2019 Federal Law Tax Update

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Overview: The Tax Cuts and Jobs Act (“TCJA”) signed into law on December 2017, made sweeping changes in both personal, business and estate tax rules.

2018 and 2019 have been years of adjustment to the storm of activity created by the TCJA.

Legislative Developments

- 2018 and 2019 have been mostly uneventful for federal legislative tax developments.

- Taxpayer First Act of 2019 is an expansion and strengthening of taxpayer rights as well as a focus on cybersecurity and protection from identity theft for taxpayers.

- The following three provisions of the Act go into effect on August 16:

  - John Doe summonses. The Act prevents IRS from issuing a John Doe summons (one that doesn't identify the taxpayer) unless the information sought to be obtained is narrowly tailored and pertains to the failure (or potential failure) of the person or group or class of persons referred to in the statute to comply with one or more provisions of the Code which have been identified. (Code Sec. 7609(f) , as amended Act Sec. 1204(a))

  - Designated summonses. The Act requires that before issuing a designated summons (an administrative summons issued to a large corporation or person to whom the corporation has transferred the requested books and records), the Commissioner of the relevant operating division of IRS and the Chief Counsel must review and provide written approval of the summons. The written approval must state facts establishing that IRS had previously made reasonable requests for the information and must be attached to the summons. Also, IRS must certify in any subsequent judicial proceedings that a reasonable request for the information was made. (Code Sec. 6503(j) , as amended by Act Sec. 1207)

Legislative Developments

- Notice to taxpayer of IRS contact with third party. The Act provides that IRS may not contact any person other than the taxpayer with respect to the determination or collection of the tax liability of the taxpayer without providing the taxpayer with notice at least 45 days before the beginning of the period of the contact. This replaces a requirement that reasonable notice be provided "in advance" to the taxpayer. The period of contact may not be greater than one year. The Act requires that notice be provided only if there is a present intent at the time such notice is given for IRS to make such contacts. (Code Sec. 7602(c)(1) , as amended Act Sec. 1206)

Legislative Developments

- Some technical corrections were discussed, but due to the political climate, little progress was made on technical corrections of the TCJA.

- Tax extenders are being discussed. Expired/Expiring in 2018/2019
  - Lower AGI threshold for itemized medical expense deduction (2018)
  - New Markets Tax Credit (2019)
  - Work Opportunity Tax Credit (2019)
  - Look-through treatment of payments between related CFCs for purposes of Subpart F (2019)
  - Beginning of construction date for wind facilities eligible to claim the electricity PTC (or ITC in lieu of the PTC) (2019)
  - Moratorium on ACA taxes/fees on med device makers, health insurers (2019)
  - Reduced excise taxes on beer, wine, distilled spirits (2019)

- Elimination of the sunset in 2026 of the individual provisions of the 2017 Tax Act was discussed prior to the November 2018 elections. The sun-setting provisions were included in the 2017 Tax Act (1) to meet the $1.5 trillion deficit limit authorized in the budget resolution authorizing the reconciliation act in 2017, and (2) to avoid the Byrd rule which would have been triggered if the Act had the effect of producing additional deficits outside the 10-year budget window of the 2017 Tax Act.

- Republican leaders in 2018 considered a “second round of Trump tax cuts,” sometimes referred to as “Trump Tax Cut 2.0.” Central to the proposal would have been removing the sunset of the individual tax cuts in the 2017.

Legislative Developments

- **SECURE Act** proposal (H.R. 1994, Setting Every Community Up for Retirement Enhancement Act of 2019) would make various changes regarding retirement benefits.

- Among the proposed changes are the following:

  - Deferring the minimum required beginning date age to age 72 rather than age 701/2 (effective for individuals who reach age 701/2 after December 31, 2019) (costing $8.86 billion over 10 years) (A similar Senate proposal would extend the required beginning date age to 75 and remove it entirely for pensions worth up to $100,000);

  - Eliminating the prohibition on contributions to an IRA after age 701/2;

Legislative Developments

- **SECURE Act** proposal (H.R. 1994, Setting Every Community Up for Retirement Enhancement Act of 2019) would make various changes regarding retirement benefits.

- Requiring that long-time part-time workers be included in 401k plans;

- Allowing a participant to withdraw $5,000 in the year after a child is born to or adopted by the participant;

- Mandating that distributions from defined contribution plans (and IRAs) be made within 10 years following the death of the participant, with exceptions for a beneficiary that is a spouse, a minor child (distributions would have to be made within 10 years after the child reached majority), a disabled or chronically ill person, or a person not more than 10 years younger than the participant (saving $15.7 billion over 10 years); the 10-year distribution rule would apply whether or not distributions to the participant had begun before the participant's death, and would apply to participants who die after December 31, 2019.

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Legislative Developments

- Former Vice President Joe Biden, beginning in his first campaign speech in April,, 2019, proposed ending the step-up in basis at death to pay for making community college free and also proposed eliminating various provisions of the 2017 Tax Act to pay for a climate plan proposal.

- Senator Elizabeth Warren proposes a 2% annual levy on wealth in excess of $50 million and 3% on wealth above $1 billion.

- Sen. Cory Booker proposes a refundable tax credit to help low- and middle-income Americans cap rental costs at 30% of their income, and would pay for the proposal by restoring 2009-era estate tax rules and closing loopholes that allow wealthy households to avoid paying taxes on investments held at death

- Senator Sanders on January 31, 2019 introduced S. 309 titled “For the 99.8 Percent Act” that reduces the basic exclusion amount to $3.5 million (not indexed) for estate tax purposes and to $1.0 million (not indexed) for gift tax purposes and increases the rates: 45% on estates between $3.5 and $10 million, 50% on $10 million - $50 million, 55% on $50 million - $1 billion, and 77% over $1 billion. (The GST rate is not specifically addressed, so presumably it would be the highest marginal estate tax rate of 77% under §2641(a)(1).) In addition, the bill would make major dramatic changes to the transfer tax system.

Legislative Developments

- Harambe, a Gorilla who has passed, may have received over 15,000 votes for President of the United States in the 2016 election.

- Harambe may adopt the 1992 Ross Perot federal tax proposal advanced in his presidential campaign which included, but was not limited to a flat tax, a consumption tax, a national sales tax, a savings tax, a value-added tax and a financial transaction tax.

- The idea, he said, is to scrap the current complicated income tax code for a simpler one that is paperless and not beholden to special interests.

2018-2019 PRIORITY GUIDANCE PLAN

Updated as of October 8, 2019

- PART 1. IMPLEMENTATION OF TAX CUTS AND JOBS ACT (TCJA) (52 Items)
  - Regulations to address the amendments to §47, the rehabilitation
  - Regulations clarifying the deductibility of certain expenses described in §67(b) and (e) that are incurred by estates and non-grantor trusts. Notice 2018-61 was published on July 30, 2018.
  - Regulations under §162(m), as amended by section 13601 of the TCJA.Guidance under amended §162(f) and new §6050X.
  - Regulations under amended §162(f) and §6050X.
  - Computational, definitional, and other guidance under §163(j). Notice 2018-64 was published on August 27, 2018, and Rev. Proc. 2018-59 was published on December 10, 2018. Proposed regulations were published on December 28, 2018.
  - Final regulations and other guidance under §168(k). Proposed regulations were published on August 8, 2018.
  - Guidance on applying the state and local deduction cap under §164.
  - Regulations on computation of unrelated business taxable income for separate trades or businesses under §512(a)(6), as added by section 13702 of the TCJA.

2018-2019 PRIORITY GUIDANCE PLAN

Updated as October 8, 2019

- PART 2. E.O. 13789 - IDENTIFYING AND REDUCING REGULATORY BURDENS
- PART 3. BURDEN REDUCTION
  - Guidance under §170(e)(3) regarding charitable contributions of inventory.
- PART 4. TAXPAYER FIRST ACT GUIDANCE
- PART 5. BIPARTISAN BUDGET ACT OF 2015 - PARTNERSHIP AUDIT REGULATIONS
- PART 6. GENERAL GUIDANCE
  - Regulations relating to the requirements under §355, including the active trade or business requirement and the prohibition on device for the distribution of earnings and profits.
  - 2. Guidance on circumstances under which an LLC can qualify for recognition under §501(c)(3).
  - Guidance concerning virtual currency.

TCJA and Other Federal Tax Developments

1. Transfer Tax Issues
2. Individual Income Tax Issues
3. Business Tax Matters
4. 2019 Developments
5. 199A Update

Transfer Tax
Increased Exemption Amount

- Adjusted for inflation the exemption amount is $11,400,000 for 2019, or $22,360,000 per couple.
- For gifts made and estates of decedents dying in 2020, the exclusion amount will be $11,580,000.
- Generation-skipping transfer (GST) tax exemption. The exemption from GST tax will be $11,580,000 for transfers in 2020
- Gift tax annual exclusion. For gifts made in 2019 and 2020, the gift tax annual exclusion will be $15,000.
- Annual exclusion for gifts to noncitizen spouses. For gifts made in 2020, the annual exclusion for gifts to noncitizen spouses will be $157,000 (up from $155,000 for 2019).

Transfer Tax
Clawback IRC §2010

- Legislative Authorization. The 2017 Tax Act amended §2001(g) to add a new §2001(g)(2) directing the Treasury to prescribe regulations as may be necessary or appropriate to address any difference in the basic exclusion amount at the time of a gift and at the time of death. Section 2001(g)(2) provides as follows:
  - (2) MODIFICATIONS TO ESTATE TAX PAYABLE TO REFLECT DIFFERENT BASIC EXCLUSION AMOUNTS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this section with respect to any difference between—
    - (A) the basic exclusion amount under section 2010(c)(3) applicable at the time of the decedent's death, and
    - (B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent.

Transfer Tax
Clawback IRC §2010

- Proposed rules would address the effect of changes to the basic exclusion amount (BEA) used in computing federal gift and estate taxes.
- The proposed regulations would update Reg. §20.2010-1 to conform to statutory changes to the determination of the BEA enacted by the 2017 tax act.
- The proposed regulations implement the effect of the increase and subsequent decrease in BEA due to the temporary nature of the amendment on gift tax and the estate tax (i.e., there will be no clawback of lifetime gifts made during the increased BEA period).
- The act increased the BEA from $5 million to $10 million (adjusted for inflation) in the case of decedents dying or gifts made after December 31, 2017, and before January 1, 2026. REG-106706-18; IR-2018-229.

Transfer Tax
Clawback IRC §2010

- Simple Explanation of Regulation's Approach. A news release issued contemporaneously with the release of the proposed regulations explained that "the proposed regulations provide a special rule that allows the estate to compute its estate tax credit using the higher of the BEA [basic exclusion amount] applicable to gifts made during life or the BEA applicable on the date of death."
- In determining the unified credit for estate tax purposes, the credit attributable to the BEA portion of the AEA is (i) the credit attributable to the BEA at the date of death, or if larger, (ii) the sum of the amounts attributable to the BEA allowable in computing the gift tax payable on the decedent's post-1976 gifts, whether or not included in the gross estate (but for any particular year, not exceeding the tentative tax on gifts during that year).

