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2024 Year-End Tax Planning Guide

BDO

Table of Contents

Introduction

In today's evolving U.S. and global tax environment, the tax implications of business decisions are not always intuitive. Integrating tax considerations throughout the decision-making process can help businesses unlock potential tax savings and efficiencies as well as identify and mitigate tax risks. Whether shifting supply chains, pursuing mergers and acquisitions, implementing sustainability initiatives, or adjusting workforce strategy — embracing a **total tax** mindset while modeling the tax impact of these decisions can lead to better outcomes that add value to your organization.

Strategic long-term tax planning remains vital for businesses aiming to reduce their overall tax liabilities and optimize cash flow. With 2024 being an election year, and with some of the changes enacted under the Tax Cuts and Jobs Act scheduled to expire at the end of 2025, keeping up with tax developments is critical to maintaining an effective comprehensive tax strategy. **BDO's 2024 Year-End Tax Planning Guide** identifies key tax strategies and other tax developments businesses should consider as they close out the year and revisit tax planning strategies for 2024 and beyond. For more information and assistance, please contact BDO.

Unless otherwise noted, the information contained in this guide is based on enacted tax laws and policies as of the publication date and is subject to change based on future legislative or tax policy changes.

Accounting Methods

Corporations and pass-through entities may have opportunities to effectively improve their federal income tax positions and, in turn, enhance their cash tax savings by strategically adopting or changing tax accounting methods. Companies that want to reduce their current year tax liability (or create or increase a current year net operating loss (NOL)) should consider accounting method changes that accelerate deductions and defer income recognition. On the other hand, for various reasons (for example, to utilize an NOL), companies may choose to undertake accounting methods planning to accelerate income recognition and defer deductions. Importantly, when undertaking any future tax planning, companies should also keep in mind current tax **proposals as well as changes** that could result based on the outcomes of the 2024 presidential and congressional elections.

The rules covering the ability to use or change certain accounting methods are often complex, and the procedure for changing a particular method depends on the mechanism for receiving IRS consent — i.e., whether the change is automatic or non-automatic. Many method changes require an application be filed with the IRS prior to the end of the tax year for which the change is requested.

The following are some of the many important issues and developments for companies to consider when reviewing their tax accounting methods in 2024:

- December 31 Deadline for Non-automatic Method Changes
- Modified Procedural Guidance for Section 174 R&E Costs
- Claiming Abandonment and Casualty Losses
- Tax Rules for Calculating Percentage of Completion Revenue
- Tax Accounting for Sales of IRA Credits
- Year-end Opportunities to Accelerate Common Deductions and Losses
- IRS Insights into Treatment of Transferable Incentives

DECEMBER 31 DEADLINE FOR NON-AUTOMATIC METHOD CHANGES

Although the IRS allows many types of accounting method changes to be made using the automatic change procedures, some common method changes must still be filed under the non-automatic change procedures. A calendar year-end taxpayer that has identified a non-automatic accounting method change that it needs or desires to make effective for the 2024 tax year must file the application on Form 3115 during 2024 (i.e., the year of change).

Notably, **Rev. Proc. 2024-23**, released on April 30, 2024, removed from the IRS list of permissible automatic method changes any change made to comply with the Section 451 all-events test applicable for accrual method taxpayers. Effective for Forms 3115 filed on or after April 30, 2024, for a year of change ending on or after September 30, 2023, this method change may only be made using the non-automatic change procedures.

Among the other method changes that must be filed under the non-automatic change procedures are many changes to correct an impermissible method of recognizing liabilities under an accrual method (for example, using a reserve-type accrual), deferred compensation accruals, and long-term contract changes under Section 460. Additionally, taxpayers that do not qualify to use the automatic change procedures because they have made a change with respect to the same item within the past five tax years will need to file under the non-automatic change procedures to request their method change.

Planning Considerations

Generally, more information needs to be provided on Form 3115 for a non-automatic accounting method change, and the complexity of the issue and the taxpayer's facts may increase the time needed to gather data and prepare the application. Therefore, taxpayers that wish to file non-automatic accounting method changes effective for 2024 should begin gathering the necessary information and prepare the application as soon as possible.

IRS RELEASES MODIFIED PROCEDURAL GUIDANCE FOR SECTION 174 R&E COSTS

On August 29, 2024, the IRS issued **Rev. Proc. 2024-34**, which provides modified procedural guidance permitting taxpayers with short taxable years in 2022 or 2023 to file an automatic accounting method change for a 2023 year for specified research or experimental expenditures (SREs) under Internal Revenue Code Section 174. The revised procedures are effective for Forms 3115 filed on or after August 29, 2024.

Effective for tax years beginning in 2022, the Tax Cuts and Jobs Act requires taxpayers to capitalize SREs in the year the amounts are paid or incurred and amortize the amounts over five or 15 years. Due to this shift in treatment, taxpayers using a different method of accounting for Section 174 costs were required to file a method change to comply with the new rules for their first taxable year beginning after December 31, 2021.

Rev. Proc. 2024-34 Provides Taxpayers Additional Flexibility

Taxpayers may want or need to file successive accounting method changes to comply with new technical guidance issued by the IRS or correct or otherwise deviate from the positions taken with the initial method change. Prior to the issuance of Rev. Proc. 2024-34, taxpayers seeking to file successive automatic changes to comply with the updated Section 174 rules could only do so for changes made for the first and second tax years (including short tax years) beginning after December 31, 2021. Thus, a taxpayer with two short taxable years in 2022 (for example, due to a transaction) that filed an automatic Section 174 method change for one or both of those years previously would not have been able to file another automatic Section 174 method change for its 2023 year. Rev. Proc. 2024-34 provides taxpayers with additional flexibility to file an automatic Section 174 method change for any taxable year beginning in 2022 or 2023, regardless of whether the taxpayer has already made a change for the same item for a taxable year beginning in 2022 or 2023. Therefore, taxpayers that have not yet filed a federal income tax return for 2023 or have timely filed their 2023 return and are within the extension period for such return (even if no extension was filed), may be able to file an automatic change for SREs even if an accounting method change has been filed for a year beginning after December 31, 2021.

Rev. Proc. 2024-34 also modifies the existing procedural rules to permit taxpayers that are in the final year of their trade or business to use the automatic procedures to change to the required accounting method for SREs for any tax year beginning in 2022 or 2023. Under the prior guidance, taxpayers could only file an SRE method change in the final year of their trade or business for their first or second taxable year beginning after December 31, 2021.

Audit Protection May Not Be Available

Importantly, the updated guidance clarifies that if a taxpayer did not change its method of accounting in an effort to comply with Section 174 for its first taxable year beginning after December 31, 2021, the taxpayer will not receive audit protection for a change made in any taxable year beginning in 2022 or 2023. With this revision, the IRS is effectively denying audit protection for all taxpayers (regardless of whether they had short periods or full 12-month years in 2022 and 2023) that did not originally file a change to comply with Section 174 with their first taxable year beginning after December 31, 2021, unless they defer filing a method change until a tax year beginning in 2024 or after.

CLAIMING ABANDONMENT AND CASUALTY LOSSES

A taxpayer may be able to claim a deduction for certain types of losses it sustains during a taxable year — including losses due to casualties or abandonment, among others — that are not compensated by insurance or otherwise. To be allowable as a deduction under Section 165, a loss must be:

- Evidenced by a closed and completed transaction
- Fixed by an identifiable event
- Actually sustained during the taxable year

The loss is allowed as a deduction only for the taxable year in which it is sustained. Further, the loss can be claimed on an originally filed tax return or on an amended tax return. It is important for businesses to be aware of any potential loss that has occurred, or may occur, in a taxable year, and to ensure that appropriate documentation and actions are taken within the taxable year to support the loss deduction.

Abandonment Losses

To substantiate an abandonment loss, some act is required to evidence a taxpayer's intent to permanently discard or discontinue the use of an asset in its business. No deduction is allowed if a taxpayer holds and preserves an asset for possible future use or for its potential future value. Suspending operations or merely not using an asset is not sufficient to establish an act of abandonment, nor is a decline in value of an asset sufficient to claim an abandonment loss. To demonstrate abandonment of an asset, a taxpayer must show both written evidence of an intention to irrevocably abandon the asset and an affirmative act of abandonment. Although some guidance exists on when a tangible asset is considered abandoned, showing abandonment of intangibles can be more challenging, and little guidance exists related to current technologies such as software, internet, or website-related intangibles.

Casualty Losses

The IRS defines a casualty broadly to include, for example, earthquakes, fires, floods, government-ordered demolitions or relocations of property deemed unsafe by reason of disasters, mine cave-ins, shipwrecks, sonic booms, storms (including hurricanes and tornadoes), terrorist attacks, vandalism, and volcanic eruptions. Importantly, casualty losses arise only from identifiable events that are sudden, unexpected, or unusual in nature, such as a natural disaster. A casualty loss does not include slow, progressive deterioration.

For a business taxpayer that needs to determine whether its gains or losses during the taxable year are treated as capital or ordinary under Section 1231, there is a special rule for involuntary conversions, which include casualties. An involuntary conversion, in relevant part, is the loss by fire, storm, shipwreck, or other casualty, or by theft, of property used in the taxpayer's business or any capital asset that is held for more than one year. If losses from involuntarily converted property exceed gains from such property, Section 1231 does not apply to determine the character of the gain or loss. A net loss will be treated as an ordinary loss. If the taxpayer does not have losses from the involuntarily converted property, the general rules under Section 1231 must be followed.

Federally Declared Disasters

Generally, casualty losses are deducted only in the year in which the casualty event occurs. However, if the casualty loss is attributable to a federally declared disaster, a taxpayer may elect to take the deduction in the prior tax year. Disaster declarations are published on the Federal Emergency Management Agency (FEMA) website. The IRS typically publishes notifications in the Internal Revenue Bulletin shortly after a declaration as well.

Note that for individuals that experience a casualty event between 2018 through 2025, casualty losses are deductible only to the extent they are attributable to a federally declared disaster.

For more information on deducting abandonment, casualty, and theft losses, read the article authored by BDO's James Atkinson, ***Developing an Action Plan for Casualty Gains and Losses*** 183 Tax Notes Federal 2303 (June 24, 2024).

TAX RULES FOR CALCULATING PERCENTAGE OF COMPLETION REVENUE

The percentage of completion method (PCM) for long-term contracts, governed by Section 460 of the Internal Revenue Code, is often misapplied by taxpayers as a method of tax accounting. Taxpayers with qualifying construction or manufacturing contracts frequently follow their book methodologies with minimal, if any, adjustments for tax purposes; however, the rules governing PCM under Section 460 differ significantly from those governing over-time recognition under GAAP. Further, PCM method changes are typically non-automatic; thus, calendar-year taxpayers seeking to change their method for long term contracts must file a Form 3115 by December 31, 2024 in order to implement the change for their 2024 tax year.

Defining Long-term Contracts — Eligibility for PCM

Qualification as a PCM-eligible long-term contract is determined on a contract-by-contract basis and has two broad requirements: (i) the contract must be for a qualifying activity (either construction or manufacturing), and (ii) the contract must qualify as long-term.

Construction is considered a qualifying activity if one of the following must occur to satisfy the taxpayer's contractual obligations:

- The building, construction, reconstruction, or rehabilitation of real property (i.e., land, buildings, and inherently permanent structures as defined in Treas. Reg. §1.263A-8(c)(3))
- The installation of an integral component to real property (property not produced at the site of the real property but intended to be permanently affixed to the real property)
- The improvement of real property

Manufacturing will satisfy the activity requirement if the item being produced (i) normally requires more than 12 calendar months to produce (regardless of the actual time from contract to delivery), or (ii) is *"unique."* In this context, unique means far more than mere customization. The Section 460 regulations provide several safe harbors to assist taxpayers with determining whether the item being manufactured is unique.

To be considered long-term under the PCM rules, a contract must begin and end in two different taxable years. Therefore, in theory, even a two-day contract from December 31 to January 1 could qualify as a long-term contract.

PCM Calculation

For tax purposes, the taxpayer's inception-to-date contract revenue corresponds to the ratio of inception-to-date contract costs incurred to total estimated contract costs. With respect to expense recognition, Section 460 mandates the accrual method for contract costs, such that deduction generally occurs in the same year the costs are taken into account in the PCM ratio's numerator. As previously noted, the tax rules governing PCM likely deviate from the book treatment of income/expenses in several aspects. For instance, under Section 460, taxpayers must follow how to determine the types and amounts of costs that are considered in the project completion rule. Further, there are specific rules pertaining to the treatment of pre-contracting costs (e.g., bidding and proposal costs), as well as look-back rules, which require a taxpayer, after the completion of a long-term contract, to perform a hypothetical recalculation of its prior years' income using the actual total contract price and actual total contract costs, rather than the estimated total contract price and estimated total contract costs used for its prior year returns.

Planning Considerations

Many taxpayers with long-term contracts may be impacted by the requirement to capitalize Section 174 R&E expenditures. Taxpayers with significant contract-specific R&E expenditures may see some opportunity to defer the recognition of income in line with the deferral of R&E expense based on the IRS's requirements for including R&E costs within the numerator and denominator of the completion percentage formula. Notice 2023-63 has clarified that the numerator of the completion percentage formula contains only the amortization of the capitalized R&E costs, not the gross amount of the year's R&E expenditures. More recent guidance (Rev. Proc. 2024-09, released on December 22, 2023) provides some limited flexibility concerning the inclusion of Section 174 costs in the denominator.

TAX ACCOUNTING CONSIDERATIONS FOR SALES OF IRA TAX CREDITS

Taxpayers either purchasing or selling certain federal income tax credits under the Inflation Reduction Act of 2022 (IRA) should be aware of specific tax accounting rules governing the treatment of amounts paid or received for those credits. These special rules are provided in Section 6418 of the Internal Revenue Code, as well as in final **Treasury regulations** published in the Federal Register on April 30, 2024.

Taxpayers unaware of the new rules might overlook them and mistakenly apply the more familiar general rules instead, potentially resulting in sellers overstating their taxable income and purchasers claiming impermissible deductions.

The special tax accounting rules apply in preparing federal income tax returns of taxpayers engaging in qualifying transfers of eligible credits in 2023 or later years.

Eligible Credits

The new tax accounting rules apply to qualifying sales of *"eligible credits,"* which Section 6418(f)(1) defines as the following tax credits:

- The portion of the credit for alternative fuel vehicle refueling property allowed under Section 30C that is treated as a credit listed in Section 38(b)
- The renewable electricity production credit determined under Section 45(a)
- The credit for carbon oxide sequestration determined under Section 45Q(a)
- The zero-emission nuclear power production credit determined under Section 45U(a)
- The clean hydrogen production credit determined under Section 45V(a)
- The advanced manufacturing production credit determined under Section 45X(a)
- The clean electricity production credit determined under Section 45Y(a)
- The clean fuel production credit determined under Section 45Z(a)
- The energy credit determined under Section 48
- The qualifying advanced energy project credit determined under Section 48C
- The clean electricity investment credit determined under Section 48E

Section 6418 allows taxpayers to elect to **transfer eligible credits** to an unrelated person (but an eligible credit can only be transferred one time). Specific requirements and procedures apply in making such an election.

Special Tax Accounting Requirements

Qualifying transfers of eligible credits are subject to specific tax accounting rules that differ from tax accounting principles generally applicable to the sale or exchange of property. Section 6418(b) provides that with respect to consideration paid for the transfer of an eligible credit, that amount:

- Must be *"paid in cash"*
- Is not includible in the seller's gross income
- Is not deductible by the purchaser of the eligible credit

In the case of eligible credits determined with respect to any facility or property held directly by a partnership or S corporation, if the partnership or S corporation makes a qualifying election to transfer an eligible credit:

- Any amount received as consideration for the transfer of the credit is treated as tax-exempt income for purposes of Section 705 (dealing with the basis of a partner's interest in a partnership) and Section 1366 (dealing with pass-through of items to S corporation shareholders)
- A partner's distributive share of the tax-exempt income must be based on the partner's distributive share of the otherwise eligible credit for each taxable year

Just as the seller would not have realized income had it used the eligible credit to reduce its own federal tax liability rather than selling the credit, the final regulations provide a step-in-the-shoes rule for the eligible credit's purchaser. The purchaser will not realize income upon its use of the credit to reduce its federal tax liability, even if the tax savings exceed the consideration paid to acquire the eligible credit.

For any eligible credit (or portion of an eligible credit) that the taxpayer elects to transfer in accordance with Section 6418, the purchaser takes the credit into account in its first taxable year ending with, or after, the seller's taxable year with respect to which the credit was determined.

Basis Adjustment Rules

Under Section 6418 and the final regulations, if a Section 48 energy credit, Section 48C qualifying advanced energy project credit, or a Section 48E clean electricity investment credit is transferred, the basis reduction rules of Section 50(c) apply to the applicable investment credit property as if the transferred eligible credit was allowed to the seller, rather than to the purchaser. Section 50(c) generally provides that if a credit is determined with respect to any property, the basis of the property is reduced by the amount of the credit (subject to certain recapture rules).

The basis adjustment will affect the computation of the seller's available cost recovery deductions for the investment property with respect to which the transferred credits arose, and so must be considered in preparing the returns of taxpayers engaged in the sale of eligible credits.

Applicability Dates

Section 6418 applies to taxable years beginning after December 31, 2022. Sellers must elect to transfer all or a portion of an eligible credit on the seller's original return for the taxable year for which the credit is determined by the due date of that return (including extensions), but not earlier than February 13, 2023.

The final regulations are applicable for taxable years ending on or after April 30, 2024. Taxpayers may apply the final regulations to taxable years ending prior to that date but must apply them in their entirety if they choose to do so.

YEAR-END OPPORTUNITIES TO ACCELERATE COMMON DEDUCTIONS AND LOSSES

Heading into year-end tax planning season, companies may be able to take some relatively easy steps to accelerate certain deductions into 2024 or, if more advantageous, defer certain deductions to one or more later years. The key reminder for all of the following year-end *"clean-up"* items is that the taxpayer must make the necessary revisions or take the necessary actions before the end of the 2024 taxable year. (Unless otherwise indicated, the following items discuss planning relevant to an accrual basis taxpayer.)

Deduction of Accrued Bonuses

In most circumstances, a taxpayer will want to deduct bonuses in the year they are earned (the service year), rather than the year the amounts are paid to the recipient employees. To accomplish this, taxpayers may wish to:

- Review bonus plans before year end and consider changing the terms to eliminate any contingencies that can cause the bonus liability not to meet the Section 461 *"all events test"* as of the last day of the taxable year. Taxpayers may be able to implement strategies that allow for an accelerated deduction for tax purposes while retaining the employment requirement on the bonus payment date. These may include using (i) a *"bonus pool"* with a mechanism for reallocating forfeited bonuses back into the pool; or (ii) a *"minimum bonus"* strategy that allows some flexibility for the employer to retain a specified amount of forfeited bonuses.

  It is important that the bonus pool amount is fixed through a binding corporate action (e.g., board resolution) taken prior to year end that specifies the pool amount, or through a formula that is fixed before the end of the tax year, taking into account financial data as of the end of the tax year. A change in the bonus plan would be considered a change in underlying facts, which would allow the taxpayer to prospectively adopt a new method of accounting without filing a Form 3115.

- Schedule bonus payments to recipients to be made no later than 2.5 months after the tax year end to meet the requirements of Section 404 for deduction in the service year.

Deductions of Prepaid Expenses

For federal income tax purposes, companies may have an opportunity to take a current deduction for some of the expenses they prepay, rather than capitalizing and amortizing the amounts over the term of the underlying agreement or taking a deduction at the time services are rendered. Under the so-called *"12-month rule,"* taxpayers can deduct prepaid expenses in the year the amounts are paid (rather than having to capitalize and amortize the amounts over a future period) if the right/benefit associated with the prepayment does not extend beyond the earlier of i) 12 months after the first date on which the taxpayer realizes the right/benefit, or ii) the end of the taxable year following the year of payment. Note that accrual method taxpayers must first have an incurred liability under Section 461 in order to accelerate a prepayment under the 12-month rule.

The rule provides some valuable options for accelerated deduction of prepaids for accrual basis companies — for example, insurance, taxes, government licensing fees, software maintenance contracts, and warranty-type service contracts. Identifying prepaids eligible for accelerated deduction under the tax rules can prove a worthwhile exercise by helping companies strategize whether to make prepayments before year end, which may require a change in accounting method for the eligible prepaids.

Inventory Write-Offs

Often companies carry inventory that is obsolete, unsalable, damaged, defective, or no longer needed. While for financial reporting inventory is generally reduced by reserves, for tax purposes a business normally must dispose of inventories to recognize a loss, unless an exception applies. Thus, a best practice for tax purposes to accelerate losses related to inventory is to dispose of or scrap the inventory by year end.

An important exception to this rule is the treatment of *"subnormal goods,"* which are defined as goods that are unsaleable at normal prices or unusable in the normal way due to damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar reasons. For these types of items, companies may be able to write down the cost of inventory to the actual offering price within 30 days after year end, less any selling costs, even if the inventory is not sold or disposed of by year end.

Continued Phase-out of Bonus Depreciation

For eligible property placed in service during 2024, the applicable bonus percentage is 60%. As such, year-end tax planning for fixed assets emphasizes cash tax savings through scrubbing fixed asset accounts for costs that can be deducted currently under Section 162 (e.g., as repairs and maintenance costs) rather than being capitalized and recovered through depreciation, assessing eligibility for immediate Section 179 expensing, and reducing the depreciation recovery periods of capital costs where possible.

CCA PROVIDES INSIGHT INTO TREATMENT OF TRANSFERABLE INCENTIVES

CCA 202304009 addresses whether a pharmaceutical or biotechnology company must capitalize costs incurred to purchase from a third party a priority review voucher (PRV) issued by the U.S. Food & Drug Administration (FDA). A PRV is a voucher entitling its holder to prioritized FDA review of a new medical treatment the applicant seeks to offer to the public. PRVs are considered valuable assets because their use can significantly reduce the time it would otherwise take to bring a new drug to market. A PRV can be held for use with a future FDA drug application or sold without restriction to another company for their use. PRVs have no expiration date and can be transferred an unlimited number of times.

In CCA 202304009, the IRS concluded that a taxpayer must capitalize the amount spent to purchase a PRV either as a cost incurred to facilitate obtaining a franchise right or as a cost incurred to acquire a new intangible asset, depending on the intended use of the voucher. The IRS also provided guidance on how the capitalized costs should be recovered.

Planning Considerations

While CCA 202304009 discusses costs to acquire PRVs, the guidance might help forecast the tax accounting treatment of various other non-tax government incentives as well. For further information and analysis, read the article authored by BDO's Connie Cunningham and James Atkinson, **IRS Provides Insight Into Treatment of Transferable Incentives** 65 TMM, 5/16/2024.

Business Incentives & Tax Credits

CREDIT FOR INCREASING RESEARCH ACTIVITIES: PROPOSED CHANGES TO FORM 6765

The IRS announced the release of a revised draft of Form 6765, Credit for Increasing Research Activities, on June 21, 2024, that reflects feedback from external stakeholders. This follows the IRS's efforts to tighten documentation requirements for claiming the research credit. In September 2023, the IRS previewed proposed changes to Form 6765, adding new sections for detailed business component information and reordering existing fields. These changes aimed to improve information consistency and quality for tax administration but were criticized as overly burdensome.

The updated draft retains Section E from the previous version but requires additional taxpayer information. The *"Business Component Detail"* section, now Section G, is optional for Qualified Small Business (QSB) taxpayers and those with total qualified research expenditures (QREs) of $1.5 million or less and gross receipts of $50 million or less. Additionally, the IRS reduced the number of business components to be reported in Section G, requiring 80% of total QREs in descending order by amount, capped at 50 business components. Special instructions will be provided for taxpayers using the ASC 730 directive. The revised Section G will be optional for all filers for tax year 2024 to allow taxpayers time to transition to the new format. As outlined by the IRS, Section G will be effective for tax year 2025.

Examination Environment

Currently, the IRS receives a significant number of returns claiming the research credit, which requires substantial examination resources from both taxpayers and the IRS. To ensure effective tax administration for this issue, the IRS aims to clarify the requirements for claiming the research credit by considering all feedback received from stakeholders before finalizing any changes to Form 6765.

In response to ongoing concerns of improper claims of the research credit, the IRS has intensified its focus on reviewing these claims for nonconformities, including conducting more audits. Navigating the complexities of the research credit can be challenging, especially with the increased scrutiny, recent case law, and the newly implemented IRS compliance measures in place.

Planning Considerations

It is important for taxpayers to accurately determine eligibility, validate and properly record contemporaneous documentation to support research credit claims, and defend against examinations. Taxpayers should partner with a trusted tax advisor to ensure compliance with IRS regulations and proper eligibility for the research credit.

General IRA Overview

The signing of the Inflation Reduction Act (IRA) on August 16, 2022, marked the largest-ever U.S. investment committed to combat climate change, allocating significant funds to energy security and clean energy programs over the next 10 years, including provisions incentivizing the manufacturing of clean energy equipment and the development of renewable energy generation.

