168(k)(2)(C) is retained in the regulations, however, the intended meaning of the reference in the proposed regulations to section 263A(e)(2)(A) should be clarified. "Property described in section 263A(e)(2)(A)" could include all property "used predominantly in a farming business" as referred to in that provision. Presumably, however, the cross-reference is intended to refer only to property held by a taxpayer that has made an election under section 263A(d)(3) to cause section 263A not to apply. This should be clarified.

2. *"Original Use" Issues*.

a. *"Syndication" transactions*. Section 1.168(k)-1T(b)(3)(iii)(B) provides a special rule for transactions in which property is sold by a lessor or any subsequent purchaser within three months after the date the property was originally placed in service by the lessor and the user of the property remains the same as when the property was originally placed in service by the lessor. This rule, by its terms, can apply to any sale of property within three months after the date on which it is placed in service, regardless of whether that sale constitutes a "syndication." Accordingly, we believe that the caption of this provision, "Syndication transaction," may be misleading and that a more generic caption, such as "Certain sales occurring within 3 months after date property originally placed in service," should be substituted.

b. *Sale-leaseback transaction followed by a syndication transaction*. Section 1.168(k)-1T(b)(3)(iii)(C) provides that "[i]f a sale-leaseback transaction that satisfies the requirements in paragraph (b)(3)(iii)(A) of this section is followed by a syndication transaction that satisfies the requirements in paragraph (b)(3)(iii)(B) of this section, the original user of the property is determined in accordance with paragraph (b)(3)(iii)(B)." A similar rule is provided by section 1.168(k)-1T(b)(5)(ii)(C). Paragraphs (b)(3)(iii) (A) through (C) taken together seem to indicate that, if property placed in service by a person is sold and leased back within three months, and a syndication transaction occurs within three months after the sale-leaseback, the property will be treated as having been placed in service by the purchaser in the syndication transaction.[4] There may, however, be other plausible interpretations of those paragraphs (and paragraph (b)(5)(ii)(C)). Clarification of the intent and scope of the rules, and an example, would be helpful to illustrate their application.

c. *Fractional interests in property.* Section 1.168(k)-1T(b)(3)(iv), which deals with fractional interests in property, provides that "[i]f, in the ordinary course of its business, a taxpayer sells fractional interests in property to <u>unrelated third parties</u>, each first fractional owner of the property is considered as the original user of its proportionate share of the property" (emphasis added). The regulation further provides that, where the taxpayer selling the fractional interests uses the property before all fractional interests are sold and the property continues to be held primarily for sale by the taxpayer, the original use of a fractional interest that is sold to an unrelated third party begins with the first purchaser of that fractional interest.

The basis for this rule appears to be in the legislative history for the Jobs and Growth Tax Relief Reconciliation Act of 2003.[5] We note that it is unclear whether the requirement that there be "unrelated third parties" means that the purchasers must be unrelated to the seller, or that they must be unrelated to each other, or both. In section 1.168(k)-1T(b)(3)(v), *Example 4*, which is intended to illustrate the operation of this provision, it is stated that the purchasers are unrelated to the seller and to each other, but it is not clear which of those facts is of significance.

We think pre-existing relationships between purchasers of undivided interests is not relevant. We recommend the regulation provide that only the relationship of the purchasers to the seller, not each other, be taken into account in determining whether the rule applies.

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4 The Tax Technical Corrections Act of 2003, as recently introduced in Congress, would amend section 168(k)(2)(D) to confirm this result. H.R. 3654, 108th Cong., 1st Sess. §3(a) (2003).

