FEDERAL TAX YEAR-END CONSIDERATIONS IN 2023

Critical tax issues for end-of-year planning

This guide reflects the tax considerations and developments that we believe may create risk or opportunity for businesses in 2023 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.

INTRODUCTION

Many taxpayers in 2023 have experienced how the loss of deductions can lead to an increase in taxable income and unexpectedly large tax liabilities that affect cash flow, liquidity and growth strategy.

As 2024 approaches, many taxpayers face extended tax-filing deadlines and year-end planning with a degree of frustration about the recent law changes that unfavorably reconfigured deductions. There's additional anxiety over the unsettled state of tax activity on Capitol Hill. Will Congress provide relief by enacting more favorable legislation?

Regardless of the outcome, the time to act is now. Key decisions, including business model considerations, choice of entity, workforce and compensation matters, and general tax planning should be top of mind. Being prepared is imperative as we head into the next few years and anticipate scheduled changes to tax legislation in the U.S.

RSM presents this guide to assist you in that preparation by summarizing tax developments and concepts that have commanded taxpayers' attention in 2023.

Tax policy in 2023: Division and uncertainty

In 2023, we saw a return to divided government. A Republican-controlled House and a Democratic-controlled Senate tempered the enactment of any significant tax legislation. Slim majorities in each chamber required near-unanimous party support or bipartisan agreement for any significant activity to occur, and neither prevailed when it came to tax legislation.

Instead, proposed tax measures from both chambers took on a general tenor of messaging, with an eye toward the 2024 presidential and congressional elections, as well as the scheduled expiration at the end of 2025 of key individual provisions enacted in the 2017 Tax Cuts and Jobs Act.

This dynamic was evident throughout the year, especially in the House. House Republican tax writers, eager to exert their newly acquired influence over that chamber's tax legislative agenda, quickly took aim at two Democratic priorities. They sought to repeal the $80 billion that was allocated to the IRS as part of the Inflation Reduction Act of 2022 (the IRA), and they attempted to roll back most, if not all, of the energy tax incentives included in the IRA.

House Republicans made some progress by clawing back 25% of the funds allocated to the IRS, which the White House agreed to as part of the debt ceiling negotiations. Despite that agreement, House Republicans continue to pursue other avenues (e.g., the annual funding/appropriations process) to reduce additional enforcement-related funding for the agency.

The tax writing committee in the House, the Ways and Means Committee, focused on a potential economic package by reporting out three bills: the Tax Cuts for Working Families Act (H.R. 3936), the Small Business Jobs Act (H.R. 3937), and the Build it in America Act (H.R. 3938).

Among other things, the package (H.R. 3938) included three major business provisions, each having some degree of bipartisan support: the extension of immediate expensing for research and experimental costs; extending the allowance for depreciation, amortization, or depletion with respect to the calculation of the limitation on the tax deduction for business interest; and bonus depreciation. At press time, progress on this measure in the House was stalled, due in large part to a group of Republican lawmakers insisting that relief from the $10,000 SALT cap enacted as part of TCJA be included in the legislation.

If those measures passed the House, they would face an uphill battle in the Senate, especially around repealing the IRA's clean energy tax incentives as a means to pay for the proposed changes. Senate Democrats would presumably require any proposal providing business tax relief, such as extending the research expensing provision, be paired with some type of support for working families, such as an expanded child tax credit. As for a potential legislative vehicle to attach any tax changes, the most likely contender would be a year-end omnibus spending measure.

GENERAL CONSIDERATIONS

Deduction and revenue planning

Tax year 2023 requires a nuanced approach to tax planning. With many tax provisions either having recently expired or phasing out over the next several years, taxpayers should model the impact of sunsetting provisions.

Many have speculated about the possibility of legislation reinstating full research and experimentation (R&E) deduction rules and 100% bonus depreciation. However, legislative action remained elusive entering the fall. Taxpayers were forced to file their 2022 tax returns without the benefit of favorable provisions, including full deduction of R&E costs and the exclusion of depreciation in calculating the section 163(j) interest expense limitation.

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Taxpayers looking to decrease current-year taxable income may benefit from:

- Accelerating deductions through use of the recurring item exception for certain liabilities paid within 8.5 months after year-end
- Inventory planning (e.g., performing a review of valuation methods or changing from a first-in, first-out (FIFO) method of identifying inventory flow to a last-in, first-out (LIFO) method)
- Deferring certain advance payments
- Restructuring contracts to defer the receipt of advance payments
- Deducting certain prepaid expenses
- Evaluating employee bonus plan requirements and passing a board resolution to pay a minimum bonus amount to support deducting all or a portion of the bonus payment liability in the year employees provide the related services
- Accelerating recovery of real property costs through cost segregation and/or tangible asset repair studies
- Reviewing mandatory and elective interest capitalization provisions
- Placing in service bonus depreciation-qualifying property before the end of the 2023 calendar year to obtain an 80% bonus depreciation deduction versus a 60% bonus depreciation deduction in 2024

Taxpayers looking to increase taxable income may benefit from:

- Changing from the overall cash method to an accrual method of accounting
- Inventory planning (e.g., performing a uniform capitalization [UNICAP] review or changing from a LIFO method of identifying inventory flow to a FIFO method)
- Electing to capitalize prepaid expenses for the current year
- Recognizing advance payments in income in the year of receipt
- Restructuring contract terms to require payment of advance payments before year-end
- Electing out of bonus depreciation for certain or all classes of an otherwise eligible asset acquisition

Many of these items require action before year-end; taxpayers should make sure to discuss with their tax advisor the applicability of one or more of these options and the required timing of related action.

Small-business taxpayer designation

The Tax Cuts and Jobs Act (TCJA) increased the average annual gross receipts threshold for defining a small-business taxpayer. This threshold is indexed yearly for inflation.

