2018 Year-End Tax Planning for Businesses

Businesses of all sizes, across all industries, have been impacted by the monumental changes to the federal tax code. To maximize tax savings and ensure compliance with the new rules, businesses need to engage in year-end planning conversations now. Certain tax savings opportunities may apply regardless of how your business is structured, while others may apply only to a particular type of business organization. No matter the type of business entity you operate, year-end tax planning should consider all possibilities to effectively lower your total tax liability.

On December 22, 2017, President Trump signed sweeping federal tax reform into law. Tax reform has significantly changed the U.S. tax system for both individuals and businesses. Some of the most impactful measures from tax reform impacting businesses include:

- The corporate rate was permanently reduced from 35 percent to 21 percent.
- The availability of cash method accounting has been expanded to small businesses.
- The corporate alternative minimum tax (AMT) was eliminated.
- The Section 199A deduction for pass-through business owners.
- The bonus depreciation rules grant full expensing and have been expanded.
- The U.S. international tax landscape has changed significantly.
- The Federal Research Credit is more valuable than ever.

This **Tax Letter** is organized into sections discussing year-end and year-round tax-saving opportunities for:

- All businesses
- Partnerships, limited liability companies, and S corporations
- C corporations

A complete summary of the tax legislative proposals under consideration is beyond the scope of this letter. As circumstances warrant, additional updates will be provided. Comprehensive tax planning for businesses also requires consideration of tax consequences impacting their individual owners.

Tax Saving Opportunities for All Businesses

2018 Versus 2019 Marginal Rates

Whether you choose to accelerate taxable income into 2018 or defer it until 2019 depends, in part, on the marginal tax rate for each year projected for your business. Generally, unless your 2018 marginal tax rate will be significantly lower than your 2019 marginal tax rate, you should defer taxable income to 2019.

The marginal tax rate is the rate applied to your next dollar of income or deduction. Projections of your business's 2018 and 2019 income and deductions are necessary to determine the marginal tax rate for each year.

In addition, the circumstances of an individual taxpayer may cause the marginal or effective tax rate to be higher in one year than in the other year. While the maximum marginal federal tax rate is 21 percent for C corporations, the maximum marginal federal tax rate for individuals is 37 percent.

Moreover, the combined effect of certain phase-out provisions for high-income individuals and the additional 3.8 percent tax on net investment income could push the effective marginal tax rate on high-income individuals to nearly 41 percent. If the relevant tax rate is expected to be approximately the same for each of 2018 and 2019, consider taking advantage of various tax rules that allow taxable income or gain to be deferred, such as sales of stock to an employee stock ownership plan, like-kind exchanges, involuntary conversions, and tax-free merger and acquisition transactions.

Cash Versus Accrual Method of Accounting

Except for farming businesses and certain qualified personal service corporations, C corporations and partnerships that have a C corporation as a partner must use an accrual method of accounting if their average annual gross receipts for the three prior taxable years exceed $25 million, regardless of the type of business in which they are engaged. The annual gross receipts threshold is increased from $5 million to $25 million as a result of tax reform for tax years beginning after December 31, 2017, and expands the number of taxpayers eligible to use the overall cash method.

Furthermore, entities that are treated as tax shelters under Section 448 are prohibited from using the overall cash method and must use the overall accrual method. An exception to the required use of the accrual method pertains to C corporations and partnerships with a C corporation partner if the average annual gross receipts over the preceding three tax years are $25 million or less. So long as the companies are not tax shelters, C corporations and partnerships with a C corporation partner are permitted to use the cash method of accounting, regardless of whether the company has inventories.

Pass-through entities (e.g., S corporations, partnerships, limited liability companies) that do not have inventories and that are not considered tax shelters under Section 448 are permitted to use the overall cash method of accounting and are not subject to any average annual gross receipts limitations.

Planning Suggestion: For federal income tax purposes, the use of the overall cash method may benefit taxpayers that generate accounts receivable that significantly exceed the accrued expenses and accounts payable. Because income is reported only when actually or constructively received, the cash method affords a deferral of income until such times as the accounts receivable amounts are received. Note however that taxpayers with contracts that provide for the receipt of advance payments may wish to avoid the overall cash method for this same reason. Where appropriate, accrual method taxpayers that meet the $25 million test for 2018 and beyond should consider filing an automatic Form 3115, Application for Change in Accounting Method change, to change to the overall cash method. The automatic Form 3115 must be attached to the timely filed (including extensions) federal income tax return for the year of change and a copy of the Form 3115 must be mailed to the IRS Covington, Kentucky office on or before the filing date of that return.

All other taxpayers, including S corporations and C corporations that are qualified personal service corporations, can use the cash method of accounting regardless of their average annual gross receipts. However, if they have inventories, they must use an accrual method for purchases and sales, with the exception of certain qualifying small business taxpayers having average annual gross receipts for the prior three taxable years of not more than $25 million, an increase from the $1 million threshold under Rev. Proc. 2001-10 or the $10 million threshold under Rev. Proc. 2002-28. Supplies consumed in the rendering of services are not inventory. In addition, some taxpayers in certain businesses have been successful in persuading courts that certain types of tangible property transferred to customers in connection with the provision of services are not inventory if the property is incidental to the performance of services.

The Internal Revenue Service has provided a de minimis exception with regard to the use of an accrual method of accounting. Under this exception, a taxpayer can use the cash method of accounting if it has average annual gross receipts of $1 million or less. If the taxpayer has inventories, it can deduct the cost of the inventory only when sold.

Revenue Recognition

Companies need to be mindful of two major developments that could impact the timing of revenue recognition for federal income tax purposes: namely, (1) the impact of the new financial accounting standards for recognizing revenue and (2) the modifications to the existing revenue recognition rules for accrual method taxpayers enacted as part of tax reform.

On May 28, 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standard Board (IASB) jointly announced new financial accounting standards for recognizing revenue, titled “Revenue from Contracts with Customers (Topic 606).” The new standards are effective for publicly-traded entities, certain not-for-profit entities, and certain employee benefit plans for annual reporting periods beginning after December 15, 2017. For all other entities, the new standards are effective for annual reporting periods beginning after December 15, 2018. Under the new standard, a taxpayer generally recognizes revenue for financial accounting purposes when the taxpayer satisfies a performance obligation by transferring a promised good or service to a customer.

An entity will recognize revenue for promised goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services based on the following five sequential steps: (i) identify the contracts with a customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligation; and (v) recognize revenue as the entity satisfies a performance obligation. A taxpayer that has adopted the new standard may wish to make a corresponding change in its method of accounting for recognizing revenue for tax purposes. To do so, the taxpayer must file an automatic consent Form 3115 request for the tax year in which the taxpayer adopts ASC 606. This automatic change enables the taxpayer to change the method of accounting to identify the performance obligation, allocate the transaction price to performance obligations, and to consider performance obligations satisfied, provided that the taxpayer’s new method of accounting is otherwise permissible under the Internal Revenue Code.

Planning Suggestion: It is imperative for taxpayers that have already implemented the standard (or are currently in the process of implementing) to examine whether any tax accounting method changes are necessary to prepare and file such method changes under the automatic procedures in the proper taxable year. Otherwise, if a taxpayer files an accounting method change related to ASC 606 in a non-implementation year, it may need to do so under the non-automatic consent provisions, which entails an IRS user fee, more IRS scrutiny, and an accelerated filing deadline.

In another development, Congress as part of tax reform modified the revenue recognition rules of Section 451 of the Internal Revenue Code that will impact accrual method taxpayers that have applicable financial statements. Under the accrual method of accounting, income is includible in the tax year in which all events have occurred that fix the taxpayer’s right to receive the income and the amount thereof can be determined with reasonable accuracy. The all events test is met at the earliest of when (1) performance occurs, (2) the income is due and payable, or (3) the income is received.

As modified by the 2017 tax reform act and effective for tax years beginning on or after December 31, 2017, Section 451(b) provides that the all events test with respect to any item of gross income (or portion thereof) shall not be treated as met any later than when such item (or portion thereof) is taken into account as revenue in the taxpayer’s applicable financial statement or such other financial statement as the Secretary may specify. Taxpayers that are presently deferring income for a period longer than books are required to file a Form 3115 to conform to the new rules. These changes are presently not included as automatic method changes, although it is possible that the government will add them to the list before the end of 2018.

Advance Payments

Cash-method taxpayers recognize revenue (including advance payments) when cash is actually or constructively received.

