Transactions and Bonus Depreciation

ABA 2020 Midyear Tax Meeting
Capital Recovery & Leasing Committee

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Overview of bonus depreciation post-TCJA
Key points to remember!

— **100%** bonus depreciation

— Magic dates for acquisition + placed in service

— Used qualified property qualifies if:
  - it is “purchased,”
  - from an “unrelated person,” and
  - is “new to me.”
Magic dates*

100% bonus depreciation for qualified property
Acquired and placed in service after September 27, 2017, and before January 1, 2023
Phased down in 20% increments beginning 2023 through 2026

50% bonus depreciation for qualified property
Acquired before September 28, 2017, and placed in service before January 1, 2018
Phased down in 10% increments for 2018 and 2019

*Special rules apply with respect to longer production period property and certain aircraft property.
Guidance

— August Proposed Regulations (08/08/2018)
  - May adopt for qualified property acquired and placed in service after September 27, 2017, during taxable years ending after September 27, 2017, and before September 24, 2019.

— Final Regulations (09/24/2019)
  - May adopt for qualified property acquired and placed in service after September 27, 2017, during taxable years ending after September 27, 2017.
  - Effective for qualified property placed in service in the first taxable year including September 24, 2019, and all subsequent taxable years.

— Additional Proposed Regulations (09/24/2019)
  - May adopt for qualified property acquired and placed in service after September 27, 2017, during taxable years ending after September 27, 2017.
Used qualified property

- The TCJA expanded the definition of property eligible for bonus depreciation to include used property acquired and placed in service after September 27, 2017, to the extent all of the following apply:

  - The taxpayer or its predecessor did not previously “use” the property at any time before the acquisition.

  - The taxpayer did not acquire the property from a related party.

  - The taxpayer’s basis in the used property is not determined in whole or in part by reference to the adjusted basis of the property in the hands of the seller or transferor.

  - The taxpayer’s basis in the used property is not determined under the provision for determining the basis of property acquired from a decedent.

  - The cost of the used property eligible for bonus depreciation does not include the basis of property determined by reference to the basis of other property held at any time by the taxpayer (e.g., in a like-kind exchange or involuntary conversion).
Prior use & “depreciable interest”

— An asset is treated as previously used (and therefore ineligible for bonus depreciation) if either the taxpayer or a predecessor previously had a “depreciable interest” in the asset.
  - A taxpayer can have a depreciable interest in only a “portion” of an asset and can claim bonus depreciation for other unowned portions of the same asset that it acquires.
  - Certain prior uses are disregarded, including initial owners in syndication transactions and certain periods of ownership of 90 days or less.

— The regulations do not define “depreciable interest.”
  - Should taxpayers assume that any prior ownership of an acquired asset by the taxpayer or a predecessor will be treated as a depreciable interest that puts bonus depreciation at risk?
  - Pre-acquisition diligence regarding past ownership history is critical.

— Property deemed acquired pursuant to a Section 338 or Section 336(e) election is not treated as previously used by a “new” target, but is treated as previously acquired by an “old” target under the sale-to-self model (i.e., QSD pursuant to Section 355(d) or (e)).
Prior use & “depreciable interest” (cont.)

— In determining whether a taxpayer has ever had a depreciable interest in acquired property, the Final Regulations generally permit the taxpayer to consider only the year in which the assets are placed in service by the taxpayer and the 5 preceding calendar years.

- Thus, if an asset is acquired and placed in service in calendar year 2020, the 5-year lookback appears to apply to 2015-2019 (and the earlier portion of 2020). If the taxpayer previously owned the asset in 2014, but had disposed of the asset by 2015, the 2020 acquisition should not be excluded from bonus depreciation as a result of the prior 2014 ownership.

- Is the safe harbor limited only to direct asset acquisitions by a taxpayer (vs. other instances where prior use is tested)?
The term “predecessor” includes:

- A transferor of an asset to a transferee in a transaction to which Section 381(a) applies;
- A transferor of an asset to a transferee in a transaction in which the transferee’s basis in the asset is determined, in whole or in part, by reference to the basis of the asset in the hands of the transferor;
- A partnership that is considered as continuing under Section 708(b)(2) and Treasury Regulation Section 1.708-1;
- The decedent in the case of an asset acquired by an estate; and
- A transferor of an asset to a trust.

Was a “predecessor” intended to have as broad a meaning as the language of the Final Regulations suggests?

- For instance, is a shareholder of a corporation a “predecessor” simply because the shareholder made a contribution of property to the corporation at some point?
Who is a predecessor?

Because X transferred “an asset” (Asset 2) to Y in a Section 721(a) transaction, Y has a transferred basis in Asset 2.

