Bonus Depreciation M&A Rules Trigger Noteworthy Results

by Emily L. Foster

The IRS's revamped approach for applying the additional first-year depreciation deduction rules to mergers and acquisitions creates some interesting anomalies.

In the second round of final bonus depreciation regulations (T.D. 9916) released in September 2020, Treasury and the IRS simplified the method for applying the bonus depreciation rules to transactions involving consolidated group members. Recasting those transactions makes taxpayers eligible for bonus depreciation but could also trigger unexpected results for the unwary.

In the final regs, the government responded to comments on the 2019 proposed rules (REG-106808-19) regarding transactions in which one consolidated group member transfers depreciable property to another member and the parent corporation, in a series of related transactions, sells the acquiring member's stock to the parent company of an unrelated consolidated group.

Under section 168(k), as expanded by the Tax Cuts and Jobs Act, acquired used property is eligible for the additional first-year bonus depreciation if, among other things, the property wasn't acquired from a related party or from one component member of a controlled group from another component member of the same group.

Practitioners commended the IRS for recognizing that if an intercompany transaction between consolidated group members is followed by the buying member leaving the group in a series of related transactions, that corporation should be eligible for the section 168(k) depreciation benefit. That is, it shouldn't be treated differently than if the buying member left the group and then purchased the depreciable assets.

The final regs eliminated the much-criticized 90-day rule under which the intercompany transaction would have been disregarded — treated as a transfer of depreciable property to an unrelated party — only if the acquiring member ceases to be a member of the group in a series of related transactions within 90 days of acquiring the property.

The government instead adopted a "delayed bonus approach" for actual and deemed acquisitions of eligible property between group members that satisfy specific requirements.

The asset acquisition and the deconsolidation must still be part of an integrated plan, but there's no longer a time requirement during which the latter transaction must occur, which means it could be a year or longer.

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The government's solution in the final regs is also intended to address many questions that it received regarding the interim period — the time between the asset acquisition and the acquiring member departing the group.

Under the final regs, unlike the proposed rules, the asset acquisition by the transferee member is treated as occurring on the actual acquisition date. The transferee member, or the target in a deemed asset acquisition, is treated for all federal income tax purposes as selling the eligible property to an unrelated third party one day after the deconsolidation date for an amount equal to the member's or target's adjusted basis in the eligible property, and immediately after acquiring identical but separate and distinct property for the same amount.

That tax fiction affords taxpayers the section 168(k) bonus depreciation benefits that they otherwise wouldn't have been able to claim under the statute, Kevin M. Jacobs of Alvarez & Marsal Taxand LLC told *Tax Notes*.

The seemingly taxpayer-favorable deemed sale and purchase approach, however, produces some anomalous results — such as for holding periods, depreciation recapture, and the section 382 rules — in part because the fiction is deemed to occur for the depreciable property for all federal income tax purposes, not just for section 168(k), according to Jacobs.

Following the Fiction

The consolidated group depreciation rules avoid the need for valuations and result in no gain or loss recognized by the buying entity, but the holding period resets by virtue of the buying member being treated immediately after it leaves the group as selling the asset and buying an identical but distinct asset, Jacobs said.

If there's a meaningful passage of time before the member acquiring the depreciable property leaves the group, asset values or holding periods determined under the tax fiction could become relevant under other code sections, Jacobs said.

Eric Solomon of Steptoe & Johnson LLP said that in recast situations like the section 168(k) rules, the challenge is coordinating the fiction with the facts — which can create inconsistencies — and the question is how far the fiction should be carried.

Based on the facts — that is, the buying member acquires the asset and leaves the group when the parent corporation sells its stock — the holding period doesn't reset under normal rules, Solomon said. But applying the theory of the recast, which is as if the acquiring member purchases the assets after it leaves the group, the holding period starts anew and that makes sense, he said.

Under the mechanics of the consolidated asset acquisition rule (reg. section 1.1502-68(c)(1)(i)), the acquiring member is eligible to write off the asset after leaving the selling group for an amount equal to the deemed sale amount.

That means the amount that can be expensed is the adjusted basis in the asset rather than the fair market value, which is an "anomalous but understandable" result, Solomon said. He noted that the fiction of the member acquiring the asset after leaving the group isn't carried through to its ultimate conclusion.

Loss Limitations

Jacobs pointed out that the construct of the rules can also affect a taxpayer's allowable losses following an ownership change that's subject to the section 382 rule.

Section 382 limits some pre-ownership-change losses that can offset future taxable income for five years after the ownership change. For loss corporations with a net unrealized built-in gain (NUBIG), the section 382 limit is increased by the amount of its recognized built-in gain (RBIG). For corporations with a net unrealized built-in loss (NUBIL), recognized built-in losses (RBILs) are subject to the section 382 limitation as if they had been incurred before the ownership change.

If there's an ownership change when the parent corporation sells the stock of the member that acquired the depreciable property and the property had appreciated in value, the resulting built-in gain would normally be factored into the NUBIG-NUBIL calculation, Jacobs said.