Transfer Tax
Clawback IRC §2010

- Example. A simple example in the proposed regulation addresses an individual (A) who made cumulative post-1976 taxable gifts of $9 million that were sheltered from gift tax by the cumulative total of $10 million in BEA allowable on the dates of the gifts. A dies after 2025 when the BEA is $5 million. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts (i.e., the tentative tax on $9 million) exceeds the credit based on the $5 million BEA applicable at the date of death, the credit applied in computing the estate tax is based on a BEA of $9 million, "the amount used to determine the credits allowable in computing the gift tax payable on the post-1976 gifts made by A." Prop. Reg. §20.2010(c)(2).

Transfer Tax

Miscellaneous Itemized Deduction
IRC §67, §642, §651, §661

- IRS intends to issue regulations on the suspension of miscellaneous itemized deductions on estates and nongrantor trusts.

- The regulations will clarify that estates and non- grantor trusts may continue to deduct expenses described in §67(e)(1) and amounts allowable as deductions under §642(b), §651 or §661, including the appropriate portion of a bundled fee, in determining the estate or nongrantor trust's adjusted gross income during taxable years, for which the application of §67(a) is suspended pursuant to §67(g). Notice 2018-61.

Individual Income Tax Inflation Adjustments

- The income tax brackets, standard deduction amounts, and many other tax items are adjusted annually for cost-of-living increases.
- These adjustments reflect, under a measure of inflation provided by the Tax Cuts and Jobs Act (TCJA; P.L. 115-97 , 12/22/2017), the average chained Consumer Price Index (CPI) for all-urban customers (C-CPI-U) for the 12-month period ending the previous August 31.
- The August 2019 CPI summary has been released by the Labor Department

Individual Income Tax Rates

2019 federal income tax brackets

(for taxes due in April 2020)

Tax rate	Single	Married, filing jointly	Married, filing separately	Head of household
10%	$0 to $9,700	$0 to $19,400	$0 to $9,700	$0 to $13,850
12%	$9,701 to $39,475	$19,401 to $78,950	$9,701 to $39,475	$13,851 to $52,850
22%	$39,476 to $84,200	$78,951 to $168,400	$39,476 to $84,200	$52,851 to $84,200
24%	$84,201 to $160,725	$168,401 to $321,450	$84,201 to $160,725	$84,201 to $160,700
32%	$160,726 to $204,100	$321,451 to $408,200	$160,726 to $204,100	$160,701 to $204,100
35%	$204,101 to $510,300	$408,201 to $612,350	$204,101 to $306,175	$204,101 to $510,300
37%	$510,301 or more	$612,351 or more	$306,176 or more	$510,301 or more

Individual Income Tax

- Dependents. For an individual who can be claimed as a dependent on another's return, the basic standard deduction for 2020 will be $1,100 (same as for 2019), or $350 (same as for 2019) plus the individual's earned income, whichever is greater. However, the standard deduction may not exceed the regular standard deduction for that individual.

- Older and blind taxpayers. For 2020, the additional standard deduction for married taxpayers 65 or over or blind will be $1,300 (same as for 2019). For a single taxpayer or head of household who is 65 or over or blind, the additional standard deduction for 2020 will be $1,650 (same as for 2019).

- Exemption amount. While the dependency exemption deduction under Code Sec. 151 is reduced to zero from 2018 through 2025, this reduction isn't taken into account for other purposes of the Code, such as who is a qualifying relative for family credit purposes, and eligibility for head-of-household status. For 2020, this amount is $4,300 (up from $4,200 for 2019).

Individual Income Tax

- Capital gains. For 2020, the capital gains tax rates will be as follows:
  - The 0% capital gains rate applies to adjusted net capital gain of up to:
  - . . . Joint returns and surviving spouses-$80,000 (up from $78,750 for 2019)
  - . . . Single filers and married taxpayers filing separately-$40,000 (up from $39,375 for 2019)
  - . . . Heads of household-$53,600 (up from $52,750 for 2019)
  - . . . Estates and trusts-$2,650 (same as for 2019)
- The 15% capital gains tax rate applies to adjusted net capital gain over the amount subject to the 0% rate, and up to:
  - . . . Joint returns and surviving spouses-$496,600 (up from $488,850 for 2019)
  - . . . Married taxpayers filing separately-$248,300 (up from $244,425 for 2019)
  - . . . Heads of household-$469,050 (up from $461,700 for 2019)
  - . . . Single filers-$441,450 (up from $434,550 for 2019)
  - . . . Estates and trusts-$13,150 (up from $12,950 for 2019)
- The 20% capital gains tax rate applies to adjusted net capital gain over the above 15%-maximum amounts.

Individual Income Tax

- Income-based limitations on Sec. 199A/qualified business income deduction. For 2020, taxpayers with taxable income above $163,300 for single and head of household returns, $326,600 for joint filers, and $163,300 for married filing separate returns are subject to certain limitations on the Code Sec. 199A deduction. The 2019 amounts were $160,700 and $321,400, and $160,725.

- Educator expenses. For 2020, eligible elementary and secondary school teachers can claim an above-the line deduction for up to $250 per year of expenses paid for books and certain other supplies used in the classroom (same as for 2019).

Individual Income Tax

- Qualified transportation fringe benefits. For 2020, an employee will be able to exclude up to $270 (up from $265 for 2019) a month for qualified parking expenses, and up to $270 a month (up from $265 for 2019) of the combined value of transit passes and transportation in a commuter highway vehicle.

- Refundable child credit. The child credit is refundable, subject to the limit described below, to the extent of the greater of:

  - . . . 15% of earned income above $2,500, or
  - . . . for taxpayers with three or more qualifying children, the excess of the taxpayer's social security taxes for the tax year over his or her earned income tax credit for the year. (Code Sec. 24(d))

- The refundable portion of the child tax credit for any qualifying child can't exceed $1,400 for 2020 (same as for 2019).

Individual Income Tax

- Earned income tax credit. For 2020, the maximum amount of earned income on which the earned income tax credit will be computed is $7,030 for taxpayers with no qualifying children, $10,540 for taxpayers with one qualifying child, and $14,800 for taxpayers with two or more qualifying children. These amounts were $6,920, $10,370, and $14,570 for 2019, respectively.

- For 2020, the phaseout of the allowable earned income tax credit will begin at $14,680 for joint filers with no qualifying children ($8,790 for others with no qualifying children), and at $25,220 for joint filers with one or more qualifying children ($19,330 for others with one or more qualifying children). These amounts were $14,450, $8,650, $24,820 and $19,030 for 2019, respectively.

Individual Income Tax

- Lifetime learning credit phaseout. For 2020, a taxpayer's MAGI in excess of $59,000 (up from $58,000 for 2019), $118,000 for a joint return (up from $116,000 in 2019) will be used to determine the reduction under Code Sec. 25A(d)(2) in the amount of the Lifetime Learning Credit otherwise allowable under Code Sec. 25A(a)(2) .

- Adoption credit. For 2020, the credit allowed for an adoption of a child with special needs will be $14,300 (up from $14,080 for 2019). The maximum credit allowed for other adoptions will be the amount of qualified adoption expenses up to $14,300 (up from $14,080 for 2019).

- For 2020, the credit will begin to phase out for taxpayers with MAGI in excess of $214,520 (up from $211,160 for 2019). The phaseout will be complete if MAGI is $254,520 (up from $251,160 for 2019).

Individual Income Tax

- Adoption exclusion. For 2020, the amount that can be excluded from an employee's gross income for the adoption of a child with special needs will be $14,300 (up from $14,080 for 2019). For 2020, the maximum amount that can be excluded from an employee's gross income for the amounts paid or expenses incurred by an employer for qualified adoption expenses furnished pursuant to an adoption assistance program for other adoptions by the employee will be $14,300 (up from $14,080 for 2019).

- For 2020, the amount excludable from an employee's gross income will begin to phase out for taxpayers with MAGI in excess of $214,520 (up from $211,160 for 2019). The phaseout will be complete if MAGI is $254,520 (up from $251,160 for 2019).

- Student loan interest deduction. For 2020, the deduction phases out ratably for taxpayers other than joint filers with MAGI between $70,000 and $85,000 (same as for 2019), and MAGI between $140,000 and $170,000 for joint filers (same as for 2019).

Individual Income Tax

Charitable Contributions and SALT Credits
IRC §164, §170, §642

- Final regulations and safe harbor notice provide rules governing the availability of charitable contribution deductions under §170 when a taxpayer receives or expects to receive a corresponding state or local tax credit. T.D. 9864, Notice 2019-12, IR-2019-109.

- Under the final regulations, a taxpayer making payments to an entity eligible to receive tax-deductible contributions must reduce the federal charitable contribution deduction by the amount of any state or local tax credit that the taxpayer receives or expects to receive in return. The regulations also apply to payments made by trusts or decedents' estates in determining the amount of their charitable contribution deductions.

- For example, if a state grants a 70 percent state tax credit pursuant to a state tax credit program, and an itemizing taxpayer contributes $1,000 pursuant to that program, the taxpayer receives a $700 state tax credit. A taxpayer who itemizes deductions must reduce the $1,000 federal charitable contribution deduction by the $700 state tax credit, leaving a federal charitable contribution deduction of $300.

Individual Income Tax

Charitable Contributions and SALT Credits
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- Under the final regulations, a taxpayer making payments to an entity eligible to receive tax-deductible contributions must reduce the federal charitable contribution deduction by the amount of any state or local tax credit that the taxpayer receives or expects to receive in return. The regulations also apply to payments made by trusts or decedents' estates in determining the amount of their charitable contribution deductions.

- For example, if a state grants a 70 percent state tax credit pursuant to a state tax credit program, and an itemizing taxpayer contributes $1,000 pursuant to that program, the taxpayer receives a $700 state tax credit. A taxpayer who itemizes deductions must reduce the $1,000 federal charitable contribution deduction by the $700 state tax credit, leaving a federal charitable contribution deduction of $300.

Individual Income Tax

State and Local Tax Refunds/Tax benefit Rule
IRC §111, §164

- Interplay between state and local tax deductions and the tax benefit rule are outlined.
- If a taxpayer receives a benefit from deducting state or local taxes in a prior year and recovers all or a portion of those taxes in the current year, the taxpayer must include in gross income either the difference in itemized deductions from the two years, or the difference between the itemized deductions and the standard deduction for the two years.
- Examples show the interaction of the tax benefit rule and the new deduction limit for state and local taxes. Rev. Rul. 2019-11, IR-2019-59.

