



Agenda

Tax Reform Changes Affecting Small Taxpayers

- The "Uniform" Definition of a Small Taxpayer
- Electing out of UNICAP
- Safe Harbor Inventory Methods
- The Overall Cash Method
- Special Topic (Farmers)
- Special Topic (Contractors)
- The 163(j) Interest Limitations

The background of the agenda slide is a grayscale photograph of a modern cable-stayed bridge with multiple tall, white, A-frame pylons and numerous stay cables. The bridge spans a body of water, and the sky is visible in the background.

Tax Cuts & Jobs Act of 2017 –
Polling Question 1

- Have you filed a Form 3115, *Application for Change in Accounting Method* for changes under Rev. Proc. 2001-10, Rev. Proc. 2002-28, or section 448?
 - » Yes
 - » No
 - » N/A

Tax Cuts & Jobs Act of 2017 –
Uniform Definition of Small Taxpayer

- New in 2018: Non-tax shelter taxpayers with less than \$25 million in average, annual gross receipts over the three prior years are considered “small taxpayers” for:
 - » The § 163(j) interest limitation
 - » The § 448 cash vs. accrual rules
 - » §§ 471 and 263A inventory rules
 - » § 460 exemption from the Percentage Completion Method for certain long-term contracts
- The \$25 million threshold is indexed for inflation starting in 2019
- Rev. Proc. 2018-57, section 3.31 increases the threshold to \$26 million for 2019

Tax Cuts & Jobs Act of 2017 – The \$25 Million Gross Receipts Test

- Use average gross receipts of the three prior years.
 - » In 2018, use 2015, 2016, and 2017.
- Short years must be annualized.
- If the taxpayer has not been in existence for three years:
 - » The taxpayer's predecessor trade or business counts as the taxpayer
 - » The taxpayer extrapolates based on the time it has been in existence during the test period.
- Definition of gross receipts:
 - » Sales net of returns, but COGS not subtracted
 - » Service income, investment income, interest, and gain on the sale of capital assets included
 - » Sales taxes collected by seller and imposed on purchaser not included

Tax Cuts & Jobs Act of 2017 – Gross Receipt Aggregation

- Gross receipts are determined at the *Single Employer* level, including:
 - » Members of a controlled group, even if not a component member
 - » Trades or businesses under common control:
 - Parent-sub T or B: >50% controlling interest owned by the parent or one of the other orgs
 - Brother-sister T or B: the same 5 or fewer individuals, estates, or trusts own a controlling interest and has effective control of the organizations (the >= 80% and >50% tests)
 - » Members of an affiliated service group (if the entities had employees)

Tax Cuts & Jobs Act of 2017 – Tax Shelters

- Tax shelters are not treated as small taxpayers.
- What is a “tax shelter”?
 - » Any non-C corp enterprise if ownership interests were ever offered for sale in an offering required to be registered with any Federal or State agency regulating the sale of securities, but not including S corps who have to register a notice of exemption with a state agency
 - » Any entity, plan, or other arrangement with a significant purpose of the avoidance or evasion of Federal income tax
 - » Syndicates
- Effect of “tax shelter” designation:
 - » Similar to current rules under Rev. Procs. 2001-10 and 2002-28:
 - Must use the accrual method
 - Must pre-TCJA inventory rules
 - » Must use PCM for all long-term contracts except home construction contracts
 - » Otherwise subject to the section 163(j) interest limitation

Tax Cuts & Jobs Act of 2017 – Syndicates

- What is a syndicate?
 - » Partnership or other non-C corp corporation if more than 35% of losses are allocated to limited partners or limited entrepreneurs during that year
 - » Exemptions for active management:
 - Individuals who actively manage the entity;
 - The spouse, children, grandchildren, and parents of an individual who actively manages the entity;
 - Individuals who actively managed the entity for at least 5 years
 - Estates of individuals who actively managed the entity or their spouse, children, grandchildren, or parents; and,
 - Others whom the Secretary determines should be treated as active management and the interest is not used for tax avoidance purposes.

