September 9, 2024

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The Honorable Commissioner Daniel Werfel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Comments addressing the treatment of unamortized section 174 costs in an M&A transaction

Dear Commissioner Werfel:

The enclosed comment letter addresses the section 174 guidance project listed on the Priority Guidance Plan published by the Treasury Department and the Internal Revenue Service. Our comment letter focuses on transactions that involve the acquisition or disposition of a trade or business—transactions commonly referred to as merger and acquisition ("M&A") transactions. In connection with M&A transactions, many taxpayers must determine the proper federal income tax treatment of costs previously capitalized under section 174.

These comments represent the view of RSM US LLP ("RSM"). RSM is the fifth largest public accounting firm in the United States ("U.S.") and is committed to guiding clients through their business challenges. RSM particularly focuses on serving clients in the middle market, which accounts for more than a third of U.S. employment and about 40% of the U.S. gross domestic product.

RSM has prepared and submits the attached comments on its own behalf. RSM has many clients that would be affected by issuance of guidance on this topic. Many companies, particularly those in the life science, technology, and manufacturing industries, regularly incur significant amounts of costs required to be capitalized under section 174.

Section 174 governs the ability of taxpayers to deduct certain research and experimental expenditures ("Section 174 Costs"). For taxable years beginning after December 31, 2021, taxpayers do not have the option to immediately deduct Section 174 Costs but must instead amortize these costs over a five-year (or fifteen-year) period.

Our comments address this question under section 174: If a taxpayer disposes of its entire business in an M&A transaction, is that taxpayer required or permitted to immediately deduct the remaining capitalized unamortized Section 174 Costs? At present, the answer to this question often is unclear and taxpayers and their advisors take diverse approaches toward answering it. This question affects capitalized Section 174 Costs that may be measured in billions of dollars.

A company that undergoes an M&A transaction must determine the treatment of its previously capitalized and unamortized Section 174 Costs following the transaction. The magnitude of the

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capitalized Section 174 Costs makes the tax question addressed in these comments important to the U.S. government, M&A target companies, and M&A acquirers.

We urge Treasury and the Service to consider our comments in this regard. We would be pleased to discuss these comments with you. To discuss these comments or related matters, please contact Nick Gruidl at Nick.Gruidl@rsmus.com, Stefan Gottschalk at Stefan.Gottschalk@rsmus.com, Eric Brauer at Eric.Brauer@rsmus.com, or Joseph Wiener at Joseph.Wiener@rsmus.com.

Sincerely,

Nick Gruidl

Enclosure

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I. Introduction

This comment letter addresses the section 174[1] guidance project listed on the Priority Guidance Plan ("PGP") published by the Treasury Department ("Treasury") and the Internal Revenue Service ("the Service").[2] Our comments address specific issues under section 174, representing part of the section 174 guidance project's scope.[3]

Section 174 now requires capitalization and amortization of certain research or experimental expenditures paid or incurred during the taxable year in connection with a trade or business ("Section 174 Costs").[4] Section 174's mandatory capitalization rule was added to the Code in The Tax Cuts and Jobs Act of 2017, effective for taxable years beginning after December 31, 2021.[5] This letter focuses on the treatment of Section 174 Costs in transactions that involve the acquisition or disposition of a trade or business—transactions commonly referred to as merger and acquisition ("M&A") transactions.

In M&A transactions, taxpayers often must determine the answer to this question: Is a taxpayer whose entire business is acquired in a M&A transaction required or permitted to immediately deduct its remaining capitalized unamortized Section 174 Costs? At present, the answer to this question often is unclear and taxpayers and their advisors take diverse approaches toward answering it.

Interpretation of the Code in accordance with its plain meaning is the federal courts' generally preferred approach.[6] Section 174(d)'s plain meaning, however, could be interpreted to require certain business entities to report amortization of Section 174 Costs on their federal income tax returns for years following the cessation of the entities' existence. The plain meaning of section 174(d) would accordingly appear to conflict with the plain meaning of section 6012's federal

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[1] Unless otherwise stated or clear from the context, all references to "section" in this letter are to the Internal Revenue Code of 1986, as amended (the "Code"), and references to "Regulation" or "Reg. section" are to regulations promulgated under the Code.

[2] Treasury, 2023–2024 PGP (Initial Version) General Tax Issues, ¶ 22 (Sep. 29, 2023); Treasury, 2023–2024 PGP (Second Quarter Update), General Tax Issues, ¶ 22 (Mar. 18, 2024), Treasury, 2023–2024 PGP (Third Quarter Update), General Tax Issues, ¶ 22 (June 25, 2024) available at https://www.irs.gov/pub/irs-counsel/2023-2024-third-quarter-update.pdf.

[3] In September 2023, the Service released Notice 2023-63, 2023-39 I.R.B. 919, which provides interim guidance on section 174. Although the Notice in part provides preliminary guidance on the treatment of unamortized Section 174 Costs in certain M&A transactions, the Notice does not address the treatment of the costs in many common forms of M&A transactions (for example, those involving partnerships or partially taxable asset sales). We discuss these transaction forms below.

[4] Section 174(a).

[5] TCJA, Pub. L. No. 115-97, section 13206 (2017).

[6] The plain meaning principle is a long-standing maxim repeatedly expressed by the Supreme Court: ". . . the words of statutes – including revenue acts – should be interpreted where possible in their ordinary, everyday senses." *Crane v. Comm'r*, 331 U.S. 1 (1947), *citing Old Colony R.R. Co. v. Comm'r*, 284 U.S. 552 (1932).

income tax return filing requirements as well as with common business sense.[7] As discussed further below, there are uncertainties regarding the meaning of section 174(d)'s references to:

- Transactions in which property with respect to which Section 174 Costs are paid or incurred is disposed of, retired, or abandoned;
- Losses that shall not be allowed; and
- Amortization that shall continue.

We believe that it is important for Treasury and the Service to address the treatment of Section 174 Costs in M&A transactions in a comprehensive and administrable way because (1) the proper interpretation of section 174(d) is uncertain, (2) taxpayers' deductions at stake may total billions of dollars, and (3) taxpayers and tax practitioners apply a diversity of views and approaches in practice.

In summary, we recommend that Treasury and the Service adopt regulations reflecting the following principles:

1. Section 174 Costs are not tax basis in other property: Capitalized Section 174 Costs are not treated as part of the tax basis in any particular item of property for federal income tax purposes. Alternately, Capitalized Section 174 Costs are not treated as part of the tax basis in any particular item of property for federal income tax purposes other than Capitalized Section 174 Costs.
2. Covered Property Dispositions do not result in accelerated cost recovery: Section 174(d) generally prevents a taxpayer from deducting its previously unamortized capitalized Section 174 Costs in connection with disposal, retirement, or abandonment of property with respect to which Section 174 Costs are paid or incurred (a "Covered Property Disposition"). This prohibition should apply without regard to whether the Covered Property Disposition does (or would) give rise to a gain or a loss and without regard to whether the character of any such gain or loss is (or would be) ordinary or capital.
3. A Taxable Business Sale and Cessation is not a Covered Property Distribution: A Covered Property Disposition does not include a taxable transaction in which the taxpayer disposes of its entire trade or business in an M&A transaction and ceases operating its trade or business (a "Taxable Business Sale and Cessation"). In connection with a Taxable Business Sale and Cessation, the taxpayer generally would be allowed to deduct its remaining Section 174 Costs, applying section 165 and/or general federal tax accounting principles.
4. Retention of a threshold ownership level prevents Taxable Business Sale and Cessation qualification: Rules should be provided for determining whether a Taxable Business Sale and Cessation has occurred in a transaction involving a taxpayer's disposal of its entire trade or business where: (1) the taxpayer (or a related party) retains a degree of ownership in the transferred business, and/or (2) the transaction is partially taxable and partially tax-free with respect to the taxpayer. Under those rules, whether the taxpayer

[7] Section 6012 provides thresholds for when an entity or individual must file a tax return. The plain meaning of section 174(d) ("such amortization deduction shall continue") could be interpreted to require that an entity or person must file a tax return even where (i) the entity or person has ceased to exist or (ii) where the entity or person's income is less than the section 6012 threshold applicable to that person or entity.

may recover its previously unamortized capitalized Section 174 Costs should depend on the type of M&A transaction that has occurred and the degree of the taxpayer's continuing ownership over and participation in the taxpayer's business. For example one approach consistent with our recommendation would prohibit the taxpayer's recovery of those Section 174 Costs if the taxpayer reaches either of the following two thresholds in connection with the transaction: (a) continued direct or indirect ownership by the taxpayer (and/or a related party) of 20% or more of the business by value, or (b) the proceeds of the transaction received without recognition of gain or loss by the taxpayer (and/or a related party) total 20% or more of the total consideration received by such party (or parties).

5. Anti-abuse rule: An anti-abuse rule should be added that includes in the definition of "Covered Property Disposition" any transaction entered into by a taxpayer with the principal purpose of accelerating the deduction of Section 174 Costs (thereby preventing taxpayers who have entered into such transactions from accelerating their deduction of their Section 174 Costs as a result).

II. Background

A. Overview of section 174

Generally, taxpayers must capitalize and depreciate over their useful life business expenses associated with the development or creation of an asset with a useful life that extends beyond the current year.[8] Prior to the enactment of P.L. 115-97, commonly known as the Tax Cuts and Jobs Act (the "TCJA"), however, taxpayers could currently deduct certain research or experimental expenditures paid or incurred during the taxable year in connection with a trade or business (i.e., the Section 174 Costs now required to be capitalized under section 174(a)).[9] Alternatively, taxpayers could elect to forego a current deduction, capitalize their Section 174 Costs, and recover those costs over the useful life of the research. The period of recovery could in no case be less than 60 months.[10]

The TCJA amended section 174 as it relates to amounts paid or incurred in taxable years beginning after December 31, 2021. Under the new rule, taxpayers do not have the option to immediately deduct Section 174 Costs. Rather, these costs are chargeable to a capital account and amortized over a five-year period (or a fifteen-year period for costs attributable to foreign research).[11]

Moreover, the amended section 174 treats a taxpayer's annually capitalized Section 174 Costs as a single capital account or asset, except that a taxpayer with both domestic and foreign Section 174 Costs is required to maintain two capital accounts, one for the domestic Section

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[8] Sections 167 and 263(a).