Individual Income Tax

State and Local Tax Refunds/Tax benefit Rule
IRC §111, §164

- Situation 1: Taxpayer A paid local real property taxes of $4,000 and state income taxes of $5,000 in 2018. A's state and local tax deduction was not limited by section 164(b)(6) because it was below $10,000. Including other allowable itemized deductions, A claimed a total of $14,000 in itemized deductions on A's 2018 federal income tax return. In 2019, A received a $1,500 state income tax refund due to A's overpayment of state income taxes in 2018.
- Situation 2: Taxpayer B paid local real property taxes of $5,000 and state income taxes of $7,000 in 2018. Section 164(b)(6) limited B's state and local tax deduction on B's 2018 federal income tax return to $10,000, so B could not deduct $2,000 of the $12,000 state and local taxes paid. Including other allowable itemized deductions, B claimed a total of $15,000 in itemized deductions on B's 2018 federal income tax return. In 2019, B received a $750 state income tax refund due to B's overpayment of state income taxes in 2018

Individual Income Tax

State and Local Tax Refunds/Tax benefit Rule
IRC §111, §164

- Situation 1: State income tax refund fully includable. In 2019, A received a $1,500 refund of state income taxes paid in 2018. Had A paid only the proper amount of state income tax in 2018, A's state and local tax deduction would have been reduced from $9,000 to $7,500 and as a result, A's itemized deductions would have been reduced from $14,000 to $12,500, a difference of $1,500. A received a tax benefit from the overpayment of $1,500 in state income tax in 2018. Thus, A is required to include the entire $1,500 state income tax refund in A's gross income in 2019.
- Situation 2: State income tax refund not includable. In 2019, B received a $750 refund of state income taxes paid in 2018. Had B paid only the proper amount of state income tax in 2018, B's state and local tax deduction would have remained the same ($10,000) and B's itemized deductions would have remained the same ($15,000). B received no tax benefit from the overpayment of $750 in state income tax in 2018. Thus, B is not required to include the $750 state income tax refund in B's gross income in 2019.

Individual Income Tax
State and Local Tax Deduction

- Under prior law, taxpayers generally could deduct most state and local taxes against their federal income tax base.
- The TCJA limits the deduction to $10,000 per year for all state and local real and personal property taxes and income taxes. I.R.C. § 164(b).
- The cap runs from 2018 through 2025.

Individual Income Tax
State and Local Tax Deduction

- The cap contains an exception for real and personal property taxes that are paid or accrued in a trade or business or an activity described in I.R.C. §212 (i.e., most investment activities).
- Example: Jim owns a 50% interest in Newco, a partnership which in turns owns an office building. Newco incurs $50,000 of local property taxes and Jim's distributive share of Newco income incurs $50,000 of state income tax. Jim otherwise pays no other state and local property or income taxes.
- Jim can deduct the $50,000 of property tax, but can only deduct $10,000 of state income tax.

Individual Income Tax
State and Local Tax Deduction

- The $10,000 limit on SALT deductions has led some states to consider implementing laws providing relief from state income tax to the extent of contributions to a specified charitable fund, in hopes that the taxpayer could deduct the full charitable contribution without any $10,000 limitation.
- Despite some prior indications that such programs might be respected (see Chief Counsel Advice 201105010), on August 23, 2018, the IRS issued final regulations, published in the Federal Register on June 13, 2019, blocking these types of arrangements by disallowing a federal charitable deduction when the donor expects to receive an offsetting credit against state and local taxes.

Individual Income Tax
State and Local Tax Deduction

- The regulations are based on the generally recognized "quid pro quo" rationale of not allowing a charitable deduction to the extent that the donor receives a benefit from the donation. Under the regulations–
  - Offsetting credit–The amount of a taxpayer's charitable contribution deduction under §170(a) is reduced by the amount of any state or local tax credit that the taxpayer receives or expects to receive in consideration for the taxpayer's payment or transfer. Only the excess over the anticipated credit qualifies for the charitable deduction. Reg. §1.170A-1(h)(3)(i).
  - Not apply to offsetting deductions–The reduction or elimination of a charitable contribution deduction under §170 does not apply if a taxpayer anticipates receiving a deduction (rather than a credit) against state or local taxes not exceeding the amount of the contribution. The preamble to the proposed regulation reasons that because local rates are typically fairly low, the risk of deductions being used to circumvent the limit on the deduction for state and local taxes is comparatively low, and applying the reduction to deductions against state and local taxes would be administratively complex because of the amount of the offsetting benefit, and therefore the amount of the reduction in the federal charitable deduction, would vary depending on the local tax rate. Reg. §1.170A-1h(3)(ii).

Individual Income Tax
State and Local Tax Deduction

- Under the regulations–
  - Amount based on maximum state or local tax credit–The reduction of the charitable deduction is based on the maximum credit allowable that corresponds to the amount of the taxpayer contribution. Reg. §1.170A-1h(3)(iv).
  - De minimis exception–The reduction in the amount of the federal charitable deduction does not apply if amount of the anticipated credit for state or local tax does not exceed 15% of the amount of the donation. Reg. §1.170A-1h(3)(vi).
  - Trust charitable deduction–A similar change is made to §642(c) to limit the charitable income tax deduction for trusts in a similar manner. Reg. §1.642(c)-3(g)(1).
  - Effective date–the new rules apply to contributions made after August 27, 2018. The preamble to the proposed regulations made clear that the rules apply to preexisting as well as new state credit programs. See generally Richard Fox & Jonathan Blattmachr, IRS Proposed Regulations Nullify $10,000 Annual SALT Limitation Workaround Attempts by States and Political Subdivisions, LEIMBERG INC. TAX PL. NEWSLETTER #155 (Sept. 27, 2018).

Planning Considerations Inherent Uncertainty Arising From 2026 Sunset.

Provisions that sunset:

- The individual income tax rates and brackets
- The $10,000 cap on SALT deductions
- The limits on home mortgage interest deductions
- The 199A pass-through deduction
- The increase in the estate tax exclusion amount

Provisions that do not :

- The change to the inflation index
- The corporate flat 21% rate

Business Income Tax
Tax Rate Reduction & AMT

- Reduced to a flat 21%.
  - Before the TCJA, rates were graduated, starting at 15% for taxable income up to $50,000, with rates at 25% for income between 50,001 and $75,000, 34% for income between $75,001 and $10 million, and 35% for income above $10 million.
- The corporate AMT is repealed.

Business Income Tax

Built-in Gains or Built-in Losses Following Ownership Change
IRC §382, §1374

- Proposed rules provide guidance regarding items of income and deduction includible in calculation of built-in gains and losses under §382.
- The proposed regulations would adopt as mandatory the net unrealized built-in gain (NUBIG) and net unrealized built-in loss (NUBIL) harbor computation under §1374, and provided in Notice 2003-65, with modifications. REG-125710-18.

Business Income Tax

Changes in Accounting Periods IRC §446, §451

- Procedures modified to obtain automatic consent of the Commissioner of Internal Revenue to change methods of accounting to comply with §451 and Prop. Reg. §1.451-3 and §1.451-8. Rev. Proc. 2019-37.

Business Income Tax Changes
Depreciation

- Bonus depreciation. Under the TCJA, a 100% first-year deduction is allowed for qualified new and used property acquired and placed in service after September 27, 2017 and before 2023. I.R.C. § 168(k).
- Procedures allowing taxpayers to make a late election, or to revoke an election, under §168(k) for certain property acquired by the taxpayer after September 27, 2017, and placed in service by the taxpayer during its taxable year that includes September 28, 2017.
- The procedures apply to the three available elections under §168(k) as amended by the 2017 tax act, Pub. L. No. 115-97. Rev. Proc. 2019-33, IR-2019-135.

Business Income Tax Changes
Auto Depreciation

- Auto Depreciation Deduction Limits. Tables of limitations on depreciation deductions for owners of passenger automobiles placed in service during calendar year 2019 and amounts that must be included in income by lessees of such vehicles placed in service during calendar year 2019.
- The depreciation amounts depend on whether first-year bonus depreciation under Section 168(k) was taken and when the vehicle was acquired and placed in service. The lessee inclusion amounts start a vehicle value of $50,000. Rev. Proc. 2019-26.

Business Income Tax Changes

Depreciation Deduction for Passenger Automobiles

- IRS provides a safe harbor method for determining depreciation deductions for passenger automobiles that qualify for the 100-percent additional first year depreciation deduction under §168(k) and that are subject to the depreciation limitations for passenger automobiles.
- The safe harbor is not allowed if the taxpayer elects §179 treatment or elects out of §168(k). Rev. Proc. 2019-13.

Business Income Tax Changes

IRS Issues Notice 2019-06 on Special Enforcement Matters Under Centralized Partnership Audit Rules

- In Notice 2019-06, the IRS announced that it intends to propose regulations addressing certain special enforcement matters under Section 6241(11).
- Under Section 6241(11), in the case of partnership-related items involving special enforcement matters, the IRS may prescribe regulations providing that the centralized partnership audit regime (or any portion thereof) does not apply to those items and that those items will be subject to special rules as the IRS determines to be necessary for the effective and efficient enforcement of the Code.
- For purposes of Section 6241(11), the term "special enforcement matters" means:
  - Failure to comply with the requirements of Section 6226(b)(4)(A)(ii) (regarding the requirement for a partnership-partner or S corporation-partner to furnish statements or compute and pay an imputed underpayment).
  - Assessments under Section 6851 (relating to termination assessments of income tax) or Section 6861 (relating to jeopardy assessments of income, estate, gift and certain excise taxes).
  - Criminal investigations.
  - Indirect methods of proof of income.
  - Foreign partners or partnerships.
  - Other matters that the IRS determines by regulation present special enforcement considerations.

2019 Developments

Gross Income-Cost Of Goods Sold-Inventories-Marijuana Cigarette Container Marketing And Sales-Proof.

- Chico, TC Memo 2019-123.
- Married taxpayers weren't entitled to any COGS for their marijuana cigarette container marketing-sales business for certain years for which they failed to adequately substantiate same.
- Although taxpayers offered into evidence invoices from manufacturers of materials used in manufacturing their products, they didn't provide any information regarding beginning and ending inventories for subject years. (Raymond Chico, et ux. v. Commissioner, (2019) TC Memo 2019-123 , 2019 RIA TC Memo ¶2019-123).

2019 Developments

Tax Preparer Understated Income, Liable For Fraud Penalty

- Chico, TC Memo 2019-123.
- The Tax Court has found that a tax preparer was liable for the fraud penalty because he intentionally underreported his business income on his tax returns for three years.
- Background-underreported income. Under Code Sec. 61(a), gross income is all income from whatever source derived.
- Code Sec. 6001 requires taxpayers to maintain sufficient records to allow the IRS to determine their correct tax liability.
- Code Sec. 446(b) confers broad powers on the IRS to compute the taxable income of taxpayers who fail to keep adequate books and records.
- If any part of any underpayment of tax required to be shown on a return is due to fraud, there is an addition to tax of 75% of the portion of the underpayment that is attributable to fraud. (Code Sec. 6663(a)).