5 See, e.g., H.R. Conf. Rep. No. 126, 108th Cong., 2d Sess. 31 n. 15 (2003).

d. *"Original use" examples*. Section 1.168(k)-1T(b)(3)(v), *Example 2*, states that "[t]he use of the automobile by C as a demonstrator does not constitute a 'use' for purposes of the original use requirement. . . ." The history of the tax treatment of "demonstrator" automobiles for depreciation and other purposes includes a long series of Revenue Rulings and judicial decisions that have not previously been specifically resolved in Treasury Regulations. We question whether an example in the regulations under section 168(k) is the appropriate place to resolve an issue of potentially broader scope and significance which may continue to arise long after additional first year depreciation under section 168(k) has ceased to be available.

3. *"Binding contract."*

a. *In general*. The meaning of the term "binding contract" is significant in several respects relating to these regulations. For example, property acquired after September 10, 2001, and before January 1, 2005, will not qualify for 30 percent additional first year depreciation if acquired under a written binding contract in effect before September 11, 2001.[6] Conversely, property acquired on or after January 1, 2005, may qualify for such depreciation if acquired pursuant to a contract entered into after September 10, 2001, and before January 1, 2005.

Section 1.168(k)-1T(b)(4)(ii)(A) provides that a "contract is binding only if it is enforceable under State law against the taxpayer or a predecessor, and does not limit damages to a specified amount"; however, a provision limiting damages to an amount that is at least 5% of the total contract price is not treated as limiting damages to a specified amount. The regulations also provide, in the final sentence of the cited provision, that, if a contract provides for a full

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[6] The technical corrections legislation cited above (note 4, *supra*) would also add to section 168(k)(2)(D) a provision to the effect that "qualified property" would not include any property if the <u>user</u> of such property (as of the date on which the property is originally placed in service) or a person related to such user or the taxpayer had a written binding contract in effect for the acquisition of such property before September 11, 2001.

refund of the purchase price in lieu of any damages allowable by law in the event of breach or cancellation by the seller, the contract is not considered binding (the "nonbinding refund rule").

We question whether the nonbinding refund rule is logical or correct. Assuming that a limitation on damages is an appropriate factor for determining whether a contract is binding, the relevant limitations should be those on the liability of the buyer, not the seller. Perhaps the provision reflects an assumption that, if the seller can avoid or satisfy its obligations under a contract by refunding to the buyer any portion of the purchase price that has not been paid, the buyer is similarly capable of avoiding its obligations under the contract without any significant cost, but this may not be correct in some instances.

b. *Conditions to closing*. The final sentence of section 1.168(k)-1T(b)(4)(ii)(B) states that a "contract that imposes significant obligations on the taxpayer or a predecessor will be treated as binding notwithstanding the fact that insubstantial terms remain to be negotiated by the parties to the contract." The clear implication of this provision is that a contract that imposes significant obligations will *not* be treated as binding if *substantial* terms remain to be negotiated. This seems to us unjustifiably to impose an additional requirement of having negotiated all substantial terms, over and above the requirement relating to the binding nature of the contract, that has no basis in the statute.[7] Under UCC section 2-204, "[e]ven though one or more terms are left open, a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy." In particular, UCC section 2-305(1) provides that the parties, if they so intend, can conclude a

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[7] We believe that whether or not substantial terms remain to be negotiated should be relevant neither for purposes of determining whether a binding contract was in effect on September 10, 2001, or May 5, 2003 (where the existence of a binding contract would generally be harmful to the taxpayer, by preventing the taxpayer from claiming additional first year depreciation), nor for purposes of determining whether a binding contract is in effect before January 1, 2005 (where the existence of a binding contract could be helpful to the taxpayer, by permitting the claiming of additional first year depreciation for property described in section 168(k)(2)(B)).

contract for sale even though the price is not settled and even if the price is left to be agreed by the parties and they fail to agree. A contract should be treated as binding for purposes of the regulations if it is enforceable under local law, regardless of whether or not substantial terms remain to be negotiated.

