As a member of the RSM US Alliance, we would like to share the following with you.

2020 year-end tax considerations for businesses

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Legislative changes and other tax concerns that may affect planning

This guide reflects the tax considerations and developments that we believe may create risk or opportunity for businesses in 2020 and beyond. It is not an exhaustive list of all tax issues that may affect your business, but it is designed to help you make informed decisions related to year-end tax planning.

Please see our website for additional information on many of these issues.

Introduction

This year has brought unprecedented challenges and major disruptions for businesses as they deal with the COVID-19 pandemic, the resulting economic crisis and political crisis. In response, Congress passed the Coronavirus Aid, Relief, and Economic Security (CARES) Act that included significant tax law changes designed to provide liquidity to taxpayers. At the time of publication, Congress continues to negotiate over another round of economic relief to support taxpayers as the pandemic persists.

While the CARES Act and the impact of the pandemic are foremost in many taxpayer's minds, the IRS and Treasury continue to provide guidance related to the Tax Cuts and Jobs Act (TCJA), enacted in December of 2017. Some of the recent guidance has been taxpayer-friendly, providing opportunities for taxpayers to amend, or otherwise adjust, prior tax years to take more favorable positions.

At the same time, the United States is approaching a presidential election season with the two major-party presidential candidates presenting dramatically different tax plans as part of their platforms. The results of any election can have a significant change on tax policy and while any shifts in power would not take place until 2021, it is important to consider the long-term implications for year-end tax planning.

We have compiled this guide to help companies make informed decisions related to year-end tax planning. As we continue to receive additional guidance regarding the provisions of the CARES Act, hope for additional forms of economic relief to counter the effects of the pandemic, and assess the impact of regulations related to the TCJA, it is important to be aware of how these changes might affect year-end planning and take action where prudent.

General considerations

Deduction and revenue planning

2020 requires a more nuanced approach to tax planning. Does your tax situation provide opportunities to increase losses in 2020 to file carryback refund claims in years with higher income tax rates? Alternatively, if you expect rate increases in the near term does it make sense to accelerate revenue into 2020 and defer expenses into subsequent years or elect to forgo carrying back losses and carry those losses forward? Depending on your situation, several accounting method approaches may help accomplish those goals. A few of these include:

- Changing from the cash basis to the accrual basis of accounting, or vice versa
- Conducting inventory planning (e.g., performing a uniform capitalization—UNICAP— review or electing new last-in, first-out—LIFO—submethods)
- Accelerating certain deductions or electing to capitalize prepaid expenses for the current year
- Electing to recover self-developed software costs over 36 months or currently deduct those costs
- Deferring amounts received from advance payments for goods or services or accelerating them into income
- Properly using the recurring-item exception for taxes, rebates and refunds
- Shoring up bonus plan requirements to substantiate deducting in the year employees provide the related services or altering the facts to defer the deduction into the year paid
- Accelerating recovery of real property through cost segregation and/or repair studies

Small-business taxpayer designation

The TCJA increased the threshold for defining a small-business taxpayer to include those with average annual gross receipts of $26 million or less for the three prior tax years, for the tax year Dec. 31, 2020. This amount is indexed yearly for inflation. Those qualifying under the small business taxpayer designation may be able to use the overall cash method, be exempt from applying certain inventory rules and be exempt from the limitation on interest deductions.

Changes in financial statement treatment for revenue and leases under ASC 606 and ASC 842

Certain entities were provided an additional year to adopt ASC 606. As companies can no longer defer adopting the new audit standards, they should anticipate or plan for the federal tax implications. To the extent that companies change the timing of an item on their financial statements (such as lease payments or revenue recognition), the company may have to file Form 3115 before the tax treatment can mirror the financial statement change. When reviewing the changes to financial statements, it is also important to consider the impact of the regulations under section 451(b), which include rules on when to accelerate income recognized on the taxpayer's audited financial statements.

Bonus depreciation

One hundred percent additional first-year (bonus) depreciation is available for qualified property acquired and placed in service after Sept. 27, 2017. The IRS has issued final and re-proposed regulations related to when taxpayers acquire an asset under a written, binding contract. The TCJA expanded bonus depreciation to qualifying used property. The expansion to used property may allow certain business acquisitions to recover a portion of the purchase price immediately through 100% bonus depreciation. In addition, as part of the CARES Act, qualified improvement property is eligible for 100% bonus depreciation retroactively to Jan. 1, 2018.

Uniform capitalization regulations

In November 2018, the Treasury and IRS issued new UNICAP regulations providing taxpayers new rules and a new method for capitalizing inventory costs. The new method is one of several that taxpayers can consider when capitalizing costs to inventory and could offer simplicity and tax efficiency, in addition to compliance. The final regulations are effective for tax years beginning on or after Nov. 20, 2018; calendar-year taxpayers must apply the new regulations as of their 2019 tax returns. Changes in accounting method (generally automatic) are required to comply with the new regulations. The rules affect both producers and resellers, but affect producers more. As companies struggled to respond to the pandemic, UNICAP implementation may have been deferred to 2020. It is important to quickly address this situation as IRS exam activity regarding UNICAP is expected to increase now that the regulations are effective.

Inventory is often one of the largest assets on the balance sheet of a producer or reseller, and historic UNICAP methods are often complicated and out of compliance. Fortunately, the new regulations and the accompanying automatic change procedures offer taxpayers the opportunity to comply with the new regulations while obtaining prior-year audit protection for historic UNICAP methods. Now more than ever, taxpayers should evaluate the impact of these new rules.

Fringe benefits and related issues

The TCJA made changes to the treatment of various fringe benefits that were generally effective for the 2018 tax year. During 2020, proposed regulations were issued in some areas providing additional clarity to statutory changes. Companies need to make sure that any proposed regulations have been reviewed for any changes in treatment to positions taken in 2018 and 2019. Areas to review may include the following if not previously reviewed in detail for additional authority:

- **Loss of the employer tax deduction on most entertainment expenses:** Verify that time and business expense systems are properly collecting and marking entertainment expenses separately from meals expenses, employee recreational expenses and other business expenses, and recorded in separate general ledger accounts. Exceptions to the entertainment expense disallowance may include:
  - Sporting event tickets, concerts, golf tournament amounts that are actual charitable contributions or specific advertising expenses, etc.
  - Expenses for employee events that are nondiscriminatory, broad-based employee social and recreational events that may have an entertainment element.
- **Reduction of the tax deduction for almost all de minimis fringe benefit food and beverage expenses to 50%:** Confirm meals and business expense systems are properly collecting all de minimis fringe benefit food and beverage costs and separating them from other business costs (such as invoices that bill for both office supplies and coffee and snacks for an office pantry or break room).
- **Loss of the tax deductions for employer-provided parking and transit benefits under section 132(f):** This rule proved very burdensome for many during the 2018 and 2019 compliance cycle. Proposed regulations issued in June 2020 provide simplified methods for calculating the disallowance for parking expenses which may provide benefit either through simplified expense identification or in a reduced disallowance in some cases. Companies should review the simplified methods for use in 2020 and for potential benefit in 2018 and 2019, as the proposed regulations can be relied upon for tax years after Dec. 31, 2017.
- **Loss of the deduction for employee commuting expenses (except where necessary to ensure safety of the employee):** Confirm that any expenses incurred to cover or reimburse employee commuting costs are accounted for. This analysis requires an understanding of the definition of business travel for tax purposes; some employee arrangements that appear to be travel may actually be commuting costs. Also, remember that this provision disallows the deduction regardless of whether the benefit is included in income, unlike the transportation disallowance above.

COVID-related employee compensation and benefits impacts

Many workplaces have undergone a fundamental shift in 2020 with the COVID-19 pandemic. Beyond the immediate reaction to the economic effect of the coronavirus pandemic, companies need to understand the long-term impacts of remote workers or may want to plan how to address future disasters to shorten reaction time to help affected employees.

In addition to assistance-related measures, employers need to consider whether additional compensation or benefit changes have a tax impact or would help alleviate financial strain the company may still be under. Workforce-related areas that companies should consider include:

- Employer payroll tax deferral
- Equity compensation changes
- Deferred compensation payments
- Employee home office or other remote work expenses
- Paid time off policies including donations of paid time off
- Retirement plan changes

Changes in these areas may have already been implemented and need attention to ensure appropriate treatment for tax purposes. In other instances, companies may want to consider these areas to either help with its own liquidity situation or to further assist employees. Regardless of the motivation to implement changes in these categories, all have a tax impact and need to be carefully reviewed to avoid unintended risk.

Like-kind exchange changes

As a result of the TCJA, deferral of gain under section 1031 is limited to real property transactions as of Jan. 1, 2018. In June 2020, the IRS released new regulations describing what constitutes "real property" for purposes of section 1031. The regulations give both explicit examples of real property and factors to help determine what property qualifies. The new rules are particularly helpful for taxpayers who do business in multiple states, as state law classifications no longer weigh as heavily in defining real property. The new rules also clarify that properties are not disqualified from a like-kind exchange if less than 15% of the value of the property is composed of incidental personal property. It should be noted that even if personal property is less than 15% of the total value of the property, the personal property is still not like-kind property to real property and gain may result.