Accrual-method taxpayers recognize revenue upon the earliest of when (1) payment is earned through performance, (2) payment is due, or (3) payment is received. However, under Revenue Procedure 2004-34, payments received by an accrual-method taxpayer in advance of services being performed or goods being delivered can be deferred to the next succeeding taxable year if such payments are reported on the taxpayer's "applicable" financial statements as deferred revenue, or if earned in a later taxable year in the absence of applicable financial statements. This so-called "one-year deferral method" is also available for advance payments received for the use of intellectual property, certain guaranty or warranty contracts, and the sale, lease, or license of computer software. As part of tax reform, Congress codified the one-year deferral method. Under new Section 451(c), effective for taxable years beginning after December 31, 2017, advance payments shall either be included in gross income in the taxable year received, or deferred in accordance with books in the year received, with the remaining amounts to be included in the subsequent year. While Rev. Proc. 2004-34 may ultimately be replaced by Section 451(c), the IRS stated in a recent notice that taxpayers can continue to utilize Rev. Proc. 2004-34 and its procedural rules for the time being until further notice. If an accrual-method taxpayer wishes to change its present method of accounting for recognizing advance payments to a method consistent with the one-year deferral method described in Rev. Proc. 2004-34, generally such change can be made by filing an automatic consent Form 3115 with its timely-filed federal income tax return (including extensions). Similarly, a cash-method taxpayer desiring to change to an overall accrual method, as well as adopt the one-year deferral method for advance payments, may file a single combined automatic consent Form 3115.

Additionally, as a result of Section 451(c), the deferral techniques available to advance payments for goods under Section 1.451-5 of the Income Tax Regulations (such as the two-year deferral method for inventoriable goods) are overridden. Taxpayers that are deferring advance payments under Section 1.451-5 of the regulations would be required to file an automatic consent Form 3115 to change to either the full inclusion method or the one-year deferral method for tax years beginning after December 31, 2017.

Related-Party Transactions

According to Section 267, accrual-method taxpayers may not deduct salaries, bonuses, interest, rent, or other expenses owed to cash-method related parties until payments are made.

Related parties include:

- An individual and his or her more than 50 percent-owned corporation;
- Partnerships and their partners;
- S corporations and their shareholders;
- Two corporations having more than 50 percent common ownership; and
- A corporation and a partnership, if the same persons own more than 50 percent of each

If you are an accrual method taxpayer and have improperly deducted accrued expenses or payables prior to actual payment, please consult your advisor regarding filing an automatic Form 3115 to request IRS consent to change its method of accounting to comply with the Section 267 rules.

Unrelated Party Compensation

Accrued compensation, including bonuses and vacation pay which are payable to unrelated employees, reduces an employer's taxable income. However, these deductions are also subject to restrictions. For accrual-method employers, the fact of the liability to pay the compensation must be fixed and determinable by the end of the taxable year to generate a deduction for compensation accrued by the employer's year-end. The Service issued additional guidance in recent years on the application of these requirements to bonus plans.

In addition to the foregoing requirements, for the accrual- method employer to obtain a current deduction for compensation, the 2018 accrued compensation must be paid to unrelated employees (and cash-method independent contractors) within 2½ months after the end of the taxable year. Otherwise, this compensation is treated as deferred compensation and is deductible only when paid.

Note: Vested deferred compensation, although not currently deductible, is considered "wages" for FICA (Federal Insurance Contributions Act) and FUTA (Federal Unemployment Tax Act) tax purposes. Note also that under the Section 409A deferred compensation rules discussed below and in our 2018 Year-End Tax Letter for Individuals, certain items with deferred payment dates will now be currently taxed to the employee (with a corresponding deduction to the employer).

Planning Suggestion: *Employers with taxable years that end in October, November, or December 2018 should pay accrued compensation to unrelated employees in early 2019 (within 2½ months of the employer's year-end) in order to obtain the following advantages:*

- ***2018 deduction for employers***
- ***2019 income for employees***

Nonqualified Deferred Compensation

Section 404(a)(5) dictates the employer's deduction for deferred compensation is the taxable year that the employee is taxed on the compensation. For deferred compensation arrangements that comply with the Section 409A restrictions on the timing of distributions from, and contributions to, nonqualified deferred compensation plans the deduction will be recognized when paid. For noncompliant Section 409A taxation to the participant has deemed taxable income as the compensation vests and accordingly the employer's deduction is accelerated. Failure to properly report taxable compensation and to withhold appropriate taxes exposes the employer to reporting and under-withholding penalties, as well as liability for any unpaid taxes that should have been withheld. However, the heavier penalty is on the participants in such plans who will be subject to immediate taxation of plan balances that have not previously been taxed, plus an additional 20 percent tax penalty and interest. Plans that may be affected by these rules include salary deferral plans, incentive bonus plans, severance plans, discounted stock options and stock appreciation rights, phantom stock plans, and restricted stock units.

Under an IRS correction program for operational errors, certain errors can be corrected penalty-free in the same taxable year as the failure (or by the end of the immediately following year for non-insiders – participants other than directors, officers and ten percent owners), and limited relief for certain errors corrected thereafter or failures involving small amounts. The Service issued an additional program that allowed taxpayers to correct certain plan-document failures with no penalties if corrected more than one year prior to the payment event (or limited penalties in which the 20 percent tax is applied to only half of the account balance if, in most instances, corrected within 12 months of the payment event). Corrective action for operational failures that occurred during 2018 (and 2017 for non-insiders) should be completed by December 31, 2018, to obtain penalty-free relief; and documentary failures should be corrected immediately and sufficiently in advance of the earliest payment event to obtain penalty-free relief.

Deductible Versus Capitalizable Intangible Costs

Taxpayers that pay or incur costs to acquire or create intangible assets should be mindful of the so-called intangible capitalization regulations under Section 263(a). For example, under these regulations:

- Employee compensation, overhead, and de minimis costs are not required to be capitalized even if the costs facilitate the acquisition or creation of intangible assets.
- Prepaid expenses generally are capitalized, unless the amounts are paid or incurred to obtain a right or benefit not extending beyond the earlier of 12 months or the end of the following taxable year and otherwise meet the general timing of deduction rules of Section 461.
- Fees paid to outside vendors such as investment banks, accountants, attorneys, or other consultants for professional services rendered in connection with acquisitions, mergers, reorganizations, restructurings, recapitalizations, stock issuance, and other transactions generally are capitalized.

For certain “covered transactions,” however, certain investigatory costs incurred prior to a bright-line date (e.g., the date the letter of intent is executed) may be currently deductible. In addition, for the same covered transactions, a taxpayer may make a safe harbor election to treat 30 percent of success-based fees as facilitating the transaction (and thus capitalized) and the remaining 70 percent of the fees as not facilitating the transaction (and thus not required to be capitalized under these rules).

A business may elect to deduct start-up expenditures, and a partnership or corporation may elect to deduct organizational expenditures, in the taxable year in which the business begins, of an amount equal to the lesser of (1) the amount of such expenditures, or (2) $5,000, reduced by the amount by which such expenditures exceed $50,000. The remainder may be amortized over a 180-month period.

Under the statute, it is necessary for a taxpayer to attach a separate election statement to its timely-filed return in order to make the election. However, the regulations provide that a taxpayer is no longer required to file a separate election statement. Instead, the taxpayer is deemed to have made the election unless it chooses to forgo the deemed election by clearly electing to capitalize its start-up or organizational expenditures on a timely-filed return.

Taxpayers that wish to change the characterization of an item as a start-up expenditure or change the determination of the taxable year in which the taxpayer’s active trade or business to which the start-up expenditures relate begins may file an automatic consent Form 3115 with its timely filed (including extensions) federal tax return. Similar automatic changes are available for organizational expenditures under Section 248 and organizational fees under Section 709.

Corporate AMT Repealed

The 2017 tax reform repealed the corporate AMT, which was imposed on corporations and was added to their regular tax if and to the extent the tentative AMT exceeds the regular tax. Repeal of the corporate AMT is effective for taxable years beginning after December 31, 2017. AMT credits, or a corporation’s previous AMT liabilities, can offset the regular tax liability for any taxable year after 2017 or can be refunded for any taxable year beginning after 2017 and before 2022 for 50 percent of the excess credit for the taxable year (100 percent for taxable years beginning in 2021).

Section 199A Deduction for Qualified Business Income

Under Section 199A, for taxable years beginning after December 31, 2017, taxpayers (other than C corporations) with taxable income (before computing the QBI Deduction) at or below the threshold amount, are entitled to a deduction equal to the lesser of:

1. The combined QBI amount of the taxpayer, or
2. An amount equal to 20 percent of the excess, if any, of the taxable income of the taxpayer for the taxable year over the net capital gain of the taxpayer for such taxable year.

