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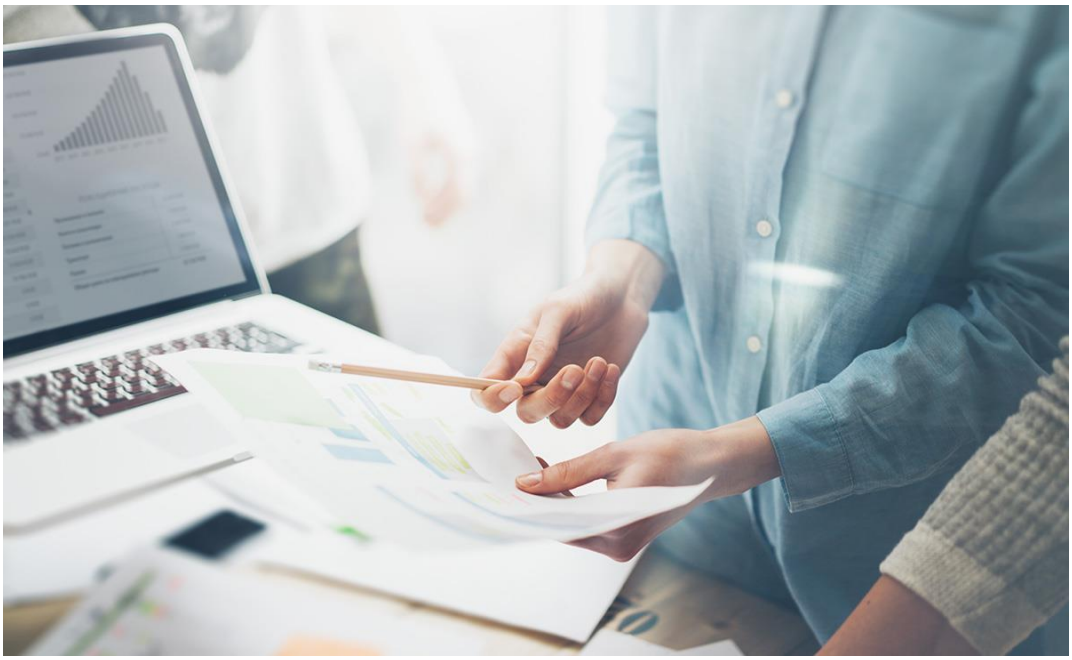
Does Your Business Have Unbilled Revenue? Final Revenue Recognition Regulations Offer Income Deferral Opportunities



Taxpayers with audited financial statements (AFS) have new opportunities under the final Sec. 451 regulations to defer recognizing income under the Sec. 451(b) book acceleration rule (see this Tax Release for a summary of the final Sec. 451 regulations). Those taxpayers with unbilled revenue or contract assets on the GAAP balance sheet may be able to defer such revenue for tax purposes under the new guidance.

Under these new rules, IRS has simplified procedures for pursuing these opportunities by permitting an application for an automatic accounting change to be filed with 2021 tax year returns. Businesses must first determine their eligibility to defer the recognition of unbilled revenue and then obtain an automatic accounting method change by completing Form 3115, Application for Change in Accounting Method, so it can be filed with the 2021 return.

Opportunities to Defer Are Based on Arrangements with Customers

Under ASC 606, businesses with an AFS may be recognizing unbilled revenue for GAAP in a number of situations prior to when such income would have historically been considered earned for tax purposes. This recognition often occurs because book may be accelerating income from future events into an earlier year (for example, estimated future commissions to be earned from contract renewals), or because book may be straight-lining revenue over a multiyear contract period (for example, a multiyear service agreement with increasing annual fees).

While the book acceleration rule under Sec. 451(b) generally requires the recognition of taxable income no later than when the revenue is recognized for book purposes, there are exceptions available under the final regulations which did not exist in previous guidance. In particular, taxpayers are not required to accelerate income when they do not have an *enforceable right* to collect the unbilled revenue if the customer were to terminate a contract on the last day of the taxable year (determined on a *what if* basis, regardless of whether the customer has actually terminated the contract). Accordingly, taxpayers may be able to defer recognizing unbilled revenue even though it has been recognized for book purposes if they can establish that they are not yet able collect the amount under the terms of the contract.

