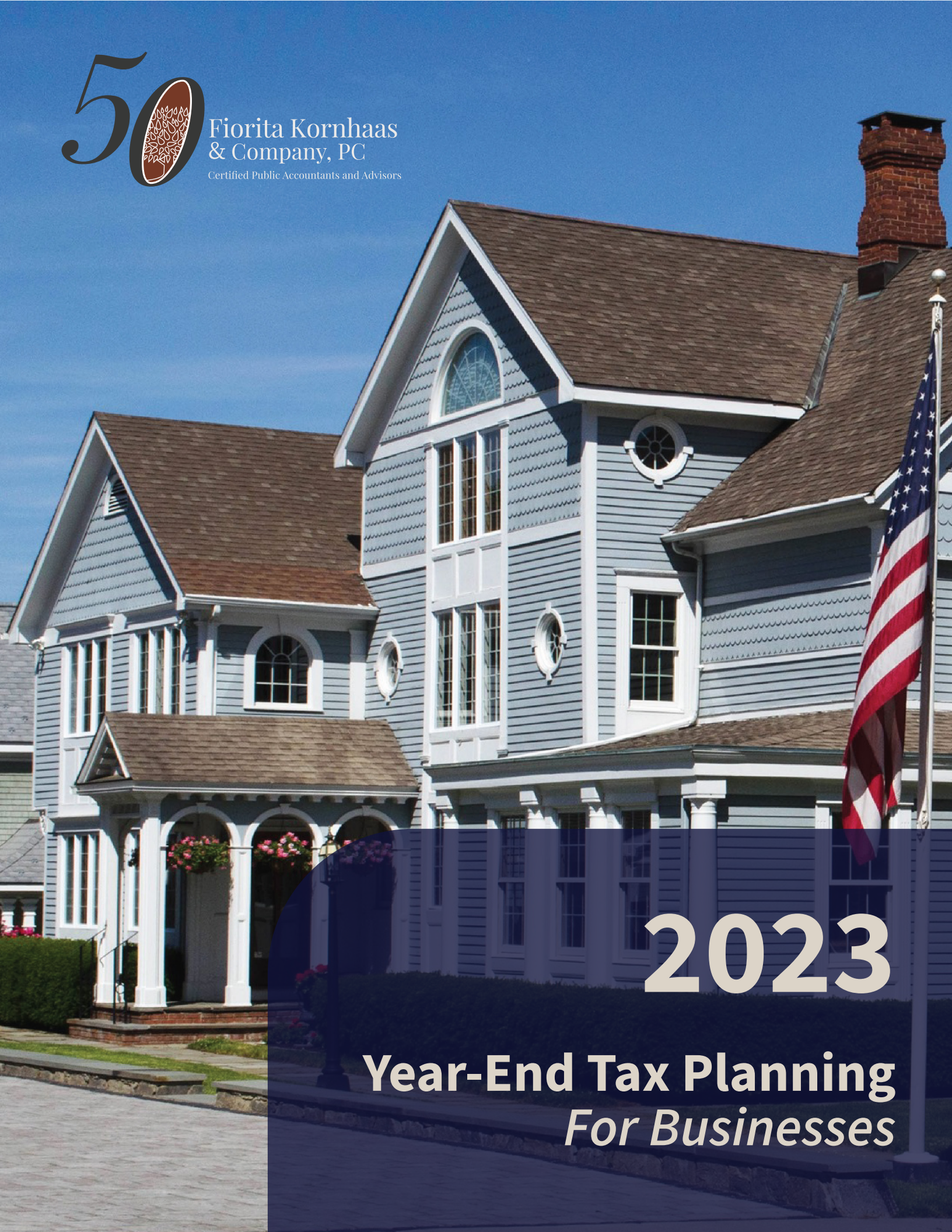

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Certified Public Accountants and Advisors

2023

Year-End Tax Planning
For Businesses

As we approach the culmination of 2023, it's pivotal for your business to proactively address year-end tax considerations. The intricate interplay of tax regulations, economic shifts, and legislative updates necessitates a meticulous approach to financial planning. Our focus is to provide you with targeted insights and actionable strategies tailored to your unique circumstances. We understand the nuances of your business, and our goal is to empower you with the knowledge and tools needed to optimize your tax position effectively. From capitalizing on available credits and deductions to strategic financial planning, our comprehensive guide aims to position your business for financial success in the coming fiscal year.

This guide provides a checklist of areas where, with proper planning, businesses may be able to reduce or defer taxes over time. Unless otherwise noted, the information contained in this guide is based on enacted tax laws and policies as of the publication date and is subject to change based on future legislative or tax policy changes.

Corporate and M&A

Corporations face a variety of unique tax rules and challenges – from the new alternative minimum tax and excise tax on stock repurchases to special limitations on deductions and losses, as well as complex tax rules when buying or selling a business. To minimize taxes payable, corporations should strive to identify and plan for tax issues before they arise. The following are some of the key developments and other areas to consider as corporations close tax year 2023 and begin 2024:

- Section 355 PLR Pilot Program Extension
- Tax Considerations When Selling a Subsidiary
- Intercompany Balance Cleanup
- Sections 382 and 383 Limitations on Tax Attributes – Is Your Company Prepared?
- Loss Limitations on S Corporation Shareholders

Section 355 PLR Pilot Program Extension

On July 27, 2023, the IRS issued Rev. Proc. 2023-26, creating a permanent fast-track process for Private Letter Rulings (PLRs) under the jurisdiction of the Chief Counsel (Corporate).