c. *Supply agreements.* Section 1.168(k)-1T(b)(4)(ii)(D) provides that a binding contract does not include a supply or similar agreement if the amount and design specifications of the property to be purchased have not been specified. The example provided in the last sentence of this section, in describing a particular purchase order under a supply agreement that is treated as a binding contract, states that the design specifications and pricing were stated in the order. As noted above, we do not believe that the existence *vel non* of agreed pricing terms should be relevant in determining whether or not a binding contract exists, except to the extent that their absence causes the contract not to be enforceable under local law. In any event, if the existence of a pricing term is considered relevant to the result reached in the example, that requirement should be stated in the operative rule, and, if it is not relevant, the example should be changed to delete the reference to pricing.[8]

4. *Self-constructed property.*

a. *When does construction begin?* For purposes of determining when property is manufactured, constructed or produced, section 1.168(k)-1T(b)(4)(iii)(B) provides that construction begins "when physical work of a significant nature begins" and that "physical work of a significant nature will not be considered to begin before the taxpayer incurs (in the case of an accrual basis taxpayer) or pays (in the case of a cash basis taxpayer) more than 10 percent of the total cost of the property. . . ." We do not believe that the taxpayer's method of accounting

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[8] If pricing is not relevant to the determination of whether a supply agreement is binding, section 1.168(k)-1T(b)(4)(v), *Example 2*, should also be modified.

has any relevance to the non-accounting question of when construction begins. In this regard, we note that Treasury Regulation section 1.48-12(c)(3)(i) provides that "[q]ualified rehabilitation expenditures are incurred by the taxpayer ... on the date such expenditures would be considered incurred under an accrual method of accounting, regardless of the method of accounting used by the taxpayer with respect to other items of income and expense."

b. *Self-constructed components.* Section 1.168(k)-1T(b)(4)(iii)(C)(2), last sentence, provides:

> If the manufacture, construction, or production of a component begins after September 10, 2001, for qualified property, or after May 5, 2003, for 50-percent bonus depreciation property, and before January 1, 2005, but the manufacture, construction, or production of the larger self-constructed property [of which the component is to form a part] does not begin before January 1, 2005, the component qualifies for the additional first year depreciation deduction (assuming all other requirements are met) but the larger self-constructed property does not.

This rule was apparently intended to parallel the final sentence of section 1.168(k)-1T(b)(4)(iii)(C)(*1*), which contains a similar provision in the case of acquired components that will be incorporated in self-constructed property. The two situations, however, are not similar and the result is that the above rule will be difficult to apply.

In the case of an acquired component, the taxpayer's acquisition of the component does not necessarily involve any "manufacture, construction, or production" by the taxpayer. The component may "sit on the shelf" until the taxpayer is prepared to begin "physical work of a significant nature" on the "larger self-constructed property." In the case of a self-constructed component intended to form a part of a "larger self-constructed property," the "manufacture, construction, or production" of the component will itself be "manufacture, construction, or production" of the larger self-constructed property. Generally, under paragraph (b)(4)(iii)(B), construction of self-constructed property is considered to have begun only after the taxpayer has incurred or paid more than 10% of the total cost of the property (excluding the cost of certain preliminary activities). Thus, the only case in which the above-quoted rule for self-constructed components would appear to apply is one in which the taxpayer's pre-January 1, 2005 costs are 10% or less of the total cost of the "larger self-constructed property" (but more than 10% of the total cost of the component).[9] If the rule was, in fact, intended to be limited to this single circumstance, that should be made clear. If it was intended to apply to a broader range of cases, further explication is needed of when and why construction of a component[10] will not constitute construction of the larger property of which the component is to form a part.

