



2023 Year-End Tax Planner



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What's on Our Minds as 2023 Ends...



Understanding Nexus: Navigating State Income and Sales Tax Obligations for Businesses

Sonjia Barker, CPA, State & Local Tax Director

When planning for year-end, include an annual review of state income tax nexus and sales tax nexus. Nexus is a legal term that defines the level of connection between a business and a tax jurisdiction that triggers a filing obligation with that jurisdiction. Nexus is established in various ways: physical presence, economic presence, affiliates, agency, click-through, and more. While these may seem straightforward, there are many nuances to each type of nexus. Each state establishes its nexus standards, resulting in little uniformity across the country. Adding to the complexity, something that may create nexus for income/franchise tax within a state may not apply to sales/use taxes or other tax types.

Regardless of where a business is in its lifecycle, it is never too early nor too often to consider its nexus footprint and how it might impact potential state and local tax exposure.



Year-End Housekeeping for Company-Provided Vehicles

Sean Wallace, CPA, Shareholder

If your business provides an employee, including employee-owners, with a company vehicle available for personal use, then, in most cases, the value of such personal use must be included in the employee's wages. The wage inclusion is subject to federal and state income and employment taxes. Employers must withhold federal employment taxes (and pay their share of employment taxes). Federal income tax withholding on fringe benefit wage additions can be calculated as a combined total with regular wages or generally can be withheld at a flat 22% supplemental wage rate.

Alternatively, for federal income taxes only, employers can choose not to withhold, but only if they notify employees of that election promptly and properly include the value in Boxes 1, 3, 5, and 14 of a timely provided Form W-2.

What does "Personal Use of Company Vehicle" mean?

Examples of using a company vehicle for personal use include:

- Accelerating deductions for expenses such as mortgage interest and charitable donations (including donations of appreciated property) into 2023 (subject to AGI limitations).
- An employee's commute between home and work, if it is on a regular basis.
- Trips unrelated to your organization's purpose, work, trade, etc. Use for a vacation or on the weekend.
- Use by someone other than an employee of your company.

Infrequent personal usage of an employer-provided vehicle is typically deducted from an employee's salary.

How do I calculate the value of "Personal Use"?

There are several methods to determine the value of [company-provided automobiles](#), which are explained in detail by IRS Publication 15-B.

- General Value Rule
- Cents-Per-Miles Rules
- Commuting Rule
- Lease Value Rule

If you provide personal use access to your company vehicles and do not include an amount in your employee's compensation, you may be understating your employee's compensation and employer tax obligations. Because reporting and valuation can be challenging to wade through, get in touch with your Perkins team to assist in ensuring compliance.



Estate and Gift Tax Exemption Sunset Year-End 2025

Don Bielen (Business Transition & Succession), Kripa Raguram & Jordan Patterson (Legacy Planning Teams), & Tiffany Mellow & Paris Powell (Business Valuation)

The 2017 Tax Cuts & Jobs Act (TCJA) increased the basic exclusion amount (BEA) from \$5 to \$10 million (indexed for inflation) for decedents dying, gifts made, and generation-skipping transfers before 2026. It includes a sunset provision reverting the estate and gift tax exemption to its pre-2018 level **after December 31, 2025**, unless Congress acts to extend or modify it. Business owners and individuals with taxable estates above around \$7 million per individual or \$14 million per married couple may face up to a 40% estate or gift tax liability if they do not plan ahead. Engaging in careful planning and early discussions with professionals is imperative to explore opportunities to use the increased BEA amounts under a 'use it or lose it' rule.



Additionally, Oregon State residents may be subject to estate taxes of up to 16% on assets in excess of \$1 million per individual and Washington state residents up to 20% on assets in excess of \$2.193 million (adjusted annually) per individual. The sunset of the lifetime exemption amount could meaningfully impact high-net-worth individuals, business owners, and families who want to preserve and pass on their wealth or company to their beneficiaries. By transferring assets and their appreciation out of their estate before the exemption amount decreases, they can potentially save millions of dollars in estate and gift taxes and maximize the preservation of their assets for their heirs.



Various strategies and techniques exist to take advantage of the exemption amounts and reduce current and future estate taxes. Some of the possible strategies include:

- General Value rule
- In 2024, the use of the increased annual exclusion gift amounts of \$18,000 per person, and/or the lifetime exemption amounts up to \$13.61 million per person or \$27.22 million per couple.
- Form family limited partnerships (FLP) or limited liability companies (LLC) to hold the assets and provide for valuation discounting, centralized management, and asset protection.
- Sale to a defective grantor trust (IDGT) to transfer the asset's appreciation out of the estate while retaining an income stream for a predetermined timeframe.
- Funding a spousal lifetime asset trust (SLAT) to transfer appreciation while retaining the income from the spouse.
- Establishing a grantor-retained annuity trust (GRAT) to transfer assets to an irrevocable trust for the heirs while retaining an annuity payment for a fixed term for the grantor.
- Other simple strategies include making payments directly to medical providers and educational organizations, as these are not treated as transfers of property by gifts.



These are a few strategies to consider before the 2025 sunset. Depending on the size of the estate and family goals, the addition of generation-skipping transfer tax (GSTT) provisions could magnify the effectiveness of these strategies and preserve assets for multiple generations. Each strategy has advantages, disadvantages, risks, and costs, which may not be suitable for every situation. It is advisable to seek professional guidance from experienced estate planning attorneys and CPAs, exit planners, and financial advisors before making any decisions or taking any actions.



It is essential to have assets formally valued by a qualified appraiser to satisfy IRS requirements for gift and estate tax return purposes. A qualified appraisal must be filed with the gift or estate tax return to document the fair market value with adequate disclosure to start the 3-year statute of limitations. The valuation of a business interest may include factors such as a key person, related party transactions, and discounts for lack of marketability, control, or voting rights. A valuation can be an essential part of gift and estate planning and should also be used as part of an exit plan to build and maximize value through a third-party sale.

As life events, tax laws, economic conditions, and asset values change, it is essential to connect regularly with a collaborative legacy planning team (estate planning CPAs and attorneys, exit planners, appraisers, and financial advisors) to monitor and update plans.



2023 Year-End Tax Planning for Individuals

With rising interest rates, inflation and continuing market volatility, tax planning is as essential as ever for taxpayers looking to manage cash flow while paying the least amount of taxes possible over time. As we approach year end, now is the time for individuals, business owners and family offices to review their 2023 and 2024 tax situations and identify opportunities for reducing, deferring or accelerating their tax obligations.

The information contained within this article is based on federal laws and policies in effect as of the publication date. This article discusses tax planning for federal taxes. Applicable state and foreign taxes should also be considered. Taxpayers should consult with a trusted advisor when making tax and financial decisions regarding any of the items below.

Individual Tax Planning Highlights

2023 Federal Income Tax Rate Brackets

Tax Rate	Joint/Surviving Spouse	Single	Head of Household	Married Filing Separately	Estate & Trusts
10%	\$0 – \$22,000	\$0 – \$11,000	\$0 – \$15,700	\$0 – \$11,000	\$0 – \$2,900
12%	\$22,001 – \$89,450	\$11,001 – \$44,725	\$15,701 – \$59,850	\$11,001 – \$44,725	-
22%	\$89,451 – \$190,750	\$44,726 – \$95,375	\$59,851 – \$95,350	\$44,726 – \$95,375	-
24%	\$190,751 – \$364,200	\$95,376 – \$182,100	\$95,351 – \$182,100	\$95,376 – \$182,100	\$2,901 – \$10,550
32%	\$364,201 – \$462,500	\$182,101 – \$231,250	\$182,101 – \$231,250	\$182,101 – \$231,250	-
35%	\$462,501 – \$693,750	\$231,251 – \$578,125	\$231,251 – \$578,100	\$231,251 – \$346,875	\$10,551 – \$14,450
37%	Over \$693,750	Over \$578,125	Over \$578,100	Over \$346,875	Over \$14,450

2024 Federal Income Tax Rate Brackets

Tax Rate	Joint/Surviving Spouse	Single	Head of Household	Married Filing Separately	Estate & Trusts
10%	\$0 – \$23,200	\$0 – \$11,600	\$0 – \$16,550	\$0 – \$11,600	\$0 – \$3,100
12%	\$23,201 – \$94,300	\$11,601 – \$47,150	\$16,551 – \$36,100	\$11,601 – \$47,150	-
22%	\$94,301 – \$201,050	\$47,151 – \$100,525	\$63,101 – \$100,500	\$47,151 – \$100,525	-
24%	\$201,051 – \$383,900	\$100,526 – \$191,950	\$100,501 – \$191,950	\$100,526 – \$191,950	\$3,101 – \$11,150
32%	\$383,901 – \$487,450	\$191,951 – \$243,725	\$191,951 – \$243,700	\$191,951 – \$243,725	-
35%	\$487,451 – \$731,200	\$243,726 – \$609,350	\$243,701 – \$609,350	\$243,726 – \$365,600	\$11,551 – \$15,200
37%	Over \$731,200	Over \$609,350	Over \$609,350	Over \$365,600	Over \$15,200

Timing of Income & Deductions

Taxpayers should consider whether they can minimize their tax bills by shifting income or deductions between 2023 and 2024. Ideally, income should be received in the year with the lower marginal tax rate, and deductible expenses should be paid in the year with the higher marginal tax rate. If the marginal tax rate is the same in both years, deferring income from 2023 to 2024 will produce a one-year tax deferral, and accelerating deductions from 2024 to 2023 will lower the 2023 income tax liability. Actions to consider that may result in a reduction or deferral of taxes include:

- Delaying closing capital gain transactions until after year end or structuring 2023 transactions as installment sales so that gain is deferred past 2023 (also see Long Term Capital Gains, below).
- Considering whether to trigger capital losses before the end of 2023 to offset 2023 capital gains.
- Delaying interest or dividend payments from closely held corporations to individual business-owner taxpayers.
- Deferring commission income by closing sales in early 2024 instead of late 2023.

- Accelerating deductions for expenses such as mortgage interest and charitable donations (including donations of appreciated property) into 2023 (subject to AGI limitations).
- Evaluating whether non-business bad debts are worthless by the end of 2023 and should be recognized as a short-term capital loss.
- Shifting investments to municipal bonds or investments that do not pay dividends to reduce taxable income in future years.

On the other hand, taxpayers that will be in a higher tax bracket in 2024 may want to consider potential ways to move taxable income from 2024 into 2023, such that the taxable income is taxed at a lower tax rate. Current year actions to consider that could reduce 2024 taxes include:

- Accelerating capital gains into 2023 or deferring capital losses until 2024.
- Electing out of the installment sale method for 2023 installment sales.
- Deferring deductions such as large charitable contributions to 2024.



Long-Term Capital Gains

The long-term capital gains rates for 2023 and 2024 are shown below. The tax brackets refer to the taxpayer's taxable income. Capital gains also may be subject to the 3.8% Net Investment Income Tax.

2023 Long-Term Capital Gains Rate Brackets

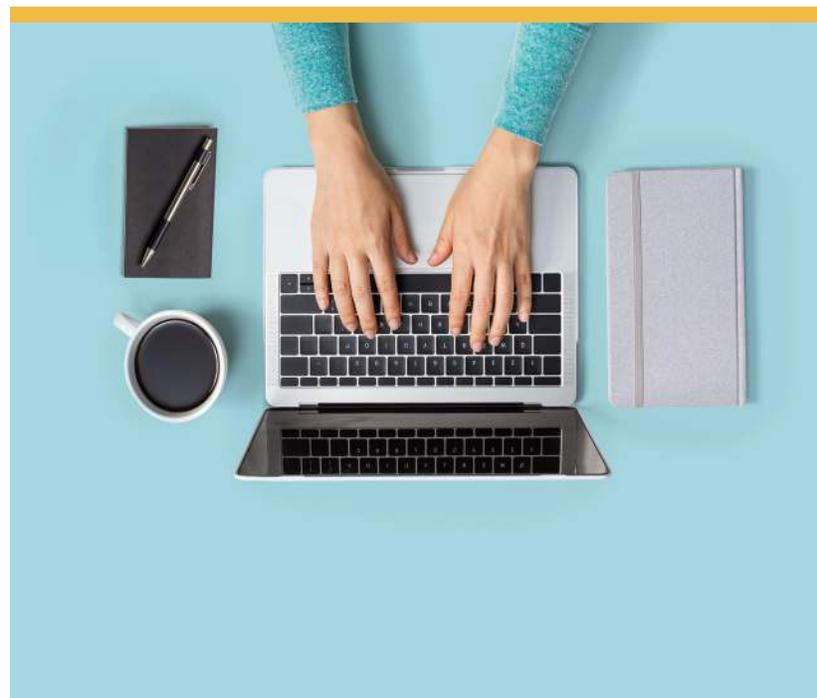
Tax Rate	Joint/Surviving Spouse	Single	Head of Household	Married Filing Separately	Estate & Trusts
0%	\$0 - \$89,250	\$0 - \$44,625	\$0 - \$59,750	\$0 - \$44,625	\$0 - \$3,000
15%	\$89,251 - \$553,850	\$44,626 - \$492,300	\$59,751 - \$523,050	\$44,626 - \$276,900	\$3,001 - \$14,650
20%	Over \$553,850	Over \$492,300	Over \$523,050	Over \$276,900	Over \$14,650

2024 Long-Term Capital Gains Rate Brackets

Tax Rate	Joint/Surviving Spouse	Single	Head of Household	Married Filing Separately	Estate & Trusts
0%	\$0 - \$94,050	\$0 - \$47,025	\$0 - \$63,000	\$0 - \$47,025	\$0 - \$3,150
15%	\$94,051 - \$583,750	\$47,026 - \$518,900	\$63,001 - \$551,350	\$47,026 - \$291,850	\$3,151 - \$15,450
20%	Over \$583,750	Over \$518,900	Over \$551,350	Over \$291,850	Over \$15,450

Long-term capital gains (and qualified dividends) are subject to a lower tax rate than other types of income. Investors should consider the following when planning for capital gains:

- Holding capital assets for more than a year (more than three years for assets attributable to carried interests) so that the gain upon disposition qualifies for the lower long-term capital gains rate.
- Considering long-term deferral strategies for capital gains such as reinvesting capital gains into designated qualified opportunity zones.
- Investing in, and holding, "qualified small business stock" for at least five years.
- Donating appreciated property to a qualified charity to avoid long term capital gains tax (also see *Charitable Contributions*, below).



Net Investment Income Tax

An additional 3.8% net investment income tax (NIIT) applies on net investment income above certain thresholds. Net investment income does not apply to income derived in the ordinary course of a trade or business in which the taxpayer materially participates. Similarly, gain on the disposition of trade or business assets attributable to an activity in which the taxpayer materially participates is not subject to the NIIT.

In conjunction with other tax planning strategies that are being implemented to reduce income tax or capital gains tax, impacted taxpayers may want to consider deferring net investment income for the year.

Social Security Tax

The Old-Age, Survivors, and Disability Insurance (OASDI) program is funded by contributions from employees and employers through FICA tax. The FICA tax rate for both employees and employers is 6.2% of the employee's gross pay, but only on wages up to \$160,200 for 2023 and \$168,600 for 2024. Self-employed persons pay a similar tax, called SECA (or self-employment tax), based on 12.4% of the net income of their businesses.

Employers, employees, and self-employed persons also pay a tax for Medicare/Medicaid hospitalization insurance (HI), which is part of the FICA tax, but is not capped by the OASDI wage base. The HI payroll tax is 2.9%, which applies to earned income only. Self-employed persons pay the full amount, while employers and employees each pay 1.45%. An extra 0.9% Medicare (HI) payroll tax must be paid by individual taxpayers on earned income that is above certain adjusted gross income (AGI) thresholds, i.e., \$200,000 for individuals, \$250,000 for married couples filing jointly and \$125,000 for married couples filing separately. However, employers do not pay this extra tax.



Long-Term Care Insurance & Services

Premiums an individual pays on a qualified long-term care insurance policy are deductible as a medical expense. The maximum deduction amount is determined by an individual's age. The following table sets forth the deductible limits for 2023 and the estimated deductible limits for 2024 (the limitations are per person, not per return):

Age	Deduction Limitation 2023	Deduction Limitation 2024
40 or under	\$480	\$470
Over 40 but not over 50	\$890	\$880
Over 50 but not over 60	\$1,790	\$1,760
Over 60 but not over 70	\$4,770	\$4,710
Over 70	\$5,960	\$5,880

Retirement Plan Contributions

Individuals may want to maximize their annual contributions to qualified retirement plans and Individual Retirement Accounts (IRAs).

- The maximum amount of elective contributions that an employee can make in 2023 to a 401(k) or 403(b) plan is \$22,500 (\$30,000 if age 50 or over and the plan allows "catch up" contributions). For 2024, these limits are \$23,000 and \$30,500, respectively.
- The SECURE Act permits a penalty-free withdrawal of up to \$5,000 from traditional IRAs and qualified retirement plans for qualifying expenses related to the birth or adoption of a child after December 31, 2019. The \$5,000 distribution limit is per individual, so a married couple could each receive \$5,000.
- Under the SECURE Act, individuals are now able to contribute to their traditional IRAs in or after the year in which they turn 70½.
- Beginning in 2023, the SECURE Act 2.0 raised the age that a taxpayer must begin taking required minimum distributions (RMDs) to age 73. If the individual reaches age 72 in 2023, the required beginning date for the first RMD is April 1, 2025, for 2024. If the taxpayer reaches age 73 in 2023, the taxpayer was 72 in 2022 and subject to the age 72 RMD rule in effect for 2022. If the taxpayer reached age 72 in 2022, the first RMD was due April 1, 2023, and the second RMD is due December 31, 2023.
- Individuals age 70½ or older can donate up to \$100,000 to a qualified charity directly from a taxable IRA.
- The SECURE Act generally requires that designated beneficiaries of persons who died after December 31, 2019, take inherited plan benefits over a 10-year period. Eligible designated beneficiaries (i.e., surviving spouses, minor children of the plan participant, disabled and chronically ill beneficiaries and beneficiaries who are less than 10 years younger than the plan participant) are not limited to the 10-year payout rule. Special rules apply to certain trusts.
- Under proposed Treasury Regulations (issued February 2022) that address required minimum distributions from inherited retirement plans of persons who died after December 31, 2019, and after their required beginning date, designated and non-designated beneficiaries will be required to take annual distributions, whether subject to a ten-year period or otherwise. Beneficiaries can take a wait-and-see approach by calculating what those 2022 distributions would be, then wait to see if final Treasury Regulations are issued, before the end of 2022, that clarify the distribution requirement under the ten-year rule.
- Small businesses can contribute the lesser of (i) 25% of employees' salaries or (ii) an annual maximum set by the IRS each year



to a Simplified Employee Pension (SEP) plan by the extended due date of the employer's federal income tax return for the year that the contribution is made. The maximum SEP contribution for 2023 is \$66,000. The maximum SEP contribution for 2024 is \$69,000. The calculation of the 25% limit for self-employed individuals is based on net self-employment income, which is calculated after the reduction in income from the SEP contribution (as well as for other things, such as self-employment taxes).

Foreign Earned Income Exclusion

The foreign earned income exclusion is \$120,000 in 2023 and increases to \$126,500 in 2024.

Alternative Minimum Tax

A taxpayer must pay either the regular income tax or the alternative minimum tax (AMT), whichever is higher. The established AMT exemption amounts for 2023 are \$81,300 for unmarried individuals and individuals claiming head of household status, \$126,500 for married individuals filing jointly and surviving spouses, \$63,250 for married individuals filing separately and \$28,400 for estates and trusts. The AMT exemption amounts for 2024 are \$85,700 for unmarried individuals and individuals claiming head of household status, \$133,300 for married individuals filing jointly and surviving spouses, \$66,650 for married individuals filing separately and \$29,900 for estates and trusts.

