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Treasury Issues Further Guidance on Bonus Depreciation Rules, Declines to Amend Legislative Drafting Glitch

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On September 13, 2019, the Treasury Department issued final and proposed regulations providing guidance on the 100% bonus depreciation rules under Section 168(k) of the U.S. Internal Revenue Code, as amended (the "Code"), which was revised as part of the Tax Cuts and Jobs Act on December 22, 2017 (the "TCJA"). The TCJA raised the bonus depreciation deduction to 100% for qualified property acquired and placed in service after September 27, 2017 and before January 1, 2023. The TCJA also expanded bonus depreciation by allowing taxpayers to apply it to additional types of new property and to certain used property.

After being rushed through Congress, the TCJA contained a glaring omission with respect to its new bonus depreciation rules: Under the pre-TCJA rules, qualified improvement property ("QIP")—improvements to an interior portion of a non-residential building made after the building was first placed in service—met the definition of qualified property for bonus depreciation purposes. Yet, as we have previously examined, the TCJA amendment neglected to classify QIP as having a recovery period of 20 years or less, meaning that QIP is not qualified property for purposes of the bonus depreciation rules. Instead, QIP remains subject to a 39-year depreciation life.

Although Congress intended to simplify the depreciation rules with respect to tenant improvements and to provide a 15-year depreciation life for qualified improvement property, the actual language of the TCJA has fallen far short of achieving that desired result. The newly released final regulations further highlight that deficiency. In the preamble of the final regulations, the Treasury noted that although multiple commenters requested clarification that QIP placed in service after 2017 is qualified property eligible for the additional first year depreciation deduction, the plain language of the statute is clear, and the Treasury cannot mend a legislative drafting glitch through regulations. Rather, Congress must enact a legislative change. Until that happens, the inability to depreciate tenant improvements will continue to be a hurdle for landlords seeking to improve their properties.

Final Regulations

Under Section 168(k), a taxpayer may deduct the bonus depreciation amount in the year in which the taxpayer places the qualified property in service for use in its trade or business or for the production of income. The final regulations issued on September 13, 2019 finalized the proposed regulations issued in August 2018, which provided guidance on the four requirements for property to be "qualified property" and thus be eligible for bonus depreciation: (1) the property must be a specific type of property; (2) the original use of the property must begin with the taxpayer or, if it is used property, it must meet certain acquisition requirements; (3) the taxpayer must place the property in service after September 27, 2017 and before January 1, 2027; and (4) the taxpayer must acquire the property after September 27, 2017. The final regulations also provided guidance on elections under Section 168(k) under which a taxpayer may elect out of bonus depreciation or elect to claim 50% bonus depreciation in lieu of 100% bonus depreciation.

Under the TCJA's bonus depreciation rules, qualified property must be one of the following types of property: (a) MACRS property with a recovery period of 20 years or less, (b) depreciable computer software, (c) water utility property, or (d) a qualified film production, qualified television production, or qualified live theatrical production for which a deduction otherwise would have been allowable under Code Section 181 and which was initially released, broadcast, or staged live, respectively, after September 27, 2017.

Although the final regulations provide guidance on these types of property, the Treasury declined to carve out via regulation a revision to Congress's drafting glitch that neglected to classify QIP as having a recovery period of 20 years or less. Instead, the Treasury stated that such a change must come through legislative action.

Proposed Regulations

The newest tranche of proposed regulations expanded on the guidance provided in the final regulations and withdrew the prior proposed regulations that were not adopted in the final regulations. The proposed regulations provide rules relevant to leased and used property, bring clarity to the definition of "binding contract" for purposes of entity acquisitions, add special rules for consolidated groups, and provide rules regarding components of larger self-constructed property for which manufacture began before September 28, 2017, when those components were acquired or self-constructed after September 27, 2017.

Leasing Property to a Trade or Business and Property Described in Code Section 168(k)(9). Among other explanations, the proposed regulations clarify when a taxpayer that leases property to a trade or business described in Code Section 168(k)(9) may claim additional first year depreciation for the property, how to determine whether property is primarily used in a trade or business for purposes of Code Section 168(k)(9)(A), and when floor plan financing is "taken into account" for purposes of Code Section 168(k)(9)(B).

Depreciable Interest in Used Property. The proposed regulations also provide that, with respect to used property, if a taxpayer (a) acquires property and places it in service, (b) did not previously have a depreciable interest in the property, (c) disposes of the property to an unrelated party within 90 calendar days after the date the taxpayer originally placed the property in service, and (d) reacquires the property and again places it in service, the taxpayer's depreciable interest in the property during that 90-day period is not taken into account for determining whether the property was used by the taxpayer at any time prior to its reacquisition by the taxpayer.

Depreciable Interest in Partnership Property. In addition, the Treasury clarifies in the proposed regulations the extent to which a person is treated as having a depreciable interest in property by virtue of being a partner in a partnership that holds that property.

Acquiring Property Under a Binding Contract. In general, depreciable property meets the acquisition date requirement of Code Section 168(k) if the property is acquired by the taxpayer after September 27, 2017, or is acquired by the taxpayer pursuant to a written binding contract entered into by the taxpayer after September 27, 2017. The proposed regulations clarify the definition of "binding contract" for purposes of the acquisition of an entity or substantially all of the assets of a trade or business, including that the contract must be enforceable under state law against the parties to that contract. The proposed regulations further provide that the acquisition date of property acquired under a contract that is not a written binding contract is the date on which the taxpayer paid or incurred more than 10% of the total cost of the property.

Special Rules for Consolidated Groups. The 2018 proposed regulations introduced the "Group Prior Use Rule," under which a member of a consolidated group that acquires depreciable property is treated as having a prior depreciable interest in that property if the consolidated group had a depreciable interest at any time prior to the member's acquisition of the property. The newly issued proposed regulations explain that the Group Prior Use Rule applies only as long as a corporation remains a member of a consolidated group; when a member leaves the consolidated group, it does not continue to have a depreciable interest in the property unless it actually owned that property.

Components of Larger Self-Constructed Property. The proposed regulations further explain that a taxpayer may elect to take the additional first-year depreciation deduction on one or more components of certain larger self-constructed property acquired or self-constructed after September 27, 2017, when the larger self-constructed property is qualified property for which manufacture, construction, or production began before September 28, 2017, provided that the components are not otherwise ineligible for first year depreciation deduction.

This second round of guidance is helpful in clarifying the 100% bonus depreciation rules. Pending the Treasury issuing final regulations, taxpayers may rely on the proposed regulations for taxable years ending on or after September 28, 2017. Meanwhile, the tax community and those impacted by the drafting glitch can hope that Treasury's express refusal to amend it will encourage Congress to pass a technical corrections bill to eliminate it.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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