Mid-Year Accounting & Tax Update

Financial Executives International-
June 2019

Building a better
working world

Agenda

Accounting update

- Final Accounting Standards

Let’s talk digital

Tax Update

- US tax reform and other key updates

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Final accounting guidance

Building a better working world

Revenue from contracts with customers
ASC 606 disclosures

- Key principle: Help financial statement users understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers
- SEC staff comment letters issued to companies that early adopted ASC 606 focused on several disclosure topics, including:
  - Identifying performance obligations
  - Recognition over time or at a point in time
  - Amortization of certain capitalized contract costs
  - Disaggregation of revenue
  - Significant payment terms
- The staff often encouraged entities to refine and supplement their disclosures included in future filings, especially those related to significant judgments and estimates

> "The reporting includes a substantial step forward for corporate reporting, including additional disclosures, and for greater consistency between the information reported and the underlying economics of contracts with customers."
>
> – SEC Chief Accountant Wesley Bricker

Revenue from contracts with customers Private company reminders

- ASC 606 is effective for private companies for fiscal years beginning after 15 December 2018 and interim periods within fiscal years beginning after 15 December 2019
- Full retrospective or modified retrospective adoption may be elected
  - Practical expedients may be elected but must be applied consistently to all contracts within all periods presented
  - Additional disclosures are required if practical expedient(s) elected
- New disclosures include those on contracts with customers, disaggregation of revenue, contract balances, performance obligations and significant judgments
- Many private companies have found that implementing ASC 606 requires more effort than anticipated

Improvements to nonemployee share-based payment accounting (ASU 2018-07)

Applies to instruments issued to nonemployees in exchange for goods and services, not for raising capital or selling goods and services

<table>
<tr><th></th><th colspan="2">Nonemployees</th><th>Employees</th></tr>
<tr><td></td><td>Before ASU 2018-07</td><td>After ASU 2018-07</td><td>ASC 718</td></tr>
<tr><td>Measurement date for equity-classified awards</td><td>Earlier of:
▶ Performance commitment date
▶ Performance completion date</td><td colspan="2">Generally grant date</td></tr>
<tr><td>Term</td><td>Contractual term</td><td>Expected term or contractual term</td><td>Expected term</td></tr>
<tr><td>Post-vesting classification</td><td>Reassessed when performance is complete</td><td colspan="2">Reassessed if modified after grantee is no longer providing goods or services</td></tr>
</table>

Improvements to nonemployee share-based payment accounting (ASU 2018-07) (continued)

- Allows nonpublic entities to use two practical expedients for nonemployee awards that are already available for employee awards
  - The same accounting policies must be used for awards to both employees and nonemployees
- Applies to equity-classified awards that don't have a measurement date and unsettled liability-classified awards
  - Recognize a cumulative-effect adjustment to retained earnings at beginning of the annual period of adoption
  - Remeasure incomplete assets that include nonemployee share-based payment costs (e.g., work-in-process inventory, construction-in-progress)

Effective for calendar year-end entities		
Public business entities (PBEs)	Non-PBEs	Early adoption?
Q1 2019	2020	Permitted if ASC 606 has been adopted

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Tax reform – reclassification of certain tax effects from AOCI (ASU 2018-02)

- Gives companies the option to reclassify to retained earnings the stranded tax effects from tax reform in accumulated other comprehensive income (AOCI)
  - Does not change the ASC 740 prohibition on backward tracing
- Provides a policy election to reclassify to retained earnings all tax effects related to items in AOCI stranded as a result of US tax reform even if they don't directly relate to the change in federal rate
  - Includes available-for-sale securities, pensions/employee benefit plans, foreign currency, hedging
- Includes new disclosure requirements for all entities, even if the option is not elected

Effective date for calendar year-ends		
All entities	Transition method	Early adoption?
Q1 2019	Retrospective or period of adoption	Yes

Tax reform – Staff Accounting Bulletin No. 118 (ASU 2018-05)

- Provides guidance when the accounting for income tax effects of US tax reform is:
  - Completed
  - Incomplete but the company has a reasonable estimate
  - Incomplete and the company doesn't have a reasonable estimate
- Allows provisional amounts to be reported during a measurement period that:
  - Began in the reporting period that included the enactment date (22 December 2017)
  - Ends when a company has obtained, prepared and analyzed the information needed to complete the accounting requirements under ASC 740
    - Expectation of good faith effort to update provisional amounts
  - Should not extend beyond one year from enactment date
- Includes additional disclosure requirements

Disclosure framework

- The FASB made changes to its Conceptual Framework and issued two ASUs as part of its project to improve the effectiveness of disclosures
- A new chapter in the Conceptual Framework provides a framework for the Board to use when evaluating new and existing disclosure requirements
  - The new chapter also discusses considerations for the Board to use in evaluating interim disclosures
- The FASB reinstated the definition of materiality that was used in FASB Concepts Statement No. 2
  - The definition of materiality is consistent with other definitions of materiality in the financial reporting system

Disclosure framework (continued)

- Topic-specific disclosure reviews
  - Final standards were issued on disclosures related to defined benefit plans (ASU 2018-14) and fair value measurement (ASU 2018-13)
  - Income taxes: FASB is redeliberating exposure draft
  - Inventory: FASB is conducting additional outreach in response to comments received on exposure draft
- Evaluation of interim reporting requirements – more research needed

Cloud computing – implementation costs (ASU 2018-15)

- A customer in a cloud computing arrangement (i.e., hosting arrangement) that is a service contract will follow the internal use software guidance in ASC 350-40 to determine which implementation costs to defer and recognize as an asset
- Certain implementation costs incurred will be deferred and recognized as an asset
  - Expense over the term of the hosting arrangement
  - Classify expense in the same income statement line item as the hosting arrangement fees
- Customers will follow existing US GAAP to account for other implementation costs
- New guidance does not affect the accounting for the hosting arrangement component of a contract

Effective dates for calendar-year entities		
PBEs	Non-PBEs	Early adoption?
Q1 2020	2021	Yes

Other final guidance
Codification improvements

- Amendments to the Codification include technical corrections, clarifications and other minor improvements
- The FASB issued the following guidance:
  - Codification Improvements (ASU 2018-09)
  - Codification Improvements to Topic 942, Financial Services – Depository and Lending (ASU 2018-06)
  - Codification Improvements to Topic 995, U.S. Steamship Entities: Elimination of Topic 995 (ASU 2017-15)
  - Technical Corrections and Improvements (ASU 2016-19)

Other final guidance (continued)

Clarifying the scope and the accounting guidance for contributions received and contributions made (ASU 2018-08)

- Clarifies how entities determine whether to account for a transfer of assets as an exchange transaction or a contribution
- Clarifies that a contribution is conditional if the agreement includes both:
  - A barrier (or barriers) that must be overcome for the recipient to be entitled to the resources
  - A right of return for the assets transferred (or a right of release of the promisor's obligation to transfer assets)
- Applies to all entities (including business entities) that receive or make contributions, except for certain transactions such as transfers of assets business entities receive from government entities

Effective date for calendar year-end companies		
	PBEs and not-for-profit conduit bond obligors	All others
Resource recipients	Q1 2019	2019
Resource providers	Q1 2019	2020

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Other final guidance (continued)
Long-duration insurance contracts (ASU 2018-12)

- Assumptions used in the measurement of the liability for future policyholder benefits will be reviewed on at least an annual basis, and changes will be applied in earnings on a cumulative catch-up basis
- Discount rate assumptions will be updated quarterly in the measurement of the liability for future policyholder benefits using an upper-medium grade fixed-income instrument yield (‘A’ rating)
- All market risk benefits will be measured at fair value through current earnings (except for own-credit risk, which will be reflected in other comprehensive income)
- Deferred policy acquisition costs will be amortized on a constant level basis over the expected life of the contract
- Disclosures will be expanded