Overall, the act modifies many of the current energy-related tax credits and introduces significant new credits and structures intended to facilitate long-term investment in the renewables industry. Capital investments in renewable energy or energy storage; manufacturing of solar, wind, and battery components; and the production and sale or use of renewable energy are activities that could benefit from the over 20 new or expanded IRA tax credits. The IRA also introduced new ways to monetize tax credits and additional bonus credit amounts for projects that meet prevailing wage and apprenticeship, energy community, and domestic content requirements.

45X — Advanced Manufacturing Production Tax Credit

The 45X advanced manufacturing production credit continues to be a valuable production tax credit meant to encourage the production and sale of energy components in the U.S., specifically related to solar, wind, batteries, and critical mineral components. To be eligible for the credit, components must be produced in the U.S. or U.S. possessions and be sold by the manufacturer to unrelated parties. The Department of Energy has released a full list of eligible components as defined in the IRA, with specific credit amounts that vary according to the component. Manufacturers can also monetize 45X credits through a direct payment from the IRS for the first five years under Internal Revenue Code Section 6417. They may also transfer a portion or all the credit to another taxpayer through the direct transfer system Section 6418 election. The 45X credit is a statutory credit with no limit on the amount of funding available; however, the credit will begin to phase out beginning in 2030 and will be completely phased out after 2033. Manufacturers cannot claim 45X credits for any facility that has claimed a 48C credit.

48E and 45Y Clean Electricity Investment and Production Credits

For energy property and qualified facilities placed in service after December 31, 2024, Sections 48E and 45Y will replace the longstanding investment tax credit and production tax credit under Sections 48 and 45. The new provisions adopt a technology-neutral approach, whereby qualification for the credits will generally not be based on specific technologies identified in the IRC, but rather on the ability to generate electricity without greenhouse gas emissions. This represents a significant departure from historical practices and is expected to expand the range of technologies eligible for tax credits. Other relevant provisions of the IRA, such as bonus credit additions and monetization options, will still apply to the new Sections 48E and 45Y.

45Z Clean Fuel Production Credit

The clean fuel production credit under Section 45Z will become effective for transportation fuel produced at a qualified facility after December 31, 2024. On May 31, 2024, the IRS issued Notice 2024-49, providing guidance on the necessary registration requirements to claim the credit. Fuel that meets additional criteria to qualify as sustainable aviation fuel (SAF) will be eligible for an increased credit amount. As in the case of other renewable credits, the emissions rate is crucial for purposes of the 45Z credit, because the emissions factor for the fuel will directly impact the credit amount. Additionally, prevailing wage and apprenticeship rules will apply to Section 45Z qualified facilities, with certain exceptions.

Planning Considerations

With the passage of Section 6418 as part of the IRA, certain renewable energy tax credits can now be transferred by companies that generate eligible credits to any qualified buyer seeking to purchase tax credits. Through credit transfers, taxpayers have the option to sell all or a portion of their credits in exchange for cash as part of their overall renewable energy goals if they are not able to fully utilize the benefit. Companies with a high amount of taxable income and therefore a larger appetite for tax credits are able to purchase these credits at a discount, with the sale proceeds improving the economics of clean energy development.

The market rate for the sale of credits will be highly dependent on the type of credit being transferred, as well as the substantiation and documentation related to the seller's eligibility for the credit taken and any bonus credit amounts claimed. The current rate seen in the market for transferring credits is around $0.93 to $0.96 per $1 of credit, but these amounts are subject to change based on specific fact patterns for each individual transaction and the overall market trend.

Taxpayers considering buying or selling tax credits that are transferable under the IRA should be looking ahead and forecasting their potential tax liability and resulting appetite for buying and selling credits. These credits can be transferred and utilized against estimated quarterly payments as soon as transfer agreements are finalized. This expedited reduction in cash outlay for the buyer and monetization of credits for the seller is a consideration that should be taken into account for taxpayers interested in entering the market of transferring credits.

BONUS CREDITS

The Inflation Reduction Act not only introduced new and expanded credits for the investment in and production of renewable energy and its related components but also included provisions for bonus credit amounts subject to specific requirements.

The prevailing wage and apprenticeship (PWA) requirement is a 5x multiplier for certain credits that can bring the credit rate from 6% up to 30% by paying prevailing wages to all labor related to the construction, installation, alteration, and repair of eligible property. Additionally, taxpayers must ensure that a specific percentage of these labor hours is performed by qualified apprentices.

The IRS and the Treasury Department issued final regulations on the PWA requirements in June 2024, and projects starting in 2025 and after will be unable to utilize the beginning of construction exemption. Other common credit additions available for taxpayers meeting energy community and domestic content requirements provide a 10% addition to the base rate of the credit. Taxpayer documentation will be required to substantiate the claim of these bonus credit amounts and will need to be presented to a buyer in the event that these credits are transferred under Section 6418.

Planning Considerations

Taxpayers that have current or proposed investments or activities for which they plan to utilize the PWA multiplier should be formulating a documentation strategy and procedure. In the event of an IRS audit or transfer of these credits, taxpayers will be required to substantiate the wages paid to laborers, as well as the number of hours performed by registered apprentices. Depending on the size and amount of labor involved in qualified investments or production, documentation for PWA purposes, as well as for the domestic content requirements, will likely be a highly burdensome task if not planned for at the outset of a project.

NEW MARKETS TAX CREDIT

The federal New Markets Tax Credit (NMTC) program was established in 2000 to subsidize capital investments in eligible low-income census tracts. The subsidy provides upfront cash in the form of NMTC-subsidized loans at below-market interest rates (3%-3.5%). The loan principal is generally forgiven after a seven-year term, resulting in a permanent cash benefit. Funding for these subsidized loans is highly competitive and expected to be depleted quickly.

The U.S. Treasury's Community Development Financial Institutions (CDFI) Fund recently announced that, for 2025 only, it will double its annual allocation of NMTC funds.

Planning Considerations

Taxpayers across multiple industries may be good candidates for the NMTC.

Applying for the NMTC program involves several steps that help ensure the funding is allocated to projects that will have a meaningful impact on low-income communities. Applicants for the credit are evaluated based on the community impact derived from the investments (such as job creation, community services provided, etc.). In a program as highly competitive as the NMTC, applying early can make the difference between securing a portion of the limited funds available or missing out on funding opportunities. Early applicants are often better positioned to take advantage of available opportunities, and additional benefits may be possible for those who act swiftly.

The following initial questions will help determine if a project is viable for NMTC:

- Address of the proposed project
- High-level project description (a few sentences)
  - Status of construction/timeline of capital expenditures (midstream projects are permitted)
  - Estimated number of direct jobs to be created by the project

Taxpayers with ongoing or planned capital investments for later in 2024 or 2025 that are eligible to receive NMTC financing should begin reaching out to community development entities. Early outreach provides qualified active low-income community businesses a strong advantage in securing this financing due to the competitive nature and limited funds of the program.

Capital Markets

TREASURY TAX REVIEW

Treasury groups are facing unprecedented challenges from volatile market conditions. Uncertain interest rates, volatile credit markets, currency fluctuations, and strained commodity markets have all been affecting financing, investing, and cash management and have caused treasurers to reevaluate how and when to hedge various risks. These activities will generally have significant tax consequences and the need for tax departments to be involved in these decisions has never been greater. Companies should evaluate all of the treasury activities from a tax perspective on a regular basis. A few areas of focus are highlighted below:

- Tax Considerations of Debt Refinancing Transactions
- Tax Hedging Identification and Documentation Processes
- Cash Pooling
- Branch Foreign Currency Gains and Losses (see **Section 987 Regulations Expected to be Finalized Before Year-End** in the International Tax Section of this guide)

TAX CONSIDERATIONS OF DEBT REFINANCING TRANSACTIONS

Over the past year, many companies have refinanced their existing debt to secure current interest rates, with the potential for rates to decrease in the future. Refinancing transactions that result in a *"significant modification"* of the debt under applicable regulations can have disparate tax consequences depending on the specific circumstances. Although the regulations provide relatively clear rules for determining when a modification is *"significant,"* the application of these rules is highly fact-dependent and frequently requires relatively complex calculations.

Companies should review their debt modification transactions undertaken during the year to confirm their tax impact. Companies that are considering changes to existing credit facilities in the coming year should likewise assess whether the proposed change would amount to a significant modification and, if so, determine the tax implications of the modification.

Tax Treatment of Debt Modifications

The U.S. federal income tax treatment of debt refinancing transactions is highly fact-specific and requires careful analysis. Certain refinancing transactions may be treated as a taxable retirement of the existing (refinanced) debt, which may give rise to the ability to write off any unamortized debt issuance costs and original issue discount, the latter as *"repurchase premium."* However, in certain situations a refinancing transaction may also give rise to taxable ordinary income in the form of *"cancellation of indebtedness income."*

The tax consequences of a debt refinancing transaction hinge in part on whether the transaction results in a significant modification of the debt under rules set out in Treas. Reg. §1.1001-3, which results in a deemed retirement of the existing debt in exchange for a newly issued debt instrument.

When Is a Modification Significant?

As a threshold matter, a modification includes not only a change to the terms of an existing debt instrument but would also include an exchange of an old debt instrument for a new one or the retirement of an existing debt instrument using the proceeds of a new debt instrument. Stated differently — it is the substance, not the form, that governs whether debt has been modified for federal income tax purposes.

Whether a modification of a debt instrument constitutes a significant modification depends on the materiality of the changes. The regulations provide a general *"economic significance"* rule and several specific rules for testing whether a modification is significant. In practice, most debt modifications are covered by two specific rules governing changes in the yield to maturity of a debt instrument (the change in yield test) and deferrals of scheduled payments (the deferral test).

Under the change in yield test, a modification is significant if the new yield of the modified debt instrument differs from the old yield of the unmodified debt instrument by more than 25 basis points (i.e., 1/4 of 1%) or 5% of the unmodified yield. Various changes, such as adjusting the interest rate, altering payment schedules, or paying modification fees, can impact the yield. It is not uncommon for a modification with only a minor (or no) change to the stated interest rate to result in a significant modification due to changes in the yield to maturity that result from the payment of modification fees or changes to the due dates for certain payments. This issue is often overlooked.

Under the deferral test, a modification is significant if it causes a material deferral of payments. While the test does not define *"material deferral,"* it offers a safe harbor: a deferral is not significant if all payments are unconditionally made within the safe harbor period. This safe harbor period starts on the first deferred payment date and lasts for the lesser of five years or 50% of the original term (e.g., the deferral safe harbor for a five-year debt instrument would be two-and-a-half years).

In applying both the change in yield test and the deferral test, taxpayers are required to consider the cumulative effect of the current modification with any prior modifications (or, in the case of a change in yield, modifications occurring in the past five years). This cumulative rule is particularly noteworthy for taxpayers who routinely modify their debt (and often incur modification fees in connection with the modification), as the results of certain modifications may not be significant when viewed in isolation but may be significant when combined with prior modifications.

Tax Implications of Significant Debt Modifications

A significant modification results in the deemed retirement of the existing debt instrument in exchange for a newly issued debt instrument. The existing debt instrument will be deemed retired for an amount equal to the *"issue price"* of the newly issued debt instrument, together with any additional consideration paid to the lenders as consideration for the modification.

The issue price of a debt instrument depends on whether the debt instrument was issued for cash or property. If a significant amount (generally 10%) of the debt was issued for money, the issue price will be the cash purchase price. Otherwise, assuming the debt instrument is in excess of $100 million, the issue price will be its fair market value (or the fair market value of the property for which it was issued) if it is *"publicly traded."* In all other cases, the issue price of the debt instrument will generally be its stated principal amount.

If the issue price of the modified debt instrument (i.e., the repurchase price) is less than the tax adjusted issue price of the old debt instrument, a borrower will incur cancellation of indebtedness income, which is generally taxed as ordinary income in the current tax year. If instead the repurchase price exceeds the adjusted issue price (this may occur when the old debt instrument had unamortized original issue discount or where the debt is publicly traded and has a fair market value in excess of its face amount), the borrower will incur a repurchase premium. Repurchase premium is deductible as interest expense. Special rules apply to determine whether such repurchase premium is currently deductible or is instead amortized over the term of the newly issued debt instrument.

The retirement of an existing debt instrument may also give rise to the ability to deduct any unamortized debt issuance costs. As a general matter, the determination of whether any unamortized debt issuance costs should be written off or carried over and amortized over the term of the new debt instrument generally follows the same analysis as repurchase premium. Notably, debt issuance costs are deducted as ordinary business expenses under Section 162, and therefore are not subject to the limitation on business interest expense deductions under Section 163(j).

Finally, a significant modification may give rise to a number of additional tax implications that companies should consider, including the potential for foreign currency gain or loss and the need to *"mark-to-market"* existing tax hedging transactions.

Potential Benefits of Using Hedges in Debt Refinancing

When refinancing existing debt, taxpayers might want to consider the potential benefits of integrating the newly issued debt instrument with a hedge under Treas. Reg. §1.1275-6. In times of market volatility, hedging helps reduce exposure to significant market fluctuations related to the financing transaction, offering an additional layer of protection in unpredictable conditions. Additionally, this integration can serve as a valuable planning tool by impacting the calculation of the business interest expense deductibility limitation under Section 163(j), a benefit that is often overlooked.

The passage of the Tax Cuts and Jobs Act (TCJA) broadened the scope of Section 163(j)'s deductibility limit and provided a formulaic approach to determine the maximum deduction allowed for a company's business interest. In general, Section 163(j) limits the deduction of business interest to the sum of the taxpayer's business interest income, 30% of the taxpayer's adjusted taxable income (ATI), and any floor plan financing interest for the tax year. Disallowed interest can be carried forward to future years, subject to certain limitations.

Treasury Reg. §1.1275-6 allows taxpayers to integrate a qualifying debt instrument (QDI) with a hedge (or combination of hedges) when their combined cash flows resemble those of a fixed or variable rate debt instrument. This integration ensures more accurate timing and character of income, deductions, gains, or losses. The combination of cash flows creates a synthetic debt instrument, which is governed by the rules of Treas. Reg. §1.1275-6, rather than the separate rules that would apply to each component. Because the synthetic debt instrument is governed under the integration rules, any net payments made or received with regard to the synthetic debt instrument are characterized as interest (interest income or interest expense). In contrast, without integration, the debt instrument and hedge would be treated separately, and any gain from the hedge would be considered ordinary income rather than interest, providing no impact on the Section 163(j) business interest limitation.

The following example highlights the differences in treatment between integration and non-integration, illustrating the impact (if any) on the Section 163(j) business interest limitation calculation.

Facts: Corporation X borrows $100 million at a fixed rate of 8% from an unrelated party. Based on current market predictions, Corporation X enters into an interest rate swap (swap) with an unrelated bank. Under the terms of the swap, Corporation X receives fixed payments at 8% and pays a floating rate tied to SOFR (Secured Overnight Financing Rate). The floating rate is below 8%, resulting in a gain for Corporation X at the end of the year. Corporation X would like to deduct all of its interest expense; however, it is subject to the Section 163(j) limitation. Corporation X wants to increase the amount of interest it is permitted to deduct under Section 163(j).

Situation 1

No Integration. Corporation X does not integrate the QDI with the interest rate swap. While Corporation X benefits economically from receiving more fixed payments than it pays under the floating rate, the gain from the swap is not treated as interest for tax purposes. Instead, the gain is considered ordinary income and thus not included in the Section 163(j) calculation, and Corporation X is unable to increase the amount of interest it is allowed to deduct.

Situation 2

Integration under Treas. Reg. §1.1275-6. Corporation X chooses to integrate the QDI and the interest rate swap under Treas. Reg. §1.1275-6, creating a synthetic debt instrument. As a result, Corporation X is deemed to incur interest expense on the synthetic instrument as an integrated transaction. Such interest expense is essentially the interest expense on the debt netted with the gain on the swap and therefore produces the benefit for Section 163(j).

REVIEW TAX HEDGING IDENTIFICATION AND DOCUMENTATION PROCESSES

Most companies enter into hedging transactions to manage risk that arises in their business, such as interest rate, currency, and commodity price risk. These transactions are subject to tax hedging rules, and failure to follow the requirements under those rules could result in negative tax consequences. The tax hedging rules impose a same-day identification requirement with timing and character whipsaw rules that may apply if such transactions are not timely identified.

As part of year-end reviews and planning for next year, companies should review these rules and the sufficiency of their hedging identification and documentation processes to ensure that they meet the requirements.

Tax Hedge Qualification & Character

To qualify as a tax hedge, the transaction must occur within the normal course of business and be used to manage interest rate, currency, or commodity price risk with respect to ordinary property or ordinary obligations (incurred or to be incurred) by the taxpayer. For this purpose, property is ordinary if a sale or exchange of the property could not produce capital gain or loss under any circumstances. Taxpayers may manage risk on a transaction-by-transaction basis or, alternatively, may manage aggregate risk (i.e., they may enter into one or more foreign currency contracts to manage aggregate foreign currency risk).

Gain or loss on a tax hedging transaction will be ordinary income or loss if the transaction is properly identified and documented in a timely manner.

Same-Day Identification Requirement

The tax hedging rules require that each tax hedging transaction be identified as such no later than the close of the day on which the hedge was entered into. The hedged item must be identified substantially contemporaneously with the tax hedging transaction, but in no case more than 35 days after the hedging transaction was entered into.

An identification must identify the item, items, or aggregate risk being hedged. Identification of an item being hedged involves identifying a transaction that creates risk and the type of risk that the transaction creates. This identification is made in (and retained as part of) the company's tax files and is not sent to the IRS. A GAAP (or IFRS) hedge identification will not satisfy the tax hedge identification requirement unless the taxpayer's books and records make clear that such identification is also being made for tax purposes. Additional regulatory guidance is provided for certain categories of hedging transactions, including hedges of debt issued (or to be issued) by the taxpayer, inventory hedges, and hedges of aggregate risk.

Taxpayers are given significant flexibility regarding the form of such identification. For companies that enter into tax hedging transactions infrequently, a same-day identification may be prepared and saved in the company's tax files. However, this approach is often challenging for taxpayers that enter into hedging transactions routinely (often on a daily basis). For taxpayers who enter into hedging transactions more frequently, the same-day identification requirement can be satisfied through a tax hedging policy. A tax hedging policy will identify the types of transactions entered into to manage risk and the risk managed (and how such risk is managed) and will identify all transactions described in the policy as tax hedging transactions. If properly prepared, the tax hedging policy will serve as identification (for tax hedging purposes) of any transactions described in the policy.

Hedge Timing Rules

Treasury regulations provide special tax accounting rules for tax hedging transactions known as the *"hedge timing rules."* The hedge timing rules provide a general requirement that the method of accounting used to account for hedging transactions must clearly reflect income by matching the recognition of income, deduction, gain, or loss on the hedging transaction to the recognition of income, deduction, gain, or loss on the hedged item. Special rules are provided for specific types of hedging transactions.

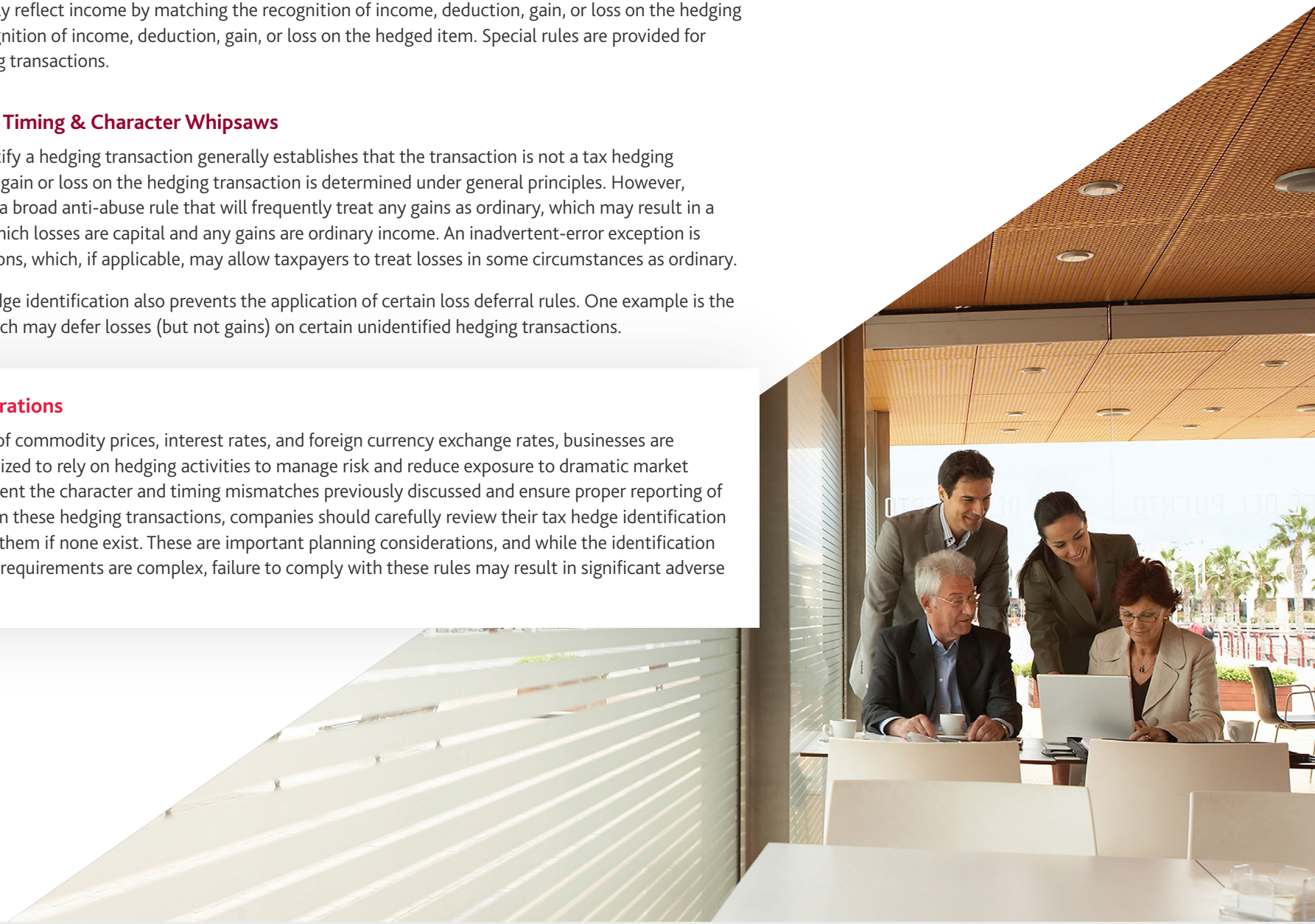
Failure to Identify — Timing & Character Whipsaws

Failure to properly identify a hedging transaction generally establishes that the transaction is not a tax hedging transaction. As a result, gain or loss on the hedging transaction is determined under general principles. However, the regulations provide a broad anti-abuse rule that will frequently treat any gains as ordinary, which may result in a character whipsaw in which losses are capital and any gains are ordinary income. An inadvertent-error exception is provided in the regulations, which, if applicable, may allow taxpayers to treat losses in some circumstances as ordinary.

A proper and timely hedge identification also prevents the application of certain loss deferral rules. One example is the tax *"straddle"* rules, which may defer losses (but not gains) on certain unidentified hedging transactions.

Planning Considerations

Given the volatility of commodity prices, interest rates, and foreign currency exchange rates, businesses are increasingly incentivized to rely on hedging activities to manage risk and reduce exposure to dramatic market movements. To prevent the character and timing mismatches previously discussed and ensure proper reporting of gains and losses from these hedging transactions, companies should carefully review their tax hedge identification policies or establish them if none exist. These are important planning considerations, and while the identification and documentation requirements are complex, failure to comply with these rules may result in significant adverse tax consequences.



CASH POOLING

Cash pooling is a banking tool that provides enhanced cash management for companies that choose to implement such a structure. It generally involves the consolidation of participants' cash accounts and the assignment of a pool leader or *"header."* The benefits include increased interest income, lower banking fees, lower cost of borrowing, and potentially cash centralization (zero balancing, described below). There are several tax and non-tax considerations when implementing a cash pooling structure that require careful analysis.

Physical Pooling (Zero Balancing)

Physical pooling involves the sweeping of cash from the participants' accounts to the pool leader and therefore creates the ability to centralize the organization's cash. The goal of physical pooling is to create a series of intercompany loans from both a U.S. and non-U.S. perspective.

Notional Pooling

Notional pooling, on the other hand, does not involve the sweeping or physical movement of cash. The bank consolidates the participants' accounts for purposes of calculating the total interest income that is credited to the pool leader. Each participant maintains their own third-party banking relationship and may or may not be credited a share of the pool benefit depending upon how the pooling arrangement is structured.