The combined QBI amount is generally equal to the sum of (A) 20 percent of the taxpayer's QBI with respect to each qualified trade or business plus (B) 20 percent of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership (PTP) income of the taxpayer for the taxable year.

QBI with respect to each qualified trade or business is generally defined to mean any item of domestic income, gain, loss, and deduction attributable to a qualified trade or business. A qualified trade or business is generally defined to include any trade or business determined under Section 162 except for a specified service trade or business (SSTB) or the trade or business of performing services as an employee. However, the exception for QBI generated from an SSTB does not apply where the owner has taxable income below the threshold amount.

An additional limitation applies to taxpayers with taxable income (calculated before the QBI Deduction) in excess of the threshold amount. For these taxpayers, their QBI Deduction is subject to a limitation based on the amount of (a) W-2 wages or (b) W-2 wages and the unadjusted basis immediately after acquisition of qualified property attributable to the QBI generated from each qualified trade or business.

The threshold amount for 2018 is equal to $315,000 for individuals filing joint returns and $157,500 for all other taxpayers. The limitations and exclusions subject to these threshold amounts are subject to a phase-in over the $100,000 and $50,000 of taxable income generated by joint filing and other taxpayers, respectively, earned above the threshold amounts. Therefore, for joint filing taxpayers, the phase-in occurs between $315,000 and $415,000 and for other taxpayers the phase-in occurs between $157,500 and $207,500. The threshold amount is subject to cost-of-living adjustments in subsequent taxable years.

Recently proposed regulations provide much-needed guidance. However, in order to maximize the Section 199A benefits, pass-through entities will need to work through a number of potentially complex steps including: (1) identify each trade or business conducted by the pass-through entity, (2) evaluate whether each identified trade or business is an SSTB, (3) identify and allocate each item of QBI to each identified trade or business, (4) determine and allocate W-2 wages and UBIA of qualified property to the QBI attributable to each identified trade or business, (5) confirm the ability to satisfy the reporting requirements, and (6) evaluate applicability of the de minimis and anti-abuse rules.

Interest Expense Deduction Limitation

For taxable years beginning after December 31, 2017, Section 163(j) may limit the deductibility of business interest expense to the sum of (1) business interest income; (2) 30 percent of the adjusted taxable income of the taxpayer; and (3) the floor plan financing interest of the taxpayer for the taxable year (applicable to dealers of vehicles, boats, farm machinery or construction machinery).

For purposes of the Section 163(j) limitation, adjusted taxable income is equal to the taxable income of the taxpayer without regard to (1) any nonbusiness income, gain, deduction or loss, (2) business interest and business interest income, (3) any net operating loss (NOL) deduction, and (4) any deduction allowable for depreciation, amortization or depletion. However, for taxable years beginning after December 31, 2021, the adjusted taxable income calculation will no longer exclude the deduction allowable for depreciation, amortization, or depletion.

For Partnerships

The Section 163(j) interest limitation is applied at the partnership level and any interest expense limitation or “excess business interest expense” is then allocated to each partner as a separately stated item. The partner is required to carryforward its share of the excess business interest which may be deducted to the extent the partnership allocates excess business income to that partner in a future year, i.e., taxable income generated by the partnership in excess of the amount needed to deduct current year partnership interest expense. If the taxpayer is unable to deduct the excess business interest before disposing of its partnership interest in a taxable transaction, the suspended excess business interest expense will reduce gain recognized on the transaction (or increase the recognized loss).

The new rules contain exceptions allowing certain taxpayers to avoid application of the Section 163(j) business interest expense limitation, including (1) any taxpayer that has annual gross receipts under $25 million, (2) regulated public utilities, (2) an electing real property trade or business, and (4) an electing farming business.

Consideration should be given to qualifying for one of the available exceptions. To the extent a partnership expects to generate excess business interest, care should be taken to ensure accurate tracking and reporting of the appropriate amounts, including future excess taxable income. Proper maintenance of Section 704(b) and tax basis capital accounts will be critical in this regard.

For C Corporations

The new rules under Notice 2018-18 provide that all interest expense of a C corporation will be considered properly allocable to a trade or business (solely for purposes of Section 163(j)). Similarly, all interest income earned by a C corporation will be considered business interest income. Thus, both interest income and interest expense of a C corporation cannot be treated as excludable investment items under the Section 163(j) limitation. Forthcoming regulations are expected to provide guidance on whether and to what extent interest expense of a partnership with a C corporation partner will be treated as non-business interest.

For S Corporations

The new rules provide that the rules for C corporations regarding business interest expense and income are not applicable for S corporations. This clarifies that S corporation interest expense and income are not automatically considered as business interest, and is consistent with the statutory requirement that the taxable income of an S corporation is generally determined in the same manner as in the case of an individual. The rules for S corporations are expected to be broadly similar to the forthcoming partnership regulations. For example, the rules similar to those on a partner’s share of business interest income and floor plan financing will apply to S corporations and their shareholders.

Depreciation Deductions

The timing of asset acquisitions is critical to obtain maximum depreciation deductions. Using other depreciation rules to your advantage will also reduce your taxes.

Caution: *Generally, no depreciation is allowable if the property is placed in service and disposed of in the same taxable year.*

Bonus Depreciation

From time to time, Congress has enacted "bonus" depreciation provisions to give businesses additional first- year depreciation deductions, and thus to provide significant incentives for making new investments in depreciable tangible property and computer software. The 2017 tax reform increases such bonus depreciation allowances from 50 percent to 100 percent for qualified property acquired and placed in service after September 27, 2017, and before 2023 (January 1, 2024, for longer production period property and certain aircraft). In effect, the new rule permits "full expensing" of purchases of qualifying property.

The 100 percent allowance is phased down by 20 percent per calendar year for property placed in service in taxable years beginning after 2022 (after 2023 for longer production period property and certain aircraft). A new election allows taxpayers to claim 50 percent bonus depreciation, instead of 100 percent bonus, for the first tax year ending after September 27, 2017.

A taxpayer-favorable development is that bonus depreciation is now permitted for both new and used property acquired by purchase provided the property was not used by the taxpayer before the taxpayer acquired it (i.e., the taxpayer did not have a depreciable interest in the property prior to acquisition) and it was not used by a related party. Bonus depreciation is not available for property primarily used in certain regulatory public utility businesses and property used in a trade or business that has had floor plan financing indebtedness (unless the taxpayer is not a tax shelter and is exempt from the interest limitation rules by meeting the small business gross receipts test of Section 448(c)).

Planning Suggestion: *Plan purchases of eligible property to assure maximum use of this annual asset expense election and bonus depreciation as the 100 percent bonus depreciation deduction ends after 2023. The ability to claim 100 percent bonus depreciation on new and used qualified property benefits taxpayers that acquire assets that constitute a trade or business, rather than acquisitions of stock, because the buyer can potentially deduct much of the purchase price in the year of purchase.*

Application of Bonus Depreciation to Partners and Partnerships

To claim the bonus depreciation deduction, the applicable property must satisfy four requirements: (1) the depreciable property must be of a specific type, (2) the original use of the depreciable property must commence with the taxpayer or used property must meet specific acquisition requirements, (3) the depreciable property must be placed in service by the taxpayer within a specified time period, and (4) the depreciable property must be acquired by the taxpayer after September 27, 2017. In the context of partnership transactions, availability of bonus depreciation will be dependent upon on a number of factors and the nature of the transaction. The following summary details whether bonus depreciation will be available in several common situations:

- **Section 743(b) Basis Adjustments –** Bonus depreciation is generally available
- **Section 734(b) Basis Adjustments –** Bonus depreciation is not available
- **Section 704(c) Remedial Allocations –** Bonus depreciation is not available
- **Zero Basis Property –** Bonus depreciation is not available
- **Basis Determined under Section 732 –** Bonus depreciation is not available

There is now a greater incentive to structure a transaction as a sale of a partnership interest, either directly or indirectly via a “disguised sale of partnership interests.” These partnership interest acquisition transactions ensure that the basis step-up occurs via Section 743(b), rather than other types of transactions such as partner redemptions or equity contributions. These alternative transactions would produce similar results with either Section 704(c) remedial allocations or a Section 734(b) basis adjustment.

Qualified Improvement Property

Tax reform eliminated the qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property asset classifications from Section 168 for property placed in service after December 31, 2017, and replaces them with the qualified improvement property (QIP) classification. QIP is defined as any improvement to an interior of a building that is nonresidential real property as long as that improvement is placed in service after the building was first placed in service by any taxpayer. With the expanded definition of QIP, the intent of Congress was that QIP would be assigned a 15-year life, and thus be eligible for bonus depreciation. Due to a drafting error, the 2017 tax reform legislation does not assign such 15-year life to QIP. Unless and until a technical corrections bill is passed, QIP acquired after September 27, 2017, and placed in service after December 31, 2017, will be subject to a 39-year recovery period and will not be eligible for bonus depreciation.