Effective dates for calendar-year entities		
	Non-PBEs	
Q1 2021	2022	Yes

Final guidance – reminders

- Accounting for certain financial instruments with down round features (ASU 2017-11)
- Service concession arrangements – determining the customer of the operation services (ASU 2017-10)
- Scope of modification accounting (ASU 2017-09)
- Premium amortization on purchased callable debt securities (ASU 2017-08)
- Improving the presentation of net periodic pension cost and net periodic postretirement benefit cost (ASU 2017-07)
- Employee benefit plan master trust reporting (ASU 2017-06)
- Clarifying the scope of asset derecognition guidance and accounting for partial sales of nonfinancial assets (ASU 2017-05)
- Simplifying the test for goodwill impairment (ASU 2017-04)
- Clarifying the definition of a business (ASU 2017-01)

Final guidance – reminders (continued)

- Statement of cash flows – restricted cash (ASU 2016-18)
- Statement of cash flows – classification of certain cash receipts and cash payments (ASU 2016-15)
- Intra-entity transfers of assets other than inventory (ASU 2016-16)
- Presentation of financial statements of not-for-profit entities (ASU 2016-14)
- Improvements to employee share-based payment accounting (ASU 2016-09)
- Contingent put and call options in debt instruments (ASU 2016-06)
- Effect of derivative contract novations on existing hedge accounting relationships (ASU 2016-05)
- Recognition of breakage for certain prepaid stored-value products (ASU 2016-04)
- Balance sheet classification of deferred taxes (ASU 2015-17)

Let’s talk Digital

Reinventing in the age of digital disruption

Building a better working world

Agenda slide

1. Digital Disruption
2. Governing Disruption
3. Digital Transformation

Key takeaways

Trends and cutting edge technology are fundamentally changing our lives on an ever accelerating basis. It is incumbent on organizations and leaders to prepare for and embrace the disruptive technology frontier. Digital Transformation strategies are imperative to future success and relevance.

Rob Roetzel
Technology Risk Services

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Is your business fit for a digital world?

The better the question. The better the answer.
The better the world works.

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Digital Disruption

Digital Disruption – trends, opportunities, and threats

The digital megatrend creates opportunities and threats up and down the value chain

Opportunities

Kakao bank acquired **3m** customers within **six weeks** by launching a digital-only bank [1]

67% of investors want companies to undertake disruptive innovation projects even if they are risky and have no short-term returns [2]

66% of global companies are investing upwards of US$ 5m in analytics, and 78% of organizations agree that analytics are changing the nature of competitive advantage [3]

81% of organizations have already adopted cloud computing [4]

Threats/issues

Shortage of requisite talent to drive AI adoption is the top challenge to an enterprise-wide AI program, according to 80% of executives [5]

76% of the organizations have increased their cybersecurity budget after a serious breach [3]

50% of organizations spend more than 5% of their annual budgets on innovation, yet 42% say budget is their biggest barrier to progress [6]

50% of the CEOs feel that they have not implemented an adequate response to disruption, putting market leadership and capitalization at risk [2]

Source:
1: EY analysis
2: How can you be both the disruptor and the disrupted? (2017)
3: EY Forbes Insights
4: EY Global Innovation survey
5: AI creates jobs yet talent crisis remains according to EY poll
6: EY GISS 2018

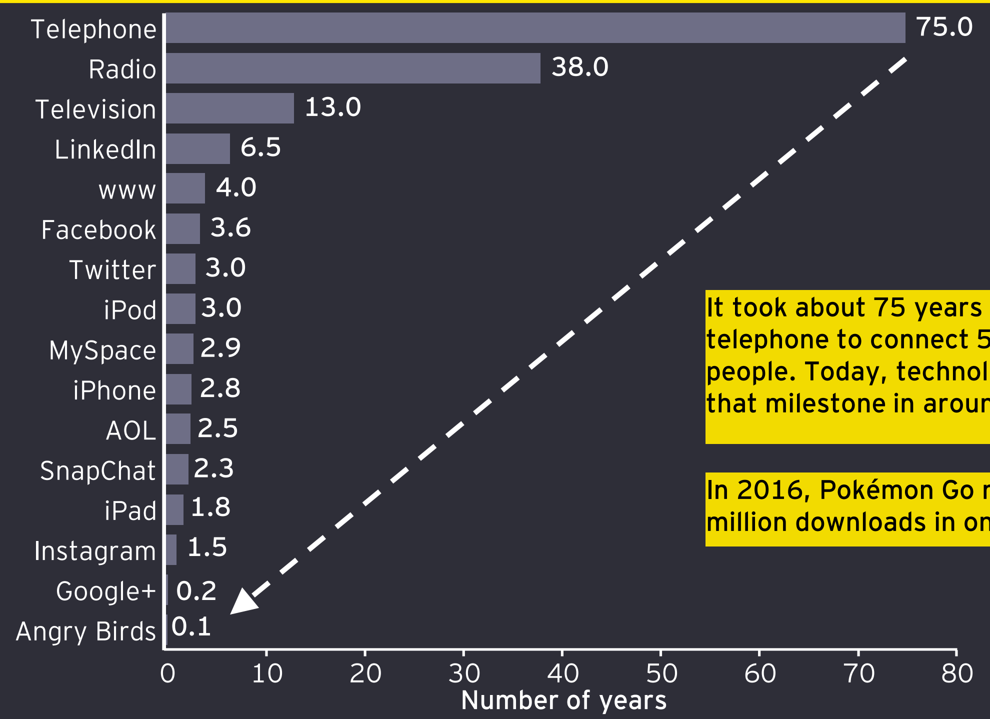
Digital Disruption - fundamentally changing our lives with fast evolving business models and rapidly changing customer expectations

The power of disruption

1. The world's largest taxi company **Uber** owns no taxis
2. The world's largest accommodation provider **Airbnb** owns no real estate
3. The largest communications companies - **Skype**, **WhatsApp**, **Facebook Messenger** - own no infrastructure
4. The world's most valuable retailer **Alibaba** has no inventory
5. The most popular media platform **Facebook** creates no content
6. The world's largest movie house **Netflix** owns no cinemas

Source: Press articles, EY analysis

Time taken to reach 50 million global customers



It took about 75 years for the telephone to connect 50 million people. Today, technologies reach that milestone in around a month.

In 2016, Pokémon Go reached 50 million downloads in only 19 days

Digital disruption is transformation that is caused by emerging digital technologies and business models. These innovative new technologies and models can impact the value of existing products and services offered in the industry. This is why the term disruption is used, as the emergence of these new digital products/services/businesses disrupts the current market and causes the need for re-evaluation.

Digital Disruption - cutting edge technologies such as AI, MASA are being offered with digitalization

AI and Advanced Machine Learning, which include deep learning, neural networks and natural-language processing, can encompass more advanced systems that understand, learn, predict, adapt and potentially operate autonomously

Intelligent apps, including technologies like virtual personal assistants (VPAs), have the potential to transform the workplace by making everyday tasks easier and its users more effective

Virtual reality (VR) and augmented reality (AR) transform the way individuals interact with each other and with software systems creating an immersive environment

Creation of vertical ecosystems: Becoming ecosystem managers in a B2B2C business model For e.g. eHealth, Connected Car, SmartX

Blockchain and distributed-ledger concepts are gaining traction because they hold the promise of transforming industry operating models in industries such as music distribution, identify verification and title registry

The **mesh app and service architecture (MASA)**, a multichannel solution architecture that leverages cloud and serverless computing, containers and micro-services as well as APIs and events to deliver modular, flexible and dynamic solutions

Digital technology platforms are the building blocks for a digital business and are necessary to break into digital. Every organization will have some mix of digital technology platform

Source: EY analysis

Digital Disruption – technologies enabling new and better ways to create, design and deliver services, driving business impact

Grow top line

New services

Amazon

Intelligent personal assistants

Customer experience

Alibaba

AR/VR enabled online shopping experience

Customer experience

Disney

Personalized park experiences (wearables and mobile apps)

New solution

Maersk

Blockchain supply chain solutions

Digital Enablers drive business impact

Cost reductions

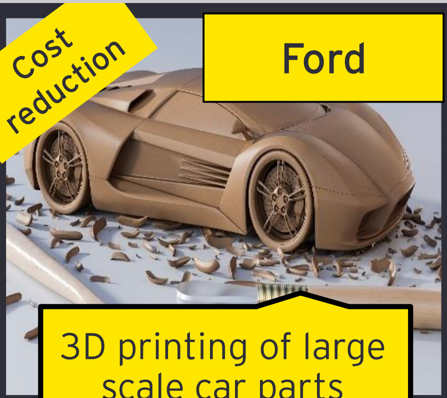
MSOCIAL

Room service robots

Cost reductions

Vodafone

RPA for back office processes



Cost reduction

Ford

3D printing of large scale car parts

Optimize bottom line

Source: Press articles, EY analysis

Governing Disruption

Governing Disruption – how boards are governing disruptive technology

Corporate Board Member and EY recently conducted a survey of 365 corporate directors on the topic of disruptive technology. Here's what they found:

1

Resources

Directors divided on whether boards have appropriate resources to move companies forward in era of digital disruption.