5. *Qualified leasehold improvement property.* "Qualified property" for purposes of section 168(k) includes "qualified leasehold improvement property" as defined in section 168(k)(3). Section 1.168(k)-1T(c)(1)(i) of the proposed regulations provides that "qualified leasehold improvement property" ("QLIP") means any "improvement, which is section 1250 property, to an interior portion of a building that is nonresidential real property if ... [t]he improvement is made under or pursuant to a lease by the lessee (or any sublessee) of the interior portion, or by the lessor of that interior portion...." This language reiterates, without explanation, the statutory language of section 168(k)(3)(A)(i). The phrase "under or pursuant to a lease" would seem to mean that any improvement that is <u>permitted</u> by a lease should qualify as QLIP, without regard to whether the improvement is <u>required</u> under the lease. We believe that this is

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9 A related problem arises in the case of self-constructed components that were manufactured, constructed, or produced on or before September 10, 2001, and incorporated after that date in larger self-constructed property. Section 1.168-1T(b)(4)(iii)(C)(*2*) suggests that such components are ineligible for additional first year depreciation, but that the "larger self-constructed property" is not ineligible if its manufacture, construction, or production began after September 10, 2001. Again, the question arises of how one distinguishes construction of the component from construction of the larger property. For example, if the taxpayer fabricated part of one blade for a turbine prior to September 11, 2001, with the intent of incorporating that blade in a turbine that the taxpayer would manufacture, and of then incorporating that turbine in a power plant that the taxpayer would build, it is clear that the blade, if itself a component, will not qualify for additional first year depreciation, but what about the turbine? Or the entire power plant?

10 In this regard, a definition of the term "component" would also be helpful.

the correct result -- specifically, that, at least in the case of improvements made by the lessee, the provision was intended to cover any improvement permitted under a lease. To prevent any controversy, however, the regulation should be clarified to make this explicit.[11]

6. *Depreciation deductions for alternative minimum tax purposes*. Section 1.168(k)-1T(d)(1)(iii), last sentence, states that "[t]he 30-percent or 50-percent additional first year depreciation deduction for alternative minimum tax ("AMT") purposes is based on the unadjusted depreciable basis of the property for alternative minimum tax purposes." Since the circumstances where a taxpayer's initial basis in property is different for AMT purposes than for regular tax purposes are unusual (e.g., property acquired in a section 1031 exchange where the relinquished property had a different adjusted basis for AMT purposes than for regular tax purposes), an example illustrating the operation of this provision and of its correlative provision, section 1.168(k)-1T(d)(2)(ii) (relating to the depreciation deduction allowable for AMT purposes with respect to the remaining adjusted depreciable basis after reduction by additional first year depreciation), would be helpful.

7. *Redetermination of basis*.

a. *Redetermination on or after January 1, 2005*. Section 1.168(k)-1T(f)(2) provides various rules for adjusting additional first year depreciation deductions if a redetermination of basis occurs in a subsequent year, for example, due to contingent purchase price or to a reduction of purchase money indebtedness that is treated as a purchase price

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[11] One possible rationale for making additional first year depreciation available for QLIP is that the 39-year recovery period otherwise applicable to nonresidential real property works a hardship on lessees whose leases may be for substantially shorter terms and who are thus required to recover the cost of their improvements over a period substantially in excess of the economic useful life of those improvements to the party making them. In such a case, the hardship on the lessee is no less if the improvements are voluntary than if they are mandatory.

reduction under section 108(e)(5).[12] These rules are restricted, in general, to cases in which the redetermination occurs prior to January 1, 2005, so that, for example, it appears that no additional first year depreciation deduction would be allowable for additional purchase price paid on or after January 1, 2005, with respect to property acquired before 2005. We perceive no statutory or policy basis for restricting the redetermination rules in this way. We also note that current law gives no clear guidance that would be applicable to redeterminations not covered by the proposed rule, because, for example, they occurred on or after January 1, 2005.[13]

b. *Decrease in basis*. Section 1.168(k)-1T(f)(2)(ii) provides that, in the case of a decrease in basis, there is an inclusion in gross income in the year in which the decrease in basis occurs for the excess additional first year depreciation previously claimed, as well as for excess depreciation previously claimed other than additional first year depreciation. The portion of the decrease in basis that was not previously recovered through additional first year depreciation is included in income over the remaining recovery period of the property. These income inclusions represent a change from the approach taken in Proposed Regulation section 1.168-2(d)(3), which, in the case of a decrease in basis, reduces future depreciation deductions by the amount needed to offset the excess depreciation previously taken.[14] The approach of the section 168(k)