For tax years beginning in 2023, a small-business taxpayer is one with average annual gross receipts of $29 million or less for the three prior tax years. Those qualifying under the small-business taxpayer designation may be able to use the overall cash method and may be exempt from applying certain inventory rules as well as the limitation on business interest deductions.

Changes in financial statement treatment for leases under ASC 842

For private companies, Accounting Standards Codification (ASC) 842 (requiring all leases to be recorded on the balance sheet) generally became effective for 2022. While the analysis of the leasing standard is applicable only for financial statement purposes, it gives taxpayers the opportunity to determine if their lease classification is accurate under federal income tax principles.

Taxpayers often complete their financial statement of leases for tax without applying the appropriate tax tests. Accordingly, with a change in financial accounting treatment of an item, taxpayers should understand and be familiar with new book-to-tax adjustments that may be required to maintain accurate tax records. This may be especially relevant given the dynamic environment of the commercial real estate market. Because the standard was generally effective for 2022, taxpayers that failed to assess the impact for tax purposes for 2022 should evaluate for 2023, including determining whether remedial action for 2022 treatment is needed.

Bonus depreciation

Bonus depreciation is presently 80% for property placed in service during calendar year 2023. It phases down to 60% for property placed in service during 2024. Bonus depreciation continues phasing down by 20% each year after. (These timelines are extended for one year for certain long-production-period property.)

Taxpayers should plan for and model the impact of decreasing bonus depreciation in future years, particularly considering the loss of the depreciation addback to compute adjusted taxable income (ATI) under the business interest expense limitations put in place by the TCJA.

In addition, a taxpayer with bonus eligible property that they plan to place into service in 2024 may want to consider accelerating placing that property into service in 2023 to benefit from the higher bonus depreciation percentage.

Inventory planning

- Lower of cost or market valuation method
  - Companies that purchased additional inventory to ensure supply may benefit from a review of their inventory valuation method. While many companies follow a lower of cost or market method for financial accounting purposes, the federal income tax rules differ.
  - Moving from a cost method to a lower of cost or market method may generate additional deductions. As prices for many direct materials and finished goods have decreased, an inventory valuation at cost may be overstated and companies could benefit from reviewing the tax lower of cost or market rules.

- Review of subnormal goods
  - Companies should review whether any finished goods on hand are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, or odd or broken lots. There may be an opportunity to write down these goods to a bona fide selling price, less the direct cost of disposition.
- Obsolete goods
  - Companies with obsolete goods may wish to review their inventory before year-end and determine how to establish the value of any obsolete goods for federal income tax purposes. This may involve the physical scrapping of goods or valuing as a subnormal good, in line with the paragraph above.

Like-kind exchange changes

Like-kind exchanges under section 1031 may be limited to real property transactions but remain a useful tool to change real estate holdings without a gain recognition event.

Recent regulations helped clarify what constitutes real property for purposes of section 1031, which includes considerably more than under depreciation rules. The new rules are particularly helpful for taxpayers that 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.

As market conditions change, like-kind exchange can be a useful way to dispose of properties that may be less desirable without significant changes to tax planning strategies for the year of sale. 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.

Research and development tax credit

The research and development (R&D) tax credit is consistently one of the most popular incentives in the tax code. The repeal of the AMT 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 startup 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 continues to be the preferred method elected by many taxpayers, because it relies only on the prior three years' qualified research expenses to compute the base amount, whereas the regular credit method requires a much more complex base amount computation that can be difficult to document. The alternative simplified credit election should be made by completing section B on Form 6765 on the original tax return.

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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. Businesses may now be performing additional work to adapt to the return to offices or hybrid conditions.

The IRS is asking for more detailed information and documentation during R&D credit examinations. Taxpayers must ensure they document R&D project activities and differentiate R&D project costs in their accounting records.

Businesses need to adapt to the reality of capitalization for R&D expenditures under section 174. Prior to 2022, 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 is often creating a material impact on their taxable income. Congressional action would be required to change this outcome. While a return to full expensing remains a real possibility in future legislation, businesses are stuck with capitalization in the meantime.

Although most companies implemented this change in 2022, businesses that have traditionally expensed 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. Others may not have projected the impact of this change going forward. Whether an item is a section 174 cost or section 162 cost was previously less important, as both could generate a current deduction. But going forward, businesses may find they need to put more active planning into this process.

The IRS and Treasury Department have steadily released guidance on how to navigate this process and will continue to release rules and detail in the coming year. Accordingly, businesses should keep an eye out for updates and continue their tax planning and compliance discussions to keep up with the latest guidance.

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. 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.

Affordable Care Act update

To avoid Affordable Care Act (ACA) penalties, large employers need to file Form 1095-C's each year and offer health coverage that meets ACA requirements to substantially all employees. This requirement applies to any employer that averaged at least 50 full-time employees (including full-time equivalents) during the preceding calendar year, or that was in a group of related companies meeting the large-employer criteria.

The IRS is assessing substantial penalties on employers that failed to file Form 1095-C's in prior years. Therefore, employers should review their compliance efforts and correct any filing failures. Employers that failed to offer ACA-compliant health coverage should understand their potential risk for noncompliance.

In addition, employers with employees residing in the following states should ensure they are meeting the state filing requirements: California, Massachusetts, New Jersey, Rhode Island and the District of Columbia.

Compensation and benefit issues

From a tax perspective, most payments, whether direct or indirect, to or on behalf of employees will be taxable compensation; however, certain plans can be designed to reduce the tax impacts. It is imperative for companies to coordinate such programs with human resources, tax, legal and other applicable parties to achieve optimal results without assuming unintended risk.

If the current economic conditions are having an impact on your business, you may want to closely evaluate your company's compensation and benefits.