Rev. Proc. 2017-52, issued on September 21, 2017, began an 18-month pilot program to expand the IRS ruling policy on Section 355 to again include transactional rulings. Specifically, under the fast-track process, taxpayers may request transactional rulings from the IRS on "covered transactions," which include transactions intended to qualify as tax-free under Sections 368(a)(1)(D) and 355, and distributions intended to qualify as tax-free under Sections 355(a) and (c). The expansion did not extend transactional rulings to the issues of device prohibition, business purpose, or Section 355(e). Transactional rulings may, however, include the collateral tax consequences related to covered transactions, including consequences associated with E&P, basis, and relevant consolidated return regulations.

The pilot program received extremely positive feedback from practitioners. When the initial 18-month term expired, many wondered if the program would be extended. Rev. Proc. 2023-26 makes the pilot program permanent.

Tax Considerations When Selling a Subsidiary

The consolidated return regulations present special tax issues when a corporation is acquired out of a consolidated federal income tax group. To properly plan for these issues, taxpayers may find it beneficial to regularly assess tax positions relating to non-core subsidiary members that may be sold for various business reasons — such as to refocus on the core business, raise capital, or streamline operations. By doing so, a company can strategically evaluate the tax implications and make informed decisions earlier in the disposition process.

Intercompany Balance Cleanup

Intercompany receivables and payables are commonly established between members of consolidated groups, and, if not settled regularly, these balances can grow over time. Taxpayers often seek to eliminate intercompany balances for general administrative purposes or in advance of a contemplated M&A transaction. Given that balances between members of the same affiliated group may eliminate in the consolidation process of preparing financial statements, taxpayers might otherwise ignore their existence, until they

realize that eliminating the balances for tax purposes involves certain hurdles.

Sections 382 and 383 Limitations on Tax Attributes – Is Your Company Prepared?

Internal Revenue Code Sections 382 and 383 govern the use of a corporation's net operating losses (NOLs), Section 163(j) business interest expense carryforwards, tax credits, and similar tax attributes following an "ownership change." A lack of attention to these code sections can result in unexpected tax liabilities and penalties — which can also affect the company's financial statements. Companies that effectively manage their Section 382 and 383 limitations can proactively plan for as well as potentially mitigate the impact of these rules on their tax attributes.

Loss Limitations on S Corporation Shareholders

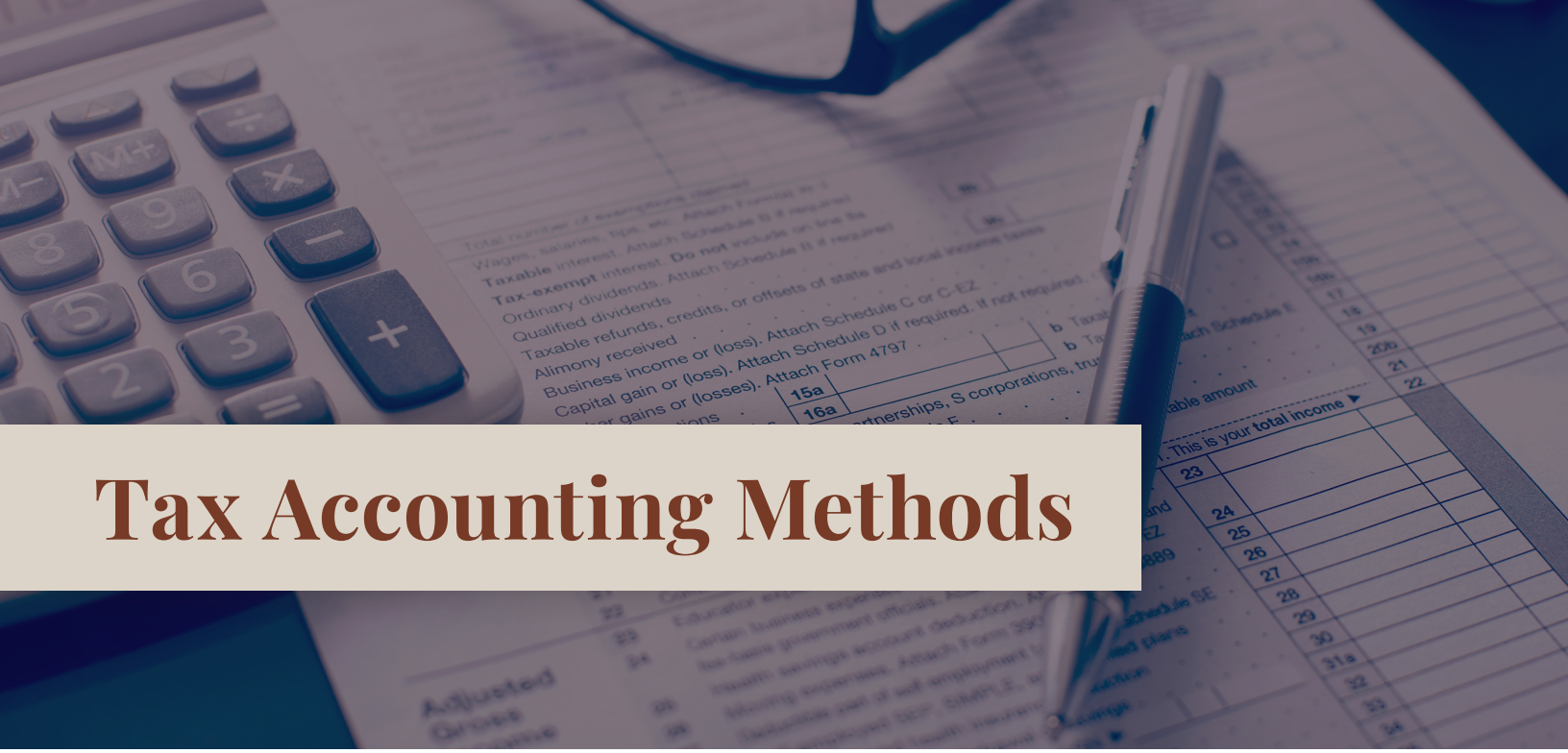
Prior to year end, owners of S corporations should consider tax planning opportunities that could help mitigate potential limitations on taxable losses passed through from S corporations.