Kiddie Tax

The unearned income of a child is taxed at the parents' tax rates if those rates are higher than the child's tax rate.

Limitation on Deductions of State & Local Taxes (SALT Limitation)

For individual taxpayers who itemize their deductions, the Tax Cuts and Jobs Act introduced a \$10,000 limit on deductions of state and local taxes paid during the year (\$5,000 for married individuals filing separately). The limitation applies to taxable years beginning on or after December 31, 2017, and before January 1, 2026. Various states have enacted new rules that allow owners of pass-through entities to avoid the SALT deduction limitation in certain cases.

Charitable Contributions

Cash contributions made to qualifying charitable organizations, including donor advised funds, in 2023 and 2024 will be subject to a 60% AGI limitation. The limitations for cash contributions continue to be 30% of AGI for contributions to non-operating private foundations. Tax planning around charitable contributions may include:

- Creating and funding a private foundation, donor advised fund or charitable remainder trust.
- Donating appreciated property to a qualified charity to avoid long term capital gains tax.

Estate & Gift Taxes

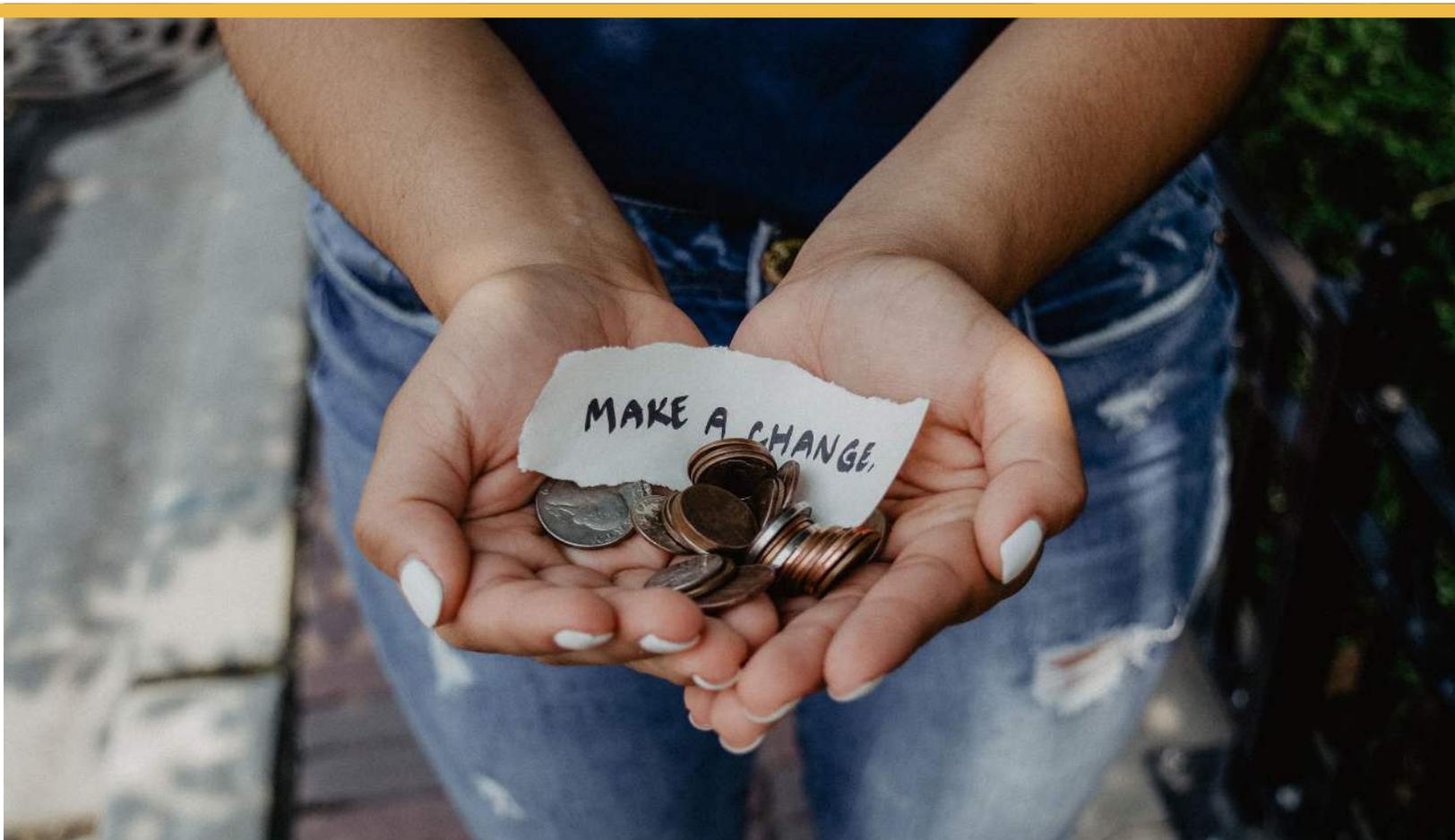
For gifts made in 2023, the gift tax annual exclusion is \$17,000 and for 2024 is \$18,000. For 2023, the unified estate and gift tax exemption and generation-skipping transfer tax exemption is \$12,920,000 per person. For 2024, the unified estate and gift tax exemption and generation-skipping transfer tax exemption is \$13,610,000. All outright gifts to a spouse who is a U.S. citizen are free of federal gift tax. However, for 2023 and 2024, only the first \$175,000 and \$185,000, respectively, of gifts to a non-U.S. citizen spouse is excluded from the total amount of taxable gifts for the year. Tax planning strategies may include

- Making annual exclusion gifts.
- Making larger gifts to the next generation, either outright or in trust.
- Creating a Spousal Lifetime Access Trust (SLAT) or a Grantor Retained Annuity Trust (GRAT) or selling assets to an Intentionally Defective Grantor Trust (IDGT).

Net Operating Losses & Excess Business Loss Limitation

Net operating losses (NOLs) generated in 2023 are limited to 80% of taxable income and are not permitted to be carried back. Any unused NOLs are carried forward subject to the 80% of taxable income limitation in carryforward years.

A non-corporate taxpayer may deduct net business losses of up to \$289,000 (\$578,000 for joint filers) in 2023. The limitation is \$305,000 (\$610,000 for joint filers) for 2024. A disallowed excess business loss (EBL) is treated as an NOL carryforward in the subsequent year, subject to the NOL rules. With the passage of the Inflation Reduction Act, the EBL limitation has been extended through the end of 2028.





2023 Year-End Tax Planning for Businesses

As businesses pursue transformational changes to their operational strategies, they must consider the tax implications of those decisions from the outset. Whether considering supply chain shifts, pursuing M&A, implementing ESG strategies, or adjusting your workforce, you need to model the tax impacts of those business decisions. Failure to consider tax in planning could result in unintended, adverse tax impacts or missed savings. This issue is at the center of a total tax mindset. Working with tax professionals who understand the interplay between changing laws, economic forces, and the tax implications of all business decisions positions companies for success.

Tax planning is as essential as ever for businesses searching for ways to optimize cash flow by managing their long-term tax liabilities. Perkins & Co's 2023 Year-End Tax Guide identifies tax strategies and considers how they may be influenced by recent administrative guidance and potential legislative changes that remain under consideration.

The information contained within this article is based on information as of December 4, 2023. Taxpayers should consult their trusted advisors when making tax and financial decisions regarding any items in this piece.

State & Local Taxes

With thousands of taxing jurisdictions, from school boards to counties and states, and many different types of taxes, state and local taxation is complex. Each tax type comes with its own set of rules—by jurisdiction—all of which require a different level of attention.

This article provides a high-level overview to help companies with 2023 year-end SALT planning considerations, and it provides guidance on how to hit the ground running in 2024.

LIQUIDITY EVENTS

Liquidity events take the form of IPOs; financings; sales of stock, assets, or businesses; and third-party investments. Those events involve different forms of transactions, often driven by business or federal tax considerations; unfortunately, and far too often, the SALT impact is ignored until the 11th hour or later.

A liquidity event is not an occasion for surprises. When a taxpayer is contemplating any form of transaction, state and local taxes should not be overlooked. Knowledgeable SALT professionals can help identify planning opportunities and point out potential pitfalls, and it is never too early to involve them. If you wait until after the transaction occurs or until the state tax returns are being prepared, it may be too late to leverage their insight.

From state tax due diligence to understanding the total state tax treatment of a transaction to properly reporting and documenting state tax impacts, addressing SALT at the outset of a deal is critical. If involved before the year-end liquidity event, SALT professionals can suggest helpful adjustments to the transaction that may be federal tax-neutral but could result in identifying significant state tax savings or costs now, rather than later. After the liquidity event, because the state tax savings or costs already have been identified, they can be properly documented and reported post-transaction. Further, because SALT expertise was involved at the front end, state tax post-transaction integration, planning, and remediation can be more seamlessly pursued.

INCOME/FRANCHISE TAXES

If anything has been learned from the last six years of federal tax legislation, it's that state income tax conformity cannot be taken for granted. While states often conform to myriad

federal tax provisions, it's important to verify S corporations are treated as such by each state they operate in. Further, S corporations must confirm that their status applies to state income taxes. Not asking those questions early can lead to a misunderstanding and potential issues later.

Several states don't conform to federal entity tax classification regulations. Some, including New York, require a separate state-only S corporation election. New Jersey now allows an election out of S corporation treatment. Making those elections—or not—can lead to different state income tax answers, so it's important to understand the available options before the transaction occurs.

Asking important questions early can help provide clarity in the decision-making process:

- If the liquidity event will result in gain, how is the gain going to be treated for state income tax purposes?
- Is it apportionable business gain or allocable nonbusiness gain?
- Is a partnership interest, stock, or asset being sold?
- How will the gain be apportioned?
- Was the seller unitary with the partnership or subsidiary, or did the assets serve an operational or investment function for the seller?
- Will the gross receipts or net gain from the sale be included in the sales factor, and, if so, how will they be apportioned?

Those are just some of the questions that are never asked on the federal level because they don't have to be. But they are material on the state level and, again, are unwelcome surprises.

SALES/USE TAXES

Most U.S. states require a business to collect and remit sales and use taxes even if it has only economic, and no physical, presence. Remote sellers, software licensors, and other businesses that provide services or deliver their products to customers from a remote location must comply with state and local taxes.

Left unchecked, those state and local tax obligations—and the corresponding potential liability for tax, interest, and penalties—will grow. Moreover, neglecting your sales and use tax



obligations could result in a lost opportunity to pass the sales and use tax burden to customers as intended by state tax laws.

A company could very well experience material sales and use tax obligations resulting from a sale, even though the transaction or reorganization is tax free for federal income tax purposes. To avoid any material issues, several steps should be taken:

- Determine nexus and filing obligations;
- Evaluate product and service taxability;
- Quantify potential tax exposure;
- Mitigate and disclose historical tax liabilities;
- Consider implementing a sales tax system; and
- Maintain sales tax compliance.

REAL ESTATE TRANSFER TAXES

Most states impose real estate transfer taxes (RETTs) or conveyance taxes on the sale or transfer of real property, or controlling interest transfer taxes when an interest in an entity holding real property is sold. Few taxpayers are familiar with RETTs, and the complex rules and compliance burdens associated with those state taxes could prove costly if they are not considered up front.

STATE PTE TAX ELECTIONS

Most states impose real estate transfer taxes (RETTs) or conveyance taxes on the sale or transfer of real property, or controlling interest transfer taxes when an interest in an entity holding real property is sold. Few taxpayers are familiar with RETTs, and the complex rules and compliance

burdens associated with those state taxes could prove costly if they are not considered up front.

Roughly 35 states now allow pass-through entities (PTEs) to elect to be taxed at the entity level to help their residents avoid the \$10,000 limit on federal itemized deductions for state and local taxes known as the “SALT cap.” Those PTE tax elections are much more complex than simply checking a box to make an election on a tax return. Although state PTE tax elections are meant to benefit the individual members, not all elections are alike, and they are not always advisable.

Before making an election, a PTE should model the net federal and state tax benefits and consequences to the PTE—for every state in which the PTE operates, as well as for each resident and nonresident member—to avoid potential unintended tax results. A thorough evaluation of whether to make a state PTE tax election (or elections) should be completed before the end of the year, modeling the net tax benefits or costs, as should a determination of timing elections, procedures, and other election requirements (e.g., owner consents, owner votes to authorize the election, and partnership or LLC operating agreement amendments). If those steps are completed ahead of time, then the table has been set to make the election in the days ahead.

When considering a state PTE tax election, one of the most important issues to evaluate is whether members who are nonresidents of the state for which the election is made can claim a tax credit

for their share of the taxes paid by the PTE on their resident state income tax returns. If a state does not offer a tax credit for elective taxes paid by the PTE, then a PTE tax election could result in additional state tax burden that exceeds some members' federal itemized deduction benefit (\$0.37 is less than \$1.00). Therefore, as part of the pre-year-end evaluation and modeling exercise, PTEs should consider whether the election would result in members being precluded from claiming other state tax credits—which ordinarily would reduce their state income tax liability dollar for dollar—in order to receive federal tax deductions that are less valuable.

DOES P.L. 86-272 STILL EXIST?

P.L. 86-272 is a federal law that prevents a state from imposing a net income tax on any person's net income derived within the state from interstate commerce if the only business activity performed in the state is the solicitation of orders of tangible personal property that are sent outside the state for approval or rejection and, if approved, are filled by shipment or delivery from a point outside the state.

The Multistate Tax Commission (MTC) adopted a revised statement of its interpretation of P.L. 86-272 which, for practical purposes, largely nullifies the law's protections for businesses that engage in activities over the internet. To date, California and New Jersey have formally adopted the MTC's revised interpretation of internet-based activities, while Minnesota and New York have proposed the interpretation as new rules. Other states are applying the MTC's interpretation on audit without any notice of formal rulemaking.

Online sellers of tangible personal property that have previously claimed protection from state net income taxes under P.L. 86-272 should review their positions. Online sellers that use static websites that don't allow them to communicate or interact with their customers—a rare practice—seem to be the only type of seller that the MTC, California, New Jersey, and other states still consider protected by P.L. 86-272.

The effect of the MTC's new interpretation on a taxpayer's state net income tax exposure should be evaluated before the end of the year. Structural changes, ruling requests, or plans to challenge states' evolving limitation of P.L. 86-272 protections applicable to online sales can be put into place.

However, nexus or loss of P.L. 86-272 protection can be a double-edged sword. For example, in California, if a company is subject to tax in another state using California's new standard, then it is not required to throw those sales back into its California numerator for apportionment purposes.

PROPERTY TAX

For many businesses, property tax is the largest state and local tax obligation and a significant recurring operating expense that accounts for a substantial portion of local government tax revenue. Unlike other taxes, property tax assessments are ad valorem, meaning they are based on the estimated value of the property. Thus, they could be confusing for taxpayers and subject to differing opinions by appraisers, making them vulnerable to appeal. Assessed property values also tend to lag true market value in a recession.

Property tax reductions can provide valuable above-the-line cash savings, especially during economic downturns when assessed values may be more likely to decrease. The current economic environment amplifies the need for taxpayers to avoid excessive property tax liabilities by making sure their properties are not overvalued.

Annual compliance and real estate appeal deadlines can provide opportunities to challenge property values. Challenging real property assessments issued by jurisdictions within the appeal window may reduce real property tax liabilities. Taking appropriate positions on personal property tax returns related to any detriments to value could reduce personal property tax liabilities. Planning for and attending to property taxes can help a business minimize its total tax liability.

Conclusion: There are 50 states and thousands of local taxing jurisdictions that impose multiple different tax types. Ensuring that your company is in compliance with those state and local taxes—and only paying the amount of tax legally owed—can help reduce your total tax liability. As a taxpayer, it is more efficient to be proactive, rather than reactive, when it comes to state and local taxes. Being proactive will help identify issues and solutions that can be applied to other taxing jurisdictions, as well as helping limit audits, notices, penalties, and interest.



Real Estate

THE INFLATION REDUCTION ACT & THE CHIPS ACT

The structuring of real estate transactions can have significant tax implications, and new regulatory or statutory developments can change the calculation of how best to approach a transaction from a tax perspective. As part of year-end planning and looking ahead to the coming year, real estate businesses should review how current tax rules apply to their transactions and the effects of any changes to those rules – including the following:

- Evaluate Structure and Tax Consequences of Real Estate Debt Workout Transactions
- Prepare for Proposed Limit on Domestically Controlled REIT Status That Would Subject More Foreign Investors to U.S. Tax
- Consider Electing Real Property Business Exception from Section 163(j) Business Interest Expense Limitation

EVALUATE STRUCTURE & TAX CONSEQUENCES OF REAL ESTATE DEBT WORKOUT TRANSACTIONS

In a recent memorandum decision, the Tax Court has held that a taxpayer had Section 1001 gain or loss, and not cancellation of debt (COD) income, with respect to the sale of real property subject to a nonrecourse loan that was cancelled or retired as part of the sale transaction (Parker v. Commissioner, T.C. Memo 2023-104).

This decision serves as a reminder of the importance of properly evaluating and structuring a debt workout transaction in light of possibly alternative federal income tax consequences.

Based on the particular facts and circumstances, taxpayers may wish to consider whether such a transaction can be structured to generate COD income or Section 1001 gain. For example, a taxpayer may be eligible for one or more exceptions to the recognition of COD income under Section 108. Full or partial exclusion of COD income may be more beneficial than recognition of capital gain resulting from a Section 1001 transaction. Structuring a transaction to achieve either capital gain or COD income is complex with numerous pitfalls and traps for the unwary.

TAX TREATMENT OF RECOURSE VERSUS NONRECOURSE DEBT

It is essential to understand the difference in the income tax treatment of retirement or cancellation of recourse versus nonrecourse debt as part of a sale or exchange of the underlying property collateral.

If the debt is nonrecourse, the gain will generally be Section 1001 gain or loss (generally capital gain or Section 1231 gain, assuming the real property collateral is not dealer property), rather than COD income, which is characterized as ordinary income.

Conversely, if the debt is recourse, there will be COD income to the extent the debt balance exceeds the fair market value of the real property collateral, and Section 1001 gain or loss to the extent the fair market value exceeds (or falls short of) the adjusted tax basis in the property.

Alternatively, if a nonrecourse loan is not retired but instead is substantially modified and assumed or taken subject to by the buyer, the transfer may trigger COD income that generally will be allocated to the seller under Reg. §1.1274-5(b).

Similarly, COD income can be generated from a substantial modification of a nonrecourse loan that is not part of a sale or exchange of the underlying real property collateral.

GROSS INCOME EXCLUSIONS

COD income may qualify for one of several gross income exclusions under Section 108, e.g., the exclusion for qualifying real property business indebtedness under Section 108(c). Conversely, Section 1001 gain does not qualify for any such exclusion.

DETERMINING WHETHER DEBT IS RECOURSE OR NONRECOURSE

Determining whether a debt is recourse versus nonrecourse is not always easy. For this purpose, the Section 1001 regulations provide guidance as to whether a liability is recourse versus nonrecourse. When analyzing a partnership debt workout, the definition of recourse versus nonrecourse under Section 752 should generally not be used.

In contrast to Section 752 where recourse versus nonrecourse is determined based on the partners' economic risk of loss, the determination of recourse versus nonrecourse status under Section 1001 depends on whether the creditor's rights are limited to a particular asset or group of assets. Recourse indebtedness for Section 1001 means all the debtor's assets may be reached by creditors if the debt is not paid while nonrecourse indebtedness is where the creditor's remedies are limited to the collateral for the debt. See *Raphan v. United States*, 759 F.2d 879 (Fed. Cir. 1985).

