2020 year-end tax letter

As we write our annual tax-planning letter, we are constantly reminded that this is no ordinary year. The fall continues to be dominated by a highly partisan election, a second wave of COVID-19, an economy struggling to recover from the worldwide pandemic and a wildly fluctuating stock market.

Adding to this mix of uncertainty is the ever-changing tax landscape. 2020 has seen not only continued guidance relating to the Tax Cuts and Jobs Act (TCJA), but also the passage of the Coronavirus Aid, Relief, and Economic Security (CARES) Act. The CARES Act contains numerous revisions to the TCJA, which in some cases require taxpayers to redo returns two years after the fact. The CARES Act also introduced the PPP loan program, the rules for which were written hastily and leave several important questions still unanswered.

All of this created a perfect storm for taxpayers — businesses and individuals alike. Besides continuing economic uncertainty, tax rates could be in play depending on the election results. The prospect for increasing rates could hinge on control of the Senate, especially if the Democrats win the White House. While a change in control of the House of Representatives is not anticipated, if Republicans retain their majority in the Senate, it is unlikely any meaningful rate changes would be enacted.

In addition, the economic downturn, coupled with trillions of dollars of enacted stimulus legislation, has created a federal deficit exceeding $3 trillion annually. At the end of June (the close of the government’s third quarter), the deficit represented 13.1% of GDP, a level not seen since World War II. To reduce this amount, anticipate either higher tax rates or a combination of spending cuts and restrictions on deductions. In terms of limiting deductions, remember the business interest limitation using 30% of adjusted taxable income is temporarily increased to 50% through 2020 (returning to 30% in 2021). Furthermore, 100% bonus depreciation is set to expire for assets placed in service after Dec. 31, 2022. Congress may choose to limit other deductions in attempts to raise revenue.

While many are facing difficult times, business does not stand still. Solid financial and tax planning is needed now more than ever. With our year-end letter, we have always urged readers to not only do their annual tax planning, but to use this period to conduct a full financial review of their portfolios and estate planning as well. This year, such a financial review is not just recommended, it is critical.

In the coming weeks and months, managing cash and minimizing current taxes is even more important as the economy recovers. The CARES Act presents some one-time opportunities for taxpayers to reduce taxes and obtain refunds from prior years. For example, while the TCJA had repealed the net operating loss (NOL) carryback rules, the CARES Act reinstated them for 2018, 2019 and 2020 losses. If you have a taxable loss in 2020, careful analysis is needed to maximize the tax benefit of such loss since a 2020 loss can be carried back five years. However, losses incurred in 2021 will no longer be eligible for any carryback. As a result, this represents your last chance to recover tax payments made in 2015 through 2019. If you need cash currently, look into filing an NOL carryback return as soon as possible after year-end to expedite your refund.
In addition to these NOL changes, our 2020 year-end tax-planning letter focuses on tax topics with the above economic and political backdrop in mind. We examine multiple pieces of CARES Act and TCJA guidance (including Paycheck Protection Program debt forgiveness, the employee retention credit and payroll tax deferral), analyze pass-through loss and cancellation of indebtedness strategies, summarize tax capital reporting, define the home office deduction as well as review a myriad of international and state and local tax changes.

As always, your Baker Tilly advisor is ready to assist you in meeting your financial and tax objectives.

*Visit the sections below for more information about the most pressing year-end tax issues:*

- Business interest limitation rules (section 163(j)) — Where do we stand?
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**Conclusion**

We will continue to keep you informed of the latest developments by sending updates to assist you with planning throughout the remainder of the year. See our [2020 Tax Planning Guide](#) for additional ways to help you reduce your taxable income by taking advantage of every tax break to which you are entitled.
Business interest limitation rules (section 163(j)) – Where do we stand?

By Mike Schiavo

The business interest expense deduction limitation — the infamous section 163(j) — was enacted as part of the Tax Cuts and Jobs Act (TCJA). In addition to being a major revenue-raiser, this provision is one of the most complicated sections of the tax reform law, but since the TCJA passed in late 2017, the Treasury Department and the IRS have been busy cranking out rules and guidance to help taxpayers implement the new law — and 2020 was no exception.

Here is where things stand as of early fall:

**Coronavirus Aid, Relief, and Economic Security (CARES) Act changes**

Prior to the CARES Act, the business interest expense deduction was limited to the sum of the taxpayer’s business interest income, plus 30% of adjusted taxable income (ATI), plus floor plan financing interest expense. The CARES Act added several special rules, which should be taken into account for 2020 tax planning, including:

— The Act retroactively increased the section 163(j) limitation to 50% of ATI (up from 30%) for 2019 and 2020, for taxpayers other than partnerships. Taxpayers have the option of electing out of this rule and using 30% instead of 50%.

— For partnerships, the increase to 50% only applies for 2020. Partners allocated excess business interest expense (EBIE) from 2019 can deduct 50% of that amount as an interest deduction in their 2020 tax year, without limitation.

— The Act also allows taxpayers to elect to use their 2019 ATI to calculate the 2020 section 163(j) limitation. This election will be helpful for taxpayers experiencing losses in 2020 due to current economic conditions.

Of course, no discussion of the CARES Act would be complete without mentioning qualified improvement property (QIP) and the interaction of the bonus depreciation rules with section 163(j). Taxpayers with real property trades or businesses can elect out of the business interest expense
deduction limitation, but the trade-off is that they must use longer depreciation recovery periods for nonresidential real property, residential real property and QIP — and, under these rules, QIP would not be eligible for bonus depreciation. However, due to a drafting error in the TCJA, QIP was not eligible for bonus depreciation — this was known as the “retail glitch.” For many real estate taxpayers, since tenant improvements weren’t eligible for bonus anyway, this meant there was very little downside to making the election out of the interest limitation.

Fast forward to the CARES Act. More than two years after passage of the TCJA, Congress finally got around to fixing the retail glitch. Of course, many taxpayers may have made different decisions regarding the real property trade or business election if QIP had been eligible for bonus depreciation all along. Fortunately, in a series of revenue procedures released in April, Treasury and the IRS gave taxpayers the chance to revoke the real property trade or business election, make a late election and correct or catch up depreciation for QIP. The deadline for making these changes for 2018, 2019 and/or 2020 returns generally is Oct. 15, 2021.

**Final regulations**

As we discussed in our previous tax alert, the IRS issued final section 163(j) regulations in late July. In terms of year-end planning, here are some things to keep in mind:

- Take advantage of the cost of goods sold depreciation add-back. In computing the interest limitation, ATI is analogous to earnings before interest, taxes, depreciation and amortization (EBITDA). For 2020 and 2021, manufacturers and other taxpayers who are required to capitalize depreciation to inventory can add back those amounts when computing ATI. This is a taxpayer-favorable change in the final regulations, which will result in a larger interest deduction. However, starting in 2022, the ATI component must be calculated without the add-back for depreciation and amortization, meaning a lower limit and smaller interest deductions.

- Consider a “protective” real property trade or business election. Rental real estate activities that do not rise to the level of a trade or business, such as triple net lease arrangements, generally are not subject to the section 163(j) business interest expense limitation. Whether an activity rises to the level of a trade or business is based on all the facts and circumstances and, in some situations, it may not be immediately clear if rental real estate is a trade or business or not. Under the final regulations, taxpayers conducting rental real estate activities can make the real property trade or business election on a protective basis. This ensures any business interest expense incurred in the activity will be excepted from the limitation, if the IRS later determines the taxpayer was operating a trade or business.

- Watch out for the tax shelter rule. For 2020, taxpayers with average annual gross receipts of $26 million or less are exempt from the section 163(j) limitation. Under the final regulations, exempt partnerships and S corporations do not have to separately state business interest, and the interest expense is not subject to further testing at the partner or shareholder level. However, there’s a catch — this exemption does not apply to tax shelters, which are defined much more broadly than one would anticipate. A “tax shelter” for this purpose is an entity, other than a C corporation, if more than 35% of the losses during the taxable year are allocated to limited partners or limited entrepreneurs. A “limited entrepreneur” is a person who has an interest in an entity (other than a limited partnership interest) and who does not actively participate in the management of the entity. Whether a taxpayer
actively participates in management is based on facts and circumstances. With losses in many sectors continuing to pile up due to the pandemic, taxpayers that were planning to rely on the section 163(j) exemption need to make sure they don't fall into the tax shelter trap.

— Make sure you know what “interest” is. The 2018 proposed regulations defined interest broadly and included many items not traditionally viewed as interest in the eyes of borrowers. In response to comments, the IRS removed a number of items from the definition of interest, including loan commitment fees, debt issuance costs and certain hedging costs. For partnerships, the IRS acknowledged that guaranteed payments for the use of capital typically are a return on a partner’s investment, not interest expense. Under the final rules, guaranteed payments for the use of capital will only be treated as business interest expense in certain abusive situations.
Will refunds from losses become a lifeline for struggling businesses?

By Patrick Balthazor

It should come as no surprise that the year 2020 will be a tough one for many taxpayers. A large number of businesses are struggling, particularly in certain sectors. The restaurant and hospitality industries have been particularly hard hit, and they are not alone. Many will show tax losses for 2020. While the losses are not favorable, they may provide somewhat of a lifeline to struggling entities. The ability to use these losses against taxable income from prior years or to offset income in future years may provide businesses with much-needed cash.

The Coronavirus Aid, Relief, and Economic Security (CARES) Act, which was enacted in March 2020, provided stimulus measures to aid businesses that generate net operating losses. These losses may then be utilized to produce tax refunds via carrybacks of the losses to earlier tax years or to offset income in later tax years. Some of the more significant provisions in the CARES Act that can assist in creating refunds include:

— The temporary increase under section 163(j) in the percentage limitation on business interest deductions to 50% of adjusted taxable income (ATI) from 30% of ATI. This provision is discussed in more detail in this letter.

— The effective date for the provision that caps business losses for noncorporate taxpayers to $250,000 annually ($500,000 for joint filers) has been pushed back to taxable years beginning in 2021. This allows taxpayers to utilize the loss in the current year without the cap or to increase a net operating loss that may be carried back to prior tax years.

— For taxable years beginning before Jan. 1, 2021, the provision under the Tax Cuts and Jobs Act that limited the use of net operating losses to 80% of taxable income is not applicable. Thus, losses incurred and used in tax years before 2021 can offset 100% of taxable income. In addition, net operating losses for taxable years beginning after Dec. 31, 2017, and before Jan. 1, 2021, are allowed to be carried back to each of the five preceding taxable years. An election may be made to carry the losses forward.
The prospect of carrying back the loss may seem attractive for taxpayers that have net operating losses in tax years 2018 through 2020. The taxpayer will likely receive the refund quicker if the loss is carried back as opposed to carrying it forward to future tax years. Some taxpayers (especially corporations) may have been in a higher tax bracket in prior years. However, the decision to carry the loss back versus electing to carry it forward should be based on a careful modeling of the consequences. Many factors, including the alternative minimum tax for individuals, repatriation income under section 965 and foreign tax credits must be considered. The application of these factors may result in a carryback refund at a much lower effective tax rate than if an election were made to carry the loss forward. As many practitioners have said: model, model, model. A lack of modeling may result in an inefficient use of the net operating loss.

It should be noted that many states may not conform to the federal changes in the CARES Act. In some cases, federal conformity is automatic, but many states may require action by the legislature. Given the pandemic, some legislative bodies may not be in session. This complicates the situation for state purposes when taxpayers do not know if the state will allow some of the favorable changes made by the CARES Act. Modeling becomes much more difficult when it is uncertain how the states will react.

**Form 4466**

Corporate taxpayers may also want to consider filing Form 4466 to obtain a refund of overpayments. This form can provide a quick refund of estimated taxes when a corporation has overpaid its tax. It may only be used by corporations that have an overpayment of at least 10% of their liability and at least $500. The form is filed after the end of the tax year and before the due date of the return (including extensions). While the filing of Form 4466 is not necessarily limited to corporations that have net operating losses, it is most often used in these situations. In many cases, corporations do not file their returns until many months following the end of their tax year. They may have made estimated payments during the year, but now they are finding they overpaid for the year. Filing Form 4466 before filing the federal income tax return will accelerate the tax refund as the IRS is required to act on the Form 4466 within 45 days after its filing.
Loan modifications: Take care of them so they don't take care of you

By Patrick Balthazor

As some taxpayers struggle with a tough economy, it is inevitable that some will be discussing loan restructurings with their lenders. This may take the form of reducing interest rates, extending payment terms or simply canceling all or a portion of the debt. In these situations, it is imperative taxpayers receive good advice from their attorneys and tax counsel. They must understand how the restructuring affects their cash position, in addition to knowing the tax consequences. All too often, taxpayers do not receive proper advice during the process, creating unfortunate results. Given the complexity of debt restructurings, especially on the tax side, it is always better to seek advice during the process rather than after.

This article provides guidance that will enable those going through the process of a loan restructuring to have a basic understanding of the consequences. Armed with knowledge, better decisions can be made.

The general rule is that income from the cancellation of debt (COD) is not includible in gross income if the taxpayer is insolvent, in bankruptcy or the debt is qualified farm indebtedness; however, the exclusion from gross income does not come without consequences. In most cases, it is more in the nature of a deferral of the consequences since certain tax attributes must be reduced. The attributes to be reduced include net operating loss carryovers, certain credit carryovers, capital loss carryovers and the basis of assets. There is a defined order in which the attributes must be reduced, but a taxpayer may elect to first reduce the basis of depreciable assets before reducing other attributes. The attributes are reduced after the tax is determined for the year of discharge. The reduction of tax attributes has the effect of deferring the consequences of the COD, allowing the taxpayer time to recover instead of facing the immediate consequence of having the COD included in current income. The detrimental effects of the reduced tax attributes are then dealt with in future tax years.

