



# TaxNewsFlash

## United States

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### **Proposed bonus depreciation regulations and 2018 filing season: Opportunities and pitfalls**

The U.S. Treasury Department and IRS on August 3, 2018, released for publication in the Federal Register proposed regulations (REG-104397-18) implementing changes to the additional first-year depreciation deduction (“bonus depreciation”) that were enacted as part of the new tax law in the United States, Pub. L. No. 115-97 that is sometimes referred to as the Tax Cuts and Jobs Act (“Act”).

The proposed regulations were published in the Federal Register on August 8, 2018. Read the [proposed regulations](#) [PDF 321 KB] (31 pages)

The regulations are proposed to be effective for property placed in service during or after the tax year the proposed regulations are finalized, but taxpayers can rely on them now. As such, taxpayers that have or would like to take positions on their 2017 federal income tax returns that may differ from the proposed regulations may do so, but they should review those positions in light of the proposed regulations.

Under the Act, qualified property is generally eligible for 100% bonus depreciation if it is acquired and placed in service after September 27, 2017, and before 2023 (with certain long-lived property, transportation property, and aircraft eligible through 2023). Bonus depreciation phases out after 2022 on a set schedule. Under the Act, both new and used property are generally eligible for bonus depreciation.

The proposed regulations clarify a number of areas that were left unclear from the statute, including when qualified property is “acquired,” when “used” property will be eligible for bonus depreciation, and how the new rules apply in the context of partnership items, such as those arising in the context of sections 704(c), 732, 734(b), and 743(b).

## **Key issues for the 2017 tax year: Elections**

As under prior law, a taxpayer is required to claim bonus depreciation unless it elects out. The “election out” is made on an asset recovery class basis. Taxpayers may have any number of reasons for electing out, including avoiding the expiration of income tax credits or net operating losses. If a taxpayer fails to elect out of bonus depreciation on its originally filed return, its only recourse is to request “9100 relief,” which can be an expensive process. Therefore, taxpayers should consider now whether the election should be made and for which recovery classes.

In addition, for the tax year that includes September 27, 2017, taxpayers that are otherwise eligible for 100% bonus depreciation can elect to claim 50% bonus depreciation instead. This election differs from the general “election out” provision in that this election, if made, applies to all qualified property of the taxpayer and cannot be made on a class-by-class basis.

Both the election out of bonus depreciation and the election to claim 50% in lieu of 100% bonus depreciation are made entity by entity and by member of a consolidated group (although the group files a single election statement).

Finally, there will be only one remaining opportunity to elect to claim refundable alternative minimum tax (AMT) credits in lieu of claiming bonus depreciation under section 168(k)(4). Taxpayers may want to consider this election as well to accelerate the refund of these credits. For tax years beginning after 2017, AMT credits are refundable on a set schedule over a period of years without having to forgo bonus depreciation.

### **Qualified property**

Property eligible for bonus depreciation includes:

- Tangible depreciable property with a MACRS GDS recovery period of 20 years or less
- Computer software depreciable under section 167(f)(1)
- Water utility property
- Specified fruit and nut plants
- Qualified film, television, and live theatrical production property

In addition, qualified property includes “qualified improvement property” (QIP) that is acquired and placed in service after September 27, 2017, and before 2018. QIP acquired before September 28, 2017, and placed in service by December 31, 2019, potentially is eligible for bonus depreciation under former section 168(k) (as in effect before amendment by the Act). QIP acquired after September 27, 2017, and placed in service after 2017 is not currently eligible for bonus depreciation. So long as they are made after the building’s initial placed-in-service date, most improvements to the

interior of nonresidential real property are QIP, other than expansions, elevators, escalators, or structural work.

Qualified property does not include:

- Property required to use ADS (property for which ADS is elected remains bonus eligible):
  - Foreign-use property, tax-exempt use property, and tax-exempt bond-financed property
  - Nonresidential real, residential rental, and QIP owned by an electing real property trade or business (as defined in section 163(j)(7)(B))
  - Real property owned by an electing farming business (as defined in section 163(j)(7)(C))
  - Property > 50% personal use
- Property for which the taxpayer has elected out of bonus depreciation
- Property placed in service and disposed of in the same tax year
- Property for which the taxpayer has elected out of section 168
- Property primarily used in the business of a regulated utility (if placed in service in a tax year beginning after 2017)
- Property used in a business with “floor plan financing” (FPF) if interest on the FPF was taken into account in computing the business interest expense limitation under section 163(j) (if placed in service in a tax year beginning after 2017)

### **Original use / certain used property**

To be eligible for 100% bonus depreciation, qualified property must meet either the “original use requirement” or the “used property acquisition requirement.” The original use requirement is met if the original use of the property—i.e., the first use to which the property is put—commences with the taxpayer. Additional capital expenditures incurred by a taxpayer to recondition or rebuild property acquired or owned by the taxpayer satisfy the original use requirement; however, the cost of reconditioned or rebuilt property does not satisfy the original use requirement (but may satisfy the used property acquisition requirement). For this purpose, property that contains used parts will not be treated as reconditioned or rebuilt if the cost of the used parts is not more than 20% of the total cost of the property (whether acquired or self-constructed).

The used property acquisition requirement is met if: (1) the property was not used by the taxpayer or a predecessor at any time prior to the acquisition; (2) the property is acquired by purchase, and not from a “related party” (as defined in section 179(d)(2)); and (3) to the extent the cost of the property is not determined by reference to the

basis of other property held at any time by the acquiring taxpayer (for example, in the case of a like-kind exchange). For this purpose, the property is treated as used by the taxpayer or a predecessor if such party had a depreciable interest in the property at any time prior to the acquisition, whether or not depreciation was claimed.