2

Management

Most boards rely on management as primary source for staying current on industry trends, emerging technologies and innovation.

3

Adoption

Directors say biggest challenge to adopting emerging technologies are those related to integration and talent.

4

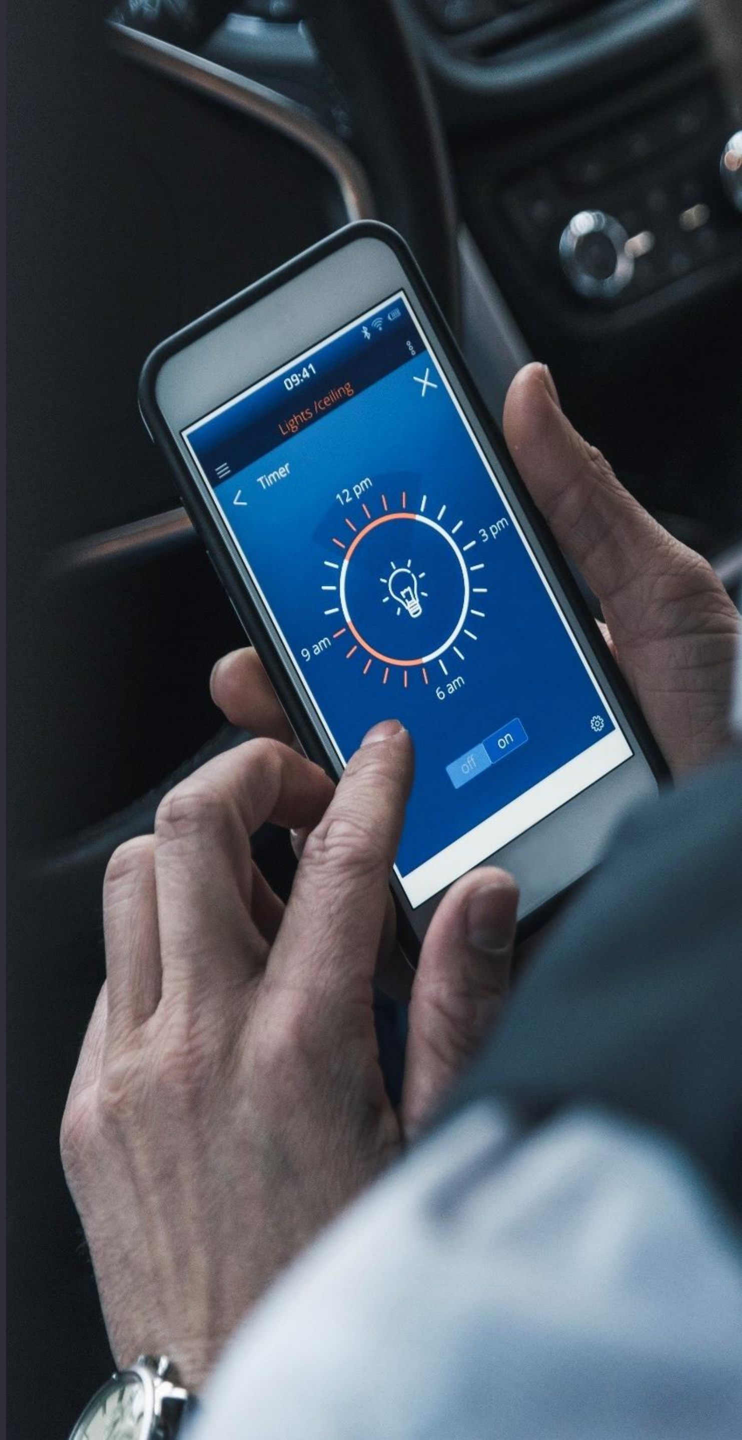
On the agenda

Boards can help organizations mitigate risks from emerging technologies by including topic on full board agenda and reviewing organizations risk management framework.

5

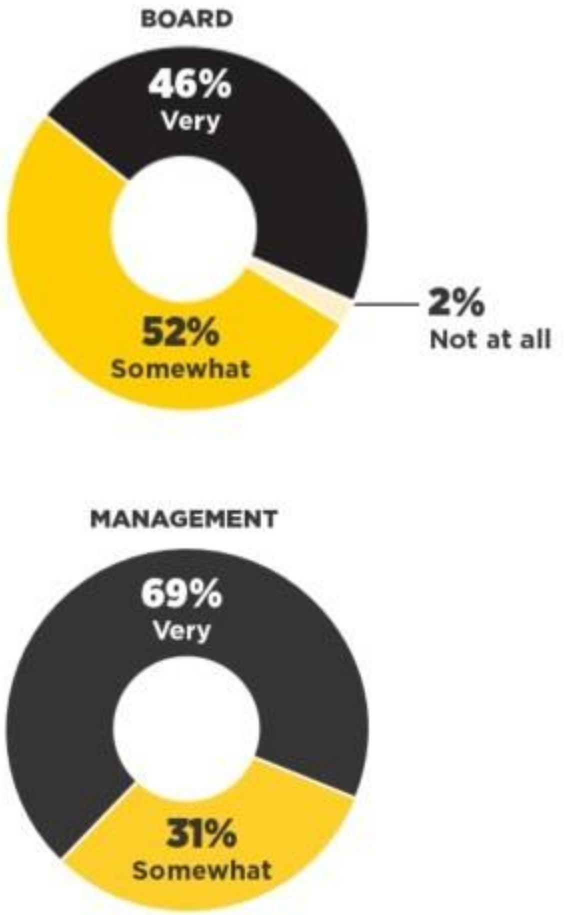
Education

Majority of directors agree boards can enhance oversight of disruptive technology through tailored board training and education.



Governing Disruption – survey key findings

How attuned is your board/management team to the potential disruption of your organization and industry?



Top ways boards stay current on megatrends, industry trends, emerging technologies and potential innovation inflection points

What is the biggest challenge your organization faces in adopting emerging technologies?