As mentioned earlier, the general rule applies if a taxpayer is insolvent and only to the extent that the taxpayer is insolvent. For this purpose, insolvency is defined as the excess of the taxpayer's liabilities over the fair market value of the taxpayer's assets immediately before the debt discharge. For example, if a taxpayer has liabilities of $50,000 and assets with a fair market value of $40,000 immediately before debt is discharged, only $10,000 of debt discharge can be excluded from income as that is the amount
of the taxpayer’s insolvency. Any amount above that is included in taxable income. The purpose of the
general exclusion rule is that the exclusion should only apply to the extent that a debtor is insolvent. It
does not apply to the extent a debtor is made solvent after the discharge.

For taxpayers other than partnerships, insolvency is determined at the taxpayer level. There is an
exception for partnerships. Partnerships pass the COD income through to the partners and the partners
must each determine if they are insolvent and able to exclude the income.

There are times it is obvious a taxpayer is insolvent and able to take advantage of the insolvency
exclusion. But, in many cases, the taxpayer may hold assets with fair market value not readily known. In
these cases, it is strongly recommended an independent appraisal be performed. A reliable appraisal
will mitigate disputes with the IRS.

In some cases, the entire amount of debt principal and accrued interest is simply canceled. This
generally results in COD income in the amount of the principal that is canceled plus any accrued interest
deducted by the taxpayer. Accrued interest that has not been deducted, such as by a cash basis
taxpayer, is not considered COD income since no benefit was received from a deduction. The IRS has
reserved in the regulations whether carryforwards of interest deductions under section 163(j) are
considered deducted and could be COD income if canceled.

When debt is not canceled outright, the debtor and creditor often negotiate a modification of the loan
terms. This can involve a change in the interest rate, an extension of the payment terms and a number
of other changes. Most debt modifications result in what the IRS would deem a “significant
modification.”

There are numerous examples of significant modifications defined in the regulations and the threshold
for a significant modification is quite low. The importance of a significant modification to a debt
instrument is that it triggers a deemed exchange of the old debt for new debt. It is this deemed
exchange that may result in COD. If there is a significant modification, the old debt is deemed to be
satisfied with an amount of money equal to the issue price of the new debt. As a general example,
reducing the principal amount of a debt will, in many cases, lead to an issue price of the new debt equal
to its revised principal balance. As the old debt is deemed satisfied with an amount of money equal to
the issue price of the new debt (with a lower principal balance), there will be COD income since the old
debt was deemed to be paid off at a lesser amount than the principal balance of the old debt.

As noted above, the issue price of debt that is modified is an important consideration in whether or not
the modification results in COD. There are different rules related to the issue price of debt that is
publicly traded versus debt that is not publicly traded. The issue price of debt that is publicly traded is
its fair market value. For debt that is not publicly traded and has adequate stated interest, the issue
price is its stated principal amount. Debt that is not publicly traded can often have many modifications,
but as long as principal is not reduced and there is adequate stated interest, there is no COD.
Discussing loan modifications with your lender can be uncomfortable and stressful. Possessing a basic knowledge of the consequences can alleviate some this discomfort. The following points should always be kept in mind.

— Get good legal and tax advice.
— Carefully consider whether bankruptcy is an option.
— If relying on insolvency to exclude COD income, an asset appraisal may be necessary.
— While the tax consequences are important, do not lose sight of the cash flow issues.
— Know the consequences and have a strategy before the debt is modified. Do not wait to determine the consequences after the fact.
Lease modifications: Beware of potential tax ramifications

By Paul Dillon and Mike Schiavo

It comes as no surprise that the unprecedented economic downturn caused by the COVID-19 pandemic is prompting many commercial tenants to seek rent relief. Cash-strapped businesses may be negotiating with their landlords for all kinds of concessions, in the hopes of surviving the coming weeks and months until economic activity picks up again. While modifying leases may be commonplace in the current economy, failing to factor in the tax considerations can lead to unintended consequences.

At inception, generally all leases must be tested under IRC section 467. This section was enacted in 1984 primarily as an anti-abuse provision to stop tax-shelter-type transactions that were intended to take advantage of income and deduction timing differences between accrual and cash basis taxpayers. When such situations arise, section 467 may apply to eliminate timing differences and put both the landlord and tenant on the same terms for recognizing income and deductions. Generally, most standard commercial leases will not be subject to any complex calculations at inception.

However, many lease modifications in the current economy may inadvertently run afoul of these rules and result in significant tax modifications. Anytime there is a substantial modification to a lease, it must be retested under section 467, and that is when things could get tricky. The section 467 rules control the timing of rental income and expense for tax purposes in certain situations where there is significant deferred or prepaid rent and/or stepped rents. Depending on the magnitude of the changes, section 467 may require the landlord and tenant to use the accrual method to recognize rental income and expense regardless of their regular accounting method. Further, if the renegotiated lease has significant deferred (or prepaid) rent within the meaning of section 467, the regulations could deem that a loan exists between the parties, forcing them to recognize interest income and expense as well. In other words, the tax results may be much different than the business deal due to these complicated rules.

By way of a brief illustration: Assume a tenant has a 10-year lease in place for $100,000 per month. They ask to defer 24 months of rent, which will be payable in the final year of the lease. In total, $2.4 million has been deferred, $1.2 million for 2019 and $1.2 million for 2020. This modification causes the lease to have deferred rent under section 467 and may require the parties to recognize rental income and expense under the proportional rental accrual approach.
Assume the amount recognized as rent for 2019 under the proportional rental accrual method is $1 million. This means the landlord would recognize $1 million of gross rents in the current year and be deemed to make a loan back to the tenant in a like amount. Consequently, the tenant would receive a corresponding rental deduction. The $200,000 difference is treated as imputed interest that would be recognized by the parties over the term of the deemed loan.

The regulations state that a lease modification is “substantial” if the legal rights and obligations that are altered and the degree to which they are altered is “economically substantial” based on all the facts and circumstances. There are some safe harbors for changes in lease terms due to lessor refinancing, CPI adjustments, expense pass-throughs and de minimis adjustments to fixed rent. But given the severity of the current economic situation, rent holidays, deferrals and/or restructured payment schedules may be significant enough to cross the substantial modification threshold. If this is the case, the modified lease is treated as a new lease as of the effective date of the changes and must be analyzed under section 467.

A section 467 rental agreement is an agreement for the use of tangible property, that has total payments greater than $250,000, and that has prepaid rent, deferred rent and/or increasing or decreasing rent (“stepped rent”). Certain “disqualified” sale-leasebacks and long-term leases may also fall under section 467 if there is a tax avoidance motive behind the transaction.

A few key concepts are likely to be relevant in the current round of commercial lease renegotiations. A lease “specifically allocates” fixed rent if it unambiguously specifies, for periods no longer than a year, the fixed amount of rent for which the lessee becomes liable, and the total amount of fixed rent specified equals the total amount of fixed rent payable under the lease for the same period. There is an important nuance here. If a disconnect exists between how rent is allocated under the lease and when it is due and payable, that could cause section 467 issues, including deferred rent.

“Deferred rent” is a technical term of art in the section 467 world: If the cumulative rent allocated by the lease at the end of a calendar year is greater than the cumulative rent payable at the end of the following year, a lease has section 467 deferred rent. Unless the lease has adequate stated interest (110% of the applicable federal rate), rental income and expense, and interest income and expense must be recognized using present value calculations. This likely will come as an unpleasant surprise to landlord and tenant.

The section 467 rules are complex, full of defined terms and may be unfamiliar to many landlords and tenants. Whenever you renegotiate lease terms, no matter how small the changes, it is important to consult your Baker Tilly advisor to make sure you do not trigger unintended tax consequences.
Tax issues created by PPP loan forgiveness

By Paul Dillon, Michael Wronsky and Patrick Balthazor

The Coronavirus Aid, Relief, and Economic Security (CARES) Act expressly provides that Paycheck Protection Program (PPP) loan forgiveness is excluded from gross income. Generally, debt cancellation creates taxable income for the borrower unless specific exclusions available under the tax code apply (see loan modification article). In exchange for escaping current taxation under these exceptions, taxpayers are required to reduce their tax attributes (net operating losses, basis in depreciable assets, etc.). The CARES Act does not incorporate this concept.

While the cancellation is excluded from gross income for federal purposes, the Treasury Department has ruled that expenses funded by subsequently forgiven PPP loan proceeds are nondeductible for federal tax purposes. Despite the fact that the CARES Act was silent on the matter, the IRS released Notice 2020-32, which provides that no deduction is allowed for an otherwise deductible expense if the payment of the expense results in the forgiveness of a covered loan under the CARES Act, and the income associated with the forgiveness is excluded from gross income. Immediately following the release of Notice 2020-32, many ranking members in Congress (on both sides of the aisle) rebuked the IRS’ position, stating the intent of the CARES Act was for the expenses to remain deductible. While several bills have been introduced to override the notice (most recently the House’s Health and Economic Recovery Omnibus Emergency Solutions (HEROES) Act updated in late September), none have yet to pass both chambers of Congress.

The notice provides little information beyond rendering the expenses nondeductible. Several questions have arisen as a result, specifically regarding the treatment of expenses related to loan forgiveness, when any forgiveness has not occurred by the taxpayer’s taxable year-end. Unfortunately, no guidance addressing this issue is available. There has been some conjecture advancing two possible approaches:

— First, treat each year as a stand-alone matter and, if the debt forgiveness has not occurred by the close of the taxable year, there would be no limitation on deductible expenses in that year. The argument being that if there is no forgiveness during 2020, then there is no class of tax-exempt income that would limit the corresponding expenses.
— The issue is of even more pressing concern to fiscal-year taxpayers, who may already have closed tax years on extensions and have had PPP loans forgiven or are in the process of having them forgiven.

— Second, the IRS may take a view that the expenses should still be limited in accordance with Notice 2020-32. Such a position could be based on the theories behind the tax benefit rule or the open transaction doctrine. The IRS could also view the forgiveness application as ministerial in nature and has to be accounted for as the loan proceeds are expended.

There is also the issue of whether taxpayers are bound by the notice since it does not appear to follow congressional intent. Some businesses are arguing the underlying rationale of the notice is questionable given Congress clearly intended a tax benefit when this provision was enacted. As a result, some taxpayers may take a position contrary to Notice 2020-32 on their returns. For taxpayers considering such a position, they should discuss with their advisors the potential need for a formal disclosure of their position on the return.

We believe the best course of action is to continue to wait for either additional guidance from Treasury or the IRS, or for Congress to act. There have been some discussions that Congress may address this issue in a post-election session since making the PPP accommodating to borrowers (including overturning Notice 2020-32) has been an item of interest shared on both sides of the aisle. However, the willingness of members to cooperate and enact any legislation after Nov. 3 is likely dependent upon the outcome of the election and whether there is any degree of bipartisan interest in passing legislation during a lame-duck session.

It should also be noted that even though the cancellation is not included in gross income for federal purposes, the treatment at the state level could vary. States may require the cancellation be included in determining the borrower’s state taxable income depending on their respective rules.
Limited liability companies in a loss environment

By Joseph Schlueter

2020 is a year that will not soon be forgotten. As businesses and their owners approach the end of this tumultuous year, limited liability companies (LLCs), partnerships and other pass-through entities should take some time to evaluate their tax situation. An important part of the focus needs to be on fully understanding the structure of their LLC for the purpose of minimizing potential surprises while maximizing the effectiveness of their income tax structure. In addition, LLC owners will also need to understand how the various limitations within the tax code might affect their ability to currently utilize losses they might be allocated. This article will focus on LLCs and entities taxed as a partnership.

There are three primary areas of focus as the end of the year comes into view:

1. Allocation of loss under the terms of the LLC operating agreement
2. Limitations on deductibility of allocated loss
3. Advantages to the use of preferred equity

1. Loss allocations

A business loss needs to pass through several limitations before it can be claimed and fully utilized on the individual owner’s tax return. Before a loss even confronts those limitations lies perhaps the most important hurdle of all — a correct allocation of the loss under the terms of the LLC operating agreement. Preparing a correct allocation of an LLC’s operating loss can be a complex undertaking. It begins with the operating agreement as executed by the LLC members, which represents the ownership contract among the LLC members. This contract should fully and clearly outline the members’ rights as it relates to profit and loss allocations as well as cash distributions and other rights.

In performing any year-end projections and analysis, begin by verifying a correct understanding of the terms of the agreement.
— Does the LLC have any preferred equity? If so, verify whether the agreement is drafted to require allocations of income to the preferred return even if there is an overall loss for the year. This is an area that can definitely produce some unexpected surprises depending upon the manner in which the agreement is drafted.

— Does the agreement contain cash distribution waterfalls that will impact the allocation of any income or loss in a manner that is disproportionate to overall unit ownership?

— Will current-year allocations of loss be affected by prior-year allocations of profits?

— Are proper capital account records being maintained as required under the terms of the operating agreement? Correct income and loss allocations begin and end with what are known as the section 704(b) capital accounts.

— Will any members exhaust their capital thus limiting any further allocation of loss to that member?

— Has there been any new capital contributed to the LLC during the year? If so, does it require or result in a “chargeback” of prior-year debt-financed losses that are now funded by the new equity?

These represent some of the primary considerations the LLC and its advisors need to be on top of in order to accurately project the anticipated allocations for the year. Following a year like 2020, the last thing anyone needs are surprises with unanticipated allocations from their LLC in March 2021. Avoiding such a surprise requires full knowledge of the terms of the agreement and how terms are applied.