Tax Cuts & Jobs Act of 2017 –
Polling Question 2

- Will the tax shelter or the gross receipt aggregation rules present obstacles to taking advantage of the TCJA small business taxpayer provisions for your firm or your clients?
 - » Yes
 - » No
 - » N/A

Tax Cuts & Jobs Act of 2017 –
UNICAP – General Rules

- **UNICAP** - Non-tax shelter taxpayers that meet the \$ 25 million gross receipts test are exempt from the uniform capitalization rules of § 263A.
- Which rules?
- All of them.
 - » Capitalization of additional section 263A costs into inventory;
 - » Capitalization of additional section 263A costs into self-constructed assets;
 - » Capitalization of interest under section 263A(f).

Tax Cuts & Jobs Act of 2017 – UNICAP – Where do we go from here?

- **Where do the changes leave us?**
- Reversion to pre-TRA '86 law?
 - » Full absorption for manufacturers and acquisition costs for retailers.
 - » Restaurants and other “producers” no longer subject to UNICAP inventory capitalization.
 - » Self-constructed assets may go back to *Comm'r v. Idaho Power Co.*, 418 U.S. 1 (1974), which provides few new opportunities.
 - » Given the repeal of former section 189, will construction period interest and taxes remain capitalizable for small businesses?
 - » Great potential for unwinding cost segregation studies' indirect allocations of interest and property taxes.
- Something else?
 - » Unlikely, but treatment of section 263A as independent capitalization statute might unwind pre-'86 treatment.
 - » Prime or direct costing for everything? (Very unlikely)

Tax Cuts & Jobs Act of 2017 – UNICAP – Tax Shelters

- But what about tax shelters?
- In a change from prior law, there is no current de minimis exemption from UNICAP for small reseller tax shelters!
- Small retailers that meet the definition of a syndicate may be required to switch back-and-forth onto and off UNICAP depending on whether they have a net loss for the year (not taking into account capital gains/losses).
- The less-than-\$200,000-in-indirects exemption from UNICAP for small producers who have elected the Simplified Production Method is intact based on the legislative history. Other exemptions not based on gross receipts should also survive.
- Restaurants that meet the definition of a syndicate and have a loss would be required to use UNICAP if they have more than \$200,000 in indirects.

Tax Cuts & Jobs Act of 2017 –
Polling Question 3

- Are most taxpayers currently compliant with section 263A(f), i.e. use the avoided cost method of capitalizing interest for applicable property?
 - » Yes
 - » No
 - » N/A

Tax Cuts & Jobs Act of 2017 –
Inventory

- **Inventories** - Non-tax shelter taxpayers that meet the \$ 25 million gross receipts test will “not be required to account for inventories” under § 471.
- Instead, they will be allowed to use an accounting method that:
 - » Conforms to their financial or book accounting treatment of inventories, or
 - » Treats inventories as non-incidental materials and supplies
 - Inventoriable items treated as non-incidental materials and supplies are consumed and used in the year the taxpayer provides the items to a customer.
 - Several possible interpretations of how NR&M treatment works.

Tax Cuts & Jobs Act of 2017 – A New Inventory Conformity Requirement?

- Qualified small businesses shall be treated as clearly reflecting income if their inventory method:
conforms to such taxpayer's method of accounting reflected in an applicable financial statement of the taxpayer with respect to such taxable year or, if the taxpayer does not have any applicable financial statement with respect to such taxable year, the books and records of the taxpayer prepared in accordance with the taxpayer's accounting procedures.
- Unanswered questions:
 - » Does this apply to the overall inventory method OR the overall method plus all submethods?
 - » Will all changes to the book method now require a tax method change?
 - » Does this open the door to formerly impermissible tax methods: Gross Profit Percentage, LLCM, MTM, etc?
- Due to the LIFO conformity requirement, taxpayers should be able to continue the LIFO method for book and tax, though they might have to follow their book submethods.

Tax Cuts & Jobs Act of 2017 – Non-incident Materials & Supplies

- Unclear landscape due to limited guidance.
- Option 1: Rev Proc 2001-10/2002-28 Method
 - » Capitalize into inventory only goods purchased for resale and the raw materials (and raw material content of WIP and FG) of manufactured goods.
 - » Labor and overhead are expensed as incurred or paid.
 - » Inventory deducted when provided to customers.
- Option 2: First Principles Approach
 - » Like Option 1, but raw materials might be deductible when used in the production process.
 - » May require more rigorous differentiation of RM and materials & supplies.
- Option 3: The DMSH Approach
 - » Like Option 1 or 2 but with using the DMSH to accelerate deductions.
 - » Possible problems with regulatory requirements of DMSH.
 - » JCT Blue Book approves of this approach, but requires book inventory expensing
- TPR complications – do the 1.263(a)-2 regs require additional capitalization?

