2019 YEAR-END TAX PLANNING FOR BUSINESSES

All businesses seek to reduce costs, and year-end tax planning presents the chance for significant savings that affect your bottom line. After substantial changes to the federal tax code, businesses need to ensure continued compliance with new rules and understand how to optimize their tax liability for both 2019 and 2020.

Tax planning for businesses also entails determining how this impacts the individual owners, so we recommend reviewing the ***2019 Year-End Tax Planning for Individuals Letter*** as well.

To fully grasp all the potential tax savings, each business must assess its total tax liability. This requires a review of the entire tax portfolio, including income tax, indirect tax, property tax, payroll tax, and excise tax, as well as tax credits, incentives and customs and duties. This will help illuminate the total tax impact of decisions made across the business, providing a complete portrait of how these affect tax liability for the entire organization and individual owners.

Once you assess your business' current financial posture and define a vision for the future, you can analyze the gaps and plan ahead. By determining the projected marginal tax rate for each year, you can weigh the advantages of accelerating income or deductions into 2019 or deferring them until 2020. Important considerations include:

- Bonus depreciation and expensing rules
- The new qualified business income deduction
- Potential changes to your entity status
- Compensation deductions
- Business loss claims

If you can't reduce your overall tax liability for this year, then it's generally best to defer as much tax liability as possible to 2020.

This *tax letter* focuses on federal income tax planning, but your business should also delve into the complexities of applicable state taxes.

TAX SAVING OPPORTUNITIES FOR ALL BUSINESSES

2019 VERSUS 2020 MARGINAL TAX RATES

Whether you choose to accelerate taxable income into 2019 or defer it until 2020 depends, in part, on your business's projected marginal tax rate for each year. Generally, unless your 2019 marginal tax rate will be significantly lower than your 2020 marginal tax rate, you should defer income and accelerate deductions to reduce your 2019 taxable income.

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 effect of the additional 3.8 percent tax on net investment income could push the effective marginal tax rate on high-income individuals to almost 41 percent. If the relevant tax rate is expected to be approximately the same for each of 2019 and 2020, 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. Some additional ways to defer income and accelerate deductions are discussed below.

Installment Sales

Generally, a sale occurs on the transfer of property. If gain will be realized on the sale, income recognition will normally be deferred under the installment method until payments are received, so long as one payment is received in the year after the sale. Therefore, if a business is expecting to sell property prior to the end of 2019, and it makes economical sense, consider selling the property and reporting the gain under the installment method to defer payments (and tax) until 2020 or later.

Delay Billing

If a business uses the cash method of accounting, you may consider delaying year-end billing to clients to that payments are not received until 2020.

Bad Debts

If a business used the accrual method, business accounts receivable should be analyzed and those receivables that are totally or partially worthless should be written off. By identifying specific bad debts, the business should be entitled to a deduction. The business may be able to complete this process after year's end if the write-off is reflected in year-end financial statements.

Current-Year Bonuses

In general, a business's liability for employee bonuses accrues and is deductible for the current year even though the bonus is paid in the following year, if all the events are satisfied that fix the liability and the taxpayer does not have a unilateral right to cancel the bonus at any time prior to payment. Generally, the taxpayer may accelerate the bonus deduction into the current year while the employees will report he income in the following year. Furthermore, any compensation arrangement that defers payment will be currently deductible only if paid within 2½ months after the employer's year-end.

Prepayment of Taxes

For businesses that pay payroll taxes on a quarterly basis, consider accelerating 4th quarter payroll taxes at December 31 year-end and do not wait until January 15, 2020.

TOP ACCOUNTING METHOD CHANGES TO CONSIDER FOR 2019

Cash flow continues to be an important focus for many companies in the current economy. Accounting method changes provide a valuable opportunity for taxpayers to reduce their current tax expense and increase cash flow by accelerating deductions, deferring income based on current tax law, or both. Accounting methods affect the timing of an item, or items, of income or expense reported on the federal income tax return. Once an accounting method change for an item has been adopted or established on prior year tax returns, a taxpayer wishing to change the timing of reporting an item must generally file a Form 3115, Application for Change in Accounting Method, with the IRS to receive permission to change to a different method of accounting.

For the 2019 taxable year, businesses should be mindful of the following top accounting method changes:

1. Revenue recognition conformity
2. Deferral of advance payments
3. Cash versus accrual method of accounting
4. Uniform capitalization

Each of these method changes is covered in more detail below.