The Internal Revenue Code limits an S corporation shareholder's taxable losses and deductions passed through from S corporations as follows:

- First, a shareholder's losses and deductions from an S corporation are generally limited under Section 1366 to the extent of their basis in the S corporation's stock and any loans they have made directly to the S corporation. Losses exceeding the shareholder's basis may be carried forward to future years, subject to the same basis limitation.
- Next, Section 465 limits losses and deductions from an S corporation to the shareholder's "at-risk" amount, which generally includes the shareholder's cash or property contributed to the S corporation, plus amounts borrowed for use by the S corporation if the shareholder is personally liable for repayment of the debt.
- Section 469 then imposes a limit on the losses and deductions based on the shareholder's involvement in the S corporation's business. A shareholder's losses from passive activities (including their passive involvement in the S corporation's business) can only offset income from other passive activities. Exceptions exist for real estate professionals and for taxpayers with active participation in certain activities. The classification of a shareholder's activities as passive or active (an activity in which they materially participate, as defined under Treas. Reg. §1.469-5T) must be determined every year.

In addition to these three hurdles, individual shareholders are subject to the rules for excess business losses (EBLs). A non-corporate taxpayer may deduct net business losses of up to $289,000 ($578,000 for joint filers) in 2023. A disallowed excess business loss (EBL) is treated as an NOL carryforward in the subsequent year, and is limited to 80% of taxable income. The Inflation Reduction Act extended the EBL rules through the end of 2028.

With proper planning, S corporation shareholders may be able to take steps before year end to help minimize loss limitations related to shareholder tax basis, at-risk amounts, or passive activities. Planning opportunities may also exist to help maximize the benefit of EBL carryforwards. However, certain planning strategies must be undertaken before the end of the taxable year.



Tax Accounting Methods

A taxpayer's tax accounting methods determine when income is recognized and costs are deducted for income tax purposes. Strategically adopting or changing tax accounting methods can provide opportunities to drive tax savings and increase cash flow. However, the rules covering the ability to use or change certain accounting methods are often complex, and the procedures for changing methods depend on the mechanism for receiving IRS consent — that is, whether the change is automatic or non-automatic. Many method changes require an application be filed with the IRS prior to the end of the year for which the change is requested.

Among others, taxpayers should consider the following tax accounting method implications and potential changes for 2023 and 2024, which are further discussed below.

Items taxpayers should review by year end:

- Be mindful of the December 31st deadline for non-automatic method changes
- Verify eligibility to use small business taxpayer exceptions and evaluate method implications
- Year-end clean-up Items: accelerate common deductions/ losses, if appropriate
- Revisit the de minimis book safe harbor for write-offs of tangible property
- Consider methods implications of potential M&A transactions
- Items to review in early months of 2024:
- Review latest specified research and experimental expenditures guidance (Section 174) and evaluate implications on 2023 tax year
- Review opportunities for immediate deduction of fixed assets
- Consider the UNICAP historic absorption ratio election
- Review leasing transactions for compliance with tax rules
- Evaluate accounting method changes for controlled foreign corporations

Items to review in early months of 2024:

Review Latest Section 174 Guidance and Evaluate Implications on 2023 Tax Year

The Tax Cuts and Jobs Act (TCJA)

The Tax Cuts and Jobs Act (TCJA) made significant changes to Internal Revenue Code Section 174, which deals with the deduction of research and experimental (R&E) expenses. Prior to the TCJA, businesses could deduct these expenses in the year they were incurred. However, the TCJA introduced new rules that require businesses to capitalize and amortize R&E expenses over a five-year period or 15-year period for foreign costs, starting from the midpoint of the taxable year in which the expenses were incurred. This change applies to R&E expenses incurred in tax years beginning after December 31, 2021. The changes to Section 174 also included language defining any software developed internally or by third parties as Section 174 expenses. Prior to the change, taxpayers rarely treated its R&E expenses as Section 174 expenses and elected to deduct these costs under Section 162.

Business Incentives & Tax Credits

Employee Retention Credit

The employee retention credit (ERC) is a refundable payroll tax credit for wages and health plan expenses paid or incurred by an employer (1) whose operations were either fully or partially suspended due to a COVID-19-related governmental order; or (2) that experienced a significant decline in gross receipts during the COVID-19 pandemic. The ERC has arguably been one of the most valuable provisions originating under the Coronavirus Aid, Relief, and Economic Security Act — the CARES Act — offering significant payroll tax relief for employers who kept employees on their payroll and continued providing health benefits during the COVID-19 pandemic.

Eligible employers can file a claim retroactively until the statute of limitations closes on April 15, 2024, for the 2020 ERC and April 15, 2025, for the 2021 ERC. Note that the U.S. government has repeatedly revised the requirements for U.S. taxpayers to claim the ERC since its initial codification into law. As a result, many eligible taxpayers have been uncertain as to whether they may properly claim this often-valuable tax credit.

Employers should be certain that one of the two paths for eligibility is satisfied:

- Gross receipts in a calendar quarter were less than 80% of the gross receipts for the corresponding quarter in 2019; or
- Business operations were fully or partially suspended during the calendar quarter because of orders from a governmental authority due to COVID-19.

Most eligibility disputes involve the partial suspension test. While most businesses were adversely impacted by COVID-19 related to government actions, not all are eligible for ERC under this provision. To be eligible under the partial suspension test, the suspension must have been material.

Identifying the relevant government orders is another common issue. Qualifying orders must have been mandatory, in effect, and must have caused a suspension of operations for the entire period during which the employer paid the wages supporting the ERC claim.

