59th Annual

Southwestern Ohio Tax Institute

Presented by the Cincinnati Bar Association Taxation Practice Group

Friday, December 7, 2018

59th ANNUAL

SOUTHWESTERN OHIO TAX INSTITUTE
DECEMBER 7, 2018

AGENDA

8 a.m.	**Registration & Continental Breakfast**	
8:25 a.m.	**Welcome & Opening Remarks** Benjamin D. Cramer, Esq., *Chair, CBA Taxation Practice Group*	
8:30 a.m.	**Ohio State & Local Tax Update** Jeremy A. Hayden, Esq. and Christopher T. Tassone, Esq., *Frost Brown Todd LLC*	**TAB A**
9:30 a.m.	**Best Practices for Drafting Operating Agreements in Light of Recent Changes in IRS Audit Rules for LLCs and Partnerships** Howard L. Richshafer, Esq., *Wood & Lamping LLP*	**TAB B**
10:30 a.m.	**Break**	
10:45 a.m.	**Opportunity Knocks: Understanding the Federal Opportunity Zone Program** Colleen M. Haas, Esq., *Frost Brown Todd LLC*	**TAB C**
11:15 a.m.	**Section 199A Qualified Business Income Deduction – Background and Planning Opportunities** Bill Tucker, C.P.A., Nichole Williams, C.P.A. and John Wolfenden, J.D., *Truepoint Wealth Counsel LLC*	**TAB D**
12 p.m.	**Interacting with the Office of Chief Counsel: Tips & Suggestions** Richard J. Hassebrock, Esq., *Senior Counsel, Small Business/ Self-Employed Division, Office of Chief Counsel, IRS, Cincinnati, OH*	**TAB E**
12:30 p.m.	**Adjourn**	

TAB
A

Jeremy A. Hayden
Member, *Frost Brown Todd LLC*

Jeremy A. Hayden is a Member of Frost Brown Todd. Jeremy has held several leadership roles within the firm, including chairing the firm's State and Local Tax, Entrepreneurial Services, and Estate Planning practice groups, respectively and he has served on the firm's Client Relations committee. Jeremy is also active in many community and professional organizations.

Jeremy regularly represents both taxpayers and governmental clients on state and local tax matters, including the litigation of significant tax controversies. Representative clients include Lexmark, CSX, UPS, NASCAR, and JB Hunt along with many mid-market companies.

Mr. Hayden is an adjunct faculty member at the University of Cincinnati College of Law where he teaches State and Local Taxation. Mr. Hayden is also the lead author on the Ohio Commercial Activity Tax treatise for Thomson Reuter's Checkpoint Catalyst.

Mr. Hayden received his J.D. from the University of Kentucky College of Law and his Masters in Taxation from the University of Cincinnati. Mr. Hayden received the *Young Professional Alumni Award* from the University of Kentucky College of Law, and he has been recognized as a member of the *40 Under Forty* by the Cincinnati Business Courier, an *Ohio Super Lawyers® Rising Star* by Thomson Reuters, and for inclusion in *The Best Lawyers in America* for Mergers and Acquisitions.

Christopher T. Tassone
Associate, *Frost Brown Todd LLC*

Chris is an associate in Frost Brown Todd's Cincinnati office. His practice focuses on tax and corporate law. He counsels individuals and businesses on a wide range of federal, state, and local tax issues. He regularly represents clients before the IRS and in proceedings with the Ohio Board of Tax Appeals. Prior to joining FBT, Chris worked in the National Tax Department of Ernst & Young, LLP where he focused in the areas of tax credits, economic incentives, and excise taxes.

Chris is a graduate of the University of South Carolina and the Ohio State University Moritz College of Law. Chris is also an adjunct professor at the University of Cincinnati College of Law where he teaches State and Local Taxation.

Ohio State & Local Tax Update

Southwestern Ohio Tax Institute

By: Jeremy Hayden and Chris Tassone

December 7, 2018

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Presentation Overview

I. Ohio Commercial Activity Tax
II. U.S. Constitutional Case Update
III. Ohio Sales and Use Tax
IV. Ohio Municipal Income Tax
V. Ohio Personal Income Tax
VI. Ohio Real Property Tax
VII. Procedural Issues & Miscellaneous

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I. Ohio Commercial Activity Tax

A. Situsing

1. <u>SMK Industries, LTD. v. Testa</u>, BTA 2017-703 (Apr. 30, 2018)

- Out-of-state clothing manufacturer completed sales of merchandise to Ohio customers.
- The manufacturer argued its gross receipts were not sitused to Ohio because it delivers the merchandise to the buyers in the state of Texas (specifically, its warehouse in El Paso), not the state of Ohio.
- BTA reviewed R.C. 5751.033(E) which provides that gross receipts for tangible personal property are sitused where property is received after all transportation is complete when delivered by motor carrier.
- Key inquiry is the "ultimate destination" of the goods, not where title transfers when delivered to common carrier.
- The BTA affirmed its holding in *Dupps Co. (*which confronted an opposite set of facts, but still ruling that goods that are "ultimately received" outside of Ohio should <u>not be sitused</u> to Ohio).
- **Holding – Because gross receipts were based on sales with Ohio "ship to" addresses, they were subject to CAT. Assessment and penalties were valid.**

I. Ohio Commercial Activity Tax

A. Situsing

2. <u>Defender Security Company D/B/A Defender Direct v. Testa</u>, BTA 2016-1030 (Mar. 6, 2018)

- Authorized dealer for security services sold alarm services contracts for customers based in Ohio to ADT for a fee.
- Taxpayer applied for a refund of CAT paid on these contracts under the argument that the contracts should not be sitused to Ohio since ADT "receives the benefit of the contracts outside Ohio", i.e., at the location of ADT's principal place of business (out of state).
- BTA reviewed R.C. 5751.033(I) which provides that gross receipts for the sale of services shall be sitused based on the purchaser's benefit in the state.
- The BTA ruled against the taxpayer because the benefit to ADT of the alarm services contracts is wholly received in Ohio, where the ultimate security monitoring services are provided to protect individuals and property in Ohio.
- **Holding – Because gross receipts were based on contracts for services in Ohio, they were subject to CAT. Denial of refund upheld.**

I. Ohio Commercial Activity Tax

A. Situsing (and Sufficiency of Evidence)

3. <u>USC Consulting Group v. Testa</u>, BTA 2017-2246 (Jun. 8, 2018)

- Management consulting company was assessed CAT liability and penalties based on the services provided to its customers in Ohio.
- The commissioner evaluated the receipts based on R.C. 5751.033(I) with respect to the proportion of the purchaser's benefit in the state.
- The taxpayer argued that it performed consulting services for the benefit of the customer's plant locations outside of Ohio, but the payments were made from the customer's billing address in Ohio. Thus, no benefit was actually received in Ohio and sales should be sitused elsewhere.
- Taxpayer unfortunately did not provide any evidence to substantiate this contention beyond what was provided in the Notice of Appeal.
- **Holding – Because taxpayer did not provide evidence supporting its situsing methodology, it failed to meet its burden on appeal to demonstrate error in the commissioner's determination. Assessment and penalties upheld.**

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I. Ohio Commercial Activity Tax

B. Agency Exemption

1. <u>Willoughby Hills Dev. & Distrib., Inc. v. Testa</u>, Ohio Supreme Court, Slip Opinion No. 2018-Ohio-4488 (Nov. 7, 2018)

- Court upheld BTA decision denying agency exemption under R.C. 5751.01(F)(2)(I) to a third-party fuel supplier that distributed Sunoco fuels to gas stations.
- Taxpayer argued that, despite contract language to the contrary, it was effectively an agent of Sunoco under the *control test*, such that Sunoco exercises control over taxpayer through its brand and image requirements. Sunoco also exercised control over the credit-card programs that taxpayer helped to implement with customers.
- Court rejected *control test* and focused on the contract language in rejecting principal-agent relationship:
  - Explicit disclaimer of taxpayer as agent for Sunoco
  - Taxpayer had no actual authority; needed Sunoco's approval to enter commitments/obligations
- **Holding – No actual agency-principal relationship, agency exclusion was disallowed. Denial of refund valid.**

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I. Ohio Commercial Activity Tax

C. Penalty Abatement

1. FGI Holdings, LLC v. Testa, BTA 2017-2275 (May 23, 2018)

- Taxpayer failed to file CAT returns between Jan. 2014 and Jun. 2016.
- Taxpayer requested abatement of penalty assessed for failure to file because it was unaware of its obligation to file the returns.
- **Holding - The BTA affirmed the penalties because the taxpayer presented no evidence that the commissioner abused his discretion and the commissioner's conduct complied with R.C. 5751.06. Further, the taxpayer had not paid any of the outstanding taxes assessed as of the date of the final determination.**
- Contrast this with the decision in Renacci v. Testa (2016), in which the Ohio Supreme Court held that the imposition of penalties was unlawful because the payment delay resulted from a legal dispute about the taxability of the income, and the taxpayers had reasonable cause to resist paying the tax based on a reasonable interpretation of the Ohio statute in question.

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II. U.S. Constitutional Updates

A. *Wayfair* Decision and Constitutional Implications

1. S. Dakota v. Wayfair, Inc., 138 S. Ct. 2080, 2084 (2018)

- New SD statute required online retailers, without a physical presence in the state, to collect and remit sales tax when (on an annual basis) sellers:
  - Deliver more than $100,000 of goods and services into the state; or
  - Engage in 200 or more separate transactions for the delivery of goods and services into the state
- SCOTUS departed from *stare decisis* and struck down the physical presence test established *Quill Corp. v. North Dakota* where court upheld physical presence requirement.
- SCOTUS agreed 5-4 that SD had established a new standard for "economic nexus"

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II. U.S. Constitutional Updates

A. *Wayfair* decision and Constitutional Implications

1. <u>S. Dakota v. Wayfair, Inc.</u> (cont'd)

- SCOTUS's rationale for new economic nexus standard:
  - Safe harbor for small businesses
  - No retroactive application
  - South Dakota is a party to the Streamlined Sales Tax Agreement

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II. U.S. Constitutional Updates

B. Ohio Department of Taxation "Statement on U.S. Supreme Court Wayfair ruling"

- Issued on 6/21/2018 by Gary Gudmundson, Communications Director, Ohio Department of Taxation
- *Today's decision does not have an immediate, direct impact on Ohio. The Court ruled on the laws of another state; not on Ohio's tax laws.*
- *We anticipate that we'll see some out-of-state retailers begin to voluntary charge and collect Ohio sales tax, but otherwise sales tax rules and laws in Ohio will stay the same until the General Assembly decides whether or not to change them.*

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II. U.S. Constitutional Updates

C. Ohio's current nexus standards

- General bright line nexus
  - $50,000 in Ohio property; $50,000 in Ohio payroll; $500,000 in taxable gross receipts; or at least 25% of the person's total property, total payroll, or total taxable gross receipts within Ohio
- In-state software nexus ("cookie nexus") (R.C. 5741.01(I)(2)(h))
  - Uses in-state software to sell or lease taxable tangible personal property or services to consumers and $500,000 in gross receipts
- Network nexus (R.C. 5741.01(I)(2)(i))
  - Provides or enters into an agreement with another person to provide a content distribution network in this state to accelerate or enhance the delivery of the seller's web site to consumers and $500,000 in gross receipts
- Will these stand up under new economic nexus standards post *Wayfair*?

