YEAR-END TAX PLANNING OPPORTUNITIES FOR BUSINESSES

December 6, 2018
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Year-End Tax Planning Opportunities for Businesses
Today’s Discussion Topics

- International Tax Update
- Choice of Entity Considerations
- Section 199A Deduction & Reporting Requirements
- Section 168(k) Bonus Depreciation
- Section 163(j) Business Interest Limitation
International Tax Update
International Tax Landscape

United States
- Businesses are working through with aftereffects and unintended consequences (perhaps) of U.S. federal tax reform
- Guidance on several key provisions has been released; more coming soon

Global
- Countries continuing to implement legislation to address Base Erosion and Profit Shifting (BEPS) action items
- Uncertainty surrounding Brexit

Common Themes
- Continued focus on interplay between substance and the digital economy.
- Increased complexity and documentation & reporting requirements
Flashback to 2017: U.S. Tax Reform Wish List

- 40%: Shift to a territorial tax system
- 20%: Simplified tax code
- 17%: Lower tax burden on capital gains
- 12%: Tax incentives to repatriate foreign earnings
- 9%: Reduced corporate tax rate
- 2%: Changes to the tax treatment of carried interest

Source: BDO’s 2017 Annual Tax Outlook Survey
The Results with an International Lens

<table>
<thead>
<tr>
<th><strong>“Hybrid” territorial tax system</strong></th>
<th>Payments to Foreign Hybrid Entities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global Low-Taxed Intangible Income (GILTI)</td>
<td>“Transition Tax” (Toll Charge on Mandatory Repatriation of Foreign Earnings)</td>
</tr>
<tr>
<td>Foreign Derived Intangible Income (FDII)</td>
<td>Interest expense limitations for all taxpayers</td>
</tr>
<tr>
<td>Base Erosion and Anti-Abuse Tax (BEAT)</td>
<td></td>
</tr>
</tbody>
</table>
“Hybrid” Territorial Tax System

Section 245A

- 100% dividends received deduction for certain foreign source portion of dividends received from specified 10% owned foreign corporations by U.S. C corporations (other than RICs or REITs) that are U.S. shareholders of those foreign corporations and meet certain holding period requirements
- Excludes PFICs
- No deduction for hybrid dividends

2019 Considerations

- Impact on operations (cash needs, planning strategies, etc.)
- Interplay with previously taxed earnings as a result of Transition Tax
- Financial reporting considerations (e.g. impact on APB 23 assertion)
Transition Tax
Section 965

- Taxed certain foreign corporations’ earnings and profits not previously subject to U.S. taxation

- Generally a 15.5% tax on accumulated foreign earnings held in cash or cash equivalents and 8% tax on all other accumulated foreign earnings

- U.S. shareholders may elect to pay the net tax liability under Section 965 over an eight year period in installments

2019 Considerations

- Calculation and income inclusion still required for certain taxpayers (depending on year end)

- Ongoing considerations include impact on tax basis (including elections), trigger of deferred tax liability on sale or intercompany restructurings, impact on M&A transactions, and foreign exchange gain/loss on repatriation

- Proposed regulations issued; additional guidance anticipated
Global Low-Taxed Income (GILTI)
Section 951A

- U.S. shareholders of any controlled foreign corporation (“CFC”) must include GILTI in gross income for a taxable year in a manner generally similar to inclusions of Subpart F income

- GILTI with respect to a U.S. shareholder for a tax year is the excess (if any) of such shareholder’s “net CFC tested income” for such year over the shareholder’s “net deemed tangible income return” for such year

- Domestic C corporations generally receive a deduction of 50% of the GILTI inclusion

2019 Considerations

- Calculating GILTI can be very complex and involves interplay amongst multiple areas of the tax code (expense allocation, interest deductibility, foreign tax credits, etc.)