For tangible personal property, the full expensing election may provide relief for those taxpayers affected by this change. Although the gain from the sale of personal property may no longer be deferred in a like-kind exchange, the full expensing deduction may be used to offset the gain triggered.

With many taxpayers evaluating the character of their assets under the new rules for qualified improvement property and UNICAP, many taxpayers will need guidance on which assets qualify for a like-kind exchange.

Affordable Care Act update

The IRS is currently assessing penalties on applicable large employers (ALEs) for Affordable Care Act (ACA) compliance failures for 2018 and prior years. A company is an ALE if it averaged at least 50 full-time employees (including full-time equivalents) during the preceding calendar year, or was in a group of related companies that met the large employer criteria. ALEs that fail to offer employee health insurance that meets ACA standards may be assessed a shared responsibility payment by the IRS. In order to avoid this penalty, a large employer must offer minimum essential health coverage to substantially all (95%) of its employees and their dependents. This coverage must be affordable and provide minimum value (by covering a certain percentage of all medical expenses incurred by employees).

To determine which employers owe the penalty, the IRS requires ALEs to file Forms 1095-C and 1094-C to report workforce and health plan information. For 2020, the due date to provide employees with Form 1095-C is Jan. 31, 2021 (just like Form W-2), and an employer must file Form 1095-C and the related Form 1094-C to the IRS by Feb. 28, 2021 (if filing on paper), or March 31, 2021 (if filing electronically).

The IRS is assessing substantial penalties on ALEs that failed to file Forms 1095-C and 1094-C in prior years. Therefore, companies subject to the ACA requirements should review their compliance efforts and understand any potential risk for noncompliance.

In addition to these federal filing requirements, several states impose their own information reporting requirements on employers with employees residing in the state. Employers are required to file Forms 1095-C and 1094-C (or alternate forms) directly to the state so that the state can enforce its own individual mandate penalty on residents without health coverage. States with reporting requirements for 2020 include California, Massachusetts, New Jersey, Rhode Island and the District of Columbia.

Research and development tax credit

The research and development (R&D) tax credit is repeatedly one of the most popular incentives in the tax code. The repeal of the alternative minimum tax after 2017 as part of the TCJA has made it easier to utilize the R&D tax credit to reduce current tax liabilities.

A small business start-up may claim the credit, up to $250,000, against its FICA payroll tax liability if it had less than $5 million in gross receipts for the current taxable year and no gross receipts for any taxable year prior to the five-taxable-year period ending with the current taxable year. If you wish to make this election and are using an outside payroll provider, it is important to discuss this with them as soon as possible, as the payroll provider must file certain forms on your company's behalf.

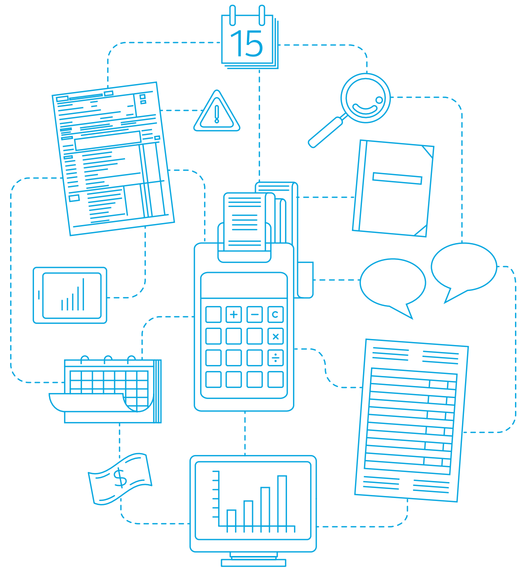
In addition, the alternative simplified credit (ASC) continues to be the preferred method elected by many taxpayers, because it relies only upon the prior three years' qualified research expenses to compute the base amount, where the regular credit method requires a much more complex base amount computation that can be difficult to document. The ASC election should be made by completing section B on Form 6765 on the original tax return.

As a result of the COVID-19 pandemic, businesses may have performed R&D in new areas of technology to enable more employees to work remotely, create a touchless work environment, provide services in new ways or convert production processes to new safety products such as masks or hand sanitizers.

The IRS is asking for more detailed information and documentation during R&D credit examinations. It is critical that taxpayers document R&D project activities and differentiate R&D project costs in their accounting records.

Work opportunity tax credit

The WOTC program was designed to encourage employers to hire and retain individuals from specific target groups with employment barriers and is available for employees who begin work by Dec. 31, 2020. The program also applies to employers that hire qualified long-term (27 weeks or more) unemployed individuals.



The WOTC equals 40% of the first $6,000 of wages, with higher wage limits for long-term family assistance recipients and qualified veterans for the first tax year an employee is hired. The credit is reduced to 25% for individuals who work at least 120 hours, but fewer than 400 hours, during the one-year period beginning on the employment date.

There is no credit for individuals who work fewer than 120 hours in their first year of employment. The WOTC also includes 50% of second-year wages for the tax year for wages paid to long-term family assistance recipients.

Families First Coronavirus Response Act payroll credits

The Families First Coronavirus Response Act (FFCRA) implemented mandatory paid sick leave and paid family leave for employers with fewer than 500 employees. Depending on certain requirements tied to COVID-19, employees must be provided paid time off under the FFCRA before using other paid time off provided by the employer. The requirements for the paid leave include categories other than time provided for employees directly infected with the coronavirus and, among others, may include time provided for employees who may be homeschooling children. Employers are then allowed a payroll tax credit for the amount of paid leave wages provided under the FFCRA provisions. The paid leave is primarily a legal matter that companies should review with legal counsel to determine whether any leave provided to employees is under the FFCRA. If FFCRA leave has been provided, employers may be eligible for tax credits.

CARES ACT Employee Retention Credit

The CARES Act Employee Retention Credit provides a refundable payroll tax credit for 50% of qualified wages (up to $10,000 of wages) paid or incurred by employers between March 13, 2020, and Dec. 31, 2020. Qualified wages are generally those paid to employees when they are not providing services because their employer fully or partially suspends operations due to government orders or experiences a significant decline in gross receipts due to COVID-19. For employers with 100 or fewer full-time employees, qualified wages are the wages paid to all employees, including those still providing services during this time.

As the end of the year approaches, taxpayers who have been claiming this credit on a quarterly basis should make sure that they reconcile eligible wages and employment taxes eligible for the credit through December so that their fourth quarter Form 941 will be correct. In addition, those that have not been claiming the credit and did not receive a Paycheck Protection Program loan still have an opportunity to review whether they might be eligible and have qualified wages and amend filings to claim credits that were not previously reported.

Employer credit for paid family and medical leave

This tax credit was enacted as part of the TCJA and provides a tax credit of between 12.5% and 25% for wages paid to qualifying employees on family or medical leave in calendar years 2018 or 2019 and was extended for 2020. To qualify, employers must maintain a written family and medical leave policy providing qualifying employees at least two weeks of paid family and medical leave and paying at least 50% of the normal wage rate during the leave period. There are special rules regarding part-time employees and payments to employees earning above a certain amount are not eligible. Business taxpayers should review their family and medical leave policies and determine if they qualify.

Energy credits

Tax credits for many types of renewable energy were retroactively reinstated by the Bipartisan Budget Act of 2018. The residential energy efficient property credit was extended with certain reduced-rate modifications through 2021. The business energy investment credit was further extended for solar and extended with a phase-out for other renewables as follows:

- The 26% investment tax credit for qualified solar property is available through 2020, with a 22% credit available in 2021. For construction that begins after 2021, the credit is reduced to 10%.
- The 26% investment tax credit for fiber-optic solar lighting, qualified fuel cell property and qualified small wind property is available through 2020, with a 22% credit available if construction begins in 2021 and no credit if placed in service after 2023.
- The 10% investment tax credit for qualified microturbine property and combined heat and power system property (with certain rate modifications) is available if construction begins before 2022.
- The credit remains at 10% for geothermal equipment with no expiration.

The renewable electricity production tax credit (PTC) for large wind projects is at a rate of 1.5 cents per kilowatt-hour of electricity sold each year for 10 years. If taxpayers make an election to claim the investment tax credit related to qualified wind property in lieu of the PTC, the credit rate is 15.6% if construction begins in 2020. Taxpayers who wish to take advantage of the PTC when the property is placed in service should plan to either spend more than 5% of the eligible wind farm construction costs by the end of 2020 or take steps to begin physical work of a significant nature on the facility.

Alternative fuel credits

The $0.50 per gallon alternative fuel credit and alternative fuel mixture credit were retroactively extended through Dec. 31, 2020, and the $1 per gallon biodiesel mixture credit was extended through Dec. 31, 2022. In addition, refund opportunities may still exist for certain unclaimed credits for prior years, if elected as an income tax credit and filed on Form 4136 along with an amended federal income tax return.

There is still an opportunity for qualified sellers or users to register as alternative fuelers by filing Form 637 and then filing refund claims for open years for an elective income tax credit in lieu of the standard excise tax credit or payment.

Excise tax rapid assessment

During year-end planning, consider evaluating excise tax. In the current uncertain economy, reducing excise tax liability and identifying excise tax credits can enhance a company's bottom line and provide liquidity. Moreover, evaluating excise taxes and planning opportunities can improve a company's EBITDA as excise taxes are treated as an above the line cost of goods sold.