Pooling Considerations

There are many tax-related and non-tax considerations that must be evaluated upon the implementation of a cash pooling structure. The type of pooling arrangement (physical vs. notional) depends largely upon the cash management goals of the company. One important determination is the location of the pool leader. The additional interest/pooling benefit will likely be taxable in the jurisdiction of the pool leader; therefore, choosing a country where such income is not highly taxed is important. Further, a jurisdiction with a robust banking network is important as well.

With respect to physical pooling, a strong treaty network between the pool leader and the participants is important to reduce withholding tax as much as possible. Other tax considerations include transfer pricing with respect to the appropriate interest rate, foreign currency exposure and potential hedging, Subpart F and GILTI considerations, foreign tax credits, etc.

Notional pooling often reduces or eliminates foreign currency and withholding tax exposure as the participants are transacting with the third-party bank. The choice of location for the pool leader is equally important for notional pooling as it is for physical pooling. The determination of whether the pooling benefit is allocated to the participants and the characterization of such benefit should be conducted including a transfer pricing analysis.

Depending upon the corporate structure and the location of participants with excess cash and those that have funding requirements, companies may want to entertain a physical pool in some regions and a notional arrangement in others. For example, most Asian countries do not have a significant treaty network, which would make notional pooling more attractive. Europe has a fairly thorough treaty network, and thus physical pooling tends to be very effective in those countries.

Planning Considerations

Cash pooling has been a popular cash management tool for several years. For companies that have a cash pooling structure in place, it is important to have a pooling agreement between the third-party bank and the participants, including the pool leader. The agreement should be clear regarding the type of pooling arrangement that is in place in order to reduce any risk of recharacterization regarding the entities that are borrowing and lending. Such agreement should be reviewed, as well as the accounting for the cash pooling, to ensure that the agreement is being followed by accounting and tax. This type of year-end review could help alleviate the risk of potential recharacterization, which could lead to a whole host of issues, including withholding tax, Subpart F issues, foreign currency issues, etc.

Corporate Tax and M&A

During 2024, the U.S. Department of the Treasury and the IRS issued important tax guidance for U.S. corporations — including long-awaited proposed regulations on the corporate alternative minimum tax and final procedural regulations on the stock repurchase excise tax. These and other key tax developments corporate taxpayers should consider when planning for 2024 and beyond include:

- Corporate Alternative Minimum Tax Guidance Includes Detailed Proposed Regulations
- IRS, Treasury Issue Final Procedural Regulations on Stock Repurchase Excise Tax
- Tax Court Rules for Taxpayer on Related-Party Advances
- IRS Rules Stock Contributions Will Not Result in Deemed Dividends or Application of Gift Tax
- Uncertainties Surround Treatment of S Corporation State Law Conversions
- IRS Rules Professional Corporation Arrangement Requires Consolidation

CORPORATE ALTERNATIVE MINIMUM TAX GUIDANCE INCLUDES DETAILED PROPOSED REGULATIONS

The Inflation Reduction Act of 2022 (IRA) created a new corporate alternative minimum tax (CAMT) for taxable years beginning after December 31, 2022. Since being signed into law, the U.S. Department of the Treasury and the Internal Revenue Service have released multiple pieces of guidance culminating in **proposed regulations**.

Prior Guidance

Prior to issuing proposed regulations, the following notices addressed the application of the CAMT:

- **Notice 2023-7** announced the intent to issue proposed regulations on the CAMT treatment of consolidated groups, depreciation of property under Section 168, troubled corporations, and the determination of applicable corporation status. Importantly, this Notice contained a first-year safe harbor that allowed taxpayers to use a simplified method to determine applicable corporation status
- **Notice 2023-20** provided interim guidance on the CAMT treatment of variable contracts, certain reinsurance and coinsurance agreements, and adjustments for fresh start accounting
- **Notice 2023-42** provided penalty relief for underpayments of estimated taxes relating to a taxpayer's CAMT liability for any tax year that begins after December 31, 2022, and before January 1, 2024
- **Notice 2023-64** provided interim guidance on the determination of a taxpayer's applicable financial statement and adjusted financial statement income (AFSI), including as it relates to consolidated groups and certain foreign corporations
- **Notice 2024-10** provided targeted relief to reduce double-counting of AFSI for a controlled foreign corporation that pays a dividend to a U.S. shareholder
- **Notice 2024-33** extended the relief for CAMT liability estimated tax payments due on or before April 15, 2024
- **Notice 2024-47** further extended the relief for CAMT liability estimated tax payments due on or before August 15, 2024

Taxpayers may generally rely on these notices from their publication date to the publication of the proposed regulations (discussed below).

In the above-mentioned guidance, the Service released Form 4626, Alternative Minimum Tax — Corporations, and accompanying instructions for corporate taxpayers to report their applicable corporation calculations and CAMT liability. In addition, Schedule K to Form 1120, U.S. Corporation Income Tax Return, was modified to add Line 29 relating to CAMT.

Proposed Regulations

The proposed regulations conform to many aspects of the prior notices but expand on the interim guidance in noteworthy ways, some of which are described below. The length and detail of the proposed regulations highlight the technical complexity of administering and complying with the CAMT regime.

Effective Dates

The proposed regulations are prospective in nature. In general, the proposed regulations apply to tax years and transfers ending or occurring, respectively, after September 13, 2024 (i.e., the date the proposed regulations were published in the Federal Register). However, certain aspects of the proposed regulations have different effective dates tied to the date the final regulations are published in the Federal Register, or to the period between September 13, 2024, and the date the final regulations are published in the Federal Register.

Taxpayers may rely on the proposed regulations, subject to a consistency requirement.

Safe Harbor

Notice 2023-7 contained a safe harbor that allowed a taxpayer to use a simplified method with fewer adjustments to calculate its AFSI for purposes of determining its applicable corporation status, which dictates whether the corporation is subject to the CAMT regime. The safe harbor reduced the threshold AFSI needed to be an applicable corporation from $1 billion to $500 million (and from $100 million to $50 million for the U.S.-specific prong of the foreign-parented multinational group test). The original safe harbor was only available for the first taxable year beginning after December 31, 2022.

The proposed regulations contain a slightly modified version of the $500 million (or $50 million) safe harbor that is available for years not covered by the original safe harbor.

Other Noteworthy Areas

The following are key areas in which the proposed regulations provide new or more detailed guidance:

- Calculating a corporate partner's distributive share of partnership AFSI
- Creating deemed foreign-parented multinational groups when there is a non-corporate parent
- Addressing purchase accounting and other AFSI impacts resulting from M&A transactions
- Adjusting AFSI for financial statement loss carryforwards
- Allowing corporations to cease being applicable corporations
- Providing relief for bankruptcy or insolvency transactions

Penalty Waiver: Notice 2024-66

In addition to the proposed regulations, the Service issued **Notice 2024-66**, which provides a waiver for additional taxes imposed on a corporation that fails to make estimated tax payments related to its CAMT liability for tax years beginning after December 31, 2023, and before January 1, 2025.

As with the previous waivers, this waiver only covers taxes imposed under Section 6655 and does not waive additional taxes for underpayments under other code sections, such as Section 6651, which imposes additional tax for payments not made by the due date of the corporation's return (without extension).

Planning Considerations

The proposed CAMT regulations are substantial in detail, technical complexity, and length and include guidance on many areas applicable to M&A transactions. For example, the proposed regulations address certain effects of M&A transactions on the calculation of AFSI. The proposed regulations also significantly increase the scope of the definition of a foreign-parented multinational group to include some common investment structures. Taxpayers should carefully review the potential impact of the proposed regulations when engaging in M&A transactions and restructurings.

IRS, TREASURY ISSUE FINAL PROCEDURAL REGULATIONS ON STOCK REPURCHASE EXCISE TAX

Under the new corporate excise tax, a 1% corporate-level tax is imposed on net stock repurchases occurring after December 31, 2022. The excise tax applies to *"covered corporations,"* which are generally publicly traded domestic corporations, with certain foreign-owned domestic structures being included as well.

The excise tax was enacted as part of the Inflation Reduction Act of 2022, and the Service provided interim guidance in the form of Notice 2023-2 in December 2022. In April 2024, Treasury released proposed regulations incorporating the operating rules set forth in the notice, proposing additional guidance on foreign stock acquisitions, and responding to feedback received with respect to the notice. Separately but on the same day, Treasury also released proposed procedural regulations that articulate how to report and pay the excise tax.

Specifically for the procedural regulations, the Department of the Treasury and the IRS released **final regulations** on June 28, 2024. The final regulations largely adopt the **proposed regulations**. For taxable years ending on or before June 28, 2024, stock repurchase excise tax returns were required to be filed by October 31, 2024 (the due date for Form 720 for the third quarter of calendar year 2024). If a covered corporation has more than one taxable year ending after December 31, 2022, and on or before June 28, 2024, it should file a single Form 720 with a separate Form 7208 attached for each year.

Consistent with the proposed regulations, future stock repurchase excise tax returns must be filed by the due date of Form 720 for the first full calendar quarter after the end of the taxable year of the covered corporation. For example, a covered corporation with a tax year ending on December 31, 2024, must file its return by April 30, 2025 (the due date for a first-quarter Form 720).

Planning Considerations

Taxpayers should be aware that in certain leveraged transactions — those involving third-party debt — there may be ambiguity in the application of the excise tax depending on the nature of the funding and the obligors on the facility. Any transactions involving exchanges of public company stock should consider these rules and their impact on structuring.

TAX COURT RULES FOR TAXPAYER ON RELATED-PARTY ADVANCES

In *Estate of Thomas H. Fry v. Commissioner of Internal Revenue*, TC Memo 2024-8 (2024), the Tax Court held Section 385(c), which generally binds a taxpayer to its initial characterization of an investment as either debt or equity, did not apply to cash advances where no formal instruments had been issued. This case may have implications for corporations with undocumented related-party advances.

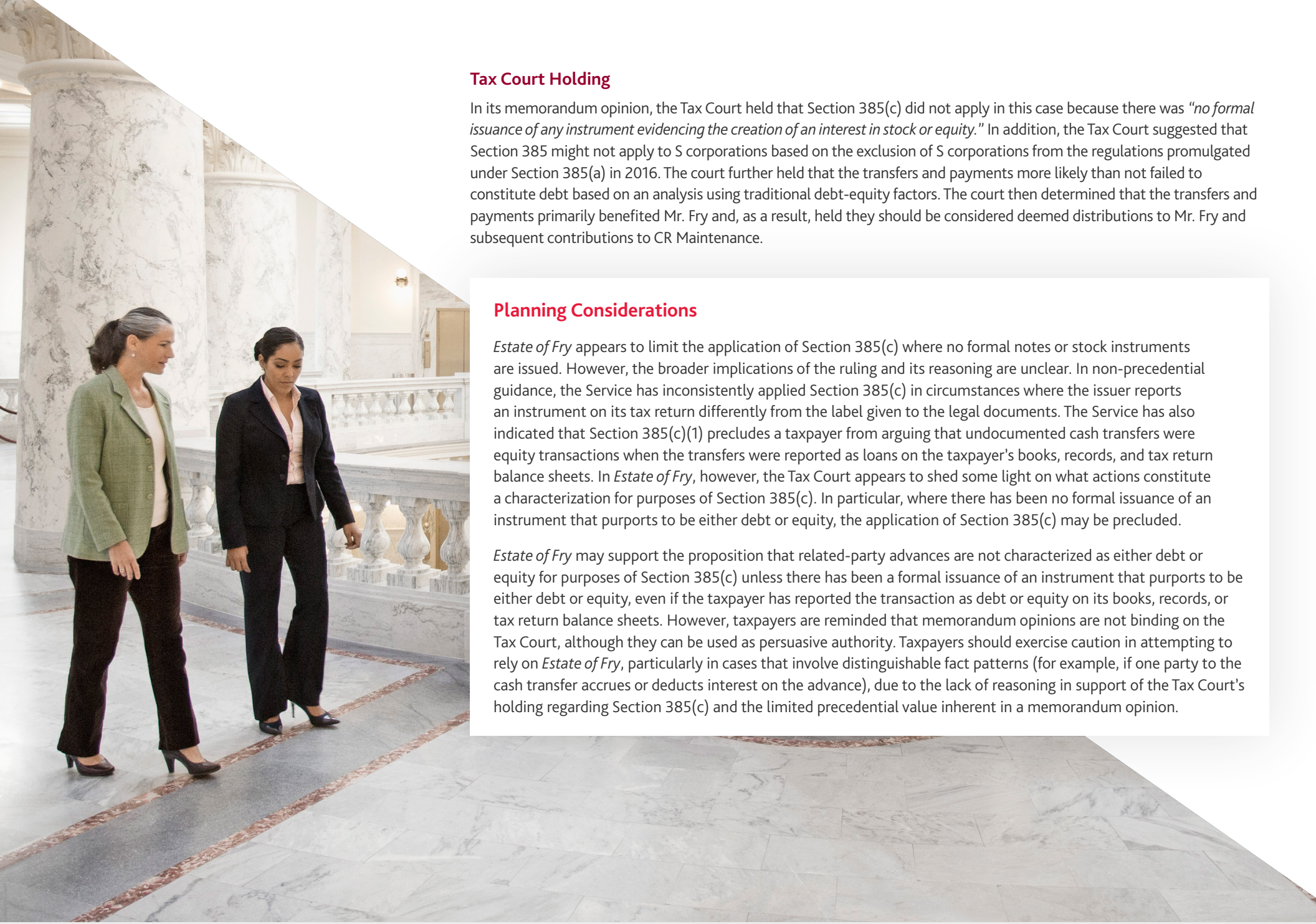
Determining Debt or Equity Treatment for Tax Purposes

Determining whether an interest in a corporation is debt or equity is a fact-intensive inquiry. Courts have traditionally applied multi-factor tests that look at the intent and relationship of the parties, the financial condition of the corporation, and each party's legal and economic rights. As these factors are weighted in each case, and the form or name of the instrument is not necessarily determinative of its treatment, taxpayers face uncertainty as to whether the IRS will agree with their chosen characterization.

In addition, Section 385(c) binds taxpayers to their characterization of an interest in a corporation once a position is taken. The IRS, on the other hand, is not bound by the taxpayer's characterization and has the ability to reclassify an instrument from debt to equity, and vice versa. As a result, taxpayers should perform a detailed assessment to determine the correct treatment before reporting a position on a return. In practice, however, this does not always occur, and later discovery that an instrument's treatment may be questionable often results in taxpayers' performing this assessment after the fact, thereby potentially triggering the application of the Section 385(c) rules.

Estate of Fry v. Commissioner

Mr. Fry was the sole shareholder of two S corporations, Crown and CR Maintenance. CR Maintenance encountered financial difficulties, and Crown provided financial assistance that allowed CR Maintenance to continue operations. In particular, Crown transferred money directly to CR Maintenance and paid bills on CR Maintenance's behalf. The amounts were accounted for as loans on both parties' general ledgers and tax returns but were not otherwise documented. CR Maintenance did not claim interest deductions and Crown did not report interest income related to the amounts. In a dispute concerning Mr. Fry's basis in his CR Maintenance stock, Mr. Fry argued that these transactions should not be considered debt but, instead, should be treated as constructive equity contributions and distributions. The Service disagreed with Mr. Fry, asserting that Section 385(c) precluded him from recharacterizing the transactions as equity contributions.



Tax Court Holding

In its memorandum opinion, the Tax Court held that Section 385(c) did not apply in this case because there was *"no formal issuance of any instrument evidencing the creation of an interest in stock or equity."* In addition, the Tax Court suggested that Section 385 might not apply to S corporations based on the exclusion of S corporations from the regulations promulgated under Section 385(a) in 2016. The court further held that the transfers and payments more likely than not failed to constitute debt based on an analysis using traditional debt-equity factors. The court then determined that the transfers and payments primarily benefited Mr. Fry and, as a result, held they should be considered deemed distributions to Mr. Fry and subsequent contributions to CR Maintenance.

Planning Considerations

Estate of Fry appears to limit the application of Section 385(c) where no formal notes or stock instruments are issued. However, the broader implications of the ruling and its reasoning are unclear. In non-precedential guidance, the Service has inconsistently applied Section 385(c) in circumstances where the issuer reports an instrument on its tax return differently from the label given to the legal documents. The Service has also indicated that Section 385(c)(1) precludes a taxpayer from arguing that undocumented cash transfers were equity transactions when the transfers were reported as loans on the taxpayer's books, records, and tax return balance sheets. In *Estate of Fry*, however, the Tax Court appears to shed some light on what actions constitute a characterization for purposes of Section 385(c). In particular, where there has been no formal issuance of an instrument that purports to be either debt or equity, the application of Section 385(c) may be precluded.

Estate of Fry may support the proposition that related-party advances are not characterized as either debt or equity for purposes of Section 385(c) unless there has been a formal issuance of an instrument that purports to be either debt or equity, even if the taxpayer has reported the transaction as debt or equity on its books, records, or tax return balance sheets. However, taxpayers are reminded that memorandum opinions are not binding on the Tax Court, although they can be used as persuasive authority. Taxpayers should exercise caution in attempting to rely on *Estate of Fry*, particularly in cases that involve distinguishable fact patterns (for example, if one party to the cash transfer accrues or deducts interest on the advance), due to the lack of reasoning in support of the Tax Court's holding regarding Section 385(c) and the limited precedential value inherent in a memorandum opinion.

IRS RULES STOCK CONTRIBUTIONS WILL NOT RESULT IN DEEMED DIVIDENDS OR APPLICATION OF GIFT TAX

A shareholder may, for valid business reasons (e.g., to improve the marketability of an investment), voluntarily surrender shares to the capital of a corporation, which raises questions of how the surrender impacts the other shareholders in the corporation. In **PLR 202406002**, the IRS ruled that a proposed voluntary surrender of shares to the capital of a corporation will not create deemed dividend income for the noncontributing shareholders and will not result in a taxable gift to the noncontributing shareholders.

In the proposed transaction, an executive of the company and a series of trusts established by that executive will contribute a proportionate amount of their common shares to the company for no consideration. The contribution of the shares may occur in one or more installments. The company has in place a share repurchase program, but neither the executive nor the trusts have participated in the program. The share repurchase program and the proposed contribution each have separate independent business purposes.

Income tax rulings

Citing *Commissioner v. Fink*, 483 U.S. 89 (1987), the Service ruled in PLR 202406002 that the executive and the trusts will not recognize gain or loss as a result of the contribution and that the basis in the shares contributed will be preserved in the basis of the executive's and the trusts' respective retained shares. In addition, the Service ruled that the contribution will be a contribution to the capital of the company and, therefore, will not be taxable to the company under Internal Revenue Code (IRC) Section 118(a).

The Service also indicated that the noncontributing shareholders will not recognize income as a result of the contribution and specifically provided that the contribution will not be treated as a distribution of property to the noncontributing shareholders. The ruling is subject to many key representations, including that (i) there is no belief that any purchase pursuant to the share repurchase program will be taxed as a dividend to the participating shareholder or is a dividend within the meaning of IRC Sections 301 and 302; (ii) the contribution is an isolated transaction; and (iii) the contribution is not part of a plan to periodically increase the proportionate share of any shareholder in the assets or earnings and profits of the company. Nevertheless, the contribution will have the economic effect of increasing the noncontributing shareholders' proportionate interest in the assets and earnings and profits of the company.

IRC Section 305(c) provides a broad rule that creates a deemed distribution of stock in certain transactions involving a corporation and its shareholder(s) (e.g., recapitalizations), which may be taxable under the general distribution rules of Section 301. By ruling that the contribution will not result in a deemed distribution to the noncontributing shareholders (likely because no deemed dividend results when a recapitalization is not undertaken pursuant to a plan to increase a shareholder's proportionate interest in the assets or earnings and profits of the corporation), the IRS eliminated any potential taxation of the economic benefit conferred on the noncontributing shareholders under Section 305 or Section 301.

Gift tax rulings

The Service also ruled that gift tax will not apply to the increase in value bestowed on the noncontributing shareholders by the executive and the trusts as a result of the contribution, because the contribution is a transaction occurring in the ordinary course of business (i.e., it is undertaken for bona fide business reasons, it is an arm's length transaction, and the executive and the trusts lack donative intent). The Service also recognized that the executive and the trusts are conferring an economic benefit on each other and between each of the trusts. However, the Service ruled that these are effectively value-for-value exchanges and, therefore, will not be subject to gift tax.

Planning Considerations

PLR 202406002 closes the loop started by *Commissioner v. Fink* and provides answers that avoid adding unintended tax consequences and complexity to a transaction that is usually undertaken for independent, nontax business reasons. In *Fink*, the Supreme Court denied a loss to a corporation's dominant shareholder following the shareholder's voluntary surrender of shares to the corporation, viewing the surrender as a contribution to capital. Instead, the Court held that the basis in the contributed shares must be added to the shares retained by the shareholder. The Supreme Court case serves as authority for the shareholder's gain or loss and basis consequences resulting from a stock surrender. The classification of the transaction as a contribution to the capital of a corporation supports the application of IRC Section 118(a) to prevent the transferee corporation from including any amount in its gross income. With the issuance of PLR 202406002, taxpayers and practitioners now have an indication of the Service's view of the other aspects of a stock surrender—namely, the treatment to the noncontributing shareholders. Taxpayers considering surrendering shares to the capital of a corporation should consult with their advisors regarding the application of PLR 202406002 to their facts.

UNCERTAINTIES SURROUND TREATMENT OF S CORPORATION STATE LAW CONVERSIONS

Comments submitted on behalf of the American Bar Association Section of Taxation (ABA tax section) in a letter dated July 2, 2024, suggest the IRS should supplement or expand its 2008 guidance on F reorganizations involving S corporations and qualified subchapter S subsidiaries (QSubs) to include consequences of an F reorganization accomplished by state law conversion to a limited liability company (LLC). The additional guidance is needed to address uncertainties in planning and other transactions commonly used by S corporations and their shareholders.

Summary of 2008 IRS Guidance

Rev. Rul. 2008-18 provides guidance on whether, in an F reorganization involving an S corporation, the historic Subchapter S election and employer identification number (EIN) continue for the reorganized (surviving) entity. The revenue ruling addresses two specific transactions, each of which meet the requirements of an F reorganization under Section 368(a)(1)(F):

Situation 1: The shareholder of an S corporation contributes all of the S corporation stock to a newly formed corporation (Newco). A valid QSub election is made for the contributed corporation, causing it to be a disregarded entity treated as a division of Newco.

Situation 2: In a plan of reorganization, an S corporation creates a newly formed corporation (Newco), which also creates a newly formed corporation (Mergeco). Mergeco merges into the S corporation, with the S corporation's shareholder receiving the stock of Newco. A valid QSub election is made for the S corporation (now a subsidiary of Newco), causing it to be a disregarded entity treated as a division of Newco.

The 2008 ruling concludes that under these two fact patterns, the historic S corporation election does not terminate but continues for the corporation that is the survivor of the reorganization (Newco). However, Newco must obtain a new EIN.

Uncertainties Surrounding S Corporation State Law Conversions

Rev. Rul. 2008-18 does not address the continuation of an S corporation election or EIN when the S corporation undergoes an F reorganization (with or without a QSub election made for the contributed corporation) through a state law *"conversion"* to an LLC. Whether a QSub election is necessary in a state law conversion is also unclear, since — assuming no entity classification election is made to treat the LLC as a regarded corporation — the surviving LLC would be disregarded under Treas. Reg. §301.7701-3. If a QSub election is required by the IRS, the election would not be valid if made after the corporation converts to an LLC.

In addition, any delay by the state in processing the conversion raises questions about whether the subsidiary loses its S corporation status in the reorganization transaction and, therefore, reverts to C corporation status for a period of time. If so, the corporation could be subject to built-in gains tax under Section 1374.

Comment Letter Recommendations

To address the uncertainties for S corporations surrounding F reorganizations accomplished by state law conversions, the ABA tax section in its comment letter recommends the IRS supplement or expand Rev. Rul. 2008-18 to address a third situation:

Situation 3: The shareholder of an S corporation contributes all of the S corporation stock to a newly formed corporation (Newco). The contributed corporation is converted under state law from a corporation to an LLC for which no entity classification election is made. In addition, no QSub election is made for the contributed corporation.

The comment letter concludes that this fact pattern should have the following consequences:

- The historic S corporation election would not terminate but would continue for the newly formed corporation as the survivor of the reorganization
- The LLC (formerly the S corporation) would retain its historic EIN
- The newly formed survivor corporation would need to obtain a new EIN
- The LLC would be respected as a disregarded entity, eliminating the need to make a QSub election, and would not be treated as a C corporation for federal income tax purposes for any period of time during the reorganization transaction, including for purposes of taxing built-in gains under Section 1374

Should the IRS not accept the comment letter's suggestions to update or supplement their 2008 guidance, the ABA tax section alternatively recommends the IRS provide a streamlined procedure for curing a timely but invalid QSub election. This would be similar to **Rev. Proc. 2013-30**, where an election has been deemed invalid because the subsidiary did not meet the domestic corporation requirement at the time the election was made.

