BDO UNITED STATES

PROPOSED BONUS DEPRECIATION REGULATIONS RELEASED UNDER SECTION 168(K) ENACTED BY TAX REFORM

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On August 3, the IRS and Treasury Department released the much-anticipated proposed regulations implementing the expanded depreciation provisions under Section 168(k) as enacted by the 2017 tax reform act, commonly referred to as the Tax Cuts and Jobs Act (TCJA). The new regulations were published in the Federal Register on August 8, and address such issues as the definition of qualified property, when used property is eligible for bonus depreciation, when property is acquired and placed in service, rules applicable to self-constructed property, how to compute the depreciation, and the time and manner for making elections. Lastly, the regulations deal with certain issues affecting partnerships and consolidated groups of corporations, which have been covered in another BDO Tax alert regarding the new proposed regulations released for Section 168(k).

The regulations are proposed to apply to qualified property placed in service, and specified plants planted or grafted during or after a tax year that includes the date of publication of final regulations in the Federal Register. Taxpayers may rely on the proposed regulations for qualified property acquired and placed in service, and plants planted or grafted, after September 27, 2017, for tax years ending on or after September 28, 2017.

Prior to the TCJA, taxpayers could claim a 50 percent bonus depreciation deduction for qualified property placed in service, where the original use of the property was with the taxpayer, through the end of 2017. Then the bonus depreciation deduction was subsequently phased down to 40 percent and 30 percent for qualified property placed in service in 2018 and 2019, respectively. These provisions continue to apply for qualified property acquired before September 28, 2017, and placed in service after September 27, 2017.

The TCJA amends the previous Section 168(k)(1)(A) by eliminating 50 percent to an applicable percentage. For qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023, that percentage now becomes 100 percent. An additional year is allowed for certain aircraft and longer production-period property. For tax years 2023 through 2026, the applicable percentage is reduced each calendar year by 20 percent. Thus, after 2026, the applicable percentage is reduced to zero, with an additional year allowed for certain aircraft and longer production-period property.

Qualified property defined

As denoted in Section 168(k)(2), the definition of qualified property has three elements: (1) the property must be of a specified type; (2) the use of the property must originate with the taxpayer or meet the acquisition requirements for used property; and (3) the property must be placed in service within a specified time.

Property types

Under the TCJA, property eligible to be qualified property is any of the following:

- Modified Accelerated Cost Recovery System (MACRS) property with a recovery period of 20 years or less
- Computer software as defined in Section 167(f)(1)(B) for which a deduction is allowable under Section 167(a) without regard to Section 168(k)

- Water utility property
- A qualified film or television production as defined in Section 181(d), or a qualified live theatrical production as defined in Section 181(e), for which a deduction would have been allowable without regard to Section 181(a)(2) or 181(g)
- A specified plant as defined in Section 168(k)(5)(B) and for which the taxpayer has made an election to apply Section 168(k)(5)

Qualified property acquired and placed in service after September 27, 2017, and before January 1, 2018, is also qualified property.

- Qualified leasehold improvement property
- Qualified improvement property under prior definition
- Qualified restaurant property
- Qualified retail improvement property

Either qualified property also must have the original use commence with a taxpayer or a taxpayer has to have an eligible acquisition of qualified used property. The original use standard existed under prior law, and the proposed regulations retain this rule, including the 20 percent rule for reconditioned or rebuilt property. The proposed regulations also retain the same rules for fractional ownership property.

The proposed regulations provide two definitions of qualified improvement property (QIP), one for purposes of Section 168(k)(3) before the TCJA and one for Section 168(e)(6) as amended by the TCJA. QIP acquired after September 27, 2017, and placed in service after September 27, 2017, but before January 1, 2018, is considered qualified property eligible for bonus depreciation. But the proposed regulations do not address whether QIP placed in service after December 31, 2017, is eligible for bonus depreciation.

MACRS property with a recovery period of ten years or more that is held by an electing farm business under Section 168(j)(7)(B) are not eligible for bonus depreciation for taxable years beginning after December 31, 2017.