** Percentages may not add up due to rounding*

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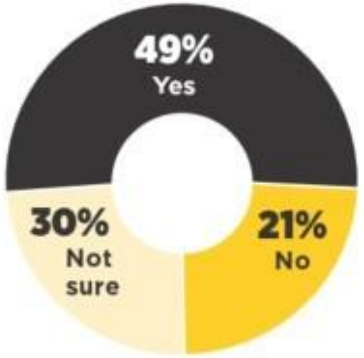
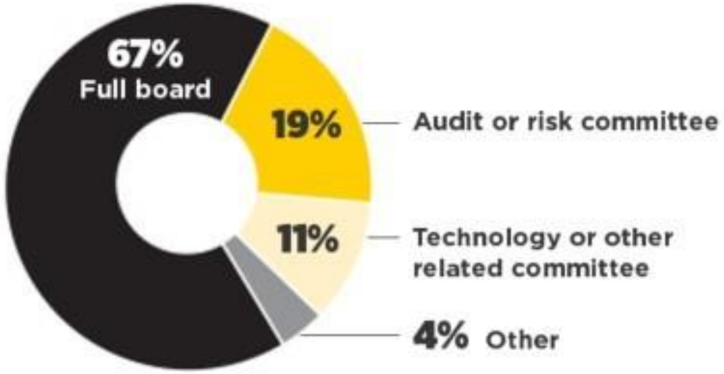
Governing Disruption – survey key findings continued

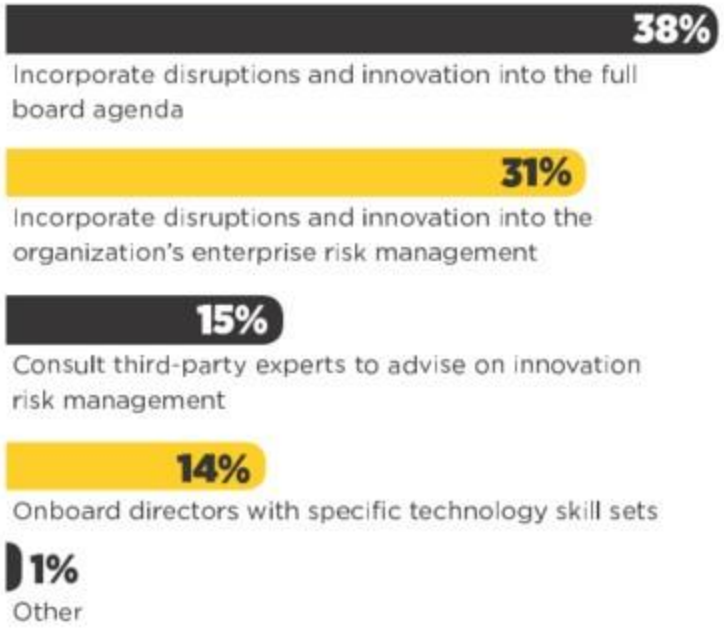
Do you believe the time your board/committee invests in discussing emerging technologies is sufficient to properly assess risk?



Where does oversight of emerging technologies reside within your board?



In your opinion, what is the most important action boards can take to help their organizations navigate disruptive risks?



What are the top 2 areas that would most enhance your board or committee's effectiveness in its oversight of disruptive technologies?

54% Better understanding of emerging trends and potential impacts to business models through tailored board training and education

50% Better integration of technology disruption into our discussions about strategy and risk

36% More focused time on the agenda for open discussion on emerging technologies

28% Re-evaluating board composition and augmenting director skill sets in technology

18% Enhanced board reporting from the management team

4% Shifting oversight responsibilities to a formalized or ad-hoc committee

** Percentages may not add up due to rounding*

Governing Disruption – embracing the disruptive technology frontier

Findings of the survey reveal clear opportunities for boards to strengthen their governance of disruptive technologies.

- Use independent data and resources to identify potential disruption.
- Verify the implementation of disruptive technologies includes appropriate risk management process aligned to organizations risk management framework.
- Pursue education and refreshment to address knowledge gaps and identify risks as well as potential unknowns related to disruptive technology.
- Strategically challenge if the company has the right culture, skills, and training required to succeed in this transformative age.

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Is the board allocating sufficient time on its agenda?

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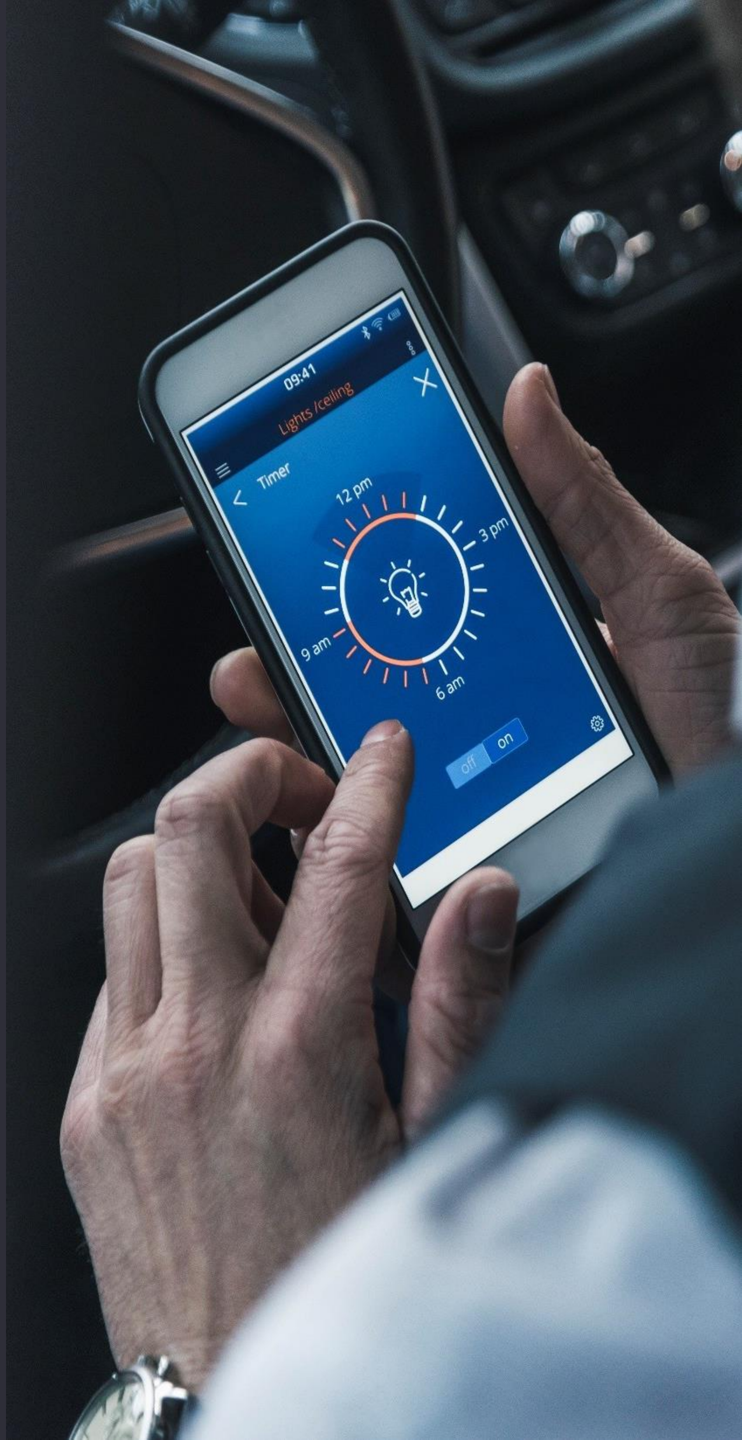
Does the board have the right mix of relevant skills, expertise, perspectives, and experiences that allow for effective oversight of technological innovation and disruption?



