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Partnership Tax *Matters*

With ***Partnership Tax* Matters,** we at **Harris Winick Harris LLP** help our clients keep abreast of the rapidly changing rules related to the taxation of partnerships by providing analysis of current developments in relevant federal case law, administrative guidance, and legislation. This edition of our newsletter focuses on certain partnership-related aspects of recently issued regulatory guidance with respect to the expanded "bonus" depreciation rules that were put in place under Section 168(k) of the Internal Revenue Code of 1986, as amended (the "Code") by The Tax Cuts and Jobs Act of 2017 (the "TCJA").[1]

We first provide a brief summary of the TCJA's primary changes to the depreciation rules under Code Section 168(k). Certain implications of these changes for tax partnerships and their partners are then discussed. After outlining the approach to these issues that was taken under recently issued regulations (the "Final Regulations"), we highlight certain partnership-related concerns that remain to be resolved under the bonus depreciation regime.

Implications of the TCJA for Bonus Depreciation in the Partnership Context

Background

Prior to enactment of the TCJA, Code Section 168(k) provided taxpayers with an additional first-year, or "bonus," depreciation deduction on "qualified property" acquired before January 1, 2020. Such depreciation generally was scheduled to apply at rates of 50%, 40%, and 30% of a property's adjusted tax basis for properties placed in service in 2017, 2018 and 2019, respectively. For this purpose, "qualified property" was defined as property whose "original use" commenced with the taxpayer.[2] As a result, under prior law, purchased properties that had been previously used (by anyone) generally did not qualify for additional first-year depreciation.

The TCJA modified Code Section 168(k) in several respects. Most importantly, it extended bonus depreciation to qualified property placed in service prior to the year 2027, it increased the applicable rates of such depreciation, and it expanded the definition of "qualified property" to

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[1] P.L. 115-97, 131 Stat. 2054 (Dec. 22, 2017).

[2] Former Code Section 168(k)(2)(A)(ii). "Qualified property" included tangible property subject to the modified adjusted cost recovery system ("MACRS") that had a recovery period of less than or equal to 20 years, as well as certain other types of property.

which such bonus depreciation is applicable. Under the new law, additional first-year depreciation generally applies at a rate of 100% to otherwise qualified property that is placed in service during any year before 2023, and at rates of 80%, 60%, 40%, and 20% for qualified property placed in service during each of 2023, 2024, 2025, and 2026, respectively. Moreover, "qualified property" now includes not only property whose "original use" commences with the taxpayer (i.e., new property), but also purchased property that was previously used, as long as the taxpayer did not use the property prior to its acquisition[3] and it was acquired from an unrelated party in a taxable transaction.[4] One important consequence of the TCJA's expansion of the bonus depreciation regime to include previously used properties is that bonus depreciation (i.e., currently, 100% expensing) now applies to qualified property acquired in "taxable asset acquisitions" (as defined for purposes of Code Section 1060), provided that all other requirements of Code Section 168(k) are met.

In the immediate wake of the TCJA's enactment, there was significant uncertainty regarding the extent to which additional first-year depreciation would apply to certain indirect acquisitions of property through tax partnerships, an issue that was moot before bonus depreciation was extended to acquisitions of previously used property. In particular, legislative changes under the TCJA failed to specify whether additional first-year depreciation might be available with respect to special basis adjustments under Code Sections 734(b) and 743(b), which result from certain partnership redemptions and transfers of partnership interests, respectively. Similarly, following enactment of the TCJA, it was unknown whether bonus depreciation would apply to remedial allocations under Code Section 704(c) that result from valuations and revaluations ("book-ups") of partnership property and generally are designed to provide a "non-contributing" partner with tax attributes that are on par with those that the partner would have obtained in a direct taxable acquisition of partnership property.