[9] Section 174(a), as applicable for amounts paid or incurred in taxable years beginning before January 1, 2022, amended by section 13206(a) of the TCJA.

[10] Sections 174(b) and (f)(2), as applicable for amounts paid or incurred in taxable years beginning before January 1, 2022, amended by section 13206(a) of the TCJA.

[11] Section 174(a), as applicable to amounts paid or incurred for taxable years beginning after December 31, 2021.

174 Costs and one for the foreign Section 174 Costs. We believe this approach (the "Single Capital Account Approach") is correct, while we understand that some practitioners disagree. Guidance issued by the Service to date is consistent with the Single Capital Account Approach.[12]

Regulations that address the elective capitalization of deductible research costs under pre-TCJA section 174 state that the elective capitalization under prior law was not permitted for expenditures producing property with an ascertainable useful life.[13] The required amortization period for capitalized costs under pre-TCJA section 174 was 60 months or longer, with the taxpayer retaining discretion in that regard and permitted to set up multiple pools of capitalized costs treated as deferred expenses under prior law.[14] Project-by-project pooling was permitted.[15] Then, if the research at a later date resulted in property with an ascertainable useful life, that property's useful life would provide the time period over which deduction of the remaining capitalized costs would be allowed.[16]

Those regulations, promulgated in 1957, recognized that the elective capitalization of research costs would apply based on the activity funded by the relevant expenditures and did not require the production of any identifiable property. A regime that requires associating research expenses with the property created through those expenses would appear contrary to Congressional intent underlying section 174.[17]

Now, section 174(a) requires identical treatment for all "a taxpayer's specified research or experimental expenditures for any taxable year." As a result of the different amortization periods for domestic and foreign research, a taxpayer may have two separate pools of Section 174 Costs for a given taxable year. However, those pools are undifferentiated by property produced, research project, or any other aspect or element of the expenditures in the pools.[18]

Section 174(d)'s prohibition of losses with respect to the disposition, retirement, or abandonment of property with respect to which Section 174 Costs relate also clearly support the Single Capital Account Approach. Section 174(d) provides that taxpayers may not deduct unamortized Section 174 Costs merely because the project or activity attributable to the

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[12] Notice 2023-63, 2023-39 I.R.B. 919.

[13] Reg. section 1.174-4(a)(2).

[14] Reg. section 1.174-4(a)(3).

[15] Reg. sections 1.174-4(a)(3) and -4(a)(5).

[16] Reg. section 1.174-4(a)(4).

[17] *See* S. Rep. No. 83-1622, at 33 (1954); H.R. Rep. No. 83-1337, at 28 (1954).

[18] Section 174 Costs are pooled each year and are amortized from that pool beginning in the tax year in which they are incurred. This pooling approach applies even where all of a taxpayer's Section 174 Costs relate to a single project continuing over multiple years.

expenditures (such as a self-created intangible asset) was disposed of, retired, or abandoned.[19] Section 1749d)'s text reads:

> If any property with respect to which specified research or experimental expenditures are paid or incurred is disposed, retired, or abandoned during the period during which such expenditures are allowed as an amortization deduction under this section, no deduction shall be allowed with respect to such expenditures on account of such disposition, retirement, or abandonment and such amortization deduction shall continue with respect to such expenditures.[20]

If a taxpayer disposes of its entire business in an M&A transaction, it is unclear whether section 174(d) prohibits the taxpayer from deducting any remaining unamortized Section 174 Costs.[21] This lack of clarity stems from multiple factors.

One factor contributing to the lack of clarity is that section 174(d)'s plain meaning could require a taxpayer that has disposed of all its business assets but has not yet dissolved or liquidated (actual or de-facto) to continue amortizing the costs despite a lack of business activity.

For example, would retention of the unamortized capitalized Section 174 costs represent an asset that prevents a corporation from undergoing a de-facto liquidation?[22] If so, would the corporation receive amortization deductions where it no longer operates a business?

Additionally, section 174(d)'s plain meaning could be read in a way that runs counter to section 446(b)'s mandate that a taxpayer's method of accounting should clearly reflect the taxpayer's income. Under that rule, for example, deferred income items and deferred deduction items generally are accelerated when a taxpayer disposes of all of its business assets.[23] Any required accounting method that does not apply a similar principle to a taxpayer's Section 174 Costs in the event of a sale of all of the taxpayer's business assets generally would not clearly reflect the

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[19] Section 174(d). *See also* H.R. Rep. No. 115-466, at 424-25 (2017).

[20] Section 174(d).

[21] *See*, *e.g.*, Richman, "ABA Section of Taxation Meeting: Research Amortization Dispositions Raise Unprecedented Issues," *Tax Notes Federal*, May 8, 2023 (officials of Treasury and the Service note the lack of clarity regarding the treatment of Section 174 Costs upon an M&A transaction).

[22] *See*, *e.g.*, *Estate of Maguire v. Comm'r*, 50 T.C. 130 (1968) (a corporation may undergo a de facto liquidation for federal tax purposes even if the corporation does not liquidate under state law); Rev. Rul. 76-525, 1976-2 C.B. 98 (a corporation that retains any property for the purpose of continuing the operation of the existing business or for the purpose of engaging in a new business has not de facto liquidated).

[23] *See*, *e.g.*, Section 195(b)(2) (start-up costs); *Shellabarger Grain Products Co. v. Comm'r*, 146 F.2d 177 (7th Cir. 1944) (capitalized organization costs deductible for corporation under contractual obligation to dissolve and to cease engaging in business even though corporation had not yet dissolved); *Rotolo v. Comm'r*, 88 T.C. 1500 (1987) (inventory costs attributable to uncompleted contracts deductible in corporate liquidation context). *See also* Section 165 and Reg. section 1.165-1 (abandoned or worthless property); section 195(b)(2) (start-up costs).

taxpayer's income and as a result would appear contrary to section 446(b), which requires that a taxpayer's method of accounting clearly reflect the taxpayer's income.[24]

There are a number of routes available to Treasury and the Service to bring clarity to the application of section 174(d) to M&A transactions. One route would be to issue guidance providing that Section 174 Costs represent tax basis in the property with respect to which specified research or experimental expenditures are paid or incurred (Respect to Which Property) and that this tax basis may be recovered upon sale or disposition of the Respect to Which Property so long as such sale or disposition does not result in a loss. Some practitioners advocate tax return filing positions taking this route.

However, this route suffers from several shortcomings. First, authorizing a deduction upon any sale of Respect to Which property appears to conflict with section 174(d)'s instruction "and such amortization shall continue." Second, authorizing a deduction upon any sale of Respect to Which property conflicts with the Single Capital Account approach, discussed above. Notice 2023-63 (discussed below) rejects this route, perhaps for these reasons.[25]

Another route to bringing clarity to the application of section 174(d) to M&A transactions is to interpret section 174(d)'s reference to dispositions of property to refer specifically to transactions that do not involve the taxpayer's disposition of its entire trade or business and the taxpayer's cessation of the operation of its trade or business. This, in our opinion, is a reasonable and administrable approach.

We believe this approach is consistent with both section 174 and with the rest of federal income tax law. Under federal income tax law, deferred income items and deferred deduction items generally are accelerated when a taxpayer disposes of all of its business assets, as noted above.[26] Additionally, accelerating any remaining deferred income or deduction items upon a taxpayer's cessation of business provides for a clear reflection of income as required by section 446(b). We provide further support for this approach below. We accordingly request that Treasury and the Service bring clarity to the application of section 174(d) by generally prohibiting property dispositions from accelerating recovery of capitalized Section 174 Costs while simultaneously providing an exception for certain M&A transactions that involve a

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[24] We discuss below whether this acceleration approach is appropriate in all transaction structures. For example, one issue we discuss below is whether a fully tax deferred section 351 or section 721 transaction (structures that generally accelerate deferred items such as advance payments for services) should generate an immediate deduction of Section 174 Costs.

[25] 2023-39 I.R.B. 919.

[26] *See*, *e.g.*, *Shellabarger Grain Products*, 146 F.2d 177; *Rotolo*, 88 T.C. 1500. *See also* section 165 and Reg. section 1.165-1; section 195(b)(2).

disposition of all of a taxpayer's trade or business assets and the cessation of the taxpayer's conduct of the trade or business.

B. Interim guidance under Notice 2023-63

In September 2023, the Service released Notice 2023-63 (the Notice),[27] which provides interim guidance on the application of section 174. The Notice in part provides preliminary guidance on the treatment of unamortized Section 174 Costs when a taxpayer disposes of its business in certain M&A transactions.

Section 7 of the Notice addresses the treatment of unamortized Section 174 Costs if property with respect to which such costs were paid or incurred is disposed of, retired, or abandoned in certain transactions during the section 174 amortization period. The Notice provides helpful guidance confirming the treatment of unamortized Section 174 Costs in the context of tax-free transactions under section 381(a) and the taxable liquidation or dissolution of corporations that do not fall within section 381(a).