2019 Developments
Tax Preparer Understated Income, Liable For Fraud Penalty

- To establish fraud, the IRS must prove that:
  - (1) an underpayment of tax exists; and
  - (2) the taxpayer intended to evade taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of taxes. (Parks, (1990) 94 TC 654) The IRS must prove both elements by clear and convincing evidence. (Code Sec. 7454(a)).
- Fraudulent intent may be inferred from various kinds of circumstantial evidence, or "badges of fraud," including:
  - (1) consistent understatement of income;
  - (2) inadequate records;
  - (3) failure to file tax returns;
  - (4) implausible or inconsistent explanations of behavior;
  - (5) concealment of income or assets; and
  - (6) failure to cooperate with tax authorities. (Estate of Trompeter, (CA 9 2006) 97 AFTR 2d 2006-1147).

2019 Developments

S Corporation Providing Management Services to Medical Marijuana Dispensary was Engaged in "Trafficking in Controlled Substances" for Purposes of Section 280E

- In Alternative Health Care Advocates, 23 the Tax Court held that Alternative Health Care Advocates (Alternative), which operated as a medical marijuana dispensary, and Wellness Management Group, Inc. (Wellness), an S corporation, which provided management services to Alternative, were each subject to Section 280E.
- The Tax Court disallowed all trade or business deductions claimed by each entity, other than the cost of goods sold amount allowed to Alternative in the IRS audit.
- Additionally, the court sustained Section 6662(a) substantial underpayment penalties against Alternative and the Wellness shareholders.

2019 Developments

S Corporation Providing Management Services to Medical Marijuana Dispensary was Engaged in "Trafficking in Controlled Substances" for Purposes of Section 280E

- Analysis. Section 280E provides:
  - No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.
- Alternative argued that while it was selling marijuana, Section 280E does not preclude dispensaries operating legally under state law from deducting expenses related to the sale of medical marijuana. The court rejected this argument, stating that Section 280E applies to medical marijuana dispensaries even though they are operating in compliance with the laws of their jurisdictions. 24 Thus, the court found that Alternative was engaged in "trafficking" a controlled substance within the meaning of Section 280E .

2019 Developments

Executor Could Not Represent Estate Pro Se

- Grossetti, (DC NY 9/26/2019) 124 AFTR 2d ¶2019-5293.
- A district court has held that an estate's executor could not represent the estate pro se until he showed that he was also the estate's sole beneficiary and creditor.
- Background. An estate's executor who is not an attorney can represent the estate in court (pro se), but only when the estate has no beneficiaries or creditors other than the executor. (Pridgen, (CA 2 1997) 113 F.3d 391).
- Facts. Mr. Grossetti was appointed the executor of a decedent's estate. After the decedent died, Grossetti discovered that the decedent was owed an income tax refund. The IRS disputed the amount of the refund.
- Grossetti, not an attorney, brought suit in district court on the estate's behalf to determine the amount of the refund.
- Decision. The district court found that Grossetti's complaint only stated that he was the estate's executor; it did not show that he was the sole beneficiary of the estate and that the estate had no other creditors.

2019 Developments

Real Estate Professional's Rental Activity Was Passive

- Eger, (DC CA 8/30/2019) 124 AFTR 2d ¶2019-5195.
- A district court has held that a taxpayer's rental activity was passive, even though the taxpayer was a real estate professional.
- Background. A taxpayer's ability to deduct losses from businesses in which he or she does not materially participate ("passive activities") is limited. (Code Sec. 469(a)(1)).
- Rental activity from properties is typically considered passive activity. (Code Sec. 469(c)(2)).
- However, if a taxpayer qualifies as a real estate professional, then rental activity generally is not considered passive. (Code Sec. 469(c)(7)).
- But even if a taxpayer is a real estate professional, the taxpayer's rental activity is passive if the average period of customer use for the rental property is seven days or less (seven-day exception). Reg. § 1.469-1T(e)(3)(ii)(A) . A "period of customer use" is defined as each period during which a customer has a continuous or recurring right to use the property. (Reg. § 1.469-1(e)(3)(iii)(D)).

2019 Developments

Real Estate Professional's Rental Activity Was Passive

- Facts. The Egers owned rental properties in Mexico, Colorado, and Hawaii.
- For each of the properties, the Egers entered into management agreements. The management agreements gave the managers the exclusive right to market and rent out the properties. But the Egers could use the properties if they gave advance notice. The Egers, though, never did use the properties.
- The Egers deducted the losses generated by the properties against their non-passive income under Code Sec. 469(c)(7) . Both parties agreed that Mr. Eger was a real estate professional.
- The IRS contended that the seven-day exception applied to the three properties because the average period of customer use for each of them was seven days or less. Under the IRS's approach, the customers were the end-user guests who stayed in the rental properties.
- The Egers asserted that the customers were the three management companies. Therefore, according to the Egers, the average period of customer use was far greater than seven days, which means that the exception did not apply and, therefore, their rental activity was not a passive activity.
- Decision. The district court found that the three management companies did not have a continuous or recurring right to use the properties because the Egers retained significant rights to use the properties throughout the year. Therefore, the management companies were not the customers to which the seven-day exception applied. Since the end-user guests were the customers, and they rented the properties for less than seven days on average, the seven-day exception applied and the rental losses were considered passive.

2019 Developments

Court Finds Car Awarded To Teenager For Good Grades, Attendance Was Taxable

- Conyers v IRS, Tax Court docket no. 13969-18.
- According to the Tax Court, a car awarded to a high school senior for good grades and attendance was a prize. Therefore, the value of the car was includible in her taxable income.
- Background. Generally, prizes and awards are taxable to the recipient as gross income. (Code Sec. 74(a)).
- However, prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement, that meet the following criteria, are excluded from gross income: (1) the recipient was selected without any action on his part to enter the contest or proceeding; (2) the recipient is not required to render substantial future services as a condition to receiving the prize or award; (3) upon the recipient's request, the prize donor must immediately transfer the prize or award to a governmental unit or a qualified tax-exempt organization. (Code Sec. 74(b)).

2019 Developments

Court Finds Car Awarded To Teenager For Good Grades, Attendance Was Taxable

- Facts. In 2016, Ms. Conyers was a high school senior. That year, Ms. Conyers was awarded a car by a local car dealership during its annual "Strive to Drive" competition. Ms. Conyers accepted the car and registered it in her name.
- The "Strive to Drive" was an academic initiative that encouraged good grades and attendance for local high school seniors. Students did not enter their names in the competition; rather, local high schools automatically entered students who had perfect attendance or good grades into the drawing. At the end of the school year, the dealership randomly picked a name from among the qualifying high school seniors whose names had been entered.
- Parties' arguments. Ms. Conyers asserted the car was a gift under Code Sec. 102 and, thus, should be excluded from taxable income. The IRS contended that Ms. Conyers received the car as a prize and, therefore, the value of the car was taxable income to Ms. Conyers.
- The Tax Court also found that the value of Ms. Conyers' car did not qualify for income exclusion under the Code Sec. 74(b) exception because she accepted the car and transferred title to her name.

2019 Developments

Tax Court Uses Income Approach To Value Gifts Of Limited Partnership Interests

- Estate of Jones, TC Memo 2019-101.
- The Tax Court used the income approach to value gifts of limited partnership interests in a partnership that produced timber.
- Background. When determining the fair market value of an interest in a partnership, the value of the partnership's assets may be considered (Reg §25.2512-3(a)) as well as the partnership's net worth, its earning power and capacity to make distributions, its good will, the economic outlook in the industry, its management, its position in the industry, the degree of control of the business represented in the interest to be valued, and the value of interests in similar, publicly traded partnerships. (Reg §25.2512-2(f)(2)).
- Generally, there are three accepted approaches to valuing equity interests in closely held businesses, two of which are: (1) the income approach and (2) the asset-based approach. (Estate of Noble, TC Memo 2005-2)

2019 Developments

Tax Court Uses Income Approach To Value Gifts Of Limited Partnership Interests

- The income approach uses either the direct capitalization method or the discounted cashflow method to convert the anticipated economic benefits that the holder of the interest would realize into a single present-valued amount. (Estate of Noble) Generally, the income approach is used when valuing an operating company that sells products or services to the public. (Estate of Andrews, (1982) 79 TC 938).
- The asset-based approach values the interest by reference to the company's assets net of its liabilities. (Estate of Noble) Generally, the asset-based approach is used when valuing a holding or investment company that receives most of its income from holding debt, securities, or other property. (Estate of Andrews).
- An asset-based approach necessarily assumes access to the value of underlying assets through a hypothetical sale. The less likely the business is to sell its assets, the less weight is assigned to an asset-based approach. (Estate of Giustina, (CA 9 2014) 114 AFTR 2d 2014-6848).

2019 Developments

Tax Court Uses Income Approach To Value Gifts Of Limited Partnership Interests

- Burga, (DC CA 8/16/2019) 124 AFTR 2d ¶2019-5153.
- A district court has held that some documents created by an accountant were protected under the tax practitioner privilege and under the holding in Kovel because the documents were produced to help an attorney to give legal advice, not merely to produce a tax return.
- Background. The Code's tax practitioner privilege provides that, with respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney. (Code Sec. 7525(a)(1)).
- Generally, the tax practitioner privilege does not apply to communications regarding the preparation of tax returns. (McEligot, (DC CA 2015) 115 AFTR 2d 2015-1433).

2019 Developments

Tax Court Uses Income Approach To Value Gifts Of Limited Partnership Interests

- The Court of Appeals for the Second Circuit has held that attorney-client privilege also applies to communications made in the presence of an accountant who is indispensable to the consultation between lawyer and client.
- The court held that the privilege attached to a communication made to the attorney, in the presence of an accountant employed by the attorney, if the communication was made in confidence for the purpose of getting legal advice from the lawyer. (Kovel, (CA 2 1961) 9 AFTR 2d 366).
- Like the tax practitioner privilege, Kovel does not protect communications made in the presence of an accountant if the accountant is there merely to provide accounting services. (Gonzales, (CA 9 2012) 110 AFTR 2d 2012-6083).

2019 Developments

CFO Was Liable For The Trust Fund Recovery Penalty

- McClendon v. U.S., (DC TX 1/22/2019) 123 AFTR 2d ¶2019-363.
- A district court, granting IRS's motion for summary judgment, has concluded that a chief financial officer (CFO) was liable for the trust fund recovery penalty under Code Sec. 6672 . The court determined that he was a responsible person who willfully failed to pay the taxes of the company.
- Background. Code Sec. 6672 imposes a responsible person penalty (which is also known as the trust fund recovery penalty or the 100% penalty) on any person who: (1) is responsible for collecting, accounting for, and paying over payroll taxes; and (2) willfully fails to perform this responsibility. The amount of the penalty is equal to the amount of the tax that was not collected and paid.
- In determining whether an individual is a responsible person, the 5th considers various factors, including whether the taxpayer: (1) served as an officer of the corporation-employer or a member of its board of directors; (2) owned a substantial amount of stock in the company; (3) participated in day-to-day management of the company; (4) had the ability to hire and fire employees; (5) determined which creditors to pay and when to pay them; or (6) possessed check writing authority.
- Not every factor must be present; instead, a court must consider the totality of the circumstances to determine whether the individual in question had the effective power to pay the taxes owed. There can be more than one responsible person in a business. (Barnett, (CA 5 1993) 71 AFTR 2d 93-1614).