The primary sectors affected by excise taxes include energy, transportation (ground, air, and water), industrial manufacturing, certain consumer goods, food and beverage, and life science. Importers and exporters may also be subject to certain excise taxes. Even banks, insurance companies and credit card issuers may encounter excise taxes in their business.

Moreover, end users in industries such as building, construction, aerospace and defense, farming, power and utilities, and logistics may claim certain refundable excise tax credits. Manufacturers of nonbeverage products such as perfumes, food products, or medicines that use taxed alcohol in production may qualify for a drawback of the tax paid. Additionally, nonprofit entities or state and local governments often qualify for exemptions from excise tax or credits on the purchase of taxed articles such as fuel, tires and firearms.

All companies can benefit from a fresh look at excise taxes. An excise tax rapid assessment includes:

- Reviewing whether the business faces any excise tax exposure
- Evaluating opportunities for reducing existing excise tax liabilities
- Identifying credit opportunities
- Reviewing compliance operations for improving efficiency
- Identifying excise tax costs passed on by vendors and reviewing whether tax has been properly determined

Should an area of risk be identified, companies can take a deeper dive into remediating the problem. If a credit or savings opportunity is uncovered, this may ultimately improve the company's profitability and operational efficiency.

Air transportation planning

The CARES Act provides an aviation tax holiday on air transportation taxes and certain jet fuel taxes for domestic commercial aviation through Dec. 31, 2020. For transportation of persons, this holiday provides relief from the section 4261 taxes (including a tax of 7.5% of the amount paid for domestic transportation). For cargo airlines, this holiday provides relief from the section 4271 cargo excise tax (6.25% of the amount paid for domestic transportation). The aviation tax holiday also reduced the rate of tax on fuel used in commercial aviation to a tax rate of only $0.001 per gallon on fuel (regularly $0.044 per gallon). The holiday period begins March 28, 2020, and ends Dec. 31, 2020.

Companies that have significant air travel spend should consider accelerating purchases of air transportation for persons or property such that the purchase occurs in 2020 and thus still within the aviation tax holiday period. This may also include companies that purchase bulk amounts of airline miles for mileage award programs (such as banks, hotels, grocery stores, utility companies, etc.). Additionally, individuals who purchase large blocks of travel with private aviation services may also consider accelerating payment for 2021 air travel so that the payment for transportation is made before the end of this year.

IRS account transcripts

A company's IRS account transcript contains useful information, including the information necessary to confirm estimated payments or credit elects applied to the 2020 tax year before preparing an extension or filing the return. For prior years, the account transcript can identify items of which the company may be unaware, such as penalty or interest assessments, math error adjustments or examination indicators. Thus, companies should consider ordering an account transcript in January 2021 for 2020 and earlier years. Beginning June 28, 2019, the IRS stopped transmitting transcripts to requesting companies via fax. Instead, the IRS will mail the transcript to the company's address of record. The transcript can take up to two weeks to be transmitted by mail. For this reason, we recommend that you make the request by Jan. 15, 2021, to ensure it is received timely. Those tax professionals who have a signed authorization Form 2848 from the taxpayers have the ability to obtain electronic versions of IRS transcripts in near real-time. This is possible for those tax professionals who have an electronic mail box with the IRS Transcript Delivery Service. To order a transcript to be mailed, call the IRS business line at +1 800 829 4933.

Tax return due date reminders

For tax years beginning after Dec. 31, 2015, tax return due dates changed. Calendar year C corporation returns and most fiscal year returns are due on the 15th day of the fourth month following the end of the fiscal year, and S corporation and partnership returns are due on the 15th day of the third month following the end of the fiscal year. Form 7004 provides for an automatic extension of six months after the regular due date.

For C corporations with a fiscal year ending on June 30, the effective date change is delayed until the first tax year beginning after Dec. 31, 2025. Accordingly, those returns are due Sept. 15.

The deadline for filing Forms W-2, W-3, reports with the Social Security Administration and Forms 1099 MISC and 1099-NEC (previously Form 1099-MISC reporting nonemployee compensation in Box 7) is Jan. 31 for paper or electronic filing.

Accounting for income taxes under ASC 740

In preparation for year-end, companies should assess the impact of the CARES Act on their provision for income taxes, both for the current year and prior years. The CARES Act made several retroactive changes to the tax law and several areas, such as net operating loss (NOL) carryback claims and adjustments to the limitations on interest deductions under section 163(j) and NOL utilization may require additional attention in the current year. Companies may want to begin evaluating the impact of these items on their provision prior to year-end. These tax law changes may also affect companies that are using the reversal of deferred tax liabilities to support the realization of deferred tax assets (specifically, interest expense and NOLs). Companies should begin scheduling these reversals, adjusting for any amounts that were carried back, to ensure that the expected timing of these reversals supports the realization of deferred tax assets.

Companies that did not follow earlier sets of proposed regulations in prior years related to the section 163(j) interest limitation and recorded a reserve for unrecognized tax benefits should evaluate the release of those reserves in connection with the final regulations that were enacted in July 2020. Additionally, if a company believes it will benefit from the the global intangible low-taxed income (GILTI) excusion, companies can now reflect the benefit of this exclusion under the final regulations. This benefit can be reflected for both 2018 and 2019 under the final high-tax exception regulations. This decision may require complex analysis and companies should ensure they understand all of the implications prior to preparing the year-end provision. Companies should also pay careful attention to the release of any additional tax legislation, final regulations or other IRS guidance between now and year-end and make adjustments as necessary.

In addition, there have been a number of state tax law change during the course of the year, and the above federal law changes can have varying state impacts, depending on the application of each states conformity to federal tax law changes.

Corporate and transactional considerations

Financially distressed company tax issues

As the COVID-19 pandemic continues to disrupt the U.S. economy, many companies may need to restructure their debt, which may unfortunately result in bankruptcy filings. When involved in a debt workout or restructuring, it is critical that businesses evaluate their restructuring options. With effective analysis and planning, companies can maximize available tax benefits and mitigate tax costs associated with issues such as NOLs, cancellation or modification of indebtedness, and the disposition of struggling subsidiaries. Corporations facing economic hardship should be proactive in working with their tax advisors to ensure maximum company value is preserved through proper planning.

CARES Act: Net operating loss considerations and important dates

The CARES Act implemented taxpayer-favorable changes to section 172 for the deduction of NOLs. The act suspended the limitation of deductions for NOLs to 80% of the taxpayer's pre-NOL taxable income for tax years beginning before Jan. 1, 2021, and instead allows the full offset of taxable income. The CARES Act also amended section 172(b) to allow for the carryback of losses arising in a taxable year beginning after Dec. 31, 2017, and before Jan. 1, 2021, to each of the five taxable years preceding the loss year, including those with a maximum corporate tax rate of 35%.

Corporations looking to take advantage of or opt out of the reinstated NOL carryback provisions of the CARES Act should keep in mind the following important deadlines:

- Corporations have until Dec. 30, 2020, to file Forms 1139 to elect to claim refundable minimum tax credits in the 2018 tax year under section 53(e)(5).
- Corporations generally have one year from the close of the taxable year to carry back a NOL via Form 1139. Forms 1139 carrying back NOLs generated in the 2019 calendar year must be filed on or before Dec. 31, 2020.
- Corporations who wish to waive the NOL carryback period for NOLs generated in the 2018 or 2019 tax year may do so by attaching a statement to the taxpayer's federal income tax return for the first taxable year ending after March 27, 2020.

File Form 4466 in January to obtain a quick refund

Corporations can receive a quick refund (generally in less than 45 days) of federal estimated tax payments in excess of the company's estimate of its tax liability for the year. The company must file Form 4466 after the close of its tax year but before the un-extended due date of its Form 1120 to receive this quick refund. The company can designate that the excess amount be credited to another IRS liability. Penalties may apply if the requested refund (or credit to another liability) leaves the corporation underpaid for estimated tax purposes.

Consider filing an automatic extension even if the return will be filed on time

The timely filing of Form 7004, *Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns,* will provide an automatic six-month extension of time to file a Form 1120 corporate income tax return for calendar-year corporations.

Filing the extension may be beneficial even if the corporation files the return the next day. A valid automatic extension request extends the time for a calendar-year corporation to file its return for six months from the original due date of the return. Note that for calendar-year corporations, the original due date for Form 1120 is April 15, 2021.

The extension period allows companies time to make corrections to the return, up to the extended due date, without penalty—including making timely tax elections or applying automatic accounting method changes if omitted from the initial filing. A subsequently filed return containing these items filed before the extended due date would supersede the previously filed return that omitted them. The superseding return becomes the official return and the statute of limitations on assessment will expire (under normal circumstances) three years from the date the taxpayer files the return.

Accelerating subsidiary stock losses

For consolidated taxpayers, two planning opportunities may be available to accelerate and recognize losses in the current year. Consolidated groups with an insolvent subsidiary should evaluate whether it makes sense to claim a worthless stock deduction. Claiming the deduction may require liquidating the insolvent subsidiary or converting it into a limited liability company (LLC). Alternatively, a disposition of the subsidiary stock could accelerate the recognition of the loss. Corporations may want to consider whether accelerating a subsidiary stock loss can increase an NOL available to carryback to tax years during which the maximum corporate rate was 35%.