On September 13, 2019, the Treasury Department and the IRS released the Final Regulations,[5] adopting (with some modifications) previously proposed regulations (the "2018 Proposed Regulations")[6] regarding the TCJA's revisions to the bonus depreciation regime, and addressing

[3] Under the Final Regulations, lack of prior use by the taxpayer includes lack of prior use by any "predecessor," a provision deemed necessary to preclude taxpayer abuse by churning assets. The Final Regulations define "predecessor" to include, *inter alia*, a transferor of an asset to a transferee in a carryover basis transaction (such as a tax-free contribution to a partnership pursuant to Code Section 721(a)) and a partnership that is deemed a continuation of another partnership following a partnership merger or division, pursuant to Code Section 708(b)(2). Treas. Reg. §1.168(k)-2(a)(2)(iv)(B) and (C).
[4] See Code Sections 168(k)(2)(E)(ii)(II) and 179(d)(2) and (3).
[5] T.D. 9874 (Sep.13, 2019).
[6] 83 F.R. 39292 (Aug.8, 2018). The 2018 Proposed Regulations were proposed to be effective upon finalization, but they could be relied upon by taxpayers for qualified property acquired and placed in service after September 27, 2017, during taxable years ending on or after September 28, 2017, and before the date of finalization.

certain implications of the new rules for the application of bonus depreciation in the partnership context. The discussion that follows summarizes aspects of the Final Regulations that address the extent to which partnership special basis adjustments (under Code Sections 734(b) and 743(b)) and remedial allocations (under Code Section 704(c)) will be eligible for bonus depreciation following enactment of the TCJA. In addition, we discuss special rules that govern application of additional first-year depreciation in situations where property is acquired, placed in service, and contributed to a partnership, all in the same taxable year.

Bonus Depreciation in the Partnership Context under the Final Regulations

Much of the debate regarding how bonus depreciation should be applied to partnership special basis adjustments and remedial Section 704(c) allocations has revolved around whether partnerships should be viewed as separate entities or as aggregates of their partners for purposes of the analysis. Certain comments to the 2018 Proposed Regulations urged the application of aggregate principles by analogy to the anti-churning rules of Code Section 197(f)(9).[7] This position was based, in part, on the notion that the very purpose of the partnership basis adjustments under Code Sections 734(b) and 743(b) and remedial Section 704(c) allocations is to enable the "acquiring" partner of a partnership to have access to tax attributes that correspond with what would have been available if the interest in partnership property that the partner acquired indirectly had instead been acquired directly from the partnership's other partners.

Despite the foregoing, in promulgating the Final Regulations, the Treasury Department and IRS declined to adopt an overarching aggregate approach to applying bonus deprecation in the partnership context, stating that the purpose of Code Section 168(k) differed from that of Code Section 197(f)(9), and noting that, in contrast to Code Section 197(f)(9), Code Section 168(k) contained no statutory language that would support an overall aggregate approach.[8] Instead, determination of the eligibility of partnership basis adjustments and remedial Code Section 704(c) allocations for bonus depreciation was determined on a "case-by-case" basis, with the results described below.[9]

Under the Final Regulations, bonus depreciation is not available with respect to Code Section 704(c) remedial allocations, regardless of whether they result from property contributions or revaluations of partnership property[10] The preamble to the Final Regulations explains that applying bonus depreciation to Code Section 704(c) remedial allocations would be inappropriate because the underlying depreciable property is contributed to a partnership in a Code Section 721

[7] New York State Bar Association Tax Section Report No. 1405, Report on Proposed Regulations under Section 168(k) Relating to Immediate Expensing of Capital Investments (November 2, 2018).
[8] T.D. 9874 (Sep.13, 2019).
[9] Id.
[10] Treas. Reg. §1.168(k)-2(b)(3)(iv)(A).

transaction, resulting in violation of the requirement that "qualified property" not be carryover basis property.[11] Arguably, the preamble inappropriately ignores that (1) it is the non-contributing partner who is entitled to tax benefits (such as deductions of bonus depreciation) when the remedial allocation method is being used to comply with Code Section 704(c) and (2) the amount of the remedial allocation is driven by the property's fair market value (i.e., book basis) at the time of the property's valuation or revaluation, rather than carryover basis. Both factors militate in favor of allowing additional first-year depreciation with respect to such allocations.

