

Tax and A&A

# CORPORATE TAX UPDATE

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## » Agenda

- Pass-through Basis Disclosure
- Choice of Entity
- Change of Accounting Method
- Interest Expense Limitation
- Qualified Business Income Deduction
- Nondeductible Parking



# PASS-THROUGH BASIS DISCLOSURE



## › Partnership Basis Reporting Requirement

- 2018 Form 1065 instructions require reporting of negative tax basis capital accounts by partnerships to partners
  - Required for most partnerships who do not report capital accounts on Schedule K-1 Line L on Tax Basis
    - i.e. report on GAAP, § 704(c), and “Other”
    - Report on Schedule K-1 using code AH
    - Partnerships that are exempt from completing schedule L, M-1, and M-2 are not required to report negative tax basis capital information



## › Partnership Basis Reporting Requirement

- What is “Tax Basis Capital”
  - Generally considered as equity, calculated using tax principles
    - + Cash contributed to the partnership
    - + Tax basis of property contributed to the partnership (net of liabilities)
    - - Cash distributed from the partnership
    - - Tax basis of property distributed from the partnership (net of liabilities)
    - + Share of taxable income and tax-exempt income
    - - Share of taxable loss and nondeductible, noncapital expenditures



## › Partnership Basis Reporting Requirement

- Is there a safe harbor approach to determine whether a partnership has an obligation to report negative tax basis capital account information?
  - Yes, in April of 2019 IRS issued Form 1065 FAQ's
  - Includes a safe harbor approach
    - Partnerships may calculate a partner's tax basis capital account by subtracting the partner's share of liabilities under §752 from the partner's outside basis in the partnership
    - Partnership using the safe harbor must report negative tax basis capital account information as equal to the excess, if any, of the partner's share of partnership liabilities under §752 over the partner's outside basis
  - Does this provide any benefit to the partnership if it doesn't know the outside basis of a partner's interest?



## › Partnership Basis Reporting Requirement

- What if the partnership can't comply timely with the new requirement
  - IRS understands that some partnerships are having trouble complying with the new requirement and provides penalty relief with release of Notice 2019-20 in March of 2019
    - Provides additional time for partnerships to provide the required information for tax years beginning after 12/31/2017 and before 1/1/2019
    - Penalty relief for the following
      - Failure to furnish a partner a Schedule K-1 (Form 1065)
      - Failure to file a Schedule K-1 with partnership return (Form 1065)
      - Failure to file a Schedule K-1 (Form 8865)



## › Partnership Basis Reporting Requirement

- What conditions must be satisfied for penalty relief
  - Timely file and otherwise complete schedule K-1 (includes extension)
  - Partnership files a schedule with IRS no later than one year after the original, unextended due date of the form to which the Schedule K-1 was to be attached including the following:
    - Partnership's name, EIN, and Reference ID if any
    - Partner's name, address, and TIN
    - Partner's tax basis capital account at the beginning and end of the tax year at issue



## › Partnership Basis Reporting Requirement

- What is new for 2019 returns?
  - IRS Draft Schedule K-1 for Form 1065 was released on October 18, 2019 and includes new box L which requires disclosure of a partner’s tax basis capital account
  - This replaces prior Schedule K-1 Form 1065 box L which allowed for the partnership to choose the method in which partner’s capital account balances were disclosed
    - Tax Basis
    - GAAP
    - § 704(b)
    - Other



## › Partnership Basis Reporting Requirement

<b>L</b>	<b>Partner’s Capital Account Analysis</b>	
		<b>Tax Basis Capital</b>
<b>Beginning capital account</b>	. . . \$	_____
Capital contributed during the year	. . . \$	_____
Current year net income (loss)	. . . \$	_____
Other increase (decrease) (attach explanation)	\$	_____
Withdrawals & distributions	. . . \$ (	_____ )
<b>Ending capital account</b>	. . . \$	<u>_____</u>



## ENTITY SELECTION



### › Tax Reform – Tax Rate Changes

- Corporate tax rate reduced from 35% to 21%
- Maximum individual tax rate reduced from 39.6% to 37%
- Income from flow-through entities may be eligible for a 20% deduction
  - If fully utilized, the effective rate on pass-through income would be reduced to 29.6%



## » Why Consider Analyzing Choice of Entity?

- Increase after tax cash to owners
- Increase cash available for reinvestment in the business
- Confirm an owner's entity choice accomplishes its originally desired goal under new laws
- Optimizes tax distribution policies in light of lower rates