For example, if the contract provides that the taxpayer is not allowed to bill for work performed to date in the event of an early termination, such unbilled revenue may be deferred for tax purposes until it is invoiced to the customer. Similarly, while book may be recognizing a potential project completion bonus over the course of the contract, such unbilled revenue may be deferred for tax purposes until the project is complete and the taxpayer has the right to bill for such amount. Opportunities may also exist under multiyear service contracts that contain increasing annual fees over the contract term. In such situations, book may be straight lining the revenue (and thus, accelerating the revenue) over the contract term, but tax may defer recognizing such unbilled revenue as the taxpayer does not have the right to collect the incremental fees associated with future years until it may invoice such amounts in the applicable later year.

Common fact patterns where opportunities may exist include:

- Arrangements where ability to bill and collect depends on customer acceptance or project completion;
- Fees or commissions that are contingent upon future contract renewals;
- Escalating annual base fees for rent, licenses or subscription fees (for example, multiyear contracts for SaaS services);
- Contract terms that restrict the ability to collect if a customer early terminates the contract; or
- Situations where book has recognized revenue that is contingent upon a future event.

Taxpayers are required to change to the final Sec. 451 regulations for their 2021 taxable year and may do so by filing Form 3115 with the 2021 return. While some taxpayers may already be in compliance with the new rules, they should evaluate the deferral opportunities available under the final regulations and consider making an accounting method change.

The Takeaway

While the combined effects of ASC 606 and the book acceleration rule generally result in the acceleration of income recognition for tax purposes, opportunities are available to continue to defer such income depending on your company's arrangements with its customers. In particular, taxpayers may be able to defer recognizing unbilled revenue if they do not have an enforceable right to bill the customer as of the end of the taxable year. For eligible taxpayers, the revenue deferred by applying the enforceable right rule may be significant. As such, existing contracts and arrangements with customers should be reviewed to determine if the taxpayer is eligible to apply the *enforceable right standard* to income from unbilled revenue or contract assets. In addition, procedures should be established to identify and track relevant customer arrangements going forward.

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Opportunities for Double Discounts in Real Estate Portfolio Gifts – Blockage Discounts

In trust and estate tax planning, a well understood and often used tax saving transaction is the partial interest gift discount when a non-controlling partial (or fractional) ownership interest is gifted between family members. In this case, once the fair market value of 100% of the subject real estate portfolio is established, a discount study is performed for the partial interest of the ownership amount that is transferred via a gift. The discount study reflects the impact on the value of a partial interest for factors such as lack of control over the operation and disposition of the real estate and a lack of marketability due to the difficulty in selling an interest that is not publicly traded and is not easily financeable.

Blockage Adjustments Require an Assessment of Market Demand

There are also situations where the taxpayer may be in a position to benefit from a discount at both the real estate portfolio level, called a *blockage adjustment*, and another discount (lack of control, marketability, etc.) at the partial interest gift level. The concept of a blockage adjustment was initially considered and created as a principle of tax law when a large block of shares could be valued at an amount less than the individual pricing of the shares because the larger block could be difficult to sell at the full retail price at a particular date of value. This issue was traditionally prevalent among founders of companies, or their heirs, because of substantial ownership of shares in one stock. As a result, the valuation included creation of a discounted cash flow patterning the *sell-off* of the stock over a reasonable period as measured by market demand and supply forecasts. The key component in justifying this additional blockage adjustment lies in an assessment of market demand. Evidence of a large number of holdings of an asset alone is not enough; if demand is high there will be no discount applied.

The following two court cases clarify the use and process employed in a blockage adjustment:

Case 1: Jane Z. Astleford v. Commissioner, T.C. Memo 2008-128

In this case, the petitioner's expert utilized the sales comparison approach and identified farm comparables similar to the Subject's 1,187 acres of farmland in Minnesota. The expert argued that the sale of the entire Subject property would reduce the price per acre at which the property could be sold. The expert then utilized an absorption discount rate of 25% and calculated the net present value over a four-year period, which decreased the price per acre. The IRS expert also utilized the market approach and concluded that there should not be an additional market absorption discount to his comparables. While the court disagreed with the taxpayer's 25% discount, they did however determine that a four-year absorption and 10% discount rate was appropriate. This case confirms that a market absorption discount is appropriate for poorly diversified assets.

Case 2: Estate of Auker v. Commissioner, T.C. Memo 1998-185

Taxpayer's representative applied a 15% market absorption discount to each parcel of the Subject property. The argument was made that the 15% market absorption discount was applied because a sale of the property all at once would have depressed the market and required the seller to accept less for the property than the seller would have accepted if the properties were sold separately over time. IRS argued the discount did not apply because the representative did not establish that a skilled broker could not sell the property in a reasonable amount of time. The court held that the market absorption discount could be applied to three apartment complexes because they were the only properties directly owned by the decedent; the other properties were entity owned. The court also held that the market could not have handled the sale of all three complexes. The court found that the first complex would be sold within 18 months, the second within 30 months, and the third within 42 months. Ultimately, the court implied a market absorption discount existed in the Fair Market Value of the properties.