Tax Cuts & Jobs Act of 2017 – Definition of an Applicable Financial Statement

An applicable financial statement is certified as being prepared on a GAAP basis and which is either:

- A 10-K or annual statement to shareholders required to be filed by the taxpayer with the SEC,
- An audited financial statement of the taxpayer which is used for--
 - » credit purposes,
 - » reporting to shareholders, partners, or other proprietors, or to beneficiaries, or
 - » any other substantial nontax purpose but only if there is no 10-K,
- If there are no 10-K or audited financials described above, a financial statement filed by the taxpayer with any other Federal agency for non-Federal tax purposes,
- A financial statement on an IFRS basis and is filed by the taxpayer with an SEC-equivalent agency that is no less stringent than the SEC, and
- If there is no 10-K or IFRS equivalent, a financial statement filed by the taxpayer with any other regulatory or governmental body specified by the Secretary.

Tax Cuts & Jobs Act of 2017 – Cash vs. Accrual

- § 448 applies to C corps, partnerships with a C corp partner, and tax shelters
- Non-tax shelter C corps and partnerships with a C corp partner must use the accrual method if they fail the gross receipts test
- TCJA increased the gross receipts test threshold from \$5 million to \$25 million
- Personal service corps are not required to use the accrual method
- Partnerships w/o C corp partners and S corps do not fall under § 448 and can use the cash method unless they fail the \$25 million gross receipts test and are required to use an inventory method (or are tax shelters).

Tax Cuts & Jobs Act of 2017 – Cash Method Issues

- Under the cash method, the cost of inventoriable items are deductible only in the year provided to the customer, or in the year in which the taxpayer actually pays for the goods, whichever is later.
- Practical application: Under the cash method, if NR&M inventory turns slower than the taxpayer pays its inventory vendors, the taxpayer will essentially be on a FIFO method at cost.
- Open A/R, (terms of ≤ 120 days), included in income when actually or constructively received. Longer terms require analysis under case law.
- New section 451(j), which defers income for FITP no later than for financial purposes, does not restrict the ability of small businesses to adopt the cash method.

Tax Cuts & Jobs Act of 2017 – Special Topic - Farmers

- Under current law, farming businesses can generally use the cash method.
- Former section 447 required farming C corps and farming partnerships with a C corp partner to use the accrual method of accounting using a \$1 million gross receipts test, (\$25 million for family farm C corps).
- The TCJA raises the gross receipts test to the standard \$25 million.
- Farms that elect out of the section 163(j) interest limitation must use the Alternative Depreciation System for all assets with a recovery period of ten or more years.

Tax Cuts & Jobs Act of 2017 – Special Topic - Contractors

- TCJA expanded the exception for small construction contracts from the requirement to use the Percentage-of-Completion Method for non-tax shelter taxpayers.
- Qualifying contracts are contracts for the construction or improvement of real property if:
 - » When the contract is entered into, it is expected to be completed within two years of commencement; and,
 - » The taxpayer meets the \$25 million gross receipts test the year into which the contract was entered.
- If the above two requirements are not met for a home construction contract, section 263A applies.

Tax Cuts & Jobs Act of 2017 – Rev Proc 2018-40

- Rev Proc 2018-40 modifies Rev Proc 2018-31 to include automatic method change procedures for the TCJA small business taxpayer provisions.
- DCN 233: Accrual-to-Cash method change.
- DCN 234: Election off section 263A (except for small business taxpayer home construction contracts).
- DCN 235: Change to NR&M or Book inventory treatment.
- DCN 236: Change from PCM or change to no longer use section 263A for small business home construction contracts.

Tax Cuts & Jobs Act of 2017 –
Rev Proc 2018-40 Issues

- The 5-year item eligibility rule is waived for the 2018-2020 tax years, but just for these changes. If flip flop method changes occur, the taxpayer may have to file a nonautomatic method change.
- DCNs 233, 234, and 235 can be filed on one Form 3115. DCN 236 has no concurrent changes.
- DCN 236 uses a cut-off basis; all others use a 481(a) adjustment.
- If a new method change reverses a prior one with a remaining 481(a) adjustment period, the taxpayer can net the 481(a) adjustments or treat them separately.
- The Service has requested comments on these method change procedures and the substantive issues surrounding them.
- Small taxpayer/short Form 3115 filings will be permitted.