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[12] Example 2 in section 1.168(k)-1T(f)(2) indicates that the redetermination rules apply to situations where an adjustment is made under section 1017 by reason of a discharge of indebtedness that may or may not be secured by the property the basis of which is being adjusted. It is not clear why the regulations take this position, and we urge that Example 2 and the operative rules be revised to indicate that an adjustment under section 1017, the regulations under which provide a comprehensive regime for the adjustment of basis in the context of a discharge of indebtedness to which section 108 applies, will not result in the application of the redetermination rules.

[13] Compare Proposed Regulation section 1.168-2(d)(3), which was proposed in 1984 and has not yet been finalized.

[14] Near its conclusion, section 1.168(k)-1T(f)(2)(iv), *Example 2*, does, presumably inadvertently, use the vocabulary of reducing depreciation deductions, rather than that of including an amount in income, in that the depreciation deduction for the year in which the reduction in purchase price occurs is computed by subtracting the income inclusion amounts resulting from the decrease in basis from the depreciation otherwise allowable for

proposed regulations can perhaps be justified with respect to the amount of additional first year depreciation to be "recaptured" (as the taxpayer received a "lump-sum" benefit by claiming additional first year depreciation, a "lump-sum" detriment in the year of the basis decrease seems correct), and may provide a necessary rule as to the character of that "recapture" to the extent that it exceeds the otherwise allowable depreciation in the year of the redetermination. There is, however, no evident need to make a change here to the character rules that would apply in other situations, by making a separate inclusion in income rather than a reduction in depreciation otherwise allowable -- which change could have consequences with respect to REIT and RIC qualification requirements based on income, the 6-year statute of limitations under Code section 6501(e) for substantial omissions of income, and myriad other matters.[15] If the IRS has concluded that the income inclusion approach is more appropriate than a reduction of allowable depreciation even where the income inclusion is less than the remaining depreciation otherwise allowable, an explanation for this conclusion should be provided.

c. *Timing of adjustments to basis*. Section 1.168(k)-1T(f)(2)(iii) provides that, for purposes of the redetermination of basis rules: (1) an increase in basis occurs in the taxable year an amount is taken into account under section 461; and (2) a decrease in basis occurs in the taxable year an amount is taken into account under section 451. Since the event in question is, by hypothesis, giving rise to a basis adjustment, rather than to an item of income or deduction, it seems unnecessary and confusing to tie the timing of the adjustment to these accounting method rules concerning the timing of income and deductions. Also, one apparent effect of applying the

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the year. (Elsewhere, the Example talks of inclusions in taxable income, rather than in gross income.) There also appears to be an arithmetic error in the Example, in that $50,000 multiplied by .30 is $15,000, not $4,500.

[15] Compare Treasury Regulation section 1.743-1(j)(4)(ii)(A), which provides for a gross income inclusion to a partner with respect to whom a downward adjustment to the basis of partnership property has been made under Code sections 754 and 743, but only after the partner's share of all depreciation from the partnership has been abated.

accounting method rules, as is hinted at in section 1.168(k)-1T(f)(2), *Example 2*, but not stated explicitly in the operative provisions of the proposed regulations, is to create an apparent inconsistency with the portion of Code section 1017(a) that provides that basis is reduced at the beginning of the taxable year following the taxable year in which a discharge of indebtedness giving rise to basis reduction occurs. If it is intended that the regulation override the timing rule of section 1017(a) -- a result with which we do not agree -- this should be stated explicitly in the operative provisions; otherwise, *Example 2* should be corrected to conform to section 1017(a).