2. Limitations on loss deductibility

With the income or loss for the year appropriately allocated to the LLC members, there will be four additional hurdles at the individual taxpayer level that could impact the ability to fully utilize the loss in the current year.

— Tax basis
— Amount at risk
— Passive activity limitations
— Business loss limitations (for 2021 and beyond)

There is typically not a significant amount of proactive year-end planning involved with these limitations. The importance lies more with making sure these attributes are properly understood and correctly applied within the context of any year-end planning or projections. These limitations are presented here in the order in which they are applied for a particular year.

Tax basis. The tax basis for a member’s LLC interest influences all tax implications related to that ownership, including the ability to currently deduct losses, whether distributions are taxable or nontaxable, and the amount of any gain or loss recognized on the disposition of the interest. The tax basis for an LLC member’s ownership interest includes that member’s allocable share of LLC liabilities. In a year like 2020, it will not be surprising for businesses to have undergone a substantial change in either the amount or the nature of its outstanding liabilities. Changes to the amount and the character
of the debt will have a direct effect on individual member’s tax basis and could result in either greater loss deductibility or alternatively might result in income recognition if a member’s share of liabilities is reduced. In either event, it will be important for LLC members to be made aware of any significant changes expected for 2020, so their overall tax planning can be properly completed.

**Amount at risk.** Having determined whether there is sufficient tax basis to claim a loss, the next limit to be addressed is the at-risk limitation under section 465. This limitation is based upon the amount of the LLC member’s investment that is “at risk.” These rules can be complicated and a trap for the unwary. It is important for an LLC member to make sure they or their tax preparer are sufficiently versed in the application of these rules to avoid costly mistakes in planning or in the final tasks of tax return compliance.

**Passive activity limitations.** The next loss limitation to be considered has been a part of the Internal Revenue Code for several decades. As part of a proper year-end plan, it is necessary to understand what activities might be subject to passive activity rules. Within these broad and generally well-known rules exist subtle rules related to the treatment of interest income received by a taxpayer that has loaned money to an activity in which they are a passive owner. It would not be unexpected in 2020 to have seen passive investors make significant loans to businesses in which they own a passive interest, either on an emergency basis or as a more permanent investment. In this circumstance, any interest income generated could be utilized to offset some of the interest expense incurred by the business and allocated to that LLC member.

**Excess business loss limitations.** The Tax Cuts and Jobs Act created a new limitation on the ability to utilize pass-through losses. This new provision, contained in section 461(l), limits an individual taxpayer to the deduction of no more than $250,000 of business loss for a year ($500,000 in the case of taxpayers filing jointly). Any excess business loss incurred during a year will carry over to the following tax year. This limitation was originally effective for the 2018 tax year, but the Coronavirus Aid, Relief, and Economic Security (CARES) Act amended this provision so it is not effective until the 2021 tax year. To the extent there is some flexibility in a business to incur losses/expenditures in 2020 rather than delaying until 2021 when the limitation is scheduled to take effect, this could be a helpful consideration.

The bottom line with all of these various limitations is that it is important to be aware of the potential for these limitations to alter the taxable income landscape of a taxpayer.

3. **Use of preferred equity**

In the year that is 2020, the financing landscape for most businesses has undertaken a significant change. Included in that change can be loans from LLC members, either in the form of short-term emergency loans or as part of a more significant long-term financing plan. Careful consideration should be taken as the end of the year approaches whether any such loans would be better served structured as preferred equity. Some of the benefits to preferred equity are an improved balance sheet, greater ability to manage cash-flow impact related to servicing the preferred equity and, for the investor, more favorable tax treatment of losses incurred in the event the investment is not recovered. Depending on the overall facts and circumstances surrounding the preferred equity investment, it will also help the LLC avoid potential business interest expense limitations that might otherwise be encountered under section 163(j).
4. Other considerations

Given the upheaval that has occurred this year, it is common knowledge that many businesses have permanently ceased operations. For owners of these businesses, it will be necessary to understand the final treatment of any investment remaining in the failed business. In the case of an LLC, will any remaining investment be eligible for an ordinary loss or a capital loss? Will any amounts loaned to such a business be eligible for favorable treatment as a business bad debt, or will the less favorable nonbusiness bad debt treatment be required. If an investor knows prior to the end of the year that they have this situation, it is wise to consult with their tax advisor as early as possible so these issues can be analyzed and the expected tax return positions can be understood.

Summary. For LLCs and entities taxed as a partnership, along with their owners, the end of a year like 2020 requires making certain that all of these factors are understood well in advance of receiving the 2020 tax returns for filing. Avoiding unexpected surprises and ensuring the overall debt and equity structures are positioned for maximum effectiveness is an important aspect to year-end business and tax planning.
Carried interests in 2020 and beyond
By Joseph Schlueter

The Tax Cuts and Jobs Act of 2017 (TCJA) enacted legislation to address partnership carried interests. On July 31, 2020, the Treasury Department finally published long-awaited proposed regulations. This article will address some of the primary considerations for impacted partnerships and taxpayers as the end of the year approaches.

Background

Following almost a decade of being tossed around like a political football, the partnership "carried interest" finally became the subject of direct legislation in 2017. Historically, a carried interest represented a special allocation of profit to the managers of a fund that achieved not only a specified base return for its capital investors, but also significant additional profit above that threshold. The standard split on the excess profit above the targeted return has been 20% for the manager and 80% for the investors. In the arena of investment partnerships and funds, this additional profit would typically be in the form of capital gains recognized on the underlying investments or in the sale of the partnership interest received, thus providing the holder of the carried interest with income taxed at favorable rates in exchange for the management and investment service provided. The rules outlined in section 1061, as enacted in the TCJA, seek to minimize the potential favorable rates for carried interests by requiring a holding period of three years for long-term capital gain treatment instead of the typical one-year holding period.

Although the carried interest structure originated and grew primarily in the financial services industry, the carried interest as well as the related issuance of a profit interest to employees has gained widespread usage through a variety of industries. In turn, this made it difficult to craft legislation to specifically target Wall Street — the primary political target of the legislation. As with any targeted piece of tax legislation, regulations become an important part of defining the boundaries of the rules. With the issuance of proposed regulations in 2020, application of the law gains greater clarity.

The general carried interest rules

The carried interest rules revolve around a few key concepts, most notably applicable partnership interests (APIs) that are issued to a taxpayer in connection with the performance of substantial services
in an “applicable trade or business.” The term applicable trade or business is defined in the Internal Revenue Code to mean any regular and continuously conducted activity that consists in whole or in part of raising or returning capital, and either invests in or develops “specified assets.” Specified assets are, in turn, defined in general as securities, commodities, real estate held for rental or investment, cash or cash equivalents, or options or derivative contracts with respect to any such assets. These definitions, as contained within the IRC, were intended to carefully target the three-year holding period rule of section 1061 to specific taxpayers.

The 2017 legislation included broad authority for the Treasury Department to issue regulations or similar guidance to carry out the purposes of the carried interest law. The tax law as written in the IRC left several important questions unanswered, primarily around the determination of holding periods in both partnership assets as well as partnership interests.

**Overview of the regulations**

The proposed regulations define key terms, clarify issues related to holding periods, describe in greater detail calculation of the amounts subject to section 1061 treatment, provide rules applicable to tiered partnership structures and outline various exceptions, reporting rules and transfers of partnership interests to related parties. For the purpose of year-end tax planning, this article will focus on the holding period issues.

**Primary year-end considerations**

For a partnership and its partners subject to the rules under section 1061, as noted above, the rule will recharacterize certain net long-term capital gain with respect to an API. Capital gains that do not meet a three-year holding period are treated as short-term capital gains and, therefore, taxed at ordinary rates. Two potential exit transactions can occur with respect to an API: a sale of the partnership interest or a sale by the partnership of underlying investment assets.

**Sale of assets.** If a partnership sells assets, the proposed regulations properly clarify that the partnership’s holding period in the assets sold will control the treatment of the sale, irrespective of the length of time partners have held their interest in the partnership. For example, if Able has held her partnership interest for two years and API partnership sells an investment asset that it held for four years, the four-year holding period will control the ultimate treatment of any gain on sale. This is consistent with long-established partnership rules and is certainly a taxpayer-favorable aspect of the proposed regulations. If an API is considering the sale of assets held for more than three years, but is concerned about the tax treatment for individuals holding interest in the API for less than three years, the proposed regulations clarify that long-term treatment will be retained for the resulting gain.

**Sale of partnership interests.** In the sale of a partnership interest, the proposed regulations provide for a look-through to the underlying assets held by the partnership to impact the final determination of the holding period to be applied to any gain on the sale of the partnership interest. Upon the sale of an interest in an API, the first determination will be with respect to the period of time such interest was held by the partner. For example, if Able held her interest in API partnership for four years at the time of sale to an unrelated third party, the proposed regulations apply Able’s holding period to the section 1061 determination, subject to the look-through. The general look-through rule will apply if “substantially all”
of the assets of the partnership are “specified assets” that have been held for three years or less. “Substantially all” for this purpose is defined as 80% or more of the fair market value of the assets. For a fund that might typically turn its portfolio investments in less than three years, this look-through rule will be extremely difficult to maneuver around, even when an individual’s ownership of an API exceeds three years.

Add-on investments to portfolio companies. An area that was not specifically addressed in the proposed regulations but that may be a consideration in 2020 involves the treatment of the holding period of an investment in a portfolio company if the API makes an additional investment in the portfolio company but does not take back additional shares of stock, for example. The questions presented in this type of situation are whether a new holding period will be created or will the existing holding period be tacked on to the new investment. With the lack of direct guidance on this point, affected partnerships might consider making such investments through loans rather than equity or, if debt needs to be avoided, consider a special class of preferred equity to limit potential future appreciation to the newly issued class of stock, thus limiting the potential exposure to section 1061 treatment.

Summary

The carried interest rules enacted in 2017 are narrowly targeted to specific taxpayer situations. The proposed regulations issued in 2020 did not increase the overall scope of section 1061’s reach and are generally favorable for taxpayers, all things considered. For partnerships that fall within the reach of section 1061, the proposed regulations provide some much-needed guidance and clarity on issues related to the holding period and should assist with understanding the overall impact on affected partners as it relates to the sale of underlying partnership assets as well as the rules that will be applied to sales of the partnership interests.
Final 2020 bonus depreciation regulations

By Mike Schiavo

The IRS has released yet another batch of regulations on bonus depreciation. These final regulations address various questions left unresolved by the 2019 final and proposed regulations as well as several issues raised by the Coronavirus Aid, Relief, and Economic Security (CARES) Act.

The most important news is that the IRS confirmed the interaction of bonus depreciation with the floor plan financing interest rule. Under section 163(j), property used in a trade or business that has floor plan financing indebtedness is not eligible for bonus depreciation, if the floor plan interest expense is “taken into account” in the interest limitation calculation. If the taxpayer’s total business interest expense is greater than the sum of the amounts calculated under the first two components of the interest limitation formula — i.e., business interest income plus a percentage of adjusted taxable income — the floor plan financing interest is “taken into account,” and the taxpayer’s property is not bonus eligible. Taxpayers cannot opt out of this rule. The IRS is planning to issue transition guidance for taxpayers that took a different approach to this calculation on prior returns.

The 2020 final regulations also provide guidance on bonus depreciation for used property. Prior to tax reform, used property was not eligible for bonus depreciation. The Tax Cuts and Jobs Act relaxed this rule, as long as taxpayers do not have a “prior depreciable interest” in the property they are acquiring. For partnerships, this meant that anyone who was a partner during a five-year lookback period when the partnership owned property was deemed to have a prior depreciable interest in that property. Thus, in many common partnership transactions, property acquired from a partnership by one of the partners would not be eligible for bonus. The final regulations withdraw this partnership look-through rule. A partner will not be treated as having a prior depreciable interest in partnership property solely by virtue of being a partner in a partnership.

Finally, the regulations also clarify when qualified improvement property acquired in a tax-free transfer (such as a contribution to a partnership or corporation) is eligible for bonus depreciation, outline when taxpayers can treat one or more components of larger self-constructed property as eligible for bonus, and address the acquisition of property by members of consolidated groups.
Partnership tax capital – 2020 reporting requirements loom

By Michael Wronsky

After providing a year-long reprieve, the IRS will require that partnerships present on their 2020 tax returns and corresponding Schedules K-1 partner capital using the tax basis method. For partnerships, compliance will be an extremely challenging and time-consuming endeavor. This article provides background of the requirement and its related developments, an overview of tax capital and the most recent IRS-prescribed calculation methods.

Background

Partnerships have long had the option of reporting partner capital account balances on a Schedule K-1 using generally accepted accounting principles (GAAP), on an Internal Revenue Code (IRC) section 704(b) basis (broadly, the economics of the partnership arrangement), on a tax basis or using any other acceptable method of accounting (for example, International Financial Reporting Standards, GAAP, etc.). In broad terms, a partner’s tax capital account is calculated using the rules and principles under the IRC — it is increased by contributions of property made by the partner to the partnership and the partner’s distributive share of the partnership’s taxable income; it is decreased by distributions of property made by the partnership to the partner and the partnership’s taxable losses. A partner’s tax capital account is additionally increased or decreased in connection with sales or transfers of their interest in the partnership, basis adjustments of the partner’s interest or the partnership’s property as well as several other possible transactions.