2019 Developments

CFO Was Liable For The Trust Fund Recovery Penalty

- Facts. Dr. Robert L. McClendon founded Family Practice Associates, a professional medical association, in '79. Richard T. Stephen, Jr., was the chief financial officer of Family Practice from '95 to 2009. Stephen ran Family Practice's day-to-day operations, managed Family Practice's finances, controlled the company's bank accounts, was responsible for preparing and filing payroll-tax returns, maintained Family Practice's books and records, paid creditors and determined the order of payment, and was authorized to hire and fire employees.
- Family Practice began to accumulate tax debt in 2003. By 2009, Family Practice owed over $11 million in employee payroll taxes. Stephen knew of Family Practice's failure to file corporate tax returns and to make federal-tax deposits. From 2003 to 2009, Stephen paid Family Practice's creditors, other than IRS, after learning of the unpaid tax debt.
- Court's conclusion. The district court, granting IRS's motion for summary judgment, found that Richard Stephen was a responsible person who willfully failed to pay Family Practice's payroll taxes from July 2003 to October 2008. Accordingly, it held that he was indebted to IRS for $4,323,344 as of Aug. 27, 2012, plus prejudgment and post-judgment interest.

2019 Developments

Tax Court Grapples With Emotional Distress And Exclusion For Physical Injuries Or Sickness In Settlement

- Doyle, TC Memo 2019-8.
- The Tax Court has held that a former employee couldn't exclude amounts he received under a settlement agreement with the company under Code Sec. 104(a)(2) . The Court found that while the taxpayer suffered various ailments as the consequence of the emotional distress he suffered when he was fired him, the settlement payments weren't on account of personal physical injuries or physical sickness within the meaning of Code Sec. 104(a)(2).
- Background. Code Sec. 104(a)(2) excludes from gross income damages taxpayers receive for personal physical injury or physical sickness. Because emotional distress is not considered a physical injury or physical sickness, taxpayers must include damages they receive for emotional distress in their gross income unless the damages are paid for medical care attributable to the emotional distress. (Code Sec. 104(a)) But damages for emotional distress attributable to a physical injury or physical sickness are excluded from income under Code Sec. 104(a)(2) (Reg § 1.104-1(c)).

2019 Developments

Tax Court Grapples With Emotional Distress And Exclusion For Physical Injuries Or Sickness In Settlement

- Facts. Daniel Doyle was employed by Wacom. He had watched executives at other companies in the tech sector get caught up in anticompetitive schemes- schemes that led to guilty pleas, prison time, and quite large fines. So, when he found himself in what he thought was a similar situation, he consulted an attorney who advised him that he should either leave Wacom immediately or bring his complaints to the company's CEO. Doyle chose the latter, and met with Wacom's CEO and executive vice-president. He was fired a week later.
- While Doyle indicated that he had always been very healthy, that all changed when Wacom fired him. He couldn't sleep, couldn't digest food properly, and had lots of other health problems. He struggled with chronic headaches, he couldn't concentrate, and he had neck, shoulder, and back pain. His relationship with his wife suffered, and he believes that he'll deal with some of these issues for the rest of his life.
- These troubles prompted him to threaten to sue Wacom for five different causes of action: breach of contract, antitrust violations, civil conspiracy, failure to pay wages, and wrongful discharge. (Doyle's complaint said nothing about personal physical injuries or sicknesses or even emotional distress.) Wacom quickly agreed to a confidential settlement agreement less than two months later.
- Under the agreement, Wacom paid Doyle "$350,000 as settlement for his alleged unpaid wages" and "$250,000 as settlement for his alleged emotional distress damages."

2019 Developments

No Business Expense Deductions Allowed For Horseless Horse Activity

- McMillan, TC Memo 2019-108.
- The Tax Court has determined that the IRS properly disallowed business expense deductions an individual claimed for her horse activity because it wasn't a trade or business. The individual was also required to include a previously excluded $70,000 lawsuit settlement in gross income.
- Background-settlement income. Code Sec. 104(a)(2) excludes from gross income damages received, by suit or agreement, for personal physical injuries or physical illness. To qualify for this exclusion, a taxpayer must show that the damages were received for personal injuries or sickness. (Schleier, (S Ct 1995) 75 AFTR 2d 95-2675).
- Emotional distress is not treated as a physical injury or physical illness nor are physical manifestations of emotional distress, such as insomnia, headaches or stomach problems. (Pettit, TC Memo 2008-87).

2019 Developments

No Business Expense Deductions Allowed For Horseless Horse Activity

- Background-business expenses. Generally, Code Sec. 162(a) allows a taxpayer to deduct ordinary and necessary expenses incurred in carrying on a trade or business.
- For an activity to be considered a trade or business, the taxpayer must (1) be regularly and actively involved in the activity; (2) have begun the activity; and (3) intend to make a profit from the activity. A taxpayer's sporadic participation in an activity does not qualify as regular and active involvement in that activity. (McManus, TC Memo 2019-457).
- A business has begun when it starts to function as a going concern and performs the activities for which it was organized. (Heinbockel, TC Memo 2013-125).
- Expenses of a not-for-profit activity are deductible only to the extent the activity generated income. This is commonly known as the hobby loss rule. (Code Sec. 183).

2019 Developments

No Business Expense Deductions Allowed For Horseless Horse Activity

- Reg. §1.183-2(b) provides nine nonexclusive factors that can be used to determine whether an activity is being carried on "for profit." These factors are: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer and his or her advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) whether the assets used in the activity are expected to increase in value; (5) the success of the taxpayer in carrying on similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) the extent to which the taxpayer derives personal pleasure or enjoyment from the activity.
- Facts-settlement. The taxpayer, Denise McMillan, sued her homeowners' association (HOA) in connection with the construction, maintenance, and upkeep of her property, which she settled for $70,000. The parties settled the case. The settlement documents described the case as a dispute over alleged nuisances, construction defects, and the emotional distress caused by the HOA ignoring her complaints. The settlement documents did not mention that Denise suffered any personal physical injury or illness or that any of the settlement was compensation for such injury or sickness. However, Denise testified that the settlement compensated her for physical symptoms related to the emotional distress the HOA caused her. Most of the settlement went to pay Denise's attorney.
- Facts-horse activity. Denise was a trained dressage rider who participated in "horse activities" for five decades. However, in 2008 Denise's only horse died, and Denise did not own a horse in 2010.

2019 Developments

S Election Inadvertently Terminated By Operating Agreement Amendment

- PLR 201930023.
- In a Private Letter Ruling, the IRS has concluded that a limited liability company (LLC)'s S election was inadvertently terminated after its members adopted an amendment to the distribution provisions in the LLC's operating agreement.
- Background. Code Sec. 1361 defines a small business corporation (S corporation) as an eligible domestic corporation, which does not have (1) more than 100 shareholders; (2) a shareholder who is not an U.S. resident individual (there are exceptions); and (3) more than one class of stock. (Code Sec. 1361(b)(1)).
- A corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. (Reg. §1.1361-1(l)(1)) Whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is determined by looking at the corporation's governing provisions, including any binding agreements relating to distributions and liquidation proceeds. (Reg. §1.1361-1(l)(2)(i)).
- An entity's election to be taxed as an S corporation may be terminated if the entity ceases to qualify as an S corporation. (Code Sec. 1362(d)(2)) A corporation ceases to qualify as an S corporation if it has more than one class of stock. (Code Sec. 1361(b)(1)).

2019 Developments

S Election Inadvertently Terminated By Operating Agreement Amendment

- Facts. The taxpayer, an LLC, elected to be treated as an S corporation effective Date 2. On Date 3, the LLC's members agreed to amend the LLC's operating agreement to provide that all distributions would be made to the members in proportion to their respective membership interests, including upon liquidation.
- On Date 4, the members adopted the amendment, which stated that upon liquidation, distributions would be paid to members with positive capital accounts in accordance with their respective positive capital account balances.
- On Date 5, the amendment was amended to correct the liquidating distribution language and to provide for distributions on a pro rata basis in accordance with each member's ownership percentage.
- S election termination inadvertent. The IRS concluded that the LLC's S election terminated on Date 4 because the first amendment did not provide the members with identical rights to distribution and liquidation proceeds as required by Reg. §1.1361-1(l)(1) . However, that termination was inadvertent within the meaning of Code Sec. 1362(f) and was promptly corrected. Therefore, the termination of the LLC's S election was disregarded and, provided the LLC was otherwise eligible to be an S corporation and that the LLC's S election was not otherwise terminated, the LLC remained an S corporation on Date 4 and thereafter.

2019 Developments

Employee Stock Compensation Not Second Class Of Stock

- PLR 201918013.
- In a Private Letter Ruling (PLR), IRS has concluded that an S corporation's employee stock compensation plan did not create a second class of stock. The transfer and repurchase restrictions on the plan's shares were disregarded when determining whether the shares awarded under the plan had identical rights to other stock issued by the S corporation.
- Facts. The taxpayer, an S corporation, adopted an employee stock compensation plan that authorized the corporation to sell shares of its stock to key employees or to grant shares or options to purchase shares to such employees. Shares acquired under the plan were subject to certain restrictions; they could not be transferred without the prior written consent of the taxpayer's Chairman of the Board, and the corporation could repurchase the shares under certain circumstances, for example upon termination of employment, at fair market value or the forfeiture repurchase price.
- Transfer restrictions and repurchase provisions disregarded. The transfer restrictions and repurchase provisions were disregarded when determining whether the plan's shares confer identical rights to other stock issued by the S corporation. The transfer restrictions and repurchase provisions were bona fide agreements to redeem or repurchase stock under Reg. §1.1361-1(l)(2)(iii)(B).

2019 Developments

No Private Right Of Action To Demand Inspection Of Exempt Organization's Information Return

- Pardeux v. The US Mendicant Buddhist Cong., (DC CA 7/12/2019) 124 AFTR 2d ¶2019-5050.
- A federal magistrate has held that an individual does not have a private right of action when a tax-exempt organization refused to provide copies of its information returns to him.
- Background. Certain tax-exempt organizations must make their information returns available to any individual. (Code Sec. 6104(d)(1)).
- If the organization fails to provide the returns, it is subject to a penalty of $20 per day. (Code Sec. 6652(c)(1)(C)).
- If a person is denied the access to the returns after requesting them, the person can alert the IRS to the possible need for enforcement action. (Reg. § 301.6104(d)-1(g)).
- The fact that a federal statute has been violated and some person harmed does not automatically give rise to a private cause of action in favor of that person. (Cannon v. Univ. of Chicago, (S Ct 1979) 441 U.S. 677).

