2020 Federal Tax Update

Tony Nitti, CPA, MST

CERTIFIED PUBLIC ACCOUNTANTS
& BUSINESS CONSULTANTS

RubinBrown

Disclosure

- RubinBrown provides general information on its website and on various electronic media platforms. The contents should not be construed as the rendering of advice regarding specific situations. If accounting, legal or other expert assistance is needed, consult with your professional business advisor.
- Readers should not act upon information presented without individual professional consultation.
- Any federal tax advice contained in this communication (including any attachments): (i) is intended for your use only; (ii) is based on the accuracy and completeness of the facts you have provided us; and (iii) may not be relied upon to avoid penalties.

RubinBrown

Tax Policy Update

CERTIFIED PUBLIC ACCOUNTANTS
& BUSINESS CONSULTANTS

Joe Biden's Tax Plan-
Individual Provisions

- Return the top ordinary individual income tax rate to 39.6%
  - Prior to the passage of the TCJA, the top individual rate on ordinary income – items such as wages, interest, and business income -- was 39.6%. The TCJA reduced the rate to 37%, but Biden would return it to 39.6%
  - Presumably, the rate increases would simply take place at the current 37% bracket (approx. $520K single; $620K MFJ).
- Additional 12.4% Social Security tax on employees earning more than $400,000
  - Under current law, employees and self-employed individuals pay a 12.4% Social Security tax on the first $137,700 of wages or self-employment income, split evenly between the employer and employee (a self-employed taxpayer pays the full 12.4%). Biden's plan calls for adding an additional 12.4% tax on wages or self-employment income in excess of $400,000, to again be split between employer and employee.

Joe Biden's Tax Plan- Individual Provisions

- 39.6% capital gains and dividends rate on incomes greater than $1M
  - For those with income in excess of $1 million, Biden would tax long-term capital gains and dividends at the same rate that is applied to ordinary income, or 39.6%.

- Eliminate 20% QBI deduction for incomes over $400,000
  - The TCJA allows taxpayers who operate business as an S corporation, partnership, or sole proprietorship to claim a deduction equal to 20% of the qualified income earned in the business. Biden would eliminate the deduction for those taxpayers with taxable income in excess of $400,000.
  - Bigger question: if the corporate rate goes to 28%, and the top individual rate goes to 39.6% and the top capital gains rate goes to 39.6%, what happens to Section 199A? Is it still a 20% deduction?

RubinBrown

Joe Biden's Tax Plan- Individual Provisions

- Changes to itemized deductions
  - A taxpayer deducts the greater of the standard deduction and the sum of their itemized deductions. After the TCJA doubled the standard deduction while limiting or eliminating many itemized deductions, the number of itemizers dropped from near 30% to under 10%. Biden's plan would further limit itemized deductions in two ways.
    - First, Biden would reinstate the "Pease limitation," which would reduce a taxpayer's overall itemized deductions when income exceeds $400,000.
    - In addition, Biden would cap the total benefit of itemized deductions at a rate of 28%. Thus, for a high-earning taxpayer, the final dollar of income would be taxed at 39.6%, while the final dollar of expense would give rise to only a 28% deduction.

RubinBrown

Joe Biden's Tax Plan- Individual Provisions

- Changes to individual tax credits
  - Expand the Earned Income Tax Credit for childless workers aged 65
  - Strengthen the Child Tax Credit (CTC) for 2021 "as long as economic conditions require"
    - Increase the CTC to $3,000 per child (ages 6-17) and $3,600 (children under 6)
    - Make the CTC fully refundable
  - Expanded Child and Dependent Care credit
    - Up to an $8,000 credit for low and middle class families, increased from $3,000
  - New first-time homebuyer tax credit
    - Up to $15,000
    - The credit is advanceable at the time real estate is purchased, instead of when the return is filed

RubinBrown

Joe Biden's Tax Plan- Estate Provisions

- Changes to estate tax
  - Biden would eliminate the tax-free "step up" in basis upon death, taxing any appreciation in assets at that time.
  - Biden has proposed returning the estate tax exemption to $3.5M, and the maximum rate back up to 45%. These returns to 2009 levels will help fund the proposed 12 weeks of paid family and medical leave envisioned in the FAMILY Act

RubinBrown

Joe Biden's Tax Plan- Corporate Provisions

- Increase the corporate income tax rate to 28%
  - The hallmark of the TCJA was the reduction in the corporate rate from 35% to 21%. Biden would increase the rate to 28%

- Corporate minimum tax on book income
  - In the most unconventional proposal in the Biden plan, the former Vice President would create a new "minimum tax" for corporations, requiring businesses with financial statement income in excess of $100 million to pay the greater of their regular corporate income tax or a 15% tax on their financial statement income.

RubinBrown

Consolidated Appropriations Act, 2021

CERTIFIED PUBLIC ACCOUNTANTS
& BUSINESS CONSULTANTS

RubinBrown

Loan & Grant Programs

- EIDL advance grant will reopen, allowing qualifying businesses who did not receive the full $10,000 advance to reapply for the difference
  - To qualify a business must be in a low-income community, employ no more than 300 employees, and have suffered an economic loss of greater than 30 percent during an 8-week period between 3/2/20 and 12/31/21 when compared to a comparable 8-week period before 3/2/2020 or during 2019.
- Borrowers of traditional Section 7 SBA loans who had six months of their principal and interest paid under the CARES Act will have three to eight more months of payments made by the SBA beginning February 2021
- EIDL advance and SBA payments on Section 7 loans will not be taxable income to the recipient, expenses paid with funds will be tax deductible, and the amounts are treated as tax-exempt income for passthrough basis
- Emergency Financial Aid Grants
  - Not included into gross income of recipients
  - Not treated as described in § 25A(g)(2)(A-C)

Shuttered Venue Operators Grant

- **High-level summary**:
  - New grant program for certain small shuttered venue operators of up to the lesser of:
    - 45 percent of 2019 gross earned revenue for those in operation on 1/1/19,
    - Average monthly gross earned revenue for each full moth in operation during 2019 x 6 for those who began operations after 1/1/19, or
    - $10M
  - $15B in available funds
  - Supplemental grants may be obtained equal to 50 percent of the initial grant received

Credits & Deductions

- Minimum low-income housing tax credit rate § 42
  - Establishes a 4% rate floor for calculating credits related to acquisitions and housing bond-financed developments for purposes of the low-income housing tax credit, effective after 2020
- Depreciation of certain residential rental property over 30-year period
  - The recovery period applicable to residential rental property place in service before Jan. 1, 2018, and held by a § 163(j)(7)(B) electing real property trade or business is 30 years (rather than 40)

RubinBrown

Extension of Expiring Provisions

The bill revives several provisions that were set to expire at the end of 2020 – some permanently, some for shorter durations.

Provisions made **permanent**:

- 7.5% AGI threshold for unreimbursed medical expenses as an itemized deduction
- **Section 179D deduction upon making energy efficient improvements to commercial buildings and systems**
- The deduction for qualified tuition expenses will expire at the end of 2020 but be replaced with increased income phaseout thresholds on the Lifetime Learning Credit
- Exclusion from gross income of certain state and local tax benefits for volunteer firefighters and emergency responders
- § 45G Railroad track maintenance credit, with modifications of credit rate from 50 to 40 percent after 2022

RubinBrown

Extension of Expiring Provisions

A few provisions were **extended for five years, until December 31, 2025** (when many of the TCJA provisions are slated to sunset as well):

- **The New Markets Tax Credit § 45D**
- The Work Opportunity Tax Credit § 51
- **Tax-free forgiveness of principal residence mortgage debt forgiveness § 108(a)(1)(E)**
  - **Exclusion is reduced to $750,000 and $375,000 after 2020**
- Immediate expensing of certain qualified film and television and live theatrical productions § 181(g)
- Allowing employers to pay up to $5,250 of an employee's qualified tuition, student loan and interest tax-free to an employee § 127(c)(1)(B)
- Look-through rule for related controlled foreign corporations (CFCs) § 954(c)(6)

RubinBrown

Extension of Expiring Provisions

Provisions that were **extended for five years, until December 31, 2025 (continued):**

- 7-year recovery period for motorsports entertainment complexes § 168
- Oil spill liability trust fund rate
- Employer credit for paid FMLA § 45S
- Extension of carbon oxide sequestration credit § 45Q
- **Empowerment zone tax incentives:**
  - **Designations extended to 2025**
  - **No more § 179 increase for empowerment zone property placed in service after 2020**
  - **No more nonrecognition of gain on rollover of empowerment zone investments after 2020**

RubinBrown

Extension of Expiring Provisions

Provisions **extended through 2021:**

- Credit for electricity produced from certain renewable resources § 45
- **Extension and phaseout of energy credit § 48**
  - **Energy investment tax credit for solar and residential energy-efficient property extended through 2021**
- Treatment of mortgage insurance premiums as qualified residence interest § 163(h)
- Credit for health insurance costs of eligible individuals § 35
- Indian employment credit § 45A
- Mine rescue team training credit § 45N
- Classification of certain race horses as 3-year property § 168

Extension of Expiring Provisions

Provisions **extended through 2021**:

- Production credit for Indian coal facilities § 45(e)(10)
  - One year extension (strikes "15-year period" and inserts "16-year period")
- **Energy efficient homes credit § 45L**
- Extension of excise tax credits relating to alternative fuels § 6426(d) and (e), and § 6427(e)(6)(C)
- Extension of residential energy-efficient property credit and inclusion of biomass fuel property expenditures § 25D
  - Extension through 2021, with one-year phasedown delays
  - Biomass fuel property included after 2020
- Black lung disability trust fund excise tax § 4121

Employee Retention Credit

CERTIFIED PUBLIC ACCOUNTANTS
& BUSINESS CONSULTANTS

CARES Act Employee Retention Credit

- Section 2301. Employee retention credit for employers subject to closure due to COVID–19
  - The credit is to encourage employers to retain employees and maintain salary
  - The credit is against the employer's share of the Social Security tax, so 6.2% of wages paid. (but as we'll see, it ends up being a credit against all payroll deposits).
  - The credit reduces payroll taxes AFTER any qualified family/sick leave credit.
- Fully refundable tax credit for employers equal to 50% of "qualified wages" (including allocable qualified health plan expenses) that Eligible Employers pay their employees.
  - The maximum amount of qualified wages taken into account with respect to each employee for all calendar quarters is $10,000, so that the maximum credit for an eligible employer for qualified wages paid to any employee is $5,000.
  - Qualified wages paid after March 12, 2020, and before January 1, 2021.
- ~~An employer may NOT claim the ERC if it has received – and does not return – a PPP loan prior to May 14, 2020.~~
- Link to IRS FAQs: https://www.irs.gov/newsroom/faqs-employee-retention-credit-under-the-cares-act

Employee Retention Credit-Changes for 2020

- Section 206 of the Consolidated Appropriations Act, 2021 does NOT change any computational aspects of the ERC for 2020; rather, all the computational changes are in Section 207 and apply in 2021.
- MOST IMPORTANT CHANGE: Section 206(c)(2)(B) strikes Section 2301(j) from the CARES Act. Section 2301(j) had previously provided that "if an eligible employer receives a covered loan under paragraph (36) of section 7(a) of the Small Business Act (a PPP loan), such employer shall not be eligible for the credit under this section."
- Section 206(e) provides that, in general, the amendments made by this section take effect as if included in the provisions of the CARES Act to which they relate.
- Thus, PPP borrowers are now eligible for an ERC back to the beginning of the program – March 12, 2020. It's just a matter of how to claim that credit.