Top Accounting Method Change #1: Revenue Recognition

Companies need to be aware 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.

For the 2019 year, the new financial accounting standards for recognizing revenue, titled "Revenue from Contracts with Customers (ASC 606)," are effective for non-publicly traded entities. 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. Depending on the type of revenue stream, in many cases ASC 606 can trigger an acceleration of income into revenue (for example, upfront payments for term licenses of software), although, to a lesser extent, certain revenue streams are decelerated. A taxpayer that has adopted the new standard in 2019 for financial reporting purposes may wish to make a corresponding change in its method of accounting for recognizing revenue for tax purposes.

In another significant development, Congress, as part of tax reform, modified the revenue recognition rules of Section 451 that will specifically impact accrual method taxpayers that have applicable financial statements (AFS). Historically, under the accrual method, income for which a realization event has been triggered is includible in the taxable 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, Section 451(b) effectively provides that an accrual method taxpayer with an applicable financial statement must include an item of income under Section 451 upon the earlier of when the all events test is met or when the taxpayer includes such item in revenue in an applicable financial statement. Thus, taxpayers that are presently deferring income for tax purposes later than when they take the income into revenue on the applicable financial statements are required to attach Form 3115 to the timely filed (including extensions) federal income tax return to comply with the new rule.

Top Accounting Method Change #2: Deferral of Advance Payments

Cash-method taxpayers recognize advance payments when the cash is actually or constructively received. Accrual-method taxpayers are generally required to recognize advance payments in the taxable year of receipt. However, under Revenue Procedure (Rev. Proc.) 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 (AFS) 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), 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 other guidance pursuant to Section 451(c), the IRS stated in a recent notice that taxpayers can continue to use 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 a Form

3115 with the federal income tax return. 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 Form 3115.

Additionally, as a result of Section 451(c), the longer 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 are advised to file Form 3115 to change to either the full inclusion method or the one-year deferral method beginning in the 2019 taxable year.

Top Accounting Method Change #3: Cash Versus Accrual Method of Accounting

For federal income tax purposes, the use of the overall cash method may benefit taxpayers that generate accounts receivable that significantly exceed the accrued expenses and accounts payable. Because income is reported only when actually or constructively received, the cash method affords a deferral of income until such times as the accounts receivable amounts are received. Note, however, that taxpayers with contracts that provide for the receipt of advance payments may wish to avoid the overall cash method for this same reason. For the 2019 taxable year, any taxpayer (including C corporations and partnerships that have a C corporation as a partner) is permitted to use the overall cash method of accounting if the average annual gross receipts for the three prior taxable years do not exceed $26 million and the entity is not treated as a tax shelter under Section 448. Where appropriate, accrual method taxpayers that meet the $26 million test for 2019 should consider filing a Form 3115 to change to the overall cash method.

Pass-through entities (e.g., S corporations, partnerships, limited liability companies classified as partnerships) that do not have inventories, do not have a C corporation as a partner, and are not considered tax shelters under Section 448 are permitted to use the overall cash method of accounting, regardless of the average annual gross receipt limitations.

Top Accounting Method Change #4: Uniform Capitalization

Section 263A requires taxpayers to capitalize direct and indirect costs properly allocable to real or tangible personal property produced by the taxpayer, as well as real property and personal property described in Section 1221(a)(1) acquired by the taxpayer for resale (i.e., the "UNICAP" rules). Generally, the costs required to be capitalized for tax purposes under Section 263A exceed the amounts required to be capitalized for financial accounting purposes and such "additional Section 263A" costs are added to inventory. 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, small business producers and resellers are exempted from the requirement to capitalize additional Section 263A costs if the average annual gross receipts for the three prior taxable years do not exceed $26 million and the entity is not treated as a tax shelter under Section 448. A small business taxpayer that meets the $26 million test for 2019 and wishes to be exempted from Section 263A should attach a Form 3115 to the timely filed (including extensions) federal income tax return for the year of the change.

For certain taxpayers with inventory that are not exempted from Section 263A, UNICAP must be addressed in 2019. In recent years, the IRS has expressed concerns related to the potential distortion of income resulting from producers including negative Section 263A costs in their simplified methods of accounting for allocating Section 263A costs to ending inventory. To address this issue, the IRS and Treasury issued final negative Section 263A regulations effective for taxable years beginning on or after November 20, 2018.

