

# Proposed Bonus Depreciation Regulations Clarify Impact on Certain Transactions

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The Internal Revenue Service (IRS) and Department of the Treasury recently proposed regulations that shed light on how the new, expanded bonus depreciation regime may work in the context of many common acquisitions involving corporations and partnerships. Pending the release of final regulations, a taxpayer may rely on the proposed rules with respect to property acquired and placed in service after September 27, 2017.<sup>1</sup> As such, these proposed regulations should be of interest to businesses that may be contemplating a reorganization, or a sale or acquisition of either individual assets or an entire business.

As background, prior to the enactment of the Tax Cuts and Jobs Act (TCJA), Section 168(k) of the Internal Revenue Code<sup>2</sup> provided an immediate write-off of 50 percent of the cost of certain qualifying property for the tax year in which the property was placed in service by the taxpayer, but only if no one else had ever used the property before in a trade or business. TCJA expands on former Section 168(k)'s definition of "qualifying property,"<sup>3</sup> increases the amount of the immediate deduction to 100 percent of such property's cost and for the first time allows taxpayers to claim bonus depreciation for "used" property.<sup>4</sup>

Amended Section 168(k) imposes many of the same limitations with respect to used property that apply under Section 179(d). For example, bonus depreciation does not apply to used property where the taxpayer has acquired the property: (i) from a transferor that is related (within the meaning of Sections 267 or 707(b)); (ii) from a component member of a controlled group; or (iii) in a transaction that results in the taxpayer having a carryover basis. Thus, property transferred in most Section 332, 351, 368, 721 and 731 transactions generally would not qualify. A number of questions arose about the scope of these limitations under amended Section 168(k). The proposed regulations provide some clues as to what the final answers might be.

## Section 336(e) Elections

It seemed clear that otherwise qualifying "used" property that is treated as acquired by the fictional newly formed corporation (New Target) in a Section 338(h)(10) election would be eligible for bonus depreciation under amended Section 168(k). It was unclear, though, whether the same result applies for property that is treated as acquired by New Target in a Section 336(e) election. A Section 336(e) election shares many of the same characteristics of a Section 338 election, an observation that the IRS made in the preamble to the proposed regulations. The proposed regulations would modify the Section 179 regulations to permit Section 179 to apply to property deemed to have been acquired by New Target as a result of a Section 336(e) election, meaning that such property (if otherwise qualifying) would be eligible for bonus depreciation.<sup>5</sup>

<sup>1</sup> Prop. Reg. §§1.168(k)-2(g)(2) and 1.179-6(b)(2).

<sup>2</sup> All section references are to the Internal Revenue Code.

<sup>3</sup> Qualifying property generally includes tangible Modified Accelerated Cost Recovery System property with a life of 20 years or less, certain computer software, certain water utility property, certain qualified film or TV productions, qualified live theatrical productions, certain botanical plants and so-called qualified improvement property, provided that the property is acquired after September 27, 2017, and placed into service before January 1, 2027.

<sup>4</sup> The bonus depreciation applicable rate is phased out 20 percentage points a year over five years beginning in 2023. Thus, 100 percent bonus depreciation is available only for the next five years. Certain other property (sometimes called "longer production period property") also can be qualified property. For that type of property, the placed-in-service deadlines and the phase-outs of the bonus depreciation percentage are different.

<sup>5</sup> Prop. Reg. §1.179-4(c)(2).

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## Related Transactions Analyzed as One Transaction

It also seemed clear that bonus depreciation would be permitted for otherwise qualifying used property acquired by a subsidiary from an unrelated seller, where the parent of the subsidiary first contributes cash to the subsidiary and the subsidiary then uses the cash to purchase the property. On the other hand, there was concern that the subsidiary would not be entitled to bonus depreciation if the parent instead first purchased the property directly and then contributed the property to the subsidiary, because the subsidiary technically would acquire a carryover basis in the property in the second leg of the transaction. The proposed regulations provide that the ordering won't matter. In the case of a series of related transactions, the transfer of property would be treated as made from the original transferor to the ultimate transferee, and the relationship between the original transferor and the ultimate transferee would be tested immediately after the last transaction in the related series of transactions.<sup>6</sup> As a result, in the above scenario, the subsidiary would be viewed as directly purchasing the property from the unrelated seller, and thus the property would be eligible for bonus depreciation.