## » Entity Choice Review – Key Factors

- Succession Planning
  - Owner's exit strategy (sale or passing on to future generations)
  - Estate planning
- Tax Rates
  - Owner's Individual Tax Rate
  - High Effective State Tax Rate
  - Ability to use 199A Deduction
- Cash Flow Needs
  - Are earnings distributed or reinvested
  - What is rate of return on reinvested earnings
- Tax Attributes
  - Do NOLS Exist
  - Suspended Losses
  - E&P and AAA



## › Use a Pass-through When

- Taxable exit is likely
- High or moderate levels of discretionary distributions
- Ability to claim the 20% pass-through deduction (Sec. 199A)
- Significant portion of return on investment derived from unrealized appreciation in business assets, relative to current income
- Active investors



## › Use a C Corporation When

- Taxable exit is unlikely or in distant future
- Modest discretionary distributions
- Alternative means to generate cash for owners
- Inability to claim 20% pass-through deduction (Sec. 199A)
- Passive investors
- Significant state income tax on operating income





**ACCOUNTING  
METHOD CHANGES –  
TAX REFORM UPDATE**



**› Tax Cuts and Jobs Act Changes for Companies  
with Gross Receipts <\$26 Million**

- Expanded availability of the cash method of accounting
- Reduced requirements to account for inventories
- Decrease in applicability of §263A (UNICAP)
- Increase in long-term contract accounting threshold



## ➤ Expanded Use of Cash Method of Accounting

- Increased thresholds of:
  - \$1 million of gross receipts with inventory
  - \$5 million average annual gross receipts for corporations or partnerships with corporations as a partner
- New threshold under §448(b)(3):
  - \$26 million in average annual gross receipts over the prior 3 taxable years
- Aggregation rules do apply for:
  - Controlled groups
  - Trades or business under common control



## ➤ Accrual to Cash Example

• Accounts Receivable	\$1,000,000
• Prepaid Expenses	\$50,000
• Accounts Payable	\$200,000
• Accrued Expenses	\$75,000
	-----
• Net 481a adjustment	\$775,000
• Tax Rate	35%
	-----
• Tax Savings	\$271,250



## › Accounting for Inventories

- Does not mean that you no longer have to capitalize inventory
- §471(c) provides an exemption for taxpayers that meets §448(b)(3) or \$26 million in average annual gross receipts
  - Can treat inventory as non-incidental materials and supplies, or
  - A method that conforms to the taxpayer's method of accounting reflected in their applicable financial statement (AFS) or if no AFS, the books and records of the taxpayer prepared in accordance with the taxpayer's accounting procedure
- May ease administrative burden of tracking inventory and cost of goods sold



## › Application of §263A (UNICAP)

- Creates an exemption from §263A for taxpayers that met §448(b)(3) or \$26 million average annual gross receipts
- Increased from \$10 million for reseller and retailers
- Procedures are now also eligible for the exemption
- Would provide one-less book to tax difference needed to be calculated



## › Long-term Contract Accounting

- §460(e) expands exception for certain construction contracts
- Will not have to use percentage of completion method if gross receipts test of \$26 million is met and the anticipated completion date is less than two years from commencement
- Increases previous threshold of \$10 million
- This will apply on a cut-off basis and only apply to contracts entered into after December 31, 2017



## › Focus Points

- Gross receipts less than \$26 million – all
- Corporations or partnerships with corporations as a partner – accrual to cash
- High receivable & low payable/accrued expense businesses – accrual to cash
- Procedures – 263A & inventories
- Resellers between \$10 million and \$26 million of gross receipts – 263A
- Contractors between \$10 million and \$26 million of gross receipts – completed contract



## ➤ How and Why to File for a Change?

- File Form 3115 to change any of the preceding accounting methods
- Due date is same as federal income tax return (including extensions)
- REV PROC 2018-40 provides automatic consent to any taxpayer filing Form 3115 for the preceding changes
- Any pending applications can be converted to the automatic consent procedures
- Provides availability to administer cash planning opportunities if cash method is elected
- Should free up admin resources at taxpayer's level and reduce number of book to tax differences
- Could provide an additional temporary write-off in current year



**INTEREST  
EXPENSE  
LIMITATION**



## › Interest Expense Limitation

- As amended by the Tax Cuts and Jobs Act, for any entity with average gross receipts greater than \$26 million, the deduction of business interest expense is generally limited to the sum of the following:
  - Business interest income
  - 30% of adjusted taxable income
  - Floor plan financing
- Disallowed interest carries forward indefinitely, to be retested annually