8. *Special rules relating to like-kind exchanges and involuntary conversions*.

a. *In general*. Section 1.168(k)-1T(f)(5) addresses the application of the additional first year depreciation rules to certain property that is acquired in a like-kind exchange described in section 1031(a), or in connection with an involuntary conversion of property in a transaction to which section 1033 applies.

The proposed regulations could be read to confer an unintended benefit in the case of taxpayers who acquired property prior to September 11, 2001, in order to replace property that was ultimately requisitioned or condemned after September 10, 2001, but as to which the threat or imminence of condemnation existed prior to that date.

Section 1.168(k)-1T(f)(5)(i) provides that the additional first year depreciation rules apply to eligible MACRS property acquired as replacement property for property involuntarily converted in a transaction governed by Code section 1033, if the "time of replacement" is after September 10, 2001, and before January 1, 2005. "Time of replacement" is defined in section 1.168(k)-1T(f)(5)(ii)(F) as the later of : (1) when the property received in the exchange or involuntary conversion is placed in service; or (2) the time of disposition of involuntary converted property. If the threat or imminence of condemnation existed prior to

September 11, 2001, and the taxpayer, as permitted by section 1033, acquired other MACRS property for replacement purposes prior to that date, a literal reading of the proposed regulations would make the replacement property eligible for additional first year depreciation, so long as the "old" property is not requisitioned or condemned until after September 10, 2001. We do not believe that it was intended that such replacement property qualify for additional first year depreciation, and the proposed regulations should accordingly be clarified.

b. *Requirement that exchanged property be MACRS property.* Section 1.168(k)-1T(f)(5)(ii)(A) provides that the rules of section 1.168(k)-1T(f)(5) apply only if the exchanged or involuntarily converted property is MACRS property. In cases not subject to the anti-churning rules of section 168(f)(5), we do not perceive any policy reason or any statutory language that would preclude additional first year depreciation from applying if the exchanged or involuntarily converted property was subject to ACRS or to the pre-1981 depreciation rules.

c. *Definition of "remaining carryover basis" and "remaining excess basis."* Section 1.168(k)-1T(f)(5)(ii)(I) and (J) provides definitions of "remaining carryover basis" and "remaining excess basis." The definitions add complexity and confusion to the calculation of basis and are apparently necessitated by the rule that additional first year depreciation must be calculated separately with respect to (i) the carryover basis and (ii) "excess basis" (that is, any excess of the basis of the acquired property over the carryover basis). Since no reason is articulated for the separate calculations, perhaps the provision can be simplified by eliminating the requirement of separate calculations.

Also, in section 1.168(k)-1T(f)(5)(iii)(A), the purpose of the reference to section 1.168(k)-1T(d) should be clarified. If the intent is to indicate that rules similar to those of paragraph (d), such as the rule disallowing additional first year depreciation for property acquired and disposed of in the same year, apply with respect to like-kind exchanges, it is not apparent why the last sentence of paragraph (f)(5)(iii)(A) refers only to property described in section 168(k)(2)(B) and to alternative minimum tax purposes.[16]

d. *Clarification of "same taxable year" rule*. We suggest that the second sentence of section 1.168-1T(f)(5)(iii)(B), regarding the disallowance of additional first year depreciation for property that is placed in service and disposed of in the same taxable year, be clarified through the addition of the italicized words below:

> However, the additional first year depreciation deduction is not allowable for the exchanged or involuntarily converted MACRS property or the exchanged or involuntarily converted computer software if the *exchanged or involuntarily converted* MACRS property or computer software, as applicable, is placed in service and disposed of in an exchange or involuntary conversion in the same taxable year.

e. *Examples*. Section 1.168(k)-1T(f)(5)(v), *Example 2*, is incorrect. The assumed facts indicate that the property that was destroyed had a depreciable basis at that time of $160,000, and that the insurance proceeds were also $160,000. Since no gain is realized upon the involuntary conversion, section 1033 does not apply.