- Significant challenges in getting data needed for calculation

- Proposed regulations issued; additional guidance anticipated
Foreign Derived Intangible Income (FDII)

Section 250

- Deduction for U.S. C corporations (other than RICs or REITs) of 37.5% of certain foreign-derived intangible income (reduced to 21.875% for taxable years beginning after 12/31/2025)

- FDII generally includes income derived in connection with (1) property that is sold by the taxpayer to any person who is not a U.S. person and that the taxpayer establishes to the satisfaction of the Secretary is for a foreign use or (2) services provided by the taxpayer that the taxpayer establishes to the satisfaction of the Secretary are provided to any person, or with respect to property, not located within the United States

2019 Considerations

- Calculating FDII can be very complex and involves interplay amongst multiple areas of the tax code (income sourcing rules, NOLs, GILTI, etc.)

- Guidance anticipated next year
Base Erosion and Anti-Abuse Tax (BEAT)

Section 59A

- Requires certain corporations to pay additional tax in situations where such corporations make “base erosion payments” to foreign related parties and certain thresholds and conditions are satisfied
  - Base erosion payments generally are paid or accrued to a related foreign person and certain other conditions are met
- Applies to certain corporations with average annual gross receipts of at least $500 million (three year testing period) and a “base erosion percentage” of 3% or more for the tax year
- Mechanically functions as an alternative minimum tax

2019 Considerations

- Calculating BEAT can be very complex and involves interplay amongst multiple areas of the tax code
- Guidance anticipated soon
Other Relevant Updates

- **Section 956** - proposed regulations provide relief for corporations to the extent such corporation would otherwise have been allowed a dividends received deduction had the CFC made an actual distribution.

- **Section 163(j)** - proposed regulations generally provide that section 163(j) and regulations thereunder apply to determine the deductibility of a CFC’s business interest expense in the same manner as those provisions apply to determine the deductibility of a domestic C corporation’s business interest expense.

- **Foreign Tax Credit Regulations** - proposed regulations address (1) allocation and apportionment of certain deductions, (2) certain transition rules, (3) addition of separate categories under section 904(d), (4) calculation of the exception from subpart F of high-taxed income, (5) determination of deemed paid credits under section 960/section 78 gross up, and (6) application of the section 965(n) election.
Other Relevant Updates

- **Section 958(b)** - repeal now allows downward attribution from a foreign person to a U.S. person
  - Can result in unanticipated filing requirements with respect to CFC’s that have not in the past been subject to U.S. reporting

- **Section 951(b)** - expansion of the definition of U.S. shareholder to include U.S. persons who own 10% or more of the total value of all classes of stock of a foreign corporation

- **Section 951(a)** - elimination of the requirement that a corporation be controlled for an uninterrupted period of 30 days before subpart F inclusions apply
Update on Regulatory Guidance

- Treasury has recently issued regulations addressing the interest expense limitation under 163(j) and foreign tax credit issues with the GILTI and BEAT tax.

- Treasury has announced its intent to issue additional proposed regulations by addressing anti-hybrid provisions under Section 267A, foreign derived intangible income, the participation exemption and accounting for previously taxed income.

- Treasury’s goal is to have these all finalized by June 22, 2019 to ensure regulations apply retroactively to the relevant effective dates.
International Landscape - Closing Thoughts

- Many countries are focused on driving competitiveness through enhancing the corporate tax environment.
- However, there are evolving global requirements to increase tax transparency, exchange tax information and require enhanced substance in cross-border transactions.
- International trade and tariffs have taken center stage with a focus on U.S.-China trade tensions and Brexit.
- These fundamental changes in the U.S. and international tax landscape require businesses with global operations to assess and potentially change their current structures and supply chains.
Choice of Entity Considerations
Choice of Entity Considerations

Tax Rate Changes

- The 35% tax rate for C corporations has been reduced to 21%.
- Including the highest dividend tax rate of 20%, the total federal tax rate (for both the corporation and individual shareholders) is 39.8% (excludes consideration for state taxes).
- Assuming no Section 199A deduction, the combined rate for passive owners of a partnership is 40.8% (excludes consideration for state taxes).
- Change of entity structure may be appropriate in order to maximize cash flow and returns to investors.
Choice of Entity Considerations

Section 199A Deduction

- Section 199A provides a deduction of up to 20% of “qualified business income” generated in a pass-through entity.

- The 20% Section 199A deduction for qualified business income combined with the new maximum individual tax rate of 37% results in an effective maximum tax rate of 29.6% on qualified business income.