The IRS introduced a significant modification with respect to partner capital account reporting via the instructions to the 2018 Form 1065, U.S. Return of Partnership Income: Any partnership that uses any non-tax basis method described above must disclose a partner’s beginning and ending capital account balances on a tax basis, if either amount is negative. While IRC rules prohibit a partner’s tax basis in their partnership interest from ever being negative, deficits in a partner’s tax capital account can arise in certain situations, most commonly when the partner is allocated partnership losses or receives a distribution funded by debt incurred by the partnership. The IRS’ interest in tracking these negative balances correlates to ensuring compliance with the requirements that (1) a partner must have sufficient basis in their partnership interest to utilize these losses on their personal returns and avoid
capital gains on distributions, and (2) the partner generally must eventually recapture the capital account deficits as income in certain situations (such as when the debt is repaid or the partner’s interest is sold or redeemed).

Thereafter, in October 2019, the IRS released draft instructions for the 2019 Form 1065, which mandated that partner capital be reported by all partnerships on a tax basis for all partners. In response, taxpayers and practitioners lobbied the IRS to delay this requirement, citing the significant administrative and financial burden that would result from attempting to comply in such a short time frame (the extended due date for 2019 calendar-year returns was less than a year away from the issuance of the instructions). In December, the IRS acquiesced, releasing Notice 2019-66, which pushed back the mandatory tax capital reporting to 2020 (please see our previous tax alert).

Notice 2020-43

While the Notice 2019-66 relief was most welcome, the additional year still left many partnerships with the massive undertaking of creating tax capital from inception within a relatively short time frame. Further, there was no guidance, either formal or informal, on how it should be computed — only the general principles described above. In June 2020, the IRS issued Notice 2020-43, which outlined two approaches for calculating partner tax capital: the modified outside basis and modified previously taxed capital methods. However, controversy surrounded the clarity: Under the notice, these were the only two methodologies partnerships could use, and each can be administratively difficult to implement, create distortive results or both.

Modified outside basis method

Use of the modified outside basis method involves the partnership determining or being provided by the partners, the partners’ adjusted bases in their partnership interests and subtracting from these amounts the partners’ distributive shares of the partnership’s liabilities. For smaller, closely held partnerships, this is a relatively straightforward approach. However, for larger partnerships and, in particular, partnerships that are part of tiered structures, computing and/or gathering the necessary information from the partners could be an enormous and costly administrative burden and required on an annual basis. Small and large partnerships alike may also run into issues with partners being unwilling to share their outside basis information or not having the information at all. In short, several partnership taxpayers could be unable to fully comply with the modified outside basis method for reporting partner tax capital.

Modified previously taxed capital method

The modified previously taxed capital method broadly requires a hypothetical liquidation approach; whereby a partner’s tax capital account will be equal to the amount of cash the partner would receive if the partnership sold all its assets for cash equal to the assets’ “fair market value.” This figure would be adjusted by any gain or loss the partner would be allocated as a result of the transaction. As a general matter, fair market value can be highly subjective, and measuring the capital accounts on this basis can produce distortive and/or useless results. Similar to the modified outside basis method, calculating this hypothetical liquidation annually could be a significant undertaking for many partnerships.
Baker Tilly, along with many other practitioners, submitted comments to the Treasury Department, highlighting the above issues and the significant difficulties they would create for taxpayers. In mid-October, the IRS again relented, providing in the draft instructions for the 2020 Form 1065 that the more commonly utilized “transactional approach” for computing tax capital would be the only methodology allowed. However, as discussed further below, this method is not without flaw.

Transactional approach

*Under the transactional approach, partner tax capital is generally computed by increasing a partner’s account by:*  
1. Amounts of money and the tax basis of property contributed by the partner to the partnership (less any liabilities to which the latter is subject), and  
2. Allocations of income or gain to the partner by the partnership;

*And decreased by:*  
1. Amounts of money and the tax basis of property distributed to the partner by the partnership (less any liabilities to which the latter is subject), and  
2. Allocations of loss or deduction to the partner by the partnership.

The instructions go on to say that tax capital should be adjusted by the partners’ shares of any increase or decrease to the tax basis of partnership property under section 734(b) (broadly, these are adjustments that can arise when a partnership distribution of cash causes gain or loss to be recognized by the distributee partner or when the tax basis of property distributed by the partnership must be adjusted in the hands of the distributee partner). Further, the instructions state that tax capital should not include any basis adjustments under section 743(b) (generally, these are adjustments that can arise when a partner sells or exchanges their partnership interest or passes away) and, to the extent a section 743(b) adjustment is included in a partner’s tax capital account as of Jan. 1, 2020, it should be removed.

Lastly, the instructions allow partnerships that have previously maintained their capital accounts on a nontax basis to use the modified outside basis and modified previously taxed capital methods to determine tax basis capital as of Jan. 1, 2020, only.

What’s next?

We are hopeful the IRS will issue a notice to supplement the draft 2020 Form 1065 instructions to provide more authoritative and definitive guidance on computing tax capital. As a closing reminder, while the transactional approach will be easier for partnerships to administer in computing tax capital than the modified outside basis and modified previously taxed capital methods, it may still be a significant undertaking for partnerships that have to create tax capital schedules from inception. *Specifically, for partnerships that formed several years ago, have numerous partners, have undergone ownership changes or a combination thereof, this could be a time-intensive and difficult exercise that should be started as soon as possible.*

We encourage you to reach out to your Baker Tilly tax advisor regarding how any of the above may affect your tax situation.
Employee benefits and executive compensation update

By Christine Faris and Devin Tenney

As we move into the final quarter of 2020, this will be a year where there has been significant legislative and regulatory impact in the areas of employee benefits and executive compensation. The Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 repealed the maximum age for IRA contributions and delayed the age for required minimum distributions (RMDs) to age 72. The Families First Coronavirus Response Act (FFCRA) established two new payroll tax credits, and the Coronavirus Aid, Relief, and Economic Security (CARES) Act created the employee retention credit and payroll tax deferral to help small business employers. With all of that said, the following topics of interest will be important for you to consider for both year-end tax planning and perhaps tax planning in the coming year:

1. **Maximum age for IRA contributions repealed**: One of the purposes of the SECURE Act was to help individuals save for retirement. This was partly accomplished by repealing the age limit for making contributions to a traditional IRA. Prior to 2020, an individual who attained age 70½ during the calendar year was not permitted to make contributions to a traditional IRA.

2. **Required age for RMD delayed**: Another change made by the SECURE Act was to delay the age requirement to begin taking RMDs from age 70½ to age 72. The CARES Act went a step further by eliminating RMDs for 2019 and 2020. These changes allow taxpayers to retain their retirement savings in tax-favored arrangements, thus delaying income tax on the RMDs.

3. **Employer payroll tax credits for emergency paid sick leave and emergency family and medical leave**: The FFCRA created the emergency paid sick leave and expanded emergency family and medical leave benefits for employees who are unable to work due to COVID-19. For employers who provide either or both types of emergency leave, the employer is entitled to refundable payroll tax credits equal to the amount of wages required to be paid under the emergency sick pay or emergency family medical leave pay requirements. The emergency paid sick leave entitles employees up to 10 days (80 hours) of sick pay at rates of up to $5,110, or $511 per day, depending on the reason for the leave. The emergency family and medical leave entitles employees up to an additional 10 weeks (40 hours per week) of pay up to $200 per day. The payroll credits are designed to offset these amounts. The credits are claimed on Forms 941, 941-X or 7200 against the employer portion of Social Security
taxes (not Medicare taxes). Any credit in excess of total employer Social Security taxes on the wages with respect to the employment of all employees of the employer the excess is a refundable credit to the employer. The credits are allowed for wages paid through Dec. 31, 2020.

4. **Employee retention credit**: The CARES Act created the employee retention credit (ERC) to provide assistance to employers who continue to pay their employees despite their operations being affected by COVID-19. Broadly, the ERC is a refundable quarterly payroll tax credit against certain employer payroll taxes. The ERC is available to employers of all sizes that have experienced either (1) a full or partial suspension in their operations as a result of governmental order or (2) a significant decline in gross receipts due to COVID-19. The amount of the credit is 50% of qualified wages paid or incurred from March 13, 2020, through Dec. 31, 2020. Qualified wages are generally limited to $10,000 per employee, subject to employer size restrictions. Employers may claim the ERC on a timely filed Form 941, through an adjustment with Form 941-X or in advance via Form 7200 in the same manner as the FFCRA credits discussed above.

5. **Employer payroll tax deferral**: The CARES Act permits employers to defer timely payment of the employer’s portion of Social Security tax that would otherwise be required to be made during the period from March 27, 2020, through Dec. 31, 2020, without penalty or interest charges. Employers must pay 50% of the deferred amount by Dec. 31, 2021, and the remainder by Dec. 31, 2022. Employers are not required to make a special election to be able to defer deposits and payments of these employment taxes. Deferral of the employer’s share of Social Security tax is reported on Forms 941 or 941-X.

6. **Transition relief expires on Dec. 31, 2020, to amend certain executive nonqualified deferred compensation arrangements**: Prior to the Tax Cuts and Jobs Act (TCJA), the $1 million executive compensation deduction limitation applied to a covered executive until the executive had, in general, a termination of employment. As a result, if the employer expected that the company’s tax deduction would be limited due to the $1 million executive compensation deduction limitations, the employer could delay payments under the nonqualified deferred compensation (NQDC) arrangement until the limitation no longer applied. However, the TCJA broadened the scope of the $1 million deduction limitation to provide that once an executive is a covered employee, the executive will remain a covered employee regardless of employee status or death. Under the TCJA, a payment could be delayed indefinitely. Because elimination of the delay would otherwise be an impermissible acceleration of payment, the Treasury Department issued proposed regulations that may be relied upon permitting employers to amend their NQDC arrangements to eliminate the delay provision. However, such an amendment must be made no later than Dec. 31, 2020.

7. **Extended due date for adopting a qualified retirement plan**: An employer may adopt a qualified retirement plan for a taxable year after the last day of the taxable year provided it is adopted before the due date, including extensions, for filing the employer’s tax return for the taxable year. For example, an employer who wants to adopt a qualified retirement plan for calendar year 2020 has until Sept. 15, 2021, for a partnership or corporate employer, or Oct. 15, 2021, for a self-employed employer, to adopt the plan.

8. **Reminder for 401(k) plan sponsors**: Long-term, part-time employee eligibility requirements take effect in 2021: For sponsors of 401(k) plans, a key upcoming change is the requirement to expand eligibility to long-term, part-time employees, effective for plan years beginning on or after Jan. 1, 2021. Under this rule, if a part-time employee has worked at least 500 hours in three consecutive years and is at least age 21 by the last day of the three consecutive year period, he or she must be
offered the opportunity to make elective deferrals to the employer’s 401(k) plan. For purposes of determining whether an employee has worked at least 500 hours per year in three consecutive years, plans are not required to take into account hours of service in plan years beginning before Jan. 1, 2021. As a result, although affected plan sponsors will need to start tracking hours for this purpose beginning in 2021, plans will not be required to permit qualifying long-term, part-time employees to make deferrals under 401(k) plans before plan years starting in 2024.

9. **Pooled employer plans for retirement benefits are permitted**: Unrelated employers without any commonality may pool their resources by participating in a new type of multiple employer plan (MEP). The new retirement plans, referred to as pooled employer plans or open MEP, are treated as a single plan. In addition, the “one bad apple” rule will no longer apply provided the procedure is followed for ensuring that one employer’s failure to meet the qualification requirements will not result in the disqualification of the MEP or open MEP. This is effective for plan years beginning after Dec. 31, 2020.

10. **Nonrefundable tax credit for startup costs of adopting a new qualified retirement plan**: An employer with 100 or fewer employees may be eligible for a nonrefundable income tax credit for startup costs of adopting a new qualified retirement plan. The amount of the credit for a taxable year is the greater of (1) $500 or (2) the lesser of (a) $250 multiplied by the number of nonhighly compensated employees of the eligible employer who are eligible to participate in the plan or (b) $5,000. The credit is for three years.

11. **FICA taxation rules for nonqualified deferred compensation**: We are still seeing numerous instances where employers are not taking into account deferred compensation for FICA at the appropriate time. Pursuant to the FICA “special timing rule,” deferred compensation is required to be taken into account at the later of the time of the performance of services and at such time when there is no longer a “substantial risk of forfeiture” in entitlement to the benefit — this is usually at such time as the benefit becomes vested. This, of course, is in contrast to the SECA rules, that generally require the deferred compensation to be taken into account upon actual or constructive receipt of the benefit. Employers should be focused on making sure that the deferred compensation, even if not distributed, is taken into account correctly in accordance with the “special timing rule” in a setting that requires payment of FICA taxes.

12. **Proposed regulations interpreting Internal Revenue Code section 457 rules**: In the summer of 2016, the Department of the Treasury issued proposed regulations interpreting section 457 deferred compensation rules which apply to tax-exempt organizations and governmental subdivisions. These proposed regulations primarily addressed issues attendant with the granting and administration of “ineligible plans of deferred compensation” under section 457(f) and are slated to become effective until following such time that final regulations have been issued. As of the time of the preparation of this letter, we have seen no activity by the current administration that would suggest that these regulations will be finalized anytime soon. Therefore, for the present, we are regarding these proposed regulations as an indication of the IRS’ interpretation of certain income tax issues attendant with the application of section 457 rules, and nothing more.
Proposed regulations issued to implement TCJA small business taxpayer simplified accounting methods

By Kathleen Meade

On July 29, 2020, the IRS and Treasury Department released proposed regulations to implement the small business taxpayer simplified accounting method provisions enacted under the Tax Cuts and Jobs Act (TCJA) for tax years beginning after Dec. 31, 2017. The proposed regulations clarify the gross receipts test requirements and provide guidance for implementing the small business taxpayer simplified method provisions. However, positions taken on the treatment of syndicates and the inventory accounting exception are likely to be less favorably received and may create additional uncertainty, complexity and administrative burden for affected taxpayers. Although these regulations are not yet effective, taxpayers may rely on them for taxable years beginning after Dec. 31, 2017, provided they consistently implement all the applicable rules for each adopted provision.