Key Elements to Analyze Include Property Type and Geographical Dispersion

As noted in the cases with respect to real property applicability of a blockage adjustment, there are typically two key elements to analyze. The first is to determine that the assets being valued are similar in property type. As an example, a broad category of multi-family assets in a particular state is likely not specific enough – the asset type must be similar enough to appeal to the same class of investor or buyer. A more likely category for real estate would be for two- to four-unit residential properties. The second element to analyze is the geographic dispersion of the assets being valued. Demand would need to be measured within the geographic boundaries dictated by the assets being valued. If there is significant dispersion, it is less likely a blockage adjustment is appropriate. Using the two-to four-unit residential properties as the property type, a more typical geographic boundary would be within one neighborhood or district of a particular city.

The following attributes are likely required to be analyzed to properly measure demand for the particular property type and geography identified when analyzing real property demand:

- Number of sales per year;
- Number of listings per year;
- Typical marketing time (number of months);
- Typical investor return expectations; and/or

- Most probable buyer(s) assessment.

When evaluating blockage adjustments, it is noted that sellers will distribute chunks of a product to not dilute values and maximize total returns. This distribution will result in an elongated time frame which is the basis for the blockage concept and analysis. Measuring market demand is critical to the analysis as it allows the evaluator to understand the additional product being added to the market based upon the individual owner's holdings. Once the demand is assessed, the supply can be layered in as to not influence pricing, and the difference between that estimate and the full retail value indicates the appropriate blockage adjustment.

Example Engagement – Blockage Adjustment

Taxpayer has a similar property type (ranches) that are in a similar geographic area (State of Montana). Given this property type and size of ownership, an assessment would then be made of market demand, most probable buyers, and other related items and utilize the data to develop an opinion based upon the example numbers shown below that illustrates a need for a blockage adjustment.

In aggregate, the Montana ranches that are being valued (approximately 400,000 acres in aggregate) range between 5,000 and 75,000 acres, with an average of approximately 40,000 acres per ranch, which is significantly larger than a majority of the transactions in the marketplace. In reviewing the total acreage sold for ranches throughout the state, which was gathered through conversations with multiple brokers and buyers and sellers and a review of publicly available data, it appeared that aggregate demand was about 200,000 acres per year and an elongated time frame to sell the properties was warranted.

Based upon the evaluation of the market supply and demand, a three-to-five-year absorption period is deemed to be appropriate to sell off the subject properties throughout the state. The application of this absorption period, along with an inclusion of marketing and sales costs and a rate of return, would conclude to a range of potential blockage adjustments which would be applied to the retail value before the partial interest discount study. This represents an appropriate and significant adjustment to the overall value of the subject properties based upon the blockage concept.

The Takeaway

As large owners of any asset type are evaluating making gifts or any other adjustments to their holdings, consideration should be given to a potential blockage adjustment. Along with discounts for lack of marketability and control, a blockage discount can be extremely important in evaluating the fair market value of the asset and may generate significant savings.