Depending on the facts (e.g., a full recourse loan to a limited liability company with no guarantees by the LLC members or their affiliates), it may be unclear whether debt is recourse or nonrecourse for Section 1001 purposes. The Tax Court in *Great Plains Gasification Associates v. Commissioner*, T.C. Memo 2006-276, agreed with the IRS when it appeared

to argue that Section 752 and the regulations thereunder determine whether partnership debt is characterized as recourse or nonrecourse. However, the IRS appeared to reverse its position in CCA 201525010, when it ruled that the implication created by *Great Plains Gasification* was erroneous. The IRS further stated that Section 752 is limited to determining the partners' basis in the partnership. As primary authority for this conclusion, the IRS cites Reg. §1.752-1(a), which states that the definitions of recourse and nonrecourse liabilities found in this paragraph only apply "for purposes of Section 752." In some cases, it may be possible to conclude that there is substantial authority for either position.

PLANNING CONSIDERATIONS

Taxpayers may prefer COD income to capital gain or vice versa depending on the taxpayer's specific situation. For example, a taxpayer may prefer COD income if the taxpayer is insolvent, in bankruptcy, or otherwise eligible for another COD income exclusion. Another taxpayer who is eligible for the lower capital gains rates, but not eligible for a COD income exclusion, would generally prefer capital gain to COD income.

There may be tax planning opportunities in these situations. Key factors to be considered include the following:

- Is there a preference for COD income over capital gain?
- Is any property being transferred as a result of the workout?
- Is the liability recourse or nonrecourse?

With careful and proactive planning, achieving desired results may be possible. For example, if the taxpayer would prefer COD income where the debt is nonrecourse, the debtor could negotiate a reduction of the debt. The forgiveness of all or a portion of a nonrecourse debt without the transfer of the collateral will result in COD income rather than gain from the sale of the property. Alternatively, the debtor could possibly transfer cash equal to the fair value of the collateral instead of transferring the collateral to the lender. In *Gershkowitz v. Commissioner*, 88 T.C. 984 (1987), the Tax Court appeared to allow results similar to these situations.

However, in a later opinion, *2925 Briarpark, Ltd. V. Commissioner*, T.C. Memo 1997-298, aff'd 163

F.3d 313 (5th Cir. 1999), the Fifth Circuit Court of Appeals in affirming the Tax Court decision held against the taxpayer where the lender had agreed to release the property from all liens if the debtor sold the property for a minimum sales price. The court reasoned that the sale of the property and the cancellation of the debt were too closely intertwined to be treated as two separate transactions. Therefore, the debtor was required to recognize gain from the sale of the property rather than COD income.

These two court cases show that while not easy, it may be possible to accomplish a taxpayer's desired results through careful planning.

PREPARE FOR PROPOSED LIMIT ON DOMESTICALLY CONTROLLED REIT STATUS THAT WOULD SUBJECT MORE FOREIGN INVESTORS TO U.S. TAX

Proposed Treasury regulations ([REG-100442-22](#)) issued in December 2022 would limit the eligibility of a real estate investment trust (REIT) to qualify as a "domestically controlled REIT," thereby curtailing – potentially retroactively – the common use of such structures to avoid U.S. income tax on foreign investors' gains on sales of REIT stock.

Many private real estate partnership funds hold U.S. real property through REITs. The general rule under Section 897(a)(1) and (c) is that gain to a foreign investor on the sale of a "United States real property interest" (USRPI) is treated as "effectively connected income" and, thus, is subject to U.S. income tax. For this purpose, under Section 897(c)(1) and (2), a USRPI includes stock of a "US real property holding corporation," which generally includes a REIT that holds U.S. real property as its primary asset.

However, U.S. income tax is generally not imposed if the REIT qualifies as a "domestically controlled REIT" (DC REIT), which includes a REIT in which less than 50 percent of the value of its stock was held, directly or indirectly, by foreign investors at all times during the REIT's existence during the five-year period preceding the sale of the REIT stock. Although attribution rules are provided in several other contexts under Section 897, the statute does not define the term "directly or indirectly" for this purpose.

It appears to be well accepted that the foreign status of a REIT's direct and indirect owners is determined by looking through to the partners in a U.S. partnership that owns stock of the REIT. By contrast, the IRS ruled in PLR 200923001 that a U.S.

corporation owned by foreign investors is treated as a U.S. shareholder of the REIT, i.e., there is no look-through to the foreign shareholders of the U.S. corporation. Under this approach, foreign investors can own more than 50 percent of the stock of a DC REIT, i.e., 49 percent directly and the balance indirectly through a U.S. corporation. Moreover, the favorable result in PLR 200923001 was cited with approval in the legislative history to section 322(b)(1)(A) of the Protecting Americans from Tax Hikes Act of 2015, Public Law 114-113, div. Q.

Accordingly, the REIT structure with foreign investors owning more than 50 percent of REIT stock, in part through a U.S. corporation, has been adopted by many private real estate partnerships in anticipation of the U.S. income tax exemption for foreign investors' gain on the sale of DC REIT stock.

On December 29, 2022, Treasury and the IRS issued Proposed Reg. §1.897-1(c)(3), which, if adopted in final form, would substantially curtail eligibility for DC REIT status. The proposed rule would require a look-through to the domestic or foreign status of the shareholders of a nonpublic U.S. corporation for this purpose unless the U.S. corporation is owned, directly or indirectly, less than 25 percent by foreign shareholders, in which case the U.S. corporation would qualify as a domestic REIT shareholder for this purpose. Moreover, this rule would effectively apply retroactively because of the five-year lookback in determining DC REIT status.



PLANNING CONSIDERATIONS

These proposed DC REIT regulations have caused a fair amount of controversy, and Treasury has indicated that it is considering how the effective date provisions might be changed to grant relief from the retroactive effect of the regulations.

Nevertheless, it would appear prudent to avoid excess foreign direct and indirect ownership of a REIT for which the foreign shareholders may be seeking favorable U.S. income tax treatment on stock sale gains. Companies should assess the risks and opportunities that may be available through DC REIT status.

CONSIDER ELECTING REAL PROPERTY TRADE OR BUSINESS EXCEPTION FROM SECTION 163(J) BUSINESS INTEREST EXPENSE LIMITATION

Some taxpayers engaged in construction and other real property trades or businesses that are subject to the business interest expense limitation under Internal Revenue Code Section 163(j) may benefit from making the real property trade or business election. There are some key factors to review when considering this potentially underused election.

SECTION 163(J) BUSINESS INTEREST EXPENSE LIMITATION

Enacted changes to Section 163(j) provided a new limitation on the deduction for "business interest expense" of all taxpayers unless a specific exclusion applies under Section 163(j). Section 163(j) generally limits the amount of business interest expense that can be deducted in the current year and is

effective for tax years beginning after December 31, 2017. Under Section 163(j)(1), the amount allowed as a deduction for business interest expense is limited to the sum of (1) the taxpayer's business interest income for the taxable year; (2) 30% of the taxpayer's adjusted taxable income (ATI) for the taxable year; and (3) the taxpayer's floor plan financing interest expense for the taxable year.

The term ATI means the tentative taxable income of the taxpayer adjusted for various items including business interest expense and net operating loss deductions, among others. For taxable years beginning on or after January 1, 2022, a taxpayer is no longer allowed to add back depreciation and amortization in calculating ATI. As a result, more taxpayers are being subjected to the Section 163(j) business interest expense limitation. Therefore, it is more important to determine whether a taxpayer qualifies for a specific exclusion from Section 163(j).

Section 163(j)(3) provides an exemption for certain small businesses if the average annual gross receipts of such entity for the three-taxable-year period ending with the taxable year which precedes such taxable year does not exceed \$25 million (\$29 million for taxable years beginning in 2023). Aggregation rules apply when determining the annual gross receipts limitation.

REAL PROPERTY TRADE OR BUSINESS ELECTION

Of particular interest to taxpayers in the real estate industry who do not qualify for the small business exemption is the electing real property trade or business (RPTOB) exception under Section 163(j)



(7)(B). Any trade or business which is described in Section 469(c)(7)(C) and which makes an election under Section 163(j)(7)(B) is eligible for this exception. Taxpayers who make a RPTOB election are required to use the alternative depreciation system (ADS) for nonresidential real property, residential real property, and qualified improvement property (QIP).

The real property trades or businesses listed in Section 469(c)(7)(C) include any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

PLANNING CONSIDERATIONS

Real estate businesses that fall into the above categories and have interest limited under Section 163(j) should consider whether it is beneficial to file a RPTOB election. The RPTOB election may be underutilized for certain taxpayers such as taxpayers in the construction and management industries.



Additionally, since these types of real estate companies may not own significant real property, there may be very little to no downside for making the election in the form of reduced depreciation deductions.

The RPTOB election is made for each trade or business of a taxpayer. Therefore, if a taxpayer has more than one trade or business and one or more of the taxpayer's trades or businesses are not eligible to make the RPTOB election or the taxpayer chooses not to make the RPTOB election for an eligible trade or business, the taxpayer must allocate interest expense, interest income, and other items of expense and gross income between the taxpayer's excepted and nonexcepted trades or businesses. The allocation rules for this purpose are complex and are detailed in Reg. Section 1.163(j)-10.

DEPRECIATION CONSIDERATIONS

As mentioned above, if a taxpayer has made a RPTOB election out of the Section 163(j) business interest expense limitation, the taxpayer must use ADS under Section 168(g) for nonresidential real property, residential real property, and QIP.

QIP is defined under Section 168(e)(6) as "any improvement made by the taxpayer to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service" but not including any improvement for which the expenditure is attributable to (i) the enlargement of the building, (ii) any elevator or escalator, or (iii) the internal structural framework of the building. QIP is depreciable over a MACRS recovery period of 15 years.

If the taxpayer has not made a RPTOB election and is not otherwise required to use ADS, the taxpayer's cost of QIP may qualify for bonus depreciation. The bonus depreciation percentage is 100% for property placed in service before 2023 and 80% for property placed in service after December 31, 2022, and before January 1, 2024.

However, if a taxpayer has made a RPTOB election, the taxpayer is required to use ADS for QIP and the taxpayer's cost of QIP would not qualify for bonus depreciation. The ADS recovery period for QIP is 20 years.

It is important to analyze the effect a RPTOB election may have on the depreciation deductions of a taxpayer to quantify the potential benefits of making the election.



Partnerships

The IRS in the past year has been actively challenging partnerships' tax positions in court – from the valuation of granted profits interests to limited partner self-employment exemption claims and the structuring of leveraged partnership transactions. At the same time, the agency is dedicating to new funding and resources to examining partnerships.

These developments, along with some reporting and regulatory changes, mean there are several tax areas partnerships should be looking into as they plan for year end and the coming year:

- Review Valuation of Granted Profits Interests, Partners' Capital Accounts
- Consider Active Limited Partners' Potential Liability for Self-Employment Tax
- Prepare for Expanded IRS Audit Focus on Partnerships
- Review Structure of Leveraged Partnership Transactions, Application of Anti-Abuse Rules
- Prepare for New Reporting on 2023 Form 1065 Schedule K-1
- Evaluate Before Year End Expiration of Partnership Bottom-Dollar Guarantee Transition Rules

REVIEW VALUATION OF GRANTED PROFITS INTERESTS, PARTNERS' CAPITAL ACCOUNTS

In a recent Tax Court case, the IRS attempted — unsuccessfully — to supplant the fair market value agreed to by unrelated parties in a partnership transaction with its expert's higher estimate, asserting

that the taxpayer received a taxable capital interest in exchange for services provided to a partnership, not a nontaxable profits interest. If structured and substantiated properly, profits interests can be valuable tools for compensating providers of services to partnerships at no immediate tax cost. Although the court upheld the taxpayers' valuation, the IRS challenge highlights the importance for partnerships to:

- Properly determine, support and document value when granting and establishing rights to profits interests, and
- Strongly consider revaluing partners' capital accounts according to Treasury regulations to reflect fair market value when profits interests are granted.

The case, *ES NPA Holding LLC v. Commissioner*, T.C. Memo 2023-55 (May 3, 2023), involved a partnership (ES NPA) that provided services to another partnership in exchange for a partnership interest. The taxpayers contended that interest was a profits interest, which was not immediately taxable. The IRS argued that, under its higher estimation of the value of the underlying business, ES NPA took a capital interest in the partnership that ostensibly should be immediately taxable.

Relying on the fair market value negotiated among the parties to the transaction, the Tax Court agreed with the taxpayer that there was not a taxable capital shift between partners. Unsurprisingly, the Tax Court also concluded — premised on the IRS's

guidance in Revenue Procedure 93-27 — that receipt of a profits interest will not result in the immediate recognition of taxable income. What is somewhat surprising is that the IRS challenged whether the interest was, in fact, a profits interest.

FACTS IN ES NPA HOLDING

Under the basic facts, a partnership (NPA, LLC) had three classes of units, including Class A, Class B and Class C units. Upon liquidation of NPA, LLC, the Class A and Class B units were to receive 100% of the original capital assigned to these units before any amounts would be distributable to the Class C units – which were the units that ES NPA received in exchange for its services.

After an unrelated third party purchased 70% of the company for \$21 million, the parties to the transaction agreed that the original capital assigned to the Class A and Class B units was \$21 million and \$9 million, respectively. Thus, the total agreed to value of NPA, LLC was \$30 million. Under this valuation, the Class C units held by ES NPA would have \$0 value in the event of a hypothetical liquidation of NPA, LLC, at the time of the transaction – suggesting ES NPA received only a profits interest in NPA, LLC.

IRS CHALLENGE

Despite the parties' agreement as to the \$30 million equity valuation, the IRS argued that the value of NPA, LLC was \$52.5 million. Using this value, the IRS determined that the liquidation value of the Class C units held by ES NPA was in excess of \$12 million (rather than \$0). Assuming this valuation is accurate, the Class C units would be considered capital interests and would not be eligible for the safe harbor under Revenue Procedure 93-27, which generally exempts from immediate taxation profit interests – but not capital interests – received in exchange for the provision of services to a partnership.

Based on its arguments, the IRS appears to believe that such a capital shift would be immediately taxable to the recipient. Although not specifically addressed in the Tax Court's decision, receipt of a capital interest in exchange for the performance of services is generally a taxable event under established case law. However, there is some question around whether a capital interest received for purposes other than the performance of services would be immediately taxable.

TAX COURT'S HOLDING

Ultimately, the Tax Court concluded that the best estimate of fair market value in this case was the purchase price agreed to by unrelated parties. While acknowledging that formal valuation reports may be helpful in establishing fair market value, the Tax Court noted that such appraisals are not required. Rather, as in this case, deference was provided to the transaction price agreed to by unrelated taxpayers. Importantly, the Tax Court noted the testimony of the selling taxpayer was credible and unbiased. The Tax Court further noted, "we find nothing in the record to dispute a finding that the transaction was arm's length and bona fide."

WHAT IF THE COURT ACCEPTED THE IRS'S NARROW READING OF ITS OWN REVENUE PROCEDURE?

Although this case is a "win" for the taxpayer, the IRS presumably didn't go to court without reason. The IRS believed the recipient of the Class C units should immediately recognize taxable income. However, the IRS's primary argument sought to prevent application of Revenue Procedure 93-27 via a narrow reading of the guidance. The IRS's primary argument was not whether the Class C units represented a capital interest. What if the Tax Court agreed that Revenue Procedure 93-27 didn't apply to these facts?

Revenue Procedure 93-27 is a safe harbor provision that states the IRS will not treat receipt of a profits interest as immediately taxable. If the Tax Court agreed that the safe harbor didn't apply, as argued by the IRS, the IRS would still need to address judicial precedent holding that receipt of a profits interest is not taxable because the value of the interest received is speculative. Thus, the IRS would then have had to successfully argue that the Class C units had value beyond speculation. Given the result in the IRS's secondary, capital shift argument, it seems unlikely that it would have prevailed.

KEY CONSIDERATIONS AND TAKEAWAY

Acknowledging the taxpayer's success in this case, it is important to note that the IRS sought to challenge the taxpayer in court. This is presumably not a decision taken lightly by the IRS. Is this a warning sign to taxpayers when structuring transactions where the buyer anticipates future upside that may or may not be speculative?

There are a few important factors that, if the facts had been different, potentially could have altered the outcome of the case:

- The Tax Court found the selling taxpayer's testimony to be credible and unbiased, with nothing in the record indicating something other than an arm's-length transaction.
- The facts did not indicate that the taxpayer needed the cash to support further business operations, was simply looking to monetize his investment as quickly as possible or otherwise facing circumstances prompting the seller to sell at a discount.
- The lack of taxpayer relatedness was important in supporting the use of the agreed fair market value.
- The discussion within the Tax Court's opinion doesn't address whether the property owner ever sought other bids for his business or if that would have changed the court's analysis and conclusion regarding the credibility and unbiased nature of the witness.

Ultimately, while a positive outcome for the taxpayer in this case, the IRS's decision to take this case to trial should serve as a cautionary tale. Taxpayers are well advised to closely scrutinize the factors in their own transactions to ensure the fair market value positions are fully documented and supported.

When issuing a profits interest, it's critical to document the valuation of the partnership and to strongly consider a book up of capital accounts to reflect the valuation. Analyzing and documenting whether the bargaining positions of the parties are truly adversarial would presumably help substantiate the parties' agreement of value.

CONSIDER ACTIVE LIMITED PARTNERS' POTENTIAL LIABILITY FOR SELF-EMPLOYMENT TAX

A judicial resolution may be near for the unanswered question of whether limited partners in state law limited partnerships may claim exemption from self-employment (SECA) taxes — despite being more than passive investors. Depending on the outcome in the pending Soroban Capital Partners litigation, limited partners in state law limited partnerships who actively participate in the partnership's business may lose the opportunity to claim this exemption. If this happens, these limited partners would likely become subject to SECA tax on their partnership income.

SECA taxes can be substantial for active partners in profitable partnerships. The SECA tax rate consists of two parts: 12.4% for social security (old-age, survivors, and disability insurance) and 2.9% for Medicare (hospital insurance). While the 12.4% social security tax is currently limited to the first \$160,200 of self-employment earnings, partners who are subject to SECA tax must pay the 2.9% Medicare part of the tax on their entire net earnings from the partnership. There is also an additional 0.9% Medicare tax on all earnings from the partnership over a certain base amount (currently \$125,000; \$200,000; or \$250,000 depending on the partner's tax filing status).

WHY ARE SOME LIMITED PARTNERS IN JEOPARDY OF LOSING THEIR SECA TAX EXEMPTION?

Under Internal Revenue Code Section 1402(a) (13), the distributive share of partnership income allocable to a "limited partner" is generally not subject to SECA tax, other than for guaranteed



payments for services rendered. However, the statute does not define “limited partner,” and proposed regulations issued in 1997 that attempted to clarify the rules around the limited partner exclusion have never been finalized.

More recently, courts have held — in favor of the IRS — that members in limited liability companies (LLCs) and partners in limited liability partnerships (LLPs) that are active in the entity’s trade or business are ineligible for the SECA tax exemption. Despite these IRS successes, some continue to claim that state law controls in defining “limited partner” in the case of a state law limited partnership and, therefore, limited partners in state law limited partnerships — even active limited partners — may be eligible for the SECA tax exemption. This issue has yet to be specifically addressed by the courts, but Soroban Capital Partners may be the first case to squarely resolve it.

WHAT IS THE ISSUE IN THE SOROBAN CAPITAL PARTNERS LITIGATION?

The Soroban Capital Partners litigation filed with the Tax Court involves a New York hedge fund management company formed as a Delaware limited partnership. The taxpayers challenge the IRS’s characterization of partnership net income as net earnings from self-employment subject to SECA tax. According to the facts presented, each of the three individual limited partners spent between 2,300 and 2,500 hours working for Soroban, its general partner and various affiliates – suggesting that the limited partners were “active participants” in the partnership’s business.

In its March 2 objection to the taxpayers’ motion for summary judgment, the government contends that the term “limited partner” is a federal tax concept that is determined based on the actions of the partners – not the type of state law entity. Citing previous cases, the government asserts that the determination of limited partner status is a “facts and circumstances inquiry” that requires a “functional analysis.” The taxpayers in Soroban, on the other hand, argue that such a functional analysis does not apply in the case of a state law limited partnership and that, in the case of these partnerships, limited partner status is determined by state law.