## › Definitions

ADJUSTED TAXABLE INCOME	
Pre 01/01/2022	Post 12/31/2021
Taxable Income	Taxable Income
+ Interest Expense	+ Interest Expense
- Interest Income	- Interest Income
+/- Pass-through items	+/- Pass-through items
+/- Non trade or business items	+/- Non trade or business items
+ Depreciation Expense	
+ Amortization Expense	



## › Definitions

- Business Interest – interest paid or accrued on indebtedness allocable to a trade or business
  - Investment interest is **NOT** included in this definition
  - Note that for C-Corporations **ALL** interest is business interest
- Excess Business Income – excess of ATI over business interest
- Excess Business Interest – excess of business interest over ATI



## › Calculation

- The amount of interest allowed as a deduction cannot exceed the **SUM** of:
  - 30% of adjusted taxable income
  - Business interest income
  - Floor plan financing
- Note that this limitation is applied at the filer level
  - For affiliated corporations that file a consolidated return, the limitation is applied at the consolidated level
  - Disregarded entities do not apply the limitation



## › Carryforward (Disallowed Interest)

- Business interest disallowed under this provision is carried forward indefinitely
  - Treated as paid/accrued in each succeeding tax year until deducted
  - Is only offset by excess income from the **SAME ACTIVITY**
- Note that excess limitation (excess business income) is **NOT** carried forward



## › Pass-Through Application

- Limitation applied at the entity level
- Carryforwards maintained at the owner level (for Partnerships)
  - Reported to owners
  - Excess business income is also reported to owners
- Owners generally cannot net excess business income from one pass-through entity with carryforward interest from another
  - Excess business income IS added to the owner's adjusted taxable income
- Basis is immediately decreased for interest expense – regardless of deductibility
  - Recaptured on sale/disposition





## Exemptions

- Certain real estate/farming businesses
  - ADS election required
- Regulated utilities
- Floor plan financing
- \$26 million or less gross receipts test
  - Aggregation rules
  - Further guidance necessary



## ADS Election

- Note that this election is **IRREVOCABLE**
- Remaining basis on assets in service depreciated using ADS
- All future assets placed in service use ADS

Asset category	Applying interest limitation		Electing out of interest limitation	
	Depreciable life (years)	Eligible for bonus?	Depreciable life (years)	Eligible for bonus?
Nonresidential real property	39	No	40	No
Residential rental property	27.5	No	30	No
Qualified improvement property — under tax reform	39	No	40	No
Qualified improvement property — if Congress passes a technical corrections bill	15	Yes	20	No
Most other tangible property	5 to 15	Yes	5 to 15	Yes



## › Real Property Trade or Business

- Code Section 769(c)(7)(C)
  - Real property development, redevelopment, construction, reconstruction
  - Real property acquisition, conversion
  - Real property rental, operation, management or leasing



## › Aggregation Rules

- Section 52(a) - Section 1563 (Corporations)
  - Parent-Subsidiary controlled group
    - Parent must directly own at least 50% of the vote or value of subsidiary
  - AND*
    - Any other corporation that is owned at least 50% by other members of the group are considered part of the group
  - Brother-Sister controlled group
    - Five or fewer shareholders, who are individuals, trusts or estates own at least 50% of all the vote or value of the stock of each entity, but only counting the lowest amount of stock each shareholder owns in every corporation
  - AND*
    - Five or fewer shareholders own at least 80% of each entity, but only counting each shareholder that owns interest in all entities



## › Aggregation Rules

- Section 52(b) (Partnerships, proprietorships, etc.)
  - Same Parent-Subsidiary and Brother-Sister definitions
    - Trusts – determined by “actuarial interest”
    - Partnership – determined by ownership of capital OR profits interest
    - Proprietorship – by definition is owned more than 50%



## QUALIFIED BUSINESS INCOME DEDUCTION (QBI)



## › Qualified Business Income Deduction

- Overview
  - Section 199A permits the owners of sole proprietorships, S Corporations and partnerships to take a deduction of 20% against their income from the business
    - Reduces the top effective rate to 29.6%
    - Effective for tax years ending after December 31, 2017 and before January 1, 2026
    - Deduction is allowed for trusts and estates that own an interest in a flow-through entity



## › Qualified Business Income Deduction

- Qualified Business Income Deduction Limitations
  - Specified Service Trade or Business (SSTB)
  - Wage and investment limitations
    - THE GREATER OF:
      - 50% of the W-2 wages with respect to the business, or
      - 25% of the W-2 wages with respect to the business plus 2.5% of the unadjusted basis of all qualified property
  - Overall Limitation – The deduction is limited to 20% of the excess of taxable income over the sum of any net capital gain