Planning Considerations

A QSub can provide tax planning opportunities where there is a business reason to maintain S corporation operations in a separate subsidiary. For example, since a QSub is a disregarded entity, the sale of an interest in a QSub is treated as a sale of its assets for federal income tax purposes, which provides the buyer with a step-up in the tax basis of the acquired assets. There may be other benefits as well, and F reorganizations may be used in pre-transaction planning structuring. For more information on Rev. Rul. 2008-18 and the use of F-reorganizations and QSubs, see BDO's article ***"F" Reorganization Under Rev. Rul. 2008-18: Timing Of QSUB Election Is Key***.

IRS RULES PROFESSIONAL CORPORATION ARRANGEMENT REQUIRES CONSOLIDATION

Many states, through licensing and regulation of professions like medicine or law, restrict or prohibit business ownership by unlicensed individuals or entities. To invest in these types of businesses without violating state law, investors often must enter into contractual arrangements pursuant to which the investor acquires economic rights without changing the ownership of legal title. In **PLR 202417008**, the IRS ruled that a professional corporation must join an investor's existing consolidated group as a result of legal agreements that granted the investor beneficial ownership of the professional corporation's stock.

In the PLR, two professional corporations, PC1 and PC2 (together, the PCs), entered into agreements with a member of an existing consolidated group (Sub), either directly or indirectly through a disregarded entity of Sub, for administrative and management support services. In addition, the PCs and their respective shareholders entered into agreements with Sub (or its disregarded entity) restricting (i) the transferability of the shares in the PCs and (ii) the ability of the PCs to undertake certain corporate actions.

Citing IRC Section 1504(a) and Rev. Rul. 84-79, the IRS ruled that upon executing the above-mentioned agreements, PC1 and PC2 will join the consolidated group with respect to which Sub is a member. For a corporation (other than a common parent) to join a consolidated group, Section 1504(a) requires that members of a consolidated group directly own a certain amount of stock in the corporation. Case law and IRS guidance (including Rev. Rul. 84-79) indicate that direct ownership for purposes of Section 1504(a) means beneficial ownership (which is generally determined based on the economic substance of the arrangement), not mere possession of legal title. The IRS found that the legal agreements between the PCs, the shareholders of the PCs, and Sub (or its disregarded entity) separated legal title (i.e., legal ownership) from the economic rights (i.e., beneficial ownership), the latter of which Sub (or its disregarded entity) obtained as result of the contractual arrangements.

Planning Considerations

The PLR is consistent with similar rulings previously issued by the IRS, all of which are predicated on state law not prohibiting beneficial ownership by non-professionals and underscore the beneficial ownership aspect of the Section 1504(a) test. PLR 202417008 highlights the contractual arrangements involved in the transfer or acquisition of beneficial ownership, giving investors interested in participating in the economics of certain regulated businesses a view of the key legal documents and provisions the IRS evaluated in applying Section 1504(a).

Customs & International Trade

As 2024 comes to a close, companies that import tangible merchandise into the U.S. should consider available duty mitigation strategies. The Biden administration has maintained all existing Section 301 China tariffs (either 25% or 7.5% as imposed under the Trump administration) and recently announced its final determinations for steep tariff hikes on certain Chinese-origin products such as electric vehicles, batteries, semiconductors, solar cells, etc. Former president Trump also indicated his intention to more than double the existing China tariffs and impose widespread tariffs up to 20% on all U.S. imports if he is elected in November.

Duty drawback, the first sale rule (FSR), and cost unbundling can help U.S. importers legitimately mitigate the impact of normal duties, as well as the additional tariffs. These measures can have a significant financial impact on businesses' profitability given that customs duties are an *"above the line"* cost, i.e., they are always cash.

DUTY DRAWBACK

Many businesses involved in importing goods into the U.S. may not realize they have a significant opportunity for cash refunds through the duty drawback program. Duty drawback is the refund of duties (including Section 301 tariffs), taxes, and fees paid on imported merchandise that is exported unused, or used to manufacture a product that is exported. Eligible drawback claims result in a refund of 99% of the duties, taxes, and fees paid on imported merchandise. A drawback request can be filed within five years from the date the goods were imported into the U.S.; the first set of drawback claims typically takes eight to 10 months for recovery but 30~45 days for claims thereafter if privileges are secured.

The main types of duty drawback are:

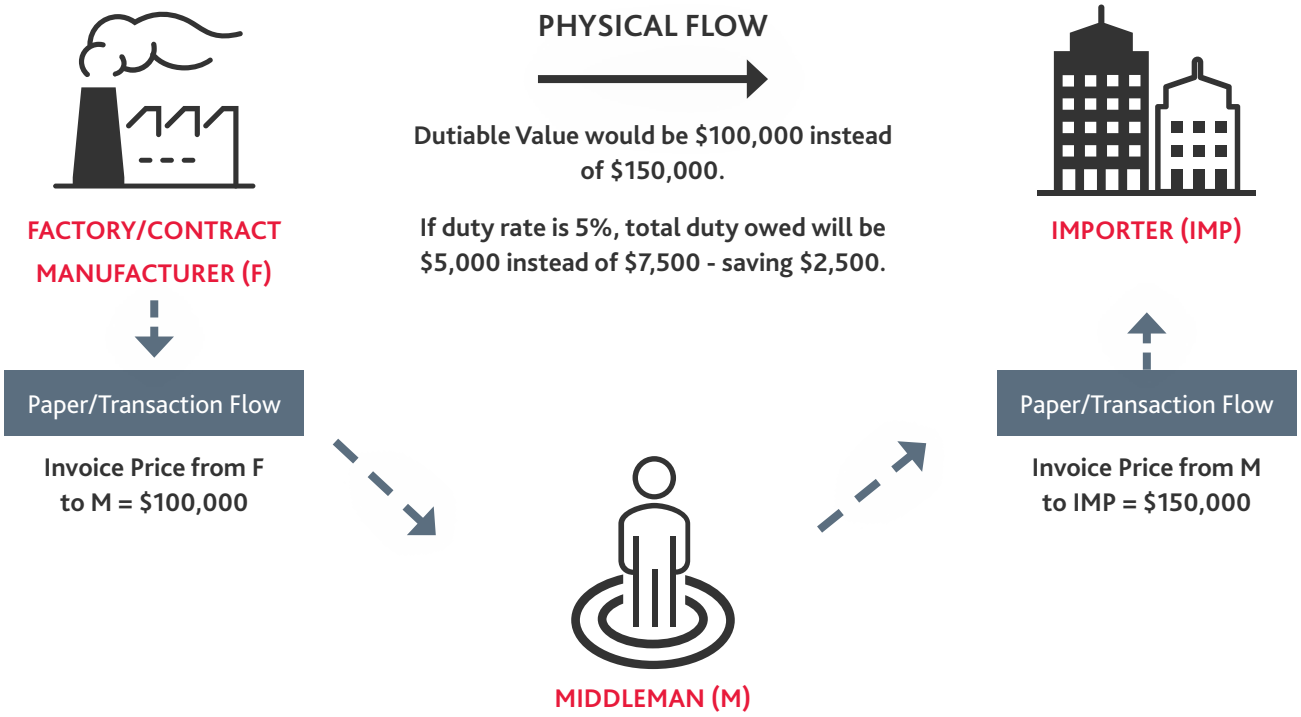
- **Unused Merchandise Direct Identification:** Merchandise unused in the U.S. that is imported and exported (or destroyed) and matched at the Product/Item No. level
- **Unused Merchandise Substitution:** Merchandise unused in the U.S. that is imported and exported (or destroyed) and matched at the HTS number level (U.S. customs classification system for products)
- **Manufacturing Direct Identification:** Components that are imported and further manufactured in the U.S. into an article that is exported (or destroyed), and matched to components of the same Product/Item No.
- **Manufacturing Substitution:** Components that are imported and further manufactured in the U.S. into an article that is exported (or destroyed) and matched to components of the same Harmonized Tariff Schedule (HTS) number level (U.S. Customs classification system for products)

The duty drawback process can be complex and challenging, but with the right experienced professionals, businesses can potentially unlock financial benefits. BDO's Customs and International Trade team is equipped to assist companies in setting up new duty drawback programs or evaluating existing programs to optimize savings objectives.

FIRST SALE RULE

Importers must report the correct value of merchandise imported into the U.S. Under U.S. Customs and Border Protection (CBP) rules, value is normally the price reflected on the commercial invoice issued from a foreign seller to a U.S buyer. However, if an earlier sale exists in the supply chain (e.g., from a foreign manufacturer to the foreign seller), the importer may consider applying the FSR. For instance, many transactions involve the use of a contract manufacturer selling to a middleman that re-sells the merchandise to the U.S. importer. Such a scenario implicates the FSR, under which the lower factory to middleman price and not the middleman price to the U.S. importer can be used as the value reported to CBP.

Customs Valuation — FSR Illustration



Under the illustration, if the U.S. importer can satisfy specific conditions, the customs value can be determined based on the factory's selling price to the middleman (i.e., $100,000), rather than the middleman's selling price to the U.S. importer (i.e., $150,000). Consequently, the total duty owed by the U.S. importer can be reduced by $2,500. To import goods under the FSR, (1) the goods must be clearly destined for export to the U.S., (2) there must be a bona fide sale between the parties, and (3) the first sale value must be an arm's length amount. Given that the FSR can reduce Normal Trade Relations (NTR) duties and additional duties such as Section 301 China tariffs, U.S. importers should consider taking steps to potentially lower the customs value of merchandise imported into the U.S.

COST UNBUNDLING

Businesses can consider other ways to legally lower the value of imported merchandise (i.e., the basis of duties) through cost unbundling exercises that examine key cost elements for goods to determine whether they are required to be included in customs value. For example, certain management fees, buying commissions, exclusive distribution rights fees, and U.S. R&D costs are generally considered nondutiable, so if these costs/fees are already included in the value of the imported merchandise, U.S. importers may deduct them from the final customs value. However, given that identification of nondutiable cost elements is highly technical and has to be ascertained on a case-by-case basis, professional advice should be sought.

Global Employer Services

SEC SETTLEMENT DATE CHANGE AFFECTS EQUITY COMPENSATION PLAN ADMINISTRATION

Effective May 28, 2024, the Securities and Exchange Commission (SEC) amended the rules under the Securities Exchange Act of 1934 to shorten the securities transaction settlement cycle for most broker-dealer security transactions. As a result, companies should verify that their payroll tax procedures can meet the deposit rules for equity compensation.

Settlement dates are referred to as T+1, T+2, T+3, and so forth, and "*T*" stands for transaction date, the day the transaction takes place. The numbers 1, 2, or 3 denote the number of subsequent days on which the transfer of money and security "*settlement*" takes place. Weekends and public holidays are not included in the day count.

Prior to the change, the standard settlement cycle for all stocks was T+2, but is now T+1, which accelerates the date on which participants in equity compensation plans utilizing a same-day sale arrangement become the shareholders of record entitled to appreciation, dividends, etc. Plans such as stock-settled restricted stock units (RSUs), stock options, stock appreciation rights (SARS) and Employee Stock Purchase Plans (ESPPs) will all be impacted.

The accelerated settlement date also marks the beginning of the timeline on which withheld income and employment taxes must be deposited along with the employer's share of employment taxes.

Coordination between broker, payroll department, tax department, and transfer agent is important to ensure that the employer makes timely payroll tax deposits under the accelerated timeline. While the coordination process should be reviewed in the context of tax compliance, the scrutiny also provides an opportunity to review the plan's efficiency and employee satisfaction. This will be especially important when dealing with globally mobile populations.

Planning Considerations

Automation: Given the constraint on timing and resources imposed by the new regulations, companies may evaluate opportunities for automation such as **BDO's Global Equity Mobility Solution** (GEMS) tool. GEMS is an automated solution that utilizes transaction data and cross-border travel information to help companies avoid risk when working through their payroll reporting and withholding obligations.

Fair market value (FMV) considerations: Companies may want to revisit the FMV they use for valuation purposes. If using the closing price on the day of vesting, for example, the companies are shortening the window to execute all the steps to meet T+1 settlement and T+2 tax deposit deadlines.

Awards settlement: Share delivery would need to be initiated on the transaction date for settlement to occur on T+1. Therefore, withholding taxes will need to be finalized on the day of the transaction, which might prompt companies to revisit the alternatives they provide their employees to fund the taxes, such as net settlement, sell-to-cover, and cash payment, because some of the options may further delay settlement.

WELLNESS PLANS PURPORTING TO AVOID PAYROLL TAXES MIGHT BE TOO GOOD TO BE TRUE

On two different occasions, the IRS has alerted employers to beware of companies misrepresenting nutrition, wellness, and general health personal expenses as medical care expenses for health flexible spending arrangements (FSAs), health savings accounts (HSAs), health reimbursement arrangements (HRAs), or medical savings accounts (MSAs), collectively health spending plans.

A May 2024 IRS news release — IR 2024-65 — addressed a concern that people may be misled by promoters of health spending plans as to which general health and wellness expenses will be reimbursed to employees and points out that personal expenses are not considered medical expenses under IRC Section 213(d) and therefore are not deductible or reimbursable under FSAs and other health spending plans.

In Chief Counsel Advice (CCA) 202323006, issued on June 9, 2023, the IRS makes it clear that unless participants have qualifying Section 213(d) medical expenses, the cash benefits paid to them from these wellness plans will be taxable wage income, subject to both income and employment taxes. See IRS Pub. 502 for a discussion of what is and is not a Section 213(d) medical expense. Also, the IRS has provided frequently asked questions on medical expenses related to nutrition, wellness, and general health to determine whether a food or wellness expense is a medical expense to help distinguish medical from personal expenses.

The news release reiterates the items covered in CCA 202323006 and emphasizes that only plans that pay or reimburse bona fide medical expenses as defined by IRC Section 213(d) qualify an employee to make pretax contributions to a health benefit account and that distributions not used for IRC Section 213(d) medical expenses are taxable. Thus, contributions to plans that provide for the payment of non-medical wellness expenses are not deductible and payments under the plans are not tax free under FSA, HSA, HRA, and MSA rules. If the plan does not satisfy the IRC requirements, **all payments made to all participants in the plan, even allowable reimbursements for actual medical expenses, are includible in income.**

The promoters, some of which are former employee retention credit promoters, typically provide seemingly credible materials that often include a reliable legal opinion on the validity of the tax savings generated when employees make elective deferrals to health care arrangements under IRC Section 125. However, the legal opinion usually does not opine on the type of expenses discussed by the promoter or address how the payment of *"wellness"* expenses impacts the intended tax benefits.

Planning Considerations

As noted in CCA 202323006 and IR-2024-65, wellness plans often do not provide the tax benefits represented by promoters. Moreover, once an employer begins operating a defective wellness plan that allows reimbursements that are not eligible for tax-free treatment, it may be years before this fact comes to light, creating significant problems for employers who must correct past Forms W-2, Forms 941, etc. for open tax years.

Accordingly, a review of the proposed wellness or any other plan offering FICA exemption by a trusted tax advisor should be obtained prior to adoption. If one of these plans has already been implemented, consideration should be given to terminating the plan. Continued operation of the plan carries the risk of an IRS payroll examination through which the IRS might seek to collect taxes, penalties, and interest related to the failure to withhold and remit taxes when due and assert penalties based on the employer's incorrect filing and issuing of its Forms W-2.

Typically, the statute of limitations is three years, but it could be six years for substantial understatements. Employee morale issues can also arise, because employees may be required to amend their past years' Forms 1040 individual income tax returns.

NEW REQUIREMENT TO COVER LONG-TERM PART-TIME EMPLOYEES IN 401(K) AND 403(B) PLANS

The Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act of 2019) and the SECURE 2.0 Act of 2022 (collectively, SECURE) enacted a new mandate that, starting in 2024, long-term, part-time (LTPT) employees must be allowed to make salary deferrals into their employer's 401(k) plan. Starting in 2025, 403(b) plans are subject to the LTPT rules and LTPT employee eligibility is reduced from three years of service to two years of service.

The systems used by many 401(k) and/or 403(b) plan service providers may not be ready for the required implementation starting with the first plan year beginning on or after January 1, 2024, for 401(k) plans (i.e., January 1, 2024, for calendar year 401(k) plans) and the first plan year beginning on or after January 1, 2025, for 403(b) plans (i.e., January 1, 2025, for calendar year 403(b) plans).

Some executives may view this change as an issue that does not require their attention and that will be handled by their human resources (HR) staff and the 401(k) plan service providers. But not complying with the rules might be costly for the employer if corrective contributions for LTPT employees who were not allowed to participate are required, along with ancillary costs.

New Mandate

For decades, 401(k) plans could exclude employees who work fewer than 1,000 hours of service per year, even if the employee worked for the employer for many years. Employees who worked over 1,000 hours generally could not be excluded from the plan (with certain non-hours-based exceptions). In contrast, 403(b) plans are subject to the so-called *"universal availability"* rule, which makes almost all employees eligible to make elective deferrals into the plan, with certain exceptions.

To improve access to workplace retirement savings plans, the 2019 SECURE Act required 401(k) plans to allow employees who have worked at least 500 hours in three consecutive years (based on employment with the employer from January 1, 2021, onward) to make elective deferrals to the plan. Thus, if an employee had 500 hours of service in 2021, 2022, and 2023 (but never had 1,000 hours of service per year), that employee must be allowed to make salary deferrals into the employer's 401(k) plans starting with the first plan year beginning on or after January 1, 2024. For plan years beginning in 2025 and later, SECURE 2.0 of 2022 reduces the three-year measurement period to two years. In addition, 403(b) plans become subject to the LTPT employee rules starting with the first plan year beginning on or after January 1, 2025.

Why Should Employers be Concerned?

While employers are not required to match the LTPT employee deferrals and LTPT employees are excluded from the annual tests that otherwise apply to all employees (e.g., coverage, nondiscrimination, and top-heavy requirements), there might be some increased cost to the plan sponsor for including LTPT employees in the 401(k) plan.

Planning Considerations

While plan sponsors might rely on their plan service providers to identify eligible LTPT employees, liability for noncompliance remains on the employer. The risk associated with not allowing LTPT employees to make elective deferrals to a 401(k) or 403(b) plan can be avoided if the plan lowers the plan's eligibility rules or determines eligibility on the elapsed time method instead of the counting hours method of determining eligibility to make salary deferrals under the plan.

SECURE provides numerous exceptions from coverage, nondiscrimination, and top heaviness tests for employees who participate in the plan solely on account of the LTPT employee provisions. Any employee that satisfies the more generous plan document provisions will not qualify for the confusing rules that otherwise apply to LTPT employees. Still, avoiding LTPT employee status altogether might be cost effective.

BDO can assist your review of your 401(k) and/or 403(b) plan provisions to evaluate the cost benefit analysis of implementing the LTPT employee rules.

IRS DRASTICALLY EXPANDS ELECTRONIC FILING REQUIREMENT FOR MOST TAX AND INFORMATION RETURNS

Almost all federal tax and information returns filed on or after January 1, 2024, must be submitted to the IRS electronically instead of on paper.

Under the new rules, filers of 10 or more returns of **any type** for a calendar year generally will need to be filed electronically with the IRS. Previously, electronic filing was required if the taxpayer filed more than 250 returns **of the same type** for a calendar year.

Who is affected?

Practically all filers with the IRS of 10 or more information returns — when counting any type, such as Forms W-2, Forms 1099, Affordable Care Act Forms 1094 and 1095 and Form 3921 (for incentive stock options) and other disclosure documents -- are impacted by this change for 2023 returns that will be filed in 2024. Even workplace retirement plans may need to file Form 1099-Rs (for benefit payments) and other forms electronically with the IRS starting in 2024, for the 2023 plan or calendar year.

Which returns are affected?

In addition to the information returns that are the primary focus of this article, the new rules cover a broad variety of returns, including partnership returns, corporate income tax returns, unrelated business income tax returns, withholding tax returns for U.S.-source income of foreign persons, registration statements, disclosure statements, notifications, actuarial reports and certain excise tax returns.

How to count to 10?

The 10-return threshold for mandatory electronic filing is determined on the aggregate number of different types of forms and returns. The aggregation rules are confusing because the filings included in the count change depending on which form the determination is made. Also, some filers must be aggregated with all entities within the controlled or affiliated service group to determine if 10 or more returns are being filed for the tax year. For instance, Form 5500 employee benefit plan filers (but not Form 8955-SSA employee benefit plan filers) must count the filings of the employer who is the *"plan sponsor"* and other entities in the employer's controlled and affiliated service group.

Example 1: Company A is required to file five Forms 1099-INT (Interest Income) and five Forms 1099-DIV (Dividends and Distributions), for a total of 10 information returns. Because Company A is required to file a total of 10 information returns, Company A must file all of its 2023 Forms 1099-INT and 1099-DIV electronically, as well as any other return(s) that are subject to an electronic filing requirement. The reason for this result is that *"specified information returns"* such as Forms 1099 and W-2 must be aggregated when counting to determine whether the new 10-or-more threshold for electronic filing is met.

Example 2: Corporation X, a C corporation with a fiscal year end of September 30, was required to file one Form 1120 (U.S. Corporation Income Tax Return) during the calendar year ending December 31, 2023, six Forms W-2 (for employees), three Forms 1099-DIV (for dividend distributions), one Form 940 (Employer's Annual FUTA Tax Return) and four Forms 941 (Employer's Quarterly Federal Tax Return). Because the Form 1120 aggregation rules include returns of any type during the calendar year that ends with or in the taxable year and Corporation X is required to file more than 10 returns of any type during calendar year 2023, Corporation X is required to file its Form 1120 electronically for its taxable year ending September 30, 2024.

Planning Considerations

The new mandatory electronic filing rules are complicated and penalty exposure may be significant.

Filers must, for the first time, pay particular attention to the total number of returns across all return types, because the new electronic filing threshold is determined based on the aggregate total, not the number of returns per return type. This might require coordination between different departments within an organization and immediate consultation with the IT department and/or software provider to ensure there is adequate time to implement technology solutions or software upgrades before the filing deadline.

Affected employers may need significant lead time to implement new software, policies, and procedures to comply with the new rules. Simply doing the *"same as last year"* will not work for many employers.

BDO can help employers understand and comply with the new rules, which could include facilitating electronic filing.

Even if filers are not required to file electronically under the new rules, they may want to consider doing so, as electronic filing has become more common, accessible, and economical. Electronic filing may reduce administrative efforts compared to paper filing, increase accuracy, and improve record retention.

Income Tax - ASC 740

Correctly accounting for and disclosing income taxes under ASC 740 is complex. As the end of the year draws closer, now is a good time to evaluate your company's income tax accounting policies.

That is especially so this year, given the impending effective date of Accounting Standards Update (ASU) No. 2023-09, "*Income Taxes (Topic 740): Improvements to Income Tax Disclosures,*" which the Financial Accounting Standards Board (FASB) issued in late 2023. Given the potential complexity of the ASU's new requirements, firms should consider whether processes, systems, and internal controls should be modified to facilitate effective implementation.

Special attention should be given to your tax function's internal controls, which are vital to reducing risk and capitalizing on available resources.

This year-end planning guide walks you through the most important aspects of the ASU, as well as what to consider in designing strong internal tax controls that can help reduce reporting errors.

FASB ISSUES FINAL ASU TO IMPROVE INCOME TAX DISCLOSURES

In response to feedback from the investor community requesting the disclosure of additional information pertaining to income taxes, the FASB issued ASU **2023-09** in December 2023. One of the ASU's overarching themes is the disaggregation of information that may previously have been aggregated or commingled, a change that's expected to provide greater transparency and consistency. In particular, the disclosure requirements seek to increase visibility into various income tax components that affect rate reconciliation, as well as the qualitative and quantitative aspects of those components.

Main Provisions

The ASU requires public business entities ((PBEs) replacing the term "*public entities*") to disclose additional information in specified categories with respect to the reconciliation of the effective rate to the statutory rate for federal, state, and foreign income taxes. It also requires greater detail about individual reconciling items in the rate reconciliation if the impact of those items exceeds a threshold.

Under the ASU, PBE information pertaining to taxes paid (net of refunds received) must be disaggregated for federal, state, and foreign taxes and further disaggregated for specific jurisdictions if the related amounts exceed a quantitative 5% threshold. That threshold is determined by multiplying 5% by the product of pretax income (or loss) from continuing operations and the applicable federal statutory rate, and it essentially emulates the requirement in SEC Regulation S-X.

The ASU also describes items that need to be disaggregated based on their nature, which is determined by reference to the item's fundamental or essential characteristics.

Updated Annual Disclosure Requirements

Rate Reconciliation

ASU 2023-09 specifies categories for which disclosures associated with the rate reconciliation are required, and each category has varying degrees of qualitative and/or quantitative disclosure.