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III. Ohio Sales & Use Tax

A. Bad Debt Regulation Revision

- **Ohio Admin. Code § 5703-9-44**
- Department of Taxation added provision to qualify for bad debt deduction:
  - Vendor must be claimant; and
  - Bad debt deduction must appear on the books and records of vendor.
- Became effective Apr. 3, 2018.

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III. Ohio Sales & Use Tax

B. Manufacturing Exemption

1. Lafarge North America, Inc. v. Testa, 2018-Ohio-2047 (Ohio Supreme Ct. May 31, 2018)

- Pelletized-slag manufacturer used bulldozer to break up slag; loaders to transfer the slag to trucks which transported it to a screening plant; and machinery at plant to sort pieces for sale.
- The commissioner assessed use tax for bulldozers, loaders, and trucks after determining they were not part of manufacturing process. BTA affirmed.
- Ohio Adm.Code 5703-9-21(B)(1) – "Manufacturing operation begins when the raw materials or parts are committed to the manufacturing process."
- Commissioner argued that cutting slag and transporting was simply pre-production transportation of raw materials.

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III. Ohio Sales & Use Tax

B. Manufacturing Exemption (cont'd)

1. Lafarge North America, Inc. v. Testa, 2018-Ohio-2047 (Ohio Supreme Ct. May 31, 2018)

- However, slag did not undergo any significant change after arriving at screening plant. All crushing and transformational processes occur at slag mountain.
- **Holding – Activities at slag mountain were a part of the manufacturing process and associated purchases are not subject to use tax.**
- *Remanded for determination of expenses associated with slag manufacturing and landfill operations, subject to use tax, which used same vehicles.

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III. Ohio Sales & Use Tax

C. Real Property Exemptions

1. <u>Palace Hotels, LLC v. Testa</u>, BTA 2016-1300 (Mar. 5, 2018)

- Taxpayer constructed pool and recreation building adjacent to its Holiday Inn hotel.
- Tax Commissioner assessed use tax on construction of building as business fixture on grounds that the improvements would not benefit any other type of business.
- Taxpayer claims many of the improvements (*e.g.*, roof, plumbing, electrical) benefit the property generally, not the specific business conducted there, and so are not business fixtures.
- Taxpayer claims sales were construction contracts, and so construction contractor, not building owner, owes sales tax under O.A.C. 5703-9-14. Taxpayer contends the commissioner erroneously assessed tax on itemized services performed by the construction manager that are not subject to sales and use tax under Ohio law.

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III. Ohio Sales & Use Tax

C. Real Property Exemptions (cont'd)

1. <u>Palace Hotels, LLC v. Testa</u>, BTA 2016-1300 (Mar. 5, 2018)

- **Update:** BTA reversed commissioner's determination with respect to exemptions for improvements and professional services but upheld imposition of penalties and interest.
- Improvements satisfied definition of R.C. 5701.02(B) as real property and were improperly assessed.
- Therefore, professional engineering services associated with improvements were also exempt.
- However, taxpayer presented no evidence or argument supporting its contention that commissioner abused his discretion imposing penalties and interest for unpaid taxes.

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III. Ohio Sales & Use Tax

D. Reseller Exemption

1. <u>Karvo Paving Co. v. Testa</u>, BTA 2016-782 (Jan. 4, 2018)

- Construction contractor had many contracts with ODOT for repaving roads. During construction, contractor provided traffic maintenance equipment for use on-site. ODOT engineer directed <u>use</u> and <u>placement</u> of equipment.
- Contractor argued that ODOT has possession of equipment, exempting it from use taxation under R.C. 5739.01(E) because it transfers equipment in same form as it receives it.
- **Holding - Primary use of property controls. Contractor has no say in type, size, or amounts of equipment included in contract. Equipment is exempt from use taxation.**
- **Add'l holdings –**
  - **Transactions between a corporation controlled by contractor's owner and taxpayer were not taxable because they were between members of an affiliated group; and**
  - **Leases of equipment from affiliated corporation to contractor were not "casual leases" because affiliate corporation was engaged solely in the business of leasing.**

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III. Ohio Sales & Use Tax

D. Reseller Exemption (cont'd)

2. <u>The Cincinnati Reds, LLC v. Testa</u>, Slip Opinion No. 18-Ohio-4669

- "This one belongs to the Reds" as Supreme Court reverses 2017 BTA Decision.
- Use tax on promotional giveaway items – sale-for-resale exclusion.
- Cincinnati Reds argued its purchases of bobbleheads and other team merchandise given away to fans who attend certain games are not subject to use tax because they are resold as part of the cost of admission to the game.
- Prior BTA decision based on the finding that the Reds intended to "give away" promotional items for free rather than to resell them.
- Court relied heavily on BTA testimony of Reds CFO, Doug Healy.
- Facts that persuaded the Court included the following:
  - Fans were aware of the promotional items in advance of the game and purchased tickets with the "contractual expectation" to receive the items.
  - Reds provide replacement items of equivalent value (*e.g.,* other item or free tickets) to fans that did not receive the promotional item advertised.
- **Holding – Reseller exemption upheld; Supreme Court concluded the promotional items were resold, included as part of the consideration for the ticket price.**

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III. Ohio Sales & Use Tax

E. Production of Oil & Natural Gas Exemption

1. Stingray Pressure Pumping v. Testa, BTA 2015-1465 (Jan. 17, 2018)

- Taxpayer engaged in hydraulic fracturing of crude oil. Commissioner determined that silos, belts, and other equipment used to supply sand to blender where materials are mixed prior to use in fracturing operations, were subject to use tax.
- Taxpayer argued that equipment was exempt because it could not be separated from "production processes."
- BTA determined that the proper inquiry is actual usage of equipment, not sequence of events. Using the "direct use" test, the "actual drilling is the appropriate place for the commencement of the activity of production."
- **Holding – Exemption denied because equipment is adjunct to the drilling process.**
- Takeaway: exemptions are narrowly construed.

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III. Ohio Sales & Use Tax

F. Prescription Device Exemption

1. Rowitz (et. al.) v. Testa, BTA 2017-250, 2017-251, 2017-252, 2017-253 (Feb. 20, 2018)

- Taxpayer challenged commissioner's denial of sales tax refund for feminine hygiene products on 3 grounds:
  1. Subjecting products to sales tax violated Equal Protection Clauses of U.S. and Ohio Constitutions;
  2. FDA's classification of feminine hygiene products as "medical devices" preempts state taxation; and
  3. Sales of feminine hygiene products are exempt under Ohio law.
- Both commissioner and BTA acknowledged constitutional and federal preemption arguments but lacked authority to make determination.
- **Holding – Regarding third argument, feminine hygiene products not exempt under R.C. 5739.01 because that section refers to exemption for defined items that are provided under prescription per § 5739.02(B)(18) or (19).**

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III. Ohio Sales & Use Tax

F. Prescription Device Exemption (cont'd)

2. *2017 Ohio Senate Bill No. 8*

- Beginning July 1, 2019 – Corrective eyeglasses and contact lenses are exempt from sales and use tax.
- Corrective eyeglasses and contact lenses were added to the definition of "prosthetic device" in R.C. 5739.01(JJJ).
- Sales of "prosthetic devices" are exempt under R.C. 5739.02(B)(19).

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III. Ohio Sales & Use Tax

G. Sufficiency of Evidence

1. **Dal & S Mahoning, Inc. v. Testa, BTA 2016-2348 (Dec. 27, 2017)**
   - Taxpayer objected to assessment of sales tax and appealed, stating that "we have evidence showing my client was paying the correct sales tax."
   - Taxpayer did not submit any evidence to commissioner to support its objections to his assessment and provided no explanation to BTA for failing to submit evidence.
   - **Holding – Appeal denied because taxpayer never explained why it failed to present evidence of its claims to commissioner when disputing assessment.**
   - ***See also*** **CSI Controls v. Testa, BTA 2017-122 (Jan. 4, 2018)** – Assessment affirmed because taxpayer did not provide explanation for discrepancies between proof of payment and invoice amount.

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III. Ohio Sales & Use Tax

G. Sufficiency of Evidence (cont'd)

2. *See also*

- **Shapoval v. Testa, BTA 2017-484 (Feb. 26, 2018)** – Purchase of truck not exempt because taxpayer failed to present any evidence to support claim that truck was primarily used for transporting tangible personal property of others under § 5739.02(B)(32).
- **Fomo Products, Inc. v. Testa, BTA 2017-2332 (Jun. 4, 2018)** – Taxpayer's handwritten notation stating sales tax return should be used to file use tax, without further evidence, was not sufficient to reverse commissioner's determination that taxpayer failed to file use tax.
- **Monigold v. Testa, BTA 2017-181 (Jan. 4, 2018)** - Failure to present seller's affidavit attesting to purchase price to Commissioner constituted unsworn statement.

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III. Ohio Sales & Use Tax

H. Statute of Limitations

1. **City Tan, LLC and City Tan South, LLC, v. Testa, BTA 2017-579 (Apr. 23, 2018)**

- Taxpayer filed refund request for Ohio sales taxes that it intended to send to the IRS as federal excise taxes.
- Commissioner granted partial refund to amounts paid within four years of the date of filing refund application and denied the rest under Ohio's statute of limitations R.C. § 5739.07 (D).
- Taxpayer appealed to BTA relying on statement from Ohio Department of Taxation's website stating that SOL did not apply if refund was for federal adjustment.
- **Holding – Website instructions related to since-repealed corporation franchise tax. Further, Rev. Code § 5739.07(D) does not provide exception for refund claims arising from erroneously paid sales taxes due instead to federal government.**

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IV. Ohio Municipal Income Tax

A. Centralized Administration and Collection

1. Admin Ruling 5703-41-01 Effective as of January 1, 2018.

- Businesses, except for sole proprietorships and certain utilities, **may elect** to file a **single return through the Ohio Business Gateway** for all municipal net profit tax (but not employee withholding).
  - Computation and apportionment under R.C. 718.80 - 718.95
  - Administration and collection by Ohio Department of Taxation instead of by municipality or municipality's designated administrator (*e.g.*, RITA)
  - Administration includes audit, assessment, and appeals
- Election deadline is March 1 for calendar-year taxpayers.
- Election automatically renews annually unless taxpayer terminates.