Among other things, the final regulations contain a new modified simplified production method (MSPM) for allocating negative Section 263A costs to ending inventory. The MSPM allows larger producers (i.e., taxpayers with average annual gross receipts exceeding $50 million) to take into account negative Section 263A costs by computing two new absorption ratios (pre-production ratio and production ratio) and then applying each ratio to separate categories of costs in ending inventory to determine the total amount of additional Section 263A costs to capitalize for tax purposes.

NONQUALIFIED DEFERRED COMPENSATION

Section 404(a)(5) dictates that the employer's deduction for deferred compensation is allowed 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 allowed when paid. For noncompliant arrangements, Section 409A taxation to the participant deems 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 placed 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.

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 minimum tax 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

On January 18, 2019, the Department of the Treasury and the IRS issued widely anticipated final regulations concerning the deduction for qualified business income under Section 199A (the QBI Deduction). The final regulations clarify several aspects and make a number of changes to the rules contained in the proposed regulations. Broadly, several key areas of consideration addressed in the final regulations include:

- Determination of a trade or business for purposes of Section 199A
- Calculation of QBI
- Clarification of the meaning of certain SSTBs
- Modification of the SSTB anti-abuse rules
- Application of the W-2 Wages and UBIA of qualified property limitations
- Application of the trade or business aggregation rules

Given the complexity of determining the QBI Deduction, taxpayers should carefully consider the rules contained within the final regulations. As noted in the preamble to the final regulations, there are still a number of areas where detailed guidance has not been provided. As a result, taxpayers and their advisors will need to evaluate other sources of guidance in reaching final conclusions.

BUSINESS TRAVEL, MEALS, AND ENTERTAINMENT EXPENSES

Although significantly limited, business deductions for meal and entertainment expenses are still available in certain circumstances. This may mean that businesses will need to track those expenses differently in their accounting systems than they have in the past. It could also mean that they will need to request more information on invoices that could involve both entertainment and meals.

EMPLOYEE TRANSPORTATION EXPENSES

Employers may not deduct expenses paid or incurred in 2019 for transportation benefits provided to employees for commuting between home and work unless the expense is necessary to ensure the safety of the employee. Except for bicycle commuting benefits, all or a portion of the benefit still is excludible from the employee's income, however.

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, or farm machinery or equipment).

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.

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 $26 million for 2019, (2) regulated public utilities, (3) an electing real property trade or business, and (4) an electing farming business.

Comprehensive proposed regulations were published in the Federal Register on December 28, 2018. Final regulations are expected before the end of 2019 but have not been published as of the date of publication of this letter. Among the significant aspects of the proposed regulations (including matters that have yet to be resolved) are the following items:

- The broad definition of "interest" for purposes of Section 163(j), including amortized debt issuance costs, guaranteed payments for the use of capital, repurchase/retirement premium, certain commitment fees, and market discount
- The broad definition of "tax shelter," which includes an expanded category of taxpayers not eligible for exemption from Section 163(j) as a small business including certain passive investors
- The inability to increase adjusted taxable income by depreciation, amortization, and depletion capitalized to inventory under the uniform capitalization rules

- A complex set of calculations to allocate certain "excess" items to partners of partnerships.
- The treatment of "self-charged interest" between passthrough entities and their owners, or between passthrough entities under common control
- Whether the exemption for floor plan financing interest (coupled with the disallowance of bonus depreciation under Section 168(k)) is effectively elective
- The application of Section 163(j) to consolidated groups, including the treatment of members joining or leaving a group and the application of limitations under Sections 382 and 383 and the separate return limitation year rules
- The application of Section 163(j) to foreign corporations and other foreign persons

PAY OR PLAY EXCISE TAX

For the 2019 plan year, if the business has 50 or more full-time equivalent employees, they could be subject to an excise tax, which could be as much as $2,500 per full-time employee, for failure to offer a health care plan that is minimum essential coverage to at least 95% of the full-time employees if at least one employee obtains subsidized coverage through a public health insurance exchange. If the business does offer coverage but it is not adequate or is unaffordable, the excise tax could be $3,750 for each full-time employee who obtains subsidized coverage through an exchange. Smaller employers should review whether they have undergone, or will soon undergo, any changes to their business structure that would require them to be aggregated with other entities and subject them to potential liability. Larger employers should consider their health care plan options in light of this potential excise tax liability.