Background

The TCJA favorably amended certain small business taxpayer methods of accounting to increase the gross receipts test threshold to $25 million, index it for inflation and eliminate the requirement that the test be met for all prior tax years. These changes enable more taxpayers to use the cash method of accounting and can exempt them from the often costly and onerous uniform capitalization (UNICAP) requirements, comply with the percentage-of-completion method (PCM) rules and accounting for inventories. However, under the TCJA small business taxpayer provisions, tax shelters (including syndicates) remain ineligible for the small business taxpayer simplified methods regardless of their gross receipts levels. For purposes of this rule, a syndicate is defined as a partnership or other entity (other than a C corporation) which allocates more than 35% of the entity’s losses for the taxable year to limited partners or limited entrepreneurs.

UNICAP exception

The proposed regulations, which are generally taxpayer favorable, remove the now obsolete small reseller exemption and replace it with the UNICAP small business taxpayer exception enacted under the TCJA.
The 2017 tax reform increased the gross receipts threshold to $25 million from $10 million and extended the UNICAP exception to producers as well as resellers. However, unlike the small reseller definition that generally included only receipts from sales of goods and services, the small business taxpayer test includes income from other sources such as interest, dividends, rents and royalties. This has implications for other simplifying conventions under the UNICAP rules. For example, the addition of receipts from other sources may cause a taxpayer to exceed the threshold and require an accounting method change. There are also special rules for farm trades or businesses.

**Cash method of accounting**

The proposed rules reflect amendments made by the TCJA to the gross receipts test for taxable years beginning after Dec. 31, 2017. As noted, the TCJA increased and indexed the gross receipts test threshold but left other cash method provisions unchanged, such as the short year and aggregation rules and the exclusion of tax shelters from using the cash method. Unfortunately, the proposed rules also contain unfavorable provisions that may significantly limit use of the cash method in certain circumstances.

**Syndicates**

Consistent with pre-TCJA rules, syndicates are classified as tax shelters ineligible to use the cash method. Syndicate status will only apply for a year in which the entity has a loss and not in a year the entity is profitable and meets the gross receipts test. Thus, a syndicate’s eligibility for the small business taxpayer methods may change yearly and, further, may not be determinable until after year-end, which can significantly complicate tax planning and delay tax reporting for these entities.

Syndicates, or tax shelters, are defined much more broadly than one would anticipate. A “tax shelter” for this purpose is an entity, other than a C corporation, if more than 35% of the losses during the taxable year are allocated to limited partners or limited entrepreneurs. A “limited entrepreneur” is a person who has an interest in an entity (other than a limited partnership interest) and who does not actively participate in the management of the entity.

The proposed regulations may actually increase the likelihood of an entity becoming a syndicate because the section 163(j) business interest limitation does not apply to small business taxpayers. Although intended to simplify the process of determining an entity’s syndicate status, this rule may also create a trap for the unwary if the entity is profitable after taking into account the interest limitation, but has a loss and is a syndicate under the 35% loss rule because the interest deduction is not limited for this purpose.

Affected entities may need to evaluate the trade-offs of implementing strategies to avoid a tax loss (e.g., election to opt out of bonus) versus losing eligibility for the favorable small business taxpayer simplified methods of accounting. To allow adequate time for planning, the proposed regulations provide an election that permits a taxpayer to apply the 35% loss rule by electing to use the allocated taxable income or loss of the immediately preceding taxable year, rather than the current-year amounts.
Taxpayers should carefully consider whether the election is beneficial because it applies for all purposes for which status as a tax shelter is relevant (e.g., section 163(j) interest deduction limitation) and is irrevocable unless the taxpayer obtains IRS permission.

In summary, the proposed rules related to syndicates are generally unfavorable and have implications beyond the small business taxpayer simplified methods (e.g., section 163(j) small business taxpayer provisions). Additionally, entities that move in and out of syndicate status may be prevented from making frequent changes back to the cash method in years they cease to be a syndicate. Consequently, entities treated as syndicates may derive limited or no benefit from the favorable small taxpayer provisions if the proposed rules are finalized in their current form. The Treasury Department and the IRS continue to study the definition of a tax shelter, which may indicate that changes to these rules could be forthcoming.

**Inventory exception**

The TCJA provided welcome simplification by permitting eligible small business taxpayers to either treat inventory as non-incidental materials and supplies or, alternatively, to follow the inventory method of accounting used in its applicable financial statements (AFS) or, if the taxpayer does not have an AFS, in the books and records prepared in accordance with the taxpayer’s accounting procedures. The proposed regulations provide guidance for implementing this inventory accounting exception for small business taxpayers. However, several proposed provisions limit book/tax conformity, potentially resulting in added complexity and administrative burden and undermining the legislative intent to simplify inventory accounting for small business taxpayers.

For example, the proposed regulations allow small business taxpayers to treat non-incidental materials and supplies as “used or consumed” in the later of the year the taxpayer provides the item to the customer or the year the items are paid for (cash method) or incurred (accrual method). The regulations also permit taxpayers to use most inventory accounting methods to identify these non-incidental materials and supplies, with the exception of the last in, first out (LIFO) and lower of cost or market (LCM) valuation methods. Finally, guidance is provided on the definition of AFS, the types and amounts of costs that can be recovered for tax purposes, and when such costs may be taken into account.

Some of the additional requirements and restrictions are surprising and contrary to the simplification purpose expressed by the Treasury Department and the IRS. If finalized in their current form, these provisions could require significant taxpayer resources to analyze and reconcile differences between book and tax inventory and accounting records, which may effectively reduce or eliminate the benefit of using the small business simplified inventory method for many.

**Long-term contract exceptions**

The proposed regulations incorporate amendments made by the TCJA that modify the small construction contract PCM exception and homebuilder UNICAP exemption to increase the gross receipts threshold and revise the PCM lookback rules to reflect the repeal of corporate alternative minimum tax (AMT) and the enactment of base erosion and anti-abuse tax (BEAT). Notably, the modified lookback rules apply to both small and large taxpayers. Additionally, the proposed rules clarify when and how a taxpayer adopts a method of accounting for a long-term contract and provide guidance
for determining the classification of long-term contracts when a taxpayer becomes a small business taxpayer or ceases to qualify as a small business taxpayer.

**Accounting method changes**

The proposed regulations provide no method change procedures and generally direct taxpayers to use existing guidance to implement changes to and from the small business taxpayer simplified methods.

In August 2018, the IRS issued procedures for eligible small business taxpayers to obtain automatic IRS consent to change to the small business taxpayer simplified methods, generally effective for tax years beginning after Dec. 31, 2017.

Under these procedures, the rule prohibiting the filing of an automatic method change if the same item was changed within the past five tax years (including the year of change) is temporarily waived for changes filed for a taxpayer’s first, second or third taxable year ending on or after Dec. 31, 2017. Thereafter, a taxpayer requesting a change within the five-year waiting period is required to apply under the more onerous and costly advance consent procedures. Although the TCJA favorably modified the gross receipts test so taxpayers could requalify for the small business taxpayer simplified methods, the proposed rules unfortunately appear to limit a taxpayer’s ability to make such changes on a frequent basis.
Home office deduction

By Michelle Hobbs

Since the spring, taxpayers across the country have turned kitchens, living rooms, bedrooms or other rooms of their homes into temporary offices. With so many people currently working from home and the likelihood that this could continue for the foreseeable future, a reasonable question becomes whether a home office deduction is now available. This article will address the requirements to take this deduction on a tax return.

Business use of home

In general, certain taxpayers can deduct business expenses related to their personal residence for space used exclusively and regularly in connection with a trade or business. Self-employed taxpayers or individual partners in partnerships can qualify. Employees working from a home office are no longer eligible to take a home office deduction. This itemized deduction was suspended from 2018 through 2025 to help “pay for” the doubling of the standard deduction under the Tax Cuts and Jobs Act (TCJA).

Eligibility for a home office deduction is created if the space is exclusively used (and is the principal location) to meet with patients, clients or customers in the normal course of business, or is where management or administrative functions (such as billing, maintaining books and records, ordering supplies, scheduling appointments, etc.) are performed. Occasional duties conducted at other locations, including hotels and customer sites, will not necessarily preclude the taxpayer from qualifying for a home office deduction. There are special rules for daycare providers not discussed in this article.

Once it is determined the taxpayer can take a home office deduction, certain expenses of the home are divided between personal and business use. Personal expenses cannot be used in this computation. Costs directly associated with the trade or business, such as painting or repairs of the business space, would be deductible in full as a home office expense. Indirect expenses, including homeowners insurance, rent (if the taxpayer does not own the home) and utilities, are allocated to the home office using the percentage of the home being used for business (typically determined through a square-footage allocation). The same percentage of mortgage interest and real estate taxes would be deducted as part of the home office deduction instead of an itemized deduction on Schedule A.
Homeowners can also depreciate (accounting for the wear and tear of the structure but not the land) the business portion of their home. Permanent improvements made to the home office can be depreciated as well. However, depreciation of the home office has to be recaptured as ordinary income once the home is sold. In other words, the cumulative amount of depreciation deducted is not eligible for the primary residence sale exclusion.

The home office deduction is limited (using a formula) if total business expenses are less than the gross income. Any carryover can be deducted the following year subject to the same limitation. In addition, special rules exist when taxpayers operate more than one business in the home or have more than one place of business.

**Simplified method**

In an effort to reduce the recordkeeping burden on taxpayers, the IRS introduced the simplified method to determine the home office deduction amount. Instead of tracking separate expenditures of the home as described above, merely multiply $5 by the allowable square footage of the business portion of the home (using the smaller of 300 square feet or the actual space). The deduction cannot exceed the net income (receipts less nonhome-related expenses) from the business use of the home. Using this method means taxpayers do not need to adjust the amount of mortgage interest or real estate tax reported on Schedule A when itemizing deductions. The home office space is also not depreciated under the simplified method (meaning no recapture is necessary upon subsequent sale).

Taxpayers can alternate between using actual expenses or the simplified method from one tax year to the next. However, any carryover of actual expenses cannot be used in a tax year when the simplified method is used to compute the home office deduction.

**IRS resources**

In addition to your Baker Tilly tax advisor, the IRS website has several resources available to assist taxpayers in taking advantage of the home office deduction. Form 8829, Expenses for Business Use of Your Home, with its instructions, along with Publication 587, Business Use of Your Home, and FAQs - Simplified Method for Home Office Deduction can all be used to help determine eligibility and calculation.
Opportunity zones – reminder of COVID-19 relief and remaining areas of uncertainty

By Colin Walsh and Michael Wronsky

The opportunity zone (OZ) space is among the innumerable sectors of the economy adversely impacted by COVID-19. From reservations on the part of potential investors due to liquidity considerations, to questions about the viability of going concern on the project side, uncertainty abounds. In an effort to alleviate some of these concerns, in June, the IRS continued its efforts to provide taxpayers with coronavirus-related compliance relief via OZ-focused Notice 2020-39, which relaxed many of the program’s timing requirements.

Pandemic aside, additional compliance questions remain unanswered after 544 pages of comprehensive final regulations were released in December 2019. This article serves as a reminder of the relief provided by Notice 2020-39 as well as an overview of the remaining gray areas as they have emerged in practice. Lastly, we provide a brief comparison of what could be next for the OZ provisions, based on details on the respective candidates’ tax platforms that have been released ahead of the forthcoming presidential election.

Notice 2020-39

The IRS provided investors and qualified opportunity funds (QOFs) extensions to comply with many rules that require time-sensitive actions to take advantage of the OZ tax benefits. For a more detailed discussion of Notice 2020-39, please see our previous tax alert, but in summary, the provided relief automatically:

— Allows taxpayers until Dec. 31, 2020, to invest eligible gain in exchange for a QOF investment if their 180-day investment period otherwise would have ended on or after April 1, 2020, and before Dec. 31, 2020.

— Deems a QOF’s failure to meet the requisite 90% asset test standard to be due to a reasonable cause and, consequently, no penalties will be due if the QOF’s: (1) last day of the first six-month period of its taxable year or (2) the last day of its taxable year falls between April 1, 2020, and Dec. 31, 2020.
“ Stops the clock” on any 30-month substantial improvement period being utilized by a QOF or qualified opportunity zone business (QOZB) to qualify its property as QOZB property (QOZBP) from April 1, 2020, through Dec. 31, 2020. For example, if as of April 1, 2020, a QOZB was two months into its 30-month period over which it plans to renovate a building, the third month would not start until Jan. 1, 2021.

In addition to the automatic relief, the notice also confirms that the national emergency declaration issued by the president in reaction to COVID-19 triggers the availability of the federal disaster relief included in the OZ regulations. Specifically, a QOZB will have more time to acquire or construct property, or start a business within an OZ pursuant to a working capital safe harbor (WCSH).

QOZBs generally can apply up to two consecutive 31-month WCSH periods to carry out a written plan for the aforementioned purposes, but the OZ regulations allow for “not more than an additional 24 months” in light of a federally declared disaster. It is unclear based on the wording of the regulations and the notice whether the additional 24 months is automatic or if QOZBs must demonstrate they need the extra time based on facts and circumstances. However, informal commentary by IRS officials suggests the latter is true. We therefore strongly recommend that QOZBs utilizing this relief provision be diligent and thorough in maintaining documentation to support its need to do so, should it be questioned or challenged upon IRS examination.