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IV. Ohio Municipal Income Tax

A. Centralized Administration and Collection (cont'd)

2. <u>City of Athens, et. al. v. Ohio State Tax Commissioner</u>, Franklin County Ct. of Com. Pleas (Feb. 21, 2018)

- 160 Municipalities challenged arguing that law deprived them of home-rule authority.
- "The entire matter comes down to the resolution of one question: Does the general assembly have the constitutional authority to enact the Collection Provisions?"
  - Home Rule Amendment is not absolute.
  - General Assembly has authority to pass laws that limit power of municipalities to levy taxes.
- **Holding: The law is an appropriate exercise of the general assembly's authority.**
- Appeal filed by City of Athens on Mar. 23, 2018.

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IV. Ohio Municipal Income Tax

B. Employee Stock Options

1. Willacy v. City of Cleveland Board of Income Tax Review, BTA 2017-513 (Apr. 23, 2018)

- Taxpayer received stock options from employer as a resident of OH but did not exercise them until after retiring as a resident of FL. Employer withheld municipal income taxes and taxpayer requested a refund because income was intangible and appreciation occurred after she became a FL resident.
- **Holding – Stock options are compensation, not intangible income. They are taxable where the options were granted, not where the employee resided when exercising the options.**
- Taxpayer appealed the decision on May 18, 2018.

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V. Ohio Personal Income Tax

A. Professional Employer Organization Payment Changes

- S.B. 8 passed Dec. 22, 17
- Ohio Department of Taxation makes correction to business income deduction framework by allowing passthrough entities using PEO's to make payments to 20% or more owners to be eligible for business income deduction.
- Previously, passthrough entities using PEO's were not eligible for the deduction and were being subject to numerous audits on the premise that the owners using a PEO was not a "business owner" since often their W-2s come from the PEO, not directly from the business.
- Applies retroactively to Jan. 1, 2013.

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V. Ohio Personal Income Tax

B. Subsidized Health Insurance Premiums

- H.B. 24 passed on Mar. 30, 2018 (and effective the same date)
- Updated language to § 5747.01(a)(11)
- If taxpayer's medical care expenses exceed 7.5% of Ohio AGI, subsidized health insurance premiums are deductible retroactively for tax year 2018
- Effective as of Mar. 30, 2018

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V. Ohio Personal Income Tax

C. Pay to Play

1. Williams, Jr. v. Testa, BTA 2017-2249 (May 22, 2018); Hemmerle, Jr. v. Testa, BTA 2017-121 (Jan. 3, 2018)

- Commissioner assessed taxpayers for failing to file personal returns. Taxpayers argued they were not subject to Ohio taxes but did not pay assessed amount or file amended returns.
- **Holding – Taxpayer must have filed return and paid assessment before petitioning for reassessment.**

2. Craig, Jr. v. Testa, BTA 2017-855 (Jun. 8, 2018)

- Taxpayer argued that he was unaware that he needed to file amended return prior to receiving commissioner's final determination.
- **Holding – Commissioner has no duty to inform taxpayer of requirement to file amended return to preserve right to petition for reassessment.**

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V. Ohio Personal Income Tax

D. Domicile

1. Rongxing Li and Jue Tian v. Testa, BTA 2017-1916 (Jun 4, 2018)

- Commissioner assessed taxpayers for failure to file 2015 personal tax returns. Taxpayers moved to China in 2014 and argued that they were not OH residents in 2015 and had no income from OH.
- Taxpayers presented no evidence that they filed affidavit of non-Ohio domicile with the commissioner. Therefore, R.C. 5747.24(C) and (D) domicile test applies – individual with 183 or more contact periods presumed domiciled in OH in the absence of "clear and convincing evidence to the contrary."
- Taxpayers did not present evidence that they had fewer than 183 contacts. Federal tax returns indicated several in-kind donations made to OH organizations in 2015 and listed OH address as home address.
- **Holding – Taxpayers failed to present sufficient evidence to rebut presumption that taxpayers' domicile was Ohio. Assessment affirmed.**

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V. Ohio Personal Income Tax

D. Domicile (cont'd)

2. H.B. 292

- Signed into law on Jun. 15, 2018.
- Addresses ambiguity after Cunningham v. Testa.
- An individual having an abode outside Ohio and meeting the contact period test is irrebuttably a nonresident if the individual:
  - Does not claim a federal depreciation deduction on their non-Ohio abode;
  - Does not hold an Ohio drivers license;
  - Did not claim homestead exemption on their Ohio home; and
  - Did not claim in-state tuition at Ohio university.
- Importantly, reinstates direct right of appeal to Ohio Supreme Court from BTA decisions for Tax Commissioner and municipal income tax cases.
- See IT-2018-01 (issued Aug. 31, 2018)

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V. Ohio Personal Income Tax

D. Domicile (cont'd)

3. IT 2001-01 (Nexus Standards & Filing Safe Harbors for Individuals)

- Originally issued in 2001, reissued Feb. 15, 2018
- Describes standards applied by OH Department of Taxation used to determine whether a nonresident individual has a nexus with OH, and is therefore, subject to OH individual income tax.
- Generally – a nonresident has a nexus with OH if the individual earns compensation for services performed in OH; has real, tangible, or intangible property in OH; or, directly or indirectly engages in OH trade or business.
- Typically, work performed in OH on behalf of nonresident by non-employee professional does not create nexus (e.g., accountant, lawyer).
- If a nonresident does have a nexus with OH, however, Department of Taxation will not require filing and payment of income tax if contacts are limited to certain safe harbors.

V. Ohio Personal Income Tax

E. Employer Withholding

1. <u>Peth v. Testa</u>, BTA 2016-2609 (Dec. 27, 2017)

- Commissioner assessed taxpayer as responsible party for income tax withholding liability of corporation for 2005. Taxpayer sold business in 2002 before reacquiring for $1 a year later. Taxpayer claimed he never reopened business after purchasing it.
- Corporate records indicated that taxpayer was the president of the corporate entity during the period assessed.
- **Holding – Taxpayer was responsible party for satisfying withholding taxes from corporation because he was the president during the taxable year.**

V. Ohio Personal Income Tax

E. Employer Withholding (cont'd)

2. <u>Clapp v. Testa</u>, BTA 2017-321 (Jan. 22, 2018)

- Taxpayer, as responsible party, challenged underlying corporate assessment and claimed he had limited responsibility over financial affairs.
- **Holding – Responsible party may not challenge corporate assessment when corporation failed to do so. Taxpayer was liable because he was a corporate officer even though he did not supervise or participate in fiscal duties.**

3. *See also*

- **<u>Spradlin v. Testa</u>, BTA 2016-2103 (Dec. 27, 2017) -** Treasurer remained responsible party even though she was removed as an authorized signer from corporate bank accounts;
- **<u>Hatfield v. Testa</u>, BTA 2016-2490 – 2016-2508 (Dec. 27, 2017) –** Shareholder and corporate officer was responsible party for three affiliated entities even though operating agreement designated another officer as responsible for tax matters.

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VI. Ohio Real Property Taxes

A. Charitable Use and Public-Schoolhouse Exemption

1. <u>Breeze, Inc. v. Testa</u>, 2017-Ohio-7801 (Ohio Supreme Ct. Sep. 26, 2017)

- Court refused to affirm BTA decisions denying exemptions.
- Taxpayer is a property owner that holds title to property used by community schools.
- Taxpayer sought two exemptions:
  - Public-schoolhouse exemption, former R.C. 5709.07(A)(1).
  - Charitable-or-public-public-use exemption, R.C. 5709.12 & 5709.121.
- Neither exemption is available if the lessor's intent in leasing the property is to generate a profit.
- BTA found that the property was leased with a view to profit because taxpayer collected a substantial excess of rental income over expenses.

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VI. Ohio Real Property Taxes

A. Charitable Use and Public-Schoolhouse Exemption (cont'd)

1. <u>Breeze, Inc. v. Testa</u>, BTA 2012-2216 (May 21, 2018)

- The Court found that the focus should be on the lessor's <u>intent</u> to generate a profit, not solely the fact that rent exceeded expenses.
  - The BTA's argument was unreasonable, so the Court <u>remanded</u> the case to the BTA to determine whether the lessor intended to generate a profit and whether the property qualifies under either of the claimed exemptions.
- **Update:** Commissioner's argument that the taxpayer formed a for-profit entity has "little or no bearing on" his whether he intended to profit from the lease of the property.
- **Holding - Evidence was insufficient to find evidence of intent by taxpayer to profit from lease of property. Property is exempt under R.C. 5709.07(A)(1).**

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VI. Ohio Real Property Taxes

A. Charitable Use and Public-Schoolhouse Exemption (cont'd)

2. <u>Sri Saibaba Temple Society of Ohio v. Testa</u>, BTA 2016-2094 (Jan. 10, 2018)

- Taxpayer owned property adjacent to temple with house and barn used occasionally for meetings and storage for temple. Taxpayer further asserted that the property was purchased "primarily for future use." Commissioner denied exemption request under R.C. 5709.07.
- Evidence indicated that any use is "occasional at best, and that the use made is not religious in nature." Meetings that are administrative in nature do not qualify for public worship exemption.
- **Holding – Taxpayer must have "specific plan for future exempt use" when claiming exemption for undeveloped land.**

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VI. Ohio Real Property Taxes

B. Appraisal Requirements

1. <u>Lowe's Home Centers, Inc. v. Washington County Board of Revision</u>, 2018-Ohio-1974 (Ohio Supreme Ct. May 22, 2018)

B. Lowe's challenged assessor's valuation methodology and presented appraisal using sales comparison and income approaches to obtain reconciled value. BTA upheld assessor's valuation because Lowe's appraisal relied too heavily on second-generation sales.

C. While county's appraisal methodology may have been appropriate, BTA made no express findings about its analysis. "BTA's key job in a battle-of-the appraisals dispute is to weigh evidence and assess the credibility of the appraisals."

D. Holding – BTA must reconsider assessor's appraisal report because it did not take into account comparable sales of lease-encumbered properties.