9. *Change in use*. Section 1.168(k)-1T(f)(6)(iii)(B) and (iv)(B) contains rules relating to the consequences of the change in use of depreciable property that appear to be inconsistent. When the use of property is changed, after the taxable year in which it is placed in service, from a depreciable use that is not eligible for additional first year depreciation (for example, equipment placed in service outside the United States) to a depreciable use that is generally eligible for additional first year depreciation, the taxpayer is denied additional first year

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[16] A correction to the proposed regulations that was published in the Federal Register (68 Fed. Reg. 63,734 (2003)) added the phrase, "(for example, use the remaining carryover basis as determined for alternative minimum tax purposes)" at the end of paragraph (f)(5)(iii)(A). This correction does not, however, eliminate the need for clarification of the purpose of the reference to section 1.168(k)-1T(d), as referred to in the text above.

depreciation. Such a taxpayer is thereby treated less favorably than when the use of the property is changed from a nondepreciable personal use to a depreciable use, in which case the taxpayer is eligible for additional first year depreciation. This seems illogical, as a regulation under section 167 and a proposed regulation under section 168 both indicate that property which is ready for use in a personal activity is considered to be placed in service (Reg. §1.167(a)-11(e)(1)(i), Prop. Reg. §1.168-2(l)(2)). If the IRS has now concluded that property ready for use in a personal activity is not yet "placed in service," this should be stated expressly.

10. *Earnings and profits*. Section 1.168(k)-1T(f)(7) provides that the additional first year depreciation deduction is not allowable for purposes of computing earnings and profits. This provision interprets section 312(k), and we believe a cross-reference to this provision in the section 312 regulations would prove helpful.

11. *Section 754 election*. Section 1.168(k)-1T(f)(9) provides that if qualified property is placed in service by a partnership and the partnership terminates during the same taxable year under Code section 708(b)(1)(B), any increase in basis of the qualified property due to a "section 754 election" is eligible for the additional first year depreciation. However, it appears from the proposed regulation that additional first year depreciation would not be available with respect to similar section 754 adjustments in the case of a non-terminating transfer of a partnership interest, if a partnership has acquired or constructed, but has not yet placed in service, qualified property. It is not clear that this distinction is intended, or appropriate. We suggest that the regulation be clarified to provide that any section 754 adjustment that arises before or during the year in which property is placed in service will be taken into account for this purpose.

B. ADDITIONAL FIRST YEAR DEPRECIATION DEDUCTION FOR QUALIFIED NEW YORK LIBERTY ZONE PROPERTY.

1. *Real property.* Section 1400L authorizes additional first year depreciation for certain eligible real property which either rehabilitates real property that was damaged, or replaces real property that was destroyed or condemned, in the September 11, 2001, terrorist attack (and which meets the other requirements of section 1400L(b)(2)(A)).

Section 1.1400L(b)-1T(b)(4) provides the following list of exclusions from the definition of "real property": (1) property described in section 1245(a)(3)(B) (relating to depreciable property used as an integral part of a specified activity or as a specified facility); (2) property described in section 1245(a)(3)(D) (relating to a single purpose agricultural or horticultural structure); and (3) property described in section 1245(a)(3)(E) (relating to a storage facility used in connection with the distribution of petroleum or any major product of petroleum). We are not aware of any basis in the statute or legislative history for these exclusions, and we suggest that they be deleted.

2. Q*ualified New York Liberty Zone property.* Section 1.1400L(b)-1T(c)(2)(i)(B) describes New York Liberty Zone property as:

> Nonresidential real property or residential real property depreciated under section 168, but only to the extent it rehabilitates real property damaged, or replaces real property destroyed or condemned, as a result of the terrorist attacks of September 11, 2001. Property is treated as replacing destroyed or condemned property if, as part of an integrated plan, the property replaces real property that is included in a continuous area that includes real property destroyed or condemned. . . .