## › Qualified Business Income Deduction

- Lower Income Taxpayers
  - If taxable income is less than the “threshold amount” for the year, able to ignore the wage and investment limitations and also whether or not the business is an SSTB
  - Taxable income threshold
    - \$160,700 for individual taxpayers
    - \$321,400 for married taxpayers filing jointly
  - Phase-in range
    - \$210,700 for individual taxpayers
    - \$421,400 married taxpayers filing jointly



## › Qualified Business Income Deduction

- Specified Service Trades or Businesses
  - Specifically not eligible for the 20% QBI deduction if above the income thresholds
  - Include the performance of services in the following fields:
    - Health
    - Law
    - Accounting/Actuarial Science
    - Performing Arts
    - Consulting
    - Athletics
    - Financial and Brokerage Services
  - Final regulations issued on January 18, 2019 help to provide some clarity



## › Qualified Business Income Deduction

- Specified Service Trade or Business (continued)
  - Health
    - SSTB includes physicians, pharmacists, nurses, dentists, vets, physical therapists, etc.
    - SSTB does not include health clubs, spas, payment processing, research, testing, or manufacture and/or sales of pharmaceuticals or medical devices
    - SSTB may or may not include surgery centers and senior living facilities based on facts and circumstances
  - Law
    - SSTB includes lawyers, paralegals, legal arbitrator, mediator
    - SSTB does not include printers, delivery services, or stenographers



## › Qualified Business Income Deduction

- Specified Service Trade or Business (continued)
  - Accounting/Actuarial Science
    - SSTB includes accountants, enrolled agents, return preparers, auditors, and actuaries
    - SSTB does not include – No examples given
  - Performing Arts
    - SSTB includes actors, singers, musicians, entertainers, directors, etc.
    - SSTB does not include the maintenance and operation of equipment or facilities for use in the performing arts or the provision of services by persons who broadcast or disseminate audio or video performing arts



## › Qualified Business Income Deduction

- Specified Service Trade or Business (continued)
  - Consulting
    - SSTB includes provision of professional advice and counsel to clients to assist in achieving goals and solving problems and includes advocacy with intention of influencing decisions made by government
    - SSTB does not include performance of services such as sales, training, or educational courses
  - Athletics
    - SSTB includes athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, etc.
    - SSTB does not include maintenance or operation of equipment or facilities for use in athletic events nor does it include the services of broadcasting or disseminating video or audio of athletic events



## › Qualified Business Income Deduction

- Specified Service Trade or Business (continued)
  - Financial services
    - SSTB includes services to clients including managing wealth, advising on finances, retirement planning, providing advice on valuations, mergers, acquisitions, dispositions and raising capital
    - SSTB does not include taking deposits or making loans
  - Brokerage services
    - SSTB includes persons arranging transactions between buyers and sellers of securities for a commission or fee
    - SSTB does not include services provided by real estate agents and brokers nor does it include insurance agents or brokers



## › Qualified Business Income Deduction

- Rental Real Estate Enterprises
  - Do they qualify as a trade or business with respect to the Qualified Business Income Deduction?
    - IRS Issues Notice 2019-07 to provide some clarity on whether an interest in rental real estate rises to the level of a trade or business
    - On September 24, 2019 Treasury and the IRS release Rev-Proc. 2019-38 to provide a safe harbor under which rental real estate will be treated as a trade or business for purposes of QBI



## › Qualified Business Income Deduction

- Rev-Proc 2019-38
  - If the requirements of the safe harbor are met, the rental real estate enterprise will be treated as a single trade or business
  - In order to satisfy the safe harbor, taxpayers and pass-through entities must satisfy all of the requirements of the procedure
  - Failure to satisfy the requirements of the safe harbor does not preclude a taxpayer or the service from establishing that an interest in rental real estate is a trade or business for purposes of the QBI deduction





## › Qualified Business Income Deduction

- Rev Proc. 2019-38 (continued)
  - In order to meet the safe harbor, taxpayers or pass-through entities may either treat each interest in a similar property as a separate enterprise or may treat all interests in all similar properties as a single rental real estate enterprise
    - Residential combined with other residential
    - Commercial combined with other commercial



## › Qualified Business Income Deduction

- Rev Proc. 2019-38 (continued)
  - Requirements of meeting the safe harbor
    - Separate books and records are maintained to reflect income and expenses of the rental real estate enterprise
    - Rental real estate enterprises in existence less than four years, must have 250 or more hours of services performed per year with respect to the enterprise. Rental real estate enterprises in existence more than four years, must have 250 or more hours of services in and 3 of the 5 consecutive years ending with the taxable year
    - The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents regarding hours, description, dates, and who performed services.
    - Taxpayer attaches a statement to the return including the address of the properties, properties disposed of or acquired in the year, and a representation that the requirements of the revenue procedure are satisfied