Questions to ask include:

- Are long-term incentive plans for your key employees still incentivizing?
- Can costs be reduced by offering noncash rewards instead of cash benefits?
- Do new plans need to be offered to increase retention of key personnel who will help the company through this cycle?

Again, any new plans or changes to existing plans will have tax implications to consider.

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 2024 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 2024 for 2023 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, which can take up to two weeks. For this reason, we recommend that you make the request by Jan. 15, 2024, to ensure it is received in a timely manner.

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 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. 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 June 30, the effective date change is delayed until the first tax year beginning after Dec. 31, 2025. Accordingly, those returns remain due Sept. 15 for tax year 2023.

The deadline for filing Forms W-2 and W-3, reports with the Social Security Administration, and Form 1099-NEC (previously Form 1099-MISC, reporting nonemployee compensation in Box 7) is Jan. 31 for paper or electronic filing. The deadline for filing Forms 1094-1095C and 1099-MISC is March 31 if e-filed, Feb. 28 if paper filed.

Extra scrutiny for employee retention credit claims

The Coronavirus Aid, Relief, and Economic Security (CARES) Act and subsequent pandemic relief legislation enabled employers to claim the employee retention credit (ERC) on Form 941. The IRS has issued multiple news releases warning employers to be wary of third parties advising employers to claim the credit who may not actually be eligible. Because of the perceived abuse of this relief program, the IRS is actively examining ERC claims to ensure the employer meets eligibility requirements and to ensure that the credit was correctly calculated using qualified wages. Eligibility is determined on a quarter-by-quarter basis.

If faced with an examination, employers must be able to show that they sustained either a full or partial suspension of operations due to orders from an appropriate governmental authority, or a significant decline in gross receipts during 2020 or the first three quarters of 2021. They must also show they correctly computed qualified wages under the complex set of rules governing ERC claims.

Employers who claim this credit must also be sure to reduce wage deductions on their corresponding income tax return by the amount of the credit claimed. Employers should discuss any ERC claims with their tax preparer.

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IRS expands e-filing, with new penalties for more paper forms

The IRS has imposed or tightened the e-filing requirement for many tax returns. In final regulations published Feb. 21, 2023, the IRS listed rules affecting the filing of partnership returns, corporate income tax returns, unrelated business income tax returns, withholding tax returns, information returns, registration statements, disclosure statements, notifications, actuarial reports and excise tax returns. In general, most taxpayers who file at least 10 forms with the IRS will be required to file those forms electronically.

These final regulations reflect changes made by the Taxpayer First Act (TFA) and are effective Feb. 23, 2023; however, the tightened e-filing requirement for most affected returns will apply to filings required in 2024. The final regulations require e-filing of many returns and other documents not previously required to be e-filed. According to the IRS, the regulations required only 13%-16% of the largest paper information return filers to file electronically, but the actual percentage doing so has been much higher.

E-filing requirements have been newly imposed or tightened for:

- Form 990 series (exempt organizations)
- Form 1042 (Annual Withholding Tax Return for U.S. Source Income of Foreign Persons)
- Form 1042-S (Foreign Person's U.S. Source Income Subject to Withholding) (for nonfinancial institutions)
- Form 1065 (U.S. Return of Partnership Income)
- Form 1094 series and Forms 1095-B and 1095-C (health insurance related)
- Form 1097-BTC (Bond Tax Credit)
- Forms 1098 (Mortgage Interest), 1098-C (Contributions), 1098-E (Student Loan Interest), 1098-Q (Qualifying Annuity), 1098-T (Tuition)
- Form 1099 series
- Form 1120/1120-S (corporate income tax returns)
- Form 1120-POL (Certain Political Organizations)
- Form 4720 (certain excise taxes related to exempt organizations)
- Form 5227 (Split-Interest Trust)
- Form 5330 (Excise Taxes Related to Employee Benefit Plans)
- Form 5500 series (employee benefit plans)
- Form 8038-CP (Return for Credit Payments to Issuers of Qualified Bonds)
- Form 8300 (Report of Cash Payments over $10,000 Received in a Trade or Business)
- Form 8596 (Information Return for Federal Contracts), 8596-A (Quarterly Transmittal)
- Form 8918 (Material Advisor Disclosure Statement)
- Form 8955-SSA (Annual Registration Statement)
- Form 8966 (FATCA Report)
- Schedule SB (Single-Employer Defined Benefit Plan Actuarial Information)

CHIPS and Science Act and the advanced manufacturing investment credit

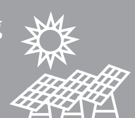
The CHIPS and Science Act was signed into law Aug. 9, 2022. This act provides funding for billions of dollars of grants to promote domestic manufacturing of semiconductors. Many of these grants target workforce development, semiconductor technology R&D, domestic manufacturing capability, research lab to fabrication plant transition of technology, and other activities.

The CHIPS and Science Act also created the new advanced manufacturing investment credit under section 48D. This credit incentivizes capital expenditures in facilities in which the primary purpose is the manufacturing of semiconductors or equipment used to manufacture semiconductors, The credit rate is 25% of eligible property placed in service in the taxable year. The new section 48D credit also offers taxpayers the ability to treat an allowable credit as a payment of income tax that can then be refunded.

Energy credits

Businesses may be able to claim general business credits for investment in qualifying renewable energy projects. Residential credits are also available.

Businesses interested in understanding which energy credits apply to them should consider a clean energy assessment.



Now is a good time to evaluate qualifying investments and document the amount of credit that can be claimed. Below are some of the qualifying credits and deductions. Hundreds of pages of the IRA are dedicated to more than two dozen provisions that extend and modify existing credits or create new credits. This massive piece of legislation requires guidance from the Treasury Department, which will be critical for taxpayers to interpret and follow to ensure compliance with the new provisions.

