

# Alerts & Publications

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## Treasury Releases Guidance on the Application of New Bonus Depreciation Rules to Partnership Basis Adjustments

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On August 3, 2018, the Treasury released proposed regulations (the “Proposed Regulations”) providing long-awaited clarification on the availability of 100% first-year expensing (“100% Bonus Depreciation”) to partnership basis adjustments triggered by certain partnership transactions. In particular, the Proposed Regulations provide as follows:

- Taxpayers generally may claim 100% Bonus Depreciation on partnership asset basis step-ups triggered by the acquisition of a partnership interest (“743 Basis Step-Ups”).
- Partnership asset basis step-ups triggered by a distribution to a partner in excess of the partner’s outside basis in its partnership interests (“734 Basis Step-Ups”) do not qualify for 100% Bonus Depreciation.
- Remedial allocations (i.e., allocations in respect of deemed basis attributable to the contribution of property at a higher fair market value than the transferor’s tax basis) (“Remedial Allocations”) are not eligible to be depreciated under the 100% Bonus Depreciation rules.

### I. Background

Among the many tax law changes introduced by the Tax Cuts and Jobs Act in December 2017 was the introduction of 100% Bonus Depreciation for certain qualifying property acquired and placed in service after September 27, 2017.<sup>1</sup> The provision allows the taxpayer to claim depreciation

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deductions equal to its entire basis in qualifying property in the year the property is placed in service, rather than over the prescribed class life of the property.

Various forms of accelerated bonus depreciation have existed for years, but typically property was only eligible for bonus depreciation if the property was “originally placed in service” by the taxpayer (i.e., the property had never been used by any person/taxpayer before its acquisition). A key component of the 100% Bonus Depreciation regime is that the property need not be originally placed in service by the taxpayer—taxpayers may claim 100% Bonus Depreciation on property previously used by other taxpayers, provided the property otherwise meets the bonus depreciation requirements. Property previously used by the taxpayer (or a predecessor) or acquired from a related taxpayer<sup>2</sup> is not eligible for 100% Bonus Depreciation.

The Proposed Regulations provide much anticipated guidance on the application of these rules to certain partnership basis adjustments.

## II. 743 Basis Step-Ups

The Proposed Regulations clarify that 743 Basis Step-Ups generally are eligible for 100% Bonus Depreciation. Code section 743 provides that if a taxpayer acquires an interest in a partnership with a proper Code section 754 election in place, the acquiring partner is entitled to a step-up in the inside basis of the partnership assets, generally based on the difference between the amount paid for the partnership interest and the partnership’s inside basis in the property to which such acquired interest relates. The 743 Basis Step-Up is solely for the account of the acquiring partner (i.e., the corresponding depreciation is solely for the account of the acquiring partner), with the result that such increased basis is treated as property newly placed in service by the acquiring partner—prior use by the partnership is not relevant to qualification for the new 100% Bonus Depreciation rule.

As described in the preamble to the Proposed Regulations, 743 Basis Step-Ups were ineligible for bonus depreciation under prior law because the property to which the basis step-up relates is not “original use” property. Thus, under prior law, the relevant property was treated as previously used by the partnership prior to the acquisition of the interest by the acquiring partner, and the original-use requirement of prior law was not satisfied.

The new 100% Bonus Depreciation rules have dropped the original-use requirement, and thus the Proposed Regulations allow 100% Bonus Depreciation on this basis step-up. For these purposes, the Proposed Regulations adopt an approach analyzing whether the acquiring partner has used the property, rather than whether the partnership has previously used the property. This approach is premised on the fact that the 743 Basis Step-Up is solely for the account of the acquiring partner and the related depreciation does not affect the existing partners.

Importantly, even if the acquiring partner is an existing partner in the partnership, such acquiring partner is generally able to utilize 100% Bonus Depreciation on its 743 Basis Step-Up on the basis that the acquiring partner had not previously used the portion of partnership assets being acquired through acquisition of the partnership interest. Moreover, the acquiring partner may claim 100% Bonus Depreciation on the 743 Basis Step-Up even if the underlying partnership has elected out of bonus depreciation and, alternatively, the acquiring partner may elect out of 100% Bonus Depreciation on the 743 Basis Step-Up even if the underlying partnership has not elected out of 100% Bonus Depreciation.

