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Section 199A Implementation and IRS Examination Issues: Critical QBI Issues for Individual and Business Taxpayers

TUESDAY, FEBRUARY 11, 2020

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Michel R. Stein, Principal, **Hochman Salkin Toscher Perez**, Beverly Hills, Calif.

Steven Toscher, Principal, **Hochman Salkin Toscher Perez**, Beverly Hills, Calif.

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***Section 199A Implementation and IRS
Examination Issues: Critical QBI Issues for
Individual and Business Taxpayers***

Tuesday, February 11, 2020

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STEVEN TOSCHER specializes in civil and criminal tax controversy and litigation. He is a Certified Tax Specialist in Taxation, the State Bar of California Board of Legal Specialization, a Fellow of the American College of Tax Counsel and has received an “AV” rating from Martindale Hubbell. In addition to his law practice, Mr. Toscher has served as an Adjunct Professor at the USC Marshall School of Business since 1995, where he teaches tax procedure. He has also served on the faculty of the American Bar Association Criminal Tax Fraud Program since 1998. He is a former Internal Revenue Agent with the Internal Revenue Service and a trial attorney with the Tax Division of the United States Department of Justice in Washington where he received its Outstanding Attorney Award.

Mr. Toscher is past-Chair of the Taxation Section of the Los Angeles County Bar Association and served as a member of the Editorial Board for the Los Angeles Lawyer during 1996-1999. He is a member of the Accounting and Tax Advisory Board of California State University, Los Angeles, Office of Continuing Education.

Mr. Toscher was the 2018 recipient of the Joanne M. Garvey Award. The award is given annually to recognize lifetime achievement and outstanding contributions to the field of tax law by a senior member of the California tax bar.

Mr. Toscher is a frequent lecturer to professional groups and author on civil and criminal tax controversy topics. He is frequent contributor to the Los Angeles Lawyer, The Journal of Tax Practice and Procedure and Tax Management Bureau of National Affairs. He is a co-author of “Tax Crimes,” Bureau of National Affairs - Tax Management, Publication 636 2nd.

Mr. Toscher received his Bachelor’s Degree in Accounting from the University of Nevada, Las Vegas (with honors), and received his Law Degree from the University of San Diego (summa cum laude). Mr. Toscher is a member of the State Bars of California, Nevada, and Colorado. Mr. Toscher has been a member of the Faculty of the ABA Criminal Fraud Program for many years.



MICHEL R. STEIN is a principal at Hochman Salkin Toscher Perez, specializing in controversies, as well as tax planning for individuals, businesses and corporations. For almost 20 years, he has represented individuals with sensitive issue civil tax examinations where substantial penalty issues may arise, and extensively advised individuals on foreign and domestic voluntary disclosures regarding foreign account and asset compliance matters.

Mr. Stein is well respected for his expertise and judgment in handling matters arising from the U.S. Government's ongoing enforcement efforts regarding undeclared interests in foreign financial accounts and assets, including various methods of participating in a timely voluntary disclosure to minimize potential exposure to civil tax penalties and avoiding a criminal tax prosecution referral. He has assisted hundreds of individuals who have come into compliance with their foreign reporting requirements through the OVDP, Streamline or otherwise.

Throughout his career, Mr. Stein has represented thousands of individual, business and corporate taxpayers involved in civil examinations and administrative appeals, tax collection matters as well as with possible assertions of fraudulent conduct and in defending criminal tax investigations and prosecutions at every administrative level within the IRS. He has litigated tax cases in the U.S. Tax Court, the U.S. District Court, and various U.S. Circuit Courts of Appeal. He continues to provide tax advice to taxpayer's and their advisors around the world.



CORY STIGILE specializes in tax controversies as well as tax, business, and international tax. His representation includes Federal and state tax controversy matters and tax litigation, including sensitive tax-related examinations and investigations for individuals, business enterprises, partnerships, limited liability companies, and corporations. His practice also includes complex civil tax examinations, administrative appeals and tax collection proceedings (where he is widely respected for achieving meaningful resolutions of difficult tax collection issues). Mr. Stigile frequently writes and lectures on topics involving taxation.