This language reiterates the words of section 1400L(b)(2)(B), but does not define the ambiguous word "continuous." Guidance on this issue would be helpful.

3. *Property not eligible for additional first year depreciation deduction under section 1400L(b).* Section 1.1400L(b)-1T(c)(2)(ii) states that property described in section 1.168(k)-

1T(b)(2)(ii), *i.e.*, property described in section 168(f), property required to be depreciated under the alternative depreciation system, property included in any class of property for which the taxpayer elects not to deduct additional first year depreciation under section 168(k), and qualified New York Liberty Zone leasehold improvement property, is not eligible for additional first year depreciation under section 1400L(b) as qualified New York Liberty Zone property.

The exclusion for property required to be depreciated under the alternative depreciation system accords with section 1400L(b)(2)(C)(ii), and the exclusion for qualified New York Liberty Zone leasehold improvement property accords with section 1400L(b)(2)(C)(iii). Similarly, because section 168 does not apply to property described in section 168(f), such property (unless perhaps it is computer software or water utility property) will not be described in section 168(k)(2)(A)(i) and will thus not be included in the definition of qualified New York Liberty Zone property in section 1400L(b)(2)(A).

The statement in the proposed regulations that property included in any class of property for which the taxpayer elects not to deduct additional first year depreciation under section 168(k) is not eligible for additional first year depreciation may be based on section 1400L(b)(2)(C)(iv), captioned "Election Out," which states: "For purposes of [section 1400L(b)], rules similar to the rules of section 168(k)(2)(C)(iii) [relating to elections not to apply section 168(k)] shall apply." It could be argued that this provision implies that, if an election not to have section 168(k) apply is made, that election should also cause section 1400L(b) not to apply.

However, the statutory language may be reasonably interpreted <u>not</u> to require the exclusion from the benefits of section 1400L(b) of property included in any class of property for which the taxpayer has elected not to deduct additional first year depreciation under section 168(k). The fact that the Code directs that similar "election out" rules will apply to both section

168(k) and section 1400L(b) does not mean that the same election must be made with respect to both provisions, and there is no apparent policy reason for requiring the same election to be made for purposes of 1400L(b) as is made for purposes of section 168(k). In our view, the better interpretation is that the Code permits a taxpayer to elect not to apply section 168(k) to its property of a particular class to the extent that such property is not located within the New York Liberty Zone, while still being entitled to the benefits of section 1400L(b) for its property of the same class that is located within the New York Liberty Zone; and the regulations should be revised to confirm this rule.

4. *Qualified New York Liberty Zone property: acquisition of property by purchase*. Section 1.1400L(b)-1T(c)(5)(ii) provides that certain transferees, including a new partnership resulting from a technical termination under section 708(b) and an acquiror in certain carryover basis transactions, are deemed to acquire property by "purchase" (a prerequisite to the treatment of the property as qualified New York Liberty Zone property). This rule should apply only if the old "transferor" partnership had itself acquired the property by purchase, as the mere existence of a technical termination does not provide sufficient reason to deem the statutory "purchase" requirement to have been met.

5. *Effective dates*. "Qualified New York Liberty Zone property" as defined in section 1400L potentially includes any property that is placed in service before December 31, 2006 (December 31, 2009, in the case of nonresidential real property) and meets the other requirements of that definition. Accordingly, the statement in section 1.1400L(b)-1T(g)(1) that "[t]his section expires on September 4, 2006,"[17] appears to be too limited. Section 1.1400L-1T

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[17] As per a notice of correction of the proposed regulations that was published in the Federal Register (68 Fed. Reg. 63,734 (2003)). Prior to the publication of that notice, the proposed regulations referred to an expiration date of September 7, 2006.

should apply to any qualified New York Liberty Zone property acquired by the taxpayer prior to January 1, 2007 (January 1, 2010, in the case of non-residential real property and residential rental property).[18]

[18] Code section 1400L(b)(2)(A) (flush language).