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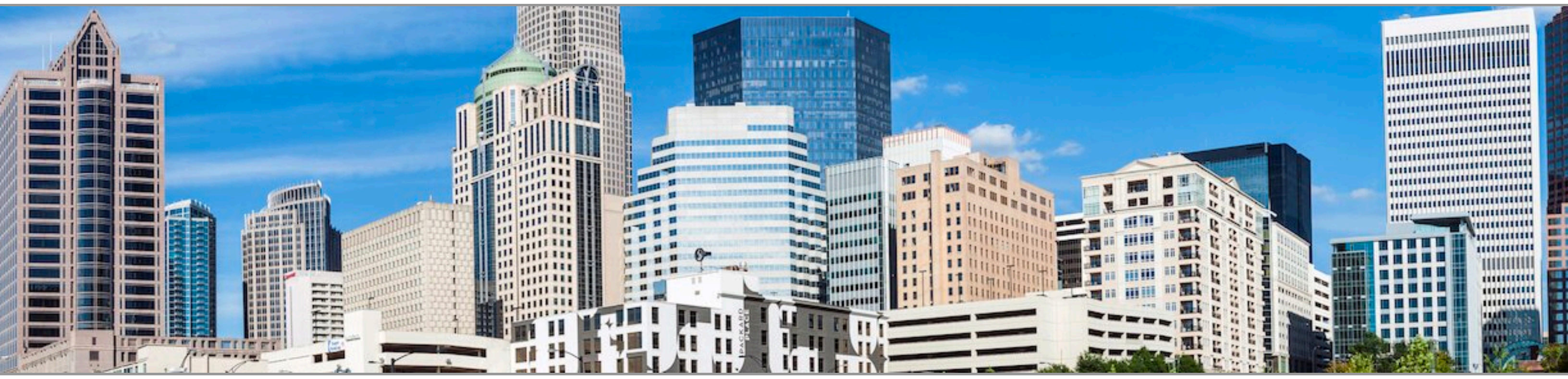

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2021 year-end tax considerations for businesses

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2021 year-end tax considerations for businesses

Legislative changes and other tax concerns that may affect planning

This guide reflects the tax considerations and developments that we believe may create risk or opportunity for businesses in 2021 and beyond. It is not an exhaustive list of all tax issues that may affect your business, but it is designed to help you make informed decisions related to year-end tax planning.

Please see our website for additional information on many of these issues.

Introduction

An unprecedented response to the continued challenges of the global pandemic was broadened in 2021 following the 2020 Coronavirus Aid, Relief, and Economic Security (CARES) Act. In late December 2020, Congress passed the Consolidated Appropriations Act, 2021 (CAA), providing over $900 billion in relief to businesses and individuals, followed by the first major legislative package of the Biden administration, the American Rescue Plan Act of 2021 (ARPA), providing an additional $1.9 trillion of relief to businesses, individuals and state governments.

The tax policy landscape remains fluid. The release of the House Ways and Means draft bill on Sept. 13 has set in motion a series of events, still transpiring, on Capitol Hill coalescing around advancing President Joe Biden's Build Back Better agenda, inclusive of potential tax law changes. The dynamics of a 50-50 balance of power in the Senate have been on full display throughout the process. Divergent views among House Democratic moderates and progressives as to social spending programs and the scope of revenue-raising measures have repeatedly emerged at critical junctures, at times threatening the overall course of events.

The tax policy path ahead will continue to evolve, and must be monitored accordingly. Tax rates may be increased, new code provisions added and existing code amended. Nevertheless, the time for taking action as we head into the year-end for some taxpayers is now. Key decisions, including business model considerations, choice of entity, workforce and compensation matters, and general tax planning into a (presumably) higher tax rate environment should all be top of mind. All individuals, whether high-wage earners or otherwise, as well as estates and trusts, pass-through entities, and many others are facing some of the most significant changes in decades. International provisions, specifically those amended by the Tax Cuts and Jobs Act (TCJA), are also receiving renewed scrutiny and are likely to be included in any additional tax reform. Being prepared, flexible and ready to respond to this new landscape will be critical as we head into 2022.

General considerations

Deduction and revenue planning

2021 may require a nuanced approach to tax planning. With many companies anticipating rate increases in the near term, accelerating revenue into 2021 and deferring expenses into subsequent years may need to be considered. New revenue recognition regulations and looming unfavorable taxpayer changes to bonus depreciation, required capitalization and amortization of research and experimentation costs, and the loss of the depreciation addback for section 163(j) (interest expense limitation), add significant complexity to planning. Depending on a taxpayer's situation, several accounting method approaches may help maximize benefit and reduce exposure. A few of these include:

- Changing from the cash basis to the accrual basis of accounting, or vice versa, if applicable
- Conducting inventory planning (e.g., performing a uniform capitalization—UNICAP— review or electing new last-in, first-out—LIFO—submethods)
- Accelerating certain deductions or electing to capitalize prepaid expenses for the current year
- Electing to recover self-developed software costs over 36 months or currently deduct those costs
- Accelerating advance payments into income
- Properly using the recurring-item exception for taxes, rebates and refunds
- Shoring up bonus plan requirements to substantiate deducting in the year employees provide the related services or altering the facts to defer the deduction into the year paid
- Accelerating recovery of real property through cost segregation and/or repair studies
- Electing to capitalize research and experimentation costs for new projects over a period of not less than 60 months
- Electing out of bonus depreciation for certain or all classes of otherwise eligible asset acquisitions

Small taxpayer designation

The TCJA increased the threshold for defining a small-business taxpayer to include those with average annual gross receipts of $26 million or less for the three prior tax years, for the tax year Dec. 31, 2021. This amount is indexed yearly for inflation. Those qualifying under the small business taxpayer designation may be able to use the overall cash method, be exempt from applying certain inventory rules and be exempt from the limitation on interest deductions.

Revenue recognition under section 451

While all companies required should have adopted ASC 606 (or IFRS 15), some entities may not have had the time or resources to become 100% compliant. Further, with new regulations and accompanying procedural changes under section 451 now in full effect, ensuring compliance and planning around some of the more unfavorable provisions could require considerable additional time and resources.

In addition, companies that are required to recognize revenue for the sale of a good over time, and were previously recognizing revenue for the sale of a good at a point in time, will want to review a potentially favorable cost offset provision contained with the final revenue recognition regulations, released in December 2020.

Changes in financial statement treatment for leases under ASC 842

Most private companies and nonprofit organizations with significant lease activity will want to adopt by Jan. 1, 2022, depending on their year-end. Otherwise, lease activity recorded throughout the year will have to be redone throughout the 2022 reporting year. While the analysis of the leasing standard is mostly a financial accounting initiative, it gives taxpayers the opportunity to determine if their lease classification is accurate under federal income tax principles. Taxpayers often follow their financial statement treatment of leases for tax without applying the appropriate tax tests. And of course, with a change in financial accounting treatment of an item, taxpayers will need to understand and be familiar with new book-to-tax adjustments that may be required to maintain accurate tax records.

Bonus depreciation

One hundred percent additional first-year (bonus) depreciation is available for qualified property acquired and placed in service after Sept. 27, 2017. The IRS has issued final and re-proposed regulations related to when taxpayers acquire an asset under a written, binding contract. The TCJA expanded bonus depreciation to qualifying used property. The expansion to used property may allow certain business acquisitions to recover a portion of the purchase price immediately through 100% bonus depreciation. In addition, as part of the CARES Act, qualified improvement property is eligible for 100% bonus depreciation retroactively to Jan. 1, 2018.

The bonus depreciation amount phases down to 80% for property placed in service after Dec. 31, 2022, and before Jan. 1, 2024, and then phases down by 20% each year after. Taxpayers should model out the impact of 100% bonus depreciation in 2022 with the loss of the depreciation addback to compute adjusted taxable income (ATI) under the interest expense limitations put in place by the TCJA.

Uniform capitalization regulations

In November 2018, the Treasury and IRS issued new UNICAP regulations providing taxpayers new rules and a new method for capitalizing inventory costs. The new method is one of several that taxpayers can consider when capitalizing costs to inventory and could offer simplicity and tax efficiency, in addition to compliance. The final regulations are effective for tax years beginning on or after Nov. 20, 2018; calendar-year taxpayers must apply the new regulations as of their 2019 tax returns. Changes in accounting method (generally automatic) are required to comply with the new regulations. The rules affect both producers and resellers, but affect producers more. As companies continue to struggle to respond to the pandemic, UNICAP implementation may have been deferred to 2021. The IRS has indicated that since the TCJA guidance is coming to an end, the IRS will pivot to enforcement. We expect UNICAP to be on the list of items the IRS will examine. It is important to quickly address this situation as IRS exam activity regarding UNICAP is expected to increase now that the regulations are effective.

Inventory is often one of the largest assets on the balance sheet of a producer or reseller, and historic UNICAP methods are often complicated and out of compliance. Fortunately, the new regulations and the accompanying automatic change procedures offer taxpayers the opportunity to comply with the new regulations while obtaining prior-year audit protection for historic UNICAP methods. Now more than ever, taxpayers should evaluate the impact of these new rules.

Fringe benefit issues

The past year has brought not only final regulations on fringe benefit-related items in the TCJA but also changes to the work environment that may have impacts on the treatment of certain fringe benefits. Areas to review may include the following :

- Entertainment and food and beverage expenses:
  - Verify that time and business expense systems are properly collecting and marking business entertainment expenses separately from food and beverage expenses, employee recreational expenses and other business expenses, and recording them in separate general ledger accounts. Confirm business expense systems are properly collecting all de minimis fringe benefit food and beverage costs and separating them from other business costs (such as invoices that bill for both office supplies and coffee and snacks for an office pantry or break room).
  - Review the opportunity for 100% deductible meals provided by a restaurant.
- Loss of tax deductions for employer-provided parking, transit and commuting:
  - Final regulations provided a favorable exception for rural areas that should be reviewed for potential deductions that can be preserved.
  - Final regulations confirm that commuting expenses are not deductible regardless of whether the benefit is included in income, unlike the transportation disallowance above.
  - The change in transportation and commuting expenses related to the COVID-19 pandemic may change the application of these rules from what was applicable in prior years.
- The current environment continues to see a shift to worker shortages and an increase in remote or hybrid workers. Companies should continue to monitor their benefit policies for compliance in various jurisdictions as well as their ability to meet company needs. Examples include:
  - Are paid time off (PTO) policies adequate to attract and retain talent?
  - Should the company provide tax-free student loan payments under the temporary expansion of section 127?
  - What equipment or other expenses are employees incurring that the company may need to review its accountable plan for?

Like-kind exchange changes

Deferral of gain under section 1031 is limited to real property transactions. In late 2020, the IRS released final regulations describing what constitutes "real property" for purposes of section 1031. The regulations give both explicit examples of real property and factors to help determine what property qualifies. The new rules are particularly helpful for taxpayers who do business in multiple states, as state law classifications no longer weigh as heavily in defining real property. The new rules also clarify that properties are not disqualified from a like-kind exchange if less than 15% of the value of the property is composed of incidental personal property.

For taxpayers anticipating rate increases, like-kind exchange may require more planning to make transactions as successful as possible. Some taxpayers in the early stages of like-kind exchanges may want to consider terminating the transaction by failing to identify or acquire replacement property, depending on the law change and when they want to recognize gain. Like-kind exchange remains an effective estate planning option, as inheritors of replacement property may receive a stepped-up basis and would not realize gain upon sale.

