

# 2019 YEAR-END TAX PLANNING GUIDE

## FOR BUSINESSES



Business tax planning is very complex. Careful planning involves more than just focusing on lowering taxes for the current and future years. How each potential tax saving opportunity affects the entire business must also be considered.

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# CONTENT

01	Introduction
02	Tax Saving Opportunities for All Businesses
23	Tax Saving Opportunities for Partnerships, Limited Liability Companies, and S Corporations
29	Tax Saving Opportunities for C Corporations
33	Conclusion

# Introduction

All businesses seek to reduce costs, and year-end tax planning presents the chance for significant savings that affect your bottom line. After substantial changes to the federal tax code, businesses need to ensure continued compliance with new rules and understand how to optimize their tax liability for both 2019 and 2020. Depending on the type and structure of your business, this 2019 Year-End Tax Planning Guide for Businesses can help determine the opportunities for saving on year-end and year-round taxes for the following entities:

- All businesses
- Partnerships, limited liability companies, and S corporations
- C corporations

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

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

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

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

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

This guide was written prior to the release of the inflation-adjusted tax rate schedules and other key tax figures for 2020. See [IRS Revenue Procedure 2019-44](#) for updates on the figures discussed in this guide for 2020.

This tax guide focuses on federal income tax planning, but your business should also delve into the complexities of applicable state taxes. Consult your [Lumsden McCormick advisor](#) regarding relevant factors for planning around state taxes, and whether certain software solutions can help navigate compliance and liability matters.

# Tax Saving Opportunities for All Businesses

## 2019 Versus 2020 Marginal Tax Rates

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

The marginal tax rate is the rate applied to your next dollar of income or deduction. Projections of your business's 2019 and 2020 income and deductions are necessary to determine the marginal tax rate for each year.

Your [Lumsden McCormick advisor](#) can be consulted to recommend how your business can recognize income and deductions between these years to minimize your tax liability (Also see our **2019 Year-End Tax Planning Guide for Individuals**).

In addition, the circumstances of an individual taxpayer may cause the marginal or effective tax rate to be higher in one year than in the other year. While the maximum marginal federal tax rate is 21 percent for C corporations, the maximum marginal federal tax rate for individuals is 37 percent. Moreover, the effect of the additional 3.8 percent tax on net investment income could push the effective marginal tax rate on high-income individuals to almost 41 percent.

If the relevant tax rate is expected to be approximately the same for each of 2019 and 2020, consider taking advantage of various tax rules that allow taxable income or gain to be deferred, such as sales of stock to an employee stock ownership plan, like-kind exchanges, involuntary conversions, and tax-free merger and acquisition transactions.

## Top Accounting Method Changes to Consider for 2019

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

## Top Accounting Method Changes to Consider for 2019 (cont.)

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

1. Revenue recognition conformity
2. Deferral of advance payments
3. Cash versus accrual method of accounting
4. Uniform capitalization
5. Deduction for unrelated party compensation

Each of these method changes is covered in more detail below. Please consult your [Lumsden McCormick advisor](#) who can assist in determining whether these considerations (and other method changes) will impact your business and the action steps needed to be taken for implementation.

### Top Accounting Method Change #1: Revenue Recognition

Companies need to be aware of two major developments that could impact the timing of revenue recognition for federal income tax purposes, namely (1) the impact of the new financial accounting standards for recognizing revenue and (2) the modifications to the existing revenue recognition rules for accrual method taxpayers enacted as part of tax reform.

For the 2019 year, the new financial accounting standards for recognizing revenue, titled "Revenue from Contracts with Customers (Topic 606)," are effective for non-publicly traded entities in general. Under the new standard, a taxpayer generally recognizes revenue for financial accounting purposes when the taxpayer satisfies a performance obligation by transferring a promised good or service to a customer. Depending on the type of revenue stream, in many cases ASC 606 can trigger an acceleration of income into revenue (for example, upfront payments for term licenses of software), although, to a lesser extent, certain revenue streams are decelerated. A taxpayer that has adopted the new standard in 2019 for financial reporting purposes may wish to make a corresponding change in its method of accounting for recognizing revenue for tax purposes. To do so, the taxpayer must attach an automatic consent Form 3115 request to the timely filed (including extensions) federal income tax return for the taxable year in which it adopts ASC 606 to change the method of accounting to identify the performance obligation, allocate the transaction price to performance obligations, and to consider performance obligations satisfied, provided that the new method is otherwise permissible under the Internal Revenue Code.



## Top Accounting Method Change #1: Revenue Recognition

In another significant development, Congress, as part of tax reform, modified the revenue recognition rules of Section 451 that will specifically impact accrual method taxpayers that have applicable financial statements (AFS). Historically, under the accrual method, income for which a realization event has been triggered is includible in the taxable year in which all events have occurred that fix the taxpayer's right to receive the income, and the amount thereof can be determined with reasonable accuracy. The all events test is met at the earliest of when (1) performance occurs, (2) the income is due and payable, or (3) the income is received. As modified by the 2017 tax reform, Section 451(b) effectively provides that an accrual method taxpayer with an applicable financial statement must include an item of income under Section 451 upon the earlier of when the all events test is met or when the taxpayer includes such item in revenue in an applicable financial statement. Thus, taxpayers that are presently deferring income for tax purposes later than when they take the income into revenue on the applicable financial statements are required to attach an automatic consent Form 3115 to the timely filed (including extensions) federal income tax return to comply with the new rule.

Your [Lumsden McCormick advisor](#) can assist you in navigating through these complex revenue recognition rules and the impact on your business.

## Top Accounting Method Change #2: Deferral of Advance Payments

Cash-method taxpayers recognize advance payments when the cash is actually or constructively received. Accrual-method taxpayers are generally required to recognize advance payments in the taxable year of receipt. However, under Revenue Procedure (Rev. Proc.) 2004-34, payments received by an accrual-method taxpayer in advance of services being performed or goods being delivered can be deferred to the next succeeding taxable year if such payments are reported on the taxpayer's "applicable" financial statements as deferred revenue, or if earned in a later taxable year in the absence of applicable financial statements. This so-called "one-year deferral method" is also available for advance payments received for the use of intellectual property, certain guaranty or warranty contracts, and the sale, lease, or license of computer software. As part of tax reform, Congress codified the one-year deferral method. Under new Section 451(c), advance payments shall either be included in gross income in the taxable year received, or deferred in accordance with books in the year received, with the remaining amounts to be included in the subsequent year. While Rev. Proc. 2004-34 may ultimately be replaced by other guidance pursuant to Section 451(c), the IRS stated in a recent notice that taxpayers can continue to use Rev. Proc. 2004-34 and its procedural rules for the time being until further notice. If an accrual-method taxpayer wishes to change its present method of accounting for recognizing advance payments to a method consistent with the one-year deferral method described in Rev. Proc. 2004-34, generally such change can be made by filing an automatic consent Form 3115 with the timely-filed federal income tax return (including extensions) and mailing a copy of the Form 3115 to the IRS no later than the filing date of that return. Similarly, a cash-method taxpayer desiring to change to an overall accrual method, as well as adopt the one-year deferral method for advance payments, may file a single combined automatic consent Form 3115.