- Limitations on the Section 199A deduction may result in an inability to obtain a 29.6% tax rate.

- Calculation of the Section 199A deduction requires careful analysis and application of new terms & concepts.
Choice of Entity Considerations
Cash Flow Differences

$100,000 of Taxable Income & Tax Distributions Only

C Corporation

After-Tax Earnings $79,000
Tax $21,000

Partnership
No Section 199A

After-Tax Earnings $59,200
Tax $40,800

Partnership
Full Section 199A

After-Tax Earnings $66,600
Tax $33,400
Choice of Entity Considerations
Cash Flow Differences

$100,000 of Taxable Income & Full Distributions

C Corporation

After-Tax Earnings $60,200
Tax $39,800

Partnership

No Section 199A

After-Tax Earnings $59,200
Tax $40,800

Partnership

Full Section 199A

After-Tax Earnings $66,600
Tax $33,400
**Choice of Entity Considerations**

### Cash Reinvested

<table>
<thead>
<tr>
<th>Initial Taxable Income</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth Rate*</td>
<td>5%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Totals</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>C Corporation</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxable Income</td>
<td>100,000</td>
<td>108,950</td>
<td>118,701</td>
<td>129,325</td>
<td>140,900</td>
<td><strong>597,876</strong></td>
</tr>
<tr>
<td>Taxes</td>
<td>(21,000)</td>
<td>(22,880)</td>
<td>(24,927)</td>
<td>(27,158)</td>
<td>(29,589)</td>
<td>(125,554)</td>
</tr>
<tr>
<td>Cash Available for</td>
<td>79,000</td>
<td>86,070</td>
<td>93,774</td>
<td>102,167</td>
<td>111,311</td>
<td><strong>472,322</strong></td>
</tr>
<tr>
<td>Reinvestment</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| **Partnership**     |        |        |        |        |        |                 |
| Taxable Income      | 100,000| 107,960| 116,554| 125,832| 135,848| **586,194**     |
| Taxes               | (40,800)| (44,048)| (47,554)| (51,339)| (55,426)| (239,167)       |
| Cash Available for  | 59,200 | 63,912 | 69,000 | 74,493 | 80,422 | **347,027**     |
| Reinvestment        |        |        |        |        |        |                 |

**Incremental C Corp Reinvestment Benefit**

| Benefit    | 19,800 | 22,158 | 24,774 | 27,674 | 30,889 | 125,295 |

*On both income and reinvested earnings.*
Choice of Entity Considerations

Cash Reinvested

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Available for Reinvestment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>59,200</td>
</tr>
<tr>
<td>Year 2</td>
<td>63,912</td>
</tr>
<tr>
<td>Year 3</td>
<td>69,000</td>
</tr>
<tr>
<td>Year 4</td>
<td>74,493</td>
</tr>
<tr>
<td>Year 5</td>
<td>80,422</td>
</tr>
</tbody>
</table>

- **C Corporation**: Blue line
- **Partnership**: Orange line

Year-End Tax Planning Opportunities for Businesses
Choice of Entity Considerations

Important Considerations

- Number of revenue streams and business activities
- Profitability of company and projected future operations and growth
- Nature of business (e.g., service business vs. non-service business)
- Foreign and state tax footprint
- Business objectives with respect to use of after-tax cash (e.g., distributions to owners or reinvestment in business)
- Expected rate of return on cash reinvestments
- Objectives of owners including potential exit strategy and timing
Choice of Entity Considerations

Important Considerations

- Required Calculations:
  - Section 704(b) and tax basis capital accounts
  - Partner outside tax basis in partnership interest
  - Partnership inside tax basis in partnership assets
  - Total and per-partner share of partnership liabilities

- Identification of inside/outside basis disparities

- Treatment of vested vs. unvested profits interests

- Possible taxable capital shifts
Section 199A Deduction & Reporting Requirements
Section 199A Deduction & Reporting Requirements

General Rules

- Tax Reform reduced corporate and individual rates and changed the potential benefit of a passthrough vs. corporate entity.

