BDO TAX TALK

Summer Webinar Series

TAX REFORM FALLOUT

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With you today

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Agenda

- Section 199A
- Section 163(j)
- International Tax Developments
- Family Offices
- Accounting Methods
- Selected Corporate Tax Issues

Section 199A

Section 199A Deduction

Identifying Trades or Businesses

- Section 199A is calculated on a trade or business by trade or business basis as determined under section 162
- Taxpayers must identify each trade or business and apply the rules separately to each trade or business conducted
- Neither the statute nor regulations define the term "trade or business"
- Extensive case law exists but there are many uncertain areas, *e.g.*, rental real estate
- Once identified, each trade or business must be characterized as a QTB or SSTB
- Updates from final regulations
  - General trade or business analysis under section 162 and case law
  - Notice 2019-07: rental real estate trade or business safe harbor
  - Multiple trades or businesses within an entity – consider Treas. Reg. § 1.446-1(d)

Section 199A Deduction

Multiple Trades of Businesses

- Comments from the preamble to the final regulations
  - Treasury and the IRS acknowledge that an entity can conduct more than one trade or business under section 162
  - Court decisions that help define the meaning of "trade or business" provide taxpayers guidance in determining whether more than one trades or businesses exist
  - Treasury and the IRS believe that multiple trades or businesses will generally not exist within an entity unless different methods of accounting could be used for each trade or business under section 1.446-1(d)
  - Section 1.446-1(d) explains that no trade or business is considered separate and distinct unless a complete and ***separable*** set of books and records is kept for that trade or business
  - Trades or businesses will not be considered separate and distinct if, by reason of maintaining different methods of accounting, income of the taxpayer is not clearly reflected

Section 199A Deduction

Identifying Trades or Businesses

- The preamble to the final regulations provides a non-inclusive list of facts to considered to determined whether a rental real estate activity is a trade or business:
  - The type of rented property (commercial real property versus residential property),
  - The number of properties rented,
  - The owner's or the owner's agents day-to-day involvement,
  - The types and significance of any ancillary services provided under the lease, and
  - The terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease).
- Treasury also noted that "[p]roviding bright line rules on whether a rental real estate activity is a section 162 trade or business for purposes of section 199A is beyond the scope of these regulations"

Section 199A Deduction

Notice 2019-7

- Notice 2019-07 provides a proposed safe-harbor for determining whether a rental activity will be considered a trade or business.
- To qualify, the following requirements must be satisfied:
  - Separate books and records are maintained for each rental real estate enterprise;
  - For year beginning before 1/1/2023, the taxpayer provides 250 or more hours of rental services per year. For years beginning after 12/31/2022, the 250 hour requirement can be met in any three of the five consecutive taxable years that end with the current taxable year; and
  - The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services.

Section 163(j)

Section 163(j) Interest Limitation

General Rules

- Interest paid or accrued on indebtedness is generally deductible subject to certain limitations
- Deduction allowed for business interest cannot exceed the sum of:
  - The taxpayer's business interest income for the taxable year;
  - 30% of the taxpayer's adjusted taxable income for the taxable year (limited to $0, i.e., can't be negative); plus
  - The taxpayer's floor plan financing interest for the taxable year.
- Business interest that is not deductible in the current year is carried forward indefinitely (subject to restrictions for partnerships discussed later)
- Carryforward amounts are treated as business interest paid or accrued in the next succeeding taxable year
- Definition of "interest" for purposes of section 163(j)

Section 163(j) Interest Limitation

Small Business Exemption

- The section 163(j) business interest limitation doesn't apply to taxpayers with gross receipts of less than $25 million, except for a tax shelter precluded from using the cash method
- A "tax shelter" is any one of the following:
  - Any enterprise (other than a C corporation) if the offering of interests is required to be registered with any federal or state agency having the authority to regulate the offering;
  - Any syndicate (within the meaning of section 1256(e)(3)(B)); and
  - Any tax shelter (as defined in section 6662(d)(2)(C)(ii)).
- The term "syndicate" means any partnership or other entity (other than a corporation which is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs

Section 163(j) Business Interest Limitations

Application to Flow-Through Entities

- Partnerships apply the limitations at the entity level, subject to a three-part statutory approach:
  - The adjusted taxable income of a partner is determined without regard to the partner's distributive share of any item from the partnership, except that the partner may increase adjusted taxable income by the partner's share of "excess taxable income" of the partnership
  - Any excess business interest allocated to a partner is carried forward at the partner level (reducing basis immediately) and is allowed only against excess taxable income of the partnership in subsequent taxable years
  - Excess taxable income is generally defined as the excess of 30% of adjusted taxable income over the business interest of the partnership (exclusive of floor plan financing interest)
- S corporations will use the first and third provisions but not the second (thus requiring carryovers of excess business interest at the corporate level)