The Notice provides that a corporation acquired via an acquisitive section 368(a) reorganization may not deduct its unamortized Section 174 Costs. The Notice provides for an identical result upon the tax-free liquidation of a corporation under section 332.[28] By contrast, the Notice provides that a corporation that ceases to exist due to a non-section 381(a) transaction (e.g., a taxable liquidation or dissolution governed by sections 331, 336, and/or 1001) may deduct its unamortized Section 174 Costs.[29] The Notice also provides that a taxpayer that disposes of the assets of a business (even in a section 1060(c) applicable asset acquisition)[30] may not immediately deduct its unamortized Section 174 Costs and that the acquirer may not amortize any of the seller's Section 174 Costs. The Notice provides welcome clarification of the position of Service and Treasury concerning the treatment of unamortized Section 174 Costs in these situations.

However, the Notice does not address various open questions that remain regarding the treatment of unamortized Section 174 Costs following many forms of M&A transactions.

The Notice provides limited guidance on the application of section 174(d) where a taxpayer disposes of its business in a taxable asset sale but remains in existence. An example in the Notice describes a Company X that sells to Company Y property with respect to which its Section 174 Costs were incurred.[31] The example does not clarify whether the company was a corporation and whether it disposed of all or merely some portion of its business assets. The

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[27] Notice 2023-63, 2023-39 I.R.B. 919, section 7.05(1)(c).

[28] Notice 2023-63, section 7.04(1). Note, however, that the facts surrounding the corporation's liquidation should, in our view, sometimes permit the deduction of such costs. An example is when the corporation liquidates as part of a section 338 or section 336(e) election transaction, as we discuss further below.

[29] Notice 2023-63, section 7.04(2)(a).

[30] Under section 1060(c), an applicable asset acquisition generally refers to a taxable transfer of assets that constitute a trade or business.

[31] Notice 2023-63, sections 7.05(1)(a) and 7.05(1)(b).

Notice concludes that the Company X continues amortizing and is not permitted to immediately deduct its unamortized Section 174 Costs. In computing its gain or loss under section 1001, Company X does not offset its amount realized by its adjusted basis in unamortized Section 174 Costs. Company Y in no way amortizes any portion of the Section 174 Costs paid or incurred by Company X. The Notice clarifies that that same analysis would apply if Company X's asset sale met the definition of an applicable asset acquisition under section 1060.[32] Consistent with the language of section 174(d), the example makes clear that a company cannot deduct its unamortized Section 174 Costs merely because it sells the specific property with respect to which Section 174 Costs were paid or incurred.

It is unclear how broadly taxpayers should read this example. A broad reading would conclude that a taxpayer selling assets—even if it sells its entire business and is left with an empty shell that remains in existence solely to receive deferred payments, for example—is not entitled to deduct unamortized Section 174 Costs. However, we believe that interpretation of section 174(d) is should not apply.

In addition, the Notice states that unamortized Section 174 Costs may not be deducted where the assets of the business are transferred to a corporation in a section 351 exchange.[33] Here, too, it is unclear whether this rule is appropriate with regard to a taxpayer that transfers its entire business in a section 351 transaction and receives significant boot under section 351(b) and only a small interest in the corporate transferee. We note that the Service has privately ruled that a section 351 transfer with boot can represent a taxable acquisition and covered transaction under Reg. section 1.263(a)-5.[34] We discuss this further below.

The Notice further states that taxpayers may not rely on section 7 of the Notice if the property is contributed to or distributed/transferred from a partnership.[35]

This letter discusses issues relating to M&A transactions not addressed in the Notice and sets forth recommendations and possible solutions. First, this letter further discusses the interpretation of section 174(d), including the interaction of section 165(a) and section 174(d). Next, the letter discusses certain specific M&A transactions where, we believe, it is appropriate for the taxpayer to deduct unamortized Section 174 Costs—e.g., fully taxable asset sales in which the seller disposes of its entire business. Third, the letter discusses certain specific M&A transactions where, we believe, it is inappropriate for the taxpayer to deduct unamortized Section 174 Costs—e.g., acquisitive reorganizations, tax-free liquidations, and section 351 exchanges within a consolidated group. Fourth, the letter discusses certain specific M&A transactions where it is less clear if a taxpayer may deduct unamortized Section 174 Costs—e.g., partially taxable asset transactions in which the seller retains a rollover interest in the business following the transaction. Lastly, the letter discusses potentially abusive situations

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[32] Notice 2023-63, section 7.05(1)(c).

[33] Notice 2023-63, section 7.05(1)(c).

[34] PLR 201319009 (May 10, 2013) (section 351 with boot transaction constituted a "covered transaction" within the meaning of Reg. section 1.263(a)-5(e)(3)(ii) (generally covering a taxable acquisition of an ownership interest in a business entity), thereby affecting the acquiring corporation's recovery of its transaction costs).

[35] Notice 2023-63, section 10.01.

involving a transaction effected with a principal purpose of accelerating unamortized Section 174 Costs.

III. Disposing an entire business and treatment of unamortized Section 174 Costs

A. Interpretation of section 174(d)

We believe it is proper to interpret section 174(d)'s reference to disposition, retirement, or abandonment of property to refer to transactions that do not involve the taxpayer disposing of its entire trade or business and ceasing to operate its trade or business. This interpretation is consistent with general principles of federal tax law discussed above, namely: (1) acceleration of deferred income items and deferred deduction items when a taxpayer disposes of all of its business assets is proper, and (2) acceleration of any remaining deferred income or deduction items upon a taxpayer's cessation of business provides for a clear reflection of income as required by section 446(b) ("the General Acceleration Principles").[36] We will next discuss additional reasons why this interpretation is proper.

A pivotal question, in our view, is the scope of section 174(d). Does section 174(d) disallow a deduction in every possible situation involving a disposal of property to which Section 174 Costs relate? Or is the section 174(d) limitation confined to situations in which a specific item of property, or perhaps a specific business line, is disposed?

If the latter reading is correct, a taxpayer that disposes of all its business assets and completely ceases its operations may immediately deduct its remaining unamortized Section 174 Costs, notwithstanding section 174(d). In our view, the latter reading is more appropriate, for multiple reasons.

First, the language "any property with respect to which specified research or experimental expenditures are paid or incurred is disposed..." suggests that the provision addresses the disposal of specific items of property, not the disposal of items of property as part of the complete cessation of the taxpayer's trade or business. Second, the language "and such amortization deduction shall continue with respect to such expenditures" likewise implies that the provision addresses a taxpayer that is continuing to operate a trade or business. Third, the General Acceleration Principles noted above should inform the interpretation of section 174(d). Fourth, section 165 (discussed below) and section 6012 (discussed above) should inform the interpretation of section 174(d). Fifth, section 174(d)'s restriction appears to be aimed at large business entities that divest of certain assets or one of their business lines; applying that restriction to an entity that completely ceases its business seems overly broad (and below we note several analogous provisions in the Code that draw just such a distinction). And sixth, the notion underpinning section 174(d)—that a taxpayer may not deduct but should instead continue amortizing its Section 174 Costs even after disposing of the business assets relating to those costs—does not apply where the business entity ceases its operations completely. In that case, disallowing the taxpayer to take a current-year deduction could cause the taxpayer to

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[36] *See*, *e.g.*, *Shellabarger Grain Products*, 146 F.2d 177; *Rotolo*, 88 T.C. 1500. *See also* section 165 and Reg. section 1.165-1; section 195(b)(2). Accelerating any remaining deferred income or deduction items upon a taxpayer's cessation of business provides for a clear reflection of income as required by section 446(b).

perpetually lose the deduction associated with those costs, and that result seems anomalous, overly harsh, and inconsistent with the intent of section 174(d).

Consider the following scenario—a fully taxable asset sale, in which an S corporation that incurred Section 174 Costs sells its entire business and ceases its operations, but does not cease to exist:

> Base Example: Seller, a subchapter S corporation for U.S. federal income tax purposes, runs a business that it bought several years ago. Seller incurred Section 174 Costs in the course of creating a separate section 197 intangible asset (e.g., computer software).[37] Seller sells its entire business to Buyer in a fully taxable asset sale. After the sale, Seller ceases to operate any business and holds only cash.

In this example, where Seller's sale of its entire business rendered its unamortized Section 174 Costs obsolete and worthless, we believe section 174(d) does not prevent Seller from writing off those costs. We do not think it is appropriate, nor does the Notice support the conclusion, that section 174(d) eliminates the ability to take a deduction in such a situation. Rather, in our view Seller is entitled to deduct its unamortized Section 174 Costs since Seller no longer operates any business (i.e., an identifiable loss event has occurred) and the costs no longer have current or future potential value.[38]

What is the practical result if section 174(d) is read to prevent Seller from deducting its unamortized Section 174 Costs even when it ceases its entire business? As noted, Section 174 Costs are capitalized (and amortized) separately from the assets to which they are attributable. When Seller disposes of all of the assets of its business, it does not dispose of its unamortized Section 174 Costs. Therefore, these costs are not recovered as tax basis when calculating Seller's gain or loss on the sale of its business despite potentially contributing to the overall value of Seller's business. Because Seller ceases conducting its business, amortization of Section 174 Costs in subsequent taxable years typically has no benefit (or limited benefit). Seller would therefore be subject to a non-economic tax because Seller would be unable to deduct its unamortized Section 174 Costs as worthless nor utilize the costs to reduce its gain

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[37] Unless otherwise stated, assume for purposes of this discussion that the relevant Section 174 Costs are not attributable to foreign research (within the meaning of section 41(d)(4)(F)) and, therefore, are amortizable ratably over a 5-year period.

[38] The transaction in this example provides the appropriate time for deduction under the General Acceleration Principles discussed above. Further, there is little difference, from an economic perspective, between this base example and a situation where an S corporation is treated as undergoing a section 331 liquidation as part of a section 336(e) or section 338(h)(10) election. An overly broad reading of the Notice would permit the S corporation to deduct its costs in such a case but prohibit it in the case of the base example, and such a distinction seems illogical.

realized from the disposition of the business. This unjust result was likely not the intention of Congress when it enacted section 174(d).

