Pennsylvania
CPA JOURNAL
Summer 2018 | Volume 89, Number 2

Business Transformations

New Depreciation Rules Affect Mergers and Acquisitions

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The Tax Cuts and Jobs Act modifies rules related to depreciating tangible property, net operating losses (NOLs), interest expense limitations, and the taxation of foreign income. One area that remains mostly untouched are the rules related to taxable and nontaxable reorganizations, spin-offs, incorporations, and liquidations. Having said that, future mergers and acquisitions (M&A) will be affected in one way or another as buyers and sellers adjust to the new tax regime. This article touches on one aspect of tax reform that will transform M&A: the modification of depreciation rules.

To understand how new rules for depreciating certain tangible property will impact M&A, we need to look at the old rules. Previous depreciation rules provided taxpayers with an additional first-year depreciation deduction equal to 50 percent of the cost of certain qualifying property in the year in which it was placed into service. This immediate deduction was commonly known as "bonus depreciation," and it was set to be phased out gradually starting after Dec. 31, 2017. Generally, qualifying property was deemed to be modified-accelerated-cost-recovery-system property with a recovery period of 20 years or less, including computer software. Qualifying property also needed to be what is called "original use property," which means its first use must begin with the taxpayer. Newly acquired but previously used property did not qualify.

The new rules for expensing certain tangible property increased the additional first-year depreciation deduction from 50 percent to 100 percent for qualifying property acquired and placed into service after Sept. 27, 2017, and before Jan. 1, 2023, at which point the deduction will begin to eventually phase out. The increase from 50 percent to 100 percent is a nice benefit, but this alone would not have an impact in M&A since most acquisitions include previously used property. This is where the removal of the "original use" requirement comes into play. The Tax Cuts and Jobs Act provides for immediate expensing with the acquisition of all qualifying property of both new and previously used assets (with some exceptions).

With the allowance of 100 percent tax write-off of used qualifying property, coupled with the reduction of the corporate rate (from 35 percent to 21 percent) imposed on corporate sellers, there could soon be a shift toward more asset acquisition as well as stock acquisitions subject to a Section 338(h)(10) election – the election to treat a stock acquisition as an asset acquisition for tax purposes. Asset acquisition or stock acquisition with a 338(h)(10) election would give taxpayers a stepped-up basis to fair market value of a newly acquired assets coupled with an immediate expense for qualifying assets.

While it would be no surprise if we see more asset acquisitions with taxpayers looking to take advantage of the immediate expensing of the stepped-up basis in newly acquired assets, it will not materially benefit everyone. The new depreciation rules only apply to tangible property and do not apply to intangible assets, which continue to be amortized on a straight-line basis over 15 years. Therefore, a target company would have to be heavily capital-intensive (e.g., manufacturing industry) for the new rules to play any type of significant role when determining how to structure a deal. There will be an increased focus on purchase price allocations as there is an increased incentive for a buyer to allocate as much of the purchase price as possible to qualifying tangible property, while the seller will continue to look to maximize the allocation of the purchase price to capital gain assets versus ordinary gain assets. It will ultimately come down to an appraisal or valuation to determine allocations, but there will be more pressure to deviate, even if just by a nominal amount, from the perspectives of the buyer versus the seller.

Additionally, we could see more 338(g) elections for transactions involving U.S. shareholders and foreign entities. This is due to an international provision under the new law that taxes the global intangible low-taxed income (GILTI) of a U.S. shareholder's foreign subsidiaries. While the details of GILTI are outside the scope of this article, it is essentially an inclusion into U.S. taxable income of an amount of a controlled foreign corporation's (CFC) income, similar to existing Subpart F income treatment. Even though foreign assets do not qualify for bonus depreciation, U.S. buyers of foreign CFCs may look to make a 338(g) election to step up the basis of its tangible property, essentially increasing the net deemed tangible income return and reducing potential GILTI income.

Pennsylvania has disallowed bonus depreciation (see Pennsylvania Corporate Tax Bulletin 2017-02). As this issue went to press, there are two bills (House Bill 2017 and Senate Bill 1056) before the General Assembly that would reverse the Department of Revenue ruling.

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