Unanswered OZ compliance questions

**QOF decertification process**

Despite the welcome relief provided by Notice 2020-39, the scope of the economic crisis surely has caused investor groups and project managers to question whether staying the course of their OZ plans is economically feasible. When the decision is reached to dissolve a QOF, the regulations prescribe a voluntary decertification process whereby a QOF withdraws its status as such and, as a consequence, its investors are deemed to have inclusion events and must recognize their deferred gains.

However, the regulations delegate designing the decertification process to the IRS and, to date, no guidance or forms have been released on the matter. We do know that under the regulations, decertification will not be effective until the month that follows the month specified by the QOF, which cannot be any earlier than the month the QOF applies for decertification. As such, to the extent decertification is planned for 2021, fund managers must take care to maintain the 90% asset standard through the month subsequent to the designated decertification month to avoid penalties.

What is reasonable cause?

As discussed, a QOF that fails to hold 90% of its assets in QOZBP will be charged potentially steep penalties, unless it can demonstrate that the failure was due to reasonable cause. Despite being lobbied by taxpayers and practitioners to detail what constitutes reasonable cause for this purpose, the Treasury Department declined to do so when finalizing the OZ regulations. As a result, once Notice 2020-39’s automatic relief period ends on Dec. 31, 2020, taxpayers who run afoul of this requirement will
have to determine whether their facts and circumstances present an adequate defense to penalty assessment.

The preamble to the final OZ regulations do provide a hint in pointing to Section 20.1 of the Internal Revenue Manual (IRM) as the standard for determining whether reasonable cause has been established with respect to the 90% asset test. The IRM in general outlines that reasonable cause requires the taxpayer to have exercised “ordinary business care and prudence,” and their failure to comply with the law at issue was due to circumstances beyond their control. Potential instances as outlined by the IRM may include the death, serious illness or unavoidable absence of the person with the sole authority to direct the QOF’s actions; fire, casualty, natural disaster or other disturbance; an inability to obtain records; reliance on erroneous advice. It is critical to note that these are merely examples and may not on their own rise to the level of reasonable cause.

Zero divided by zero still undefined

To determine whether the 90% asset standard has been met, a QOF must divide the total QOZBP over its total assets. If the quotient is greater than or equal to 0.9, no penalty is due; if less, the QOF must self-assess a balance due. As part of this exercise, a QOF can exclude from both the numerator and the denominator contributions of capital it received no longer than six months before the testing date, so long as those contributions were continuously held in cash, cash equivalents or debt instruments with terms of 18 months or less. For QOFs whose only assets are these excludable contributions, this presents a mathematical quandary as it must report zero for its QOZBP over zero for its total assets—a result that is undefined. This is a common fact pattern in a QOF’s initial year, e.g., investors contribute cash to the QOF just a few days before Dec. 31, and the QOF still holds this cash on Dec. 31.

The QOF should not be assessed any penalties in this scenario, as the ability to exclude recently contributed capital is clearly available so that fund managers have adequate time to deploy the funds to acquire “good” QOZBP. However, as a matter of compliance, it is unclear whether the quotient should be reported as one or zero. If the former, no further calculation is necessary (greater than 0.9); if the latter, a calculation would be required, but the result would be zero as the QOF has no balance of “bad” assets to assess a penalty on. Informal commentary from the IRS promotes the former approach; however, we are hopeful the form instructions will be updated in due course to reflect this. For the time being, we recommend that QOFs with the “zero divided by zero issue” check the yes box on line 14 of the Form 8996 to avoid confusion with the IRS.

Challenges for existing property owners

In spring 2020, Treasury issued technical corrections to the final OZ regulations. The final OZ regulations contained an example in which an individual realized gain from the sale of real property to a QOF and then invested that gain in the buyer QOF. The final OZ regulations disallowed the individual’s investment under the step transaction and circular cash flows doctrines. The property acquired by the QOF was also deemed a “bad asset” because it was acquired from a related party. For OZ purposes, “related party” is defined as more than a 20% ownership interest.

Prior to the issuance of the technical corrections, many practitioners believed that existing OZ landowners could sell land to a QOF and then subsequently acquire a less than 20% ownership interest
in that QOF. The technical corrections established that the step transaction and circular cash flow doctrine will be applied even if the existing property owner acquires a less than 20% ownership interest in the QOF.

What remains unclear is whether an existing OZ property owner can use unrelated gains to acquire an interest in a QOF. For instance, assume an individual both sells real property to a QOF and sells stock to an unrelated third party. Can that investor use the gains from the sale of the stock to acquire an interest in the QOF? This issue remains gray. Existing OZ property owners should exercise caution and consult with tax advisors before proceeding with such a scenario.

OZs post-presidential election

The potential for significant tax legislation in 2021, of course, not only hinges upon the outcome of the presidential election, but also the results in both chambers of Congress. That said, it should be noted the available information surrounding the tax platforms of both the Trump and Biden campaigns include mentions of changes to OZs.

Few details have been offered by the Trump campaign, though “expanding opportunity zones” is among them. It is unclear what this would entail, but it stands to reason (and the president’s advisors have alluded to) it would mean additions to the existing 8,766 OZs designated by Treasury.

The Biden campaign’s platform echoes long-standing bipartisan calls to add reporting requirements to the program rules and corresponding reviews by Treasury to ensure that the program is achieving its intended benefit of aiding low-income communities. Additional incentives would be created to encourage partnerships between OZ project management and local not-for-profits and community leadership, to promote coordination such that the benefits to the local economies and job creation are optimized.

We encourage you to reach out to your Baker Tilly tax advisor regarding how any of the above may affect your tax situation.
Residency rules and state trust taxation – Beware the traps

By Randi A. Schuster

In recent years, there have been numerous state tax cases around the country highlighting the different tax treatments and definitions of resident trusts. Trust residency is defined differently by each state. Even though the particular state rules may not be applicable to a taxpayer at the present time, it is important to be aware of the differences. Trustees, beneficiaries and grantors move constantly, and the fluidity can cause unexpected tax results. In California, even if the trust was created as a resident trust of another state, trusts are considered resident in California if there is a trustee or a beneficiary residing there. Last year, the Supreme Court addressed state taxation of a trust and the determination of residency in North Carolina. Although the specific case only affects North Carolina, the statute in effect made the trust taxable there because of beneficiary residence.

Earlier this year, a New York Advisory Opinion caused a great deal of discussion by ruling that a trust was subject to tax in New York because it failed the statutory exemption to taxation. In making that determination, the New York State Department of Taxation and Finance’s Office of Counsel looked through a mutual fund to determine source income of exempt bond interest. Although this is a New York ruling and is only applicable to New York trusts, combined with other rulings across the country, it does serve as an alarm for trustees. They need to be aware of the movement of beneficiaries (and of their own relocation) and the effect that can have on the taxation of the trusts.

Example

In February, the Office of Counsel ruled that the trust in question was a New York state resident trust and did not qualify for the exemption from tax.

New York state tax law defines a resident trust as a trust, or portion of a trust, consisting of property of:

(i) a person domiciled in this state at the time such property was transferred to the trust, if such trust or portion of a trust was then irrevocable, or if it was then revocable and has not subsequently become irrevocable, or
(ii) a person domiciled in this state at the time such trust, or portion of a trust, became irrevocable, if it was revocable when such property was transferred to the trust but has subsequently become irrevocable.

There was no question that the trust met the definition of a resident trust, but New York has a statutory exception to the taxation of a resident trust if there is insufficient nexus to tax the trust. However, in order for a resident trust to qualify for the exemption the law, three conditions must be met:

1. All trustees must be domiciled outside of New York state.
2. The entire corpus of the trust must be located outside of New York state.
3. All of the trust’s income or gain must be sourced outside New York state. For the purpose of sourcing the trust corpus, intangible property shall be deemed “located in [New York] if one or more of the trustees are domiciled in the state of New York.” Tax Law § 605(b)(3)(D)(ii)

The trust that is the subject of the ruling met the first two exceptions, but the counsel ruled that it failed the third point.

The corpus of the trust includes two types of intangible investments. Approximately 15% is invested in a tax-exempt municipal bond fund. Approximately 15% of the total income generated by the bond fund is from New York tax-exempt bonds. The approximately 85% remaining corpus consists of a limited partnership interest in a publicly traded partnership. Less than 1% of the partnership’s income is New York source income. Thus, in the aggregate, New York source income accounts for less than 5% of the trust’s total income. All the income of the trust has been retained, and no distributions have been made to the trust beneficiaries.

The interpretation that “all” means all is a harsh result and should serve as a caution to trustees of trusts that are resident New York trusts relying on the statutory exemption. In this instance, New York tax-exempt bond income served as the hook to tax the entire trust — income that would not even be taxable in New York.

**Conclusion**

Although this ruling is for a New York trust, it should serve as a warning to all trustees. With Trustees and beneficiaries moving from state to state, review of trust residency and taxation should become part of an annual checklist. Even the smallest infraction of a state’s residency rules can cause unexpected tax results.
Time running out for year-end estate planning

By Mark Smith

2020 has been an interesting year for many reasons. As we approach year-end, we recommend doing a number of things from an estate and gift tax-planning standpoint. Those ideas are discussed below. However, with 2020 being a presidential election year, a significant planning opportunity might exist this year that otherwise may not occur again.

Background

For 2020, the estate, gift and generation-skipping-tax exemption is set at $11.58 million per person and is scheduled to increase each year by a cost-of-living factor. However, that level of exemption is due to sunset after 2025, when it would return to half that amount. The $5 million level of exemption (adjusted annually by a cost-of-living adjustment or COLA) came into the law in 2011. Prior to then, the exemption level had reached $3.5 million.

The estate tax law also allows an adjustment in basis to the date of death fair market value when one passes away. We normally think of this as a step-up in basis, since, most of the time, assets have increased in value from the time of purchase. This has been the law for many years.

In this presidential election year, Democratic presidential nominee Joe Biden proposes, among other things, to “return the exemption levels to historic norms” and “eliminate the step-up in basis for inherited assets.” Whether historic exemption levels mean the $5 million level referred to above or the pre-2011 $3.5 million level is unclear.

Of course, the changes that Biden proposes would be possible only if he wins the presidency, and the Democrats take the Senate and retain majority in the House. In January 2021, new legislation could be introduced to effect these changes. New law could possibly be effective retroactively to Jan. 1, 2020.

The next few months may be the last time individuals will have an exemption of $11.58 million. If it is used to shelter gifts in 2020, the use would likely be grandfathered even if the exemption level is reduced in the future. In this scenario, the use is the “excess” of the current level over what it might be reduced to, to be considered “used.” For example, gifts of $9 million in 2020 will use $4 of the “excess” over the $5 million level if the law is changed to reduce the exemption to $5 million. If gifts of only $5
million are made in 2020 and the exemption level is reduced to $5 million, the opportunity to use the “excess” will have been lost.

**Use the “excess” exemption the current law provides**

Clients with the wealth to take advantage of this historically high exemption level have many ways to make gifts in 2020. While this article will not be able to discuss all the options in detail, there are ways to make gifts that are straightforward. Of course, there are also more complicated techniques requiring time and planning — and time is quickly running out to do so before year-end. The following strategies should be discussed with your estate planning advisors.

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- Gifts of business interests in S corporations, partnerships or limited liability companies (LLCs) could take advantage of discounts when transferring minority interests in nonvoting stock, limited partnership interests or LLC membership interests. Use of discounts allows more value to be included in the gift.

  - This shifting of business ownership might already be part of succession planning for your business and now could be a good time to make this type of transfer.

- For those clients apprehensive about giving up the cash flow from assets gifted away, there are various techniques to address this, such as the spousal limited access trust (SLAT). The SLAT is an irrevocable trust which has the benefit of removing assets via gift from the estate, but allowing the spouse and other beneficiaries to have access to the assets and their income.

  - The SLAT features of the trust can then be combined with longer trust terms, so the trust assets can benefit multiple generations. Finally, those trusts can be created as “grantee” trusts so the trust creator/settlor continues to pay the income taxes on the income generated by the trust assets. This allows the trust assets to grow, without the need to pay taxes, and the settlor’s taxable estate to be reduced further.

  - With a grantor SLAT, gifts can be made to the trust and assets can be sold to the trust, without recognition of gain on the sale. The sale is usually accomplished by the SLAT issuing a promissory note to the seller.

  - If the transfer is via a sale right now, that promissory note could be forgiven by Dec. 31, 2020, if there is a change in Washington that might threaten the exemption level. If the president is re-elected, the decision of what to do with the promissory note could be delayed until 2025.

- Gifts by one spouse to a lifetime trust for the benefit of the other spouse is another planning option. However, this does not remove the assets from both spouses’ taxable estates like the SLAT does.

- Gifts to trusts for the benefit of the settlor’s children and future generations — not benefitting the settlor’s spouse. This trust could be generation skipping and could also be taxed to the grantor.

- Gifts to any of these types of trusts do not have to be with business assets. The gifts could be of investment assets, cash or any other type of transferable asset. Unfortunately, IRAs, annuities and other like assets cannot be transferred by gift during one’s lifetime.

- Gifts into trusts for the benefit of the trust beneficiaries also provides asset protection for those beneficiaries and that should not be overlooked.
Finally, taxpayers who have already engaged in significant transfer planning in recent years (in response to earlier tax law changes) may have significant promissory notes still outstanding from earlier sales to grantor trusts. Those promissory notes, or some portion of them, can be forgiven by Dec. 31, 2020, to use the excess exemption.