Also, because the ERC was intended to benefit small businesses, requirements exist that all businesses under common owners be aggregated into a single employer. This rule prevents large businesses from splitting into many entities to qualify. The same aggregation rule used to determine the size of an employer is applied to determine whether the employer experienced a partial suspension that was more than nominal.

In response to mounting concerns over a surge in improper claims for the ERC, on September 14, 2023, the IRS announced an immediate moratorium on processing new claims for the pandemic-era relief program. The moratorium, effective until at least the end of the year, aims to protect businesses from scams and predatory tactics. While the IRS continues to process previously filed ERC claims received before the moratorium, the agency warns that increased fraud concerns will result in longer processing times.

However, the pause on processing new claims does not modify the statute of limitations that expires on April 15, 2024, for wages paid in 2020. Therefore, an employer considering

a new request for a legitimate ERC claim should proceed after carefully reviewing Information Releases 2023-169 and 2023 -170, which the IRS released on September 14, 2023. For employers who would like to make a change to a pending claim that has not been processed or paid, the IRS is expected to issue guidance in the near future.

The IRS has also intensified its focus on reviewing ERC claims for compliance concerns, including conducting audits and criminal investigations on promoters and businesses submitting dubious claims. Hundreds of criminal cases are currently under investigation, and thousands of ERC claims have been referred for audit. Those with pending claims should expect extended processing times, while those yet to file should review the guidelines and consult trusted tax professionals.

As the IRS continues to refine its efforts to assist businesses facing questionable ERC claims, it advises businesses to carefully consider their situation and explore the options available to them. The IRS reminds anyone who improperly claims the ERC that they must pay it back, possibly with penalties and interest.

The IRS has stated that it will develop an ERC settlement program in late 2023 for employers that already received an ERC payment based on a claim now believed by the employer to be overstated. Under the settlement program, employers will be able repay the excess ERC amounts while avoiding penalties and other future compliance actions.

Additionally, to assist businesses affected by aggressive promoters, the IRS is developing a special withdrawal option for businesses that have filed an ERC claim but have not yet had it processed. Details of this program are expected to be announced in the coming months.

Given the increased IRS scrutiny of ERC claims, employers should reevaluate their ERC positions regarding eligibility and the amount of the claim. The IRS recommends that taxpayers seek advice from a trusted tax advisor.

Employers that have already filed a claim not prepared by a trusted tax advisor should verify whether any of the red flags or other concerns listed in the two IRS Information Releases apply to their situation. If they do, they should have any already submitted claim reviewed by a trusted tax professional. If the review does not support the claim as it was filed, corrective action should be pursued.

Global Employer Services

Utilizing Qualified Retirement Plan Enhancements to Improve Recruitment, Retention, and Employee Satisfaction

The SECURE 2.0 ACT of 2020 introduced over 90 changes to the federal rules governing workplace retirement plans. Many of the changes introduced by SECURE 2.0 are beneficial to employees and up to the discretion of the plan sponsor. Adopting some of these employee-favorable provisions might reassure employees that they can access their savings if needed before retirement, leading to overall increased employee savings and increased employee satisfaction.

Further guidance on many of the new provisions is needed, but every employer, whether for-profit or tax-exempt, that currently maintains a qualified retirement plan or is considering a future plan should evaluate their compliance with mandatory provisions and the cost benefit of adopting some of the many employee-friendly optional provisions.

After the provisions to be adopted are narrowed down, any necessary operational changes that require systems or processes updates can be identified. Written amendments to the plan document to reflect the implemented changes are not required until the end of the plan year beginning in 2025. Government employers have until the end of their 2027 plan year to amend the plan document.

Changes effective December 29, 2022

- SECURE 2.0 allows de minimis financial benefits, such as low-value gift cards, as incentives to encourage employees to elect to contribute to 401(k) and 403(b) plan. Prior to this change such incentives violated the IRS's "contingent benefit rule."
- Employers may allow plan participants to designate matching and nonelective contributions as Roth contributions.
- Plans or IRAs may allow affected participants additional access to retirement funds in the event of federally declared disasters that occur on or after January 26, 2021, by allowing penalty-free distributions up to $22,000 per disaster to affected participants, while spreading the income tax liability over three years if not repaid prior to the taxable date. Plans can also allow increased participant loans of $100,000 instead of the regular $50,000 loan limit for disasters that occur on or after January 26, 2022.
- Plan sponsors can rely on employees' self-certification that the employee has experienced a deemed hardship for purposes of taking a hardship withdrawal.
- Cash balance plans with variable interest crediting rates may use a projected "reasonable" interest crediting rate that does not exceed 6%, thereby allowing credits that increase benefits for older, longer-service workers without risking failing the anti-backloading rules that otherwise may create problems for cash balance plans.
- The act allows 403(b) plans to invest in Collective Investment Trusts (CITs) in addition to mutual funds and/or annuity contracts.
- Employers with 100 or fewer employees earning at least $5,000 in annual compensation can receive a general tax credit of up to $500 for three years, if they make military spouses (1) eligible for defined contribution plan participation within two months of hire; (2) upon plan eligibility, are eligible for any match or non-elective contribution that they would have been otherwise eligible for at two years of service; and (3) 100% vested in employer contributions. The credit is equal to $200 per participating non-highly compensated military spouse, plus 100% of employer contributions made to the military spouse, up to $300. The credit is available for the year the military spouse is hired and the two succeeding taxable years. Employers may rely on the employee's certification that they are an eligible military spouse.

