# Tax Saving Opportunities for All Businesses

## 2018 Versus 2019 Marginal Tax 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' 2018 and 2019 income and deductions are necessary to determine the marginal tax rate for each year.

Your advisor can be consulted to recommend how your business can recognize income and deductions between these years to minimize your tax liability.

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 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. Please contact your advisor to assist in the determining whether the cash method makes sense from a federal tax standpoint. 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. Your advisor can assist you in navigating through these complex revenue recognition rules and the impact on your business.

On May 28, 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards 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 on the 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 entity.

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. Please consult with your advisor before year-end to determine if your bonus plan or plans meet these requirements.

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, 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 taken in 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, 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).

Your advisor can be consulted for information about how to change your tax method of accounting to comply with these rules.

## START-UP AND ORGANIZATIONAL EXPENDITURES

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, (3) 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. Please consult your advisor for further information regarding bonus depreciation.

## 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. Your advisor can be consulted for further information and assistance.

## 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 to Property

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. Your advisor can be consulted for further information and assistance.

### 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. Your advisor can be consulted for further information and assistance.

## 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 thresholds 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. Your advisor can be consulted for further information and assistance.

## 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 Suggestions:** 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. Your advisor can assist you in determining whether you are eligible to make a grouping election for the year and, if so, whether to make such an election.

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. Your advisor can assist you in determining whether your rental real estate income is subject to this tax.

## 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. Your advisor can help you review whether changes should be made to your inventory costing method. 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.