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TAX PLANNING
for challenging times

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Executive summary: Tax planning for challenging times

Businesses and taxpayers across the country are continuing to adapt to the challenges posed by the COVID-19 pandemic and its resulting impact on the economy. These challenges include government-imposed limitations on business operations, fluctuating demand for certain goods and services, difficulty maintaining supply chains and operational functions, and all of the indirect impacts as these issues reverberate across the economy. As businesses plan for the coming months and years, this guide is intended to support that effort by exploring the many tax planning opportunities available to companies facing a challenging economy. While this guide focuses on tax planning opportunities, other business planning opportunities are addressed in our COVID-19 resource center.

This guide explores many individual topics but can be best framed in terms of phased planning opportunities.

Immediately below, you will find a general overview of the topics included in this guide.

Want to discuss your tax planning strategies?

One of our tax experts will get back to you shortly.

This guide is intended to provide general information about planning opportunities and is not intended to provide a complete description of each issue. This guide cannot be relied upon to avoid tax exposure, penalties, or any similar purpose. Your tax advisor should always be consulted before acting on any tax planning strategy.

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Short-term tax planning: Accessing tax attributes through refunds, utilizing credits, and deferral of tax payments

A fundamental aspect of many planning opportunities in this guide is the utilization of net operating loss (NOLs) or the minimizing of taxable income. There are new opportunities available to carry back such losses to the prior five years, enabling taxpayers to obtain immediate refunds, potentially to tax years that were subject to higher tax rates. Limitations on the use of business losses by individuals have also been suspended and may create opportunities for individuals to fully deduct losses from businesses. The new rules for NOL utilization will almost always be beneficial, but taxpayers will need to consider whether any other tax regimes — such as the alternative minimum tax (AMT) or state and local taxes — could still result in tax liabilities in loss years.

There are also a variety of opportunities for taxpayers to maximize short-term cash flow by deferring tax payments. Ultimately, this is a timing opportunity, so proper planning must take into account the fact that these payments will be due at a future date. However, these can be crucial for preserving current cash. Specific to 2020, new opportunities include deferral of certain payroll tax deposits and relief for the payment of estimated taxes. However, other existing tax payment deferral or refund acceleration provisions are also newly relevant during these times. Future guidance and legislation should be monitored for potential expansion of tax deferral opportunities.

Employers should consider opportunities to take advantage of tax credits and other employment incentives. Some of these incentives were already available, but COVID-19 legislation has created refundable credits for the retention of employees, with respect to certain paid sick leave and paid family leave. The new credits can be monetized through the payroll tax system, meaning that cash can be generated immediately. Other existing tax credits are also available, which can help reduce or eliminate any remaining current, prior, or future income tax liabilities.

Medium term planning: Recognition of income and deductions and tax return filings

Tax planning over the medium term focuses on minimizing tax in the current year, increasing current losses to carry back to previous years, or otherwise looking for tax refund opportunities that can be filed currently. This includes consideration of the timing of income and deductions, opportunities related to previously filed tax returns, and debt renegotiation. Determining the best time to report income and how to correctly classify the treatment of income or expense items can lead to positive planning opportunities.

Taxpayers can complete numerous accounting method changes to accomplish different goals. For example, the cash method of accounting is typically advantageous and was made available to a greater number of taxpayers beginning in 2018. Payroll taxes and prepaid expenses can be deducted at different times to allow for maximum cash flow. Depreciation planning is always an attractive option, and the CARES Act has made this even easier with a technical correction that allows for 100%bonus depreciation on qualified improvement property. Inventory capitalization is also relevant, particularly because new rules create a variety of opportunities for challenging economic times. When considering

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LONG-TERM PLANNING:

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any planning opportunities related to income and deductions, it's also important to evaluate the potential impact of those items under state and local and international tax rules.

The IRS has provided temporary relief for partnerships to file amended returns outside of the administrative adjustment request process. This may allow for amendments to prior-year returns to generate losses that can be carried back by the individual owners. More broadly, there may be opportunities to file amended returns or even superseding returns before the extended due date for all return types. Accordingly, tax positions on all recent tax returns should be evaluated for opportunities.

Debt can play a significant role for troubled companies during trying times in both positive and negative ways. When trade receivables become worthless, taxpayers write these debts off in order to obtain ordinary deductions. Planning related to the timing of those write offs can often provide significant benefits. On the other hand, modifications to existing debts can generate taxable income through the recognition of cancellation of indebtedness (COD) income. With proper planning the potential impact of COD income can be managed. Temporary increases to the business interest expense limitation for 2019 and 2020 will be helpful, but businesses will generally need to evaluate whether their existing debt structures are sustainable.

Long-term planning: Opportunities with facilities, structures, and transactions

Longer-term tax planning should generally take a more holistic view of business operations, entity structures, and transaction planning opportunities. As a starting point, taxpayers must consider the best use of their assets and facilities, as those items can be the source of tax planning opportunities. Idled facilities and underutilized assets often require evaluation of whether the carrying amount is recoverable in comparison to its cash flow potential. Consequently, taxpayers should also identify opportunities for fixed asset write-offs.

A broad range of possibilities exist for opportunistic business restructuring. This includes opportunities for C corporations to elect S corporation status while minimizing the value of C corporation built-in gains. Decreased business valuation may even make the taxable conversion of a corporation to a partnership attractive in trying times. Similarly, certain business combination opportunities may free up tax losses due to increases in tax basis in equity interests.

Worldwide planning is another key for troubled companies. Companies must determine what considerations are important if they are profitable in foreign countries but not the U.S. Likewise, state and local planning is just as important. For example, companies need to understand the differences between the federal rules and the state and local rules to evaluate opportunities and potential exposures.

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MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Bankruptcy is an alternative that may be necessary depending on the circumstances. Businesses that are considering bankruptcy should specifically consider the impact of that process on their tax filings and the potential tax impact of any modifications to existing debts.

Long-term business planning should take into account the tax aspects of acquisition or exit transactions. For acquisitions, early planning for the use of post-acquisition deductions or losses is of great benefit. When a troubled business is being acquired, the tax and legal considerations that exist become even more significant and proper due diligence becomes essential. This would even encompass topics like current year payroll taxes due to expanded tax credit programs.

Other tax planning topics

Based on the circumstances of the taxpayer, there are a variety of tax planning topics that might fit within any of the categories described above. One category would include planning related to tax payments, collections and penalties. In certain situations, persons responsible for paying federal payroll taxes could be held personally responsible for taxes that are not paid by an employer. Businesses should consider taking a closer look at any tax sharing agreements that may currently exist to determine whether a liability could result. While many collection deadlines have been postponed, taxpayers need to stay actively involved in understanding the changes in these policies moving forward.

Businesses would also do well to consider planning in relation to compensation. For example, there's an opportunity to make tax-free payments to employees under disaster relief provisions. Taxpayers should also consider restructuring their employee benefits plans because it's likely that businesses will see changes in business valuation, and government incentive programs could cause executive compensation limitations. This type of planning could be integrated into any of the planning phases previously discussed, given the significance of employee compensation to the income of most businesses.

Financial accounting for income taxes is also extremely important to businesses looking to navigate their way through the COVID-19 pandemic and aftermath. While the accounting for income taxes is not a cash generating activity, ensuring that they are accounted for properly up front can help to minimize issues that may arise with lenders or regulators and create more predictable projections. One of the most common considerations that can substantially change a financial statement is the need for any deferred tax valuation allowances on deferred tax assets. Similarly, monitoring tax legislation for financial statement impacts in all relevant jurisdictions is critical to timely report those changes.

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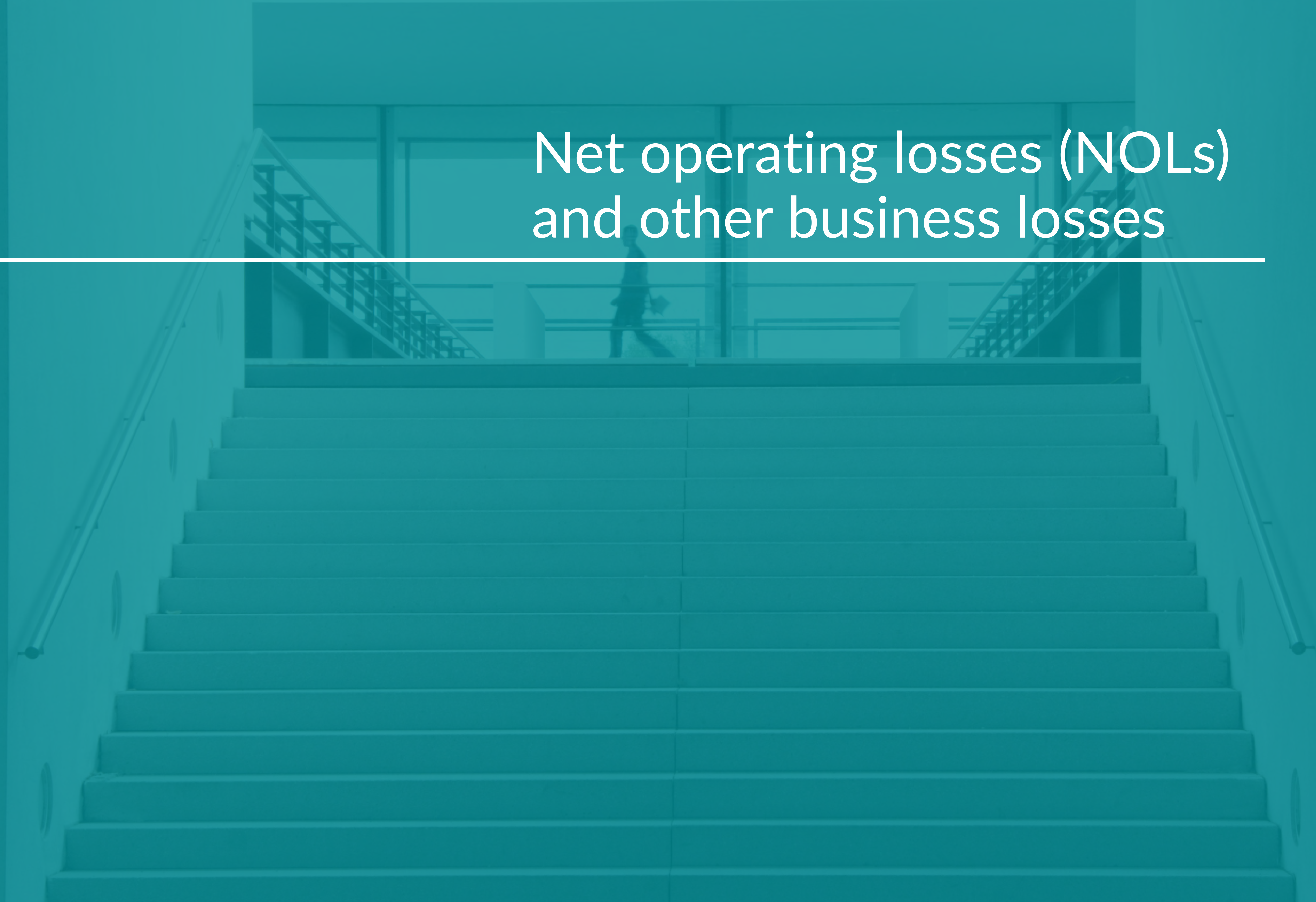

Net operating losses (NOLs) and other business losses

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LONG-TERM PLANNING:

OTHER:

Net operating losses (NOLs) and other business losses

Utilize net operating loss carrybacks to obtain refunds

The Tax Cuts and Jobs Act (TCJA) repealed all net operating loss (NOL) carrybacks for 2018 and later tax years. However, the Coronavirus Aid, Relief, and Economic Security (CARES) Act was enacted in March 2020 and retroactively restored NOL carrybacks for 2018, 2019, and 2020 by permitting a carryback to the five previous tax years. The CARES Act also temporarily repealed, through 2020, the TCJA provision allowing no more than 80% of taxable income to be offset by NOLs. The new relief provision creates an opportunity for the taxpayer to file original or amended returns that carry back NOLs and generate cash refunds.

Carrying back an NOL is generally advantageous compared to carrying it forward since it can generate immediate cashflow, while the benefit of any carryforward is dependent on future profits. Because the current five-year carryback extends to years where tax rates were higher, a 2020 loss could result in an even greater tax benefit. Carrying back NOLs preserves a greater amount of income in subsequent years, and could allow for the possibility of carrying back NOLs recognized in the future. Taxpayers are permitted to waive an NOL carryback but this decision should be scrutinized closely before it's made. Businesses should model which scenario is more advantageous.

Maximize losses to utilize NOL carrybacks

With a limited window to carry back NOLs, taxpayers will often benefit from managing the timing of events within their control to maximize losses/deductions in 2020 and defer income/gains to future tax years. There are many opportunities available in order to accomplish this goal, which are discussed throughout this guide. In particular, see the sections discussing Tax accounting methods, Business acquisition and sales, and Business restructuring for further details.

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MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Fully deduct losses from businesses (individuals only)

For individuals with flow-through businesses or sole proprietorships, the TCJA originally limited net business losses to $500,000 (or $250,000 for single taxpayers) beginning in the 2018 tax year. Any net business losses in excess of those amounts were suspended and carried forward to future years as if they were an NOL.

The CARES Act retroactively and temporarily repealed the excess business loss limitation until 2021. This allows individuals to amend 2018 and 2019 tax returns to remove this limitation and deduct the full loss, subject to all other applicable limitations. There is no election out of this temporary repeal, so taxpayers are required to deduct the full amount of the loss in the year it was generated, even if a 2018 excess loss was already carried forward and absorbed in 2019. However, any NOLs created by this change can be carried back five years. Affected taxpayers will need to plan carefully to fully utilize this benefit in prior tax years and to maximize the value of the tax relief this provision can provide in 2020.

File tentative refund claims for expedited processing

To obtain a cash refund from an NOL carryback, a taxpayer must file either an amended return for the year to which the loss is carried back or a tentative refund claim (Form 1139 for corporations and Form 1045 for individuals). A tentative refund claim is usually the preferred method because, in most cases, it will get the refund to the taxpayer sooner. The IRS is generally required to act on these claims within 90 days and usually isn't permitted to audit the claim prior to paying the refund.