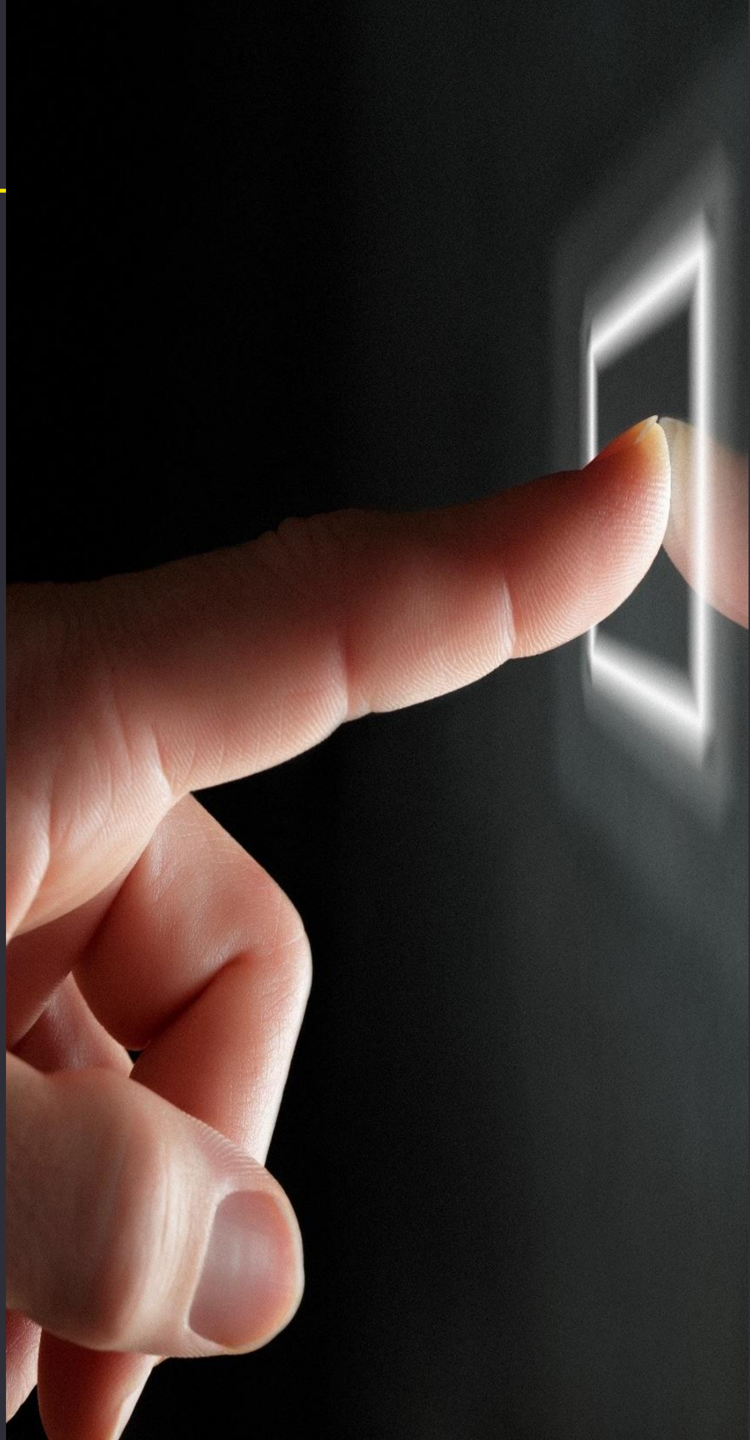
Digital Transformation

Digital Transformation - a buzzword cloud to be understood

What really is Digital Transformation?

Digital Transformation - program impact overview

- TECHNOLOGY
  - Creating an open and flexible technology architecture that is aligned to future requirements and regulations
- PEOPLE
  - Creating a different culture and talent model to transform the organization at the same time as new digital technology is being developed
- BUSINESS
  - Fully integrated business strategy that shows where digital enables and provides services for a better customer journey
- OPERATIONS
  - Digital Transformation drives growth as well as the optimization of operational efficiency through intelligent automation and process re-design



Digital Transformation – most strategies are not delivering on expectations despite demonstrated efforts and investments

Digital Transformation efforts are coming up short on intended ROI, in part because Digital Transformation is as much a leadership issue as it is a strategy, technology, culture, and talent issue

Main Challenges to a Successful Digital transformation

- Complex legacy IT systems
- Inadequate Data Architecture
- Difficulty to move past the pilot stage and scale up
- Organizational resistance to change & key talent gap
- Lack of a clear vision from the leadership and lack of ownership
- Uncertainty towards the overwhelming number of technologies
- Low value generated by the business cases
- Difficult front to back and back to front integration
- Difficult coordination among business units
- Difficulty to integrate partners and accelerators

Digital Transformation - value proposition for program

Organizations need to rethink their business strategy and operating model for a digital age.

Digital is disrupting all parts of the value chain of any organization. It touches every angle of every business, from marketing and sales to supply chain and risk, and from people and innovation to finance and tax strategy.

Digital transformation involves solving bigger and more complex end-to-end business transformation challenges.

A digital strategy and transformation brings together organization-wide capabilities and assets to help survive and thrive in the age of transformation.

The result is a more holistic and strategic view that combines design, technology and innovation skills with finance and risk insights and organization-wide insights.

The value is illustrated in the following EY client examples:

- Reduced innovation process length from **18 months** to **100 days** and rationalized the portfolio of **200 ideas** to **20 ideas for a fintech** company
- Reduced time for setting up a fund from **10 days to 3.5 hours** by standardizing jurisdictional processes for a **banking** client
- Helped **banking** client launch a digital-only bank and acquire **2.1m new customers** in 35 days

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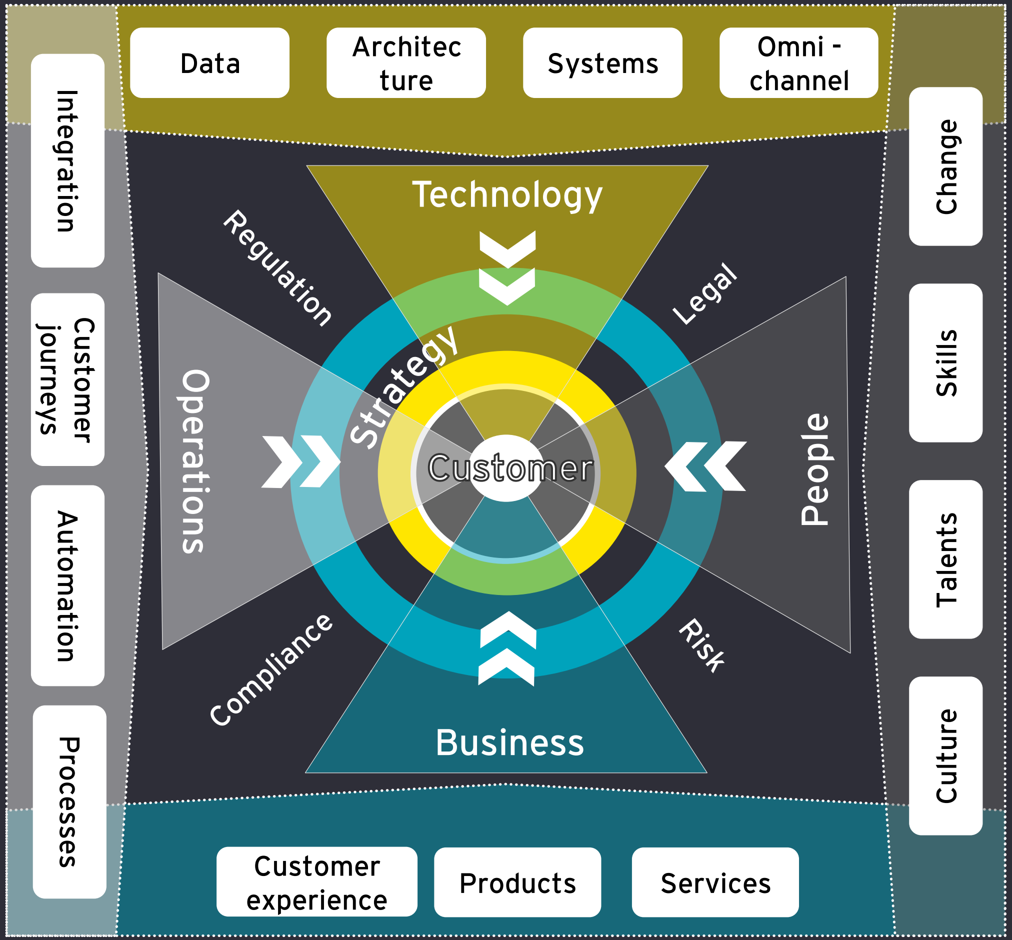
Digital Transformation - embedded in the way of working across the organization

The notion of a one-off Digital Transformation "project" makes no sense anymore, effective digital strategy and transformation requires an intense implication of all actors of the transformation

Customer journeys need to be designed so that customer experience a seamless service across all chosen channels

Creating an open and flexible technology architecture that is aligned to future requirements and regulations

Integrated front to back approach to ensure that digital innovation drives growth as well as the optimization of operational efficiency through intelligent automation and process design



Fully integrated business strategy that shows where digital enables the company to provide services in a better way to help their customers make better decisions and meet customer expectations

Develop data management and analytics capability as an integral part of the digital transformation

Creating a different culture and talent model to transform the organization at the same time as new digital technology is being developed

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Digital Transformation – questions to ask in this transformative age

How do we stop "doing" digital and start to "be" digital?