## Top Accounting Method Change #2: Deferral of Advance Payments (cont.)

Additionally, as a result of Section 451(c), the longer deferral techniques available to advance payments for goods under Section 1.451-5 of the Income Tax Regulations (such as the two-year deferral method for inventoriable goods) are overridden. Taxpayers that are deferring advance payments under Section 1.451-5 of the regulations are advised to file an automatic consent Form 3115 to change to either the full inclusion method or the one-year deferral method beginning in the 2019 taxable year.

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

For federal income tax purposes, the use of the overall cash method may benefit taxpayers that generate accounts receivable that significantly exceed the accrued expenses and accounts payable. Because income is reported in gross income only when actually or constructively received, the cash method affords a deferral of income until such times as the accounts receivable amounts are received. Note, however, that taxpayers with contracts that provide for the receipt of advance payments may wish to avoid the overall cash method for this same reason. For the 2019 taxable year, any taxpayer (including C corporations and partnerships that have a C corporation as a partner) is permitted to use the overall cash method of accounting if the average annual gross receipts for the three prior taxable years do not exceed \$26 million and the entity is not treated as a tax shelter under Section 448. The 2017 tax reform provisions increased the annual gross receipts threshold from \$5 million to \$25 million for taxable years beginning after December 31, 2017, and Revenue Procedure 2018-57 adjusted the threshold to \$26 million for inflation for taxable years beginning in 2019.

Where appropriate, accrual method taxpayers that meet the \$26 million test for 2019 should consider filing an automatic consent Form 3115 to change to the overall cash method by the due date of the return, including extensions. This method change is automatic, and no user fee is required. The automatic Form 3115 must be attached to the timely filed (including extensions) federal income tax return for the year of the change and a copy of the Form 3115 must be mailed to the IRS Ogden, Utah office on or before the filing date of that return.

Pass-through entities (e.g., S corporations, partnerships, limited liability companies classified as partnerships) that do not have inventories, do not have a C corporation as a partner, and are not considered tax shelters under Section 448 are permitted to use the overall cash method of accounting, regardless of the average annual gross receipt limitations. To request a change to the overall cash method, such entities would need to file a non-automatic consent Form 3115 with the IRS during the year of the change to the extent that the small business automatic change discussed above does not apply. As a result, this method change request is due by the end of the tax year and an IRS user fee does apply.

Please contact your [Lumsden McCormick advisor](#) to help determine whether switching to the overall cash method makes sense from a federal tax standpoint.

## Top Accounting Method Change #4: Uniform Capitalization

Section 263A requires taxpayers to capitalize direct and indirect costs properly allocable to real or tangible personal property produced by the taxpayer, as well as real property and personal property described in Section 1221(a)(1) acquired by the taxpayer for resale (i.e., the “UNICAP” rules). Generally, the costs required to be capitalized for tax purposes under Section 263A exceed the amounts required to be capitalized for financial accounting purposes and such “additional Section 263A” costs are added to inventory. This tax requirement increases taxable income to the extent that inventory is on hand at year-end. Special rules apply to LIFO inventories.

As a result of tax reform, small business producers and resellers are exempted from the requirement to capitalize additional Section 263A costs if the average annual gross receipts for the three prior taxable years do not exceed \$26 million and the entity is not treated as a tax shelter under Section 448. A small business taxpayer that meets the \$26 million test for 2019 and wishes to be exempted from Section 263A should attach the automatic consent Form 3115 to the timely filed (including extensions) federal income tax return for the year of the change and a copy of the Form 3115 must be mailed to the IRS Ogden, Utah office on or before the filing date of that return.

For certain taxpayers with inventory that are not exempted from Section 263A, UNICAP must be addressed in 2019. In recent years, the IRS has expressed concerns related to the potential distortion of income resulting from producers including negative Section 263A costs in their simplified methods of accounting for allocating Section 263A costs to ending inventory. Negative Section 263A costs arise when a particular cost is capitalized for book purposes but is not required to be capitalized under Section 263A (for example, assets subject to bonus depreciation).

To address this issue, the IRS and Treasury issued final negative Section 263A regulations effective for taxable years beginning on or after November 20, 2018. Among other things, the final regulations contain a new modified simplified production method (MSPM) for allocating negative Section 263A costs to ending inventory. The MSPM allows larger producers (i.e., taxpayers with average annual gross receipts exceeding \$50 million) to take into account negative Section 263A costs by computing two new absorption ratios (pre-production ratio and production ratio) and then applying each ratio to separate categories of costs in ending inventory to determine the total amount of additional Section 263A costs to capitalize for tax purposes. Affected taxpayers changing to the MSPM must assess the impact of the new rules on their existing Section 263A calculations, file an automatic consent Form 3115 with the timely filed (including extensions) federal income tax return for the year of change, and mail a copy to the IRS on or before the filing date of that return. Your [Lumsden McCormick advisor](#) can help your business to evaluate and calculate the impact of the final regulations.



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



## Top Accounting Method Change #5: Deduction for Unrelated Party Compensation

Accrued compensation, including bonuses and vacation pay that are payable to unrelated employees, reduces an employer’s taxable income. However, these deductions are also subject to restrictions. For accrual-method employers, the liability to pay the compensation must be fixed and determinable, under the terms of the policy, plan or arrangement, by the end of the taxable year. The IRS issued additional guidance in recent years on the application of these requirements to bonus plans. Please consult with your [Lumsden McCormick advisor](#) before year-end to determine if your bonus plan or plans meet these requirements.

In addition to the foregoing requirements, for the accrual-method employer to obtain a current deduction for compensation, the 2019 accrued compensation must be paid to unrelated employees (and cash-method independent contractors) within 2½ months after the end of the taxable year in which the related services are rendered. Otherwise, this compensation is treated as deferred compensation and is deductible only when paid.

*Note: Vested deferred compensation, although not currently deductible, is considered “wages” for FICA (Federal Insurance Contributions Act) and FUTA (Federal Unemployment Tax Act) tax purposes. Note also that under the Section 409A deferred compensation rules discussed next and in our 2019 year-end Tax Guide for Individuals, certain items with deferred payment dates will now be currently taxed to the employee (with a corresponding deduction to the employer).*

### PLANNING SUGGESTION

Employers with taxable years that end in October, November, or December 2019 should pay accrued compensation to unrelated employees in early 2020 (within 2½ months of the employer’s year-end) to take advantage of a 2019 deduction for employers and 2020 income for employees.