RubinBrown

Two Scenarios Giving Rise To The Credit

- The key: to be eligible for the ERC, during a calendar quarter in 2020, an employer must satisfy one of the two scenarios:
  - Scenario 1: The employer was required to fully or partially suspend operations during any calendar quarter in 2020 due to orders from an appropriate governmental authority limiting commerce, travel, or group meetings due to COVID-19; or
  - Scenario 2: The employer experienced a significant decline in gross receipts during the calendar quarter when compared to the same quarter in 2019.

RubinBrown

Fully Or Partially Suspending Operations

- Operations partially suspended for purposes of the Employee Retention Credit:
  - The operation of a trade or business is partially suspended if:
    - An appropriate governmental authority imposes restrictions on the employer's operations
    - The orders limit commerce, travel, or group meetings (for commercial, social, religious, or other purposes) due to COVID-19 and
    - The orders affect an employer's operations of its typical operations.
  - All three of the above tests must be met.

RubinBrown

Orders From An Appropriate Governmental Authority

- Governmental orders include:
  - An order from the city's mayor stating that all non-essential businesses must close for a specified period;
  - A State's emergency proclamation that residents must shelter in place for a specified period, other than residents who are employed by an essential business and may travel to and work at the workplace location;
  - An order from a local official imposing a curfew on residents that impacts the operating hours of a trade or business for a specified period.
- Statements from a governmental official, including comments during press conferences or in interviews with the media, do not rise to the level of a governmental order for purposes of the Employee Retention Credit.
- Additionally, the declaration of a state of emergency by a governmental authority is not sufficient to rise to the level of governmental order if it does not limit commerce, travel, or group meetings in any manner. Further, such a declaration that limits commerce, travel, or group meetings, but does so in a manner that does not affect the employer's operation of its trade or business does not rise to the level of a governmental order.

RubinBrown

Governmental Orders

- Shutting down voluntarily for a period of time to protect your employees does not qualify as there has been no government order affecting your business.
- If a government order requires you to reduce your hours, you have been partially suspended.
- An essential business's loss of customers due to a government order requiring non-essential businesses to close does not mean your business has been partially suspended. If your business loses enough customers however, you may still be eligible for the credit if you experience a significant decline in gross receipts.
- An employer with an essential business may be considered to have a full or partial suspension of operations if the business's suppliers are unable to make deliveries of critical goods or materials due to government orders that cause the supplier to suspend its operations.
- If an employer's workplace is closed by government order but the employer is able to continue operations comparable to its operations prior to the closure by requiring its employees to telework, the employer's operations are not considered to have been fully or partially suspended.
- If an employer's workplace is closed by government order for certain purposes but may remain open for other purposes the operations would be considered partially suspended.

Government Orders Example

- Example: Governor of State Y issues an order that all non-essential businesses must close from March 20, 2020 until April 30, 2020. The order provides a list of non-essential businesses, including gyms, spas, nightclubs, barber shops, hair salons, tattoo parlors, physical therapy offices, waxing salons, fitness centers, bowling alleys, arcades, racetracks, indoor children's play areas, theaters, chiropractors, planetariums, museums, and performing arts centers. Employers that provide essential services may remain open.
  - This satisfies all three tests for a non-essential business. There has been:
    - An order from a an appropriate government authority, that
    - Limits commerce, and that
    - Affects the operations of the employer's trade or business.
  - Thus, these businesses have an eligible quarter in both Q1 and Q2 of 2020.
- Example : Mayor of City Y holds a press conference in which she encourages residents to practice social distancing to prevent the spread of COVID-19. The statement during the press conference is not an order limiting commerce, travel, or group meetings. Accordingly, the mayor's statement would not be a governmental order for purposes of the ERC.

Gross Receipts

- "Gross receipts" for purposes of the ERC for an employer other than a tax-exempt organization has the same meaning as when used under Section 448(c) of the Code. Under the Section 448(c) regulations
  - Receipts include total sales (less returns and allowances) and income from services provided (IRC Sec. 448(c))
  - Receipts also include interest, dividends, rents and royalties and sale of assets (reduced by the basis of such assets).
  - Gross receipts are NOT reduced by cost of goods sold.
- The CARES Act does not require that the significant decline in gross receipts be related to COVID-19. However, employers should keep records for the relevant calendar quarters in 2019 and 2020 to document the significant decline in gross receipts. The records should be available for IRS review for at least four years.

Significant Decline In Gross Receipts

- A significant decline in gross receipts is calculated by determining the first calendar quarter in 2020 (if any) in which an employer's gross receipts are less than 50% of its gross receipts for the same calendar quarter in 2019. If the gross receipts drop by more than 50%, you count that quarter as a quarter eligible for the credit.
- Each quarter in 2020 after that counts as a significant decline until the end of the first quarter in which gross receipts are greater than 80% of its gross receipts for the same calendar quarter in 2020.

Significant Decline In Gross Receipts Cont'd

- **Example**: Employer I's gross receipts were $100,000, $190,000, and $230 000 in the first, second, and third calendar quarters of 2020, respectively. Its gross receipts were $210,000, $230,000, and $250,000 in the first, second, and third calendar quarters of 2019, respectively.
- Thus, Employer I's 2020 first, second, and third quarter gross receipts were approximately 48%, 83%, and 92% of its 2019 first, second, and third quarter gross receipts, respectively. Accordingly, Employer I had a significant decline in gross receipts commencing on the first day of the first calendar quarter of 2020 (the calendar quarter in which gross receipts were less than 50% of the same quarter in 2019) and ending on the first day of the third calendar quarter of 2020 (the quarter following the quarter for which the gross receipts were more than 80% of the same quarter in 2019). Thus, Employer I is entitled to a retention credit with respect to the first and second calendar quarters.

Qualified Wages

- Qualified Wages
  - Qualified wages are wages (as defined in Section 3121(a)) and compensation (as defined in Section 3231(e)) paid by an Eligible Employer.
  - Qualified wages include the Eligible Employer's qualified health plan expenses that are properly allocable to the wages.
  - The definition of qualified wages depends, in part, on the average number of full-time employees (as defined in Section 4980H) employed by the Eligible Employer during 2019.
- Qualified wages for any employee cannot exceed the amount the employee would have been paid for working the same duration during the 30 days preceding the period
- Qualified wages are capped for each employee at $10,000 TOTAL, for all quarters.

Qualified Wages Cont'd

- The determination of an employer's full-time equivalent employees is critical in computing the ERC. The key is: is it 1) 100 or fewer, or 2) over 100?
- The term "full-time employee" (FTE) means an employee who, with respect to any calendar month in 2019, had an average of at least 30 hours of service per week or 130 hours of service in the month (130 hours of service in a month is treated as the monthly equivalent of at least 30 hours of service per week), as determined in accordance with section 4980H of the Internal Revenue Code.
- An employer that operated its business for the entire 2019 calendar year determines the number of its full-time employees by taking the sum of the number of full-time employees in each calendar month in 2019 during which it was in business and dividing that number by the number of months.
- An employer that started its business operations during 2020 determines the number of its full-time employees by taking the sum of the number of full-time employees in each full calendar month in 2020 in which the employer operated its business and dividing by that number of months, consistent with the approach discussed above for employers that began business operations during 2019.

RubinBrown

Qualified Wages Cont'd

- If the Eligible Employer averaged more than 100 FTEs in 2019, qualified wages are the wages paid to an employee for time that the employee is not providing services due to an economic hardship, specifically, either (1) a full or partial suspension of operations by order of a governmental authority due to COVID-19, or (2) a significant decline in gross receipts. In simpler terms, if you have more than 100 FTEs in 2019, you have to be paying people NOT TO WORK during an eligible quarter.
- For employers with more than 100 FTEs, qualified wages taken into account for an employee may not exceed what the employee would have been paid for working an equivalent duration during the 30 days immediately preceding the qualifying quarter.
- An eligible employer that averaged more than 100 FTEs in 2019 may not treat as qualified wages amounts paid to employees for paid time off for vacations, holidays, sick days or other days off. These amounts were accrued prior to the eligible quarter.

RubinBrown

Qualified Wages Cont'd

- If the Eligible Employer averaged 100 or fewer FTEs in 2019, qualified wages are all wages paid to any employee during any quarter described in Scenario 1 or 2.

Qualified Wages Cont'd

- This is the big difference when determining the ERC:
  - More than 100 FTEs in 2019: you only include wages paid to people NOT TO WORK;
  - Less than or equal to 100 FTEs in 2019, you include wages paid to ALL EMPLOYEES, regardless of whether they are working or not.

Qualified Wages Cont'd

- **Example**: Employer P is a local chain of full service restaurants in State X that averaged more than 100 FTEs in 2019. State X forced P to discontinue sit-down service to customers for Q2 and Q3 of 2020. P continues to pay its kitchen staff to come in a prepare food every day. It also pays its wait staff to stay at home and not work. Even though P had its operations partially suspended, because P has more than 100 FTEs for 2019, only those wages paid to employees NOT TO WORK are eligible for the credit. The amount P pays its kitchen staff to cook are not eligible for the ERC. The wages paid to the wait staff, however, are eligible wages.
- Example. In the example above, if P had less than 100 average monthly FTEs in 2019, ALL wages paid during Q2 and Q3 to ALL employees would be eligible for the credit.
- **Example**: If Employer P in the above example averaged more than 100 FTEs in 2019 and was forced to discontinue sit-down service for Q2 and Q3 and cut all employees hours to 20% of normal but still paid them 100% of normal pay, the 20% paid to provide services is NOT eligible for the credit but the 80% P continued to pay them to NOT work is eligible for the credit.