Over the last five years, many digital initiatives have done little more than digitize the front end of yesterday's business. Companies are putting a digital front end on top of an expensive, cumbersome legacy operating model: organization chart, technology, incentives.

In order to start "being" digital, businesses must think about the tactical spend that's being wasted, start considering digital from every angle, think about the technology as well as human elements of digital and, finally, accept that change is constant and inevitable.

This is how a company can start to realize the full implications of a digital reinvention.

For example, once an automotive company starts shifting from a focus on selling cars to being a "future of mobility" platform provider, everything changes. This digital transformation will not be a project, or a coherent program – but a collection of projects and initiatives happening in parallel, aligned to a common vision and purpose.

Where is the disruption coming from and how can a company respond to it?

Companies must understand what is happening in the market in order to set their overall purpose and ambition and define how it manifests itself with regards to customer and brand proposition. The key is to define the desired portfolio allocation of resources and spend and decide how much is going to be allocated toward creating new vs. sustaining the old business.

How will funding and capital be allocated to each digital initiative and how will the right balance of people and skills be injected into each program?

Companies must orchestrate all the different digital initiatives that are going on within their organization against the company's strategic priorities. There is no one-size-fits-all allocation, as this will vary considerably by sector, level of disruption, ambition level, etc., but a useful starting point is 70:20:10 (70% Sustain, 20% Enhance, 10% Disrupt). For each initiative, companies can adopt a "shared service" function, injecting specialists to accelerate and unblock program delivery, e.g., architects, cyber specialists, data privacy experts.

How can constant cycles of change and iteration be brought to life?

Business leaders know it's extremely difficult to balance the day-to-day running of a business, while simultaneously driving disruptive innovation. To be successful, a company needs an innovation capability, whether it's a lab, a network of labs or a culture of innovation. These labs are often removed from the day-to-day running of the company, giving them space to create like a start-up (ex. EY wavespace™).

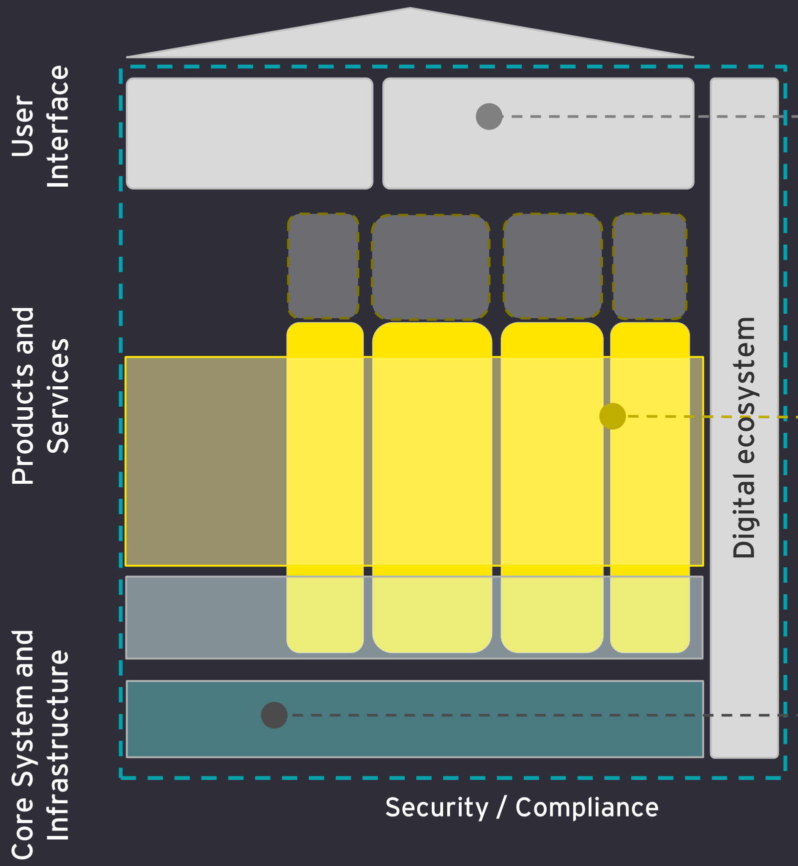
What is a digital factory?

"Digital Factory" is a market term used to describe the physical environment or network of environments that you need to accelerate digital transformation and convert innovation into industrialisation. Typically these are more than just a digital innovation lab. They include design studios, research labs, showcase environments, offshore development hubs and specialist CoEs (centers of excellence).

Digital Transformation – successful programs were driven by a clear vision at the beginning of the journey

Illustration of a platform architecture providing a large spectrum of services by delivering a seamless, reliable and secured customer experience

Simplified description of the platform model



Levers of differentiation

The **"User Interface"**, as the backbone of the digital experience, to enable the distribution of proprietary or third party products

The **"Products and the Services"**, that support the design and development of components that can be monetized to serve own needs or the needs of third parties and customers

The **"Core system and Infrastructure"**, flexible and taking into account the existing mainframe and the possible technological evolutions

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Inventions alone don’t create huge value. Not unless they disrupt something.

James McQuivey

Forrester

Thank you.

Questions?

Tax Update

Building a better
working world

Notice

- This presentation is provided solely for the purpose of enhancing knowledge on tax matters. It does not provide tax advice to any taxpayer because it does not take into account any specific taxpayer's facts and circumstances.

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Agenda

- Overview and Key Provisions
- 199A Deduction
- Section 162 vs. 212
- Questions & Miscellaneous Other Items

Overview of US tax reform

What's in the new law?

Lower rates	The final US tax reform legislation includes a significant reduction in the business tax rate as well as individual tax rates.
Broader tax base	To pay for the proposed lower rates, the new law includes a wide array of base-broadening provisions (e.g., limitations on deductions), although the controversial border adjustment proposal was taken off the table. The base-broadening provisions extend to both business and individual taxation.
New international tax system	Republicans were unified in moving towards a territorial system of taxation, with the new law imposing a transition tax (or toll charge) on previously untaxed accumulated foreign earnings with the rate determined by whether the earnings are in cash or non-cash assets.
Timing	▶ **White House:** Republican Framework released on September 27th ▶ **Congress:** Budget resolution – October 26th ▶ **House:** Legislative language – November 2nd; Passage – November 16th ▶ **Senate:** Legislative language – November 9th; Passage – December 2nd ▶ **Reconcile bills:** December 15th ▶ **Final Senate and House votes:** December 19. December 20 ▶ **Signing by President:** December 22

Key business provisions in the new law

Corporate tax rate and corporate alternative minimum tax (AMT)

- 21% tax rate, effective 1/1/2018
- Eliminates corporate AMT

Interest expense deduction

- Limits deduction to net interest expense that exceeds 30% of adjusted taxable income (ATI). Initially, ATI computed without regard to depreciation, amortization or depletion. Beginning in 2022, ATI would be decreased by those items. Regulated utilities are generally excepted.

Expensing

- Allows immediate write-off of "qualified property" placed in service after 9/27/2017 and before 2023. The increased expensing would phase down starting in 2023 by 20 percentage points for each of the five following years. Eliminates original use requirement. "Qualified property" excludes certain public utility property and floor plan financing property. Taxpayers may elect to apply 50% expensing for the first tax year ending after 9/27/2017.

Key business provisions in the new law

Net operating losses (NOLs)

- Limits NOLs to 80% of taxable income for losses arising in tax years beginning after 2017. Repeals carryback provisions, except for certain farm and property and casualty losses; allows NOLs to be carried forward indefinitely.

Like-kind exchanges

- Limits to exchanges involving real property only. Current law applies to exchanges if property disposed of on or before 12/31/2017 or the property received in the exchange is received on or before such date.