## Nonqualified Deferred Compensation

Section 404(a)(5) dictates that the employer’s deduction for deferred compensation is allowed in the taxable year that the employee is taxed on the compensation. For deferred compensation arrangements that comply with the Section 409A restrictions on the timing of distributions from, and contributions to, nonqualified deferred compensation plans, the deduction will be allowed when paid. For noncompliant arrangements, Section 409A taxation to the participant deems taxable income as the compensation vests and accordingly the employer’s deduction is accelerated. Failure to properly report taxable compensation and to withhold appropriate taxes exposes the employer to reporting and under-withholding penalties, as well as liability for any unpaid taxes that should have been withheld. However, the heavier penalty is placed on the participants in such plans who will be subject to immediate taxation of plan balances that have not previously been taxed, plus an additional 20 percent tax penalty and interest. Plans that may be affected by these rules include salary deferral plans, incentive bonus plans, severance plans, discounted stock options and stock appreciation rights, phantom stock plans, and restricted stock units.

Nonqualified Deferred Compensation (cont.)

Under an IRS correction program for operational errors, certain errors can be corrected penalty-free in the same taxable year as the failure (or by the end of the year that follows immediately) for non-insiders, or participants other than directors, officers and 10 percent owners, and there is limited relief for certain errors corrected thereafter or failures involving small amounts. The IRS launched an additional program that allows taxpayers to correct certain plan document failures with no penalties if corrected more than one year prior to the payment event, or with limited penalties in which the 20 percent tax penalty is applied to only half of the account balance if, in most instances, the failures are corrected within 12 months of the payment event. Corrective action for operational failures that occurred during 2019 (and 2018 for non-insiders) should be completed by December 31, 2019, to obtain penalty-free relief. Documentary failures should be corrected immediately and sufficiently in advance of the earliest payment event to obtain penalty-free relief.

Corporate AMT Repealed

The 2017 tax reform repealed the corporate AMT, which was imposed on corporations and was added to their regular tax if and to the extent the tentative minimum tax exceeds the regular tax. Repeal of the corporate AMT is effective for taxable years beginning after December 31, 2017. AMT credits, or a corporation’s previous AMT liabilities, can offset the regular tax liability for any taxable year after 2017 or can be refunded for any taxable year beginning after 2017 and before 2022 for 50 percent of the excess credit for the taxable year (100 percent for taxable years beginning in 2021).

Section 199A Deduction for Qualified Business Income

Under Section 199A, for taxable years beginning after December 31, 2017, taxpayers (other than C corporations) with taxable income (before computing the QBI Deduction) at or below the threshold amount, are entitled to a deduction equal to the lesser of:

- 1. The combined QBI amount of the taxpayer, or
- 2. An amount equal to 20 percent of the excess, if any, of the taxable income of the taxpayer for the taxable year over the net capital gain of the taxpayer for such taxable year.

The combined QBI amount is generally equal to the sum of (A) 20 percent of the taxpayer’s QBI with respect to each qualified trade or business plus (B) 20 percent of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership (PTP) income of the taxpayer for the taxable year.

QBI with respect to each qualified trade or business is generally defined to mean any item of domestic income, gain, loss, and deduction attributable to a qualified trade or business. A qualified trade or business is generally defined to include any trade or business determined under Section 162, except for a specified service trade or business (SSTB) or the trade or business of performing services as an employee. However, the exception for QBI generated from an SSTB does not apply where the owner has taxable income below the threshold amount.

Section 199A Deduction for Qualified Business Income (cont.)

An additional limitation applies to taxpayers with taxable income (calculated before the QBI Deduction) in excess of the threshold amount. For these taxpayers, their QBI Deduction is subject to a limitation based on the amount equal to the greater of (a) 50 percent of W-2 wages or (b) 25 percent of W-2 wages plus 2.5 percent of the unadjusted basis immediately after acquisition of qualified property attributable to the QBI generated from each qualified trade or business.

The threshold amount for 2019 is equal to \$321,400 for individuals filing joint returns, \$160,725 for married individuals filing separate returns, and \$160,700 for single individuals and heads of household. The limitations and exclusions subject to these threshold amounts are subject to a phase-in over the \$100,000 and \$50,000 of taxable income generated by joint filing and other taxpayers, respectively, earned above the threshold amounts. Therefore, for joint filing taxpayers, the phase-in occurs between \$321,400 and \$421,400 and for single individuals and heads of households the phase-in occurs between \$160,700 and \$210,700. The threshold amount is subject to cost-of-living adjustments in subsequent taxable years.

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

Broadly, several key areas of consideration addressed in the final regulations include:

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

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





# Interest Expense Deduction Limitation

For taxable years beginning after December 31, 2017, Section 163(j) may limit the deductibility of business interest expense to the sum of (1) business interest income, (2) 30 percent of the adjusted taxable income of the taxpayer, and (3) the floor plan financing interest of the taxpayer for the taxable year (applicable to dealers of vehicles, boats, or farm machinery or equipment).

For purposes of the Section 163(j) limitation, adjusted taxable income is equal to the taxable income of the taxpayer without regard to (1) any nonbusiness income, gain, deduction or loss, (2) business interest and business interest income, (3) any net operating loss (NOL) deduction, and (4) any deduction allowable for depreciation, amortization, or depletion. However, for taxable years beginning after December 31, 2021, the adjusted taxable income calculation will no longer exclude the deduction allowable for depreciation, amortization, or depletion.

The new rules contain exceptions allowing certain taxpayers to avoid application of the Section 163(j) business interest expense limitation, including (1) any taxpayer that has annual gross receipts under \$26 million for 2019 (increased for inflation from the 2018 level of \$25 million), (2) regulated public utilities, (3) an electing real property trade or business, and (4) an electing farming business. Consideration should be given to qualifying for one of the available exceptions.

Comprehensive proposed regulations were published in the Federal Register on December 28, 2018. Final regulations are expected before the end of 2019 but have not been published as of the date of publication of this guide.

When finalized, the regulations would apply to taxable years ending after the date on which the final regulations are published in the Federal Register. For earlier taxable years, taxpayers may rely on the proposed regulations, provided they are consistently applied by the taxpayer and all related persons. Among the significant aspects of the proposed regulations (including matters that have yet to be resolved) are the following items:

- The broad definition of “interest” for purposes of Section 163(j), including amortized debt issuance costs, guaranteed payments for the use of capital, repurchase/retirement premium, certain commitment fees, and market discount.
- The broad definition of “tax shelter,” which includes an expanded category of taxpayers not eligible for exemption from Section 163(j) as a small business including certain passive investors.
- The inability to increase adjusted taxable income by depreciation, amortization, and depletion capitalized to inventory under the uniform capitalization rules.
- A complex set of calculations to allocate certain “excess” items to partners of partnerships.
- The treatment of “self-charged interest” between passthrough entities and their owners, or between passthrough entities under common control.
- Whether the exemption for floor plan financing interest (coupled with the disallowance of bonus depreciation under Section 168(k)) is effectively elective.