Under the functional analysis adopted by the Tax Court in previous cases, to determine who is a limited partner, the court looks at the relationship

of the owner to the entity’s business and the factual nature of services the owner provides to the entity’s operations. For the SECA tax exemption to apply, the government states (citing case law), “an owner must not participate actively in the entity’s business operations and must have protection from the entity’s obligations.”

WHAT SHOULD LIMITED PARTNERS DO PENDING THE OUTCOME OF THE SOROBAN CASE?

Limited partners who actively participate in the partnership’s business should review their facts and circumstances and potential exposure to SECA tax. Although there is currently no clear authority precluding active limited partners of a state law limited partnership from claiming exemption from SECA tax, such a position should be taken with caution and a clear understanding of the risks—including being subject to IRS challenge if audited. The IRS continues to focus on scrutinizing such claims through its [SECA Tax compliance campaign](#). Moreover, the opportunity to claim the exemption could be significantly narrowed depending on the outcome of Soroban Capital Partners.

PREPARE FOR EXPANDED IRS AUDIT FOCUS ON PARTNERSHIPS

The IRS on September 8, 2023, announced that it will leverage funding from the Inflation Reduction Act to take new compliance actions, including actions focused on partnerships and other high income/high-wealth taxpayers. It intends to use artificial intelligence (AI) and improved technology to identify potential compliance risk areas. Subsequently, on September 20, the IRS further announced plans to establish a new work unit to focus on large or complex pass-through entities. The new pass-through area workgroup will be housed in the IRS Large Business and International (LB&I) division and will include the people joining the IRS under a new IRS hiring initiative. The creation of this new unit is another part of the IRS’s new compliance effort.

With respect to partnerships, the IRS announcement on new enforcement efforts indicates that the IRS will focus on two key areas:

- Expanding its Large Partnership Compliance program by using AI to identify compliance risks, and
- Increasing use of compliance letters focused on partnerships with balance sheet discrepancies.



LARGE PARTNERSHIP COMPLIANCE AND AI

The IRS began focusing on examinations of the largest and most complex partnership returns through its Large Partnership Compliance pilot program launched in 2021. It now plans to expand the program to additional large partnerships, using AI to select returns for examination. The AI, which has been developed jointly by experts in data science and tax enforcement, uses machine learning technology to identify potential compliance risks in partnership tax and other areas.

The IRS stated that it plans, by the end of this month, to have opened examinations of 75 of the largest partnership in the U.S. in a cross section of industries – including hedge funds, real estate investment partnerships, publicly traded partnerships, and large law firms.

COMPLIANCE LETTERS AND BALANCE SHEET DISCREPANCIES

The IRS has identified ongoing discrepancies in balance sheets of partnerships with over \$10 million in assets. The IRS announcement explains that there have been an increasing number of partnership returns in recent years showing discrepancies in balances between the end of one year and the beginning of the next year – many in the millions of dollars, without any required attached statement explaining the discrepancy.

The IRS states that it did not previously have the resources to follow up and engage with large partnerships on these discrepancies. Using its new resources, the IRS plans to approach the issue by mailing out compliance letters to around 500 partnerships starting in early October. Depending on the partnerships' responses, the IRS might take additional action, including potential examination.

PLANNING CONSIDERATIONS

With the passage of the Bipartisan Budget Act of 2015 (BBA), promulgating new centralized partnership audit rules, there has been an increased focus on partnership compliance. In conjunction, recent reporting updates for Schedule K-1, Schedule K-2, and Schedule K-3 require partnerships to now disclose additional information. This new announcement from the IRS reflects the agency's continued focus on partnership compliance using a variety of tools, including AI, and further highlights the necessity for consistent and accurate partnership reporting.

With the IRS signaling its areas of focus, taxpayers can proactively enhance their "exam readiness." Prior to initiation of an exam, taxpayers may wish to consider taking steps such as confirming application of the BBA partnership audit rules across entities within a complex structure, identifying open tax years for entities subject to

these rules, assessing completeness of existing tax return workpapers and relevant documentation, and establishing a framework of the exam response process.

Once an audit notice or compliance letter arrives, prepared taxpayers will be ready to implement their exam process. Key to a taxpayer's exam process will be considering designation of the partnership representative, availability of documentation that the IRS will likely request, familiarity with operating agreements and other transaction documents, and accessibility of qualified advisors to assist in the exam process.

REVIEW STRUCTURE OF LEVERAGED PARTNERSHIP TRANSACTIONS, APPLICATION OF ANTI-ABUSE RULES

On May 12, the Department of Justice (DOJ) filed its opening brief in its appeal to the Seventh Circuit of the Tax Court's decision in *Tribune Media Co. v. Commissioner* (T.C. Memo 2021-122). The government views the Tax Court's ruling as paving the way for inappropriate income tax planning, potentially enabling taxpayers to follow the roadmap created by the taxpayer in *Tribune Media* to implement leveraged partnership transactions without triggering taxable gain while avoiding incurring meaningful economic risk.

The appeal is primarily focused on perceived errors by the Tax Court in applying a liability allocation anti-abuse rule under Treas. Reg. §1.752-2(j) and the general partnership anti-abuse rule under Treas. Reg. §1.701-2. If successful on appeal, the case would likely be remanded to the Tax Court for a determination regarding applicability of the liability allocation and general anti-abuse rules. It is unclear whether the Tax Court would reach a different conclusion upon remand.

The initial brief submitted by DOJ contains a discussion of factors determined to be relevant in concluding the taxpayer's guarantee was without substance. Consideration should be given to these factors – summarized in the conclusion below – when structuring or evaluating transactions.

SUMMARY OF RELEVANT FACTS

In 2009, Tribune Media Company completed a transaction in which it contributed the Chicago Cubs baseball team to a partnership in exchange for an interest in the partnership plus a \$714 million cash distribution. Under the disguised sale of property rules in section 707(a)(2)(B), the

\$714 million would be viewed as a consideration received in connection with a partial sale of the Chicago Cubs baseball team. However, through use of liability guarantees, a significant portion of the debt used to fund the cash distribution was allocated to Tribune Media. Under an exception to the disguised sale rules, distributions funded by debt allocated to the distributee are not treated as disguised sale consideration.

Based on rules described in Treas. Reg. §1.752-2, to the extent a partner bears economic risk of loss (EROL) with respect to a liability, the liability will be allocated to the partner. For purposes of determining whether a taxpayer has EROL with respect to a particular liability, the regulations provide for an analysis relying on hypothetical facts. Under Treas. Reg. §1.752-2(b), a partner bears EROL with respect to a liability to the extent that, if the partnership constructively liquidated, the partner or a related person would be obligated to make a payment with respect to the liability. For purposes of this analysis, regulations require the constructive liquidation to be determined under all the following hypothetical facts:

- All the partnership's liabilities become payable in full.
- With the exception of property contributed to secure a partnership liability (see Treas. Reg. §1.752-2(h)(2)), all the partnership's assets, including cash, have a value of zero.
- The partnership disposes of all its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditors' right to repayment is limited solely to one or more assets of the partnership).
- All items of income, gain, loss or deduction are allocated among the partners.
- The partnership liquidates.

To benefit from the debt financed distribution exception to the disguised sale rules, Tribune Media agreed to guarantee a portion of the debt used to fund the distribution. The objective of this guarantee was to create EROL resulting in an allocation of the liability to Tribune Media. Based on the terms of the executed agreements and the general rules described in Treas. Reg. §1.752-2, Tribune Media properly bore EROL. As shown on applicable income tax returns, partnership liabilities were allocated to Tribune Media and reflected its EROL.



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LIABILITY ALLOCATION ANTI-ABUSE RULE

Upon examination, the IRS concluded that the parties’ attempt to create EROL violated the anti-abuse rule under Treas. Reg. §1.752-2(j), which generally provides that an obligation of a partner to make a payment may be disregarded if facts and circumstances indicate that a principal purpose of the arrangement is to eliminate the partner’s EROL with respect to that obligation.

As discussed in both the Tax Court’s opinion and DOJ’s opening appeals brief, the parties structured an arrangement that met the literal requirements to create EROL under Treas. Reg. §1.752-2. However, under the government’s view of the facts, *Tribune Media* did not bear meaningful risk of loss. The government noted that that “[t]he Tax Court and *Tribune* itself concluded that *Tribune* had no more than a ‘remote’ risk under the Senior Guarantee” with “myriad protections in place that all but assured *Tribune* would never be called upon to repay any portion of the Senior Debt.”

It appears that, in evaluating applicability of the section 752 anti-abuse rule, the Tax Court focused on the fiction that is deemed to occur for purposes of determining EROL under Treas. Reg. §1.752-2. Consequently, the Tax Court assumed the debt became due and all relevant assets became worthless. Under this interpretation, *Tribune Media* would be called upon to satisfy the outstanding liability. Consequently, the Tax Court concluded that the actual and remote risk to *Tribune Media* wasn’t relevant to the anti-abuse rule under Treas. Reg. §1.752-2(j). With this ruling the Tax Court would significantly limit the potential effectiveness of the anti-abuse rule.

The government views the reference in Treas. Reg. §1.752-2(j) to “facts and circumstances” to mean a required analysis of the actual economic arrangement of the parties. This contrasts with the view apparently taken by the Tax Court. In the Tax Court’s analysis, the anti-abuse analysis was conducted under the lens of the hypothetical factual assumptions required under the general rule of Treas. Reg. §1.752-2(b). The different views, of course, could have dramatic results in terms of whether and when the anti-abuse rule may apply.

GENERAL PARTNERSHIP ANTI-ABUSE RULE

Upon examination, the IRS concluded that the In addition to the liability allocation anti-abuse rule under Treas. Reg. §1.752-2(j), the government has also taken issue with the Tax Court’s application of the general partnership anti-abuse rule under Treas. Reg. §1.701-2. In its decision, the Tax Court

noted that the Treas. Reg. §1.701-2 anti-abuse rules apply only “to the function of the partnership as a whole.” The government, on the other hand, points out that Treas. Reg. §1.701-2(a)(2) requires that “[t]he form of each partnership transaction must be respected under substance over form principles.”

Ultimately, DOJ believes the Tax Court has misapplied the general anti-abuse rule. Acknowledging that the totality of the transaction may have had a business purpose, analyzing specific aspects under the general anti-abuse rule is appropriate. Similar to the discussion around the liability allocation anti-abuse rule, a recharacterization of the loan guarantee could have a significant impact on the tax consequences to the parties involved.

CONCLUSION

Based on the status of the Tribune Media case and the government’s appeal, there are a few important factors for consideration and reasonably drawn conclusions.

The government disagrees with the manner in which the Tax Court applied both the liability allocation anti-abuse rule and the general anti-abuse rule. It is reasonable to conclude that, if faced with a similar fact pattern, the IRS will challenge application of the debt-financed distribution exception to the disguised sale rules. In its brief, DOJ described the following factors as critical in its determination that the loan guarantee was without economic substance:

- The Cubs’ baseball club had strong revenue flow and structural protections built into the transaction ensuring the ability of the Cubs to meet its financial obligations. In particular, the Cubs had stable and growing cash flow streams from long-term media rights agreements along with strong ticket sale revenue. Debt service arrangements were structured to pull from these cash flow streams.
- As part of obtaining approval from Major League Baseball to complete the transaction, several parties to the transaction executed an operating support agreement intended to provide a “financial safety net” to the Cubs in times of economic uncertainty.
- To prevent potential creditor seizure of the Cubs baseball team, the Commissioner of Major League Baseball had the authority to take significant actions, including requiring

funding additional equity contributions, the sale of the team and the provision of a super-senior loan to fund operating expenses.

- There is unique value to the collateral associated with a major league baseball team. Based on S&P valuations, upon a distressed asset sale, a 40% reduction in the value of the collateral would still yield significant value
- Tribune Media documented its belief that the possibility of its guarantees would be called upon was remote. On its financial statements, Tribune Media disclosed the guarantees in the notes but did not record a liability, create a reserve, or report any value associated with the guarantees.

The Tax Court evaluated application of both the liability allocation anti-abuse rule and the general anti-abuse rule. The Tax Court concluded that the liability allocation anti-abuse rule was inapplicable. This conclusion was premised on application of the hypothetical transactions described in Treas. Reg. §1.752-2(b), i.e., the loan becomes due and payable, and the obligor has no assets with which to satisfy the obligation. Under this assumption, the Tax Court concluded that the remoteness of the guarantor’s obligation is not relevant. If this approach is accurate, application of the liability allocation anti-abuse rule would certainly seem to be significantly limited. If appropriate to analyze this anti-abuse rule under actual facts, it’s unclear whether the Tax Court would have reached a different end result.

Until resolved on appeal, taxpayers should be able to rely on the Tax Court’s ruling in Tribune Media to structure transactions involving debt-financed distributions. However, taxpayers should likewise be prepared for IRS challenge if audited.

PREPARE FOR NEW REPORTING ON 2023 FORM 1065 SCHEDULE K-1

Based on the status of the Tribune Media case and the government’s appeal, there are a few important factors for consideration and reasonably drawn conclusions.

The IRS included new and modified reporting requirements in its [draft 2023 Form 1065 Schedule K-1](#), released on June 14, 2023, including:

- A modified reporting requirement concerning decreases in a partner’s percentage share of the partnership’s profit, loss and capital, and

- A new reporting requirement relating to partnership debt subject to guarantees or other payment obligations of a partner.

DECREASES IN A PARTNER'S SHARE OF PARTNERSHIP PROFIT, LOSS AND CAPITAL

The modification to the Schedule K-1 reporting reflected on the draft 2023 Schedule K-1 concerns certain decreases in a partner's percentage share of the partnership's profit, loss and capital from the beginning of the partnership's tax year to the end of the tax year.

Reporting a partner's percentage share of the partnership's profit, loss and capital at the beginning and the end of the tax year is not a new requirement. Prior versions of the Schedule K-1 require the partnership to check a box indicating if a decrease in a partner's percentage share of profit, loss and capital from the beginning of the tax year to the end of the tax year is due to a sale or exchange of partnership interests. The draft 2023 Schedule K-1 refines this reporting by distinguishing, in Part II, Item J, between decreases due to sales of partnership interests and decreases due to exchanges. Partnerships must check one box if a decrease in a partner's percentage share of profit, loss and capital from the beginning to the end of the partnership tax year is due to a sale of partnership interests and a separate box if the decrease is due to an exchange of partnership interests.

While it is unclear why the IRS distinguishes a sale from an exchange in this context, in the absence of clarifying instructions to the 2023 Form 1065, an exchange of partnership interests should be interpreted broadly to encompass any non-sale transfers of partnership interests, whether taxable or not, including by gift, a redemption or otherwise.

PARTNERSHIP DEBT SUBJECT TO GUARANTEES OR OTHER PAYMENT OBLIGATIONS OF A PARTNER

The new reporting requirement reflected on the draft 2023 Schedule K-1 underscores the importance of properly classifying partnership liabilities as recourse or nonrecourse under the Section 752 rules. The draft 2023 Schedule K-1, in Part II, Item K3, requires the partnership to check a box if a partner's share of any partnership indebtedness (also reported on the Schedule K-1) is subject to guarantees or other payment obligations by the partner.

The existence of a guarantee or other partner payment obligation is relevant in determining whether a partnership liability is considered recourse or nonrecourse under the rules of Section 752. Regulations state that a partnership liability is a recourse liability to the extent that any partner or related person bears an economic risk of loss with respect to the obligation. A partner that has an obligation to make a net payment to a creditor or other person with respect to a partnership liability upon a constructive liquidation of the partnership, including pursuant to a deficit restoration obligation (DRO) in the partnership agreement, is considered to bear the economic risk of loss of that partnership liability. A partner's payment obligation with respect to partnership debt may arise pursuant to any contractual guarantees, indemnifications, reimbursement agreements or other obligations running directly to creditors, to other partners or to the partnership.

The existence of a debt guarantee or other payment obligation by the partner with respect to a partnership liability may indicate that the partner bears some or all of the economic risk of loss for such liability, which is a key factor in classifying a partnership liability as recourse or nonrecourse under the rules of Section 752.



EVALUATE BEFORE YEAR END EXPIRATION OF PARTNERSHIP BOTTOM-DOLLAR GUARANTEE TRANSITION RULES

The transition period for “bottom-dollar” guarantees ended on October 4, 2023, and in some cases partners that were relying on bottom-dollar guarantees for partnership tax basis would have needed to have new arrangements in place by that time if they intended to preserve tax basis associated with a bottom-dollar guarantee. However, partners in some partnerships may have until the end of the partnership tax year to set up new arrangements.

BOTTOM-DOLLAR GUARANTEES & TRANSITION PERIOD

A bottom-dollar guarantee is a guarantee by a partner of an amount of partnership debt, where the partner pays only if the creditor collects less than the full amount of the debt from the partnership. Further, in a bottom-dollar guarantee, even if the creditor does not collect the full amount of the debt, the bottom-dollar guarantor pays nothing provided the creditor collects at least the amount of the bottom-dollar payment obligation. For example, a lender loans ABC partnership \$100 secured by land and partner A guarantees the bottom \$10 of the loan. If the lender can only recover \$11 of the \$100 loan, then Partner A has no obligation on the guarantee. However, if the lender can only recover \$6 of the \$100 loan, then Partner A would be liable for \$4 under the guarantee (\$10 bottom guarantee less \$6 recovered).

Regulations under Section 752 issued in 2019 curtailed the use of bottom-dollar payment obligations to establish economic risk of loss for a guarantor to be allocated recourse liabilities on partnership debt incurred after October 5, 2016, unless special transition rules applied. The transition rules in the 2019 regulations allowed taxpayers to continue using bottom-dollar guarantees for debt existing on October 5, 2016, to the extent the basis associated with the allocation of liabilities in connection with the bottom-dollar guarantee under the old rules protected a negative capital account prior to that date.

The transition rules were effective for only a seven-year period that ends on October 4, 2023.

TAX IMPLICATIONS OF TRANSITION PERIOD ENDING

Upon expiration of the seven-year transition period on October 4, 2023, any debt supported by a bottom-dollar guarantee during the transition period will no longer be adequate to support the allocation of the debt to the guarantor and the liability must be reallocated among the partners based on the rules of Section 752. If debt allocations change due to the expiration of the transition period, a partner with a negative tax capital amount no longer supported by debt may recognize gain under Section 731.

Despite the final demise of bottom-dollar guarantees, other options may be available for partners to achieve desired tax results, such as using “vertical slice guarantees,” under which a partner guarantees a percentage of each dollar of debt, and intelligently managing non-recourse liability allocations.

PLANNING CONSIDERATIONS

Partnerships should review liability allocations to ensure that tax deferrals continue as planned. The transition period under the 2019 regulations ended October 4, 2023, but there may still be time to make arrangements to preserve tax basis before the end of the partnership tax year.

Partners are required to determine the adjusted basis of their interest in a partnership only when necessary for the determination of their tax liability or that of any other person. Otherwise, the determination of the adjusted basis of a partnership interest is ordinarily made as of the end of a partnership tax year. Therefore, if a partner is not otherwise required to determine the adjusted basis of his or her partnership interest in order to determine the partner’s own tax liability or that of any other person for the period between October 4, 2023, and the end of the partnership’s tax year, the partner may have until the end of the partnership’s tax year to set in place alternative arrangements.

Partnerships must disclose bottom-dollar guarantees on Form 8275 for tax years ending on or after October 5, 2016, in which the guarantee is undertaken or modified.