Is X now a predecessor to Y more broadly, such that immediate expensing of Y’s cost basis of Asset 1 is not permitted?
Testing relatedness

— Property must be acquired from an unrelated party.
  ▪ Persons generally are not related if they do not have a relationship described in Section 179(d)(2)(A) (generally, Section 267 or Section 707(b)), and are not both component members of the same controlled group within the meaning of Section 179(d)(2)(B).

— Series of related transactions rule
  ▪ August Proposed Regulations: relationship between the original transferor and the ultimate transferee is tested only after the final transaction in the series (intermediaries disregarded).
  ▪ Additional Proposed Regulations: relationship between parties is tested after each step in the series, and between the original transferor and the ultimate transferee after the final transaction in the series.

— How should taxpayers interpret the term “series of related transactions,” which the Additional Proposed Regulations do not define?
  ▪ For example, is a taxable stock purchase from an unrelated seller followed by an immediate Section 331 liquidation eligible for bonus depreciation to the extent of the qualified property (like goodwill is eligible for amortization in such case under the Section 197 regulations)?
Testing relatedness (cont.)

Series of related transactions rule (cont.)

- Any intermediary (i.e., a taxpayer other than the original transferor or ultimate transferee) is disregarded so long as that intermediary: (1) never places the property in service; or (2) places in service and disposes of the property in the same taxable year.

  - Relationship tested between the party from which the disregarded party acquired the property and the party to which the disregarded party disposed of the property.

- Intermediate step disregarded if “step-in-the-shoes” transaction described in Section 168(i)(7).

  - Relationship tested between: (1) the transferor in the disregarded step and the party to which the transferee in the disregarded step disposed of the property; and (2) the transferee in the disregarded step and the party to which the transferee in the disregarded step disposed of the property (i.e., the transferee in the next step after the disregarded step has to test relatedness to the two prior transferors).

- Ex. 31 of the Additional Proposed Regulations provides that an unrelated individual who buys property from a father and sells the property to the father’s daughter in a series of related transactions may qualify for additional first-year depreciation.

  - When is it appropriate to respect the intermediary in a series of related transactions as eligible for the deduction?
Caveat emptor ("let the buyer beware")

— Partner-to-partner stock attribution

- Under Section 267(c)(1), S is deemed to own its proportionate share of C stock owned by H.

- Under Section 267(c)(3), S, an individual, is treated as owning all of the shares of C stock owned by its partners in H.
Eligibility of bonus depreciation in a consolidated group context
Consolidated group rules

— Generally, as in the August Proposed Regulations, the Additional Proposed Regulations would deny bonus depreciation if a member of a consolidated group acquires property and the group previously had a depreciable interest in the property.

— In turn, a consolidated group would be deemed to have a depreciable interest in property at any time that a current or former member of the group had a depreciable interest in the property while a member of the group.

  ▪ So, if a member of the consolidated group previously used an asset, then sold the asset, then a different member of the group bought the asset from a third party on the market, the later acquisition generally would not be eligible for bonus depreciation. Note that the same result occurs if the seller member leaves the group prior to selling the asset.

  ▪ It is not clear that the 5-year lookback limit applies for purposes of the consolidated return rules.
Consolidated group rules (cont.)

— Under the Additional Proposed Regulations, if a series of related transactions includes (i) an acquisition of property by a member of a consolidated group and (ii) a transaction in which one or more target corporations join the same group, then, if the target corporation(s) ever had a depreciable interest in the acquired property, no bonus depreciation would be available.

- Bonus depreciation would be disallowed only if the target corporations previously directly held the acquired assets.

- If a buying consolidated group purchases both assets and target corporation stock out of a selling consolidated group, and the target corporations never directly held the acquired assets, the fact that other members of the selling consolidated group previously used the acquired assets would not prevent bonus depreciation.

- What result if a member of a consolidated group acquires an asset and, in an unrelated subsequent transaction, a corporation that previously had a depreciable interest in the property becomes a member of the same consolidated group?
“Sell the buyer” rules

The Additional Proposed Regulations also include special rules for certain “sell the buyer” transactions in which qualified property is sold between a seller member and a buyer member within a consolidated group (or deemed sold in a transaction subject to Section 338 or Section 336(e)) and, as part of the same series of related transactions, the buyer member ceases to be a member of the consolidated group.

- Similar transactions have been the subject of private letter rulings that predated the TCJA’s changes to the bonus depreciation rules and generally did not address Section 168 depreciation issues.
“Sell the buyer” rules (cont.)