Section 179 Expensing Election

If you purchase certain depreciable property, you may elect to treat a specified dollar amount as a deduction for property placed in service during the taxable year. However, the benefits of this election are phased out if more than a specified dollar amount of qualifying property is placed in service. Tax reform increased the maximum deduction and phase-out threshold for Section 179 property. For 2018, the maximum amount that can be expensed is $1,000,000 and is reduced on a dollar-for-dollar basis for eligible property placed in service in excess of $2,500,000. Both amounts are indexed for inflation annually. The election is available for tangible personal property (including a new provision for assets used in lodging), qualified real property, and off-the-shelf computer software. Further, the 2017 tax reform act expands the definition of Section 179 property to allow taxpayers to elect to include qualified improvements made to nonresidential real property, and improvements to roofs, HVAC, fire protection systems, alarm systems and security systems.

Personal Property Versus Real Property

For regular tax purposes, real property depreciation deductions are available over 27½ years for residential rental property and 39 years for nonresidential property. However, depreciation deductions may be accelerated for real property components that are essential to manufacturing or other special business functions.

> ***Example:*** *Taxpayer constructed a $10 million manufacturing facility, which was placed in service during 2018. The design required an overhead crane, a special reinforced foundation to support equipment, and other specific features to accommodate the manufacturing process. A cost segregation study revealed that approximately $5 million of the facility’s cost can be recovered over seven years instead of 39 years for regular tax purposes (without considering the bonus depreciation provisions described above).*

> **Planning Suggestion:** *Arrange for a cost segregation study to identify personal property and determine optimum depreciable lives for both new and prior acquisitions and construction. The position of the Service is that the present depreciation method for property previously misclassified can be changed, and the full amount of any prior depreciation understatement can be deducted in the current year.*

Tangible Property Regulations

Taxpayers should continue to be compliant with the tangible property regulations, which address, among other items, the following provisions:

- De minimis expensing safe harbor election($2,500 without an applicable financial statement (AFS) and $5,000 with an AFS);
- Small taxpayer safe harbor expensing election;
- Deductible routine maintenance safe harbor for equipment and buildings;
- Deductible repair and maintenance costs Versus capitalizable improvement costs;
- Election to conform to financial accounting to capitalize deductible repair and maintenance expenses; and
- Partial disposition of property.

Repair and Maintenance Versus Capital Improvements

For regular tax purposes, costs must be capitalized that result in a betterment or restoration, or adapt property to a new or different use. Costs not meeting these criteria are potentially eligible for current deduction as a repair and maintenance expense. These criteria can lead to a more generous repair and maintenance deduction for tax purposes compared to the book treatment, capitalizing such costs.

> ***Example:*** *Taxpayer incurred $500,000 in costs for a $10 million facility to repair walls, replace broken light fixtures, apply new paint inside and out, repair a damaged floor, and reseal the floor. Such costs are potentially deductible as repair and maintenance expenses for tax purposes.*

> **Planning Suggestion:** *Deductible costs capitalized in current and prior taxable years can be deducted in the current year, net of any prior depreciation claimed. Arrange for a fixed asset review to identify deductible repair and maintenance costs.*

Remodel/Refresh Safe Harbor for Restaurants and Retailers

In November 2015, the Service issued Rev. Proc. 2015- 56, which provides a safe-harbor method of accounting for most retailers and restaurants that incur refresh or remodel expenditures on qualified buildings. This procedure is significant as restaurants and retailers can deduct 75 percent of qualified remodel-refresh expenses, as opposed to capitalizing and depreciating the costs over 15 or 39 years.

To qualify, a company must have an AFS. A qualified taxpayer must include the capitalizable portion of any expenditures under the remodel/refresh safe harbor in a general asset account going forward. Further, taxpayers wishing to use the remodel safe harbor are not permitted to make the partial disposition election.

Planning Suggestion: *Retailers and restaurants that have incurred deductible remodel-refresh costs capitalized in current and prior taxable years can deduct those costs in the current year, net of any prior depreciation claimed. Arrange for a fixed asset review to identify deductible remodel-refresh costs.*

International Tax Provisions under Tax Reform

The 2017 tax reform legislation enacted several significant international tax provisions including, but not limited to, the Section 965 “repatriation tax”; the foreign derived intangible income (FDII) deduction; the “base erosion and anti-abuse tax” (BEAT); the Section 245A dividends received deduction for the foreign source portion of dividends received by domestic corporations from specified 10 percent owned foreign corporations; new rules denying a deduction for any disqualified related party amount paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity under Section 267A; modifications to the definition of “U.S. shareholder” for controlled foreign corporation (CFC) rules; and the new anti-deferral regime of global intangible low-taxed income (GILTI).

Very generally, the FDII deduction provides a deduction for certain domestic corporations that service foreign customers or markets when certain requirements are satisfied. The new anti-deferral regime of GILTI taxes U.S. shareholders of CFCs on certain types of income earned by the CFCs in a manner generally similar to subpart F income. This provision substantially expands the CFC anti-deferral rules. The BEAT imposes an additional tax on certain corporations that erode the U.S. tax base generally through certain types of payments made to related foreign persons when certain thresholders are met.

The IRS and Treasury have issued guidance throughout the year regarding the 2017 tax reform act’s new international provisions, including Notices, a publication, a Q&A on reporting and proposed regulations for the Section 965 transition tax as well as proposed regulations for GILTI. Additional guidance is expected in the next several months including proposed regulations to be issued for the BEAT, Section 267A, foreign tax credit rules, the Section 245A dividends received deduction, the FDII deduction and previously taxed income rules.

Some of the key topics that taxpayers should consider before year end and in planning for 2019 include repatriating in a tax efficient manner foreign earnings that were taxed under Section 965 or foreign earnings that can qualify for the Section 245A dividends received deduction; estimating the impact of GILTI, the FDII deduction, the BEAT and Section 267A; and reviewing CFC status for the modifications made for purposes of determining “U.S. shareholder” status.

The international tax provisions of tax reform have and will continue to impact many taxpayers. Taxpayers should reach out to their advisor to evaluate their overall structures and supply chains, and the impact that each of these provisions could have on their particular facts and circumstances.

Federal Research Credit

Enacted in 1981 to incentivize taxpayers to increase investments to try to develop or improve products, processes, and software, the Research Credit has become even more valuable as a result of recent tax reform.

The corporate tax rate's reduction to 21 percent effectively increased the net benefit of the Research Credit by more than 21 percent. The elimination of the corporate AMT means that such companies, who weren't permitted to use the Research Credit to offset their AMT, now can benefit from the credit by offsetting any current regular income tax or carrying the credit forward for up to 20 years.

Furthermore, Research Credits generated in tax years 2016- 2020 may be used to offset up to $250,000 per year of the employer's portion of that year's FICA payroll tax if the taxpayer has (1) gross receipts less than $5 million in the tax credit year and (2) no gross receipts for any taxable year preceding the five-taxable-year period ending with the tax credit year.

Finally, a 2017 IRS directive continues to provide Large Business & International (LB&I) taxpayers a "safe harbor" for qualified research expenses (QREs) determined following the directive. QREs determined by the directive start with taxpayers' GAAP ASC 730 research and development (R&D) expenses, which are then adjusted in various ways. The directive has already benefitted taxpayers who use it, enabling them to simplify their processes to identify and support QREs on exam, save time and money, and enjoy greater certainty regarding their Research Credit tax asset.

These developments have increased the Research Credit's value, and companies who aren't looking into this opportunity should, especially if they incur expenses related to services in any technological field, e.g., physics, chemistry, biology, engineering, computer sciences. If you aren't looking into Research Credits because you think your activities don't qualify or you think you don't have the required documentation, please consult with a Research Credit specialist: activities don't even have to succeed to qualify; there are no specific documentation requirements; and there is case law allowing Research Credits even where no documentation was produced.

Work Opportunity Tax Credit

The work opportunity tax credit (WOTC) has been available in the past to employers that pay wages to an individual who is a member of a "target group." An individual who fits into one of the following target groups qualifies for the credit: (1) qualified Temporary Assistance to Needy Families (TANF) recipient; (2) qualified veteran; (3) qualified ex-felon; (4) designated community resident; (5) vocational rehabilitation referral; (6) qualified summer youth employee; (7) qualified food stamp recipient; (8) qualified SSI recipient; or (9) qualified long-term unemployment recipient. Legislation enacted in 2015 extended the WOTC through 2019. This legislation also enhanced the WOTC for employers that hire certain long- term unemployed individuals.