Normally, a tentative refund claim must be filed within 12 months of the loss year (e.g., Dec. 31, 2020 for a 2019 calendar year NOL). After that date, only amended tax returns can be filed. A special rule has been put in place for 2018 NOLs that permits tentative refund claims to be filed through June 30, 2020. In order to expedite refunds, the IRS is also temporarily permitting tentative refund claims to be filed via fax — but only if they relate to an NOL carryback or AMT credit refund claim (no other matter can be included on a faxed filing).

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MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Additional NOL considerations for internationally active businesses

Another TCJA provision stated that all businesses were required to recognize all cumulative earnings of those subsidiaries during their 2017 tax year and pay tax on that income at reduced rates ("transition tax"). After 2017, income of foreign subsidiaries must be recognized in the United States if it exceeds certain thresholds, although some businesses might be eligible for a reduced tax rate. C corporations that export products might be eligible for a special deduction, and large C corporations that have expenses to foreign related parties might pay a base erosion tax that functions similarly to an alternative minimum tax.

An NOL carryback can't be used to offset income that generated the transition tax. A taxpayer can elect to skip that year all together when doing its NOL carryback. Each of these provisions has a complex interaction with NOLs, and should be reviewed closely before a loss is carried back to a tax year that includes any of these items. Furthermore, if an NOL is carried back to a year that includes one of these items, the refund will generally be applied against the tax due in later years. As a result, this would reduce the immediate cash refund.

Consider special rules for carrying back 2017 fiscal year NOLs

The CARES Act requires that an NOL generated in a tax year that began in 2017 but ended in 2018 (i.e., a 2017 fiscal year) be carried back two years. The TCJA had previously provided that a 2017 fiscal year NOL could only be carried forward. This rule typically applies only to C corporations since individuals generally can't use a fiscal year. A tentative refund claim can be filed by July 27, 2020, to obtain a refund from this carryback. Amended returns can be filed to obtain refunds until the expiration of the statute of limitations for the 2017 fiscal year.

If a taxpayer would prefer to waive the carryback and only carry the NOL forward, it must file an election to do so by July 27, 2020. A waiver should be considered when the benefits of the NOL carryforward have already been realized in a subsequent tax year, but modeling should be performed to ensure that carrying the NOL back to a higher tax rate year prior to the 2017 fiscal year isn't more advantageous. As discussed above, consideration should also be given to the preservation of income in later tax years in order to increase the likelihood that any future losses can potentially be carried back as well.

> "An NOL carryback cannot be used to offset income that generated the transition tax."

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

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Accelerate refunds on alternative minimum tax (AMT) credits

The TCJA repealed the AMT for C corporations for 2018 and later years. Under that law, all AMT credits accumulated through 2017 were to be refunded over several years from 2018 through 2021. The CARES Act accelerated the refundability of all remaining AMT credits into 2019. Any benefit can be claimed on an original, superseding, or amended 2019 tax return, as applicable. The CARES Act also created an election to permit the credits to be fully refundable in 2018. A tentative refund claim is permitted to be filed through Dec. 30, 2020, at which point, only an amended return would be permitted to claim the credit in 2018.

Consider qualified business income deduction (QBID) in context of NOL carryback

The TCJA enacted the QBID, which is a deduction of 20% of qualified business income for individuals, estates, and trusts. In general, QBID isn't available when the qualified income of the taxpayer from all sources results in a loss. However, that loss is required to be carried forward and treated as a qualified business loss in subsequent years, reducing the QBID in those later years when qualified income exists. This is still true even if the actual business losses are used to offset other income or otherwise carried back as a part of an NOL. This mismatch of when the tax loss is utilized compared to when it' is factored in to the QBID calculation can significantly reduce QBID in future years. Generally, the NOL carryback is still favorable since it would result in taxes being refunded, potentially in higher tax rate years. However, the creation of a qualified business loss will impact QBID computations in future years and should be evaluated.

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MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Tax refunds and payments

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Tax refunds and payments

Maximize cashflow by deferring income tax payments

Taxpayers are generally required to make quarterly payments of estimated taxes. The IRS has postponed the due date for certain income tax payments scheduled in the spring of 2020, including amounts due with 2019 tax returns as well as first- and second- quarter estimated tax payments, to July 15, 2020. Many states have followed suit, although some aren't covering all taxes or conforming to the extended federal due dates. Some states have also deferred the payment of sales and use, employer withholding, and other tax types while others have not. As time unfolds, it's possible that further payment due date extensions will occur. Taxpayers should keep a close eye on these updates to ensure they are maximizing their cash flow. However, it's important to remember that you will need sufficient cash on hand when these amounts come due.

Defer the employer payroll tax where possible

The CARES Act provides employers the ability to defer the payment of the employer's 6.2% Social Security taxes otherwise due from March 27, 2020 through Dec. 31, 2020. Half of the deferred amount is due at the end of 2021, and the remainder is due at the end of 2022. Taxpayers that obtain loan forgiveness under the Payroll Protection Program and from certain other forgivable loans aren't permitted to defer any payroll taxes once the forgiveness has been approved. This deferment is expected to be beneficial in many cases since it is, in substance, a multiyear interest-free loan. However, the appropriate tax years for the associated payroll tax deductions related to these payments will need to be considered.

"The IRS has postponed the due date for certain income tax payments scheduled in the spring of 2020, including amounts due with 2019 tax returns as well as first- and second- quarter estimated tax payments, to July 15, 2020."

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MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

File Form 4466 to obtain quick refunds of corporate tax payments

A corporation can claim a refund of any overpaid estimated taxes by filing Form 4466 after year-end but before the original due date of the tax return. For the 2019 tax year, this due date is extended as a result of the general due date extension applicable to most tax filings. Therefore, taxpayers that expect overpayments on their 2019 tax returns may want to consider filing Form 4466 to recover such overpayments if such overpayments aren't needed to be applied to cover 2020 estimates. The IRS generally must act on the request within 45 days of the filing date, resulting in quicker access to overpayments when the tax return can't be filed yet or when the taxpayer is concerned that a refund requested on a return will not be received quickly enough.

Extend the time for a corporation expecting a NOL carryback to pay taxes by filing Form 1138

A corporation can extend the payment of tax for Year 1 if it's expecting an NOL in Year 2 that can be carried back. This avoids the problem of paying the Year 1 tax when it will simply be refunded later due to a Year 2 loss. The form must be filed after the beginning of Year 2 but only taxes that are due after the date the form is filed can be extended (i.e., Year 1 extension payments due in Year 2 or assessments made in Year 2 but related to a prior year). This may be particularly helpful for taxpayers that have balances due for 2019 or earlier years but expect an NOL in 2020.

Apply for an extension of time for payment of tax due to undue hardship

Any taxpayer can file Form 1127 to apply for up to a six-month extension to pay tax due if the payment would cause an undue hardship on the taxpayer. The hardship must be more than a simple inconvenience. It must be proven that substantial financial loss would result without an extension (e.g., selling property at "fire sale" prices). The application process requires a submission of extensive proof to support these claims. When an extension of time is unlikely to be accepted or simply not desired, taxpayers can apply to pay tax due in installments by filing Form 9465.

Evaluate the amount of required estimated tax payments

Taxpayers are generally required to pay estimated taxes based on what they expect to owe for the year. However, certain taxpayers are permitted to pay in an amount equal to their prior year tax liability on a quarterly basis. Individuals are permitted to do this even if their prior year tax liability was $0. However, corporations generally can't rely on the prior year tax liability if tax was $0. Those corporations with zero-balance prior-year tax liability must pay based on their current year tax liability, if one is expected.

> "Taxpayers are generally required to pay estimated taxes based on what they expect to owe for the year."

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Consider adjustments to individual tax withholding

If an individual had no tax liability in the prior year and no tax liability is expected in the current year (without consideration for tax payments made), wage withholding can be eliminated. This would require the filing of a new W-4 with the employer indicating that the taxpayer is exempt.

Extend tax filings to preserve superseding tax return opportunities

Even when taxpayers file returns by the original due date, they should consider filing an extension before filing the original return in order to preserve the right to file a superseded return until the extended due date. A superseding return essentially completely replaces the originally filed return as if the original filing never happened. This treatment allows taxpayers take certain actions on a superseding return that wouldn't otherwise be available in an amended tax return. For example, certain elections can't be made or revoked on an amended tax return but can be made on a superseding return.

In general, a superseding tax return can be filed whenever the due date for a tax return hasn't yet passed. The due date takes into account an extension only if the extension was filed prior to the original tax return filing. This year, the IRS has postponed the tax filing for essentially all federal tax returns due between April 15, 2020 and July 15, 2020. Taxpayers are still permitted to request extensions beyond July 15 to the extent that tax law permits further extensions.

Extending the due date as far as possible, regardless of when the original return is filed, gives a taxpayer more flexibility to react to the frequent changes in the economic and regulatory landscape driven by the current health crisis.

Consider temporary relief to amend partnership tax returns

The IRS has provided temporary relief from the partnership amended return rules for certain partnerships through Sept. 30, 2020. That relief allows a more streamlined process for the filing of traditional amendments rather than following the newer procedures. Under the new rules beginning in 2018, any partnership that is subject to the centralized partnership audit procedures isn't permitted to file a traditional amended return. Instead, the partnership must file an administrative adjustment request (AAR). The result of an AAR can lead to a reduction or loss of tax benefits for partners when an AAR is filed to take advantage of tax savings.

When an AAR is filed with a favorable adjustment, the partner isn't permitted to amend their return for the year that the adjustment is made but instead must recalculate the partner's tax liability for that year (and any subsequent years that would have been impacted), with the net tax benefit included on the current year tax return of the partner as a nonrefundable credit. If the partner doesn't have a sufficient tax liability to absorb the credit in the current year, then the remainder of that credit is lost. Therefore, partnerships looking to take advantage of tax planning opportunities should closely scrutinize these rules prior to filing the AAR.

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MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Tax credits and employment incentives

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Tax credits and employment incentives

Claim the employer tax credit for employee retention

Certain employers may claim a refundable credit equal to 50% of qualified wages, including healthcare expenses, paid to employees during 2020. This credit can provide substantial cash flow savings for a business during 2020 because it allows employers to apply the credits to reduce or eliminate current payroll tax deposits. Qualified wages are limited to $10,000 (leading to a $5,000 maximum credit per employee).

To qualify, the employer must meet one of two requirements:

1. The operation of the employer's business must be partially or fully suspended due to government orders, which limit commerce, travel, or group meetings due to COVID-19.
2. The gross receipts of the business in 2020 must have declined for a quarter to less than 50% of the gross receipts from the same quarter in 2019.

If at least one of those requirements is met, an employer with 100 or fewer employees can include all wages paid as qualified wages. An employer with more than 100 employees can only include wages paid to employees who aren't providing services as a result of at least one of the two conditions above as qualified wages.

"Certain employers may claim a refundable credit equal to 50% of qualified wages, including healthcare expenses, paid to employees during 2020. This credit can provide substantial cash flow savings for a business during 2020 ... "

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MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Claim the paid sick leave credit

The paid sick leave credit provides a 100% credit for any COVID-19-related sick leave wages and healthcare expenses that an employer is required to pay to an employee under the Families First Coronavirus Response Act (FFCRA). Generally, only employers with less than 500 employees are required to provide this sick leave in certain specified circumstances, including when an employee:

1. Is subject to a federal, state, or local quarantine isolation order related to COVID-19.
2. Has been advised by a healthcare provider to self-quarantine due to concerns related to COVID-19.
3. Is experiencing symptoms of COVID-19 and is seeking a medical diagnosis.

Depending on the reason for the employee's absence, the sick leave is limited to either $200 or $511 per day. The FFCRA limits the required leave to 10 days, leading to a maximum credit of $2,000 or $5,110 (plus healthcare expenses) per employee. Qualified wages aren't subject to employer payroll taxes but employee payroll tax withholding is still required. This requirement only covers the period of April 1, 2020 through Dec. 31, 2020. An employer who voluntarily pays sick leave or pays an amount in excess of the required amount isn't eligible for credits on those amounts.

Claim the paid family leave credit

The FFCRA includes a provision similar to the paid sick leave credit that requires employers to provide paid family leave to certain employees and offsets the cost of the leave with a tax credit. Like the sick leave provision, it's a credit equal to 100% of any wages and healthcare expenses that an employer is required to pay under the FFCRA.

An employer is only required to pay eligible employees up to $200 per day under the required paid family leave for up to 10 weeks, and the tax credit is limited to this amount. Employees are eligible for paid family leave under FFCRA if they can't perform services, including telework, because of a need to care for a child whose school or place of care is closed or whose childcare provider is unavailable due to COVID-19. Any wages paid in excess of $200 aren't eligible for the credit. Any healthcare expenses are creditable in addition to the $200 per day. Therefore, the maximum credit is $10,000 per employee ($200 per day *5 days a week *10 total allowable weeks of paid family leave) plus healthcare expenses. Qualified wages aren't subject to employer payroll taxes, but employee payroll tax withholding is still required. The effective date of the credit covers the period of April 1, 2020 through Dec. 31, 2020.

> "The FFCRA includes a provision similar to the paid sick leave credit that requires employers to provide paid family leave to certain employees and offsets the cost of the leave with a tax credit."

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Claim the family medical leave credit

Since 2018, a credit is available for businesses that provide paid family medical leave to employees. The credit ranges from 12.5 to 25% of wages paid to qualified employees while they are on up to 12 weeks of leave. Documentation requirements have led many employers to forego this credit in previous years. However, as these plans are revisited as a result of the FFCRA requirements, businesses should review the applicability of this credit to determine if it provides additional benefits where the FFCRA credits leave off.

Hire employees using the work opportunity tax credit

The work opportunity tax credit (WOTC) provides employers with incentives to hire workers in specifically designated categories that have significant barriers to employment. Recipients are classified in designated categories, such as long-term family assistance recipients, supplemental nutrition assistance program recipients, and long-term unemployed individuals, among many other categories. The credit ranges from $2,400 to $9,600 per employee depending on when the wages are paid and the designated category of the employee.

Unfortunately, the WOTC credit isn't allowed for rehired employees (those employed by the employer at any previous time). Employers who are being forced to lay off or furlough employees due to the current economic conditions need to understand that they can't claim the credit when those employees return. However, employers who hire different employees when conditions permit might be eligible.

In order to qualify, employees must be certified at the time they are hired. This can often be a cumbersome process but taxpayers should ensure that they have processes in place for when they begin to hire employees in the future to maximize this credit. While this credit currently is set to expire after 2020, it has been extended many times in the past.

Employer payroll tax deferral

See Tax refunds and payments.

