LAW360

Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Federal Tax Regs To Watch In 2020

By **Amy Lee Rosen**

Law360 (January 1, 2020, 12:04 PM EST) -- From regulations on accrual accounting and income recognition to the tax treatment of advance payments and whether non-revenue-generating companies can conduct tax-free spinoffs, the IRS and Treasury will be tackling several significant tax regulations in 2020.

Here, Law360 examines federal tax regulations that practitioners should monitor in the new year.

Income Recognition

The Internal Revenue Service in 2020 likely will finalize rules on income recognition in response to Congress' statutory attempt to simplify accounting for businesses.

Under the Tax Cuts and Jobs Act, Congress changed Section 451(b) of the tax code to require businesses to match information on a financial statement to the income reported for tax purposes. Under that section, a corporation must declare taxable income only when it is fixed and determinable under the "all events test." Fixed and determinable means income is only recognized when a corporation has a right to the income and the amount can be determined with reasonable accuracy.

In response to the TCJA changes, the IRS issued proposed rules in September clarifying when items are included in income for businesses that use an accrual method of accounting. The rules specifically said revenue includes all transaction price amounts that will be on an applicable financial statement but excludes certain items subject to Section 461, such as allowances, adjustments, rebates, chargebacks, refunds or rewards, as well as amounts included in costs of goods sold.

According to the proposed rules, the IRS believes it must follow a mandate to accelerate the recognition of income, but the rules will delay some deductions under Section 461, which could create a timing mismatch, according to Kevin Spencer, a tax partner at McDermott Will & Emery LLP.

For example, under the rules a manufacturer may have to recognize income in a period earlier than when it can recognize the offsetting costs of goods sold, he said.

"So there is a mismatch in timing of income and arguably overstating income," Spencer told Law360. "It remains to be seen whether the IRS and Treasury will incorporate a percentage of completion methodology into the regulations, which would better match income and offsets to income."

Advance Payments

In 2020 the government will also likely finalize regulations proposed in September under Section 451(c) allowing an accrual-method taxpayer to either include an advance payment in gross income in the year of receipt or use a deferral method of accounting.

Section 451(c) was added to the tax code by the TCJA and covers how to treat payments received for future goods and services. The provision codified a long-standing safe harbor that allows a one-year deferral for advance payments currently available under Revenue Procedure 2004-34. The TCJA allowed businesses with an applicable financial statement to use a deferral method of accounting for advance payments, but the IRS determined that businesses without an applicable financial statement should also be allowed to use a deferral method similar to that outlined in the revenue procedure.

The 451(c) regulations also included a definition of advance payments and provided acceleration rules for when a taxpayer ceases to exist.

The proposed rules expand the potential application of the deferral method beyond goods and services to other qualifying activities, such as the use of intellectual property and the sale of eligible gift cards, according to Scott H. Rabinowitz, tax counsel at Skadden Arps Slate Meagher & Flom LLP.

The proposed regulations exclude from the definition of advance payments any payments received for "specified goods," which may pave the way for even longer deferral in some cases, he said.

However, this exemption should be broadened to include all advance payments related to the sale of goods so as to avoid the taxation of gross receipts, since courts have rarely found that gross receipts with no offsetting deduction for cost of sales are subject to tax, Rabinowitz said.

Tax practitioners expect the 451(b) and (c) final regulations to come out in the summer of 2020, before the IRS' guidance year ends, Ellen McElroy, a tax partner at Eversheds Sutherland, told Law360.

"That'll be a really important package in 2020 just because of the scope of taxpayers that are affected by the provision," she said.

Tax-Free Spinoffs

The IRS and Treasury in 2020 may create a new regime for Section 355 tax-free spinoffs, as they have been processing comments from practitioners on whether to expand or modify the "active trade or business requirement" for the transactions.

In May, the IRS and Treasury said they had been studying whether and to what extent corporations may undergo a tax-free spinoff under IRC Section 355 when a business doesn't generate income but has engaged in substantial research and development activities, which often occurs in the technology and pharmaceutical industries.