The WOTC operates as follows: if the worker works at least 400 hours in the first year, the credit is 40 percent of the first $6,000 of wages paid. If the worker works at least 120 hours and less than 400, the credit is 25 percent. Therefore, once the employee works the requisite 120 hours, he or she qualifies the previous 120 hours for the 25 percent credit.

Once the employee works the requisite 400 hours, he or she qualifies the previous 400 hours for the 40 percent credit. In some cases, the employer may want to extend the tax return to qualify some workers for the 40 percent credit.

A welfare-to-work credit is available to employers of long- term family assistance recipients. A "long-term family assistance recipient" is a member of a family receiving assistance under TANF or successor program for specified time periods.

The amount of the credit is equal to 35 percent of the “qualified first-year wages” and 50 percent of the “qualified second-year wages.” The amount of qualified wages with respect to an individual cannot exceed $10,000 per year. Thus, the maximum credit is $8,500 per qualified employee.

If a welfare-to-work credit is allowed to an employer with respect to an individual for any taxable year, the employer cannot also take a work opportunity credit with respect to that individual for that taxable year.

Employers are also eligible to receive a tax credit equal to 25 percent of qualified expenses for employee child care facilities and 10 percent of qualified expenses for employee child resource and referral services, up to $150,000 per taxable year.

Employee Retention Credit for Employers in Federal Disaster Zones

Taxpayers located in a federally-declared disaster zone and rendered inoperable as a result of a natural disaster may be eligible for an employee retention credit. In the past, the federal government has offered such a credit to employers equal to the lesser of $2,400 of 40 percent of the wages paid to each affected employee during applicable relief periods to help employers retain essential staff during a disaster recovery period.

Paid Family Leave Credit

The Family and Medical Leave Credit, enacted by tax reform, offers support in the form of a tax credit to employers who provide non-insured paid family and medical leave to employees who need time away from their jobs for exigent circumstances during 2018 and 2019. The amount of the credit begins at 12.5 percent of leave payments provided the replacement rate of wages is at least 50 percent of the employee full time wage with the credit increasing as the replacement rate of wages increases with the maximum credit being 25 percent for wages continued at 100 percent.

Caution: *While the tax credits expire after the two-year period, the paid family and medical leave program itself may not be easily terminated in light of employee expectations. In absence of the federal subsidy, employers would incur additional costs for this ongoing program.*

New Markets Tax Credit

Congress has authorized the allocation of $3.5 billion of new markets tax credits for each year from 2015 through 2019.

Opportunity Zone Program

The opportunity zone program was created in the 2017 tax reform legislation to promote investment in economically distressed communities. There are now over 8,700 certified qualified opportunity zones (QOZs) in all 50 states, the District of Columbia, Puerto Rico and the Virgin Islands.

Investors must invest in a qualified opportunity fund (QOF) within 180 days after the sale or exchange of a capital asset. The QOF is an investment vehicle that must hold at least 90 percent of its assets in QOZ property, which includes QOZ stock, QOZ partnership interest, or QOZ business property. Investment of capital gains in a QOF can result in beneficial tax incentives, including the following:

- Deferral of tax due on the capital gains invested in the QOF until December 21, 2026
- Basis step-up on the capital gains invested of 10 percent if the investment is held for five years and 15 percent if the investment is held for seven years

- Permanent exclusion from taxable income post-acquisition capital gains on investments in QOFs that are held at least ten years.

Treasury released proposed regulations, a revenue ruling and a draft form on October 19, 2018. Although this guidance answered many questions, the preamble to the proposed regulations states that Treasury is working on additional regulations to address other issues. This was the first step of a larger regulatory project that should provide greater certainty in the near future.

Planning Suggestion: *Taxpayers with recognized capital gain should consider making an investment in a QOF to obtain significant tax savings.*

Passive Losses

Generally, passive losses currently offset only passive income. Unused passive losses are carried to future years. An unused (suspended) loss generally is deductible when a taxpayer disposes of his or her interest in the passive activity. Regulations define "activity" broadly, and include provisions for the "grouping" of certain undertakings into a single activity.

For the last several years, however, individual taxpayers have had to be mindful of the passive loss rules even if their activities have consistently generated net taxable income.

Income from passive activities and net gains from dispositions of interests in passive activities will be subject to the 3.8 percent tax on net investment income of high-income individuals. In contrast, if income from a trade or business is not from a passive activity, e.g., because the individual is a material participant in the activity, this additional tax will not be imposed on the income from the activity. Taxpayers had a one-time opportunity to make new or different "grouping" elections for 2013 or 2014, or in any subsequent year in which they would first be subject to this tax.

Personal service corporations (PSCs) are subject to the passive loss restrictions. "Closely-held C corporations" (other than PSCs) can use passive losses to offset active income except for interest, dividends, or other portfolio income. A closely-held C corporation is defined as a C corporation in which more than 50 percent of the value of its outstanding stock is owned by five or fewer individuals.

Planning Suggestion: *Your advisor can assist you in determining whether it would be advisable for you to transfer personally owned passive loss activities to your closely-held corporation (if it is not a PSC). Also, if you anticipate having unusable passive losses this year, those losses may be available to offset gains from partnership or S corporation distributions in excess of your basis.*

Because of the possible application of the additional 3.8 percent tax on net investment income of high-income individuals for 2018, taxpayers should consider the effect of any grouping elections made in prior years for activities that would otherwise be considered as two or more different activities. After 2014 (when a one-time opportunity to make a new or different grouping election expired), taxpayers may only make a grouping election in unusual circumstances. The most likely of such circumstances to occur is that the taxpayer first became subject to this tax in 2015 or a subsequent year.

Passive losses of S corporations and partnerships are passed through to their owners. Special rules apply to publicly-traded partnerships.

Rental Real Estate

Rental real estate activities are generally passive regardless of the taxpayer's level of participation. However, for real estate professionals, rental real estate activities are not automatically passive but are subject to the general material participation tests. A taxpayer is a real estate professional if during the taxable year:

- More than 50 percent of the taxpayer's personal services are performed in real property businesses, and
- More than 750 hours of service are performed in real property businesses.

For both of these tests, the taxpayer may only consider real property businesses in which he materially participates. If a joint return is filed, these two tests are met only if they are separately satisfied by either spouse. However, in determining material participation, a spouse's participation is taken into account. Services performed as an employee are ignored unless the employee owns more than 5 percent of the employer.

Once a taxpayer qualifies as a real estate professional, he must generally determine whether he materially participates in each of his rental real estate activities separately to determine whether it is passive or non-passive. However, the taxpayer may alternatively elect to treat all of his or her interests in rental real estate as a single activity. The election is irrevocable but is often necessary to meet the material participation requirements.

A closely-held C corporation will satisfy these tests if more than 50 percent of its gross receipts are derived from real property businesses in which the corporation materially participates.

Real property businesses are those engaged in real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage.

Beginning in 2013, individual taxpayers with investments in rental real estate have had another potential tax consequence to consider. Even though the special rules for real estate professionals may permit an individual to treat income from rental real estate as income from a non-passive activity, such income is not necessarily exempt from the additional 3.8 percent tax on net investment income of high-income individuals. In order to exclude rental real estate income from this tax, the taxpayer must be able to demonstrate that the income is from the conduct of a trade or business.

Inventories

For taxable years beginning after 1986, specified overhead costs, which previously were deductible for tax and generally not capitalized for book purposes, have to be capitalized by being added to inventory under the Section 263A uniform capitalization rules. This tax requirement increases taxable income to the extent that inventory is on hand at year-end. Special rules apply to LIFO inventories.

As a result of tax reform, the average annual gross receipts test that exempts small resellers from the requirement to capitalize additional Section 263A costs under the uniform capitalization rules (UNICAP) is increased from $10 million to $25 million, and is expanded to both producers and resellers. Taxpayers should be aware of the increased threshold, as more businesses are now eligible to be exempted from UNICAP for 2018 and subsequent years by filing an automatic Form 3115.

Planning Suggestion: *Some taxpayers that are subject to UNICAP either have not complied with these uniform capitalization rules, or have either included too little or too much overhead into their inventory cost. The Service provides incentives for voluntarily making corrective changes to accounting methods, and permits taxpayers to file a Form 3115 to change to various simplified methods automatically.*

Rescinding a Transaction

Because tax consequences are based on an annual accounting concept that uses the facts as they exist at the end of a taxable year, transactions occurring during the year may be disregarded if properly rescinded before year-end.