Other estate-planning moves that should be considered before year-end

— Annual exclusion gifts: the limit for 2020 is $15,000
  
— Medical bills of family members: pay directly to the medical provider, not to your family member for their use in paying their bill
  
— Tuition of a child or grandchild: pay directly to the educational institution
  
— Grantor retained annuity trust (GRAT): fund with an asset with a value that has been depressed by the current situation, but which has the potential to return to historic values; GRATs work well when the transferred assets grow at a rate greater than the current section 7520 rate (0.4% in October)
  
— Depressed value assets: make an outright gift to your children
  
— Personally owned life insurance policies: transfer into irrevocable trusts to remove the value of the policy from the taxable estate
  
— Higher interest rate notes: refinance those notes that have been created from prior transactions; current AFR rates for October 2020 are 0.14% for the short term (three years or less); 0.38% for midterm (four to nine years); and 1.12% for long term (more than nine years)
  
— Intrafamily loans: consider making new loans or refinancing existing loans to take advantage of the low AFR rates; this is not a transfer technique, but it is designed to slow the growth of assets in your estate if you loan money and take back a note with these low interest rates

Comparing the current income tax rates to estate and gift tax rates, the income tax basis of the assets used to make gifts is now more important than before. Gifting higher basis assets is more beneficial than lower basis assets because of the current step-up in basis that can occur on death with lower basis assets included in the estate. Basis needs to be considered in any gift strategy. However, transactions with grantor trusts may continue to give the donor flexibility to address this issue. In addition, if business assets are used in a succession planning situation, consider whether that asset will be sold in future generations when discussing the impact of basis. Finally, the possible elimination of the step-up in basis rules would change our thinking again on all transfers. Please consult your estate tax advisor before deciding which assets to gift.

Finally, there are states with their own estate tax regimes and those states usually do not have the same federal exemption level of $11.58 million. Only one state has a gift tax for lifetime gifts. Planning needs to also factor in the impact of lifetime giving in excess of those state exemptions. As long as the state does not require you to include those prior gifts in the state’s taxable estate calculation, you can move more asset value to heirs during lifetime with gifts than if you wait until death to transfer those assets. Again, consult your estate tax advisor.
State and local tax update

By Donna Scaffidi

As 2020 comes to a close, uncertainty remains. Employers and schools balance between in-person and remote participation. While unemployment numbers declined through the summer, new jobless claims appear to be steadily rising again. Businesses running out of federal stimulus money may now be forced to lay off employees, which would drive more people to state unemployment lines. What does this mean for states? Without federal relief and with no other way to replace revenue lost to pandemic-related shutdowns, budgets have been slashed, employees have been laid off or furloughed and legislators are looking at other avenues to refill their coffers.

We begin this article where we left off this past summer.

Tax increases

In July, we reported New York’s Assembly and Senate have nearly identical bills to increase state tax rates for individuals, and Illinois’ ballot imposes a question regarding a constitutional amendment to adopt graduated rates thus increasing taxes for individual and corporate citizens. The New York bills are still pending, and the Illinois voters will have decided the fate of the amendment in November.

Two new states worth mentioning are New Jersey and California.

On Sept. 30, the New Jersey governor signed a nine-month budget for the remainder of fiscal year 2021. The budget contains corporate and individual tax increases and a potential rebate for New Jersey families. However, the millionaire’s tax is grabbing all the attention. The top tax rate of 10.75% will apply to taxable incomes of $1 million retroactive to tax years beginning on or after Jan. 1, 2020.

California has bill AB 2088 “in committee process.” The bill intends to impose a tax of 0.4% on worldwide net worth of residents in excess $15 million for married filing separately and $30 million for married filing jointly. Worldwide net worth is calculated in a similar manner to Internal Revenue Code (IRC) for estate taxes under Chapter 11 as of June 15, 2020. The bill lists the assets to include (list is not limited) and exclude (real property directly held, mortgages and other liabilities associated with realty). The tax would be assessed on the value as of Dec. 31. The bill contains rules for part-year and temporary residents as well as residents who generated their wealth prior to moving into California. If
the bill passes, it is effective immediately. However, the state has much to consider if this bill is to become law, as the bill requires additional rules not yet written.

Change of residency

In recent weeks, the inquiries from clients about moving from high-tax states has increased. While this is nothing new, there appears to be a resurging interest. The pandemic has certainly proven we can work remotely which may be prompting one to ponder where they live and work since, for right now, it is one and the same for so many of us. Moving from high-tax states, like California, New Jersey, New York and even Minnesota and Wisconsin, pose residency audit risks. The taxpayer’s former residency must be considered abandoned in order for the challenging state to recognize new residency. Advanced planning is key to managing this risk. Careful considerations to each individual’s facts, circumstances and intent are critical as well as researching a state’s specific residency and domiciliary laws, regulations and cases.

States response to the Coronavirus Aid, Relief, and Economic Security (CARES) Act

Back when we reported in July, 21 states and the District of Columbia had not yet adjourned their 2020 legislative sessions. By early October 2020, that number increased to 32. Sixteen states are either still in session or in special session, leaving three that have not yet convened. Therefore, there is still likelihood of a state adopting in full or in part or decoupling in full or in part the CARES Act.

Taxpayers are expressing most concern with whether states will follow the forgiveness of loans (Section 1106 of the CARES Act) similar for federal income tax purposes if qualifications of the program are met. States with rolling conformity to the IRC will automatically conform to the CARES Act unless the state decouples as New York did. Other jurisdictions with rolling conformity that have not decoupled from the CARES Act include Alabama, Colorado, District of Columbia, Illinois, Maryland, New Jersey, Pennsylvania and Tennessee (this list is not all inclusive). Any state with a conformity date prior to March 27, 2020, will need to either (1) adopt in full or in part, (2) decouple in full or in part from the IRC or (3) do nothing. Wisconsin adopted only specific sections of the CARES Act and New York, as noted above, decoupled in full. Caution should be made even if a state has not yet adopted Section 1106 as a state-specific statute may provide relief.

The majority of states adopted the business interest limitation provisions under the Tax Cuts and Jobs Act (TCJA). However, as noted above, unless the state has rolling conformity, the new provisions under the CARES Act will not apply. Therefore, those states conforming to section 163(jj) will need to follow TCJA provisions to determine allowed interest deduction.

Aggressive enforcement of nexus laws

States have not slowed down their attempts to find the nonresident, nonvoting taxpayer. Nexus remains an important element of managing a business’s overall state tax risk. With the budget shortfalls expected through 2022 as indicated by the Center for Budget and Policy Priorities, we should continue to expect taxpayers to receive nexus inquiries from state and local taxing authorities.
Back in July, we reminded clients of the Wayfair decision. Given the broad implications for companies beyond remote sellers, it bears repeating and a bit of expansion to include prior cases.

Prior to the Wayfair decision, states were looking to the Geoffrey, Inc v South Carolina Tax Commission decision for inspiration to impose income taxes based on the economic realities of using intangibles in the state. In 1993, post the certiorari denial to hear Geoffrey, states began to enact what was dubbed “Geoffrey’s nexus” laws. Hence, the beginning of economic nexus for income tax purposes. Additionally, numerous states’ “doing business” statutes contain language or equivalent language “deriving income from sources within state.” Therefore, unless a taxpayer qualifies for Federal Public Law 86-272 (P.L. 86-272) protection from income taxation, it may very well have nexus and therefore a legal requirement to file and pay income taxes. P.L. 86-272 is available only to sellers of tangible personal property. With respect to orders placed from outside of state and that ship goods from outside of state, some states require the seller to use third-party common carriers while others may permit delivery in own vehicles.

As a reminder, for those employers considering allowing employees to continue teleworking post the state of emergency or stay-at-home orders, they need to understand the nexus implications not only for income, non-income and sales taxes, but also payroll withholding and unemployment insurance.

Both physical presence and economic standards must be analyzed for all state taxes when performing a nexus study. Proactive understanding of an organization’s nexus footprint is the ultimate strategy to begin managing risk.

**Increase in state audit activity**

Unfortunately, in the last several months, clients continued to receive letters notifying them of state’s intention to audit. These, like nexus questionnaires and notices, should be taken seriously. Notices, especially if there is an adjustment to tax, may require a response within a certain time frame. Otherwise, opportunity to object could be lost. Therefore, when in doubt, engage the services of a tax professional or attorney to handle these situations.
U.S. international tax update
By Jim Alajbegu, Chris Brown and Matt Damone

As we draw closer to the end of a notorious 2020, significant U.S. international tax legislation is being released at a fast and furious pace. The IRS and Treasury Department continue to issue regulatory guidance interpreting the Tax Cuts and Jobs Act (TCJA). At the same time, countries from around the globe and the Organization for Economic Cooperation and Development (OECD) are continuing to discuss comprehensive reform of international tax rules, specifically related to digital taxation. Responding to challenging times has resulted in unilateral measures by countries, such as a tax on digital services. While uncertainty remains, the Treasury and IRS will continue to be active in guidance related to multinationals and ensuring the U.S. remains competitive in a global tax landscape.

IRS and Department of Treasury issue regulations and notices

Final section 250 foreign-derived intangible income and global intangible low-taxed income regulations: In July 2020, the Treasury and IRS issued final regulations (T.D. 9901) regarding the deduction for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI) under section 250. The final regulations finalize the proposed section 250 regulations issued in March 2019 with a number of modifications discussed below. The final regulations replace the strict FDII documentation requirements contained in the proposed section 250 regulations with more relaxed substantiation requirements. The final regulations also removed the taxable income limitation ordering rule contained in the proposed regulations and allow taxpayers to use any reasonable method in determining the limitation (including using the proposed regulation’s ordering rule until further guidance is issued). Also, the final regulations provided guidance related to digital content transactions, electronically supplied services and advertising services. Finally, the final regulations revise the property services provisions to allow property to be temporarily located in the U.S. in certain circumstances, resulting in an expansion of taxpayers that might now be eligible for a FDII deduction (e.g., certain U.S. contract/toll manufacturers). The final regulations apply for tax years beginning on or after Jan. 1, 2021. For tax years beginning before 2021, taxpayers may rely on either the final regulations or the proposed regulations. However, the set of regulations chosen must be applied by the taxpayer in their entirety (with some exceptions such as the application of the transition documentation rule when applying the proposed regulations for all tax years beginning before 2021).
Final and proposed high-tax exception under GILTI and Subpart F: In July 2020, the Treasury and IRS also issued final (T.D. 9902) and proposed (REG-127732-19) GILTI and Subpart F income high-tax exception regulations. The final regulations provide for an annual election to apply the GILTI high-tax exclusion and maintain the threshold rate at which income is deemed high-taxed income as a rate in excess of 90% of the highest U.S. corporate rate (i.e., 18.9% under current law). Qualifying computations of high-taxed income are made on a newly defined “tested unit” basis, rather than on a controlled-foreign-corporation-by-controlled-foreign-corporation (CFC-by-CFC) or qualified business unit-by-qualified business unit basis. Additionally, under the final regulations, the controlling domestic shareholder (subject to newly prescribed notice requirements) makes the GILTI high-tax exclusion election and, once made, is binding on all U.S. shareholders of the CFC group. The regulations also contain consistency rules requiring application of an annual election to all CFCs in a “CFC group.” The final GILTI high-tax regulations are effective for years beginning on or after July 23, 2020; but retroactive application of the final regulations to years beginning after Dec. 31, 2017, and before July 23, 2020, is permitted if certain requirements are satisfied. Taxpayers filing amended returns to retroactively apply the GILTI high-tax are subject to prescribed filing deadlines (e.g., filing within 24 months of the unextended due date for the original return). The 2020 proposed regulations, if enacted as issued, will provide for a single unified high-tax exception election for both GILTI-tested income and Subpart F. Additionally, there are new requirements under the proposed regulations for maintenance by U.S. shareholder of contemporaneous documents supporting high-tax exception computations.

Final and proposed section 245A regulations: In August 2020, the Treasury and IRS published final proposed regulations under section 245A that limit the deduction for certain dividends received by U.S. persons from foreign corporations under section 245A and the exception to Subpart F income under section 954(c)(6) for certain dividends received by CFCs. The final regulations generally adopt the approach and the structure of the 2019 proposed regulations with certain modifications. The 2020 proposed regulations provide detailed mechanics for the coordination of the extraordinary disposition rules under the final regulations and the disqualified basis rules under the 2019 final GILTI regulations. Very broadly, section 245A(e) denies a section 245A(a) dividends-received deduction for hybrid dividends and tiered hybrid dividends for domestic and CFCs, respectively. Section 267A generally disallows a deduction for interest or royalties paid or accrued to the extent payment produces a deduction/no income inclusion as a result of a hybrid or branch arrangement. The final regulations retained the basic structure of proposed hybrid arrangement regulations issued in 2019 with certain revisions such as: (1) withholding taxes generally should not be viewed as neutralizing a deduction/no inclusion outcome; (2) clarifying application of the hybrid deduction account method and (3) revising the long-term deferral provisions. The proposed regulations adjust hybrid deduction accounts to take into account earnings and profits of a CFC that are included in income by a U.S. shareholder and contain conduit financing rules involving equity interests that give rise to deductions (or similar benefits) under foreign law.