2019 Developments

Tax Court Rejected Attorney's Argument That He Had "Basis In His Labor" Dumb Lawyer Case

- Worsham, TC Memo 2019-132.
- The Tax Court has rejected as frivolous an attorney's argument that he had "basis in his labor" that the IRS was required to consider when determining his federal tax liability for the income generated by his performance of legal services.
- Background. The income tax applies to income from personal services and taxpayers have no basis in their labor for purposes of determining their income tax liability for income from personal services. (Howard, TC Memo 2000-222)
- Facts. Since 2004, Michael Worsham, a licensed attorney, has believed that he was not required to file federal income tax returns or to pay federal income taxes. Since Worsham did not file personal income tax returns for several years, the IRS did it for him and then sent him deficiency notices for the taxes due.
- Worsham objected to the deficiency notices, claiming that the IRS's calculations of his income were inaccurate because they failed to account for his "basis in his labor" when determining the tax on his income from the performance of legal services. Worsham also contended that the value or cost of his labor was its fair market value and, therefore, he had no gain to be taxed.

2019 Developments

IRS Answers Frequently Asked Questions About Virtual Currency Transactions

- Frequently Asked Questions on Virtual Currency Transactions (10/9/2019).
- The IRS has released additional guidance on the tax treatment of virtual currency transactions in the form of Frequently Asked Questions (FAQs). The newly released set of FAQs address various virtual currency topics for taxpayers who hold virtual currency as a capital asset.
- In Notice 2014-21, 2014-16 IRB 938 , the IRS explained what virtual currency is, how convertible virtual currency (like Bitcoin) has an equivalent value in real currency, and that cryptocurrency is a type of virtual currency that uses cryptography to digitally record transactions on a distributed ledger.
- In Notice 2014-21, the IRS explained that virtual currency is treated as property for federal income tax purposes and provided examples of how longstanding tax principles applied to transactions involving virtual currency. See "IRS details tax treatment of virtual currency (such as Bitcoin) as property."
- On October 9, 2019, the IRS issued Rev Rul 2019-24, 2019-44 IRB , which addressed common questions regarding the tax treatment of a cryptocurrency hard fork. See "IRS issues additional guidance on virtual currency transactions."

2019 Developments

IRS Answers Frequently Asked Questions About Virtual Currency Transactions

- New guidance. The newly released FAQs address various virtual currency topics for taxpayers who hold virtual currency as a capital asset. The new FAQs expand upon the examples provided in Notice 2014-21 and apply the same tax principles to additional situations. They note that:
- …A taxpayer selling virtual currency must recognize capital gain or loss on the sale (FAQ 4), and virtual currency received in exchange for performing services is ordinary income. (FAQ 8)
- …A taxpayer receiving virtual currency in exchange for performing services must report income equal to the fair market value of the virtual currency (in U.S. dollars) when received. In a cryptocurrency transaction that occurs on the blockchain (an on-chain transaction), virtual currency is received on the date and time the transaction is recorded on the distributed ledger. (FAQ 11)
- …In an arm's length transaction, a taxpayer's basis in virtual currency received in exchange for services is the fair market value of the virtual currency (in U.S. dollars) when the virtual currency is received. (FAQ 12) The basis of property exchanged for virtual currency is the fair market value of the property at the time of the exchange. (FAQ 17)
- …When exchanging property for virtual currency, the gain or loss is the difference between the fair market value of the virtual currency when received and the adjusted basis of the property exchanged. (FAQ 19)
- …The fair market value of virtual currency obtained through a cryptocurrency exchange is the amount that is recorded by the cryptocurrency exchange for that transaction in U.S. dollars. (FAQ 25)

2019 Developments

IRS Sends Letters To Virtual Currency Owners Advising Them To Pay Back Taxes

- In an Information Release (IR 2019-132, 7/26/19), the IRS announced that it has begun sending letters to taxpayers that may have failed to report income and pay the resulting tax from virtual currency transactions or did not report their transactions properly.
- Notice 2014-21 provides that a taxpayer who receives virtual currency as payment for goods or services must, in computing gross income, include the fair market value of the virtual currency, measured in U.S. dollars, as of the date that the virtual currency was received.
- The IRS has been concerned that taxpayers selling, exchanging, or otherwise disposing of virtual currency have not been properly reporting those transactions. Thus, the IRS has started sending educational letters to taxpayers. The names of these taxpayers were obtained through various ongoing IRS compliance efforts.
- There are three variations of the educational letter:
  - Letter 6173-sent to taxpayers when, for one or more of tax years 2013 through 2017, the IRS has not received either a federal income tax return or an applicable form or schedule reporting the taxpayer's virtual currency transactions.
  - Letter 6174-sent to taxpayers when the IRS has information that the taxpayers have or had one or more accounts containing virtual currency, where the IRS believes that the taxpayer may not know the requirements for reporting transactions involving virtual currency.
  - Letter 6174-A-sent to taxpayers when the IRS has information that the taxpayers have or had one or more accounts containing virtual currency but may not have properly reported the transactions involving virtual currency.

2019 Developments

Settlement In Employee's Drug Related Death And Indemnification Of CEO Not Deductible

- Cavanaugh, Jr. v. Comm, (CA5 3/29/2019) 123 AFTR 2d ¶2019-566.
- The Court of Appeals for the Fifth Circuit, affirming the Tax Court, has concluded that an S corporation couldn't deduct its payment of legal fees and settlement costs arising out of a lawsuit against it and several of its employees based on the employees' conduct during a holiday weekend in which another employee died after using cocaine.
- The corporation also couldn't deduct its reimbursement of a settlement payment made with regard to the lawsuit by its CEO from his personal funds.
- Background. Under Code Sec. 162(a) , a taxpayer may deduct ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business.

2019 Developments

Settlement In Employee's Drug Related Death And Indemnification Of CEO Not Deductible

- The Supreme Court has said that a taxpayer can deduct litigation expenses incurred in defending a lawsuit that arises in connection with or results from the taxpayer's business. (U.S. v. Gilmore, (S Ct 1963) 11 AFTR 2d 758) Whether legal fees incurred in defending a lawsuit arose from a taxpayer's business depends on whether the underlying legal claim originated from that business (i.e., the origin of the claim test).
- Facts. James Cavanaugh was the CEO, founder, and sole shareholder of Jani-King International, Inc. (Jani-King), a successful janitorial-services franchisor. For the 2002 Thanksgiving holiday, Cavanaugh vacationed at his villa in St. Maarten with his girlfriend and Jani-King employee, Colony Anne (Claire) Robinson. They were accompanied by Cavanaugh's bodyguard, and another Jani-King employee. The parties agreed that the trip was for pleasure and not to conduct or further any Jani-King business.
- While on the trip, Robinson suffered fatal cardiac arrest after ingesting a large amount of cocaine. In August of 2003, Robinson's mother sued both Cavanaugh and Jani-King (alleging that its employees were all acting within the scope of their employment), seeking damages for her daughter's wrongful death and under other causes of action.

2019 Developments

Settlement In Employee's Drug Related Death And Indemnification Of CEO Not Deductible

- Tax Court decision. The Tax Court concluded that Jani-King couldn't deduct the settlement costs or legal fees because none of the Jani-King employees' conduct on the Thanksgiving weekend, whether proven or alleged, arose from Jani-King's profit-seeking activities. The employees were engaged in non-profit-seeking activities that didn't arise from or further Jani-King's business, and were far from any company property.
- The Tax Court also found that Jani-King reimbursement of Cavanaugh's settlement payment wasn't deductible as an ordinary and necessary business expense. It was neither a payment that Jani-King was legally obliged to make nor a voluntary payment with a sufficient business purpose. (Cavanaugh, TC Memo 2012-324 , see No deduction allowed to settle suit in employee's drug related death or indemnify CEO).
- Appellate decision. The Fifth Circuit denied the deductions for the settlement and legal expenses and the reimbursement to the CEO.
- The Fifth Circuit rejected Cavanaugh's argument that Gilmore didn't apply because it did not address a situation where a corporation was directly named in the underlying suit. Relying primarily on Kopp's Co, Inc, Cavanaugh argued that the court must give significant weight to a corporation's direct exposure to a monetary judgment, rather than examining the origin of the claim.

2019 Developments

Transferee Liability For Tax On Sale Of Business

- Hawk, 924 F.3d 821, 123 AFTR2d 2019-1822 (CA-6, 2019).
- In Hawk, the Court of Appeals for the Sixth Circuit affirmed the Tax Court's decision imposing transferee liability for unpaid taxes arising from the sale of a privately held corporation.
- Facts: Billy Hawk and his wife, Nancy Sue Hawk, owned a bowling business, Holiday Bowl. After Billy died in 2000, his two sons attempted to operate the bowling alleys for some time but did not succeed. Thus, in 2003, Nancy Sue and Billy's estate sold the bowling alleys to a third party in exchange for $4.2 million in cash, generating a liability of about $1 million in federal taxes and $200,000 in state taxes.
- Later that year, in an effort to lower the corporate taxes triggered by the sale, the Hawks' sold Holiday Bowl to another company, MidCoast, for $3.4 million, a price equal to Holiday Bowl's cash less 64.25% of its estimated tax liability for the year. To finance the transaction, MidCoast borrowed $3.4 million from Sequoia Capital, LLC. That same day, MidCoast resold Holiday Bowl stock to Sequoia for a slightly higher purchase price. Sequoia paid for the Holiday Bowl stock through a credit against the Sequoia loan.
- After the sale, MidCoast transferred Holiday Bowl to Sequoia in exchange for the cancellation of Sequoia's loan and about $320,000 cash. The Hawks expected to keep an extra $200,000 to $300,000 by structuring the transaction this way. They would soon come to learn that there is no such thing as a free lunch.
- Holiday Bowl's outstanding taxes were never paid, thus prompting a government investigation, from which the Tax Court concluded that Sequoia's loan to MidCoast was a sham, that Holiday Bowl simply distributed cash to the Hawks, and that the Hawks were liable as Holiday Bowl's fraudulent transferees. The U.S. filed suit against Nancy Sue and Billy's estate to recover Holiday Bowl's unpaid taxes.

2019 Developments

Transferee Liability For Tax On Sale Of Business

- Hawk, 924 F.3d 821, 123 AFTR2d 2019-1822 (CA-6, 2019).
- Section 6901 permits the IRS to pursue action against the transferees of delinquent transferor taxpayers.
- Section 6901(a) does not create a substantive liability but merely provides a procedural mechanism for the IRS to collect the transferor's existing unpaid tax liability. Under Section 6901(a) , the IRS may establish transferee liability if an independent basis exists under applicable state law or equity principles for holding the transferee liable for the transferor's debts.
- The IRS bears the burden of proving that the taxpayer is liable as a transferee but not of proving that the transferor is liable for tax.
- Applied to the instant case, Section 6901 prompts three questions:
- (1) Did Holiday Bowl owe any taxes?
- (2) Are the Hawks transferees of Holiday Bowl?
- (3) If so, are the Hawks liable to the government under Tennessee's fraudulent transfer statute?