Utilize the research credit against payroll tax liability

A business with research activity is eligible for the research tax credit. This credit is meant to subsidize an increase in research expenditures when compared to prior years. If research expenditures decrease, this will cause the credit to be reduced or eliminated for the year. Certain startup businesses may elect to apply part or all of their research credits against the company's payroll tax liability. This payroll tax credit election may benefit businesses that have little or no income tax liability.

The research credit is an income tax credit, which only benefits those businesses with taxable income. However, it can be carried back to the preceding year if there isn't enough tax in the current year, and it can be carried forward for 20 years to offset tax in subsequent years when the business is profitable. This carryforward of a research credit can help a business conserve cash in those later years when it's looking to pay down debt incurred during the less profitable years.

"The work opportunity tax credit (WOTC) provides employers with incentives to hire workers in specifically designated categories that have significant barriers to employment."

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Consider claiming the alternative fuel credit for propane forklifts

The alternative fuel credit allows a refundable income tax credit of 50 cents per gallon of alternative fuel either sold for use in a motor vehicle or used by a business in a motor vehicle. While this would appear relatively narrow in its application, thinking creatively can lead to savings. For example, propane is one form of alternative fuel and a forklift qualifies as a motor vehicle. Therefore, many distribution or manufacturing businesses qualify for this credit on propane used to fuel their forklifts. In order to claim the credit, certain requirements, including a registration requirement, must be met.

Investigate state and local tax incentives

Many state and local jurisdictions provide various income, franchise, or sales or use tax credits, including additional credits for research activities, property tax abatements, and other cash incentives for employment, investment, and research activities. Each jurisdiction has different requirements and thresholds. Some jurisdictions might require a business to apply for these benefits, while others provide it merely by meeting the defined requirements.

Businesses should investigate potential incentives available in each jurisdiction in which they operate or anticipate operating in the future to determine what might be available to them. While many of these incentives are designed around growth and investment, businesses that understand the available opportunities will be much better suited to maximize the benefits of these types of programs at the time they begin to grow and invest. Jurisdictions may also offer incentives to retain businesses. These programs should be reviewed to determine any available benefits for retaining certain jobs or locations within a specific jurisdiction.

“Businesses should investigate potential incentives available in each jurisdiction in which they operate or anticipate operating in the future to determine what might be available to them.”

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Potential tax liabilities in loss years

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MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

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Potential tax liabilities in loss years

Be mindful of limitations on NOL utilization AMT

Taxpayers with current or accumulated losses often still owe some federal, state, or local tax. This occurs because of limitations on the ability to fully utilize an NOL or because of AMT regimes. For example, beginning in 2021, corporate NOLs generated in 2018 or later are only available to offset up to 80% of taxable income. Individuals have a more immediate issue with the AMT as NOLs limited to 90% of taxable income for AMT purposes, leaving them with AMT income even though NOLs are available to fully offset regular tax income. This situation can be especially onerous when income from a significant income generating event, such as the forgiveness of debt, can't be fully offset with NOL carryforwards.

State taxes may still apply in loss years

Even when federal NOLs or current year losses exist on a consolidated or combined basis, state and local taxes must be considered. This may include corporations in a consolidated group, disregarded entities not treated as a separate federal entity, or other related businesses. These taxpayers might have to file separate tax returns in certain states and local jurisdictions. Such standalone entities might have taxable income to create tax liabilities even though losses exist on a consolidated or combined basis. In addition, state rules for calculating and carrying over NOLs may differ from federal tax law. Franchise or net worth taxes also must be considered as these are typically based on assets or equity and may remain positive even when losses are incurred. Individuals need to consider the state impact of an NOL as some states may limit the utilization of an NOL.

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LONG-TERM PLANNING:

OTHER:

Foreign withholding tax requires special consideration

Businesses that receive payments from foreign related parties or third parties can sometimes be subject to foreign jurisdiction withholding taxes. Typically, the payments relate to interest, royalty, dividend, and other service-type transactions. The withholding tax rate varies by jurisdiction, and tax treaties between the United States and the jurisdiction might help reduce the rate or eliminate the application of the tax altogether. The United States and many other countries have requirements to prove residency in order to qualify for benefits. Those requirements can be complex.

If a taxpayer doesn't have U.S. tax paid in the current year, the ability to claim a foreign tax credit could be limited, representing a cash tax cost. See the international section for more detailed discussion of foreign tax credit criteria. If a taxpayer is anticipating losses and has the ability to revisit a foreign payment agreement, they can potentially institute a "gross-up" clause. Under such a provision, the payor provides the payee the expected net amount after application of foreign jurisdiction withholding tax, and the payee receives the same desired economic return on a lending, property use, or service transaction with the foreign party.

Caution: The BEAT tax may apply in a loss year

Even when federal NOLs exist, there is the potential for residual tax liabilities due to the application of the base erosion and anti-abuse tax (BEAT). BEAT applies generally to larger U.S. corporations and corporate groups that may have the ability to reduce their U.S. tax liabilities by making deductible payments to foreign related parties. Typically, the actual application of BEAT applies to taxpayers who have low to no taxable income and incur losses, effectively operating as a new AMT for larger corporations.

BEAT applies to tax years beginning Jan. 1, 2018 for corporations with aggregated gross receipts of $500 million or more. Corporations that have related parties need to be mindful of the expanded "controlled group" definition that applies for BEAT. A taxpayer could itself be under $500 million of gross receipts but have a BEAT tax liability due to its controlled group members having sufficient aggregate gross receipts for BEAT to apply.

"The United States and many other countries have requirements to prove residency in order to qualify for benefits. Those requirements can be complex."

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LONG-TERM PLANNING:

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Tax accounting methods and income deferral

Tax accounting methods and income deferral

Scrutinize tax accounting methods to identify planning opportunities

Taxpayers with losses available for carryback often benefit from timing events that are within their control to increase that loss and maximize the current cash refund. At the same time, taxpayers should plan and document their actions to ensure that any loss reported can be supported under the rules and will not be adjusted under a future IRS exam that would recapture some of the cash refunds. On the other hand, healthy companies typically benefit from timing events that are within their control to reduce taxable income.

Accounting method changes are a powerful way to accomplish any of these goals. In general, tax accounting methods cover the timing of income and deductions. If a taxpayer has been accounting for income or expenses incorrectly, or if a taxpayer wants to change from one permissible accounting treatment to another, the taxpayer can file for a change in accounting method and record a current year catchup to taxable income for all prior amounts that would have been recognized if the new method had always been used. Any favorable adjustment can be recognized all at once, while any unfavorable adjustment can be spread over four years. When a change of method is made, the IRS is generally prohibited from imposing an adjustment to that same item in any prior year, even if it was treated incorrectly in a prior year.

There are many methods of accounting to consider when planning to reduce taxable income, to maximize an NOL, or to protect the amount of NOLs generated in a previous tax year. Some of them are discussed below while others are discussed in Depreciation, Inventory, Bad debts, and elsewhere throughout this guide.

- CASH METHOD OF ACCOUNTING: While certain small taxpayers are permitted to use the cash method of accounting as discussed below, many large taxpayers are also permitted to use it. The cash method is available to larger taxpayers as long as they're not C corporations, don't have losses allocated to owners not active in management, and don't rely on inventory as a material income-producing factor. Therefore, many service businesses can qualify for the cash method regardless of how large they are. The cash method of accounting is typically very advantageous.

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LONG-TERM PLANNING:

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- **DEDUCTIONS FOR DEFERRED COSTS:** Book accounting principles often require a variety of costs to be capitalized and expensed only when the related revenue is recognized. For example, certain costs incurred at the outset of a service contract (e.g., setup costs) might be required to be capitalized and spread over the life of the contract for book accounting purposes. However, tax rules often don't require the same cost deferral. Similarly, commissions or other internal costs incurred in many transactions aren't capitalized for tax purposes even if they might be capitalized for book accounting purposes.
- **CHANGING METHODS OF ACCOUNTING TO GET ACCRUED COMPENSATION DEDUCTIONS:** Accrued compensation deductions can arise from changing to a proper method of accounting if amounts were inappropriately deducted in the past or from changing the underlying arrangements to make them deductible. Compensation accruals are generally deductible if the underlying services have been provided, the liability is fixed, and the amount is paid within 2 ½ months of year-end. There is some flexibility on the 2 ½-month rule (as discussed in the Deferred compensation section), which can create opportunities to deduct additional amounts.

  The determination of whether accrued bonuses and commissions are fixed as liabilities is particularly important. If any other event that could occur after year-end that would result in the amount not getting paid, the liability is often not considered fixed and might not be deductible. For example, if the employee must still be employed at the time of payment to be eligible, it's not fixed until the date of payment.

  Additionally, if the amount is discretionary and the company has the ability to change it at any point until it's paid (regardless of whether it intends to change it), then the liability may not be fixed.
- **DEDUCTION FOR PAYROLL TAXES:** Payroll taxes can generally be deducted in the year that the related compensation liability becomes fixed, even if the compensation and the payroll taxes aren't paid until after year-end. The primary requirement is that the payroll taxes are paid within 8.5 months of year-end. This can apply to year-end compensation accruals, year-end bonuses, vacation pay, or any other items of employee compensation.
- **DEDUCTION FOR PREPAID EXPENSES:** Taxpayers can deduct prepaid expenses in the current year instead of capitalizing the expense over the useful life if the purchased benefit doesn't extend beyond (the earlier of) either 12 months or the end of the taxable year after the taxable year in which the payment is made. This often applies to prepaid insurance policies or prepaid government fees.
- **DEDUCTION FOR PROPERTY TAXES:** Prepaying property taxes that were assessed in the current tax year but aren't due until the subsequent year could be beneficial to taxpayers. This opportunity depends on the specific timing of when property taxes become legal liabilities in each jurisdiction but is ultimately dependent on ensuring that the liability is paid within 8.5 months of year-end. Alternatively, a ratable accrual election can be made to deduct property taxes on a ratable basis over the year they are assessed regardless of when they are paid. A ratable accrual election can be especially beneficial for fiscal year taxpayers where the assessment date for many taxes doesn't fall until after year-end.

"A ratable accrual election can be especially beneficial for fiscal year taxpayers where the assessment date for many taxes doesn't fall until after year-end."

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MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

- **ELECTING TO DEFER ADVANCE PAYMENT REVENUE UNTIL RECEIPT:** Accrual method taxpayers may elect to defer income associated with certain advance payments for one year following the year in which such income was received. In some cases, they may be able to simply match the book accounting for the treatment of advance payments. This provides an opportunity to either adopt this method or to change book accounting policies to obtain more favorable tax results.
- **DEDUCTION FOR SOFTWARE DEVELOPMENT COSTS:** Software development costs can often be expensed immediately even if they are capitalized and amortized on a taxpayer's books.
- **DEDUCTION FOR SELF-INSURED MEDICAL BENEFITS:** A liability for self-insured medical benefits (often referred to as an incurred but not reported liability or IBNR) can be deducted for tax purposes in the year that medical services are provided to employees as long as the plan is administered by a third party. The amount of the liability must be determinable with reasonable accuracy.
- **INCOME FROM STATE TAX REFUNDS:** Most businesses record the benefit of state tax refunds in the year that the losses or credits giving rise to the refund are generated. However, if a refund claim is filed in a state (e.g., amended return, NOL carryback return, etc.), it may be possible to defer the recording of income for that tax refund until the state has formally approved the refund claim. This often will not occur until a year after the event giving rise to the refund claim.
- **PENSION PLAN PAYMENTS:** Pension plan payments can be deducted in the year prior to the year they are made if they are made by the due date of the business tax return, including extensions, and are made on account of that prior year. To the extent that cash is available, it might make sense to accelerate multiple periods worth of payments to maximize NOL carrybacks to periods with higher tax rates.
- **LITIGATION SETTLEMENTS:** Distressed companies may be more likely to become involved in commercial litigation than other companies. These disputes are often either settled before judgment, or in some circumstances, resolved by court judgments or arbitrator decisions. Determining the tax consequences of these resolutions isn't always an easy matter if the amounts paid aren't specifically itemized in the resolution. It's possible for a single settlement to include some portions that are deductible, some that are capitalized and expensed over time, and others that are not deductible at all. The tax treatment of a settlement is based on a factual determination of what specifically was settled, which is not always clear, especially when multiple claims have been raised. For example, certain sexual harassment claims aren't deductible but lost wages due to wrongful termination are. A single settlement that covers both claims may lead to more difficult tax determinations unless the settlement directly addresses the allocation.

> "Distressed companies may be more likely to become involved in commercial litigation than other companies."

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MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Take advantage of cash, inventory, and long-term contract methods

The TCJA created additional opportunities for businesses with less than $26 million in gross receipts on average over the prior three tax years. For businesses that qualify, these tend to be significant tax planning opportunities that can result in meaningful deductions.
These businesses are able to:

1. Utilize the cash method of accounting even if they have inventory.
2. Opt out of inventory capitalization requirements under Section 263A and other rules and instead either follow their book method of inventory accounting or treat all inventory as materials and supplies.
3. Avoid the percentage of completion method for certain construction contracts.

However, otherwise qualifying businesses that are structured as flow-through entities aren't permitted to utilize these methods if they have a loss and more than 35% of that loss is allocable to owners not active in management.

These rules provide significant advantages to taxpayers during times of economic hardship. For example, recognition of income can be deferred until cash is received under the cash method. On the other hand, taxpayers using the accrual method may have to recognize income before receiving payment. Therefore, taxpayers who meet the gross receipts thresholds but are on the accrual method should consider a method change.

Continue to evaluate revenue recognition

The U.S. GAAP and IFRS both recently adopted new revenue recognition standards. This is causing many businesses to rethink the way that they record revenue on their books. For example, revenue that was previously recognized at a point in time (e.g., when inventory was sold) might now be recognized over a period of time (e.g., as production is occurring). The specifics depend on each business's facts and the terms of customer contracts.

Ordinarily, this would have minimal impact for tax reporting because income tax laws have separate rules for determining when revenue should be recognized. However, the TCJA created a mandatory book conformity on revenue for taxpayers with audited financial statements. Therefore, some taxpayers might have to accelerate the recognition of revenue to match their book accounting. To make matters worse, the mandatory book conformity doesn't apply to expenses, even when revenue is accelerated. As a result, it's possible that revenue may be recognized in Year 1 on the tax return to match book recognition but the expenses aren't deductible until Year 2 when they are incurred under tax law. Taxpayers might have some influence on this result through altering contracts or otherwise revisiting their application of the applicable accounting standards to ensure they are minimizing any adverse tax impacts.

