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Proposed Regulations on Immediate Expensing Provide Greater Clarity for the Energy Industry

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On August 3, 2018, the IRS and Treasury Department released proposed regulations (the Proposed Regulations) that interpret and clarify the new bonus depreciation regime under the Tax Cuts and Jobs Act (TCJA). As discussed ***here*** in greater detail, the TCJA provides businesses the opportunity to take a special depreciation deduction (Bonus Depreciation) equal to 100% of the cost of any qualified property. Qualified property generally includes depreciable property subject to the modified accelerated cost recovery system (MACRS) with a recovery period of 20 years or less that is placed in service after September 27, 2017, in the case of new property, or acquired in an arm's length transaction after September 27, 2017, in the case of used property. The available deduction is phased out, in 20% increments, from 2023 to 2026.

The Proposed Regulations generally have been well-received by taxpayers. Aside from being favorable to taxpayers in several respects, the Proposed Regulations provide clarity to certain aspects of the Bonus Depreciation regime, and such clarity should permit taxpayers, including those in the energy industry, to plan projects and structure transactions with greater certainty.

First, the Proposed Regulations provide rules regarding when new property is treated as placed in service and when used property is treated as acquired. The TCJA did not provide clear guidance on these topics and, as a result, many sponsors and investors in the energy industry questioned whether they could claim Bonus Depreciation for projects that were underway when the TCJA was enacted. In the case of self-constructed property, the Proposed Regulations provide that property is eligible for Bonus Depreciation if the taxpayer began construction activities after September 27, 2017, but the property will not be eligible if such activities began before such date. Construction activities are deemed to begin when the taxpayer commences physical work of a significant nature with respect to the property, which requires a facts-and-circumstances analysis. Taxpayers, however, can take comfort that certain preliminary planning activities, such as designing, researching and securing financing, and certain preliminary physical work, such as clearing the site and test drilling, will not be viewed as construction activities under the Proposed Regulations. As a result, even if a taxpayer conducted these activities with respect to a property on or before September 27, 2017, the property still should be eligible for Bonus Depreciation when completed. Taxpayers seeking greater certainty can rely on a safe harbor providing that physical work of a significant nature does not begin until the taxpayer incurs more than 10% of the total cost of the property, not including the cost of land and the cost of any preliminary activities described above.

In the case of property acquired by the taxpayer from an unrelated party, property acquired after September 27, 2017 generally will be eligible for Bonus Depreciation, but only if the taxpayer did not enter into a binding written contract to acquire the property on or before this date. This limitation applies both to property that the taxpayer engages a third party to construct on its behalf and used property that the taxpayer acquires from a third party. For purposes of this rule, a contract is binding if it is enforceable under State law against the taxpayer, or its predecessor, and does not limit damages for failure to perform to a specified amount (for example, by means of a liquidated damages provision).

The Proposed Regulations provide additional guidance regarding when Bonus Depreciation is available for used property. Many taxpayers in the energy industry have been eager to avail themselves of Bonus Depreciation in this context, which provides a new opportunity for tax savings in the year of an asset acquisition. For this purpose, eligible acquisitions of used property include direct asset acquisitions and other transactions that are treated as asset acquisitions for tax purposes (including, for example, the acquisition of all of the outstanding equity of a partnership or disregarded entity). Some taxpayers have been deterred from taking Bonus Depreciation due to a vague prohibition in the TCJA against the deduction for property "used by the taxpayer at any time prior to such acquisition." The Proposed Regulations clarify that property is deemed to have been used by a taxpayer if the taxpayer previously owned a depreciable interest in the property. For example, a taxpayer that owns an item of depreciable equipment, sells it, and later reacquires it for cash would not be eligible for Bonus Depreciation on the reacquired equipment. By contrast, a taxpayer that leases an item of depreciable equipment, but takes no depreciation deductions, and later acquires it for cash would be eligible for Bonus Depreciation upon the acquisition.

In addition, the Proposed Regulations provide clear guidance and examples concerning partial acquisitions of depreciable property. Under these rules, if a taxpayer owns a partial interest in depreciable property, either directly or indirectly through a partnership, and then acquires an additional interest in the same property for cash, the additional interest would be eligible for Bonus Depreciation even though the taxpayer owned, and continues to own, the first partial interest. If, however, the taxpayer owns a partial interest in a property, sells it, and later acquires a new partial interest in the same property for cash, the taxpayer would be treated as previously owning a partial depreciable interest in the property up to the amount of the initial interest, and therefore would not be eligible to take Bonus Depreciation on such portion of the interest.

Many taxpayers were anticipating that the Proposed Regulations would apply an outer limit to the number of years a taxpayer must look back to determine whether the taxpayer, or its predecessor, would be treated as owning a depreciable interest in property. Without such a limit, a taxpayer could be required to engage in burdensome due diligence to determine whether Bonus Depreciation is available, or accept the risk that it previously owned a depreciable interest in such property. The Proposed Regulations, however, request comments on whether a limited look-back period should be included in the final regulations and, if so, how long the period should be, which has given taxpayers reason to be optimistic that the IRS and Treasury Department will consider adding this feature to the final regulations.

Finally, the Proposed Regulations provide guidance on the availability of Bonus Depreciation in connection with various partnership transactions. As expected, the Proposed Regulations confirm that a step-up in the basis of partnership property in connection with a taxpayer's

acquisition of a partnership interest, when an election under section 754 of the Code is in effect, is eligible for Bonus Depreciation, provided that the acquirer did not previously own a depreciable interest in the partnership property. This guidance confirms most practitioners' view that Bonus Depreciation should be available regardless of whether used property is acquired directly, by means of a taxpayer's acquisition of an undivided interest in the property, or indirectly, by means of a taxpayer's acquisition of an interest in a partnership owning the property.

Bonus Depreciation, however, is not available when a partnership distributes cash or property to its partners and, as a result, there is an increase in the basis of the partnership's remaining property. The preamble to the Proposed Regulations explains that the partnership would be treated as previously owning a depreciable interest in the property, and such property neither would be original use property nor newly-acquired property for purposes of the TCJA and the Proposed Regulations. Some taxpayers also were optimistic that remedial allocations of depreciation and amortization would be eligible for Bonus Depreciation. The preamble to the Proposed Regulations, however, provides that remedial allocations are not eligible for Bonus Depreciation because the underlying partnership property would have been received by the partnership in a nontaxable transaction described in section 721 of the Code, and therefore the partnership would have a carryover basis in such property that is not eligible for Bonus Depreciation, and also because the partnership would be treated as previously owning a depreciable interest in such property.

Per the preamble to the Proposed Regulations, the Proposed Regulations may be relied upon by taxpayers until the IRS and Treasury Department issue final regulations concerning Bonus Depreciation. Comments to the Proposed Regulations or requests for a public hearing must be submitted by October 9, 2018.