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VI. Ohio Real Property Taxes

B. Appraisal Requirements (cont'd)

2. <u>Milanov v. Franklin County Board of Revision</u>, BTA 2016-1936, etc. (May 11, 2018)

B. Owners of condominium units argued auditor's valuation of individual units was inappropriate because it relied on "allocation method" rather than sales comparison approach.

C. OH Supreme Court held that "the best evidence of 'true value in money' of real property is an actual, recent sale of the property in an arm's-length transaction."

D. R.C. 5311.11 provides that condo units are separate parcels for taxation purposes.

E. Holding – Valuation improperly utilized a volume discount for condominium units where dozens of separate individuals owned condominium units and could transfer such units individually.

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VI. Ohio Real Property Taxes

C. Real Property Valuation Procedure

1. <u>Life Path Partners v. Cuyahoga Cty. Bd. Of Revision, 2015-Ohio-0759 (Ohio Supreme Ct. Jan. 16 (2018)</u>

- Taxpayer challenged valuation of its property for 2009 that was not resolved until Nov. 2012. Taxpayer subsequently challenged 2012 valuation after Mar. 31, 2013 deadline but satisfied all statutory requirements for continuing-complaint jurisdiction and sent letter to BOR requesting such jurisdiction. However, BOR dismissed complaint as untimely.
- R.C. 5715.19(D) is clear that if BOR does not make determination within 90 days of complaint filing, the filing is valid for "any ensuing year until [the] complaint is finally determined."
- Statute is not as clear on mechanics of asserting continuing-complaint jurisdiction.
- **Holding – BTA's decision was contrary to plain language of the statute. Remanded to BOR for resolution of complaint.**

VI. Ohio Real Property Taxes

C. Real Property Valuation Procedure (cont'd)

2. <u>MDM Holdings, Inc. v. Cuyahoga Cty. Bd. of Revision</u>, 2015-Ohio-1065 (Ohio Supreme Ct. Jan. 24, 2018)

- Similar facts. Taxpayer sent letter requesting continuing-complaint jurisdiction. County had rule barring continuing-complaint requests not filed within 30 days of the final decision rendered in the proceeding regarding the original complaint.
- BOR dismissed complaint as untimely.
- As stated in *Life Path Partners*, "nothing in [R.C. 5715.19(D)] authorizes the BTA to dismiss a continuing complaint for lack of timeliness."
- **Holding – BTA and county board of revision did not have authority to establish deadline for filing complaint that was contrary to plain language of the statute.**

VI. Ohio Real Property Taxes

C. Remission of Late Payment Penalties

1. <u>Holmes v. Testa</u>, BTA 2017-400 (Feb. 27, 2018)

- Commissioner assessed late payment penalties. Taxpayer requested remission of penalties because he was challenging 500% increase in valuation of property.
- Under R.C. 5715.39(C), late payment penalties will only be remitted when failure to make timely payment is due to reasonable cause, not willful neglect.
- Commissioner found that taxpayer could have availed himself of ability to "tender pay" taxes but did not.
- **Holding – Taxpayer's failure to avail himself of "tender pay" option while challenging property valuation was not a reasonable cause.**

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VI. Ohio Real Property Taxes

D. Exemptions

1. <u>City Life Enterprises, LLC v. Testa</u>, BTA 2016-1833 (Jan. 19, 2018)

- Taxpayer owned 3-story property and leased the property to its parent entity which was charitable organization. Tenant operated 1 story as promotional embroidery shop while other 2 stories were vacant.
- As a threshold matter, prospective plans for charitable use must be concrete – the "owner must show that it is 'actively working toward [an] actual use for the public benefit.'"
- Further, owner's use determines whether property is exempt, not tenant's.
- **Holding – Owner's use of property consisted only of actions as landlord. Tenant's use was not material to determination.**

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VI. Ohio Real Property Taxes

D. Exemptions (cont'd)

2. <u>Step By Step Academy v. Testa</u>, BTA 2016-2125 (Feb. 20, 2018)

- Nonprofit taxpayer owned several properties, two of which were leased to Ohio State University. Taxpayer provided educational and behavioral health services to children with disabilities but commissioner determined that use of property was not exclusively for charitable purposes and denied exemption.
- Taxpayer's activities did satisfy statutory requirements of charitable institution and all properties it occupied were used exclusively for charitable purposes.
- Under R.C. 5709.121(A) property owned by charitable institution is exempt if it is leased to a tenant and used for charitable or other exempt purposes. However, not enough evidence to determine use of leased premises by OSU.
- **Holding – Exemption granted for all properties owned by taxpayer except those leased to OSU.**

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VI. Ohio Real Property Taxes

D. Exemptions (cont'd)

4. <u>Mission of Mary Cooperative v. Testa</u>, BTA 2016-611(Feb. 20, 2018)

- Nonprofit used property for "urban agriculture, native land restoration, public recreation, and education." Taxpayer argued that although use was agricultural, it still satisfied charitable use exemption criteria of with R.C. 5709.12.
- Taxpayer's articles of organization indicated its purpose was specifically created for charitable purposes and operated consistent with its articles.
- Although 1/12 of land is dedicated to growing crops for sale, proceeds are used to support community agriculture programs.
- **Holding – Where property's owner's use of property is for charitable purposes, income received from sale of crops that is incidental and ancillary to charitable use does not disqualify the property from exemption.**

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VII. Procedural Issues & Miscellaneous

A. Right of Direct Appeal

1. H.B. 292

- Updates R.C. 5717.04 to reinstate direct right of appeal to Ohio Supreme Court from BTA decisions for Tax Commissioner and municipal income tax cases.
- Effective Sept. 13, 2018.

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VII. Procedural Issues & Miscellaneous

B. State Tax Incentives and Right of First Offer

1. **State of Ohio and City of Columbus v. Precourt Sports Ventures LLC, *et. al.***

- State and City sued Columbus Crew/MLS/PSV for trying to relocate to Austin, TX.
  - State argues that R.C. 9.67 requires owner of a professional sports team that uses a tax-supported facility to give 6 months' notice of intent to abandon facility and provide local groups an opportunity to purchase the team.
- On Apr. 19, 2018, Crew/MLS/PSV filed motion to dismiss:
  - Defendants argue that they do not receive support from the city. MLS is the owner of the Crew but the complaint does not allege that MLS receives support from the city.
  - Statute also violates dormant commerce clause because it favors OH citizens over those from other states.
  - Forced sale of team violates federal and state constitutions.
- On Sept. 4, 2018, hearing held at Franklin County Court of Common Pleas
- On Oct. 12, 2018, owner Anthony Precourt announced his plans to sell the team so that it may remain in Columbus.
- On Dec. 3, 2018, court denied Defandant's motion to dismiss.

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VII. Procedural Issues & Miscellaneous

C. Enterprise Zones

1. HB 69

- Modifications to R.C. 5709.634 with respect to “retail facilities exclusion” - Businesses that primarily make retail sales typically ineligible for incentives of enterprise zones
- Exclusion does not apply if zone is located in impacted city or the school board waives the exclusion
- HB 69 modifies school board waiver in 2 ways
  - Provides that waiver applies on facility-by-facility basis and does not preclude exclusion of other retail facilities; and
  - Adds townships as party that may negotiate enterprise zone agreements with retail businesses. Currently only municipal corporations and counties may negotiate after school board waives exclusion.

VII. Procedural Issues & Miscellaneous

D. Statutory Interpretation

1. Lottery Subi 3 v. Testa, BTA 2016-655 (Dec. 18, 2017)

- Corporation purchased lottery prizes from lottery winner and OH Lottery Commission withheld 4%. Commissioner denied refund request because tax credit that formerly existed under franchise tax no longer existed.
- Corporation argued that they had no corporate franchise tax liability for the year and were entitled to refund.
- R.C. 5703.05(B) permits refunds where law has changed, resulting in overpayment. The statute contemplates this situation where corporation can no longer avail itself of CFT refund and the individual income tax refund is inapplicable to corporation.
- **Holding – Commissioner erred in denying refund request because the statute permits the corporations refund request.**

VII. Procedural Issues & Miscellaneous

E. Requirement to file Notice of Appeal with Tax Commissioner

1. <u>City of Lyndhurst (et. al.) v. Testa</u>, BTA 2017-1409, 2017-1410, 2017-1411 (Mar. 19, 2018)

- Taxpayer filed notices only with BTA, not with commissioner. Commissioner moved to dismiss for lack of jurisdiction.
- R.C. 5717.02's statutory filing requirements are "mandatory [and] jurisdictional."
- **Holding – Docketing of appeal by BTA does not relieve taxpayer of duty to file notice of appeal with commissioner.**

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VII. Procedural Issues & Miscellaneous

F. Specification of Errors

1. <u>Congress Family Plowing & Landscaping, LLC v. Testa</u>, BTA 2017-653 (Apr. 18, 2018)

- Taxpayer appealed sales tax assessment for failing to file return.
- In its petition for reassessment, taxpayer argued that it had no liability but did not provide evidence to support that return was filed or that assessment was incorrect.
- In appeal to BTA, taxpayer did not submit narrative specifying commissioner's errors.
- **Holding – Taxpayer must specify errors for BTA to have jurisdiction.**

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VII. Procedural Issues & Miscellaneous

G. Abatement of Penalties

1. Paramount Technologies v. Testa, BTA 2016-2640; 2017-545 (Apr. 17, 2018)

- Company failed to remit income taxes for 2003-2015 as a result of employee embezzling tax funds for personal use. Commissioner partially abated penalties for failure to file because company did not immediately pay taxes or penalties due after discovering employee's fraud.
- Commissioner's ability to abate penalties is discretionary. For abuse to have occurred, commissioner's conduct must have been "so palpably and grossly violative of fact and logic that it evidences . . . perversity of will."
- Even though company claims it cannot pay all outstanding taxes due to embezzlement, that does not qualify as abuse of discretion.
- **Holding – Where non-payment was the result of employee embezzlement, employer must still pay all outstanding taxes to qualify for full abatement.**

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VII. Procedural Issues & Miscellaneous

H. Garnishments

1. State of Ohio, Dept. of Taxation v. Dunlap, 2017-CA-0012 (Oh. Ct. App. Apr. 20, 2018)

- Taxpayer challenged order of garnishment issued as a result of failure to pay income taxes. Taxpayer also failed to assign error and state issues presented in her brief although court proceeded to review appeal.
- Taxpayer's assertion that underlying judgment is invalid fails because taxation in OH is voluntary.
- Court has previously recognized that garnishment hearings are not proper vehicle for challenging underlying judgment.
- **Holding – Taxpayer cannot challenge the underlying judgment once the court has initiated garnishment proceedings.**