B. Interaction of section 174(d) and section 165

Section 165(a) states: "There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise." Reg. section 1.165-1(a) adds:

> Section 165(a) provides that, in computing taxable income under section 63, any loss actually sustained during the taxable year and not made good by insurance or some other form of compensation shall be allowed as a deduction subject to any provision of the internal revenue laws which prohibits or limits the amount of deduction.[39]

Section 165, on its face, would appear to permit a taxpayer to deduct remaining unamortized Section 174 Costs upon the disposition of the assets to which those costs relate. However, section 174(d) provides that a deduction is not allowed when property produced by Section 174 Costs is disposed. In line with the caveat of Reg. section 1.165-1(a) that losses otherwise permitted under section 165 can be disallowed under other provisions of the Code, section 174(d) acts to limits the application of section 165(a). However, although section 174(d) limits the application of section 165 where a taxpayer disposes of certain business assets, that limitation would appear inappropriately broad if applied to a situation in which a taxpayer disposes of its entire business.

To establish a section 165(a) deduction generally, a loss must be evidenced by a closed and completed transaction, fixed by identifiable events, and actually sustained during the taxable year.[40] Notably, the section 165 regulations provide that the usefulness of property may terminate due to the discontinuance of the associated business, through a transaction, or through permanently discarding the property.[41] Section 174(d), in our view, defers any such deduction until the end of the 5-year amortization period—but not past the point in time when the taxpayer no longer operates any business and any unamortized Section 174 Costs have no remaining current or potential value.

In the following two sections, we discuss several Code and regulatory provisions that indicate that amortizable costs should be eligible for section 165 loss treatment.

C. Treatment of start-up expenditures under section 195

The current tax treatment of Section 174 Costs is analogous to the tax treatment of section 195 start-up expenditures. Similar to section 174(a), section 195(a) disallows taxpayers from

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[39] Reg. section 1.165-1(a).

[40] Reg. section 1.165-1(b).

[41] Reg. section 1.165-2(a). Although this regulation relates specifically to the worthlessness or abandonment of non-depreciable property, other regulations address the abandonment of depreciable property. *See* Reg. section 1.167(a)-8(a)(4) (a taxpayer that irrevocably abandons depreciable property may recognize loss in the amount of the asset's adjusted basis).

deducting most of their start-up expenditures in the year they arise.[42] Instead, a taxpayer generally must amortize its start-up expenditures ratably over a 180-month period.[43] In effect, the Code creates a deferral mechanism for both start-up expenditures and Section 174 Costs by requiring that these costs be capitalized to a separate asset (or capital account).

If a taxpayer completely disposes of its trade or business prior to the end of the 180-month period, section 195 explicitly provides that the taxpayer may deduct any remaining deferred start-up expenditures "to the extent allowable under section 165."[44] This section 195 provision therefore acknowledges that section 165 provides a basis to permit a deduction for deferred expenditures remaining after the sale or disposition of the associated business. Section 165 similarly provides a basis for a taxpayer to deduct unamortized Section 174 Costs remaining after the sale or disposition of the associated business and which have therefore become worthless.

D. Worthlessness or abandonment of section 197 intangibles

Like the rule provided in section 174(d) governing the deduction of unamortized Section 174 Costs, the Code and regulations contain special limitations on a taxpayer's ability to recognize losses on a section 197 intangible.

If a taxpayer disposes of a section 197 intangible that was acquired in a transaction or series of related transactions in which it acquired other section 197 intangibles, the taxpayer may not recognize any loss. Rather, the taxpayer must increase its basis in the retained section 197 intangibles pro rata by the amount of the disallowed loss.[45] This loss disallowance (or deferral) rule applies not only to a traditional sale but also to situations in which a taxpayer would otherwise recognize a loss due to abandonment or worthlessness.[46] The "retained intangibles" are all amortizable section 197 intangibles, or rights to use or interests in amortizable section 197 intangibles, that were acquired in the same transaction or series of related transactions as the transferred intangible and that are retained after its disposition.[47] This rule prevents taxpayers from effectively shortening the fifteen-year amortization period of multiple section 197 intangibles acquired together by disposing of some at a loss and retaining others.

For example, assume a corporation acquires two separate section 197 intangibles—a patent and a customer-based intangible—as part of its overall (taxable) purchase of a business. The patent becomes worthless a few years into its fifteen-year amortization period. Under section 197(f)(1)(A), the corporation does not recognize any loss on the worthlessness of the patent. Rather, the remaining adjusted basis in the patent is allocated to the customer-based intangible and amortized over the remainder of the fifteen-year period. If, however, the corporation

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[42] In some situations, taxpayers may currently deduct some portion of their start-up expenditures. *See* section 195(b).

[43] Section 195(b)(1).

[44] Section 195(b)(2).

[45] Section 197(f)(1)(A); Reg. section 1.197-(g)(1)(i)(A).

[46] Reg. section 1.197-2(g)(1)(i)(B).

[47] Reg. section 1.197-(g)(1)(i)(A).

disposed of the entire business, section 197(f)(1) does not disallow a deduction on the worthlessness of the patent.[48]

The loss disallowance rule of section 174(d) is similar to the loss disallowance rule of section 197(f)(1). Namely, section 174(d) prevents a taxpayer from writing off unamortized Section 174 Costs when the specific asset or project for which the expenditures were incurred is disposed of or abandoned, as the unamortized Section 174 Costs could potentially create value elsewhere in the business. By contrast, a taxpayer's disposition of its entire trade or business renders unamortized Section 174 Costs worthless under section 165, similar to section 165's effect on unamortized section 197 costs.

E. Acceleration of capitalized costs when a taxpayer ceases to conduct business

As noted above, courts generally permit taxpayers to accelerate deduction of their capitalized costs when the taxpayer has ceased conducting business and will dissolve or liquidate. In *Shellabarger Grain Products*, the Seventh Circuit held that the taxpayer's capitalized organizational costs were deductible during the year when the corporation undertook a contractual obligation to dissolve and to cease engaging in business even though the corporation had not yet dissolved.[49] In *Rotolo v. Comm'r*, 88 T.C. 1500 (1987), the liquidating taxpayer was permitted to deduct inventory costs with respect to inventory that was produced under contract and had not yet been sold.[50] Courts have allowed these deductions whether or not they relate to salable property and whether or not the costs pertain to worthless property that could trigger a section 165 loss deduction.

F. Interpreting section 174(d) – Summary

In short, we believe that section 174(d) is best interpreted as preventing taxpayers from immediately deducting unamortized Section 174 Costs where only the specific asset, project, or product line for which the expenditures were incurred is disposed of or abandoned. Essentially, section 174(d) reinforces the treatment of Section 174 Costs as a capitalized cost/asset separate from the specific asset or project that the research expenditures helped create or enhance. Further, section 174(d) acknowledges that the unamortized Section 174 Costs could create value elsewhere in the taxpayer's business(es) even if the original asset or project to which they were directed is disposed of or abandoned. By contrast, a taxpayer that disposes of

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[48] The legislative history to section 197(f)(1)(A) states that "these special rules do not apply to a section 197 intangible that is separately acquired (i.e., a section 197 intangible that is acquired other than in a transaction or series of related transactions that involve the acquisition of other section 197 intangibles). Consequently, a loss may be recognized upon the disposition of a separately acquired section 197 intangible." H.R. Rep. No. 213, 103d Cong., 1st Sess. 685 n.21 (1993).

[49] *Shellabarger Grain Products*, 146 F.2d 177.

[50] *Rotolo*, 88 T.C. 1500.

its entire business typically has no further use for unamortized Section 174 Costs. In that case, the unamortized Section 174 Costs should be deductible under the authorities discussed above.

IV. Unamortized Section 174 Costs and specific M&A transactions

As discussed above, we believe that taxpayers are generally entitled to immediately deduct unamortized Section 174 Costs that remain after the disposition or cessation of the taxpayer's business. With regard to certain M&A transactions, however, this result is not as clear. In this section, we discuss M&A transactions in which (1) an immediate deduction appears appropriate, (2) an immediate deduction appears inappropriate, and (3) it is unclear whether an immediate deduction is appropriate.

A. An immediate deduction of unamortized Section 174 Costs appears appropriate

With regard to certain fully taxable asset transactions, based on the above explanation it appears clear taxpayers (sellers or transferors) may immediately deduct remaining unamortized Section 174 Costs. These general categories include:

- Taxable Liquidations: A corporation completely liquidates under sections 331(a) and 336(a). This assumes that the taxpayer did not enter into the transaction with an abusive primary purpose of immediately deducting the unamortized Section 174 Costs.

- Dissolution of Insolvent Corporations: Fully taxable dissolutions of corporations resulting in a worthless stock deduction (section 165(g)) and corporate level gain or loss under section 1001.

If a corporation ceases to exist (e.g., through liquidation or dissolution) in a non-section 381(a) transaction, the Notice allows the corporation to immediately deduct its unamortized Section 174 Costs. This rule encompasses the aforementioned taxable liquidations and dissolution of insolvent corporations. As noted above, we welcome this clarification and agree that it is the appropriate result. The Notice does not, however, discuss whether the same result would apply with regard to other taxable asset transactions in which a taxpayer ceases to operate its trade or business.

- Fully Taxable Asset Sales: The seller disposes of (and ceases to operate) its entire trade or business. This category includes a taxpayer's sale of 100% of the equity of a limited liability company (LLC) treated as an entity disregarded from its owner for federal income tax purposes, where that LLC conducted the taxpayer's entire trade or business.

- Deemed Asset Sales: The relevant parties make an election under section 338(g), section 338(h)(10), or section 336(e) to treat a sale or disposition of a target corporation's stock as a taxable sale of the target corporation's assets for federal income tax purposes. Neither the seller (or disposer) of the stock nor its subsidiaries or affiliates

continue to operate a business that is the same as (or similar to) the business that incurred the unamortized Section 174 Costs.

