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In this article, Cannon argues that section 168(h)'s tax-exempt use property limitation, which restrains the availability of 100 percent expensing under section 168(k), is likely to apply to investment fund acquirers.

The 2017 legislation known as the Tax Cuts and Jobs Act (P.L. 115-97) made significant changes to section 168(k) — a provision that has long permitted an amount of accelerated cost recovery for some assets as they are placed in service. These changes increased both the magnitude and availability of this incentive. Specifically, as modified by the TCJA, section 168(k) made it possible to immediately recover 100 percent of the basis of qualified property, including specified used property.

Lurking within new section 168(k), however, are limitations that advisers (particularly those who advise investment fund clients) must remain keenly aware of to help their clients appropriately factor the availability of immediate expensing into their acquisition models. One of those limitations (the tax-exempt use property limitation) is particularly likely to be applicable to fund acquirers. After providing some brief background on the changes that the TCJA made to section 168(k), this article discusses that limitation and suggests a few strategies that can be used to mitigate the effect of the limitation.[1]

I. 100 Percent Expensing Background

Section 168(k) is not new. Former section 168(k) allowed taxpayers to immediately recover a portion of the basis of qualifying property in the year it was placed in service. The portion of the basis that could be recovered immediately, however, was relatively limited (and was slated to decrease in the future). Moreover, this incentive was available only to the original user of the property, which limited the universe of taxpayers that were able to avail themselves of the incentive.[2]

The TCJA made various modifications to section 168(k), but two are particularly notable. First, the legislation permits taxpayers to immediately recover 100 percent of the basis of "qualified property" placed in service after September 27, 2017, and before January 1, 2023, rather than the partial percentages permitted under prior law. Second, the legislation eliminates the requirement that the original use of property must begin with the taxpayer, thereby extending 100 percent expensing to some used property.

These changes substantially expand the magnitude of the benefit afforded by section 168(k) and make the benefit available to a new class of acquirers — namely, those who acquire used property. This new class of investors includes many investment funds.

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[1] Those selling their businesses to investment funds should also be aware of the tax-exempt use property rules, given that the availability of accelerated cost recovery may have a bearing on how much the investment fund acquirer is willing to pay.

[2] Under former section 168(k), the percentage of a property's basis that could be recovered immediately was limited to 50 percent, and this percentage was scheduled to decrease to 40 percent in 2018 and 30 percent in 2019. *See* section 168(k)(6)(A) and (B) (as in effect before the TCJA).

II. The Tax-Exempt Use Property Trap

A. Background

When available, 100 percent expensing provides a powerful economic incentive that increases investment returns for fund acquirers and their investors. Yet it is important to keep in mind that the incentive is not unlimited. Various criteria and limitations under section 168(k) must be satisfied, including the rule in section 168(k)(2)(D) that makes property to which the alternative depreciation system under section 168(g) applies ineligible for bonus depreciation.[3]

The alternative depreciation system applies to several types of property.[4] Among these is "any tax-exempt use property."[5] The extensive tax-exempt use property rules in section 168(h) are not intuitive, making the provision a trap for the unwary.

B. Tax-Exempt Entities

At the heart of section 168(h) is the definition of tax-exempt entity. Without a tax-exempt entity, there can be no "use" by an exempt entity and, hence, no tax-exempt use property.

1. Broad sweep.

This definition sweeps more broadly than one would think based on the ordinary usage of the phrase "tax-exempt entity." Specifically, in addition to including any organization (other than a cooperative as described in section 521) that is exempt from tax under sections 1 through 1400U-3 (such as traditional section 501(c)(3) organizations), section 168(h) specifies that tax-exempt entities include any of the following types of organizations: (1) "the United States, any State or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing"; (2) "any foreign person or entity"; and (3) any "Indian tribal government described in section 7701(a)(4)."[6]

2. Application to investors in private investment funds.

Critically, several of these types of investors make up a substantial portion of most private investment funds, raising the possibility in nearly every fund acquisition (or joint venture involving a fund) that some portion of the acquired property may be tax-exempt use property. For this reason, some further refinement of the categories of tax-exempt entities is in order.

a. 'Super tax-exempts.'

As noted, tax-exempt entities include agencies or instrumentalities of the United States, and any state or its political subdivision. Importantly, this part of the definition sweeps in state pension plans, which are major investors in most large investment funds. These investors are sometimes referred to as "super tax-exempt"[7] because, unlike ordinary tax-exempt investors (such as section 501(c)(3) organizations), these investors take the position that they are not subject to any U.S. federal income tax, including on income that would constitute unrelated business taxable income to a nongovernmental exempt organization.[8] As a result, super tax-exempt investors do not generally structure their investments in investment funds through blocker corporations.

b. Non-U.S. investors.