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VII. Procedural Issues & Miscellaneous

I. Public Utility Excise Tax

1. <u>Cobra Pipeline Company, Ltd., v. Testa</u>, Ohio BTA 2016-260; 2016-604; 2016-605; 2016-1083; 2017-301 (Dec. 13, 2017)

- Taxpayer assessed public utility excise tax and property taxes and argued that it is not a public utility. Taxpayer owned pipelines that move natural gas to pipelines owned by other companies and does not itself operate transmission lines.
- Taxpayer argued that under R.C. 5727.02's primary-business test, the fact that 61% of its lines originated with producers and terminated in transmission lines.
- Commissioner argued that company's revenues and primary customers established that it was a public utility.
- **Holding – Under the primary business test, pipeline use is not dispositive. The tax commissioner may consider a company's revenues and primary customers when determining whether a taxpayer is a public utility.**

VII. Procedural Issues & Miscellaneous

I. Public Utility Excise Tax (cont'd)

2. <u>Rockies Express Pipeline, LLC v. Testa</u>, Ohio BTA 2016-144 (Apr. 23, 2018)

- Taxpayer operated natural gas pipeline in several states, including OH. Dep't. of Taxation assessed excise tax for receipts where gas entered and exited pipeline in OH.
- Taxpayer argued that all its receipts are derived from interstate commerce and are exempt under R.C. 5727.33(B)(1).
- R.C. 5727.01(D)(5) definition of "public utility" encompasses transportation of gas both wholly and partially within OH. Excluding all taxpayer's receipts would render statute meaningless.
- **Holding – Pipeline companies operating in multiple states may not exclude receipts where resource entered and exited its pipeline in Ohio on the basis that those receipts are "derived wholly from interstate business."**

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VII. Procedural Issues & Miscellaneous

J. Notice of Appeal

1. <u>NASCAR Holdings, Inc. v. Testa</u>, 2015-Ohio-1157 (Ohio Supreme Ct. Dec. 21, 2017)

- NASCAR appealed assessment and its notice of appeal was signed by FL attorney not licensed in OH. BTA dismissed appeal finding that attorney engaged in unauthorized practice of law.
- NASCAR argued that any authorized agent may file appeal on taxpayer's behalf even if that agent engages in UPL. Since FL attorney was authorized agent, case should be remanded for determination on the merits.
- BTA erred in distinguishing NASCAR's appeal on grounds that agent was an attorney. Proper inquiry is whether the taxpayer authorized agent to file appeal.
- **Holding – A corporation may authorize an attorney not licensed in Ohio as its agent to file a notice of appeal and this does not deprive BTA of jurisdiction or otherwise warrant dismissal.**

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Questions?

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TAB
B

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Curriculum Vitae

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Howard is partner in charge of the Tax Controversy Group at the Cincinnati law firm Wood & Lamping, LLP. He has practiced law for over 38 years. He is also a licensed Ohio CPA. He has a BBA degree in accounting from the University of Cincinnati, and, received his Juris Doctorate (law) degree from Salmon P. Chase College of Law. He is licensed to practice law in all Ohio courts, U.S. District Court in Cincinnati, the 6TH Circuit Court of Appeals, and the United States Tax Court.

Howard's practice primarily concentrates in federal civil and criminal tax problems and litigation.

From 1968 to 1978, he was a federal agent with the U.S. Treasury Department/IRS. While there, he served in several technical and management positions.

For approximately 36 years, he has taught in the graduate Tax program at UC. He teaches federal Corporate Tax I, II, and III, Federal Estate and Gift Tax, Fiduciary Tax, Consolidated Tax, and IRS Practice and Procedure. Mr. Richshafer currently teaches "Taxation of Business Entities" in the graduate accounting program at UC's Lindner College of Business.

From 1998-2002, the Ohio Supreme Court appointed him the inaugural Chair of the Federal Tax Specialization Board. This Board, comprised of tax lawyers considered experts, certified Ohio lawyers as Federal Tax Specialists.

He served on the CBA's Federal Tax Committee from 1997 to 2002; and served as Committee Chair from 2001 to 2002.

Since 1999, Mr. Richshafer has been included in Woodward & White's *The Best Lawyers in America®* under federal taxation. The publisher named him "2013 Cincinnati Litigation & Controversy Tax Lawyer of the Year," "2014 Cincinnati Tax Law "Lawyer of the Year," and "2017 Cincinnati Tax Law "Lawyer of the Year."

He has authored over 100 tax articles including a manual on "Ohio Limited Liability Companies," which he co-authored. His articles have been published in the *Journal of Taxation*, *Ohio Lawyer*, and *Corporate Controller*.

Mr. Richshafer is the author of "Deductions for Profit-Motivated Activities," which is part of Lexis-Nexis® online Federal Tax Research Library.

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DECEMBER 7, 2018

"NEW IRS AUDIT RULES FOR PARTNERSHIPS/LLC'S: UPDATED"

BY

HOWARD L RICHSHAFER, ESQ./CPA

1

HISTORY

- **2014 GAO REPORT:**
  - IRS EXPERIENCING PROBLEMS AUDITING PARTNERSHIPS/LLC'S.
  - GAO PROPOSES ADDITIONAL TAX DEFICIENCIES AGAINST PARTNERSHIPS VS. PARTNERS THEMSELVES.
- **NOVEMBER 2015:**
  - "BIPARTISAN BUDGET ACT" ("BBA") ENACTED INTO LAW (TITLE 26 USC (INTERNAL REVENUE CODE).
- **JUNE & DECEMBER 2017:**
  - TREASURY ISSUES HUNDREDS OF PAGES OF PROPOSED REGS.
- **2018:** TECHNICAL CORRECTIONS ACT.
- **AUGUST 2018:** NEWLY PROPOSED REGS.

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MAJOR CHANGES

- Partnerships (and LLC's) now directly liable for additional tax, interest, penalties (resulting from IRS audit).
- IRS will collect from partnership---not partners.
- "Opt-out" election.
- "Push-out" election.
- "Imputed underpayment" computation.
- "Pull-In" procedure (added by Tech. Corrections Act).
- "Partnership Representative ("PR").
  - Sole authority to bind entity and all partners.
- All partners will have severely limited rights.
- Effective date: tax years beginning after 12/31/2017.

3

"Imputed Underpayment"

- IRS AUDITS PARTNERSHIP'S TAX RETURN (FORM 1065).
- PROPOSES ADJUSTMENTS TO INCOME/DEDUCTIONS.
- CALCULATES "IMPUTED UNDERPAYMENT."
- IRS MUST USE HIGHEST INDIVIDUAL OR CORP MARGINAL TAX RATE TO IRS' ADJUSTMENTS.
  - CURRENTLY (2018) = 37% (INDIVIDUALS) OR 21% (C CORPS).
- REVIEWED-YEAR RATES USED TO COMPUTE UNDERPAYMENT.
  - EXAMPLE:
    - IRS AUDITS TAX YEAR 2018.
    - AUDIT OCCURS IN 2020.
    - 2018 REVIEWED-YEAR RATES MUST BE USED. HENCE 37%.
    - 2020 PARTNERSHIP LIABLE FOR "IMPUTED UNDERPAYMENT."
    - HENCE: PARTNERS OF 2020 PARTNERSHIP INDIRECTLY BEAR ADDITIONAL FINANCIAL TAX BURDEN.

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"Imputed Underpayment"

- **Example.**
  - IRS determines partnership overstated business expenses by $35,000, and, understated income by $45,000.
  - "Imputed Underpayment":
    - $80,000 times 37%, or **$29,600.**
    - **Partnership** directly liable for $29,600 in tax (plus interest, and any penalties).
- Although partnership directly liable for $29,600 Imputed Underpayment, any reviewed-year partner has option to file amended tax returns and pay pro-rata Imputed Underpayment.
- Under 2018 Technical Corrections Act, IRS must issue procedures allowing reviewed-year partners to pay imputed underpayment without filing amended tax returns. This is called the "**Pull-in Procedure**."

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IMPUTED UNDERPAYMENT MODIFICATION PROCEDURE

- PR CAN "MODIFY" IMPUTED UNDERPAYMENT.
- MODIFICATION CAN REDUCE IMPUTED UNDETRPAYMENT IN THREE WAYS:
  1. REQUIRE REVIEWED YEAR PARTNERS TO AMEND OR PAY TAX.
  2. IDENTIFY TAX-EXEMPT PARTNERS HAVING NO INCOME TAX OBLIGATION.
  3. IDENTIFY C CORP PARTNERS WITH LOWER TAX RATE (E.G., 21%), OR, NON-CORP PARTNERS WITH LOWER CAPITAL GAIN OR DIVIDEND TAX RATES (e.g., 15-20%).
- **MODIFICATION PROCEDURE:**
  - PR HAS 270 DAYS FROM IRS' AIUDIT REPORT TO ELECT MODIFICATION. 270 DAYS CAN BE EXTENDED BY AGREEMENT.
  - IRS MUST APPROVE MODIFICATIONS.

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"PUSH-OUT" ELECTION

- ONLY PR AUTHORIZED TO MAKE "PUSH-OUT" ELECTION.
- ELECTION FORCES EVERY REVIEWED-YEAR PARTNER TO PAY PRO-RATA IMPUTED UNDERPAYMENT (PLUS PENALTIES/INTEREST).
- IF ELECTION MADE, PARTNERSHIP NOT LIABLE FOR IMPUTED UNDERPAYMENT.
  - PR CAN ELECT PUSH-OUT BUT ONLY w/i 45 DAYS AFTER IRS AUDIT REPORT SHOWING IMPUTED UNDERPAYMENT.
  - PR MUST NOTIFY REVIEWED-YEAR PARTNERS OF ELECTION.
  - IRS COLLECTS ADDITIONAL TAX FROM REVIEWED-YEAR PARTNERS.
  - REVIEWED-YEAR PARTNERS MAY NOT RAISE PENALTY DEFENSES.
  - REVIEWED-YEAR PARTNERS HAVE NO RIGHT TO ADMINISTRATIVE OR JUDICIAL APPEAL.
  - REVIEWED-YEAR PARTNERS LEGALLY BOUND TO PAY.
- PUSH-OUT ELECTION ABSOLVES PARTNERSHIP EVEN IF REVIEWED-YEAR PARTNERS DON'T PAY IMPUTED UNDERPAYMENT.