PBEs

The following categories must be included in annual disclosures in the rate reconciliation in tabular form both in amounts in the applicable reporting currency and in percentages:

- State and local income taxes in the country of domicile net of related federal income tax effects
- Foreign tax effects, including state or local income taxes in foreign jurisdictions
  - Reflects income taxes imposed by foreign jurisdictions
  - Disaggregation is required when individual reconciling items equal or exceed the 5% threshold. This would include the statutory rate differential between the foreign jurisdiction and that of the county of domicile
  - If an individual foreign jurisdiction meets the 5% threshold, it must be separately disclosed as a reconciling item. Further disaggregation is required for that jurisdiction for cross-border tax laws, tax credits, and nontaxable or nondeductible items that meet the 5% threshold
- Effects of changes in tax laws or rates enacted in the current period
  - Applies to federal taxes of the country of domicile
  - Reflects the cumulative tax effects of a change in enacted tax laws or rates on current or deferred tax assets and liabilities at the date of enactment
- Effect of cross-border tax laws
  - Applies to incremental income taxes imposed by the jurisdiction of domicile on income earned in foreign jurisdictions. When the country of domicile taxes cross-border income but also provides a tax credit on the same income during the same reporting period, the tax effect of both the cross-border tax and its related tax credit may be presented on a net basis
  - Disaggregation required when individual reconciling items equal or exceed the 5% threshold and by nature of the item
- Tax credits
  - Applies to federal taxes of the country of domicile
  - Disaggregation required when individual reconciling items equal or exceed the 5% threshold and by nature of the item
  - This category does not include foreign tax credits
- Changes in valuation allowances
  - Applies to federal taxes of the country of domicile. For example, any change in valuation allowance in a foreign jurisdiction would be included in the foreign tax effects category and separately disclosed as a reconciling item if greater than the 5% threshold
- Nontaxable or nondeductible items
  - Applies to federal taxes of the country of domicile
  - Disaggregation required when individual reconciling items equal or exceed the 5% threshold and by nature of the item
- Changes in unrecognized tax benefits
  - Aggregate disclosure of changes in unrecognized tax benefits is allowed for all jurisdictions
  - This category reflects reconciling items resulting from changes in judgment related to tax positions taken in prior annual reporting periods
  - When an unrecognized tax benefit is recorded in the current annual reporting period for a tax position taken or expected to be taken in the same reporting period, the unrecognized tax benefit and its related tax position may be presented on a net basis in the category in which the tax position is presented

The FASB has determined that all reconciling items should be presented on a gross basis. However, it will allow net presentation of the effects of specific cross-border tax laws and the associated effects of foreign tax credits, as well as the netting of current-year uncertain tax positions and current-year tax positions against the relevant category. If a foreign jurisdiction meets the 5% threshold, it must be disclosed as a reconciling item. Irrespective of whether any foreign jurisdiction satisfies the 5% threshold, any individual item meeting the 5% threshold must be disclosed by nature.

PBEs must disclose the state and local jurisdictions that contribute to the majority (greater than 50%) of the effect of the state and local tax category, beginning with the state or local jurisdiction having the largest effect and proceeding in descending order.

If the information is not otherwise evident, PBEs must explain any disclosed reconciling items in the categories above, including their nature, effect, and underlying causes, as well as the judgment used in categorizing them.

It is noteworthy that the FASB decided to align the disclosure requirements with those in SEC Regulation S-X Rule 4-08(h)(2). The federal rate for a foreign entity should normally be that of the entity's jurisdiction of domicile. However, if that rate is other than the U.S. corporate rate, both the rate and the basis for its use must be disclosed.

Entities Other Than PBEs

For entities other than PBEs, a qualitative disclosure of the nature and effect of the categories of items discussed above is required along with the individual jurisdictions that result in a significant difference between the statutory and effective tax rates. A numerical reconciliation is not required.

Income Taxes Paid

The ASU requires that all entities annually disclose the amount of income taxes paid (net of refunds received) disaggregated by federal, state, and foreign jurisdictions. It requires further disaggregation for any jurisdiction where the amount of income taxes paid is at least 5% of the total income taxes paid. In quantifying the 5% threshold for income taxes paid, the numerator of the fraction should be the absolute value of any net income taxes paid or income taxes received for each jurisdiction and the denominator should be the absolute value of total income taxes paid or refunds received for all jurisdictions in the aggregate.

Income Statement

The ASU makes some minor changes to the required income statement disclosures relating to income taxes, stipulating that income (loss) from continuing operations before income tax expense (benefit) be disclosed and disaggregated between domestic and foreign sources. It mandates the disclosure of income tax expense (benefit) from continuing operations disaggregated by federal, state, and foreign jurisdictions. Income tax expense and taxes paid relating to foreign earnings that are imposed by the entity's country of domicile would be included in tax expense and taxes paid for the country of domicile.

Eliminated Disclosures

ASU 2023-09 eliminates the historic requirement that entities disclose information concerning unrecognized tax benefits having a reasonable possibility of significantly increasing or decreasing in the 12 months following the reporting date. It also removes the requirement to disclose the cumulative amount of each type of temporary difference when a deferred tax liability is not recognized because of the exceptions to comprehensive recognition of deferred taxes related to subsidiaries and corporate joint ventures. Entities should continue to disclose the types of temporary differences for which deferred tax liabilities have not been recognized under ASC 740-30-50-2(a), (c), and (d).

Effective Dates and Transition

All entities should apply the ASU prospectively with an option for retroactive application to each period in the financial statements. For PBEs, the guidance will be effective for fiscal years beginning after December 15, 2024, and for interim periods for fiscal years beginning after December 15, 2025. For entities other than PBEs, the guidance will be effective for fiscal years beginning after December 15, 2025, and for interim periods beginning with fiscal years beginning after December 15, 2026. Early adoption is allowed.

Planning Considerations

- When developing a plan to implement the new disclosure requirements, consider whether amounts meeting the 5% threshold are material to help guide an assessment of the jurisdictions and items that will be disaggregated in the disclosures. Specifically, it may be prudent to quantify those amounts in order to effectively assess the materiality of the amounts disaggregated.
- Given the potential complexity of, and the resources necessary to satisfy, the new requirements established by the ASU, consider whether adoption will be made prospectively or retrospectively. Also contemplate the modifications to processes, procedures, systems, and internal controls that will be necessary to facilitate an effective implementation process. Those considerations will be of particular importance for entities with foreign operations.

REDUCING RISK WITH TAX INTERNAL CONTROLS

Internal controls are complex. Two decades after the enactment of Section 404 of the Sarbanes-Oxley (SOX) Act, income-tax-related material weaknesses continue to plague companies, with a **recent report** showing that tax-related restatements account for approximately 12% of all restatements.[1]

Without proper internal controls, companies may be susceptible to reporting errors, which can lead to reputational risk and financial burdens stemming from remediation. Companies with strained or limited in-house resources must prioritize income tax accounting and reporting before it is too late.

Correctly accounting for and disclosing income taxes under ASC 740 is increasingly important to mitigate a company's risk of restatement, material weakness, and SEC comments. In-depth knowledge of tax and financial reporting, proper audit documentation, and clear and transparent disclosures can help reduce income reporting risk.

While all public companies must be SOX compliant, many have not refreshed income tax controls since initial implementation, and new guidance has changed the standards required for compliance.

Controls often fail because they are not adequately designed or operating as intended. For instance, it is unlikely that one overarching management review control can cover all the areas of an income tax provision or clearly identify the nature of the review procedures for each key provision component. Controls also might lack supporting evidence of performance and review.

Planning Considerations

If that sounds familiar, it's probably time to examine your control framework. Improper design and execution of internal controls can result in material weaknesses and costly remediation, even with management review procedures in place.

1 Center for Audit Quality, *"Financial Restatement Trends in the United States: 2013-2022"* (June 2024).

The inherent benefits of a strong control environment may be crucial to a private company, despite internal controls often being viewed as a *"public company problem."* Private companies are not immune from intense stakeholder scrutiny into accountability and risk and may want to consider implementing internal controls similar to those required by SOX Section 404. Public-company-level controls could be useful in the event of rapid growth, an initial public offering, or a sale to a private equity buyer.

Planning Considerations

Companies with a clear understanding of the inherent risks that come from inadequate accounting practices demonstrate the ability to think big picture and be better prepared for growth or change in ownership.

There are many reasons to strengthen income tax accounting internal controls, including to reduce reputational risk, minimize consulting fees, preserve investor confidence and market capitalization, and improve resource capacity.

Planning Considerations

- **Reputational risk:** SOX, which is intended to protect investors from accounting errors and fraudulent financial reporting, requires the establishment of internal controls and reporting methods to ensure those controls. Corporations often view SOX compliance as onerous and expensive; however, the cost and effort to remediate can be far greater than the cost to implement and execute strong controls.
- **Consulting fees:** The direct costs of remediating a material weakness — with or without a restatement — can be particularly burdensome. They can include audit, remediation, and legal fees, and they add up quickly.
- **Investor confidence and market cap:** A material weakness can spark worries from investors about reduced future performance. Regardless of their validity, investor concerns are often demonstrated by a drop in stock price. With restatements posing the risk of possible stock decline, the impact on market capitalization for any given company could be in the billions.
- **Resource Capacity:** Focusing on the remediation and/or restatement of a past event is not a value-added use of already-strained resources. Tax capacity could be used more effectively to generate cost-saving ideas, improve and streamline processes, and focus on managing risk and delivering value.

International Tax

PROPOSED DUAL CONSOLIDATED LOSS REGULATIONS

The Department of the Treasury and the IRS on August 6 released proposed regulations on the dual consolidated loss (DCL) rules and their interaction with the Pillar Two global taxing regime. The proposed regulations also make several changes to how DCLs are calculated and introduce a new disregarded payment loss rule.

DCL Rules

The DCL rules apply to ordinary losses of a dual resident corporation (DRC) or a separate unit. A separate unit for purposes of the DCL rules is a foreign branch or hybrid entity that is owned by a domestic corporation. S corporations are not subject to the DCL rules, and domestic corporations will be treated as indirectly owning a separate unit that is owned by a partnership or grantor trust.

Subject to certain exceptions, such as certifying no foreign use, under Section 1503(d), a DCL of a DRC or separate unit generally cannot be used to offset U.S. taxable income of a domestic affiliate (no *"domestic use"*). This means that the DCL may be used only for U.S. federal income tax purposes against the income of the DRC or separate unit that incurred the DCL.

Proposed Regulations

The proposed regulations provide guidance in the following areas:

- DCLs and the interaction with Pillar Two
- Calculation of DCLs, including the following:
  - Removal of U.S. inclusions, dividends (including under Section 1248), gain on the sale from stock, as well as deductions (including under Section 245A) attributable to such income
  - Intercompany transactions, such that if a member of a consolidated group is a DRC or a U.S. member that owns a separate unit, the counterparty consolidated group member's income or gain on the intercompany transaction will not be deferred
  - Clarification that items that are not (and will not be) on the books and records of the separate unit are not included in the separate unit's income or DCL calculation
- New disregarded payment loss rules

Disregarded Payment Loss Rules

A significant development in the proposed regulations is the introduction of a new set of disregarded payment loss (DPL) rules, which operate independently of the DCL rules. To address certain deduction/non-inclusion outcomes, the DPL rules would apply to some disregarded payments (interest, royalties, and structured payments) that are deductible in a foreign country but are not included in U.S. taxable income because the payments are disregarded. The DPL rules would require a consenting domestic owner of a disregarded payment entity to include in U.S. taxable income the amount of any DPL, subject to certain calculation requirements, if a triggering event occurs within 60 months. The new DPL rules will likely have the significant effect of creating deemed income recognition in the U.S. without any corresponding deduction or basis increase.

Since no express statutory authority exists for the new DPL rules, under the proposed regulations, Treasury would implement the DPL rules in coordination with the entity classification election rules under Treas. Reg. §301.7701-3(c), which means that when a specified eligible entity either elects to be disregarded for U.S. tax purposes or defaults to a disregarded entity under the general rules of Treas. Reg. §301.7701-3(b), the domestic owner would be deemed to consent to the new DPL rules.

Effective Dates

The proposed regulations would generally apply to tax years ending on or after August 6, 2024.

The DPL consent rules would apply to the acquisition and formation of new entities, as well as entity classification elections filed, on or after August 6, 2024. For entities already in existence, the DPL consent rules would apply as of August 6, 2025, which would allow taxpayers time to restructure their existing operations before the DPL rules enter into effect.

The intercompany transaction regulations would apply to tax years for which the original U.S. income tax return is due without extensions after the date the final DCL regulations are published in the Federal Register. This means that if the final regulations are published by April 15, 2025, they would apply to calendar year 2024.

Once the proposed regulations are finalized, taxpayers can choose to apply them retroactively to open tax years, subject to consistency requirements.

Planning Considerations

Although still in proposed form, the DCL proposed regulations are lengthy and complex and many of the changes will apply retroactively to calendar year 2024 once the proposed regulations are finalized. Taxpayers will need to closely monitor disregarded payment losses arising from interest, royalties, or other structured payments, to ensure timely certification, as well as potential income recognition. Additionally, taxpayers will need to consider adjustments to DCL calculations going forward to take into account the new rules regarding removing items that are not on the separate unit's books and records and U.S. inclusions, among other items. The removal of these items could have a significant effect by unintentionally creating a DCL or increasing the amount of any existing DCL, among other possible upshots.

BDO can help taxpayers consider the impact these proposed regulations could have on their DRCs or separate units before the regulations are finalized, allowing time for restructuring operations if necessary.

TAX COURT HOLDING THAT FOREIGN FUND ENGAGED IN U.S. BUSINESS VIA INVESTMENT MANAGER RAISES PLANNING ISSUES

The Tax Court in a November 15, 2023, decision held that a non-U.S. investment fund partnership was engaged in a U.S. trade or business through the activities of its U.S. investment manager that acted as its agent. Consequently, the partnership was liable for withholding taxes for the portion of its effectively connected income allocable to its foreign partners (*YA Global Investments LP V. Commissioner*, 161 T.C. No. 11).

Planning Considerations

Based on the court's rationale, investment funds with foreign partners should consider the following to reduce the risk of being subject to taxation because they're deemed to be engaged in a U.S. trade or business:

- Existing investment management agreements between U.S.-based asset managers and offshore partners and investors should be evaluated and possibly restructured in light of the *YA Global case*. New investment management agreements should not allow the investment fund to give interim instructions to the investment manager.
- Neither the investment fund nor the investment manager should receive any type of fee from a portfolio company. The investment fund should derive only a return on the capital invested. If an investment fund would receive fees from portfolio companies, care and consideration should be given to the implications of this case.
- The taxpayer should maintain documentation demonstrating reliance on tax advice, the basis for such reliance, and the specific date in which a prior filing position is modified and the reason for such modification. BDO can assist clients to determine the existence of a U.S. trade or business in cases where there might be exposure under the enumerated principles of the *YA Global case*.
- Because the partnership in *YA Global* failed to file the required Forms 8804, Annual Return for Partnership Withholding Tax (Section 1446), it was left open to assessment despite the fact that the statute of limitations had run out for partnership Form 1065 and the partners. BDO can assist clients evaluate whether to file a Form 8804 when there are foreign partners and potentially effectively connected income and a U.S. trade or business, perhaps even on a *"protective"* basis.

PREPARING FOR THE IMPACT OF OECD PILLAR TWO IMPLEMENTATION

In December 2021, the OECD released the framework for the Pillar Two global minimum tax. These rules — known as the global anti-base erosion (GloBE) model rules — are intended to ensure multinational enterprises (MNEs) with global revenues above EUR 750 million ($800 million) pay a 15% minimum tax rate on income from each jurisdiction in which they operate. This minimum tax is imposed either on the ultimate parent entity through the income inclusion rule (IIR) or on another operating entity in a jurisdiction that has adopted the rules through the undertaxed payments rule (UTPR). Additionally, many jurisdictions could impose a qualified domestic minimum top-up tax (QDMTT) on profits arising within their jurisdiction.

Common structures likely to be impacted by these rules include:

- Tax havens, low-tax jurisdictions, and jurisdictions with territorial regimes
- Notional interest deduction regimes
- Intellectual property (IP) boxes and other incentives regimes
- Low-taxed financing, IP, and global centralization arrangements

Every global organization within the revenue scope needs to address Pillar Two, with a differing landscape depending on that organization's profile and footprint. Even if an MNE is not subject to a top-up tax, it will still need to demonstrate that it falls below the threshold. Therefore, large MNEs should expect a significant increase in their compliance burden, as the rules require a calculation of low-taxed income based on the accounting income by constituent entity on a jurisdictional basis and reporting of the Pillar Two calculation to the tax authorities.

Implementation Timeline

The OECD does not legislate or implement laws. However, at least 25 jurisdictions have enacted laws adopting the OECD's Pillar Two rules into domestic legislation, and more are expected to follow. Many of these laws are effective January 1, 2024; some jurisdictions — for example, some EU member states — back-dated the effective date to January 1, 2024.

The jurisdictions that have already enacted Pillar Two rules include:

- Canada
- EU countries (including France, Germany, Ireland, Italy, Luxembourg, and the Netherlands), with the exception of some smaller countries, such as the Baltic states, that have opted to exercise their right to delay implementation of the Pillar Two rules to 2029
- Japan (applying to fiscal years beginning on or after April 1, 2024)
- Norway
- South Korea
- Switzerland (the rules include only a QDMTT that is effective January 1, 2024, with an income inclusion rule (IIR) expected to become effective January 1, 2025)
- United Kingdom

Significant markets that have yet to implement Pillar Two include Brazil, China, India, and the U.S.; however, the rules may still apply to MNEs headquartered or otherwise operating in these jurisdictions if they have operations in a jurisdiction that has implemented the rules.

The OECD published additional administrative guidance on the application of the Pillar Two rules on June 17, 2024. The new guidance supplements the previously released commentary and the first three installments of administrative guidance. This guidance addressed a number of issues under the GloBE rules, including:

- The application of the recapture rule applicable to deferred tax liabilities (DTL), including how to aggregate DTL categories and methodologies for determining whether a DTL reversed within five years
- Clarification on how to determine deferred tax assets and liabilities for GloBE purposes when the rules result in divergences between GloBE and accounting carrying value of assets and liabilities
- The cross-border allocation of current and deferred taxes, allocation of profits and taxes in certain structures involving flow-through entities, and the treatment of securitization vehicles

The new guidance provides additional detail on how the GloBE rules are intended to operate for MNEs. This administrative guidance will be incorporated into the commentary to the GloBE model rules.

Planning Considerations

Now that the GloBE rules are in effect in a significant number of jurisdictions, MNEs that may be within the scope of the rules should consider the following steps:

- Undertake an impact assessment to determine high-risk areas and identify the potential impact on effective tax rate (ETR) and cash tax
- Keep ongoing communications with the board of directors and other stakeholders
- Assess the impact on compliance and design a roadmap to implement a plan for Pillar Two compliance

BDO can assist MNEs with:

- Impact assessments and modeling
  - Explain, evaluate, and communicate appropriate Pillar Two responses
  - Model ETR and cash tax impact, as well as supply chain and broader organizational effects
  - Identify structuring options for the capital and operational supply chain
  - Identify data and compliance implications and a roadmap for Pillar Two readiness
  - Assist with compliance efforts
- ASC 740 consultation
  - Assist in addressing specific accounting complexities
- Operational and legal restructuring and simplification
  - Assist with legal and operational restructuring and simplification to address the ETR impact and additional compliance obligations
  - Perform transfer pricing analysis to ensure optimization for Pillar Two purposes
- Technology implementation
  - Define data requirements and sourcing
  - Assist with selection and implementation of technology for calculations and compliance
  - Define and integrate data and processes with existing ecosystem and obligations
- Communication
  - Prepare board presentations on the impact of Pillar Two

SECTION 987 REGULATIONS EXPECTED TO BE FINALIZED BEFORE YEAR-END

The Treasury Department and the IRS have announced their intention to finalize the 2023 proposed regulations under Internal Revenue Code Section 987 by the end of calendar year 2024. This will have significant implications for taxpayers that have a qualified business unit that uses a functional currency different from its owner (a *"Section 987 QBU"*).

Background

On November 9, 2023, the Treasury Department and the IRS issued **proposed regulations** providing guidance under Section 987 and related provisions (Sections 861, 985 through 989, and 1502) relating to the determination of taxable income or loss and foreign currency gain or loss with respect to Section 987 QBUs.

The 2023 proposed regulations include three key elections:

- An election to treat all items of a Section 987 QBU as marked items (the *"current rate election"*)
- An election to recognize all foreign currency gain or loss with respect to a Section 987 QBU on an annual basis (the *"annual recognition election"*)
- An election to recognize the pretransition Section 987 gain or loss ratably over 10 years (the *"10-year installment election"*)

Terminations After November 9, 2023

The 2023 proposed regulations provide that the effective date will be accelerated regarding any QBU that terminates after the date the proposed regulations were issued, November 9, 2023. The effective date will be immediately before such terminations. Generally, gains upon termination would be recognized immediately, while losses may be deferred or potentially lost depending on the facts. Any Section 987 termination after November 9, 2023, and before the proposed regulations are finalized should be reviewed to determine the consequences of any gain or loss.

Transition to Final Regulations

The 2023 proposed regulations provide a transition rule that will require all QBUs to be deemed terminated and the calculation of a pretransition Section 987 gain or loss as of 12/31/2024 for calendar year taxpayers. The methodology used to calculate the amount of pretransition Section 987 gain or loss is determined based on whether or not the taxpayer has historically applied an eligible pretransition method.

The 2023 proposed regulations provide that eligible pretransition methods include:

- The 1991 proposed regulations
- The 1991 proposed regulations applying an *"earnings only"* method, as long as that method has been consistently applied to all QBUs
- Any other reasonable method consistently applied that results in the same amount of Section 987 gain or loss as the 1991 proposed regulations

No Eligible Pretransition Method

If a taxpayer has not applied an eligible pretransition method (including doing nothing) then the 2023 proposed regulations require the pretransition Section 987 gain or loss to be computed using a *"simplified method."* This method is generally a simplified foreign exchange exposure pool (FEEP) computation that requires taxpayers to determine the net equity of each QBU for the initial year of each QBUs existence translated into the functional currency of the home office owner of such QBU. Such net equity is compared to the Dec. 31, 2024, net equity value, also translated into the home office functional currency. The difference between these amounts is then adjusted for Section 987 gains and losses recognized over the life of the QBU to determine the amount of pretransition gain or loss.

The source and character of the pretransition Section 987 gain or loss is based on the tax book value (asset method) of Treas. Reg. §1.861-9. Taxpayers may make an election to recognize the pretransition loss over 10 years. Alternatively, without the election, pretransition gains will be treated as unrecognized Section 987 gain or loss that will be recognized upon remittance, and pretransition losses will generally be treated as suspended losses and recognized to the extent that section 987 gains are recognized in the future.

Eligible Pretransition Method

If a taxpayer has been applying Section 987 using an eligible pretransition method, then that method should be followed to determine the amount of pretransition Section 987 gain or loss. The source and character of the pretransition Section 987 gain or loss is based on the tax book value (asset method) under Treas. Reg. §1.861-9. Taxpayers may make an election to recognize the pretransition loss over 10 years. Alternatively, without the election, pretransition gains and losses will be treated as described above.

Planning Considerations

Once the proposed Section 987 regulations are finalized, the effective date is expected to be Dec. 31, 2024; however, some determinations may be made before the regulations are effective. For example, determining if an eligible method has been established will be important in calculating the amount of pretransition Section 987 gain or loss. If an eligible method has not been established, then taxpayers will need to complete the calculations as described above over the life of each QBU. Taxpayers need not wait until 2025 to complete these calculations and may get started on the calculations immediately.

Once the regulations are effective, the FEEP approach requires taxpayers to acquire balance sheet information for each QBU. Obtaining this balance sheet information may involve leveraging multiple accounting systems and taxpayers may want to start reviewing how this information will be obtained sooner rather than later.

Partnerships

The IRS in the past year has continued to ramp up its scrutiny of partnerships' tax positions, including several pieces of new guidance taking a multiprong approach to partnership *"basis shifting"* transactions that the agency views as having the potential for abuse. At the same time, the IRS is dedicating new funding and resources to examining partnerships.

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

- Evaluate Partnership 'Basis Shifting' Transactions That Are Subject of New IRS Scrutiny
- Plan for Partnership Form 8308 Expanded Reporting and January 31 Deadline
- Review Limited Partner Eligibility for SECA Tax Exemption
- Consider Effect of Proposed Rules on Transactions Between Partnerships and Related Persons
- Double-Check Positions on Inventory Items and Unrealized Receivables Under Section 751(a)
- Keep an Eye on Challenges to IRS Rules, Including Partnership Anti-Abuse Rules, Under Loper Bright
- Watch for New Form for Partners to Report Partnership Property Distributions
- Prepare for Partnership Obligations Under Corporate Alternative Minimum Tax Regulations

EVALUATE PARTNERSHIP 'BASIS SHIFTING' TRANSACTIONS THAT ARE SUBJECT OF NEW IRS SCRUTINY

The IRS and Treasury have made clear that they intend to take a harder stance on transactions involving basis shifting between partnerships and related parties. On June 17, 2024, the IRS launched a multiprong approach to curtail inappropriate use of partnership rules to inflate the basis of assets without causing meaningful changes to the economics of a taxpayer's business.