2019 Developments

Transferee Liability For Tax On Sale Of Business

- Hawk, 924 F.3d 821, 123 AFTR2d 2019-1822 (CA-6, 2019). Best lines from the case.
- In closing his recommendation, the broker, warily but not warily enough, said: "[I]f it seems too good to be true, it probably is. But maybe this is the exception." Id. at 798.
- The bottom line? The Hawks' "extensive emphasis on their due diligence and lack of knowledge of illegality" doesn't shield them from the sham nature of the transaction and absolve them of transferee liability. Feldman, 779 F.3d at 460.
- For those readers still with us, you might wonder: Was there a way to make this tax-reduction strategy work? Was it ever possible for MidCoast to offset Holiday Bowl's taxes with net operating losses, say by making the Sequoia loan a kosher one and dotting another "i" and crossing another "t" in the underlying transactions? The answer is "maybe" in the abstract and "not likely" here.

2019 Developments

Transferee Liability For Tax On Sale Of Business

- Hawk, 924 F.3d 821, 123 AFTR2d 2019-1822 (CA-6, 2019).
- The court found that the Sequoia loans were shams, finding that Sequoia provided funds to MidCoast not as a bona fide lender but to create the appearance of a loan and to disguise the true nature of the transaction as a liquidating distribution.
- The court found that the stock purchase by MidCoast should be characterized as a complete liquidation of Holiday Bowl and a liquidating distribution to the Hawks.
- The court concluded by holding that the Hawks were transferees under Section 6901 and therefore liable for the tax liability.
- The Hawks' attempted tax-reduction strategy failed because it lacked economic substance. In the court's words, "it was nothing but misleading labels and distracting forms." The Hawks' professional advisors were apparently aware of the potential application of transferee liability to their clients, but they failed to take sufficient actions to protect them from the application of transferee liability.

Business Income Tax Changes Overview. Section 199A

- § 199A permits owners of sole proprietorships, S corporations, or partnerships to deduct up to 20% of the income earned by the business.

Section 199A.
QBI Deduction Overview

- Deduction equal to 20% of domestic qualified business income ("QBI") from a sole proprietorship, partnership, or S corporation.
  - Taxpayer's QBI deduction is generally the total of 20% times the QBI from each qualified trade or business.
- Deduction available to individuals, estates, and trusts, with certain limitations.
- Intended to reduce overall tax burden on flow-through income in a manner proportionate to the reduction of C corporation tax rate.
- Effective for taxable years beginning after December 31, 2017.

Section 199A Limits

- Overall Limitation:
  - Taxpayer's total QBI deduction for the year cannot exceed 20% of the excess of the taxpayer's taxable income over the sum of net capital gains for the year.
- Other Rules:
  - QBI deduction is a reduction to taxable income (i.e., not to adjusted gross income).
  - QBI deduction is available regardless of whether a taxpayer itemizes deductions.

Section 199A

Definition of Qualified Trade or Business

- A "qualified trade or business" is any business other than a "specified service trade of business" or the trade of business of performing services. The goal of this provision is to deny the deduction to those who would be applying it against income that should be taxed as wage income rather than income from the investment of ownership of a business.
- Example: A is an employee, but not an owner, of a qualified business. A receives a salary of $100,000 in 2018. A is not permitted a § 199A deduction against the wage income because A is not engaged in a qualified business.

Section 199A Definition of QBI

- QBI (qualified business income):
  - Net amount of qualified items of income, gain, deduction, and loss
  - Must be from a qualified trade or business
  - Must be effectively connected with the conduct of a trade or business within the United States
- QBI generally does not include capital gains and losses, dividends, or interest income (unless interest is properly allocable to a trade or business)
- If the net QBI attributed to a taxpayer is negative, the negative amount is treated as a QBI loss in the following year

Section 199A

The Amount of the Deduction

- The amount of the deduction is the lesser of (A) the taxpayer's "combined qualified business income", or (B) 20% of the excess of the taxpayer's taxable income over the taxpayer's net capital.
- The amount of the deduction is capped at the amount of the taxpayer's taxable income less capital gain, so the amount calculated will be reduced to taxable income less capital gain, if necessary.
- Example: A, a married taxpayer, has $100,000 of qualified business income, $100,000 of long-term capital gain, and $30,000 of deductions, resulting in taxable income of $170,000. A's § 199A deduction is limited to the lesser of $20,000 (20% of $100,000) or $14,000 (20% of $70,000, the excess of taxable income of $170,000 over net capital gain of $100,000).

Section 199A

W-2 Wages Limit

- Limitation on QBI deduction based on W-2 wages of business:
  - QBI deduction is limited to the greater of:
    - (i) 50% of the owner's allocable share of W-2 wages paid by the business OR
    - (ii) 25% of that W-2 wage share plus 2.5% of the original cost basis of qualified property.
- Limitation Phased-in.
  - This limitation does not apply to a taxpayer with less than $160,700 (single) or $321,400 (joint) in taxable income.
  - Limitation phase-in begins at $160,700 (single) or $321,400 (joint) over the next $50,000 (single) or $100,000 (joint) in taxable income.
  - Complete phase-in of limitation at $210,725 (single) or $421,400 (joint).

Section 199A

Phase-In- If taxable income does trigger phase-in of limits

- Example: H and W file a joint return on which they report taxable income of $336,400, of which $306,400 is ordinary income from H's interest in an S corporation. The S corporation is not a specified service trade or business. H's allocable share of the business's W-2 wages is $80,000, and his share of the business's unadjusted basis in its qualified property is $600,000. Because H and W's taxable income is between the lower and higher thresholds, only a partial wage and capital limitation applies.
- The reduction ratio is calculated as $336,400 less $315,000 = $15,000 of excess taxable income above the lower threshold, divided by $100,000 = 15%.
- Next, the excess amount is calculated. The deductible QBI amount of the business with no wage and capital limitation applied is 20% of QBI of $300,000 = $61,280.
- The deductible QBI amount for the business with a full wage and capital limitation is the greater of
  - (1) 50% of W-2 wages, or $40,000, or
  - (2) the sum of 25% of W-2 wages ($20,000) plus 2.5% of the unadjusted basis of the qualified property immediately after its acquisition: $600,000 × 0.025 = $15,000, for a sum of $35,000. The deductible QBI amount with a full wage and capital limitation is therefore $40,000. The difference between $61,280 and $40,000, or $21,280, is the excess amount.
- The 15% reduction ratio multiplied by the excess amount of $21,280 is $3,192. The deductible QBI amount for the business is therefore 20% of QBI, $60,000, less $3,192, or $56,808. Because H and W have only one qualified business, their combined QBI amount is also $56,808 before applying the overall limitation of $67,280 (20% of $336,400). H and W's Sec. 199A deduction is $56,808.

Section 199A

W-2 Wages Limit

- The W-2 and qualified property-based limitations do not apply when the taxpayer claiming the deduction has taxable income for the year of less than $321,400 (if married filing jointly; $160,700 for all other taxpayers).
- Taxable income for these purposes is determined without regard to any 199A deduction.

Section 199A

- Example: A is a sole proprietor. The business generates $100,000 of qualified business income during 2019 but pays no W-2 wages and has no qualified property. A files jointly with his wife for 2019, and their combined taxable income for the year, including the qualified business income, is $250,000.
- Absent this exception, A's tentative deduction of $20,000 would be limited to zero, the greater of:
- • 50% of W-2 wages = $0; or
- • 25% of W-2 wages plus 2.5% of unadjusted basis of qualified property = $0.
- Because A's taxable income for 2019 is less than $321,400, however, the W-2 limitations do not apply, and A is entitled to claim the full $20,000 deduction.

Section 199A

- The W-2 limitations are phased in over the next $100,000 of taxable income (if married filing jointly; $50,000 for all other taxpayers). Thus, once taxable income reaches $421,400 for a married taxpayer filing jointly ($210,700 for all other taxpayers), the W-2 limitations apply in full.
- Example: A is a sole proprietor. During 2019, the business generates $400,000 of qualified business income, pays $120,000 of W-2 wages, and has $100,000 of qualified property. A files jointly with his spouse for 2019, and their combined taxable income for the year, including the qualified business income, is $600,000.
- A's tentative deduction is $80,000 ($400,000 × 20%). Because A's taxable income for 2019 is greater than $421,400, however, the W-2 limitations apply in full. As a result, A's deduction is limited to the greater of:
- • 50% of W-2 wages = $60,000; or
- • 25% of W-2 wages ($30,000) plus 2.5% of unadjusted basis of qualified property ($2,500) = $32,500.
- Thus, A is entitled to a $60,000 deduction in 2019.

Section 199A

4 Types of Businesses

	Non-Service	Service
Taxable income less than $321,400 (MFJ)	20% deduction	20% deduction
Taxable income greater than $321,400 but less than $421,400	Limitation Phased-in	Deduction phased-out
Taxable income greater than $421,400	W-2/Capital limit applies	Deduction phased-out

Section 199A

Specified Services

- QBI does not include income from certain disqualified service businesses, defined as:
  - 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 is the reputation or skill of one or more of its employees or owners (section 1202(e)(3)(A), but without regard to engineering or architecture); or
  - services that consist of investing and investment management; trading; or dealing in securities, partnership interests, or commodities.

Section 199A

Specified Services - Exception

- A specified service trade or business may be treated as a qualified trade or business, despite fitting the definition of a specified service trade or business, ***if*** the taxpayer's income qualifies the trade or business for another phased in limitation:
  - If the taxpayer's income is less than $160,700 (single) or $321,400 (joint) in taxable income, the specified service trade or business shall not fail to be treated as a Qualified trade or business because it meets the definition of a specified service business.
  - Limitation begins at $160,700 (single) or $321,400 (joint) over the next $50,000 (single) or $100,000 (joint) in taxable income.
  - Complete phase-in of limitation at $210,700 (single) or $421,400 (joint).

Section 199A

Specified Services - Exception

- Example: A, a single taxpayer, is an attorney who operates her business as a partnership. The partnership pays no W-2 wages during the year. During 2019, A earns $100,000 from her law business and has total taxable income of $150,000.
- While A would otherwise be barred from claiming a deduction under § 199A by virtue of being engaged in a specified service business, because A's taxable income is less than $160,700, the prohibition on specified service businesses does not apply.
- In addition, because taxable income is less than $160,700, the W-2 limitations do not apply. As a result, A's final deduction is $20,000 (20% of $100,000).

Section 199A

Specified Services - Exception

- The ability for owners of a specified service business to claim the deduction is phased out over the next $100,000 of taxable income (if married filing jointly; $50,000 for all other taxpayers), so that once taxable income exceeds $421,400 (if married filing jointly; $210,700 for all other taxpayers), the deduction is lost completely. The W-2-based and property-based limitations are phased in over the same span of taxable income.
- Example: Assume the same facts as in the previous example, except A has taxable income of $230,000. Because taxable income exceeds $210,700, A is not entitled to any deduction under § 199A.