HEALTH REIMBURSEMENT ARRANGEMENTS

Certain small employers that want to assist their employees in obtaining health insurance may choose to set up a qualified small employer health reimbursement arrangement (QSEHRA). The QSEHRA, unlike other health reimbursement arrangements, is a tax-favored arrangement that is not considered a group health plan and does not expose the employer to excise taxes for not satisfying ACA insurance market requirements. It's available to employers that have fewer than 50 full-time equivalent employees, do not offer any health plan, and meet other requirements.

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 carry forward its share of the excess business interest that 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 proposed regulations reserve on several important partnership issues including when a lower-tier partnership (LTP) allocates excess items to a partner that is also a partnership (UTP), does the UTP continue to allocate the excess items to its partners? The answer to this question can have significant ramifications including the ability of partners to utilize allocated losses, determination of ultimate allowable deduction against either ordinary income or capital gain, and potential complexity in tracking and reporting excess items. There are generally two approaches in answer to this question:

1. Aggregate Approach: Under an aggregate approach, the LTP would apply the rules of Section 163(j) to the extent applicable. Any excess items would be allocated to its partners, including a UTP. The UTP would then allocate excess items out to its partners. Ultimately, upper-tier partners who are not partnerships would apply the Section 163(j) carryover rules to determine eventual utilization of excess business interest.
2. Entity Approach: Under an entity approach, the LTP would apply the rules of Section 163(j) to the extent applicable. Any excess items would be allocated to its partners, including a UTP. Since the rules of Section 163(j) would be applied separately at each entity, a UTP would hold its allocable share of excess business interest until it receives an allocation of excess taxable income or disposes of its interest in the LTP.

Neither approach is perfect or necessarily precisely what Congress intended, however, the Entity Approach is generally easier to administer and may mitigate potential complexities in the event of transactions involving direct and indirect partners of UTP. While either approach appears to have merit, final regulations may provide more certainty.

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 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. Unlike the treatment of partnerships, disallowed business interest expense of an S corporation is carried forward at the entity level. Except for this significant difference, the rules for S corporations are broadly similar to the proposed regulations for partnerships.

For C Corporations

The proposed rules provide that all interest expense of a C corporation will be considered properly allocable to a trade or business 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. The regulations further provide that interest expense of a partnership allocated to a C corporation partner will be treated as business interest, even if characterized as investment interest at the partnership level. Similar rules recharacterize items of investment income, gain, loss, and deductions when allocated to a C corporation partner.

DEPRECIATION

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). 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.

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 the bonus depreciation, as the 100 percent bonus depreciation deduction ends after 2023. The ability to claim 100 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. Further, typically only MACRS (Modified Accelerated Cost Recovery System) property with a recovery period of 20 years or less is eligible for bonus depreciation. ***Taxpayers with new real estate construction or major renovations should arrange for a cost segregation study to identify eligible personal property. The personal property will have a lower tax life, making it eligible for bonus depreciation.

APPLICATION OF BONUS DEPRECIATION TO PARTNERS AND PARTNERSHIPS

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. Pursuant to the final regulations, 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. The preamble to the final bonus depreciation regulations specifically stated that legislative action is required to remedy this error. 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 2019, the maximum amount that can be expensed is $1,020,000 and is reduced on a dollar-for-dollar basis for eligible property placed in service in excess of $2,550,000. 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 improvement property, and improvements to roofs, HVAC, fire protection systems, alarm systems, and security systems.

***Planning Suggestion*:** With the expanded definition of Section 179 property, qualifying taxpayers can fully expense certain assets that are not eligible for bonus depreciation.

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 2019. 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 IRS 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.***

Remodel/Refresh Safe Harbor for Restaurants and Retailers

In November 2015, the IRS 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 applicable financial statement (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. Due to the drafting error, qualified improvement property (which now includes qualified leasehold improvements, qualified retail property, and qualified restaurant property) has a 39-year life for property acquired and placed in service after December 31, 2017. Using the remodel/refresh safe harbor to identify current repairs is extremely beneficial. Further, a cost segregation study can identify personal property with a lower class life, making it bonus eligible. Arrange for a fixed asset review to identify deductible remodel-refresh costs.