- Small employers are eligible for a plan start-up credit, effective for taxable years beginning after December 31, 2022. The start-up credit for adopting a workplace retirement plan increases from 50% to 100% of administrative costs for small employers with up to 50 employees. The credit remains 50% for employers with 51-100 employees. Employers with a defined contribution plan may also receive an additional credit based on the amount of employer contributions of up to $1,000 per employee. This additional credit phases out over five years for employers with 51-100 employees. The start-up credits are available for three years to employers that join an existing MEP, regardless of how long the plan has been in existence. The MEP rule is retroactively effective for taxable years beginning after December 31, 2019; therefore, plans that joined an MEP in 2020, 2021, or 2022 can file retroactively for this credit.
- SIMPLE and Simplified Employee Pensions (SEPs) can accept Roth contributions effective for taxable years beginning after December 31, 2022. In addition, employers can offer employees the ability to treat employee and employer SEP contributions as Roth contributions (in whole or in part).
- Employers of domestic employees (nannies, housekeepers, etc.) can provide retirement benefits for those employees under a SEP.

Changes taking effect in 2024

- Employers may treat an employee's qualified student loan payments as employee contributions to a 401(k) plan, 403(b) plan, governmental 457(b) plan, or SIMPLE IRA that is entitled to an employer matching contribution. For nondiscrimination testing of elective contributions, plans may separately test the employees who receive matching contributions on student loan repayments.
- Defined contribution plans may offer short-term emergency savings accounts to non-highly compensated employees. These accounts will be funded with employee after-tax Roth payroll deductions up to $2,500 (indexed for inflation). Employers may automatically enroll employees into these accounts at no more than 3% of their salary. Contributions are eligible to receive matching contributions. Participants can make up to one withdrawal per month. When employees terminate employment, they may take their emergency savings accounts as cash or roll them over into their new employer's Roth 401(k) plan (if any) or into a Roth IRA.
- Employers can retroactively amend a workplace retirement plan to increase participants' benefits for the prior plan year, so long as the amendment is adopted no later than the extended due date of the employer's federal income tax return for such prior year.
- The 10% penalty on early withdrawals before age 59 1/2 is waived for certain emergency expenses based on a participant's self-certification that they meet the necessary criteria.
- Employers that do not sponsor a workplace retirement plan may offer a new, safe harbor "starter" deferral-only plan that automatically enrolls employees at 3% to 15% of their compensation. The annual contribution limit is the same as for IRAs ($6,500, with an additional $1,000 for catch up contributions for employees who are age 50 or older. Starter plans are exempt from most nondiscrimination testing rules. This change is effective for plan years beginning after December 31, 2023.
- Employers may replace a SIMPLE IRA during the plan year with a SIMPLE 401(k) that requires mandatory employer contributions. Also, employers with SIMPLE plans may make additional employer contributions above the existing 2% of compensation or 3% of employee elective deferrals requirement. Additional employer contributions must be uniformly made and cannot exceed the lesser of 10% of compensation or $5,000 (indexed for inflation). In addition, the annual deferral limit and the catch-up contribution at age 50 is increased by 10% in the case of an employer with no more than 25 employees. An employer with 26 to 100 employees would be permitted to provide higher deferral limits, but only if the employer either provides a 4% matching contribution or a 3% employer contribution.

Changes taking effect in 2025

- A provision designed to increase retirement savings will be effective for 401(k) and 403(b) plans adopted after December 29, 2022, requiring employees to be automatically enrolled for minimum elective deferral contributions. However, participants can opt out of automatic enrollment or automatic escalation.
- Effective December 29, 2025, retirement plans can distribute up to $2,500 per year to pay for certain long-term care insurance premiums. Such distributions are exempt from the 10% early withdrawal penalty that might otherwise apply.

State and Local Tax

With thousands of taxing jurisdictions, from school boards to counties and states, and many different types of taxes, state and local taxation is complex. Each tax type comes with its own set of rules — by jurisdiction — all of which require a different level of attention.

This article provides a high-level overview to help companies with 2023 year-end SALT planning considerations, and it provides guidance on how to hit the ground running in 2024.

Liquidity Events

Liquidity events take the form of IPOs; financings; sales of stock, assets, or businesses; and third-party investments. Those events involve different forms of transactions, often driven by business or federal tax considerations; unfortunately, and far too often, the SALT impact is ignored until the 11th hour or later.

A liquidity event is not an occasion for surprises. When a taxpayer is contemplating any form of transaction, state and local taxes should not be overlooked. Knowledgeable SALT professionals can help identify planning opportunities and point out potential pitfalls, and it is never too early to involve them. If you wait until after the transaction occurs or until the state tax returns are being prepared, it may be too late to leverage their insight.

From state tax due diligence to understanding the total state tax treatment of a transaction to properly reporting and documenting state tax impacts, addressing SALT at the outset of a deal is critical. If involved before the year-end liquidity event, SALT professionals can suggest helpful adjustments to the transaction that may be federal tax-neutral but could result in identifying significant state tax savings or costs now, rather than later. After the liquidity event, because the state tax savings or costs already have been identified, they can be properly documented and reported post-transaction. Further, because SALT expertise was involved at the front end, state tax post-transaction integration, planning, and remediation can be more seamlessly pursued.

Income/Franchise Taxes

If anything has been learned from the last six years of federal tax legislation, it's that state income tax conformity cannot be taken for granted. While states often conform to myriad federal tax provisions, it's important to verify S corporations are treated as such by each state they operate in. Further, S corporations must confirm that their status applies to state income taxes. Not asking those questions early can lead to a misunderstanding and potential issues later.

Several states don't conform to federal entity tax classification regulations. Some, including New York, require a separate state-only S corporation election. New Jersey now allows an election out of S corporation treatment. Making those elections — or not — can lead to different state income tax answers, so it's important to understand the available options before the transaction occurs.

Asking important questions early can help provide clarity in the decision-making process:

- If the liquidity event will result in gain, how is the gain going to be treated for state income tax purposes?

- Is it apportionable business gain or allocable nonbusiness gain?
- Is a partnership interest, stock, or asset being sold?
- How will the gain be apportioned?
- Was the seller unitary with the partnership or subsidiary, or did the assets serve an operational or investment function for the seller?
- Will the gross receipts or net gain from the sale be included in the sales factor, and, if so, how will they be apportioned?