# Interest Expense Deduction Limitation (cont.)

- The application of Section 163(j) to consolidated groups, including the treatment of members joining or leaving a group and the application of limitations under Sections 382 and 383 and the separate return limitation year rules.
- The application of Section 163(j) to foreign corporations and other foreign persons.

If any of these items could affect your business, please contact your [Lumsden McCormick advisor](#).

## For Partnerships

The Section 163(j) interest limitation is applied at the partnership level and any interest expense limitation or “excess business interest expense” is then allocated to each partner as a separately stated item. The partner is required to carry forward its share of the excess business interest that may be deducted to the extent the partnership allocates excess business income to that partner in a future year, i.e., taxable income generated by the partnership in excess of the amount needed to deduct current year partnership interest expense. If the taxpayer is unable to deduct the excess business interest before disposing of its partnership interest in a taxable transaction, the suspended excess business interest expense will reduce gain recognized on the transaction (or increase the recognized loss).

The proposed regulations reserve on several important partnership issues including when a lower-tier partnership (LTP) allocates excess items to a partner that is also a partnership (UTP), does the UTP continue to allocate the excess items to its partners?

The answer to this question can have significant ramifications including the ability of partners to utilize allocated losses, determination of ultimate allowable deduction against either ordinary income or capital gain, and potential complexity in tracking and reporting excess items. There are generally two approaches in answer to this question:

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

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

To the extent a partnership expects to generate excess business interest, care should be taken to ensure accurate tracking and reporting of the appropriate amounts, including future excess taxable income. Proper maintenance of Section 704(b) and tax basis capital accounts will be critical in this regard.

For S Corporations

The new rules provide that the rules for C corporations regarding business interest expense and income are not applicable for S corporations. This clarifies that S corporation interest expense and income are not automatically considered as business interest, and is consistent with the statutory requirement that the taxable income of an S corporation is generally determined in the same manner as in the case of an individual. Unlike the treatment of partnerships, disallowed business interest expense of an S corporation is carried forward at the entity level. Except for this significant difference, the rules for S corporations are broadly similar to the proposed regulations for partnerships. For example, the rules similar to those on a partner’s share of business interest income and floor plan financing will apply to S corporations and their shareholders.

For C Corporations

The proposed rules provide that all interest expense of a C corporation will be considered properly allocable to a trade or business (solely for purposes of Section 163(j)). Similarly, all interest income earned by a C corporation will be considered business interest income. Thus, both interest income and interest expense of a C corporation cannot be treated as excludable investment items under the Section 163(j) limitation. The regulations further provide that interest expense of a partnership allocated to a C corporation partner will be treated as business interest, even if characterized as investment interest at the partnership level. Similar rules recharacterize items of investment income, gain, loss, and deductions when allocated to a C corporation partner.

Depreciation

The timing of asset acquisitions is critical to obtain maximum depreciation deductions. Using other depreciation rules to your advantage will also reduce your taxes.

**Caution: Generally, no depreciation is allowable if the property is placed in service and disposed of in the same taxable year.**

Bonus Depreciation

From time to time, Congress has enacted “bonus” depreciation provisions to give businesses additional first-year depreciation deductions, and thus to provide significant incentives for making new investments in depreciable tangible property and computer software. The 2017 tax reform increases such bonus depreciation allowances from 50 percent to 100 percent for qualified property acquired and placed in service after September 27, 2017, and before 2023 (January 1, 2024, for longer production period property and certain aircraft). In effect, the new rule permits “full expensing” of purchases of qualifying property. The 100 percent allowance is phased down by 20 percent per calendar year for property placed in service in taxable years beginning after 2022 (after 2023 for longer production period property and certain aircraft). A new election allows taxpayers to claim 50 percent bonus depreciation, instead of 100 percent bonus, for the first taxable year ending after September 27, 2017. To claim the bonus depreciation deduction, the applicable property must satisfy four requirements: (1) the depreciable property must be of a specific type, (2) the original use of the depreciable property must commence with the taxpayer or used property must meet specific acquisition requirements, (3) the depreciable property must be placed in service by the taxpayer within a specified time period, and (4) the depreciable property must be acquired by the taxpayer after September 27, 2017.

Bonus Depreciation (cont.)

A taxpayer-favorable development is that bonus depreciation is now permitted for both new and used property acquired by purchase provided the property was not used by the taxpayer before the taxpayer acquired it (i.e., the taxpayer did not have a depreciable interest in the property prior to acquisition) and it was not used by a related party. Bonus depreciation is not available for property primarily used in certain regulatory public utility businesses and property used in a trade or business that has had floor plan financing indebtedness (unless the taxpayer is not a tax shelter and is exempt from the interest limitation rules by meeting the small business gross receipts test of Section 448(c)).

In September 2019, Treasury and the IRS released final regulations and another round of proposed regulations relating to bonus depreciation. These regulations provide guidance relating to date of acquisition, the ability of floor plan financing entities to take bonus depreciation, and components of self-constructed property. Taxpayers should review their depreciation records to determine if there are opportunities for missed bonus depreciation under the new guidance.

Further, Revenue Procedure 2019-33 provided additional time for taxpayers to make or revoke an election for property acquired after September 27, 2017, and placed in service during the taxpayer’s taxable year that includes September 28, 2017, since the August 2018 proposed regulations were released so close to the filing deadline. Taxpayers should review their 2017 tax return and make any required election change.

PLANNING SUGGESTION

Plan purchases of eligible property to assure maximum use of this annual asset expense election and the bonus depreciation, as the 100 percent bonus depreciation deduction ends after 2023. The ability to claim 100 bonus depreciation on new and used qualified property benefits taxpayers that acquire assets that constitute a trade or business, rather than acquisitions of stock, because the buyer can potentially deduct much of the purchase price in the year of purchase. Further, typically only MACRS (Modified Accelerated Cost Recovery System) property with a recovery period of 20 years or less is eligible for bonus depreciation. Taxpayers with new real estate construction or major renovations should arrange for a cost segregation study to identify eligible personal property. The personal property will have a lower tax life, making it eligible for bonus depreciation. Please consult your [Lumsden McCormick advisor](#) for further information regarding bonus depreciation.



## Application of Bonus Depreciation to Partners and Partnerships

The recently issued proposed regulations clarify that a partner is considered to have a depreciable interest in property held by a partnership to the extent of its ratio of the share of depreciation deductions allocated to the partner over the total amount of the deductions for the current and prior five taxable years.

In the context of partnership transactions, availability of bonus depreciation will be dependent upon on a number of factors and the nature of the transaction. Pursuant to the final regulations, the following summary details whether bonus depreciation will be available in several common situations:

- **Section 743(b) Basis Adjustments** – Bonus depreciation is generally available
- **Section 734(b) Basis Adjustments** – Bonus depreciation is not available
- **Section 704(c) Remedial Allocations** – Bonus depreciation is not available
- **Zero Basis Property** – Bonus depreciation is not available
- **Basis Determined under Section 732** – Bonus depreciation is not available

There is now a greater incentive to structure a transaction as a sale of a partnership interest, either directly or indirectly via a “disguised sale of partnership interests.” These partnership interest acquisition transactions ensure that the basis step-up occurs via Section 743(b), rather than other types of transactions such as partner redemptions or equity contributions.