Each of these transactions constitutes a fully taxable asset transaction. As a result, the buyer (or transferee) does not take carryover basis in the assets of the business. In addition, the seller (or transferor) ceases to operate the business and does not have a continuing interest in the business. It therefore appears appropriate to permit an immediate deduction of the unamortized Section 174 Costs.

Further, if the parties to a transaction make a section 338(h)(10) or section 336(e) election, Old Target is treated as liquidating after the deemed transfer of its asset and liabilities to New Target.[51] The deemed liquidation of Old Target may qualify as taxable (typically under section 331) or as tax-free under section 332 (and thus constitute a section 381(a) transaction), depending on the situation. If Old Target is an S corporation, the deemed liquidation will typically qualify as taxable under section 331. Accordingly, pursuant to the Notice, Old Target should be entitled to immediately deduct its unamortized Section 174 Costs.[52]

By contrast, if Old Target is wholly owned by a corporate parent, the deemed liquidation will often qualify as a tax-free section 332 liquidation. Accordingly, the Notice would not support an immediate deduction in that case.

The status of Old Target's deemed liquidation as a section 381(a) transaction, in our view, should not alone control the treatment of its unamortized Section 174 Costs. Rather, in our view, Old Target should be entitled to immediately deduct its unamortized Section 174 Costs if its corporate parent and affiliates do not continue to conduct Old Target's business (or a similar business).

B. An immediate deduction of unamortized Section 174 Costs appears inappropriate

1. Situations where an immediate deduction appears inappropriate

With regard to certain transaction categories, in our view, taxpayers should not be permitted to immediately deduct remaining unamortized Section 174 Costs. In these transactions, the taxpayer does not sell, dispose of, or cease to operate the business. This category includes certain tax-free transactions under section 332 or section 368 (i.e., section 381 transactions), certain related-party transfers under section 351 or section 721, and any sale of a partnership interest in which the partnership's existence continues. In each of these cases, the equity holders continue operating the business enterprise in a modified form; the unamortized Section 174 Costs have therefore not become "worthless" in the hands of the taxpayer. These cases stand in contrast to situations that would qualify as Taxable Business Sale and Cessations described above, for which we advocate authorizing full acceleration of Section 174 Cost

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[51] Reg. section 1.338(h)(10)-1(d)(4); Reg. section 1.336-2(b)(1)(iii).

[52] Notice 2023-63, section 7.04(2)(a) ("... if a corporation ceases to exist for Federal income tax purposes in a transaction or series of transactions to which section 381(a) does not apply, the corporation is allowed a deduction equal to the unamortized [section 174] expenditures in its final taxable year").

deductions.[53] As such, in the following transactions, it appears the taxpayers should not immediately deduct their unamortized Section 174 Costs.

- Acquisitive Reorganizations / Tax-Free Liquidations: Tax-free reorganizations under sections 368(a)(1)(A), (C), (D), (F), or (G) or tax-free liquidations under section 332 (i.e., transactions subject to section 381(a) in which tax attributes carry over to a successor corporation).

  As noted above, the Notice clarifies that corporations that cease to exist in a section 381(a) transaction may not immediately deduct their unamortized Section 174 Costs. We agree that this is the appropriate result.[54]

- Section 351 Exchanges within a Consolidated Group: Tax-free exchanges of assets under section 351(a) that occur entirely between members of the same consolidated group.

- Formation of Partnerships by Consolidated Group Members: Members of the same consolidated group effecting tax-free transfers to a partnership under section 721 where the entire partnership is owned by consolidated group members.

- Sale / Disposition of Partnership Interest: A partner's sale or disposition of the partner's partnership interest where the partnership continues its existence.[55] (Note, however, that a partner's treatment upon such a sale is not clear. A partner's sale of a partnership interest generates ordinary income or loss—and not capital gain—to the extent attributable to unrealized receivables, inventory items, or other assets of the partnership (known colloquially as "hot assets").[56] Unamortized Section 174 Costs appear to fall outside the category of a capital asset or section 1231 asset.[57] It therefore appears

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[53] A Taxable Business Sale and Cessation, as described above, would include some section 351 and section 721 transactions, provided that the business sellers' equity interests following the transaction are sufficiently small. We discuss these partially taxable transactions further below.

[54] In our view, however, an exception should in some cases apply when a section 381 transaction is coupled with another transaction. For example, in the case of a stock sale with a section 338(h)(10) or section 336(e) election involving a deemed section 332 liquidation of Old Target into its corporate parent (which constitutes a section 381 transaction), an immediate deduction should sometimes be available, as discussed above.

[55] Consider, however, what value the buyer may attribute to unamortized section 174 costs for purposes of a section 743 adjustment. Further, the seller must consider how to treat such expenditures under section 751 (e.g., ordinary property, section 1231 property, capital asset, or other treatment). See also Reg. section 1.195-2(a) (technical termination of a partnership is not a disposition of its trade or business causing immediately deduction of start-up costs).

[56] Section 751(a).

[57] Reg. section 1.751-1(d)(2)(ii).

appropriate for a seller to take an ordinary loss to the extent of the seller's share of the amount of the unamortized costs.

2. Which entity continues amortizing the Section 174 Costs?

In transaction forms involving section 351 or section 721 transfers with continuing amortization required, another question arises: Which entity—the transferor or the transferee—should continue amortizing the Section 174 Costs?

Where the transferor has contributed only some assets of its business in the section 351 or section 721 transfer, it appears clear that (pursuant to the language of section 174(d)), the transferor should continue amortizing the Section 174 Costs. Where, however, the transferor transfers all its assets (or, perhaps, all the assets pertaining to a single line of business), it is not entirely clear whether the transferee or transferor should continue amortizing the Section 174 Costs.

The Notice implies that the transferor continues amortizing the Section 174 Costs.[58] Some argue to the contrary, relying on several arguments. An approach that permits the transferee to continue amortizing the Section 174 Costs reflects the tax policy of a clear reflection of income, as failing to follow this approach separates the tax deductions from the business assets that generated those deductions. Furthermore, common sense dictates that the amortization remains with the business that gave rise to the amortization. Additionally, such an approach would parallel the general rules regarding inheritance of amortization; in a section 351 or 721 transfer, the transferee steps into the shoes of the transferor regarding depreciation and amortization of the assets transferred.[59] Finally, an approach that requires the transferor to continue amortizing the Section 174 Costs could produce unduly harsh results, such as when the transferor completely ceases its operations and cannot thereafter utilize the remaining amortization deductions.

Permitting the transferee to amortize the Section 174 Costs, however, arguably runs counter to (i) the language of section 174(d), (ii) the Single Capital Account Approach described above, and (iii) the notion that Section 174 Costs do not constitute property transferred in a transaction.

Note further that complexities would arise under the "transferee amortizes" approach. Such complexities include, for example, the application of provisions such as sections 704, 752, 357, 358, and 362, all of which (in one form or another) often require some sort of valuation of the capitalized costs (which, in the case of Section 174 Costs, typically cannot be reasonably determined).

Businesses taxed as partnerships may incorporate via one of several methods, and the particular method taken might impact the treatment of the Section 174 Costs. The various

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[58] Notice 2023-63, section 7.04(1)(d).

[59] Section 168(i)(7) (following a section 351 or section 721 transfer, the transferee steps into the shoes of the transferor and continues to depreciate or amortize the assets received using the same method and life that the transferor used prior to the transfer).

methods include:

- Formless Conversion: In many states, the partnership (or LLC taxed as a partnership) can file a form to convert to a corporation under a state-law formless conversion statute.
- Check-the-box: The partnership can "check the box" to be taxed as a corporation.[60] In such a case, the entity retains its prior legal status (partnership or LLC) for non-tax purposes and is treated as a corporation for tax purposes.
- Merger: The partnership can merge into a newly formed corporation under a state law cross-entity merger statute.
- Contribution: The partnership or its partners can form a new corporation and transfer the business assets to the newly formed corporation. This can take one of three forms, as described in Rev. Rul. 84-111:[61]
    a. The "assets-over" method: The partnership transfers all its assets to a newly formed corporation in exchange for stock of the corporation and the corporation's assumption of the partnership liabilities. The partnership then liquidates by distributing the corporate stock received to the partners in proportion to their partnership interests.[62]
    b. The "assets-up" method: The partnership distributes all partnership assets and liabilities to the partners in liquidation of the partnership. The partners then transfer the assets to the corporation in exchange for the corporation's stock and the corporation assumes the liabilities that the partners had assumed from the distributing partnership.[63]
    c. The "interests-over" method: The partners transfer all their partnership interests to a newly formed corporation in exchange for corporate stock. The transfer terminates the partnership (since the partnership will then have a single owner), and the partnership's assets and liabilities become the assets and liabilities of the corporation.[64]

Regulations state that where the partnership makes a check-the-box election to be treated as a corporation, the "assets over" transactions are deemed to occur.[65] Similarly, where the partnership converts into a corporation under a formless conversion statute, "assets over" treatment applies.[66]

Irrespective of the method chosen, the incorporation generally constitutes a section 351 contribution (of either assets or interests) to the corporation in exchange for its stock. However,

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[60] *See* Reg. section 301.7701-3(g)(1)(i). A check-the-box election is an entity classification election pursuant to Reg. section 301.7701-3.

[61] Rev. Rul. 84-111, 1984-2 CB 88.

[62] *See* Rev. Rul. 84-111, Situation 1.

[63] *See* Rev. Rul. 84-111, Situation 2.

[64] *See* Rev. Rul. 84-111, Situation 3.

[65] Reg. section 301.7701-3(g)(1)(i).

[66] Rev. Rul. 2004-59, I.R.B. 2004-24.