Businesses interested in understanding which energy credits apply to them should consider a clean energy assessment. An assessment provides review of the particular facts of the business and recommends potential credits and cost-savings opportunities.

New energy credit concepts

Prevailing wage and apprenticeship requirements. Several new energy credits have been modified by the IRA to include base and bonus rates. Aside from a few exceptions, taxpayers must satisfy both requirements to properly claim a credit at a bonus rate.

To satisfy the prevailing wage requirement, taxpayers must demonstrate that individuals employed (through themselves, contractors or subcontractors) to perform construction, alteration or repair services on certain property must be paid no less than prevailing wages for the locality in which the property or project is located. Depending on the credit, this requirement may be limited to the construction of the property or project or may be extended to include a period after the property or project is placed in service.

To satisfy the apprenticeship requirement, taxpayers must demonstrate that qualified apprentices were utilized under each of three tests. There are tests for participation, the apprentice-to-journeyworker ratio, and the percentage of labor hours performed by apprentices. The requirement is made up of three sub requirements:

- The percentage of total labor hours must be performed by a qualified apprentice.
  - The percentage is 10% for projects that began construction in 2022.
  - The percentage is 12.5% for projects that began construction in 2023.
  - The percentage is 15% for projects that begin construction after 2023.
- The percentage of labor hours performed by qualified apprentices is subject to apprentice-to-journeyworker ratios of the Department of Labor or applicable state apprenticeship agency.
- A taxpayer, contractor or subcontractor that employs four or more individuals to perform construction, alteration or repair work on qualified property must employ at least one or more qualified apprentices.

Domestic content credit adder. The investment tax credit (ITC) percentage for certain clean energy projects can be increased by 10% (or 2% if the energy project does not meet the prevailing wage and apprenticeship requirements) if the domestic content requirement is met. The domestic content requirement is complex, but essentially all steel and iron must be produced in the U.S.; additionally, a percentage of the manufactured components must be produced in the U.S.

Energy communities credit adder. The credit percentage for certain clean energy credits can be increased by 10% (or 2% if the prevailing wage and apprenticeship requirements are not met) if the energy project is placed in service after 2022 in an energy community. An energy community is defined as:

- A brownfield site;
- A metropolitan or nonmetropolitan statistical area that: (i) has (or, at any time after Dec. 31, 2009, had) 0.17% or greater direct employment, or 25% or greater local tax revenues, related to the extraction, processing, transport, or storage of coal, oil, or natural gas; and (ii) has an unemployment rate at or above the national average unemployment rate for the previous year; or
- A census tract (or a directly adjoining tract) in which a coal mine closed after 1999 or a coal-fired electric generating plant was retired after 2009.

Elective payments. Applicable taxpayers may make an annual election to treat certain credits as a payment of income tax instead of a claim for a credit ("direct pay"). The following are applicable entities under section 6417:

- Any organization exempt from federal income tax
- Any state or political subdivision thereof
- The Tennessee Valley Authority
- Certain Indian tribal governments
- Any Alaska Native corporation
- Certain cooperatives furnishing electric energy in rural areas

The following credits are eligible for direct pay:

- Section 30C, Alternative fuel refueling property credit
- Section 45(a), Renewable electricity production credit (PTC)
- Section 45Q, Credit for carbon oxide sequestration
- Section 45U, Zero-emission nuclear power production credit
- Section 45V, Credit for production of clean hydrogen
- Section 45W, Qualified commercial clean vehicles credit
- Section 45X, Credit for advanced manufacturing production
- Section 45Y, Clean electricity production credit
- Section 45Z, Clean fuel production credit
- Section 48, Energy credit (ITC)
- Section 48C, Qualifying advanced energy project credit
- Section 48E, Clean electricity investment credit

In effect, some energy credits will become refundable for applicable taxpayers. Elective payments are available for taxable years beginning after Dec. 31, 2022.

Transferability. Eligible taxpayers may elect to transfer all or a portion of certain credits to an unrelated taxpayer in exchange for cash. The cash proceeds received are not includable in gross income. The transferee taxpayer purchasing the credits for cash may not deduct the cash payment. The following credits are available for transferability under section 6418:

- Section 45(a), Renewable electricity production credit (PTC)
- Section 45Q, Credit for carbon oxide sequestration
- Section 45U, Zero-emission nuclear power production credit
- Section 45V, Credit for production of clean hydrogen
- Section 45X, Credit for advanced manufacturing production
- Section 45Y, Clean electricity production credit
- Section 45Z, Clean fuel production credit
- Section 48, Energy credit (ITC)
- Section 48C, Qualifying advanced energy project credit
- Section 48E, Clean electricity investment credit

The transfer of the aforementioned credits is available to eligible taxpayers for taxable years beginning after Dec. 31, 2022. Notably, the investment tax credit, production tax credit and fuel credits are set to expire Dec. 31, 2024. Technology-neutral credits under new sections 45V, 45Z and 48E will be effective Jan. 1, 2025.

Business credits

Investment tax credit. Businesses that place in service and continue to own qualified energy property may claim a nonrefundable investment income tax credit.

Generally, the credit is calculated using the new concept of a base rate of 6% and a bonus rate of 30% if the prevailing wage and apprenticeship requirements are met. However, the credit with respect to some energy property is calculated using a base rate of 2% and a bonus rate of 10%.

There are additional opportunities to increase the credit percentage for the use of domestic contents (by 2% or 10%); for placing solar and wind property in service in low-income communities (by 10% or 20%); or for construction of solar energy property in low-income communities.

Electrochromic ("dynamic" or "smart") glass, microgrid controller property, interconnection property, certain biogas facilities, and energy storage technology placed in service after Dec. 31, 2022, will now be eligible for the credit.

