Syndicate-Related Issues

12/02/2021

BRIANNA KOMPPA, CPA

Disclaimer

The information contained in this presentation is provided solely for general illustration and guidance and does not create a business or professional services relationship. The application and impact of laws can vary widely based on the specific facts involved. Accordingly, the presentation is provided with the understanding that by providing it, the authors and publishers are not engaged in rendering legal, accounting, tax, or other professional advice and services. As such, it should not be used as a substitute for consultation with professional accounting, tax, legal or other competent advisers. Before making any decision or taking any action, you should obtain appropriate professional guidance.

While we have made every attempt to ensure that the information contained in this presentation has been obtained from reliable sources, Wipfli is not responsible for any errors or omissions, or for the results obtained from the use of this information. All information is provided "as is", with no guarantee of completeness, accuracy, timeliness or of the results obtained from the use of this information, and without warranty of any kind, express or implied, including, but not limited to warranties of performance, merchantability and fitness for a particular purpose. In no event will Wipfli, its related entities, partnerships or corporations, or the partners, principals, agents or employees thereof be liable to you or anyone else for any decision made or action taken in reliance on the information in this presentation or for any consequential, special or similar damages, even if advised of the possibility of such damages.

Wipfli Tax Update 2021

- Topics to be covered:
  - Syndicates – A Refresher
  - A Solution to the Iterative Sec. 163(j) Syndicate Loop
  - Election to Use Prior Year Allocations for Syndicate Test
  - Request for Change in Accounting Method

Syndicates – A Refresher

- Under TCJA, qualifying small business taxpayers enjoy many tax benefits
  - Exempt from Sec. 163(j) business interest expense deduction limitation
  - Eligible to use the cash method of accounting rather than the accrual method
  - Eligible to use the completed contract method of accounting for long-term contracts rather than the percentage completion method
  - Exempt from maintaining inventories
  - Exempt from capitalizing costs under the Sec. 263A UNICAP rules
- To qualify as a “small business”, taxpayers:
  - Must have average annual gross receipts for the three prior tax years of $25 million or less
  - Must not be a tax shelter (including a syndicate)

Syndicates – A Refresher

- Tax shelter determination
  - Taxpayers must make an annual determination of whether they are a tax shelter
  - One type of tax shelter is an entity that meets the definition of a syndicate
    - Being s syndicate is the most likely way a pass-through entity will be considered a tax shelter
    - Syndicate = any non-C corporation entity where more than 35% of the entity's taxable losses in a given tax year are allocated to limited partners or limited entrepreneurs
    - Limited partner/limited entrepreneur = a person who has an equity interest in an enterprise and does not actively participate in the management of that enterprise's business operations

Syndicates – A Refresher

- Tax shelter determination (continued)
  - Taxable loss for purposes of syndicate test
    - The excess of deductions over the amount of income recognized by the entity, using the method of accounting used by the entity for federal income tax purposes
    - The following items are EXCLUDED from the computation of taxable loss for purposes of syndicate test
      - Gains or losses from the sale of capital assets
      - Gains or losses from property used in the taxpayer's trade or business subject to the allowance for depreciation under Sec. 167
      - Gains or losses from real property used in the taxpayer's trade or business

Solution to the Sec. 163(j) Iterative Syndicate Loop

- A dilemma that came up for taxpayers that were trying to calculate whether they had a tax loss for purposes of determining whether they were a syndicate was how the Sec. 163(j) business interest limitation rules interplayed with that calculation
- Question: Should a taxpayer apply the Sec. 163(j) business interest expense limitation when calculating tax loss for purposes of the syndicate test?
  - Applying Sec. 163(j) limitation would decrease chance of having a tax loss = pro-taxpayer
  - Not applying Sec. 163(j) limitation would increase chance of having a tax loss = anti-taxpayer
- In addition, if the answer was the Sec. 163(j) should be applied, some taxpayers would be caught up in a circular loop of applying the limitation, having taxable income and therefore not being a syndicate, thus not being subject to Sec. 163(j), claiming 100% of their interest expense, causing them to have a tax loss and therefore being a syndicate......