The guidance focuses on complex transactions involving related-party partnerships through which taxpayers *"strip"* basis from certain assets and shift that basis to other assets where the increased basis is intended to generate tax benefits — through increased cost recovery deductions or reduced gain (or increased loss) on asset sales — in transactions that have little or no economic substance.

To address what it deems the inappropriate use of such transactions to generate tax benefits, the IRS has taken several steps:

- **Notice 2024-54** describes two sets of upcoming proposed regulations addressing the treatment of basis shifting transactions involving partnerships and related parties
- Additional proposed regulations (**REG-124593-23**), issued concurrently with Notice 2024-54, identify certain partnership basis shifting transactions as reportable Transactions of Interest
- **Revenue Ruling 2024-14** notifies taxpayers that engage in three variations of these related-party partnership transactions that the IRS will apply the codified economic substance doctrine to challenge inappropriate basis adjustments and other aspects of these transactions

The IRS stated that the types of related-party partnership basis shifting transactions described in the current guidance cut across a wide variety of industries and individuals. It stated that Treasury estimates the transactions could potentially cost taxpayers more than $50 billion over a 10-year period. The IRS added that it currently has *"tens of billions of dollars of deductions claimed in these transactions under audit."*

Basis Shifting Transactions Under IRS Scrutiny

An IRS Fact Sheet released concurrently with the basis shifting guidance states that there are generally three categories of basis shifting transactions that are the focus of the new guidance. It describes these three categories of transactions as:

- **Transfer of partnership interest to related party:** A partner with a low share of the partnership's inside tax basis and a high outside tax basis transfers the interest in a tax-free transaction to a related person or to a person who is related to other partners in the partnership. This related-party transfer generates a tax-free basis increase to the transferee partner's share of inside basis.
- **Distribution of property to a related party:** A partnership with related partners distributes a high-basis asset to one of the related partners that has a low outside basis. The distributee partner then reduces the basis of the distributed asset, and the partnership increases the basis of its remaining assets. The related partners arrange this transaction so that the reduced tax basis of the distributed asset will not adversely impact the related partners, while the basis increase to the partnership's retained assets can produce tax savings for the related parties.
- **Liquidation of related partnership or partner:** A partnership with related partners liquidates and distributes (1) a low-basis asset that is subject to accelerated cost recovery or for which the parties intend to sell to a partner with a high outside basis and (2) a high-basis property that is subject to longer cost recovery (or no cost recovery at all) or for which the parties intend to hold to a partner with a low outside basis. Under the partnership liquidation rules, the first related partner increases the basis of the property with a shorter life or which is held for sale, while the second related partner decreases the basis of the long-lived or non-depreciable property. The result is that the related parties generate or accelerate tax benefits.

Notice 2024-54: Forthcoming Proposed Rules Governing Covered Transactions

Notice 2024-54 describes two sets of proposed regulations that the IRS plans to issue addressing certain partnership basis-shifting transactions (covered transactions):

- **Proposed Related-Party Basis Adjustment Regulations.** Proposed regulations under Sections 732, 734, 743, and 755 would provide special rules for the cost recovery of positive basis adjustments or the ability to take positive basis adjustments into account in computing gain or loss on the disposition of basis adjusted property following certain transactions.
- **Proposed Consolidated Return Regulations.** Proposed regulations under Section 1502 would provide rules to clearly reflect the taxable income and tax liability of a consolidated group whose members own interests in a partnership.

Generally, for purposes of the notice and planned proposed rules, covered transactions:

- Involve partners in a partnership and their related parties
- Result in increases to the basis of property under Section 732, Section 734(b), or Section 743(b)
- Generate increased cost recovery allowances or reduced gain (or increased loss) upon the sale or other disposition of the basis-adjusted property

The IRS intends to propose that the Proposed Related-Party Basis Adjustment Regulations, when adopted as final regulations, would apply to tax years ending on or after June 17, 2024.

The IRS states that the proposed applicability date for the Proposed Consolidated Return Regulations will be set forth in the proposed regulations once issued.

Proposed Rules Identifying Basis Shifting as Transaction of Interest

The proposed regulations issued concurrently with Notice 2024-54 identify related-partnership basis adjustment transactions and substantially similar transactions as reportable Transactions of Interest.

Under the proposed rules, disclosure requirements for these transactions would apply to taxpayers and material advisors with respect to partnerships participating in the identified transactions, including by receiving a distribution of partnership property, transferring a partnership interest, or receiving a partnership interest.

Generally, the identified Transactions of Interest would involve positive basis adjustments of $5 million or more under subchapter K of the Internal Revenue Code in excess of the gain recognized from such transactions, if any, on which tax imposed under subtitle A is required to be paid by any of the related partners (or tax-indifferent party) to such transactions — specifically, Section 732(b) or (d), Section 734(b), or Section 743(b) — for which no corresponding tax is paid.

Notification that IRS Will Challenge Basis Stripping

In Revenue Ruling 2024-14, the IRS notifies taxpayers and advisors that the IRS will apply the codified economic substance doctrine to challenge basis adjustments and other aspects of certain transactions between related-party partnerships. The IRS will raise the economic substance doctrine with respect to transactions in which related parties:

- Create inside/outside basis disparities through various methods, including the use of partnership contributions and distributions and allocation of items under Section 704(b) and (c)
- Capitalize on the disparity by either transferring a partnership interest in a nonrecognition transaction or making a current or liquidating distribution of partnership property to a partner
- Claim a basis adjustment under Sections 732(b), 734(b), or 743(b) resulting from the nonrecognition transaction or distribution

Planning Considerations

The IRS guidance package highlights a ramping up of IRS scrutiny of the described partnership basis shifting transactions, but there are still questions with respect to how specifically the final rules will aim to address these transactions. Additional detail should become available when the IRS issues the proposed regulations described in Notice 2024-54. In drafting those rules, the IRS will have the opportunity to take into account comments submitted on the Notice.

Moreover, particularly in light of the Supreme Court's **recent decision** to overturn *Chevron* deference in *Loper Bright Enterprises. v. Raimondo*, taxpayers are likely to challenge the IRS's authority to issue the planned regulations.

Nonetheless, taxpayers that have structured partnership basis shifting transactions or transactions that merely fall under the mechanical rules like those described in the guidance should evaluate the effects of the anticipated rules on their transactions and consider next steps for compliance.

PLAN FOR PARTNERSHIP FORM 8308 EXPANDED REPORTING AND JANUARY 31 DEADLINE

The IRS in October 2023 released a revised Form 8308, Report of a Sale or Exchange of Certain Partnership Interests, seeking additional information on partnership interest transfers. The revised form was initially required for transfers occurring on or after January 1, 2023, affecting 2024 filings. However, the IRS in January 2024 provided some penalty relief with respect to 2023 transfers, provided certain action was taken by January 31, 2024. It is unclear if the IRS will provide such relief again in 2025 with respect to 2024 transfers.

The IRS relief provided in the past year responded to concerns, which are still relevant, that partnerships will not have the information necessary to complete the new Part IV of Form 8308 in time to meet the January 31 deadline for furnishing information to the transferor and transferee.

Expanded Form 8308 Reporting

Partnerships file Form 8308 to report the sale or exchange by a partner of all or part of a partnership interest where any money or other property received in exchange for the interest is attributable to unrealized receivables or inventory items (that is, where there has been a Section 751(a) exchange).

The IRS significantly expanded the Form 8308 reporting requirements in the revised form released in October. For transfers occurring on or after January 1, 2023, the revised Form 8308 includes expanded Parts I and II and new Parts III and IV. New Part IV is used to report specific types of partner gain or loss when there is a Section 751(a) exchange, including the partnership's and the transferor partner's share of Section 751 gain and loss, collectibles gain under Section 1(h)(5), and unrecaptured Section 1250 gain under Section 1(h)(6).

Furnishing Information to Transferors and Transferees

Partnerships with unrealized receivables or inventory items described in Section 751(a) (Section 751 property or *"hot assets"*) are also required to provide information to each transferor and transferee that are parties to a Section 751(a) exchange.

Under the regulations, each partnership that is required to file a Form 8308 must furnish a statement to the transferor and transferee by the later of (1) January 31 of the year following the calendar year in which the Section 751(a) exchange occurred or (2) 30 days after the partnership has received notice of the exchange.

Generally, partnerships must use the completed Form 8308 as the required statement, unless the form covers more than one Section 751 exchange. If the partnership is not providing the Form 8308 as the required statement, then it must furnish a statement with the information required to be shown on the form with respect to the Section 751(a) exchange to which the person is a party.

A penalty applies under Section 6722 for failure to furnish statements to transferors and transferees on or before the required date, or for failing to include all the required information or including incorrect information.

Penalty Relief with Respect to 2023 Transfers

The IRS issued guidance (Notice 2024-19) providing penalty relief for partnerships with unrealized receivables or inventory items that would fail to furnish Form 8308 by January 31, 2024, to the transferor and transferee in certain partnership interest transfers that occurred in 2023. To qualify for the relief, among other requirements, partnerships generally still had to furnish to the transferor and transferee Parts I-III of Form 8308 by the January 31, 2024, deadline.

Notice 2024-19 stated that, with respect to Section 751(a) exchanges during calendar year 2023, the IRS would not impose penalties under Section 6722 for failure to furnish Form 8308 with a completed Part IV by the regulatory due date (i.e., generally, January 31, 2024).

To qualify for last year's relief, the partnership was required to:

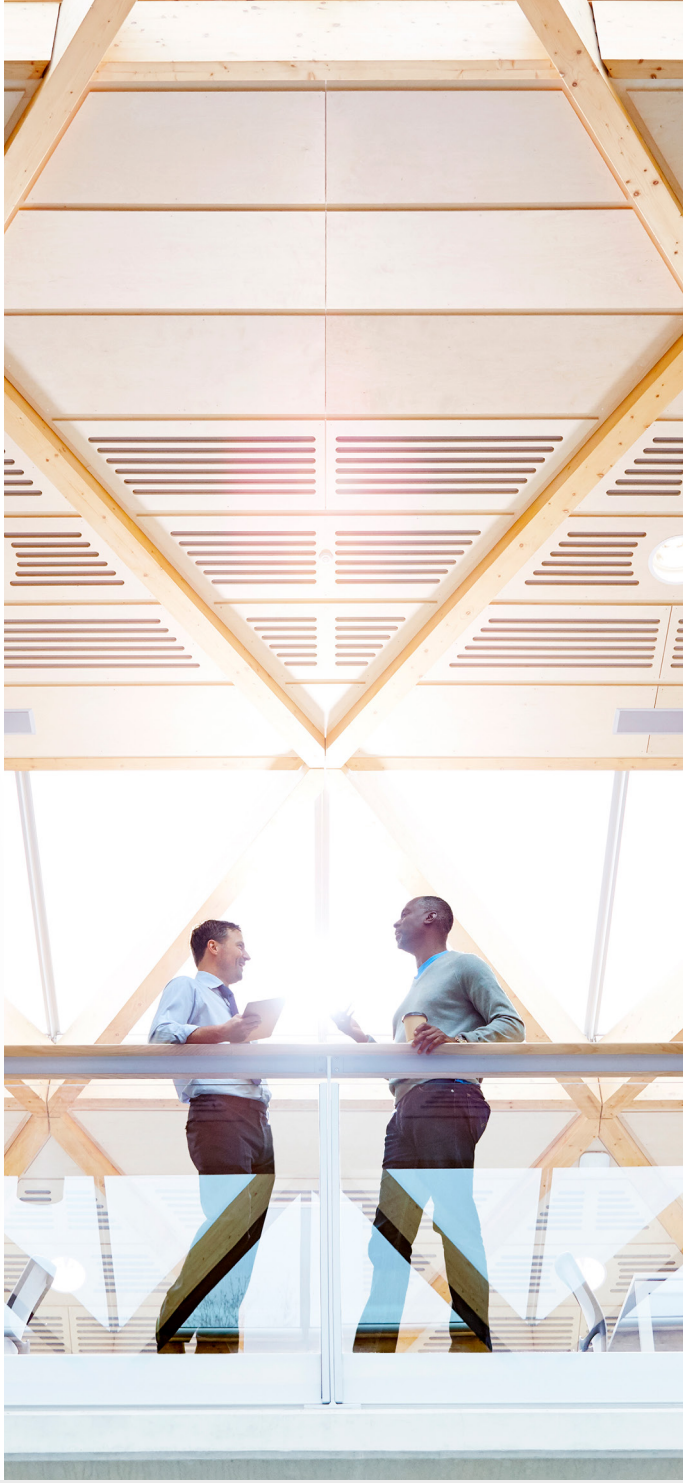
- Timely and correctly furnish to the transferor and transferee a copy of Parts I, II, and III of Form 8308, or a statement that includes the same information, by the later of January 31, 2024, or 30 days after the partnership is notified of the Section 751(a) exchange
- Furnish to the transferor and transferee a copy of the complete Form 8308, including Part IV, or a statement that includes the same information and any additional information required under the regulations, by the later of the due date of the partnership's Form 1065 (including extensions) or 30 days after the partnership is notified of the Section 751(a) exchange

Planning Considerations

While the requirement of furnishing Form 8308 statements is not new, the inclusion of actual *"hot asset"* (i.e., unrealized receivables or inventory items) information within Form 8308 for transfers in 2023 and later has created difficulties.

Prior to 2023, this requirement could be satisfied by providing a taxpayer with a Form 8308 that merely notifies the transferor that they will have some amount of hot asset recharacterization. With the new form, partnerships are now required to provide actual recharacterization amounts.

The penalty relief for furnishing information in 2024 on 2023 transfers was welcome. However, it is unclear if the IRS will extend the relief for an additional year or otherwise address concerns about the availability of the information necessary to timely meet the requirement.



REVIEW LIMITED PARTNER ELIGIBILITY FOR SECA TAX EXEMPTION

There is some additional clarity in the ongoing dispute between the IRS and some partnerships over whether an active *"limited partner"* is eligible for the statutory exemption from self-employment (SECA) tax.

The U.S. Tax Court on November 28, 2023, responding to a Motion for Summary Judgment, held that nominally being a limited partner in a state law limited partnership is insufficient to qualify for the statutory exemption from SECA tax for limited partners (*Soroban Capital Partners v. Commissioner*, 161 T.C. No. 12). The court agreed with the government that the statutory exemption requires a functional analysis of whether a partner was, in fact, active in the business of the partnership and a limited partner in name only.

SECA Tax Exemption for Limited Partners

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

In recent years, courts have held — in favor of the IRS — that members in limited liability companies (LLCs) and partners in limited liability partnerships (LLPs) that are active in the entity's trade or business are ineligible for the SECA tax exemption.

Despite these IRS successes, some — including the taxpayer in the Soroban case — continued to claim that state law controls in defining *"limited partner"* in the case of a state law limited partnership. This specific issue — i.e., the application of the exemption in the case of a state law limited partnership — had not previously been addressed by the courts.

Soroban Capital Partners' Position and IRS Challenge

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

The government contended that the term *"limited partner"* is a federal tax concept that is determined based on the actions of the partners — not the type of state law entity. Citing previous cases, the government asserted that the determination of limited partner status is a *"facts and circumstances inquiry"* that requires a *"functional analysis."* The taxpayers in *Soroban*, on the other hand, argued that such a functional analysis does not apply in the case of a state law limited partnership and that, in the case of these partnerships, limited partner status is determined by state law.

Under the functional analysis adopted by the Tax Court in previous cases (not involving state law limited partnerships), to determine who is a limited partner, the court looks at the relationship of the owner to the entity's business and the factual nature of services the owner provides to the entity's operations.

Tax Court's Analysis

To answer the question of whether Soroban's net earnings from self-employment should include its limited partners' distributive shares of ordinary business income, the court turned first to two preliminary questions:

- What is the scope of the Section 1402(a)(13) SECA tax exemption for *"a limited partner, as such"*?
- If the exemption requires looking through to the limited partner's role in the partnership, does that inquiry concern a partnership item to be resolved in a TEFRA partnership-level proceeding?

With respect to the scope of the exemption — noting that neither the statute nor regulations define limited partner — the court highlighted that the statute expressly applies the exemption to *a "limited partner, as such*." In interpreting statutes, the court explained that it looks at the ordinary meaning of the terms and that it must avoid rendering any words or clauses to be meaningless. Thus, the court interpreted the addition of the words *"as such"* to signify that Congress intended the exemption to apply to something more specific than a limited partner in name only.

Having concluded that a functional analysis is necessary to determine limited partner status for purposes of the exemption, the court turned to whether this inquiry concerned a *"partnership item"* under the applicable TEFRA procedures. The court explained that partnership items are those that (1) are required to be taken into account for the partnership tax year under subtitle A of the Internal Revenue Code and (2) are more properly determined at the partnership level.

The court stated the first prong is easily resolved — subtitle A generally requires partnerships to state the amounts of income that would be net earnings from self-employment in the hands of the recipients. The court further determined the second prong was satisfied, stating that a functional analysis of the partners' activities involves factual determinations that are necessary to determine Soroban's aggregate amount of net earnings from self-employment.

Accordingly, the court held that a functional analysis applies to determine whether a partner in a state law limited partnership is a limited partner for SECA tax exemption purposes, and, for a TEFRA partnership, that inquiry concerns a partnership item subject to a TEFRA proceeding.

Planning Considerations

The *Soroban* case appeared to be a big win for the government. By denying Soroban's Motion for Summary Judgment and granting the government's Motion for Partial Summary Judgment, the Tax Court cleared the way for this case to continue. Once the court proceeds with a functional analysis based on the facts, it can rule on whether the government's Final Partnership Administrative Adjustments for tax years 2016 and 2017 should be upheld.

Based on prior court cases, the functional analysis will likely center around the roles and activities of the individual partners. If they are merely passive investors, then the analysis likely results in them being classified as limited partners under the SECA statute. However, if they are active in the business and/or are able to contractually bind the business under state law, the court is likely to reach the opposite conclusion.

The *Soroban* case involves a partnership subject to TEFRA. Although self-employment tax is not covered under the centralized partnership audit regime enacted by the Bipartisan Budget Act of 2015 (BBA), it's unclear how the IRS will attempt to address this treatment in audits of partnerships subject to the BBA rules instead of TEFRA.

CONSIDER EFFECT OF PROPOSED RULES ON TRANSACTIONS BETWEEN PARTNERSHIPS AND RELATED PERSONS

The Department of the Treasury and IRS in November 2023 issued proposed regulations (REG-131756-11) relating to the tax treatment of transactions between partnerships and related persons. The proposed amendments to the regulations under Sections 267 and 707 relate to the disallowance or deferral of deductions for losses and expenses in certain transactions with partnerships and related persons.

Tax Treatment of Transactions with Related Parties Under Current Regulations

In general, Section 267(a)(1) provides that a taxpayer may not deduct a loss on the sale or exchange of property with a related person as defined in Section 267(b). Section 267(a)(2) sets forth a *"matching rule"* that provides that if because of a payee's method of accounting, an amount is not (unless paid) includible in the payee's gross income, the taxpayer (payor) may not deduct the otherwise deductible amount until the payee includes the amount in gross income if the taxpayer and payee are related persons within the meaning of Section 267(b) on the last day of the taxpayer's taxable year in which the amount otherwise would have been deductible.

As part of enacting the Internal Revenue Code of 1954, Congress added Section 707(b)(1) to the Code to address the sale or exchange of property between a partnership and a partner owning, directly or indirectly, more than 50% of the capital or profits interest in the partnership. Given a lack of statutory and regulatory guidance addressing transactions between a partnership and a related person who was not a partner, the Treasury Department and the IRS issued Reg. §1.267(b)-1(b) in 1958.

Reg. §1.267(b)-1(b) applies an aggregate theory of partnerships to provide that any transaction described in Section 267(a) between a partnership and a person other than a partner is considered as occurring between the other person and the members of the partnership separately. Specifically, Reg. §1.267(b)-1(b) provides that if the other person and a partner are within any of the relationships specified in Section 267(b), no deductions with respect to the transaction between the other person and the partnership will be allowed: (i) to the related partner to the extent of the related partner's distributive share of partnership deductions for losses or unpaid expenses or interest resulting from the transactions, and (ii) to the other person to the extent the related partner acquires an interest in any property sold to or exchanged with the partnership by the other person at a loss, or to the extent of the related partner's distributive share of the unpaid expenses or interest payable to the partnership by the other person as a result of the transaction.

Conflict with Statute and Proposed Amendments

Although the U.S. Tax Court upheld the validity of Reg. §1.267(b)-1(b) and its use of the aggregate theory, subsequent statutory changes to Sections 267 and 707(b) have made Reg. §1.267(b)-1(b) inconsistent with the statute. The statutory changes to Sections 267 and 707(b) enacted since 1982 indicate that Congress intended for a partnership to be viewed as an entity, rather than as an aggregate of its partners, in applying the rules of Sections 267 and 707(b). Therefore, the loss disallowance rules of Sections 267(a)(1) and 707(b)(1), the gain recharacterization rules of Section 707(b)(2), and the matching rule of Section 267(a)(2) similarly should be applied at the partnership level and not the partner level.

Accordingly, the IRS proposed changes to the regulations under Section 267, including removing Reg. §1.267(b)-1(b), to conform the regulations with the current statute.

Application of Proposed Regulations

Once the proposed regulations are finalized, Reg. §1.267(b)-1(b) will be stricken. This means that transactions described in Section 267(a) between a partnership and a person other than a partner will no longer be considered as occurring between the other person and each partner separately.

Consider the following example from the current Reg. §1.267(b)-1(b):

> *Example (1). A, an equal partner in the ABC partnership, personally owns all the stock of M Corporation. B and C are not related to A. The partnership and all the partners use an accrual method of accounting, and are on a calendar year. M Corporation uses the cash receipts and disbursements method of accounting and is also on a calendar year. During 1956 the partnership borrowed money from M Corporation and also sold property to M Corporation, sustaining a loss on the sale. On December 31, 1956, the partnership accrued its interest liability to the M Corporation and on April 1, 1957 (more than 2½ months after the close of its taxable year), it paid the M Corporation the amount of such accrued interest. Applying the rules of this paragraph, the transactions are considered as occurring between M Corporation and the partners separately. The sale and interest transactions considered as occurring between A and the M Corporation fall within the scope of section 267(a) and (b), but the transactions considered as occurring between partners B and C and the M Corporation do not. The latter two partners may, therefore, deduct their distributive shares of partnership deductions for the loss and the accrued interest. However, no deduction shall be allowed to A for his distributive shares of these partnership deductions. Furthermore, A's adjusted basis for his partnership interest must be decreased by the amount of his distributive share of such deductions. See section 705(a)(2).*

Once the proposed regulation is finalized, the transactions would be treated as occurring between the ABC Partnership (as an entity) and M Corporation. Under Section 267(b)(10), a corporation and a partnership are related if the same persons own (A) more than 50% in value of the outstanding stock of the corporation, and (B) more than 50% of the capital interest, or the profits interest, in the partnership. In this case, A owns 100% of M Corporation and only 33-1/3% of ABC Partnership. Accordingly, since the partnership and corporation are unrelated, the partners can deduct the accrued interest liability to M corporation, and the partners can also deduct the loss on sale of property to M Corporation.

Planning Considerations

Given the fact that Treasury and IRS have stated in the Notice of Proposed Rulemaking that statutory changes in the 1980s indicate that Congress intended for a partnership to be viewed as an entity, rather than as an aggregate of its partners, there may be reasonable basis to take such a position even before the proposed regulations are issued in final form, as long as a disclosure is made. Taxpayers should consult with their BDO tax advisers if considering relying on the proposed regulations.

DOUBLE-CHECK POSITIONS ON INVENTORY ITEMS AND UNREALIZED RECEIVABLES UNDER SECTION 751(a)

On appeal from the Tax Court, the U.S. Court of Appeals for the D.C. Circuit has clarified the application of the recharacterization provision under Section 751(a).

Reversing the Tax Court, the circuit court held that gain attributable to inventory (Section 751(a) property) in the sale of a partnership interest by a nonresident alien is still the sale of a partnership interest under Section 751(a) and not taxable as U.S.-source income under the law applicable in the year at issue (***Rawat v. Commissioner***, July 23, 2024).

Taxation of Gain on Partnership Dispositions by Nonresident Aliens

Gain or loss on the sale of partnership interests is generally taxed as a capital gain or loss under Section 741. However, to the extent the gain or loss is attributable to inventory and unrealized receivables — *"Section 751(a) property"* — the gain or loss is recharacterized as ordinary.

Specifically, Section 751(a) states that an amount realized on the sale of a partnership interest that is attributable to inventory items of the partnership *"shall be considered as an amount realized from the sale or exchange of property other than a capital asset."*

Section 864(c)(8), enacted by the Tax Cuts and Jobs of 2017 (TCJA), treats a nonresident alien's gain or loss from the sale of an interest in a U.S. partnership as taxable U.S.-source income. However, before the enactment of the TCJA, personal property law controlled, and a nonresident alien's gain or loss from the sale of personal property was generally treated as foreign-source but could be treated as U.S.-source under certain exceptions, including for inventory. A U.S. partnership interest is personal property for purposes of this rule.