Under the delayed bonus approach, however, because the acquiring member is treated as having sold the asset for an amount equal to its adjusted basis, there's no gain, Jacobs explained.

The built-in gain immediately reappears when the member is deemed to have purchased an identical but distinct asset for the amount of the adjusted basis. But because that asset was acquired after the ownership change, it's not eligible for what otherwise would be a favorable RBIG under section 382 when the asset is sold during the recognition period, Jacobs said.

It's unclear how often that situation might occur, but it's possible, Jacobs said. He also noted that if the property's value instead declines, taxpayers would avoid the detriments of RBIL because under the section 168(k) fiction, the property is sold at neither a gain nor a loss.

All-or-Nothing Approach Challenged

The implications for the holding period and section 382 limitations, as well as depreciation recapture under sections 1245 and 1250, are natural results of the section 168(k) regs because of the IRS's stance that the fiction applies for all federal income purposes, Jacobs said. But he questioned the government's rationale for that position.

"Treating the deemed sale and purchase of eligible property as applicable solely for purposes of sections 168 and 179 . . . could lead to complications and inconsistencies," the regs' preamble says.

According to Treasury and the IRS, "taxpayers would be required to treat each piece of eligible property as two separate assets: (1) an asset that exists for purposes of sections 168 and 179; and (2) an asset that exists for all other Federal income tax purposes."

But Jacobs argued that taxpayers often must maintain separate books and records for assets because of different treatment under various code sections, such as for purposes of determining depreciation for corporations subject to the alternative minimum tax.

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Interim Period Unsettled

According to the regs' preamble, the transferee member must recognize depreciation on all depreciable transferred assets, and the transferor member must recognize gain or loss during the interim period in accordance with section 168(i)(7) and reg. section 1.1502-13(c)(2).

Section 168(i)(7)(B) provides that for specified transactions, including consolidated group intercompany transfers, the transferee steps into the shoes of the transferor for the purposes of computing depreciation on the carryover basis.

In a simple transaction in which S and B are members of a consolidated group and S sells specified assets to B, and then B leaves the group, section 168(i)(7) requires B to bifurcate the basis in the property to recover it under applicable section 168 rules, Andrew J. Dubroff of EY explained.

If S has a basis of $25 and sells the asset to B for $100, B steps into S's shoes to the extent that the $100 corresponds to the basis that S had before the sale. B depreciates $25 over the remaining life of the asset and recovers the remaining $75 under normal section 168 rules applicable for that property, Dubroff said.

Questions remain, however, on how to compute depreciation during the interim period for a series of transactions involving a qualified stock purchase that's treated as an asset acquisition under section 338(h)(10), according to Dubroff. It's unclear whether section 168(i)(7) applies in those situations, he said.

Example 6 of reg. section 1.1502-68(d) illustrates that situation: A parent corporation, S, B, and T (the target) are members of a consolidated group. S owns all of the stock of T, and T owns a depreciable interest in property. B acquires all of the stock of T from S on January 1, 2019, and S and B make a section 338(h)(10) election for B's qualified stock purchase. As part of the same series of related transactions, the parent corporation sells all of the stock of B to the parent corporation of an unrelated consolidated group on June 1, 2019.

The regs explain that under section 338(h)(10), the target is treated as two separate corporations. As a result of the election, Old T is treated as transferring all of its assets to an unrelated person at the close of the acquisition date (January 1, 2019), and New T is deemed to acquire those assets from an unrelated person, after which Old T is deemed to liquidate.

Under the section 168(k) consolidated deemed acquisition rule (reg. section 1.1502-68(c)(2)(i)), New T is treated as transferring depreciable property to an unrelated person on June 2, 2019, for an amount equal to the target's adjusted basis and immediately after acquiring deemed replacement property for the same amount.

In that example and others, Treasury and the IRS "very carefully do not tell you anything about how to compute the depreciation in the interim," while B remains in the original group, Dubroff said. "Yet, this was a hot issue, and it could make an economic difference . . . because the depreciation period in the group could be quite long."

The unanswered question is whether the deemed sale of assets of Old T to New T is an intercompany transaction, and therefore subject to section 168(i)(7), requiring the new target entity to bifurcate the asset's adjusted basis for purposes of computing depreciation, Dubroff said.

Some clues exist under section 338(h)(10) guidance that Old T and New T are unrelated, and other hints suggest that it's an intercompany transaction subject to the carryover basis rule, Dubroff said.

Solomon noted that the issue of how to depreciate assets during an interim period is irrespective of section 168(k).

The bonus depreciation reg package is narrowly tailored to address the implications of the TCJA, Jacobs observed, adding that it's understandable that the broader issue of the interplay between sections 338 and 168(i) — unaffected by the law — wasn't addressed.

The transferee member or the target entity may elect not to apply the consolidated asset acquisition or deemed acquisition rules for qualifying transactions. The regs outline the procedures for making the election, which may be revoked by filing a private letter ruling request and obtaining IRS consent. ■