Affordable Care Act update

The IRS is currently assessing penalties on applicable large employers (ALEs) for Affordable Care Act (ACA) compliance failures for 2019 and prior years. A company is an ALE if it averaged at least 50 full-time employees (including full-time equivalents) during the preceding calendar year, or was in a group of related companies that met the large employer criteria. ALEs that fail to offer employee health insurance that meets ACA standards may be assessed a shared responsibility payment by the IRS. In order to avoid this penalty, a large employer must offer minimum essential health coverage to substantially all (95%) of its employees and their dependents. This coverage must be affordable and provide minimum value (by covering a certain percentage of all medical expenses incurred by employees).

To determine which employers owe the penalty, the IRS requires ALEs to file Forms 1095-C and 1094-C to report workforce and health plan information. For 2021, the due date to provide employees with Form 1095-C is Jan. 31, 2022 (just like Form W-2), and an employer must file Form 1095-C and the related Form 1094-C to the IRS by Feb. 28, 2022 (if filing on paper), or March 31, 2022 (if filing electronically).

The IRS is assessing substantial penalties on ALEs that failed to file Forms 1095-C and 1094-C in prior years. Therefore, companies subject to the ACA requirements should review their compliance efforts and understand any potential risk for noncompliance.

In addition to these federal filing requirements, several states impose their own information reporting requirements on employers with employees residing in the state. Employers are required to file Forms 1095-C and 1094-C (or alternate forms) directly to the state so that the state can enforce its own individual mandate penalty on residents without health coverage. States with reporting requirements for 2021 include California, Massachusetts, New Jersey, Rhode Island and the District of Columbia.

Research and development tax credit

The research and development (R&D) tax credit is repeatedly one of the most popular incentives in the tax code. The repeal of the alternative minimum tax after 2017 as part of the TCJA has made it easier to utilize the R&D tax credit to reduce current tax liabilities.

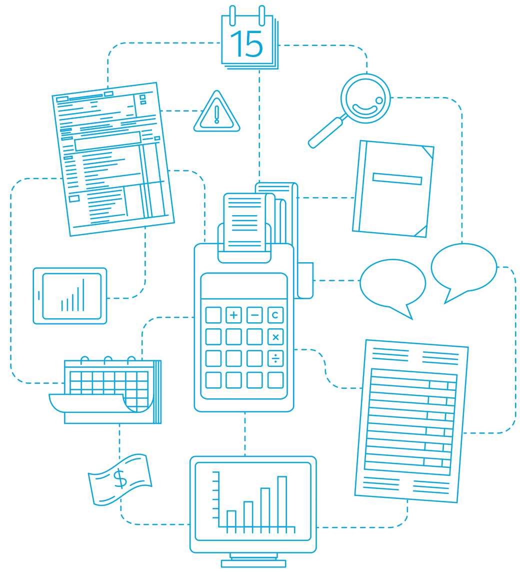
A small business start-up may claim the credit, up to $250,000, against its FICA payroll tax liability if it had less than $5 million in gross receipts for the current taxable year and no gross receipts for any taxable year prior to the five-taxable-year period ending with the current taxable year. If a business making this election is using an outside payroll provider, it is important to discuss the election with the provider as soon as possible because the provider must file certain forms on the business's behalf.

In addition, the alternative simplified credit (ASC) continues to be the preferred method elected by many taxpayers, because it relies only upon the prior three years' qualified research expenses to compute the base amount, where the regular credit method requires a much more complex base amount computation that can be difficult to document. The ASC election should be made by completing section B on Form 6765 on the original tax return.

As a result of the COVID-19 pandemic, businesses may have performed R&D in new areas of technology to enable more employees to work remotely, create a touchless work environment, provide services in new ways or convert production processes to new safety products such as masks or hand sanitizers.

The IRS is asking for more detailed information and documentation during R&D credit examinations. It is critical that taxpayers document R&D project activities and differentiate R&D project costs in their accounting records.

Business may need to start planning for looming capitalization for R&D expenditures under section 174. Up to this point, R&D expenditures could be expensed as incurred or electively capitalized and recovered over a period of not less than 60 months. Beginning with tax years beginning after Dec. 31, 2021, domestic R&D expenditures must be capitalized and recovered over five years. Foreign R&D expenditures must be capitalized and recovered over 15 years. For companies with significant R&D, this could create a material impact on their taxable income. Congressional action would be required to change this outcome.



In the meantime, companies should understand and quantify the full impact. Businesses that expense their R&D expenditures may not have tracked all section 174 expenses and, instead, identified only the subset that qualified for the R&D credit under section 41. Whether an item is a section 174 cost or section 162 cost was previously less important, as both could generate a current deduction, but that is scheduled to change beginning in 2022 without further congressional action.

Work Opportunity Tax Credit

The Work Opportunity Tax Credit (WOTC) program was designed to encourage employers to hire and retain individuals from specific target groups with employment barriers and is available for employees who begin work by Dec. 31 2020. The program also applies to employers that hire qualified long-term (27 weeks or more) unemployed individuals.

The WOTC equals 40% of the first $6,000 of wages, with higher wage limits for long-term family assistance recipients and qualified veterans for the first tax year an employee is hired. The credit is reduced to 25% for individuals who work at least 120 hours, but fewer than 400 hours, during the one-year period beginning on the employment date.

There is no credit for individuals who work fewer than 120 hours in their first year of employment. The WOTC also includes 50% of second-year wages for the tax year for wages paid to long-term family assistance recipients.

Paid sick leave and paid family leave payroll tax credits

From January through September of 2021, employers with fewer than 500 employees could voluntarily provide paid sick leave and paid family leave to employees affected by COVID-19. Paid leave could be offered to employees unable to work due to seeking a medical diagnosis or immunization, or experiencing an illness, quarantine or need to care of family members, including children due to school or daycare closures. Employers are allowed a payroll tax credit for eligible paid leave wages and must separately identify these wages on Form W-2 or alternative statement.

COBRA premium assistance

Employers sponsoring group health plans were required to pay 100% of the cost of COBRA (short for the Consolidated Omnibus Budget Reconciliation Act, the U.S. law that concerns the continuation of group health care benefits after termination of employment) coverage for certain employees for the six-month period of April 1, 2021, through Sept. 30, 2021. In general, employees losing their group health plan coverage due to a reduction of hours or involuntary termination of employment at any time between October 2019 and September 2021 were eligible for the assistance. Employers could claim 100% of the COBRA premium assistance as a refundable tax credit on their payroll tax returns. Special rules apply to certain employers such as those participating in collectively-bargained health plans, railroad employers and churches.

Employee Retention Credit

The Employee Retention Credit (ERC) was extended into 2021 and expanded to provide additional incentive. The ERC provides a refundable payroll tax credit for 50% of qualified wages (up to $10,000 of wages) paid or incurred by employers between March 13, 2020, and Dec. 31, 2020, and a 70% (up to $10,000 of wages per quarter) for 2021. Qualified wages are generally those paid to employees when they are not providing services because their employer fully or partially suspends operations due to government orders or experiences a significant decline in gross receipts due to COVID-19. An expanded definition of a qualifying small employer and a significant decline in gross receipts allows for lucrative credits for some struggling businesses in 2021.

Employer credit for paid family and medical leave

This tax credit was enacted as part of the TCJA and provides a tax credit between 12.5% and 25% for wages paid to qualifying employees on family or medical leave. The credit was first effective in 2018 and has been extended through 2024. To qualify, employers must maintain a written family and medical leave policy providing qualifying employees at least two weeks of paid family and medical leave and paying at least 50% of the normal wage rate during the leave period. There are special rules regarding part-time employees and payments to employees earning above a certain amount are not eligible. Business taxpayers should review their family and medical leave policies and determine if they qualify.

Energy credits

Businesses may be able to claim general business credits for investment in qualifying renewable energy projects. Residential credits are also available. Now is a good time to evaluate qualifying investments and document the amount of credit that can be claimed. The following are some of the qualifying credits and deductions.

Business credits

Investment tax credit. Businesses that place in service and continue to own a qualified facility may claim an energy investment tax credit (ITC). The credit is calculated using varying percentages of the cost basis of qualified energy property that is placed in service during the tax year. The credit rates depend on the year in which construction begins.

- For property placed in service before 2026, a 26% investment tax credit for qualified solar property where construction begins in 2020 through 2022, 22% credit if construction begins in 2023, and 10% credit for property placed in service in 2026 or for property where construction begins after 2023.
- For property placed in service before 2026, 26% investment tax credit for fiber-optic solar lighting, qualified fuel cell property, qualified small wind property, and waste energy recovery property if construction begins in 2020 through 2022, and 22% credit if construction begins in 2023.
- The 10% investment tax credit for qualified microturbine property and combined heat and power system property (with certain rate modifications) is available if construction begins before 2024.
- The credit remains at 10% for geothermal equipment with no expiration.

Production tax credit. The renewable electricity production tax credit (PTC) for large wind projects is at a rate of 1.5 cents per kilowatt-hour of electricity sold each year for 10 years. Taxpayers can elect to claim the ITC related to qualified wind property in lieu of the PTC, with a reduced credit rate. For construction that began in 2020, the ITC credit rate is 18%. Taxpayers who wish to take advantage of the PTC when the property is placed in service should plan to either spend more than 5% of the eligible wind farm construction costs by the end of 2021 or take steps to begin physical work of a significant nature on the facility.

A new credit was added for 2021 for offshore wind projects. Taxpayers that begin construction after 2016 and before 2026 for these projects are eligible to claim the PTC or ITC at the full statutory credit rate—currently 2.5 cents per kilowatt hour (adjusted annually for inflation) for the PTC and 30% for the ITC.

Carbon capture and sequestration credit. The section 45Q credit for carbon oxide sequestration is a performance-based tax credit incentivizing carbon capture and sequestration or utilization. The credit amount is based on the metric tons of captured carbon oxide per year over a 12-year period. Taxpayers must capture carbon oxide from ambient air or qualified industrial facility. Captured carbon oxide must be placed in secure geological storage, used as a tertiary injectant in enhanced oil or natural gas recovery project, or utilized in another qualifying manner. Taxpayers must begin construction on a facility and carbon capture equipment before Jan. 1, 2026.

Section 179D energy efficient commercial building deduction. The energy efficient building deduction under section 179D has been made permanent. In addition, the deduction amount will be indexed to inflation for tax years beginning after 2020. Finally, the ASHRAE 90.1 standards used as a baseline to measure energy efficiency improvement have been updated from the 2007 standards to now reference the standards from no later than two years before the date that construction of the property begins.

Alternative fuel refueling property credit. The section 30C credit for qualifying alternative fuel vehicle refueling property is extended for property placed in service by Dec. 31, 2021.

Alternative **and electric hybrid vehicles**. The section 30B credit for new qualified fuel cell motor vehicles was extended for property placed in service by Dec. 31, 2021. Additionally, taxpayers who own or are lessors of new qualified plug-in electric drive motor vehicles may be eligible for a credit when the vehicle is placed in service.

Residential credits

Nonbusiness energy property credit. The section 25C credits for nonbusiness energy property is extended for property placed in service by Dec. 31, 2021.

Alternative fuel refueling property credit. The section 30C credit for qualifying alternative fuel vehicle refueling property is extended for property placed in service by Dec. 31, 2021.

New energy efficient home credit. The energy efficient home credit under section 45L has been extended for one year and is applicable to homes acquired through Dec. 31, 2021.

