GASSMAN CROTTY & DENICOLO P.A.
ATTORNEYS AT LAW

THE THURSDAY REPORT

Issue # 261 Thursday, February 21, 2019

Re: The Get Smart Report

Consider us your partner in battling evil...but with less spy equipment!

In This Issue:

We welcome contributions for future Thursday Report topics. If you are interested in making a contribution as a guest writer, please email Alan at agassman@gassmanpa.com

Before becoming a box office hit in 2008 starring Steve Carrell and Anne Hathaway, Get Smart was a hysterical American Television Series intended to be a sort of James Bond spoof. Maxwell Smart, aka Agent 86, was a spy for the CONTROL agency. With his partner, Agent 99, Smart spent five seasons between 1965 and 1970 battling the rival spy agency KAOS.

> Maxwell Smart: I'm getting complaints from the landlord about the gun battles in the hall, and the bombs in the lobby, and the knife fights in the elevator.
> Chief: Well, when you rent an apartment to a secret agent, you've got to expect those things.
> Maxwell Smart: But he doesn't know I'm a secret agent.
> Chief: Well, how do you explain people attacking you and shooting at you?
> Maxwell Smart: Well, I told him I work for the Bureau of Internal Revenue.

Who knew the IRS could be such a thrilling workplace!

Just Missed It By That Much!
By Alan Gassman and Brandon Ketron

Leimberg Information Services, Inc.

Steve Leimberg's Income Tax Planning
Email Newsletter Archive Message #174

Date:12-Feb-19

Subject: Alan Gassman and Brandon Ketron - Just Missed It by That Much!

"The revised Preamble and Final Regulations to Section 199A that were issued on February 4, 2019 are a welcome clarification for practitioners and taxpayers who are already working hard to revisit their present structures and arrangements in order to have the benefit of the QBI deduction. Nevertheless, many issues remain outstanding, and in some cases the examples are unworkable, so further clarification will be welcomed."

Alan Gassman and **Brandon Ketron** provide members with important follow-up commentary on the final 199A regulations. Members who wish to learn more about this topic should consider watching their **LISI** webinar on February 22nd at 1pm titled: "199A Planning After the New and Now Modified February 4th Final Regulations: What We Can and Should Do Now That the Dust Has Settled." For more information click this link: Alan Gassman and Brandon Ketron.

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Here is their commentary:

EXECUTIVE SUMMARY:

In the 1960's sitcom "Get Smart" Agent Maxwell Smart would often comment on big flaws and mistakes by saying "I missed it by that much" and holding his fingers only one inch apart. For the most part, the Treasury Department and the IRS got the Section 199A Regulations where they wanted them...but not exactly.

On February 4th, the Treasury Department and Internal Revenue Service quietly issued revised Final Regulations to correct some minor errors from the preamble and "Final" Regulations that were issued on January 18th of this year. A copy of the red-lined compare can be obtained by emailing agassman@gassmanpa.com.

Those of us who concluded that the Treasury intended to require entities having both SSTB (Specified Service Trade or Business) and non-SSTB income would have to keep separate books, records, and other indicia of separateness and have read the new February 4th Regulations were even more confused to find the word "separable" substituted for the word "separate", which we first took as a signal that the IRS would not be requiring separate books and records as long as they were separable. Upon further analysis we determined that this was due to the fact that the January 18th Preamble to the Final Regulations originally misquoted the actual language of Treasury Regulation 1.446(d)(1), which was referred to as being the authority for the separate accountings requirements.

Are separate books and records required to be maintained in order to separate out Non-SSTB activities, or do the activities just have to be separable? Although the use of the word "separable" in the text of the Regulations is curious, and would by our view justify enough separate detail in line items labeled for revenues and expenditures on a typical computerized accounting software, the drafters of the Final Regulations left in an example that requires separate books and records for the separation, and therefor seem to intend that separate books and records are required to be maintained to allow for the net income from Non-SSTB activities under a single entity owned at least in part by high earning taxpayers to be eligible for the Section 199A deduction, although it would be nice if they would revise the Regulations one more time and change that example.

The above and below analysis adds to our prior newsletter *Handling Specified Service Trades or Businesses & Non- Specified Service Trades or Businesses Under One Entity - What Rules Apply and Are Separate Books and Records Required?* LISI Income Tax Planning Newsletter #172 (January 28, 2019).

While the distinction seems somewhat innocuous, this is a big and expensive question for thousands of taxpayer and their advisors who need to know whether they need to set up separate accounting systems for separate operations under one entity or move these out into separate entities. What we got was a slight tipping of the Ouija Board, but certainly not solid guidance.

Other clarifications in the revised Final Regulations enable practitioners to understand what occurs with respect to assets held by partnerships that will be Qualified Property, when there is a Section 754 election in place and there is a death of a partner, the redemption of a partner or the sale of a partnership interest from one partner to the other, and also clarify cooperative income treatment.

The like kind exchange rule impact on qualified property where there is boot received or new consideration paid by an exchanger was also clarified, and is fair and logical.

FACTS:

"CALL FOR HELP WITH YOUR SHOE PHONE"

Internal Revenue Code Section 199A was enacted as part of the 2017 Tax Cuts and Jobs Act on December 22, 2017 to allow up to a 20% income tax deduction on Qualified Business Income ("QBI"), which can come from trade or business income from S-corporations, entities taxed as partnerships, and trades and businesses owned individually or by married couples, and for estates and trusts receiving QBI.

DON'T MISS THE HALLWAY DOORS IF YOU ARE RUNNING LATE - EFFECTIVE DATES

Proposed Regulations were published in the Federal Register on August 16, 2018 and could be relied upon until the issuance of Final Regulations which occurred on January 18, 2019. The revised Final Regulations released on February 4, 2019 replace the January 18th Regulations, and Taxpayers can rely upon either the Proposed Regulations or the February 4th Final Regulations on any 199A issues on their 2018 tax returns. For 2019 only the February 4th Final Regulations can be relied upon, according to the letter that accompanied this revision, which did not describe what was revised, or provide a redlined edition of the clarifications that were most likely pointed out almost immediately after the issuance of the "final" January 18th Regulations when thousands of tax professionals read the 248 pages of the Preamble and Regulations and came away confused over some of the language provided.

"WOULD YOU BELIEVE" SEPARATE BOOKS AND RECORDS ARE STILL REQUIRED

One big and unpleasant surprise was the observation in the Preamble that the Treasury Regulations under Internal Revenue Code Section 446 require that separate books and records would need to be kept when an entity has both SSTB and Non-SSTB lines of business in order for the Non-SSTB income to be eligible for the 20% deduction if it constitutes more than 10% of the total gross receipts and the taxpayer is over the $157,500/$315,000 threshold limitation. It is noteworthy that these tests in the Proposed and Final Regulations are based on gross receipts and not net income, as indicated in the summary chart below.

Examples in the Regulations describe a veterinary practice that sells dog food and a landscaping company that provides traditional landscaping, and also consulting services related to landscaping design. For some reason the Treasury and IRS chose to use the rules that control when Taxpayers with separate businesses under one entity want to use separate methods of accounting, such as if a product sales division is on the accrual method of accounting while the services and repair division owned by the same entity is on the cash method of accountings

The January 28th Preamble reads as follows, with the word "separate" underlined below:

> The Treasury Department and the IRS also believe that multiple trades or businesses will generally not exist within an entity unless different methods of accounting could be used for each trade or business under §1.446-1(d). Section 1.4461(d) explains that no trade or business is considered separate and distinct unless a complete and **separate** [emphasis added] set of books and records is kept for that trade or business. Further, trades or businesses will not be considered separate and distinct if, by reason of maintaining different methods of accounting, there is a creation or shifting of profits and losses between the businesses of the taxpayer so that income of the taxpayer is not clearly reflected.

The February 4th Preamble changed the word "separate" to "separable" in the above quoted language, as a result of the Treasury misquoting the actual text of Treasury Regulation Section 1.446-1(d)(2). The use of the word "separable" in the text of the Regulations is curious, but it appears that the IRS intends that separate books and records at a minimum are required to be maintained to allow for the income and expenses associated with Non-SSTB activities under a single entity to be eligible for the Section 199A deduction for high-earning taxpayers, even though we don't think that this is required by the word "separable".

This is not much authority in this area. In CCA201430013, the Office of Chief Counsel determined that a parent Company and its wholly owned LLC operated two separate trades and businesses when the subsidiary disregarded LLC primarily manufactured products, and its parent Company performed sales, marketing, distribution, research and development, administrative, and headquarter functions. Relevant factors included that the Company and LLC kept separate books and records, the Company and LLC were in different geographic locations, and that the Company and LLC only shared employees who were high-level executives. The CCA further stated that even though the LLC was treated as disregarded for federal income tax purposes, it does not mean that the LLC cannot have a separate trade or business. This confirms that separate taxable entities are not necessarily required in order for separate trades or businesses to be considered separate.

In Revenue Ruling 74-280, the IRS ruled that a bank's bond department was required to use the accrual method of accounting, while other activities of the bank could use different methods of accounting if complete and separate set of books and records are maintained for each separate trade or business. While the Revenue Ruling does not provide any guidance on factors to determine if there is a separate trade or business, it does indicate that separate books and records are required if the taxpayer wishes to treat non-bond activities as a separate trade or business.

Further, but non-precedential, guidance can be found in the 2004 Tax Court Memorandum decision of *Herbert C. Haynes, Inc. v. Comm'r*, (T.C. Memo 2004-185) which held that a taxpayer was not permitted to use different methods of accounting for separate activities because no separate books and records were maintained, and as a result the taxpayer did not have trades or businesses that could be considered separate and distinct from the taxpayer's other activities.