Final section 163(j) regulations – international provisions: In September 2020, the Treasury and IRS released final (T.D. 9905) and proposed (REG-107911-18) section 163(j) regulations covering the potential limitation of business interest expense deduction to the sum of the taxpayer’s business interest income, 30% of adjusted taxable income (ATI) and floor plan financing income for the year. The proposed and final regulations confirm that section 163(j) applies to CFCs and other foreign corporations with income relevant for U.S. federal income tax purposes. Most of the international provisions are contained in the proposed regulations. The 2020 proposed section 163(j) regulations
overhaul the requirements related to CFCs that can be members of a CFC group and now apply quasi-U.S. consolidated group rules to determine members of a CFC group and calculate a group’s single section 163(j) limitation. The CFC group election is revocable after being in effect for 60 months — but cannot be made again until 60 months after revocation. The 2020 proposed section 163(j) regulations allow a U.S. shareholder with a CFC group election to increase its ATI for its portion of certain deemed inclusions of a CFC that are attributable to the CFC’s excess taxable income (if any). The final section 163(j) regulations generally are effective for tax years beginning 60 days after the date they are published in the Federal Register (Sept. 3, 2020) but can be applied to taxable years beginning after 2017 if taxpayers and related parties satisfy certain consistency requirements. The 2020 proposed section 163(j) regulations would generally apply to taxable years beginning on or after 60 days after the date they are published as final regulations in the Federal Register. However, taxpayers and related parties may apply the 2020 proposed section 163(j) regulations to tax years beginning after 2017 if they early adopt the final regulations and certain consistency requirements are satisfied. Alternatively, taxpayers and related parties can apply the 2018 proposed section 163(j) regulations to taxable years beginning after December 2017 and before the effective date of the 2020 proposed section 163(j) regulations, if certain consistency requirements are satisfied.

Final base erosion and anti-abuse tax (BEAT) regulations: In September 2020, the Treasury and IRS released final regulations under section 59A (T.D. 9910). The BEAT rules require certain corporations to pay a minimum tax on taxable income as computed without certain deductions for certain payments to foreign related parties. The 2020 final regulations generally adopt the 2019 proposed regulations issued Dec. 2, 2019, with certain modifications, including allowing taxpayers an election to waive deductions for purposes of calculating their base erosion percentage. The final regulations provide additional guidance on determining the aggregate group and provide rules related to partnerships.

Notice 2020-69 related to S corporations’ treatment of GILTI: In September 2020, the Treasury issued Notice 2020-69 providing notice that regulations are expected that would allow certain S corporations to elect entity-level treatment for purposes of the GILTI rule. The election can be made for a timely filed return (including extensions) for tax years ending on or after Sept. 1, 2020. Until regulations are issued, Notice 2020-69 states that taxpayers may rely upon the notice provided the S corporation and all shareholders that are U.S. shareholders of the CFC consistently apply the rules of the notice.

Section 958(b) final and proposed downward attribution relief regulations: In September 2020, final regulations (T.D. 9908) and a notice of proposed rulemaking published in the proposed rules section of the Federal Register (REG-110059-20) providing certain relief provisions after the repeal of the “downward attribution” rules of section 958(b)(4) were issued. The final regulations finalize proposed regulations that were issued in October 2019 with certain modifications such as: (1) expanding the scope to apply to amounts payable under section 267(a)(3) to a related foreign CFC that does not have any section 958(a) U.S. shareholders and (2) finalizing certain reporting requirements. The notice of proposed rulemaking provides regulations covering the section 954(c)(6) look-through rules to ensure that their operation is consistent with application before the repeal of section 958(b)(4). The notice of proposed rulemaking also modifies the regulations under section 367(a) regarding the direct or indirect transfer of stock or securities of a domestic corporation by a U.S. person to a foreign corporation to ensure the attribution rules are applied consistently following the repeal of section 958(b)(4).
**Proposed foreign tax credit regulations (REG-101657-20):** In late September 2020, the Treasury and IRS issued proposed regulations providing guidance on many aspects of foreign tax credits including (1) expense allocation; (2) foreign tax liability; (3) deductions of life insurance companies and (4) the definition of foreign branch category and financial services income. In addition, final regulations under T.D. 9922 finalized proposed foreign tax credit regulations published in December 2019. Final section 901(m) regulations (T.D. 9895) covering the limitation of foreign taxes paid or accrued in connection with covered asset acquisitions as foreign tax credits, issued in March 2020. The final regulations generally adopted the 2016 proposed regulations and separate notices with certain revisions and made modifications to the 2016 proposed regulations necessary to reflect statutory changes by the TCJA.

**Additional delay in applicability dates for section 987:** On Sept. 17, 2020, the Treasury and IRS issued Notice 2020-73 announcing their intention to amend the applicability date of certain final section 987 and related final regulations by one additional year. As such, certain 2016 final regulations and the related 2019 final regulations would apply to the taxable year beginning on Jan. 1, 2022, for calendar-year taxpayers.

**Final regulations address source of income from some property sales:** In October 2020, the IRS issued final regulations (T.D. 9921) addressing the source of income from property sales. The regulations retain the rules of the proposed December 2019 regulations with some revisions. For example, the final regulations provide that certain principles of Treas. Reg. Sec. 1.954-3(a)(4) may apply in determining the location of production activities for sourcing purposes.

**U.S. international tax: COVID-19 relief provisions**

*Rev. Proc. 2020-20*

Rev. Proc. 2020-20 provided relief to some nonresident individuals who, but for COVID-19 emergency travel disruptions, would not have been present in the U.S. in 2020 long enough to be considered resident aliens. Relief was achieved by excluding up to 60 consecutive days spent in the U.S. starting on or after Feb. 1, 2020, and on or before April 1, 2020, (with the specific start date to be chosen by each individual) under the substantial presence test’s medical exception provision. Rev. Proc. 2020-20 also provided procedures for individuals to exclude certain days present in the U.S. in order to claim tax treaty benefits for dependent personal services income.

*Rev. Proc. 2020-24 and frequently asked questions*

In 2020, the IRS issued Rev. Proc. 2020-24 providing guidance on net operating loss (NOL) carryback election provisions introduced in the CARES Act. Generally, the revenue procedure provided for (1) waiver of the NOL (NOL carryback period for applicable NOLs); (2) an election to exclude from the carryback period any taxable year in which the taxpayer had a section 965(a) repatriation tax inclusion or (3) an election to waive any carryback period, to reduce any carryback period or to revoke any election made under section 172(b) to waive any carryback period for a taxable year that began before Jan. 1, 2018, and ended after Dec. 31, 2017. The IRS also released frequently asked questions (FAQ) to clarify certain issues from the application of Rev. Proc. 2020-24 including taxpayers may file an election to either waive the entire carryback period or to exclude all of section 965 years from the carryback period, and the statements that taxpayers use to make the elections.
Rev. Proc. 2020-27

Rev. Proc. 2020-27 provided relief to individuals that reasonably expected to qualify for the section 911 exclusions that left (1) China on or after Dec. 1, 2019 or (2) another foreign country on or after Feb. 1, 2020, (but on or before July 15, 2020) if the individual otherwise established he or she would have met the ordinarily applicable qualified individual eligibility requirements but for a “COVID-19 emergency.”

Rev. Proc. 2020-30

Rev. Proc. 2020-30 addressed the application of COVID-19 travel restrictions (such as transportation disruptions, shelter-in-place orders, quarantines etc.) on foreign branches. According to the revenue procedure, certain activities conducted in a foreign country for a consecutive 60 calendar-day period in 2020 by individuals temporarily present there due to travel disruptions will not be taken into account for purposes of determining whether a domestic corporation has a foreign branch separate unit. As a result, such activities will not give rise to a foreign branch separate unit under section 1503(d) and the taxpayer will not have an obligation to file a Form 8858, Information Return of U.S. Persons with Respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs).

Digital economy initiative

The international community has committed to an inclusive framework initiative on tax challenges to the digitalization of the economy. In May 2019, the OECD issued a work plan presenting a two-pillar approach: Pillar One addressed taxable nexus and the allocation of taxing rights among jurisdictions and Pillar Two addressed the global anti-base erosion (GloBE) issue and a global minimum tax. Initial targets aimed for agreement on Pillar One and Two approaches to be adopted by 2020 year-end. Recent updates have altered this projected timeline. See the following major 2020 updates:

— January: OECD Secretariat report released and inclusive framework meetings held
— February: G-20 finance ministers agree to seek Pillar One and Two agreements by end of 2020
— February: OECD releases economic impact statement on proposed corporate income tax (CIT) gains from both pillars
— June: European countries simultaneously propose and adopt digital services taxes (DST) aimed at global technology multinational enterprises (MNEs)
— June: U.S. Treasury Secretary releases letter halting negotiations on the Pillar One initiative, citing COVID-19 and targeted DST by European countries
— October: Inclusive framework meeting on key policy features of a solution

A European Union summit on digital issues is expected to be held in March 2021. Early OECD analyses estimated a $100 billion increase in global tax revenue from Pillar One and Pillar Two.
Digital services tax: European movement

Multiple European countries adopted and proposed DSTs as means to finance efforts made to combat COVID-19. The European Union Commission enacted measures to tax digital MNEs contrary to plans being considered by the OECD. Countries which have announced DSTs include Austria, France, Hungary, Italy, Spain, Turkey and the UK. U.S. trade representative investigations into simultaneous European DSTs have, in part, pushed the U.S. Treasury Department to announce retraction from Pillar One negotiations with the OECD and member nations (see above). Absent a compromise to the inclusive framework, DSTs may be implemented by most countries.

Transfer pricing updates

Transfer pricing continues to be the top concern in global tax reform. Global tax transparency has led to a focus on the income allocation rules and how countries will seek to generate more tax revenues and increase transfer pricing enforcement. The expected outcome will inevitably be greater uncertainty, increased compliance costs and increased litigation. A strategic and comprehensive transfer pricing policy that is adaptable to these changes will be critical for multinational businesses.

**BEPS Actions 4, 8-10; Transfer Pricing Guidance on Financial Transactions:** The OECD released guidance for determining whether the conditions of certain financial transactions between associated enterprises are consistent with the arm’s-length principle. This guidance describes applications of transfer prices in financial transactions such as intragroup loans, cash pooling, hedging, financial guarantees and transactions within insurance companies. Guidance on these aspects of financial transactions have been introduced to avoid transfer pricing disputes and double taxation.

**Individual country 2020 updates**

1. **Argentina:** In May 2020, the Argentinian tax authorities released General Resolution 4717/2020. The resolution expanded transfer pricing reporting and compliance rules for MNEs operating in Argentina. Key transfer pricing compliance details and deadlines for the submission of a master file, transfer pricing study and a new affidavit form are laid out by the resolution.

2. **Mexico:** In January 2020, Mexico introduced tax reforms including measures disallowing deductions of payments made to related parties in low-tax jurisdictions and certain interest deductions. An “anti-tax haven” provision within the updates determine that payments made directly or indirectly to related parties subject to low taxation or through a structured agreement are not deductible for Mexican corporate income tax purposes.

3. **Chile:** In February 2020, Chilean tax authorities introduced a tax modernization bill, which makes changes to existing transfer pricing compliance. The most significant changes increase pressure on companies by giving tax authorities the possibility of requiring companies to file transfer pricing affidavits to taxpayers domiciled in Chile who carry out transactions with CFCs. This change aligns Chilean transfer pricing rules with that of other modern nations.

4. **Colombia:** Colombian tax authorities issued filing deadlines for transfer pricing documentation at the end of 2019, effective in fiscal year 2020. Local and master file as well as country-by-country (CbC) reports are obligated for applicable entities. Transfer pricing information and local files, if applicable, were due in July 2020, while master file and CbC reports are due from Dec. 10-23, 2020.
5. Brazil: In December 2019, the OECD released the study “Transfer Pricing in Brazil: Towards Convergence with the OECD Standard,” which detailed conclusions of a joint project to examine the similarities and divergences between the Brazilian and OECD transfer pricing approaches. Brazil plans to adopt OECD transfer pricing guidelines in the near future, effecting MNEs conducting business in Brazil.

**Transfer pricing court cases**

1. **European Union v. Apple, Inc.:** In 2020, the European Union General Court annulled the European Commission’s decision involving Apple Inc. and its Irish headquarters entity. Initially, the European Commission found that Ireland’s tax rulings constituted unlawful and incompatible state aid provisions and ordered Ireland to recover over 13 billion euros from Apple, Inc. The European Union General Court held that the Commission did not prove the Irish tax ruling in question gave rise to a selective state aid advantage for Apple Inc.

2. **Canada v. Cameco Corporation:** In 2018, the Canadian Revenue Agency (CRA) levied tax assessments on Cameco Corporation after determining that an Asset Purchase and Transfer of Liabilities Agreement entered between Cameco Corporation and its Swiss subsidiary did not constitute an arm’s-length transaction. This decision was due to the substantial increase in the value of the assets involved. Disagreeing with the decision of the CRA, Cameco Corporation appealed to the Canadian Tax Court, which ruled in favor of Cameco Corporation. The decision was appealed by the CRA to the Canadian Federal Court of Appeal (CFA) in June 2019. In June 2020, the CFA dismissed the appeal and ruled in favor of Cameco Corporation, dismissing the CRA’s assessment.

3. **Altera Corporation v. U.S. Court of Appeals for the 9th Circuit:** In 2020, the U.S. Supreme Court announced its denial of petition to hear Altera Corporation’s appeal of a 9th Circuit Court ruling. The 9th Circuit Court initially ruled against Altera Corporation arguing the validity of Treas. Reg. Section 482, addressing cost sharing of stock-based compensation. This case has spanned over eight years and the result has confirmed stock-based compensation must be included in costs shared under qualified cost-sharing arrangements. This case is considered to contribute to the movement away from the arm’s length.
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