Rev. Rul. 84-111, overturning a prior revenue ruling,[67] directs that the specific method used determines the resulting tax basis, gains or losses (if any), and holding periods. Accordingly, the specific method chosen might also affect whether, following the transaction, the shareholders or the corporation continue amortizing the Section 174 Costs.

The rationale to permit the transferee corporation to continue amortizing the Section 174 Costs may appear stronger in an interests-over than in an assets-over. In an interests-over, the partnership itself (and not merely its assets) is transferred to the newly formed corporation. In such a case, a position generally disallowing amortization to transfer from entity to entity would not necessarily prevent the newly formed corporation from continuing the amortization, as the partnership itself has been transferred to the newly formed corporation (and as a result has become a disregarded subsidiary of that newly formed corporation).

In contrast, the rationale to permit the transferee corporation to continue amortizing the Section 174 Costs may be less strong in an assets-over. In that case, the entity that generated the amortization (the partnership) has not been transferred to the corporation; its assets have been transferred. Permitting the transferee corporation to continue the amortization would require in some circumstances that Section 174 Costs are transferred from one entity to another.

Furthermore, the rationale to permit the transferee corporation to continue amortizing the Section 174 Costs may be stronger in an incorporation via check-the-box election or state law formless conversion than via a straight assets-over (where the partnership transfers all its assets to a newly formed corporation in exchange for stock of the corporation). In the former two scenarios, from a nontax perspective, the entity's assets and liabilities do not undergo a transfer (notwithstanding the tax fiction generally treating those scenarios as a deemed assets-over transaction sequence). By contrast, in an actual assets-over transaction sequence (as described in Rev. Rul. 84-111), the assets and liabilities are in fact transferred to a new legal entity.

If Treasury and the Service would conclude that the transferee corporation does *not* inherit the Section 174 Costs following any of the above methods of incorporating a partnership, what would happen to the remaining Section 174 Costs? Because the partnership no longer remains in existence, are the future deductions simply lost? Is the basis perhaps shifted to the corporate stock (a capital asset) under sections 732 or 358, as the case may be? Do the partnership's (former) partners inherit the remaining deductions?

If the transferee corporation does not inherit the Section 174 Costs, it would be reasonable to permit the partnership's (former) partners to inherit the partnership's remaining Section 174 Costs, applying a step-in-the-shoes principle akin to those applied under Reg. sections 1.704-

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[67] Rev. Rul. 70-239, 1970 C.B. 74.

3(a)(6)(ii) and -3(a)(7).[68]

Treasury and the Service may find tax policy considerations weighing in favor of either approach for section 351 and section 721 transactions that do not involve a Taxable Business Sale and Cessation (described above). This letter focuses on Taxable Business Sale and Cessation transactions, which involve the acquisition or disposition of a trade or business—not just the transfer of a business to a new corporation, subsidiary, group member, or lower tier partnership. Many of these Taxable Business Sale and Cessation transactions are partially taxable transactions, raising potentially significant issues, which we discuss immediately below.

C. Transactions where it is less clear whether an immediate deduction of unamortized Section 174 Costs is appropriate

1. Overview—the effect of a rollover or continuing interest

Corporate and partnership M&A transactions frequently involve partially taxable asset acquisitions in which an unrelated party acquires a significant interest in the business and the selling equity holders retain a rollover (or continuing) interest in the acquired business. As an initial matter, consider the effect of limiting the immediate deduction of unamortized Section 174 Costs to taxable corporate liquidations:

- S corporation liquidates, 10% rollover interest: S Corporation owns 100% of the membership interests of T LLC, an entity treated as a disregarded entity (DRE). Buyer LLC, a partnership, purchases 100% of the T LLC interests from S Corporation for cash. S Corporation liquidates, and certain of its shareholders contribute a portion of that cash to Buyer LLC in exchange for a 10% rollover interest.

  Because S Corporation undergoes a taxable liquidation under section 331, the Notice permits it to immediately deduct any unamortized Section 174 Costs.[69] How would such costs be treated if S Corporation instead sold 90% of T LLC to Buyer LLC and directly held the remaining 10% interest of T LLC without liquidating? A strict reading of the Notice suggests that S Corporation cannot immediately deduct its unamortized Section 174 Costs because it does not liquidate. In both cases, the shareholders of S Corporation directly or indirectly have a continuing (minority) interest in T LLC. The only difference is whether the shareholders hold their rollover interest directly (as in the above example, where the S corporation liquidates) or indirectly (where the S corporation does not liquidate but remains as a holding company). Reaching a different result regarding Section 174 Costs in these two similar situations seems inappropriate.

As discussed above, we believe that a taxpayer may immediately deduct its unamortized Section 174 Costs when it disposes of its entire business in a fully taxable asset sale. It is less

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[68] Rules governing the allocation of the inherited Section 174 Costs amongst the partnership's various partners would presumably need to address various complicated Subchapter K issues.

[69] The Notice would reach the same result if Seller's shareholders instead sold the stock of the S corporation, obtained a 10% rollover interest in the acquiring entity, and made a section 338(h)(10) or section 336(e) election.

clear, however, whether this holds true where the taxpayer sells only a portion of its business in a partially taxable asset acquisition. To what degree should the seller's rollover or continuing interest prevent the seller from immediately deducting unamortized Section 174 Costs? In other words, at what point does a seller's rollover or continuing interest in a business suggest the seller continues to operate the business enterprise and therefore provide grounds for disallowing the immediate deduction?

Several provisions in the Code and regulations might assist in addressing this question.

Technical terminations and start-up expenditures

As discussed above, the section 195 rule governing the treatment of start-up expenditures resembles the section 174 rule governing the treatment of research costs, as each provision requires taxpayers to amortize the relevant expenditure over a period of time and not deduct the expenditure in the year paid or accrued. Section 195(b)(2) allows taxpayers that dispose of their business before the end of the 180-month amortization period to immediately deduct any remaining deferred start-up expenditures to the extent permitted under section 165.

Under former section 708(b)(1)(B), a sale of 50% or more of a partnership's interest caused a "technical" termination of the partnership followed by the formation of a new partnership under section 721.[70] Under that regime, a partnership that underwent a technical termination was not permitted to immediately deduct any remaining deferred start-up expenditures. Rather, the new partnership was required to continue amortizing the deferred items over the 180-month period.[71]

This rule, which did not permit the immediate deduction of deferred section 195 expenditures. may suggest by analogy that sellers may not immediately deduct unamortized Section 174 Costs simply by transferring the business enterprise to a new entity in a fully tax deferred section 351 or section 721 transaction. In those cases, a seller's interest in the new entity reflects the seller's continued operation of the business enterprise.

Section 197(f)(9) anti-churning rules

The anti-churning rules of section 197(f)(9) may shed light on the percentage of rollover (continuing) equity interest that causes a seller to be treated as continuing to operate its trade or business for section 174(d) purposes.

Section 197, which permits amortization of the costs to acquire certain intangible property, generally applies to assets acquired after August 10, 1993, the date of its enactment as part of the Omnibus Budget Reconciliation Act of 1993.[72] The anti-churning rules of section 197(f)(9) are designed to ensure that section 197 only applies to intangible assets newly acquired after the section 197 effective date. The anti-churning rules apply to "section 197(f)(9) intangibles," which are certain intangibles held at any time during the transition period (generally, July 25,

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[70] Technical terminations were eliminated by section 13504(a)(1)-(2) of the TCJA. (P.L. 115-97).

[71] Reg. sections 1.195-2 and 1.708-1(b)(6).

[72] P.L. 103-66.

1991 to August 10, 1993).[73] The anti-churning rules prevent the amortization of these intangibles under section 197 unless they are transferred after August 10, 1993, in a transaction giving rise to a significant change in ownership or use.

In relevant part, the anti-churning rules provide that a section 197(f)(9) intangible acquired by a taxpayer after August 10, 1993, does not qualify for amortization under section 197 if the taxpayer or a related person held or used the intangible or an interest therein at any time during the transition period.[74] The anti-churning rules generally define relatedness between persons by reference to the relationships set forth in section 267(b) and section 707(b), but they substitute "20 percent" for "50 percent" each place the latter appears.[75] Relatedness is tested immediately before and immediately after the acquisition transaction (or series of related transactions).[76]

Under these rules, a person is treated as related to a partnership if the person owns, directly or indirectly, more than 20 percent of the capital or profits interest in the partnership. Similarly, a person is treated as related to a corporation if the person owns more than 20 percent of the value of the corporation's stock.[77]

The anti-churning rules' related party 20 percent threshold could be a helpful, objective measure for whether a seller that retains some amount of rollover (or continuing) interest in a target business should be treated as continuing to operate that trade or business for purposes of section 174. A rationale for analogizing to these rules is that they are designed to determine whether certain intangibles are treated as newly acquired after the section 197 effective date or, conversely, if the purchaser is too related to the selling party (and the seller is therefore treated as holding a continuing interest in the post-transaction business). The section 197 anti-churning rules could therefore provide a helpful example for designing a rule addressing whether a seller that retains a rollover equity interest in a target business after the business is sold should be treated as continuing to operate that trade or business following the transaction.[78]

Section 368 COBE and section 355 ATB rules

In addition to the anti-churning rules, the section 368 continuity of business enterprise ("COBE") rule and the section 355 active trade or business ("ATB") rule also can inform whether a seller

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[73] Reg. section 1.197-2(h)(1)(ii).

[74] Reg. section 1.197-2(h)(2). The transition period generally is the period beginning on July 25, 1991 and ending on August 10, 1993. Reg. section 1.197-2(h)(4).

[75] Reg. section 1.197-2(h)(6)(i)(A) and -2(h)(6)(i)(B). Persons also are considered related for this purpose if they are engaged in trades or businesses under common control (within the meaning of section 41(f)(1) (A) and (B)). Reg. section 1.197-2(h)(6)(i)(C).