Dividends received deduction (DRD)

- Reduces the deduction for dividends received from other than certain small businesses or those treated as "qualifying dividends" from 70% to 50%. Reduces the deduction for dividends received from 20%-owned corporations from 80% to 65%.

Key business provisions in the new law

Section 179 expensing

- Increases to $1m for "qualified property" placed in service in tax years beginning after 2017, with a phase-out beginning at $2.5m. Expands "qualified property" to include certain depreciable personal property used to furnish lodging, and improvements to nonresidential real property (such as roofs, heating, and property protection systems).

Research credit

- Retains research credit. Requires research and experimentation (R&E) expenditures to be amortized over 5 years; 15 for R&E conducted outside the US. R&E specifically includes expenses for software development. Requires amortization for expenses incurred in tax years beginning after 2021.

Domestic production deduction (current law IRC Section 199)

- Repeals the deduction for tax years beginning after 2017.

Key international provisions in the new law

Domestic corporations allowed a 100% deduction for the foreign-source portion of dividends received from 10%-owned (vote or value) foreign subsidiaries. (Deduction is not available for capital gains or directly earned foreign income.)

- One-time transition tax on post-1986 earnings of 10%-owned foreign subsidiaries accumulated in periods of 10% US corporate shareholder ownership; 15.5% rate on cash and cash equivalents and 8% rate on the remainder
- Mandatory annual inclusion of "global intangible low-taxed income" (GILTI) determined on an aggregate basis for all controlled foreign corporations owned by the same US shareholder; partial credits for foreign taxes properly attributable to the GILTI amount
- Domestic corporations allowed a deduction against foreign-derived intangible income (37.5% deduction initially, reduced to 21.875% for tax years beginning after 2025) and mandatory GILTI inclusion (50% deduction initially, reduced to 37.5% for tax years beginning after 2025)
- No deduction for certain related-party payments made pursuant to a hybrid transaction or entity
- If certain thresholds are met, a "base erosion and anti-abuse tax" levied on an applicable taxpayer's taxable income determined without regard to certain deductible amounts paid or accrued to foreign related persons, depreciation or amortization on property purchased from foreign related persons, and certain reinsurance payments to foreign related persons; generally 10% rate for tax years beginning before 2026 and 12.5% thereafter (but 11% and 13.5% for banks and registered securities dealers)

Key pass-through provisions in the new law

Allows individual taxpayers to deduct 20% of domestic "qualified business income" (QBI) from a pass-through entity (PTE) such as a partnership (including limited liability company), S corporation, or sole proprietorship ("qualified businesses" or PTEs) subject to certain limitations and thresholds. Trusts and estates may take the deduction. Effective for tax years beginning after 2017 and before 2026.

- QBI for a tax year means the net amount of domestic qualified items of income, gain, deduction, and loss with respect to a taxpayer's qualified businesses. "Qualified businesses" do not include specified services trades or businesses such as accounting, law, health, several other professions, and service businesses related to investing, but does include engineering and architecture trades.
- Deduction is limited for taxpayers with income above $315,000 (mfj) to the greater of 50% of the W-2 wages, or the sum of 25% of the W-2 wages plus 2.5% of the unadjusted basis of all qualified property. Limitation fully phased-in for taxpayers with income of $415,000 and above (mfj). For taxpayers with income from specified service businesses, deduction starts being phased out at $315,000 (mfj) income amount and fully phases out over a $100,000 range (mfj) at $415,000 (mfj) income amount.
- Other key changes include repeal of partnership technical termination rules; a rule imposing a three-year holding period to treat capital gain as long-term capital gain for certain partnership interests held in connection with the performance of certain services; and a rule limiting taxpayers' (other than C corporations) ability to deduct business losses for tax years beginning after 2017 and before 2026, with excess business losses carried forward.

Section 199A deduction

Overview

- Section 199A, the deduction for QBI, is available for taxable years beginning after December 31, 2017, and before January 1, 2026.
  - Guidance under Proposed Reg. Sections 1.199A-1 through 1.199A-6 and 1.643(f)-1 was released August 8, 2018.
  - Final Regulations published on February 8, 2019

Overview: deduction calculation

- The deduction is equal to the QBI amount for each of the taxpayer's qualified trades or businesses, plus 20% of a taxpayer's (1) qualified real estate investment trust (REIT) dividends, and (2) qualified publicly traded partnership (PTP) income.
- The deduction cannot exceed 20% of taxable income (reduced by net capital gain) of the taxpayer for the taxable year.

		QBI*					+	REIT/PTP*		
Section 199A deduction	=	**Qualified TorB #1** QBI amount	+	**Qualified TorB #2** QBI amount	+	**Other qualified TorBs** QBI amount	+	**Taxpayer's** qualified REIT dividends x 20%	+	Taxpayer's qualified PTP income x 20%

*If the QBI or REIT/PTP amount is an overall loss, it is treated as zero for the deduction calculation and is carried forward to the next year.

TorB = Trade or business

Overview: potential benefit

- The Section 199A deduction is a permanent tax benefit that reduces a taxpayer's federal effective tax rate (ETR).
- The potential benefit is a reduction in ETR of up to 7.4 percentage points.

Section 199A effective tax rate impact			
	With Section 199A	Without Section 199A	
Taxable income before Section 199A	$ 1,000,000	$ 1,000,000	
Section 199A deduction limited to 20% of taxable income	$ (200,000)	$ –	
Taxable income after Section 199	$ 800,000	$ 1,000,000	
Federal tax at 37%	$ 296,000	$ 370,000	**Difference**
Effective tax rate	29.6%	37.0%	**7.4%**

Overview: limitations

- For taxpayers with taxable income above the phase-in range:
  - QBI for **each trade or business** is limited by the greater of:
    - 50% of the trade or business's W-2 wages attributable to QBI; or
    - 25% of the trade or business's W-2 wages attributable to QBI **plus** 2.5% of the unadjusted basis immediately after acquisition (UBIA) of the trade or business's qualified property for each qualified trade or business
  - QBI does not include income from a specified service trade or business (SSTB).
- QBI is limited to income that is effectively connected with the conduct of a US trade or business.

Operational rules (Prop. Reg. Section 1.199A-1)

- Proposed regulations under Section 1.199A-1 define key terms, including:
  - Trade or business
  - Relevant pass-through entity (RPE)
- Proposed regulations under Section 1.199A-1 provide general computational rules for the Section 199A deduction.
- Proposed regulations under Section 1.199A-1 provide special computational rules:
  - Netting of negative QBI amounts with qualified REIT dividends and qualified PTP income
  - Carryforward of negative QBI amounts from qualified trades or businesses
  - Carryforward where sum of qualified REIT dividends and qualified PTP income is negative

Determination of W-2 wages and UBIA of qualified property (Prop. Reg. Section 1.199A-2)

- The W-2 wage rules and UBIA of qualified property are relevant for taxpayers that have taxable income in excess of the taxable income threshold, as W-2 wages or the UBIA of qualified property are limitations to the deductible amount of trade or business QBI.
  - Taxpayers with taxable income at or below the taxable income threshold do not apply wage and qualified property limitations to determine the QBI of a trade or business.

Determination of W-2 wages and UBIA of qualified property (Prop. Reg. Section 1.199A-2)

- Trades or businesses may take into account W-2 wages paid by another person (e.g., professional employer organizations) if the trade or business is the common employer.
- W-2 wages are allocated among multiple trades or businesses
  - In general, if there are multiple trades or businesses
  - Allocated further to each trade or business QBI
  - Acquisitions and dispositions
- Short taxable years
  - Short taxable years that do not include December 31

Determination of W-2 wages and UBIA of qualified property (Prop. Reg. Section 1.199A-2)

- Proposed regulations generally reiterate the statutory definition of qualified property.
- Proposed regulations provide guidance on whether certain items are treated as qualified property, namely:
  - Improvements made to qualified property that has already been placed in service;
  - Basis adjustments under Sections 734(b) and 743(b); and
  - Property acquired near the year-end

Determination of W-2 wages and UBIA of qualified property (Prop. Reg. Section 1.199A-2)

- Proposed regulations interpret UBIA of qualified property to mean the basis of qualified property as of the placed-in-service date.
- Proposed regulations provide that the UBIA of qualified property must be determined for each trade or business by the individual or RPE that directly conducts the trade or business before aggregation occurs.
- Special rules apply in the case of a trade or business conducted by an RPE.