Investigate opportunities to obtain government grants

Many government and other programs are being created to provide direct support to businesses through grants. In general, government grants will be considered as taxable income. On the plus side, the underlying

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SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

expenses that result from spending those funds can be deductible. However, a mismatch in timing can occur if either the funds are not fully spent by year-end or if the funds are spent on items that must be capitalized and spread over a period of years. In cases where a grant isn't considered to be taxable income, the underlying expenditures supported by that grant are usually not deductible.

Disaster losses may be deductible in the prior year

Losses incurred in qualified disasters can generally be deducted on the tax return for the year that precedes the loss year. The COVID-19 pandemic has been declared a disaster for the entirety of the United States so all taxpayers are permitted to take advantage of this disaster tax relief. However, any loss must be attributable to the disaster and the types of losses that carry back are generally limited to property losses rather than general expenses or lost revenue. Given the unique nature of this disaster, documenting qualified disaster losses might be more complicated. The election to accelerate the losses should take into account the potential benefits of loss carrybacks.

Special accounting methods for hedging transactions

A hedging transaction is one that the taxpayer enters into in the normal course of trade or business for the purpose of reducing risks such as price changes, fluctuations in foreign currency values, or changes in interest rates. As prices and interest rates continue to fluctuate, hedging transactions will continue to be prevalent.

To be considered a hedge for tax purposes, documentation must be completed on the day the hedging transaction is entered into. In the absence of proper documentation, there is a risk that any loss on a sale of the hedge could be considered capital, while any gains could be treated as ordinary income.

Hedging transactions have their own specific method of accounting for tax purposes. The rules generally require that the hedge and the hedged item be considered as a single item for purposes of determining how income or loss should be recognized. For example, an interest rate swap that converts a variable interest rate to a fixed rate would be combined with the corresponding debt, so that the expense recognized on the debt and the effects of the hedge will equal a fixed rate of interest on the debt. These rules are complex and must be applied separately to the specific facts and circumstances of each hedging transaction in which a taxpayer participates.

Consider post-acquisition accounting method opportunities

Close scrutiny of tax accounting methods is important for all businesses, but it's especially important to businesses immediately after an acquisition. The first year of tax filings after an acquisition is typically the best opportunity for a taxpayer to change to proper methods. Any acquisition creates a substantial amount of work for the parties, so it's common for a review of tax accounting methods to be overlooked. However, it can be an ideal time to examine, understand and, if necessary, modify elections and to help minimize future surprises and maximize cash flow.

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SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Depreciation

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Depreciation

Maximize losses through depreciation planning

Depreciation analysis can be a particularly powerful accounting method planning tool because the associated tax savings tend to be very significant, particularly for capital-intensive businesses. The potential acceleration of tax savings attributable to the correction of an erroneous depreciation process or the election of a more favorable method is magnified when the number of fixed assets grows. For example, a business that discovers that tooling assets currently being depreciated over a seven-year life are actually eligible for a three-year recovery period could claim higher deductions in the current year and potentially amend prior years for a refund. Depreciation reviews often identify assets that were disposed in prior years but never deducted. It's worth taking another look at depreciable assets to make sure depreciation deductions have been maximized. Small changes in depreciation across a broad range of assets can add up to big tax dollars. Depreciation planning is one additional item within the overall category of tax accounting methods. As discussed in the Tax accounting methods section, planning can be used to both maximize losses to carry back to prior years and to protect prior-year depreciation deductions from IRS scrutiny.

Claim depreciation quicker by completing a cost segregation study

Standard rules for real estate assets require that they be depreciated over 27.5 or 39 years. A cost segregation study identifies the individual components of real property that fit into other asset classes and reclassifies them into the appropriate shorter-lived categories so depreciation can be claimed more quickly. In some cases, a study will identify assets eligible for bonus depreciation that allows 100% of an asset's cost to be deducted immediately. Most significant pieces of real property will have some components that will qualify for a shorter depreciable life, but a preliminary cost-benefit analysis should be prepared to determine if the potential benefit is worth the cost of undertaking the study. A business looking to maximize current losses should definitely consider whether a cost segregation study should be part of the strategy.

"The potential acceleration of tax savings attributable to the correction of an erroneous depreciation process or the election of a more favorable method is magnified when the number of fixed assets grows."

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Utilize bonus depreciation to fully expense certain property

Bonus depreciation has existed for almost 20 years in a variety of forms, with expensing amounts ranging from 30% of the cost of eligible property all the way to 100%. The current percentage is among the most favorable in the history of the program, as the TCJA increased the bonus depreciation percentage to 100% through 2023. After 2023, the percentage will phase down over a period of years. Because the rules have changed over time, often on a retroactive basis, it's very common for businesses to not have taken full advantage of all available opportunities. A review of depreciable assets for the proper application of the bonus depreciation rules in effect at the time the property was placed in service often leads to additional deductions.

Claim excess depreciation for qualified improvement property

Qualified improvement property (QIP) has been eligible for bonus depreciation since 2016. The TCJA attempted to adjust the manner in which QIP qualified for the 100% bonus depreciation for 2018 and later tax years. However, the legislation was drafted incorrectly and QIP ended up not being eligible for bonus depreciation at all. That law also required that QIP be depreciated over 39 years rather than the 15 years that was intended.

The CARES Act has retroactively corrected that error, but many 2018 and 2019 tax returns were already filed before that correction was made.

Taxpayers have an opportunity to claim the excess depreciation now for QIP placed in service in 2018 and 2019 by amending affected returns or making accounting method changes. The specific procedure for correction will depend on each taxpayer's facts. The increased expense could result in the added benefit of creating losses in 2018 and/or 2019 that could be carried back to prior years under the CARES Act, allowing taxpayers to obtain refunds in tax years where the top tax rate was higher than it is today.

Scrutinize repairs for deduction opportunities

A repair cost that must be capitalized for book purposes may still be fully deductible in the current year on your tax return. While many businesses addressed this issue in 2014 when relevant rules on the topic were reissued, it is possible that a number of new items have since been capitalized that can be expensed in a current period.

Fixed asset write-offs

See Asset valuation, transfer, and write-off opportunities.

"A review of depreciable assets for the proper application of the bonus depreciation rules in effect at the time the property was placed in service often leads to additional deductions."

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MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Inventory

Write down inventory using the lower of cost or market (LCM) inventory method

The LCM inventory method might allow for write-downs of depressed inventory still on hand. This deduction is available when the replacement cost of purchased inventory or the reproduction cost of produced inventory is less than the basis of the inventory. It's common for the tax and book calculations for LCM adjustments to be different, so a book deduction will not always lead to a similar tax deduction. Taxpayers might be eligible for an automatic accounting method change to the LCM method of accounting, but the LCM method doesn't apply to taxpayers using LIFO.

Write down subnormal inventory

In addition to the potential benefits of taking LCM write-downs, subnormal inventory may also be written down. Subnormal inventory includes inventory that is unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, as long as the inventory is actually offered for sale at a written-down price within 30 days after the end of the tax year. However, excess stock doesn't qualify for the deduction. While the timing for this write-down may have passed for calendar year taxpayers in 2019, it may still be available currently for fiscal year taxpayers and it can also be considered as a year-end planning item for all taxpayers in 2020.

"The LCM inventory method may allow for write-downs of depressed inventory still on hand."

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Assess inventory capitalization

Section 263A requires that a specific method of accounting be used to capitalize costs related to purchasing, storing, and handling purchased inventory, as well as production costs for inventory produced. This often causes the cost of inventory to be higher for tax purposes than it is for book purposes. A review of inventory capitalization methodologies may uncover opportunities to accelerate tax deductions. Rules that went into effect for the 2019 tax year create additional opportunities for tax inventory capitalization that can further exacerbate both favorable and unfavorable adjustments to inventory costs.

Look for trade or cash discounts and other "negative" inventory costs

Under the Section 263A rules in effect for the first time in the 2019 tax year, taxpayers have a greater opportunity to remove from inventory costs that don't have to be capitalized for income tax purposes. Under the old rules, that was more difficult to do. Examples of items that can create opportunities to reduce tax inventory costs, to the extent that the book amount of the cost is included in inventory, include unfavorable book-tax differences on depreciation expense, selling and distribution costs, freight-out costs, research costs under Section 174, Section 179 expense, Section 165 losses, depreciation on temporarily idle equipment, income taxes, strike expenses, and warranty and product liability costs. Trade and cash discounts earned can also reduce the cost of the related inventory acquired even if they are recorded directly into income for book purposes (i.e., recorded on a gross basis).

> "A review of inventory capitalization methodologies may uncover opportunities to accelerate tax deductions."

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Bad debts

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Bad debts

Write off business bad debts

When a trade receivable becomes wholly or partially worthless, a taxpayer generally may write it off to obtain an ordinary deduction. While there is no bright-line test for determining the value of a trade receivable, relevant factors to consider in determining if a decrease in value has occurred include serious financial reverses of the debtor, insolvency, lack of assets, persistent refusals to pay, abandonment of the business, bankruptcy and receivership, status or value of any security, and expiration of the statute of limitations.

The fact that a debtor has filed for bankruptcy is often not enough to justify a partial worthlessness without a specific analysis of how the bankruptcy and financial condition of the debtor will impact the likelihood of collecting some or all of the debt. However, factors may exist that suggest no decrease in value has occurred such as the creditors' failure to press for payment, creditors' willingness to make further advances, availability of collateral or guarantees, or the debtors earning capacity and continued operations.

Still, the creditor doesn't need to be an incorrigible optimist in making a determination of value. To be deductible, a trade receivable must be specifically written-off or reserved on the taxpayer's books versus being included in a general allowance for doubtful accounts. A wholly worthless trade receivable must be written-off in the year it becomes worthless.

"Factors may exist that suggest no decrease in value has occured."

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Consider the timing for bad debt determination

In order to secure a tax deduction, taxpayers are generally not required to make a final determination of whether a debt is uncollectible (or partially uncollectible) until the end of their tax year. While many taxpayers are becoming increasingly concerned about the current collectability of their receivables, they can take some comfort in the fact that by year-end, it's possible that economic conditions will allow for a more complete and simpler analysis on the collectability of receivables versus the middle of the tax year.

Related party receivables are subject to greater scrutiny

The IRS and state authorities generally apply a higher level of scrutiny to bad debt deductions between related parties. This may include advances between related businesses, family members, or between owners and their business. The emphasis and focus on documentation supporting any deduction likely needs to be more robust than for unrelated party bad debt. This is true even in consolidated groups where the federal tax impact might not be significant, but the state and local tax impact is significant if each legal entity is filing separate returns.

Careful analysis should be taken to determine whether a bad debt expense is an ordinary or a capital loss in these scenarios because any income recognized on the cancellation of the debt will always be ordinary. This character mismatch can lead to significant tax liabilities even when ownership is identical. Even if a related party receivable isn't wholly or partially worthless, a careful evaluation of the potential future tax ramifications is important because planning to resolve the obligations before that event occurs may result in significantly more favorable tax consequences. For internationally active taxpayers, consider the local rules in regard to debt restructuring and cancellation of debt income.

Estimated taxes may be impacted by bad debts

A midyear determination of a bad debt deduction may affect the calculation of annualized taxable income for estimated tax purposes. This might make midyear determinations more important if the related bad debt deductions can reduce tax estimates and improve current cash flows. However, the same information must be obtained regardless of the timing of the deduction.

Sales tax and gross receipts tax implications of bad debts

If a taxpayer is using the accrual method of accounting, many states require the taxpayer to remit sales tax even if the taxpayer has not yet collected it from the customer. If the receivable ultimately becomes worthless, the taxpayer may be entitled to a refund of the sales tax previously remitted to a state. For states with gross receipt taxes, taxpayers might be able to deduct bad debts if those gross receipts have been reported in prior periods when the sale occurred.

"... it's possible that economic conditions will allow for a more complete and simpler analysis on the collectability of receivables versus the middle of the tax year.

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MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Cancellation of debt (COD) and debt renegotiations

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Cancellation of debt and debt renegotiations

Opportunities to exclude COD gain from income

A debtor's gain from the cancellation of debt (COD) is taxable. This includes any COD where a creditor accepts an amount less than what was originally owed. This can include both interest and principal. However, COD may be excluded from income in various circumstances including, when a taxpayer is bankrupt or insolvent, among other exclusions. The insolvency exception allows an insolvent taxpayer to exclude COD income from taxable income to the extent of its insolvency.

These exclusions do come at a price because they generally require that the tax attributes of the taxpayer be reduced (i.e., NOLs, general business credits, basis in assets, etc.). However, when reducing the tax basis of assets, that basis cannot be reduced below the amount of the remaining liabilities of the taxpayer.

When historically successful businesses incur debt that doesn't create a tax attribute, it's possible to exclude COD without having to reduce any attributes. For example, debt incurred to fund a distribution or to redeem an owner would typically not create a tax attribute that would be subject to reduction and may be eligible for forgiveness without significant tax consequence. However, a detailed analysis must be performed to determine the proper tax effects. Jurisdictions outside the United States have their own provisions that must be considered. The local jurisdiction provisions can be as complex as the U.S. rules related to COD income.

Forgiveness of payroll protection loans is subject to special rules

The CARES Act sets forth the rules related to Paycheck Protection Program loans for eligible businesses with 500 or fewer employees. The amount of the loan is 2.5 times the average monthly payroll costs and is limited to a maximum of $10 million. Proceeds may be used for only covered expenses including payroll costs (including paid sick, medical, or family leave and costs related to continuation of group healthcare benefits), mortgage interest payments, rent, utilities, and interest on certain other existing debt obligations. Amounts used for certain covered expenses will convert to a grant and only accrued interest will have to be repaid.

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SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

The forgiveness amount is subject to reduction if the average number of employees is reduced or if reductions in employee compensation in excess of 25% occur.

The CARES Act specifically provides that any forgiveness of these loans is not included in taxable income but also doesn't require the taxpayer to reduce its tax attributes as is discussed above for other COD income. Certain related expenses are nondeductible so taxpayers, while initially focused on receiving the money associated with the loan, need to fully understand the entire transaction. Further, an analysis must also be completed at the state and local level to determine if the loan forgiveness will be excluded from income for state and local tax purposes. While taxpayers are initially focused on receiving the money, they should understand the entire transaction.