<table>
<thead>
<tr>
<th>Pre-Tax Reform Effective Tax Rates</th>
<th>Corporate Entity</th>
<th>Passthrough Entity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entity Level Tax</td>
<td>35.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Owner Level Tax</td>
<td>15.5%</td>
<td>43.4%</td>
</tr>
<tr>
<td>Total Effective Tax Rate</td>
<td>50.5%</td>
<td>43.4%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Post-Tax Reform Effective Tax Rates</th>
<th>Corporate Entity</th>
<th>Passthrough Entity (no 199A)</th>
<th>Passthrough Entity (with 199A)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entity Level Tax</td>
<td>21.0%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Owner Level Tax</td>
<td>18.8%</td>
<td>40.8%</td>
<td>33.4%</td>
</tr>
<tr>
<td>Total Effective Tax Rate</td>
<td>39.8%</td>
<td>40.8%</td>
<td>33.4%</td>
</tr>
</tbody>
</table>
Section 199A Deduction & Reporting Requirements

General Rules

- The section 199A deduction is generally available to Individuals, Trusts, and Estates.
- C corporations or their shareholders do not benefit from the section 199A deduction.
- For calendar year taxpayers, the Section 199A deduction applies to years:
  - Beginning after December 31, 2017, and
  - Ending before January 1, 2026
Section 199A Deduction & Reporting Requirements

General Rules

▶ The section 199A deduction is generally equal to the lesser of:

1) The taxpayer’s *combined qualified business income amount* or
2) 20 percent of the taxpayer’s taxable income in excess of capital gains

▶ Taxpayer’s combined qualified business income amount is equal to the sum of:

1) 20 percent of the taxpayer’s *qualified business income (QBI)* with respect to each *qualified trade or business (QTB)* plus
2) 20 percent of the aggregate amount of qualified real estate investment trust dividends and qualified publicly traded partnership income

▶ Subject to potential limitation based on W-2 wages and depreciable property
Section 199A Deduction & Reporting Requirements

General Rules

▷ QBI is equal to the net amount of *qualified items of income, gain deduction, and loss* with respect to any QTB of the taxpayer.

▷ Qualified items of income gain, deduction, and loss include effectively connected income/expense recognized during the taxable year, excluding:

  • Capital gains/losses, dividends, interest (unless allocable to a trade or business), annuities, qualified REIT dividends, qualified PTP income, certain section 954 items of income, gain, loss, or deduction, and guaranteed payments (deduction for guaranteed payments is included in QBI)

▷ QBI is determined separately for each QTB.

▷ Items of QBI are allocated to passthrough owners.
Section 199A Deduction & Reporting Requirements

General Rules

- A QTB generally includes any trade or business except a *specified service trade or business* (SSTB).

- An SSTB includes any trade or business involving services in the fields of:
  - Health, law, accounting, actuarial sciences, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading, or dealing in securities, partnership interests, or commodities
  - The principal asset of the trade or business is the *reputation or skill* of one or more of its employees or owner

- The SSTB exclusion does not apply for taxpayers with taxable income of less than $315,000 for joint filers and $157,500 for all other filers.

- The SSTB exclusion is subject to phase-in for taxpayers with taxable income between $315,000 - $415,000 for joint filers and $157,500 - $207,500 for all other filers.
The section 199A deduction may be subject to a limitation based on W-2 wages and unadjusted basis immediately after acquisition (UBIA) of qualified property attributable to QBI.

When applicable the section 199A deduction is limited to the greater of:
- 50% of the W-2 Wages attributable to the QBI or
- 25% of the W-2 Wages attributable to the QBI plus 2.5% of the UBIA of qualified property attributable to the QBI

The W-2 wages and capital limitation does not apply for taxpayers with taxable income less than $315,000 for joint filers and $157,500 for all other filers.

The W-2 wages and capital limitation is subject to phase-in for taxpayers with taxable income between $315,000 - $415,000 for joint filers and $157,500 - $207,500 for all other filers.
Section 199A Deduction & Reporting Requirements

W-2 Wages & Capital Limitation

- W-2 wages includes amounts paid with respect to employment of employees during the calendar year ending during such taxable year.
  - W-2 wages do not include any amount which is not properly allocable to the QBI of a trade or business.
  - W-2 wages do not include any amount which is not properly included in a return filed with the SSA on or before the 60th day after the due date (including extensions) for such return.
Section 199A Deduction & Reporting Requirements

Illustration

Facts

- ABC, LLC is owned equally by partners A, B, and C (all individuals). ABC, LLC sells widgets to end users and also assists clients with evaluations of their business needs, sometimes resulting in the purchase of widgets.