Aggregated Groups

- An Eligible Employer, for purposes of the Employee Retention Credit, includes all members of an aggregated group that are treated as a single employer under Sections 52 or 414.
- As a result, these employers must be aggregated for purposes of the following rules applicable to the Employee Retention Credit:
  - Determining whether the employer has a trade or business operation that was fully or partially suspended due to orders related to COVID-19 from an appropriate governmental authority.
  - Determining whether the employer has a significant decline in gross receipts.
  - Determining whether the employer has more than 100 full-time employees
- The amount of the Employee Retention Credit must be apportioned among members of the aggregated group on the basis of each member's proportionate share of the qualified wages giving rise to the credit.

Employee Retention Credit-Changes for 2020

- Now that Section 2301(j) has been removed from the CARES Act and PPP borrowers can claim the ERC, ground rules are needed to avoid claiming a credit and forgivable expenses for the same amounts.
- Section 206(c)(1) amends the definition of forgivable PPP payroll costs in Section 7A(a)(12) of the Small Business Act by adding, "Such payroll costs shall not include qualified wages taken into account in determining the credit allowed under Section 2301 of the CARES Act or qualified wages taken into account in determining the credit allowed under subsection (a) or (d) of section 303 of the Taxpayer Certainty and Disaster Relief Act of 2020."
- Stated in another way, this Section 206(c) established an important ordering rule: any payroll costs – W-2 wages or health care costs – for which a taxpayer claims an ERC (or a new disaster ERC as allowed by the latest bill) are NOT eligible to be forgiven as part of the PPP process. Thus, while a taxpayer may BOTH claim the ERC and borrow a PPP loan, they cannot do it on the SAME wages or health care costs, and the priority goes to the ERC rather than the PPP.

RubinBrown

Employee Retention Credit-Changes for 2020

- Section 2301(g)(1) will allow a taxpayer to elect to not include certain wages and allocable health care costs in the computation of the ERC credit. Clearly, this would be done so as to preserve those costs for PPP forgiveness.
- Section 2301(g)(2) is then further amended to require the SBA to issue guidance providing that if a taxpayer elects under Section 2301(g)(1) to count wages for PPP forgiveness rather than the ERC credit, if it turns out that PPP payroll costs are NOT forgiven, the payroll costs can STILL be treated as qualified wages for purposes of the ERC.

RubinBrown

Employee Retention Credit-Changes for 2020

- Putting it all together, assume a taxpayer borrowed $100,000 as a PPP loan on April 3, 2020. During the second and third quarters of 2020, the taxpayer has “eligible quarters” and is thus eligible for the ERC. Over the 24-week covered period, the taxpayer spends $80,000 on W-2 wages and qualified health care costs and $20,000 on rent. Included in those wages are $40,000 of qualified wages eligible for the ERC. The taxpayer would rather have the $40,000 in payroll costs forgiven than claim an ERC on those amounts. The general rule of new Section 7A(a)(12), however, provides that the $40,000 of qualified wages are eligible for the ERC, and are NOT eligible to be forgiven.
- The taxpayer may then elect, however, under Section 2301(g)(1) to treat the $40,000 of qualified ERC wages as “payroll costs” for purposes of PPP forgiveness. If the loan is fully forgiven, no ERC can be claimed on the $40,000 of wages. It appears, however, that if the loan is eventually not forgiven, Section 2301(g)(2) and future guidance from the SBA will allow the $40,000 of qualified wages to revert BACK to the ERC and be eligible for the credit.

RubinBrown

Employee Retention Credit-Changes for 2020

- If the taxpayer had previously applied for forgiveness, how do they make the election under Section 2301(g) to count the payroll costs in the PPP forgiveness that has already been applied for?
- I don’t see where Section 206 accommodates a situation in which a business has ALREADY FILED for forgiveness in 2020 and now wants to claim the ERC. I presume the business is treated as having made the election under Section 2301(g)(1) to have passed the payroll costs on from the ERC to the PPP, and are no longer eligible for the credit?

RubinBrown

Employee Retention Credit-Changes for 2021

- Section 207(a)(1) extends the ending date for the ERC from December 31, 2020 to June 30, 2021.
- The section then makes a series of computational changes to the credit that apply only for 2021; they are NOT retroactive to 2020.

RubinBrown

Employee Retention Credit-Changes for 2021

- **Old**: For 2020, Section 2301(a) of the CARES Act allowed an employer to claim a credit of 50% of qualified wages.
- **New**: For 2021, Section 207(b) amends Section 2301(a) of the CARES Act and increases the credit percentage from 50% to 70%.
- **Old**: For 2020, Section 2301(b)(1) of the CARES Act capped the "qualified wages" that could be paid to any one employee at $10,000 for ALL quarters.
- **New**: For 2021, Section 207(c) amends Section 2301(b)(1) of the CARES Act and increases the maximum amount of creditable, qualified wages to $10,000 for ANY quarter. Thus, in 2020, if A were paid $10,000 in Q3 and $10,000 in Q4, the resulting credit would be $5,000 (capped at 50% of $10,000 in wages TOTAL). In 2021, however, if A were paid $10,000 in Q1 and $10,000 in Q2, the resulting credit would be $14,000, 70% of $10,000 wages for EACH QUARTER).

RubinBrown

Employee Retention Credit-Changes for 2021

- **Old:** To be eligible for a credit, an employer needed to experience at least one quarter in 2020 in which 1) operations were fully or partially suspended by government order, or 2) the business experienced a precipitous drop in gross receipts. More specifically, Section 2301(c)(2)(A)(ii)(II) provided that the latter requirement was met if during 2020, the business experienced a quarter in which gross receipts were less than 50% of the receipts in the same quarter in 2019. From that point on, every subsequent quarter was also an eligible quarter until the END of the first quarter in which gross receipts exceeded 80% of the receipts from the same quarter in 2019.
- **New:** Section 207(d)(1) makes significant changes to the gross receipts test of Section 2301(c)(2)(A)(ii)(II). For 2021, the test is satisfied for any quarter of the first half of 2021 in which gross receipts is less than 80% of the same quarter in 2019. Thus, in the first quarter of 2021, a business would compare its receipts in that quarter to the first quarter of 2019, NOT the first quarter of 2020. The comparison to 2019 rather than 2020 makes a lot more sense when we move on to Q2 of 2021, because in all likelihood, gross receipts for Q2 of 2019 will be significantly higher than those of Q2 of 2020, such that a comparison to 2019 will make it much easier to establish an eligible quarter.
- If, however, a business did not exist at the beginning of the same quarter of 2019, the same quarter in 2020 is substituted.

Employee Retention Credit-Changes for 2021

- Section 207(d)(2) then gives businesses – for 2021 only – the option to elect to satisfy the gross receipts test by looking at the immediately preceding calendar quarter, and comparing that quarter to the corresponding quarter in 2019. To illustrate, an employer who could not satisfy the gross receipt test in Q1 of 2021 could nonetheless have an eligible quarter for that stretch of time by electing to compare gross receipts in Q4 of 2020 to Q4 of 2019. If there is a drop of more than 20% quarter-over-quarter, Q1 of 2021 will be an eligible quarter.
- At this time, it is not clear if the election is permanent; requiring the employer to then determine whether an eligible quarter exists for Q2 of 2021 by looking to Q1 receipts, but that seems illogical, as in the example above, had Q1 been an eligible quarter in its own right, the need would not have arisen to make the election for that quarter. In all likelihood, the election will be made quarter-by-quarter.

Employee Retention Credit-Changes for 2021

- **Old**: For 2020, under Section 2301(c)(3)(A) of the CARES Act, the definition of “qualified wages” hinged on whether the business had more than 100 full-time equivalent employees in 2019 as determined under Section 4980H. If the business had MORE than 100 FTEs, only wages paid to employees not to provide services during an eligible quarter were “qualified wages.” If the business had fewer than 100 FTEs, however, then ALL wages paid to employees during an eligible quarter (or eligible part of quarter if the business were only shut down for a portion of the quarter) were “qualified wages.” For examples of this differing treatment, please read the link from the beginning of this article.
- **New**: For 2021, Section 207(e) increases the threshold number of employees before a change in treatment arises from 100 to 500.
  - Importantly, Section 207(e)(2) then strikes Section 2301(c)(3)(B) of the CARES Act, which had previously capped qualified wages paid to any one employee at what the employee would have been paid for working an equivalent duration during the 30-day period immediately before the eligible quarter in which wages were paid.
  - Stated in English, this rule prevented an employer from artificially inflating the ERC by increasing pay to an employee during an eligible quarter. That rule no longer exists, meaning an employer could pay bonuses to an employee and increase the credit, subject to the $10,000 per quarter cap, of course.

Employee Retention Credit-Changes for 2021

- Section 207(g) then adds an entirely new component to the ERC regime for 2021: the ability for small employers to receive the credit – which is typically taken by reducing required payroll tax deposits — in ADVANCE.
- If an employer has fewer than 500 FTEs, it may elect for any calendar quarter to receive an advance payment of the credit for that quarter in an amount not to exceed 70% of the average quarterly wages paid by the employer in 2019.
- As one would expect, the advance credit would then need to be reconciled against the actual credit, a process we’ve gotten used to with the premium tax credit received when acquiring health insurance on a state exchange. If the advance payments end up exceeding the actual credit due, the employer’s payroll tax is increased for the calendar quarter by the excess.

Employee Retention Credit-Changes for 2021

- Example: In 2020, X Co. has gross receipts for Q2, Q3 and Q4 of $100,000, $120,000 and $150,000. In 2019, X Co. had gross receipts for Q2, Q3 and Q4 of $210,000, $155,000 and $180,000. Gross receipts in Q2 dropped by more than 50% when compared to Q2 of 2019, and were then at 77% for Q3 and 83% for Q4. Because eligible quarters for 2020 start once receipts drop by more than 50% and continue until the END of a quarter in which receipts exceed 80% of the receipts for the same quarter in 2019, each quarter is an eligible quarter. X Co. has fewer than 100 FTEs, and during those quarters, paid salary to employees in the following sums:

	Q2	Q3	Q4
A	$8,000	$7,000	$10,000
B	$12,000	$10,000	$11,000
C	$4,000	$,4,000	$4,000
D	$2,000	$2,000	$2,000

- In Q2, X Co. has $24,000 in qualified wages ($8,000 + $10,000 + $4,000 + $2,000). B is topped out and disqualified for the rest of 2020, because in 2020, the maximum amount of qualified wages for any one employee is $10,000 for ALL quarters. In Q3, X Co. has $8,000 in qualified wages ($2,000 + $0 + $4,000 + $2,000). A is now topped out and disqualified for the rest of 2020. In Q4, X Co. has $4,000 in qualified wages ($0 + $0 + $2,000 + $2,000). C was topped out during the quarter. The total credit is $18,000 (50% * $36,000).