His more recent speaking engagements include “Back to Basics on The Ethics of Federal Tax Practice: Best Practices 101” for the American Bar Association Tax Section, “The Administrative Tax Controversy Case from Examination to Appeals” for the ABA Tax Section, “Tax Settlements – IRS Appeals, FTB Settlement Bureau and CDTPA Settlement Section” for the Channel Counties Santa Barbara Discussion Group of CalCPA, “Income Tax Update” for California State University, Los Angeles, “Tax Identity Theft” for the Taxation Technical Committee of the Los Angeles Chapter of CalCPA, “Best Practices in ‘Settling’ Cases with the IRS and FTB for the Glendale Estate Planning Counsel, the “IRS Audit Programs and Other Hot Tax Controversy Issues” for the Santa Clarita Valley Discussion Group of the Los Angeles Chapter of CalCPA, “Updates on Civil and Criminal Tax (Federal) for the Best of CLE program in Santa Monica, California, and the “Tips and Tricks for IRS, FTB & SBE Settlements” panel at the Los Angeles County Bar Association Practitioner’s Conference. He was also interviewed by Bloomberg Law regarding IRS Wealth Squad audits focusing on the super-rich. Mr. Stigile was awarded the distinction of Super Lawyer Rising Star in 2012 through 2016, as recognized and published in Los Angeles Magazine. He is also on the Planning Committee of the Annual UCLA Extension Tax Controversy Institute and a member of the Western States Bar Association.

QUALIFIED TRADE OR BUSINESS

- **Types of Business**
 - Sole proprietorship
 - Partnership
 - S Corporation
 - Real estate investment trust
 - Trust
- **Trade or Business**
 - “IRC Section 162 / Case Law. See final regulations.
 - Groetzinger, 480 US 23 (1987). Gambling could be a trade or business.
 - Continuity and regularity.
 - Primary purpose to earn a profit.
 - Performance over a substantial period of time.

QUALIFIED TRADE OR BUSINESS (cont.)

- **Items that are Not a Qualified Trade or Business**
 - Performing Services as employee
 - Payments to independent contractors
 - Partners guaranteed payments
 - Earnings from investments such as capital gains, dividends and interest
 - Specified services trade or business “unless under thresholds”
- **Issue Concerning Real Estate**
- **Qualified Business Income**
- **Reasonable Compensation Issue**

IRC Section 199A Timeline and Audit Cycle

- **Legislation Enacted 12/22/17 (effective tax years beginning on or after 1/1/18, and through 2027)**
- **Proposed Regulations – August, 2018**
- **Rev. Proc. 2018-64**
- **Rental Real Estate Safe Harbor–1/18/19 (Notice 2019-07)**
- **Final Regs – 2/1/19 (and separate COOP Regs)**
- **FAQ's – Last updated 1/10/20**
 - <https://www.irs.gov/newsroom/tax-cuts-and-jobs-act-provision-11011-section-199a-qualified-business-income-deduction-faqs>
- **2018 Form 1040's first filed by 4/15/19, or 10/15/19 with extension**
- **Should start seeing examinations within next year**

Trade or Business Vs. Hobby Analysis

- **2018 Proposed Regulations**
 - **Defines trade or business as a trade or business under section 162**
 - **Reg. §1.199A-1(b)(14)**
- **Cases addressing Section 162 often cite Groetzinger, 480 US 23 (1987).**
 - **Trade or Business vs. Hobby or Investment Activities**
 - **i.e. Regular, continuous, and substantial activities in connection with a trade or business operated to generate a profit.**
- **Note – TCJA’s Elimination of miscellaneous itemized deductions (i.e. Section 212 or 183 expenses) (IRC Section 67(g)).**
 - **Enhanced incentive to substantiate profit motive and nature of activities.**