Global Employer Services

UTILIZING QUALIFIED RETIREMENT PLAN ENHANCEMENTS TO IMPROVE RECRUITMENT, RETENTION, AND EMPLOYEE SATISFACTION

The SECURE 2.0 ACT of 2020 introduced over 90 changes to the federal rules governing workplace retirement plans. Many of the changes introduced by SECURE 2.0 are beneficial to employees and up to the discretion of the plan sponsor. Adopting some of these employee-favorable provisions might reassure employees that they can access their savings if needed before retirement, leading to overall increased employee savings and increased employee satisfaction.

Further guidance on many of the new provisions is needed, but every employer, whether for-profit or tax-exempt, that currently maintains a qualified retirement plan or is considering a future plan should evaluate their compliance with mandatory provisions and the cost benefit of adopting some of the many employee-friendly optional provisions.

After the provisions to be adopted are narrowed down, any necessary operational changes that require systems or processes updates can be identified. Written amendments to the plan document to reflect the implemented changes are not required until the end of the plan year beginning in 2025. Government employers have until the end of their 2027 plan year to amend the plan document.

CHANGES EFFECTIVE DECEMBER 29, 2022

- SECURE 2.0 allows de minimis financial benefits, such as low-value gift cards, as incentives to encourage employees to elect to contribute to 401(k) and 403(b) plan. Prior to this change such incentives violated the IRS's "contingent benefit rule."
- Employers may allow plan participants to designate matching and nonelective contributions as Roth contributions.
- Plans or IRAs may allow affected participants additional access to retirement funds in the event of federally declared disasters that occur on or after January 26, 2021, by allowing penalty-free distributions up to \$22,000 per disaster to affected participants, while spreading the income tax liability over three years if not repaid prior to the taxable date. Plans can also allow increased participant loans of \$100,000 instead of the regular \$50,000 loan limit for disasters that occur on or after January 26, 2022.
- Plan sponsors can rely on employees' self-certification that the employee has experienced a deemed hardship for purposes of taking a hardship withdrawal.
- Cash balance plans with variable interest crediting rates may use a projected "reasonable" interest crediting rate that does

not exceed 6%, thereby allowing credits that increase benefits for older, longer-service workers without risking failing the anti-backloading rules that otherwise may create problems for cash balance plans.

- The act allows 403(b) plans to invest in Collective Investment Trusts (CITs) in addition to mutual funds and/or annuity contracts.
- Employers with 100 or fewer employees earning at least \$5,000 in annual compensation can receive a general tax credit of up to \$500 for three years, if they make military spouses (1) eligible for defined contribution plan participation within two months of hire; (2) upon plan eligibility, are eligible for any match or non-elective contribution that they would have been otherwise eligible for at two years of service; and (3) 100% vested in employer contributions. The credit is equal to \$200 per participating non-highly compensated military spouse, plus 100% of employer contributions made to the military spouse, up to \$300. The credit is available for the year the military spouse is hired and the two succeeding taxable years. Employers may rely on the employee's certification that they are an eligible military spouse.

- Small employers are eligible for a plan start-up credit, effective for taxable years beginning after December 31, 2022. The start-up credit for adopting a workplace retirement plan increases from 50% to 100% of administrative costs for small employers with up to 50 employees. The credit remains 50% for employers with 51-100 employees. Employers with a defined contribution plan may also receive an additional credit based on the amount of employer contributions of up to \$1,000 per employee. This additional credit phases out over five years for employers with 51-100 employees. The start-up credits are available for three years to employers that join an existing MEP, regardless of how long the plan has been in existence. The MEP rule is retroactively effective for taxable years beginning after December 31, 2019; therefore, plans that joined an MEP in 2020, 2021, or 2022 can file retroactively for this credit.
- SIMPLE and Simplified Employee Pensions (SEPs) can accept Roth contributions effective for taxable years beginning after December 31, 2022. In addition, employers can offer employees the ability to treat employee and employer SEP contributions as Roth contributions (in whole or in part).
- Employers of domestic employees (nannies, housekeepers, etc.) can provide retirement benefits for those employees under a SEP.

CHANGES TAKING EFFECT IN 2024

- Employers may treat an employee's qualified student loan payments as employee contributions to a 401(k) plan, 403(b) plan, governmental 457(b) plan, or SIMPLE IRA that is entitled to an employer matching contribution. For nondiscrimination testing of elective contributions, plans may separately test the employees who receive matching contributions on student loan repayments.
- Defined contribution plans may offer short-term emergency savings accounts to non-highly compensated employees. These accounts will be funded with employee after-tax Roth payroll deductions up to \$2,500 (indexed for inflation). Employers may automatically enroll employees into these accounts at no more than 3% of their salary. Contributions are eligible to receive matching contributions. Participants can make up to



one withdrawal per month. When employees terminate employment, they may take their emergency savings accounts as cash or roll them over into their new employer's Roth 401(k) plan (if any) or into a Roth IRA.

- Employers can retroactively amend a workplace retirement plan to increase participants' benefits for the prior plan year, so long as the amendment is adopted no later than the extended due date of the employer's federal income tax return for such prior year.
- The 10% penalty on early withdrawals before age 59 1/2 is waived for certain emergency expenses based on a participant's self-certification that they meet the necessary criteria.
- Employers that do not sponsor a workplace retirement plan may offer a new, safe harbor "starter" deferral-only plan that automatically enrolls employees at 3% to 15% of their compensation. The annual contribution limit is the same as for IRAs (\$6,500, with an additional \$1,000 for catch up contributions for employees who are age 50 or older. Starter plans are exempt from most nondiscrimination testing rules. This change is effective for plan years beginning after December 31, 2023.
- Employers may replace a SIMPLE IRA during the plan year with a SIMPLE 401(k) that requires mandatory employer contributions. Also, employers with SIMPLE plans may make additional employer contributions above the existing 2% of compensation or 3% of employee elective deferrals requirement. Additional employer contributions must be uniformly made and cannot exceed the lesser of 10% of compensation or \$5,000 (indexed for inflation). In addition, the annual deferral limit and the catch-up contribution at age 50 is increased by 10% in the case of an employer with no more than 25 employees. An employer with 26 to 100 employees would be permitted to provide higher deferral limits, but only if the employer either provides a 4% matching contribution or a 3% employer contribution.

CHANGES TAKING EFFECT IN 2025

- A provision designed to increase retirement savings will be effective for 401(k) and 403(b) plans adopted after December 29, 2022, requiring employees to be automatically enrolled for minimum elective deferral

contributions. However, participants can opt out of automatic enrollment or automatic escalation.

- Effective December 29, 2025, retirement plans can distribute up to \$2,500 per year to pay for certain long-term care insurance premiums. Such distributions are exempt from the 10% early withdrawal penalty that might otherwise apply.

QUALIFIED PLAN ERRORS? NOT A PROBLEM.

The IRS has green-lighted the immediate use of most – but not all – expanded self-corrections for compliance failures involving tax-qualified retirement plans. This guidance – set out in [IRS Notice 2023-43](#) – came out before an official update of the Employee Plans Compliance Resolution System (EPCRS).

IRS Notice 2023-43 set out a dozen questions and answers explaining what taxpayers can and cannot do until the IRS formally updates EPCRS. The notice provided taxpayers certainty and generally made self-correction easier and less expensive.

WHICH ERRORS CAN BE CORRECTED AND WHEN?

SECURE 2.0 gives plans and IRAs an indefinite period to correct all "eligible inadvertent failures." Previously, significant qualification failures had to be corrected within three years after the failure occurred, although insignificant errors generally could be corrected at any time.

Even plans under IRS examination can self-correct if the taxpayer can demonstrate actions that demonstrate a specific commitment to self-correct. Whether such actions have been taken depends on facts and circumstances, but generally include proof that the plan is actively pursuing correction of the failure. The notice states that the mere completion of an annual compliance audit or a general statement of intent to correct failures is not sufficient. This is a different standard than that provided in Rev. Proc. 2021-30, which is intended to eliminate arguments over who found the error first.

The notice requires that any self-correction be completed "within a reasonable period of time after the failure was identified." Correcting failures within 18 months after discovery is deemed to be reasonable, except for employer eligibility failures. Those failures must be corrected no later than six months after the failure was discovered, but only if

the employer stops all contributions to the plan as soon as practicable after discovering the failure.

Importantly, the notice confirms that qualification failures that happened before SECURE 2.0 was enacted on December 29, 2022, can be self-corrected under the expanded SECURE 2.0 relief. For corrections that were already made based on the expanded SECURE 2.0 relief from December 29, 2022 (the date SECURE 2.0 was enacted) through May 25, 2023 (the date the notice was released), the IRS will allow taxpayers to use a good faith, reasonable interpretation of the new SECURE 2.0 relief. Compliance with the notice is deemed to be reasonable, good faith compliance.

WHAT IS AN ELIGIBLE INADVERTENT FAILURE?

An eligible inadvertent failure is a plan operational, document, or demographic failure that violates the IRC qualification requirements. The failure occurred despite the plan having regular practices and procedures for plan oversight and administration that satisfy existing EPCRS standards. It does not include any failure that is egregious, diverts or misuses plan assets, or directly or indirectly relates to an abusive tax avoidance transaction.

The notice lists failures that cannot be self-corrected until the IRS updates EPCRS, including:

- Failure to initially adopt a written plan;
- Correcting an operational failure by plan amendment that conforms the plan document to the plan's prior operations in a manner that is less favorable for a participant or beneficiary than the original plan terms;
- Significant failures in a terminated plan;
- Certain demographic failures;
- Failures in orphan (abandoned) plans;
- Employee stock ownership plan (ESOP) failures involving IRC Section 409;
- Excess contributions to a SEP or SIMPLE IRA that allows the excess to remain in the plan; and
- Failures in SEPs or SIMPLE IRAs that do not use the IRS model plan documents and even for model plans when excess contributions remain in the IRA account.

The notice immediately eliminated certain long-standing EPCRS requirements for self-correcting eligible inadvertent failures:

- A favorable IRS approval letter is no longer needed to use EPCRS;



- Plan loan failures can now be self-corrected without an IRS filing; and
- Significant failures, if they were inadvertent, can be self-corrected at any time (instead of only within three years after the plan year in which the error occurred).
- A plan sponsor is not required to self-correct and may continue to submit VCP applications to the IRS even for failures that are eligible for self-correction.

IS A REORGANIZATION OR SHAREHOLDER BUYOUT ON THE HORIZON?

Shareholders should continue to recognize the usefulness of employee stock ownership plans (ESOPs) despite some issues noted in a recent IRS press release.

For decades, ESOPs have evolved into a well-regulated ownership transition tool that provides significant tax advantages to the selling business owner, the company sponsoring the ESOP, and its employees. For business owners, the Internal Revenue Code enables certain shareholders (depending on entity tax structure) the opportunity to defer capital gains associated with stock sold directly to the ESOP. Further, if a company is an S corporation with an ESOP trust owner, the ESOP trust will be allocated its pro rata share of income/loss as a shareholder. Because an ESOP trust is exempt from federal (and most state) income taxes, the ESOP does not pay taxes on that allocation. Thus, S corporations that are 100% owned by an ESOP trust operate with significant tax and cash flow advantages. Lastly, employees participate in the company's equity growth through a tax-deferred retirement vehicle, with no out-of-pocket cost to the employees.

Research continues to show that ESOPs improve retirement security and economic well-being. However, the IRS issued a press release on August 9, 2023, expressing concern that certain ESOP versions were being aggressively marketed that will not pass muster because they appear to shelter taxable income while not providing true, broad-based ownership to employees.

The IRS specifically expressed concern about situations where a business creates a "management" S corporation, 100% owned by an ESOP, that subsequently lends the owners of its lower-tier business affiliates (who were the original owners of the S corporation before

the ESOP owned 100% of the S corporation) a significant amount of the S corporation's business income. Under the arrangement, such loans are never intended to be repaid, thus transferring the S corporation's income to a few highly paid individuals. In turn, those uncollectable loans reduce the value of the S corporation stock held by the ESOP, because cash is lent out and potentially worthless loans remain.

In addition to the "management" S corporation ESOP scheme, the IRS identified three other ESOP issues that are part of its current enforcement and compliance efforts:

Improper Valuation of Employer Stock. The valuation of employer stock has been an issue for the ESOP industry for many years because the Employee Retirement Income Security Act of 1974, as amended (ERISA) requires that ESOPs pay no more than "adequate consideration" (i.e., fair market value) for employer stock. The SECURE 2.0 Act, which became law on December 29, 2022, directs the U.S. Department of Labor,



Employee Benefits Security Administration (EBSA) to provide guidance on the definition of “adequate consideration” for ESOPs. As a best practice, any company considering an ESOP should engage an independent trustee to act as an ERISA fiduciary with respect to the ESOP participants. This independent trustee should rely on a qualified independent appraiser, as defined under ERISA rules, to determine the fair market value of the stock being sold to the ESOP.

Prohibited Allocation of Shares to Disqualified Persons. Prohibited allocations of employer stock to disqualified persons is an issue arising from IRC Section 409(p), an anti-abuse provision enacted to promote broad-based ownership by rank-and-file employees. ESOP transactions should be properly screened by those qualified to assess IRC Section 409(p) allocation issues. When a selling shareholder, their family members, or a highly compensated management team seems likely to receive a disproportionate allocation of company equity in the ESOP, there may be a compliance issue that should be addressed on the front end before the allocation is made. Companies should do their diligence, in consultation with qualified, reputable advisors, so that prohibited allocations are avoided. This due diligence involves detailed compliance testing before any ESOP transaction and continued monitoring post-transaction.

Prohibited Transaction Rules for ESOP Loans. Under IRC Section 4975(c)(1)(B), prohibited transactions include any direct or indirect sale, exchange, lending of money or extension of credit, or various other transactions between a qualified plan and a “disqualified person” (a person with certain relationships to the plan). Due to the nature of an ESOP transaction and the parties involved, in the absence of an exception, an ESOP transaction would inherently be defined as a prohibited transaction.

However, there is a statutory prohibited transaction exemption for stock acquisition loans made to ESOPs under IRC Section 4975(d)(3), as long as the loan is (1) primarily for the benefit of the plan participants, (2) at a reasonable interest rate, and (3) any collateral given to the disqualified person selling the shares consists solely of qualifying employer securities. Further, ERISA Section 408(e) provides a separate statutory exemption relating to the acquisition or sale by the plan of qualifying

employer securities, provided that the acquisition or sale by the plan is (1) for adequate consideration (or for marketable securities, at a price no less favorable to the plan than the price determined under ERISA Section 407(e)(1)), (2) no commission is charged on the sale, and (3) the plan is an eligible account plan.

Planning

It is important for any company and business owner considering an ESOP structure to engage a qualified ESOP advisor with the experience necessary to navigate the complex regulatory and tax requirements associated with ESOP transactions. A prospective or current ESOP company that receives proper advice from qualified professionals throughout the plan implementation, transaction process, and the ongoing administration of the plan will benefit from the tax advantages ESOPs can provide.

Be Aware that the Deduction for Accrued Deferred Compensation Could be in Jeopardy

The U.S. Court of Appeals for the Seventh Circuit recently affirmed a 2022 Tax Court decision, concluding that an accrual basis partnership that sold substantially all its assets in 2012 cannot take an ordinary tax deduction in the same year for the net present value of a non-qualified deferred compensation (NQDC) liability that was assumed by the buyer, even when a deemed payment was made to the buyer through a price reduction. The seller calculated the net present value of the assumed NQDC liability to be \$10.7 million and included that amount in its reported capital gain from the sale of assets, in addition to deducting the \$10.7 million as an ordinary business expense to incentivize the buyer to assume the liability.

The case -- *Hoops, LP v. Commissioner*, 7th Cir. No. 22-2012 (Aug. 9, 2023) -- involved the sale of the Memphis Grizzlies NBA professional basketball team.

This case upsets what appears to be a common interpretation among deal advisors that a purchase price adjustment results in a deduction for the seller when the buyer assumes the seller’s NQDC liability as part of a sale of a business.

Taxpayer’s Argument

The seller viewed the \$10.7 million reduction in sales price as a deemed payment to the buyer as compensation for assuming the NQDC obligation. The seller argued that the deduction was for



the payment “from one company to another company for the second company to assume the first company’s liability” and was not an NQDC payment. As an expense of the sale, the \$10.7 million would be immediately deductible as an ordinary and necessary business expense under IRC Section 162(a) and Treas. Reg. §1.461-4(d)(5)(i) without the constraints of Section 404(a)(5), which governs deductions of NQDC.

The seller also urged the court to take a practical approach that allowed the 2012 deduction considering it might not ever be able to claim the deduction under the Section 404(a)(5) NQDC rules if the buyer failed to pay the benefits to the employees or if the seller no longer existed when the payment was made.

Lastly, if a deduction was not allowed upon closing, seller requested that its capital gain be reduced by the \$10.7 million sales price reduction.

IRS’s and Court’s View

Notwithstanding the fact that Treas. Reg. §1.461-4(d)(5)(i) sometimes accelerates a deduction in connection with the sale of a taxpayer’s trade or business, it does not apply when a more specific provision of the law dictates the tax treatment of the transaction. See Treas. Reg. §1.461-1(a)(2)(i).

The Tax Court noted that Section 461 and its related regulations direct accrual method taxpayers to look first to other relevant Code sections before applying Section 461’s timing provisions. Section 404(a)(5) provides that an accrual basis taxpayer (such as the seller) can deduct deferred

compensation only in the tax year when it pays the employees or contributes to certain tax-qualified retirement plans. Because the seller did neither but provided cash through the purchase price adjustment to the buyer to pay the future compensation, the seller’s deduction was untimely.

The IRS, the Tax Court, and the Seventh Circuit all disagreed with the seller’s position that the cash concession to the buyer should not be governed by the NQDC rules, noting that if the sale had never happened, Section 404(a)(5) would have prevented the seller from claiming the deduction in 2012 because no payments had been made to a qualified retirement plan or to the employees. The Seventh Circuit noted that “[i]n this way, Section 404(a)(5) creates what we might call a ‘matching rule’ between employer and employee, where Congress intended for employers to deduct deferred compensation expenses and employees to report income in the same tax year.”

That determination was based on interpreting the Tax Code to require that explicit statutory provisions – i.e., Section 404(a)(5)’s “specific regulation of non-qualified deferred compensation plans must prevail over [Treas. Reg. Section] 1.461-4(d)(5)(i)’s broader treatment of assumed liabilities in connection with the sale of businesses more generally.” The Seventh Circuit noted that the liability assumed by the buyer wasn’t just any liability, but rather was “a liability for deferred compensation based on services already rendered” by two employees in prior years. Thus, the detailed rule of Section 404(a)(5) applies to that liability.

In other words, the court concluded, "Section 404(a)(5) leaves us with a firm conviction of Congress's intent to treat the deductibility of deferred-compensation salary plans differently from ordinary service expenses – and that this special treatment prevails over any general provisions otherwise applicable to liabilities assumed in asset sales."

The Tax Court reached a similar conclusion in *Jacobs v. Commissioner*, 45 T.C. 133, 134-35 (1965), finding that the nature of the underlying obligation survives the sale transaction. Therefore, Section 404(a)(5) continues to apply to the \$10.7 million and provides a clear rule that bars the seller from claiming a 2012 deduction because the seller did not pay the employees the NQDC during that year.

In the *Hoops* case, Section 404(a)(5) precludes deducting the deferred compensation liabilities until the time payment is made to the employees.

Additionally, Treas. Reg. §1.461-4(d)(5)(i) only accelerates a deduction to which the taxpayer would have been entitled "but for the economic performance requirement." Here, economic performance was not the requirement that prevented *Hoops* from claiming a deduction in the year of sale, but rather it was the Section 404(a)(5) requirements.

The court also rejected taxpayer's request that a practical approach be taken and noted that "parties can and do account for tax risk as an economic matter by negotiating contractual provisions to minimize and compensate for such financial contingencies."

Finally, the court did not think it appropriate to reduce the sales proceeds by \$10.7 million when calculating the capital gain from the sale of assets because of the buyer's assumption of liability in that amount.