[76] Reg. section 1.197-2(h)(6).

[77] *Id.*

[78] Because Treasury and the IRS may choose in this regard to make applicable the related party rules under section 267 and/or the constructive ownership rules under 318, it is important to note that both section 267 and section 318 are overbroad as applied to partnerships and partners in some situations. That is, partners and/or partnerships can be treated as related parties or as constructive owners as a result of only a small amount of overlapping economic

has ceased operating its trade or business and, therefore, whether a seller's Section 174 Costs should be treated as worthless.

The section 368 COBE rule provides that a transaction does not qualify as a section 368 tax-free reorganization unless an acquiring corporation either continues the target corporation's historic business or uses a significant portion of the target corporation's assets in a business.[79] The section 368 regulations provide that, for purposes of this rule, where a target corporation owns partnership interests, the corporation is generally treated as owning the business assets of the partnership if the target corporation and its qualified group members (a) own a 33-1/3% or higher interest in a partnership (a "significant interest"); or (b) own a 20% or higher interest in the partnership and have active and substantial management functions with respect to the partnership's business.[80]

For a transaction to qualify as a tax-free distribution under section 355(a), each of the distributing corporation and controlled corporation must be engaged in an active trade or business immediately after the distribution.[81] In assessing whether a corporation meets the active trade or business requirement, proposed regulations provide that a partner in a partnership is attributed the trade or business assets and activities of that partnership during the periods it owns a "significant interest" or a "meaningful interest" in the partnership.[82]

Similar to the rules governing partnerships and COBE under section 368, the section 355 proposed regulations provide that a "significant interest" is a 33-1/3% or higher interest. A partner has a "meaningful interest" if it owns a 20% or higher interest and performs active and substantial management functions for the partnership business. These activities include, for example, significant decisions regarding business issues or overall supervision, direction, and control of operating employees.[83]

Accordingly, perhaps a seller's retention of a partnership interest at or above the COBE or ATB thresholds suggests the seller has continued operating the business for purposes of section 174.

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ownership. *See* Sections 267(c)(3), 318(a)(2)(A), and 318(a)(3)(A). Treasury and the IRS recognized this overbreadth in writing regulations under section 336(e), and crafted an exception in Reg. section 1.336(e)-1(b)(12) to ownership attribution under sections 318(a)(2)(A) and 318(a)(3)(A) for partners owning less than five percent (by value) of a partnership. *See* T.D. 9619 Preamble, 78 F.R. 28467, at 28473-28474 (May 15, 2013) (summarizing comments received, which pointed out section 318's overbreadth, and explaining the section 336(e) regulations' exception). We recommend that any related party measurement Treasury and the IRS may choose to apply in regulations affecting the treatment of capitalized Section 174 Costs in M&A Transactions should be similarly crafted with exceptions to the noneconomic and overbroad related party or constructive ownership rules that may apply, such as sections 267(c)(3), 318(a)(2)(A), and 318(a)(3)(A).

[79] Reg. section 1.368-1(d).

[80] Reg. section 1.368-1(d)(4)(iii)(B) and (5), Examples 8 and 10.

[81] Section 355(b)(1)(A).

[82] Prop. Reg. section 1.355-3(b)(2)(v).

[83] Prop. Reg. section 1.355-3(b)(2)(v)(A) – (C); Prop. Reg. section 1.355-3(d)(2), Example 22.

As a final note, there are two views (often in tension) of how to treat a partnership: (a) the aggregate theory, under which co-owners have an undivided interest in the partnership's assets; and (b) the entity theory, under which the partnership is viewed as a separate and distinct taxpayer. Although we do not explore these two views here, we note that under a pure aggregate theory of partnerships, the immediate deduction of unamortized Section 174 Costs when a seller retains any interest in the partnership is difficult to countenance. However, the Code does not wholly adopt either of the aggregate or entity theories.

2. Partially taxable partnership transactions

We next apply the factors discussed above to several common partially taxable asset acquisitions involving partnerships.

Rev. Rul. 99-5 transactions**:** The following examples involve transactions in which a seller ("S") is the sole owner of a limited liability company ("T LLC") treated as a disregarded entity for Federal income tax purposes. Upon S's sale of part of its interest in T LLC to an unrelated purchaser ("P"), S is treated as selling a proportionate amount of its assets to P in a taxable asset transaction. Together, S and P are treated as contributing their respective amount of T LLC assets to a newly formed partnership in a tax-free contribution under section 721.[84]

- Rev. Rul. 99-5 – Transaction 1: S, a corporation, owns 100% of the membership interests of T LLC, an entity treated as a DRE. P acquires 70% of T LLC for cash. S is treated as selling 70% of the T LLC assets to P. P and S are then treated as transferring 70% and 30%, respectively, of the assets to a new partnership under section 721. S no longer operates T LLC's business. A former shareholder of S becomes an employee of T post-transaction and is active in the business.

  Has the seller continued operating its business for purposes of section 174? When viewed through the lens of the section 197 anti-churning rules, S's retention of a greater than 20% interest in T LLC causes it to be treated as continuing to operate its business. Therefore, the immediate deduction of unamortized Section 174 Costs would appear inappropriate.

  Viewed through the lens of the ATB and COBE rules, however, S's retention of a less than 33-1/3% interest in T LLC causes it to be treated as no longer operating its business. Accordingly, perhaps the deduction of unamortized Section 174 Costs should be permitted.

Where S retains a greater than 33-1/3% interest, the argument for worthlessness is perhaps weaker.

- Rev. Rul. 99-5 – Transaction 2: S, a corporation, owns 100% of the membership interests of T LLC, an entity treated as a DRE. P acquires 50% of T LLC for cash. S is

[84] Rev. Rul. 99-5, 199-6 I.R.B. 8.

treated as selling 50% of the T LLC assets to P. P and S are each treated as transferring 50% of the assets to a new partnership under section 721. S no longer operates T LLC's business.

On the one hand, several factors suggest that an immediate deduction of unamortized Section 174 Costs is available here as well. S has sold 50% of the assets of the business, a substantial disposition, and S has ceased operating the business in corporate form. Further, the transaction was not entered into with a principal purpose to accelerate the immediately deduction of unamortized Section 174 Costs. However, some factors suggest an immediate deduction should not be permitted. S has retained a significant interest in the business it was operating. Viewed through the section 197 anti-churning lens, S's retention of a much greater than 20% interest in T LLC would cause it to be treated as continuing to operate its business. Viewed through the COBE / ATB lens, the answer is likely the same.

If a Rev. Rul. 99-5 transaction (or similar transaction) does not rise to an identifiable event allowing for an immediately deduction of unamortized costs, then consider which party should report the continued amortization of Section 174 Costs. The most reasonable answer is that S would retain the tax account and continue amortizing the costs over the five- (or fifteen-) year period.

Rev. Rul. 99-6 transactions: The following examples involve transactions in which two partners ("PTR 1" and "PTR 2") each own an interest in T LLC, which is treated as a partnership for Federal income tax purposes. PTR 2 acquires PTR 1's entire interest and PTR 2 becomes the sole owner of T LLC. PTR 1 must treat the transaction as a sale of its T LLC partnership interest. PTR 2 must treat T LLC as making a liquidating distribution of assets and, following this distribution, PTR 2 acquires PTR 1's portion of the T LLC assets in a taxable asset transaction.[85]

- Rev. Rul. 99-6 Transaction 1: PTR 2 owns 15% and PTR 1 owns 85% of T LLC. PTR 2 acquires all of PTR 1's interest in T LLC. PTR 2 is treated as receiving its 15% share of the assets in a liquidating distribution and as acquiring the remaining 85% of T LLC assets from PTR 1. PTR 2 did not operate T LLC's business prior to the transaction and was a passive partner.

  When viewed through the lens of the section 195 anti-churning rules, because PTR 2's initial ownership was less-than-20%, PTR 1 may be viewed as not continuing its business. The result should be the same when viewed through the lens of the COBE / ATB rules. PTR 2 held only a minority interest (i.e., less than 33-1/3%) in T LLC and neither operated nor was active in the business of T LLC prior to the transaction. Because PTR 1 is treated as selling its partnership interest (versus selling assets), it

[85] Rev. Rul. 99-6, 1999-6 I.R.B. 6, Situation 1.

appears reasonable for PTR 1 to claim a deduction for its share of T LLC's unamortized Section 174 Costs.[86]

It is less clear, however, whether T LLC could immediately deduct unamortized Section 174 Costs had PTR 2 (a) owned a 33-1/3% (or more) interest in T LLC or (b) a 20% (or more) interest in T LLC.

- Rev. Rul. 99-6 Transaction 2: PTR 1 owns 50% and PTR 2 owns 50% of T LLC. PTR 2 acquires all of PTR 1's interest in T LLC. PTR 2 is treated as receiving its 50% share of the assets and acquiring the remaining 50% of T LLC assets from PTR 1. PTR 2 did not operate T LLC's business prior to the transaction and was a passive partner.

  On the one hand, several factors suggest that an immediate deduction of unamortized Section 174 Costs should be permitted here as well. A sale of 50% of the assets of the business is a substantial disposition, and, for Federal tax purposes, T LLC has ceased operating the business due to the termination of the partnership. T LLC incurred the costs and not PTR 2, who was only a 50% owner. A significant change in the ownership of the business has occurred, the entity operating the business is no longer operating it, and the transaction was not entered into with a purpose of accelerating the immediate deduction of unamortized Section 174 Costs. However, some factors suggest an immediately deduction should not be permitted. A 50% partner is continuing the business. Whether the continuation by a 50% owner compels a conclusion that T LLC did not have an identifiable event allowing for an immediate deduction is not clear.