Residential energy efficient property credit. The section 25D credits for residential energy efficient property is expanded and extended for property placed in service through Dec. 31, 2023. The phase out of these credits has also been adjusted for property placed in service from Jan. 1, 2020, through Dec. 31, 2022, with a rate at 26%, and for property placed in service from Jan. 1, 2023, through Dec. 31, 2023, with a rate at 22%.

A new category of energy efficient property is added to the credit for property placed in service after Dec. 31, 2020. The new section 25D(a)(6) will allow for a credit for qualified biomass fuel property expenditures, defined as expenditures relating to property that uses the burning of biomass fuel to heat a residence or to heat water for use in such residence if it has a thermal efficiency rating of at least 75% (measured by the higher heating value of the fuel). Biomass fuel is defined as any plant-derived fuel available on a renewable or recurring basis.

Alternative fuel credits

The $0.50 per gallon alternative fuel credit and alternative fuel mixture credit is effective through Dec. 31, 2021, and the $1 per gallon biodiesel mixture credit is effective through Dec. 31, 2022. In addition, refund opportunities may still exist for certain unclaimed credits for prior years, if elected as an income tax credit and filed on Form 4136 along with an amended federal income tax return.

There is still an opportunity for qualified sellers or users to register as alternative fuelers by filing Form 637 and then filing refund claims for open years for an elective income tax credit in lieu of the standard excise tax credit or payment.

Excise tax rapid assessment

During year-end planning, consider evaluating excise tax. In the current uncertain economy, reducing excise tax liability and identifying excise tax credits can enhance a company's bottom line and provide liquidity. Moreover, evaluating excise taxes and planning opportunities can improve a company's EBITDA as excise taxes are treated as an above the line cost of goods sold.

The primary sectors affected by excise taxes include energy, transportation (ground, air and water), industrial manufacturing, certain consumer goods, food and beverage, and life science. Importers and exporters may also be subject to certain excise taxes. Even banks, insurance companies and credit card issuers may encounter excise taxes in their business.

Moreover, end users in industries such as building, construction, aerospace and defense, farming, power and utilities, and logistics may claim certain refundable excise tax credits. Manufacturers of nonbeverage products such as perfumes, food products or medicines that use taxed alcohol in production may qualify for a drawback of the tax paid. Additionally, nonprofit entities or state and local governments often qualify for exemptions from excise tax or credits on the purchase of taxed articles such as fuel, tires and firearms.

All companies can benefit from a review of excise taxes. An excise tax rapid assessment includes:

- Reviewing whether the business faces any excise tax exposure
- Evaluating opportunities for reducing existing excise tax liabilities
- Identifying credit opportunities
- Reviewing compliance operations for improving efficiency
- Identifying excise tax costs passed on by vendors and reviewing whether tax has been properly determined

Should an area of risk be identified, companies can take a deeper dive into remediating the problem. If a credit or savings opportunity is uncovered, this may ultimately improve the company's profitability and operational efficiency.

Air transportation

Companies that pay aircraft management companies for the operation of private planes should evaluate their agreements and structuring in light of new regulations issued by the IRS implementing section 4261(e)(5). If structured properly, payments from aircraft owners are exempt from the 7.5% air transportation excise tax. Additionally, to the extent management companies have been collecting this tax, companies may be able to claim a refund of tax.

IRS account transcripts

A company's IRS account transcript contains useful information, including the information necessary to confirm estimated payments or credit elects applied to the 2021 tax year before preparing an extension or filing the return. For prior years, the account transcript can identify items of which the company may be unaware, such as penalty or interest assessments, math error adjustments or examination indicators. Thus, companies should consider ordering an account transcript in January 2022 for 2021 and earlier years. Beginning June 28, 2019, the IRS ceased transmitting transcripts to requesting companies via fax. Instead, the IRS will mail the transcript to the company's address of record. The transcript can take up to two weeks to be transmitted by mail. For this reason, we recommend that you make the request by Jan. 15, 2022, to ensure it is received timely. To order a transcript to be mailed, call the IRS business line at +1 800 829 4933. If your business was affected by a disaster, the IRS will waive the usual fees for a transcript. Please review the IRS disaster relief website for specific procedures pertaining to a specific declared disaster.

Tax return due date reminders

Tax return due dates have changed for tax years beginning after Dec. 31, 2015. Calendar year C corporation returns and most fiscal year returns are due on the 15th day of the fourth month following the end of the fiscal year, and S corporation and partnership returns are due on the 15th day of the third month following the end of the fiscal year. Form 7004 provides for an automatic extension of six months after the regular due date.

For C corporations with a fiscal year ending on June 30, the effective date change is delayed until the first tax year beginning after Dec. 31, 2025. Accordingly, those returns are due Sept. 15.

The deadline for filing Forms W-2, W-3, reports with the Social Security Administration and Forms 1099 MISC and 1099-NEC (previously Form 1099-MISC reporting nonemployee compensation in Box 7) is Jan. 31 for paper or electronic filing.

Accounting for income taxes under ASC 740

With COVID-19's continued impact on the economy, companies affected by the pandemic will need to assess the need for a valuation allowance, considering the positive and negative evidence available at year-end. Companies should be aware that for years beginning on or after Jan. 1, 2022, ATI for purposes of determining deductible interest under section 163(j) will no longer include addbacks for depreciation, depletion and amortization. Companies scheduling the reversals of existing temporary differences for purposes of assessing the amount of valuation allowance required will need to reflect the change to ATI to support the realization of section 163(j) carryforwards.

Congress continues to consider a variety of tax proposals that may affect corporate taxpayers. Under ASC 740, a change in tax law is not reflected until it is enacted. Companies will need to carefully monitor these proposals and be prepared to act if tax law changes are enacted before year-end. Companies should also be prepared for changes coming to the treatment of research and experimental expenditures under section 174. A change under TCJA to require capitalization of such expenditures will go into effect in 2022 to require the capitalization of section 174 expenditures. This shift from current deductions to capitalizing these expenses could have a significant impact on companies. While Congress may take action to modify this rule, companies should begin assessing the potential impact of the rule on their provisions, especially for companies preparing quarterly provisions or with foreign subsidiaries that have substantial research and experimental expenditures.

There have been a number of state tax law change during the course of the year, and the above federal law changes can have varying state impacts, depending on the application of each state's conformity to federal tax law changes. Additionally, companies should continue to monitor for states adopting the new guidance from the Multistate Tax Commission (MTC) addressing internet activities and protection under P.L. 86-272 for the sale of personal tangible property. The guidance, issued in August 2021, provides specific examples of activities that are or are not deemed to be doing business in a state and could result in significant state tax liabilities going forward for companies that sell tangible personal property online. See the state and local tax section below for additional information. From an ASC 740 perspective, as states adopt the guidance, companies need to assess whether their activities are still protected under P.L. 86-272, if new state filings are required going forward, or if a reserve for unrecognized tax benefits is required as a result of a decision to not file a tax return.

Corporate and transactional considerations

Financially distressed company tax issues

Although much of the disruption to the U.S. economy caused by COVID-19 has passed, there are still many companies that need to restructure their debt, which may result in bankruptcy filings. When involved in a debt workout or restructuring, it is critical that businesses evaluate their restructuring options. With effective analysis and planning, companies can maximize available tax benefits and mitigate tax costs associated with issues such as net operating losses (NOLs), cancellation or modification of indebtedness, and the disposition of struggling subsidiaries. Corporations facing economic hardship should be proactive in working with their tax advisors to ensure maximum company value is preserved through proper planning.

CARES Act: Net operating loss considerations and important dates

The CARES Act implemented taxpayer-favorable changes to section 172 for the deduction of NOLs. The act suspended the limitation of deductions for NOLs to 80% of the taxpayer's pre-NOL taxable income for tax years beginning before Jan. 1, 2021, and instead allows the full offset of taxable income. The CARES Act also amended section 172(b) to allow for the carry back of losses arising in a taxable year beginning after Dec. 31, 2017, and before Jan. 1, 2021, to each of the five taxable years preceding the loss year, including those with a maximum corporate tax rate of 35%.

Corporations looking to take advantage of or opt out of the reinstated NOL carryback provisions of the CARES Act should keep in mind the following important deadlines:

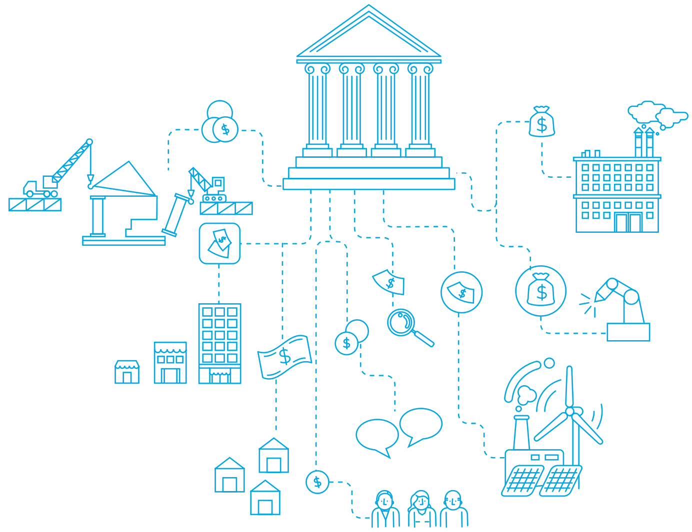
- Corporations generally have one year from the close of the taxable year to carry back an NOL via Form 1139, *Corporation Application for Tentative Refund*. To be able to carry back 2020 calendar year losses, corporations have until Dec. 31, 2021, to file Form 1139. After Dec. 31, 2021, corporations will not be able to carry back losses using the Form 1139.
- Corporations can still carry back 2018, 2019 and 2020 losses after Dec. 31, 2021, by filing the amended tax returns (Form 1120X) for the carryback years. The period for filing such amended tax returns is the period which ends three years after the time prescribed by law for filing the return for the taxable year of the net operating loss.
- Corporations cannot file Form 1139 to request the refund of Alternative Minimum Tax (AMT) credit generated by way of NOL carryback, but are able to file 2018 (with an election under section 53(e)(5)) or 2019 amended returns and request the refund of the AMT credit.
- Corporations can file amended 2020 tax returns to request AMT credit refund only to the extent they are able to offset regular tax. For this reason, corporations anticipating taxable losses in 2020 and future tax years may not be able to utilize the benefit of the excess AMT credit carryforwards.

File Form 4466 in January to obtain a quick refund

Corporations can receive a quick refund (generally in less than 45 days) of federal estimated tax payments in excess of the company's estimate of its tax liability for the year. The company must file Form 4466 after the close of its tax year but before the un-extended due date of its Form 1120 to receive this quick refund. The company can designate that the excess amount be credited to another IRS liability. Penalties may apply if the requested refund (or credit to another liability) leaves the corporation underpaid for estimated tax purposes.

Consider filing an automatic extension even if the return will be filed on time

The timely filing of Form 7004, *Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns,* will provide an automatic six-month extension of time to file a Form 1120 corporate income tax return for calendar-year corporations.



Filing the extension may be beneficial even if the corporation files the return the next day. A valid automatic extension request extends the time for a calendar-year corporation to file its return for six months from the original due date of the return. Note that for calendar-year corporations, the original due date for Form 1120 is April 15, 2022.

The extension period allows companies time to make corrections to the return, up to the extended due date, without penalty—including making timely tax elections or applying automatic accounting method changes if omitted from the initial filing. A subsequently filed return containing these items filed before the extended due date would supersede the previously filed return that omitted them. The superseding return becomes the official return and the statute of limitations on assessment will expire (under normal circumstances) three years from the date the taxpayer files the return.