INTERNATIONAL TAX PROVISIONS

The IRS and Treasury issued guidance throughout the year including, but not limited to, temporary regulations under Section 245A (deduction for foreign source-portion of dividends received by domestic corporations from specified 10 percent owned foreign corporations), final regulations under Section 951A (global intangible low-taxed income included in gross income of U.S. shareholders), proposed regulations under Section 958 (rules for determining stock ownership), final regulations under Section 956 (investment of earnings in U.S. property), final regulations under Section 965 (treatment of deferred foreign income upon transition to participation exemption system of taxation), proposed regulations under Section 250 (foreign-derived intangible income and global intangible low-taxed income) and proposed regulations under the passive foreign income corporation provisions of the Code. In addition, the IRS and Treasury issued numerous Notices and Revenue Procedures dealing with international tax provisions. The final regulations under Section 951A and proposed regulations under Section 958 substantially modify the treatment of domestic partnerships and their partners for certain anti-deferral provisions. The final regulations under Section 956 substantially modify the rules applicable to corporate U.S. shareholders in controlled foreign corporations. For planning purposes, companies should consider how these modifications can impact their overall structures and supply chains, and the impact that these provisions could have on their particular facts and circumstances.

FEDERAL RESEARCH AND DEVELOPMENT (R&D) 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 currently 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 taxable years 2016 through 2020 may potentially be used to offset up to $250,000 per year of the employer's portion of that year's FICA payroll tax.

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. 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 client service professional: 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.

EMPLOYER CREDIT FOR FAMILY AND MEDICAL LEAVE ACT WAGES

For wages paid in 2019, an eligible employer may take a paid family and medical leave credit of between 12.5% and 25% of the wages paid to the employee, depending on what portion of the employee's normal wages are paid during the leave (minimum of 50% of wages).

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. To take part in the program, investors must invest in a qualified opportunity fund (QOF) within 180 days after the sale or exchange of a capital asset. Note that if the capital gain is received through a Schedule K-1 and the pass-through entity has not elected to defer the gain, then the 180-day period with respect to the taxpayer's eligible gain begins on the last day of the pass-through's taxable year. 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 31, 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.

***Planning Suggestion*:** Taxpayers with recognized capital gains should consider making an investment in a QOF to obtain significant tax savings. As the end of 2019 quickly approaches, so does the deadline to obtain

all of the tax benefits available in the Opportunity Zone program. Your client service professional can be consulted for further information and assistance.

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 tests, the taxpayer may only consider real property businesses in which he or she 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 or she must generally determine whether he or she 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. 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.

TAX SAVING OPPORTUNITIES FOR PARTNERSHIPS, LIMITED LIABILITY COMPANIES, AND S CORPS

PARTNERSHIPS

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

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

On September 30, 2019, the IRS posted copies on its website of draft 2019 Form 1065, U.S. Partnership Return of Income, draft 2019 Form 1065 (Schedule K-1), Partner's Share of Income Deductions, Credits, etc., draft 2019 Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, and draft 2019 Form 8865 (Schedule K-1), Partner's Share of Income, Deductions, Credits, etc. If finalized in the current form, information that would be required under the revised forms includes:

1. Net unrecognized Section 704(c) built-in gains/loss at the
1. beginning and end of the year
2. Tax basis capital accounts
3. Breakout of guaranteed payments for services vs. capital
4. Disclosure around tiered liability allocations
5. Section 751 hot asset gains/losses

To include the proposed required information, it will be critically important for partnerships to accurately maintain Section 704(b) and tax basis capital accounts. To the extent that this information hasn't been previously maintained, steps to begin building these capital accounts are ***strongly*** encouraged.

LIMITED LIABILITY COMPANIES

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

S CORPORATIONS

All pass-through entities, including partnerships and S corporations, should evaluate their choice of entity as a result of tax reform and the new reduced corporate tax rate. The Section 199A deduction may reduce a pass-through owner's maximum individual effective tax rate from the highest rate, 37 percent, to as low as 29.6 percent. Converting from a pass-through entity to a C corporation or vice versa requires complex analysis and planning. Shareholders of existing S corporations should consider the following year-end planning tips:

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

Under certain conditions, an S corporation that sells appreciated property will be subject to tax on "built-in gains" (generally the property's appreciation prior to the corporation becoming an S corporation or prior to being acquired from a C corporation in a tax-free transaction).

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

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

The built-in gains tax generally applies only to gains recognized during a five-year recognition period. Thus, the tax will not be imposed if the S corporation had completed a five-year recognition period at the time the built-in gain is recognized. The tax applies when an S corporation has converted from C corporation status, but it also applies to assets that an S corporation has acquired from a C corporation in a tax-free transaction.