Example (1): *A calendar-year taxpayer sells property at a gain on July 1, 2018. If the buyer and seller properly rescind the sale by December 31, 2018, the sale may be disregarded for tax purposes.*

Example (2): *A regular corporation and its shareholders are calendar-year taxpayers. The shareholders make capital contributions to the corporation during 2018 for an expansion project which is later abandoned. If the capital contributions are properly rescinded and returned to the shareholders by December 31, 2018, the contributions may be treated as though they were never made and thus will have no tax effect. However, if they are returned after 2018, they may be treated as dividends or other taxable distributions.*

Caution: *State-law considerations should be taken into account in determining whether a transaction may be rescinded. In addition, the Service announced that it will no longer provide letter rulings to taxpayers on the question of whether a particular transaction may be rescinded for federal tax purposes. Although the decision was made in order to allow the Service and Treasury to study the issue further, the Service also announced in 2013 that it did not plan to issue any further published guidance on this issue for the foreseeable future. Your advisor and your attorney should be consulted if you wish to rescind a transaction and achieve tax consequences as if the transaction and rescission had not occurred.*

Tax Obligations and Opportunities under *Wayfair*

On June 21, the Supreme Court of the United States issued its widely anticipated decision in *Wayfair*, allowing states to impose a tax payment or tax collection obligation on out- of-state business, regardless of whether the business has a physical presence in the state. While *Wayfair* dealt with remote seller sales and use tax collection obligations, states may now tax a business even if the business has no in-state physical presence. Overnight, remote sellers, licensors of software, financial services, franchisors, and other businesses that provide services or deliver their products to customers from a remote location must start complying with state and local taxes. Left unchecked, these state and local tax obligations and correlated liabilities from tax, interest, and penalties will grow over time. A business is likely impacted by *Wayfair* if any of the following apply:

1. The business makes sales into states in which it is not registered or filing sales/use tax
2. The business ships goods or provide services to customers located in states where it has little or no in-state physical presence.
3. The business makes retail sales of tangible
4. The company provides online services or make sales of digital
5. The business licenses software or provides access to
6. The business received a “nexus questionnaire” or received audit or tax notices from any state where it is not currently registered for sales/use

Businesses for which any of the above apply should be taking steps to minimize potential exposures from tax, interest, and penalties that are arising now from *Wayfair*, and plan around the very fluid state changes that are happening and will occur in the near future.

As a first step, businesses will need to determine their nexus and filing obligations in states and localities if they have not done so already. Over 20 states have enacted economic presence nexus statutes for sales and use tax purposes and nine states have enacted economic “factor presence” statutes for income tax purposes. In many states, the sales/use tax economic nexus threshold begins at $100,000 or more in sales, and/or 200 or more transactions on an annual basis.

The number of states that adopt similar economic nexus statutes is expected to continue to grow.

When examining such nexus and filing obligations, businesses will need to determine whether the products and services that they sell or purchase are subject to the state and local sales and use tax.

Since *Wayfair* is not limited to state and local sales or use taxes, taxpayers also need to evaluate their income tax nexus, not only for the nine states that have enacted economic factor-presence nexus statutes, but the additional states with income tax economic nexus case law and statutory or administrative authorities for asserting economic nexus as well. Nonetheless, potential limitations on state income tax jurisdiction could still apply depending on a taxpayer’s facts and circumstances, including so-called Public Law 86-272 federal law protections for sellers of tangible personal property.

In states where nexus and tax exposure exists for prior periods, businesses should quantify the historical sales and use tax and state income tax exposures using historical sales and income data and totals by state and by product. For some businesses, the state tax exposure amount may need to be recorded as a liability for financial reporting purposes.

In addition to nexus determination and potential exposure quantification, taxpayers should also consider the various sales/use tax compliance automation solutions that could be available. One result from *Wayfair* is that taxpayers with physical presence in no or one or two states may now find themselves with sales or use tax collection obligations in thousands of state and local jurisdictions. Automated sales or use tax calculation, collection, and remittance software may be a necessary solution. And from an income tax perspective, state sales factor sourcing rules could now take on the added importance of determining an out-of-state company’s income tax nexus with a state.

Further courses of action include mitigating and disclosing historical tax liabilities (e.g., by obtaining documentation to demonstrate state tax obligations owed by your customers and not your business, or pursuing a Voluntary Disclosure Agreement or participating in an Amnesty program) and improving existing processes through tax automation technology. Lastly, it also should be understood that the ramifications of the Wayfair decision are not limited to U.S.-based companies.

Remote sellers and service providers based in foreign countries and with no U.S. permanent establishment may now also have a taxable economic nexus for U.S. state and local tax purposes, as U.S. tax treaties are generally inapplicable (with the exception of the non-discrimination article) to subnational taxes.

The following sections discuss important business considerations at the federal level, including updates on new tax legislation resulting from tax reform.

Tax Saving Opportunities for Partnerships, Limited Liability Companies, and S Corporations

Partnerships

Regulations governing the allocation of partnership income and loss can sometimes lead to unanticipated results. The allocation of losses may be particularly sensitive to routine changes in partnership liabilities. Even if these changes do not affect allocations, they may trigger income to the partners in certain circumstances. Contributions, distributions, and interest transfers can also present income recognition issues. Many of these issues depend on the position of the partnership at the end of its taxable year. Therefore, unforeseen tax consequences can often be mitigated with year-end planning. For example, the implementation of loan guarantees or indemnification agreements can sometimes prevent tax problems related to partnership liabilities.

For tax years beginning after December 31, 2017, significant and generally unfavorable changes have been made to the way partnership returns will be audited by the IRS. The new rules may cause a partnership itself to become liable for underpayments of federal tax by its members and former members relating to their respective shares of partnership income. Various elections are available that may allow a partnership to reduce or eliminate its potential liability, including elections to push tax liabilities out to the partners to whom the adjustments are allocable, to reduce deemed underpayment amounts to reflect the character of the affected items and tax status of the partners, or in limited circumstances to avoid the new audit rules entirely. Changes to partnership agreements and ownership structures may be necessary to take full advantage of these elections.

Partnerships should discuss the appropriate actions with their tax advisors.

A partnership must generally file its federal income tax return by the 15th day of the third month following the end of its taxable year (unless such date falls on a weekend or holiday, in which case the filing date is the next day that is not a Saturday, Sunday, or holiday), but an automatic extension of six months is available upon request. As a result, the due date of a partnership return for the year ending December 31, 2018, can be extended until September 16, 2019.

Limited Liability Companies

Generally, the same federal tax rules that apply to a partnership also apply to a two-or-more member limited liability company (LLC) that is properly classified as a partnership, rather than a corporation, under applicable income tax regulations. Under these same regulations, a single-member LLC owned by an individual can choose to be classified either as a disregarded entity, i.e., sole proprietorship (Schedule C business), or as a corporation, and a single- member LLC owned by a corporation can choose to be classified as a disregarded entity, i.e., part of its corporate owner or a division, or as a separate corporate subsidiary.

S Corporations

All pass-through entities, including partnerships and S corporations, should evaluate their choice of entity as a result of tax reform and the new reduced corporate tax rate. The new Section 199A deduction resulting from tax reform may reduce a pass-through owner’s maximum individual effective tax rate from the highest rate, 37 percent, to 29.6 percent.

Converting from a pass-through entity to a C corporation or vice versa requires complex analysis and planning, and is not covered under this newsletter.

Shareholders of existing S corporations should consider the following year-end planning tips:

- Shareholders must have basis in their stock or in loans to the corporation in order to take advantage of anticipated losses. Basis may be increased by additional capital contributions or direct shareholder loans to the corporation.
- If the corporation has earnings and profits (E&P) on hand which were accumulated during the time it was a regular C corporation, any additional investments in the corporation by the shareholders should be made as loans, rather than as capital contributions, to avoid taxable dividends if these investments are later returned to the shareholders. Shareholder loans should always be well-documented.
- After a shareholder's basis in stock of an S corporation has been reduced to zero, the shareholder's basis in a loan to the corporation is reduced by pass-through losses and increased by the pass-through of subsequent years' income. Because loan repayments may produce taxable income for the shareholder, they should be timed, if possible, to result in the least amount of tax. Advances should be evidenced by a written document in order to obtain favorable capital gain treatment if gain will result when the loan is repaid. Delaying loan repayments beyond 12 months (for long-term capital gain treatment) will allow any gain to be taxed at the lower (20 percent) capital gains tax rate.
- Distributions to shareholders which exceed the corporation's accumulated adjustments account (AAA) may result in inadvertent dividends if the corporation has E&P accumulated from the time it was a C corporation. Therefore, distributions should be delayed if the amount of the AAA balance at year-end is uncertain.
- Dividends received by non-corporate shareholders from domestic and qualified foreign corporations are taxed at a maximum 20 percent rate. Accordingly, S corporations with C corporation E&P should avoid making an actual or a deemed dividend distribution of this E&P, unless there are other compelling reasons for generating taxable dividend income.
- Consider making gifts of S corporation stock to shift income between family members. Gifts of nonvoting stock may be made to keep voting control, if desired.
- Under certain conditions, an S corporation that sells appreciated property will be subject to tax on "built-in gains" (generally the property's appreciation prior to the corporation becoming an S corporation). A built-in gain is determined as follows:

Example:

Total gain on asset's sale	$1,000,000
Less appreciation accruing while an S corporation	300,000
Built-in gain	$ 700,000

If an S corporation has sold property and recognized built-in gains, it should consider offsetting these gains by recognizing built-in losses. Alternatively, the built-in gains tax may be deferred or, in some circumstances, eliminated if the corporation's taxable income can be eliminated.