Accelerating section 481 adjustments in the year of an M&A transaction

Taxpayers have the ability to accelerate income into the year of certain mergers and acquisitions (M&A) transactions and possibly the year prior under rules provided by the IRS. These rules can provide tax advantages in situations where section 382 limitations would limit the ability to offset such income post-transaction. For certain accounting method changes, a taxpayer must file the method change request prior to the end of the tax year in order to obtain this treatment.

Identifying unamortized debt issuance costs

Companies that have refinanced debt or taken out new debt during the tax year should evaluate whether any previously unamortized debt issuance costs are eligible for accelerated tax deduction during the current year. In addition, companies should also assess whether certain fees paid to lenders as part of the refinancing or issuance of new debt may qualify as original issue discount (OID). Any amounts treated as OID must be amortized over the life of the debt and may be subject to the business interest limitation under section 163(j).

Section 163(j) interest limitations

Section 163(j) generally limits the deduction of business interest to the sum of the taxpayer's business interest income for the year and 30% (50% for certain years under the CARES Act, depending on the taxpayer) of the taxpayer's adjusted taxable income for the year. Final regulations for section 163(j) were released in July of 2020 that provided for taxpayer-favorable changes from the 2018 proposed regulations, including but not limited to:

- Adding back depreciation, depletion and amortization capitalized under section 263A in computing adjusted taxable income (ATI)
- Applying a narrower definition of interest
- Increased availability of the real property trade or business elections

Prior to the end of the tax year, taxpayers should consider converting debt to equity or refinancing debt in order to reduce the amount of interest subject to section 163(j) for the remainder of the year.

Deferred financing costs and section 163(j)

The final section 163(j) regulations apply a narrower definition of what is considered interest for purposes of section 163(j). Debt issuers typically incur significant costs in connection with the issuance of debt, including debt financing related costs. These costs must be analyzed and classified between costs treated as original issue discount (OID), a form of interest and non-OID related costs. The final section 163(j) regulations reinforce the importance of analyzing these costs if the corporation's ability to deduct its business interest is limited by the section 163(j) rules. Corporations should analyze significant debt financing-related costs to maximize deductibility.

Federal income tax mulligan

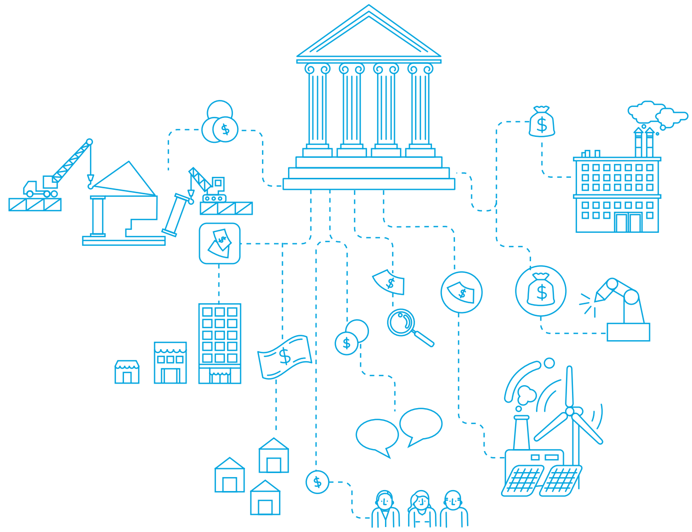
While not a new ruling, Rev. Rul. 80-58 allows taxpayers to rescind a transaction. While this is difficult to accomplish and little guidance exists in this area, this ruling does provide an avenue for rescission. However, to successfully complete a rescission, it must occur within the same tax year as the transaction. As a result, this item warrants consideration during year-end planning.

Section 382 closing of the books election

Corporations should carefully monitor changes in stock holdings and stock issuances that occur during the year in order to identify whether the company has undergone a section 382 ownership change. Corporations undergoing a section 382 ownership change may make a closing-of-the-books election. Addressing whether or not the corporation will make the election may result in significant tax benefits.

The corporation may prefer to maximize the amount of its income for the taxable year treated as accruing prior to the ownership change to maximize use of NOL deductions (or certain other deductions). If it files a closing-of-the-books election with its timely filed tax return, the corporation closes its books at the date of change for section 382 purposes, thereby specifically measuring income and deductions pre- and post-change. Without the election, under the default rule, the corporation applies daily proration of the entire year's items of income and deductions.

Addressing the closing-of-the-books election decision before the end of the year can assist with year-end tax planning since it helps position the company to determine whether acceleration of income or deduction items would be advantageous.



Accelerating an ownership change

On Sept. 10, 2019, the IRS and Treasury proposed new regulations under section 382, which provide a limitation of certain tax attributes (e.g., NOLs) where a corporation undergoes an ownership change. One major departure from the current rules is the proposed removal of one of the two safe harbors for calculating the recognition of built-in gain (or loss): the section 338 approach. The section 338 approach is generally more favorable for companies in built-in gain positions. Companies in a built-in gain position tend to be those that derive most of their value from self-created intangibles with no tax basis. It is expected that life science and technology companies would be particularly affected by the removal of the section 338 approach.

Companies that are contemplating an ownership change in the near future (e.g., a stock offering) should consider accelerating the ownership change to take advantage of the section 338 approach before the IRS and Treasury finalize the regulations as proposed.

Projecting earnings and profits

During year-end planning, it may be important for a corporation to project the remaining current-year earnings and expected 2021 earnings along with cumulative earnings and profits. These projections can aid companies planning to distribute cash (or other property) to shareholders in deciding the tax year in which to make the distribution.

Form 8937, *Report of Organizational Actions Affecting Basis of Securities*

C and S corporations that take organizational actions that affect the basis of securities in the hands of stockholders generally must file Form 8937 within 45 days of the transaction date, or by Jan. 15 of the year following any such actions that take place in December.

Organizational actions include stock splits, stock dividends and distributions that are fully or partially nontaxable, and some reorganizations. S corporations may report the required Form 8937 information on Schedule K-1 instead of Form 8937, and a company may meet Form 8937 filing requirements through appropriate postings on the company's website.

Corporations should analyze their transactions to ensure that they timely meet the filing requirements under Form 8937.

Realizing maximum benefits through a transaction cost analysis

When a company engages in a transaction such as a merger, sale of an entity, acquisition of an entity or business combination (either on the buy-side or the sell-side), the IRS requires costs incurred to facilitate the transaction to be capitalized. With stock transactions, these costs generally are capitalized into stock basis and are not recoverable until such stock is sold. Alternatively, with asset transactions, these costs generally are capitalized and amortized over a period of time, typically over 15 years on a straight-line basis. In contrast, costs that do not facilitate a transaction can generally either be deducted as incurred or amortized over 15 years.

Performing a TCA allows a company to identify nonfacilitative costs and maximize tax deductions. A TCA involves a thorough analysis of activities performed and expenses incurred in connection with exploring and entering into a merger or acquisition transaction. The study results in the determination and proper documentation of the appropriate federal income tax treatment of transaction costs. Without proper documentation, all transaction costs generally must be capitalized, rather than deducted during the year paid or incurred.

Section 162(m)

The TCJA affected public companies by significantly changing the rules of section 162(m) for the $1 million limitation on executive compensation. Under the changes, performance-based compensation (other than under limited transition relief) is no longer exempt, a broader group of companies are subject to section 162(m) limitations, and the list of "covered employees" whose compensation is subject to the limitation is expanded. Under the new covered employee definition, once a person is a covered employee in any year after 2017, the employee is always a covered employee, and the company is subject to the limitation on tax deductions for compensation paid to that individual over $1 million, even if the amounts are paid at retirement or death. As more time passes without the performance-based exception, more executive arrangements will lose grandfathering status and be subject to disallowance; the passage of time also puts more compensation at risk of a disallowed deduction because the $1 million limitation is not adjusted for inflation. Proposed regulations released in December 2019 largely follow earlier guidance from August 2018, but do provide clarity and shed light on some fact patterns through examples that companies should review and understand.

International tax considerations

Foreign-derived intangible income planning

The FDII rules are an incentive for U.S. companies to sell goods and provide services to foreign customers. By using the FDII regime, as well as the decreased federal corporate income tax rate, U.S. corporations may be able to significantly reduce the group's overall tax burden where eligible functions such as R&D or certain services are relocated to the United States.

Global intangible low-taxed income planning

The GILTI regime requires certain shareholders of foreign corporations to include certain items into current income. GILTI can apply to a broad swath of taxpayers in any industry, so U.S. shareholders need to assess whether they may have exposure to this income inclusion. Planning opportunities to limit a taxpayer's exposure to GILTI are available and should be considered in order to minimize the impact of this tax scheme, including a new exception for income subject to a high foreign tax.