SPECIAL CONSIDERATIONS FOR PASS-THROUGH ENTITIES

Recharacterization of Certain Long-Term Capital Gains Under Section 1061

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

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

Partnerships that issue applicable partnership interests and are engaged in an applicable trade or business should ensure procedures are in place to accurately track holding periods in investment companies and assets bearing in mind the multiple holding periods that can result from "add-on" investments. Further, determination of a partner's share of capital gains will likely require detailed record-keeping and tracking of partner Section 704(b) and tax basis capital accounts.

Like-Kind Exchanges Under Section 1031

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

TAX SAVING OPPORTUNITIES FOR C CORPORATIONS

RETENTION OF CORPORATE EARNINGS

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

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

PERSONAL SERVICE CORPORATIONS

PSCs have historically been denied the benefit of the lower corporate tax brackets and were taxed at a flat 35 percent rate, but they are now taxed at the same 21 percent rate as other C corporations. A PSC is a corporation that performs services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting and also meets certain stock ownership tests.

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

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

CORPORATE STOCK AND STOCK OPTIONS

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

Caution: Corporate deductions may be lost if the equity compensation is not timely reported on a Form W–2, in the case of an employee, or a Form 1099-NEC, in the case of an independent contractor.

Incentive stock options and options granted under a qualifying employee stock purchase plan have a separate reporting requirement. Form 3921, Exercise of an Incentive Stock Option Under Section 422(b), and Form 3922, Transfer of Stock Acquired Through an Employee Stock Purchase Plan Under Section 423(c), must be furnished to employees no later than January 31, 2020, and filed with the IRS by February 28, 2020 (on paper), or March 31, 2020 (electronically), for 2019 ISO exercises and employee stock purchase plan purchases.

Caution: Companies with publicly traded stock or registered debt may not be allowed to deduct compensation in excess of $1 million paid to certain covered employees. For taxable years beginning after December 31, 2017, the performance-based pay exception that previously allowed a full deduction of most stock options no longer exists unless the transition rules apply.

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

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

PLANNING FOR NOLS

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

Corporations that have experienced an "ownership change," as that term is defined in Section 382, will be subject to a limitation on the use of their pre-change NOLs and certain other tax attributes to offset post-change income or tax liability, as the case may be. In general, the basic annual limitation is the product of the value of the corporation's stock immediately before the ownership change and the long-term tax-exempt rate for the month of the change. In addition, the limitation may be enhanced during the five-year recognition period immediately following the ownership change by the amount of any net recognized built-in gains during that period, subject to an overall limitation equal to the corporation's net unrealized built-in gain (NUBIG) as of the change date. Conversely, if the corporation has a net unrealized built-in loss (NUBIL) at the time of the ownership change, it may be required to apply the annual imitation to any net recognized built-in losses during the recognition period.

Proposed regulations issued in September 2019 would, if adopted as final regulations, make significant changes to the manner of determining a corporation's NUBIG or NUBIL and identifying its recognized built-in gains and losses during the recognition period. A complete description of these rules is beyond the scope of this letter. However, the proposed rules will have a detrimental effect on loss corporations with a NUBIG that use their business assets during the recognition period rather than selling them in taxable transactions. These rules are proposed to be effective for ownership changes that occur after the date on which final regulations are published in the Federal Register. If you expect to have an ownership change in the near future, you should consult your client service professional to analyze how these rules, if adopted, would apply to the post-change limitation on the use of these attributes.

SUCCESSION AND FAMILY BUSINESS PLANNING

Year-end is the traditional gift-giving season. This should also be a time to plan for your company's succession and the transfer of your wealth to your heirs in a manner that minimizes transfer taxes. Owners of closely-held businesses may way to consider gifting an interest in the business (corporate stock or interest in family limited partnerships or LLCs). A taxpayer may take advantage of valuation discounts (marketability and minority discounts) and the 2019 gift tax exclusion of $15,000 per done ($30,000 when gift-splitting) when gifting family business interest before year end. We urge you to consult with one of our financial planning professionals for ideas to preserve your family wealth.

CONCLUSION

Business tax planning is very complex. Careful planning involves more than just focusing on lowering taxes for the current and future years. How each potential tax saving opportunity affects the entire business must also be considered. In addition, planning for closely-held entities requires a delicate balance between planning for the business and planning for its owners. Please use this letter as a guideline only, and work with your Smith Leonard tax advisor for specific strategies appropriate to your particular situation.