Watch for complications when applying COD rules to a partnership

In a corporation or S corporation, the insolvency exclusion is determined at the entity level. However, in the case of a partnership (including an LLC taxed as a partnership), insolvency is determined at the partner level. If a partner of a distressed business is solvent, they can't exclude any partnership COD income from their taxable income even though the partnership itself may be insolvent. This can be particularly problematic if some partners are exiting before a cancellation event occurs, leaving the remaining partners with a higher share of the future taxable income.

One action that the partners should consider is whether an amendment to the operating agreement could help to prevent this scenario in some manner. Additionally, the entity should consider converting to a corporation in order to avoid the COD income becoming taxable to its partners. While this conversion is a very complex transaction and may create a current tax liability to the partners, it's possible that any tax created would be less than the tax on the COD income that would otherwise be recognized. Legal issues should also be considered in these transactions.

Significant modifications of debt may trigger COD income

A significant modification of debt is treated as a deemed exchange of the "old" debt for "new" debt. A modification could be significant if it includes a change in yield, change in the timing of payments, change in the principal balance, change in the obligor, or change in the nature of the instrument. COD income may be generated if the deemed issue price of the "new" debt is less than the principal balance of the "old" debt.

This analysis needs to be performed whenever any debt instrument is modified to ensure the proper treatment of any COD income that may result and any original issue discount that may be created. In addition, the potential application of the applicable high-yield obligations (AHYDO) provisions should be considered. In situations where businesses are materially modifying existing financing arrangements, either with financial institutions or other subordinated debt holders, the tax implications of such modifications should be contemplated.

"Certain related expenses are nondeductible so taxpayers, while initially focused on receiving the money associated with the loan, need to fully understand the entire transaction."

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Evaluate property foreclosures for COD income

Both real and tangible personal property may be acquired by incurring debt and the acquired property often serves as collateral for the loan. Distressed companies are often faced with the prospect of losing the property through foreclosure when cash flow difficulties arise. If the lender forecloses on the property, COD income may result. However, this may also be treated as a sale or exchange of the underlying property, with separate tax consequences from the COD income. Even though the COD might be excluded from income, any gain from the deemed exchange of the property would not be so an overall taxable gain can result from the transaction.

Examine debt issuance costs in connection with any loan transactions

When a debt instrument is issued, any costs associated with its issuance are capitalized and deducted over the term of the debt using an effective interest rate method. When a debt is satisfied prior to maturity, any remaining debt issuance costs can be immediately expensed. When a debt is modified, renegotiated, or refinanced prior to maturity, the deductibility of the remaining issuance costs depends on the specifics of the transaction, including whether the same lender or different lenders are involved. Importantly, even where amounts are expensed, proposed regulations generally treat debt issuance costs as interest for purposes of the Section 163(j) limitations.

Evaluate form of loan satisfaction: Capital contribution vs. exchange for stock

When an owner has made loans to a business and is willing to give up their rights to that loan, the specific form of the transaction is critical because similar transactions may lead to very different tax results. For example, a contribution of the debt to the capital of a corporation may sometimes be accomplished without triggering COD income, even if it was clear that some or all of the outstanding amount could never be repaid. Alternatively, an exchange of the debt for stock of a corporation or an interest in a partnership may result in COD income to the extent that the value of the equity received is less than the amount owed on the debt. When a 100% owner is involved, these transactions are similar from an economic perspective but may have varying tax implications. Anytime an owner is considering disposing of a debt from its business, thorough consideration should be given to all available options before the transaction is complete.

Related party COD income

See Related party receivables.

> "Distressed companies are often faced with the prospect of losing the property through foreclosure when cash flow difficulties arise. If the lender forecloses on the property, COD income may result."

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SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Business interest expense limitation

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Business interest expense limitation

Consider the impact of the business interest expense limitation on NOL creation

The TCJA included a new provision that limits the amount of business interest that a taxpayer can deduct in a year to 30% of the taxpayer's adjusted taxable income (ATI), plus its business interest income, plus any floor plan financing interest. ATI is the taxable income of the business, before NOLs and the QBID, plus interest expense, depreciation, amortization, and several other items. This limitation is applied at the entity level, even for partnerships and S corporations.

The overall impact of the limitation is to reduce the interest deduction of highly leveraged businesses unless they are also profitable. As economic pressures mount and debt loads and interest expense increase while profits and ATI decrease, this can exacerbate the overall impact of the limitation. When NOLs could not be carried back, business losses were not as significant as they are now because both the limited interest expense and the business loss would carryforward. However, now that NOLs can be carried back again, an interest expense limitation that reduces a current year NOL can still cause reduced cash flow for a business.

Use the temporary increase to the business interest expense limitation

The CARES Act increased the amount of the interest expense limitation from 30% of ATI to 50% of ATI for tax years beginning in 2019 and 2020. This will reduce the impact of the limitation for many businesses. However, partnerships are only eligible to take advantage of the 50% limitation increase for tax years beginning in 2020. Partnerships still get some benefit with respect to 2019 because any interest expense that was limited in 2019 becomes 50% deductible in 2020 while the remainder continues to be subject to the interest limitation rules. For businesses other than partnerships, amended or superseding 2019 tax returns may be necessary if returns were already filed before this change was enacted.

"The overall impact of the limitation is to reduce the interest deduction of highly leveraged businesses unless they are also profitable."

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Election to use 2019 ATI for 2020

The CARES Act also allows businesses to elect to use their 2019 ATI amount to determine their 2020 business interest limitation. If a business's profits decrease in 2020 as a result of the COVID-19 pandemic, while debt loads and interest expense increase, the business should consider this immensely valuable election.

Elect out of the interest limitation as a real property trade or business

Businesses that perform real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage have the ability to elect out of the interest limitation altogether. However, those businesses that elect out are required to depreciate their property using the longer lives under the Alternative Depreciation System. They are also not permitted to claim bonus depreciation on any real property.

The CARES Act now permits bonus depreciation on QIP retroactive to 2018. Because this change was made retroactively, the IRS is permitting a one-time do-over for businesses to decide again for 2018 whether they would like to make this election or revoke a previous election. Any business that could be eligible for the election should review this opportunity closely because the election/revocation is otherwise irreversible once it is made.

Help minimize the limitation by planning

It can be difficult for many businesses to modify their capital structure to significantly change the amount of interest expense that is being incurred. Although the calculation is very formulaic, there may still be creative techniques available that can work for some businesses. For example, consideration could be given to whether a lender would be willing to take preferred equity with a fixed return rather than a debt instrument. If structured properly, returns on the equity wouldn't be viewed as interest expense even though it might look and feel like interest expense. Preferred equity certainly has different features than debt instruments but this may be palatable to some lenders. Another example is situations where only certain depreciation is added back to taxable income to arrive at ATI. Businesses may have an opportunity to revisit how depreciation is classified within different parts of the business to ensure that the allocation of depreciation eligible for the addback is maximized.

Caution: Future guidance may alter this limitation

As the business interest expense limitation is still relatively new, all of the guidance from the IRS and Treasury isn't yet finalized. Therefore, taxpayers should expect to see continued developments on the provision as enacted by the TCJA and changes made by the CARES Act. It's possible that finalized guidance may differ substantially from previous guidance or from positions claimed on previously filed tax returns. Businesses should continue to reevaluate their business interest expense limitation calculations based on the most recent guidance, including the impact new guidance has on the calculation of interest limitations on prior returns. To the extent that there are changes, amended tax returns should be considered.

"The CARES Act now permits bonus depreciation on QIP retroactive to 2018."

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

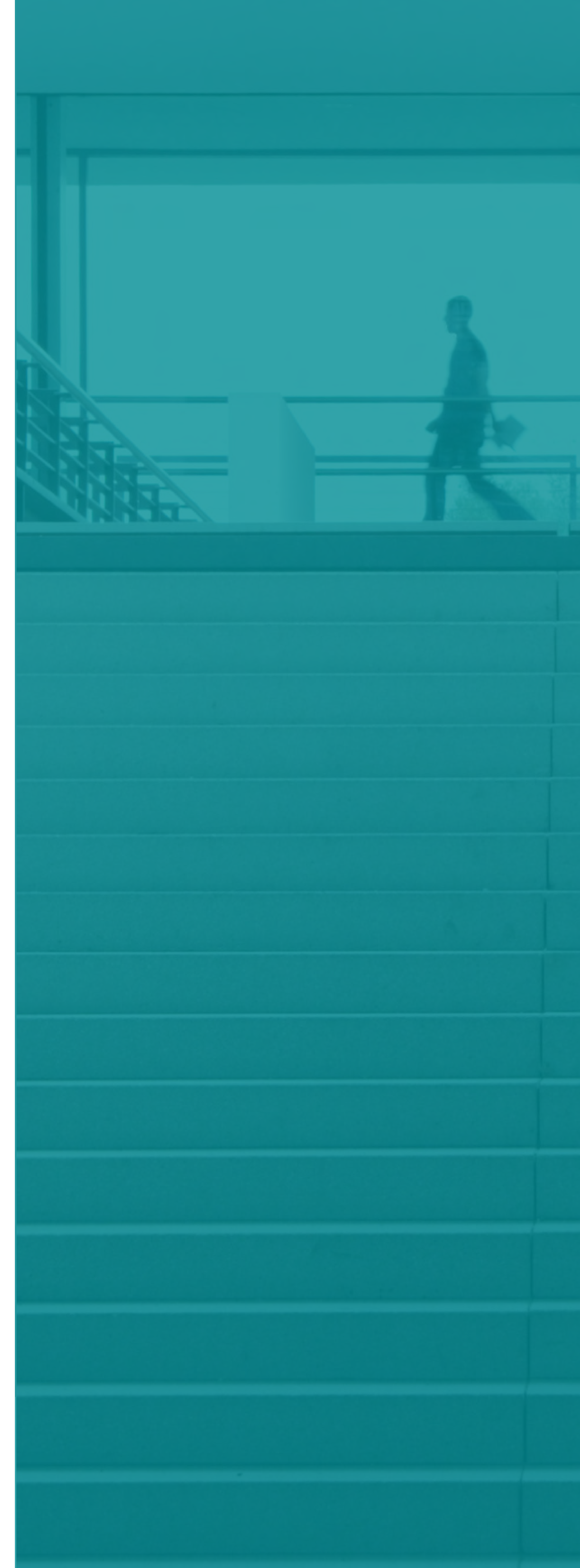
OTHER:

Limitation of interest carryforwards

Business interest expense carryforwards are subject to the Section 382 limitation in the same manner as NOLs. Therefore, when a C or S corporation undergoes an ownership change of more than 50% over a three-year period, the utilization of the carryforward may be limited. This becomes particularly problematic if the interest expense that is limited increases during tougher economic times. Previous versions of interest expense limitations weren't necessarily treated in this manner so this treatment will be new to many corporations even if they have previously undergone ownership changes in the past.

Caution: State and local tax jurisdictions may apply different interest expense rules

Many state and local jurisdictions have decoupled from various elements of the interest expense limitation rules. It's also possible that the favorable changes made by the CARES Act will not be followed by states once each state legislature has an opportunity to act. Therefore, state tax obligations could be much higher than anticipated to the extent that interest expense deductions are more restrictive at the state and local level. Additionally, if a business has losses overall, this impact is often minimized because some states don't permit NOLs to be carried back. Therefore, NOLs and excess interest expense will both carry forward.



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SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Idle and excess capacity facilities

Maximize tax depreciation on idled assets

When facilities are idled or assets are underutilized, financial accounting principles often require the evaluation of whether the carrying amount of a long-lived asset is recoverable compared to its potential to generate future cash flows. If this condition is met, an impairment loss would be measured as the difference between the carrying amount and fair value of the asset. Depreciation will also cease on assets that are idled or no longer otherwise in use. For tax purposes, assets generally cannot be written down until disposed of but may continue to be depreciated even if they're no longer in use. Fixed asset records should be closely monitored to ensure that tax depreciation is maximized.

Identify opportunities for fixed asset write-offs

While assets generally cannot be written-off until disposed of, it's possible to write off certain assets if they are abandoned but not physically disposed. This may occur when an asset is permanently withdrawn from service (usually by physically segregating the abandoned assets from productive assets). These abandoned assets may even be kept on hand to use for spare parts as long as the equipment itself isn't on "standby" in case of productive equipment failures. The tax consequences depend on the form of the transaction, the reason for the transaction, the timing, the asset's estimated useful life, and whether the asset is accounted for in a separate or multiple asset account.

"**When facilities are idled or assets are underutilized,** financial accounting principles often require the evaluation of whether the carrying amount of a long-lived asset is not recoverable compared to its potential to generate future cash flows."

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Consider transferring capital assets among facilities

When facilities are idled or closed, assets are commonly transferred to other facilities. The tax implications of transferring assets between facilities should be considered, particularly if the facilities transferring or receiving capital assets are held by separate legal entities. The form of the transfer may involve a sale, intercompany lease, or a distribution/contribution. It's often the case that intercompany transfers are recorded on the books as a sale at book value, rather than fair market value, using intercompany loans.

From a tax perspective, it's important to actively decide on the appropriate value and characterization of the transfers and to record them consistently with those decisions. This is true even if filing consolidated tax returns, since any deferred intercompany gains might have current or future tax consequences, or if the transfers are between disregarded entities, since certain states don't follow the disregarded federal status and may separately tax the transactions. The form of the transaction could have other state and local sales tax or transfer tax implications. It's always important to substantiate and document asset transfers so the separate legal entities maintain accurate books in case of a bankruptcy or other legal claims against the entities. Further, these transactions should be carefully structured to optimize the specific tax situation.

Reduced use of facilities may impact property taxes and income and franchise taxes

Some states or municipalities have provisions allowing for reduced personal property tax assessments for idled or scrap property. For real property within any state, there potentially could be valuation reductions due to functional or economic obsolescence. Functional obsolescence is the inability of the property to perform the function for which it was originally designed or intended while economic obsolescence occurs when the property owner can no longer earn a fair rate of return on the ownership or operation of the property. A slowing economy may cause a property to be employed at less than normal capacity, leading to economic obsolescence.

State and local property tax laws as well as the current fair market value, use, and utilization of all personal and real property should be evaluated to determine if property tax-saving opportunities exist. States with a property factor in the apportionment fraction may also allow a taxpayer to exclude idled facilities from the factor. Excluding property may allow a taxpayer to reduce the amount of taxable income apportioned to a jurisdiction.

"When facilities are idled or closed, assets are commonly transferred to other facilities."

