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IRS Issues Proposed Regulations That Address Tax Reform Changes to Bonus Depreciation

The Proposed Regulations Include Detailed Rules Regarding the Acquisition Requirements Applicable to Used Property But Do Not Address a Key Legislative Omission Relevant to Improvements to Real Property

SUMMARY

Last week, the Internal Revenue Service and the Treasury Department issued proposed regulations (the "Proposed Regulations")[1] addressing bonus deprecation rules for certain property acquired and placed in service after September 27, 2017. In general, as a result of the enactment of comprehensive tax reform legislation (the "Act")[2] in December 2017, the Internal Revenue Code of 1986, as amended (the "Code"), now permits a depreciation allowance of 100% ("Bonus Depreciation") of the adjusted basis of certain types of property in the year that such property is placed in service, if the property is acquired and placed in service after September 27, 2017 and before January 1, 2023 and certain other requirements are met. In a significant change, the Code now provides that a taxpayer generally need not be the first user of property to be eligible for Bonus Depreciation; however, the taxpayer cannot be treated as having used the property previously. Some noteworthy provisions of the Proposed Regulations are as follows:

- Under the Act, certain property with a statutory recovery period of 20 years or less is eligible for Bonus Depreciation. The legislative history of the Act stated that certain improvements to real property ("qualified improvement property") would have a statutory recovery period of 15 years, with the result that qualified improvement property would be eligible for Bonus Depreciation. However, the text of the Act did not provide a recovery period that is specifically applicable to qualified improvement property. The Proposed Regulations do not address this apparent omission with respect to property placed in service after December 31, 2017.
- Tax basis that is increased in connection with a transfer of a partnership interest may be eligible for Bonus Depreciation.

- Tax basis in property held by a partnership that is attributable to so-called "remedial allocations" or to adjustments to partnership basis in connection with certain partnership distributions generally is not eligible for Bonus Depreciation under the Proposed Regulations.
- The Proposed Regulations provide rules for determining the extent to which the sale and subsequent reacquisition of a portion of property by a taxpayer will cause the taxpayer to be treated as having previously used the property. The Proposed Regulations also effectively treat a series of "related transactions" as a single transaction for purposes of determining whether property acquired pursuant to such related transactions is acquired from a related party.
- Property treated as acquired pursuant to an election to treat a stock disposition as an asset sale is treated under the Proposed Regulations as acquired by purchase for purposes of Bonus Depreciation eligibility.[3]

The above provisions are discussed in more detail below.

DISCUSSION

A. Types of Property Eligible for Bonus Depreciation

Bonus Depreciation applies to certain "qualified property." "Qualified property" includes, among other types of property, certain tangible depreciable property with a recovery period under the Modified Accelerated Cost Recovery System ("MACRS") of 20 years or less.

"Qualified improvement property" is defined as "any improvement to an interior portion of a building which is nonresidential real property" if the improvement is placed in service after the building is first placed in service. The legislative history of the Act stated that qualified improvement property is subject to a 15-year MACRS recovery period under the Act, meaning that such property would be eligible for Bonus Depreciation. However, in what appears to be a drafting error, the Act did not provide a MACRS recovery period specifically applicable to "qualified improvement property." The result is that despite clear legislative intent, qualified improvement property may not be eligible for Bonus Depreciation.

The Proposed Regulations do not provide that qualified improvement property is eligible for Bonus Deprecation, and the preamble to the Proposed Regulations does not address the absence of an applicable recovery period in the statute, apparently leaving Congress to fix the statutory omission. However, the Proposed Regulations provide that "qualified leasehold improvement property," "qualified restaurant property" and "qualified retail improvement property," which were subject to differential treatment under the Code prior to the Act and were replaced by "qualified improvement property" by the Act, are eligible for Bonus Depreciation if such improvements were acquired by the taxpayer after September 27, 2017 and placed in service by the taxpayer after September 27, 2017 and before January 1, 2018.

B. Used Property

Under the Act, Bonus Depreciation generally may apply to property in the hands of a taxpayer who is not the first user of the property, but only if the taxpayer purchases the property and is not treated as having previously used the property. The Proposed Regulations treat property as having been used by the

taxpayer prior to acquisition (and thus not eligible for Bonus Depreciation) if the taxpayer or a "predecessor" to the taxpayer had a depreciable interest in the property at any time before the acquisition, whether or not the taxpayer or the predecessor claimed depreciation deductions for the property. If a taxpayer initially acquires a depreciable interest in a portion of a property (a fractional interest in an airplane, for example) and subsequently acquires an additional depreciable interest in the same property, the additional depreciable interest is not treated as being previously used by the taxpayer by virtue of the taxpayer's ownership of the first depreciable interest. However, if a taxpayer holds a depreciable interest in a portion of a property, sells such portion or a part of such portion, and subsequently acquires a depreciable interest in another portion of the same property, the taxpayer is treated as previously having a depreciable interest in the property up to the amount of the portion for which the taxpayer held a depreciable interest in the property before the sale.