Base erosion and anti-abuse tax planning

The BEAT is an additional tax designed to ensure that corporations with significant base erosion payments made to related foreign parties pay a certain amount of U.S. federal income tax. This tax is in addition to a corporation's regular income tax liability. Taxpayers with more than $500 million of average annual gross receipts and deductible payments to foreign related parties should carefully consider the impact of tax credits (such as the R&D credit) and NOLs on the likelihood of paying the BEAT.

Foreign tax credit planning

Throughout 2019 and 2020, the Treasury and IRS issued many FTC regulation packages setting forth several transition rules and elections that may limit taxpayers' ability to use excess FTCs going forward. Taxpayers with significant pre-TCJA carryforward or post-TCJA carryback credits should carefully consider how their unused FTCs may be limited and which election may be available to allow for an efficient utilization of FTCs. Additionally, the CARES Act grants taxpayers an extended carryback period for their NOLs. Taxpayers choosing to take advantage of this new carryback period should consider how this may affect their FTC position, as a carryback may limit or minimize the capacity to claim credits for prior year foreign taxes.

Base erosion and profit shifting and country-by-country compliance

In line with the Organisation for Economic Co-operation and Development's BEPS project, the IRS issued final regulations in 2016 requiring annual country-by-country reporting (CbCR) by U.S. taxpayers that are the ultimate parent of a multinational enterprise group. This tax filing requirement applies to companies with $850 million or more in global group revenues.

Taxpayers who wish to avoid filing in non-U.S. countries should consider filing Form 8975, *Tax Jurisdiction and Constituent Entity Information*, with the IRS, because filing this form in the United States will satisfy any filing requirements in other countries.

This reporting requirement is still relatively new and may have required taxpayers to significantly change their information reporting processes. Accordingly, affected taxpayers should carefully review the financial and administrative impact CbCR may have had on their compliance function and reevaluate if necessary.

Transfer pricing planning

In addition to considering whether to file Form 8975, taxpayers should consider a variety of important transfer pricing issues before year-end. In particular, taxpayers should consider whether to re-evaluate their existing transfer pricing to account for COVID-19 related shifts in the market place. Changing existing transfer pricing policies may help prevent large losses from being trapped in one jurisdiction while significant income builds up in another. In addition, taxpayers should ensure that year-end true-ups are performed with respect to any cost allocations and should reconcile financial statement results to those required by any relevant transfer pricing documentation that is in place.

Taxpayers should ensure that intercompany transactions are supported by an appropriate agreement. Moreover, taxpayers should conduct a high-level risk assessment of global intercompany activity and consider whether to update any existing transfer pricing documentation, either because of a change in facts or because the documentation is out-of-date.

Planning for payments between and from foreign subsidiaries

U.S. taxpayers generally pay tax on foreign income earned by a non-U.S. subsidiary when the subsidiary makes a distribution of income to the U.S. shareholder. However, payments made between offshore subsidiaries often trigger income inclusions to a U.S. shareholder, even if the U.S. shareholder receives no money.

The TCJA did not make permanent an exception to the law that allows a foreign subsidiary to pay another foreign subsidiary without triggering income to U.S. shareholders. As a result, the exception is scheduled to expire for taxpayers with tax years starting on or after Jan. 1, 2021. It is unclear whether Congress will make this exception permanent as part of a possible extenders package.

In addition, the Treasury and IRS issued regulations addressing the deduction for dividends received from certain foreign corporations. These rules are extremely complex and limit the deduction in significant ways. Taxpayers should consider their planning alternatives in order to mitigate potential income inclusions arising from payments between foreign subsidiaries, or with respect to distributions from those subsidiaries.

Intercompany loan planning

Under current law, a loan or equity investment in a U.S. company by a related foreign subsidiary can result in an income inclusion to a U.S. shareholder of the foreign subsidiary. Even a guarantee by a foreign subsidiary can trigger an income inclusion.

Many taxpayers are unaware of this rule and may have such U.S. investments in place at any given time. However, taxpayers can minimize the adverse impact of this rule by reducing or eliminating U.S. investments or guarantees by foreign subsidiaries before the end of the year, although regulations significantly limit the extent to which an income inclusion may arise in these situations

The changes to the anti-deferral rules under the TCJA should result in fewer taxpayers having exposure to this rule; however, taxpayers using a CFC or its assets as collateral for borrowing should remain aware that certain traps remain.

Review cost-sharing agreements

The story of *Altera v. Commissioner* is a long one. In July 2018, the U.S. 9th Circuit Court of Appeals overturned the U.S. Tax Court's unanimous 2015 decision in *Altera v. Commissioner*, which had effectively invalidated the IRS cost sharing regulations. In July 2019, a Ninth Circuit panel of three judges confirmed the 2018 decision. In August 2019, Altera filed a petition for an en banc review by the entire 9th Circuit Court. Altera's request was denied, leading Altera to request Supreme Court review. In June 2020, the Supreme Court finally put this saga to rest when it declined to hear the case, leaving the Ninth Circuit decision standing. The Ninth Circuit Court decision reversed the U.S. Tax Court's decision on this issue, holding that the Treasury's rule was not arbitrary and capricious, because the Treasury provided a sufficient basis for its decision-making. Many taxpayers have taken positions for financial accounting purposes and in protective tax returns claiming a benefit under the decision of the Tax Court. These taxpayers should immediately evaluate the impact of the Supreme Court's final resolution. Taxpayers should evaluate whether to adjust their ASC 740 reserves and whether this decision will affect interim tax provisions as a potential change in law.

For an overview of the legal issues in *Altera*, see [Altera seeks Supreme Court review after Ninth Circuit reversal](), which highlights the case the Supreme Court ultimately declined to hear.

Exporters should consider a domestic international sales corporation

The U.S. provides incentives to boost exports of some domestic goods. Taxpayers may exclude tax commissions paid to a domestic international sales corporation for supporting overseas sales. When ultimately paid to individual DISC shareholders, DISC commissions are taxable at a 20% rate instead of the higher corporate or individual rates that apply to ordinary business income.

DISCs involve little cost, but a new legal entity must be established, which requires a separate tax return, and all shareholders must elect DISC status before the tax year begins. Thus, interested taxpayers should make a DISC election for 2021 before Jan. 1, 2021.

Key global information reporting action points

Prepare to file new 1099-NEC forms

Non-U.S. companies that are 50% or more U.S. owned and U.S. companies paying compensation for services should be prepared to file new IRS Form 1099-NEC, *Nonemployee Compensation*. Form 1099-NEC must now be used instead of IRS Form 1099-MISC, box 7, to report payments of nonemployee compensation (such as payments to vendors for services) made during 2020. This is a significant change as Form 1099-MISC has historically been one of the most common and frequently used information returns filed by companies across multiple industries to report payments for services.

The new 1099-NEC forms are due by Jan. 31 annually and may require updates to your systems, policies and procedures. Therefore, companies should begin discussions with their tax operations, technology and compliance teams as well as their service providers now to plan for this change. Companies will also need to build in sufficient lead time for requesting budget approvals, drafting recipient guides, renegotiating service agreements and designing new substitute forms as needed.

Consider the reporting implications of debt forgiveness

Lenders cancelling or restructuring debts this year should consider the reporting implications going forward and plan accordingly. The IRS recently clarified in Notice 2020-12 that lenders are not required to file IRS Forms 1099-C, *Cancellation of Debt*, to report the amount of qualifying forgiveness with respect to covered loans made to small businesses under the Paycheck Protection Program administered by the Small Business Administration under Title I of the CARES Act.

Section 6050P of the Code and sections 1.6050P-1 and 1.6050P-2 of the regulations generally require certain entities that discharge at least $600 of a borrower's indebtedness to file an IRS Form 1099-C, Cancellation of Debt, with the IRS and furnish a copy of the form to the borrower. However, according to Notice 2020-12, when all or a portion of the stated principal amount of a PPP loan is forgiven because the eligible recipient satisfies the forgiveness requirements of the CARES Act, for federal income tax purposes only, the lender is not required to, and should not, file a Form 1099-C as a result of the qualifying forgiveness. Lenders should therefore evaluate loans to confirm reporting requirements as soon as possible before year-end and to avoid issuance of 1099-C forms that are not required.

Consider 1099-R implications of COVID-19-related IRA distributions

Relief provided for coronavirus-related individual retirement account (IRA) distributions under the CARES Act will affect taxpayers' 2020 IRS Forms 1099-R, *Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* Under the CARES Act, coronavirus related distributions of up to $100,000 made to qualified individuals can be treated as distributions made from eligible retirement plans (including IRAs) between Jan. 1 and Dec. 30, 2020. As such, the distributions are not subject to the 10% additional tax that otherwise generally applies to distributions made before an individual reaches age 59 ½. The CARES Act also allows IRA owners to skip certain required minimum distributions (RMDs) that they would have been required to take from their IRAs in 2020 (including 2019 RMDs that were due on April 1, 2020, for IRA owners who turned age 70½ in 2019). The impact of these relief provisions should be considered when preparing 2020 Forms 1099-R and may require changes to your systems and procedures, additional training for preparers, and revisions to your customer disclosures and individual retirement account agreements.