The Final Regulations also provide that properties whose basis is derived under Code Section 732 (i.e., properties distributed by a partnership to a partner) and special basis adjustments under Code Section 734(b) are each ineligible for additional first-year depreciation.[12] With respect to Code Section 734(b) basis adjustments, the preamble to the Final Regulations explains that such ineligibility results from the fact that a Code Section 734(b) basis increase results in a change to the common basis of partnership property.[13] As such, the adjustment inures to the benefit of the partnership's pre-existing partners with respect to property previously owned and used by them, albeit indirectly. Accordingly, the preamble indicates that Code Section 734(b) basis adjustments fall short of the requirement that "qualified property" be either new or not previously used by the taxpayer.

In contrast to the inapplicability of bonus depreciation to Code Section 704(c) remedial allocations and Code Section 734(b) basis increases, in the case of certain transfers of partnership interests, the Final Regulations allow additional first-year depreciation deductions for Code Section 743(b) basis adjustments that represent "qualified property" and satisfy the remaining requirements of Code Section 168(k). For purposes of analyzing the eligibility of a Code Section 743(b) basis adjustment for bonus depreciation, the Final Regulations treat each partner as owning and using such partner's proportionate share of each of the properties of the partnership.[14] As a result, a positive Section 743(b) adjustment generally is eligible for bonus depreciation if (1) neither the transferee partner nor any of its predecessors is treated as having owned the portion of the partnership's underlying property to which the Section 743(b) basis adjustment is allocated and (2) the transferee partner acquired the partnership interest in a taxable transaction from an unrelated person.[15] Moreover, despite the general rule that Code Section 704(c) remedial allocations are not eligible for bonus depreciation, the additional first-year depreciation deduction generally does apply to the portion of a Code Section 743(b) basis

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[11] T.D. 9874 (Sep.13, 2019). See also Code Section 168(k)(2)(E)(ii)(II), referring to Code Section 179(d)(2)(C).
[12] Treas. Reg. §1.168(k)-2(b)(3)(iv)(B) and (C).
[13] T.D. 9874 (Sep.13, 2019).
[14] Treas. Reg. §1.168(k)-2(b)(3)(iv)(D)(1).
[15] Id.

increase that is attributable to Section 704(c) built-in gain in a partnership that uses the Code Section 704(c) remedial allocation method (provided that the requirements of Code Section 168(k) and the Final Regulations are otherwise satisfied).[16]

Lastly, the Final Regulations generally provide that the Code Section 168(k) bonus depreciation deduction is not allowed with respect to qualified property that is placed in service and disposed of during the same taxable year.[17] An exception is provided for situations where a qualified property is placed in service and then transferred in a transaction described in Code Section 168(i)(7), including a Code Section 721(a) contribution to a partnership.[18] In such cases, except as described in the following sentence, the additional first year depreciation deduction is allowed, and it is allocated between the transferor and transferee on a monthly basis. However, for Code Section 721(a) contributions such as the deemed contribution described in Situation 1 of Revenue Ruling 99-5,[19] where qualified property is contributed to a partnership that has a partner (other than the transferor) who held a depreciable interest in the qualified property in the same taxable year as the transferor, the qualified property is deemed to be placed in service by the transferor, and the transferor is allocated all of the allowable bonus depreciation.[20] Parallel rules apply to claiming bonus depreciation with respect to any Code Section 743(b) adjustment that arises from the purchase of a partnership interest where the partnership interest is later disposed of in a Code Section 168(i)(7) transaction in the same taxable year.[21]

Open Issue Regarding Partners' Deemed Prior Use of Partnership Properties

As discussed above, a property is eligible for bonus depreciation only if (1) it is new, or (2) the property was not used by the taxpayer at any time before its acquisition.[22] For this purpose, the Final Regulations define prior use of property by reference to whether a taxpayer previously held a "depreciable interest" in the property, where the scope of a prior "depreciable interest" is limited to a safe harbor look-back period of five calendar years.[23] One question left open under the Final Regulations is how one determines a partner's "depreciable interest" in property held