The term "foreign person or entity" generally includes any foreign government, any international organization, any agency or

[3] Section 168(k)(2)(D) (providing that qualified property for which 100 percent expensing is available does not include "any property to which the alternative deprecation system under [section 168(g)] applies, determined — (i) without regard to paragraph (7) of [section 168(g)] . . . and (ii) after application of section 280F(b)").

[4] Although the focus of this article is on the tax-exempt use property limitation, it bears noting that there are also other kinds of ineligible property. *See, e.g.*, section 168(g)(1)(A) (tangible property used predominantly outside the United States is ineligible, subject to exceptions in section 168(g)(4)).

[5] Section 168(g)(1)(B).

[6] Section 168(h)(2)(A).

[7] *See, e.g.*, Ryan Schneider, "Alternative Lending Funds and Unrelated Business Taxable Income," *Tax Notes*, May 1, 2017, p. 675 n.2; and James B. Sowell and Jon G. Finkelstein, "Tax Reform and Investment in U.S. Real Estate," *Tax Notes*, Apr. 16, 2018, p. 285, 313.

[8] *See* Andrew W. Needham, "Private Equity Funds," Section VIII.A.2.b in *BNA Tax Mgmt. Portfolio*, 735-3rd T.M. (2010) (discussing super tax-exempts). It is notable that in the House-proposed bill that ultimately became the TCJA, there was a proposal that would have subjected super tax-exempt entities to tax on UBTI, but that proposal was not included in the conference agreement. *See* H. Rep. No. 115-466, at 404-405 (Conf. Rep.).

instrumentality of a foreign government or international person, and any person who is not a U.S. person.[9] This definition is broad, sweeping in both foreign governmental investors (so-called section 892 investors[10]) and all other non-U.S. investors. A foreign person or entity does not, however, include a person concerning a particular piece of property "if more than fifty percent of the gross income for the taxable year derived by the foreign person or entity from the use of that property is subject to U.S. federal income tax."[11] In other words, the determination whether a person or entity is a foreign person or entity is property-specific. If more than half of the gross income generated from that property is subject to U.S. federal income tax, the person or entity is not treated as a foreign person or entity. In measuring whether at least half of the gross income from property is subject to U.S. tax, the statute provides that exclusions or exemptions do not apply for purposes of determining the aggregate amount of gross income, but do apply to determine the portion of gross income that is subject to tax.[12] This principle tends to reduce the likelihood that the 50 percent threshold will be met, because exemptions are disregarded for purposes of the denominator but factored in for purposes of the numerator.

An example illustrates this principle. Assume that Individual, a citizen and resident of Country A, purchases a widget-making machine and uses that machine to make and sell widgets in the United States, generating $1,000 of gross income. Assume further that under an applicable U.S. statutory incentive for investing in widget-making machines, 30 percent of the gross income generated from manufacturing and selling widgets within the United States is exempt from tax and that under the applicable U.S.-Country A income tax treaty, 25 percent of all U.S. gross income generated by Country A citizens (without reduction for any other incentive) is exempted from U.S. tax. For purposes of measuring whether at least half of Individual's income from the widget-making machine is subject to U.S. tax, the full amount of gross income generated from the machine ($1,000) would be taken into account and treated as the denominator of the fraction, notwithstanding the applicable statutory and treaty exclusions. For purposes of determining the numerator, however, the 30 percent statutory exclusion and 25 percent treaty exclusion are both taken into account (so that the numerator is only $450, since there is a $300 statutory exclusion and a $250 treaty exclusion). Thus, the fraction of income subject to U.S. tax is 45 percent, meaning that Individual is treated as a foreign person or entity in relation to the widget-making machine.

Moreover, it is worth noting that the tax code specifies that the term "tax-exempt entity" does not include foreign partnerships or foreign passthrough entities, although ownership by tax-exempt entities through these types of passthrough entities can also result in property being treated as tax-exempt use property.

C. 'Use' by a Tax-Exempt Entity

1. Leases.

As well as including a broad definition of tax-exempt entity, section 168(h) contains a broad definition of what it means for a tax-exempt entity to use property. While some parts of the use rule are intuitive, others are not.