The case illustrates the notion that when both Section 404(a)(5) and Section 461 apply to a set of facts to determine the deduction timing rules, Section 404(a)(5) must be applied first. Even if the seller's future obligation is "settled" upon closing by a payment to the buyer or a sales price reduction, that payment does not satisfy the Section 404(a)(5) requirements for deductibility until the amounts are paid to or are reportable by the employees. As the *Hoops* case shows, the commonly used purchase price adjustment does not work to accelerate the deduction for NQDC to

the date of closing.

Often a seller like *Hoops* that has sold substantially all its assets ceases to exist soon after the transaction, and therefore has no opportunity to benefit from the future tax deduction created by payment to the employees. Thus, the deferred compensation deduction may simply be lost because of the deal, because the seller may never realize the deferred compensation deduction at all and the buyer is not entitled to the deduction because only the service recipient is entitled to the compensation deduction, and not by virtue of paying a liability assumed from the seller.

While the income tax deduction would be cleaned up by having the seller pay its compensation liability before the asset sale, complicated rules under Section 409A that govern deferred compensation arrangements prohibited the acceleration of agreed upon NQDC payments except in limited circumstances. Violations of Section 409A could trigger excise tax of 20% plus additional interest imposed on the employees (who, in turn, typically would sue the employer).

If the seller cannot pay its compensation liability without violating Section 409A before the asset sale and take the deduction, then the buyer, who cannot benefit from the deduction, when payment is made in the future might decrease the offered purchase price.

Protect Against Late Filing Fees by Preparing for Upcoming Expanded Electronic Filing Requirement for 2023 Tax and Information Returns

The IRS finalized regulations in 2023 significantly expanding mandatory electronic filing of tax and information returns that require almost all returns filed on or after January 1, 2024, to be submitted to the IRS electronically instead of on paper.

Under the new rules, filers of 10 or more returns of any type for a calendar year generally will need to file electronically with the IRS. Previously, electronic filing was required if the filing was more than 250 returns of the same type for a calendar year. The new rules broadly apply to all types of returns, but the most urgent are common workplace IRS information forms, such as Form W-2 and 1099 filings, and employee benefit plan filings that are due early in 2024.

For many employers, simply doing the "same as last year" will not work.

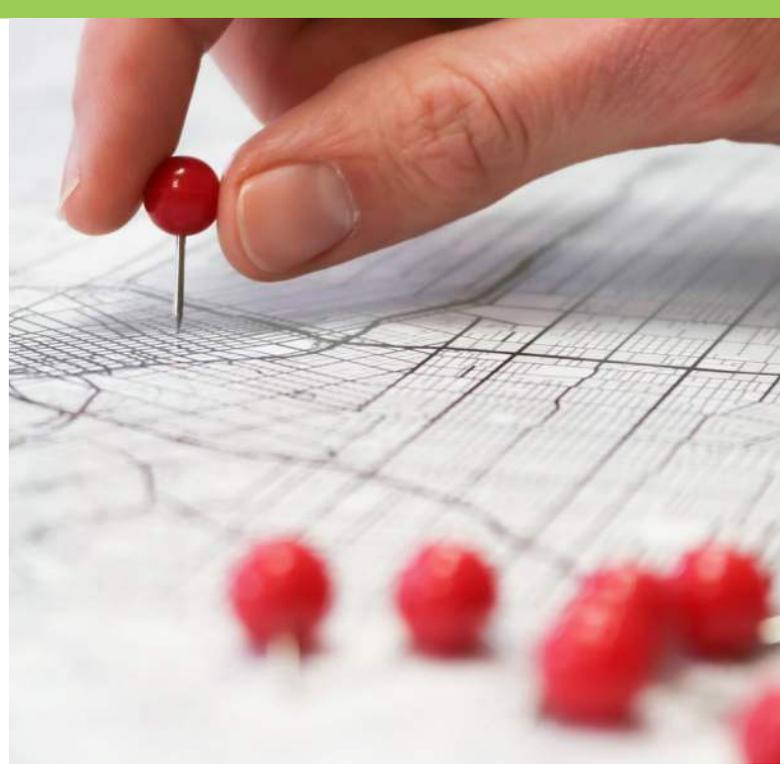
Who is affected? Practically all filers with the IRS of 10 or more information returns when counting any type, such as Forms W-2, Forms 1099, Affordable Care Act Forms 1094 and 1095, and Form 3921 (for incentive stock options) and other disclosure documents are impacted by this change this year – that is, for 2023 returns that will be filed in 2024. Even workplace retirement plans may need to file Form 1099-Rs (for benefit payments) and other forms electronically with the IRS starting in 2024, for the 2023 plan or calendar year.

Which returns are affected? In addition to information returns, the new rules cover a broad variety of returns, including partnership returns, corporate income tax returns, unrelated business income tax returns, withholding tax returns for U.S.-source income of foreign persons, registration statements, disclosure statements, notifications, actuarial reports and certain excise tax returns.

How to count to 10? A significant change introduced by the new regulations is that the 10-return threshold for mandatory electronic filing is determined on the aggregate number of different types of forms and returns. The aggregation rules are confusing because the filings included in the count change depending on which form the determination is made. Also, some filers must be aggregated with all entities within its controlled or affiliated service group to determine if 10 or more returns are being filed for the tax year. For instance, Form 5500 employee benefit plan filers (but not Form 8955-SSA employee benefit plan filers) must count the filings of the employer who is the “plan sponsor” and other entities in the employer’s controlled and affiliated service group.

What can taxpayers do? Any payers that currently file any returns on paper should consult with their tax advisor to determine if the new electronic filing requirements apply to them based on the number of returns they anticipate filing in 2024 for tax year 2023.

For the first time, filers must pay particular attention to the total number of returns across all return types, because the new electronic filing threshold is determined based on the aggregate total, not the number of returns per return type. This might require coordination between different departments within an organization and immediate consultation with the IT department and/or



software provider to ensure there is adequate time to implement technology solutions or software upgrades before the 2024 filing deadline.

The IRS’s new -- and free -- online portal for filing these returns electronically, Information Returns Intake System (IRIS), is especially helpful for small filers dealing with electronic filing for the first time. According to the IRS, IRIS is secure, accurate, and does not require any special software. This free service is available to filers of any size.

Forms 1094, 1095, 1099, and 5498. Forms 1094 and 1095 series (Affordable Care Act coverage reporting), Form 1099 series (including 1099-R for retirement plan benefit payments) and Form 5498 Series (for IRA contributions) required to be filed after December 31, 2023, must be filed electronically if the filer is required to file 10 or more “specified information returns” during the calendar year that includes the first day of the plan year.

Counting Rules for Each Form. When determining whether a filer for a retirement plan’s Forms 1099-R must file those forms electronically, the filer would count only its “specified information returns” (like Forms W-2, 1099 series, 1094 series, and 1095 series). The requirement to include filings by entities in the sponsor’s controlled or affiliated group applies only to electronic filing of the plan’s Form 5500.

What about corrected returns? Generally, if an original return is required to be filed electronically, any corrected return corresponding to that

original return must also be filed electronically. If an original return is permitted to be filed on paper and is filed on paper, any corrected return corresponding to that original return must be filed on paper.

Are there any waivers or exemptions? Filers that are required to file fewer than 10 returns during the calendar year when counting all types may use IRS paper forms, but only if the paper form is machine-readable.

In cases of undue hardship, the IRS may waive the mandatory electronic filing requirement. The main factor in determining hardship is the amount, if any, by which the cost of electronic filing exceeds the cost of paper filing. Religious waivers will also be considered. Waiver requests must be made in accordance with applicable IRS revenue procedures and must specify the type of filing and the period to which it applies. Electronic filing is also generally waived if the IRS's system does not support it for a particular form or situation.

What are the penalties for noncompliance?

A failure to file in the required manner (for example, electronically or on machine-readable paper forms) is considered a failure to file. The penalties differ based on the type of return. For information returns, such as Forms W-2 and Form 1099 series, the penalty under Internal Revenue Code Section 6721 would apply, which is up to \$310 per information return (for 2023 information returns required to be filed in 2024) with an annual maximum penalty of \$3,783,000 (\$1,891,500 for small businesses with annual gross receipts of no more than \$5 million). Penalty amounts are indexed and change annually.

Update Remote Work Policies to Balance Current Employee Demand & Risk Environment

Many employees now expect the flexibility allowed during the COVID-19 pandemic to continue. Given the high demand for talent and the need to remain competitive, businesses may be willing to stretch historical policies to attract and retain resources. Setting precedent with policy exceptions not fully vetted can quickly create issues that are not only difficult to correct but can also be costly for the company and employee.

Allowing even one employee to work remotely for a short period of time can come with a high price tag, including the need to perform a permanent

establishment (PE) review to determine if corporate nexus is established by having an employee in their desired location. If a PE is established, the requirements likely waterfall into registration, reporting of compensation, and tax withholding/remittance issues.

The exceptions that were made under the COVID emergency with the expectation that they would be temporary should be thoroughly reevaluated now before being permanently adopted. Guidelines should be put in place to help the organization understand potential obligations prior to approving employees' requests to change their work location to, for example, work from their personal residence or from a remote location different from the employer's geographic location.

The risks and complexities that come with remote work arrangements aren't new, but the monetary cost is magnified due to the number of employees taking advantage of this flexibility. Tax authorities are under pressure to find revenue, and remote workers provide an opportunity to identify potential tax exposures.

Operating under the radar is not a prudent approach for businesses. A proactive approach that develops a remote worker policy that mitigates risk and aligns with overall business objectives is advised.

How to Create a Remote Worker Policy

Step 1: Build a team and identify the stakeholders.

The first step in developing a remote worker policy is to identify all parties that will need to be involved. This includes key leadership, who will need to buy into the policy and understand the complexities and potential exposures. It also includes those who will develop the plan and be knowledgeable to address and own several facets of mobility -- human resources, information technology/security, legal, and tax departments.

Step 2: Define the objectives and parameters of the policy.

After the team is developed, the next step is to bring everyone together and brainstorm ideas of what they want to accomplish, keeping in mind the importance of in-person work to develop relationships and a culture including tight-knit teams balanced by the benefit of removing the geographic limitation on your eligible candidate pool.

The wish list will likely need to be narrowed to create a framework for the policy because not everything can be accomplished. While it's possible to have more than one policy for different employee populations, it's important that there be only one version to avoid the company being called to task for internal inequities. This policy will need to evolve to meet the changing needs of the organization and its workforce.

Step 3: Develop a method to collect data.

The key to successfully managing the risks of a remote workforce is to identify and track where employees are working. There are a few ways to accomplish this, including surveys that ask employees to self-report, time sheets to match time worked with location, software to track employee travel, and IP tracing on company-issued laptops and equipment (which may have privacy implications that should be reviewed by the legal department).

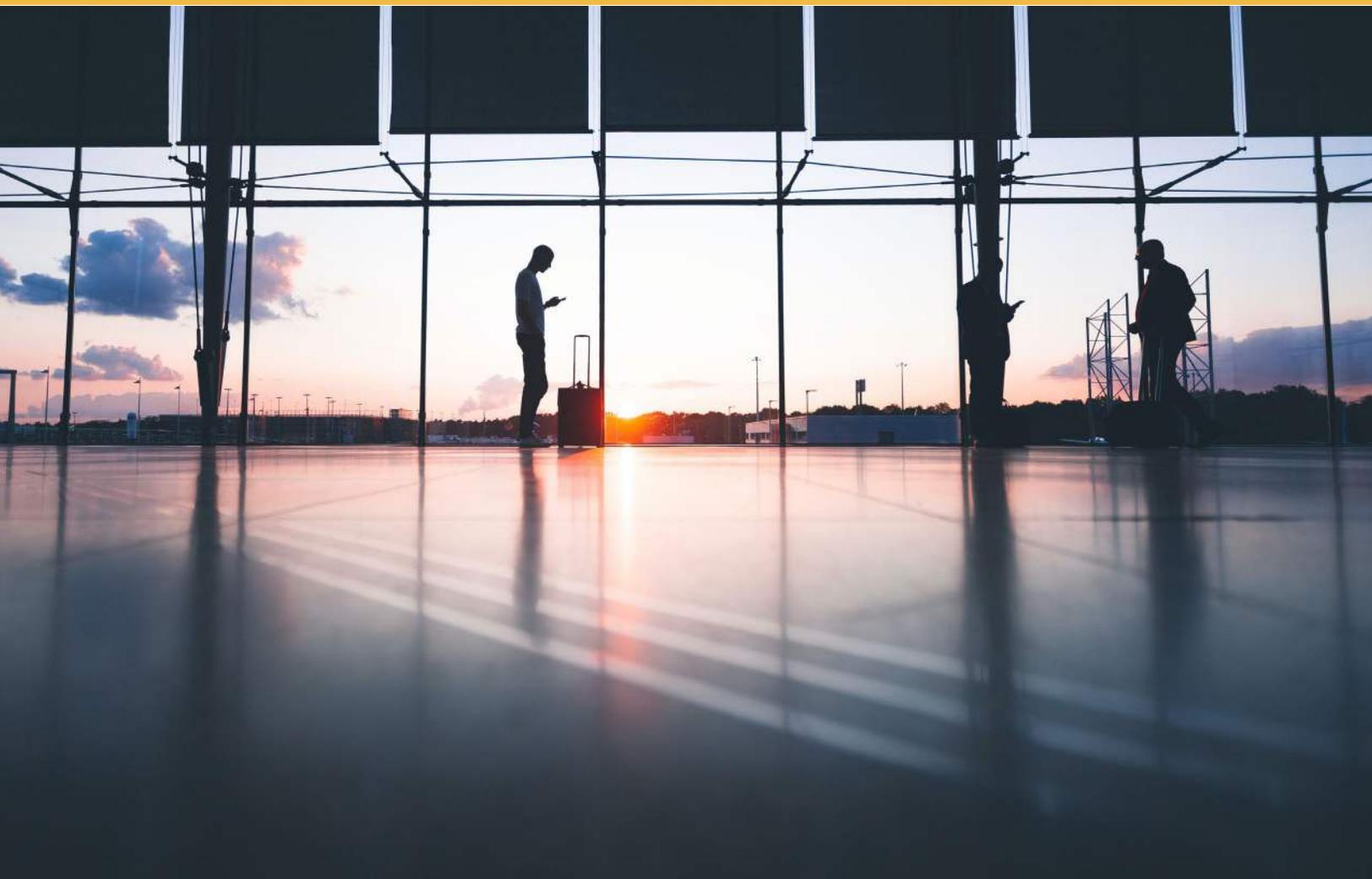
Step 4: Communicate, implement, and refine

The final step is implementation. Employee education and communication is key. Businesses

need to make clear to employees why the policy is important. Down the road this can help employees understand their role in ensuring compliance and why a request may be denied. HR and company leadership will be integral to change management.

Once the policy is put in place, it becomes the employees' responsibility to follow it, so determining when to make this obligation an employee responsibility is important. Has everyone been made aware? Have they been given an opportunity to ask questions? Is there a system in place for employees to acknowledge that they received and understand the policy?

While remote work can be a great benefit for employees, businesses should consider the cost of remaining compliant with obligations created by remote working arrangements. When new employee requests are received, the approval process must be streamlined and concrete. Making adjustments retroactively can expose an organization to unnecessary costs and penalties. Lastly, businesses should have a check-in process to review performance and make sure the policy continues to align with the organization's direction.



Business Incentives & Tax Credits

EMPLOYEE RETENTION CREDIT

The employee retention credit (ERC) is a refundable payroll tax credit for wages and health plan expenses paid or incurred by an employer (1) whose operations were either fully or partially suspended due to a COVID-19-related governmental order; or (2) that experienced a significant decline in gross receipts during the COVID-19 pandemic. The ERC has arguably been one of the most valuable provisions originating under the Coronavirus Aid, Relief, and Economic Security Act — the CARES Act — offering significant payroll tax relief for employers who kept employees on their payroll and continued providing health benefits during the COVID-19 pandemic.

Eligible employers can file a claim retroactively until the statute of limitations closes on April 15, 2024, for the 2020 ERC and April 15, 2025, for the 2021 ERC. Note that the U.S. government has repeatedly revised the requirements for U.S. taxpayers to claim the ERC since its initial codification into law. As a result, many eligible taxpayers have been uncertain as to whether they may properly claim this often-valuable tax credit.

Employers should be certain that one of the two paths for eligibility is satisfied:

- Gross receipts in a calendar quarter were less than 80% of the gross receipts for the corresponding quarter in 2019; or
- Business operations were fully or partially suspended during the calendar quarter because of orders from a governmental authority due to COVID-19.

Most eligibility disputes involve the partial suspension test. While most businesses were adversely impacted by COVID-19 related to government actions, not all are eligible for ERC under this provision. To be eligible under the partial suspension test, the suspension must have been material.

Identifying the relevant government orders is another common issue. Qualifying orders must have been mandatory, in effect, and must have caused a suspension of operations for the entire period during which the employer paid the wages supporting the ERC claim.

Also, because the ERC was intended to benefit small businesses, requirements exist that all businesses under common owners be aggregated into a single employer. This rule prevents large businesses from splitting into many entities to qualify. The same aggregation rule used to determine the size of an employer is applied to determine whether the employer experienced a partial suspension that was more than nominal.

In response to mounting concerns over a surge in improper claims for the ERC, on September 14, 2023, the IRS announced an immediate moratorium on processing new claims for the pandemic-era relief program. The moratorium, effective until at least the end of the year, aims to protect businesses from scams and predatory tactics. While the IRS continues to process previously filed ERC claims received before the moratorium, the agency warns that increased fraud concerns will result in longer processing times.

However, the pause on processing new claims does not modify the statute of limitations that expires on April 15, 2024, for wages paid in 2020. Therefore, an employer considering a new request for a legitimate ERC claim should proceed after



carefully reviewing Information Releases 2023-169 and 2023-170, which the IRS released on September 14, 2023. For employers who would like to make a change to a pending claim that has not been processed or paid, the IRS is expected to issue guidance in the near future.

The IRS has also intensified its focus on reviewing ERC claims for compliance concerns, including conducting audits and criminal investigations on promoters and businesses submitting dubious claims. Hundreds of criminal cases are currently under investigation, and thousands of ERC claims have been referred for audit. Those with pending claims should expect extended processing times, while those yet to file should review the guidelines and consult trusted tax professionals.

As the IRS continues to refine its efforts to assist businesses facing questionable ERC claims, it advises businesses to carefully consider their situation and explore the options available to them. The IRS reminds anyone who improperly claims the ERC that they must pay it back, possibly with penalties and interest.

The IRS has stated that it will develop an ERC settlement program in late 2023 for employers that already received an ERC payment based on a claim now believed by the employer to be overstated. Under the settlement program, employers will be able repay the excess ERC amounts while avoiding penalties and other future compliance actions.

Additionally, to assist businesses affected by aggressive promoters, the IRS is developing a special withdrawal option for businesses that have filed an ERC claim but have not yet had it processed. Details of this program are expected to be announced in the coming months.

Given the increased IRS scrutiny of ERC claims, employers should reevaluate their ERC positions regarding eligibility and the amount of the claim. The IRS recommends that taxpayers seek advice from a trusted tax advisor.

Employers that have already filed a claim not prepared by a trusted tax advisor should verify whether any of the red flags or other concerns listed in the two IRS Information Releases apply to their situation. If they do, they should have any already submitted claim reviewed by a trusted tax professional. If the review does not support the claim as it was filed, corrective action should be pursued.

CREDIT FOR INCREASING RESEARCH ACTIVITIES: PROPOSED CHANGES TO FORM 6765 AND EXAM ENVIRONMENT

The IRS on September 15, 2023, released a preview of proposed changes to Form 6765, Credit for Increasing Research Activities, which taxpayers use to claim the research credit. The proposed changes, likely to become effective at the beginning of the 2024 tax year, include a new Section E with five questions seeking miscellaneous information and a new Section F for reporting quantitative and qualitative information for each business component, required under Section 41 of the Internal Revenue Code.