Solution to the Sec. 163(j) Iterative Syndicate Loop

- Iterative syndicate loop – an example of the problem

1. Partnership has a $100,000 tax loss, including interest expense of $300,000 and a non-business capital gain of $50,000
2. For purposes of determining whether Partnership is a syndicate, its tax **loss** would be $150,000 ($100,000 tax loss less non-business capital gain of $50,000)
3. Assume that >35% of that loss would be allocated to limited entrepreneurs, the partnership would be a syndicate and subject to the Sec. 163(j) limitation
4. Once the Sec. 163(j) limitation is then applied and the interest expense deduction is reduced, the partnership now has taxable **income** of $105,000
    - 30% x $150,000 ATI = $45,000 interest allowed
    - $300,000 total interest - $45,000 disallowed interest = $255,000 disallowed interest
    - $150,000 tax loss + $255,000 disallowed interest = $105,000 taxable income

Solution to the Sec. 163(j) Iterative Syndicate Loop

- Iterative syndicate loop (continued)
  5. Since the partnership has taxable income, it no longer is a syndicate and can avoid the Sec. 163(j) limitation
  6. Without the application of the Sec. 163(j) limitation, the partnership is back to having a tax loss
  7. Repeat the above steps in an endless loop
- Final Regs. provide that Sec. 163(j) limitation should NOT be considered when calculating whether a taxpayer has a tax loss for purposes of the syndicate test (stop at Step #3 in the above example)

Election to Use Prior Year Allocations for Syndicate Test

- As summarized above, taxpayers that met the definition of a syndicate in a given tax year are
  - Potentially subject to the Sec. 163(j) business interest expense limitation
  - Unable to use the favorable accounting methods for small business taxpayers listed above
- As a result of the economic downturn caused by the pandemic, claiming large bonus or Sec. 179 depreciation deductions, or a large Sec. 481(a) subtraction adjustment – a taxpayer that is normally profitable can easily generate a taxable loss and become a syndicate if that loss is allocated to passive investors

Election to Use Prior Year Allocations for Syndicate Test

- In order to provide such taxpayers relief if they have a single loss year, the IRS issued final regulations on 1/5/21 allowing taxpayers to elect to use their **prior** year's taxable income or loss allocations to determine syndicate status for the **current** tax year
- This will allow taxpayers to avoid, or at least delay for one year, being subject to Sec. 163(j) and having to switch to the unfavorable accounting methods
- Details regarding the election
  - For flow-through entities, the election is made at the entity level, not the investor level
  - It is an annual election, but irrevocable for that year once made
  - Applies to all provisions in the Code that reference the definition of a tax shelter under Sec. 448(a)(3)

Election to Use Prior Year Allocations for Syndicate Test

- Time and manner of making the election
  - The election is made by attaching a statement to the taxpayer's timely filed tax return (including extensions) for the year to which it relates
  - The statement must indicate that the taxpayer is making the election under 1.448-2(b)(2)(iii)(B)
  - Hopefully, our tax software will generate the statement if preparer checks the appropriate input box, but if not, the sample election statement should look similar to this:
    - The taxpayer hereby elects under Reg 1.448-2(b)(2)(iii)(B) to use the prior year's allocations to test if the entity is a syndicate for purposes of the determining if the taxpayer is a small business taxpayer as defined under IRC 448

Election to Use Prior Year Allocations for Syndicate Test

- These final regulations are generally applicable for tax years beginning on or after January 5, 2021 (for contracts *entered into* in such years in the case of the small business exemption final regulations under Sec. 460 on accounting for long-term contracts)
- However, a taxpayer may apply these regulations for a tax year beginning after December 31, 2017, and before January 5, 2021, provided that the taxpayer satisfies certain requirements

Request for Change in Accounting Method

- Final Reg. 1.448-(2)(b)(2)(v)
  - Under this provision, a tax shelter (including a syndicate) must change its method of accounting in the year it becomes a tax shelter using the automatic change procedures.
  - The 5-year restriction
    - The final regulations removed a 5-year restriction contained in the proposed regulations which would have barred taxpayers who had to change their method of accounting because they became a syndicate in a given year from switching back to a more favorable method in a future year when they are no longer deemed a syndicate
    - The preamble to the final regulations indicated the IRS will release procedural guidance under the automatic change procedures which will address the waiver of this restriction, and presumably, provide the procedure for switching back to a more favorable method. Once the taxpayer is no longer a tax shelter/syndicate