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Consider whether Section 263A will require capitalization

When a facility is idled, GAAP may require some or all costs allocable to the idled facility to be immediately expensed and not capitalized into the cost of inventory. Tax rules may require the taxpayer to continue capitalizing costs such as insurance, taxes, rent, and other similar costs. However, depreciation and amortization expense related to a temporarily idled facility can be immediately expensed under Section 263A as long as the idling isn't ordinary (i.e., closing a facility on a weekend is ordinary while a two-week shutdown for retooling isn't ordinary). The overall adjustment related to this issue may lead to a significant increase in capitalized Section 263A costs for tax purposes.

Adjust practical capacity inventory

If a facility isn't idled, but is simply operating at less than normal or maximum capacity, financial accounting principles may require fixed and variable facility costs that are associated with the unused capacity to be immediately expensed and not capitalized into the cost of inventory. This method of accounting is specifically barred by tax rules and may result in a significant increase in capitalized Section 263A costs for tax purposes.

"When a facility is idled, GAAP may require some or all costs allocable to the idled facility to be immediately expensed and not capitalized into the cost of inventory."

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MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Asset valuation, transfer, and write-off opportunities

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MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Asset valuation, transfer, and write-off opportunities

Changes in valuation offer planning opportunities

Many planning strategies throughout this guide are dependent on values being reduced. In the current uncertain environment, valuations can be challenging. This is particularly true when a valuation is based on future cash flows or future profitability. Depending on one's view of the world, cash flow and profitability could pick up quickly or be reduced for an extended period of time.

In general, taxpayers should obtain a contemporaneous valuation of an asset from a reputable valuation expert whenever a planning strategy is dependent on value and there is no objective third party source for that value (e.g., public quotes for actively traded stocks). This is particularly true if a more pessimistic worldview is used to support a lower value. A self-created valuation model may be viewed much more skeptically if it is scrutinized by the IRS down the road.

Consider gifting and estate planning opportunities based on new valuations

As many assets decrease in value, gifting and estate planning strategies have become increasingly attractive. Potential strategies include:

- Gifting of assets that are depressed in value but have a high likelihood of future appreciation can be an effective way to transfer future value while minimizing current gift tax effects. Stay cautious of gifting assets that have a built-in loss (the adjusted basis is greater than fair market value), or else that loss may be permanently disallowed.

"In the current uncertain environment, valuations can be challenging. This is particularly true when a valuation is based on future cash flows or future profitability."

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

- Loaning money to businesses or related individuals can be done at very low rates since the target Applicable Federal Rate (AFR) is very low (the short and midterm rates are around 1%). While long-term loans may have slightly higher interest rates than short-term loans, the long-term savings opportunity may still be significant.
- Setting up certain trusts (such as a grantor-retained annuity trust or a charitable lead annuity trust) whose gift tax implications vary with interest rates could also be very beneficial.
- Selling assets to intentionally defective grantor trusts to benefit from depressed asset values, low AFRs, and potential valuation discounts.

Identify worthless securities for potential write-offs

If a corporation owns more than 80% of another corporation, a security of the subsidiary corporation can be written-off by the parent as an ordinary deduction if it becomes worthless. Eligible securities may include stock and certain debt obligations as long as certain other requirements are satisfied. Other consequences may result from this deduction and must be explored. If the security isn't a security of a subsidiary corporation, the write-off will generally result in a capital loss. For individuals, partnerships, or S corporations holding equity investments in other entities, a write-off of a worthless capital asset can still be done, but the resulting loss likely remains a capital loss.

Think creatively about loss harvesting

Any loss property that has a basis in excess of its fair market value may be "harvested" via sale to obtain additional tax deductions. Examples might include real estate whose value has declined, operating equipment no longer used in the business, obsolete inventory that hasn't been deducted for tax purposes, receivables that may be worth less than what you're owed, or intangible assets from previous defunct business acquisitions. In fact, any asset on a balance sheet that has decreased in value should be examined to determine the potential tax benefit. The potential drawback with such actions is this may require physically disposing of or abandoning the assets rather than just checking a box on a tax form. That could mean throwing them out, selling them, or perhaps selling them and leasing them back if they're still required by the business. It may alternatively involve taking overt steps to abandon property even if it's still legally held.

"If a corporation owns more than 80% of another corporation, a security of the subsidiary corporation can be written-off by the parent as an ordinary deduction if it becomes worthless."

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SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Business restructuring

Revisit opportunities for C corporations to elect S corporation status

The conversion of a C corporation to an S corporation can be advantageous now because the potential for built-in gains tax may be minimized. Since S corporations aren't subject to entity-level taxes, any gains inherent in assets at the time that a C corporation makes an S election can be subject to an entity-level tax in the S corporation. However, that tax is limited to the gain inherent at the time of the election. If those built-in gains are minimized because values have decreased, then any potential tax liability from the built-in gains tax is also minimized. To the extent that flow-through taxation has been attractive, now may be the perfect time to revisit S corporation status.

Decreased values might make the conversion of a corporation to a partnership attractive

The goal of most business restructuring transactions is to avoid the imposition of tax on the restructuring. Making sure that it's tax-free is much less important when inherent business values have declined and there may be minimal gains or losses. This brings into play many restructuring opportunities that at once were too costly. For example, a C corporation could convert to an LLC and be taxed as a partnership in a fully taxable conversion. If the tax liability is minimal, the added benefits of operating in a flow-through structure into the future may more than make up for any upfront costs. However, it's possible that any losses inherent in related-party restructuring transactions can be limited or disallowed altogether, so this should be looked at closely.

"The goal of most business restructuring transactions is to avoid the imposition of tax on the restructuring."

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Consider business combination opportunities to utilize tax attributes

In some cases, businesses that have been acquired or started at different points in time may not be structured in the most tax-efficient way. For example, a foreign corporation or any investment fund may own multiple corporate entities each on a standalone basis. This type of structure wouldn't allow for losses of one entity to offset income in another.

Certain restructuring techniques could be available in these scenarios to mitigate this issue. These include the creation of a holding company structure to allow for the filing of consolidated corporate tax or a conversion to flow-through entities that would allow for income and losses to be netted at the owner level. Any solution will become complex, but the future tax benefits and cash flow effects can outweigh the upfront costs.

Unlock flow-through losses through basis creation

An owner can typically only utilize losses from a flow-through entity to the extent it has basis in that entity. However, certain techniques might be available to create basis that will allow excess losses to be used currently.

Some taxpayers use traditional techniques such as making loans or capital contributions to entities to create basis. Some business owners may prefer to actually combine a business with a high basis with a business that lacks basis in order to use current or suspended losses. This strategy can be time-sensitive because losses in excess of certain thresholds can be deducted in 2020 but will be deferred beginning in 2021 due to the excess business loss rule. These business combinations and basis creation transactions should be planned carefully to make sure that they accomplish their intended tax results. The transactions should also be reviewed carefully from an asset protection standpoint.

Consider worldwide tax planning for potential restructurings

Taxpayers should consider their worldwide tax structure to make sure that worldwide tax is minimized. This may include restructuring international operations to maximize the use of losses and foreign tax credits.

While this could be a costly endeavor, the long-term efficiency of the restructured business may allow for increased cash flow on a worldwide basis. Even businesses that restructured in 2018 or later in response to the significant changes to the international tax rules enacted as a part of the TCJA may still benefit from revisiting that previous plan to the extent that profitability in different regions may be substantially different in a post-COVID-19 reality.

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

A tax-free reorganization may be less valuable

While tax-free reorganizations generally become less common when values have decreased significantly, they can still make sense in the right situation. However, note that structuring a tax-free reorganization when a company has very little or no value can be difficult and might not be possible in many cases (at least not in the form that may be desired by the owners). In some cases, if values have decreased significantly, it may be more beneficial to make the reorganization taxable to harvest any losses that may exist for the company or its shareholders.

Consider potential gain recognition when contributing property to an entity

It can be difficult to capitalize a new entity with an existing business or property on a tax-deferred basis if the tax basis of the property contributed doesn't exceed associated liabilities. This is especially true when capitalizing a corporate entity as opposed to a partnership. Generally, contributing shareholders must recognize gain on contributions to corporations to the extent of the insolvency of the contributed business.

Caution: State and local tax considerations add complexity

Any business restructuring decision must also include consideration for the state and local income, franchise, gross receipts, sales and use, and property taxes. The state and local tax profile of a restructured business can change considerably. For example, merging one corporation that has sales tax nexus in only one state with another corporation that has sales tax nexus in multiple states would subject the first corporation's revenue to sales tax compliance in all the states in which the second corporation has sales tax nexus. The income or franchise tax apportionment formulas of a combined business may also significantly shift the tax burden of the combined business compared to the previous tax burdens of the standalone businesses. On the other hand, the ability to utilize business losses across entities could provide a benefit that outweighs other considerations.

> "The state and local tax profile of a restructured business can change considerably."

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Business acquisition and sales

Offset losses with income in acquisition structuring

When evaluating how and where to structure an acquisition, consider the effects on federal and state returns, including methods to offset losses with income, changes to unitary filings, apportionment dilution, and other issues. The specific form of the transaction (i.e., use of a new consolidated corporate subsidiary, a new brother-sister corporation, a disregarded entity, etc.) can drastically change the tax results of the overall deal. It's best to plan and project these scenarios early in the due diligence process to allow ample time to gather information and perform necessary calculations.

Acquisition of troubled businesses

When a troubled business is being acquired, more significant tax and legal considerations exist. Modeling future tax consequences of the acquisition under various turnaround scenarios illustrates the range of possible tax outcomes factoring into the economics of the transaction. If certain pieces of the acquired business are less strategic or problematic, acquiring those assets in a separate legal entity might allow for that entity to be dealt with on its own without interfering with the operations of the rest of the business (e.g., bankruptcy). However, it still may be desirable to keep that business in a structure that will allow any losses incurred to offset income from the more successful pieces of the business. These competing factors can be resolved with proper planning and structuring before the acquisition occurs.

"It's best to plan and project these scenarios early in the due diligence process to allow ample time to gather information and perform necessary calculations."

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

Consider the impact of Section 382 on post-acquisition loss utilization

Section 382 might limit a corporation's ability to use NOLs, business interest expense, and other tax attribute carryovers (e.g., capital losses, credits, tax basis in fixed assets and other assets, etc.) to offset income following a change in ownership. An ownership change occurs when greater than 50% of the value of a corporation's stock changes ownership within a three-year period. The annual limitation on the utilization of these tax attributes is based on a percentage (the tax-exempt interest rate published monthly by the IRS) of the value of the loss corporation at the time of the ownership change. That interest rate is lower than it has been historically, which severely limits a corporation's ability to utilize its losses.

Section 382, built-in gains and losses

Section 382 might also limit deductions for built-in losses and certain accruals or deferred deductions. However, the recognition of built-in gains in assets may enable the taxpayer to increase the amount of the annual limitation applied to its tax attributes. A built-in loss limitation can be very costly for a business undergoing an ownership change but the recognition of a built-in gain can be very beneficial. The calculations necessary to support either scenario can be very complex and require significant analysis. Proper care should be given to these limitations prior to consummating any change in the ownership of a corporation.

Section 382, built-in gains and losses, proposed regulations

The IRS recently proposed rules that would increase the amount of built-in losses and reduce the amount of built-in gains for most corporations. If that rule becomes effective prior to a change in ownership, the utilization of any unclaimed losses will likely become even more restrictive than today — particularly for businesses that tend to carry significant loss or credit carryforwards while still maintaining a lot of value in their assets (e.g., technology companies, biotech/pharmaceuticals, manufacturers with significant bonus depreciation, etc.). See our article for further details.

Prevention of NOL carrybacks into a prior consolidated group

With NOLs now being eligible for carryback again, the acquisition of a corporate subsidiary from another consolidated group creates additional considerations. If the target corporation is allocated a portion of the consolidated loss of the acquiring group in a post-acquisition period, the target corporation must carry that loss back to its prior tax years. If the target corporation's prior tax years are included in its previous consolidated group, the seller must file a refund claim for that portion of the NOL and the cash refund would be paid to the seller.

"The IRS recently proposed rules that would increase the amount of built-in losses and reduce the amount of built-in gains for most corporations."

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

This might not be a problem if the seller had agreed to this process in the sale documents and agreed to provide that cash refund back to the buyer. If that wasn't negotiated (which it may not have been since NOL carrybacks were repealed in 2018 and only came back when the CARES Act was enacted in March 2020) or was simply undesirable, an election is available to prevent the NOL from being carried back to a previous consolidated group. That election must be made in the year of the acquisition, which might not be the same year as the loss is incurred.

Consider potential impact of unified loss rules

When the stock of a corporation is acquired, that corporation's tax attributes, such as its basis in its assets, are generally retained and carry over to post-acquisition periods. However, when the stock of a subsidiary is acquired from a consolidated group and the selling consolidated group recognizes a loss on the sale, it may be necessary to reduce the inside basis of tax attributes of the acquired subsidiary. Alternatively, the seller may make an election to reduce its loss on the sale and allow the subsidiary to retain its attributes. This rule must be considered before an acquisition is agreed to because the effects may only be determinable by the seller, and the election to retain tax attributes can only be made by the seller. The purchaser might need to try to protect itself in acquisition agreements or at least understand the consequences of the transaction by requesting appropriate information upfront.

Loss carryover waivers

In a consolidated group, adjustments must be made to the basis of the parent's investment in subsidiaries using a similar methodology as an individual's basis in S corporation stock. With regard to NOLs and capital losses, an adjustment to basis occurs only when the loss is utilized, not necessarily when the loss is incurred. However, if an NOL or capital loss expires unused, basis must be reduced at that point (note that while the TCJA created an unlimited carryforward for new NOLs, NOLs incurred in 2017 or earlier years are still subject to a 20-year carryforward). However, if a corporation is acquired into a consolidated group, an election exists that can treat all or a portion of the loss carryover as expiring immediately before the subsidiary joins the group. This election may prevent negative-basis adjustments for the expiration of losses that aren't expected to be used (e.g., if Section 382 limited the utilization of those carryovers to the point where they mathematically couldn't be used before they expire), which will lead to significantly decreased gains or increased losses if the subsidiary is ever sold.