Production tax credit. The PTC provides a credit for each kilowatt of electricity produced at qualifying facilities and sold to an unrelated party. Qualifying resources are generally sources of renewable electricity, and include wind, biomass, municipal solid waste (including landfill gas and trash), geothermal, hydropower, and marine and hydrokinetic energy. The IRA also revived the PTC for solar energy (previously sunsetted in 2006) for facilities that commence construction before Jan. 1, 2025.

Taxpayers have the option of a base credit rate of 0.5 cent/kilowatt-hour, or a bonus credit rate of 2.5 cents/kilowatt-hour (inflation-adjusted values) for facilities that meet the prevailing wage and apprenticeship requirements.

To claim the credit at the bonus credit rate, taxpayers must satisfy the prevailing wage requirements for the duration of the construction of the project and for each year during the 10-year credit period, and apprenticeship requirements during the construction of the project. If a facility meets the domestic content requirements, the credit rate is increased by 10%.

This credit allows for a direct pay option for tax-exempt entities. Taxpayers ineligible for the direct pay election may opt to transfer the credit to another taxpayer.

Clean hydrogen production tax credit. The IRA created a new tax credit for the production of clean hydrogen produced by a taxpayer at a qualified clean hydrogen facility during the 10-year period beginning on the date such facility is placed in service. The credit amount is equal to the base rate of 60 cents or the bonus rate of $3, which is then multiplied by the volume of clean hydrogen produced by the taxpayer during the taxable year. To claim the bonus credit rate, taxpayers must satisfy the prevailing wage and apprenticeship requirements for the duration of the project during the 10-year credit period.

Facilities that begin construction after Dec. 31, 2032, will not be eligible for the credit. This credit allows for a direct pay option. Taxpayers ineligible for the direct pay election may opt to transfer the credit to another taxpayer.

Qualifying advanced energy project credit. The IRA provides $10 billion in funding for the section 48C qualifying advanced energy project credit. This is an application-based credit; the Treasury Department, in conjunction with the Department of Energy, will review applicant projects and award credit allocations to winning projects.

If awarded a credit allocation, a taxpayer can claim the credit in the year the qualifying property is placed in service. The amount of this credit is up to 30% of the qualifying property. Certain prevailing wage and apprenticeship requirements must be met for the highest credit rate. Projects that may qualify involve building, modifying, expanding or reequipping a facility for the production or recycling of certain types of renewable energy property. Other projects may qualify if they reequip an industrial or manufacturing facility with equipment designed to reduce greenhouse gas emissions by at least 20% through the installation of certain property.

The Treasury Department will award credits to applicant projects based on a set of six standards. The application requires the submission of a concept paper. After submittal, the Department of Energy reviews and sends the taxpayer a letter of encouragement/discouragement regarding their energy project. It is important to note that a letter of discouragement does not preclude a taxpayer from submitting a full application. However, a concept paper must be submitted in order to be considered for a credit allocation. Concept papers for the first round of funding (equal to $4 billion of the $10 billion) were due July 31, 2023.

Advanced manufacturing production credit. The IRA added a new credit under section 45X for production and sale in the U.S. of certain clean energy components and critical minerals. This credit is calculated as a rate per eligible component produced and sold by a taxpayer during the taxable year.

Eligible components are generally items that will be used in the production or installation of solar, wind, or battery technology or in the production of certain critical minerals. This credit is set to begin phasing out during calendar year 2030 and is totally phased out for eligible components sold after Dec. 31, 2032. A direct pay option is available for claimants.

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 a qualified industrial facility. Captured carbon oxide must be placed in secure geological storage, used as a tertiary injectant in an 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, 2032. The IRA increased the maximum credit rates for this credit, added prevailing wage and apprenticeship requirements, lowered minimum thresholds for industrial facilities and provided for a direct pay option for claimants.

Sustainable aviation fuel credit. The IRA added a new excise tax credit for each gallon of sustainable aviation fuel sold as part of a qualified fuel mixture. The maximum credit amount is $1.75 per gallon of sustainable aviation fuel. This credit must be claimed as a credit against excise tax liability; any remaining credit may be claimed as an excise tax payment or refundable income tax credit. The credit shall apply for fuel sold or used after Dec. 31, 2022, through Dec. 31, 2024.

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, Standard 90.1 of the American Society of Heating, Refrigerating and Air-Conditioning Engineers (ASHRAE), used as a baseline to measure energy-efficiency improvement, has been updated from the 2007 version to reference the standard from no later than two years before the date on which 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, 2032. The maximum credit for property installed after Dec. 31, 2022, is $100,000 per unit of property. The credit has a base rate of 6% and, if certain requirements are met, a bonus rate of 30%. Property must be placed in service after Dec. 31, 2022, in a low-income or rural census tract to qualify.

Biodiesel, renewable diesel and alternative fuels credits. The IRA extended the income and excise tax credits for biodiesel and biodiesel mixtures at $1 per gallon through Dec. 31, 2024. Also extended are the 50-cent-per-gallon excise tax credits for alternative fuels and alternative mixtures through Dec. 31, 2024, for fuels used or sold after Dec. 31, 2021.

Credit for qualified commercial clean vehicles. The new section 45W credit for new qualified commercial clean vehicles will be available for property placed in service after Dec. 31, 2022. The credit is the lesser of the product of an applicable percentage and the vehicle's purchase price, or the incremental cost of the vehicle. The maximum credit for vehicles with a gross vehicle weight rating under 14,000 pounds is $7,500, while the maximum credit for other vehicles is $40,000.