Determination of W-2 wages and UBIA of qualified property (Prop. Reg. Section 1.199A-2)

- Proposed regulations provide guidance regarding the placed in service date for qualified property acquired in certain transactions, such as:
  - Like-kind exchanges under Section 1031;
  - Involuntary conversions under Section 1033; or
  - Property acquired in certain nonrecognition transactions described in Section 168(i)(7)(B), including:
    - Section 721 contribution to a partnership; or
    - Section 351 contribution to a corporation
- Proposed regulations clarify that the applicable recovery period for qualified property is unaffected by additional first-year depreciation deduction allowable under Section 168.

QBI, qualified REIT dividends, qualified PTP income (Prop. Reg. Section 1.199A-3)

- Qualified business income is the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer.
- Proposed regulations address the treatment of certain items as QBI, such as:
  - Section 1231 gains or losses
  - Gains treated as ordinary under Section 751(a) or (b)
  - Reasonable compensation
  - Section 707(a) and (c) payments
  - Interest "properly allocable to" a trade or business
- The proposed regulations' definition of qualified REIT dividends and qualified PTP income is consistent with the statute.

QBI, qualified REIT dividends, qualified PTP income (Prop. Reg. Section 1.199A-3)

- Proposed regulations clarify that taxpayers must allocate items between multiple trades or businesses operated directly or by the same entity.
  - The same allocation method is not required for all items of income, gain, deduction, or loss.
  - Allocation methods used must be reasonable and consistently applied.
- Income from a rental real property held directly by the individual taxpayer may or may not constitute QBI, depending on whether the rental operation meets the definition of a trade or business.
  - This issue is not unique to Section 199A; it also exists in Section 1411.

QBI, qualified REIT dividends, qualified PTP income (Prop. Reg. Section 1.199A-3)

- Proposed regulations address the interaction of the QBI computation with losses suspended as a result of outside basis limitations, at-risk rules, or passive activity loss rules.
- Certain losses are taken into account in the QBI computation only when allowed for a tax year, not in the year they are suspended.
- Pre-Tax Cuts and Jobs Act (TCJA) suspended losses not taken into account.
  - No ordering rule provided

Aggregation (Prop. Reg. Section 1.199A-4)

- Proposed Reg. Section 1.199A-4 provides rules that allow taxpayers to aggregate trades or businesses.
- Aggregation is allowed (but not required) if certain criteria are met, providing some flexibility to taxpayers.
- Aggregation allows taxpayers to treat multiple trades or businesses as a single trade or business for purposes of applying the wage and qualified property limitations.

Aggregation (Prop. Reg. Section 1.199A-4)

- To aggregate multiple trades or businesses:
  - Each trade or business must independently qualify as a trade or business;
  - There must be majority ownership by same person or group of persons;
  - No trade or business may be a SSTB; and
  - Trades or businesses must be integrated
- Proposed Reg. Section 1.199A-4 includes rules related to aggregation consistency, reporting and disclosure.

SSTB; performing services as an employee (Prop. Reg. Section 1.199A-5)

- For taxpayers with taxable income in excess of the phase-in range, a trade's or business's characterization as an SSTB excludes the trade or business from being treated as a qualified trade or business.
- An SSTB is any trade or business involving the performance of services in the fields of:
  - Health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners
  - A trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities

SSTB; performing services as an employee (Prop. Reg. Section 1.199A-5)

- De minimis exception:
  - Gross receipts less than $25m: less than 10% SSTB gross receipts
  - Gross receipts $25m or more: less than 5% SSTB gross receipts
- Anti-abuse rules:
  - SSTB includes a trade or business that provides 80% or more of its property or services to an SSTB if there is 50% or more common ownership.
  - If trade or business provides less than 80% of property or services to an SSTB with common ownership, the portion of the trade or business providing property or services to the SSTB is treated as part of the SSTB.
  - An incidental qualified trade or business is treated as part of an SSTB with common ownership.
  - Rules establish a presumption relating to former employees.

RPEs, PTPs, trusts and estates (Prop. Reg. Section 1.199A-6)

- The proposed regulations provide special computational and reporting rules for RPEs, PTPs, and trusts and estates.
- Trusts and estates are treated as RPEs to the extent that they allocate QBI and other items to beneficiaries.
  - The example in the proposed regulations creates an unusual scenario where a trust distributes negative QBI, W-2 and UBIA.
- Proposed regulations confirm that electing small business trusts (ESBTs) are entitled to the Section 199A deduction.
  - It is unclear if the S portion and the non-S portion of the trust each apply the threshold amount.

Treatment of multiple trusts (Prop. Reg. Section 1.643(f)-1)

- The proposed regulations provide anti-abuse provisions with respect to the creation of multiple trusts:
  - Proposed Reg. Section 1.199A-6(d): Trusts formed or funded with a significant purpose being the receipt of a deduction under Section 199A will not be respected
  - Proposed Reg. Section 1.643(f)-1: Multiple trusts treated as a single trust if:
    - They have substantially the same grantors and beneficiaries; and
    - A principal purpose is to avoid federal income tax
  - Application of Proposed Reg. Section 1.643(f)-1 is broader than Proposed Reg. Section 1.199A-6(d)

Section 162 vs Section 212

Section 162 vs. Section 212 expenses

Lender Management, LLC vs. Commissioner, T.C. Memo 2017-246 (Dec. 13, 2017):

- Tax Court case where family invested through investment partnerships with a management entity overseeing the investments.
  - IRS disallowed Section 162 business expense deduction and allowed them pursuant to Section 212.
- Issue: Did the management entity carry on a "trade or business" within the meaning of Section 162?
- Holding: Management entity's activities did carry on a "trade or business" under the Internal Revenue Code (IRC).
  - Activities went far beyond activities of investor.
  - Management entity received profits interest, which increased incentive to provide high-quality management services.
  - Management services were provided to and for the benefit of other besides itself.

Section 162 vs. Section 212 expenses

Hellman vs. Commissioner, Docket Nos. 8486-17, 8489-17, 8494-17, 8497-17

- Case pending before the Tax Court
  - Summary judgment motions under consideration
- Court asked to determine whether management entity activity constitutes “trade or business” in the aftermath of *Lender* decision.
- Factual differences from *Lender*:
  - Management entity is managed by three family members, who are the sole owners of the management entity and of all underlying investment partnerships.
  - There are outside investors.

Questions & Miscellaneous Other Items

Tax Shelters excluded from Small Business Exception for 163(j)

- "Small businesses" taxpayers (defined as those with average gross receipts over a three-year period of less than $25 million), except "tax shelters," excluded.
  - The term tax shelter may include many partnerships or S Corporations that allocated more than 35% of their losses to passive investors for the taxable year in question.
  - Aggregation rules apply.

Schedule E Basis Reporting for S-Corporation Interests

Schedule E (Form 1040) 2018 | Attachment Sequence No. **13** | Page **2**

Name(s) shown on return. Do not enter name and social security number if shown on other side. | **Your social security number**

Caution: The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II **Income or Loss From Partnerships and S Corporations – Note:** If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column **(e)** on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column **(f)** on line 28 and attach **Form 6198** (see instructions).

27 Are you reporting any loss not allowed in a prior year due to the at-risk, excess farm loss, or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section . . . . ☐ **Yes** ☐ **No**

28	**(a)** Name	**(b)** Enter **P** for partnership; **S** for S corporation	**(c)** Check if foreign partnership	**(d)** Employer identification number	**(e)** Check if basis computation is required	**(f)** Check if any amount is not at risk
A			☐		☐	☐
B			☐		☐	☐
C			☐		☐	☐
D			☐		☐	☐

Passive Income and Loss	**Nonpassive Income and Loss**

Thank You

EY

Building a better
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