Clearly, in the modern age of QuickBooks and similar software products, taxpayers are able to separately tag and track line items in their financial statements that can show revenues and expenses associated with different operations, such as traditional veterinary practice revenues and expenses, and revenues and expenses associated with the sale of dog food and other non-health related products while using simple cost accounting concepts to reasonably allocate common overhead.

Unfortunately, these new changes do not eliminate the degree of confusion that still exists by having examples which specifically indicate that separate books and records need to be kept, and further point out that the entities in the examples that were able to separate SSTB from non SSTB income not only maintained separate books and records, but also had separate employees and other characteristics. These examples read as follows:

> (A) Example 1 to paragraph (c)(1). Landscape LLC sells lawn care and landscaping equipment and also provides advice and counsel on landscape design for large office parks and residential buildings. The landscape design services

include advice on the selection and placement of trees, shrubs, and flowers and are considered to be the performance of services in the field of consulting under paragraphs (b)(1)(vi) and (b)(2)(vii) of this section. Landscape LLC separately invoices for its landscape design services and does not sell the trees, shrubs, or flowers it recommends for use in the landscape design. Landscape LLC maintains one set of books and records and treats the equipment sales and design services as a single trade or business for purposes of Sections 162 and 199A. Landscape LLC has gross receipts of $2 million.

$250,000 of the gross receipts is attributable to the landscape design services, an SSTB. Because the gross receipts from the consulting services exceed 10% of Landscape LLC's total gross receipts, the entirety of Landscape LLC's trade or business is considered an SSTB.

(B) Example 2 to paragraph (c)(1). Animal Care LLC provides veterinarian services performed by licensed staff and also develops and sells its own line of organic dog food at its veterinarian clinic and online. The veterinarian services are considered to be the performance of services in the field of health under paragraphs (b)(1)(i) and (b)(2)(ii) of this section. Animal Care LLC separately invoices for its veterinarian services and the sale of its organic dog food. Animal Care LLC maintains separate books and records for its veterinarian clinic and its development and sale of its dog food. Animal Care LLC also has separate employees who are unaffiliated with the veterinary clinic and who only work on the formulation, marketing, sales, and distribution of the organic dog food products. Animal Care LLC treats its veterinary practice and the dog food development and sales as separate trades or businesses for purposes of Section 162 and 199A. Animal Care LLC has gross receipts of $3,000,000. $1,000,000 of the gross receipts is attributable to the veterinary services, an SSTB. Although the gross receipts from the services in the field of health exceed 10% of Animal Care LLC's total gross receipts, the dog food development and sales business is not considered an SSTB due to the fact that the veterinary practice and the dog food development and sales are separate trades or businesses under Section 162.

"GOOD THINKING 99" - 754 PARTNERSHIP BASIS MYSTERY RESOLVED

The other changes to the Final Regulations help to confirm what was apparently intended in the earlier released Final Regulations, although our careful reading on the 743(b) excess basis adjustment provisions did not enable us to decipher exactly what was intended until we read reports by other commentators who may be clairvoyant, or at least much smarter than we are.

What we do know now is that a 754 election will only allow the partner in a partnership to receive a UBIA ("Unadjusted Basis Immediately After Acquisition") attributable to the increase or decrease in the fair market value of the property from the original UBIA or the property, but not to the extent that the partnership (or a predecessor owner where there is carryover basis over basis) has taken depreciation on the specific asset, and we see no reason why taxpayers conducting their business under partnerships should be treated worse than the co-owners of property.

For example, A, B and C are equal partners in ABC partnership. A, B and C purchase a building for $900,000, and each partner's share of the UBIA is $300,000. A sells his interest to D for $500,000 when the building is worth $1,500,000 and the tax basis of the building is $600,000 (assuming $300,000 of depreciation has been taken).

Under a typical 743 basis adjustment, D would receive a basis increase of $300,000. However, for purposes of Section 199A, D's UBIA adjustment is limited to $200,000, which is the difference between the purchase price ($500,000) and A's original UBIA in the property ($300,000).

As indicated above, the depreciated portion is not restored for UBIA purposes. The $200,000 "excess 743(b) basis adjustment" is treated as a new item of qualified property that is placed into service on the day the partnership interest was transferred, and the $300,000 of UBIA allocated to D from the partnership's initial purchase of the building continues to be treated as placed in service when the partnership initially placed the building in service.

“DON’T GET YOUR NOSE STUCK IN AN ELEVATOR” UBIA IS A HIGH THRESHOLD

When an entity has no wages and must qualify for the 199A capital aided deduction based upon the 2.5% formula, the ratio of qualified property needed to take the entire 20% is quite challenging. For example, an active rental business, having $100,000 of net bottom line income would have to have $800,000 of UBIA in order to use the full $20,000 Section 199A deduction.

This means that QBI cannot exceed 12.5% of the value of qualified property, if no wages are paid, to be fully deductible. As the result of this, taxpayers who have worked hard and conservatively to eliminate most or all debt on their properties are being encouraged by the tax law to take on debt, so that the interest expense will reduce QBI to 12.5% of UBIA.

Partnerships won't be under more pressure than non-partnership entities to do this, which will cause joint and several liability when required to obtain and maintain financing, and possible economic collapse if and when recessions and lower demand for commercial space and possible residential rate reductions occur. This is an example of where tax law impacts US economy, and not necessarily for the better. In this case, to benefit for banking industry, which was also spared from being assessed as an SSTB.

“THE CONE OF SILENCE IS LIFTED ON” - 1031 LIKE KIND EXCHANGES

In the 1031 exchange arena, the revisions bring clarity to language that simply did not make sense because of the reversal of the word “transfer” with “transferee” in three places. Now it is clear that these rules are logical and seemingly fair. A taxpayer who exchanges property and also puts new cash into the replacement property purchase will have higher UBIA to the extent of the cash put in, while a taxpayer who exchanges property and receives cash or other “boot” will have a lower UBIA to the extent of cash received.

COMMENT:

"PARTIALLY SAVED FROM KAOS, BUT WHERE IS CONTROL WHEN YOU NEED IT"

The revised Preamble and Final Regulations to Section 199A that were issued on February 4, 2019 are a welcome clarification for practitioners and taxpayers who are already working hard to revisit their present structures and arrangements in order to have the benefit of the QBI deduction. Nevertheless, many issues remain outstanding, and in some cases the examples are unworkable, so further clarification will be welcomed. See How the Final 199A Regulations Changed the Definition of Performance of Services in the Field of Health, LISI Income Tax Planning Newsletter #168 (January 21, 2019).

We can be glad that the IRS and Treasury writers did a good job on the Regulations considering the lack of time and vague statutory language. Let's be glad that they were not drafted by a robot, like Hymie the Robot on *Get Smart,* who had the following conversation with Agent 86 (Don Adams).

[Knocking door sound]

Agent 86 (Maxwell Smart): "Answer the Door Hymie."

Hymie the Robot: "I'm sorry door, what was the question?"

Chief: "Now listen carefully". . .

This newsletter describes the examples, which seem to assume that pharmacies are not required to give contraindication and patient advice, that testing facilities would not notify doctors when results are abnormal, and that stem cell procedures would allow for extraction and injection without medical personnel.

Chief: "Did you get that?"

Maxwell Smart: "Not all of it."

Chief: "What part didn't you get?"

Maxwell Smart: "The part after 'Now listen carefully'."

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Alan Gassman

Brandon Ketron

CITE AS:

LISI Income Tax Planning Newsletter #174 (February 12, 2019) at http://www.leimbergservices.com

When Is Rental Real Estate a "Trade or Business" Under 199A

by Alan Gassman & Martin Shenkman

Leimberg Information Services, Inc.

Steve Leimberg's Income Tax Planning
Email Newsletter Archive Message #175

Date:18-Feb-19

Subject: Alan Gassman & Martin Shenkman - When is Rental Real Estate a "Trade or Business" Under 199A?

"The 2017 Tax Cuts and Jobs Act introduced the new, and sometimes problematic, Section 199A to the Internal Revenue Code. Section 199A was designed to provide taxpayers with a twenty percent (20%) deduction for qualified business income (QBI) earned through qualifying 'trades or business.' This deduction for business owners was added in response to the significant tax cut the Act created for large corporations. Unfortunately, among other myriad complexities and uncertainties in 199A, there is no single accepted definition of 'trade or business' so many taxpayers have been in limbo not knowing whether their activities qualify. Once a practitioner has parsed through this complexity to determine if a real estate rental arises to the level of a trade or business, the Regulations contain an array of ancillary provisions, exceptions and special rules that may affect the application of that determination or even negate it.

On January 18th, the IRS released the highly anticipated Final Regulations intended to shed light on the many confusing aspects of Section 199A. Much like the Proposed Regulations, the Final Regulations do not provide a bright line definition of 'trade or business.' The Final Regulations state that for the purposes of Section 199A, ***a qualifying trade or business is defined as a trade or business under Section 162 of the Internal Revenue Code other than the trade or business of performing services as an employee****.*

This newsletter will focus primarily on using the new Final Regulations as well as previous court decisions to define and understand what is meant by the term 'trade or business' for purposes of determining whether a real estate investor with a triple net lease can qualify for the 199A deduction under the Final Regulations, as corrected."

Alan Gassman and **Martin Shenkman** provide members with important commentary that examines an issue that many advisors and their clients are struggling with, namely, when is rental real estate a "trade or business" for Section 199A purposes?

Alan Gassman, JD, LL.M. is the founding partner of the law firm of **Gassman, Crotty & Denicolo, P.A.**, in Clearwater, Florida. Alan is a frequent contributor to LISI, and has authored several books and many articles on Estate and Estate Tax Planning, Trust Planning, Creditor Protection Planning, and associated topics. You can contact Alan at agassman@gassmanpa.com.