Those are just some of the questions that are never asked on the federal level because they don't have to be. But they are material on the state level and, again, are unwelcome surprises.

Sales/Use Taxes

Most U.S. states require a business to collect and remit sales and use taxes even if it has only economic, and no physical, presence. Remote sellers, software licensors, and other businesses that provide services or deliver their products to customers from a remote location must comply with state and local taxes.

Left unchecked, those state and local tax obligations — and the corresponding potential liability for tax, interest, and penalties — will grow. Moreover, neglecting your sales and use tax obligations could result in a lost opportunity to pass the sales and use tax burden to customers as intended by state tax laws.

A company could very well experience material sales and use tax obligations resulting from a sale, even though the transaction or reorganization is tax free for federal income tax purposes. To avoid any material issues, several steps should be taken:

- Determine nexus and filing obligations;
- Evaluate product and service taxability;
- Quantify potential tax exposure;
- Mitigate and disclose historical tax liabilities;
- Consider implementing a sales tax system; and
- Maintain sales tax compliance.

Real Estate Transfer Taxes

Most states impose real estate transfer taxes (RETTs) or conveyance taxes on the sale or transfer of real property, or controlling interest transfer taxes when an interest in an entity holding real property is sold. Few taxpayers are familiar with RETTs, and the complex rules and compliance burdens associated with those state taxes could prove costly if they are not considered up front.

State PTE Tax Elections

Roughly 35 states now allow pass-through entities (PTEs) to elect to be taxed at the entity level to help their residents avoid the $10,000 limit on federal itemized deductions for state and local taxes known as the "SALT cap." Those PTE tax elections are much more complex than simply checking a box to make an election on a tax return. Although state PTE tax elections are meant to benefit the individual members, not all elections are alike, and they are not always advisable.

Before making an election, a PTE should model the net federal and state tax benefits and consequences to the PTE — for every state in which the PTE operates, as well as for each resident and nonresident member — to avoid potential unintended tax results. A thorough evaluation of whether to make a state PTE tax election (or elections) should be completed before the end of the year, modeling the net tax benefits or costs, as should a determination of timing elections, procedures, and other election requirements (e.g., owner consents, owner votes to authorize the election, and partnership or LLC operating agreement amendments). If those steps are completed ahead of time, then the table has been set to make the election in the days ahead.

When considering a state PTE tax election, one of the most important issues to evaluate is whether members who are nonresidents of the state for which the election is made can claim a tax credit for their share of the taxes paid by the PTE on their resident state income tax returns. If a state does not offer a tax credit for elective taxes paid by the PTE, then a PTE tax election could result in additional state tax burden that exceeds some members' federal itemized deduction benefit ($0.37 is less than $1.00). Therefore, as part of the pre-year-end evaluation and modeling exercise, PTEs should consider whether the election would result in members being precluded from claiming other state tax credits — which ordinarily would reduce their state income tax liability dollar for dollar — in order to receive federal tax deductions that are less valuable.

Does P.L. 86-272 Still Exist?

P.L. 86-272 is a federal law that prevents a state from imposing a net income tax on any person's net income derived within the state from interstate commerce if the only business activity performed in the state is the solicitation of orders of tangible personal property that are sent outside the state for approval or rejection and, if approved, are filled by shipment

or delivery from a point outside the state.

The Multistate Tax Commission (MTC) adopted a revised statement of its interpretation of P.L. 86-272 which, for practical purposes, largely nullifies the law's protections for businesses that engage in activities over the internet. To date, California and New Jersey have formally adopted the MTC's revised interpretation of internet-based activities, while Minnesota and New York have proposed the interpretation as new rules. Other states are applying the MTC's interpretation on audit without any notice of formal rulemaking.

Online sellers of tangible personal property that have previously claimed protection from state net income taxes under P.L. 86-272 should review their positions. Online sellers that use static websites that don't allow them to communicate or interact with their customers — a rare practice — seem to be the only type of seller that the MTC, California, New Jersey, and other states still consider protected by P.L 86-272.

The effect of the MTC's new interpretation on a taxpayer's state net income tax exposure should be evaluated before the end of the year. Structural changes, ruling requests, or plans to challenge states' evolving limitation of P.L. 86-272 protections applicable to online sales can be put into place.

However, nexus or loss of P.L. 86-272 protection can be a double-edged sword. For example, in California, if a company is subject to tax in another state using California's new standard, then it is not required to throw those sales back into its California numerator for apportionment purposes.

Property Tax

For many businesses, property tax is the largest state and local tax obligation and a significant recurring operating expense that accounts for a substantial portion of local government tax revenue. Unlike other taxes, property tax assessments are ad valorem, meaning they are based on the estimated value of the property. Thus, they could be confusing for taxpayers and subject to differing opinions by appraisers, making them vulnerable to appeal. Assessed property values also tend to lag true market value in a recession.

Property tax reductions can provide valuable above-the-line cash savings, especially during economic downturns when assessed values may be more likely to decrease. The current economic environment amplifies the need for taxpayers to avoid excessive property tax liabilities by making sure their properties are not overvalued.

Annual compliance and real estate appeal deadlines can provide opportunities to challenge property values. Challenging real property assessments issued by jurisdictions within the appeal window may reduce real property tax liabilities. Taking appropriate positions on personal property tax returns related to any detriments to value could reduce personal property tax liabilities. Planning for and attending to property taxes can help a business minimize its total tax liability.

Conclusion

There are 50 states and thousands of local taxing jurisdictions that impose multiple different tax types. Ensuring that your company is in compliance with those state and local taxes — and only paying the amount of tax legally owed — can help reduce your total tax liability. As a taxpayer, it is more efficient to be proactive, rather than reactive, when it comes to state and local taxes. Being proactive will help identify issues and solutions that can be applied to other taxing jurisdictions, as well as helping limit audits, notices, penalties, and interest.