Tax Cuts & Jobs Act of 2017 –
Polling Question 4

- Does Rev. Proc. 2018-40 provide substantive guidance on the TCJA small business taxpayer provisions?
 - » Yes
 - » No
 - » N/A

Section 163(j) Interest Limitation

- Section 163 Interest Expensing
 - » Taxpayers' interest deduction generally limited to 30% of adjusted taxable income plus floor plan financing interest (for dealerships).
 - » Exceptions
 - Small taxpayers with less than \$25 million in average, annual gross receipts over the prior three years determined at the single employer level, (i.e. possibly aggregated with other related entities depending on complex rules).
 - Electing farmers.
 - Electing real property trades or businesses.
 - Electric, sewage, gas, steam, or water utilities.
 - » Effect on Bonus Depreciation and ADS
 - Utilities do not receive bonus depreciation.
 - Electing farmers must use ADS for longer life assets and those assets do not receive bonus depreciation.
 - Electing real property trades or businesses must use ADS for QIP, 39-year, and 27.5-year property. If there is a technical correction, 15-year QIP would not qualify for bonus depreciation.

The Interest Deduction Limitation

- For tax years beginning after 12.31.17, Congress added § 163(j) to provide a general limit on deductible interest.
- Deductible business interest is limited to the sum of that year's:
 - » Box 1: Business interest income
 - » Box 2: 30% of the adjusted taxable income (this cannot be negative!)
 - » Box 3: Floor plan financing interest.
- Adjusted taxable income is taxable income net of business interest income, NOLs, § 199A, pre-2022 depreciation, and anything not allocable to a trade or business.
- Non-tax shelter taxpayers that meet the \$25 million gross receipts test are exempt from this limit.
- Other exempt taxpayers include employees, electing farmers, electing real property trades or businesses, electrical energy, water, or sewage disposal services, local gas or steam distributors, and certain gas or steam pipeline transportation companies.

Tax Cuts & Jobs Act of 2017 – Floor plan financing interest

- "Floor plan financing interest" means interest paid or accrued on floor plan financing indebtedness.
- "Floor plan financing indebtedness" means debt –
 - » (1) used to finance the acquisition of motor vehicles held for sale or lease, and
 - » (2) secured by the acquired inventory.
- "Motor vehicle" is any of the following:
 - » Any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road.
 - » A boat.
 - » Farm machinery or equipment.
- "Motor vehicles" seems to exclude at least some construction equipment, jet skis, fifth wheels, trailers, and parts and accessories.
- If a dealership has floor plan financing interest that falls into Box 3, its property is ineligible for bonus depreciation under § 168(k)(9)(B).

Tax Cuts & Jobs Act of 2017 – Electing Real Property Trades or Businesses

- A real property trade or business that makes an election under § 163(j)(7)(B) is exempt from the interest limitation
- The exemption arises because the electing real property trade or business is no longer considered a trade or business for purposes of the interest limitation.
- "Real property trade or business" uses the definition under § 469(c)(7)(C):
 - "Real property trade or business" means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.*
- If a taxpayer makes this election, its nonresidential real property, residential rental property, and qualified improvement property become mandatory ADS property under MACRS.
- Under the ADS, these 3 groups receive 40-year, 30-year, and 40-year recovery periods and are ineligible for bonus depreciation.
- If Congress makes technical corrections, QIP should receive a 20-year ADS recovery period.

Tax Cuts & Jobs Act of 2017 – Section 163(j) Summary

- Non-tax shelter taxpayers that meet the \$25 million test are exempt from the interest limitation rules.
- Electing real property trades or businesses are exempt from the limit, but it comes at the cost of the ADS (and no bonus depreciation) for 27.5-year and 39-year property.
- Electing farmers are exempt from the limit, but it comes at the cost of ADS (and no bonus) for 10 year or greater recovery period property.
- Dealership operating entities, if they pay or incur floor plan financing interest, lose bonus depreciation altogether.

Tax Cuts & Jobs Act of 2017 – Polling Question 5

- Is the small taxpayer exemption from the section 163(j) interest limitation the best of both worlds?
 - » Yes
 - » No
 - » N/A

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