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Here is their commentary:

EXECUTIVE SUMMARY:

The 2017 Tax Cuts and Jobs Act introduced the new, and sometimes problematic, Section 199A to the Internal Revenue Code.[i] Section 199A was designed to provide taxpayers with a twenty percent (20%) deduction for qualified business income (QBI) earned through qualifying "trades or business." This deduction for business owners was added in response to the significant tax cut the Act created for large corporations. Unfortunately, among other myriad complexities and uncertainties in 199A, there is no single accepted definition of "trade or business" so many taxpayers have been in limbo not knowing whether their activities qualify. Once a practitioner has parsed through this complexity to determine if a real estate rental arises to the level of a trade or business, the Regulations contain an array of ancillary provisions, exceptions and special rules that may affect the application of that determination or even negate it.

On January 18th, the IRS released the highly anticipated Final Regulations intended to shed light on the many confusing aspects of Section 199A. Much like the Proposed Regulations, the Final Regulations do not provide a bright line definition of "trade or business." The Final Regulations state that for the purposes of Section 199A, **a qualifying trade or business is defined as a trade or business under Section 162 of the Internal**

Revenue Code other than the trade or business of performing services as an employee.

This newsletter will focus primarily on using the new Final Regulations as well as previous court decisions to define and understand what is meant by the term "trade or business" for purposes of determining whether a real estate investor with a triple net lease can qualify for the 199A deduction under the Final Regulations, as corrected.

COMMENT:

Section 199A points to Section 162 for the definition of a "trade or business," however, even looking past the repetition of the phrase "trade or business," Section 162 does not provide a clear definition either. Section 162 states that expenses can be deducted when they are incurred for a legitimate and active trade or business. Section 199A of the Act modifies the Section 162 definition of what constitutes "trades and businesses" by excluding "the trade or business of performing services as an employee and 'specified service' trades or businesses ("SSTBs"). SSTBs involve the performance of services in law, accounting, financial services, and several other enumerated fields, or when the business's principal asset is the reputation or skill of one or more owners or employees." Thus the 199A definition of "trade or business" begs the question: who actually qualifies as a trade or business for the 199A deduction?

We do know that SSTBs and services as an employee are both excluded. Those two concepts are also fraught with nuance and uncertainty but will not be addressed in this newsletter. Rather, this newsletter will explore the remaining territory of what is a business for 199A other than these two special situations, with a focus on how a real estate trade or business is defined for purposes of applying 199A.

While the definition of a "trade or business" under Section 162 and case law is complex and in many cases quite fact specific, the analysis is much more complicated. Even apart from the SSTB and employee exclusions, the 199A Regulations include a range of other comments affecting the definition of what is a trade or business for purposes of 199A. We will start by reviewing how the Courts have defined the term "trade or business" in order to give the Internal Revenue Code definitions some context, particularly since many of these cases are cited by the new Regulations.

Case History Defining "Trade or Business"

The Supreme Court has been faced with the task of defining a "trade or business" in tax context multiple times over the last century. Going back to 1911, the Court in *Flint v. Stone Tracey* used the Bouvier Dictionary to broadly define a business as "that which occupies the time, attention and labor of men for the purpose of a livelihood or profit."[ii] In 1935, the U.S. Supreme Court provided a limitation to the definition by distinguishing between an active trade and an investor.[iii] In *Snyder v. Commissioner,* the Court determined that an investor seeking to merely increase his personal holdings was not engaged in a trade or business,[iv] however, Justice Brandeis also stated that a taxpayer who made his livelihood from buying and selling on the stock exchange would be a trade or business.[v] This was the first of many instances where the activity level of the taxpayer is a deciding factor in whether the definition of a "trade or business" applies.

Not long after *Snyder*, the Court was faced with two "trade or business" cases in one year which centered upon estate preservation. In the 1941 *Higgins v. Commissioner* case, also cited in the new Final Regulations, the Supreme Court stated that determining whether a taxpayer is 'carrying on a business' "requires an examination of the facts in each case" therefore highlighting that this is a factual determination.[vi] In *Higgins* specifically, the Court determined that a taxpayer managing and preserving his own estate did not qualify as carrying on a business.[vii] Additionally, in *City Bank Farmers Trust v. Helvering,* the Supreme Court used the same analysis to determine that asset conservation and maintenance by way of estate or trust efforts is not a trade or business.[viii]

These cases highlight the Supreme Court's ongoing struggle in deciding whether a certain activity qualifies as a trade or business without a succinct definition from Congress or its agencies. In its 1987 sentinel case *Commissioner v. Groetzinger,* a case cited in the new Regulation, the U.S. Supreme Court laid out a definition for what qualifies as a trade or business that is still good law.[ix] In *Groetzinger*, the Court determined that a full-time gambler who wagered for himself alone was engaged in a "trade or business" within the meaning of the applicable Internal Revenue Code.[x] The Court rejected the previously used 'goods and services' test reasoning that almost every activity could potentially satisfy the test leading to litigation over the meaning.[xi]

The Court held that to be engaged in a trade or business:

1. The taxpayer's involvement must be continuous and regular; and
2. The primary purpose of the activity must be for income or profit.[xii]

The Court cautioned future courts to examine the facts of each case, refusing to create a bright line rule, and highlighted that it is the responsibility of Congress to make changes or revisions to this Court's interpretation of the definition.[xiii] While it is true that Congress has the ultimate responsibility to define "trade or business" as used in its rules and proposed regulations, they have not done so. In fact, the new Final Regulations cite back to the two definitional requirement in *Groetzinger* so it follows that the best definition or test available still comes from the Supreme Court in *Groetzinger.*

It is important to keep in mind that the Supreme Court only hears a select number of cases. The majority of disputes related to tax matters are heard by the Tax Court. The Tax Court has held that, beyond the definition provided in *Groetzinger,* the threshold test for deduction of income expenses under Section 162 is twofold: (1) whether the primary purpose and intention of the taxpayer was to make a profit,[xiv] and (2) the level of activity involved. Along with the new Final Regulations, the IRS also released a Notice that included a safe harbor for real estate activities related to the level of activity necessary to qualify as a trade or business. This safe harbor will be discussed further below.

By way of illustration, if a taxpayer loses money by participating in a hobby, the taxpayer cannot receive benefits of income tax deductions by calling the hobby a trade or business. In the 1988 U.S. Tax Court case of *Seebold v. Commissioner,* a married couple decided to breed horses to add to their retirement income.[xv] In this case, the court explicitly placed greater weight on the objective factors showing the couple's intent to profit rather than simply their statement of intent.[xvi] For example, they worked hard to learn the subject area, sought advice from experts in the field, used a veterinarian for the purpose of breeding, and consulted an accountant.[xvii] Moreover, Mrs. Seebold eventually quit her job to work on the breeding farm full time.[xviii]

The Tax Court determined that this level of activity met the threshold in that the primary purpose and intention of the Seebolds was to incur a profit, regardless of the loss they sustained when they first started, and the Seebolds' horse breeding qualified as a trade or business.[xix] As a result, in addition to the *Groetzinger* test, taxpayers must also be able to show that the primary purpose and intent of the activity is to incur a profit, and the taxpayer bears the burden of proving they meet this threshold before benefitting from the 199A deduction.

There are several factors that taxpayers may wish to document if there is any uncertainty as to whether their real estate involvement may qualify as a trade or business. Real estate investors attempting to qualify for trade or business status could pursue and corroborate the following:

- Save internet research on real estate rental matters to corroborate work done in an effort to educate him/herself on the subject.
- Document consultations with experts, e.g. saving emails and other correspondence.
- Hire professional experts, including CPAs, and save all bills and payments thereto.
- Maintain time records.
- Prepare a financial plan to reflect the need for income to support the argument that the intent is to earn a profit.

As illustrated above, taking proactive steps to corroborate intent at the time activities and actions are completed may be a prudent way to prepare for the possibility of a future challenge.

Application to Real Estate

The issue of whether a taxpayer is engaging in a trade or business is an issue of fact that involves analyzing the scope of activities that the taxpayer is engaged in, either personally or through an agent. Many commentators on the Proposed Regulations requested a bright line rule or factor based test from the IRS to no avail. The new Final Regulations state: "Whether an activity rises to the level of a Section 162 trade or business, however, is inherently a factual question…accordingly, the Treasury Department and the IRS have concluded that the factual setting of various trades or businesses varies so widely that a single rule or list of factors would be difficult to provide in a timely and manageable manner and would be difficult for taxpayers to apply."

Even without a definitive test, passive ownership of a rental property is commonly not enough to qualify as a trade or business, although active management of such a property historically has been viewed as a trade or business. Since qualifying as a trade or business is based on a question of fact, the line distinguishing passive ownership and active ownership can easily become blurry.

The new Final Regulations do provide four factors that have been used by courts for years to consider whether a real estate venture qualifies as a trade or business.[xx] First, the IRS will consider the type of property owned and/or managed by the taxpayer (i.e. commercial, residential, condominium, or personal). Second, the court will consider the number of properties rented out by the taxpayer. Third, and what seems to be most important, the court will consider the day to day involvement of the owner or agent, and fourth, the court will consider the type of rental (i.e. triple net lease, traditional lease, short term lease, or long-term lease).