Section 355 has been around since 1951 and allows a corporation to spin off a subsidiary and distribute the stock in the new company to its shareholders tax-free if certain conditions are met. Qualifying for Section 355 requires both the distributed and controlling corporations to be engaged in the active conduct of a trade or business for the five years preceding the spinoff. However, the definition of

“active” under regulations from 1955 has historically focused on whether or not the former parent and new companies are both generating income.

The IRS may decide that companies that are not immediately earning income, such as startups and pharmaceutical companies, can take part in Section 355 transactions, according to David Zimmerman, a tax lawyer at Miller & Chevalier Chtd.

“It's definitely true over the years that there are very, very active businesses that just don't produce income for long, long periods of time,” he said. “I think they'll look very closely at what are the activities being performed, how many employees there are, what do they do, what are the reasons you haven't produced income, like regulatory hurdles.”

The IRS may have delayed changing the “active trade or business” requirement to not requiring the generation of revenue simply because the current income requirement is easy to administer and is objective, which may be making it harder to come up with an equally easily managed new regime, Zimmerman told Law360.

“I think [right now] the IRS is struggling to come up with a ruling program that will allow them to issue rulings, based on meaningful criteria, that will be administrable,” he said.

Bonus Depreciation

The IRS in 2020 will finalize rules on Section 168(k), which provides a 100% deduction for the cost of depreciable business assets that have a recovery period of 20 years or less for the first year the property is placed in service.

The agency in September floated proposed rules on the 100% first-year expensing deduction to clarify how the provision applies to property acquired by consolidated business groups. The rules specifically addressed the treatment of used property acquired by consolidated groups and sales of property between members of a group. Property that generally qualifies for the deduction includes machinery, equipment, computers, appliances and furniture, the IRS said.

McElroy told Law360 that, from what she had heard, IRS and Treasury are far along on the final rules, so it would not surprise her if they came out in the first quarter in 2020. However, the New York State Bar Association in late November issued comments on the package that raised concerns about how the rules should apply to partnerships. Addressing those concerns may delay the final rules, McElroy said.

“I would think, depending on how long it takes the IRS and Treasury to address those concerns, that could lengthen when the package comes out, but I would expect we'll probably see it in the first quarter,” McElroy said.

Unrelated Business Taxable Income

Nonprofits continue to await regulations interpreting the new “silo” rules enacted as part of the TCJA. Those rules require nonprofits with two or more unrelated trades or businesses subject to unrelated business taxable income, or UBTI, to compute income and loss from each unrelated trade or business separately.

Although the IRS issued Notice 2018-67 in August 2018 proposing certain reasonable good-faith

interpretations of the statute, the notice is not regulatory guidance. In the notice, the IRS requested comments on items related to the silo rules under IRC Section 512(a)(6), but the government also said it intended to issue proposed regulations on how to identify those separate trades or businesses in order to calculate UBTI.

The regulations should only require tax-exempt organizations to separately compute an item of unrelated business income or loss if the item in fact arises from a trade or business, Alexander Reid, a partner at Morgan Lewis & Bockius LLP, told Law360. Doing so will require the government to take a position on what actually constitutes a trade or business, he said.

Reid said he hoped the IRS would follow a 1987 U.S. Supreme Court decision, Commissioner v. Groetzinger, and its progeny, which define a trade or business as a profit-seeking activity that is conducted with regularity and continuity, as opposed to an activity that is merely profit-seeking, he said.

“What hangs in the balance is whether or not a nonprofit's investment activity should be treated as a trade or business requiring separate computation,” Reid said. “It would greatly simplify application of the new statute to exclude such income.”

Investment activity is always carried on for profit, but it is not always conducted with regularity and continuity, so it should not automatically be treated as an unrelated trade or business when conducted by a nonprofit organization, he said.

--Editing by Tim Ruel and Vincent Sherry.

All Content © 2003-2020, Portfolio Media, Inc.