Is Gain from Section 751(a) Property Treated as Gain from Selling Inventory?

Rawat, a nonresident alien, sold her interest in a U.S. partnership in 2008 for $438 million, with $6.5 million of her gain attributable to the sale of the company's inventory. The IRS asserted that the gain attributable to inventory was U.S.-source and taxable. Therefore, Rawat owed $2.3 million in taxes on it. Rawat argued that the inventory-attributed gain was foreign-source and nontaxable. The Tax Court agreed with the government.

The dispute centered on the interpretation of Section 751(a): whether it causes gain from a partnership interest sale that is attributable to inventory merely to be taxed as ordinary income or actually to be treated as the sale of inventory and therefore potentially U.S. source in the hands of a nonresident alien.

There was no dispute that the statute required gain attributable to Section 751(a) property to be taxed as ordinary income if it was taxable to Rawat as U.S.-source income.

D.C. Circuit Finds Narrow Interpretation of Section 751(a)

The D.C. Circuit Court found relevant that the definition of *"ordinary income"* in Section 64 parallels the language in Section 751(a), with both Code sections referring to gain from the sale or exchange of property that is not a capital asset. It follows, the court reasoned, that the language of Section 751(a) that states that gain (or an amount realized) attributable to inventory *"shall be considered as an amount realized from the sale or exchange of property other than a capital asset"* may be read more plainly to mean *"shall be considered as ordinary income."*

The court stated that this interpretation is further supported by the fact that Section 751(a) operates as a carveout to the general rule in Section 741 that gain on the sale of a partnership interest is treated as capital gain. The court further pointed to legislative history indicating Section 751(a) was enacted to end efforts to evade taxation as ordinary income.

On the contrary, the government argued that, under the statute, gain on the sale of a partnership interest from inventory or Section 751(a) property is not just taxed as ordinary income but is taxed as a sale of inventory rather than as of a partnership interest. The result being that the gain could be U.S.-source income to a nonresident alien under the pre-TCJA law.

However, the D.C. Circuit rejected the argument put forth by the government and previously accepted by the Tax Court. The D.C. Circuit noted that Section 751(a) states that the applicable gain is to be treated as ordinary income, nothing more, and that Congress would have stated more if it meant more. The broader reading of Section 751(a) is not supported by other sections of the Code using similar language or the legislative history, the court concluded.

Accordingly, the court held that the sale by Rawat of the partnership interest attributable to inventory was still the sale of a partnership interest, and accordingly, under the law applicable at the time, was foreign-source income and non-taxable.

Planning Considerations

This court case has limited direct applicability after the TCJA enacted Section 864(c)(8). However, the court case is instructive in that it supports the idea that, absent a specific statutory exception, the entity theory of partnerships (rather than the aggregate theory) controls with respect to the sale of a partnership interest. Section 751(a) is merely a recharacterization provision and it does not operate to dictate that a partnership interest sale be deemed to be an actual sale of inventory.

Because the Tax Court's judgment has now been reversed by the circuit court, taxpayers that have relied on a similar theory as that adopted by the Tax Court in *Rawat* should review their positions. Although the reversal of the Tax Court in *Rawat* was a win for the taxpayer in the current case, taxpayers have taken other taxpayer-friendly positions based on a similar interpretation of Section 751(a) as argued by the government and originally accepted by the Tax Court in *Rawat*.

KEEP AN EYE ON CHALLENGES TO IRS RULES, INCLUDING PARTNERSHIP ANTI-ABUSE RULES, UNDER *LOPER BRIGHT*

In its June 2024 decision in ***Loper Bright***, the Supreme Court overturned the longstanding Chevron doctrine, which gave deference to agency interpretations of silent or ambiguous statutes if the interpretation was reasonable. In overturning this principle, the Supreme Court held that courts must exercise independent judgment.

In light of the *Loper Bright* decision, taxpayers are bringing new challenges to IRS regulations, including in the *Tribune Media* case involving the application of a liability allocation anti-abuse rule under Treas. Reg. §1.752-2(j) and the general partnership anti-abuse rule under Treas. Reg. §1.701-2. For a detailed discussion of the relevant facts and anti-abuse rules, see **BDO's Tax Alert**, *"Government Appeals Tax Court Decision on Leveraged Partnership Transactions, Anti-Abuse Rules."*

Generally, in the *Tribune Media* case, the government appeals a Tax Court decision that it views as paving the way for inappropriate income tax planning, potentially enabling taxpayers to follow the roadmap created by the taxpayer in Tribune Media to implement leveraged partnership transactions without triggering taxable gain while avoiding incurring meaningful economic risk.

Loper Bright Arguments in *Tribune Media*

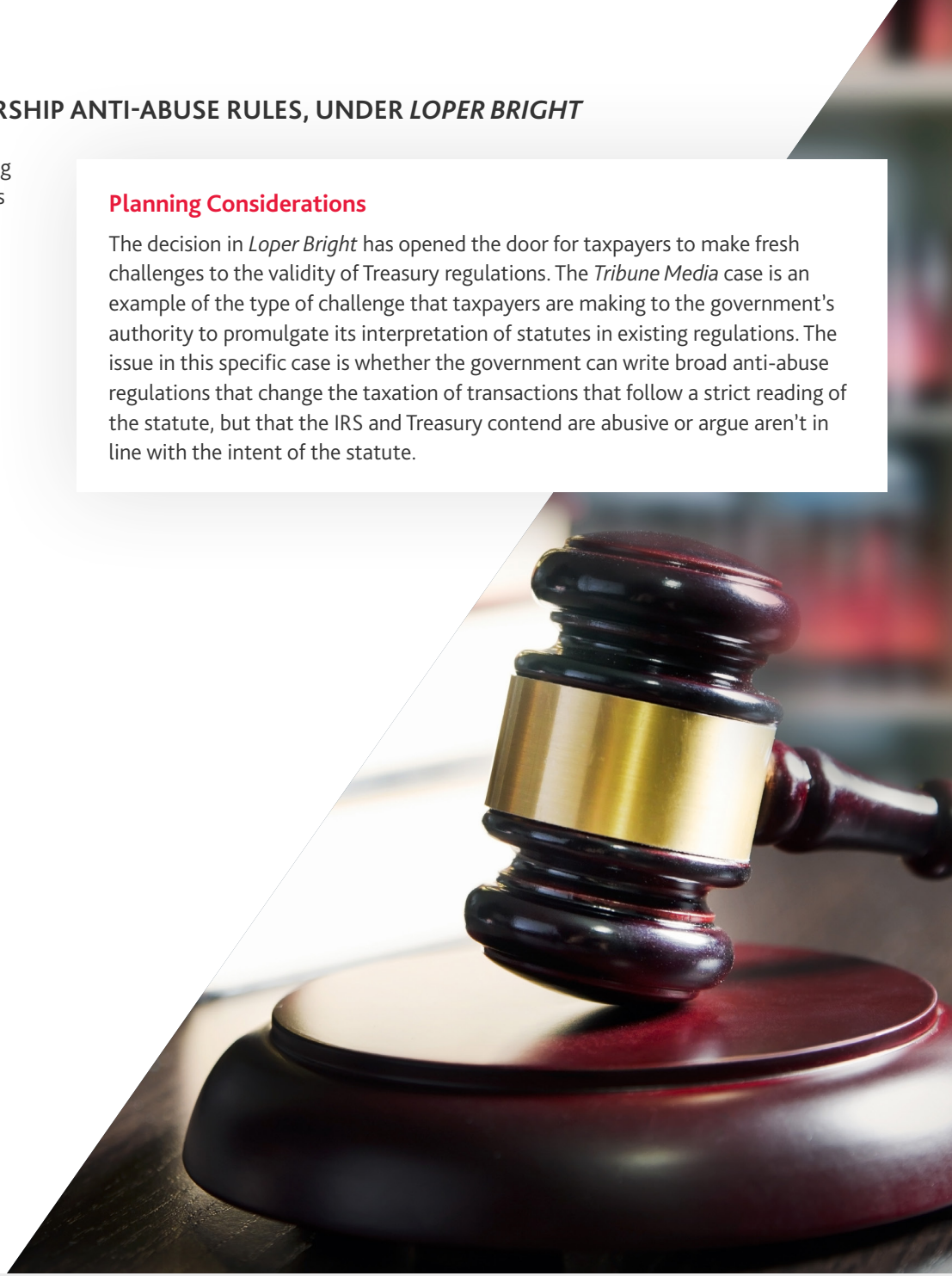
Tribune Media and the government have supplemented their arguments in their pending appeal before the Seventh Circuit on leveraged partnership transactions and the application of partnership anti-abuse rules. Tribune Media has submitted a letter to the court arguing that the U.S. Supreme Court's decision in *Loper Bright* reinforces its argument that the general anti-abuse rule in question is invalid.

In its letter to the Seventh Circuit regarding the effect of *Loper Bright* in its case, Tribune Media challenges the validity of the general anti-abuse rule. It notes that, although the government does not expressly claim Chevron deference for the rule, the *Loper Bright* decision instructs the court to carefully scrutinize whether the IRS had the authority to issue the rule, which Tribune Media argues is regulatory overreach as *"the agency even contends that it can invalidate a transaction that follows 'the literal words' of a statute that Congress enacted."*

In its response, the government contends that the anti-abuse rule does not rely on Chevron deference, is based on established case law, and was promulgated within the bounds of authority granted to the IRS by Congress.

Planning Considerations

The decision in *Loper Bright* has opened the door for taxpayers to make fresh challenges to the validity of Treasury regulations. The *Tribune Media* case is an example of the type of challenge that taxpayers are making to the government's authority to promulgate its interpretation of statutes in existing regulations. The issue in this specific case is whether the government can write broad anti-abuse regulations that change the taxation of transactions that follow a strict reading of the statute, but that the IRS and Treasury contend are abusive or argue aren't in line with the intent of the statute.



WATCH FOR NEW FORM FOR PARTNERS TO REPORT PARTNERSHIP PROPERTY DISTRIBUTIONS

The IRS has released a draft of new **Form 7217**, Partner's Report of Property Distributed by a Partnership, and related **instructions**.

The form is to be filed by any partner receiving a distribution of property from a partnership in a non-liquidating or liquidating distribution. However, partners do not have to file the form for

- Distributions that consist only of money or marketable securities treated as money
- Payments to the partner for services other than in their capacity as a partner under Section 707(a)(1)
- Payments for transfers that are treated as disguised sales under Section 707(a)(2)(B)

The partner uses the form to report the basis of distributed property, including any basis adjustments to the property required by Section 732(a)(2) or (b). The two-page draft Form 7217 is broken into two parts, with Part I used for reporting the aggregate basis of the distributed property on the distribution date and Part II covering the allocation of basis of the distributed property.

Partners are to file a separate Form 7217 for each date during the tax year that they actually (not constructively) receive distributed property subject to Section 732 — even if property distributions received on different days were part of the same transaction.

The instructions state that Forms 7217 are to be due when the partner's tax return is due, including extensions. They add that partners should file their Forms 7217 attached to their annual tax return for the tax years in which they actually received distributed property subject to Section 732.

Planning Considerations

The draft form is a continuation of the IRS's recent efforts to expand required disclosures from partnerships. Based on an initial review of the draft version of the form, it appears likely they IRS will need to make some modifications to appropriately capture the information being requested by the form.

PREPARE FOR PARTNERSHIP OBLIGATIONS UNDER CORPORATE ALTERNATIVE MINIMUM TAX REGULATIONS

The IRS on September 12, 2024, issued proposed regulations on the corporate alternative minimum tax (CAMT), enacted by the Inflation Reduction Act, that include significant new provisions for partnerships with corporate partners subject to the CAMT.

For tax years beginning after December 31, 2022, the CAMT imposes a 15% minimum tax on the adjusted financial statement income (AFSI) of large corporations (generally, those with average annual AFSI exceeding $1 billion).

The proposed regulations set out rules for determining and identifying AFSI, including applicable rules for partnerships with CAMT entity partners. For a general discussion of the CAMT proposed regulations, see the Corporate Tax section of this guide.

CAMT Statute, AFSI Adjustments & Partnerships

Generally, the CAMT is imposed on AFSI — as determined under Section 56A — of an applicable corporation. Under Section 56A, AFSI means, with respect to any corporation for any tax year, the net income or loss of the taxpayer set forth on the taxpayer's applicable financial statement for that tax year, adjusted as further provided within that Code section.

Adjustments to AFSI are set out in Section 56A(c). Regarding partnerships, Section 56A(c)(2)(D) states that, except as provided by the Secretary, if the taxpayer is a partner in a partnership, the taxpayer's AFSI with respect to such partnership is adjusted to take into account only the taxpayer's distributive share of such partnership's AFSI. It adds that the AFSI of a partnership is the partnership's net income or loss set forth on that partnership's applicable financial statement, as adjusted under rules similar to the rules set forth in Section 56A.

Proposed Rules on Partner's Distributive Share of Partnership AFSI

The IRS sets out in Prop. Reg. §1.56A-5 rules under Section 56A(c)(2)(D) regarding a partner's distributive share of partnership AFSI. The IRS explains that it is proposing adopting a *"bottom-up"* method which it believes is consistent with the statute and is more conducive to taking into account Section 56A adjustments. Under the proposed *"bottom-up"* method, a partnership would calculate its AFSI and provide this information to its partners. Each partner would then need to determine its *"distributive share"* of the partnership's AFSI.

The proposed rules generally provide that, if a CAMT entity is a partner in a partnership, its AFSI with respect to its partnership investment is adjusted as required under the applicable regulations to take into account the CAMT entity's distributive share of the partnership's AFSI.

Under the proposed rules, a CAMT entity's distributive share amount is computed for each tax year based on four steps:

1. The CAMT entity determines its distributive share percentage
2. The partnership determines its modified financial statement income
3. The CAMT entity multiplies its distributive share percentage by the modified financial statement income of the partnership (as reported by the partnership)
4. The CAMT entity adjusts the product of the amount determined in step (3) above for certain separately stated Section 56A adjustments

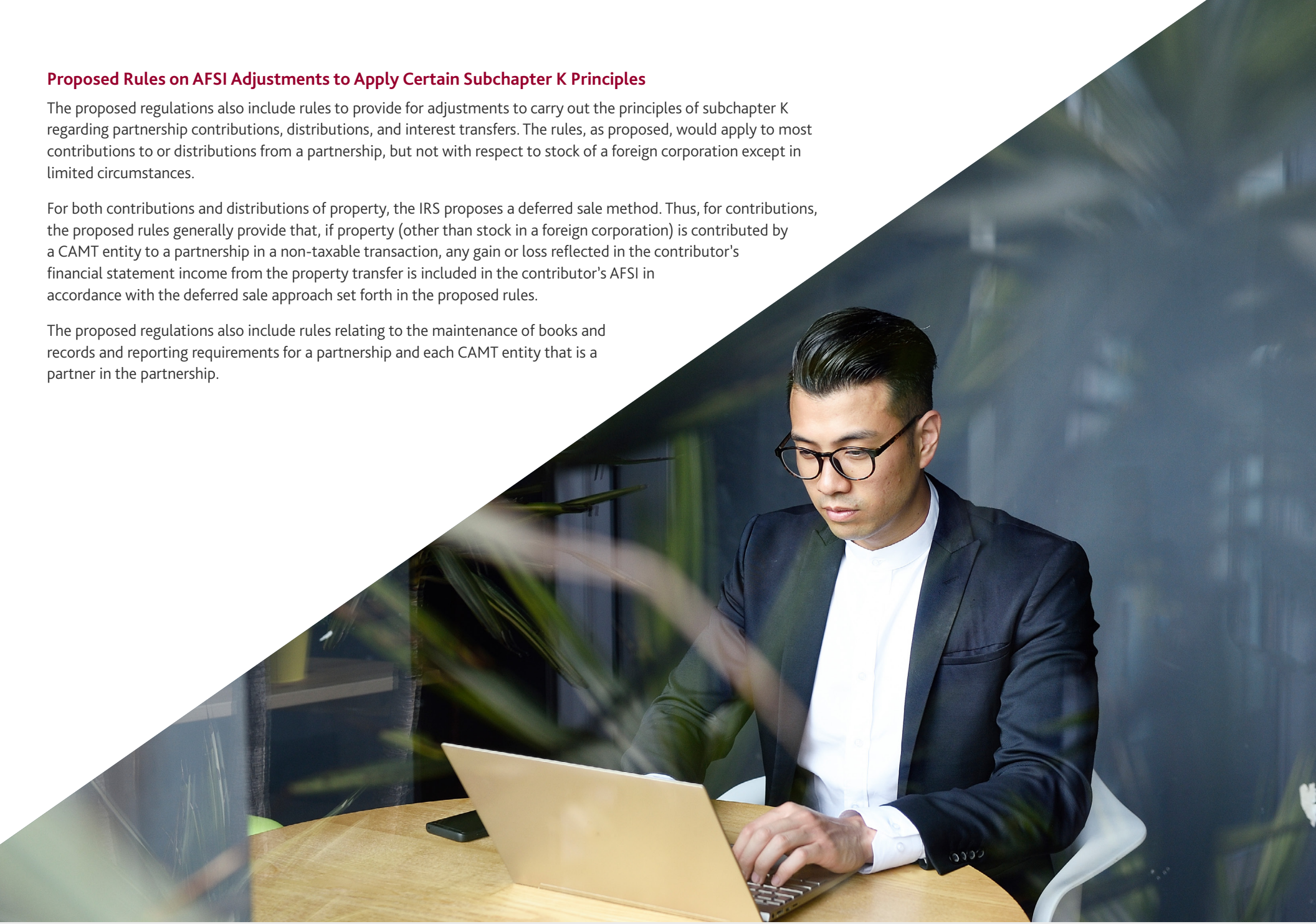
There are also related reporting and filing requirements in the proposed rules. Because a CAMT entity may require information from the partnership to compute its distributive share of a partnership's AFSI, the proposed regulations would require a partnership to provide the information to the CAMT entity if the CAMT entity cannot determine its distributive share of the partnership's AFSI without the information and the CAMT entity makes a timely request for the information.

Proposed Rules on AFSI Adjustments to Apply Certain Subchapter K Principles

The proposed regulations also include rules to provide for adjustments to carry out the principles of subchapter K regarding partnership contributions, distributions, and interest transfers. The rules, as proposed, would apply to most contributions to or distributions from a partnership, but not with respect to stock of a foreign corporation except in limited circumstances.

For both contributions and distributions of property, the IRS proposes a deferred sale method. Thus, for contributions, the proposed rules generally provide that, if property (other than stock in a foreign corporation) is contributed by a CAMT entity to a partnership in a non-taxable transaction, any gain or loss reflected in the contributor's financial statement income from the property transfer is included in the contributor's AFSI in accordance with the deferred sale approach set forth in the proposed rules.

The proposed regulations also include rules relating to the maintenance of books and records and reporting requirements for a partnership and each CAMT entity that is a partner in the partnership.



State & Local Tax

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

This SALT guide can help companies with 2024 year-end planning considerations, and it provides guidance on how to hit the ground running in 2025.

STATE PASS-THROUGH ENTITY TAX ELECTIONS

Roughly 36 states now allow pass-through entities (PTEs) to elect to be taxed at the entity level to help their residents avoid the $10,000 limit on federal itemized deductions for state and local taxes (the *"SALT cap"*). Those PTE tax (PTET) elections are much more complex than simply checking a box to make an election on a tax return. Although state PTET elections are meant to benefit the individual members, not all elections are alike, and they are not always advisable.

Before making an election, a PTE should model the net federal and state tax benefits and consequences for every state where it operates, as well as for each resident and nonresident member, to avoid unintended tax results. Before the end of the year, taxpayers should thoroughly consider whether to make a state PTET election, modeling the net tax benefits or costs, and evaluate timing elections, procedures, and other election requirements. If those steps are completed ahead of time, the table has been set to make the election in the days ahead.

When considering a state PTET election, a key question is whether members who are nonresidents of the state for which the election is made can claim a tax credit for their share of the taxes paid by the PTE on their resident state income tax returns. If a state does not offer a tax credit for elective taxes paid by the PTE, a PTET election could result in an additional state tax burden that exceeds some members' federal itemized deduction benefit.

Therefore, as part of the pre-year-end evaluation and modeling exercise, PTEs should consider whether the election would result in members being precluded from claiming other state tax credits — which ordinarily would reduce their state income tax liability dollar for dollar — in order to receive federal tax deductions that are less valuable.

LIQUIDITY EVENTS

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

A liquidity event is not an occasion for surprises. When contemplating any form of transaction, state and local taxes can't be overlooked. SALT experts can identify planning opportunities and point out potential pitfalls, and it is never too early to involve them. If you don't consult them until after the transaction occurs or the state tax returns are being prepared, you've left it too late.

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

INCOME/FRANCHISE TAXES

If anything has been learned from the last seven years of federal tax legislation, it's that state income tax conformity cannot be taken for granted. While states often conform to many federal tax provisions, are you certain an S corporation is treated as such by all the states where it operates? Is that federal disregarded entity disregarded for state income tax purposes as well? Not asking the question can lead to the wrong result.

Several states don't conform to federal entity tax classification regulations. Some, including New York, require a separate state-only S corporation election. New Jersey now allows an election out of S corporation treatment. Making those elections — or not — can lead to different state income tax answers, but you should make that decision before the transaction, not when the tax return is being prepared.

If the liquidity event will result in gain, how is the gain going to be treated for state income tax purposes? Is it apportionable business gain or allocable nonbusiness gain? Is a partnership interest, stock, or asset being sold? How will the gain be apportioned? Was the seller unitary with the partnership or subsidiary, or did the assets serve an operational or investment function for the seller? Will the gross receipts or net gain from the sale be included in the sales factor, and, if so, how will they be apportioned?

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

SALES/USE TAXES

Most U.S. states require a business to collect and remit sales and use taxes even if it has only economic, not physical, presence. Remote sellers, software licensors, and other businesses that provide services or deliver their products to customers from remote locations must comply with state and local taxes.

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

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

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

REAL ESTATE TRANSFER TAXES

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

PROPERTY TAXES

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

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

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

P.L. 86-272

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

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

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

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

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

Tax Automation & Innovation

An effective tax function needs the breadth and depth of technical knowledge to assess the impact of tax changes on a business's overall tax liability and adjust tax strategies accordingly. That requires adaptability to meet tighter reporting deadlines while dealing with shrinking headcounts, demands for more real-time information, and the expectation of cross-functional collaboration. In other words, business leaders are pushing tax departments to do more work more quickly and accurately than ever before.

That's where tax automation and innovation come in. The end of the year, which falls between compliance and reporting busy seasons, is the perfect time to prepare an organization for quick-win transformation and deploy data readiness best practices to ensure a streamlined close.

WHAT CAN THE TAX FUNCTION FEASIBLY ACCOMPLISH BEFORE YEAR END?

Companies can use the precious post-compliance season to lay the groundwork for tax process implementation and improvements to go off without a hitch during the tax provision reporting period, which is the most compressed deadline during the tax life cycle. This year, that may include additional complexity because of the OECD Pillar Two reporting requirements. So, what can feasibly be done in two to three months?

Identify and Execute Quick Wins

Regardless of whether a company is in the nascent or late stages of relying on technical tax solutions, several important steps — ideally revisited annually — can contribute to more consistent and lasting success.

- Perform a post-mortem on the prior year end. Which workstreams took the longest and how can that be avoided this year? Can those workstreams be automated with simple pre-work, or is an extract, transform, load (ETL) tool or software necessary?
- Ask what return-to-provision items popped up as material in the 2023 compliance finalization. Was that caused by a lack of detailed data or information? A lack of time or review?
- Poll tax team members individually. What are they most concerned with executing for the year-end close? What process or file is the most challenging, and how can they streamline ahead of time or replace with a better, more automated solution?
- Will a hard close save time or duplicate work for the team?
- Draft a tax team workplan with specific dates for completion, sign-off, and review. Plan for live, daily debriefs across the entire tax team to avoid miscommunication and reliance on email alone.
- Specify tax technology best practices, including importing tax rates enacted through November 30 into the tax provision software to review the impact of any rate changes on beginning deferred balances (refreshing only if any law/rule changes occur in December, as discussed below); ensuring all users can access the necessary and appropriate data; and updating blended state current/deferred tax rates based on recently filed tax returns, as applicable (unless recomputing live apportionment rates).

Streamline the Year-End Close and Plan for Possible Tax Law Changes

If a business is behind with its year-end close or has concerns about accounting for potential last-minute federal tax changes, it should consider five year-over-year processes that can help it realize more consistent and lasting success.

Fine-tune technologies and processes. Roll over the last period's dataset within the tax provision system and relevant workpapers and perform system entity maintenance. Create a detailed year-end-close workplan with clearly defined roles, responsibilities, and timelines and prepare and test tax analytics dashboards.