Based on this analysis, taxpayers seeking to qualify might take the following proactive steps:

- When making a new investment, consider the likelihood that the type of property being considered will qualify if this is not inconsistent with overall goals. For example, purchasing a commercial property is more likely to qualify then renting a vacation home, and purchasing multiple properties may be more favorable than a four-family house.
- Document the daily activities. This can be done with a calendar program or perhaps an Excel spreadsheet. Even documenting simple and easily overlooked items may be useful to "fill-out" the documentation and demonstrate a more regular involvement, such as providing the dates on which supplies are purchased, the dates on which internet research is conducted, the dates emails are sent to an agent, prospective tenant, repair contractor, and so on.
- Taxpayers should be certain that the real estate attorney drafting and negotiating the lease understands the implications. It may be possible to charge a higher rent and leave property tax, insurance, and other expenses to be paid for by the owner. That might not meaningfully impact the economics of the transaction but it may impact the potential characterization of the transaction for Sections 162 or 199A trade or business characterization.

In the 1946 case *Hazard v. Commissioner,* the Tax Court ruled that even one single family rental was a trade or business.[xxi] The Internal Revenue Service has since adopted the same reasoning and the rule still stands in most jurisdictions.[xxii] It would therefore be reasonable for the IRS to continue to follow the *Hazard* standard with regards to 199A deductions and allow single family or single property rentals to qualify as a trade or business, however, much case law has shown that simply renting the property alone is not enough. As noted above, if the taxpayer has options when purchasing a new real estate investment, such as structuring a more sustainable investment for QBI purposes, doing so may be feasible.

Practically speaking, how much change will a taxpayer tolerate for the amount of the deduction?

In *Neill v. Commissioner*, the 1942 Tax Court ruled that the mere collection of rent without any other activity was not enough to constitute a trade or business.[xxiii] In *Hendrickson v. Commissioner*, the Tax Court ruled that a passive investment in an oil gas well where the owner simply purchased the lease and collected income from it did not qualify as a trade or business.[xxiv] Therefore, while it is possible for a rental business to constitute a "trade or business", simply owning the business and collecting money is not enough. Even so, as indicated above, it may not be difficult for taxpayers to document a quantum of activity, modify lease terms, etc. to support the active trade or business characterization.

Based on the relevant case law, in order to qualify as engaging in a trade or business, the taxpayer must have some active role in running the rental. In *Schwarcz v. Commissioner,* the Tax Court determined that a landlord owning, managing, and operating apartment buildings was engaging in a trade or business.[xxv] Interestingly, the owner could do so through an agent and would still qualify.[xxvi] While most or all rental activities can be handled through an agent, having the owner personally visit and inspect the property at least once a month (even if from the outside so as not to disturb a tenant) to take photos that can be stored to prove the dates and actuality of the inspections may be prudent to help support the taxpayer's position.

In certain tax cases not related to the 199A deduction, taxpayers may have want to avoid being labeled as a trade or business in order to avoid paying additional taxes as a trade or business. In *Bennett v. Commissioner,* two partners leased equipment to site organizations allowing people to play a form of lottery called keno under the company name of Lucky Keno.[xxvii] The partners both reported their business income from Lucky but did not report self-employment tax.[xxviii] The partners argued that they did not have to pay the self-employment tax because Lucky was a passive owner of the equipment and not actively engaged in trade or business.[xxix] The Tax Court disagreed, stating that the partners oversimplified their role.[xxx] Lucky's name was on all of the keno advertisements and Lucky controlled the funds and distributed them to the winners, municipalities, the state, and the site organizations.[xxxi] Therefore, Lucky was not a passive owner and the partners were required to pay self-employment taxes because they owned a trade or business.[xxxii]

Application Specifically to Triple Net Leases

In a triple net lease, the tenant is mostly responsible, and the lessor does very little by way of managing the rental. The tenant usually agrees to pay the normal fees, like rent and utilities, plus the three "nets" – real estate taxes, building insurance, and maintenance. Using the *Groetzinger* test, a triple net leaseholder will most likely not qualify as having a trade or business because, while owning the property for the purpose of making a profit would meet the second prong of the test, the involvement of the leaseholder is not continuous and regular enough to meet the first prong.

The Proposed Regulations under Section 199A offered two examples of real estate initiatives qualifying as a trade or business. In the first example, an individual who owns and manages land leased to airports for parking lots qualified as a Section 162 business. The management aspect of the owner is the likely reason why this example qualified as a trade or business. It is unclear how this example could apply practically because if the land is leased to airports, there is not much management left for the owner to handle. In the second example, the owner developed the same land to build parking structures and then leased the parking structures to the airports. It is noteworthy that in those prior examples the dollar value of costs incurred by the owner were insignificant relative to the rental income involved, yet those examples skirted the trade or business issue and merely assumed without further indication that they qualified. Despite this, relevant case law would suggest that this example would not qualify as a trade or business.

To alleviate the confusion here, the new Final Regulations have removed all references to land in both of these examples. The Regulations state that the examples "were not intended to imply that the lease of the land is, or is not, a trade or business for the purposes of Section 199A beyond the assumption in the examples."

Along with the new Final Regulations, the IRS also released a special notice (Notice 2019-7) to provide "notice of a proposed revenue procedure detailing a proposed safe harbor under which a rental real estate enterprise may be treated as a trade or business solely for the purpose of Section 199A."

Under the new safe harbor, rental real estate may be treated as a trade or business for the purposes of Section 199A alone as long as the following criteria are met:

1. Separate books and records are maintained for each rental activity (or the combined enterprise if grouped together);
2. Two hundred and fifty (250) hours or more of "rental services" are performed per year for the activity (or combined enterprise); and
3. The taxpayer maintains contemporaneous records, including time reports or similar documents, regarding the hours of all services performed, a description of all services performed, the dates on which such services are performed, and who performed the services.[xxxiii]

To this end, taxpayers should:

1. Be certain to maintain separate books and records. If the taxpayer uses Quicken or a similar program to track records, he/she may want to set up a new account for this.
2. If the taxpayer has commingled rental income and expenses in his/her personal checking account, then set up a new separate account for the business.
3. If the taxpayer has used one account for all rental properties then, unfortunately, separate bank accounts should be created.
4. The taxpayer should maintain a calendar and also a supporting file of saved emails, internet research, photos saved with date/time stamp, etc. to show ongoing involvement and corroborate that actions were taken supporting the hours tracked.

Suprisingly, the Notice specifically excludes triple net leases as ineligible for the safe harbor! This does not prevent the taxpayer from arguing that the real estate enterprise *should* qualify as a trade or business under the Section 162 definition if there are other considerations at play.[xxxiv] Although it is important to remember that both the Final Regulations and relevant case law say that qualifying under Section 199A involves a factual case-by-case analysis, triple net lease arrangements will most likely need to be altered in order to qualify.[xxxv] Practitioners should consider the structure of the ownership of the triple net leased properties and the aggregation rules. It may be possible to alter the structure, e.g. have all separate non-qualifying LLCs restructured into disregarded entities so that they can be aggregated for this test.

While the regulations and safe harbor are brand new and case law is scant, one Revenue Ruling has addressed the issue regarding whether a triple net lease specifically qualifies as a trade or business. Under Section 871, there are special rules for the taxation of nonresident aliens who are engaged in trade and business in the United States. This could be used as a potential argument for meeting the Section 162 definition of trade or business, nonetheless, Revenue Ruling 73-522, 1973-2 C.B. 226 stated that a rental under a net lease is not considered a trade or business for the purposes of Section 871.

The question of whether a triple net lease can constitute a trade or business was also raised with regard to withdrawal liability under the Multiemployer Pension Plan Amendments Act (MPPAA) in the 2001 7th Circuit U.S. Court of Appeals case of *Central States, Southeast and Southwest Areas Pension Fund v. Fulkerson*.[xxxvi] Thomas and Dolly Fulkerson owned several triple net leases and were also shareholders of Holmes Freight Lines, Inc. (Holmes) when it became bankrupt.[xxxvii] As a creditor, Central States used the MPPAA of 1980 to calculate the withdrawal liability of Holmes.[xxxviii] Under the MPPAA, all "trades or businesses" are treated as one employer.[xxxix] Under that theory, the Fulkerson's leasing business and Holmes were under the common control of the Fulkersons and the leasing business was thereby pulled in to help pay the remainder of what was owed to Central States.[xl] Because the leasing business was unincorporated, the Fulkersons became personally liable.

The MPPAA, like the IRC, uses the term "trade or business" but does not define it. Therefore the appellate court affirmed the Supreme Court's test in *Groetzinger,* reasoning that the test comports with the common meaning and can be used generally.[xli] In order to meet the first prong of the *Groetzinger* test, the taxpayer's involvement must be continuous and regular. Since the leases were triple net leases, Mr. Fulkerson only spent about five hours per year involved with the properties.[xlii] The properties were purchased with the intent of pure investment. The court held that the "mere holding of leases for ten years by shareholder was not such continuous and regular activity as to constitute a trade or business, for purpose of imputing withdrawal liability to company."[xliii] A similar ruling today would probably be upheld with regards to Section 199A, even with the new safe harbor, due to the 250 hour requirement. Practitioners should also be mindful of the special rules in the final Regulations as to these matters of aggregation.

In the 7th Circuit U.S. Court of Appeals case of *Central States v. Personnel,* the court reached the opposite decision with similar facts as *Fulkerson*.[xliv] In *Personnel*, the defendant was held responsible for withdrawal of liability because the defendant was much more frequently engaged in activities related to leasing, such as buying and selling multiple properties annually and advertising.[xlv] The court concluded that this conduct was both regular and continuous.[xlvi]

Based on the reasoning in these cases along with the new Final Regulations, it is clear that: (1) the *Groetzinger* test is still applicable and used by courts to determine whether an activity is a trade or business, and (2) courts truly use activity level of the taxpayer as a deciding factor. Based on the relevant case law as well as the new safe harbor provision, it seems as though the courts and the IRS are really looking for some degree of activity/time spent working with the enterprise or legal responsibility of risk on part of the taxpayer. In order to show that, an owner of a triple net lease can do a few things to increase their level of activity with the rental such as: take on responsibility for maintenance, participate in tenant management, participate in advertisement initiatives, and be more active in pursuing new leases or selling leases. Also consider the additional suggestions in previous sections of this newsletter.