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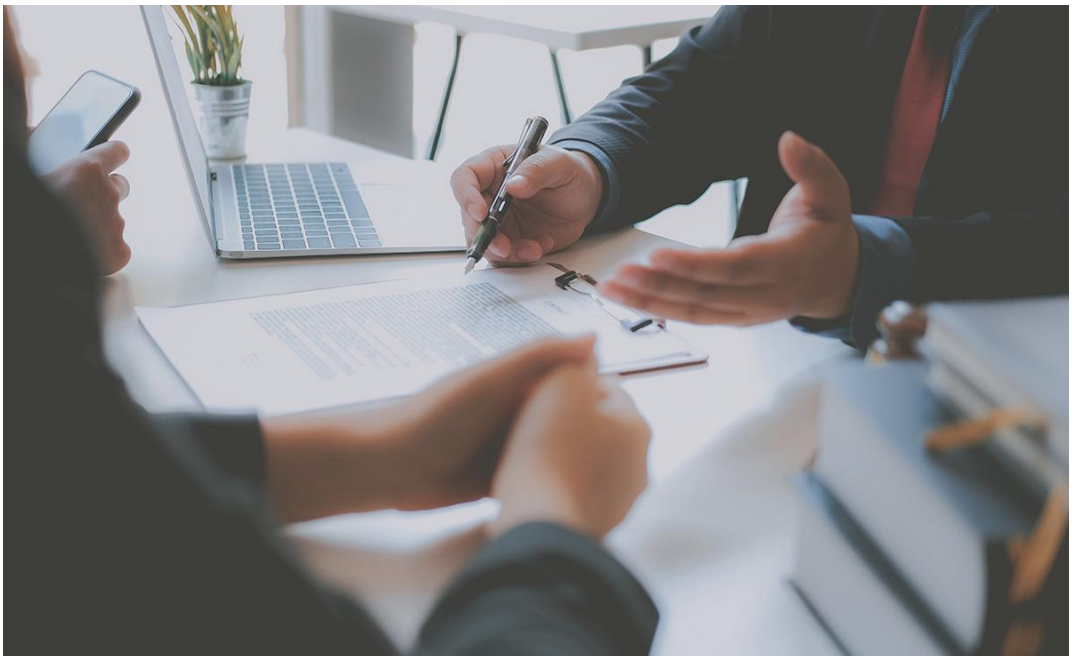
Private Equity Planning and IRC Section 2701: Anything but Special



Successful families often create multiple generations of entrepreneurs and businesspeople. In some families, younger generations start private equity funds and raise capital from both family and outside investors. It is not uncommon for a senior generation to support the business endeavors of their children and grandchildren by investing their own assets or from funds already set aside in trust. While straightforward on its face, these situations may result in unintended gift tax consequences under the Internal Revenue Code (IRC) Sec. 2701 special valuation rules that can impact the private equity industry.

Legislative History

Most estate planners are familiar with Sec. 2701 (and the other special value rules contained in Secs. 2701-2704 of Chapter 14). These rules were enacted about 25 years ago to limit taxpayers' ability to *freeze* the value of their estates using certain partnership structures. In the classic structure, a senior generation would establish a Family Limited Partnership (FLP) and capitalize with cash or other investment assets in return for preferred units. These preferred units carried a non-cumulative income preference right and included other rights such as the ability for the holder to put the units back to the FLP. The FLP would also issue common stock with little to no capital which was entitled to all of the upside in FLP appreciation over the preferred coupon. At the time of formation, the value of the common units would be extremely low due to the preferred preferences and rights, and the senior generation would gift these low-value common units to trusts with minimal gift tax cost. This transaction would result in a freeze of the senior generation's estate at the preferred interest value if the FLP paid no dividends, which was almost always the case, and therefore all appreciation inured to the common units.

After several failed attempts to curb these strategies, Congress enacted Sec. 2701, which provides that if a taxpayer gifts an entity equity interest that is junior to the retained equity interests because of the rights held in the preferred interest described above, those rights would be valued at zero, thereby artificially pushing value to the common shares. The value of those common shares would then be considerably more than their normal appraised value.

The Vertical Slice Exception and Deemed Transfer Rules

Although alternative fund interests and common/preferred interests don't track exactly, in the private equity planning world this issue is well known by fund principals and their advisors. One of the ways this trap is avoided is with what is known as the *vertical slice*. Section 2701 contain several exceptions, one of which says that if a taxpayer gifts shares of common and preferred stock, such that he has proportionately the same amount of common and preferred stock both before and after the gift, then these special valuation rules will not apply. Thus, if a fund manager owns a capital (Limited Partner) stake in his fund as well as a portion of the carry, then if he gives away 40% of his carry along with 40% of his LP interest, then the vertical slice exception will prevent application of Sec. 2701. A gift scenario is the most common Sec. 2701 application, but it can also apply in the family setting where the fund executive doesn't gift the carry, but other family members invest in the fund itself.

Let's assume Granddaughter, who has years of private equity experience, decides to start her own fund, including creating and holding a carried interest through the general partner interest of the fund. Besides unrelated money, in a legitimate third-party arrangement, the family also contributes $10 million of capital to the new fund — $5 million from Grandfather and $5 million from a grantor trust funded by Mother. Even though there is no actual gift here, Sec. 2701 would apply and requires that every time Grandfather and the Grantor Trust make capital calls, then Grandfather and Mother are deemed to be making a gift to Granddaughter.

While this result seems counterintuitive, remember the perceived abuse that Congress sought to curb with Sec. 2701 was where senior generations transferred the appreciation on their wealth to younger generations by shifting growth through controlled entities with little to no gift-tax ramifications. Looked at through this lens, even if the younger generation in the above example raises third-party capital and the senior generation invests as a limited partnership (LP) like everyone else, the carried interest still provides wealth to the junior generation created from the capital of the senior generation, much like the classic FLP example.