- ABC, LLC separately tracks its revenues and inventory costs related to its widget sales. It also tracks revenue from the business evaluation services. All other expenses are recorded as general company expenses.

- Gross widget revenue is $10M with inventory costs of $1M. Business evaluation gross revenue is $10M. Total non-inventory expenses are $10M, which includes $5M of wages paid to A, B, C, and other employees of ABC, LLC. Net income generated by ABC, LLC is $9M.
Section 199A Deduction & Reporting Requirements

Illustration

**QBI Deduction**

- Since A, B, & C are each allocated $3M of taxable income, the maximum section 199A benefit to each partner is $222,000 ($3M * 20% * 37% = $222,000).

- However, in order to support the deduction, proposed regulations create a detailed and potentially complicated analysis and reporting system.
Section 199A Deduction & Reporting Requirements

Illustration

Analysis & Reporting Requirements

- Identify and document each trade or business operated by ABC, LLC
- Determine whether each trade or business is an SSTB
- Determine the items of QBI that are properly allocable to each trade or business
- Determine the amount of expenses not specifically attributable to a particular trade or business
- Develop and apply a methodology to allocate non-specifically attributed expenses to each trade or business
- Evaluate whether all “wages” meet the definition of wages for purposes of section 199A
- Determine the amount of UBIA of qualified property that is attributable to QBI allocated to each trade or business
- Evaluate the reasonableness of proposed allocations of required amounts
### Section 199A Deduction & Reporting Requirements

#### Illustration

**Information to be developed and reported**

<table>
<thead>
<tr>
<th>Business #1 - Sale of Widgets</th>
<th>Partner A</th>
<th>Partner B</th>
<th>Partner C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualified Business Income</td>
<td>$X</td>
<td>$X</td>
<td>$X</td>
</tr>
<tr>
<td>W-2 Wages</td>
<td>$X</td>
<td>$X</td>
<td>$X</td>
</tr>
<tr>
<td>UBIA of Qualified Property</td>
<td>$X</td>
<td>$X</td>
<td>$X</td>
</tr>
</tbody>
</table>

**Description of Business #1**

Whether Business #1 is a QTB or SSTB

<table>
<thead>
<tr>
<th>Business #2 - Business Consulting</th>
<th>Partner A</th>
<th>Partner B</th>
<th>Partner C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualified Business Income</td>
<td>$X</td>
<td>$X</td>
<td>$X</td>
</tr>
<tr>
<td>W-2 Wages</td>
<td>$X</td>
<td>$X</td>
<td>$X</td>
</tr>
<tr>
<td>UBIA of Qualified Property</td>
<td>$X</td>
<td>$X</td>
<td>$X</td>
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</tbody>
</table>

**Description of Business #2**

Whether Business #2 is a QTB or SSTB

<table>
<thead>
<tr>
<th>Other Information Reporting</th>
<th>Partner A</th>
<th>Partner B</th>
<th>Partner C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualified REIT Dividends</td>
<td>$X</td>
<td>$X</td>
<td>$X</td>
</tr>
<tr>
<td>Qualified PTP Income</td>
<td>$X</td>
<td>$X</td>
<td>$X</td>
</tr>
</tbody>
</table>

Confirmation that Business #1 was not formed, ceased operations, nor was disposed during the year

Confirmation that Business #2 was not formed, ceased operations, nor was disposed during the year

Confirmation regarding Common Ownership for the majority of the tax year
The Section 199A Playbook

BDO Phased Approach

Phase 1 - Preliminary Section 199A Assessment:
Evaluate available information necessary to report QBI, W-2 wages, UBIA of qualified property, and report information to owners.

Phase 2 - Detailed Section 199A Documentation & Analysis:
Detailed analysis, computations, and documentation to provide the Company with required Section 199A reporting information.