Caution: Estimated taxes must be paid on net recognized built-in gains. (These estimates cannot be based on the preceding year's tax, if any.)

The built-in gains tax generally applies only to gains recognized during a specified recognition period. Although the recognition period was ten years when originally enacted, changes enacted by Congress over several recent years have resulted in the permanent reduction of the recognition period to five years. Thus, the tax will not be imposed if the S corporation had completed a five-year recognition period at the time the built-in gain is recognized. The tax applies when an S corporation has converted from C corporation status, but it also applies to assets that an S corporation has acquired from a C corporation in a tax-free transaction.

Other less recent changes have made more corporations eligible to become S corporations. For instance, financial institutions not using the reserve method of accounting can become S corporations; S corporations can have up to 100 shareholders and in determining the number of shareholders, extended family groups can be treated as a single shareholder; certain tax-exempt organizations can be shareholders; S corporations can hold controlling interests in other corporations; and wholly-owned domestic subsidiaries of S corporations can be disregarded as entities separate from their parent S corporations if an election is made by the S corporation.

In addition, income allocable to an employee stock ownership plan (ESOP) as a shareholder of an S corporation is not currently taxed, but rather is taxed to the ESOP beneficiary at the time of distribution.

Special Considerations for Pass-Through Entities

Recharacterization of Certain Long-Term Capital Gains under Section 1061

Gain recognized by a partnership upon sale of a capital asset held for at least one year will generally be characterized as long-term capital gain. However, capital gains recognized after December 31, 2017, with respect to “applicable partnership interests” will be treated as long-term capital gains if the capital asset has been held for at least three years.

An applicable partnership interest typically includes profit- only interests received in connection with the performance of services by the partner if the partnership is engaged in an “applicable trade or business.” An applicable trade or business includes any activity conducted on a regular, continuous, and substantial basis consisting of raising or returning capital and either (1) investing in, or disposing of, specified assets (or identifying specified assets) or (2) developing such specified assets. Specified assets include securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and an interest in a partnership to the extent of the partnership’s proportionate interest in any of the foregoing.

Partnerships that issue applicable partnership interests and are engaged in an applicable trade or business should ensure procedures are in place to accurately track holding periods in investment companies and assets bearing in mind the multiple holding periods that can result from “add-on” investments.

Further, determination of a partner’s share of capital gains will likely require detailed record-keeping and tracking of partner Section 704(b) and tax basis capital accounts.

Taxation of Gain on the Sale of Partnership Interest by a Foreign Person (Sections 864(c) and 1446)

Revenue Ruling 91-32 generally provides that a foreign partner will recognize effectively connected income (ECI) on a sale of a partnership interest to the extent a sale of underlying partnership assets would give rise to an allocation of ECI to the transferor partner. In Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner, the Tax Court rejected the holding in Rev. Rul. 91-32 thereby avoiding U.S. taxation to the selling foreign partner. The 2017 tax reform act effectively codifies the holding of Revenue Ruling 91-32 and reverses the Tax Court’s decision in Grecian Magnesite. As a result, gain recognized on the sale or exchange of a partnership interest will be treated as ECI to the extent the transferor would be allocated ECI upon a sale of assets by the partnership.

Repeal of Technical Termination Rules under Section 708(b)(1)(B)

The 2017 tax reform act repeals the technical termination rules under Section 708(b)(1)(B) for tax years beginning after 2017. Repeal of the technical termination rule is generally a favorable development, since it will eliminate the need to restart depreciation upon the sale or exchange of more than 50 percent capital and profits interest in a partnership. Additionally, the 2017 tax reform act will alleviate the common occurrence of failing to properly identify transactions, giving rise to technical terminations, which leads to late filing of required tax returns, failure to make appropriate elections, and imposition of penalties.

However, technical terminations are sometimes used for tax planning purposes. Alternatives will now need to be considered since the relative simplicity of triggering a technical termination has been eliminated.

Charitable Contributions and Foreign Taxes Taken into Account in Determining Basis Limitation (Section 704(d))

Under the general rules of Section 704(d), a partner's ability to deduct its distributive share of partnership losses is limited to the extent of the partner's outside tax basis in the partnership interest. As originally enacted, this limitation did not apply to a partner's allocable share of charitable contributions or foreign tax expenditures. The 2017 tax reform act modifies the Section 704(d) loss limitation rule to take into account charitable contributions and foreign taxes. However, in the case of a charitable contribution of property where the fair market value exceeds the adjusted tax basis the Section 704(d) basis limitation would not apply to the extent of the partner's allocable share of this excess. This provision applies to taxable years beginning after December 31, 2017.

Taxpayers that have historically been able to benefit from this exception will need to be aware of the potential decrease in their overall tax deductions.

Like-Kind Exchanges under Section 1031

Following tax reform, the Section 1031 like-kind exchange rules are now limited to transactions involving the exchange of real property that is not held primarily for sale. Section 1031 no longer applies to any other property, including personal property that is associated with real property. This provision is effective for exchanges completed after December 31, 2017, unless the taxpayer had initiated a forward or reverse deferred exchange prior to December 31, 2017. These changes will represent a significant departure from prior law. Taxpayers will need to be mindful of this limitation in real property transactions as well as exchanges of assets consisting of both real and personal property.

Substantial Built-in Loss in the Case of a Transfer of a Partnership Interest (Section 743(d))

Section 743 requires a mandatory negative tax basis adjustment upon the sale or exchange of a partnership interest if the partnership has a substantial built-in loss. A partnership generally has a substantial built-in loss if the partnership's adjusted tax basis in all of its property exceeds the fair market value of such property by more than $250,000. The 2017 tax reform act modified the definition of a substantial built-in loss. Under the 2017 tax reform act, in addition to the present-law definition, a substantial built-in loss also exists if the transferee partner would be allocated a loss in excess of $250,000 upon a hypothetical disposition by the partnership of all partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest. This provision would apply to transfers of partnership interests occurring after December 31, 2017.

Given the negative consequences of a potential downward basis adjustment it will become even more critical that partnerships properly track each partner's Section 704(b) and tax basis capital accounts. Failure to accurately track capital accounts could lead to incorrect downward adjustments resulting in increased exposure to both the transferring and non-transferring partners.

New Centralized Partnership Audit Regime

Effective for tax years beginning in 2018 partnerships will be audited by the IRS under an entirely new regime. Under the new regime, tax adjustments resulting from partnership audits will generally be assessed at the partnership level. This enables the IRS to collect tax due on partnership adjustments at the entity level, thereby effectively imposing an entity- level tax on partnerships. Although it may be possible for a partnership to "push-out" this obligation to its partners, this election will result in a higher rate of underpayment interest. Also, unlike the TEFRA rules, the new regime applies to all partnerships regardless of size or number of partners, unless the partnership is eligible to elect out and does so in a timely manner. Typically, partnerships eligible to opt out must have 100 or fewer partners and all partners must be individuals,

C corporations, foreign entities that would be treated as a C corporation if domestic, S corporations (although each shareholder is counted as a separate partner for the 100 or fewer requirement) or an estate of a deceased partner.

Importantly, partnerships with partners that include other partnerships, single-member LLCs, grantor trusts, or nominee partners will prevent a partnership from opting out of the new rules regardless of the number of partners.

This new IRS audit regime has created a number of unanswered questions and significant concern over the manner in which partnerships will be audited and potentially subjected to imputed underpayment obligation. Given these concerns, it is very important that all partnership/LLC members and managers discuss with their legal counsel and professional tax advisors changes that will most likely need to be made to the governing documents. The most significant of these changes will be the determination and identification of a designated "partnership representative" (PR). Unlike the "Tax Matters Partner" under the formerly applicable unified audit procedures, the PR will have significant decision making power and authority that will have significant impact on all partners and the partnership in the event of an examination.