Employee Retention Credit-Changes for 2021

- In 2021, X Co. has gross receipts in Q1 of $140,000 in Q1 and Gross receipts in Q1 and Q2 of 2019 were $180,000 and $210,000 respectively. Because gross receipts for each of Q1 and Q2 in 2021 were less than 80% of the receipts for the same quarters in 2019, both quarters are eligible quarters. During Q1 and Q2, X Co. paid its employees as follows:

	Q1	Q2
A	$8,000	$7,000
B	$12,000	$14,000
C	$4,000	$,4,000
D	$6,000	$6,000

- In Q1, X Co. has $28,000 in qualified wages ($8,000 + $10,000 + $4,000 + $6,000). In Q2, X Co. has $27,000 in qualified wages ($7,000 + $10,000 + $4,000 + $6,000). As opposed to 2020, B has eligible wages even after being paid $10,000 in a previous quarter, because the limit is now $10,000 per employee PER QUARTER. The total credit is $38,500 (70% * $55,000). The credit is DOUBLE what it was for 2020, despite the fact that 2021 has only two qualifying quarters, while 2020 had three.

PPP Forgiveness and Second Round

CERTIFIED PUBLIC ACCOUNTANTS
& BUSINESS CONSULTANTS

RubinBrown

Paycheck Protection Program Changes: Existing Round

- The bill reopens the original Paycheck Protection Program by earmarking $35 billion for those who have not yet borrowed.
- For those who have already partaken, the bill makes several changes to the existing program; unfortunately, <u>if a taxpayer has already applied for forgiveness, the rules discussed below will NOT apply</u>. If a borrower has not yet applied for forgiveness yet, however, the below changes are all in play.

RubinBrown

Paycheck Protection Program Changes: Deductibility of Expenses

- Ever since the IRS published Notice 2020-32, borrowers and tax professionals alike have put their faith in Congress to overrule the Service and provide a double benefit: tax-free forgiveness of loan proceeds AND deductible expenses paid with PPP funds.
- Section 276 of Division N of the latest bill does just that, providing that “no deduction shall be denied or reduced, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income.”
- Importantly, this rule applies to ALL borrowers; even those who have already applied for forgiveness. Thus, expenses paid with PPP funds are now completely deductible.
- Consider, however, WHEN does the basis increase relating to the exclusion from income arise? If it is not until the loan is forgiven – 2021 in most cases – might the taxpayer incur losses in 2020 that cannot be utilized because of a lack of basis?

Paycheck Protection Loans

- Loan forgiveness feature: Section 1106 of the CARES Act, as modified by the PPP Flexibility Act: If the PPP is used for its intended purposes, the first 24 weeks worth of certain payments shall be eligible for forgiveness on a tax-free basis (1106(b); 1106(i))
- What payments are covered during the covered period?
  - Payroll costs
  - Interest on a mortgage on real or personal property incurred before February 15, 2020 (does not include any prepayment or payment of principal)
  - Rent for a lease in force before February 15, 2020
  - Certain utilities (electricity, gas, water, transportation, telephone, or internet access) for which service started before February 15, 2020
  - Four new expenses were just added by the Consolidated Appropriations Act, 2021:

Paycheck Protection Program Changes: Existing Round

- Four new expenses eligible for use/forgiveness
- **Covered operations expenditures**. Payments for any business software or cloud computing service that facilitates business operations, product or service delivery, the processing, payment, or tracking of payroll expenses, human resources, sales and billing functions, or accounting or tracking of supplies, inventory, records and expenses.
- **Covered property damage costs**. Costs related to property damage and vandalism or looting due to public disturbances that occurred during 2020 that was not covered by insurance or other compensation.
- **Covered supplier cost**. An expenditure made by an entity to a supplier of goods that are:
  - Essential to the operations of the entity at the time at which the expenditure is made, or
  - Is made pursuant to a contract, order, or purchase order that was either:
    - in effect at any time before the covered period with respect to the loan, or
    - with respect to perishable goods, in effect before or at any time during the period.

53 RubinBrown

Paycheck Protection Program Changes: Existing Round

- **Covered worker protection**. These are operating or capital expenditures that are required to facilitate the adaptation of the business activities of an entity to comply with requirements established or guidance issued by the Department of Health and Human Services, the CDC, or OSHA during the period beginning on March 1, 2020 and ending on the date on which the national emergency declared by the President under the National Emergencies Act expires. Eligible costs are those related to the maintenance of standards for sanitation, social distancing, or any other worker or customer safety requirement related to Covid–19. The term includes:
  - The purchase, maintenance, or renovation of assets that create or expand a drive-through window facility; an indoor, outdoor, or combined air or air pressure ventilation or filtration system; a physical barrier such as a sneeze guard; an indoor, outdoor, or combined commercial real property; an onsite or offsite health screening capability; or other assets relating to the compliance with the requirements of certain protective guidance.
  - The purchase of covered materials described in section 328.103(a) of title 44, Code of Federal Regulations, or any successor regulation; particulate filtering facepiece respirators approved by the National Institute for Occupational Safety and Health, including those approved only for emergency use authorization; or 0ther kinds of personal protective equipment, as determined by the Administrator in consultation with the Secretary of Health and Human Services and the Secretary of Labor.
- Not included in the definition of covered worker protection costs, however, are residential real property or intangible property.

54 RubinBrown

Paycheck Protection Program Changes: Covered Period

- Previously, there were only two options for a covered period: 8 or 24 weeks. The Consolidated Appropriations Act, 2021, however, gives a borrower the right to choose ANY covered period beginning on the date a borrower receives the loan and ending on a date selected by the borrower during the period—
  - beginning on the date that is 8 weeks after such date of origination; and
  - ending on the date that is 24 weeks after such date of origination.
- Or stated in a simpler manner, a borrower is no longer locked into an 8 or 24 week period; instead, they can choose any period lasting BETWEEN 8 and 24 weeks as well.
- If a borrower chooses a different period, the maximum forgivable payroll costs must be prorated over the appropriate period (for example, a rank and file employee is no longer allowed to be paid a maximum of $46,154 if you use a covered period of less than 24 weeks. If you used 12 weeks, it would be half that amount).

Paycheck Protection Program Changes: Loans < $150,000

- This one is important: The bill delivers long-rumored streamlined forgiveness for loans of less than $150,000. These borrowers will only be required to submit a one-page online or paper form, and will only be subject to audit if they commit fraud or use the proceeds for improper purposes. It appears a small borrower will not be subjected to the required reductions in forgiveness amounts generally caused by slashing salaries or slashing headcount.

Paycheck Protection Program Changes: Second Round

- In addition to expanding upon the first tranche of PPP loans, the bill creates a SECOND round of loans at Section 7(a)(37) of the Small Business Act (the original PPP loans were at Section 7(a)(36)) for those who have already borrowed and fully extinguished their original PPP proceeds by the expected date of the disbursement of the second draw of PPP proceeds.
- For these borrowers, the loan is generally determined by multiplying 2.5 by the average monthly payroll for 2019, limited to $2 million.
- In addition, hard hit businesses in the hospitality industry – think: bars, restaurants and hotels – will be permitted to borrow 3.5 times average monthly payroll, again limited to $2 million. Additional computational rules are provided for seasonal employers.

57

RubinBrown

Paycheck Protection Program Changes: Second Round

- Eligibility for a second round of borrowing is more stringent than before.
  - A borrower will have to have fewer than 300 employees (down from 500), and be able to establish, in general, that they experienced a 25% drop in gross receipts during a quarter in 2020 relative to that same quarter in 2019.
    - According to the latest IFR, a business whose TOTAL receipts for 2020 is less than 75% of TOTAL 2019 receipts is also eligible; thus, no need to determine receipts by quarter.
  - Any business that has more than one physical location and that employs not more than 300 employees per physical location is eligible to receive a second draw PPP loan if it is assigned a NAICS code beginning with 72 at the time of loan disbursement and otherwise meets the eligibility criteria.
  - The same affiliation rules apply a PPP1.

RubinBrown

Paycheck Protection Program Changes: Second Round

- Eligible entities must be businesses, certain non-profit organizations, housing cooperatives, veterans' organizations, tribal businesses, self-employed individuals, sole proprietors, independent contractors, and small agricultural co-operatives.
- Ineligible entities include: entities listed in regulations at 13 C.F.R. 120.110, and except for nonprofits and religious organizations; entities involved in political and lobbying activities, entities affiliated with entities in the People's Republic of China; registrants under the Foreign Agents Registration Act; and entities that receive a grant under the Shuttered Venue Operator Grant program.

59

RubinBrown

Paycheck Protection Program Changes: Second Round

- Gross receipts do not include any forgiven PPP proceeds from round 1.
- Gross receipts includes all revenue in whatever form received or accrued (in accordance with the entity's accounting method) from whatever source, including from the sales of products or services, interest, dividends, rents, royalties, fees, or commissions, reduced by returns and allowances.
- Generally, receipts are considered "total income" (or in the case of a sole proprietorship, independent contractor, or self-employed individual "gross income") plus "cost of goods sold," and excludes net capital gains or losses as these terms are defined and reported on IRS tax return forms.
- Gross receipts do not include the following: taxes collected for and remitted to a taxing authority if included in gross or total income (such as sales or other taxes collected from customers and excluding taxes levied on the concern or its employees); proceeds from transactions between a concern and its domestic or foreign affiliates; and amounts collected for another by a travel agent, real estate agent, advertising agent, conference management service provider, freight forwarder or customs broker. All other items, such as subcontractor costs, reimbursements for purchases a contractor makes at a customer's request, investment income, and employee-based costs such as payroll taxes, may not be excluded from gross receipts.

RubinBrown

Paycheck Protection Program Changes: Second Round

- The loan is generally determined by multiplying 2.5 by the average monthly payroll for 2019 or 2020, limited to $2 million. A business can also elect to use the precise 12-month period prior to the application.
  - Payroll costs are defined in the same manner as PPP1.
- In addition, hard hit businesses in the hospitality industry – think: bars, restaurants and hotels – will be permitted to borrow 3.5 times average monthly payroll for 2019 or 2020, again limited to $2 million.
- Schedule C/no employees & partnerships generally compute the same way as PPP1, except with the choice of using 2019 or 2020.
- Additional computational rules are provided for seasonal employers and businesses that di not exist during the 1-year period preceding February 15, 2020.
- Businesses that are part of a single corporate group are limited to $4 million in the aggregate.
- Applications are to be submitted on Form 2483-SD.