Residential credits

Nonbusiness energy property credit. The section 25C credit for nonbusiness energy property is extended for property placed in service by Dec. 31, 2032. The IRA increased the credit percentage from 10% to 30% beginning in 2023. Additionally, the lifetime cap is replaced by an annual cap of $1,200, with a higher limitation of $2,000 for heat pumps and biomass stoves. Certain mixtures of qualified property can yield a credit of $3,200.

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, 2032. Property placed in service after Dec. 31, 2022, must be located in a low-income or rural census tract to qualify.

New energy-efficient home credit. The energy-efficient home credit under section 45L has been extended for homes acquired through Dec. 31, 2032.

Residential energy-efficient property credit. The section 25D credit for residential energy-efficient property is expanded and extended for property placed in service through Dec. 31, 2034, with a credit rate of 30%. The phaseout of these credits has also been adjusted for property placed in service from Jan. 1, 2033, through Dec. 31, 2033, with a rate of 26%, and for property placed in service from Jan. 1, 2034, through Dec. 31, 2034, with a rate of 22%. The credit expires after Dec. 31, 2034.

A new category of energy-efficient property is added to the credit for property placed in service after Dec. 31, 2022. The new section 25D(a)(6) will allow for a credit for qualified battery storage technology expenditures, defined as expenditures for technology with a capacity of not less than 3 kilowatt-hours, installed in connection with a dwelling unit located in the U.S. and used as a residence by the taxpayer.

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 (earnings before interest, taxes, depreciation and amortization), 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 sciences. 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.

Many companies can benefit from a review of excise taxes to identify risk exposure as well as opportunities to minimize tax liabilities through refunds or credits. An excise tax rapid assessment includes:

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

If an area of risk is identified, businesses can take a deeper dive into remediating the problem. Identified credits or savings opportunities may ultimately improve profitability and operational efficiency.

Superfund excise taxes

The Infrastructure Investment and Jobs Act (IIJA) reinstated the Superfund excise taxes imposed on chemicals and imported taxable products effective July 1, 2022, through Dec. 31, 2031. Manufacturers and importers of chemicals and substances containing chemicals may be liable for federal excise tax. Purchasers of these chemicals may see increased prices of these products. Certain end uses qualify for excise tax credits. Entities manufacturing or importing certain chemicals should assess their business operations to comply with the quarterly excise tax requirements and semimonthly deposits. Entities exporting chemicals should consider whether a refund of the Superfund excise taxes may be claimed.

Excise tax on the sale of prescription drugs

The IRA also added section 5000D, which imposes an excise tax on designated drugs sold by the manufacturers, producers or importers (collectively manufacturers) of these drugs during a period of noncompliance.

In general, the period of noncompliance for designated drugs is the period in which the manufacturer does not have a maximum fair price drug pricing agreement as part of the Medicare Drug Price Negotiation Program under section 1193 of the Social Security Act. The period of noncompliance begins after the deadline for the drug manufacturer to enter or renegotiate a Medicare drug pricing agreement or maximum fair pricing for the designated drugs. The noncompliance period ends once an agreement is reached or when a generic version of a designated drug is made available.

The tax levied on a manufacturer during a day that falls within the statutory period of noncompliance is the amount at which the applicable percentage is equal to the ratio of the tax divided by the sum of the tax and the price for which the designated drug is sold.

The applicable percentages are defined by section 5000D as:

65% for sales of a designated drug during the first 90 days of the statutory period
75% for sales of a designated drug during the 91st through 180th day of the statutory period
85% for sales of a designated drug during the 181st through 270th day in a statutory period
95% for sales of a designated drug for any subsequent day in a statutory period

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, many companies still 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.

Corporations facing economic hardship should be proactive in working with their tax advisors to ensure maximum company value is preserved through proper planning.

Inflation Reduction Act: Corporate alternative minimum tax (CAMT) and 1% excise tax on certain stock repurchases

As part of the IRA, Congress imposed a CAMT of 15% on the "adjusted financial statement income" of certain large corporations that meet a $1 billion average annual adjusted financial statement income test ($100 million in the case of certain U.S. corporations that are members of a foreign-parented multinational group—provided the multinational group also meets the $1 billion threshold). Related entities may be required to aggregate their annual adjusted financial statement income in order to determine if they are subject to the CAMT. The CAMT is effective for taxable years beginning after Dec. 31, 2022.

In addition, Congress imposed a new 1% tax on certain corporations that repurchase (buy back) their stock from their shareholders at a value in excess of $1 million per year (net of issuances). The corporations subject to this tax are domestic corporations traded on an established securities market and certain foreign corporations. The tax applies to buybacks occurring after Dec. 31, 2022.

Treatment of unamortized section 174 costs in an M&A transaction

The TCJA amended section 174 for tax years beginning after Dec. 31, 2021. Under the new rule, specified research and experimental expenditures (section 174 costs) are no longer deductible but are chargeable to a capital account and amortized over a five-year period (or 15-year period for foreign research expenditures).

Taxpayers cannot write off unamortized section 174 costs merely because the project or activity is disposed, retired or abandoned. If the taxpayer disposes of its business in a mergers and acquisitions (M&A) transaction, however, such costs arguably have no further value, and it in some cases it may be possible to write off remaining unamortized costs.

The IRS has issued interim guidance in this area that taxpayers may rely upon prior to the publication of regulations. Because this guidance is limited and leaves unanswered questions, however, the treatment of section 174 costs in the context of M&A transactions should be reviewed on a case-by-case basis; consultation with a tax advisor is highly recommended.

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 unextended 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 corporations that use the calendar year as their tax year and for corporations using fiscal years ending in any month but June. Corporations whose fiscal year ends in June receive a seven-month extension.

The six- or seven-month extension period begins on the original due date of the return. Note that for corporations using the calendar year, the original due date for a 2022 Form 1120 is April 18, 2023.