For further clarification on the complex ripple effects of the new Final Corrected Regulations, the esteemed co-author to this newsletter, Martin Shenkman, has provided the following breakdown.[xlvii]

Complex Ripple Effects of the New Final Corrected Regulations

The Regulations include a myriad of provisions that might affect how a trade or business is defined and whether or not that trade or business will qualify for the QBI deduction. Many of these nuanced rules have direct application to determining whether real estate activities will or will not qualify. Some of these are discussed below.

- **<u>Multiple Trades or Businesses</u>**: "Whether a single entity has multiple trades or businesses is a factual determination. However, court decisions that help define the meaning of "trade or business" provide taxpayers guidance in determining whether more than one trades or businesses exist." The aggregation, or decision not to aggregate, or the inability to aggregate (e.g. real estate properties that are not trades or businesses cannot be aggregated), may all affect the outcome of the analysis.
- **<u>Activity to Constitute a Trade or Business</u>**: The Regulations refer to case law to interpret what it means "…to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity

and regularity and the taxpayer's primary purpose for engaging in the activity must be for income or profit. Groetzinger, at 35."

- **<u>Books and Records</u>**: 'Section 1.446- 1(d) explains that no trade or business is considered separate and distinct unless a complete and separable set of books and records is kept for that trade or business. Further, trades or businesses will not be considered separate and distinct if, by reason of maintaining different methods of accounting, there is a creation or shifting of profits and losses between the businesses of the taxpayer so that income of the taxpayer is not clearly reflected." This appears to mean that if several businesses do not have "complete and separable sets of books and records" they cannot be separate businesses. If there is a shifting of profits that is not "clearly reflected" then to businesses cannot be separated. This might all affect the calculus of QBI for the overall enterprise. This adds requirements that practitioners will have to address in delineating businesses for purposes of the QBI deduction.
- **<u>Aggregation</u>**: The determination of a trade or business is made more complex by the possibility of aggregation. "As described in part II of this Summary of Comments and Explanation of Revisions, the final regulations incorporate the principles of section 162 for determining whether a trade or business exists for purposes of section 199A. A taxpayer can have more than one section 162 trade or business. See §1.446-1(d)(1). Multiple trades or businesses can also be conducted within one entity. A trade or business, however, cannot generally be conducted across multiple entities for tax purposes. The preamble to the proposed regulations acknowledges that it is not uncommon for what may be thought of as single trades or businesses to be operated across multiple entities, for various legal, economic, or other non-tax reasons. It is because trades or businesses may be structured this way that the proposed regulations permit aggregation." So merely determining whether the developer's activities constitute a trade or business is only part of the analysis. The Regs further provide: "The aggregation rules are intended to allow aggregation of what is commonly thought of as a single trade or business where the business is spread across multiple entities. Common ownership is an essential element of a single trade or business."
- **<u>Consistency</u>**: The Regulations also impose a consistently requirement on the delineation of a trade or business: "In cases in which other Code provisions use a trade or business standard that is the same or substantially similar to the section 162 standard adopted

in these final regulations, taxpayers should report such items consistently. For example, if taxpayers who own tenancy in common interests in rental property treat such joint interests as a trade or business for purposes of section 199A but do not treat the joint interests as a separate entity for purposes of §301.7701-1(a)(2), the IRS will consider the facts and circumstances surrounding the differing treatment." This may be a factor in determining whether future restructuring can be done to enhance QBI deductions from real estate and related endeavors since a restructuring that changes prior reporting may violate the consistency requirement.

- **Allocations**: The consistency requirements are broad and appear in several contexts in the proposed regulations. So, in addition to the above provision, consistency in allocations is also required. "The proposed regulations provide that if an individual or an RPE directly conducts multiple trades or businesses, and has items of QBI which are properly attributable to more than one trade or business, the individual or RPE must allocate those items among the several trades or businesses to which they are attributable using a reasonable method based on all the facts and circumstances. The chosen reasonable method for each item must be consistently applied from one taxable year to another and must clearly reflect the income and expenses of each trade or business."
- **1099 Filings**: The Regulations also impose an additional requirement that if an operation does not comply with Form 1099 reporting requirements, it may not meet the requirements of constituting a trade or business. The Regulations provide: "Similarly, taxpayers should consider the appropriateness of treating a rental activity as a trade or business for purposes of section 199A where the taxpayer does not comply with the information return filing requirements under section 6041." Section 6041 provides in part: "All persons engaged in a trade or business and making payment in the course of such trade or business to another person, of rent, salaries, wages, premiums, annuities, compensations, remunerations,... of $600 or more in any taxable year...required to make returns in regard thereto by the regulations hereinafter provided for, shall render a true and accurate return to the Secretary, under such regulations" So a failure of a rental activity to file 1099s will preclude it from being characterized as a trade or business for 199A even if it passes the gauntlet of the 162 analysis discussed below.

- **Disregarded Entities**: "…trades or businesses conducted by a disregarded entity will be treated as conducted directly by the owner of the entity for purposes of section 199A." This could be useful for real estate developers. For example, most developers structure operations so that every property is in a separate LLC. So, if a developer has brother-sister disregarded entities the trade or business test should be determined at the aggregate/developer level. If a developer has a family limited partnership ("FLP") that owns brother-sister "subsidiary" single member LLCs holding each property, then the trade or business test should be handled at the FLP level. However, if as many developers do the structure is a non-disregarded management company that owns 1% of each property LLC and the developer or a grantor trust owns the other 99% then it would appear that the trade or business testing and QBI calculations would have to be done at the level of each property LLC.
- **Entity Level Calculations**: Apropos to the above comments concerning disregarded entities is further comments in the Regs about testing at the entity level: "For purposes of section 199A, the determination of whether an activity is a trade or business is made at the entity level. If an RPE is engaged in a trade or business, items of income, gain, loss, or deduction from such trade or business retain their character as they pass from the entity to the taxpayer – even if the taxpayer is not personally engaged in the trade or business of the entity. Conversely, if an RPE is not engaged in a trade or business, income, gain, loss, or deduction allocated to a taxpayer from such entity will not qualify for the section 199A deduction even if the taxpayer or an intervening entity is otherwise engaged in a trade or business. As described in part II.A.3 of this Summary of Comments and Explanation of Revisions, a trade or business for purposes of section 199A is generally defined by reference to the standards for a section 162 trade or business. A rental real estate enterprise that meets the safe harbor described in Notice 2017-07, released concurrently with these final regulations, may also treated as trades or businesses for purposes of section 199A. Additionally, the rental or licensing of property if the property is rented or licensed to a trade or business conducted by the individual or an RPE which is commonly controlled under §1.199A- 4(b)(1)(i) is also treated as a trade or business for purposes of section 199A. In addition to these requirements, the items must be effectively connected to a trade or business within the United States as described in section 864(c)." For

developers who have, as illustrated above, an entity that is not disregarded, if that entity's activities do not rise to the level of a trade or business then its revenue will not qualify as QBI. This appears to be so even if the aggregate of the taxpayer's activities with respect to all entities arises to the level of a trade or business, as these cannot be aggregated if the individual entities themselves do not meet the trade or business requirement.

- **Penalties**: The Regs provide for the following: "Section 6662(a) provides a penalty for an underpayment of tax required to be shown on a return. Under section 6662(b), the penalty applies to the portion of any underpayment that is attributable to a substantial underpayment of income tax. Section 6662(d)(1) defines substantial understatement of tax, which is generally an understatement that exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000. Section 6662(d)(1)(C) provides a special rule in the case of any taxpayer who claims the section 199A deduction for the taxable year, which requires that section 6662(d)(1)(A) is applied by substituting "5 percent" for "10 percent." Section 1.199A-1(e)(6) cross-references this rule. One commenter asked for guidance on how the section 6662 accuracy penalty would be applied if an activity was determined by the IRS not to be a trade or business for purposes of section 199A. The Treasury Department and the IRS decline to adopt this suggestion as guidance regarding the application of section 6662 is beyond the scope of these regulations." Thus, when the continued lack of clarity on what real estate rentals activities might constitute a trade or business is discussed later in this newsletter, practitioners should bear in mind that the penalty for incorrectly making that determination is based on the lower 5% threshold and the Treasury refused to provide further guidance in this regard. Perhaps practitioners making "close calls" for real estate clients might mention the harsher penalty rules.
- **Previously Suspended 469 Losses**: The Regs provide that previously suspended losses under Section 469 are to be treated as losses from a separate trade or business for purposes of section 199A.
- **Guaranteed Payments for Use of Capital**: "…for purposes of section 199A, guaranteed payments for the use of capital should be treated in a manner similar to interest income. Interest income other than interest income which is properly allocated to trade or business

is specifically excluded from qualified items of income, gain, deduction or loss under section 199A(c)(3)(B)(iii)."

- **U.S. QBI**: "Section 199A(c)(3)(A)(i) provides that for purposes of determining QBI, the term "qualified items of income, gain, deduction, and loss means items of income, gain, deduction and loss to the extent such items are effectively connected with the conduct of a trade or business within the United States…" So, for a real estate developer with international interests even if the trade or business hurdle is surmounted allocations of non-US source QBI will have to be made removing that revenue.