61

RubinBrown

Paycheck Protection Program Changes: Second Round

- For eligible new borrowers, the covered period will be a choice of any stretch of time beginning on the date of disbursement and ending between 8 and 24 weeks later.
- Like the first round of loans, proceeds can be used on payroll costs, rent, utilities, mortgage principal interest, and the four new eligible buckets of expenses discussed above.
- Because PPP borrowers may now also claim the Employee Retention Credit, any wages for which a credit is computed will not be treated as forgivable payroll costs for purposes of the PPP.

62

RubinBrown

Paycheck Protection Program Changes: Second Round

- Once again, the amount of forgiveness attributable to non-payroll costs cannot exceed 40% of the total amount forgiven. Under the bill, however, the final forgiveness amount will no longer be reduced by any EIDL grant received.

CARES Act Provisions/As Modified by the Consolidated Appropriations Act, 2021.

CERTIFIED PUBLIC ACCOUNTANTS
& BUSINESS CONSULTANTS

Key Dates

- ~~6/30/20- Deadline to fax Form 1045/1139 from 2018 NOLs (Notice 2020-26);~~
- ~~7/15/20- Postponed due date for returns (Notice 2020-18, amplified by Notice 2020-23)~~
- ~~7/27/20- Amended return due to carry back or waive carryback for fiscal year NOL for year straddling December 31, 2017.~~
- ~~9/30/20- Deadline to amend Form 1065 for BBA partnerships for tax years beginning in 2018 or 2019 (Rev. Proc. 2020-23)~~
- ~~9/30/20- Deadline to provide amended K-1s to partners by partnerships applying proposed GILTI regulations under § 1.951A-5 (Rev. Proc. 2020-23 and Notice 2019-46)~~
- 10/15/21- Amended returns applying guidance on QIP (Rev Proc 2020-25)
- 10/15/21- Deadline to withdraw election from § 163(j)(7) electing as a real property T/B (Rev Proc 2020-22)
- 12/31/21- First 50% of ER portion of SS tax due under payroll tax deferral under CARES ACT § 2302 (IRS FAQ)
- 12/31/22- - Second 50% of ER portion of SS tax due under payroll tax deferral under CARES ACT § 2302 (IRS FAQ)

RubinBrown

Qualified Improvement Property Fix

RubinBrown

Qualified Improvement Property

- Qualified Improvement Property is any improvement to the interior portion of a building that is a nonresidential real property.
  - Section 2307(a)(1)(B) of the CARES Act amended the definition of qualified improvement property in section 168(e)(6) by providing that the improvement must be "made by the taxpayer."
  - More importantly, the CARES Act made a technical correction to provide qualified improvement property with a 15-year life (20 years for ADS) retroactive to 2018.

Qualified Improvement Property

- Preamble to 2020 Final Regulations: The Treasury Department and the IRS believe that an improvement is <u>made by the taxpayer</u> if the taxpayer makes, manufactures, constructs, or produces the improvement for itself or if the improvement is made, manufactured, constructed, or produced for the taxpayer by another person under a written contract. In contrast, if a taxpayer acquires nonresidential real property in a taxable transaction and such nonresidential real property includes an improvement previously placed in service by the seller of such nonresidential real property, the improvement is not made by the taxpayer.

Qualified Improvement Property

- **Example**. G, a calendar-year taxpayer, owns an office building for use in its trade or business and G placed in service such building in 2000. In November 2018, G made and placed in service an improvement to the inside of such building at a cost of $100,000. In January 2019, G entered into a written contract with H for H to construct an improvement to the inside of the building. In March 2019, H completed construction of the improvement at a cost of $750,000 and G placed in service such improvement. Both the improvement to the office building made by G in November 2018 and the improvement to the office building that was constructed by H for G in 2019 are improvements made by G under § 1.168(b)-1(a)(5)(i)(A). Further, each improvement is made to the inside of the office building, is section 1250 property, and is not described in § 1.168(b)-1(a)(5)(ii). As a result, each improvement meets the definition of qualified improvement property in section 168(e)(6) and § 1.168(b)-1(a)(5)(i)(A) and (a)(5)(ii). Accordingly, each improvement is 15-year property under section 168(e)(3) and is described in § 1.168(k)-2(b)(2)(i)(A). Assuming all other requirements of this section are met, each improvement made by G qualifies for the additional first year depreciation deduction for G under this section.

Rev. Proc. 2020-25
Options for QIP

- Bonus Depreciation. Rev. Proc. 2020-25 allows a taxpayer to change its depreciation under § 168 for qualified improvement property placed in service by the taxpayer after December 31, 2017, in its tax year ending in 2018, 2019, or 2020.

- Rev. Proc. 2020-25 provides that a taxpayer changing the depreciation of qualified improvement property to the depreciation method, recovery period, and convention required by statutory amendments made by the CARES Act is changing from an impermissible method of accounting to a permissible method of accounting.
  - Similarly, a change from not claiming to claiming the additional first-year depreciation deduction under § 168(k) for qualified improvement property that is within the scope of Rev. Proc. 2020-25 and is eligible for the additional first-year depreciation deduction is a change from an impermissible method of accounting to a permissible method of accounting.

Rev. Proc. 2020-25
Options for QIP

- A taxpayer may change from the impermissible method of determining depreciation to the permissible method by filing an amended return, a Form 3115, "Application for Change in Accounting Method," or an administrative adjustment request. (If the taxpayer files a Form 3115 the method change is DCN 244 and qualifies for automatic consent. There is no fee charged.)
- **Option 1:** The first way is through filing an amended return. Amended returns applying this guidance are due on or before October 15, 2021, but in no case later than the statute of limitations on assessment which is generally three years from the due date of the return. The amended return must include the adjustment to taxable income for the QIP change to depreciation, and any ancillary adjustments. The adjustments must also be made for taxable years after the adjustment that are affected.
- A BBA partnership that is temporarily permitted to file amended returns for 2018 and 2019 pursuant to Rev. Proc. 2020-23 must do so by September 30, 2020. A BBA partnership that chooses to instead file an Administrative Adjustment Request (AAR) to claim benefits attributable to 2018 or 2019 must do so before October 15, 2021.

RubinBrown

71

Rev. Proc. 2020-25
Options for QIP

- **Option 2:** The second option involves filing a Form 3115 with a timely-filed tax return and making a Section 481(a) adjustment on that return as an automatic change. A single Form 3115 may be used if changes are being made to multiple assets. The year of change must go on the Form 3115 per Rev. Proc. 2015-13. The automatic accounting method change number that should be used is 244. Taxpayers applying this Rev. Proc. only need to fill out the following sections of the Form 3115:
  - The identification section of page 1 (above Part I);
  - The signature section at the bottom of page 1;
  - Part I;
  - Part II, all lines except lines 11, 12, 13, 15, 16, 17, and 19;
  - Part IV, all lines; and
  - Schedule E, all lines except lines 1, 4b, 5, and 6.
- Generally, an impermissible method of accounting must be treated by the taxpayer consistently for two or more years before it is adopted. This Rev. Proc. allows QIP placed in service only one year before the year of change to be eligible to participate in either filing a Form 3115, or an amended return/AAR.

RubinBrown

72

Rev. Proc. 2020-25
Options for QIP

- **Rev. Proc. 2020-25 also generally allows a taxpayer to make a late election, or to revoke or withdraw an election under § 168(g)(7) (election to use ADS), (k)(5) (bonus for certain plants), (k)(7) (election out of bonus), or (k)(10) (election to use 50% instead of 100% bonus) for the taxpayer's 2018, 2019, or 2020 tax year, by filing either:**
  - An amended federal income tax return or amended Form 1065, "U.S. Return of Partnership Income," for the placed-in-service year of the property on or before October 15, 2021, but not later than the applicable period of limitations on assessment for the tax year for which the amended return is being filed; or
  - A Form 3115 with the taxpayer's timely filed original federal income tax return or Form 1065 for the taxpayer's first or second tax year succeeding the tax year in which the taxpayer placed the property in service, or that is filed on or after April 17, 2020, and on or before October 15, 2021. This method change also qualifies for the automatic consent procedures and is designated as a DCN 245.

RubinBrown

Changes to Interest Limitation Rules

RubinBrown

Rev. Proc. 2020-22
Business Interest Expense Election

- Rev. Proc. 2020-22 deals with:
  - Withdrawing a § 163(j)(7) election made in 2018 or 2019 to treat a business as a real property trade or business not subject to Section 163(j),
  - Making a late § 163(j)(7) election for 2018 or 2019 to treat a business as a real property trade or business not subject to Section 163(j),
  - Making an election out of the ability to use a 50% of ATI limitation for 2019 and 2020 (for partnerships, only for 2020).
  - Making an election under § 163(j)(10) to use the 2019 ATI for 2020 rather than using the 2020 ATI to calculate the deduction for business interest, as well as
  - A special provision which allows a partner to elect out of the partnership's treatment of business interest under § 163(j) in 2019.

RubinBrown

Rev. Proc. 2020-22
Business Interest Expense Election

- Option 1: Revoking a prior Section 163(j)(7) election.
  - One of the reasons that a real property trade or business might be interested in withdrawing an election under § 163(j)(7) is that if it elected out, the real property trade or business is limited to calculating depreciation on its assets over the class life of the property (see § 168(g)(8)).
    - Section 168(k)(9) specifically provides that bonus depreciation is not available to a real property trade or business which has elected out of the business interest expense treatment under § 163(j)(7).
    - Because QIP is now eligible for bonus depreciation (more on this later), a real property trade or business that previously elected out of § 163(j) might now wish to withdraw the election in order to take bonus depreciation on QIP property.

RubinBrown

Rev. Proc. 2020-22
Business Interest Expense Election

- A taxpayer will be treated as if the § 163(j)(7) election was never made if the taxpayer withdraws the election.
- Time and manner for withdrawing a § 163(j)(7) election. A taxpayer that wishes to withdraw an election for a 2018, 2019, or 2020 taxable year must timely file an amended Federal income tax return, amended Form 1065, or AAR, as applicable, for the taxable year in which the election was made, with an election withdrawal statement.
  - Except as provided in Rev. Proc. 2020-23, the amended Federal income tax return or amended Form 1065 must be filed on or before October 15, 2021, but in no event later than the applicable period of limitations on assessment for the taxable year for which the amended return is being filed.
  - In the case of a BBA partnership that chooses not to file an amended Form 1065 as permitted under Rev. Proc. 2020-23, the BBA partnership may withdraw the § 163(j)(7) election by filing an AAR on or before October 15, 2021, but in no event later than the applicable period of limitations on making adjustments under § 6235 under Prop. Reg. § 301.6241-1(a)(8).
  - The amended Federal income tax return, amended Form 1065, or AAR, as applicable, must include the adjustment to taxable income for the withdrawn § 163(j)(7) election and any collateral adjustments to taxable income or to tax liability, including any adjustments under § 481.