These alternative transactions would produce similar results with either Section 704(c) remedial allocations or a Section 734(b) basis adjustment.

## Qualified Improvement Property

Tax reform eliminated the qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property asset classifications from Section 168 for property placed in service after December 31, 2017, and replaces them with the qualified improvement property (QIP) classification. QIP is defined as any improvement to an interior of a building that is nonresidential real property as long as that improvement is placed in service after the building was first placed in service by any taxpayer. With the expanded definition of QIP, the intent of Congress was that QIP would be assigned a 15-year life, and thus be eligible for bonus depreciation. Due to a drafting error, the 2017 tax reform legislation does not assign such 15-year life to QIP. The preamble to the final bonus depreciation regulations specifically stated that legislative action is required to remedy this error. Unless and until a technical corrections bill is passed, QIP acquired after September 27, 2017, and placed in service after December 31, 2017, will be subject to a 39-year recovery period and will not be eligible for bonus depreciation.

## Section 179 Expensing Election

If you purchase certain depreciable property, you may elect to treat a specified dollar amount as a deduction for property placed in service during the taxable year. However, the benefits of this election are phased out if more than a specified dollar amount of qualifying property is placed in service. Tax reform increased the maximum deduction and phase-out threshold for Section 179 property. For 2019, the maximum amount that can be expensed is \$1,020,000 and is reduced on a dollar-for-dollar basis for eligible property placed in service in excess of \$2,550,000. Both amounts are indexed for inflation annually. The election is available for tangible personal property (including a new provision for assets used in lodging), qualified real property, and off-the-shelf computer software. Further, the 2017 tax reform act expands the definition of Section 179 property to allow taxpayers to elect to include qualified improvements made to nonresidential real property, and improvements to roofs, HVAC, fire protection systems, alarm systems and security systems.

### PLANNING SUGGESTION

With the expanded definition of Section 179 property, qualifying taxpayers can fully expense certain assets that are not eligible for bonus depreciation. Taxpayers should consult their [Lumsden McCormick advisor](#) to discuss how best to maximize their depreciation deductions.

## Personal Property Versus Real Property

For regular tax purposes, real property depreciation deductions are available over 27½ years for residential rental property and 39 years for nonresidential property. However, depreciation deductions may be accelerated for real property components that are essential to manufacturing or other special business functions.

Example: Taxpayer constructed a \$10 million manufacturing facility, which was placed in service during 2019. The design required an overhead crane, a special reinforced foundation to support equipment, and other specific features to accommodate the manufacturing process. A cost segregation study revealed that approximately \$5 million of the facility’s cost can be recovered over seven years instead of 39 years for regular tax purposes (without considering the bonus depreciation provisions described above).

### PLANNING SUGGESTION

Arrange for a cost segregation study to identify personal property and determine optimum depreciable lives for both new and prior acquisitions and construction. The position of the IRS is that the present depreciation method for property previously misclassified can be changed, and the full amount of any prior depreciation understatement can be deducted in the current year. Your [Lumsden McCormick advisor](#) can be consulted for further information and assistance.

Remodel/Refresh Safe Harbor for Restaurants and Retailers

In November 2015, the IRS issued Rev. Proc. 2015-56, which provides a safe-harbor method of accounting for most retailers and restaurants that incur refresh or remodel expenditures on qualified buildings. This procedure is significant as restaurants and retailers can deduct 75 percent of qualified remodel-refresh expenses, as opposed to capitalizing and depreciating the costs over 15 or 39 years.

To qualify, a company must have an AFS. A qualified taxpayer must include the capitalizable portion of any expenditures under the remodel/refresh safe harbor in a general asset account going forward. Further, taxpayers wishing to use the remodel safe harbor are not permitted to make the partial disposition election.

PLANNING SUGGESTION

Retailers and restaurants that have incurred deductible remodel-refresh costs capitalized in current and prior taxable years can deduct those costs in the current year, net of any prior depreciation claimed. Due to the drafting error, qualified improvement property (which now includes qualified leasehold improvements, qualified retail property and qualified restaurant property) has a 39- year life for property acquired and placed in service after December 31, 2017. Using the remodel/refresh safe harbor to identify current repairs is extremely beneficial. Further, a cost segregation study can identify personal property with a lower-class life, making it bonus eligible. Arrange for a fixed asset review to identify deductible remodel-refresh costs. Your [Lumsden McCormick advisor](#) can be consulted for further information and assistance.

International Tax Provisions

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

Taxpayers should reach out to their [Lumsden McCormick advisors](#) to evaluate their overall structures and supply chains, and the impact that these provisions could have on their particular facts and circumstances.

Federal Research Credit

Enacted in 1981 to incentivize taxpayers to increase investments to try to develop or improve products, processes, and software, the Research Credit has become even more valuable as a result of recent tax reform.

The corporate tax rate’s reduction to 21 percent effectively increased the net benefit of the Research Credit by more than 21 percent.

The elimination of the corporate AMT means that such companies, who weren’t permitted to use the Research Credit to offset their AMT, now can benefit currently from the credit by offsetting any current regular income tax or carrying the credit forward for up to 20 years.

Furthermore, Research Credits generated in taxable years 2016 through 2020 may be used to offset up to \$250,000 per year of the employer’s portion of that year’s FICA payroll tax if the taxpayer has (1) gross receipts less than \$5 million in the tax credit year and (2) no gross receipts for any taxable year preceding the five-taxable-year period ending with the tax credit year.

Finally, a 2017 IRS Directive continues to provide Large Business & International (LB&I) taxpayers a “safe harbor” for qualified research expenses (QREs) determined following the Directive. QREs determined by the Directive start with taxpayers’ GAAP ASC 730 research and development expenses which are then adjusted in various ways. The Directive has already benefitted taxpayers who use it, enabling them to simplify their processes to identify and support QREs on exam, save time and money, and enjoy greater certainty regarding their Research Credit tax asset.

These developments have increased the Research Credit’s value, and companies who aren’t looking into this opportunity should, especially if they incur expenses related to services in any technological field, e.g., physics, chemistry, biology, engineering, computer sciences. If you aren’t looking into Research Credits because you think your activities don’t qualify or you think you don’t have the required documentation, please consult with a [Lumsden McCormick advisor](#): Activities don’t even have to succeed to qualify; there are no specific documentation requirements; and there is case law allowing Research Credits even where no documentation was produced.