Section 199A

Reporting the Deduction

- The § 199A deduction does not reduce a taxpayer's adjusted gross income.
- The deduction is taken after adjusted gross income is determined, but it is not an itemized deduction; rather, the deduction is available to both taxpayers who itemize deductions and those who claim the standard deduction.
- For purposes of determining a taxpayer's alternative minimum taxable income, qualified business income is computed without any adjustments or preference items under §§ 56 through 59.
- As a result, a taxpayer's § 199A deduction for alternative minimum tax purposes will be identical to the deduction against regular tax.

Section 199A

Accuracy Related Penalty

- Section 6662 imposes a 20% accuracy-related penalty on an underpayment of tax due to a substantial understatement of tax. Generally, for taxpayers other than C corporations, the understatement is substantial if its amount for the tax year exceeds the greater of:
  - • 10% of the tax required to be shown on the return for the tax year; or
  - • $5,000.
- Part of the Act amended § 6662 to provide that any taxpayer who claims a § 199A deduction is subject to a lower threshold before a substantial-understatement penalty is applied, equal to the greater of:
  - • 5% of the tax required to be shown on the return for the tax year; or
  - • $5,000.

Section 199A

Employee Versus Independent Contractor

- Section 199A prohibits an employee from taking a 20% deduction against his or her wage income.
- A deduction is available, however, to an independent contractor, subject to the W-2 wage limitations if taxable income exceeds the thresholds.
- This advantageous treatment of independent contractors has led many to speculate that the advent of § 199A will lead to a flurry of taxpayers fleeing their role as employees in favor of being self-employed, placing a heavy burden on the IRS to properly classify workers for both income and payroll tax purposes.

Section 199A

Employee Versus Independent Contractor

- Example: A is the CEO of a manufacturing company who earns wages of $800,000 annually. In search of a § 199A deduction, A terminates her employment and forms an S corporation to provide "consulting services" to her former employer.
- The manufacturing company pays $800,000 to the S corporation in 2019, which in turn pays $200,000 of reasonable compensation to A, with the remaining $600,000 passed through as qualified business income.
- A is entitled to a deduction in 2019 of $100,000, the lesser of $120,000 (20% of $600,000) or $100,000 (50% of W-2 wages of $200,000).

Section 199A Updates

Draft Instructions For Qualified Business Income Deduction Form

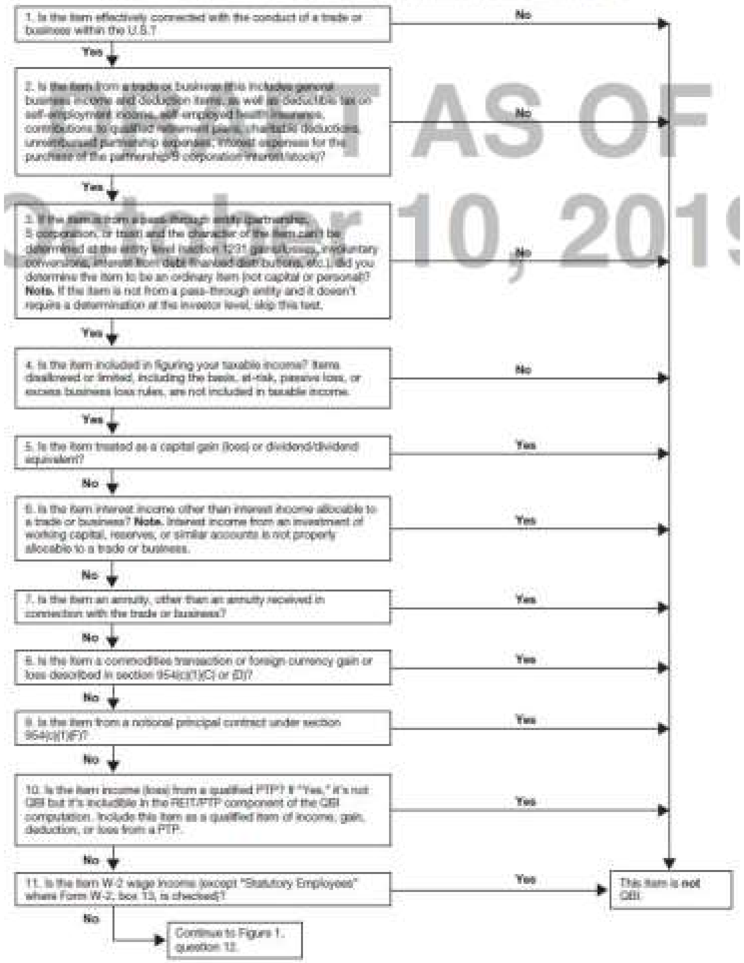
- Draft Instructions for Form 8995-A (10/10/2019)
- The IRS has released draft instructions for the draft Form 8995-A, Qualified Business Income Deduction. The instructions include detailed directions for how to fill out the form's four schedules.
- The draft instructions also include a two-page flow chart that taxpayers can use to determine if an item of income, gain, deduction, or loss is included in QBI.

Section 199A Updates

Draft Instructions For QBI

Figure 1. **QBI Flow Chart**

Use this chart to determine if an item of income, gain, deduction, or loss is included in QBI.



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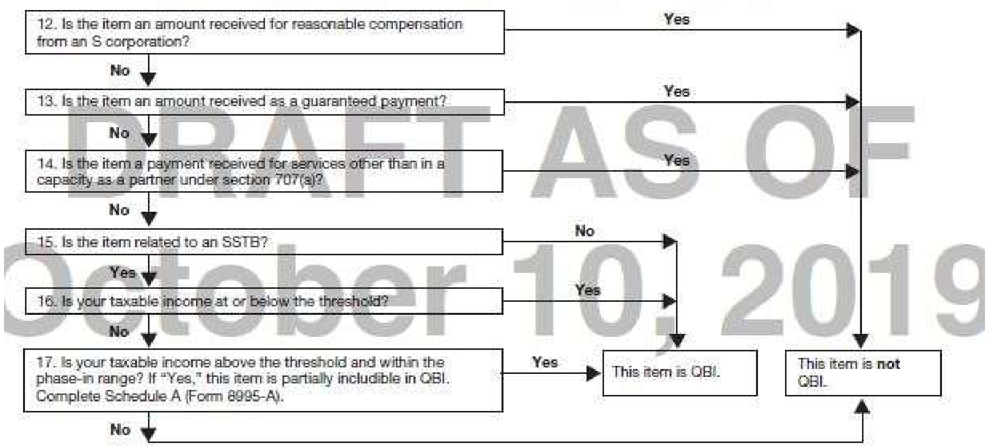
Section 199A Updates

Draft Instructions For QBI

Figure 1. **QBI Flow Chart** *(continued)*

Use this chart to determine if an item of income, gain, deduction, or loss is included in QBI.



Section 199A Updates 1/18/2019

- A package of guidance implements the new qualified business income (QBI) deduction (§199A deduction).
- Final regulations provide guidance on how pass-through entities can aggregate income with costs to qualify for the new deduction. Proposed regulations provide guidance on several aspects of the QBI deduction, including qualified REIT dividends received by regulated investment companies. A revenue procedure provides guidance on determining W-2 wages for QBI deduction purposes.
- A notice on a proposed revenue procedure provides a safe harbor for certain real estate enterprises that may be treated as a trade or business for purposes of the QBI deduction. T.D. 9847 (Fed. Reg. 2/8/2019), REG-134652-18 (Fed. Reg. 2/8/2019), Rev. Proc. 2019-11, Notice 2019-7, IR-2019-04.

Section 199A Updates 6/18/2019

- New and revised frequently asked questions to comportwith simultaneously issued proposed regulations dealingwith the deduction for qualified business income for cooperatives and their patrons. IRS – Qualified Business Income FAQs.

Section 199A Updates 6/18/2019

- Proposed revenue procedure provides computational guidance on methods and sources of data for calculating W-2 wages for purposes of §199A(g). The IRS proposed three methods, which would limit the amount of the deduction available to 50% of a specified agricultural or horticultural cooperative's W-2 wages. Notice 2019-27; IR-2019-115.

Section 199A Updates 9/24/2019

- Safe harbor provided for rental real estate enterprise to be treated as a trade or business for purposes of §199A.
- The safe harbor outlines various requirements for property owners to qualify, such as hours spent working on the real estate business, as well as documentation of those hours and work done by third-party contractors.
- Rev. Proc. 2019-38; IR-2019-158.
- Rental real estate enterprise. Solely for purposes of the safe harbor, a rental real estate enterprise is defined as an interest in real property held for the production of rents and may consist of an interest in a single property or interests in multiple properties. The taxpayer or RPE relying on the Revenue Procedure must hold each interest directly or through an entity disregarded as an entity separate from its owner under any provision of the Code.

Section 199A Updates 9/24/2019

- The safe harbor. The determination to use this safe harbor must be made annually. Solely for the purposes of Code Sec. 199A , each rental real estate enterprise will be treated as a single trade or business if the following requirements are satisfied during the tax year with respect to the rental real estate enterprise:
- 1. Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise. If a rental real estate enterprise contains more than one property, this requirement may be satisfied if income and expense information statements for each property are maintained and then consolidated;
- 2. For rental real estate enterprises that have been in existence less than four years, 250 or more hours of rental services are performed (as described under "Rental services" below) per year with respect to the rental real estate enterprise. For rental real estate enterprises that have been in existence for at least four years, in any three of the five consecutive tax years that end with the tax year, 250 or more hours of rental services are performed per year with respect to the rental real estate enterprise; and

Section 199A Updates 9/24/2019

- 3. The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. If services with respect to the rental real estate enterprise are performed by employees or independent contractors, the taxpayer may provide a description of the rental services performed by such employee or independent contractor, the amount of time such employee or independent contractor generally spends performing such services for the enterprise, and time, wage, or payment records for such employee or independent contractor. Such records are to be made available for inspection at the request of IRS.
- 4. The taxpayer or RPE attaches a statement to a timely filed original return (or an amended return for the 2018 tax year only) for each tax year in which the taxpayer or RPE relies on the safe harbor. An individual or RPE with more than one rental real estate enterprise relying on this safe harbor may submit a single statement, but the statement must list the required information separately for each rental real estate enterprise.

Section 199A Updates 9/24/2019

- Excluded real estate arrangements. The following types of property may not be included in a rental real estate enterprise and are therefore not eligible for the safe harbor:
  - (A) Real estate used by the taxpayer (including an owner or beneficiary of an RPE) as a residence under Code Sec. 280A(d) .
  - (B) Real estate rented or leased under a triple net lease. For purposes of the Revenue Procedure, a triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to pay for maintenance activities for a property in addition to rent and utilities.
  - (C) Real estate rented to a trade or business conducted by a taxpayer or an RPE which is commonly controlled under Reg § 1.199A-4(b)(1)(i) .
  - (D) The entire rental real estate interest if any portion of the interest is treated as an SSTB under Reg § 1.199A-5(c)(2) (which provides special rules where property or services are provided to an SSTB).

The End

Thank you