RubinBrown

Rev. Proc. 2020-22
Business Interest Expense Election

- Time and manner for withdrawing a § 163(j)(7) election.
  - A taxpayer also must file amended Federal income tax returns, amended Forms 1065, or AARs, as applicable, including such collateral adjustments, for any affected succeeding taxable years.
  - An example of such collateral adjustments is the amount of depreciation allowed or allowable in the applicable taxable year for the property to which the withdrawn election applies.

RubinBrown

Rev. Proc. 2020-22
Business Interest Expense Election

- Section 163(j)(7) election withdrawal statement contents. The election withdrawal statement should be titled, “Revenue Procedure 2020-22 § 163(j)(7) Election Withdrawal.” The election withdrawal statement must contain the taxpayer’s name, address, and SSN or EIN, and must state that, pursuant to Rev. Proc. 2020-22, the taxpayer is withdrawing its election under § 163(j)(7)(B) or 163(j)(7)(C).

Rev. Proc. 2020-22
Business Interest Expense Election

- Depreciation. A taxpayer that is withdrawing a prior § 163(j)(7) election must determine its depreciation for the property that is affected by the withdrawn election in accordance with § 168 on the amended Federal income tax returns, amended Forms 1065, or AARs, as applicable.

Rev. Proc. 2020-22
Business Interest Expense Election

- Option #2: Making a late § 163(j)(7) election.
  - Time for making a late § 163(j)(7) election.
    - A taxpayer may make the § 163(j)(7) election for a 2018, 2019, or 2020 taxable year by filing an amended Federal income tax return, amended Form 1065, or AAR, as applicable.
    - Except as provided in Rev. Proc. 2020-23, regarding the time to file an amended return by a partnership subject to the centralized partnership audit regime enacted as part of the Bipartisan Budget Act of 2015 (BBA partnership) for 2018 and 2019 taxable years, the amended Federal income tax return or amended Form 1065 must be filed on or before October 15, 2021, but in no event later than the applicable period of limitations on assessment for the taxable year for which the amended return is being filed.
    - In the case of a BBA partnership that chooses not to file an amended Form 1065 as permitted under Rev. Proc. 2020-23, the BBA partnership may make a late § 163(j)(7) election by filing an AAR on or before October 15, 2021, but in no event later than the applicable period of limitations on making adjustments under § 6235 for the reviewed year (see Reg. § 301.6241-1(a)(8)).

RubinBrown

Rev. Proc. 2020-22
Business Interest Expense Election

- Manner of making a late § 163(j)(7) election. A taxpayer must make the election on a timely filed amended Federal income tax return, amended Form 1065, or an AAR, as applicable, with the election statement in accordance with the rules and procedures contained in Prop. Reg. § 1.163(j)-9.
  - The amended Federal income tax return, amended Form 1065, or AAR, as applicable, must include the adjustment to taxable income for the late § 163(j)(7) election and any collateral adjustments to taxable income or to tax liability.
  - Such collateral adjustments also must be made on amended Federal income tax returns, amended Forms 1065, or AARs, as applicable, for any affected succeeding taxable year.
  - An example of such collateral adjustments is the amount of depreciation allowed or allowable in the applicable taxable year for the property to which the late election applies.
  - The taxpayer is subject to all of the other rules and requirements in § 163(j).

RubinBrown

Rev. Proc. 2020-22
Business Interest Expense Election

- Late § 163(j)(7) election statement contents. The election statement must be titled, "Revenue Procedure 2020-22 Late § 163(j)(7) Election." The election statement must contain:
  - The taxpayer's name;
  - The taxpayer's address;
  - The taxpayer's social security number (SSN) or employer identification number (EIN);
  - A description of the taxpayer's electing trade or business, including the principal business activity code; and
  - A statement that the taxpayer is making an election under § 163(j)(7)(B) or 163(j)(7)(C), as applicable.

83

RubinBrown

Rev. Proc. 2020-22
Business Interest Expense Election

- Depreciation. A taxpayer that is making a § 163(j)(7) election must determine its depreciation on the amended Federal income tax returns, amended Forms 1065, or AARs, as applicable, for the property that is affected by the late election using the alternative depreciation system of § 168(g), pursuant to § 168(g)(1)(F) or (G). See also § 163(j)(11).
  - Rev. Proc. 2019-8 explains how to change to the alternative depreciation system for existing property that is affected by the late election.

84

RubinBrown

Changes to Net Operating Loss Rules

Changes to Net Operating Losses

- Old Law:
  - After passage of the TCJA, net operating losses for 2018 and beyond could not be carried back, and when carried forward could only offset 80% of taxable income.
- New Law:
  - Net operating losses for 2018, 2019 and 2020 can be carried back for up to five years and if carried forward, can offset 100% of taxable income.
  - Come 2021, losses from pre-2018 can offset up to 100% of post-2020 taxable income, but losses from 2018 forward can only offset 80% of post-2020 income.
  - Technical correction to TCJA:
    - The TCJA was intended to apply the no carryback/80% limit carryforward rules to tax years BEGINNING after December 31, 2017. Instead, the statutory language applied the rules to tax years ENDING after December 31, 2017.
    - The CARES Act corrects this. Carryback claims for a fiscal year traversing December 31, 2017 can be made or an election to forgo the carryback can be made within 120 days after the enactment of the CARES Act.

IR 2020-67

- COVID relief for taxpayers claiming NOLs.
  - Rev. Proc. 2020-24 provides guidance to taxpayers with net operating losses that are carried back under the CARES Act by providing procedures for:
    - Waiving the carryback period in the case of a net operating loss arising in a taxable year beginning after Dec. 31, 2017, and before Jan. 1, 2021,
    - Fixing the glitch for a fiscal year C corporation with an NOL in 2018.
    - Waiving a carryback period, reducing a carryback period, or revoking an election to waive a carryback period for a taxable year that began before Jan. 1, 2018, and ended after Dec. 31, 2017.

87

RubinBrown

IR 2020-67

- First things first: How to carry back a 2018 NOL via Form 1045 or Form 1139
    - ~~In Notice 2020-26, the IRS granted a six-month extension of time to file Form 1045 or Form 1139, as applicable, with respect to the carryback of a net operating loss that arose in any taxable year that began during calendar year 2018 and that ended on or before June 30, 2019. This opportunity expired on July 15, 2020.~~
    - A taxpayer can still carryback a 2018 NOL via an amended return, however.
  - How to carry back a 2019 NOL
    - File a Form 1045 or 1139 before December 31, 2020.

88

RubinBrown

Rev. Proc. 2020-24
NOLs

- 1. Elections to waive carryback under § 172(b)(3) for NOLs arising in taxable years beginning in 2018 or 2019.
  - A taxpayer may elect under § 172(b)(3) to waive the carryback period for an NOL arising in a taxable year beginning in 2018 or 2019. Such an election must be made no later than the due date, including extensions, for filing the taxpayer's Federal income tax return for the first taxable year ending after March 27, 2020.
  - A taxpayer must make an election by attaching to its Federal income tax return filed for the first taxable year ending after March 27, 2020, a separate statement for each of taxable years 2018 or 2019 for which the taxpayer intends to make the election. The election statement must state that the taxpayer is electing to apply § 172(b)(3) under Rev. Proc. 2020-24 and the taxable year for which the statement applies.
  - Once made, the election is irrevocable.

Rev. Proc. 2020-24
NOLs

- #2/3. NOLs arising in a taxable year beginning before January 1, 2018, and ending after December 31, 2017. Taxpayers with an NOL arising in a taxable year that began before January 1, 2018, and ended after December 31, 2017, who make an application under § 6411(a) on either Form 1045 or Form 1139 with respect to a carryback of such NOL will be treated as having timely filed if the application is filed no later than July 27, 2020.
- If you missed the deadline, you can still carry back the NOL via an amended return.

Opportunity Zone Rules

91

Payroll Tax Deferrals

- Qualified Opportunity Zones
  - The IRS extended certain deadlines and requirements under the qualified opportunity zone program, including the following:
    - The 31-month working capital safe harbor period during which a qualified opportunity zone business can hold nonqualified financial property is extended by as much as 24 months.
    - Any failure by a qualified opportunity fund to meet the 90 percent asset test on a testing date that falls from April 1, 2020 through December 31, 2020 will be treated as due to reasonable cause and will be disregarded.
    - The period from April 1, 2020 through December 31, 2020 is disregarded in determining whether the 30-month test for substantial improvement of property is met.

92

Payroll Tax Deferrals Under the CARES Act

Payroll Tax Deferrals

- Section 2302 of the CARES Act allows employers to defer payment of the 6.2% employer-portion of the Social Security tax.
- The period includes all taxes required to be deposited from March 27, 2020 to December 31, 2020.
- This deferral is automatic and no election is required to be made.
- The deferred Social Security taxes are due in two installments- 50% due on or before December 31, 2021, and the remaining amount due on or before December 31, 2022.

Payroll Tax Deferrals

- Reporting of the deferral will occur on Form 941 for the Quarters 2-4.
  - Draft instructions for Form 941 Quarters 2-4 were released on June 3, 2020.
- Self-employed individuals may also take part in the deferral.
  - The deferral period for self-employed individuals is the same as for Form 941 filers, March 27, 2020 to December 31, 2020.
  - They may reduce their 1040-ES quarterly payments by an amount equal to 50% of the Social Security tax on net earnings from self-employment income.
  - Payment of the deferred portion of the self-employment taxes also occurs in 2021 and 2022.

RubinBrown

Section 163(j)

CERTIFIED PUBLIC ACCOUNTANTS
& BUSINESS CONSULTANTS

RubinBrown

Section 163(j) – In General

- IRC § 163(j) limits a taxpayer's deduction for business interest in any tax year to the sum of
  - the taxpayer's business interest income for the tax year,
  - 30% of the taxpayer's adjusted taxable income (ATI) for the tax year (but not less than zero), and
    - CARES Act: For 2019 and 2020, the 30% is changed to 50%, except in the case of a partnership. A partnership must use 30% for 2019, but uses 50% for 2020. Any business may elect to apply the 30% limitation rather than the 30% limitation for a given year. (Reg. Section 1.163(j)-2(b)(2)).
    - In 2020, a taxpayer may elect to use its 2019 ATI. (Reg. Section 1.163(j)-2(b)(3)). If 2020 is a short period, prorate the 2019 ATI (Ex. 2019 ATI is $100 and 2020 is only 6 months long. 2020 ATI is $50).
  - the taxpayer's floor plan financing interest for the tax year.
- Any business interest that is not allowed as a deduction in the current tax year under the limitation above is carried forward indefinitely and available for potential deduction in a future tax year. (Reg. Section 1.163(j)-2(c)).
- The Section 163(j) limitation applies at the taxpayer level. Thus, the limitation applies at the entity level for partnerships and S corporations

RubinBrown

Section 163(j) – Relevant Guidance

- November 26, 2018: IRS issues proposed regulations
- September 13, 2019: IRS issues final Section 168(k) regulations governing interplay between Section 163(j) and Section 168(k) as it pertains to floor plan financing interest.
- July 28, 2020: IRS releases:
  - Final Section 163(j) regulations
  - Notice 2020-59 governing treatment of assisted living facilities as real property trades or businesses
  - NEW proposed Section 163(j) regulations
  - FAQ on aggregation rules.