Application of Section 163(j) to Partnerships

Partnership Considerations

- The section 163(j) limitation is applied at the partnership level
- Section 163(j) may also apply at the partner level to the extent the partner has business interest expense
  - Business interest expense incurred directly by the partner
  - "Excess business interest" allocated to the partner by a partnership
- Deductible business interest expense reduces partnership taxable income
- Partnership net taxable income is then allocated to the partners
- Partnership ATI does not include partner-level adjustments, *e.g.*, section 743(b) adjustments
- Any deductible partnership-level business interest expense is not further subjected to the section 163(j) limitation at the partner level
- Partnership reports ***Excess Business Interest Expense***, ***Excess Business Interest Income***, and ***Excess Taxable Income***

Application of Section 163(j) to Partnerships

Partner Considerations

- Section 163(j) may also apply at the partner level
- Distinguish excess business interest from partner-incurred business interest expense
- Calculation of partner-level ATI
  - Does not include allocated partnership taxable income (no "double-counting")
  - Includes partner's share of partnership excess taxable income
  - Includes partner-level adjustments such as Section 743(b) amortization
- Excess business interest is only deductible to the extent of allocated excess taxable income from the same partnership
- Remaining excess business interest is added back to basis when partnership interest is fully disposed of
- No guidance on treatment of tiered partnership structures

International Tax Developments

Tax Reform

Final GILTI Regulations and Proposed Regulations under GILTI and Subpart F

- The GILTI Final Regulations address several areas including (but not limited to) the following areas:
  - Treatment of domestic partnerships and their partners (rejects the hybrid approach included in the prior Proposed GILTI Regulations)
  - Include Section 954(b)(4) Subpart F/insurance high tax exclusion but no general GILTI high tax exception (but see recently Proposed GILTI Regulations)
  - Scale back of anti-abuse rule that was included in Prop. Reg. 1.951-1(e)(6)
  - Basis adjustment rules for tested loss CFCs not included in Final GILTI Regulations (will be considered in a separate project and any future guidance will be prospective)
  - Pro rata share rules
  - Rules addressing tested income and loss (including rules addressing de minimis rule, full inclusion rule, and Section 952 recapture amounts)

Tax Reform

Final GILTI Regulations and Proposed Regulations under GILTI and Subpart F

- The GILTI Final Regulations address several areas including (but not limited to) the following areas (con't.):
  - Rules relating to specified interest
  - Rules addressing QBAI (including modifications to anti-abuse rules)
- The Proposed Regulations under GILTI and Subpart F address the following areas:
  - Treatment of domestic partnerships and their partners as it relates to Subpart F income and Section 956 (similar approach to approach in GILTI Final Regulations relating to Section 951A)
    - Applies to tax years that begin on or after the final regulations adopting the rules are published in the Federal Register but allows taxpayers to rely on the Proposed Regulations for CFC tax years that begin after 12/31/2017, if certain conditions are satisfied
  - A general GILTI high tax exception (applies to tax years that begin on or after the final regulations adopting the exception are published/taxpayers are *not* permitted to rely on this exception in the interim)

Other Recent International Tax Guidance

- Final Regulations under Section 956
- Temporary Regulations under Section 245A/954(c)(6)
- Final Regulations under Section 987 (certain portions)
- Proposed Regulations under Sections 954 and 958
- Proposed Regulations under Section 1446(f)
- Proposed Regulations under Section 250

Family Offices

Tax Reform – Impact on Family Offices

- IRC Section 212 (suspended)
- IRC Section 162

Section 162 Trade or Business

- No regulatory guidance
- Highly factual, case-by-case analysis
- Leading court opinions
  - Higgins v. CIR, 312 US 212 (1941)
  - Lender Management, LLC v. CIR, TC Memo 2017-246
- Hellman v. CIR – US Tax Court settled before ruling

Higgins v. CIR

- IRS conceded that the real estate activities were a trade or business
  - Permitted allocable deductions
- Dispute over deduction for expenses incurred in managing taxpayer's stock and bond portfolio
  - Employees
  - 2 offices
- IRS: "Mere personal investment activities never constitute carrying on a trade or business."
- US Supreme Court: No trade or business where taxpayer "merely kept records and collected interest and dividends from his securities, through managerial attention for his investments."