[16] Treas. Reg. §1.743-1(j)(4)(i)(B). An exception is provided whereby publicly traded partnerships ("PTPs") are unable to claim bonus depreciation on Section 743(b) basis increases that are attributable to Section 704(c) built-in gain on property that is subject to remedial allocations, due to the need to maintain fungibility of PTP units. Id.
[17] Treas. Reg. §1.168(k)-2(g)(1)(i).
[18] Treas. Reg. §1.168(k)-2(g)(1)(iii).
[19] In Situation 1 of Revenue Ruling 99-5, a disregarded limited liability company (LLC) is converted into a tax partnership when a new member, B, purchases a 50% interest in the LLC from its sole owner, A. Under the ruling, for federal tax purposes, B is deemed to have purchased a 50% interest in each of the LLC's assets directly from A, after which, A and B are treated as contributing their respective interests in the assets to the LLC in a Code Section 721(a) contribution.
[20] Id.
[21] T.D. 9874.
[22] Code Section 168(k)(2)(E)(ii)(I).
[23] Treas. Reg. 1.168(k)-2(b)(3)(iii)(B).

by a partnership. Newly issued proposed regulations (the "2019 Proposed Regulations")[24] provide tentative guidance indicating that a partner is deemed to have a depreciable interest in a portion of partnership property if the person is a partner in the partnership while the partnership owns the property. More specifically, under the 2019 Proposed Regulations, the partner's depreciable interest is equal to the partner's total share of depreciation deductions with respect to the property as a percentage of the total depreciation deductions allocated to all partners with respect to that property during the current calendar year and five calendar years immediately prior to the partnership's current year, taking into account only the period of time during which the partnership owned the property and the person was a partner.[25]

One common fact pattern whose treatment under Code Section 168(k) remains unclear despite the foregoing guidance is described in Situation 1 of Revenue Ruling 99-6.[26] In the ruling, A and B are equal partners in AB, a limited liability company ("LLC") that is treated as a tax partnership. A sells A's entire interest in AB to B for cash, after which, the business is continued by the LLC, which has become a disregarded entity owned solely by B. Revenue Ruling 99-6 provides that B's purchase of A's interest is treated, for tax purposes, as though the LLC distributed all of its assets in liquidation to A and B, after which, B is treated as having purchased the 50% of AB's assets that were deemed distributed to A. However, in considering B's ability to claim additional first-year depreciation with respect to the purchased assets, B's depreciable interest in the property of AB should be 50% (assuming that A and B shared depreciation of AB's assets equally over the entire safe harbor look-back period). One would expect that B's prior use of 50% of AB's assets should be deemed to attach to the 50% of AB's assets that were deemed distributed to B in liquidation, thereby enabling B to claim bonus depreciation with respect to all of the assets B is deemed to have purchased from A. However, it is unclear under the proposed regulation whether this result will obtain, or whether, instead, B's depreciable interest in AB's property will be treated as spread across the overall assets of AB, leaving B with an ability to claim bonus depreciation with respect to only half of the property that B is deemed to have purchased from A for cash. As the Treasury Department and IRS move to finalize regulatory guidance regarding partners' depreciable interests in partnership property, it is hoped that the eligibility of transactions such as that described in Situation 1 of Revenue Ruling 99-6 for bonus depreciation will be clarified.

[24] 84 F.R. 50152 (Sep.24, 2019).
[25] Prop. Treas. Reg. 1.168(k)-2(b)(3)(iii)(B)(5)(2019)
[26] 1999-1 C.B. 432.

Conclusion

With the promulgation of the Final Regulations, the Treasury Department has provided extensive guidance to help taxpayers navigate the application of the revised/expanded bonus depreciation rules to tax partnerships and their partners. However, important questions remain, including how a partner's "depreciable interest" in partnership assets should be gauged for purposes of applying the prior use limitation on bonus depreciation to partnership properties that are subsequently purchased by partners of the partnership.

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