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Private Equity Benefits From Bonus Depreciation on Partnership Purchases

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Following the passage of the Tax Cuts and Jobs Act in 2017, an unlimited amount of business property could be depreciated immediately. This creates significant incentive for private equity funds to structure acquisitions to allow for readjusting asset basis to reflect purchase price, known as a step-up in basis.

In the case of an acquisition of a partnership interest, a purchaser may benefit from a step-up in basis of the assets of the partnership if the partnership makes what is known as a “754 Election.” Final Treasury Regulations confirm that immediate depreciation is applicable to partnership basis adjustments after September 28, 2017.

Below is an example of how a private equity firm can structure acquisitions to benefit from the new rules.

Explanation of the Partnership Basis Step-Up

Assume that in 2013, two founding individuals, A and B, each contributed $100,000 to AB Partnership in return for a 50 percent interest. AB Partnership used the $200,000 of cash contributions to acquire depreciable equipment, such as office computers. In 2018, private equity fund C acquired B’s interest in AB Partnership for $200,000. Assume that the equipment is worth $50,000, but AB Partnership’s basis in it is zero — the result of depreciation deductions.

Absent a 754 Election, B would recognize a $100,000 gain. C would take a $200,000 basis in its interest in AB Partnership, but AB Partnership’s basis in its assets would remain zero.

On the other hand, if AB Partnership made a 754 Election — either before or in connection with C’s acquiring its interest, C’s share of AB Partnership’s asset bases would be increased (or stepped-up) to C’s $200,000 purchase price. A and B would not be treated any differently as a result of the 754 Election. The $200,000 basis adjustment would be allocated among AB Partnership’s assets based on the amount of income or gain that would be allocated to the transferee (here, C) from a hypothetical sale of the assets.

As the equipment had a $50,000 value, $25,000 (C’s 50 percent share of the value of the equipment) of the basis step-up would be allocated to the equipment, and $175,000 of the basis step-up presumably would be allocated to other asset categories — goodwill or going concern value. Regulations applicable to intangible amortization clarify that the $175,000 basis adjustment allocable to goodwill and going concern value could be amortized over 15 years.

Bonus Depreciation After Tax Reform

Under the tax reform provisions enacted in 2017, a taxpayer generally may immediately depreciate 100 percent of the cost of tangible personal property having a useful life of 20 years or less. In the tax law, property eligible for immediate depreciation was expanded to cover used property. The new bonus depreciation rules apply for property acquired and placed in service after September 28, 2017 and before January 1, 2023, with a phase-down of the percentage of the bonus depreciation for property placed in service after December 31, 2022 and before January 1, 2027.

Anti-Churning Rules

Used property is eligible for the 100 percent depreciation only if the taxpayer acquired the property in a taxable transaction from an unrelated party and did not use the property before acquiring it. The basis adjustments permitted because of a 754 Election result solely because of an election permitted by Section 754, and not as a result of an actual sale of partnership property. The party using the property (the partnership) does not change. This raises the question of whether the property should be considered to have been used by the taxpayer before it acquired the property, and thus be ineligible for immediate depreciation.

The final regulations (effective retroactively to property placed in service after September 27, 2017) provide that, with respect to 754 Elections, the anti-churning rules are determined at the partner level, with each partner being treated as having owned and used a proportionate share of the partnership assets. As long as the taxpayer acquires the partnership interest in a taxable transaction from an unrelated party, and the taxpayer did not use the property (e.g., it did not lease the property from the partnership), immediate depreciation is allowed.