— For qualifying “sell the buyer” transactions, the Additional Proposed Regulations would recharacterize the intercompany transfer for all U.S. federal income tax purposes, treating the transfer as occurring one day after the buyer member’s departure from the consolidated group.

  ▪ This recast raises many implementation questions.
  ▪ How should taxpayers treat income, cost recovery and changes in the characteristics of the qualified property prior to the buyer member’s departure?
  ▪ If this “sell the buyer” transaction is part of a larger transaction, are the steps reordered? What if the reversal of the order of the steps disqualifies the transaction from Section 355 treatment (e.g., the asset sale involves the active trade or business)?
  ▪ Does the recast apply to intercompany transfers of non-bonus-eligible depreciable property?

— In addition, the buyer member in a “sell the buyer” transaction must leave the consolidated group within 90 days.

  ▪ This appears inconsistent with the approach taken in earlier private letter rulings.
  ▪ Where does the 90-day period come from?
  ▪ What result if the buyer member leaves the group on day 91 pursuant to a binding commitment or pre-arranged plan?
Eligibility of bonus depreciation in a partnership context
Key points to remember!

— Bad news
  - Basis adjustments under Sections 732 and 734, and Section 704(c) remedial allocations

— Good news
  - Basis adjustments under Section 743(b), even if attributable to Section 704(c) built-in gain (unless a publicly traded partnership)

— Other news
  - Notification requirements on partnership transfers
  - Action required to elect out
Case-by-case basis

— The following do **not** qualify for bonus depreciation:
  - Section 704(c) remedial allocations
  - Section 732 basis of distributed property
  - Section 734(b) increase in basis of partnership property

— Immediate expensing of a Section 743(b) basis increase generally is allowable.

  - Includes the portion of the Section 743(b) basis increase attributable to Section 704(c) built-in gain (unless a publicly traded partnership).

  • “All-or-nothing” approach for non-publicly traded partnerships, even though delinkage is both permitted and required for publicly traded partnerships.
Section 743(b) basis adjustments

— A Section 743(b) basis increase is isolated to the acquiring partner, and is assigned to a specific property class (which may be a class that is eligible for bonus depreciation), assuming all other requirements are met.

— A partnership’s choice to claim or elect out of bonus depreciation for a class of qualified property placed in service during the taxable year does not extend to Section 743(b) basis adjustments arising during the same taxable year for the same class of property.

— **Affirmative** election-out requirement
  - Partnership may elect out of bonus depreciation for a partner’s Section 743(b) basis adjustment attributable to a class of qualified property.
  
  - Upper-tier partnership **cannot** make the election out on behalf of a lower-tier partnership.
  
  - Acquiror has 30 days to provide the partnership with any information necessary for the partnership to compute the partner’s basis in its partnership interest.
How much flexibility is afforded?

— LLC owns one 5-year property and one 7-year property, each having a FMV of $50x.

— A sells 1/2 of its interest to D, and B sells 1/2 of its interest to C, each for $25x cash.

— LLC makes a Section 754 election effective for the year of the transfers.

— Assume C’s and D’s Section 743(b) basis adjustments are allocated equally to the 5- and 7-year property, and all other requirements for immediate expensing are met (e.g., A and D, and B and C, are not related).
How much flexibility is afforded? (cont.)

— Can LLC elect out of bonus depreciation for the portion of C’s Section 743(b) basis increase allocated to the 5-year property without affecting the ability to claim immediate expensing for the portion of C’s Section 743(b) basis adjustment allocated to the 7-year property?

— Is consistent treatment required for D’s Section 743(b) basis adjustment, or the underlying property held by LLC?

— If C acquires an additional interest in LLC during the same taxable year, does the earlier choice preclude immediate expensing for the portion of the new Section 743(b) basis increase allocated to the 5-year property?
Partner’s prior depreciable interest

— Under the Additional Proposed Regulations, a partner’s prior depreciable interest in partnership property would be determined by reference to the partner’s total share of depreciation deductions with respect to the property during the current year and the previous 5-year period.
  
  ▪ Only the period during which the partnership owned the property and the taxpayer was a partner would be taken into account.
  
  ▪ What was the thinking behind the addition of the partnership look-through rule? The statute itself does not seem to call for such a rule.

— Is a partner’s share of depreciation deductions determined by reference to Section 704(b) book or tax?
  
  ▪ Has the government considered the interaction of the partnership look-through rule and depreciation recapture?
  
  ▪ For example, if a partner is allocated all depreciation recapture, is it really appropriate to treat that partner as a prior user? The net allocation of depreciation deductions would seem to be zero.
Partnership cross-ownership

- Partnership B purchases qualified property from Partnership A.
- Partner X is a 25% partner in Partnership B and a 67% partner in Partnership A.
- Partnership A and Partnership B are not related.