Accelerating subsidiary stock losses

For consolidated taxpayers, two planning opportunities may be available to accelerate and recognize losses in the current year. Consolidated groups with an insolvent subsidiary should evaluate whether it is beneficial to claim a worthless stock deduction. Claiming the deduction may require liquidating the insolvent subsidiary or converting it into a limited liability company (LLC). Alternatively, a disposition of the subsidiary stock could accelerate the recognition of the loss.

Accelerating section 481 adjustments in the year of an M&A transaction

Taxpayers have the ability to accelerate income into the year of certain mergers and acquisitions transactions and possibly the year prior under rules provided by the IRS. These rules can provide tax advantages in situations where section 382 limitations would limit the ability to offset such income post-transaction. For certain accounting method changes, a taxpayer must file the method change request prior to the end of the tax year in order to obtain this treatment.

Identifying unamortized debt issuance costs

Companies that have refinanced debt or taken out new debt during the tax year should evaluate whether any previously unamortized debt issuance costs are eligible for accelerated tax deduction during the current year. In addition, companies should also assess whether certain fees paid to lenders as part of the refinancing or issuance of new debt may qualify as original issue discount (OID). Any amounts treated as OID must be amortized over the life of the debt and may be subject to the business interest limitation under section 163(j).

Section 163(j) interest limitations: Taxpayer-favorable rules

Section 163(j) generally limits the deduction of business interest to the sum of the taxpayer's business interest income for the year and 30% (50% for certain years under the CARES Act, depending on the taxpayer) of the taxpayer's ATI for the year. Final regulations for section 163(j) were released in July of 2020 that provided for taxpayer-favorable changes from the 2018 proposed regulations, including but not limited to:

- Adding back depreciation, depletion and amortization capitalized under section 263A in computing ATI
- Applying a narrower definition of interest
- Increased availability of the real property trade or business elections

Prior to the end of the tax year, taxpayers should consider converting debt to equity or refinancing debt in order to reduce the amount of interest subject to section 163(j) for the remainder of the year.

Section 163(j) limitations: Change to computation of ATI

Section 163(j) generally limits the deduction of business interest to the sum of the taxpayer's business interest income for the year and 30% (50% for certain years under the CARES Act, depending on the taxpayer) of the taxpayer's ATI for the year. For tax years beginning before January 2022, ATI is computed by adding back deductions for depreciation, amortization and depletion. For tax years beginning during or after January 2022, ATI is computed without adding back these items (this change may serve to decrease ATI and the associated interest deduction). Taxpayers who would be adversely affected by this change should consider whether they can possibly accelerate 2022 interest deductions into 2021.

Federal income tax mulligan

While not a new ruling, Rev. Rul. 80-58 allows taxpayers to rescind a transaction. While this is difficult to accomplish and little guidance exists in this area, this ruling does provide an avenue for rescission. However, to successfully complete a rescission, it must occur within the same tax year as the transaction. As a result, this item warrants consideration during year-end planning.

Section 382 closing-of-the-books election

Corporations should carefully monitor changes in stock holdings and stock issuances that occur during the year in order to identify whether the company has undergone a section 382 ownership change. Corporations undergoing a section 382 ownership change may make a closing-of-the-books election. Addressing whether or not the corporation will make the election may result in significant tax benefits.

The corporation may prefer to maximize the amount of its income for the taxable year treated as accruing prior to the ownership change to maximize use of NOL deductions (or certain other deductions). If it files a closing-of-the-books election with its timely filed tax return, the corporation closes its books at the date of change for section 382 purposes, thereby specifically measuring income and deductions pre- and post-change. Without the election, under the default rule, the corporation applies daily proration of the entire year's items of income and deductions.

Addressing the closing-of-the-books election decision before the end of the year can assist with year-end tax planning, since it helps position the company to determine whether acceleration of income or deduction items would be advantageous.

Accelerating an ownership change

In September 2019, the IRS and Treasury proposed new regulations under section 382, which provide a limitation of certain tax attributes (e.g., NOLs) where a corporation undergoes an ownership change. One major departure from the current rules is the proposed removal of one of the two safe harbors for calculating the recognition of built-in gain (or loss): the section 338 approach. The section 338 approach is generally more favorable for companies in built-in gain positions. Companies in a built-in gain position tend to be those that derive most of their value from self-created intangibles with no tax basis. If these proposed regulations will be finalized in their current form, life science and technology companies would be particularly affected by the removal of the section 338 approach.

It is uncertain whether the proposed regulations will be finalized in their current form. Nonetheless, companies that are contemplating an ownership change in the near future (e.g., a stock offering) should consider accelerating the ownership change to take advantage of the section 338 approach in case the IRS and Treasury finalize the regulations as proposed.

Projecting earnings and profits

During year-end planning, it may be important for a corporation to project the remaining current-year earnings and expected 2022 earnings along with cumulative earnings and profits. These projections can aid companies planning to distribute cash (or other property) to shareholders in deciding the tax year in which to make the distribution.

Form 8937, *Report of Organizational Actions Affecting Basis of Securities*

C and S corporations that take organizational actions that affect the basis of securities in the hands of stockholders generally must file Form 8937 within 45 days of the transaction date, or by Jan. 15 of the year following any such actions that take place in December.

Organizational actions include stock splits, stock dividends and distributions that are fully or partially nontaxable, and some reorganizations. S corporations may report the required Form 8937 information on Schedule K-1 instead of Form 8937, and a company may meet Form 8937 filing requirements through appropriate postings on the company's website.

Corporations should analyze their transactions to ensure that they timely meet the filing requirements under Form 8937.

Realizing maximum benefits through a transaction cost analysis

When a company engages in a transaction such as a merger, sale of an entity, acquisition of an entity or business combination (either on the buy-side or the sell-side), the IRS requires costs incurred to facilitate the transaction to be capitalized. With stock transactions, these costs generally are capitalized into stock basis and are not recoverable until such stock is sold. Alternatively, with asset transactions, these costs generally are capitalized and amortized over a period of time, typically over 15 years on a straight-line basis. In contrast, costs that do not facilitate a transaction can generally either be deducted as incurred or amortized over 15 years.

Performing a transaction cost analysis (TCA) allows a company to identify nonfacilitative costs and maximize tax deductions. A TCA involves a thorough analysis of activities performed and expenses incurred in connection with exploring and entering into a merger or acquisition transaction. The study results in the determination and proper documentation of the appropriate federal income tax treatment of transaction costs. Without proper documentation, all transaction costs generally must be capitalized, rather than deducted during the year paid or incurred.

Potential Biden administration increase to capital gains rates

In May 2021, the Biden administration proposed to raise the capital gains tax rates from the current 20% to match ordinary income rates. In September 2021, the House Ways and Means Committee proposed to raise the capital gains rates to 25%, with an effective date of Sept. 13, 2021. It is uncertain whether either of these (or other) proposals will come to full or partial fruition, and it is also uncertain whether an increase would take place prospectively or retroactively. Taxpayers contemplating near-future sales of capital assets (e.g., stock) should consider accelerating such sales or planning into a taxable event to recognize the gain under the current lower tax rate.

Section 1202: 100% exclusion on sale of qualified small business stock

Taxpayers contemplating the sale of corporate stock should consider section 1202, which provides for a 100% exclusion from gain on the sale of certain qualified small business stock (QSBS) held for more than five years. The amount of gain a taxpayer may exclude is generally subject to a $10 million/10 times shareholder basis limitation. The taxpayer must have acquired the stock directly from the issuing corporation, and the aggregate gross assets of the QSB corporation, including amounts received through the issuance, must not have exceeded $50 million at all times through immediately after the issuance. The corporation must conduct a qualified trade or business, as defined in the statute. Note, however, that in September 2021, the House Ways and Means Committee proposed legislation to reduce the section 1202 exclusion for most taxpayers (those with an AGI of $400,000 or more) to 50% of the gain from sale of QSBS. Due to the complexities involved, taxpayers should consult with their tax advisors when considering claiming the section 1202 gain exclusion benefit.

International tax considerations

Congress is currently considering substantial changes to the international provisions of the Internal Revenue Code (Code) and these changes could significantly affect the discussion below.

Partnership K-2 and K-3 reporting schedules

The IRS released final versions (and draft instructions) of new Schedules K-2 and K-3 for Forms 1065 (U.S. Return of Partnership Income) and 8865 (Return of U.S. Persons With Respect to Certain Foreign Partnerships). Similar schedules are also required for Form 1120-S (U.S. Income Tax Return for an S Corporation). The new schedules will apply to tax years beginning in 2021.

Any person that is required to file Schedule K that has items relevant to determining U.S. tax under the international provisions of the Code must complete Schedules K-2 and K-3. The new schedules replace and supplement items previously reported on Schedule K-1, and require detailed amounts relevant to calculating the following:

- FTC limitation (including R&E and interest expense allocation)
- Global intangible low-taxed income (GILTI) and Subpart F inclusions (and section 960 deemed paid credits)
- Inclusions from a PFIC for which a QEF election has been made
- Foreign-derived intangible income (FDII) deductions
- Base erosion and anti-abuse tax (BEAT)

Not all international tax provisions are identified on the new schedules. If an international provision is relevant to determining U.S. tax and is not included on Schedules K-2 or K-3, a separate statement must be attached.

The IRS provides transition penalty relief for tax years that begin in 2021. Penalties for failing to timely file the new schedules, or for filing incorrect or incomplete schedules, will be waived if the taxpayer establishes to the satisfaction of the commissioner that it made a good faith effort to comply with the new requirements.

Taxpayers may consider verifying their partnership-reporting software has been updated to collect the additional level of detail needed to complete the new schedules.

Foreign-derived intangible income planning

The FDII regime in the code constitutes an export incentive that allows a U.S. corporation to deduct export sales revenue earned in excess of a 10% return on tangible depreciable assets (qualified business asset investment or QBAI). The deduction is currently 37.5% of a corporation's FDII, and will decrease to 21.875% beginning in 2026 unless it is repealed or amended. The deduction amount is limited to a corporation's taxable income; it cannot create or extend an NOL.

Income that is eligible for the deduction includes income from the sale, lease, license, or other disposition of intangible property and "general property," to a foreign person for foreign use. General property is defined in Treas. Reg. section 1.250(b)-3(b)(10) and essentially includes tangible property other than commodities, securities, or an interest in a partnership, trust or estate. Deduction-eligible income also includes income from the performance of services provided with respect to property located outside the United States, so the business and professional services industry may also claim FDII benefits.

Although FDII was designed to incentivize companies to keep intangibles in the United States (as a backstop to the GILTI regime), it may, in effect, provide an incentive for companies to transfer depreciable tangible assets (plant and equipment) outside the country, and thereby increase the amount of the FDII deduction. Moving tangible depreciable assets to a foreign affiliate may effectively lower the hurdle rate necessary to obtain the FDII deduction.