As an exception to the general rule described above, which disallows bonus depreciation in carryover basis transactions, the proposed regulations provide special rules for property transferred or sold between consolidated group members or transferred between related parties in transactions described in sections 332, 351, 721 and 732 (i.e., certain tax-free contributions and distributions). Under these rules, bonus depreciation is generally allowed so long as the original acquisition by the transferor meets the general requirements.

With respect to consolidated groups, generally, if a member of a consolidated group acquires depreciable property in which another member of the group (either current or previous) had a depreciable interest, the property will not satisfy the used property acquisition requirement. See below for a discussion of how the requirement is applied to certain partnership transactions.

### **Acquisition-date requirement**

To be eligible for 100% bonus depreciation, qualified property must be acquired and placed in service after September 27, 2017. As provided in the Act, property acquired under a written binding contract is treated as acquired on the date that contract is executed. Previous iterations of section 168(k) included a separate provision for qualified property manufactured, produced, or constructed by the taxpayer ("self-constructed property"), whereby that property was treated as acquired on the date construction began. The Act failed to include such a provision.

In accordance with the written-binding-contract language of the Act, the proposed regulations provide that all property acquired under a written binding contract—including self-constructed property—is treated as acquired on the date the contract was executed. This departure from prior law demands heightened scrutiny of contracts for the acquisition of qualified property to determine whether they are properly considered binding.

Under the proposed regulations, a written binding contract has each of the following elements:

- It is enforceable under state law against the taxpayer or a predecessor;
- It does not limit damages to a specified amount that is less than 5% of the contract price; and
- It is not subject to a condition within the control of either party.

Letters of intent and options are specifically excluded from written-binding-contract treatment. Similarly, supply agreements that are not specific to both amount and design specification are not considered “binding.”

The proposed regulations provide special rules for self-constructed property that is not manufactured, produced, or constructed under a written binding contract. As under prior law, the acquisition date of this property is the date physical work of a significant nature begins. The proposed regulations provide a safe harbor under which physical work of a significant nature begins when the taxpayer incurs 10% of the expected cost of the property, excluding the cost of land and any preliminary activities.

While not specified in the proposed regulations, property that is not acquired under a written binding contract and is not self-constructed property is generally treated as acquired as it is placed in the taxpayer’s physical possession or control.

Property that is acquired before September 28, 2017, is subject to the provisions of former section 168(k)—that is, as it existed before amendment by the Act. If such property meets the definition of qualified property in former section 168(k), it is eligible for 50% bonus depreciation if placed in service in 2017; 40% bonus depreciation if placed in service in 2018; or 30% bonus depreciation if placed in service in 2018.

### **Placed-in-service-date requirement**

To be eligible for 100% bonus depreciation, qualified property must also be placed in service after September 27, 2017, and before January 1, 2023. The Act provides a four-year phase down of 20% per year for qualified property placed in service in 2023 through 2026.

Certain long-lived property, transportation property, and aircraft that are placed in service in 2027 are eligible for 20% bonus depreciation on costs incurred by December 31, 2027. Such assets otherwise receive an extra year for each bonus percentage—e.g., such assets placed in service in 2023 are eligible for 100% bonus depreciation, such assets placed in service in 2024 are eligible for 80% bonus depreciation, and so on.

### **Partnership issues and special rules**

The proposed regulations contain a number of provisions addressing allocation or claiming of bonus depreciation in specific situations, including: the transfer of qualified property in certain partnership-related transactions; non-recognition transactions; basis redeterminations; like-kind exchanges and involuntary conversions; and changes in use.

The proposed regulations have particular impact on certain partnership transactions. In the favorable column, the proposed regulations provide that partnership basis step-ups under section 743(b) generally are eligible for bonus depreciation, so long as the step-up relates to qualified property, the partnership interest was not acquired from a

related party, and the acquirer or a predecessor did not previously have a depreciable interest in the acquired portion of the partnership.

On the unfavorable side, the following partnership items are not eligible for bonus depreciation:

- Basis determined under section 732(b)
- Step-ups in basis under section 734(b)
- Remedial allocations under section 704(c)
- Depreciation of zero basis contributed property under the traditional or curative method

In addition, the proposed regulations provide rules for the allocation of bonus depreciation when property is placed in service and transferred in a designated non-recognition transaction in the same tax year. The general rule provides that—when property is transferred in a transaction described under section 332, 351, 721, or 731, or in a transaction between consolidated group members—the bonus depreciation (like the regular depreciation) is allocated between transferee and transferor based upon the number of months the property is held by each party.

The proposed regulations create a new rule to address certain transactions in which qualified property is acquired and placed in service by a taxpayer, but then the taxpayer contributes the property in a section 721(a) transaction to a partnership in which one of the partners had a depreciable interest in the property. This type of fact pattern arises in transactions described in Rev. Rul. 99-5, Situation 1. In these transactions, a taxpayer buys property and contributes the property into a partnership in which the seller is also a partner. Under the proposed regulations, if the acquired property is in service at the time of its acquisition, the bonus depreciation is allocated entirely to the buyer; no bonus depreciation is claimed by the partnership. As a result, the buyer would have the obligation for any bonus depreciation elections with respect to the property.

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