A member of a consolidated group is treated as previously having a depreciable interest in any property in which the consolidated group is treated as previously having a depreciable interest.

C. Acquisition Requirements

In addition to the previous use requirements described above, a taxpayer's acquisition of property must satisfy certain additional requirements for the property to be eligible for Bonus Depreciation. In particular, property is eligible for Bonus Depreciation only if the taxpayer acquires the property by "purchase" from a person not having a specified relationship to the taxpayer. The Proposed Regulations generally mirror the provisions of the Act that establish these acquisition requirements. In addition, for purposes of determining whether a taxpayer acquired property from a related party, the Proposed Regulations provide that in the case of a series of "related transactions," property is treated as directly transferred from the original transferor to the ultimate transferee. The preamble to the Proposed Regulations notes that the ordering of steps or the use of an unrelated intermediary should not control the characterization of a transaction for this purpose.

In addition, the Proposed Regulations provide that property deemed to have been acquired as a result of an election to treat the disposition by a parent corporation of the stock of its subsidiary as a sale of the subsidiary's assets is treated as acquired by purchase for purposes of the Bonus Depreciation rules.[4]

D. Application to Partnerships

The Proposed Regulations provide that certain adjustments made to the basis of property held or distributed by partnerships do not give rise to basis that is eligible for Bonus Depreciation:

- Where a partner contributes property to a partnership and the fair market value of the property exceeds the tax basis of the property at the time of the contribution, the partnership may elect to allocate amounts of tax depreciation to the non-contributing partners in excess of the total amount of depreciation available to the partnership for tax purposes, so that the non-contributing partners are allocated depreciation deductions for tax purposes that match their depreciation allocations for book purposes.[5] Such excess allocations of tax depreciation, known as "remedial allocations," require offsetting income inclusions to the contributing partner. The Proposed Regulations provide that

remedial allocations are not eligible for Bonus Depreciation. The Proposed Regulations also provide that where partnership assets are revalued for book purposes, giving rise to a book-tax disparity that is similar to the disparity that exists in the case of property that has a built-in gain at the time the property is contributed to the partnership, remedial allocations with respect to such assets (so-called "reverse Section 704(c) allocations") also are not eligible for Bonus Depreciation.

- Where the basis of depreciable property held by a partnership is increased in connection with a distribution of other property by the partnership,[6] the Proposed Regulations provide that such increase in basis is not eligible for Bonus Depreciation.
- Where a partnership distributes property to a partner, the distributee partner's basis in the property generally is not eligible for Bonus Depreciation under the Proposed Regulations to the extent that the distributee partner's basis in the property is determined with reference to either the partnership's basis in the property prior to the distribution or the distributee partner's basis in the partnership.

However, where the basis of property held by a partnership is increased with respect to a transferee partner in connection with the transfer of an interest in the partnership to the transferee,[7] that basis increase may be eligible for Bonus Deprecation under the Proposed Regulations. More specifically, the Proposed Regulations treat each partner in the partnership as having owned and used the partner's respective proportionate share of partnership property, such that the basis increase with respect to the transferee partner is eligible for Bonus Depreciation if the transfer otherwise satisfies the applicable requirements.

The Proposed Regulations provide that where qualified property is placed in service in a taxable year and then contributed to a partnership in the same taxable year, and where one of the non-contributing partners in such partnership previously had a depreciable interest in the contributed property, Bonus Depreciation is allocated entirely to the contributing partner and not to the partnership or other partners.

E. Other Issues

The Proposed Regulations do not address the rule in the Code that provides that "qualified property" does not include any property used in a trade or business that has had floor plan indebtedness if the interest on such indebtedness was taken into account under the provision of the Code that limits the deduction for business interest.

F. Effective Date

The Proposed Regulations are proposed to apply to qualified property placed in service by a taxpayer during or after the taxpayer's taxable year that includes the date of adoption of the Proposed Regulations as final. A taxpayer may choose to apply the Proposed Regulations to qualified property acquired and placed in service by the taxpayer after September 27, 2017 during taxable years ending on or after September 28, 2017.

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ENDNOTES

1 REG-104397-18.

2 An Act To provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Public Law 115-97 (131 Stat. 2054).

3 *See* Section 336(e).

4 *See* Section 336(e); *see also* Prop. Treas. Reg. § 1.179-4(c)(2).

5 *See* Section 704(c); Treas. Reg. § 1.704-3(d).

6 *See* Section 734(b).

7 *See* Section 743.

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