One way in which a tax-exempt entity can be treated as a user of property (other than nonresidential real property) is by being the lessee of that property.[13] For this purpose, a lease is defined broadly to mean any grant of a right to use property.[14] In addition to a direct lease to an exempt entity, use can arise when property is leased to a partnership (or other passthrough entity).[15] The portion of the property leased to a

[9] Section 168(h)(2)(C).

[10] For more detailed background about section 892, see Kimberly S. Blanchard, "Section 892: Form, Function and Meaning," *Tax Notes*, July 11, 2016, p. 233.

[11] Section 168(h)(2)(B). The provision also provides that an entity is not treated as a foreign person or entity if more than 50 percent of the entity's gross income for the tax year is included in the gross income of a U.S. shareholder under section 951 (which provides for inclusions regarding ownership of controlled foreign corporations).

[12] Section 168(h)(2)(B).

[13] Section 168(h)(1)(A). The rules related to leases of nonresidential real property, which are in section 168(h)(1)(B), are more complicated, but this article does not discuss them because the long useful life of nonresidential real property renders it ineligible for bonus depreciation. The tax code, however, in its inimitable style, provides that the term "nonresidential real property" includes residential real property. Section 168(h)(1)(E).

[14] The code includes specialized rules that apply for purposes of short-term leases of specified qualified technological equipment. *See* section 168(h)(3).

partnership that is to be treated as tax-exempt use property is determined based on the tax-exempt entity owner's proportionate share of the property. The determination of the exempt entity's proportionate share is made under rules designed to maximize the portion of the property treated as tax-exempt use property.

2. Passthrough entities.

In addition to the lease rules, the code includes rules that treat some property owned indirectly by tax-exempt entities as tax-exempt use property. Different sets of rules apply for property owned through partnerships and property owned through corporations.[16] These rules will often come into play in the investment funds context.

Section 168(h)(6) contains special rules applicable to partnerships providing that when a partnership (A) includes both a tax-exempt entity and a person who is not a tax-exempt entity, and (B) any allocation to the tax-exempt entity is not a qualified allocation, then the tax-exempt entity's proportionate share of the partnership's property is treated as tax-exempt use property, subject to an exception for property that is used by a tax-exempt entity in an unrelated trade or business.[17]

A qualified allocation is an allocation that both has substantial economic effect within the meaning of section 704(b)(2) and is consistent with the tax-exempt entity being allocated the same distributive share of each item of income, gain, loss, deduction, credit, and basis during the entire period the entity is a partner in the partnership.[18] Even if the substantial economic effect requirement is satisfied, it will be very rare in the investment fund context for allocations to never vary over the life of a partnership because, for example, the fund sponsor typically takes a carried interest, which generally is not triggered until a particular internal rate of return threshold is satisfied. Accordingly, the qualified allocation rule is unlikely to save most investment fund partnerships with exempt partners from the tax-exempt use property trap.[19]

Moreover, in circumstances involving a partnership that does not meet the qualified allocation rule, the rules for determining the exempt entity's proportionate share tend to maximize the share of the partnership's property that is treated as tax-exempt use property, specifying that the tax-exempt entity's proportionate share of property owned by a partnership is to be determined on the basis of that entity's share of partnership items of income or gain (excluding gain allocated under section 704(c)), whichever results in the largest proportionate share, and further specifying that if allocations vary over the life of a partnership, the exempt entity's share is the "highest share such entity may receive."[20]

3. Exceptions to tax-exempt use and exceptions to the exceptions.

As previously noted, there is an exception to the tax-exempt use property rules to the extent that the property gives rise to income that is treated as UBTI to an exempt investor. This rule, however, as a practical matter may not solve the tax-exempt entity issue for investment funds, both because there are many investors — such as super tax-exempts — that take the position that they are not subject to tax on UBTI and because other exempt investors often invest through blocker corporations.[21]

[15] Section 168(h)(5).

[16] The code provides that rules like the partnership rules apply in the case of any passthrough entity other than a partnership and in the case of tiered partnerships. For the sake of convenience, this article discusses the passthrough rules using the term "partnership."

[17] Section 168(h)(6). In determining whether income is UBTI, the determination whether property is used in an unrelated trade or business is to be made without regard to section 514 (the unrelated debt-financed rules).

[18] Section 168(h)(6)(B). In determining whether these requirements are satisfied, the rules of section 704(c) are not to be considered. For additional explanation of section 704(b) and (c), see Eric B. Sloan and Matthew J. Sullivan, "Partnerships — Taxable Income: Allocation of Distributive Shares; Capital Accounts," in *BNA Tax Mgmt. Portfolio*, 712-4th T.M.