Filing the extension may be beneficial even if the corporation files its return the next day. 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, but the statute of limitations on assessment will still expire (under normal circumstances) three years from the date the taxpayer filed the original 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 may accelerate income into the year of certain M&A transactions and possibly into the year prior under rules provided by the IRS. These rules can provide tax advantages in situations where section 382 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 an original issue discount. Any amounts treated as such must be amortized over the life of the debt and may be subject to the business interest limitation under section 163(j).

Federal income tax mulligan

Revenue Ruling 80-58 allows taxpayers to rescind a transaction. This is not a new ruling, but rescission is difficult to accomplish, with little guidance in this area. For successful completion, a rescission must occur within the same tax year as the transaction. As a result, this item warrants consideration during year-end planning to determine whether any transactions need to be unwound prior to year-end.

Section 382 closing-of-the-books election

Corporations should carefully monitor changes in stock holdings and stock issuances that occur during the year to identify whether any have undergone a section 382 ownership change. If so, the company may make a closing-of-the-books election, which may result in significant tax benefits.

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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) when 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, which is generally more favorable for companies in a built-in gain position. Such companies tend to derive most of their value from self-created intangibles with no tax basis.

If these proposed regulations are finalized in their current form, life sciences 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 contemplating an ownership change in the near future (e.g., through 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 after the 2022 calendar year-end.

Projecting earnings and profits

During year-end planning, it may be important for a corporation to project the remaining current-year earnings and expected 2023 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 affecting 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 they meet the filing requirements in a timely manner 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 (on either the buy-side or the sell-side), the IRS requires capitalization of the costs incurred to facilitate the transaction.

With stock transactions, these costs generally are capitalized into the 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 be either deducted as incurred or amortized over 15 years.

Performing a transaction cost analysis allows a company to identify nonfacilitative costs and maximize tax deductions. It 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.

Further, during recent requests for relief under Income Tax Regulation 1.9100-1, the IRS has challenged the ability of target corporations to deduct success-based fees (e.g., investment banking or other consulting expenses) in M&A transactions.

Given this additional scrutiny, transaction cost analyses should emphasize documenting the services provided to the target corporation (and how the target benefited from such services). In addition, this scrutiny places additional pressure on making valid and timely safe harbor elections under Revenue Procedure 2011-29.

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 any time through immediately after the issuance. The corporation must conduct a qualified trade or business, as defined in the statute.

In September 2021, Congress proposed legislation reducing the section 1202 exclusion for most taxpayers (those with an adjusted gross income of $400,000 or more) to 50% of the gain from the sale of QSBS. The IRA did not curtail the ability of holders to exclude 100% of gain from the sale of QSBS. Note, however, the potential for Congress to revisit its previous attempt at curtailing a holder's ability to exclude QSBS gain.

Due to the complexities involved, taxpayers should consult with their tax advisors when considering claiming the section 1202 gain exclusion benefit.

ASC 740 considerations

Proposed improvements to income tax disclosures. The Financial Accounting Standards Board (FASB) is proceeding with drafting a final accounting standards update (ASU) regarding "Income Taxes (Topic 740): Improvements to Income Tax Disclosures" after receiving feedback and deliberating on the proposed ASU issued earlier in 2023.

The ASU is primarily focused on additional disclosures regarding the effective tax rate reconciliation and cash taxes paid by jurisdiction. The final ASU will be effective for public business entities with fiscal years beginning after Dec. 15, 2024, and interim periods within fiscal years beginning after Dec. 15, 2025, and will be applied on a prospective basis, with adoption dates for entities other than public business entities one year later than the dates for public business entities.

While the update is not immediately applicable for 2023, some companies have indicated they will need time to revise provision processes to ensure the required data is available; accordingly, companies should begin evaluating the impact of the coming final ASU on their provision.

Impacts of the Inflation Reduction Act. The CAMT was enacted as part of the Inflation Reduction Act in August 2022 and is effective for tax years beginning on or after Jan. 1, 2023. The CAMT is a 15% minimum tax on adjusted financial statement income of applicable corporations. Applicable corporations include domestically parented subchapter C corporations with average annual adjusted book income of $1 billion or more and foreign parented multinational groups with average annual adjusted book income of $100 million or more.

The IRS has provided a safe harbor calculation for 2023, which allows corporations to use a simplified calculation to determine whether they are an applicable corporation. As long as the safe harbor calculation results in average income of less than $500 million for domestically parented corporations and $50 million for foreign-parented corporations, the entity is not an applicable corporation.

While taxpayers are still waiting on significant guidance regarding the calculation of CAMT, corporations will need to evaluate whether they are an applicable corporation and, to the extent they are subject to CAMT, consider the impact on their 2023 income tax provision. Because the payment of CAMT results in a tax credit, the CAMT does not generally affect a company's effective tax rate; however, companies will need to evaluate any CAMT credit carryforwards for realizability.

The IRA introduced several clean energy incentive credits. Certain credits are eligible for direct pay and others are transferrable between taxpayers.

Companies eligible for these credits will need to evaluate the direct pay or transferability of the credits to determine the appropriate accounting. Generally, under ASC 740, if a credit is refundable without regard to taxable income, the credit would be accounted for outside of ASC 740. While there is some diversity in views, if the credit is transferable and nonrefundable, the FASB views the most appropriate treatment as including the credit in ASC 740, and to the extent a gain or loss on transfer is recognized, it would be included in income tax expense (benefit) on the income statement.

Considerations for multinational corporations. Multinational taxpayers will need to evaluate the effect on the company's income tax provision of temporary relief granted by the IRS regarding the calculation of foreign tax credits. The IRS has granted relief to taxpayers in Notice 2023-55 in determining whether a foreign tax is eligible for a foreign tax credit under sections 901 and 903.

