



AN ALERT FROM BDO'S NATIONAL TAX OFFICE &
TRANSACTION ADVISORY SERVICES

TAX REFORM

AUGUST 2018 / www.bdo.com

PROPOSED REGULATIONS UNDER SECTION 168(k) – IMPACT TO PARTNERSHIPS AND PARTNERS

Treasury has published proposed regulations regarding additional first year depreciation under Section 168(k). These regulations contain detailed provisions that can have a significant impact on depreciation deductions available to partnerships and their partners. Consequently, these proposed rules may create opportunities for new partnership investment structures.

BACKGROUND

On Friday, August 3, Treasury and the IRS published proposed regulations providing guidance regarding additional first year depreciation under Section 168(k) of the Internal Revenue Code of 1986, as amended (Bonus Depreciation). The proposed regulations affect taxpayers who deduct depreciation for qualified property acquired and placed in service after September 27, 2017. These rules describe and clarify the statutory requirements that must be met in order for depreciable property to qualify for Bonus Depreciation.

Read more ►

In general, Bonus Depreciation is available with respect to property that meets four requirements: (1) the depreciable property must be of a specific type,¹ (2) the original use of the depreciable property must commence with the taxpayer or used property must meet specific acquisition requirements,² (3) the depreciable property must be placed in service by the taxpayer within a specified time period, and (4) the depreciable property must be acquired by the taxpayer after September 27, 2017.

It is important to note that the original use of the depreciable property must begin with the taxpayer (the "Original Use Requirement"), but "used" depreciable property can now qualify for Bonus Depreciation provided the property was not previously used by the taxpayer or a predecessor and the property is not acquired in a carryover basis transaction (the "Used Property Acquisition Requirement"). Consequently, these rules will apply to most M&A transactions where a cost basis in the acquired depreciable tangible property is obtained, including: actual asset acquisitions, deemed asset sale transactions, and transactions involving the actual or deemed sale of a partnership interest when a Section 754 election is in place.

APPLICATION IN M&A TRANSACTIONS

In the context of M&A transactions, the proposed regulations provide the following important guidance:

Section 743(b) Basis Adjustments: Taxpayers will be allowed to claim Bonus Depreciation with respect to basis adjustments determined in accordance with Section 743(b). Because a Section 743(b) basis adjustment is a partner specific basis adjustment to partnership property, the proposed regulations take an aggregate view and provide that, in determining whether a Section 743(b) basis adjustment meets the Used Property Acquisition Requirement, each partner is treated as having owned and used the partner's proportionate share of partnership property. In the case of a transfer of a partnership interest, the Used Property Acquisition Requirement will be satisfied if the partner acquiring the interest, or a predecessor of such partner, has not used the portion of the partnership property to which the Section 743(b) basis adjustment relates at any time prior to the acquisition (that is, the transferee has not used the transferor's portion of partnership property prior to the acquisition), notwithstanding the fact that the

partnership itself has previously used the property. Similarly, for purposes of applying Section 179(d)(2)(A), (B), and (C), the partner acquiring a partnership interest is treated as acquiring a portion of partnership property, and the partner who is transferring a partnership interest is treated as the person from whom the property is acquired.

The proposed regulations provide that the same result will apply regardless of whether the transferee partner is a new partner or an existing partner purchasing an additional partnership interest from another partner. This treatment is warranted irrespective of whether the transferee partner may have an existing interest in the underlying partnership property, because the transferee's existing interest in the underlying partnership property is distinct from the interest being transferred. The proposed regulations also provide that Bonus Depreciation with respect to the Section 743(b) basis adjustment property is determined without regard to whether the partnership elects out of Bonus Depreciation for all other qualified property in the same class of property and placed in service in the same taxable year.

Section 734(b) Basis Adjustments: Because a Section 734(b) basis adjustment is made to the basis of partnership property (i.e., non-partner specific basis) and the partnership used the property prior to the partnership distribution giving rise to the basis adjustment, a Section 734(b) basis adjustment fails the Original Use Requirement and also fails the Used Property Acquisition Requirement. The proposed regulations thus provide that Section 734(b) basis adjustments are not eligible for Bonus Depreciation.

Section 704(c) Remedial Allocations: Under the remedial allocation method, the portion of a partnership's book basis in contributed property that exceeds its adjusted tax basis is recovered using any recovery period and depreciation (or other cost recovery) method available to the partnership for newly purchased property (of the same type as the contributed property) that is placed in service at the time of contribution. Notwithstanding this general rule, the proposed regulations provide that remedial allocations under Section 704(c) do not qualify for Bonus Depreciation.

¹ In general, the proposed regulations follow the definition of qualified property in Section 168(k) and provide that qualified property eligible for Bonus Depreciation must be one of the following: (i) Modified Accelerated Cost Recovery System (MACRS) property having a recovery period of 20 years or less, (ii) certain computer software, (iii) water utility property, (iv) a qualified film or television production, (v) a qualified live theatrical production, and (vi) a specified plant as defined in Section 168(k)(5)(B).

² Under proposed regulation Section 1.168k-2(b)(3)(ii), depreciable property eligible for Bonus Depreciation must satisfy one of two property acquisition requirements whereby the property is either originally used by the taxpayer, or the property was not previously used by the taxpayer, is acquired by purchase, and is not acquired in a carryover basis transaction.