In addition to the PR designation, there will be several matters the partnership/LLC owners will need to consider with respect to various elections, allocations, and the payment of IRS assessments. It is highly recommended that all aspects of the new rules be considered in conjunction with any potential updates or amendments to the governing documents.

Tax Saving Opportunities for C Corporations

Retention of Corporate Earnings

The new 37 percent top rate for individuals exceeds the marginal corporate tax rate. The disparity may be even greater if the combined effect of the additional hospital insurance tax on high wage-earners and the 3.8 percent tax on net investment income of high-income individuals are all considered. In this case, it may be desirable to retain corporate income by deferring compensation to employee-shareholders.

Caution: A corporation that accumulates E&P beyond its reasonable business needs may be subject to an additional 20 percent tax on its accumulated taxable income. However, up to $250,000 in E&P may generally be accumulated before this tax applies. Special rules pertain to holding, investment, and personal service corporations.

Personal Service Corporations

PSCs have historically been denied the benefit of the lower corporate tax brackets and were taxed at a flat 35 percent rate but are now taxed at the same rate as other C corporations.

A PSC is a corporation that performs services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting and also meets certain stock ownership tests.

PSCs and certain small businesses on an accrual method of accounting are permitted to eliminate from accrued service income an amount that, based upon experience, will not be collected.

Caution: A PSC that elected a fiscal year is subject to a "minimum payment" requirement. Such a PSC must monitor the level of payments (compensation, rent, etc.) to employee-shareholders to avoid postponing part or all of the deduction for these payments. Therefore, if your top individual tax rate exceeds the top rate of tax applicable to your corporation, it may be advisable to terminate a fiscal- year election, if you have not done so already.

Corporate Stock and Stock Options

A corporation may obtain a deduction by the issuance of its stock or stock options to pay otherwise deductible expenses. For example, stock issued to employees or independent contractors constitutes deductible compensation when included in the employee's or independent contractor's taxable income. The taxable event generally occurs when the stock is transferred to the service provider without a substantial risk of forfeiture. In the case of stock grants, the deduction is generally available when vested and nonqualified stock options when the option is exercised. Incentive stock options (ISOs) do not generate a deduction unless the holder of the ISO shares disposes of them before the required holding periods. These disqualifying dispositions will generate a deduction to the corporation. Companies that have issued ISOs to their employees should determine whether there have been any disqualifying dispositions of the underlying stock during the year.

Caution:

- *Corporate deductions may be lost if the equity compensation is not timely reported on a Form W-2, in the case of an employee, or a Form 1099, in the case of an independent contractor.*
- *Companies with publicly traded stock or registered debt may not be allowed to deduct compensation in excess of $1 million paid to certain covered employees. For tax years beginning after December 31, 2017, the performance based pay exception that previously allowed a full deduction of most stock options no longer exists unless the transition rules apply.*
- *In order to avoid a penalty, the IRS copy of 2018 Form 1099-MISC that reports non-employee compensation in Box 7 must be filed with the Service on January 31, 2019, at the same time as the form is required to be furnished to the independent contractor.*

Incentive stock options and options granted under a qualifying employee stock purchase plan (ESPP) have a separate reporting requirement. Form 3921, Exercise of an Incentive Stock Option Under Section 422(b), and Form 3922, Transfer of Stock Acquired Through An Employee Stock Purchase Plan Under Section 423(c), must be filed furnished to employees not later than January 31, and filed with the Service by February 28, 2019 (on paper), or April 2, 2019 (electronically), for 2017 ISO exercises and ESPP purchases.

Planning Suggestion: *For stock vested upon transfer (including transfer via the exercise of an option), fiscal-year corporations may take the deduction in the taxable year such stock is transferred to the employee or independent contractor, rather than waiting until the next taxable year in which the employee's or independent contractor's taxable year ends. If this is a change in method of accounting, a Form 3115 will be required no later than the last day of the year of change.*

Stock or stock options (warrants) issued to a lender could also result in deductible "original issue discount" as the result of allocating a portion of the issue price away from the debt instrument.

Estimated Taxes

Corporate estimated tax payments may significantly affect your business's cash flow. Accordingly, planning for the lowest required payment is essential. The requirements differ for small and large corporations.

A small corporation is one that had taxable income of less than $1 million for each of the three preceding taxable years. Conversely, a large corporation is one that had taxable income of $1 million or more for any of the three preceding taxable years. Taxable income, for this purpose, is computed without net operating and capital loss carryovers and carrybacks.

A small corporation may base its estimated tax payments on the preceding year's tax liability. However, a large corporation may base only its first estimated tax payment on the preceding year's tax liability. For either type of corporation, an estimate may be based on the preceding year's tax only if the preceding taxable year consisted of 12 months and the preceding year's return showed a tax liability.

Estimated tax payments that cannot be based on the prior year's tax can be based on 100 percent of the expected tax for the current year or tax calculated on the current year's annualized income. The annualized income method provides a safe harbor from estimated tax penalties if the expected tax for the entire year is difficult to determine. If the annualized income method is used, payments are made as follows:

Installment Number	Annualization Period	% of Tax to Be Paid
1	1st 3 months of taxable year	25
2	1st 3 months of taxable year	50
3	1st 6 months of taxable year	75
4	1st 9 months of taxable year	100

Alternatively, a corporation may annually elect one of the following annualization periods:

Installment Number	Optional Annualization Period I	OR II
1	1st 2 months of taxable year	1st 3 months of taxable year
2	1st 4 months of taxable year	1st 5 months of taxable year
3	1st 7 months of taxable year	1st 8 months of taxable year
4	1st10 months of taxable year	1st 11 months of taxable year

Option I or II must be elected by the due date of the first quarterly installment for each year. Form 8842, Election to Use Different Annualization Periods for Corporation Estimated Tax, can be used to make the election.

In some cases, lower payments may be made under the adjusted seasonal installment method. No estimated taxes are required for a particular year if the tax shown on the return for that year is less than $500.

Regulations relating to corporate estimated tax payments provide a general rule that taxpayers using the annualized income method must annualize items incurred during the quarter, as well as special rules for specific deductions and extraordinary items.

Planning Suggestion: *A corporation anticipating no 2018 tax should consider taking action to produce a small tax by reporting low taxable income so that estimated 2019 tax payments can be based on 2018 tax.*

Examples:

- X Corporation will have a $100 NOL and no tax for 2018. X must pay 2019 estimated taxes based on its 2019 regular income to avoid penalties.
- Y is a small corporation. Its 2018 return will show a $500 tax liability. Y will be able to pay only $500 as 2019 estimated taxes and avoid penalties, even though its actual 2018 tax may be much higher. If Y’s 2019 tax is $100,500, it would pay the $100,000 balance on April 15, 2020.

"Quick Refund" for Excess Estimated Tax

If estimated taxes paid exceed the expected annual tax, a corporation may apply for a "quick refund" (on Form 4466, Corporation Application for Quick Refund of Overpayment of Estimated Tax) of the excess tax before the tax return is filed, but only if this excess tax is at least $500 and 10 percent of the expected annual tax. This quick refund may be requested after the close of the corporation's taxable year, but no later than the 15th day of the fourth month following the end of the taxable year (the original due date of the corporation's income tax return). The Service must act on this refund application within 45 days after it is filed.

Example: *Z, a calendar-year corporation, paid $50,000 in estimated taxes for the first three quarters of 2018. In the fourth quarter of 2018, Z incurs a large loss so that the tax due for the year is expected to be only $10,000. Z may request a $40,000 refund after December 31, 2018, and on or before April 15, 2019. The Service must act on Z's refund application within 45 days after it is filed.*

Planning for NOLs

NOLs are a valuable corporate attribute. Even NOLs that were not fully reported on a prior year return can be carried forward. However, the ability to use an NOL carryforward may be limited where a loss corporation has experienced a change of stock ownership–for example, as a result of a merger or acquisition, the issuance of new stock, or the acquisition of outstanding stock by one or more 5 percent shareholders. Under tax reform, NOLs from post-2017 taxable years may only be used to offset 80 percent of the corporation's taxable income in any subsequent taxable year.

Succession and Family Business Planning

Year-end is the traditional gift-giving season. This should also be a time to plan for your company's succession and the transfer of your wealth to your heirs in a manner that minimizes transfer taxes.

Conclusion

Business tax planning is very complex. Careful planning involves more than just focusing on lowering taxes for the current and future years. How each potential tax saving opportunity affects the entire business must also be considered. In addition, planning for closely-held entities requires a delicate balance between planning for the business and planning for its owners.