## Basis Redetermination Provisions

An asset acquisition may involve provisions that would require the buyer to redetermine the basis of the acquired property. For example, if an asset acquisition (or deemed asset acquisition pursuant to Sections 336(e) or 338(h)(10)) provides for earn-out payments, these payments are generally considered additional purchase price that would increase the basis of the acquired property. Generally, the proposed regulations provide that bonus depreciation for any such increase in basis of qualifying property is to be computed at the bonus depreciation rate in effect for the taxable year in which the qualifying property was placed in service by the acquiring taxpayer.<sup>7</sup> So, a taxpayer that acquires property and places it in service in 2018 would still be able to claim 100 percent bonus depreciation on an increase in the basis of the property from a later earn-out payment, even if the payment is made after 2022 when the bonus depreciation percentage rate has decreased.<sup>8</sup>

<sup>6</sup> Prop. Reg. §1.168(k)-2(b)(3)(iii)(C).

<sup>7</sup> Prop. Reg. §1.168(k)-2(f)(2)(i).

<sup>8</sup> As noted above, the applicable bonus depreciation rate for bonus qualifying property acquired and placed in service after September 27, 2017, and on or before December 31, 2022, is generally 100 percent. The applicable bonus depreciation rate is generally phased down by 20 percent over five years beginning in 2023. If the property was placed in service after December 31, 2022, in a tax year to which less than 100 percent bonus depreciation was available (for example, in 2023 when the rate is only 80 percent), then the amount of the subsequent basis increase that exceeds the amount of bonus depreciation allowed or allowable for that increase (*i.e.*, 20 percent of the basis increase in the above example) would be depreciated over the remaining recovery period of the property. *Id.*

Likewise, if the basis of qualifying property is reduced in a subsequent year, the taxpayer is required to decrease the total amount of depreciation allowed for all of the taxpayer's depreciable property by the excess of bonus depreciation that the taxpayer previously claimed. If the excess additional depreciation deduction exceeds the total amount of depreciation otherwise allowed to the taxpayer, the taxpayer is required to take into account a "negative depreciation deduction" (*i.e.*, the taxpayer would essentially recognize additional income). The excess additional bonus deduction that the taxpayer claimed is determined by multiplying the decrease in basis by the applicable percentage for the taxable year the property was placed in service by the taxpayer. In addition, the amount of depreciation otherwise allowed to the taxpayer with respect to the qualifying property is also reduced over the remaining recovery period of the property.<sup>9</sup>

## Partnership Transactions

The proposed regulations also provide guidance with respect to transactions involving partnerships. Most notably, the proposed regulations take an aggregate view in determining whether a Section 743(b) basis adjustment meets the used property acquisition requirement. Pursuant to this view, each partner is treated as having owned and used only that partner's proportionate share of the partnership property. As a result, provided the transferring partner and the transferee partner are not otherwise related, the transferee partner may claim bonus depreciation with respect to the resulting Section 743(b) adjustment to the extent such adjustment relates to property that otherwise qualifies for bonus depreciation. This result applies irrespective of whether the transferee partner is a new partner or an existing partner purchasing an additional partnership interest from an existing partner.<sup>10</sup> Similarly, the proposed regulations provide that in a situation where a tax partnership is created as a result of a third party acquiring a partial interest in an entity previously treated as disregarded as separate from its owner (such as a wholly owned limited liability company),<sup>11</sup> bonus depreciation with respect to the undivided interest in any qualified property that the transferee is deemed to purchase is generally available, but it is allocated exclusively to the transferee (and not to the transferor).

On the other hand, the proposed regulations take a narrower view with respect to other partnership adjustments. For example, the proposed regulations do not allow a bonus depreciation deduction with respect to Section 704(c) remedial allocations and Section 734(b) adjustments.<sup>12</sup>

<sup>9</sup> Prop. Reg. §1.168(k)-2(f)(2).

<sup>10</sup> Prop. Reg. §1.168(k)-2(b)(3)(iv)(D).

<sup>11</sup> See Rev. Rul. 99-5, 1999-1 C.B. 434, (Situation 1).

<sup>12</sup> Prop. Reg. §1.168(k)-2(b)(3)(iv)(A) and (C).

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