FDII has come under scrutiny by the Organisation for Economic Co-operation and Development (OECD) as a harmful tax practice in connection with BEPS Action 5, based in part on the low correlation FDII requires between the intangible related eligible income and the performance of the R&D functions that create IP. The Biden administration has proposed to repeal FDII in its entirety for tax years beginning after Dec. 31, 2021. The Senate Finance Committee tax reform proposal (Senator Ron Wyden's Overhauling International Taxation framework) would replace FDII with a similar deduction for "innovation income" based on domestic R&E (deductible under section 174) and qualified training expenses for nonhighly compensated employees. As presently proposed, Senator Wyden's alternative deduction would apply to all innovation income, without reduction for 10% of QBAI, and would equalize the GILTI and FDII rates. The House Ways and Means Committee proposal (Representative Richard Neal's Build Back Better Act) retains most of the existing FDII rules but moves forward the date of implementation for the reduced 21.875% rate to tax years beginning in 2022. Representative Neal's proposal would also eliminate the taxable income limitation, allowing a FDII deduction to create or extend an NOL.

Taxpayers should carefully consider whether they are eligible to claim FDII benefits and, if so, model and assess whether potential benefits are maximized.

Global intangible low-taxed income planning

The GILTI regime subjects most of the earnings of controlled foreign corporations (CFCs) to current U.S. tax. GILTI can apply to a broad swath of taxpayers in any industry. U.S. shareholders should assess whether they may have exposure to this income inclusion. Planning opportunities to limit a taxpayer's exposure to GILTI are available and should be considered in order to minimize the impact of this tax scheme, including a new exception for income subject to a high rate of foreign tax.

Base erosion and anti-abuse tax planning

The BEAT is an additional tax designed to ensure that corporations with significant base erosion payments made to related foreign parties pay a certain amount of U.S. federal income tax. This tax is in addition to a corporation's regular income tax liability. Taxpayers with more than $500 million of average annual gross receipts and deductible payments to foreign related parties should carefully consider the impact of tax credits (such as the R&D credit) and NOLs on their potential BEAT liability. Additionally, we encourage taxpayers to review their structure for brother/sister relationships that could create an unintended aggregate group requiring a BEAT calculation.

Foreign tax credit planning

Over the past couple of years, the Treasury and the IRS have issued many foreign tax credit (FTC) regulation packages setting forth several transition rules and elections that may limit taxpayers' ability to use excess FTCs going forward. Taxpayers with significant pre-TCJA carryforward or post-TCJA carryback credits should carefully consider how their unused FTCs may be limited and which election may be available to allow for an efficient utilization of FTCs. Additionally, the CARES Act granted taxpayers an extended carryback period for their NOLs. Taxpayers choosing to take advantage of this extended carryback period should consider how this may affect their FTC position, as a carry back may limit or minimize the capacity to claim credits for prior year foreign taxes. All of this must be weighed against the possibility of a second round of tax reform which may increase tax rates.

Base erosion and profit shifting and country-by-country compliance

Consistent with the OECD's base erosion and profit shifting (BEPS) project, the IRS issued final regulations in 2016 requiring annual country-by-country reporting (CbCR) by U.S. taxpayers that are the ultimate parent of a multinational enterprise group. This tax filing requirement applies to companies with $850 million or more in global group revenues.

Taxpayers who wish to avoid filing in non-U.S. countries should consider filing Form 8975, *Tax Jurisdiction and Constituent Entity Information,* with the IRS, because filing this form in the United States will satisfy any filing requirements in other countries.

This reporting requirement is still relatively new and may require taxpayers to change their information reporting processes significantly. Accordingly, affected taxpayers should carefully review the financial and administrative impact CbCR may have had on their compliance function and reevaluate if necessary.

Transfer pricing planning

In addition to considering whether to file Form 8975, taxpayers should consider a variety of important transfer pricing issues before year-end. In particular, taxpayers should consider re-evaluating their existing transfer pricing to account for COVID-19 related shifts in the marketplace. Changing existing transfer pricing policies may help prevent large losses from being trapped in one jurisdiction while significant income builds up in another. In addition, taxpayers should ensure that year-end true-ups are performed with respect to any cost allocations and should reconcile financial statement results to those required by any relevant transfer pricing documentation that is in place.

Taxpayers should ensure that an appropriate agreement supports intercompany transactions. Moreover, taxpayers should conduct a high-level risk assessment of global intercompany activity and consider updating any existing transfer pricing documentation, either because of a change in facts or because the documentation is out-of-date.

Pillar 1 and Pillar 2 compliance

The OECD has developed draft blueprints for Pillar 1 and Pillar 2 in advance of the October 2021 G20 Finance Ministers and Inclusive Framework meetings.

The OECD and its Inclusive Framework are rapidly developing two new models for international businesses paying corporate tax. Pillar 1 affects digital and consumer-facing companies. Rights to tax profits would shift in part from countries of production (or development) to countries of consumption, based on yet-to-be-agreed formulae. Pillar 2, referred to as Global Anti-Base Erosion (GloBE), affects all sectors through reformed tax laws requiring income to be taxed at a minimum effective rate. Pillar 2 will affect companies with consolidated revenues above €750 million or equivalent, as the OECD intends to mirror the revenue threshold set for CbCR obligations.

The minimum rate remains undecided within the OECD and its Inclusive Framework. However, should the OECD reach a consensus on unilateral tax measures for all material design and implementation aspects, affected taxpayers may need to change their structures or transactions in each local jurisdiction.

The OECD is expected to finalize their proposals in October 2021. As result, taxpayers should prepare to model the impact of the final Pillar 1 and Pillar 2 proposals to assess potential incremental tax and compliance costs. It is unclear whether any new taxes imposed under Pillar 1 will be creditable foreign taxes for U.S. federal income tax purposes so taxpayers subject to tax under Pillar 1 may be facing significant new costs.

Planning for payments between and from foreign subsidiaries

Payments made between offshore foreign corporations that qualify as CFCs may trigger income inclusions under the subpart F rules to a U.S. shareholder, even if the U.S. shareholder receives no money. The CAA of 2021 extended an exception to the subpart F rules through 2025. Under the exception, dividends, interest, rents and royalties that a CFC receives from related CFCs might not be treated as subpart F income—and therefore might not be currently includible in the CFC's U.S. shareholder's income—if the payments are attributable to active income of the related CFCs. This exception had been set to expire at the end of 2020.

In addition, the Treasury and IRS issued regulations addressing the deduction for dividends received from certain foreign corporations. These rules are extremely complex and limit the deduction in significant ways. Taxpayers should consider their planning alternatives in order to mitigate potential income inclusions arising from payments between foreign subsidiaries, or with respect to distributions from those subsidiaries.

Intercompany loan planning

Under current law, a loan to a U.S. shareholder by a related foreign subsidiary can result in an income inclusion to the U.S. shareholder. Even a guarantee by a foreign subsidiary can trigger an income inclusion.

Many taxpayers are unaware of this rule and may have such U.S. investments in place at any given time. However, taxpayers can minimize the adverse impact of this rule by reducing or eliminating U.S. investments or guarantees by foreign subsidiaries before the end of the year, although regulations significantly limit the extent to which an income inclusion may arise in these situations

The changes to the anti-deferral rules under the TCJA should result in fewer taxpayers having exposure to this rule. Further, a new exception allows U.S. corporate shareholders to obtain credit support from a related foreign subsidiary without incurring U.S. tax provided certain conditions are met.

Transfer pricing considerations for Libor transition

The London Interbank Overnight Rate (Libor), a global reference point for variable interest rates paid on financial instruments, will likely be terminated and replaced by an alternative system at the end of 2021 (except for certain legacy contracts utilizing USD Libor). Alternative government-approved benchmarks for a risk-free rate (RFR) will replace the Libor-based index to determine all types of variable interest rates for contractual arrangements and financial instruments. Given the universal application of variable rate loans and other financial agreements between related entities, the Libor phase-out will significantly affect existing and new intercompany agreements based on the index.

Taxpayers affected by the Libor phase-out should identify existing intercompany agreements containing Libor references and modify affected agreements. Accordingly, with fewer than three months left before Libor is replaced, taxpayers should proactively review and amend the pricing of their affected arrangements to mitigate or prevent any future business disruptions.

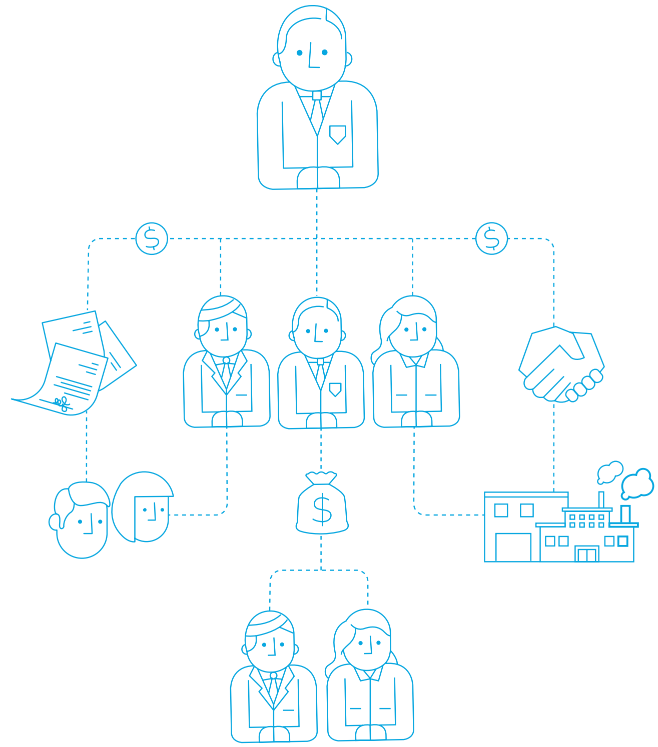
The transition away from Libor may also present opportunities to identify and implement additional tax-efficient solutions without deviating from the arm's length standard. Floating rate loans or short-term loans may allow additional flexibility to renegotiate interest rates at a later date for taxpayers considering new loan arrangements, depending on the outcome.

Transfer pricing considerations for intangible property agreements and DEMPE compliance

On Nov. 18, 2020, the IRS won a high-profile $3.3 billion transfer-pricing case with The Coca-Cola Company over royalties it received from foreign subsidiaries. In *Coca-Cola Co. v. Commissioner,* 155 T.C. No. 10 (2020), the tax court held that the IRS did not abuse its discretion by reallocating royalty income to Coca-Cola U.S. from foreign subsidiaries.

With the recent attention on BEPS, this case is a reminder that companies operating in traditional manufacturing and distribution sectors can still be exposed to substantial transfer pricing adjustments. Taxpayers need to ensure that their transfer pricing policies and intercompany agreements reflect the business's operational structure as it continues to evolve. More specifically, as many countries continue to adopt the recommendations of BEPS Action 8, taxpayers with a regional or global footprint and valuable intangible assets developed and used in multiple jurisdictions should maintain a sufficient degree of substance to earn a risk-adjusted return on intangible property.

Taxpayers with IP used or developed across multiple jurisdictions should perform detailed development, enhancement, maintenance, protection, and exploitation (DEMPE) analysis to support the functions and risks performed with respect to the company's intangible property. This determination is critical in establishing which entity or entities are entitled to the residual income attributable to the company's intangible property. Legal ownership of the intangible property is not, in and of itself, sufficient to support that entitlement to the group's residual income. Taxpayers should also review existing transfer pricing documentation to ensure that all DEMPE activities associated with intangible property are accurate and meet the compliance requirements of U.S. and non-U.S. transfer pricing rules.



For an overview of the legal issues in *Coca-Cola*, see RSM alert *Tax Court rules in favor of IRS in $3.3 billion transfer pricing case,* which highlights the U.S Tax Court decision.