CONCLUSION

Under the Proposed Regulations, being classified as a "trade or business" can provide a taxpayer with a significant tax reduction on business income. In order to be classified as a "trade or business," an owner must show that he or she is regularly and continuously involved with the property. Therefore, under the classic definition of a triple net lease, the lessor would not qualify for the 199A deduction, but may qualify based on other facts and circumstance. For non-triple net lease holders, the safest action would be to spend sufficient time on the real estate activity while maintaining contemporaneous time records in order to qualify under the safe harbor of Notice 2019-7.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Alan Gassman

Martn Shenkman

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[i] Because this newsletter is centered on new Final Regulations, as corrected, released by the IRS, a significant portion of the language used in this newsletter comes from a prior newsletter published in LISI by the same authors based on the Proposed Regulations released in 2018. *See* LISI Income Planning Newsletter #161, (November 8, 2018) at http://www.leimbergservices.com.

[ii] Flint v. Stone Tracy Co., 220 U.S. 107 (1911).

[iii] Snyder v. Commissioner, 295 U.S. 134 (1935).

[iv] Id.

[v] Id.

[vi] Higgins v. Commissioner, 312 U.S. 212 (1941).

[vii] Id. at 217.

[viii] City Bank Farmers Trust Co. v. Helvering, 313 U.S. 121 (1941).

[ix] Commissioner v. Groetzinger, 480 U.S. 23 (1987).

[x] Id.

[xi] Id.

[xii] Id.

[xiii] Id.

[xiv] Seebold v. Commissioner, 55 T.C.M. 723 (1988).

[xv] Id.

[xvi] Id.

[xvii] Id.

[xviii] Id.

[xix] Id.

[xx] *See also* Tony Nitti, IRS Provides Guidance On 20% Pass-Through Deduction, But Questions Remain, FORBES (Aug. 9, 2018), https://www.forbes.com/sites/anthonynitti/2018/08/09/irs-providesguidance-on-20-pass-through-deduction-but-questionsremain/#7cf566562ff8.

[xxi] Hazard v. Commissioner, 7 T.C. 372 (T.C. 1946).

[xxii] The Second Circuit decided in Grier v. US that "broader activity" on the part of the owner was needed in order for a rental to constitute a trade or business.

[xxiii] Neill v. Commissioner, 46 B.T.A. 197 (1942).

[xxiv] Hendrickson v. Commissioner, 78 T.C.M. 322 (1999).

[xxv] Schwarcz v. Commissioner, 24 T.C. 733 (1955).

[xxvi] Id. See also Elek v. Commissioner which states that having an agent actively manage and maintain the rental property does not disqualify the owner from engaging in a trade or business.

[xxvii] Bennett v. Commissioner, 83 T.C.M. 1429 (2002).

[xxviii] Id.

[xxix] Id.

[xxx] Id.

[xxxi] Id.

[xxxii] Id.

[xxxiii] Toni Nitti, *supra* note 22.

[xxxiv] Id.

[xxxv] The specific requirements for this safe harbor are discussed further in the newsletter: "One Particular Harbor: New Regulatory Guidance on If and When a Rental Real Estate Activity Can Qualify for the 20% Section 199A Deduction." LISI Income Tax Planning Newsletter #170, (January 21, 2019) at http;//www.leimbergservices.com.

[xxxvi] C. States, S.E. and S.W. Areas Pension Fund v. Fulkerson, 238 F.3d 891 (7th Cir. 2001).

[xxxvii] Id.

[xxxviii] Id.

[xxxix] Id.

[xl] Id.

[xli] Id.

[xlii] Id.

[xliii] Id.

[xliv] C. States, S.E. and S.W. Pension Fund v. Personnel, Inc., 974 F.2d 789 (7th Cir. 1992).

[xlv] Id.

[xlvi] Id.

[xlvii] All quotations in the following section have been pulled directly from the New Final Corrected Regulations for Section 199A.



Degrees of Protection Under Internal Revenue Code §2036(a)(2)

by Alan Gassman, Ken Crotty & John Beck

Basic Premise: A contributor to a family LLC or limited partnership may be subject to estate tax on the value of all of the assets that he or she contributed to the entity, without discounts, even if significant ownership interests in the entity were gifted or sold, if the contributor directly or indirectly retains one or more of (1) the right to control the entity, (2) the right to vote on if and when there will be a liquidation or distribution from the entity, or (3) the ability to amend the organizational documents of the entity.

Tax Court decisions have held that such retention by the contributor exists when the power is held by an individual who is also named in the contributor's durable power of attorney, as an agent.

IRC § 2035 provides that once this right has been retained, it will be considered retained until three years after it is transferred away or somehow released, unless the right is sold for adequate consideration.

Example: A mother places $994,700 of assets into a limited partnership and receives a 99% limited partner interest and a 47% interest in a company that controls the 1% general partner interest.

Her children contribute $5,300 to the limited partnership and receive a 53% interest in the company that controls the 1% general partner interest. This effectively gives the children control over the limited partnership.

Although her children could outvote her, she has the power to vote on if and when there would be a liquidation or distribution of the partnership, so 99.47% of the partnership assets may be subject to estate tax when she dies. This is the case even if she has given away some or all of the 99% LP interest.

Possible Solutions are discussed below, in simplified form. Taxpayers and advisors should not rely solely upon this write-up with respect to planning.

1. HOUSE OF BRICKS I - For new entities or for changing old entities more than three years before the death of the original contributor.

A. For a new partnership, the best practice would be for the contributor not to be a general partner, and to make sure that no individual "controlled by," or who acts as a fiduciary for the contributor, has a general partner interest or any right to vote on general partner decisions such as when liquidations or distributions should be made from the partnership.

B. Also, ensure that neither the contributor, nor any attorney-in-fact of the contributor, have any right to vote on or join in any amendment to the partnership agreement.

C. Alternatively, simply dissolve the entity with an existing issue, and use reasonable business purposes to reformulate strategies for the family without having the new entity be considered to be the "alter ego and in substance a continuation" of the original entity that is liquidated.

Keep in mind that powers given to individuals who act or are appointed to act as a fiduciary for the contributor may be considered as held by the contributor, such as when a parent gives the power to a child who is also

1 Powell v. Commissioner, 148 T.C. 392, 148 T.C. No. 18 (2017) and Strangi v. Commissioner, 417 F.3d 468 (5th Cir. 2005)

authorized to act as agent under a power of attorney for the parent.

2. HOUSE OF WOOD (HOPEFULLY STRONGER THAN HOUSE OF STICKS)

A. Contributor retains the right to control the investment decisions for the entity, but not any right to cause a liquidation, a distribution, or to vote on any amendment to the partnership agreement.

The IRS could conceivably argue that the right to control the investment decisions allows the contributor to invest the partnership assets in illiquid investments, and possibly even investments that could not be distributed, which would effectively allow the contributor to control the potential distribution of the assets of the entity.

This risk can be ameliorated by providing for an investment policy, such as "the partnership will remain invested in a conventional and diversified portfolio of publicly-traded stocks and bonds, mutual funds and ETFs owning publicly-traded stocks and bonds, and other conventional investments, as recommended by ABC financial advisors on their fiduciary fee-for-service platform, or comparable investment advisors who must be reasonably approved by the partner or partners, who have the right to make liquidation and distribution decisions."

B. Is it safe for the contributor to have the right to replace trust assets with assets of equal value? This right is commonly given to the grantor of a trust so that the trust can be disregarded for income tax purposes. If the entity documents prevent assignment of the specific interest, then the replacement right may not be a problem, but alternative strategies of achieving "defective grantor trusts" status can be considered, which could include giving the trustee or another fiduciary the ability to make distributions to the grantor's spouse without consent of an adverse party, to add one or more new beneficiaries to the trust, or to allow the grantor to borrow from the trust without adequate security.

3. HOUSE OF STICKS?

Can the contributor have the right to replace the partners who have the liquidation and distribution decision-making power?

The partnership agreement can provide that the power to make liquidations and distributions will be held by one or more individuals selected by the contributor, in their capacity as trustees of a trust for specific individuals, other than the contributor. In using this strategy, the liquidation and distribution powers must be exercised by the trustee in the capacity a fiduciary for such beneficiaries.

It would seem that it would be safe to allow the contributor to replace the acting trustees of such trust with one or more individuals who are not related to or employed by (subordinate to) the contributor, within the meaning of Code Section 672(c). The IRS could potentially argue that by retaining the right to remove and replace the partners who have liquidation and distribution decision-making powers is essentially the same as the contributor retaining that power, causing the assets to be included in the contributor's estate.

For more detail on this please email any of the authors for a copy of our more extensive white paper on this subject.

Trust Planning for the 20% Deduction under 199A

Alan was recently interviewed by Bloomberg Tax on this topic. The podcast can be listened to by CLICKING HERE.

Better yet, Eric Clapton's rendition of Over the Rainbow can be viewed by CLICKING HERE - but he forgot to wear his red shoes.