Many taxpayers had raised concerns after the 2022 final regulations were published that previously creditable foreign taxes would no longer qualify for a credit. The temporary relief allows taxpayers to largely apply the former version of the regulations in place as of April 1, 2021. The relief is available for tax years beginning on or after Dec. 28, 2021, and ending on or before Dec. 31, 2023. This relief is likely to result in the ability of a company to claim additional foreign tax credits, particularly related to foreign withholding taxes. The IRS has also indicated that it is likely to extend this relief through 2024.

The global minimum tax under Pillar 2 has been heavily discussed globally in 2023. The Pillar 2 framework from the Organisation for Economic Co-operation and Development seeks to implement a global minimum tax of 15% for companies that have greater than 750 million euros in consolidated gross receipts globally.

Several countries have adopted Pillar 2 into their domestic legislation with enactment dates beginning in 2024, while several other countries, including the U.S., are discussing the adoption of Pillar 2 in their respective legislative bodies.

Multinational taxpayers will need to evaluate the effect on the company's income tax provision of temporary relief granted by the IRS regarding the calculation of foreign tax credits.

For provision purposes, companies will need to consider the impact of the Pillar 2 rules as specific countries enact legislation, as ASC 740 requires companies to reflect changes in tax law in the period of enactment. Importantly, in a technical inquiry earlier this year, the staff of the FASB indicated they believe most Pillar 2 taxes should be accounted for as an alternative minimum tax, in which case deferred taxes would not be recognized or adjusted for the future effects of the global minimum tax.

Other critical income tax law changes. Several provisions of the TCJA that first became effective in 2022 continue to be high on the list of items that Congress has indicated should be addressed. However, no action has been taken through the early fall. Therefore, businesses must continue to deal with the capitalization of R&D expenses under section 174 costs, more stringent limitations on interest expense deduction under section 163(j), and continued scale-back of bonus depreciation. It is possible that some of these provisions could be addressed before the end of 2023, or sometime in 2024.

Finally, there have been a number of changes to state and local income tax laws and regulations, along with changes in foreign tax laws, that taxpayers should review in connection with their 2023 tax computations.

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 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 $182,100 (or $364,200 for a joint return) are subject to limitations on the deduction. These taxpayers may see the deduction reduced or completely 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 in part to be a specified service business described in the law.

Moreover, there is still uncertainty in several areas, particularly around whether certain business activities involve the performance of services in 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.

Approximately 30 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.

Pass-through businesses and their owners should carefully evaluate the potential benefits associated with electing into these regimes for the 2023 tax year. In many cases, doing so can significantly lighten 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 depreciation, 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, 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 that could be restructured to generate such a step-up, should pay particular attention to these final rules. Prior to finalizing a transaction structure, it 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. (See the explanation below about excess business losses for an additional loss limitation.)

The keys to doing so are understanding how much participation is necessary, and 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, for some activities a taxpayer may need to participate for only 101 hours. Thus, determining the hours required for a specific activity and taking action now to increase participation can provide a valuable tax deduction.

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

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 an additional hurdle 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. Most recently, the IRA extended this provision (in its current form) for an additional two years, through tax years beginning before Jan. 1, 2029. Specifically, the provision limits noncorporate taxpayers to a $250,000 ($500,000 for married couples) aggregate loss from their business activities (indexed for inflation).

Thus, 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, they may be able to deduct losses of no more than $289,000/$578,000 in 2023. Losses in excess of the annual limitation would carry forward and be treated as an NOL in the following year.

Following its original enactment, these excess business loss rules generated a series of questions. Subsequent 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."

As a result, 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 the section 199A pass-through deduction saw their top federal tax rate drop from 39.6% to 29.6%.

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 QSBS?
- 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 crucial for determining the entity type that will minimize a business's overall tax burden.

S corporations and shareholder compensation

The Treasury 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, underreporting due to 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 determined that the IRS was not identifying underreporting 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. Based on the IRS' focus on this issue, S corporations should review their existing compensation plans and arrangements to ensure proper classification of shareholder compensation.

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 either 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. However, in several cases pending before the courts in 2023, the IRS appears to be challenging even limited partnership structures.

Thus, while these changes may provide greater confidence regarding the application of certain self-employment tax exceptions to members of LLCs and LLPs, it is critical to recognize that this is a continually evolving area, with potential impact on current and future guidance due to future decisions by the courts.

Carried interest legislation

The TCJA added a new provision affecting the treatment of carried interest, defined generally as partnership interest 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 early in 2021, and are binding for taxable years beginning on or after Jan. 19, 2021. For calendar-year taxpayers, this means the final regulations are effective for 2022, for returns that will generally be filed in 2023.

The final regulations are generally more taxpayer-friendly than earlier proposed regulations, while still fulfilling the intent of the TCJA provisions. Many exceptions and nuances apply to these rules, which impose significant reporting requirements at the partnership level. For taxpayers expecting a large carried interest realization event, we recommend considering the applicability of these rules and discussing potential mitigation strategies with their tax advisors.

Taxation of carried interests continues to be a topic of much debate. Businesses need to carefully monitor any 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 some 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

Over the last few years, the IRS has subjected partners and S corporation shareholders to expanded reporting requirements. Notably, S corporation shareholders for a number of years have been required to include a basis schedule with their tax return when receiving a distribution, selling stock, recognizing a loss or receiving a loan payment.

The IRS standardized this disclosure in early 2022 with the issuance of Form 7203. Accordingly, for 2021 tax returns and later, shareholders who engage in any of these activities are now required to include Form 7203 with their return filings.

Meanwhile, partnerships are required to report the beginning and ending tax basis capital for each partner. In 2019 this partnership reporting was only required if either amount was negative; beginning in 2020 this rule applies to all partners and partnerships.

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