7

"OPT-OUT" ELECTION

- ELIGIBLE PARTNERSHIP MAY OPT-OUT OF NEW RULES.
- RESULT:
  - CURRENT PARTNERSHIP NOT LIABLE FOR UNDERPAYMENT.
  - REVIEWED-YEAR PARTNERS REMAIN LIABLE FOR IMPUTED UNDERPAYMENT.
  - OPT-OUT ELECTION ELIMINATES:
    - IMPUTED UNDERPAYMENT TO PARTNERSHIP.
    - ALSO ELIMINATES PUSH-OUT ELECTION.
- MUST HAVE 100 OR LESS "ELIGIBLE PARTNERS."
- NO PARTNER MAY BE ANOTHER PARTNERSHIP, DRE, TRUST, NOMINEE, BANKRUPT ESTATE, OR INELIGIBLE FOREIGN ENTITY.
  - MUST ATTACH OPT-OUT ELECTION TO ANNUAL TIMELY-FILED FORM 1065 (INCLUDING EXTENSIONS).
- PR MUST NOTIFY EACH REVIEWED-YEAR PARTNER OF OPT-OUT ELECTION.

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"OPT-OUT ELECTION"

EXAMPLES OF "ELIGIBLE" VS INELIGIBLE PARTNERS

EXAMPLE 1. (1065 WITH INELIGIBLE PARTNER).

- 1065 HAS 4 PARTNERS: TWO INDIVIDUALS; A C CORP, AND A PARTNERSHIP. THE 1065 MAY NOT OPT-OUT SINCE IT HAS A PARTNERSHIP AS A PARTNER.

EXAMPLE 2. (S CORP PARTNER).

- PARTNERSHIP HAS 4 PARTNERS: TWO INDIVIDUALS; A C CORP. AND AN S CORP. ONE OF THE S CORP'S SHAREHOLDERS IS A DISREGARDED ENTITY (DRE). PARTNERSHIP MAY OPT-OUT EVEN THOUGH S CORP HAS AN INELIGIBLE SHAREHOLDER.

EXAMPLE 3. (DRE INELIGIBLE PARTNER).

- PARTNERSHIP HAS 4 PARTNERS: TWO INDIVIDUALS; A C CORP. AND A SINGLE-MEMBER LLC. THIS PARTNERSHIP MAY NOT OPT-OUT SINCE IT HAS A DRE AS A PARTNER.

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"OPT-OUT ELECTION"

OPT-OUT ELECTION FORM

OPT-OUT ELECTION MUST CONTAIN:

1. EACH PARTNER'S NAME AND TAX I.D. NO;
2. EACH PARTNER'S FEDERAL TAX CLASSIFICATION (E.G., INDIVIDUAL, C CORP, S CORP, ETC.);
3. AFFIRMATIVE STATEMENT THAT PARTNER IS ELIGIBLE PARTNER;
4. IF PARTNER IS AN S CORP, EACH SHAREHOLDER'S NAME, TAX I.D. NO, AND FEDERAL TAX CLASSIFICATION;
5. ANY OTHER INFORMATION IRS REQUIRES.

(OPT-OUT ELECTION MUST BE ATTACHED TO EACH ANNUAL PARTNERSHIP TAX RETURN. (TREAS. REG. SECT. 301.6221(b)-1(c)(2)).

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NEW OPT-OUT ELECTION FORM: "SCHEDULE B-2 ELECTION OUT OF THE CENTRALIZED PARTNERSHIP AUDIT REGIME"

- IRS DEVELOPED NEW OPT-OUT ELECTION FORM IN DECEMBER 2018.
- NEW "SCHEDULE B-2, FORM 1065."
- SCHEDULE B-2 MUST BE ATTACHED TO THE 1065 EACH ANNUAL YEAR THAT OPT-OUT IS ELECTED.
- IF THIS FORM IS NOT CORRECTLY COMPLETED, IRS HAS DISCRETION TO INVALIDATE THE OPT-OUT ELECTION.

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THE "PARTNERSHIP REPRESENTATIVE"

- NOT SAME AS FORMER "TAX MATTERS PARTNER."
  - HAS BIGGER ROLE THAN TMP.
- SOLE AUTHORITY TO ACT FOR PARTNERSHIP, CURRENT PARTNERS, AND REVIEWED-YEAR PARTNERS.
- PR'S ACTS AND ELECTIONS LEGALLY BINDING ON PARTNERSHIP, CURRENT PARTNERS, REVIEWED-YEAR PARTNERS.
  - DOES NOT HAVE TO BE PARTNER. DOES NOT HAVE TO BE AN INDIVIDUAL.
  - CAN BE PARTNERSHIP ITSELF (PER FINAL REGS.).
  - CAN BE "DRE" (PER FINAL REGS.).
  - PR CAN USE FORM 2848 TO DESIGNATE ATTORNEY OR CPA TO REPRESENT PR (PER FINAL REGS.).
  - PR MUST HAVE SUBSTANTIAL U.S. PRESENCE.
- PR'S SOLE AUTHORITY CANNOT BE LIMITED BY:
  - PARTNERSHIP AGREEMENT.
  - STATE LAW, OR
  - ANY OTHER DOCUMENT.

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"PARTNERSHIP REPRESENTATIVE"

PR RESIGNATION MECHANICS

- PR MUST BE DESIGNATED (WITH EACH ANNUAL 1065).
  - EFFECTIVE (AND BINDING) UNLESS OR UNTIL IRS DETERMINES OTHERWISE.
- PR MAY RESIGN ONLY IF IRS AUDIT COMMENCES, OR, PARTNERSHIP FILES AMENDED TAX RETURN (CALLED "ADMINISTRATIVE ADJUSTMENT REQUEST").
- IF IRS DETERMINES PR DESIGNATION INVALID, PARTNERSHIP HAS 30 DAYS TO DESIGNATE ANOTHER PR.
  - IF PARTNERSHIP FAILS TO PROPERLY DESIGNATE, IRS DESIGNATES PR.
- IRS CREATED NEW FORM 8979 IF:
  - PARTNERSHIP REVOKES PR DESIGNATION;
  - PR RESIGNS; OR
  - THERE IS NO PR DESIGNATION AND PARTNERSHIP IS DESIGNATING NEW PR.

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"PARTNERSHIP REPRESENTATIVE"

REVOKING PR DESIGNATION

- PARTNERSHIP (VIA ITS PARTNERS) MAY REVOKE PR DESIGNATION.
  - REVOCATION PROHIBITED UNTIL IRS AUDIT OCCURS OR "AAR" FILED.
  - PARTNERSHIP MUST FILE FORM 8979 WITH IRS TO REVOKE.
  - PARTNERSHIP MUST ALSO NOTIFY REVOKED PR.
  - IRS MUST APPROVE REVOCATION AND REDESIGNATED PR. IRS MUST NOTIFY PARTNERSHIP.

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"PARTNERSHIP REPRESENTATIVE"

SPECIFIC PR POWERS:

- SOLE AUTHORITY TO SETTLE WITH IRS.
- EXTEND PARTNERSHIP'S SOL (AND HENCE PARTNERS' SOL).
- BINDS ALL PARTNERS TO SETTLEMENT WITH IRS.
- AGREES OR DISAGREES WITH IRS ADJUSTMENTS—WHETHER TO LITIGATE/APPEAL.
- MAKES ALL DECISIONS RELATING TO PAYING TAX AT PARTNERSHIP LEVEL, OPT-OUT, OR, TO PUSH-OUT.
- NOT REQUIRED UNDER CODE OR REGS TO CONSULT WITH OR RECEIVE APPROVAL FROM ANY PARTNER.

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"PARTNERSHIP REPRESENTATIVE"

IMPLIED PR POWERS:

- HIRES ACCOUNTANTS/LAWYERS.
- DIRECTS HOW ACCOUNTANTS/ LAWYERS WILL WORK AND WHAT ISSUES TO CONTEST.
- HIRES EXPERT WITNESSES, WHEN NECESSARY.
- BINDS PARTNERSHIP TO INVOICES FOR PROFESSIONAL SERVICES (ACCOUNTANTS/LAWYERS/EXPERTS).
- HAS UNFETTERED ACCESS TO PARTNERSHIP BOOKS, RECORDS, PRIOR AUDITS.
- CHARGES OUT VALUE OF PR'S SERVICES TO PARTNERSHIP.

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"PARTNERSHIP REPRESENTATIVE"

DIFFERENT PR IN DIFFERENT TAX YEARS:

- PARTNERSHIP DESIGNATES SIMON AS PR ON 2018 FORM 1065.
- PARTNERSHIP DESIGNATES SAMANTHA AS PR ON 2021 FORM 1065.
- IN 2021, IRS AUDITS 2018 FORM 1065.
- WHO IS PROPER PR TO HANDLE IRS AUDIT IN 2021 AND CONSEQUENCES?
  - ANSWER: SIMON. SIMON WAS DESIGNATED PR FOR 2018 REVIEWED YEAR.
    - (PROP. REGS. SECTION 301.6223-1(c)(3)).

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"ADMINISTRATIVE ADJUSTMENT REQUESTS" ("AAR")

- IF PARTNERSHIP FILES OPT-OUT ELECTION, IT MUST FILE AMENDED FORM 1065X AND K-1'S TO AMEND TAX RETURNS.
- IF PARTNERSHIP DOES NOT FILE OPT-OUT ELECTION, PARTNERSHIP OR PR MUST USE "AAR" TO AMEND 1065.
- "AAR" MUST BE FILED WITHIN 3 YRS OF 1065 FILING DATE.
- "AAR' MY NOT BE FILED AFTER IRS ISSUES NOTICE OF AUDIT.
- IF "AAR" SHOWS IMPUTED UNDERPAYMENT, PARTNERSHIP MUST EITHER PAY TAX OR ELECT TO PUSH-OUT THE ADJUSTMENTS TO REVIEWED YR PARTNERS.
- "AAR" ALSO FILED ON FORM 1065X, OR, FORM 8082 IF ELECTRONICALLY FILED.

18

AMENDING PARTNERSHIP AGREEMENTS

- CONSIDER AMENDING PARTNERSHIP AGREEMENTS.
  - LIMIT NEW PARTNERS SO AS TO QUALIFY FOR OPT-OUT ELECTION (i.e., NO INELIGIBLE PARTNERS).
  - RESTRUCTURE PARTNERS TO QUALIFY FOR OPT-OUT ELECTION?
  - MECHANICS FOR APPOINTING ORIGINAL PR.
  - SHOULD PARTNERSHIP INDEMNIFY PR?
    - REIMBURSE PR FOR EXPENSES/COSTS (e.g., HIRING EXPERTS)?
    - SCOPE OF PR'S RESPONSIBILITIES.
    - PR RESIGNATION/ LOGISTICS.
    - PR REVOCATION/REMOVAL LOGISTICS.
    - APPOINTING SUCCESSOR PR/LOGISTICS.
    - HOW TO INVOLVE PARTNERS WITH PR DECISIONS.