Lender Management, LLC v. CIR

- Disparity of ownership between family office and investment LLCs
- Profits interest
- Investment advisory and financial planning services to family members
- Did not always follow advice of outside advisors
- Family geographically disperse and not all on speaking terms

Hellman v. CIR

- Indications of a trade or business
  - Compensation structure for services
  - Nature and extent of services by family office employees
  - Expertise possessed and time devoted by employees vs. outside advisors
  - Individualization of investment strategies for different family members
  - Proportionality (or lack thereof) between profits of family office and underlying investments

Key takeaways

- Why was Lender successful where Higgins and Hellmann (likely) were not?
- Profit model vs. reimbursement model
- SEC registration

Accounting Methods

Changes in Revenue Recognition

- Section 451(b)
  - Modifies all-events test such that accrual-basis taxpayers generally may no longer be able to defer revenue beyond financial statement recognition
  - Applies only to taxpayers with an "applicable financial statement" (AFS)
  - Income first must be "realized" for tax purposes for section 451(b) to apply
- Further complications arise given interplay between section 451(b) and ASC 606 (new revenue recognition standard for financial statement reporting)

Forthcoming Regulations on Section 451(b)

- Awaiting further guidance
  - IRS to issue proposed regulations for sections 451(b) and (c)
  - Possibility of new revenue procedure for taxpayers to implement method changes for revenue recognition – may replace and/or combine existing automatic method changes currently available

Small Business Taxpayers Simplifications under TCJA

- Taxpayers with average annual gross receipts < $25 million may qualify for the following:
  - Overall cash method of accounting
  - Exemption from inventory
  - Exemption from UNICAP
  - Exemption from percentage-of-completion
- Traps for the unwary:
  - Aggregation rules
  - Tax shelters, including syndicates

Section 471 Exemption

- Two methods available for taxpayers that qualify for exemption from section 471:
  - Follow AFS treatment (or books and records of taxpayer, if no AFS)
  - Treat inventoriable costs as "non-incidental materials and supplies" under Treas. Reg. Sec. 1.162-3
    - Does not automatically give rise to immediate deduction – threshold for deduction is when amounts are "used and consumed"
    - Different treatment for manufacturers vs. resellers?
    - Stay tuned for future guidance from IRS!

Selected Corporate Tax Issues

Net Operating Losses

- Carrybacks of net operating losses are generally precluded, effective for losses arising in taxable years ending after December 31, 2017.
  - A technical correction may be necessary to achieve the intent of Congress, which was to preclude carrybacks for losses arising in taxable years ***beginning*** after December 31, 2017.
  - Farming losses and losses of certain insurance companies may still be carried back for two taxable years.
- Net operating losses may be carried forward indefinitely, effective for losses arising in taxable years beginning after December 31, 2017.
- The amount of the deduction for net operating loss carryovers is limited to 80% of the pre-NOL taxable income of the taxpayer, effective for losses arising in taxable years beginning after December 31, 2017.

Net Operating Losses (Cont'd)

- Net operating losses arising in taxable years before the effective date of the TCJA changes are subject to the rules in effect prior to amendment. As a result, such losses:
  - May be carried back to the two immediately preceding taxable years (with exceptions);
  - Will expire if not used within 20 taxable years; and
  - May offset 100% of taxable income (rather than 80%).
- The 80% limitation requires clarification or a technical correction. Assume the following:
  - Pre-2018 NOL of $20;
  - Post-2017 NOL of $70; and
  - Current year (2019 or later) taxable income of $100 (before NOL deduction).

Corporate Alternative Minimum Tax Repeal

- The corporate alternative minimum tax ("AMT") is repealed, effective for taxable years beginning after December 31, 2017 (section 55(a)).
- Notice 2018-38 confirms that, for fiscal-year corporations, the AMT rate is effectively reduced to zero for the portion of its 2017-18 taxable year beginning on January 1, 2018.
- Existing AMT credits may offset regular tax and/or refunded under section 53(e), as follows:
  - The tentative minimum tax ("TMT") is set to zero for subsequent years.
  - AMT credits may be used to reduce regular tax to the level of TMT, *i.e.*, zero.
  - An additional refundable amount seeks to refund all AMT credits in stages, in taxable years beginning in 2018 through 2021 (fully refunded by 2021).
- The provision does not eliminate all "business" AMT, as individuals will have to take into account their share of AMT adjustments and preferences from sole proprietorships, disregarded entities, and pass-through entities.

Corporate Alternative Minimum Tax Repeal (Cont'd)

- The refundable tax credits pursuant to corporate AMT repeal are not subject to sequestration.
- It remains unclear whether section 383 limits the use of refundable AMT credits following an ownership change.
- It is also unclear whether the entitlement to refundable AMT credits would be accelerated or eliminated if a corporation ceases to exist in a transaction not subject to section 381.

Corporate Tax Aspects of Section 163(j)

- In the event of an ownership change, disallowed business interest under section 163(j) is subject to the limitations provided in sections 382 and 383.
- A C corporation does not have investment interest income or expense. Accordingly, all interest of a C corporation is business interest income or expense.
  - Where a C corporation is a partner in a partnership, any interest characterized by the partnership as investment interest is recharacterized as business interest in the hands of the corporate partner.
- Additional section 163(j) guidance is provided for consolidated groups.
  - The limitation is applied at the consolidated group level.
  - Interest on intercompany obligations is disregarded for section 163(j) purposes.
  - Special provisions apply to corporations that join or leave a consolidated group.

Questions?

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