Opportunity Zone Program

The opportunity zone program was created in the 2017 tax reform legislation to promote investment in economically distressed communities. There are now over 8,700 certified qualified opportunity zones (QOZs) in all 50 states, the District of Columbia, Puerto Rico and the Virgin Islands. To take part in the program, investors must invest in a qualified opportunity fund (QOF) within 180 days after the sale or exchange of a capital asset. Note that if the capital gain is received through a Schedule K-1 and the pass-through entity has not elected to defer the gain, then the 180-day period with respect to the taxpayer’s eligible gain begins on the last day of the pass-through’s taxable year. The QOF is an investment vehicle that must hold at least 90 percent of its assets in QOZ property, which includes QOZ stock, QOZ partnership interest, or QOZ business property. Investment of capital gains in a QOF can result in beneficial tax incentives, including the following:

- Deferral of tax due on the capital gains invested in the QOF until December 31, 2026.
- Basis step-up on the capital gains invested of 10 percent if the investment is held for five years and 15 percent if the investment is held for seven years.

Opportunity Zone Program (cont.)

- Permanent exclusion from taxable income post-acquisition capital gains on investments in QOFs that are held at least ten years.

Since 2017, Treasury and the IRS have issued two rounds of opportunity zone proposed regulations, first in October of 2018 and then in April of 2019. The October 2018 guidance focused on provisions relating to real estate. The April 2019 proposed regulations provided guidance on the statutory requirements for qualified opportunity zone businesses. Final regulations are expected to be released in the fall of 2019 and will likely provide additional guidance.

PLANNING SUGGESTION

Taxpayers with recognized capital gain should consider making an investment in a QOF to obtain significant tax savings. As the end of 2019 quickly approaches, so does the deadline to obtain all of the tax benefits available in the Opportunity Zone program. Your [Lumsden McCormick advisor](#) can be consulted for further information and assistance.

Passive Losses

Generally, passive losses currently offset only passive income. Unused passive losses are carried to future years. An unused (suspended) loss generally is deductible when a taxpayer disposes of his or her interest in the passive activity. Regulations define “activity” broadly, and include provisions for the “grouping” of certain undertakings into a single activity.

For the last several years, however, individual taxpayers will be required to be mindful of the passive loss rules, even if their activities have consistently generated net taxable income.

Income from passive activities and net gains from dispositions of interests in passive activities will be subject to the 3.8 percent tax on net investment income of high-income individuals. In contrast, if income from a trade or business is not from a passive activity, e.g., because the individual is a material participant in the activity, this additional tax will not be imposed on the income from the activity. Taxpayers had a one-time opportunity to make new or different “grouping” elections for 2013 or 2014, or in any subsequent year in which they would first be subject to this tax.

Personal service corporations (PSCs) are subject to the passive loss restrictions. “Closely-held C corporations” (other than PSCs) can use passive losses to offset active income except for interest, dividends, or other portfolio income. A closely-held C corporation is defined as a C corporation in which more than 50 percent of the value of its outstanding stock is owned by five or fewer individuals.

PLANNING SUGGESTION

Your [Lumsden McCormick advisor](#) can assist you in determining whether it would be advisable for you to transfer personally owned passive loss activities to your closely-held corporation (if it is not a PSC). Also, if you anticipate having unusable passive losses this year, those losses may be available to offset gains from partnership or S corporation distributions in excess of your basis.

Because of the possible application of the additional 3.8 percent tax on net investment income of high-income individuals for 2018, taxpayers should consider the effect of any grouping elections made in prior years for activities that would otherwise be considered as two or more different activities.

Passive Losses (cont.)

After 2014 (when a one-time opportunity to make a new or different grouping election expired), taxpayers may only make a grouping election in unusual circumstances. The most likely of such circumstances to occur is that the taxpayer first became subject to this tax in 2015 or a subsequent year. Your [Lumsden McCormick advisor](#) can assist you in determining whether you are eligible to make a grouping election for the year and, if so, whether to make such an election.

Passive losses of S corporations and partnerships are passed through to their owners. Special rules apply to publicly-traded partnerships.

Rental Real Estate

Rental real estate activities are generally passive regardless of the taxpayer’s level of participation. However, for real estate professionals, rental real estate activities are not automatically passive but are subject to the general material participation tests. A taxpayer is a real estate professional if during the taxable year:

- More than 50 percent of the taxpayer’s personal services are performed in real property businesses, and
- More than 750 hours of service are performed in real property businesses.

For both of these tests, the taxpayer may only consider real property businesses in which he or she materially participates. If a joint return is filed, these two tests are met only if they are separately satisfied by either spouse. However, in determining material participation, a spouse’s participation is taken into account. Services performed as an employee are ignored unless the employee owns more than 5 percent of the employer.

Once a taxpayer qualifies as a real estate professional, he or she must generally determine whether he or she materially participates in each of his rental real estate activities separately to determine whether it is passive or non-passive. However, the taxpayer may alternatively elect to treat all of his or her interests in rental real estate as a single activity. The election is irrevocable but is often necessary to meet the material participation requirements.

A closely-held C corporation will satisfy these tests if more than 50 percent of its gross receipts are derived from real property businesses in which the corporation materially participates.

Real property businesses are those engaged in real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage.

Beginning in 2013, individual taxpayers with investments in rental real estate have had another potential tax consequence to consider. Even though the special rules for real estate professionals may permit an individual to treat income from rental real estate as income from a non-passive activity, such income is not necessarily exempt from the additional 3.8 percent tax on net investment income of high-income individuals. To exclude rental real estate income from this tax, the taxpayer must be able to demonstrate that the income is from the conduct of a trade or business. Your [Lumsden McCormick advisor](#) can assist you in determining whether your rental real estate income is subject to this tax.



Choice of Entity Decision

With one tax filing season over and done following the 2017 tax reform, many businesses may be questioning their entities’ tax status considering their overall 2018 tax liabilities. Now is as good a time as ever for businesses to revisit their choice of entity decision with their [Lumsden McCormick advisor](#), especially considering the precipitous 40 percent drop in the overall corporate tax rate from 35 percent to 21 percent. We can help you better understand the requirements and operational differences between a sole proprietorship, partnership, S corporation or C corporation, as well as the immediate and long-term costs and benefits of converting, or not converting, from your current entity status or form. When considering a choice-of-entity conversion, businesses have much to consider, including but not limited to the following:

- It is unlikely that the lower corporate rates will create an overall tax structure that would cause a corporate structure to be more tax-effective. In our experience, most choice-of-entity conversion models have shown a virtual breakeven stance as compared to the differences in effective tax rates from the prior regime from an after-tax perspective.
- Many businesses might prefer the less onerous reporting requirements following a conversion from a partnership to a corporate structure, especially as is the case for larger, publicly-traded partnerships. The benefits of reduced reporting will likely depend on factors such as the size of the partnership and the types of partners (for example, individuals and trusts or tax-exempt entities might prefer partnership form while tax-exempt taxpayers might prefer to block unrelated business income and foreign investors might prefer to block effectively connected income).