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AMENDING PARTNERSHIP AGREEMENTS

- SHOULD PR HAVE TOTAL AUTHORITY VS. PARTNERS' CONSENT?
- PROVIDE FOR POST-AUDIT SPECIAL ALLOCATIONS.
- PROVIDE FOR POST-AUDIT ADJUSTMENTS TO CAPITAL ACCOUNTS.
- ADD PROVISIONS TO ACHIEVE PARTNERS' ECONOMIC GOALS WITH SUFFICIENT FLEXIBILITY .
- PROVIDE FOR POST-AUDIT PAYMENT OF IMPUTED UNDERPAYMENT IF OPT-OUT FAILS.
- MECHANICS/AUTHORITY ALLOWING PR TO MAKE OPT-OUT ELECTION.
- MECHANICS/AUTHORITY ALLOWING PR TO MAKE PUSH-OUT ELECTION.
- PROHIBIT TRANSFERS, SALES, GIFTS, OF PARTNERSHIP INTERESTS TO NONQUALIFYING PARTNERS VIS-À-VIS OPT-OUT ELECTION.

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AMENDING PARTNERSHIP AGREEMENTS

- IDENTIFY PR AUTHORITY TO PUSH-OUT IF PARTNERSHIP LIQUIDATES/TERMINATES.
- COVENANT PROHIBITING MORE THAN 100 PARTNERS (TO ENABLE OPT-OUT) ?

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OTHER AGREEMENTS THAT MAY BE AFFECTED

- LOAN AGREEMENTS.
  - WILL CREDITORS FORCE PARTNERSHIP-DEBTOR COVENANTS TO OPT-OUT OR PUSH-OUT?
- BUY-SELL AGREEMENTS.
  - SHOULD BUYER REQUIRE COVENANT FOR PARTNERSHIP TO OPT-OUT OR PUSH-OUT?
  - SHOULD SELLER BE OBLIGATED TO INDEMNIFY BUYER FOR PRE-CLOSING IMPUTED UNDERPAYMENTS?

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CONCLUSIONS

- PROBABLY MORE IRS PARTNERSHIP AUDITS.
- NEW RULES CREATE TAX DISTORTIONS.
- CLIENTS MUST PREPARE.
- PARTNERSHIP AGREEMENTS MUST BE REVIEWED—PROBABLY AMENDED.
- REGS CONTEMPLATE TAX DUE FROM PARTNERSHIP, WITHOUT PARTNERS' ABILITY TO OBTAIN REFUNDS.
- IN MOST CASES, OPT-OUT ELECTION SHOULD BE TIMELY FILED (ANNUALLY).
- PR MUST CONSIDER/UNDERSTAND PUSH-OUT ELECTION AND MODIFICATIONS TO AVOID OVERPAYING TAX AT ENTITY LEVEL.
- MORE TAX COULD RESULT IF UNQUALIFIED PR FAILS TO MANAGE NEW RULES.
- PR SHOULD NOT BE PARTNERSHIP'S ACCOUNTANT OR LAWYER (TOO MANY CONFLICT OF INTEREST ISSUES).

23

TAB
C

COLLEEN M. HAAS is a Member in Frost Brown Todd's Cincinnati office, where her practice is primarily focused in the area of commercial real estate development and finance. Colleen represents lenders, investors and developers in structuring and closing new construction and rehabilitation projects, including transactions that involve state and federal new market tax credits, historic rehabilitation tax credits and multiple layers of financing as well as advising clients with respect to investments in qualified opportunity zones. Colleen is currently a member of Leadership Cincinnati, a member of Commercial Real Estate Women (CREW) of Greater Cincinnati, a member of the Board of Trustees and Executive Committee for Crayons to Computers and a volunteer teacher through Junior Achievement. She received both her Bachelor of Business Administration and her Juris Doctorate degrees from the University of Notre Dame.

Opportunity Knocks: Understanding the Federal Opportunity Zone Program

Southwestern Ohio Tax Institute

Cincinnati Bar Association

Colleen Haas, Frost Brown Todd LLC

December 7, 2018

1

What is a Qualified Opportunity Zone (QO Zone)?

- Enacted as part of sweeping federal tax legislation commonly referred to as the Tax Cuts and Jobs Act of 2017.
- Internal Revenue Code (IRC) Section 1400Z-2 provides significant tax incentives for taxpayers to reinvest unrealized capital gains in certain property and businesses located or operating in low-income census tracts that Treasury has designated as qualified opportunity zones ("QO Zone").

2

What is a Qualified Opportunity Zone (QO Zone)?

- Treasury has designated QO Zones in all 50 states, the District of Columbia, and five U.S. possessions – Map is FINAL
- In Ohio, Treasury designated 320 tracts in 73 counties across the state as QO Zones.
  - 30 designated QO Zones in Hamilton County.
- In Kentucky, Treasury designated 144 low-income census tracts in 84 counties across the state as QO Zones.
  - 7 designated QO Zones in Kenton (5), Campbell (1), and Boone (1) Counties
- In Indiana, Treasury designated 156 tracts in 58 counties covering all or portions of 83 cities and towns throughout the state as QO Zones.

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Qualified Opportunity Zones in Ohio

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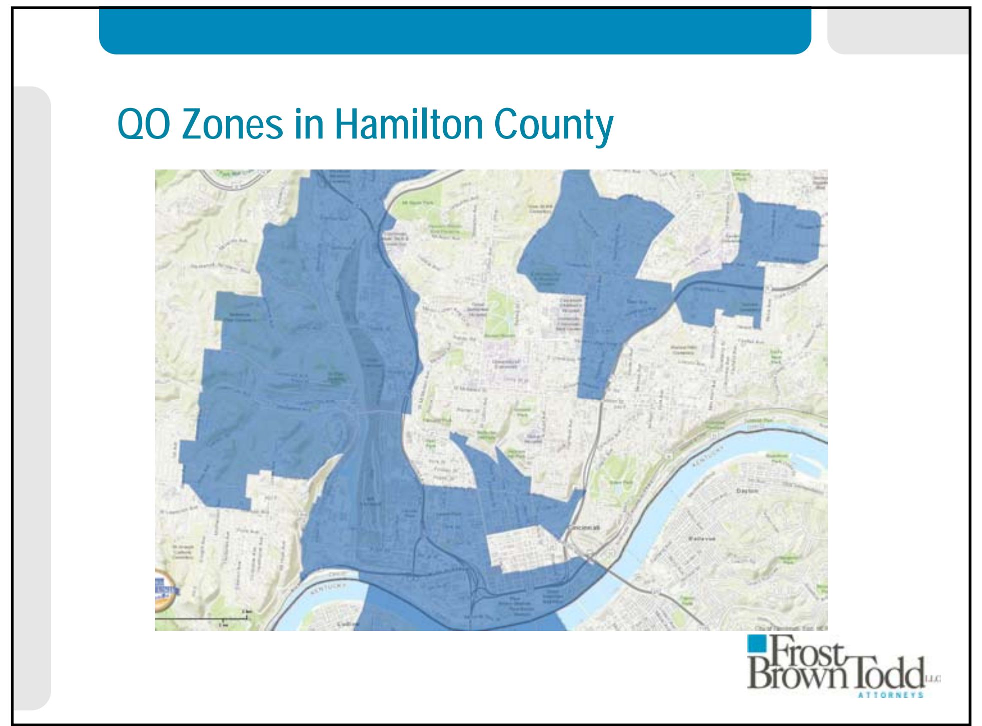

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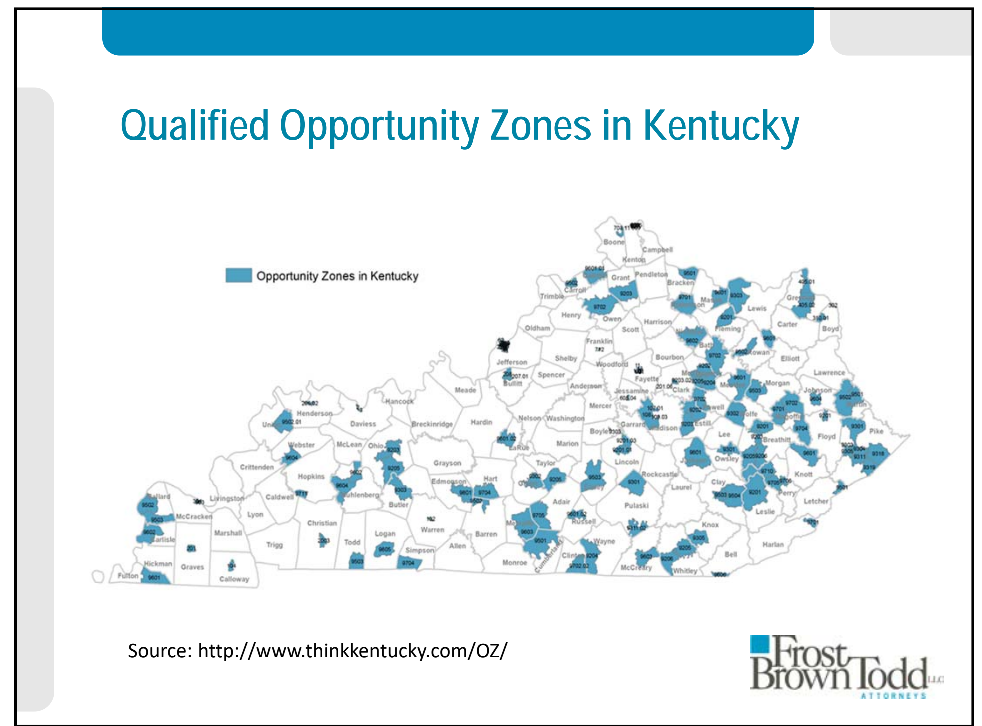