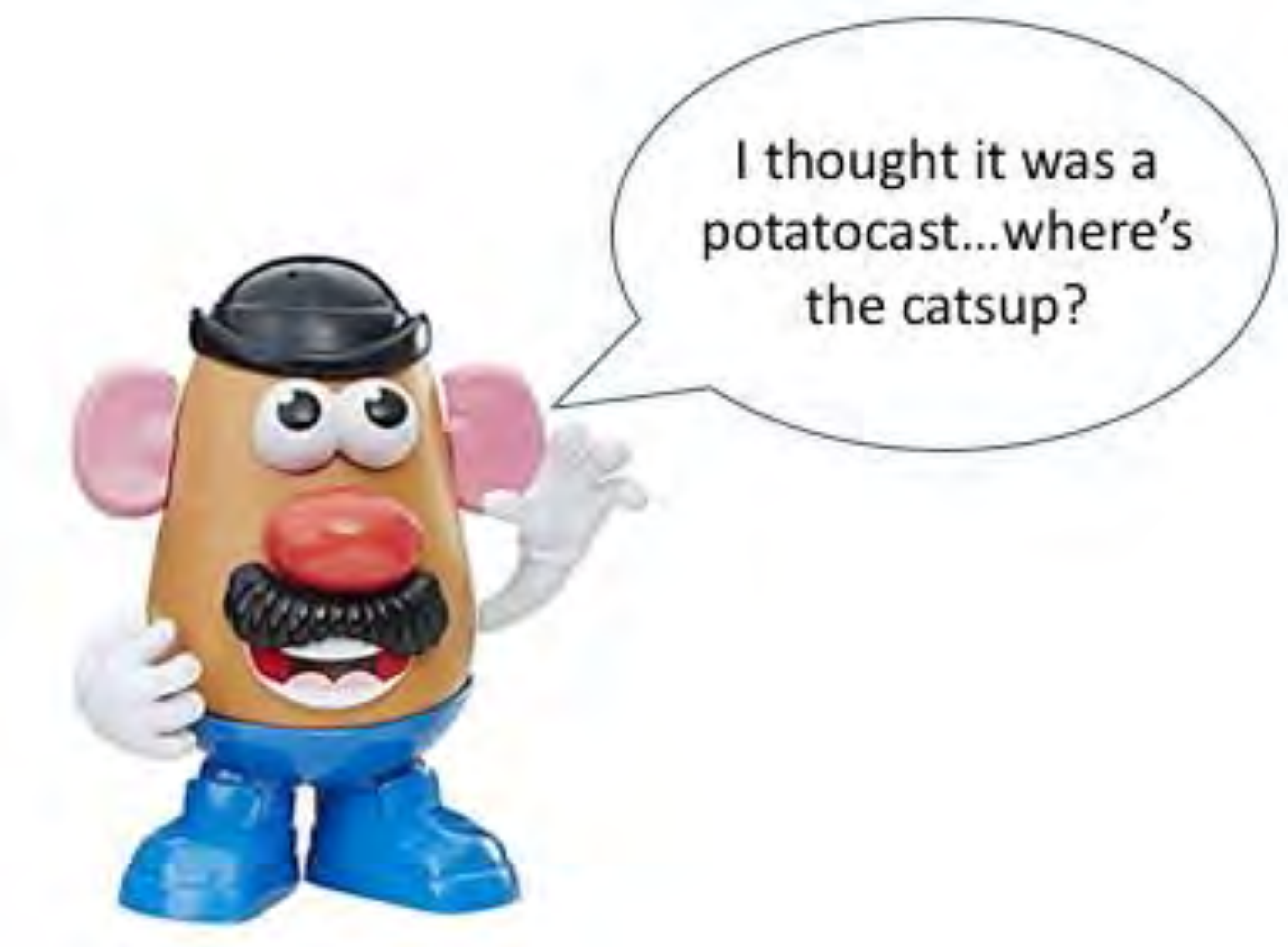
Eric Clapton's next scheduled live performances at Royal Albert Hall in London are May 13, 15 and 16, 2019.

The Album 24 Nights is the fifth live album by Eric Clapton. It was recorded live from twenty-four nights of performances at Royal Albert Hall that were given in 1990 and 1991 and released on October 8, 1991. This double album is a 'must have' for all Thursday Report readers.

Visit our booth at the University of Florida Tax Institute in Tampa at the Downtown Marriott next Wednesday through Friday, February 27th thru March 1st.

Those who attend this conference will have a special discount offer to acquire the following products for $99 each, and Alan will donate $124 for each product sold to the Dennis Calfee Chair.

Be there or be chair!



Your Irrevocable Trust Can Be Modified

by John Beck

Many people assume that because their trust is irrevocable, that it is impossible to change any of its terms. In Florida, and in many other states around the country, an irrevocable trust can be changed through a method called decanting.

Decanting was first authorized in the state of Florida via case law. In the Florida Supreme Court Case, Phillips v. Palm Beach Trust Company, 196 So. 299 (Fla. 1940) the court allowed a trustee to transfer all of the assets from an existing trust into a new trust. The court held that this was permissible because the second trust did not include any beneficiaries who were not beneficiaries of the first trust and the trustee had the absolute power to invade trust assets.

In 2014 the Florida courts again approved the decanting of an irrevocable trust in Peck v. Peck, 133 So. 3d 587 (Fla. 2d DCA 2014). In this case, the court reasoned that all of the interested parties agreed to the decanting and that the trust's terms did not prevent decanting in this specific instance.

The Florida Legislature did not codify this rule until 2007, when it enacted Fla. Stat. 736.04117. This statute required a trustee to have absolute discretion to invade the assets of the trust in order for the trust to be decanted. Although this statute may have been beneficial for a few irrevocable trusts, most trusts include language that restrict distributions to health, education, maintenance and support, or some other ascertainable standard. If such a standard was included in a trust (as it is in most trusts) the only option to decant that trust would be to rely on Florida common law.

In 2018, the Florida Senate approved House Bill 413, which modified Fla. Stat. 736.04117 to provide much more flexibility in which trusts could be decanted. Virtually all Florida irrevocable trusts can now be decanted, to varying degrees, without the need to rely on case law.

Updated Fla. Stat. 736.04117 now provides the ability to decant a trust when the trustee does not have absolute power to invade trust assets as long as the new trust grants each beneficiary of the first trust a substantially similar interests. “Substantially similar” is defined in the Statute as meaning “there is no material change in a beneficiary’s beneficial interest or in the power to make distributions and that the power to make a distribution under a second trust for the benefit of a beneficiary who is an individual is substantially similar to the power under the first trust to make a distribution directly to the beneficiary.”

This is a powerful estate planning tool as it allows practitioners to modify irrevocable trusts that may have tax inefficient provisions or to update the trust language to better suit the client’s desires. The new trust cannot grant new powers of appointment, or make any substantial modifications to existing powers of appointment.

If the trustee has an absolute power to invade the principal of the trust, the trust can be amended in any fashion mentioned above, plus a power of appointment can be added or modified for any of the current trust beneficiaries. Here again, only the beneficiaries of the first trust are allowed to be beneficiaries of the new trust. If a beneficiary is not vested, that beneficiary could be completely removed from the new trust.

Practitioners need to consider the effect of this statute when drafting trusts for their clients. If a client wants to make sure that the trust cannot be decanted, language can be added to the trust to prevent application of Fla. Stat. 736.04117. On the other hand, if the grantor of the trust wants to ensure that the terms of the trust can be changed going forward, language could be put in the trust to specify how, and to what extent, the trust may be decanted in the future.

Although the modifications that can be made to a trust through the Florida Decanting Statute are not unlimited, they do provide great flexibility in the modification of irrevocable trusts and give practitioners comfort in knowing that decanting has been blessed by the Florida Legislature.

Competitor Targeting on Google – Is It Legal?

By Kelsey Weiss

Imagine owning a company and googling your company name only to see that your competitor’s ad is the first thing to pop up! When this happens, your competitor has used Adwords, Google’s advertising service, and “bid” to use your company name as a search term. Not only is this a common scenario, but it is most likely entirely legal.

Interestingly, Google previously banned the practice of bidding on keywords of competitors. Google lifted this ban in 2008 in a successful effort to increase revenue from advertising. Since 2008, the practice known as “competitor targeting” has been permitted by Google as long as Google’s other policies are followed.
Although Google has a strict policy against trademark violation, Google does not consider search terms or keywords to a violation. In other words, Google will not permit the use of trademarked brand names in the text of ads or in the URL of ads (unless the user has a valid license to use the trademark). However, according to the Adwords website, “Google will not investigate or restrict the use of trademark terms in keywords, even if a

trademark complaint is received."

Users likely click on the first relevant result that appears after a search. Therefore, the chances of your competitor winning that click are higher if they are competitively targeting your audience. On one hand, you must be doing something right if your competitor is willing to spend a significant amount of money to advertise to your target audience. On the other hand, it is important to protect the reputation of your brand and ensure that when users search for you, they actually find you and are not instead directed to your competition.

Six Initial Steps to Consider:

If you become a victim of competitive targeting and Google will not step in, consider the following six tips:

1. Check other search engines to see the full scope of the problem.

If your competitor is using Google to target your audience, they are most likely also using Google's search partners as well as other search engines. In any case, it is best to start by looking into exactly how far your competitor has been willing to go to intercept your audience.

For example, Google frequently partners with websites such as Amazon, AOL, Ask, and Dogpile in an effort to better user experience. Additionally, other search engines such as Bing and Yahoo allow users to bid for keywords and search terms on their advertising platforms.

2. Check for potential trademark infringement.

While competitor targeting is permitted, trademark infringement is not. If your competitor has used the name of your company or brand in the text of their ad, you have several options. First, this can be used as leverage in requesting removal of the ad. Second, if your competitor is infringing your trademark, they are also violating Google's policies and will have to face those consequences. Lastly, depending on the level of infringement and damages caused, a lawsuit against the infringer may be viable.

3. Accept that neither Google nor your competitor has to take down the ad.

If your competitor is engaging in true competitor targeting, and not trademark infringement, it is important to accept that they are not required to take down the ad. Additionally, Google has made it clear that it will not get involved. Therefore, take a step back, realize that this is an allowed practice, and form a game plan using the following tips.

4. Ask your competitor to stop running the ad.

It is quite common for companies to use outside agencies to handle advertisement. In such cases, your competitor might not even be aware that they are involved in competitor targeting! Therefore, before taking any drastic action, it may be best to simply communicate with your competitor first. If you find that they are actively trying to reroute your audience to their sites, then use this as an opportunity to politely inform them that not only are you aware of what they are doing, but that you will not be sitting idly by.