[19] The qualified allocation rule of section 168(h)(6) is incorporated by reference into section 514(c)(9), which sets forth an exception to the debt-financed UBTI rules. Section 514(c)(9)(B)(vi)(II). That exception, however, is not the one that qualifying exempt investors generally rely on to avoid debt-financed UBTI when investing in leveraged real-estate partnerships. Rather, these investors more frequently rely on the exception in section 514(c)(9)(E), which is referred to as the fractions rule. For a discussion of the fractions rule and its application, see David O. Kahn, "Help With Fractions: A Fractions Rule Primer," *Tax Notes*, Feb. 22, 2010, p. 953.

[20] Section 168(h)(6)(C).

[21] Many articles have been written about blocker corporations. *See, e.g.*, Willard B. Taylor, "'Blockers,' 'Stoppers,' and the Entity Classification Rules," 64(1) *Tax Law.* 5 (2010); and Samuel D. Brunson, "Repatriating Tax-Exempt Investments: Tax Havens, Blocker Corporations, and Unrelated Debt-Financed Income," 106(1) *Nw. U. L. Rev.* 225 (2012).

Investment through blocker corporations implicates yet another tax-exempt use property trap for the unwary: the tax-exempt controlled entity rules. Under these rules, even a taxable U.S. corporation can be treated as a tax-exempt entity, depending on its ownership. The definition of tax-exempt controlled entity is important; a tax-exempt controlled entity means any corporation that is not itself an exempt entity if 50 percent or more (in value) of the stock of the corporation is held by one or more tax-exempt entities. In making this determination, however, foreign persons or entities are not treated as tax-exempt entities.[22] A modified version of the attribution rules of section 318 applies for purposes of determining whether an entity is a tax-exempt controlled entity.[23] Moreover, special rules apply for purposes of determining whether publicly traded corporations are tax-exempt controlled entities.[24]

Application of these rules can create some surprising results. If, for example, there was a U.S. corporation that was not publicly traded but was owned 50 percent by U.S. taxable investors, 1 percent by a foreign person, and 49 percent by a state pension plan (that is, a super tax-exempt), that corporation would not be treated as a tax-exempt controlled entity. Although both foreign persons and super tax-exempts generally are treated as tax exempt, for purposes of measuring whether an entity is a tax-exempt controlled entity, foreign persons are not treated as exempt. Thus, the percentage of exempt investors would be 49 percent (limited to just the super tax-exempts), which is below 50 percent. If, on the other hand, there was a corporation owned 50 percent by U.S. taxable investors and 50 percent by super tax-exempts, that corporation would be treated as a tax-exempt controlled entity because exactly 50 percent of the ownership would be treated as exempt.

[22]Section 168(h)(6)(F).

[23]Section 168(h)(6)(F)(iii)(III).

[24]Section 168(h)(6)(F)(iii)(II). Under these rules, an exempt entity's ownership is taken into account only if it is a 5 percent owner.

III. Avoiding the Trap

Considering all these rules, which define very broadly both tax-exempt entity and use, many investment funds will face the prospect that some portion of the property they own is tax-exempt use property. That recognition alone is valuable, because economic models can appropriately factor in the existence of that property. In some cases, however, tax advisers may be able to add further value by helping their investment fund advisers to create a structure that circumvents the rules.

A. Foreign Persons Are Not Exempt

The rule treating foreign persons as nonexempt for purposes of measuring whether an entity is exempt provides perhaps the most useful planning tool. Specifically, it may be possible for fund sponsors to cause foreign persons and other tax-exempt investors to invest through a common blocker corporation. This type of ownership by foreign persons effectively dilutes the percentage of the blocker that is treated as owned by tax-exempt persons, minimizing the chance that the corporation will be treated as a tax-exempt controlled entity.

As an example, assume that a fund has aggregate capital commitments of $100 million. Of this amount, $25 million is committed by traditional tax-exempt organizations and $75 million is committed by foreign investors (including section 892 investors and non-U.S. individuals). If this fund is structured as depicted in Figure 1 as Structure A (with one blocker for the foreign investors and another blocker for the tax-exempt investors), the blocker for the tax-exempt investors (the blocker entity with the thicker border) will be treated as a tax-exempt controlled entity. If, on the other hand, the fund is structured as depicted in Figure 2 as Structure B (with only one U.S. blocker), that blocker will not be a tax-exempt controlled entity because foreign persons are not treated as exempt for purposes of the tax-exempt controlled entity rules.[25]

[25]For the sake of simplicity, the general partner of the investment fund is not depicted in either the Structure A or Structure B diagram.