The IRS has also requested feedback on whether Section F should be optional for some taxpayers, including those with qualified research expenditures that are less than a specific dollar amount at a controlled group level; with a research credit that is less than a specific dollar amount at a controlled group level; or that are Qualified Small Businesses for payroll tax credit purposes.

It is important to note that if Section F were made optional for certain taxpayers, it would not exempt them from the requirement to maintain books and records or provide Section F information in a similar format, if requested; and it would not apply to amended returns for the research credit.

Examination Environment

Currently, the IRS receives a significant number of returns claiming the research credit, which requires substantial examination resources from both taxpayers and the IRS. To ensure effective tax administration for this issue, the IRS aims to clarify the requirements for claiming the research credit by considering all feedback received from stakeholders before finalizing any changes to Form 6765.

In response to ongoing concerns of improper claims of the research credit, the IRS has intensified its focus on reviewing these claims for nonconformities, including conducting a greater number of audits. Navigating the complexities of the research credit can be challenging, especially with the increased scrutiny, advancement of recent case law, and the newly implemented IRS compliance measures in place.

It is important for taxpayers to accurately determine eligibility, validate and properly record contemporaneous documentation to support

research credit claims, and defend against examinations. Taxpayers should work with a trusted tax advisor to support compliance with IRS regulations and proper eligibility for the research credit.

TAX CREDIT MONETIZATION

The signing of the Inflation Reduction Act on August 16, 2022, marked the largest-ever U.S. investment to combat climate change, allocating \$369 billion to energy security and clean energy programs over the next 10 years, including provisions incentivizing the manufacturing of clean energy equipment and the development of renewable energy generation.

Overall, the act modifies many of the current energy-related tax credits and introduces significant new credits and structures intended to facilitate long-term investment in the renewables industry. Capital investments in renewable energy or energy storage, manufacturing of solar, wind, and battery components, and the production and sale or use of renewable energy are activities that could trigger one of the over 20 new or expanded IRA tax credits. The IRA also introduced new ways to monetize tax credits and additional bonus credit amounts for projects meeting prevailing wage and apprenticeship, energy community, and domestic content requirements.

45X – ADVANCED MANUFACTURING PRODUCTION TAX CREDIT

The 45X Advanced Manufacturing Production Credit is a new production tax credit meant to encourage the production and sale of energy components within the U.S., specifically related to solar, wind, batteries, and critical mineral components. To be eligible for the credit, components must be produced in the U.S. or a U.S. possession and sold by the manufacturer to unrelated parties.

The Department of Energy has released a full list of eligible components as defined by the IRA, with specific credit amounts that vary according to the component. Manufacturers can also monetize 45X credits through a direct payment from the IRS for the first five years under Internal Revenue Code Section 6417. They may also transfer a portion or all of the credit to another taxpayer through the direct transfer system Section 6418 election. The 45X credit is a statutory credit with no limit on the amount of funding available; however, the

credit will begin to phase out in 2030 and will be completely phased out after 2033. Manufacturers cannot claim 45X credits for any facility that has claimed a 48C credit.

48C – QUALIFYING ADVANCED ENERGY PROJECT TAX CREDIT

In 2009, Congress enacted the America Recovery and Reinvestment Act, which included the 48C tax credit for qualifying advanced energy project investments. This credit initially applied to investment in facilities that produced various renewable energy assets and other property that reduced greenhouse gas emissions.

The Inflation Reduction Act provided new funding for the 48C credit and expanded the definition of qualified advanced energy projects to include facilities that produce components used in carbon capture, utilization and storage, energy grid modernization, renewable fuel generation and refinement, components of electric vehicles, and recycling facilities for eligible components. Manufacturers investing to construct, re-equip, or expand a facility that meets the definition of a qualified advanced energy project can apply for an allocation of the 48C credit.

The IRS and Department of Energy will award \$10 billion in 48C credits via a two-step application process, with \$4 billion reserved for projects located in energy communities. The base amount of the 48C credit is 6%, but the total credit can be as high as 30% if applicants meet prevailing wage and apprenticeship requirements. Recipients can claim 48C credits on federal corporate income taxes for a percentage of eligible investment costs placed into service during the current tax year. Corporations or flow-through entity shareholders who lack the ability to utilize the credits may sell them for cash under the new IRA credit transfer provisions.

Taxpayers applying for 48C allocation must submit an initial concept paper as well as a full application to be reviewed by the IRS and DOE. The first round of 48C allocation will award \$4 billion by March 31, 2024. While the current round's concept paper deadline has already passed, there will be additional rounds for the remaining \$6 billion of funding in 2024 and beyond.

6418 – TRANSFERABILITY

Under IRC Section 6418, certain renewable energy tax credits can now be transferred by companies



generating eligible credits to any qualified buyer seeking to purchase tax credits. Through credit transfers, taxpayers have the option to sell all or a portion of their credits in exchange for cash as part of their overall renewable energy goals if they are not able to fully utilize the benefit. Companies are able to purchase these credits at a discount, with the sale proceeds improving the economics of clean energy development.

The market rate for the sale of credits will be highly dependent on the type of credit being transferred, as well as the substantiation and documentation related to the seller's eligibility for the credit taken and any bonus credit amounts claimed. The current rates seen in the market for transferring credits is around \$.90 to \$.94 per \$1 of credit, but these amounts are subject to change based on specific fact patterns for each individual transaction and the overall market trend.

Taxpayers considering buying or selling tax credits that are transferable under the IRA should be looking ahead and forecasting their potential tax liability and resulting appetite for buying and selling credits. These credits can be transferred and utilized against estimated quarterly payments as soon as transfer agreements are finalized. This expedited reduction in cash outlay for the buyer and monetization of credits for the seller is a consideration that should be taken into account by taxpayers interested in entering the market of transferring credits. Note that taxpayers must be able to effectively utilize general business credits for this opportunity to be worthwhile.

BONUS CREDITS

The Inflation Reduction Act not only introduced new and expanded credits for investment in and production of renewable energy and its related components, it also included provisions for bonus credit amounts subject to meeting specific requirements. The prevailing wage and apprenticeship requirement is a 5x multiplier for certain credits that can bring the credit rate from 6% to 30% by paying prevailing wages to all labor related to the construction, installation, alteration, and repair of eligible property. Additionally, taxpayers must ensure that a certain percentage of these labor hours are performed by a qualified apprentice. Other common credit adders available for taxpayers that meet energy community and domestic content requirements provide a 10% adder to the base rate of the credit. Taxpayer documentation will be required to substantiate the claim of these bonus credit amounts and will need to be presented to a buyer in the event that these credits are transferred under 6418.

Taxpayers that have current or planned investments or activities for which they plan to utilize the prevailing wage and apprenticeship multiplier should be planning a documentation strategy and procedure. In the event of an IRS audit or transfer of these credits, taxpayers will be required to substantiate the wages paid to laborers as well as the number of hours performed by registered apprentices. Depending on the size and amount of labor involved in qualified investments or

production, documentation for PWA as well as the domestic content requirements will likely be a highly burdensome task if not planned accordingly at the outset of a project.

NEW MARKETS TAX CREDITS

The U.S. Treasury's CDFI Fund recently released its annual allocation of New Markets Tax Credits (NMTCs). The federal New Markets Tax Credit (NMTC) program was established in 2000 to subsidize capital investments in eligible low-income census tracts. The subsidy provides upfront cash in the form of NMTC-subsidized loans fixed at below-market interest (2.5-3.5%). The loan principal is generally forgiven after a seven-year term resulting in a permanent cash benefit. Funding for these subsidized loans is highly competitive and expected to be depleted quickly.

Taxpayers across many industries can be good candidates to participate in the NMTC program.

Recipients are evaluated based on the community impact derived from the investments (e.g., job creation, community services provided, etc.). Ideal projects have at least \$7 million in capital expenditure. These initial questions will help interested parties assess if a project is viable for NMTC.

- Address of proposed project
- High-level project description
- Status of construction/timeline of CAPEX (midstream projects are permitted)
- Estimate of direct jobs to be created by project (within 3 years of PIS)

Taxpayers with ongoing or planned capital investments for late 2023 or early 2024 that are eligible to receive NMTC financing should begin reaching out to community development entities. The latest round of allocation was announced on September 22, and early outreach provides qualified active low-income community businesses a strong advantage in securing this financing due to the program's competitive nature and limited funds.

A taxpayer's tax accounting methods determine when income is recognized and costs are deducted for income tax purposes. Strategically adopting or changing tax accounting methods can provide



Tax Accounting Methods

opportunities to drive tax savings and increase cash flow. However, the rules covering the ability to use or change certain accounting methods are often complex, and the procedures for changing methods depend on the mechanism for receiving IRS consent — that is, whether the change is automatic or non-automatic. Many method changes require an application be filed with the IRS prior to the end of the year for which the change is requested.

Among others, taxpayers should consider the following tax accounting method implications and potential changes for 2023 and 2024, which are further discussed below.

Items taxpayers should review by year end:

- Be mindful of the December 31st deadline for non-automatic method changes
- Verify eligibility to use small business taxpayer

- exceptions and evaluate method implications
- Year-end clean-up Items: accelerate common deductions/losses, if appropriate
- Revisit the de minimis book safe harbor for write-offs of tangible property
- Consider methods implications of potential M&A transactions

Items to review in early months of 2024:

- Review latest specified research and experimental expenditures guidance (Section 174) and evaluate implications on 2023 tax year
- Review opportunities for immediate deduction of fixed assets
- Consider the UNICAP historic absorption ratio election
- Review leasing transactions for compliance with tax rules
- Evaluate accounting method changes for controlled foreign corporations

ITEMS TAXPAYERS SHOULD REVIEW BY YEAR END: *Be mindful of the December 31st Deadline for Non-automatic Method Changes*

Although the IRS has continued to increase the types of accounting method changes that can be made under the automatic change procedures, some common method changes must still be filed under the non-automatic change procedures. Importantly, a calendar year-end taxpayer that has identified a non-automatic accounting method change that it needs or desires to make effective for the 2023 tax year must file the application on Form 3115 during 2023 (i.e., the year of change). (Technically, a taxpayer with a 12/31/23 year end has until Tuesday, January 2, 2024, to file because December 31 is a Sunday and Monday is the holiday observance of New Year's Day, therefore, Tuesday is the next business day after the due date).

Among the method changes that must be filed under the non-automatic change procedures are many changes to correct an impermissible method of recognizing liabilities under an accrual method (for example, using a reserve-type accrual), and long-term contract changes. Additionally, taxpayers that do not qualify to use the automatic change procedures because they have made a change with respect to the same item within the past five



tax years will need to file under the non-automatic change procedures to request their method change.

Generally, more information needs to be provided on Form 3115 for a non-automatic accounting method change, and the complexity of the issue and the taxpayer's facts may increase the time needed to gather data and prepare the application. Taxpayers that wish to file non-automatic accounting method changes effective for 2023 should begin gathering the necessary information and prepare the application as soon as possible to avoid a last-minute rush.

Verify Eligibility to Use Small Business Taxpayer Exceptions and Evaluate Method Implications

A taxpayer that currently qualifies as a small business taxpayer for accounting method purposes is able to use small business taxpayer accounting methods – which include the overall cash method of accounting and other simplifying provisions, such as exemptions from:

- Section 471 inventory methods;
- Section 263A uniform capitalization (UNICAP) rules;
- The Section 460 requirements to use the percentage-of-completion method for certain long-term construction contracts; and
- The Section 163(j) limit on the deductibility of business interest expense.

Generally, a small business taxpayer is a taxpayer, other than a tax shelter under Section 448(d)(3), that meets the Section 448(c) gross receipts test for a given tax year. For a tax year beginning in 2023, a taxpayer meets the gross receipts test if it has average annual gross receipts for the three prior tax years (2022, 2021, 2020) of \$29,000,000 or less. In calculating the gross receipts test, a taxpayer must follow the guidelines for items to be included or excluded from gross receipts, and include the gross receipts of all applicable entities and predecessors under the aggregation rules.

Taxpayers must evaluate each year whether they qualify as a small business taxpayer by continuing to meet the gross receipts test. In addition, taxpayers should determine whether any M&A activities they have engaged in or anticipate undertaking will affect their small business taxpayer status. If so, the taxpayer should determine

for what year accounting method changes may be required, as well as whether it may be advantageous to make the method changes earlier than required.

Taxpayers should verify as early as possible whether they remain eligible to continue to use their current accounting methods. If method changes are needed, a taxpayer needs to determine whether:

- The change(s) qualify to use the automatic change procedures (in which case Form 3115 can be filed in 2024); or
- A non-automatic accounting method change needs to be filed before the end of 2023 for the change to apply in the first year the taxpayer does not qualify as a small business taxpayer.

Additionally, if accounting method changes need to be made, taxpayers should consider the impact of the Section 481(a) adjustments on their current year tax returns as well as ensure that the methods being adopted are consistently applied.

Year-end Clean-up Items: Accelerate Common Deductions/Losses

Heading into year-end tax planning season, companies may be able to take some relatively easy steps to accelerate certain deductions into 2023 or, if more advantageous, defer certain deductions to one or more later years. The key reminder for all of the following year-end “clean-up” items is that the taxpayer must make the necessary revisions or take the necessary actions before the end of the 2023 taxable year. (Unless otherwise indicated, the following items discuss planning relevant to an accrual basis taxpayer.)

Deduction of accrued bonuses. In most circumstances, a taxpayer will want to deduct bonuses in the year they are earned (the service year), rather than the year the amounts are paid to the recipient employees. To accomplish this, taxpayers may wish to:

- Review bonus plans before year end and consider changing the terms to eliminate any contingencies that can cause the bonus liability not to meet the Section 461 “all events test” as of the last day of the taxable year. Taxpayers may be able to implement strategies that allow for an accelerated deduction for tax purposes while retaining the employment requirement on the bonus payment date. These may include

using (i) a “bonus pool” with a mechanism for reallocating forfeited bonuses back into the pool; or (ii) a “minimum bonus” strategy that allows some flexibility for the employer to retain a specified amount of forfeited bonuses.

- It is important that the bonus pool amount is fixed through a binding corporate action (e.g., board resolution) taken prior to year end that specifies the pool amount, or through a formula that is fixed before the end of the tax year, taking into account financial data as of the end of the tax year. A change in the bonus plan would be considered a change in underlying facts, which would allow the taxpayer to prospectively adopt a new method of accounting without filing a Form 3115
- *Schedule bonus payments to recipients to be made no later than 2-1/2 months after the tax year end to meet the requirements of Section 404 for deduction in the service year.*

Deduction of commission liabilities. Taxpayers with commission liabilities should consider taking the following actions prior to the end of the 2023 taxable year:

- Review commission agreements for needed revisions. By analyzing the terms of the arrangements, taxpayers can determine what event(s) must occur to fix the commission liability and meet the all events test under Section 461. Companies may consider revising commission agreements to remove contingences or otherwise better align their business goals with deduction timing for tax purposes.

One example of a contingency associated with commission liability is a requirement that a customer remain a customer for a specified time before the employee/agent is entitled to a commission. In this case, the liability would not be considered fixed until the conclusion of the specified time period, thereby precluding the taxpayer’s deduction of the commission liabilities prior to that date.

- *Consider the tax treatment of prepaid commissions and associated elections.* For financial reporting purposes, many companies capitalize commissions paid to both employees and independent contractors, typically amortizing amounts over the same period as

the related revenue stream under ASC 606. Tax requirements for capitalization of commissions and the timing of their deduction will differ based on the recipient of the commission and whether the recipient’s efforts to earn the commission facilitate the acquisition or creation of an intangible.

- The Section 263(a) requirement to capitalize commissions as facilitative costs applies to commissions paid to third parties, including independent contractors, but employee compensation is exempt from this requirement. Thus, commissions paid to employees generally can be deducted in the year the commissions are incurred.

If the taxpayer prefers to capitalize commissions paid to employees, it may opt to do so by making an annual election. The flexibility to switch between deducting and capitalizing employee commissions each year provides a helpful planning opportunity for companies.

- *Schedule accrued commission payments to employee recipients to be made no later than 2-1/2 months after the tax year end.* This



timing is necessary to meet the requirements of Section 404 for a deduction in the service year. Accrued commissions to third parties (e.g., independent contractors) would generally be deductible in the year incurred.

Deductions of prepaid expenses. For federal income tax purposes, companies may have an opportunity to take a current deduction for some of the expenses they prepay, rather than capitalizing and amortizing the amounts over the term of the underlying agreement or taking a deduction at the time services are rendered.

A cash basis taxpayer can generally deduct prepaid expenses in the year of actual payment as long as the prepaid expense meets an exception referred to as the “12-month rule.” Under the 12-month rule, taxpayers can deduct prepaid expenses in the year the amounts are paid (rather than having to capitalize and amortize the amounts over a future period) if the right/benefit associated with the prepayment does not extend beyond the earlier of i) 12 months after the first date on which the taxpayer realizes the right/benefit, or ii) the end of the taxable year following the year of payment. As taxpayers are required to meet the Section 461 all events test prior to applying the 12-month rule, accrual basis taxpayers must carefully examine the nature of their prepaids to determine whether there is a fixed and determinable liability and whether economic performance has occurred by year end.

The rules provide some valuable options for accelerated deduction of prepaids for accrual basis companies – for example, insurance, taxes, government licensing fees, software maintenance contracts, and warranty-type service contracts. Identifying prepaids eligible for accelerated deduction under the tax rules can prove a worthwhile exercise by helping companies strategize whether to make prepayments before year end, which may require a change in accounting method for the eligible prepaids.

Inventory write offs. Often companies carry inventory that is obsolete, unsalable, damaged, defective, or no longer needed. While for financial reporting inventory is generally reduced by reserves, for tax purposes a business normally must dispose of inventories to recognize a loss, unless an exception applies. Thus, a best practice for tax purposes to accelerate losses related to inventory

is to dispose of or scrap the inventory by year end.

An important exception to this rule is the treatment of “subnormal goods,” which are defined as goods that are unsaleable at normal prices or unusable in the normal way due to damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar reasons. For these types of items, companies may be able to write down the cost of inventory to the actual offering price within 30 days after year end, less any selling costs, even if the inventory is not sold or disposed of by year end.

REVISIT THE DE MINIMIS BOOK SAFE HARBOR FOR WRITE-OFFS OF TANGIBLE PROPERTY

Subject to limitations, the so-called tangible property regulations (TPR) permit a taxpayer to elect to deduct the costs of items that likewise are expensed under a written financial accounting policy in place as of the beginning of the tax year. The election must be made annually and, because it is not a method of accounting, can be made for a given year without regard to whether the taxpayer has made the election for a prior year. The taxpayer can adjust the tax benefit of the safe harbor election by modifying the associated financial accounting policy prior to the beginning of the tax year for which the election will be made, changing the ceiling amount for items eligible to be deducted.

Under the safe harbor election, taxpayers with an applicable financial statement (AFS) may deduct amounts paid for tangible property up to \$5,000 per invoice or item (\$2,500 per invoice or item for taxpayers without an AFS). Deductions must be substantiated by invoice.

Critical year-end action items are:

- Review and make desired changes to the associated financial accounting policy prior to the beginning of the upcoming tax year; and
- Plan to attach the required election statement to the timely-filed, original return for the year in which the election is to be effective.

CONSIDER METHODS IMPLICATIONS OF POTENTIAL M&A TRANSACTIONS

Taxpayers contemplating an acquisition,



disposition, or other M&A transaction should consider the opportunities for accounting methods planning as well as any procedural requirements. Both buy-side and sell-side companies can benefit from proactively considering a transaction's effects on existing accounting methods and related potential risk mitigation or planning strategies. Below are some examples of the opportunities to consider.