Phase 3 - Information Reporting Assistance:
If necessary, assist in accurately reporting per-owner required section 199A information.
The Section 199A Playbook
BDO Phased Approach

Phase 1 - Key Steps:
1. Identify each trade or business
2. Determine whether trades or businesses are QTBs or SSTBs
3. Evaluate data to identify potential QBI, W-2 wages, and UBIA of qualified property
4. Interview key personnel
5. Evaluate ability of the Company to provide accurate per-owner data

Phase 1 Deliverable:
Written report documenting our preliminary assessment, recommendations for next steps, and a proposed budget for any relevant Phase 2 services.
The Section 199A Playbook
BDO Phased Approach

Phase 2 - Key Steps:

1. Document conclusions regarding each trade(s) or business(s)
2. Document conclusions regarding status as a QTB or SSTB
3. Identify specific items of QBI attributable to each identified trade or business.
4. Determine and document QBI allocation method(s)
5. Determine W-2 wages allocable to QBI of each trade or business
6. Identify and calculate UBIA of qualified property
7. Identify any qualified REIT dividends and qualified PTP income or loss information to be reported to owners

Phase 2 Deliverable:

Written report supporting identification and classification of each trade or business, calculation of QBI, W-2 wages and UBIA of qualified property for each trade or business and identification of any qualified REIT dividends and qualified PTP income. Recommendations for Phase 3.
The Section 199A Playbook
BDO Phased Approach

Phase 3 Considerations:

1. Partnership allocations dependent on terms of operating agreement.
2. Ensure accurate capital account maintenance.
3. Targeted allocations can significantly increase complexity of allocating QBI.
Section 168(k) Bonus Depreciation
Section 168(k) Bonus Depreciation

- Section 168(k) allows additional first-year (bonus) depreciation for certain property in the “placed-in-service” year of qualified property.

- Important changes made by Tax Reform include:
  - Depreciation deduction percentage increased to 100 percent
  - Definition of qualified property expanded
  - Placed in service date extended to before January 1, 2027 or January 1, 2028 for certain property
  - Depreciation deduction percentage is reduced for property placed in service after December 31, 2022 (or December 31, 2023)
Section 168(k) Bonus Depreciation

- Bonus depreciation applies to qualified property which meets three criteria:
  - The property must be of a specified type
  - The use of the property must originate with the taxpayer or meet the acquisition requirements for used property
  - The property must be placed in service within a specified time, and
  - The depreciable property must be acquired by the taxpayer after September 27, 2017
Section 168(k) Bonus Depreciation

Qualified Property includes:

- MACRS property with a recovery period of 20 years or less
- Computer software
- Water utility property
- A qualified film or television production or qualified live theatrical production
- A specified plant, and
- Qualified improvement property acquired and placed in service after September 27, 2017, and before January 1, 2018, is also qualified property:
  - Qualified leasehold improvement property
  - Qualified restaurant property
  - Qualified retail improvement property
Section 168(k) Bonus Depreciation

- Property must be acquired after September 27, 2017
- Property cannot be treated as acquired after the date a taxpayer enters into a written binding contract
- Written binding contract includes contracts that:
  - Are enforceable under state law against a taxpayer or predecessor, and
  - Do not limit damages to a specified amount
  - However, if a contractual provision limits damages to an amount equal to at least 5 percent of the total contract price, this provision is ignored under the proposed regulations
- Written binding contracts do not include options and letters of intent
- Special rules for acquisitions of components of larger property acquisitions
Section 168(k) Bonus Depreciation

Consider application in M&A transactions:

- Section 743(b) adjustments: Bonus Depreciation May Be Allowed
- Deemed Asset Sales: Bonus Depreciation May Be Allowed
- Section 734(b) adjustments: No Bonus Allowed
- Section 704(c) remedial allocations: No Bonus Allowed
- Zero Basis Property: No Bonus Allowed
- Section 732 Basis Determination: No Bonus Allowed
Section 163(j) Business Interest Limitation
Interest Expense Deduction Limitations

For taxable years beginning after December 31, 2017, section 163(j) provides that the deduction for business interest shall not exceed the sum of:

- The business interest income for the taxable year
- 30% of the adjusted taxable income for the taxable year, and
- The “floor plan financing interest” of the taxpayer for the taxable year

Interest disallowed by virtue of this limitation is carried forward indefinitely, but any excess limitation is not carried forward.