Figure 1. Structure A — Separate Blockers

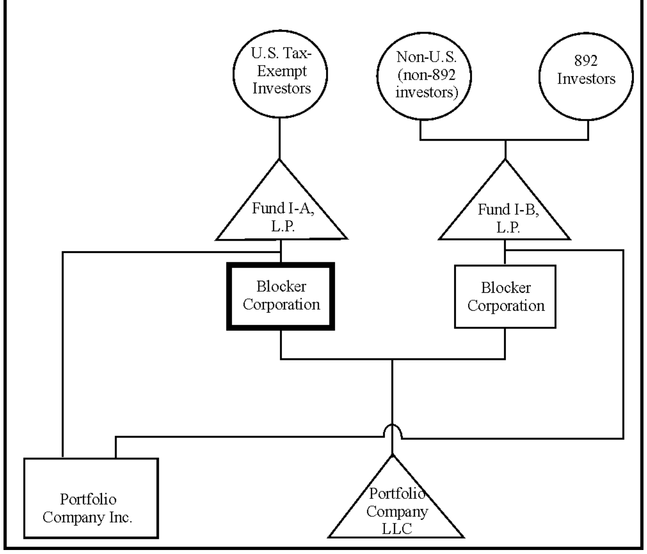
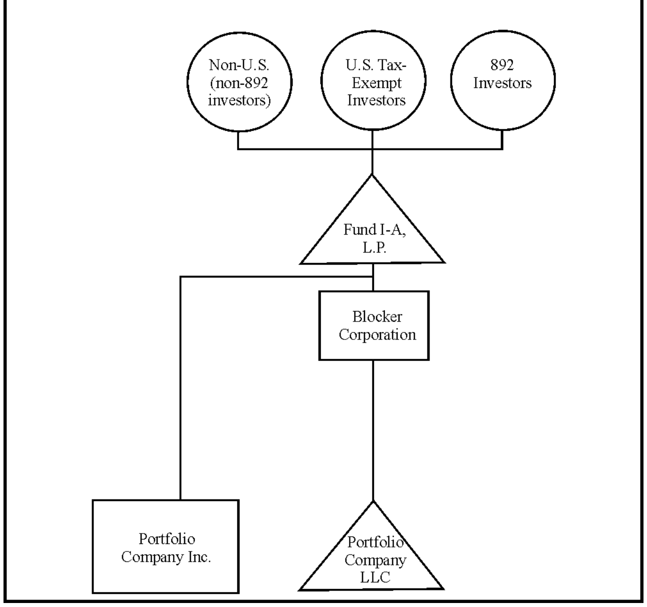


Figure 2. Structure B — Single Blocker



B. The Cleansing Election of Section 168(h)(6)(F)

If the investor base of a fund does not make the structuring described in the preceding subsection feasible, another option is to cause a blocker that would otherwise be a tax-exempt controlled entity to make a special "cleansing election" under section 168(h)(6)(F). Care should be taken in making this election, however, because it is irrevocable and binding on all tax-exempt entities holding an interest in the tax-exempt entity. It also results in all gain recognized by a tax-exempt entity on any disposition of an interest in such an entity (and any dividend or interest received or accrued by a tax-exempt entity from such tax-exempt controlled entity) being treated as UBTI.

Significantly, fund sponsors often covenant to avoid or minimize UBTI (either in the applicable fund documentation or in side letters) and making this type of election may run afoul of those commitments. Thus, absent a compelling reason for doing so (such as a renewable energy investment in which tax-exempt ownership would jeopardize the availability of anticipated tax benefits like the investment tax credit[26]), most fund sponsors will shy away from relying on the section 168(h)(6)(F) cleansing exception.

IV. Conclusion

Although 100 percent expensing is a powerful incentive, its availability is subject to meaningful limitations, including the tax-exempt use property limitation. Tax advisers, particularly those who advise investment funds and those who engage in transactions with them, must be well versed in this limitation to help their clients (a) avoid falling into the tax-exempt use property trap inadvertently and (b) structure their affairs to sidestep "tax-exempt use property" ownership whenever feasible. ■

[26] As well as being relevant to the availability of 100 percent expensing, the tax-exempt use property rules are relevant for other purposes under the code. For example, a variant of these rules applies for purposes of determining whether the investment tax credit is available. *See* section 50(b). A discussion of these other applications of the tax-exempt use property rules is beyond the scope of this article.