Prepare for renewed focus on nonresident aliens and Foreign Account Tax Compliance Act exams

Post-TCJA, the IRS's Large Business and International (LB&I) division announced several new compliance campaigns focused on enforcement of withholding, deposit and reporting requirements for payments made to U.S. nonresident aliens. The campaigns are being enforced through a variety of mechanisms including examinations and penalty assessments. The IRS also announced the launch of a campaign focused on identifying U.S. and foreign financial institutions that have failed to file Foreign Account Tax Compliance Act (FATCA) reports. Examinations started in 2020, which means that companies have a very narrow window of opportunity to become compliant. Additionally, we anticipate increased enforcement of Common Reporting Standard requirements as several jurisdictions have introduced new penalty regimes this year.

Companies should plan to spend the close of the year identifying and remediating any gaps in processes, submitting any unfiled returns, and implementing policies and procedures for ongoing compliance with these rules. The IRS has indicated that it will accept voluntary disclosures regarding noncompliance before institutions receive notices. However, penalty abatement will not be an option once a notice has been received, so take action now!

Reevaluate the FATCA and CRS status of entities in the group

To the extent that companies have acquired or created new legal entities, restructured the group this year, moved into jurisdictions that have adopted the Common Reporting Standard (CRS), or entered into an intergovernmental agreement (IGA) under FATCA, the company should plan to reevaluate or confirm the FATCA and CRS status of legal entities in the group. Entities that accept deposits, have custody of assets, perform investment activities, or serve as captive insurance companies or certain holding companies may be considered foreign financial institutions and may have FATCA and CRS reporting obligations.

Prepare to begin collecting new W-8s

Companies should begin requesting new Forms W-8 and CRS self-certifications from new investors, customers opening new accounts, or those with forms that will expire after Dec. 31, 2020. Note, however, that valid unexpired Forms W-8 can still be relied on and do not need to be replaced until they expire (generally within three years) unless there is a change in circumstances that mandates collection of a new form.

Revised procedures for final section 6050Y regulations reporting of life insurance contracts

The TCJA introduced section 6050Y, which imposed new information reporting requirements for certain life insurance contracts with reportable death benefits paid and reportable policy sales made after Dec. 31, 2018. The IRS had delayed any reporting under section 6050Y until final regulations were issued, but final regulations were issued in late 2019, so companies should be prepared to comply with reporting requirements.

According to the rules, section 6050Y reporting is required by (1) anyone who acquires a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale; (2) an issuer of a life insurance contract upon notice of a transaction required to be reported above or upon any notice of a transfer of a life insurance contract, or any interest in a life insurance contract, to a foreign person; and (3) any payor of reportable death benefits.

For purposes of these rules, reportable death benefits are defined as the amount paid at the death of the insured under a life insurance contract that was transferred in a reportable policy sale. Likewise, a reportable policy sale is defined generally as the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business or financial relationship to the insured.

Companies should evaluate their assets and business activities to ascertain whether they have a section 6050Y reporting obligation and should implement new or enhance existing systems and procedures for complying with the final 6050Y regulations going forward as needed.

Plan for Brexit

While a thorough analysis of the many tax aspects of Brexit is beyond the scope of this guide, taxpayers should be aware that beginning Jan. 1, 2021, the United Kingdom will no longer have access to the multiplicity of trade and tax directives that apply to members of the European Union. This will have a significant impact on the flow of goods and services in and of the U.K. For example, it is possible that goods and services previously not subject to U.K. or EU member tariffs may now be subject to tax. In addition, taxpayers may need to review their VAT registrations to determine if they are valid (e.g., a registration in the U.K. may not be effective in the EU necessitating a fresh registration in an EU member country). There are many other potential impacts too numerous to mention here, but it is clear that taxpayers should assess the impact of Brexit immediately on their business activities and conduct a Brexit impact assessment.

Pass-through entity considerations

Consider application of the section 199A deduction

Section 199A allows for a deduction of up to 20% of a taxpayer's qualified business income (QBI). QBI generally includes most trade or business income reportable on an individual's income tax return, often attributable to the individual's share of income from pass-through entities. However, certain exceptions do apply. Notably, foreign source income, investment income, and income from certain listed specified service trades or businesses, among other items, generally will not constitute QBI and would thus not be eligible for the deduction. For income that does constitute QBI, this deduction effectively reduces the top income tax rate applicable to that income from 37% to 29.6%. The deduction does not apply to self-employment or net investment income taxes. However, the deduction is applicable in computing alternative minimum taxable income.

Pass-through owners whose taxable income exceeds $163,300 (or $326,600 for a joint return) are subject to limitations on the deduction. These taxpayers may see the deduction reduced or fully eliminated if the business does not pay sufficient wages to its employees; does not employ sufficient amounts of tangible, depreciable assets in the business; or conducts business activities considered in whole or part to be a specified service business described in the law.

While beneficial to many, this new deduction has brought with it new reporting requirements and complexities for pass-through entities and their owners—specifically discussed in the February 2019 final regulations issued by IRS and Treasury.

Moreover, there is still uncertainty in several areas, particularly whether certain business activities involve the performance of services in certain nonqualifying specified service business fields—such as consulting and health care. Additionally, the reporting requirements associated with entity-level aggregation of businesses for purposes of calculating the deduction is a highly complex area.

Given the complexity, pass-through business owners should consult with their tax advisors when evaluating their eligibility for the 20% deduction, in assessing compliance with the final regulations, and when considering whether changes to their business could enhance the benefit.

It is also useful to note that the IRS and Treasury released additional final regulations in June 2020 that are effective for tax years beginning after Aug. 24, 2020. Perhaps most notably, these regulations provide guidance on how to handle previously disallowed losses when computing QBI. The regulations also contain rules related to dividends received by RIC's from REIT's, and rules for applying section 199A to trusts and estates.

Bonus depreciation available for certain step-up transactions

Historically, purchasers of partnership interests were able to generate additional depreciation deductions through step-up elections; however, these step-ups were not eligible for bonus deprecation, as they generally represented the indirect purchase of a used asset. As noted above, the TCJA changed this rule to allow bonus depreciation for purchases of used assets.

The final rules clarify how the rule changes affect step-up depreciation generated by the acquisition of an interest in an existing partnership and similar transactions. In many cases, but not all, the purchaser will benefit from this immediate deduction to the extent its share of the step-up is allocable to qualified assets. Although the final regulations provide clarity on the application of the bonus depreciation rules to certain step-up transactions, there is still uncertainty surrounding the availability of bonus depreciation for certain transaction structures—such as those involving the purchase of all interests in a partnership by an existing partner or the contribution of assets to a partnership in exchange for both equity and money.

Taxpayers considering transactions that may generate a step-up, or in transactions that could be restructured to generate such a step-up, should pay particular attention to these final rules. Prior to finalizing the structure of a transaction, each transaction should be analyzed to determine whether and to what extent expensing is available, as well as the corresponding tax consequences to the seller.

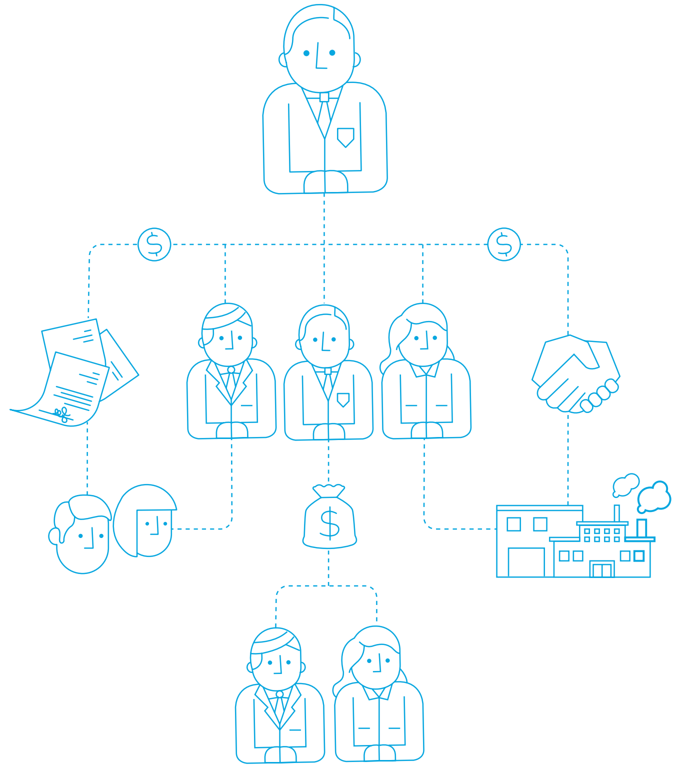
Passive loss and net investment income tax planning

Individuals, closely held C corporations and personal service corporations are generally restricted in their ability to deduct losses from passive activities. Passive losses include losses from rental activities and other business activities in which the taxpayer is not actively involved. However, taxpayers who can demonstrate the necessary level of participation may be able to generate a current deduction for these losses and generate significant income tax savings.

The keys to doing so are: (1) understanding how much participation is necessary, and (2) ensuring that the participation can be substantiated. In most cases, a taxpayer must devote at least 500 hours to an activity in order to avoid the limitations on passive losses. However, in some cases a taxpayer may only need to participate for 101 hours in an activity in order to deduct these losses. Thus, taking action now to increase one's participation can, in some instances, provide a valuable tax deduction.