We note, however, that the Proposed Regulations specify that the acquiring partner will not be eligible to claim 100% Bonus Depreciation with respect to a 743 Basis Step-Up if (i) the acquiring partner is related to the transferor<sup>3</sup> or (ii) the acquiring partner has previously used the portion of the partnership property deemed attributable to the acquired interest (e.g., the acquiring partner previously owned the relevant partnership interest or the property outright). In this respect, the Proposed Regulations treat only the acquiring partner as having used the portion of partnership property to which its existing partnership interest relates.

### III. 734 Basis Step-Ups

Code section 734 allows a basis step-up in partnership assets in respect of gain recognized by a partner due to distributions in excess of such partner's outside basis. The Proposed Regulations do not permit 100% Bonus Depreciation to be claimed on these basis adjustments.

The preamble to the Proposed Regulations distinguishes this from a 743 Basis Step-Up on the reasoning that a 734 Basis Step-Up is applicable to all of the partners, whereas a 743 Basis Step-Up is only for the account of the acquiring partner. Thus, there is not the same basis for treating a 734 Basis Step-Up as relating to property that has not been used by the taxpayer claiming 100% Bonus Depreciation. That is, the partnership itself is properly treated as the entity claiming 100% Bonus Depreciation and is treated as having used the property to which the 734 Basis Step-Up relates immediately prior to the distribution triggering the basis adjustment.

### IV. Remedial Allocations

In the event that a partner contributes property to a partnership where the fair market value of the contributed property exceeds the partner's basis in the property, Code section 704(c) provides mechanisms for special allocations of "deemed" depreciation to the non-contributing partners on the rationale that the non-contributing partners should be entitled to depreciable basis commensurate with their share of the fair market value of the contributed property (i.e., Remedial Allocations). At a very high level, these rules insure that the partner receiving remedial allocations receives the economic benefits such partner would have been entitled to had such partner actually been treated as having acquired its share of the partnership property for its fair market value—that is, not based on the

carryover basis of the party that contributed the assets.

The existing regulations provide that the partnership generally may use any depreciation methodology available to the partnership for newly placed-in-service property of the same type. Unfortunately, however, under the Proposed Regulations, 100% Bonus Depreciation is not available to remedial allocations relating to this “fair market value”/“carryover basis” disparity. In the case of Code section 704(c) contributions, the partnership’s basis in the property is determined by reference to the contributing partner’s basis and thus, as noted in the preamble to the Proposed Regulations, this result prohibits the application of 100% Bonus Depreciation in respect of such disparity.

Similarly, the Code allows partnerships, upon the occurrence of certain triggering events, to (i) revalue partnership property, (ii) increase the basis in such property for book purposes and (iii) depreciate this “book-up” accordingly for book purposes.<sup>4</sup> The general rule is that the partnership may use any depreciation methodology for such “book-ups” as would otherwise be available for newly placed-in-service property of the same type. Again, unfortunately, as is the case with Remedial Allocations, the Proposed Regulations specify that 100% Bonus Depreciation is not available in these circumstances. This result is consistent with the rationale applied in the 734 Basis Step-Up context because the “book-up” applies to the partnership as a whole, and the partnership has previously used the underlying property subject to the revaluation.

Although the above-described rules are as yet only contained in proposed regulations, the Proposed Regulations allow taxpayers to rely on these rules until the issuance of any final regulations.

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<sup>1</sup> The amount of accelerated depreciation available with respect to qualifying property begins to phase out for property acquired in 2023 and subsequent years.

<sup>2</sup> The determination of whether taxpayers are related is determined by reference to Code sections 267 and 707(b) (generally, in the case of corporations and partnerships, entities will be deemed related if they share more than 50% common ownership).

<sup>3</sup> This determination is based on the same related-party rules described in footnote 2, above.

<sup>4</sup> The triggering events permitting such revaluations generally consist of the following: (i) the issuance of a new partnership interest to a new or existing partner in connection with a contribution of money or other property; (ii) the liquidation of the partnership of money or other property to a retiring or continuing partner as consideration for an interest in the partnership; (iii) the grant of an interest in the partnership as consideration for the provision of services by an existing partner acting in its capacity as a partner or by a

new partner acting in a partner capacity in anticipation of being a partner; (iv) the issuance by the partnership of a non-compensatory option; or (v) under generally accepted accounting practices, provided substantially all of the partnership's assets consist of certain publicly traded securities.

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