Trade or Business Vs. Investment Analysis

- **Real Estate Example**
 - Real estate can be a trade or business, an investment, or personal
 - How many properties?
 - Extent of involvement in business
 - Profitability
- **Compare with case law regarding IRC Section 162 and passive losses (i.e. taxpayers seeking to establish that a business experiencing losses in early years is not a hobby or investment)**
 - Vs. with IRC Section 199A, the taxpayer is seeking a deduction for income with limitations based on wage/deployment of capital.
 - Flips to establishing a profitable enterprise is not a business.
 - See below RE aggregation

Trade or Business Analysis – Real Estate Cont'd

- **Rental Real Estate Safe Harbor**
- **Notice 2019-7**
 - IRS Recognition of Uncertainty
 - Even if safe harbor is not met, can still meet trade or business requirements under IRC Section 162
 - Rental real estate enterprises include activities in relevant passthrough entities (RPEs)

Trade or Business Analysis – Real Estate Cont'd

- **Rental Real Estate Safe Harbor Requirements**
 - 250 hours/ year for years beginning before 1/1/23; 250 hours / year
 - 3/5 consecutive taxable years for years beginning after 12/31/22;
 - Commercial and Residential cannot be combined
 - Stuck with treatment unless significant change in facts
 - No Triple Net Leases
 - Separate books and records for each real estate enterprise
 - Contemporaneous records (hours, service descriptions/dates, who performed)
 - Records requirement doesn't apply to 2018
 - Rental services do not include finance / investment
 - Taxpayer Statement (penalty of perjury)
- **Note parallels to passive loss regime.**

SPECIFIED SERVICES TRADE OR BUSINESS

- **The General List**

- Health.
- Law.
- Accounting.
- Actuarial Science.
- Performing Arts.
- Consulting.
- Athletics.
- Financial Services.
- Brokerage Services.
- Investing and investment management.
- Any trade or business where the principal asset is reputation or skill of one or more of its employees.

- **Phase Out Amounts**

SPECIFIED SERVICES TRADE OR BUSINESS (cont.)

- **Some Additional Clarifications**

- Health services generally means performance of medical services by individuals directly to a patient or subject. Includes veterinarians but not health clubs, exercise programs, skilled nursing facilities or sales of pharmaceuticals or medical devices.
- Law services does not include things you need to facilitate law practice such as clerical services, printing or delivery.
- Performing arts covers performance by individuals such as actors, singers, musicians, entertainers, directors, and similar professions. It does not include non-performers such as operators of equipment or facilities.
- Consulting includes lobbying but does not include supplying training or educational courses. Also, does not cover consulting embedded in the sale of goods or performance of services.

SPECIFIED SERVICES TRADE OR BUSINESS (cont.)

- **Some Additional Clarifications (cont.)**
 - Athletics covers participants and coaches but does not cover people in maintenance and operation of equipment or facilities or people who broadcast or disseminate video or audio of athletic events to the public. However, it may include the ownership of a professional sports team.
 - Brokerage services cover stock brokers but does not cover real estate brokers or insurance agents.
 - Investing in investment management covers investment in securities but does not cover management of real estate. Banks are excluded.
 - Reputation or skill of an individual is limited to amounts paid for endorsements or licenses of their image, name, voice, trademark or other symbol or appearing on some type of media. It does not include a contractor or someone in the building trades who has a secondary meaning to their name, such as John Smith, Contractor.
- **Specific Exclusions: Architects and Engineers**

SPECIFIED SERVICES TRADE OR BUSINESS (cont.)

- **De Minimus Rule**
 - For trades of business with gross receipts of less than \$25 million, the trade or business is not a specified service if less than 10% of the gross receipts are attributable to a specified service.
 - If trade or business has gross receipts of \$25 million or more, the trade or business is not a specialized service trade or business if less than 5% of the gross receipts are attributable to a specialized services trade or business.
 - A non-specified trade or business might be treated as a specialized service trade or business if:
 - Non-specified services trade or business provides at least 80% of its property or services to a specialized services trade or business and
 - There is at least 50% common ownership between the two businesses.

SPECIFIED SERVICES TRADE OR BUSINESS (cont.)