5. Bid on yourself.

The first option you have now is to do what your competitor has done and place a bid on your own company name. As is common with any form of bidding, the highest bid will usually win. Therefore, determine how much this is worth to you and your brand and start engaging in the practice yourself.

6. Consider fighting fire with fire.

Lastly, you have the option of placing bids on the keywords and search terms of your competitor. However, it is important to note that the same trademark policies will apply to you. Additionally, it may not be smart to enter into an unnecessary bidding war. In that case, the search engine is the real winner. Consider strategizing with your legal team before going to war.

Legal Implications:

With regards to law firms in particular, many have argued that the practice of competitive targeting is a violation of ethics rules. Each state bar association adopts its own set of rules, but they mostly fall in line with the American Bar Association Model Rules of Professional Conduct.

The American Bar Association Rule 7.1 states that, "A lawyer shall not make a false or misleading communication about the lawyer or the lawyer's services. A communication is false or misleading if it contains a material misrepresentation of fact or law, or omits a fact necessary to make the statement considered as a whole not materially misleading."

Additionally, ABA Rule 8.4 (c) states that "It is professional misconduct for a lawyer to . . . engage in conduct involving dishonesty, fraud, deceit or misrepresentation..."

Some states have used these rules to issue advisory opinions declaring it unethical to bid on the names of competitor firms in advertisements. For example, 2010 North Carolina Formal Ethics Opinion #14 specifically called out this practice as professional misconduct. Florida issued a similar proposed advisory opinion in 2012, but it faced severe criticism and was never published.

Many law firms have also attempted to bring lawsuits against competitor firms for competitive targeting but have been unsuccessful.

In a 2018 federal case, the law firm of Helmer, Conley, & Kasselman alleged that Hark & Hark, a competing firm, "wrongly used Google's sponsored search program (Google Ads) to divert clients/potential clients away from Helmer, Conley & Kasselman, P.A. by using the Helmer, Conley & Kassleman, P.A. firm name to attract clients and then re-directing them to Hark & Hark instead." The plaintiffs brought a claim under the Lanham Act for false advertising and false association. They also brought claims for unfair competition and identity theft under state statutes as well as many common law claims including unfair competition.

The New Jersey Court initially sided with the plaintiffs and issued a temporary restraining order and preliminary injunction that banned Hark & Hark from any marketing on Google Ads. Unfortunately, however, there is no binding opinion from the Court on this matter because the plaintiffs voluntarily dismissed the lawsuit on August 28, 2018. Hark & Hark were issued a permanent injunction to stop using such marketing tactics and provided a sworn declaration of cancellation for use of the search terms and keywords.

As opposed to a suit for trademark infringement, the plaintiffs in the 2013 Wisconsin case, *Habush v. Cannon*, took an alternate approach and sued under a theory of state publicity rights law (because the defendant's ad itself did not contain the names of the plaintiffs). In this case, the defendant, Cannon & Dunphy, bought keywords such as "Habush" and "Rottier." Therefore, when users searched for the competitor firm Habush, Habush & Rottier, the users would instead see the ad for Cannon & Dunphy.

According to the Appellate Court, by using the names as "invisible" ad triggers, the defendants did not make an actionable "use" of the names Habush or Rottier. The court likened this type of advertising to the defendant's buying a physical billboard and advertising next to the plaintiff's office location. Based on this ruling, if there is no trademark infringement, a publicity rights argument is likely to fail.

The legal ramifications of competitive targeting remain murky, especially for lawyers. If you find that your name or brand has been bid on, please consider following the six tips detailed above. We also recommend consulting with your legal team before engaging in any activity that could potentially land you in hot water.

Richard Connolly's World

Insurance advisor Richard Connolly of Ward & Connolly in Columbus, Ohio often shares pertinent articles found in well-known publications such as *The Wall Street Journal*, *Barron's*, and *The New York Times*. Each issue we feature some of Richard's recommendations with links to the articles.

click here to see announcement

In November, the IRS announced that individuals taking advantage of the increased gift and estate tax exclusion amounts in effect from 2018 to 2025 **will not be adversely impacted** a**fter 2025 when the exclusion amount is scheduled to drop to pre-2018 levels.**

Back to top

Humor-or something similar…

NOTES FROM OUR READERS:

Dear Thursday Report:

I love what you do, even though it is squirrelly.

Your friend,

Rocky the Squirrel

****

Dear Thursday Report:

I am always 'amoosed' at what you guys do, but please take me off of your mailing list, as that is how Boris and Natasha seem to be tracking my whereabouts.

Please also cancel my subscription and ask Dudley Do-Right to stop calling us about Amway.

Bullwinkle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KENNETH J. CROTTY
CHRISTOPHER J. DENICOLO
EMIL G. PRATESI
BRANDON L. KETRON
THE DOG HAD
A RUFF DAY


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Whether you need to touch up on your bankruptcy law, the IRA stretch rules, or the new 199A regulations we have you covered.

These books and presentations are sure to enlighten, educate and enrich the knowledge of all who read them.

*Presentation packages with webinars include Florida CPE credit

Alan Gassman
agassman@gassmanpa.com

Regardless of how good the read is... always be aware of your surroundings in Gator Country!

Professor Dennis Calfee and...his chair

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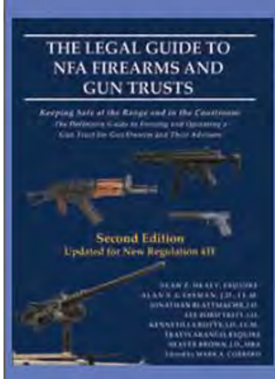

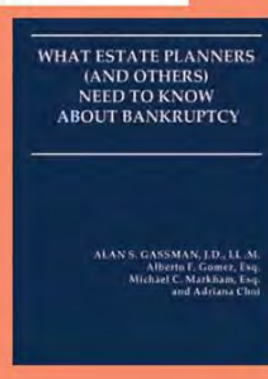

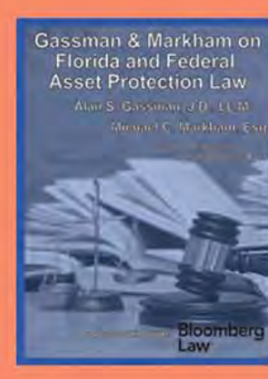

Be sure to hear Alan as he discusses the new 199A ramifications with Bloomberg…

To listen, click [HERE]

Calendar of Events

Newly announced events in RED

EVENT	DATE/TIME	LOCATION	DESC.	REGISTRATION
University of Florida Tax Law Institute Conference	February 27 - March 2, 2019,	Tampa Marriott Waterside	Check out our Silver Sponsor display table!	Please Click HERE
New Jersey Bar Association Presentation	March 11, 2019, 9:00am - 12:00PM New Jersey Law Center, New Brunswick, NJ	Strategies for Clients Who no Longer Have to Worry About Federal Estate Tax with Deirdre Wheatley		To Register click HERE
New Jersey Bar Association Presentation	March 11, 2019, 1:00 PM - 4:35 PM New Jersey Law Center, New Brunswick, NJ	*What New Jersey Lawyers Need to Know About Florida Law*		To Register click HERE
Special webinar presentation with Holly Kerr	March 5, 2019	Insurance Coverage with Holly Kerr and Alan Gassman		Email Alan at Gassman@gassmanpa.com

Special webinar presentation with John McDonald	March 6, 2019	"Selling Your Business: Advanced Planning Considerations with Chris Denicolo and John McDonald"		Email Alan at Gassman@gassmanpa.com
9th Annual Pinellas County Medical Association Continuing Medical Education Cruise	March 14-18, 2019 	Port of Tampa	Biggest Mistakes Physicians Make in Medical Practice	FOR INFORMATION AND RESERVATIONS CONTACT JEN BOLL 727-526-1571 / 1-800-422-0711

Florida Bar Association	April 18, 2019, 10:00 am – 2:00 PM	Stetson Tampa Law Center *Primary Florida and Federal Creditor Protection Laws, A Closer Look at Florida and Federal Creditor Exemption Laws and Planning* And *Putting it All Together with Leslie Share*	Contact: Agassman@gassmanpa.com
University of North Carolina Tax Institute	April 25-26, 2019	Creative Planning with Section 199A After the New Regulations	Contact: Agassman@gassmanpa.com
FSU FICPA Accounting Conference	May 6 – 8, 2019, Tallahassee, FL	Alan will be speaking on the new 199A finalized regulations	Contact: Agassman@gassmanpa.com
FICPA Mega CPE Conference for the TCJA	June 10 – 13, 2019	Alan will be speaking on the new 199A finalized regulations	Contact: Agassman@gassmanpa.com
MER Conference Internal Medicine for Primary Care	June 13 – 16, 2019, Chicago, IL	1. Lawsuits 101 2. Ten Biggest Mistakes That Physicians Make in Their Investment and Business Planning 3. Essential Creditor Protection & Retirement Planning Considerations. 4. 50 Ways to Leave Your Overhead & Increase Personal Productivity.	Contact: Agassman@gassmanpa.com
Maui Mastermind Financial Pillar Super Course	June 22-23, 2019	Hilton-Atlanta Airport Crucial Legal and Tax Principals for Accumulating Wealth	Please Click HERE
FICPA Accounting and Tax Conference	October 24, 2019	Estero, FL TBD	Contact: Agassman@gassmanpa.com
45th Annual Notre Dame Tax Institute	October 26-27, 2019	South Bend, Indiana TBD	Contact: Agassman@gassmanpa.com

Maui Mastermind Wealth Summit	November 3-8, 2019	Wailea Beach Resort, Maui	Essential Aspects and Decisions for Your Remarkable Financial Future	Please Click HERE