Perhaps even more perplexing, in the above example there was a deemed gift, but the profits interest was never actually owned by the senior generation, nor was it transferred in any way. A gift for tax purposes nonetheless results because Sec. 2701 was written to apply not just in a gifting scenario, but potentially anytime there is a contribution to, or a recapitalization of a controlled entity owned by different related generations.

In one version of the classic Sec. 2701 FLP freeze, instead of forming an FLP and gifting the common units, the senior and junior generations form an FLP and issue one class of common units. A few days later the senior generation contributes capital for newly issued preferred units and, absent the deemed transfer provisions, the same result occurs. Thus, Sec. 2701 contains rules to deem a gift even though no transfer occurred.

Planning Opportunity

As seen in the private equity example above, the deemed transfer rules capture a broad spectrum of transactions that are not abusive nor what the rules were designed to prevent. This includes instances where a senior generation contributes to a fund as a limited partner and a younger generation owns even a small amount of carry. Unfortunately, in the case of most private equity funds, which are very often structured as LPs, there is no de minimis exception for how much of the carry the younger generation can own. However, with some planning the above problem can be avoided.

In our example, Grandfather should not directly contribute to the fund, nor should any trust of which he is considered the grantor for income tax purposes (more on this below). Instead of investing directly Grandfather could consider:

- Gift and/or lending funds to Granddaughter so she can make the LP commitment and therefore the different fund equity classes are all owned by the same person.
- Funding a non-grantor trust for the benefit of heirs with a gift and allowing that trust to make the LP commitment. If Grandfather is out of gift exemption, he could lend funds to the trust to make the LP investment.

Mother has an even more unexpected Sec. 2701 problem since the LP investment came from a trust outside of her estate. Creating even more complication, Sec. 2701 also contains a byzantine set of attribution rules whereby a taxpayer is deemed to own the assets in a trust of which she is the grantor for income tax purposes. Thus, when the grantor trust makes the LP investment, Mother is deemed to own it under Sec. 2701 and there is a deemed transfer subject to the special valuation rules. These results could be avoided in one of a few ways:

- Grantor trust could distribute assets to Granddaughter so she can make the LP investment.
- Grantor trust could loan funds to Granddaughter or another child in her generation to make the LP investment.
- Mother and grantor trust could waive powers that cause grantor trust status (e.g., substitution) to make the trust non-grantor. The Chapter 14 attribution rules would not apply to a non-grantor trust in this fact pattern.
- Grantor trust could decant some assets into a non-grantor trust and allow that non-grantor trust to make the LP investment.

Finally, if Granddaughter were to transfer her carry, extra care must be taken as the LP interests owned by senior generations may be attributed to her for purposes of the deemed transfer and special valuation rules as well.

The Takeaway

Section 2701 presents uniquely difficult and less than apparent issues when planning with fund interests, even if that planning is nothing more than fund investments made by senior generation family members. It is therefore critical that such planning only be undertaken with an advisor who is experienced in identifying and avoiding what could be disastrous gift tax results.

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What Are Owners to Do: Tax Planning for Businesses in an Uncertain Environment

As we enter the second quarter of 2022, businesses and their owners face a state of change, disruption and uncertainty on both the domestic and international fronts. Despite the pending developments that have the potential to impact tax planning opportunities and challenges in 2022, there are some areas where tax planning needs are clear and where taxpayers must give their immediate attention. To that end, below are several tax-related moves that business should consider in 2022 including amending returns to capture tax benefits from the pandemic, leveraging deductions that may soon expire, and planning around expired tax benefits and current legislative uncertainty.

Amend Returns to Capture Pandemic-Related Tax Benefits

If your business did not take advantage of the temporary tax relief measures provided in connection with the COVID-19 pandemic, one relatively straight-forward step is to amend prior year tax returns to claim these benefits. Among the many potential benefits that can be obtained via an amended return are loss carrybacks and credits intended to encourage businesses and charities to retain and hire employees.

Business Losses and Interest Expense

The Coronavirus Aid, Relief, and Economic Security (CARES) Act restored the ability for businesses to carry back net operating losses (NOLs) incurred in the 2018, 2019, and 2020 tax years. The legislation also suspended the Sec. 461(l) limitation on excess business losses (EBL), which prohibits business loss deductions in excess of $500,000 for married taxpayers filing jointly or $250,000 for single filers. In addition, the CARES Act expanded the Sec. 163(j) business interest deduction percentage to 50% for the 2019 and 2020 tax years for most taxpayers.