Partnerships

The IRS in the past year has been actively challenging partnerships' tax positions in court – from the valuation of granted profits interests to limited partner self-employment exemption claims and the structuring of leveraged partnership transactions. At the same time, the agency is dedicating to new funding and resources to examining partnerships.

These developments, along with some reporting and regulatory changes, mean there are a number of tax areas partnerships should be looking into as they plan for year end and the coming year:

- Review Valuation of Granted Profits Interests, Partners' Capital Accounts
- Consider Active Limited Partners' Potential Liability for Self-Employment Tax
- Prepare for Expanded IRS Audit Focus on Partnerships
- Review Structure of Leveraged Partnership Transactions, Application of Anti-Abuse Rules
- Prepare for New Reporting on 2023 Form 1065 Schedule K-1
- Evaluate Before Year End Expiration of Partnership Bottom-Dollar Guarantee Transition Rules

Review Valuation of Granted Profits Interests, Partners' Capital Accounts

In a recent Tax Court case, the IRS attempted — unsuccessfully — to supplant the fair market value agreed to by unrelated parties in a partnership transaction with its expert's higher estimate, asserting that the taxpayer received a taxable capital interest in exchange for services provided to a partnership, not a nontaxable profits interest. If structured and substantiated properly, profits interests can be valuable tools for compensating providers of services to partnerships at no immediate tax cost. Although the court upheld the taxpayers' valuation, the IRS challenge highlights the importance for partnerships to:

- Properly determine, support and document value when granting and establishing rights to profits interests, and
- Strongly consider revaluing partners' capital accounts according to Treasury regulations to reflect fair market value when profits interests are granted.

The case, ES NPA Holding LLC v. Commissioner, T.C. Memo 2023-55 (May 3, 2023), involved a partnership (ES NPA) that provided services to another partnership in exchange for a partnership interest. The taxpayers contended that interest was a profits interest, which was not immediately taxable. The IRS argued that, under its higher estimation of the value of the underlying business, ES NPA took a capital interest in the partnership that ostensibly should be immediately taxable.

Relying on the fair market value negotiated among the parties to the transaction, the Tax Court agreed with the taxpayer that there was not a taxable capital shift between partners. Unsurprisingly, the Tax Court also concluded — premised on the IRS's guidance in Revenue Procedure 93-27 — that receipt of a profits interest will not result in the immediate recognition of taxable income. What is somewhat surprising is that the IRS challenged whether the interest was, in fact, a profits interest.

Consider Active Limited Partners' Potential Liability for Self-Employment Tax

A judicial resolution may be near for the unanswered question of whether limited partners in state law limited partnerships may claim exemption from self-employment (SECA) taxes — despite being more than passive investors. Depending on the outcome in the pending Soroban Capital Partners litigation, limited partners in state law limited partnerships who actively participate in the partnership's business may lose the opportunity to claim this exemption. If this happens, these limited partners would likely become subject to SECA tax on their partnership income.

SECA taxes can be substantial for active partners in profitable partnerships. The SECA tax rate consists of two parts: 12.4% for social security (old-age, survivors, and disability insurance) and 2.9% for Medicare (hospital insurance). While the 12.4% social security tax is currently limited to the first $160,200 of self-employment earnings, partners who are subject to SECA tax must pay the 2.9% Medicare part of the tax on their entire net earnings from the partnership. There is also an additional 0.9% Medicare tax on all earnings from the partnership over a certain base amount (currently $125,000; $200,000; or $250,000 depending on the partner's tax filing status).

Why are some limited partners in jeopardy of losing their SECA tax exemption?

Under Internal Revenue Code Section 1402(a)(13), the distributive share of partnership income allocable to a "limited partner" is generally not subject to SECA tax, other than for guaranteed payments for services rendered. However, the statute does not define "limited partner," and proposed regulations issued in 1997 that attempted to clarify the rules around the limited partner exclusion have never been finalized.

More recently, courts have held — in favor of the IRS — that members in limited liability companies (LLCs) and partners in limited liability partnerships (LLPs) that are active in the entity's trade or business are ineligible for the SECA tax exemption. Despite these IRS successes, some continue to claim that state law controls in defining "limited partner" in the case of a state law limited partnership and, therefore, limited partners in state law limited partnerships — even active limited partners — may be eligible for the SECA tax exemption. This issue has yet to be specifically addressed by the courts, but Soroban Capital Partners may be the first case to squarely resolve it.

What is the issue in the Soroban Capital Partners litigation?

The Soroban Capital Partners litigation filed with the Tax Court involves a New York hedge fund management company formed as a Delaware limited partnership. The taxpayers challenge the IRS's characterization of partnership net income as net earnings from self-employment subject to SECA tax. According to the facts presented, each of the three individual limited partners spent between 2,300 and 2,500 hours working for Soroban, its general partner and various affiliates – suggesting that the limited partners were "active participants" in the partnership's business.

In its March 2 objection to the taxpayers' motion for summary judgment, the government contends that the term "limited partner" is a federal tax concept that is determined based on the actions of the partners – not the type of state law entity. Citing previous cases, the government asserts that the determination of limited partner status is a "facts and circumstances inquiry" that requires a "functional analysis." The taxpayers in Soroban, on the other hand, argue that such a functional analysis does not apply in the case of a state law limited partnership and that, in the case of these partnerships, limited partner status is determined by state law.

Under the functional analysis adopted by the Tax Court in previous cases, to determine who is a limited partner, the court looks at the relationship of the owner to the entity's business and the factual nature of services the owner provides to the entity's operations. For the SECA tax exemption to apply, the government states (citing case law), "an owner must not participate actively in the entity's business operations and must have protection from the entity's obligations."