If a Rev. Rul. 99-6 transaction (or similar transaction) does not rise to an identifiable event allowing for an immediately deduction of unamortized costs, then consider which party should report the continued amortization of any remaining Section 174 Costs.[87] A reasonable answer might be that, in the above example, PTR 2 would step into the shoes of T LLC and continue amortizing the remaining costs over the five- (or fifteen-) year period.

3. Section 351 exchanges

The Notice states that a taxpayer that contributes its business to a corporation in a section 351 transfer may not immediately deduct its Section 174 Costs. Although arguments to the contrary may be made (for example, under the General Acceleration Principles described above), the Notice's position appears reasonable as a general matter. A taxpayer that contributes its business to a corporation in a section 351 transfer retains an indirect interest in the business.

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[86] The exiting partner's share of unamortized Section 174 Costs should, in our view, be treated as an ordinary deduction by the exiting partner. This treatment is analogous to the treatment of certain other ordinary income items under section 751. *See* Reg. section 1.751-1(a) ("[t]o the extent that money or property received by a partner in exchange for all or part of his partnership interest is attributable to his share of the value of partnership unrealized receivables or substantially appreciated inventory items, the money or fair market value of the property received shall be considered as an amount realized from the sale or exchange of property other than a capital asset").

[87] If our suggestion regarding deduction of the exiting partner's share of the unamortized Section 174 Costs is adopted, those capitalized costs would not remain after the Rev. Rul. 99-6 transaction. The remaining Section 174 Costs would be inherited by the remaining partner under the step-in-the-shoes principle of Reg. sections 1.704-3(a)(6)(ii) and -3(a)(7).

The Notice's position that section 174(d) denies an immediate deduction in this case therefore appears reasonable.

The Notice does not, however, distinguish between various common forms of section 351 transfers. Specifically, the Notice does not address (i) section 351 transfers in which the transferor is only a minority shareholder following the transfer or (ii) the effect of the transferor's receipt of significant amounts of taxable boot. In many such cases, the transferor's continuing interest in the business is slight, and the rationale to deny the transferor an immediate deduction of Section 174 Costs is therefore weak. Accordingly, it appears appropriate to permit an immediate deduction of Section 174 Costs in many such cases.

A section 351 transfer with boot (that is, where the transferor received as consideration cash or other property alongside stock) is partially taxable; in that sense, it resembles a Rev. Rul. 99-5 transaction. It, however, differs from a Rev. Rul. 99-5 transaction in that a corporation, rather than a partnership, operates the business post-transaction.

- Section 351 Exchange with Boot: S, an S corporation, transfers 100% of T LLC (a DRE) to Newco, a C corporation, in exchange for cash and stock of Newco in a transaction qualifying under section 351. S receives 30% of Newco's stock, and a private equity investor (PE) receives the remaining 70% of Newco's stock in exchange for a cash investment.

In determining whether the seller-transferor has ceased to conduct the business transferred to the corporation, several factors are relevant:

- That S has ceased operating the business.

- The extent to which the transaction (and creation of the corporation) facilitated a change in control of the business (that is, the degree of control held by the new investor).

- The amount of the corporation's stock received by the seller-transferor. On the one hand, S's 30% interest in the corporation exceeds the section 197 anti-churning threshold. On the other hand, S does not receive 80% of the voting stock and 80% of each class of non-voting stock of Newco, which represents section 368(c) control, the COBE threshold for ownership of a corporation.[88]

Note the significant difference between the COBE test for a corporation (80%) versus for a partnership (33-1/3% or 20%). This difference may stem from the aggregate theory of partnership taxation, under which a partner at times "looks through" the partnership construct to the partnership's activities.

- Partial Section 351 Exchange and Partial Taxable Exchange: S, an S corporation, transfers units of T LLC (a DRE) to Newco (C corporation) in exchange for a 30%

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[88] A taxpayer takes the business of a corporate subsidiary into account under the section 368 COBE rules only if the taxpayer's ownership of the corporation equals or exceeds the section 368(c) threshold. *See* Reg. section 1.368-1(d)(4)(ii).

interest in Newco, valued at $30, in a transaction qualifying under section 351. S sells the remaining units of T to Acquireco, a C corporation subsidiary of Newco, in a fully taxable transaction for $70.

Despite the change in structure, this transaction appears economically equivalent to the section 351 transaction with boot. The same analysis appears appropriate.

- Section 351 Exchange / Partnership Incorporation under Rev. Rul. 84-111: T, an LLC taxed as a partnership, makes a check-the-box election to treat the entity as a corporation and a new investor simultaneously invests cash in the corporation for a 30% interest.[89] All the invested cash remains in T. T's motivation to be taxed as a corporation is to facilitate the new investment.

  In this case, T (the entity previously taxed as a partnership) has ceased to operate the business. The section 351 transaction took place for valid business reasons (not with an intent to immediately deduct the unamortized Section 174 Costs), and the former partners of T did not receive section 368(c) control of T. However, the T business remains fully intact with no change other than the change to corporate form. The incorporation did not constitute a recognition event. Absent the new investment, which could have been made before or after the check-the-box election, the former partners would have retained their 100% ownership over T. Furthermore, the interests of the former partners of T exceed the section 197 anti-churning threshold. In this case, it is perhaps unreasonable to permit an immediately deduction of the unamortized Section 174 Costs.

  In this case, assuming no immediate deduction is allowed, query whether the LLC members that now become shareholders would retain the ability to amortize the costs following the deemed partnership liquidation.[90] Query further whether the answer would depend on whether the incorporation is an "assets-over" or "interests over" incorporation,[91] as the transferor in the section 351 transfer depends upon such form.

Note also that if a corporation is formed with a purpose to accelerate an immediate deduction of unamortized Section 174 Costs, the corporate formation could be subject to various anti-abuse

[89] *See* Rev. Rul. 84-111, 1984-2 C.B. 88 (describing three methods of converting a partnership to a corporation, one of which involves a partnership that transfers its assets to a newly formed corporation in exchange for stock of the corporation (colloquially called the "assets-over" method)). *See also* Reg. section 301.7701-3(g)(1)(i) (where a partnership "checks the box," the assets-over method is deemed to occur).

[90] *See* Rev. Rul. 84-111, Situation 1 ("assets-over" form of partnership incorporation).

[91] *See* Rev. Rul. 84-111, Situation 3 (describing the "interests-over" form of partnership incorporation, in which partners transfer their partnership interests to a newly formed corporation in exchange for corporate stock).

rules (e.g., judicial doctrines or section 269), as well as an anti-abuse rule that may be set out in guidance under section 174(d).

D. Abusive transactions carried out to immediately deduct Section 174 Costs

Notwithstanding the above arguments in favor of permitting an immediate deduction of Section 174 Costs upon the occurrence of certain transactions, accelerated deduction of Section 174 Costs in certain other transactions should, in our view, be viewed as potentially abusive and therefore not be permitted.

When a business enterprise is restructured into a partnership or corporation, the business owners often retain significant continuing ownership interests in the business enterprise. Taxpayers therefore sometimes have the opportunity to form or incorporate a partnership with a purpose of accelerating unamortized Section 174 Costs. Even without such a purpose, the formation or incorporation of a partnership should sometimes not be grounds for an immediate deduction of unamortized Section 174 Costs.

- Partnership Incorporation: As an operating partnership, LLC generates Section 174 Costs for several years. The LLC's owners incorporate the LLC and the former partners of LLC now own identical proportions of the new corporation's equity as they held in the LLC's (i.e., there is no change in ownership).

  Following the incorporation, the former partners of LLC have complete control (constituting section 368(c) control) of the new corporation and continue operating the business of the LLC. Accordingly, an immediate deduction of unamortized Section 174 Costs appears inappropriate. This is likely the case whether the incorporation occurred to accelerate the deduction of the costs or whether it occurred for valid business reasons.

- Partnership Formation: Corporation incurs significant Section 174 Costs for several years. Corporation transfers the assets to a newly formed partnership. A small partnership interest (1% for example) is issued to an employee or other investor, with the corporation retaining 99% of the partnership interests.

  Though the business is transferred to a new entity and the corporation ceases to operate the business directly, the business continues to be operated through the partnership.

  Moreover, if the restructuring is carried out with a purpose to accelerate the deduction of unamortized Section 174 Costs, that acceleration should be expressly prohibited by an anti-abuse rule promulgated under section 174.

A taxpayer might also attempt to trigger an immediate deduction of Section 174 Costs by entering into a partnership liquidation.

- Partnership Liquidation: LLC (taxed as a partnership), formed in order to perform research that will benefit the businesses of the members, incurs Section 174 Costs. LLC is owned entirely by members of a consolidated group or within a group of related entities (via ownership or activities). After the research is completed, LLC liquidates and

wishes to immediately deduct any unamortized Section 174 Costs. Here, though the LLC has ceased its business, the LLC's members continue operating the businesses and have benefited from the costs.

Even if not entered into with the intent to accelerate the unamortized costs, it is unclear whether an immediate deduction of unamortized Section 174 Costs is appropriate. Under a partnership aggregate theory, no such event has occurred.

Further, if the liquidation was entered into with a purpose of accelerating unamortized Section 174 Costs, that acceleration deduction should be prohibited by an anti-abuse rule promulgated under section 174.

V. Conclusion

We request that Treasury and the Service issue guidance clarifying the treatment of unamortized Section 174 Costs in an M&A transaction consistent with this letter's recommendations and with consideration of this letter's comments. As noted above, the proper interpretation of section 174(d) is uncertain, taxpayers' deductions at stake may total billions of dollars, and taxpayers and tax practitioners apply a diversity of views and approaches in practice. Guidance would be particularly helpful with regard to partially taxable transactions—which are common transaction forms in the middle market—to reduce controversy and also reduce costs borne by both taxpayers and the government.

We are pleased to offer these comments and would be happy to discuss them or related issues with you.