## ➤ Qualified Business Income Deduction

- Rev. Proc 2019-38 (continued)
  - 250 hour requirement for services
    - Services include advertising, negotiating and executing leases, verifying information in tenant applications, collection of rent, daily operation, maintenance, and repair of property, management of the real estate, and supervision of employees and independent contractors
      - Services may be performed by owners, or by employees, agents, and/or independent contractors of the owners
    - Services do not include financial or investment management activities such as financing, procuring property, reviewing financial statements, or hours spent traveling to and from the real estate
  - Leases under a triple net lease do not qualify for the safe harbor



**NONDEDUCTIBLE  
PARKING  
EXPENSE**



## › Nondeductible Parking Expense

- Tax reform amends §274(a)(4) to provide that no deduction is allowed for the expense of any Qualified Transportation Fringe (QTF) benefit that taxpayers provide to employees
- The amount of a QTF an employer provides to employees is excluded from the employee's gross income as long as it is under a certain threshold (\$265/mo. For 2019)
  - Initial thought is to cover things such as:
    - Reimbursement of parking lot/garage costs
    - Employer leased parking spaces
    - Public transportation
    - Etc.



## › Nondeductible Parking Expense

- IRS Notice 2018-99
  - Released on December 10<sup>th</sup> 2018 to provide guidance to taxpayers to determine the nondeductible amount of parking expense under §274
  - Notice indicates that nondeductible parking expense also includes indoor and outdoor garages, parking lots and other areas owned or leased by the employer where employees may park on or near the business premises
  - Taxpayers that own or lease more than one parking facility in a single geographic location may aggregate the number of spaces in those parking facilities



## › Nondeductible Parking Expense

- IRS Notice 2018-99 (continued)
  - Taxpayers that own or lease parking facilities in more than one geographic location are not permitted to aggregate the spaces in parking facilities not in the same geographic location
  - Total parking expenses include but are not limited to repairs, maintenance, utility costs, insurance, property taxes, interest, snow and ice removal, leaf removal, trash removal, cleaning, landscape costs, parking lot attendant, security, rent or lease payments, or a portion thereof
  - The notice provides a four-step process for determining the amount of nondeductible parking expense
    - After you determine the costs associated with parking lot/garage



## › Nondeductible Parking Expense

- Step #1 – Calculate the disallowance for reserved employee spaces
  - Identify the number of spaces reserved exclusively for the taxpayer's employees
  - Determine the number of reserved employee spaces in relation to total parking spaces and multiply that percentage by the taxpayer's total parking expenses for the facility
  - Product determines the disallowed deduction for reserved employee spots



## › Nondeductible Parking Expense

- Step #2 – Determine the primary use of the remaining spaces
  - Determine which of the remaining non-reserved spaces are used by employees during normal working hours
  - Determine the number of total non-reserved spaces
  - Divide the number of non-reserved spaces used by employees by the total number of non-reserved spaces
    - If the result is less than 50%, no further disallowance is calculated as the primary use of the parking facility is to provide parking to the general public
    - General public includes but is not limited to customers, clients, visitors, deliveries, patients, students, etc.
      - Does not include employees, partners, or independent contractors



## › Nondeductible Parking Expense

- Step #3 – Calculate the allowance for reserved nonemployee spaces
  - If the primary use is not parking for the general public, the taxpayer may identify the spots in the parking facility exclusively reserved for nonemployees
    - Visitors
    - Customers
    - Etc.
  - Determine the percentage of reserved nonemployee spots in relation to the remaining total parking spaces
  - Multiply the percentage above by the total parking expenses
  - The product is the remaining deduction for parking expenses



## › Nondeductible Parking Expense

- Step # 4 – Determine the remaining use and allocable expenses
  - Determine the amount of any remaining parking expenses not specifically categorized in step 1-3
  - Determine the percentage of non-reserved spaces typically used by employees
  - Multiply the remaining expense by the percentage of non-reserved spaces typically used by employees
    - This portion of the expenses associated with the parking facility is nondeductible



## › Nondeductible Parking Expense

- IRS Notice 2018-99 indicates that the Department of the Treasury and the IRS intend to publish proposed regulation under §274 which will include guidance on the determination of nondeductible parking expenses and other expenses for QTF's
- Until such guidance is issued, taxpayers may use any reasonable method as provided in the notice to determine the amount of nondeductible expenses



**FOCUSSED.  
ON YOU.**

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