Review cost-sharing agreements

A final action by the U.S. Supreme Court provides taxpayers clarity on recent case law from the Ninth Circuit reversing a 2015 U.S. Tax Court decision that effectively invalidated IRS cost-sharing regulations. The U.S. Supreme Court declined review, allowing the regulations to stand. Many taxpayers have taken positions for financial accounting purposes and in protective tax returns claiming a benefit under the decision of the tax court. These taxpayers should evaluate the impact of the U.S. Supreme Court's final resolution. For additional information on this issue, please read our tax alert, *Altera seeks Supreme Court review after Ninth Circuit reversal*, which highlights the case the U.S. Supreme Court ultimately declined to hear.

Exporters should consider a domestic international sales corporation (IC-DISC)

An interest charge domestic international sales corporation (IC-DISC) is an export incentive designed to provide a tax benefit to U.S. companies involved in (1) exporting property manufactured, produced, grown, or extracted in the United States, or (2) providing architectural or engineering services for construction projects outside the United States.

An IC-DISC is a separate corporation, normally formed by a related supplier or the owners of a related supplier, which elects to be treated as an IC-DISC within the first 90 days of the tax year for which the status will be effective. If certain tests are met (described below), the IC-DISC is generally not subject to federal income tax. However, shareholders of the IC-DISC are taxed on dividends from the IC-DISC and are required to pay interest on the income accumulated in the IC-DISC.

The IC-DISC cannot manufacture, produce, grow or extract the export property. Typically the property is manufactured, produced, grown or extracted by a related party and the IC-DISC purchases the property from the supplier for purposes of resale, or the IC-DISC sells the property on behalf of the supplier and receives a commission fee. In a commission arrangement, the supplier may claim a tax deduction for the commission fee without a corresponding income inclusion for the IC-DISC. When the income is distributed by the IC-DISC as a dividend, qualified individuals who own shares (directly or through a partnership, trust or disregarded entity) are often taxed on the dividends at reduced capital gains rates.

To qualify as an IC-DISC, at least 95% of the corporation's revenue must be qualified export receipts, and at least 95% of the corporation's assets must be qualified export assets. Qualified export receipts include primarily receipts from the sale, lease, or other disposition of export property, commissions and management service fees earned in conjunction with export property, or the provision of engineering and architectural services for a construction project located outside the U.S. Qualified export assets include principally inventory held for export, property used in the sale, lease, storage, transportation, minor assembly, or servicing of export property, and receivables from an export transaction.

The scope of the IC-DISC benefit extends beyond traditional manufactures of exported products to component part manufactures and growers that sell goods or agricultural products to U.S. companies that on-sell the products to foreign persons. U.S. developers of software and other copyrighted articles that are selling or licensing rights outside the United States may also benefit from the use of an IC-DISC.

There do not appear to be any plans to significantly amend or repeal the IC-DISC rules (first established in 1971) and it may prove to be an important planning opportunity following the anticipated repeal or amendments to FDII. However, if the capital gains rates for qualified dividends received by taxpayers with income in excess of $1 million are equalized to the top ordinary income rates, as Biden has proposed in the 2021 Green Book, the benefit of the IC-DISC may be reduced.

Key global information reporting action points

The Biden administration's proposed tax plan

The Biden administration's tax plan includes comprehensive measures focused on information reporting that could have a significant impact on companies, including banks and other financial institutions, as early as next year. According to the administration, this new focus is "driven primarily by lack of information reporting and difficulty identifying noncompliance outside of an audit" and should allow for better matching of income and increased compliance. In support of the plan, on Aug. 10, 2021, the U.S. Senate passed the Infrastructure Investment and Jobs Act (HR 3684, or the Infrastructure Bill) which, if enacted, would provide for significant investments in roads systems and other infrastructure, that would be funded by numerous revenue-raising proposals, the largest of which would impose information reporting on cryptocurrency transactions similar to those in effect now for stock and securities transactions.

If adopted, the proposed measures could significantly affect the data required to comply with information reporting and withholding obligations and should be considered as businesses develop budgets for systems and compliance programs next year. More specifically, if adopted, the proposals would:

- Require "brokers" to report sales of cryptocurrency and other digital assets on information returns filed after Dec. 31, 2022, and expand the definition of "broker" as set forth in section 6045 of the regulations to include "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person"
- Mandate electronic filing of certain information returns, such as Forms 1042, 8886 and 8300 to increase the accuracy of information returns
- Require banks and financial institutions to report gross inflows and outflows of financial accounts
- Require that an IRS Form W-9 with a taxpayer identification number (TIN) signed under penalty of perjury be provided by all payees receiving reportable payments
- Require businesses receiving any crypto assets with a fair market value over $10,000 to report these assets
- Require increased reporting and disclosure of information on cryptocurrency and crypto asset denominated transactions through information exchange agreements with other participating jurisdictions
- Lower the federal reporting threshold for filing Form 1099-K, *Payment Settlement Processor,* from $20,000 and 200 or more transactions to $600 or more with no minimum number of transactions, and
- Require payment settlement entities to report not only gross receipts on Form 1099-K, but to also report gross purchases, physical cash and payments to and from foreign accounts and transfer inflows and outflow

These changes may result in increased volumes of reportable data with different naming conventions across multiple systems that should be considered as businesses develop budgets for changes to systems and compliance plans next year.

E-filing update

Treasury released proposed regulations amending e-filing requirements and thresholds for numerous information returns that are expected to be finalized before year-end and will likely affect your processes for filing information returns, such as IRS Forms 1099 and 1042, due in 2022. Current rules require withholding agents filing 250 or more information returns to file the forms electronically. The proposed rules change this threshold from 250 to 100 or more returns beginning with returns due in 2022 and to 10 or more returns for 2023 filings and beyond. The rules are particularly burdensome for partnerships, as there is no minimum filing threshold for those with more than 100 partners. The threshold for the number of partners will be reduced from 100 to 50 in 2021 and to 10 in 2022. As such, all partnerships should be prepared to file all information returns electronically. Notably, the proposed rules leave little room for exceptions, but hardship waivers may still be requested and corrected returns must be filed in the same fashion as original returns.

Prepare to file federal and state equivalent Forms 1099-NEC

Non-U.S. companies that are 50% or more U.S. owned and U.S. companies paying compensation for services should be prepared to file new IRS Form 1099-NEC, *Nonemployee Compensation*. Form 1099-NEC must now be used instead of IRS Form 1099-MISC, box 7, to report payments of nonemployee compensation (such as payments to vendors for services). This is a significant change as Form 1099-MISC has historically been one of the most common and frequently used information returns filed by companies across multiple industries to report payments for services. Additionally, the 1099-NEC is not included in the combined federal state filing program and many states have lower filing thresholds than the $600 federal filing requirement which may increase the volume of returns required.

The 1099-NEC forms are due by Jan. 31 annually and may require updates to accounting systems, policies and procedures. Therefore, companies should begin discussions with their tax operations, technology and compliance teams as well as their service providers now to plan for this change. Companies will also need to build in sufficient lead time for requesting budget approvals, confirming their state filing requirements, drafting recipient guides, renegotiating service agreements and designing new substitute forms as needed.

Consider the reporting implications of debt forgiveness

Lenders cancelling or restructuring debts this year should consider the reporting implications going forward and plan accordingly. The IRS clarified in Notice 2020-12 that lenders are not required to file Forms 1099-C, *Cancellation of Debt*, to report the amount of qualifying forgiveness with respect to covered loans made to small businesses under the Paycheck Protection Program (PPP) administered by the Small Business Administration under Title I of the CARES Act.

Section 6050P of the code and sections 1.6050P-1 and 1.6050P-2 of the regulations generally require certain entities that discharge at least $600 of a borrower's indebtedness to file an Form 1099-C, *Cancellation of Debt*, with the IRS and furnish a copy of the form to the borrower. However, according to Notice 2020-12, when all or a portion of the stated principal amount of a PPP loan is forgiven because the eligible recipient satisfies the forgiveness requirements of the CARES Act, for federal income tax purposes only, the lender is not required to, and should not, file a Form 1099-C as a result of the qualifying forgiveness. Lenders should therefore evaluate loans to confirm reporting requirements as soon as possible before year-end and to avoid issuance of Form 1099-C when not required.

Prepare for continued focus on nonresident aliens and Foreign Account Tax Compliance Act exams

Before the global pandemic and post-TCJA, the IRS's Large Business and International (LB&I) division announced several compliance campaigns focused on enforcement of withholding, deposit and reporting requirements for payments made to U.S. nonresident aliens that are expected to continue. The campaigns are being enforced through a variety of mechanisms including examinations and penalty assessments. The IRS also announced the launch of a campaign focused on identifying U.S. and foreign financial institutions that have failed to file Foreign Account Tax Compliance Act (FATCA) reports. Examinations began in 2020, which means that companies have a very narrow window of opportunity to become compliant. Additionally, we anticipate increased enforcement of Common Reporting Standard (CRS) requirements as several jurisdictions have introduced new penalty regimes this year.

Companies should plan to spend the close of the year identifying and remediating any gaps in processes, submitting any unfiled returns, and implementing policies and procedures for ongoing compliance with these rules. The IRS has indicated that it will accept voluntary disclosures regarding noncompliance before institutions receive notices. However, penalty abatement will not be an option once a notice has been received, so take action now.

Reevaluate the FATCA and CRS status of entities in the group

To the extent that companies have acquired or created new legal entities, restructured the group this year, moved into jurisdictions that have adopted the CRS, or entered into an intergovernmental agreement under FATCA, the company should plan to reevaluate or confirm the FATCA and CRS status of legal entities in the group. Entities that accept deposits, have custody of assets, perform investment activities, or serve as captive insurance companies or certain holding companies may be considered foreign financial institutions and may have FATCA and CRS reporting obligations.

Prepare to begin collecting new W-8s

To manage withholding and due diligence requirements, companies should begin requesting new or updated Forms W-8 and CRS self-certifications from their customers, shareholders, or investors opening new accounts, or those with forms that will expire after Dec. 31, 2021. Note, however, that valid unexpired Forms W-8 can still be relied on and do not need to be replaced until they expire (generally within three years), unless there is a change in circumstances that mandates collection of a new form.

Pass-through entity considerations

Consider application of the section 199A deduction

Section 199A allows for a deduction of up to 20% of a taxpayer's qualified business income (QBI). QBI generally includes most trade or business income reportable on an individual's income tax return, often attributable to the individual's share of income from pass-through entities. However, certain exceptions do apply. Notably, foreign source income, investment income, and income from certain specified service trades or businesses, among other items, generally will not constitute QBI and would thus not be eligible for the deduction. For income that does constitute QBI, this deduction effectively reduces the top tax rate applicable to that income from 37% to 29.6%. The deduction does not apply to self-employment or net investment income taxes. However, the deduction is applicable in computing alternative minimum taxable income.

Pass-through owners whose taxable income exceeds $164,900 (or $329,800 for a joint return) are subject to limitations on the deduction. These taxpayers may see the deduction reduced or fully eliminated if the business does not pay sufficient wages to its employees, does not employ sufficient amounts of tangible, depreciable assets in the business, or conducts business activities considered in whole or part to be a specified service business described in the law.

Moreover, there is still uncertainty in several areas, particularly whether certain business activities involve the performance of services in certain nonqualifying specified service business fields—such as consulting and health care. Additionally, the reporting requirements associated with entity-level aggregation of businesses for purposes of calculating the deduction are highly complex.

Given the complexity, pass-through business owners should consult with their tax advisors when evaluating their eligibility for the 20% deduction, in assessing compliance with the final regulations, and when considering whether changes to their business could enhance the benefit.