- **Getting Pulled into SSTB States**
 - If (i) at least 50% common ownership, (ii) non-SSTB trade or business and SSTB share expenses including wages or overhead and (iii) gross receipts of non-SSTB is no more than 5% of combined gross receipts, the non-SSTB trade or business will be treated as an SSTB.

AGGREGATION

- **Purpose**
 - Where one of the related group of businesses generates income and another related business pays wages. For example, a home building organization with a construction corporation, sale corporation, and administrative corporation.
- **Constructive Ownership**
 - Constructive ownership covers parents, children grandchildren and spouses but not siblings.
- **Requirements for Aggregation**
 - Same person or groups of persons directly or indirectly own 50% or more of the trades or businesses. For S corporations its ownership of stock. For partnerships it is either capital or profits. There must be common ownership by the same person or group of persons owning 50% or more.
 - All of the items attributable to each trade or business are reported on returns of the same taxable year.
 - None of the trades or businesses are specified services trades or businesses.

AGGREGATION (cont.)

- **Requirements for Aggregation (cont.)**
 - Same person or groups of persons directly or indirectly own 50% or more interest in each of the trades or businesses. For S corporations its ownership of stock. For partnerships it is either capital or profits. There must be common ownership by the same person or group of persons owning 50% or more.
 - All of the items attributable to each trade or business are reported on returns of the same taxable year.
 - None of the trades or businesses are specified services trades or businesses.
 - The trades or businesses satisfy the relationship requirement by satisfying at least two of the three factors:
 - Trades or businesses provide products and services that are the same or customarily offered together.
 - Trades or businesses share facilities or share significant centralized business elements such as personnel, accounting, legal, manufacturing, purchasing, human resources or information technology resources.
 - Trade or businesses are operated in coordination with or in reliance upon one or more of the businesses in the aggregated groups.

Aggregation Considerations

- **Consider past/parallel reporting positions:**
 - **Passive losses**
 - “Significant Participation Activities”
 - Election to group activities (Cannot regroup - Regs. Sec. 1.469-4(e))
 - **Aggregation for IRC Section 162 deduction / NOL purposes**
- **Combined benefit/detriment of grouping in light of different regimes.**
- **Protective Claims**

AGGREGATION (cont.)

- **Trusts and Estates May be Aggregated with Individuals**
 - This is tied to the relative proportion of the trust or estates distributable net income retained or distributed.
- **Continuing Requirement**
 - Once there is aggregation, it must continue for future years unless the aggregation requirements are no longer met.

Aggregation Considerations

- **Aggregation Disclosure (FAQs), Cont'd**
 - Q25. Do I need to disclose my aggregated trades or businesses when I use the simplified worksheet in the Instructions for Form 1040 to calculate the QBI deduction?
 - A25. Yes, taxpayers should disclose their aggregations regardless of which worksheet they use to compute the QBI deduction. A failure to aggregate will not be considered to be an aggregation for purposes of the consistency requirement. So, if the taxpayer is under the threshold in 2018 and there is not a need to aggregate, it would not prevent the taxpayer from aggregating in a subsequent year when the taxpayer's taxable income exceeds the threshold amount.

Disclosure of 199A Positions

- **Consider disclosing methodologies for 199A and other reporting positions**
 - Not just 199A Aggregation positions
 - Additional Disclosure with Form 8275
 - Set forth factual basis, methodology, and authorities to support position
 - May provide penalty mitigation for substantial understatements

ALLOCATION RULES

Where taxpayer directly conducts multiple qualified trades or businesses and has items of qualified business income that are attributable to more than one qualified trade or business, the material items must be allocated among the several trades or business to which they are attributable using a reasonable method based on all facts and circumstances. Must be consistent with books and records, must be consistent from year to year, and must clearly reflect the income and expense of each trade or business.

ANTI-ABUSE RULE

- **Multiple Trusts**
- **Other Devices**

UNADJUSTED BASIS IMMEDIATELY AFTER ACQUISITION

- **Depreciable Period or If Longer, 10 Years**
- **Must Be In Use During Year**
- **Must be Held on Last Day of Year**

Thank You

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