For more information on pandemic-related tax relief see the following resources:

- NOL Carryback Opportunities for Corporations Under the CARES Act
- Maximizing 2020 Net Operating Losses for Individuals
- Tax Relief Under CARES Act and TCJA for Real Estate Businesses Impacted by COVID-19 and the Economic Downturn

Employee Retention Credit

There is still time to claim the Employee Retention Credit (ERC) in 2022. Businesses and tax-exempt organizations can claim the credit by amending their quarterly payroll tax returns for 2020 or 2021 to obtain a refundable tax credit for a percentage of the qualified wages paid to employees (70% for 2021, 50% for 2020). To qualify for the ERC, employers must have 1) fully or partially suspended business operations due to governmental orders limiting commerce, travel or group meetings due to COVID-19, or 2) experienced a significant decline in gross receipts. A broad range of employers may qualify for the ERC and it is not only for entities that experienced severe financial distress.

For general information on the ERC, see IRS Employee Retention Credit 2020 v. 2021 Comparison Chart.

Leverage These Deductions Before They Expire

Bonus Depreciation

The Tax Cuts and Jobs Act (TCJA) increased the bonus depreciation percentage from 50% to 100% for qualified property and expanded the property eligible for bonus depreciation. Businesses may immediately deduct 100% of the cost of eligible property in the year it is placed in service through 2022. The amount eligible for bonus depreciation is then phased down over four years to 80% for property placed in service in 2023, 60% in 2024, 40% in 2025, and 20% in 2026. For certain property with long production periods and for specific plants (planted or grafted) the expiration dates are extended by a year.

For more information on bonus depreciation, see the following resources:

- IRS and Treasury Issue Final and Proposed Regulations on Bonus Depreciation
- Update: CARES Act: Technical Correction for Qualified Improvement Property Provides Retroactive Tax Relief

Qualifying Business Meals

The CARES Act temporarily increased the deduction for food and beverages provided by restaurants paid or incurred after December 31, 2020 to 100% from 50% through December 31, 2022. The change comes after the TCJA generally disallowed the deduction for expenses for entertainment, amusement, or recreation effective for amounts paid or incurred after 2017, and limited the deduction for food and beverage to 50% in certain cases where it was not already so limited.

For more information on expenses for meals and entertainment see Tax Release – New Guidance on Scaled-Back Deduction for Meals and Entertainment Under the TCJA.

Be Aware of Tax Benefits That Have Expired or Where There Is Uncertainty

Research Expenses

The TCJA included a change to the treatment of research and experimental (R&E) expenses under Sec. 174. Until December 31, 2021, taxpayers could elect to immediately expense such costs. However, beginning January 1, 2022, the TCJA requires taxpayers to capitalize previously deductible R&E expenses. The TCJA provides a ratable amortization period of five years for R&E conducted in the United States and 15 years for non-U.S. activity beginning at the midpoint of the tax year incurred. Legislative efforts to reverse the new amortization requirement remain uncertain.

For more information see White Paper – With the BBB Act Stalled, Prospects Are Unclear for Reversing the New Requirement to Capitalize R&E Costs.

Business Interest Expense Limitation

The TCJA imposed a new limitation on the deductibility of net business interest expense. The CARES Act provided temporary relief by expanding the limitation to 50% from 30% of adjusted taxable income. However, in 2021, the limitation is back to the original 30%. In 2022, the limitation will become much more restrictive because depreciation and amortization will no longer be added back, absent a legislative change. Rising interest rates may also cause the interest limitation to take a bigger bite in 2022 for many taxpayers.

For more information see White Paper – Planning for Business Interest Expense Limitations in a Rising Interest Rate Environment.

Excess Business Loss Limitation

The EBL limitations for 2022 are $270,000 for single filers and $540,000 for joint filers. The EBL rules were originally set to expire at the end of 2025, but the American Rescue Plan Act extended the application to expire after 2026. Proposed legislation would permanently extend the EBL and change the nature of EBL carryforwards such that an EBL would not become an NOL but would instead be treated as a business loss subject to the EBL limitation rules during each carryforward year.

The Takeaway

Despite a seemingly everchanging world and moving target of prospective legislation and potentially expiring provisions, there are still several steps that can be taken to plan with existing known quantities. The steps outlined above take advantage of those known quantities and can offer significant tax savings for businesses and business owners.

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