Specifically, because the underlying property is contributed to the partnership in a Section 721 transaction, the partnership's basis in the property is determined by reference to the contributing partner's basis in the property. This violates the Used Property Acquisition Requirement. In addition, the partnership has already had a depreciable interest in the contributed property at the time the remedial allocation is made, which violates the Original Use Requirement. The same rule applies in the case of revaluations of partnership property (reverse Section 704(c) allocations).

Zero Basis Property: Regulation Section 1.704-1(b)(2)(iv)(g)(3) provides that, if partnership property has a zero adjusted tax basis, any reasonable method may be used to determine the book depreciation, depletion, or amortization of the property. The proposed regulations provide that Bonus Depreciation will not be allowed for property contributed to the partnership with a zero adjusted tax basis, because the Bonus Depreciation deduction gives partners the potential to shift built-in gain among partners.

Basis Determined under Section 732: Property distributed by a partnership to a partner fails to satisfy the Original Use Requirement because the partnership used the property prior to the distribution. Distributed property also fails to meet the Used Property Acquisition Requirement because the basis of the property is determined with reference to the partnership's tax basis. Therefore, the proposed regulations provide that Bonus Depreciation will not be allowed on the basis of distributed property determined under Section 732.

Deemed Asset Sale Transactions: The proposed regulations provide clarification as to the types of transactions that the new rules would apply to, including those involving Section 338(h)(10) and Section 336(e) elections. The regulations clarify that the property deemed to have been acquired by a new target corporation as a result of these deemed asset sale elections will be considered acquired by purchase for these purposes. If the property is treated as used by the taxpayer or a predecessor at any time before its acquisition of the property, or if someone other than the taxpayer or the predecessor claimed depreciation on any of those assets, it would not qualify.

BDO INSIGHTS

- ▶ The proposed regulations regarding Bonus Depreciation under Section 168(k) as it relates to partnerships and partners could have a significant impact on M&A tax planning. The ability to immediately deduct the Section 743(b) basis adjustment associated with property that meets the Used Property Acquisition Requirement can potentially enhance the return on investment to a buyer, given the ability to recover costs quickly in the form of immediate depreciation deductions rather than over longer periods of time.
- ▶ There is now a greater incentive to structure a transaction as a sale of a partnership interest, either directly or indirectly via a "disguised sale of partnership interests." These partnership interest acquisition transactions ensure that the basis step-up occurs via Section 743(b), rather than other types of transactions such as partner redemptions or equity contributions. These alternative transactions would produce similar results with either Section 704(c) remedial allocations or a Section 734(b) basis adjustment.
- ▶ The Bonus Depreciation for partnerships could also apply in some M&A transactions where the target company is not a partnership itself, but a corporate entity that owns an interest in a partnership. For example, if the target company is an S corporation or a C corporation subsidiary with an interest in a partnership, and the corporation is being sold in a transaction that is treated as a deemed asset sale for tax purposes (e.g., where an election is made under Section 338(h)(10) or Section 336(e)) such that one of the assets that is deemed to be sold is an interest in the partnership, or if the corporation sells its assets in an applicable asset sale transaction with one of the assets being an interest in the underlying partnership investment, then the buyer of the corporation could benefit from the Bonus Depreciation available on the Section 743(b) basis adjustment associated with the underlying partnership's depreciable assets.
- ▶ In situations where a buyer of a partnership interest is expecting to benefit from the Bonus Depreciation provisions, it is critical that the partnership must either already have a Section 754 election in place, or that such election is made by the partnership for the period in which the purchase of the partnership interest occurs. The failure to have a timely filed Section 754 election in place will preclude the buyer from obtaining the benefits of a Section 743(b) basis adjustment, including Bonus Depreciation deductions.

- ▶ In any transaction, it is important to quantify the tax consequences of claiming Bonus Depreciation. In certain situations, it could be advantageous to elect out of such rules and forego the benefits of Bonus Depreciation. For example, in situations where there is insufficient taxable income expected to benefit from the additional depreciation deductions allowed, and excess deductions could give rise to a net operating loss (NOL), an analysis is warranted as to whether to elect out of Bonus Depreciation as the NOL deduction is limited to 80 percent of taxable income for tax years beginning after December 31, 2017.
- ▶ In M&A transactions, Bonus Depreciation should now be available for property meeting the Used Property Acquisition

Requirement that is acquired in:

- i. Actual asset sales,
- ii. (Deemed asset sales (e.g., where Section 338 or Section 336(e) elections are made),
- iii. Actual or deemed sales of partnership interests where a Section 754 election is in place (when the partnership remains in existence),
- iv. Deemed asset sale transactions when there is a taxable partnership formation upon sale of a partial interest in a single-member LLC, and
- v. Deemed asset sale transactions when an acquirer purchases 100 percent of the outstanding partnership or LLC member interests, or where one partner buys out the partnership or LLC member interests of all other partners or LLC members.

CONTACT

JEFFREY N. BILSKY
National Tax Office Partner
Technical Practice Leader, Partnerships
404-979-7193 / jbilsky@bdo.com

AVI D. GOODMAN
Managing Director
Transaction Advisory Services
212-515-5492 / agoodman@bdo.com

Material discussed is meant to provide general information and should not be acted on without professional advice tailored to your needs.

© 2018 BDO USA, LLP. All rights reserved.