State and local tax deduction limitation workarounds

The TCJA limited the individual taxpayer deduction for state and local tax (SALT) payments to $10,000 a year ($5,000 for a married person filing a separate return). This change had a profound impact on owners of pass-through businesses—the parties that typically would be paying (either directly or indirectly) these state tax obligations as part of their individual tax filings. From a practical standpoint, the TCJA changes caused these state taxes to become nondeductible expenses.

In response to the issue, a growing number of states have adopted workarounds intended to enable the entity (and its owners) to generate a deduction for these state tax obligations. These regimes, which are typically elective, impose the tax on the entity rather than on the owner, thereby generating an entity-level deduction that avoids the $10,000 limitation.

Currently, approximately 20 states have adopted some form of SALT workaround. In addition, these and other states are taking additional steps that make the regimes more attractive—such as allowing resident shareholders a credit for taxes the business may be paying to another state. As such, pass-through businesses and their owners should carefully evaluate the potential benefits associated with electing into these regimes for the 2021 tax year. In many cases, it can significantly soften the burden associated with the $10,000 SALT limitation.

Bonus depreciation available for certain step-up transactions

Historically, purchasers of partnership interests were able to generate additional depreciation deductions through step-up elections; however, these step-ups were not eligible for bonus deprecation, as they generally represented the indirect purchase of a used asset. As noted above, the TCJA changed this rule to allow bonus depreciation for purchases of used assets.

The final rules clarify how the changes affect step-up depreciation generated by the acquisition of an interest in an existing partnership and similar transactions. In many cases, but not all, the purchaser will benefit from this immediate deduction to the extent its share of the step-up is allocable to qualified assets. Although the final regulations provide clarity on the application of the bonus depreciation rules to certain step-up transactions, there is still uncertainty surrounding the availability of bonus depreciation for certain transaction structures—such as those involving the purchase of all interests in a partnership by an existing partner or the contribution of assets to a partnership in exchange for both equity and money.

Taxpayers considering transactions that may generate a step-up, or in transactions that could be restructured to generate such a step-up, should pay particular attention to these final rules. Prior to finalizing the structure of a transaction, each transaction should be analyzed to determine whether and to what extent expensing is available, as well as the corresponding tax consequences to the seller.

Passive loss and net investment income tax planning

Individuals, closely held C corporations and personal service corporations are generally restricted in their ability to deduct losses from passive activities. Passive losses include losses from rental activities and other business activities in which the taxpayer is not actively involved. However, taxpayers who can demonstrate the necessary level of participation may be able to generate a current deduction for these losses and generate significant income tax savings (however, see discussion below regarding excess business losses for an additional loss limitation).

The keys to doing so are: (1) understanding how much participation is necessary, and (2) ensuring that the participation can be substantiated. In most cases, a taxpayer must devote at least 500 hours to an activity in order to avoid the limitations on passive losses. However, in some cases a taxpayer may only need to participate for 101 hours in an activity in order to deduct these losses. Thus, taking action now to increase one's participation can, in some instances, provide a valuable tax deduction.

In situations where the business activity generates a net profit, participation is also relevant when trying to minimize exposure to the 3.8% net investment income tax under section 1411. Owners of pass-through entities usually can avoid the tax on their distributive share of income if they participate in the business for at least 101 hours during the year.

In sum, finding ways to help owners meaningfully participate in a business can have the added benefit of significantly reducing their tax burden.

Excess business loss limitations

The excess business loss (EBL) limitation provides a new obstacle for taxpayers seeking to deduct losses from their business activities. Originally enacted as part of the TCJA, the provision's effective date was later deferred as part of the CARES Act and the government's response to the COVID-19 crisis. But the provision does apply for tax years beginning in 2021, and it limits noncorporate taxpayers to a $250,000 ($500,000 for married couples) aggregate loss from their business activities. So taxpayers expecting large losses from their S corporation, partnership or sole proprietor activities should recognize that even after navigating the basis and passive loss limitations, this final hurdle will limit their ability to enjoy the benefit of those losses to no more than $250,000/$500,000 in 2021. Losses in excess of the annual limitation would carry forward and be treated as a net operating loss.

Following its original enactment, these excess business loss rules generated a series of questions. Recent guidance has answered some of those questions. First, any excess business loss is "determined without regard to any deductions, gross income or gains attributable to any trade or business of performing services as an employee." Thus, W-2 wages are not business income for purposes of the excess business loss limitation. Additionally, net capital gains (but not losses) attributable to a trade or business are taken into account when computing an excess business loss but are limited to the taxpayer's overall capital gain net income. This change eliminates the ability of taxpayers to potentially convert capital losses into NOLs.

Taxpayers should also remember that the retroactive deferral of this provision via the CARES Act may have created some unique issues for certain taxpayers. Specifically, since the CARES Act changed the effective date of the EBL limitation retroactively, taxpayers that thought they had an NOL carryforward originating from a 2018 EBL likely are mistaken. Instead, those losses would need to be claimed on an amended 2018 tax return.

Entity choice with a changing tax landscape

Most businesses consider their entity structure only once, at the time of formation. However, passage of the TCJA, along with the potential for further changes, has led many C corporations, partnerships, LLCs and S corporations to reconsider their choice of entity. Under the TCJA, corporate tax rates were reduced from 35% to 21%, while owners of pass-through businesses, such as S corporations and partnerships, that qualified for a pass-through deduction saw their top federal tax rate drop from 39.6% to 29.6%. However, these tax rates, along with other key rules related to the taxation of business income, would change under proposals put forth by the Biden administration and Congress.

This has led many businesses to analyze whether their current tax structure is still efficient. Important questions to consider when reevaluating entity choice include:

- Why should I remain an S corporation, effectively paying a 29.6% or 37% tax rate, if I can be subject to a 21% tax rate as a C corporation?
- Can my partnership convert to C corporation status and enjoy the lower corporate tax rate or the benefit of qualified small business stock?
- Are there issues beyond the annual tax savings I should be considering?
- Are there self-employment tax implications? What about changes to how the owners are currently compensated?
- What role do state and international considerations play in this decision?
- What is the future exit strategy?

Analyzing the interplay of these potentially competing factors is complex, but understanding the implications of entity type on a business's overall tax burden is critical in light of these tax rate changes.

S corporations and shareholder compensation

The Treasure Inspector General for Tax Administration (TIGTA) released a report in August 2021 assessing IRS efforts to identify underreporting of compensation paid to S corporation shareholders— specifically the risk of S corporations disguising shareholder compensation as distributions. The report sought to determine if the IRS policies, procedures and practices adequately ensure that compensation is considered during the IRS examination process.

The report determines that the IRS was not identifying the issue as frequently as it should, and made several recommendations aimed to surface the issue more often during the audit process. In its response, the IRS rejected most of TIGTA's recommendations, suggesting that it is already looking at the issue. But the increased focus on this issue would suggest that S corporations should review their existing compensation plans and arrangements to ensure proper classification of shareholder compensation.

PPP forgiveness and pass-through considerations

Several unique issues may arise for pass-through entities and their owners in relation to forgiveness of PPP loans, particularly when deductions funded by PPP loans and the related tax-exempt income are recognized for tax purposes in different tax years.

Depending on the facts and circumstances, a pass-through entity may recognize deductions funded by PPP loans in one year, while not recognizing the tax-exempt income related to PPP loan forgiveness until a later year. Such timing differences create notable considerations, specifically in relation to a shareholder's basis in their S corporation stock, a partner's basis in their partnership interest, sales or acquisitions of partnership or S corporation interests, and the tax return presentation.

In the case of S corporations, shareholder basis challenges may arise because shareholders only increase the basis of their stock when tax-exempt income is recognized. Shareholders with current or prior year suspended losses may be forced to wait until the year the S corporation recognizes that tax-exempt income in order to take such losses. Additionally, the tax-exempt income and PPP-funded expenses are generally treated differently for accumulated adjustments account (AAA) and other adjustments account (OAA) purposes, which may result in inadvertent taxable distributions if this distinction isn't fully analyzed.

Partnerships and their owners face similar basis considerations, although these issues may be less challenging since partners are able to include their share of partnership liabilities in the basis of their partnership interest. Those liabilities may include their share of any PPP loans prior to the recognition of the related tax-exempt income. However, partners with at-risk limitations may still need to analyze how the timing of tax-exempt income recognition affects their ability to recognize their allocable share of partnership losses.

The sale or acquisition of both partnership or S corporation interests may also create issues for further consideration and analysis. More specifically, buyers and sellers of pass-through businesses with PPP loans must analyze which party will be recognizing the tax-exempt income upon forgiveness, and how that income will be allocated among the owners. Lastly, pass-through entities should consider presentational items on their tax returns in relation to the recognition of PPP-funded deductions, recognition of tax-exempt income related to PPP loan forgiveness, and when income has been recognized for book purposes but not tax purposes (and vice versa).

Self-employment tax considerations for partners

Several tax court decisions, in conjunction with other forms of guidance, including long-standing and controversial proposed regulations, have created an unclear picture as to the treatment of members of LLCs and limited liability partnerships (LLPs) under the self-employment tax rules.

The IRS has taken aggressive positions in this area. Recent decisions indicate that in certain cases LLCs may want to consider modifications to their governance rules, substantiating the fact that certain portions of income are exclusively a return of capital (and not compensation for personal services), or consider adopting a limited partnership structure. These changes may provide greater confidence regarding the application of certain self-employment tax exceptions to members of LLCs and LLPs.

In some cases, court decisions may provide planning opportunities to consider whether self-employment income may be reduced.

Carried interest legislation

The TCJA added a new provision affecting the treatment of carried interest, defined generally as partnership interests received in exchange for services in certain specified businesses in the investment and real estate industries. This provision has the practical impact of converting long-term capital gain income into ordinary, short-term capital gain income in certain circumstances.

Final regulations were issued earlier in 2021, which are binding for taxable years beginning on or after Jan. 19, 2021. For calendar-year taxpayers, this means the final regulations will be effective for 2022, returns which will generally be filed in 2023. The final regulations are generally more taxpayer friendly than earlier proposed regulations while still fulfilling the intention of the TCJA provisions. Many exceptions and nuances apply to these rules, in addition to imposing significant reporting requirements at the partnership level. We recommend that taxpayers expecting a large carried interest realization event consider the applicability of these rules and to discuss potential mitigation strategies with their tax advisors.

Taxation of carried interests continues to be a topic of much debate, with several draft proposals emerging that may impact how carried interests are taxed in the future. Businesses will need to carefully monitor these ongoing developments, including, but not limited to, potential changes in the following areas: the holding period required for long-term capital gain treatment, applicability of the rules for certain assets, and provisions addressing carry waivers or other transactions designed to circumvent the carried interest rules.

Taxpayers should also be aware that this carried interest information might be reported to all partners via Schedule K-1 footnotes, even when the carried interest rules may not be applicable to the individual partner. Taxpayers should consult their tax advisors to determine whether the carried interest recharacterization rules apply to their individual circumstances.

Pass-through basis reporting requirements

The IRS has recently subjected partners and S corporation shareholders to expanded reporting requirements. Notably, S corporation shareholders are now required to include a basis schedule with their tax return when a shareholder receives a distribution, sells stock, recognizes a loss or receives a loan payment. The IRS recently released a proposed form to provide that information. Meanwhile, partnerships are now required to report the beginning and ending tax basis capital for each partner. In 2019 this partnership reporting was only required if either amount is negative; beginning in 2020 this rule applies to all partners and partnerships.