Capture year-to-date discrete impacts. Prepare the necessary tax entries for purchase accounting events, complete return-to-provision analyses (both domestic and foreign), and assess the tax effects of audits and amended returns. Also calculate the income statement and balance sheet effects of tax law changes, keeping in mind that the impact of any changes in rules and rates are recorded in continuing operations in the interim and annual period that the changes are considered enacted for U.S. GAAP purposes. Update for known global tax rate changes and, if the accounting department is responsible for recording tax effects of equity-related items, inform it of any new tax rates.

Be ready for possible late December tax law enactment. While the status of any tax legislation is unclear pending the November election, it's still smart to monitor tax proposals and run preliminary calculations for management.

Quantify any national, state, and local/regional tax rate change effects to deferred tax assets and liabilities, ideally by using tax provision software. Consider the effects tax legislation may have on net operating losses and valuation allowances based on changes that could affect future taxable income (for example, international tax provisions).

Ensure documentation regarding key judgments is thorough. Focus on documentation for purchase accounting issues and estimates, valuation allowance conclusions, and current- and prior-year uncertain tax positions, as well as any facts supporting an indefinite reinvestment assertion.

Conduct planning meetings. Ask any external auditors whether interim work can be accelerated. Request the prepared-by-client request list and agree on timing well in advance. Have the tax team review its workplan and have users test systems access early. Ask the finance organization to outline any timing expectations for tax deliverables and when pretax book income will be finalized.

LOOKING TO 2025 AND BEYOND

Even companies that have mastered the year-end-close process should consider ways to improve and integrate their tax technology systems and more directly access and transform source data. Annually assessing data management and quality and the strength of the overall tech framework can keep a business's tax function running smoothly all year long.

Master Data Management

In an ideal world, all data would be uniformly structured and digitized. But that's not reality, especially for companies with rapid growth that have scaled to meet both business or profitability (shareholder) demands and customers' digital market demands. Those companies may have acquired entities with disparate IT infrastructures or purchased in-house finance or IT technologies (inclusive of tax) without pausing to integrate new systems. Or perhaps C-suite leaders attempted to automate the front-end customer experience by deploying more modern technology, such as generative AI.

Those changes would require back office and tax functions to understand the related effects on their companies' tax profiles or filing needs, while keeping an eye on the regulatory landscape to ensure compliance. Further, tax leaders are requesting more real-time, on-demand insights into effective tax rate drivers, total tax liabilities, and cash taxes paid worldwide.

Planning Considerations

Instead of striving for perfection in a short window, tax departments and their organizations should start with a methodology to handle data that can't be consistently structured. By digitizing as much as possible and applying an agreed methodology, organizations can reduce disruptions caused by new or dissonant data.

In selecting a master data repository or platform, a company can take the first step toward creating a hub to draw from for reporting needs and any downstream tax process or deliverable — be it for tax provision, tax compliance, audit defense, OECD Pillar Two directives, indirect tax reporting needs, or otherwise. Companies that have already taken that step are on the right path; those that haven't should consider this proven way to bring structure to disparate tax data. Once a data lake or hub has been selected, turn to the creation of high-quality data for storage and use.

Data Quality

High-quality data is the cornerstone for effective and efficient tax processes. It allows for light- or no-touch data transference from the data lake to other necessary tax or finance systems and eventually can be used to train an AI model to accurately predict, analyze, and process tax-related information.

Planning Considerations

- In determining data quality, there are many factors to assess:
  - **Accuracy:** Is the data factually correct? Does it reflect the business's financial transactions and compliance obligations for all regions and jurisdictions?
  - **Integrity:** Is the data transparently justifiable? Does it remain unaltered from its source after being processed and analyzed? Has it been safeguarded against unauthorized access, human error, or process disruptions?
  - **Relevance:** Is it the right data at the right time (especially when combining multiple data sets)? Does the information collected and analyzed directly support tax needs? Is it confused or mixed with unrelated information?
  - **Timeliness:** Does the data consistently represent a desired period or moment in time? Is it available when needed?
  - **Completeness:** Is the data quantitatively and qualitatively comprehensive? Does it include all necessary information without gaps that could lead to under- or overreporting tax obligations?
  - **Accessibility:** If the data needs to be verified or refreshed from a source, is it available without compounding unnecessary risk? Can the right people (such as tax professionals, auditors, and regulatory bodies) easily retrieve and use the data when needed?

Taking small steps and gradually introducing high-quality, master data concepts into specific functions will best position tax departments to realize the efficacy of their technologies.

Implementing Technology: Select Now, Build or Buy in 2025

Even if a company has chosen to implement a master data hub, there's no universal method for doing so. The best approach will depend on several factors that vary by organization, so tax leaders should start with gathering information and defining goals. Perform a gap analysis and understand where infrastructure is failing. Where are the bottlenecks? Can stronger solutions bridge any gaps left by current tech processes?

Planning Considerations

- In building short- and long-term roadmaps for tax innovation, a business should ask the following questions:
  - What is the budget?
  - What kind of tech staff does the organization already employ?
  - Does the tax team have any co-sourcing or outsourcing arrangements?
  - What suppliers and third-party firms does the company work with?
  - What data management policies does the company have in place?
  - What is the company's financial reporting cadence?
  - What is the company's expected growth over the next year? Three years? Five years?

Scaling Up

Even if a business already has a tax technology plan, it can be difficult to decide how, when, and why to scale up. Many business leaders are prioritizing cost optimization. While scaling up requires a significant upfront investment, it can prove cheaper than addressing shortfalls stemming from outdated processes.

Planning Considerations

In considering whether to scale up, first ask how existing tech can be improved. Identify top challenges in the tax team's ability to keep up with increasing compliance demands and determine how technology can help. Then tailor plans to complement existing capabilities and foster cross-functional collaboration.

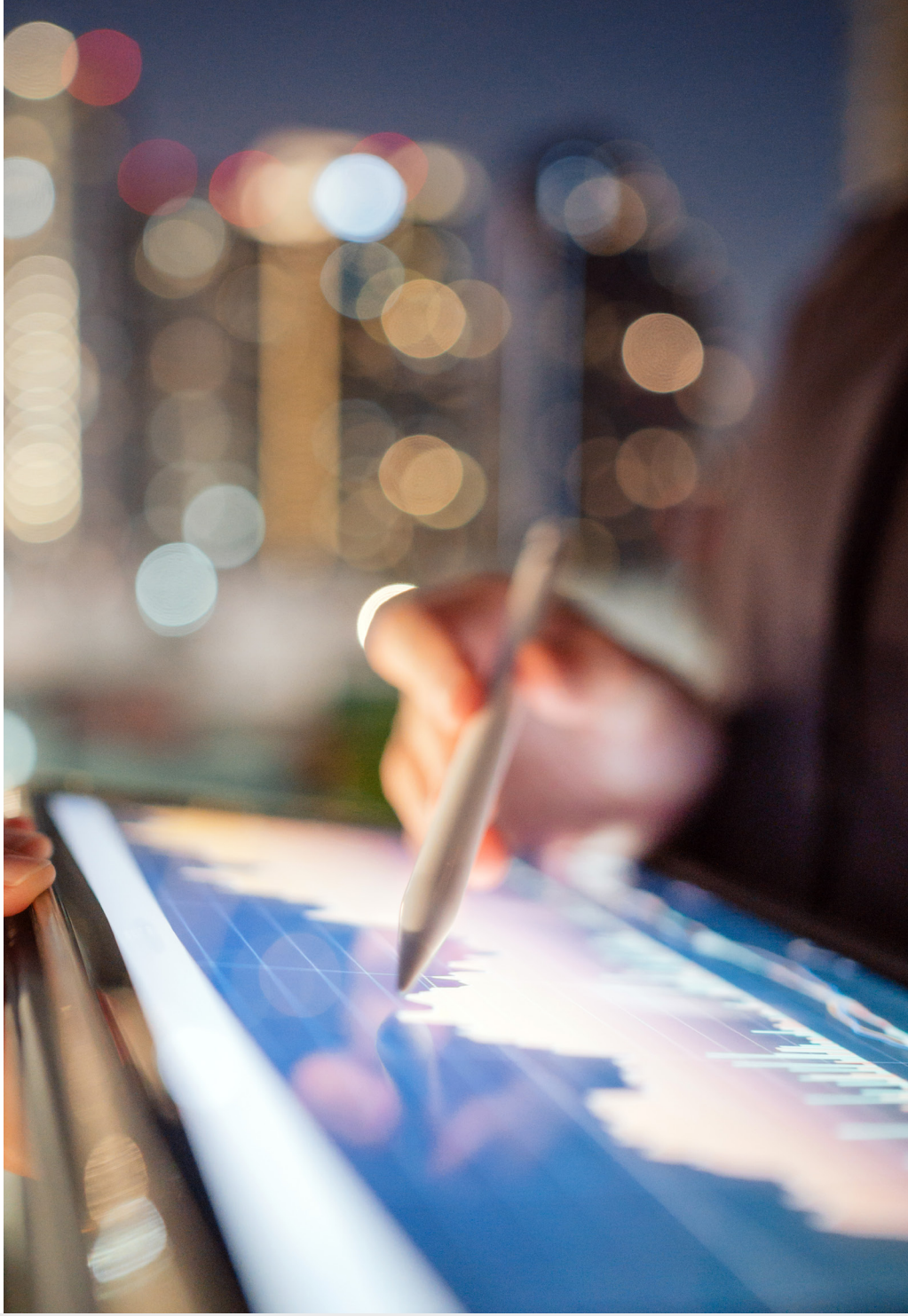
Building vs. Buying

Deciding to implement or scale up tax tech isn't the final step. Tax leaders must assess which technology investments will have the greatest returns and whether they should build or buy solutions. Buying often requires software tailored to meet a company's specific needs. And while building generally doesn't mean starting from scratch, it still requires significant resources and time.

Planning Considerations

In choosing whether to buy or build, a company should weigh the following six factors:

1. Cost
2. Urgency
3. Expertise
4. Scalability and regulatory compliance
5. Integration compatibility
6. Data security



Transfer Pricing

TRANSFER PRICING AND BEAT PLANNING

The base erosion anti-abuse tax, known as *"BEAT,"* introduced as part of Tax Cuts and Jobs Act in 2017, was intended to prevent taxpayers from reducing their U.S tax liability by shifting profits through payments to related parties in low-tax jurisdictions outside the U.S. To be subject to the BEAT, U.S. taxpayers must meet the following two requirements:

- A three-year average of gross receipts greater than $500 million (excludes regulated investment companies, REITs, or S corporations)
- A base erosion percentage for the taxable year of 3.0% or more (2.0% for banks and special entities), where *"base erosion"* percentage is defined to be the sum of all base erosion payments (defined below) divided by the total amount of deductions for the year

If a U.S. taxpayer meets the above thresholds, the following BEAT tax rate applies to its modified taxable income, adjusted for BEAT payments:

- Before calendar year 2026: 10.0%
- After calendar year 2025: 12.5%

The BEAT is an additional tax imposed on applicable taxpayers with base erosion payments including interest, royalties, and service payments to foreign related parties. A taxpayer would need to pay the additional amount by which the BEAT exceeds regular income tax if the income tax liability is lower than the BEAT liability.

Transfer Pricing and BEAT Mitigation

While BEAT, under Internal Revenue Code Section 59A, has a broad definition of base erosion payments, including services, interest, certain property/assets, and royalties, it also provides types of foreign related-party payments that are exempt from BEAT considerations.

One way to mitigate BEAT exposure is to rely on the services cost method (SCM) for outbound payments for certain intercompany services provided by non-U.S. related parties. The SCM, defined in Reg. §1.482-9(b), permits certain routine back-office and other low-value services to be charged at cost, rather than at the usual arm's length charge. If service payments meet the SCM requirements, the amounts paid or accrued can be excluded from base erosion payments. To meet the SCM exception, all the SCM requirements, except the business judgment rule, must be satisfied:

- The services provided must be specified covered services, that is, either a service specified in Rev. Proc. 2007-13 or a low-margin service to which a markup of less than 7.0% would be applied
- The service must not be an excluded activity, such as research & development, manufacturing, or resale/distribution
- The amount must reflect the total cost of the services without a markup
- Adequate books and records must be maintained in accordance with the rules under Reg. §1.59A-3(b)(3)(i)(C)

To utilize the SCM exemption under the BEAT, taxpayers should explore opportunities to classify services as SCM eligible, even if SCM was not previously selected as the transfer pricing method. For example, it is likely beneficial to separate back-office and administrative-type services, which could qualify for the SCM, from marketing services, which would not qualify for the SCM. Given that SCM eligibility does not require the business judgement test, treating certain services as low-margin services, when appropriate, can potentially reduce a BEAT liability.

Another way to mitigate BEAT exposure is to utilize Section 263A and treat certain base erosion payments as part of cost of goods sold (COGS) – i.e., inventoriable costs. For U.S. taxpayers with inventories, amounts paid or accrued to a foreign affiliate through COGS are not treated as a base erosion payment. Section 263A outlines the uniform capitalization rules in which direct and allocable indirect costs of property produced or purchased for resale must be capitalized into inventory. For example, sales-based royalties and management fees are costs that can be capitalized under Section 263A:

- Sales-based royalties can be considered capitalized costs and included in COGS as long as the underlying intangible property is connected to purchasing, production, storage, or handling of inventory. As such, sales-based royalties paid to a foreign affiliate can be excluded from base erosion payments if the costs are properly capitalized and included in COGS under Section 263A. Sales-based royalties associated with trademarks and trade names are expensed and likely not eligible for COGS inclusion.
- Management fees may also be capitalized under Section 263A when the services are directly or indirectly related to purchasing, production, storage, or handling of inventory. For example, management fees that are related to the provision of sourcing or procurement services are likely capitalizable under Section 263A.

Furthermore, there are structural/contractual changes that taxpayers can consider to reduce a BEAT liability. Those changes include, for example, restructuring of financing, creation of a regional headquarters office, and modification of customer/supplier contracts, which would eliminate or decrease the payments from a U.S. entity to a foreign affiliate.

Planning Considerations

While BEAT can have a significant impact on tax liability, BEAT planning using transfer pricing has not been a priority for many taxpayers. The strategies discussed above, and other BEAT planning using transfer pricing can be an effective approach for mitigating BEAT liability.

ADOPTING A PROACTIVE APPROACH TO TRANSFER PRICING

Adopting a proactive approach to tax process improvements can be an aspirational goal for many tax departments. Resource constraints, business pressures, new technical developments, and other factors can cause even the most meticulously planned schedules to go awry, and before anyone realizes it, year-end is upon them once again.

Rather than feeling discouraged, companies can leverage their experience to understand what is achievable and then prioritize improvement projects that are appropriately sized for their business.

Common Year-End Transfer Pricing Challenges

- **Large Transfer Pricing Adjustments:** Many companies use transfer pricing adjustments to ensure they meet their desired transfer pricing policy. However, significant year-end adjustments can have both tax and indirect tax implications, leading to further issues and risks.
- **Lack of Transparency in Calculations:** Transfer pricing calculations are often built in Excel and amended over the course of the years, perhaps to address one-time issues or changing situations. This can result in workbooks that lack a sufficient audit trail and contain hard-coded data, both of which undermine a reviewer's ability to validate the calculations. Additionally, without documentation, the process becomes dependent on the few people working directly on the process, which can create significant knowledge gaps if one of more of the key people leave the company.
- **Data Constraints:** While the mechanics of most transfer pricing calculations are not complex, difficulties arise because of the variety of data needed (revenues, segmented legal entity P&Ls, headcount, R&D spend) and the challenges in accessing that data. This can lead to shortcuts and unvalidated assumptions.

Planning Considerations

- **Develop a Multiperiod Monitoring Process:** Implement a process that tracks profitability throughout the year to help reduce significant year-end transfer pricing adjustments. This monitoring can also provide insights into whether underlying intercompany pricing policy changes are needed, allowing for a proactive approach to limit the number and magnitude of year-end adjustments.
- **Identify and Review Material Transactions:** Conduct a detailed review of calculation workbooks to pinpoint deficiencies, such as lack of version control, hard-coded amounts with no audit trail, limited or undocumented key assumptions, and an incoherent calculation process. Companies can address one or more of these issues based on timing and resources. Small changes can have a significant impact.
- **Define a Data-Focused Project:** Consider the data needed for transfer pricing calculations, investigate the form and availability of data, identify new data sources, and help data providers understand their importance in the overall process. This can be done on a pilot basis with a material transaction or group of transactions to keep the project manageable. Companies often discover new data sources and form valuable connections with data providers through these projects.

Learning from the year-end process provides clarity on areas that need improvement. These observations can be captured and converted into small improvement projects as soon as possible after year-end. While companies can't tackle everything at once, prioritizing key projects, developing a timeline with identified resources, and obtaining stakeholder buy-in quickly can significantly improve the next year-end experience.

IMPLICIT SUPPORT IN INTERCOMPANY LOANS

The IRS recently released a generic legal advice memorandum that explains the agency's position on the effect of group membership in determining the arm's length interest rate of intragroup loans.

The legal advice memorandum — AM 2023-008 — concludes that if an unrelated lender would consider group membership in establishing financing terms available to a borrower, and third-party financing is realistically available, the IRS may adjust the interest rate in a controlled lending transaction to reflect group membership.

Generic legal advice memoranda constitute legal advice, signed by executives in the National Office of the Office of Chief Counsel, and are issued to IRS personnel to provide authoritative legal opinions on certain matters, such as industry-wide issues. This memorandum provides non-taxpayer-specific legal advice on the application of IRC Section 482, and it states that the advice should not be used or cited as precedent. However, the memorandum provides insight into the Office of Chief Counsel's position on the role of implicit support in establishing an arm's length interest rate in intragroup loans.

Example

The memorandum provides an example to anchor its analysis of the topic. In the example, a non-U.S. parent company directly owns 100% of the equity of a U.S. subsidiary. The U.S. subsidiary owns operating assets and operates businesses essential to the group's financial performance. The assumption in the example is that if the U.S. subsidiary's financial condition were to deteriorate, the non-U.S. parent would likely provide financial support to it to prevent a potential default.

The example states that the U.S. subsidiary plans to obtain capital through an intragroup loan from its non-U.S. parent. An independent rating agency has determined that the non-U.S. parent has a credit rating of A, whereas the U.S. subsidiary has a BBB rating when the implicit support of the corporate group is taken into account. As an independent entity — that is, without considering the group credit profile and the non-U.S. parent's implicit support — the U.S. subsidiary would have a credit rating of B. In the example, the A credit rating corresponds to an interest rate of 7%, the BBB credit rating corresponds to an 8% interest rate, and a B rating would result in a 10% interest rate. The non-U.S. parent lends to the U.S. subsidiary at an interest rate of 10%, and the loan is not supported by an explicit guarantee from the parent.

Analysis

The starting point of the analysis is Section 482 and the regulations thereunder, which grant the IRS broad authority to adjust the results of a transaction between controlled taxpayers to comply with the arm's length standard. In the context of intercompany lending, this means that the IRS may adjust the interest rate charged so that it is an arm's length rate, which is generally the rate that would be charged in independent transactions between unrelated parties. The regulations specify that to determine an arm's length interest rate, *"[a]ll relevant factors shall be considered, including … the credit standing of the borrower."*

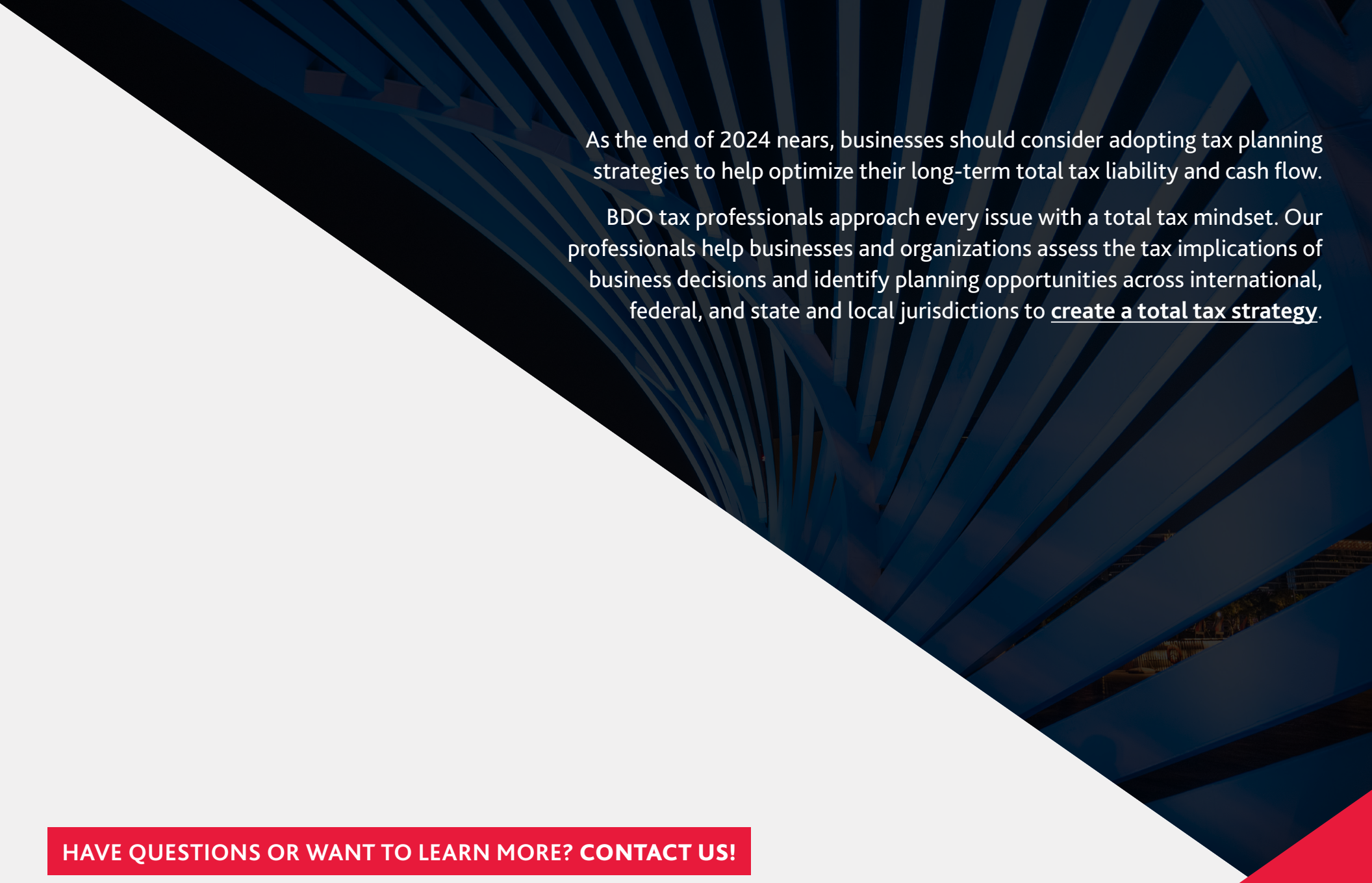
The memorandum concludes that the IRS may adjust the interest rate of the foreign parent's loan to the U.S. subsidiary to 8%, the arm's length interest rate the U.S. subsidiary would pay to an unrelated lender based on its BBB rating (if the implicit support by the foreign parent is taken into account). This rate reflects the amount the U.S. subsidiary would be willing to pay at arm's length considering the alternatives available to it. In other words, *"the controlled borrower should never accept an interest rate greater than the 8% [at which] it could borrow from the market. In short, the lender may not charge a higher interest rate based on a controlled relationship with the borrower, because an uncontrolled borrower would not accept a higher interest rate than what it could obtain from an uncontrolled lender."*

Planning Considerations

The guidance provided in the IRS memorandum is largely consistent with Chapter X of the OECD transfer pricing guidelines, released February 11, 2020, which provides guidance on the transfer pricing aspects of financial transactions. The IRS memorandum summarizes the agency's long-held position on its review of intercompany loans, particularly those to U.S. borrowers.

The IRS position on implicit support is reflected in *Eaton Corp. v. Commissioner,* No. 2608-23, which as of September 2024 was pending in U.S. Tax Court. In that case, although the IRS took the position that interest rates paid by certain U.S. borrowers should be adjusted downwards to consider implicit support, it also disallowed some deductions related to explicit intercompany financial guarantees executed with respect to the related intercompany borrowings.

Given the above, it will be important for multinational entities, particularly non-U.S.-based groups, to review their intercompany loan agreements and evaluate whether the implicit support derived from group membership is reflected in the interest rates charged to related borrowers. Borrowers should also consider whether any existing intercompany financial guarantees are still warranted, and if so, whether they should be adjusted to first consider implicit support before the application of explicit support.



As the end of 2024 nears, businesses should consider adopting tax planning strategies to help optimize their long-term total tax liability and cash flow.

BDO tax professionals approach every issue with a total tax mindset. Our professionals help businesses and organizations assess the tax implications of business decisions and identify planning opportunities across international, federal, and state and local jurisdictions to **create a total tax strategy**.

HAVE QUESTIONS OR WANT TO LEARN MORE? **CONTACT US!**

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