RubinBrown

Application of IRC § 163(j) to an Excepted Trade or Business

- “Excepted trades or businesses” in final regulations include:
  - the trade or business of being an employee,
  - an electing real property trade or business,
  - an electing farming business, and
  - certain regulated utility trades or businesses
- Each excepted trade or business is excluded from the definition of a trade or business for purposes of IRC § 163(j) and any interest properly allocable to the excepted trade or business is not business interest and not subject to the Section 163(j) limitation.

RubinBrown

Electing Real Property Trade or Business (Reg. Section 1.163(j)-1(b)(14))

- An electing real property trade or business is a real property trade or business that makes an irrevocable election under IRC § 163(j)(7)(B) to be treated as an excepted trade or business, and that is a real property trade or business as described under the passive activity loss rules of Section 469(c)(7) and Reg. Section 1.469-9(b)(2).
  - IRC § 469(c)(7)(C) defines a real property trade or business as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business. This definition is intended to include real property trades or businesses conducted by a corporation or real estate investment trust (REIT), as well as the operation or management of a lodging facility
- The final regulations exclude from the definition of a real property trade or business trades or businesses that do not play a significant or substantial role in the creation, acquisition, or management of rental real estate, or that provide personal services that are merely ancillary to a real property trade or business.
  - Thus, for example, the cultivation and harvesting of plants, crops, or trees is not a real property trade or business for purposes of IRC § 163(j)(7)(B) and IRC § 469(c)(7)(C), even though the cultivation and harvesting of crops occurs on real property.

RubinBrown

Electing Real Property Trade or Business

- One potential downside of making the election to be an excepted trade or business is that an electing real property trade or business has to depreciate its nonresidential real property, residential rental property, and qualified improvement property under the alternative depreciation system (ADS).
  - ADS often has a longer depreciation period than accelerated depreciation methods.
  - Bonus depreciation (i.e., 100% immediate expensing) under IRC § 168(k) is not available for property depreciated under the ADS.
  - See later slides for guidance on how to make the switch mid-stream.
  - Eligible real property trades or businesses considering an election out of IRC § 163(j) should look at the trade-off between currently deducting their business interest expense without limitation and deferring their depreciation deduction under the slower ADS method. In addition, for tax years after 2021, adjusted gross income will include earnings before interest and taxes but not depreciation, depletion, or amortization for purposes of IRC § 163(j). This will have the effect of lowering ATI, thereby decreasing allowed business interest deductions.

RubinBrown

Electing Real Property Trade or Business

- Final regulations:
  - A taxpayer may make a "protective" real property trade or business election even if the taxpayer satisfies the small business test. (Reg. Section 1.163(j)-9(b)(2))
    - Why would you do this? If you weren't sure if you applied the aggregation rules correctly.
  - A taxpayer may also make a real property trade or business election even if it's not sure it has a "trade or business" under the meaning of Section 162.
    - Why would you do this? If you rented property on a triple net basis, and weren't sure if it was business interest or investment interest: does the rental rise to the level of a trade or business, making the interest business interest expense? You could make a protective election out of Section 163(j) in the event the IRS held that the rental was a trade or business. (Reg. Section 1.163(j)-9(b)(3)).
  - If either election is made, all the ancillary consequences apply.
    - ADS depreciation; no bonus.

RubinBrown

Electing Real Property Trade or Business

- Anti-abuse rule: if a taxpayer (PropCo) rents more than 80% of its property to a commonly controlled trade or business (OpCo), PropCo cannot make the -9 election as a real property trade or business. (50% of ownership interests are held by related parties under the meaning of Sections 267 or 707).
- Exception in final regulations:
  - Anti-abuse doesn't apply if at least 90% of the property is rented to either:
    - An Opco that is not commonly controlled, or
    - An Opco that itself makes an election as a real property trade or business.
  - See Notice 2020-59 for when a skilled nursing facility will be permitted to make the -9 election, allowing a related PropCo to also make the election.

RubinBrown

Electing Real Property Trade or Business

- Example. X and Y are under common control. X owns one piece of real property, a hotel, that X leases to Y. Y operates the hotel and provides hotel rooms and associated amenities to third party guests of the hotel. The form of the arrangement with third party hotel guests is a license to use rooms in the hotel and associated amenities. Y is a real property trade or business that has made an election under -9.
- Because X leases at least 80 percent of X's real property to a party under common control, X is subject to the anti-abuse rule in paragraph (j)(1) of this section. However, under the de minimis exception, 100 percent of the fair market rental value of the building is leased to a party under common control that has made an election to be an electing real property trade or business. Accordingly, X is eligible to make the election for its entire trade or business.

RubinBrown

Real Property Operation and Management

- The final regulations also elaborate on the types of activities that constitute a “real property operation” and “real property management” that are treated as a real property trade or business under IRC § 469(c)(7)(C).
  - The term “real property operation” means a direct or indirect owner of real property handling the day-to-day operations of a trade or business that relates to the maintenance and occupancy of real property used, or held out for use, by customers (and where payments received from customers are principally for the customers' use of the real property) in a way that affects the availability and functionality of that real property.
  - The term “real property management” means a professional manager handling the day-to-day operations of a trade or business that relates to the maintenance and occupancy of real property used, or held out for use, by customers (and where payments received from customers are principally for the customers' use of the real property) in a way that affects the availability and functionality of that real property.
    - A professional manager is a person who is responsible for the overall management and oversight of real property on a full-time basis and that is not a direct or indirect owner of the real property

Real Property Operation and Management

- The principal purpose of a real property operation or real property management must be the provision of the use of real property (or a physical space accorded by or within the real property) to one or more customers.
- The principal purpose cannot be the provision of other significant or extraordinary personal services to customers in conjunction with the customers' incidental use of the real property or physical space, even if the customer pays for the services separately.
- Incidental services can be provided but only if those services are insubstantial in relation to the customer's use of the real property or physical space and the receipt of services is not a significant factor in the customer's decision to use the real property or physical space.

Real Property Operation and Management

- Example. D owns a building in which D operates a restaurant and bar. D's customers are paying principally for the preparation and presentation of food and beverages, which are significant or extraordinary personal services. The customers' use of the space inside the building is incidental to these services. Accordingly, D is not engaged in a real property trade or business.

RubinBrown

Real Property Operation and Management

- Example. F owns shares in P, an S corporation. P owns and operates a luxury hotel. In addition to providing rooms and suites for use by customers, the hotel offers many additional amenities such as in-room food and beverage service, maid and linen service, parking valet service, concierge service, front desk and bellhop service, dry cleaning and laundry service, and in-room barber and hairdresser service.
- P contracted with M to provide maid and janitorial services to P's hotel. M is an S corporation principally engaged in the trade or business of providing maid and janitorial services to various types of businesses, including hotels. G is a professional manager employed by M who handles the day-to-day business operations relating to M's provision of maid and janitorial services to M's various customers, including P.
- Even though P provides significant personal services to the hotel's customers, the principal purpose of P's hotel business operations is the provision of use of the hotel's rooms and suites to customers. The significant personal services are incidental to the customers' use of the hotel's real property. Accordingly, F and P are engaged in a real property trade or business.

RubinBrown

Real Property Operation and Management

- Example. Regarding the maid and janitorial services provided by M, M's operations affect the availability and functionality of real property used, or held out for use, by customers in a trade or business where payments by customers are principally for the use of real property (in this case, P's hotel). However, M doesn't operate or manage real property. Instead, M is engaged in a trade or business of providing maid and janitorial services to customers, such as P, that are engaged in real property trades or businesses.
- M's business operations are merely ancillary to real property trades or businesses. Therefore, M is not engaged in real property operations or management, and thus, M is not engaged in a real property trade or business.
- Regarding the day-to-day business operations that G handles as a professional manager of M, the business operations that G manages are not the provision of use of P's hotel rooms and suites to customers. G does not operate or manage real property. Instead, G manages the provision of maid and janitorial services to customers, including P's hotel.
- Therefore, G is not engaged in real property management. Accordingly, G is not engaged in a real property trade or business.

RubinBrown

Real Property Defined

- The final regulations define real property primarily by reference to the regulations under IRC § 469. Thus, for purposes of IRC § 163(j), the term "real property" includes:
  - land, buildings, and other inherently permanent structures that are permanently affixed to land,
  - any interest in real property, including fee ownership, co-ownership, a leasehold, an option, or a similar interest,
  - tenant improvements to land, buildings, or other structures that are inherently permanent or otherwise classified as real property, and
  - any direct or indirect right, including a license or other contractual right, to share in the appreciation in value of, or the gross or net proceeds or profits generated by, an interest in real property, including net proceeds or profits associated with tolls, rents or other similar fees.

RubinBrown

Real Property Defined

- However, real property does not include:
  - property produced for sale, such as bricks, nails, paint, and windowpanes, that is not real property in the hands of the producing taxpayer or a related person, but that may be incorporated into real property by an unrelated person,
  - natural products and deposits, such as plants, crops, trees, water, ores, and minerals, when they are harvested, severed, extracted, or removed from the land, and
  - machinery, equipment, and other assets that serve a function, even after their installation or permanent affixation to real property (i.e., an HVAC system, elevator, escalator, etc.).

Partnerships Not Subject to IRC § 163(j)

- Interest expense of an excepted small partnership (one that makes an election to avoid Section 163(j) as a real property trade or business) is NOT required to be tested at the partner level.
- However, unlike an exempt partnership, the partners do not include ANY Section 163(j) item – ATI, interest expense, business interest income, etc.. – in their own Section 163(j) computation.
- Example. A and B are 50/50 partners in Partnership AB. In 2020, AB has $100 of taxable income before interest expense, $40 of interest expense, and elects to be excluded from Section 163(j) as a real property trade or business. AB does not compute a Section 163(j) limitation, and the $20 of interest expense is NOT subject to limitation at the partner level. Unlike partners in an exempt partnership, however, A and B do not include any business income from Partnership AB in their respective ATI.