Adjusted taxable income is determined without regard to:

- Any non-business income, deduction, gain, or loss of the taxpayer
- Business interest expense or income
- Any net operating loss deduction
- Any deduction under section 199A (for qualified business income), and
- For taxable years beginning before January 1, 2022, any deduction for depreciation, amortization, or depletion
Interest Expense Deduction Limitations (Cont’d)

- Limitations do not apply to the following:
  - The trade or business of being an employee
  - Any electing real property trade or business
  - Any electing farming business, and
  - Most “regulated public utility” services (electricity, water, sewage disposal, gas, or steam).

- Electing real property trades or businesses and electing farming businesses give up their right to use full “expensing” on longer-lived categories of fixed assets.

- More complex provisions apply to business interest paid or incurred by S corporations and partnerships.

- Exception applies to any business (other than a tax shelter) that would fall below a three-year average annual gross receipts limitation of $25 million.

- Deferred interest is explicitly treated as a “pre-change loss” for purposes of section 382 (section 382(d)(3)).
Interest Expense Deduction Limitations (Cont’d)

Notice 2018-28 provides initial guidance on the scope and application of section 163(j) and requests public comments in advance of issuing proposed regulations.

Initial guidance includes the following:

- Interest expense disallowed under former section 163(j) is carried forward and subjected to new section 163(j) limitation
- All interest expense and income of a C corporation will be treated as business interest income and expense
- Section 163(j) will be applied at the consolidated group level, i.e., as one taxpayer, disregarding any intercompany interest income and expense
- Earnings and profits of a C corporation will be determined without regard to section 163(j) limitations, i.e., interest expense reduces E&P when paid or incurred rather than when deducted
- Special rules will preclude the effect of “double counting” items from partnerships, particularly in the case of exempted trades or businesses
Section 163(j) Proposed Regulations

- Substantial and comprehensive proposed regulations were released to the public on November 26, 2018.

- Interest subject to section 163(j) includes the following:
  - Stated interest
  - Imputed interest, including under sections 467, 483, 1274, and 7872
  - Commitment fees (to the extent that funds are actually borrowed)
  - Debt issuance costs
  - Accrued market discount
  - Repurchase premium; and
  - Acquisition premium
Section 163(j) Proposed Regulations (Cont’d)

For C corporations:
- All interest is business interest (income or expense)
- For a corporate partner in a partnership, investment interest and income are characterized as business interest at the partner level
- Confirms the reduction of earnings and profits when paid or incurred, not when deducted
- Allocation of section 163(j) interest to section 382 pre-change period based on days (not closing of the books)

For consolidated groups:
- Limitations applied on a consolidated basis
- Intercompany loans are disregarded
- Subsidiary stock basis is reduced only when the interest expense is absorbed by the group
- Rules are provided for members joining and leaving the group, including the application of section 382, SRLY limitations, and overlaps
Section 163(j) Proposed Regulations (Cont’d)

For partnerships:

- Limitation is applied at the partnership level
- Partners are allocated excess business interest currently, which is carried forward at the partner level
- Excess business interest of a partner requires excess taxable income in a subsequent year from the partnership or taxable disposition of partnership interest
- Except for excess taxable income of a partnership allocated to a partner, the partner’s adjusted taxable income does not include any items of income or deduction from the partnership

For S corporations:

- Rules are similar to those for partnerships, except that excess business interest is carried forward at the entity level
- Section 382 applies to the excess business interest of the corporation
Section 163(j) Proposed Regulations (Cont’d)

Other special rules are provided for:

- Controlled foreign corporations
- Foreign persons with effectively connected income
- Tax-exempt organizations
- Real estate investment trusts (subject to the exception for electing real property trades or businesses), and
- Regulated investment companies (mutual funds)

Computation of adjusted taxable income:

- To avoid duplication, taxable income is adjusted for gain attributable to depreciation or amortization of assets that had been added back to taxable income from 2018 through 2022
- Items of interest income and expense, gross income, and other deductions are to be allocated between excepted and non-excepted businesses
Questions?

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**Conclusion**

Thank you for your participation!

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