- Is Partnership B’s bonus depreciation deduction limited because of Partner X’s deemed prior depreciable interest in Partnership A’s property, notwithstanding that Partnership B is not a “prior user” of the property?
Bonus depreciation and partnership transfers
Key points to remember!

- Variances in the treatment of bonus depreciation across different kinds of partnership transactions
- Rules can be planned into, or avoided
- Form matters
- Consider Section 704(c) methods
A and B are equal partners in partnership, LLC.

In January 2019, A sells 45% of its interest in LLC to B for $45x cash.

LLC makes a Section 754 election effective for the year of the sale.

At the time of the sale, LLC has a single qualified property with a FMV of $100x and a tax basis of zero.

B’s Section 743(b) basis adjustment is $45x and is allocated entirely to the qualified property.
Transfers of acquired interests (cont.)

Assuming all other requirements are met, B’s Section 743(b) basis increase qualifies for immediate expensing. But how much?

- Is B limited to $22.5x (i.e., 50% x $45x) of the bonus depreciation deduction on B’s Section 743(b) basis increase by virtue of B’s 50% interest in LLC?

- Or is A considered to transfer a “vertical slice” of A’s portion of LLC’s property, with the effect that B’s entire Section 743(b) basis increase of $45x is eligible for the bonus depreciation deduction?
In the case of a transfer of a partnership interest, the used property acquisition requirements 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.

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.
“Step-in-the-shoes” transactions

— Qualified property placed in service and disposed of during the same taxable year generally is not eligible for immediate expensing.

— Bonus depreciation deduction is preserved if the disposition is a Section 168(i)(7) transaction (certain tax-free or related party transfers).

— Transferor and transferee must share the deduction, with the deduction allocated between the transferor and transferee based on the number of months each holds the qualified property while in service within the taxable year.

  ▪ Transferor takes into account the month in which the property was placed in service, but does not take into account the month in which the property was transferred.

  ▪ If the Section 168(i)(7) transaction is a Section 721(a) contribution, and the transferee partnership has as a pre-existing partner a person that previously used the transferred property, the transferor instead receives the entire bonus depreciation deduction.
— A owns all of the outstanding interests in LLC, which is disregarded as separate from A for Federal income tax purposes.

— On January 1, 2019, LLC acquires qualified 5-year property for $100x and places the property in service.

— On July 1, 2019, A sells a 50% interest in LLC to an unrelated purchaser, B, for $50x.

— Treated as if B purchased a 50% interest in each of LLC’s assets, followed by the contribution by A and B of their respective interests in those assets to a partnership in exchange for partnership interests in a Section 721(a) transaction.
— B is entitled to a $50x bonus depreciation deduction resulting from B’s acquisition of a 50% interest in the underlying qualified property of LLC before B’s deemed contribution of its interest in the property to the newly formed partnership (Section 704(c) property in the partnership’s hands).

— Does A receive any bonus depreciation benefit?

— Who makes the election out?

— What if the property was construction work in progress and not placed in service until a later taxable year?
Same facts as Situation 1, except on July 1, 2019, B contributes $100x to LLC in exchange for a 50% ownership interest.

Treated as a contribution of assets by A and cash by B in formation of LLC as a partnership.

B is contributing cash to the partnership (not acquiring bonus-eligible property) and thus is not eligible for immediate expensing related to the contribution.

A and B both share the partnership’s bonus depreciation deduction (LLC is allocated part of the deduction because A is treated as acquiring the qualified property and contributing it to LLC in a Section 168(i)(7) transaction in the same year).
— Same facts as Situation 1, except on July 1, 2019, B contributes $50x to LLC in exchange for a 50% ownership interest, and LLC distributes $50x to A.

— The cash distribution is treated as a partial sale by A to the newly formed partnership.

— Can the partnership claim bonus depreciation on the purchased portion?

  - That is, does the partial contribution by A cause A to be a “predecessor” of the partnership whose prior use of the qualified property is attributed to the partnership at the time of the partial purchase?
— B’s Treatment: LLC is deemed to make a liquidating distribution of all of its assets to A and B, and following this distribution, B is treated as acquiring the assets deemed to have been distributed to A in liquidation of A’s partnership interest.

— Does B have a prior depreciable interest in any portion of the property treated as distributed to A and acquired by B?

— Should the result be different from the situation in which the partnership continues with minimal additional ownership?

— Flexibility in partnership agreement to exercise self-help?
What questions do you have?
Thank you