Partnerships Not Subject to IRC § 163(j)

- If interest is suspended when a partnership is not an excepted business (year 1) and the partnership subsequently becomes an excepted business – for example, by making an election as a real property trade or business -- the disallowed interest is NOT treated as "paid or incurred" by the partner in year 2.
- In other words, the interest remains suspended. Even worse, it is not clear if the excepted partnership can allocate excess taxable income to excess business income to the partnership at this point , though I believe they should be able to, which would free up the interest. It not, interest will not be deductible until the partnership dissolves or the partner sells his interest.

113

Special Rule in 2019 and 2020

- Partnerships must use a 30% limit of ATI in 2019. The 50% limit is only available in 2020.
- Any EBIE allocated to a partner in 2019, however is subject to special rules.
  - 50% of the EBIE is automatically treated as "paid or incurred" in 2020 and is automatically deductible. The remaining 50% is subject to the typical rules; it is suspended until the partner is allocated ETI or EBII, or the partnership becomes exempt as a small business.
- A partnership can elect out of this treatment.

114

Partnerships: Tax Basis Capital Reporting and Section 704(c)

Tony Nitti, CPA, MST

CERTIFIED PUBLIC ACCOUNTANTS
& BUSINESS CONSULTANTS

RubinBrown

2019 Partnership Tax Capital Reporting

- The solution: for the 2019 tax year, the IRS intended to have every partnership report partner's capital on Sch. K on the tax basis capital method. This will make it much easier for the IRS to determine the amount of allowable losses to a partner.
- This would apply regardless of whether tax capital was negative at the beginning or the end of the tax year
- As a reminder, "tax basis capital" is different than what we think of as "tax basis."
  - Tax basis includes both "tax basis capital" AND the partner's share of Section 752 liabilities.
  - Tax basis capital is tax basis LESS the partner's share of liabilities.
- Also important to remember, you would STILL have to maintain Section 704(b) capital accounts. This is MANDATORY if the partnership has special allocations and compliance with the substantial economic effect rules apply.

RubinBrown

Relief for 2019

Notice 2019-66

- Tax basis capital reporting is not effective for 2019 but will be effective for partnership taxable years that begin on or after Jan 1, 2020
- May continue to report partner's capital consistent with 2018 instructions (tax basis, 704(b) basis GAAP basis) and must disclose method used
- If, however, your ending tax basis capital account was NEGATIVE, you were required to disclose it on the tax return.

RubinBrown

Required Reporting for 2020 Returns

Notice 2020-43 was released by IRS, for returns ending on or after December 31, 2020.

Provided two methods that will be available to report tax basis capital for 2020 partnership returns

- Modified Outside Basis Method
- Modified Previously Taxed Capital Method

One of the two proposed methods must be used, but partnerships may change between the methods by attaching a disclosure describing the change to each partner's beginning and ending capital account balance.

- The IRS, at this time, would not permit basis to be computed using a transactional approach, whereby the partnership simply "maintain" tax basis capital accounts by constantly updating the capital accounts based on income tax rules, rather than Section 704(b) principles.
- Instead, the IRS wanted a partnership to take "snapshots" at a moment in time to determine a partner's tax basis capital account, using one of the two methods described above.

118

RubinBrown

Newest Guidance - Tax Basis Capital: Transactional Approach Requirement

- Notice 2020-43 proposed barring the transactional approach as a method of computing tax basis citing inconsistent use
- Commenters complained if they had been properly reporting tax basis previously, why have to switch to one of the proposed methods in Notice 2020-43?
- The IRS agreed and will allow partnerships that have previously reported partner capital on the tax basis to continue that transactional method and they will not need to use one of the methods provided in Notice 2020-43
- In addition, the IRS now provides <u>the transactional method is the only one allowed to report partner tax basis</u> capital on Schedule K-1, following the computation of beginning partner tax basis capital for the 2020 K-1

RubinBrown

Tax Basis Capital: Transactional Approach Requirement

- In late October, the IRS released a draft of the Form 1065 instructions for 2020 partnership returns that contains a proposed requirement for reporting partner capital on the tax basis
- An IRS news release came out the same day explaining the <u>IRS's decision to require the use of the transactional approach to calculate partner tax basis capital</u>
  - What is the transactional approach?!
    - The transactional approach appears to be what the IRS refers to when a partnership has previously been reporting capital on a tax basis ("partnership reports partner contributions, share of partnership net income or loss, withdrawals and distributions, and other increases or decreases using tax basis principles as opposed to reporting using other methods such as GAAP")
- The IRS concluded that most partnerships already use the tax basis method of reporting capital, even though other methods were previously available

RubinBrown

Tax Basis Capital: Transactional Approach Requirement

- Notice 2020-43 defines the transactional approach:
- *Commenters have indicated that many partnerships that currently possess partner tax capital information generally develop and maintain partner tax capital by applying the provisions and principles of subchapter K of chapter 1 of the Code (subchapter K), including those contained in §§ 705, 722, 733, and 742 of the Code, to relevant partnership and partner events. In such a situation, commenters have indicated that partnerships maintaining tax capital (i) increase a partner's tax capital account by the amount of money and the tax basis of property contributed by the partner to the partnership (less any liabilities assumed by the partnership or to which the property is subject) as well as allocations of income or gain made by the partnership to the partner, and (ii) decrease a partner's tax capital account by the amount of money and the tax basis of property distributed by the partnership to the partner (less any liabilities assumed by the partner or to which the property is subject) as well as allocations of loss or deduction made by the partnership to the partner (Transactional Approach)*

RubinBrown

Tax Basis Capital: Transactional Approach Requirement

- The IRS news release states a plan to publish guidance granting penalty relief for the transition to tax basis reporting
- *The notice will provide that solely for tax year 2020 (for partnership returns due in 2021), the IRS will not assess a partnership a penalty for any errors in reporting its partners' beginning capital account balances on Schedules K-1 if the partnership takes ordinary and prudent business care in following the form instructions to calculate and report the beginning capital account balances. This penalty relief will be in addition to the reasonable cause exception to penalties for any incorrect reporting of a beginning capital account balance.*

RubinBrown

Tax Basis Capital: Transactional Approach Requirement

- Getting to the correct starting point at the beginning of 2020:
- Partnerships who computed partner capital in 2019 using the tax basis method should use 2019 ending capital as 2020 beginning capital
  - If a partner's 2019 ending tax basis capital was negative and subsequently recalculated to show a different amount for beginning 2020 tax basis capital, the instructions require an explanation of changes to be attached
- Partnerships who used a method other than tax basis to report partner capital in 2019 but maintained tax basis capital accounts (for example in reporting negative tax basis capital) must report each partner's beginning capital account using the tax basis method.
- How do you get there?

Tax Basis Capital: Transactional Approach Requirement

- If the partnership did not maintain tax basis records, it may recalculate each partner's 2020 beginning capital account using one of the following methods:
  - Modified outside basis method;
  - Modified previously taxed capital method; or
  - § 704(b) method
- You must use the same method for all partners, and you must attach a statement to the partners' K-1s indicating the method used to determine each partner's beginning tax basis capital account. More information is required if you use the Modified previously taxed capital method.

Modified Outside Basis Method

- The PARTNER maintains this information, does the calculation, and provides it to the partnership.
- Either the partnership or a partner will determine their outside basis in the partnership interest
- Subtract from that outside basis the partner's share of liabilities under S. 752

RubinBrown

Modified Previously Taxed Capital Method

Must calculate a hypothetical liquidation of the partnership using FMV, GAAP or S. 704(b)

Previously taxed capital is equal to:

- The amount of cash the partner would receive on liquidation, plus
- The amount of tax loss allocated to the partner from the hypothetical sale, less
- The amount of tax gain that would be allocated to the partner from the hypothetical sale

Must include a statement that a partnership is using this method and the method used to determine net liquidity value of partnership

RubinBrown

Modified Previously Taxed Capital Method - Example

Account	Tax	FMV
Cash	$500	$500
Inventory	$1,000	$1,000
Equipment	$500	$500
Land	$1,000	$8,000
Total Assets	$3,000	$10,000
Debt	$5,000	$5,000
Partner A (50%)	($1,000)	$2,500
Partner B (50%)	($1,000)	$2,500

RubinBrown

Modified Previously Taxed Capital Method - Example

Under the Modified Previously Taxed Capital Method, tax capital would be equal to:

- The amount of cash a partner would receive - $2,500 in this case after a sale for $10,000 and payment of $5,000 of liabilities.
- Plus the loss allocated to each partner - $0
- Less the gain that would be allocated to each partner – $3,500 ($10,000 amount realized less $3,000 tax basis in the assets, split between the 2 partners)
- $2,500 + $0 - $3,500 = ($1,000) tax capital for each partner

RubinBrown

Section 704(b) Method

Section 704(b) method

- The amount of Section 704(b) capital account at 1/1/2020:
  - Less: Partner's share of Section 704(c) built-in gain,
  - Plus: Partner's share of Section 704(c) built-in loss.

From That Point On

Once you've settled on your January 1, 2020 tax basis capital amount, use the transactional approach going forward.

Carried Interest Regulations

CERTIFIED PUBLIC ACCOUNTANTS
& BUSINESS CONSULTANTS

Carried Interest: Typical Structure

A typical real estate structure:

A sponsor invests no money in an LLC intended to own and operate rental real estate and an investor invests $1,000 in the LLC.

The economic deal between the investors and the sponsor is: after the investors receive their money back and a return, the sponsor would receive 20 percent of any excess proceeds and the investors would share in the remaining 80 percent.

The sponsor’s interest is a carried interest.

Win For Real Estate

- Sale of real estate by a real estate partnership is generally not pulled into the Recharacterization calculation via the § § 1231 and 1222 references in the exceptions
  - Explicitly excluded from the definition of capital asset in § 1221 is depreciable property used in the taxpayer's trade or business or real property used in the taxpayer's trade or business. The reason that some sales of real property are afforded LTCG treatment is that § 1231 provides LTCG treatment for such sales. So it's § 1231 and not § 1222 giving capital gains for real estate used in a trade or business
  - Under § 1231, gain on the sale of, among other assets, real property (other than inventory) used in a trade or business held for more than one year is LTCG. Losses on the sale of such real property are ordinary losses, and there can be a recapture of the ordinary losses by converting certain § 1231 gains into ordinary income.
  - Not all carried interests in real estate partnerships automatically avoid Recharacterization if held more than one year but not more than three. Exception N/A for real estate owned not used in a TOB
    - i.e. Vacant land held for investment, some NNN leased real estate where no services are provided

133

RubinBrown