The proposed regulations clarify the application of 100-percent bonus depreciation on used property. In order for taxpayers to qualify for this new incentive, they cannot have used the property any time prior to acquisition. Under the guidance in place now, a taxpayer is deemed to have used the property if they or a predecessor had a depreciable interest in the property at any time prior to such acquisition. This would now allow taxpayers who have leased property under a true lease to acquire the property at the end of the lease and still qualify for 100-percent bonus depreciation. There are anti-abuse provisions for members of a consolidated group, certain acquisitions pursuant to a series of related transactions and related parties.

Written binding contract rules clarified

One of the most anticipated provisions of the proposed regulations is the clarification on the definition of a written binding contract. This applies to all property, including self-constructed property, keeping in mind that to qualify for the 100-percent bonus depreciation, taxpayers must have acquired the property after September 27, 2017. Under the effective date of the new Section 168(k), taxpayers cannot treat property as acquired after the date a taxpayer enters into a written binding contract for the property. For example, if a taxpayer provides an existing purchase agreement on September 15, 2017, but does not take title to the asset until October 1, 2017, the property would not qualify for 100-percent bonus depreciation. Thus it becomes critically important what in fact constitutes a written binding contract.

The proposed regulations define a written binding contract as a contract enforceable under State law against a taxpayer or a predecessor, and that does not limit damages to a specified amount. However, if a contractual provision limits damages to an amount equal to at least five percent of the total contract price, the proposed regulations will not treat it as limiting damages to a specified amount. While the prior law was very much similar, this was when taxpayers wanted a less strict standard to continue to qualify for bonus depreciation in years where bonus

was set to expire. Making insubstantial changes to a contract will not change the date of acquisition under the written binding contract. The proposed regulations state that options and letters of intent are not binding contracts. Furthermore, the proposed regulations will not treat purchase agreements as written binding contracts until a contract provides an amount and design specifications under the contract.
Further, there is a rule that acquisitions of smaller components of a larger property under a written binding contract will not cause the larger property to be disqualified for the 100-percent bonus depreciation, but if the larger property fails to qualify for 100-percent bonus depreciation, then none of the components would qualify for 100-percent bonus depreciation.

Elections

Historically, taxpayers have been allowed to elect out of bonus depreciation under Section 168(k)(7) on an annual basis. This has been on a class-by-class basis, (e.g., five-year property, fifteen-year property). The election applies to all those assets in that particular class that are placed in service during the tax year.

The TCJA provides a new election under Section 168(k)(10), which allows taxpayers to elect to claim 50-percent bonus depreciation in lieu of 100-percent bonus depreciation for qualified property acquired after September 27, 2017, and placed in service in the first tax year ending after September 27, 2017.

However, unlike the class-by-class election out of bonus depreciation, a taxpayer must now make this election for all qualified property placed in service during that tax year. For example, if the taxpayer has $100,000 of five-year assets and $200,000 of fifteen-year assets, and the taxpayer wants to make an election to treat the qualifying assets for 50-percent bonus depreciation, they must make it for the entire $300,000. In the past, taxpayers could elect either the $100,000 of five-year or $200,000 fifteen-year assets independently.

The proposed regulations eliminate the safe harbor provision for property under construction under a written binding contract. That is, unless the property is truly self-constructed by the taxpayer, the 10 percent safe harbor provision would continue to be available. In other words, if a newly constructed building was entered into a written binding contract on September 15, 2017, but did not incur 10 percent of the costs until November 15, 2017, any qualified assets would not qualify for the new 100-percent bonus depreciation provision, unless the items were truly self-constructed by the taxpayer.

Some of the key takeaways of the proposed regulations are regarding structuring transactions around acquisitions and related party rules with divesture transactions. Although the general rule is not a bright line test, it is extremely important to understand if the taxpayer has ever had a prior depreciable interest in the property.

The IRS is proposing that the new regulations will apply to property placed in service after a taxpayer's taxable year that includes the date of publication of a Treasury decision adopting these new rules as final regulations. Therefore, barring pending issuance of the final regulations, a taxpayer may choose to apply these proposed regulations to qualified property acquired and placed in service after September 27, 2017, by a taxpayer during tax years ending on or after September 28, 2017.

Unfortunately, the proposed regulations were not available by the time many taxpayers had already filed their 2017 tax returns. While the proposed regulations are not binding, taxpayers that want to rely on them may still have an opportunity to file a superseded return, amend their 2017 return, or file an accounting method change to follow the proposed regulations beginning in 2018 with a Section 481(a) adjustment.