- Should corporate tax rates increase from the 2017 tax reform rates, the tax cost of a corporate structure will far exceed that of a pass-through structure when considering the two levels of tax. And while a conversion to a corporate structure can generally be made tax-free, a conversion back into a partnership structure will carry a potentially significant toll charge.
- The new centralized partnership audit regime will increase the risk of an IRS examination. Given the complexity of the partnership structure, the heightened risk could lead to additional costs in managing a partnership. The IRS also announced a new initiative around improving partnership compliance that includes significant expansion of required disclosure. These disclosure requirements will further increase the cost of using a partnership structure.
- A change from partnership to corporate status could trigger income to the partnership from the deemed contribution of liabilities in excess of the tax basis of the business’s assets, which may not be uncommon given the impact that bonus depreciation has had on the tax basis of tangible personal property. Moreover, the conversion could trigger the recognition of deferred revenue as well as income to partners or members with negative tax capital balances.
- While pass-through entities could eliminate double taxation, many believe that the reinvested earnings should remain in a corporate structure to avoid a second level of tax on the earnings. In such situations, taxpayers should be aware of two potential additional corporate level taxes that are imposed at the highest dividend rates: The Accumulated Earnings Tax and the Personal Holding Company Tax. Moreover, there is a loss of basis build-up to equity for undistributed earnings, which can result in an additional tax on exit.

Choice of Entity Decision (cont.)

- The availability of Section 1202 could mitigate the impact of basis build-up upon exit, as this multi-faceted and fairly complex provision could eliminate the impact of basis build-up on exit by allowing taxpayers to exclude a gain on exit equal to the greater of \$10 million, or ten times the tax basis for qualifying corporations. Section 1202 benefits could be available to businesses whose gross assets do not exceed \$50 million when a partnership incorporation transaction occurs, but the same benefit will not be available for S corporation conversions. Please reach out to your [Lumsden McCormick advisor](#) to learn more about this powerful provision.
- A switch from S corporation status to C corporation status may entail a change in the overall method of accounting for tax purposes from cash to accrual if the average annual gross receipts in the business for the last three years is in excess of \$26 million. If a business’s accounts receivables exceed its accounts payable and accrued expenses, the difference would be required to be recognized in the C corporation over the next six years if the change occurs before December 22, 2019, and the other requirements for a revocation by an “eligible terminated S corporation” are satisfied. A conversion (by revocation or otherwise) on or after December 22 would result in a four-year spread of the income recognition for tax purposes.
- In a family-owned business context, the impact of basis build-up could also be mitigated if a decedent and former shareholder leaves his or her stock for his or her children, as those shares would be stepped-up at death to the beneficiaries.

- International tax implications must be considered when making a choice of entity decision. For example, C corporations provide more favorable tax benefits when it comes to mitigating the tax impact of the new GILTI and FDII income regimes, as C corporations are entitled to a 50 percent exclusion on the income as well as a foreign tax credit of up to 80 percent lowering the effective rate on that income to under 3 percent versus an amount that can be in excess of 37 percent for partners or shareholders that are allocated that income from pass-through entities. On the other hand, a conversion from S status to C status would trigger any deferred transition tax liabilities of S corporation shareholders.

For many, the choice of entity analysis may be less about looking at current entities than about focusing on entity selection for new business ventures. Your [Lumsden McCormick advisor](#) can help you navigate through these complexities. We are able to run various projection scenarios to help businesses further evaluate the long-term impact of any conversion considerations.

If the relevant tax rate is expected to be approximately the same for each of 2019 and 2020, consider taking advantage of various tax rules that allow taxable income or gain to be deferred, such as sales of stock to an employee stock ownership plan, like-kind exchanges, involuntary conversions, and tax-free merger and acquisition transactions.



# Tax Saving Opportunities for Partnerships, Limited Liability Companies, and S Corporations

## Partnerships

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

For taxable years beginning after December 31, 2017, significant and generally unfavorable changes have been made to the way partnership returns will be audited by the IRS. The new rules may cause a partnership itself to become liable for underpayments of federal tax by its members and former members relating to their respective shares of partnership income.

Various elections are available that may allow a partnership to reduce or eliminate its potential liability, including elections to push tax liabilities out to the partners to whom the adjustments are allocable, to reduce deemed underpayment amounts to reflect the character of the affected items and tax status of the partners, or in limited circumstances to avoid the new audit rules entirely.

Changes to partnership agreements and ownership structures may be necessary to take full advantage of these elections. Partnerships should discuss the appropriate actions with their [Lumsden McCormick advisor](#).

A partnership must generally file its federal income tax return by the 15th day of the third month following the end of its taxable year (unless such date falls on a weekend or holiday, in which case the filing date is the next day that is not a Saturday, Sunday, or holiday), but an automatic extension of six months is available upon request. As a result, the due date of a partnership return for the year ending December 31, 2019, can be extended until September 15, 2020.

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

1. Net unrecognized Section 704(c) built-in gains/loss at the beginning and end of the year
2. Tax basis capital accounts
3. Breakout of guaranteed payments for services vs. capital

## Partnerships (cont.)

4. Disclosure around tiered liability allocations
5. Section 751 hot asset gains/losses

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

## Limited Liability Companies

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

## S Corporations

All pass-through entities, including partnerships and S corporations, should evaluate their choice of entity as a result of tax reform and the new reduced corporate tax rate. The Section 199A deduction may reduce a pass-through owner's maximum individual effective tax rate from the highest rate, 37 percent, to as low as 29.6 percent. Converting from a pass-through entity to a C corporation or vice versa requires complex analysis and planning, and is briefly covered in the section entitled Choice of Entity Decision (see page 24). Your [Lumsden McCormick advisor](#) can be consulted regarding choice of entity considerations, analysis, and planning.

Shareholders of existing S corporations should consider the following year-end planning tips:

- Shareholders must have basis in their stock or in loans to the corporation to take advantage of anticipated losses. Basis may be increased by additional capital contributions or direct shareholder loans to the corporation.
- If the corporation has earnings and profits (E&P) on hand that were accumulated during the time that it was a C corporation or that were acquired from a C corporation in a tax-free transaction, any additional investments in the corporation by the shareholders should be made as loans, rather than as capital contributions, to avoid taxable dividends if these investments are later returned to the shareholders. Shareholder loans should always be well-documented.
- After a shareholder's basis in stock of an S corporation has been reduced to zero, the shareholder's basis in a loan to the corporation is reduced by pass-through losses and increased by the pass-through of subsequent years' income. Because loan repayments may produce taxable income for the shareholder, they should be timed, if possible, to result in the least amount of tax. Advances should be evidenced by a written document to obtain favorable capital gain treatment if gain will result when the loan is repaid. Delaying loan repayments beyond 12 months (for long-term capital gain treatment) will allow any gain to be taxed at the lower (20 percent) capital gains tax rate.