In situations where the business activity generates a net profit, participation is also relevant when trying to minimize exposure to the 3.8% net investment income tax under section 1411. Owners of pass-through entities usually can avoid the tax on their distributive share of income if they participate in the business for at least 101 hours during the year.

In sum, finding ways to help owners meaningfully participate in a business can have the added benefit of significantly reducing their tax burden.



Reconsidering entity choice

Most pass-through businesses consider their entity structure only once, at the time of formation. However, the TCJA has taken the traditional rules and turned them upside down, leading many partnerships, LLCs and S corporations to reconsider their choice of entity. Under the TCJA, corporate tax rates were reduced from 35% to 21%, while pass-through businesses, such as S corporations and partnerships, may now qualify for a pass-through deduction that effectively cut their tax rates from 39.6% to 29.6%.

This has led many businesses to analyze whether their current tax structure is still efficient. Important questions to consider when re-evaluating entity choice include:

- Why should I remain an S corporation, effectively paying a 29.6% or 37% tax rate, if I can get a 21% tax rate as a C corporation?
- Can my partnership convert to C corporation status and enjoy the lower corporate tax rate?
- Are there issues beyond the annual tax savings I should be considering?
- Are there self-employment tax implications? What about changes to how the owners are currently compensated?
- What role do state and international considerations play in this decision?
- What is the future exit strategy?

Analyzing the interplay of these potentially competing factors is complex, but understanding the implications of entity type on a business's overall tax burden is critical in light of these tax rate changes.

While any shifts in power would not take place until 2021, results of the November election may weigh heavily on an entity choice analysis, and businesses may wish to analyze the potential impact of the candidates' proposals.

IRS compliance campaign affecting S corporations

The IRS LB&I division has identified and selected specific issues on which to focus its compliance efforts through a campaign approach. One of those campaigns focuses on S corporation shareholders who may have claimed losses in excess of their basis in the entity and shareholders' obligation to track (and report) their stock and debt basis when reporting flow-through losses from the S corporation.

S corporation shareholders can take action in anticipation of this campaign, both to ensure that they have adequate records to support their basis calculations and to potentially generate basis before year-end in order to utilize previously suspended losses.

New loss limitations

Included as part of the recently enacted CARES Act are various amendments, as well as technical corrections, to the statutory language of section 461(l), commonly referred to as the excess business loss (EBL) limitation. Most notably, the CARES Act retroactively eliminates the EBL limitation for tax years 2018 and 2019, and instead defers its effective date to tax years beginning after Dec. 31, 2020.

While this change was designed to ease the burden on taxpayers, there are certain aspects of this retroactive elimination that need to carefully considered. Specifically, since the CARES Act changed the effective date of the EBL limitation retroactively, section 461(l) no longer applies to tax year 2018. Accordingly, taxpayers that had an NOL carryforward in 2019 originating from a 2018 EBL no longer have an NOL carryforward in 2019. Thus, absent additional guidance, taxpayers with EBLs generated in 2018 will need to amend their 2018 tax returns in order to claim the loss in 2018. The EBL limitation will apply again—with certain changes—for tax years beginning after Dec. 31, 2020.

Given the complexity associated with this retroactive elimination, as well as its potential benefits, business owners with EBLs should consult with their tax advisors to ensure proper treatment for 2018 and 2019.

Planning for the new partnership audit rules

All entities organized as partnerships for federal tax purposes will be affected by the new partnership audit rules enacted in late 2015 and effective for partnership tax years beginning on or after Jan. 1, 2018. These rules, among other issues, raise the specter of a required entity-level payment of tax on any audit adjustments. Partnerships subject to these rules will need to designate a partnership representative whose powers to bind the partnership will go well beyond the tax matters partner of prior law. As a result, these new audit rules may create significant new business conflicts among current partners, as well as former partners and managers.

Since enactment, additional regulatory guidance, as well as technical corrections to the statute itself, have become effective. Most critically, both the regulations and technical corrections clarify that the "push-out" mechanism, by which partnerships can place the burden of examination-related tax adjustments on their partners—the partners in the year being examined—by issuing them statements showing their share of any adjustments, will be operable through tiered partnership structures.

Some IRS examinations applying the partnership audit procedures have begun. Potential conflicts and risks could exist now, particularly when transactions involving uncertain tax positions may be subject to audit under the new regime. Therefore, we recommend that partnerships act immediately to ensure that appropriate governance and operating provisions are in place in the partnership's governing documents to adequately protect the interests of current partners, former partners and management.

Additionally, partnerships subject to the new partnership audit rules (i.e., partnerships that are not eligible to elect out of the new rules) may no longer file an amended return, and must instead file an administrative adjustment request to correct items on a previously filed tax return. Consequently, partnerships may wish to consider extending their federal tax returns regardless of when the tax return will actually be filed. In the event the partnership identifies an incorrect item after the return is filed, but before the extended due date of the tax return, the partnership would be permitted to file a superseding return to correct the item by the extended due date. Partnerships that identify errors after filing, but that have no such extension in place, would need to file an administrative adjustment request to deal with such an error.

Self-employment tax considerations for partners

Several tax court decisions, in conjunction with other forms of guidance including long-standing and controversial proposed regulations, have created an unclear picture as to the treatment of members of LLCs and limited liability partnerships (LLPs) under the self-employment tax rules.

The IRS has taken aggressive positions in this area. Recent decisions indicate that in certain cases LLCs may want to consider modifications to their governance rules, substantiating the fact that certain portions of income are exclusively a return of capital (and not compensation for personal services), or adopting a limited partnership structure. These changes may provide greater confidence regarding the application of the self-employment tax to members of LLCs and LLPs.

In some cases, court decisions may provide planning opportunities to consider whether self-employment income may be reduced.

Partners as employees

Partnerships or LLCs may find treating partners as employees provides several benefits, including state tax benefits and overall simplification of reporting wages via Form W-2 instead of Schedule K-1. Several recent developments in the law, both favorable and unfavorable, affect when this practice may be permissible. This includes unfavorable regulations denying employee treatment under structures in which the partners of a tax partnership are employees of a single-member LLC owned by the tax partnership. The regulations also clarify that using a professional employer organization does not achieve employee status for partners in the partnership.

A partnership or LLC considering taking or maintaining a position that some of its direct or indirect partners are direct or indirect employees may want to consider adopting a tiered structure so that employees are partners in a holding company rather than the tax partnership that is their actual employer. Additionally, partnerships or LLCs considering taking this position will also want to analyze the impact such a decision may have on their partners' ability to utilize the new pass-through deduction afforded by section 199A. Specifically, W-2 wages paid to direct or indirect partners will not be considered qualified business income and, thus, are not eligible for the new deduction.

Planning in this area can generally produce the desired result with minimal hurdles.

New carried interest legislation

The TCJA added a new provision affecting the treatment of so-called carried interests, defined generally as partnership interests received in exchange for services in certain specified businesses in the investment and real estate industries. This provision has the practical impact of converting long-term capital gain income into ordinary income short-term capital gain in certain circumstances.

Many exceptions and nuances apply to this new recharacterization rule. We recommend that taxpayers expecting a large carried interest realization event consider the applicability of this new provision and discuss potential mitigation strategies with their tax advisors. Recently proposed regulations would also cause certain otherwise nontaxable transfers of carried interests, such as gifts, to become taxable to the extent of unrealized appreciation in assets held for less than three years.

Taxpayers should also be aware that this carried interest information might be reported to all partners via schedule K-1 footnotes, even when the carried interest rules may not be applicable to the individual partner. Taxpayers should consult their tax advisors to determine whether the carried interest recharacterization rules apply to their individual circumstances.

New pass-through basis reporting requirements

Forms 1065 and 1040 include new and expanded reporting requirements. Notably, S corporation shareholders are now required to include a basis schedule with their tax return when a shareholder receives a distribution, sells stock, recognizes a loss or receives a loan payment. Partnerships are now required to report the beginning and ending tax basis capital for each partner. In 2019 this reporting was only required if either amount is negative; starting in 2020 this rule applies to all partners and partnerships.

While these changes were made only to the relevant forms and instructions listed above, it is key to note that forms and instructions may have the same force and effect as an actual Treasury regulation, and thus must be carefully followed. Although the IRS did suggest the availability of certain simplified calculation methods and requested taxpayer comment, these methods are not yet formally authorized and may not be available at the time 2020 tax returns are filed.

These reporting requirements are mandatory and we recommend that pass-through entities consult with their tax advisors immediately, especially in cases where shareholders' or partners' historical tax basis information has not been tracked.

State and local tax considerations

Nexus review

Nexus is most often addressed in the context of analyzing what a company does and determining where the company could arguably have established sufficient contacts to be required to file state income and franchise tax returns. However, the question of where a company has to file only scratches the surface of the importance of determining nexus.

More than ever, businesses should consider whether nexus has been established among all state tax types. State revenue departments are increasingly scrutinizing the in-state activities of remote businesses, especially in the context of economic nexus. For sales tax, the U.S. Supreme Court issued its decision in *South Dakota v. Wayfair* in 2018, overturning the long-standing physical presence nexus standard established through *Quill v. North Dakota* in 1992. With the *Wayfair* decision, the Court has opened up the possibility for states to impose sales and use tax collection and remittance responsibilities on remote sellers based solely upon their economic presence in a state. Almost all of the states imposing a sales and use tax now require out of state vendors to collect and remit sales tax provided they meet certain transaction and sales thresholds.