Final year restrictions. In general, automatic accounting method changes are not permitted in a taxpayer's final year of a trade or business (e.g., when a taxpayer is acquired in a taxable asset acquisition). During the transaction process, taxpayers may contemplate certain changes in accounting methods, such as the correction of an impermissible method or a change in overall method. It is important to carefully consider the structure of a transaction to determine if any accounting method changes are permitted or required.

If a transaction does not result in the cessation of a trade or business, taxpayers may want to plan for the timing of an accounting method change (i.e., whether the change is made pre- vs. post-transaction). For example, certain method changes may be qualified for accelerated taxable income adjustments in a pre-transaction period.

By beginning the planning process early, taxpayers may be able to include beneficial terms in the agreement, such as limiting the pre-transaction realization of potential tax benefits to the sellers or requiring the sellers to correct potential exposure items.

Due diligence preparation. A taxpayer looking to sell part or all of a company may be able to use accounting methods planning to strengthen its profile in attracting potential buyers. A comprehensive accounting method review can uncover opportunities to mitigate potential risk and identify ways to achieve desired tax attributes well in advance of the formal due diligence process.

Post-transaction alignment. Acquisitive taxpayers should consider the impact of a transaction's structure on the tax attributes — including the tax accounting methods — of acquired companies. In situations where the acquired company's accounting methods carry over, accounting method changes can align the methods being used across the group to streamline the compliance process. Alternatively, transaction structures resulting in the adoption of new methods can provide opportunities to select methods that best align with the taxpayer's tax objectives. Taxpayers able to adopt new methods may also benefit

from the ability to establish methods that cannot be changed through the automatic procedures at a later date, such as certain percentage-of-completion methods under Section 460 or the 3-1/2 month rule for deducting certain prepaid services.

ITEMS TO REVIEW IN EARLY MONTHS OF 2024: Review Latest Section 174 Guidance and Evaluate Implications On 2023 Tax Year

The Tax Cuts and Jobs Act (TCJA)

The Tax Cuts and Jobs Act (TCJA) made significant changes to Internal Revenue Code Section 174, which deals with the deduction of research and experimental (R&E) expenses. Prior to the TCJA, businesses could deduct these expenses in the year they were incurred. However, the TCJA introduced new rules that require businesses to capitalize and amortize R&E expenses over a five-year period or 15-year period for foreign costs, starting from the midpoint of the taxable year in which the expenses were incurred. This change applies to R&E expenses incurred in tax years beginning after December 31, 2021. The changes to Section 174 also included language defining any software developed internally or by third parties as Section 174 expenses. Prior to the change, taxpayers rarely treated its R&E expenses as Section 174 expenses and elected to deduct these costs under Section 162.

IRS Notice 2023-63

In September 2023, the IRS released Notice 2023-63, which contains substantive pre-regulatory guidance on the new Section 174 capitalization requirements and announced that the Treasury and the IRS intend to issue proposed regulations consistent with the Notice. The guidance provides taxpayers with an advance look into upcoming proposed regulations, which the IRS anticipates will apply for taxable years ending after September 8, 2023.

The Notice provides valuable guidance to taxpayers in several key areas. Specifically, it provides clarity on which indirect costs should be treated as Section 174 expenses, such as overhead, depreciation, and personnel costs and which expenses should not be treated as 174 expenses, such as G&A expenses. Additionally, the Notice provides guidance and examples on software development costs that should and should not

be treated as 174 expenses, which was a key area of confusion among taxpayers. R&E performed under contract is another key area covered by the Notice. The Notice informs taxpayers that they must have no financial risk and no rights to the research in order to treat the expenses performed under contract as 162 costs instead of 174 expenses.

The Notice also provides guidance to taxpayers in the following areas:

- Methodology for allocating overhead and depreciation;
- Short tax year treatment;
- Project Completion method expense and revenue treatment;
- Cost sharing agreements; and
- Recovery of the costs for business sold or cease to exist.

Taxpayers that intend to rely on this guidance for the 2023 taxable year should begin to consider how it may differ from positions taken for the 2022 taxable year or in calculating their 2023 estimated tax payments. In doing so, taxpayers should take



special note of certain key areas of uncertainty.

For taxpayers with divergent prior positions, the IRS intends to issue new procedural guidance to assist taxpayers in making accounting method changes that are needed to conform to the new guidance.

Planning Considerations for M&A Transactions

Section 7 of the Notice addresses some basic consequences of asset dispositions, entity terminations, and carryover transactions for corporations. However, the Notice leaves unaddressed a number of interactions between Section 174 and other M&A tax rules, including those addressed below.

Section 338(h)(10). While the Notice does not specifically address Section 338(h)(10), the Notice appears to make clear that specified research and experimental (SRE) expenditures capitalized under Section 174 by a target should remain with the selling parent following a Section 338(h)(10) election. As such, the SRE expenditures will provide no current year reduction in gain from the deemed asset sale but may provide the seller utilizable amortization in future tax years. To the extent the buyer and seller are negotiating a gross up payment in conjunction with the election, treatment of the SRE expenditures in the calculation of the gross up should be addressed.

Section 382. To date there has been no guidance on the interaction of Section 174 and the safe harbors outlined in Notice 2003-65. Notice 2003-65 provides two safe harbor methodologies for calculating the NUBIG/NUBIL and RBIG/RBIL from a loss corporation's Section 382 ownership change, the 338 approach and the 1374 approach. Under both approaches, the NUBIG/NUBIL is the net amount of gain or loss that would be recognized in a hypothetical asset sale, whereby the loss corporation sells all of its assets, and the buyer assumes all of the loss corporation's liabilities.

In the absence of specific guidance, the conservative approach has been to factor the SRE expenditures into the calculation of both NUBIG/NUBIL and RBIG/RBIL. To the extent the calculated limit under this approach does not have a detrimental impact on the tax provision or tax filing positions, a company may have the opportunity to wait to see if further guidance on this issue is released. However, for other companies, the

Notice's guidance may support beneficial positions with respect to calculating NUBIG/NUBIL and RBIG/RBIL as neither the 338 or 1374 methods provide for a deemed liquidation or cessation of the loss corporation. As needed, companies should weigh the strength of these potential positions.

Unified Loss Rule. In certain situations when selling a subsidiary member at a loss, a consolidated federal income tax group can reattribute tax attributes (e.g., NOLs and deferred deductions) from the departing subsidiary to the group under an election within the unified loss rule (ULR). This election allows the group to retain valuable tax attributes.

To date there is no guidance on the interaction of SRE expenditures capitalized under Section 174 and the ULR. However, unamortized SRE expenditures (to which Section 174(d) has not been applied) appear distinguishable from deferred deductions or any other category of asset that could be electively reattributed under the ULR. As such, to the extent a group is selling a subsidiary with valuable unamortized SRE expenditures, the group should consider whether to value the SRE amortization as part of the deal consideration or seek a sale structure other than a stock sale.

Cost Sharing Arrangements (CSAs) under Reg. §1.482-7.

Under the cost sharing regulations of Reg. §1.482-7, two or more participants in a qualified CSA agree to bear intangible development costs (IDCs) in proportion to each party's expected benefit from exploiting the developed intangible property. If during the course of a year, the actual IDC expenditures of each CSA participant are not in proportion to the expected benefit, cost sharing payments are made among CSA participants to achieve the proper expense/benefit allocations. Payments received by a CSA participant payee (from another CSA participant payor) are treated as contra-costs or contra-expenses, and thus serve to reduce the payee's IDCs.

Notice 2023-63 clarifies that payments made to a CSA participant payee that incurs both immediately deductible IDCs and those that are required to be charged to a capital account should be allocated among these cost categories proportionately. If a CSA payment exceeds the total amount of IDCs in these two categories, the excess is to be treated as

income by the payee. Furthermore, to comply with the different amortization periods, taxpayers will have to segregate all IDCs that must be capitalized into U.S.-incurred expenses and non-U.S.-incurred expenses.

Although this guidance regarding Section 174 and cost sharing is welcome, open questions remain. For example, the guidance does not address the treatment of outsourced research and development (R&D) activities within a CSA, and it does not address intercompany R&D CSAs outside of qualified CSAs under Reg. §1.482-7.

It is important for taxpayers who have filed or have previously filed research and development (R&D) tax credits, have software development expenses, or are in a trade or business that incurs research expenses, to perform a Section 174 analysis. For others that may not have tracked or identified these costs or have not historically claimed the R&D tax credit, it is still necessary to identify Section 174 costs specifically, as they are now subject to capitalization. Taxpayers are encouraged to establish a methodology for calculating and documenting a consistent approach to comply with these new rules. Further, with limited guidance from the Treasury and IRS, taxpayers should consider other potential tax impacts.

REVIEW OPPORTUNITIES FOR IMMEDIATE DEDUCTION OF FIXED ASSETS

Although Congress is considering legislation that would delay the ongoing phase-out of bonus depreciation (which reduces from 80% in 2023 to 60% in 2024), considerable uncertainty remains as to the prospects for its passage. As such, year-end tax planning for fixed assets emphasizes cash tax savings through scrubbing fixed asset accounts

for costs that can be deducted currently under Section 162 rather than being capitalized and recovered through depreciation and reducing the depreciation recovery periods of capital costs where possible.

Fixed Asset Scrubs. Reviewing fixed asset registers for amounts that potentially may be recovered over a shorter depreciable life can yield cash tax benefits. For example, taxpayers may be able to reclassify certain interior improvements to a nonresidential building as “qualified improvement property” eligible for a shorter 15-year recovery period and bonus depreciation. The cash tax benefit from properly reducing the recovery period of depreciable property is achieved using the automatic accounting method change procedures.

Scrubbing fixed asset registers can also identify “ghost assets” that the company has physically disposed of in prior years but for various reasons have not been removed from the company’s accounting records. Identifying and deducting the remaining tax basis through an automatic change in accounting method can yield cash tax benefits as well.

Materials and Supplies. Scrubbing a company’s accounts for items that may be treated as materials and supplies can also yield cash tax benefits. Materials and supplies include spare parts, consumables (fuel, lubes, water, etc.) that will be used within the next 12 months; items costing no more than \$200 each; and items that have an economic useful life of no more than 12 months. This definition can apply to a surprising array of items, permitting nearly immediate cost recovery in many cases. Reviewing and adjusting the



process by which the company identifies items as materials and supplies and are key to maximizing this opportunity. This potential cash tax benefit is achieved through an automatic change in accounting method.

Additional potential benefits from reviewing the company's application of the TPR can be found in a Tax Notes article authored by BDO's James Atkinson. See J. Atkinson, "Preparing for a Post-Bonus Depreciation World," 179 Tax Notes 209 (April 10, 2023).

CONSIDER THE UNICAP HISTORIC ABSORPTION RATIO ELECTION

Under Section 263A, taxpayers must capitalize direct and indirect costs allocable to real or tangible personal property produced or acquired for resale. The types and amounts of costs required to be capitalized under Section 263A typically go beyond those required to be capitalized for financial accounting purposes. Accordingly, many taxpayers must undertake a computation each year to capitalize "additional section 263A" costs to property acquired or produced. For taxpayers seeking to streamline this often-time-consuming process, the historic absorption ratio (HAR) election may be worth considering.

The historic absorption ratio method

While the Section 263A regulations list numerous methods and sub-methods taxpayers can use to identify and allocate additional Section 263A costs to ending inventory, many taxpayers select one of the three simplified methods (simplified production method, simplified resale method, and modified simplified production method) outlined in the regulations to streamline compliance efforts and reduce potential controversy with the IRS. Although these methods are generally less administratively burdensome in comparison to other alternatives, taxpayers must still dedicate significant efforts in maintaining the annual calculations. Taxpayers currently using one of the simplified methods may be able to further streamline their compliance process by electing to use the HAR method.

A taxpayer qualifies to make the HAR election once it has consistently used one of the three simplified methods for at least three consecutive tax years. In the year the election is made, the taxpayer calculates the HAR by averaging the absorption ratios from the prior three tax years. The HAR is then applied to ending inventory for the next five

tax years, beginning with the election year. On the sixth year, the taxpayer must recompute the absorption ratio(s) using actual data for the year under the applicable simplified method:

- If the recomputed ratio(s) are within 0.5% of the HAR used for the preceding five years, the taxpayer can continue using the HAR for another five years.
- If the recomputed ratio(s) are not within the 0.5% range, then the taxpayer is required to begin another three-year testing period of calculating the actual absorption ratios.

Thus, while the HAR election still requires taxpayers to prepare Section 263A calculations for testing period years, the ability to bypass this exercise for at least five years in a row can save taxpayers a considerable amount of time in their compliance efforts.

Making and terminating the HAR election – weigh the benefits carefully

A taxpayer makes the HAR election by attaching an election statement to the tax return; no method change (Form 3115) or Section 481(a) catch-up adjustment is required. However, terminating the HAR election requires a non-automatic accounting method change, which the IRS generally will grant only in unusual circumstances. Therefore, given the inflexibility of the approach once the HAR election is made, taxpayers should carefully weigh the benefits of the administrative relief associated with making the HAR election against the trade-off of using a locked-in ratio in a year where the actual absorption ratio may be lower. Taxpayers should consider making the election for a specific tax year when the absorption ratios used for the testing period are lower than usual, as this strategy might allow them to benefit both from minimizing compliance costs and capitalizing less amounts to ending inventory.

REVIEW LEASING TRANSACTIONS FOR COMPLIANCE WITH TAX RULES

The treatment of lease arrangements is a complex area due to many factors, including the diversity of lease structures, changing U.S. GAAP practices, and nuanced tax rules. In recent years, many companies have adopted ASC 842, the new GAAP standard governing lease accounting. The tax classification of an arrangement as a lease is independent of GAAP reporting, so the adoption of ASC 842 does not necessitate a tax accounting method change.

However, given the changes in financial accounting practices, taxpayers adopting ASC 842 should perform a comprehensive tax review of their leases to ensure proper tax methods are maintained and to identify any tax accounting method changes that are needed.

A lease analysis for tax purposes generally focuses on the following three key areas:

Categorization. The classification of an arrangement as a “true” tax lease is a highly facts-based analysis that should be performed on each lease a taxpayer enters. While an arrangement may be presented as a lease for legal and/or financial reporting purposes, the tax classification depends more on the substance of the arrangement than the form. Tax treatment as a lease versus the financing of a purchase, provision of services, or other arrangement is based broadly on the (1) benefits and burdens of ownership and (2) economic substance of the transaction.

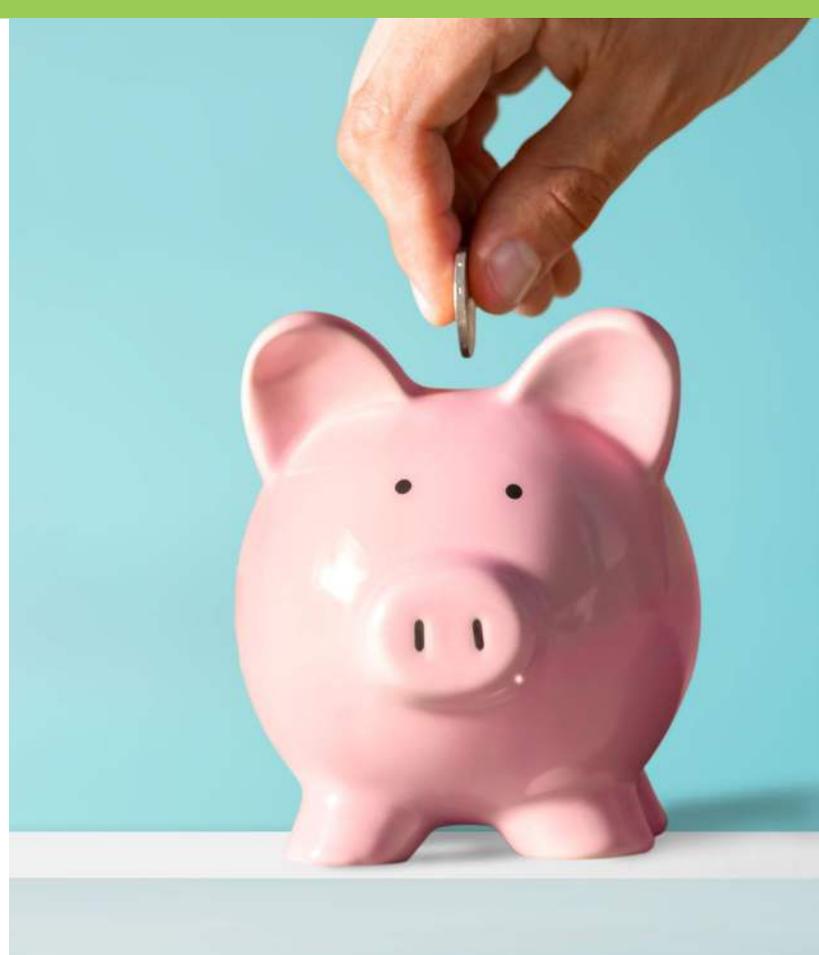
Timing of income/deductions. Taxpayers with leases may fall into special methods of accounting under Section 467. In general, a taxpayer is subject to Section 467 if the lease meets all the following criteria:

- The lease is for the use of tangible property;
- Total consideration paid under the lease exceeds \$250,000; and
- The rent schedule provides for increasing/decreasing payments throughout the term of the lease and/or there is a rent allocation schedule that differs from the payment schedule.

In most cases, taxpayers subject to Section 467 should recognize rental income (lessor) or rent expense (lessee) in line with the payment schedule. However, Section 467 may require the use of a different method, such as the proportional rental accrual method. Taxpayers with leases that are not subject to Section 467 should look to their overall method of accounting to determine the timing of income and deductions.

By undertaking a tax analysis prior to entering into a new lease, taxpayers may be able to negotiate more favorable lease terms that help align the timing of income/deductions with their overall tax objectives.

Maintaining the proper method. As mentioned



above, adoption of ASC 842 for GAAP reporting purposes will likely change the way taxpayers compute existing book-to-tax adjustments. To ensure existing tax accounting methods are properly maintained, and to prevent errors or unauthorized method changes, taxpayers should ensure they understand any new lease-related balance sheet accounts and the appropriate tax treatment for such accounts.

EVALUATE ACCOUNTING METHOD CHANGES FOR CFCs

Controlled foreign corporations (CFCs) are generally subject to the same requirements as U.S. taxpayers to use proper methods of accounting for tax purposes (for example, to calculate earnings and profits and to calculate tested income for GILTI). A CFC that has adopted an improper method of accounting or otherwise wishes to change an accounting method is required to file Form 3115.

A potential benefit of filing Form 3115 to correct an improper method is the ability to receive audit protection. If audit protection is granted, the IRS is precluded from challenging a taxpayer’s improper treatment for open tax years prior to the year of change. For CFCs or 10/50 corporations (foreign

corporations with U.S. shareholders owning at least 10% but no more than 50%), however, audit protection may be denied for a tax year before the year the method change was requested under a "150% rule." The 150% rule is met if one or more of the CFC's or the 10/50 corporation's U.S. corporate shareholders report deemed paid foreign taxes for that year that exceed 150% of the average deemed paid foreign taxes reported during the three prior tax years.

For the many CFCs that were subject to the transition tax imposed under Section 965, the 150% rule denying audit protection may have disincentivized them from filing method changes to correct improper accounting methods. Affected taxpayers may now find themselves clear of the rule for the 2023 or 2024 tax year and should consider filing method changes to clean up their impermissible methods prospectively.

Some of the more common, automatic method changes that CFCs may encounter include the following:

- Changing from computing depreciation under the General Depreciation System (GDS) to the Alternative Depreciation System (ADS);
- Switching to either the full inclusion method or the one-year deferral method for advance payments;
- Changing to a proper Section 461 method to deduct liabilities such as bonuses and commissions in the year the liability is fixed and amounts are paid within 2-1/2 months of year end; and
- Complying with Section 263A and adopting the U.S. ratio method to capitalize costs to ending inventory.