While these changes were made only to the relevant forms and instructions, it is key to note that forms and instructions may have the same force and effect as an actual Treasury regulation, and thus must be carefully followed. Although the IRS did authorize certain simplified calculation methods for the partnership reporting for tax year 2020, these methods may not be available for 2021 tax returns.

These reporting requirements are mandatory and we recommend that pass-through entities consult with their tax advisors immediately, especially in cases where shareholders' or partners' historical tax basis information has not been tracked.

State and local tax considerations

Nexus review

Nexus is most often addressed in the context of analyzing what a company does and determining where the company could arguably have established sufficient contacts to be required to file state income and franchise tax returns. However, the question of where a company must file only scratches the surface of the importance of determining nexus.

More than ever, businesses should consider whether nexus has been established among all state tax types. State revenue departments are increasingly scrutinizing the in-state activities of remote businesses, especially in the context of economic nexus. For sales tax, the U.S. Supreme Court issued its decision in *South Dakota v. Wayfair* in 2018, overturning the long-standing physical presence nexus standard established through *Quill v. North Dakota* in 1992. With the *Wayfair* decision, the court has allowed for the possibility for states to impose sales and use tax collection and remittance responsibilities on remote sellers based solely upon their economic presence in a state. Almost all of the states imposing a sales and use tax now require out of state vendors to collect and remit sales tax provided they meet certain transaction or sales thresholds.

Most states have long taken the position that companies are subject to income and franchise taxes even without maintaining a physical presence in their jurisdictions. But in a post-*Wayfair* era, states have become more focused on activities that produce economic nexus for income and franchise tax purposes. Businesses need to be aware of laws and regulations that can minimize their exposure to taxes such as Public Law 86-272, nonbusiness income allocation and factor presence standards.

Additionally, it is important to understand whether a company has any opportunities to restructure legal entities or business operations to generate benefits from establishing or eliminating nexus. For example, a company in a loss year with an expectation of generating income in future years may be well advised to establish nexus now in states it has targeted for expansion in order to protect an NOL. In some cases, this can be as easy as hiring or moving an employee earlier than originally planned; however, regardless of the necessary steps, any nexus-establishing activities must be done by year-end.

Public Law 86-272

The Interstate Income Act of 1959, commonly known as Public Law 86-272 or P.L. 86-272, generally prohibits states from imposing net income taxes on income derived from interstate commerce if the business activities in the state are limited to solicitation of orders of tangible personal property that are sent outside the state for approval and, if approved, are filled by shipment or delivery from a point outside the state. On Aug. 4, 2021, the MTC unanimously adopted an updated version of its P.L. 86-272 guidance specifically to address internet activities. This new guidance generally provides that interaction between a business and its customer via the business's website or app is business activity in the customer's state for the purposes of applying P.L. 86-272, and will be treated as exceeding protected activities to the same extent that such interactions would be unprotected if done in person. The guidance provides a carve-out for websites and apps that limit interaction to static text or photos; however, websites and apps have long been trending away from this narrow exception. MTC guidance is usually adopted by its member states, and in the short term, full adoption is anticipated in many states. Businesses currently, or considering, a P.L. 86-272 position should review the new guidance and consider proactive modeling and planning for when the states begin adoption of the guidance.

Remote worker nexus and withholding analysis

Due to COVID-19, essential and nonessential businesses have been forced to change how employees perform their duties with mandatory stay-at-home or shelter-in-place orders effective in every state. Businesses in a wide range of industries have transitioned to entirely, or mostly, remote work arrangements. While some businesses may have had remote working procedures in place, many employees worked remotely for the first time in 2020.

Almost two years into the pandemic, businesses, and employees have mostly come to embrace a 'hybrid-remote work' environment. The need to consider a number of state and local tax considerations due to remote workforce is anticipated to remain for at least a few more years.

Employees may live or spend time during the pandemic in states and localities that are different from the office or business location, especially when businesses are located near state borders. Businesses with employees should consider the following: (1) a business that does not have any offices or other operations in a state could establish income tax or sales and use tax nexus based on the presence of employees in the state, even if the employee's activities are home-based, (2) if the employee resides or works in a state that differs from the employer's state, the shifting of the employee's responsibilities to remote locations can affect the sourcing of revenues in both states that adopt cost-of-performance and market-based sourcing type regimes and (3) wages are generally sourced based on the employee's physical location or relative number of working days in the state. States generally treat any day worked in a state as part of this analysis. Accordingly, a day spent working from home in a state due to the COVID-19 pandemic is likely to be counted for purposes of allocating state wages.

Employers should consider a review of their employee locations, payroll systems, withholding responsibilities, unemployment obligations and potential loss of Public Law 86-272 protections because of remote employee activities in previously protected jurisdictions.

Gross receipts taxes review

Six states have adopted some form of gross receipts taxes (Delaware, Nevada, Ohio, Oregon, Texas and Washington). These taxes are imposed on the gross receipts of a business without regard to profit or loss. In some states, the gross receipts tax is imposed in addition to corporate income and franchise taxes. The tax generally applies to receipts generated from sales within the state. Out-of-state businesses are often unaware that they are incurring gross receipts tax liabilities. At the local level, cities in California, Washington and many other states also impose gross receipts taxes and more are considering these taxes every year.

In addition to the increased tax burden, gross receipts taxes often require new reporting and compliance obligations. Businesses should assess whether states in which they are doing business impose a gross receipts tax or are considering imposing such a tax in the coming year.

Market-based sourcing review

Over two dozen states have adopted market-based sourcing rules for services, replacing the traditional cost of performance sourcing rules. Market-based sourcing looks to the location of the customer. However, the states take different approaches to determining the market, including considering where the services are delivered, received and billed. Companies that do not analyze these different approaches often overstate or understate their sales factors.

Apportionment review

State revenue departments are scrutinizing business apportionment methods more closely than ever before. For multistate companies, particularly those with more than one business line, complying with myriad different apportionment rules can be a complex administrative burden. Correctly identifying the required apportionment method and the income subject to apportionment and allocation could save substantial amounts of income and franchise taxes.

Before year-end, it is important to extrapolate estimated apportionment data from the first through third quarters of the current year and the fourth quarter of the prior year to identify key positions for which the company will need specific, highly detailed data for its returns. Additionally, by analyzing this data, the company can determine whether more favorable apportionment can be obtained via restructuring of its legal entity structure or business operations or through requesting to use an alternative apportionment formula.

State transfer pricing review

Many states have begun conducting intensive transfer pricing audits of businesses with significant intercompany transactions. The number of audits has quadrupled since 2015, and many states are in the process of hiring more transfer pricing auditors. Moreover, many states have contracted with outside economic and legal experts to pursue suspected transfer pricing violations. These audits often lead to substantial tax adjustments, consume an inordinate amount of taxpayer resources and result in prolonged litigation.

State transfer pricing usually focuses on three related inquiries. First, most states have adopted some form of the federal transfer pricing rules under section 482 of the Code. States examine whether intercompany prices are "arm's length." Second, states examine whether the intercompany transactions have economic substance, i.e., whether the transactions have a business purpose apart from tax avoidance. Third, some states expressly disallow certain deductions for expenses between related parties. That is, the states require businesses to add back the deductions to their income. A proactive review would significantly reduce the risk and exposure of a costly transfer pricing audit and adjustment.

State income tax refund review

Many taxpayers have open periods with conservative positions taken on state and local income and franchise tax filings. It is important that taxpayers consider reviewing those positions for potential refund claims due to changing facts and circumstances of the business and changes in state and local statutory and regulatory law, as well as new guidance that may have materially changed or mitigated the previous positions. Additionally, some taxpayers will be opening up extended periods normally outside of a state's statute of limitations by carrying back federal NOLs five years as provided under the CARES Act. These extended statutes of limitations create more opportunities for a thorough look back on historic positions.

Attribute maximization review

State attribute regimes, such as state NOL calculation and usage rules, can vary significantly from the federal rules. Companies can take advantage of various planning opportunities to address attributes generated before establishing nexus, becoming a member of a combined or consolidated group, and acquiring, merging or liquidating an entity. For example, if a company has substantial tax attributes trapped in a perennially underperforming or newly acquired entity and has another entity that could fully utilize those attributes, it may be beneficial to merge those entities or, in some cases, to elect or request to file on a combined or consolidated basis.

Deduction maximization review

If a company has multiple entities in its structure, it may be beneficial to examine projections of current-year income and deductions to identify isolated current-year loss entities. It may be possible to fully utilize the deductions creating those projected losses through expense allocation, transferring payroll or property, restructuring, or electing or requesting to file on a combined or consolidated basis.

Unitary review

Depending on the circumstances, filing state income tax returns on a mandatory combined basis can provide substantial benefits or detriments to taxpayers. It is important to determine whether the business has the requisite control, integration and flow of value to establish unity and to model state income taxes on a separate and combined basis. Where sufficient value exists, it may be advisable to take steps to break or create unity. This analysis is particularly important if the company has completed, or is going to complete, a major acquisition or disposition of entities or assets during the tax year.

Credits and incentives compliance review

Taxpayers should consider maximizing cash flow amid the economic interruption of the COVID-19 pandemic through existing, renegotiated or new incentive programs. This includes a review of any incentive programs they already have in place to confirm that all compliance and performance requirements are being met to mitigate the risk of clawbacks. Taxpayers at risk of failing to meet agreed-upon targets should consider proactive communication with the economic development authority or taxing authority to either renegotiate agreements or obtain extensions to meet targets.

Taxpayers should also be aware of new or revised federal and state incentives programs enacted in the wake of the pandemic including programs targeting hiring, training, job retention and capital investment. COVID-19-specific economic assistance programs have been implemented in several states and continued throughout 2021. Taxpayers should proactively look to take advantage of these programs.

Finally, taxpayers should consider evaluating current and recent utilization of existing statutory incentives opportunities to maximize benefits. Many states allow taxpayers to retroactively claim statutory benefits and some businesses may have neglected to consider their availability in prior periods.

Regardless of whether an extended economic downturn occurs as a result of the pandemic, there are many other state credit and incentive programs that allow taxpayers to take advantage of historical growth. Taxpayers should review their state business activities and tax liabilities for all years that are still open under each state's statute of limitations to ensure that all potential benefits are captured and realized either as current or future cash flow.

State conformity to federal legislation review

In response to the coronavirus, the federal government has put into place a series of legislative relief measures, such as the CARES Act, the CAA and ARPA. Most federal agencies, including Treasury, have issued administrative rules and regulations dealing with aspects of the crisis. Federal legislative and administrative measures dealing with COVID-19 have been proposed and more are expected. Many federal tax law changes lead to state law revisions conforming to or decoupling from federal law. While some states automatically conform to changes to the Internal Revenue Code for state income tax purposes, many others have fixed-date conformity or only conform to specifically enumerated provisions. In 2021, many states selectively addressed CARES Act conformity where they did not in 2020 because of the shorter legislative sessions.

It is important for businesses to be aware of the vast differences among the state approaches to the CARES Act, and to federal tax reform, and be prepared to address those differences on relatively short notice. Conformity may affect PPP loan forgiveness, the treatment of qualified improvement property, retirement funding and distribution rules, charitable deductions, NOLs, and business interest expense among other provisions of both the CARES Act and federal tax legislation. Finally, a number of new or amended federal tax provisions are likely from the Biden administration which could further complicate any corresponding state analysis.

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