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

State and local tax

SHORT-TERM PLANNING:

MEDIUM-TERM PLANNING:

LONG-TERM PLANNING:

OTHER:

State and local tax

Consider the many differences from federal rules

As state budgets become tighter, many states are decoupling from federal rules in a number of areas. Commonly, decoupled provisions include items such as bonus depreciation, Section 179 expensing, the business interest expense limitation, net operating losses, international tax provisions, and potentially other recent tax law changes. There are also many states that simply have different rules from the federal rules in a number of common areas such as COD income and exclusions, loss limitations after acquisitions (i.e., Section 382), treatment of business acquisitions, and tax-free reorganizations.

These areas can be very complex and significant tax dollars can be at stake. Accordingly, proper planning and research needs to be performed at the state and local level whenever a significant federal issue is encountered. This is particularly true for any recent tax law changes because some states might not yet conform to the Internal Revenue Code as of the date that includes those changes so a state may decouple just because they haven't yet acted. However, states routinely adjust conformity dates so the rules can change over time as states begin to act.

Evaluate opportunities to appeal real and personal property tax assessments based on valuation changes

Property values have soared over recent years. It's expected that values will decrease in parts of the country, and it's likely that some real and personal property tax assessments will not be reflective of current values. If a taxpayer thinks this may be the case, it should consider appealing the assessment by following whatever valuation dispute process exists for their local jurisdiction. Many of these appeal processes have very strict filing deadlines that often occur early in a calendar year. It may be appropriate to plan ahead now for any future potential property tax assessment appeals.

"As state budgets become tighter, many states are decoupling from federal rules in a number of areas."

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Be mindful of potential sales and use tax exposure

Sales and use taxes are typically one of the largest sources of revenue for states. The rules are very complex and fact-specific to each transaction type and state. Taxpayers should review purchases to determine if they have under- or overpaid their sales or use tax liability. Refund claims typically allow for repayment of several years of overpaid taxes and can be filed either with a vendor or directly with the state. States have also become more aggressive in their review of underpaid sales and use taxes so any exposures should be reviewed to ensure mitigating steps are taken before asserted liabilities get too significant.

"Sales and use taxes are typically one of the largest sources of revenue for states."

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International tax

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International tax

Profitable internationally but not in the United States

Worldwide planning is very important when a U.S. parent company has little or no income due to the limitations placed on the utilization of foreign taxes and the foreign tax credit (FTC). In general, to avoid double taxation, a U.S. parent must have foreign source income (FSI) and be profitable itself in the same year that it has foreign taxes in order to maximize its utilization of FTCs. If there is net FSI available in a given year and it's not fully utilized, that tax attribute might not always carry forward. FSI can come from deemed dividends from controlled foreign corporations (CFC), earnings of disregarded foreign entities, foreign partnerships or branch operations, foreign lending, foreign royalty usage, or from foreign-manufactured export sales if they meet certain requirements.

However, the TCJA added many additional considerations for U.S. owners of entities in foreign jurisdictions and their ability to claim a credit for foreign taxes. Under the new global intangible low-taxed income (GILTI) regime, U.S. owners of CFC's now will typically have an annual deemed dividend inclusion for CFC income that exceeds a 10% return on the CFC's fixed-asset base. GILTI income creates FSI attributable to its own FTC limitation basket. Income from foreign disregarded entities, foreign branches, and foreign partnerships are attributable their own FTC limitation basket. Foreign taxes attributable to the GILTI limitation basket don't carry over, therefore mismatches in income between U.S. and foreign jurisdictions can create double taxation if an FTC can't be claimed in a given year. Foreign taxes attributable to branch activity does carry over and there is ability to carry back excess taxes to prior years and claim additional FTC. This forces a need for precise matching of the timing of income recognition in certain categories, when foreign taxes are creditable, and ensuring that the domestic tax position will permit the maximum utilization of the FTCs. Proper short-term and long-term planning and optimization of both U.S. and foreign taxable income can help to maximize FTCs and mitigate the effects of double taxation.

"The Tax Cuts and Jobs Act added many additional considerations for U.S. owners of entities in foreign jurisdictions and their ability to claim a credit for foreign taxes."

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Profitable in the United States but not internationally

Being profitable in the United States but not in foreign countries can be problematic because tax may be paid in the United States even though the company isn't profitable on a worldwide basis. Proper planning can help to avoid this scenario. For example, when a foreign subsidiary is unprofitable, it might make sense to change the foreign subsidiary's U.S. tax status from a CFC into a disregarded entity or partnership so that its losses can flow through to the U.S. return. The tax consequences to all parties of this transaction should be carefully reviewed. Long-term considerations should be factored in when changing the U.S. tax status of an entity, as subsequent changes may be limited or not permitted at all.

Foreign tax redeterminations

Many foreign tax systems have NOL carryback provisions that provide refund opportunities for taxes paid in previous years. Taxpayers taking advantage of these provisions in other jurisdictions that claimed a U.S. FTC for the taxes paid in those earlier years must amend their U.S. returns to reflect the reduction in foreign taxes incurred in those earlier periods. Any change to foreign taxes can implicate these rules including amended tax returns, tax assessments under foreign exams, or other similar adjustments. This requirement could reduce the FTC claimed in a previous year and create additional tax in the United States as well as an additional compliance cost for the amended return. This will become more pronounced as jurisdictions around the world look for opportunities to provide cash flow to businesses through their tax systems in response to the COVID-19 pandemic in the same manner as the U.S. government.

Consider transfer pricing

Transfer pricing can be more important in a depressed economy for several reasons. First, transfer pricing may help mitigate some of the issues identified above by reducing income in profitable jurisdictions and decreasing the losses in loss jurisdictions. This balancing of income can help to reduce worldwide effective taxes. Secondly, many transfer pricing methodologies are based on comparable transactions or on some type of assumed profit or cost-plus arrangement. However, when the economy suffers and prices begin to fluctuate from their historical norms, intercompany prices must be updated as well. This could present opportunities to improve tax efficiency as compensations might be eligible for reduction in order to reflect the state of the worldwide economy and thus, allow for further tax savings.

Intercompany obligations

Many taxpayers with a complex corporate structure utilize an equally intricate system of intercompany funding. Many times, this funding is done through cash transfers and journal entries without proper legal documentation supporting the movement of money between legal entities and proper interest compensation. It's important to formalize all intercompany obligations using legal documents and properly reflect the transactions in all financial records with an appropriate stated interest rate.

"Being profitable in the U.S. but not in foreign countries can be problematic because tax may be paid in the U.S. even though the company is not profitable on a worldwide basis."

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Since this funding is being done across international borders, the formalization of these obligations becomes even more important. Tax authorities might challenge the treatment of the transaction, or courts might disregard undocumented intercompany obligations if the foreign operation goes into bankruptcy. Unwinding an intercompany obligation can lead to severely adverse tax consequences such as taxable income for the borrower combined with a nondeductible loss for the lender. Knowing that before the borrower becomes distressed can provide an opportunity to change the arrangement in a more tax advantageous manner.

Section 956 and intercompany lending

Cash planning and optimization is a key business metric for a successful business. Additionally, lenders have often looked to investments in foreign subsidiaries as security for loans to the U.S. shareholder of CFCs. In the past, U.S. owners of CFCs have avoided loans from CFCs to the U.S. parent that used CFC stock and foreign assets as security because they often resulted in a deemed dividend up to the amount of the loan.

The TJCA has changed this so Section 956 no longer applies as long as the loan is from the CFC to a U.S. corporate parent and follows arm's-length principles. Banks typically are aware of these changes and may request modification of security terms of a loan. If the U.S. parent is an individual or pass-through entity that is ultimately owned by individuals, then Section 956 may still apply and could lead to significant adverse tax consequences.

International business restructuring

Many businesses undertook restructuring activities in regard to their foreign operations as a result of the TCJA. As part of reviewing current foreign operation restructuring options, a U.S. business may want to convert a foreign disregarded entity into a corporation or otherwise move assets from U.S. ownership to foreign ownership. However, recent changes no longer permit these transfers to happen on a tax-free basis and these transactions will now typically carry a U.S. tax cost. The cost can range from an immediate gain on the transfer of assets to a deemed royalty charge that occurs annually from the foreign entity to the U.S. operation. As with any restructuring activity that is undertaken, modeling of all potential tax costs should be done to support decision-making.

"When the economy suffers and prices begin to fluctuate from their historical norms, intercompany prices must be updated as well. This could present opportunities to improve tax efficiency..."

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Bankruptcy

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Bankruptcy

Tax filing requirements may not be altered by bankruptcy

When a corporation or partnership files for bankruptcy, a separate taxable estate isn't created, and tax return filing requirements for the taxpayer remain unchanged. Depending on the taxpayer's entity type, the debtor-in-possession or court-appointed trustee must file and sign the entity's income tax returns. This can cause a change in viewpoints on tax positions or an overall change in tax strategy.

Consider the impact of proceedings on tax determinations

In general, the determination of tax for a corporation or a partnership functions in much the same manner for a taxpayer in bankruptcy as it does for other taxpayers. However, the IRS often prioritizes examinations of taxpayers in bankruptcy since it may be much harder to recover assets for unknown tax obligations after a bankruptcy proceeding closes. However, a taxpayer in bankruptcy may also contest its tax obligations in the bankruptcy court, in addition to all other standard remedies.

Unpaid expenses may or may not be deductible

Many deductions aren't dependent upon when a liability is paid, including interest expense. For these deductions, the fact that the taxpayer may be rather certain that it will never have assets to satisfy accrued liabilities will have no bearing on whether amounts will be deductible. However, any future cancellation of those liabilities may result in income as discussed below. To the extent that the deduction of an expense is dependent on when it is paid, these deferred deductions can begin to accumulate once a taxpayer goes into bankruptcy if the payment of these particular items is not prioritized.

"When a corporation or partnership files for bankruptcy, a separate taxable estate isn't created, and tax return filing requirements for the taxpayer remain unchanged."

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Consider the special Section 382 rules with other rules triggered during bankruptcy

As discussed in the Business acquisition and sales section, Section 382 can severely limit the utilization of a corporation's tax attributes after it undergoes an ownership change. However, special rules apply to bankrupt corporations whereby Section 382 may not apply if new equity of the corporation is obtained by creditors and existing shareholders. In this case, many of the tax attributes that are not limited by Section 382 may still get reduced under the COD provisions but any remaining attributes will not be subject to further limitation.

Debt cancellation in bankruptcy may not generate COD income

In general, the treatment of COD in bankruptcy is very similar to COD of insolvent taxpayers as discussed in the Cancellation of debt (COD) and debt renegotiation section. One key distinction is that the amount of insolvency of a bankrupt taxpayer isn't relevant to the COD exclusion determination. Similar to the insolvency exception, the bankruptcy exception for COD income of partnerships is applied at the partner level so it's common that COD income of a bankrupt partnership is fully taxable to the partners that are not likely in bankruptcy.

Earnings and profits should be evaluated for bankruptcy-related impacts

The earnings and profits (E&P) of a corporation doesn't include COD income to the extent of the amount applied to reduce the basis of the corporation's property. Otherwise, COD income, including amounts excluded from gross income, increases the E&P of the corporation (or reduces a deficit in E&P). If there is a deficit in E&P and the interest of any shareholder of the corporation is terminated or extinguished in bankruptcy, the deficit must be reduced by an amount equal to the paid-in capital allocable to the shareholder's terminated or extinguished interest.

"Section 382 can severely limit the utilization of a corporation's tax attributes after it undergoes an ownership change."

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Liability for taxes, tax collection, and penalties

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Liability for taxes, tax collection, and penalties

Personal liability for certain taxes might exist

Persons responsible for paying federal payroll taxes (e.g., officers, controllers, clerks, etc.) can be held personally liable for taxes if they are not paid by employer. Many states also hold officers or other persons personally liable for certain unpaid taxes. This may be true even when the business itself is bankrupt or terminated. Taxpayers and their officers must be careful to understand these rules and make proper decisions on what parties to pay first if cash begins to run short.

Take a fresh look at tax-sharing agreements

When businesses file tax returns on a consolidated, combined, or unitary basis, federal or state law will often determine which entity is responsible for paying taxes or collecting refunds on behalf of the group. However, group members often have to decide how they will economically share the tax burden. This commonly applies to federal consolidated corporate tax returns but can also apply to many state and local returns.

The tax burden is typically distributed using tax-sharing agreements between the businesses included in the tax return. Without a proper tax-sharing agreement, significant issues can arise. For example, when one business is sold or otherwise enters into financial distress and a third party (e.g., buyer, tax authority, etc.) is trying to determine whether that entity paid too much or too little to the other businesses to settle taxes, the absence of a tax-sharing agreement can result in significant legal exposures.

“The tax burden is typically distributed using tax-sharing agreements between the businesses included in the tax return. Without a proper tax-sharing agreement, significant issues can arise.”

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Monitor the temporary postponement of collections deadlines

The IRS suspended a range of collection activities in response to the COVID-19 pandemic. IRS personnel were generally advised to not meet with taxpayers or their representatives, issue final notices or warn of enforcement action, request new federal tax liens, issue levies, schedule or take seizure action, issue summonses to the taxpayer or third parties, send letters proposing the investigation and assessment of payroll tax withholdings to responsible persons, or pursue civil suit proceedings.

The initial suspension covered the period through July 15, 2020. The IRS also suspended payments under installment agreements due between April 1, 2020 to July 15, 2020. The IRS has also provided itself with a 30-day extension to make certain tax assessments or take similar actions. As the COVID-19 pandemic progresses, taxpayers that have liabilities for which the IRS is pursuing collections should pay close attention to any changes in these policies.

Abatement opportunities might mitigate potential tax penalties

A taxpayer that fails to meet tax obligations might be penalized despite making reasonable efforts to comply with the law. This may include penalties such as failure to file, failure to pay, underpayment, late payment, etc. In some cases, these penalties are either flat amounts or vary with the number of forms not filed. In other cases, these penalties are dependent on the amount of tax owed.

The IRS and many states may forgive most of these penalties if the taxpayer demonstrates reasonable cause for failing to meet their obligations. Reasonable cause can vary for each penalty but generally includes a natural disaster, death, serious illness, incapacitation, or the unavoidable absence of the taxpayer or a member of the taxpayer's immediate family, among other reasons. A lack of funds doesn't provide reasonable cause; it's the taxpayer's responsibility to establish reasonable cause and maintain appropriate supporting documentation.

The IRS does have a first-time penalty abatement policy whereby taxpayers in good standing with the IRS that haven't had penalties abated in the previous three years may have certain penalties abated even if there is no reasonable cause. Taxpayers may still have to request this abatement as it is not necessarily applied automatically.