S Corporations (cont.)

- Distributions to shareholders which exceed the corporation’s accumulated adjustments account (AAA) may result in inadvertent dividends if the corporation has E&P accumulated under the circumstances described above. Therefore, distributions should be delayed if the amount of the AAA balance at year-end is uncertain or insufficient to cover the intended distributions.
- Dividends received by non-corporate shareholders from domestic and qualified foreign corporations are taxed at a maximum 20 percent rate. Accordingly, S corporations with C corporation E&P should avoid making an actual or a deemed dividend distribution of this E&P, unless there are other compelling reasons for generating taxable dividend income.
- Consider making gifts of S corporation stock to move income between family members. Gifts of nonvoting stock may be made to keep voting control, if desired.
- Under certain conditions, an S corporation that sells appreciated property will be subject to tax on “built-in gains” (generally the property’s appreciation prior to the corporation becoming an S corporation or prior to being acquired from a C corporation in a tax-free transaction). A built-in gain is determined as follows:

Example:

Total gain on asset’s sale	\$ 1,000,000
Less appreciation accruing while an S corporation	\$ 300,000
Built-in gain	\$ 700,000

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

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

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

Under the 2017 tax reform, S corporations have a limited opportunity to avail themselves of two taxpayer-favorable provisions. The first is to switch from the cash method of accounting for income tax purposes to the accrual method, the effects of which could be spread over an extended six-year period. The second is to allow for distributions of AAA balances following the post-termination transition period. These distributions would be based on a ratio of the AAA and the accumulated earnings and profits balances on the date the revocation election becomes effective. These benefits only apply if an S corporation revocation election is filed before December 22, 2019, which does not preclude the revocation from having a prospective effective date of say January 1, 2020. Please consult with your [Lumsden McCormick advisor](#) to help you through the complexities of these two taxpayer favorable provisions.

Special Considerations for Pass-Through Entities

Recharacterization of Certain Long-Term Capital Gains under Section 1061

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

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

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

Like-Kind Exchanges Under Section 1031

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

Tax Saving Opportunities for C Corporations

Retention of Corporate Earnings

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

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



Personal Service Corporations

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

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

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

Corporate Stock and Stock Options

A corporation may obtain a deduction by the issuance of its stock or stock options to pay otherwise deductible expenses. For example, stock issued to employees or independent contractors constitutes deductible compensation when included in the employee’s or independent contractor’s taxable income. The taxable event generally occurs when the stock is transferred to the service provider without a substantial risk of forfeiture. In the case of stock grants, the deduction is generally available when vested and in the case of nonqualified stock options, the deduction is generally available when exercised.

Incentive stock options (ISOs) do not generate a deduction unless the holder of the ISO shares disposes of them before the required holding periods. These disqualifying dispositions will generate a deduction to the corporation. Companies that have issued ISOs to their employees should determine whether there have been any disqualifying dispositions of the underlying stock during the year.

Caution: Corporate deductions may be lost if the equity compensation is not timely reported on a Form W–2, in the case of an employee, or a Form 1099-NEC, in the case of an independent contractor. To avoid a penalty, the IRS copy of 2019 Form 1099-NEC that reports non-employee compensation in Box 7 must be filed with the IRS on January 31, 2020, at the same time that the form is required to be furnished to the independent contractor.

Incentive stock options and options granted under a qualifying employee stock purchase plan have a separate reporting requirement. Form 3921, Exercise of an Incentive Stock Option Under Section 422(b), and Form 3922, Transfer of Stock Acquired Through an Employee Stock Purchase Plan Under Section 423(c), must be furnished to employees not later than January 31, 2020, and filed with the IRS by February 28, 2020 (on paper), or March 31, 2020 (electronically), for 2019 ISO exercises and employee stock purchase plan purchases.

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

Corporate Stock and Stock Options (cont.)

PLANNING SUGGESTION

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

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

Your Lumsden McCormick advisor can be consulted for further information regarding ISOs and nonqualified stock options. Also see our discussion of stock options in our 2019 Tax Planning Guide for Individuals.

“Quick Refund” for Excess Estimated Tax

If estimated taxes paid exceed the expected annual tax, a corporation may apply for a “quick refund” (on Form 4466, Corporation Application for Quick Refund of Overpayment of Estimated Tax) of the excess tax before the tax return is filed, but only if this excess tax is at least \$500 and 10 percent of the expected annual tax. This quick refund may be requested after the close of the corporation’s taxable year, but no later than the 15th day of the fourth month following the end of the taxable year (the original due date of the corporation’s income tax return). The IRS must act on this refund application within 45 days after it is filed.

Example: Z, a calendar-year corporation, paid \$50,000 in estimated taxes for the first three quarters of 2019. In the fourth quarter of 2019, Z incurs a large loss so that the tax due for the year is expected to be only \$10,000. Z may request a \$40,000 refund after December 31, 2019, and on or before April 15, 2020. The IRS must act on Z’s refund application within 45 days after it is filed.

Planning for NOLs

NOLs are a valuable corporate attribute. Even NOLs that were not fully reported on a prior year return can be carried forward. However, the ability to use an NOL carryforward may be limited where a loss corporation has experienced a change of stock ownership—for example, as a result of a merger or acquisition, the issuance of new stock, or the acquisition of outstanding stock by one or more 5 shareholders. Your Lumsden McCormick advisor can assist you with the appropriate planning needed to preserve and maximize the use of NOLs by your corporate business. Under tax reform, NOLs from post-2017 taxable years may only be used to offset 80 percent of the corporation’s taxable income in any subsequent taxable year.

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

### Planning for NOLs (cont.)

Conversely, if the corporation has a net unrealized built-in loss (NUBIL) at the time of the ownership change, it may be required to apply the annual limitation to any net recognized built-in losses during the recognition period.

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

### Succession and Family Business Planning

Year-end is the traditional gift-giving season. This should also be a time to plan for your company’s succession and the transfer of your wealth to your heirs in a manner that minimizes transfer taxes. We urge you to consult with your [Lumsden McCormick advisor](#) for ideas to preserve your family wealth.



## Conclusion

Business tax planning is very complex. Careful planning involves more than just focusing on lowering taxes for the current and future years. How each potential tax saving opportunity affects the entire business must also be considered. In addition, planning for closely-held entities requires a delicate balance between planning for the business and planning for its owners.

This **2019 Year-End Tax Planning Guide for Businesses** and our **2019 Year-End Tax Planning Guide for Individuals** cannot cover every tax-saving opportunity that may be available to you and your business. In as much as taxes are among your largest expenses, we urge you to meet with your [Lumsden McCormick advisor](#) who should be able to provide you with a comprehensive review of the tax-saving opportunities appropriate to your particular situation.



## Contact Us

Lumsden McCormick meets the needs of commercial businesses with a breadth of tax, audit, and consulting services, including complex business tax matters and integrated tax planning.

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