Most states have long taken the position that companies are subject to income and franchise taxes even without maintaining a physical presence in their jurisdictions. But in a post-*Wayfair* era, states have become more focused on activities that produce economic nexus for income and franchise tax purposes. Businesses need to be aware of laws and regulations that can minimize their exposure to taxes such as Public Law 86-272, nonbusiness income allocation, and factor presence standards.

Additionally, it is important to understand whether a company has any opportunities to restructure legal entities or business operations to generate benefits from establishing or eliminating nexus. For example, a company in a loss year with an expectation of generating income in future years may be well advised to establish nexus now in states it has targeted for expansion in order to protect a NOL. In some cases, this can be as easy as hiring or moving an employee earlier than originally planned; however, regardless of the necessary steps, any nexus-establishing activities must be done by year-end.

COVID-19 remote worker nexus and withholding analysis

Due to COVID-19, essential and nonessential businesses have been forced to change how employees perform their duties with mandatory stay-at-home or shelter-in-place orders effective in every state. Businesses in a wide range of industries have transitioned to entirely, or mostly, remote work arrangements. While some businesses may have had remote working procedures in place, many employees are working remotely for the first time. Additionally, as the pandemic shows signs of slowing, some businesses may transition to permanent remote work.

Employees may live or spend time during the pandemic in states and localities that are different from the office or business location, especially when businesses are located near state borders. Businesses with employees should consider the following: 1) a business that does not have any offices or other operations in a state could establish income tax or sales and use tax nexus based on the presence of employees in the state, even if the employee's activities are home-based, 2) if the employee resides or works in a state that differs from the employer's state, the shifting of the employee's responsibilities to remote locations can affect the sourcing of revenues in both states that adopt cost-of-performance and market-based sourcing type regimes, and 3) wages are generally sourced based on the employee's physical location or relative number of working days in the state. States generally treat any day worked in a state as part of this analysis. Accordingly, a day spent working from home in a state due to the COVID-19 pandemic is likely to be counted for purposes of allocating state wages.

Employers should consider a review of their employee locations, payroll systems, withholding responsibilities, unemployment obligations and potential loss of Public Law 86-272 protections because of remote employee activities in previously protected jurisdictions.

Gross receipts taxes review

Six states have adopted some form of gross receipts taxes (Delaware, Nevada, Ohio, Oregon, Texas and Washington). These taxes are imposed on the gross receipts of a business without regard to profit or loss. In some states, the gross receipts tax is imposed in addition to corporate income and franchise taxes. The tax generally applies to receipts generated from sales within the state. Out-of-state businesses are often unaware that they are incurring gross receipts tax liabilities. In the coming year, a number of states will consider adopting a gross receipts tax. At the local level, cities in California, Washington and many other states also impose gross receipts taxes and more are considering these taxes every year.

In addition to the increased tax burden, gross receipts taxes often require new reporting and compliance obligations. Businesses should assess whether states in which they are doing business impose a gross receipts tax or are considering imposing such a tax in the coming year.

Market-based sourcing review

Over two dozen states have adopted market-based sourcing rules for services, replacing the traditional cost of performance sourcing rules. Market-based sourcing looks to the location of the customer. However, the states take different approaches to determining the market, including considering where the services are delivered, received and billed. Companies that do not analyze these different approaches often overstate or understate their sales factors.

Apportionment review

State revenue departments are scrutinizing business apportionment methods more closely than ever before. For multistate companies, particularly those with more than one business line, complying with myriad different apportionment rules can be a complex administrative burden. Correctly identifying the required apportionment method and the income subject to apportionment and allocation could save substantial amounts of income and franchise taxes.

Before year-end, it is important to extrapolate estimated apportionment data from the first through third quarters of the current year and the fourth quarter of the prior year to identify key positions for which the company will need specific, highly detailed data for its returns. Additionally, by analyzing this data, the company can determine whether more favorable apportionment can be obtained via restructuring of its legal entity structure or business operations or through requesting to use an alternative apportionment formula.

State transfer pricing review

Many states have begun conducting intensive transfer pricing audits of businesses with significant intercompany transactions. The number of audits has quadrupled since 2015, and many states are in the process of hiring more transfer pricing auditors. Moreover, many states have contracted with outside economic and legal experts to pursue suspected transfer pricing violations. These audits often lead to substantial tax adjustments and prolonged litigation. Also, they consume an inordinate amount of taxpayer resources.

State transfer pricing usually focuses on three related inquiries. First, most states have adopted some form of the federal transfer pricing rules under section 482 of the Internal Revenue Code. States examine whether intercompany prices are "arm's length." Second, states examine whether the intercompany transactions have economic substance, i.e., whether the transactions have a business purpose apart from tax avoidance. Third, some states expressly disallow certain deductions for expenses between related parties. That is, the states require businesses to add back the deductions to their income. A proactive review would significantly reduce the risk and exposure of a costly transfer pricing audit and adjustments.

COVID-19 state income tax refund review

Many taxpayers have open periods with conservative positions taken on state and local income and franchise tax filings. It is important that taxpayers consider reviewing those positions for potential refund claims due to changing facts and circumstances of the business and changes in state and local statutory and regulatory law, as well as new guidance that may have materially changed or mitigated the previous positions. Additionally, some taxpayers will be opening up extended periods normally outside of a state's statute of limitations by carrying back federal NOLs five years as provided under the CARES Act. These extended statutes of limitations create more opportunities for a thorough look back on historic positions.

Attribute maximization review

State attribute regimes, such as state NOL calculation and usage rules, can vary significantly from the federal rules. Companies can take advantage of various planning opportunities to address attributes generated before establishing nexus, becoming a member of a combined or consolidated group, and acquiring, merging or liquidating an entity. For example, if a company has substantial tax attributes trapped in a perennially underperforming or newly acquired entity and has another entity that could fully utilize those attributes, it may be beneficial to merge those entities or, in some cases, to elect or request to file on a combined or consolidated basis.

Deduction maximization review

If a company has multiple entities in its structure, it may be beneficial to examine projections of current-year income and deductions to identify isolated current-year loss entities. It may be possible to fully utilize the deductions creating those projected losses through expense allocation, transferring payroll or property, restructuring, or electing or requesting to file on a combined or consolidated basis.

Unitary review

Depending on the circumstances, filing state income tax returns on a mandatory combined basis can provide substantial benefits or detriments to taxpayers. It is important to determine whether the business has the requisite control, integration and flow of value to establish unity and to model state income taxes on a separate and combined basis. Where sufficient value exists, it may be advisable to take steps to break or create unity. This analysis is particularly important if the company has completed, or is going to complete, a major acquisition or disposition of entities or assets during the tax year.

Credits and incentives compliance review in the COVID-19 economy

Taxpayers should consider maximizing cash flow amid the economic interruption of the COVID-19 pandemic through existing, renegotiated or new incentive programs. This includes a review of any incentive programs they already have in place to confirm that all compliance and performance requirements are being met to mitigate the risk of clawbacks. Taxpayers at risk of failing to meet agreed-upon targets should consider proactive communication with the economic development authority or taxing authority to either renegotiate agreements or obtain extensions to meet targets.

Taxpayers should also be aware of myriad new or revised federal and state incentives programs enacted in the wake of the pandemic including programs targeting hiring, training, job retention and capital investment. COVID-19-specific economic assistance programs are being implemented in several states. Taxpayers should proactively look to take advantage of these programs.

Finally, taxpayers should consider evaluating current and recent utilization of existing statutory incentives opportunities to maximize benefits. Many states allow taxpayers to retroactively claim statutory benefits and some businesses may have neglected to consider their availability in prior periods.

Regardless of whether an extended economic downturn occurs as a result of the pandemic, there are many other state credit and incentive programs that allow taxpayers to take advantage of historical growth. Taxpayers should review their state business activities and tax liabilities for all years that are still open under each state's statute of limitations to ensure that all potential benefits are captured and realized either as current or future cash flow.

State CARES Act and tax reform review

In response to the coronavirus, the federal government has put into place a series of legislative relief measures, such as the CARES Act. Most federal agencies, including the Treasury, have issued administrative rules and regulations dealing with aspects of the crisis. Federal legislative and administrative measures dealing with COVID-19 have been proposed and more are expected. Many federal tax law changes lead to state law revisions conforming to or decoupling from federal law. While some states automatically conform to changes to the Internal Revenue Code for state income tax purposes, many others have fixed-date conformity or only conform to specifically enumerated provisions. With the shortened state legislative sessions in 2020, many fixed-date states have not been able to update their statutory conformity with the CARES Act.

It is important for businesses to be aware of the vast differences among the state approaches to the CARES Act, and to federal tax reform, and be prepared to address those differences on relatively short notice. Conformity may affect Paycheck Protection Program loan forgiveness, the treatment of qualified improvement property, retirement funding and distribution rules, charitable deductions, NOLs, and business interest expense among other provisions of both the CARES Act and federal tax reform.

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