Installment agreements could be available when unable to pay tax liabilities

A taxpayer that can't pay the full amount of tax due in a timely manner may be allowed to pay the taxes in installments pursuant to an installment agreement. The taxpayer must request an installment agreement from the IRS and pay a fee. In determining whether to enter into an installment agreement, the IRS will consider the taxpayer's ability to pay taxes on an installment basis and evaluate the taxpayer's income and expenses. Before the IRS will enter into an installment agreement, they will require the taxpayer to pay as much of the tax liability as possible and to borrow the remainder to the extent possible. There are several types of installment agreements and the appropriate agreement will depend, in part, on the amount of taxpayer's unpaid tax liability.

"A taxpayer that cannot pay the full amount of tax due in a timely manner may be allowed to pay the taxes in installments pursuant to an installment agreement."

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Offers in compromise are an opportunity to settle tax liabilities

An offer in compromise (OIC) is an agreement between the taxpayer and the IRS to settle a tax debt for less than the full amount owed. The taxpayer must apply for an OIC and make an appropriate offer based on what the IRS considers the taxpayer's true ability to pay. To be considered for an OIC, the taxpayer must have filed all legally required tax returns, included a payment for at least one tax debt with their offer, made all required estimated tax payments for the current year, and, if the taxpayer is a business owner with employees, made all required federal tax deposits for the current quarter. The taxpayer must also submit a payment with the application. The payment may be either an initial payment of 20% of the total offer amount or an initial payment followed by additional payments made in monthly installments while the IRS considers the application. The IRS isn't required to accept an OIC request. Some states also offer OIC agreements.

State tax amnesty and voluntary disclosures should also be considered

Businesses may also want to consider if a voluntary disclosure agreement or tax amnesty is available to catch up on underpaid or underreported state and local taxes. A voluntary disclosure agreement (VDA) is an agreement between a taxpayer and a state that allows the taxpayer to remit unpaid tax liabilities for a certain number of years or periods, but the rules can vary dramatically in each state. Typically, taxpayers will pay interest but penalties will be waived in a VDA. The outcome usually depends on the tax type and taxpayer's facts and circumstances.

A tax amnesty typically requires a taxpayer to become current on all prior tax obligations. A tax amnesty can also vary widely in each state in the number of periods or years required and if penalty or interest is required to be paid. Tax amnesties are usually offered for a limited time period. If tax amnesty is offered in a state, taxpayers should determine if a VDA or amnesty is better for their specific facts and circumstances. While a business with cash flow concerns may not be in the best position to pursue this, states may be more generous in these periods due to their own budget constraints and need for additional cash flow.

> "If tax amnesty is offered in a state, taxpayers should determine if a VDA or amnesty is better for their specific facts and circumstances."

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Compensation planning

Disaster relief payments are an opportunity to make tax-free payments to employees

Businesses may make tax-free payments to their employees in order to cover disaster-related costs incurred by the employee. While an employer should generally maintain a written policy for these payments, the employer doesn't need to verify the underlying expenses incurred by the employee or otherwise validate the employees use of the funds. This can create significant flexibility for employers to support employees impacted by a disaster. Given that the COVID-19 pandemic has been declared a disaster across the entire United States, all employees would be eligible to receive these types of payments.

Deferred compensation rules should be considered when payments are made after year-end

Deferred compensation can be very favorable for employees because it's not taxed until it is received, subject to some severe restrictions and requirements, but employers are generally not permitted to deduct the amounts until the year that the compensation is paid.

In general, compensation doesn't formally become deferred compensation unless it's paid more than 2 ½ months after the end of the employer's tax year. However, the 2 ½-month threshold is merely a rebuttable presumption. Thus, if an employer can't make a payment within the 2 ½-month window — for a variety of reasons — a later payment may allow the employer to choose not to classify the amount as deferred compensation and deduct it in the year that the related services were provided. The reasons that an employer is permitted to rely on are those which demonstrate that it was impracticable, either administratively or economically, to avoid the deferral of the receipt by an employee and that the impracticability was unforeseeable as of the end of the year. The COVID-19 pandemic severely restricting the cash flow of many calendar year businesses right around the 2 ½-month point may allow many businesses to rebut the 2 ½-month presumption.

"Businesses may make tax-free payments to their employees in order to cover disaster-related costs incurred by the employee."

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Changes in business valuation often require evaluation of existing equity compensation plans

Many businesses have equity compensation arrangements including stock options, stock warrants, phantom stock plans, partnership profits interests, and other similar arrangements. As business values decrease, recently issued equity compensation arrangements might be underwater and no longer serving their intended purpose of incentivizing employees to help grow the business.

To the extent that a business's value has recently declined or the growth curve of the company has otherwise been adversely impacted, it may be worthwhile to review outstanding plans to determine if they still serve the intended purpose or if adjustments can be made to the plans to "reset" them to current valuations. In some cases, this may be as simple as canceling old equity grants and issuing new ones at a current fair market value. Ultimately, each equity compensation program is created differently and this type of strategy can't work in every case. In any case, ensuring that compensation arrangements are appropriately incentivizing employees in the intended manner is critical for many businesses. As such, tax consequences must be reviewed and the transaction must be structured carefully.

Caution: Government incentive programs may impose executive compensation limitations

It's becoming increasingly common for various government programs or loans to put restrictions on the amount of executive compensation that a business is able to pay. This is true for certain financial support programs created by the CARES Act. The TJCA also put in place further restrictions on the deductibility of executive compensation for public companies and for companies with public debt. As the economy slows, it also becomes more common for lenders to put financial covenants in place to limit the amount of compensation to certain employees.

Businesses that might end up having any of these restrictions in place might want to revisit their executive compensation strategies now to ensure that they are well positioned to work within any potential future restrictions while still appropriately incentivizing their employees.

"It's becoming increasingly common for various government programs or loans to put restrictions on the amount of executive compensation that a business is able to pay."

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Evaluate the impact of unwinding employee loans

Some employers routinely provide financial support to employees in the form of loans. This can be especially common when connected with equity awards or other business transactions where an employee may need cash to fund a particular arrangement and the employer is willing to provide those funds as a loan. However, as economic times become uncertain and the business reevaluates its workforce, unwinding outstanding loans can be especially tricky. To the extent that any amount of a loan is forgiven, whether principal or interest, that amount will likely become compensation income to the employee and the employer is required to withhold appropriate payroll taxes. Even in these cases, determining how those payroll taxes will be funded becomes important because any amount funded by the employer may also be considered additional taxable compensation.

Now could be the time for employee benefits restructuring

Any employer can face challenges restructuring an employee benefit program. In many cases, even the most trusting employees may view changes to their benefit arrangements skeptically because they often don't understand all of the details behind each benefit that might be changing. However, any negative perceptions around a restructuring may be suppressed in the current environment, particularly if other compensation changes are occurring already or there is potential for it.

While these changes do not necessarily need to be tied to cost-savings initiatives, combining those efforts can create further benefits to the business.

Employers may consider utilizing new rules to provide student loan support for employees

The CARES Act permits employers to provide tax-free payments to employees, or an employee's lenders, to cover student loan principal or interest payments through the end of 2020. These amounts are limited to $5,250 for the year and must be combined with any other tuition support being provided. While many federal student loan payments are deferred, students may also have private loans. Employers may consider this expense as a way to retain key employees.

"To the extent that any amount of a loan is forgiven, whether principal or interest, that amount will likely become compensation income to the employee and the employer is required to withhold appropriate payroll taxes."

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LONG-TERM PLANNING:

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Financial accounting for income taxes

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Financial accounting for income taxes

Work to identify income tax accounting adjustments early in the year

Many transactions have income tax consequences that may have to be reflected in a company's financial statements. Difficult economic times often give rise to unusual transactions like debt workouts, asset impairments, and bargain purchase gains. It's common for the income tax effect of transactions to be recorded in private company financial statements later in the year or after year-end. However, the income tax treatment and related financial accounting impact should be addressed as early as possible to ensure predictability of tax liabilities and to avoid significant swings in tax obligations that could cause loan covenants or other requirements to be violated.

Consider any deferred tax valuation allowances

When losses are incurred or expected, valuation allowances must be considered for all deferred tax assets. An economic downturn may cause attributes to expire that you previously thought you might utilize (e.g., credit carryforwards). In addition, the reversal of temporary differences may need to be scheduled as a result of the 80% limitation on certain existing or future NOLs. Even where excess deferred tax assets exist, a net deferred tax liability may result. Temporary tax relief legislation may have the effect of reducing or eliminating the need for a valuation allowance on certain attributes (NOLs now available for carryback). State deferred tax assets should be separately assessed as state carryover rules often differ from the federal rules and projected future apportionment will impact the need for valuation allowances.

"Many transactions have income tax consequences that may have to be reflected in a company's financial statements."

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Monitor the timing of tax legislation for financial statement impact

In general, U.S. and state tax legislation can only be reflected in the financial statement that includes the date the law was enacted. For example, the CARES Act was enacted in March 2020 but had retroactive effect as far back as 2018. However, a calendar year company wasn't able to reflect the results of the CARES Act in its 2019 financial statements, even if not issued by the date of enactment. The results can only be reflected in its 2020 financial statements, as it's the year that includes the enactment date.

For interim reporting, the results of the new legislation should be accounted for in the quarter that the enactment occurred. It's likely we will continue to see legislation enacted at both the federal and state level in response to the COVID-19 pandemic. Ensure processes exist to track which changes fall into which financial statement periods, along with multiple versions of calculations — one to support the financial statements and one to support the tax return.

The legislative process in many foreign jurisdictions differs from the United States, so the timing of when legislation is incorporated into financial statements should be addressed on a jurisdiction-by-jurisdiction basis. Businesses with foreign subsidiaries or other international activity may need to scrutinize this since it is expected many other countries will similarly respond to the COVID-19 pandemic with legislative tax incentives.

Earnings of foreign subsidiaries present complexity

One of the more complex income tax accounting concepts is the proper treatment of accumulated earnings and basis differences in foreign subsidiaries. Businesses are often able to limit the accrual of U.S. or foreign income taxes on these earnings if they otherwise intend to permanently reinvest those earnings in the foreign jurisdiction or otherwise have ways to ensure basis differences can be resolved in a tax-free manner. This is called an indefinite reinvestment assertion. The TCJA now permits U.S. corporations to obtain dividends from their foreign subsidiaries on a tax-free basis, which has caused less attention to be focused on the indefinite reinvestment assertion. However, difficult economic times often put pressure on the indefinite reinvestment assertion as cash needs suddenly change. Reconsider this assertion early to ensure sufficient time exists to measure the U.S. and foreign tax implications of no longer following an indefinite reinvestment position.

Identify transaction-related book-tax differences

Many transactions are treated in the same manner for financial accounting and for tax purposes. However, it's common for nonroutine transactions to have differing treatments. For example, fundamental differences between book and tax often exist for items such as debt restructurings, business acquisitions, transaction costs, bargain purchase gains, fixed asset

"One of the more complex income tax accounting concepts is the proper treatment of accumulated earnings and basis differences in foreign subsidiaries."

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LONG-TERM PLANNING:

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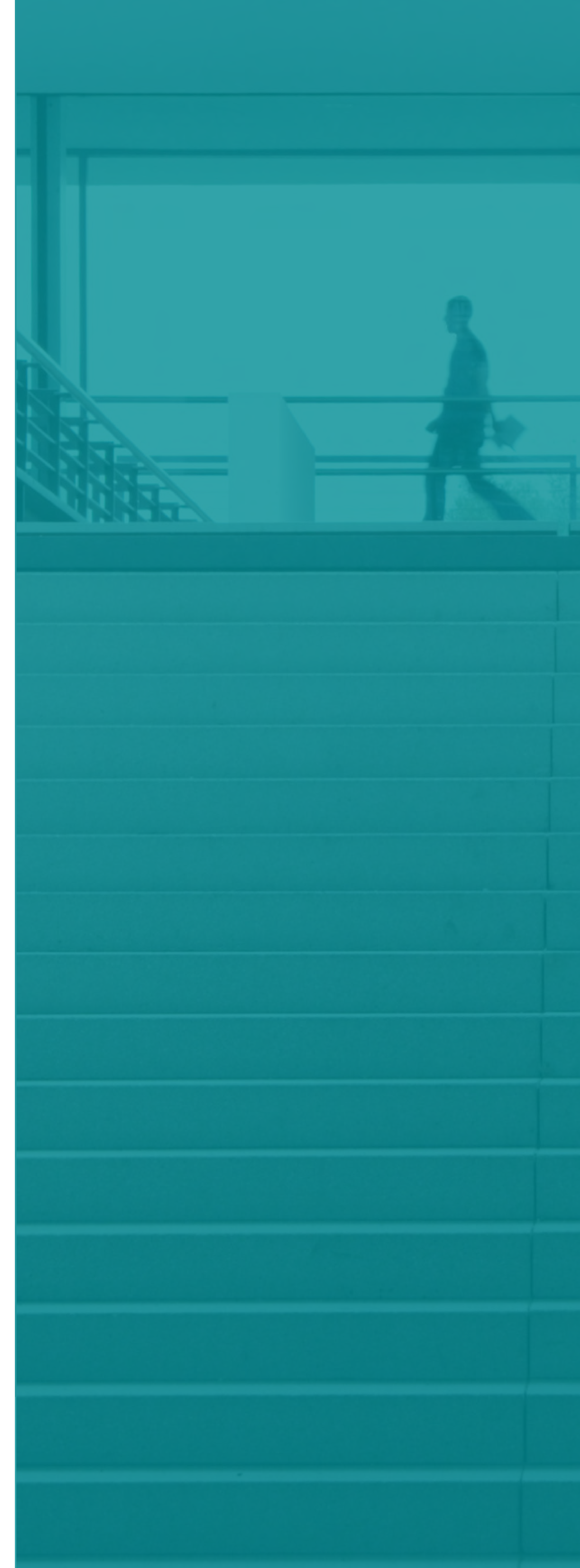
and goodwill impairment, government grant income, and other similar transactions. In tougher economic times, it's also common to have a higher frequency of these nonroutine transactions. A business would do well to involve its income tax function or outside professionals as these nonroutine transactions occur.

Caution: Accounting for business combinations presents challenges

Business combination accounting is another complex area, and the resulting income tax accounting is similarly complex. This is particularly true in an acquisition of troubled company stock. This is another area where early attention can help to ensure sufficient time exists to appropriately account for the income tax results of the transaction, avoiding unexpected adjustments to financial statements that could cause financial covenants to be missed.



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