What should limited partners do pending the outcome of the Soroban case?

Limited partners who actively participate in the partnership's business should review their facts and circumstances and potential exposure to SECA tax. Although there is currently no clear authority precluding active limited partners of a state law limited partnership from claiming exemption from SECA tax, such a position should be taken with caution and a clear understanding of the risks—including being subject to IRS challenge if audited. The IRS continues to focus on scrutinizing such claims through its SECA Tax compliance campaign. Moreover, the opportunity to claim the exemption could be significantly narrowed depending on the outcome of Soroban Capital Partners.

Prepare for Expanded IRS Audit Focus on Partnerships

The IRS on September 8, 2023, announced that it will leverage funding from the Inflation Reduction Act to take new compliance actions, including actions focused on partnerships and other high income/high-wealth taxpayers. It intends to use artificial intelligence (AI) and improved technology to identify potential compliance risk areas.

Subsequently, on September 20, the IRS further announced plans to establish a new work unit to focus on large or complex pass-through entities. The new pass-through area workgroup will be housed in the IRS Large Business and International (LB&I) division and will include the people joining the IRS under a new IRS hiring initiative. The creation of this new unit is another part of the IRS's new compliance effort.

With respect to partnerships, the IRS announcement on new enforcement efforts indicates that the IRS will focus on two key areas:

- Expanding its Large Partnership Compliance program by using AI to identify compliance risks, and
- Increasing use of compliance letters focused on partnerships with balance sheet discrepancies.

Large Partnership Compliance and AI

The IRS began focusing on examinations of the largest and most complex partnership returns through its Large Partnership Compliance pilot program launched in 2021. It now plans to expand the program to additional large partnerships, using AI to select returns for examination. The AI, which has been developed jointly by experts in data science and tax enforcement, uses machine learning technology to identify potential compliance risks in partnership tax and other areas.

The IRS stated that it plans, by the end of this month, to have opened examinations of 75 of the largest partnership in the U.S. in a cross section of industries – including hedge funds, real estate investment partnerships, publicly traded partnerships, and large law firms.

Compliance Letters and Balance Sheet Discrepancies

The IRS has identified ongoing discrepancies in balance sheets of partnerships with over $10 million in assets. The IRS announcement explains that there have been an increasing number of partnership returns in recent years showing discrepancies in balances between the end of one year and the beginning of the next year – many in the millions of dollars, without any required attached statement explaining the discrepancy.

The IRS states that it did not previously have the resources to follow up and engage with large partnerships on these discrepancies. Using its new resources, the IRS plans to approach the issue by mailing out compliance letters to around 500 partnerships starting in early October. Depending on the partnerships' responses, the IRS might take additional action, including potential examination.

Prepare for New Reporting on 2023 Form 1065 Schedule K-1

The IRS included new and modified reporting requirements in its draft 2023 Form 1065 Schedule K-1, released on June 14, 2023, including:

- A modified reporting requirement concerning decreases in a partner's percentage share of the partnership's profit, loss and capital, and
- A new reporting requirement relating to partnership debt subject to guarantees or other payment obligations of a partner.

Decreases in a Partner's Share of Partnership Profit, Loss and Capital

The modification to the Schedule K-1 reporting reflected on the draft 2023 Schedule K-1 concerns certain decreases in a partner's percentage share of the partnership's profit, loss and capital from the beginning of the partnership's tax year to the end of the tax year.

Reporting a partner's percentage share of the partnership's profit, loss and capital at the beginning and the end of the tax year is not a new requirement. Prior versions of the Schedule K-1 require the partnership to check a box indicating if a decrease in a partner's percentage share of profit, loss and capital from the beginning of the tax year to the end of the tax year is due to a sale or exchange of partnership interests. The draft 2023 Schedule K-1 refines this reporting by distinguishing, in Part II, Item J, between decreases due to sales of partnership interests and decreases due to exchanges. Partnerships must check one box if a decrease in a partner's percentage share of profit, loss and capital from the beginning to the end of the partnership tax year is due to a sale of partnership interests and a separate box if the decrease is due to an exchange of partnership interests.

While it is unclear why the IRS distinguishes a sale from

an exchange in this context, in the absence of clarifying instructions to the 2023 Form 1065, an exchange of partnership interests should be interpreted broadly to encompass any non-sale transfers of partnership interests, whether taxable or not, including by gift, a redemption or otherwise.

Partnership Debt Subject to Guarantees or Other Payment Obligations of a Partner

The new reporting requirement reflected on the draft 2023 Schedule K-1 underscores the importance of properly classifying partnership liabilities as recourse or nonrecourse under the Section 752 rules. The draft 2023 Schedule K-1, in Part II, Item K3, requires the partnership to check a box if a partner's share of any partnership indebtedness (also reported on the Schedule K-1) is subject to guarantees or other payment obligations by the partner.

The existence of a guarantee or other partner payment obligation is relevant in determining whether a partnership liability is considered recourse or nonrecourse under the rules of Section 752. Regulations state that a partnership liability is a recourse liability to the extent that any partner or related person bears an economic risk of loss with respect to the obligation. A partner that has an obligation to make a net payment to a creditor or other person with respect to a partnership liability upon a constructive liquidation of the partnership, including pursuant to a deficit restoration obligation (DRO) in the partnership agreement, is considered to bear the economic risk of loss of that partnership liability. A partner's payment obligation with respect to partnership debt may arise pursuant to any contractual guarantees, indemnifications, reimbursement agreements or other obligations running directly to creditors, to other partners or to the partnership.

The existence of a debt guarantee or other payment obligation by the partner with respect to a partnership liability may indicate that the partner bears some or all of the economic risk of loss for such liability, which is a key factor in classifying a partnership liability as recourse or nonrecourse under the rules of Section 752.

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