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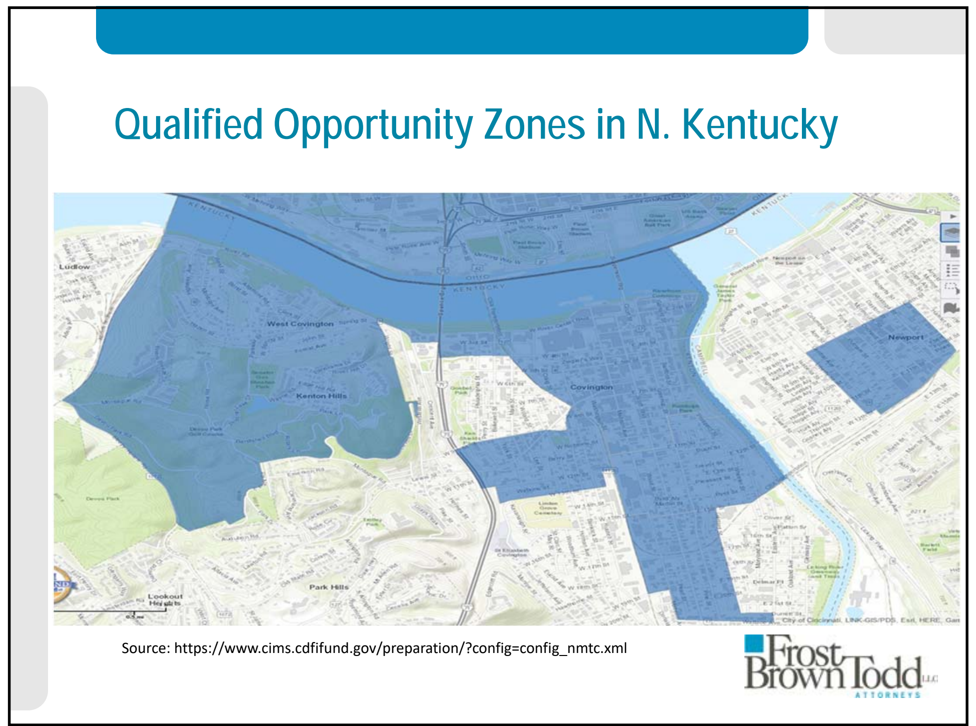

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Purpose of Qualified Opportunity Zones

- To encourage economic development in "low income areas" by providing various tax incentives for private investments in QO Zones.
- Based on analysis of Federal Reserve data, the Economic Innovation Group, a bipartisan research and advocacy organization that helped plan the initial legislation that formed the basis for the QO Zones incentives, estimated that U.S. taxpayers held $6.1 trillion in unrealized capital gain at the end of 2017. https://eig.org/news/joint-economic-hearing-promise-opportunity-zones

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Qualified Opportunity Zone Benefits

Taxpayers → Defer taxes by making timely investments → Qualified Opportunity Zone Funds (QOFs) → when invested in → Qualified Opportunity Zone Property

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QO Zones – What are the Tax Incentives?

- There are **three** separate investment incentives that a taxpayer can elect to take advantage of with respect to their investment.
  1. Temporary deferral of capital gain.
  2. Step-up in basis.
  3. Permanent exclusion of gain on appreciation.

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QO Zone Incentive – Temporary Deferral

- Taxpayer can elect under IRC Section 1400Z-2(a)(1)(A) to temporarily defer capital gain from the sale or transfer to an unrelated party of any property that the taxpayer owns as long as the taxpayer reinvests the deferred amount in a qualified opportunity fund ("QO Fund").
  - GAINS DEFERRED – Proposed regulations make it clear that deferral is only available for gain that is treated as capital gain for federal tax purposes.
  - ANY PROPERTY – There does not appear to be any restrictions on the types of property that can be sold to generate the gain – not limited to real property or business property.
- Taxpayer must reinvest the deferred amount within the 180-day period beginning on the date of the sale or transfer of the property generating the gain – proposed regulations address deferral of gain from partnership or other PTE (PTE owner's 180-day period begins at end of PTE tax year)

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QO Zone Incentive – Temporary Deferral (cont.)

- Gain deferral is temporary because the taxpayer must recognize the income in the tax year the investment is sold <u>or</u> the tax year that includes December 31, 2026, whichever is earlier.
- Treasury released guidance in the form of an FAQ indicating that a taxpayer can make an election to defer gain when it files a federal income tax return in the year gain would have been realized.
  - Anticipated that taxpayers will use Form 8949 to elect to defer gain.

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QO Zone Incentive – Basis Step-Up

- Where a taxpayer has elected temporary gain deferral, IRC Section 1400Z-2(b)(2)(B) provides a tiered <u>"step-up" in the taxpayer's basis</u> in the gain it reinvests in the QO Fund depending on how long the taxpayer holds the investment.
- Absent this statutory "step-up," the taxpayer's initial basis in the reinvested gain is zero.
- <u>"Step-Up" Holding Period</u>
  - If the taxpayer holds the investment for at least five years, the taxpayer's basis in the investment is increased by an amount that is equal to ten percent (**10%**) of the amount of capital gain that the taxpayer elected to defer.
  - If the taxpayer holds the investment for seven years, the taxpayer's basis is increased by an additional five percent (**5%**) of the deferred gain.

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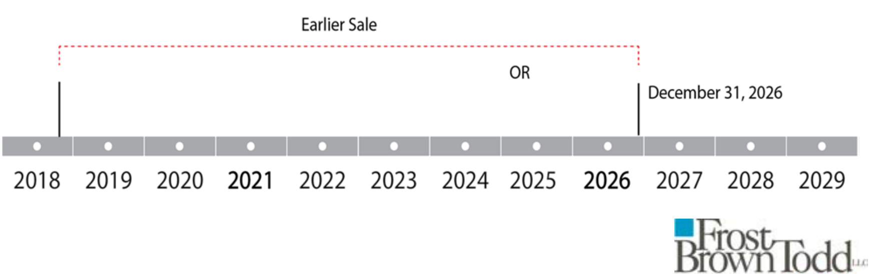
QO Zone Incentive – Basis Step-Up (cont.)

- Because the temporary gain deferral period ends no later than the tax year including December 31, 2026, the taxpayer will need to reinvest capital gain in a QO Fund and elect deferral treatment by December 31, 2019 to permit the taxpayer to hold the investment for seven years and receive the full benefit of the basis step-up provision.



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QO Zone Incentive – Permanent Exclusion

- Taxpayer can elect under IRC Section 1400Z-2(a)(1)(C) for an additional basis “step-up” that permanently excludes capital gain on the sale or transfer of an investment that the taxpayer holds for at least ten years.
- Where the taxpayer makes an election and holds the investment for at least ten (10) years, the taxpayer’s basis in the investment is equal to the fair market value of the investment on the date the investment is sold – taxpayer is able to dispose of the property tax-free.
- Assumed that taxpayer would use IRS Form 8949 to elect permanent gain exclusion.
    - Optional – taxpayer can use stepped-up basis if FMV of property decreases.
    - Proposed regulations make clear that taxpayer’s ability to make election is preserved until 12/31/2047

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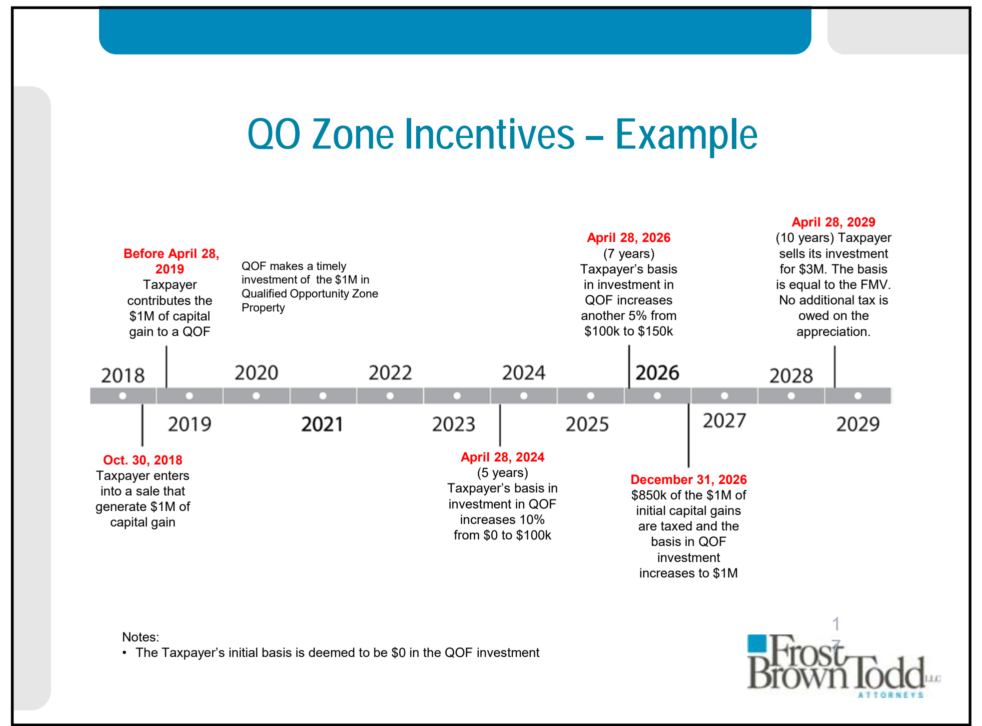

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QO Zone Incentives - Example

INVESTMENT HOLDING PERIOD	GAIN ON SALE OF ORIGINAL ASSET	GAIN ON APPRECIATION OF OZ INVESTMENT*	TOTAL TAXABLE GAIN
3 Years	$1 million	$2 million	$3 million**
5 Years	$900,000	$2 million	$2.9 million
7 Years	$850,000	$2 million	$2.85 million
10 Years	$850,000	-0-	$850,000

*** Assume OZ Investment is sold for $3 million at the end of each holding period.**
**** Absent QO Zone, this would likely be the tax result to Taxpayer for the same course of action – initial sale of asset, reinvestment in new project, and eventual sale - $1 million of gain recognized at time of asset sale and $2 million of gain recognized when new project is sold.**

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What is a Qualified Opportunity Fund (QO Fund)?

- A QO Fund is any investment vehicle organized as either a partnership (including an LLC treated as a partnership for tax purposes) or corporation that was formed for the purpose of investing in qualified opportunity zone property ("QOZ Property").
- At least 90 percent of the QO Fund's assets must consist of QOZ Property.
- IRS confirmed that a taxpayer can self-certify to become a QO Fund - Taxpayers are not required to seek pre-approval or related action to establish a QO Fund.
- To self-certify, the taxpayer will simply complete a form and attach the form to a timely filed federal income tax return for the relevant taxable year. IRS Form 8996 used for self-certification – form also used for annual 90% compliance.
- Self-certification process should simplify the general complexity typically associated with other federal incentive programs and expedite the ability of QO Funds to invest in or acquire QOZ Property.

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Investment Types in Opportunity Zones

Real Estate Development and Rehab Project in Opportunity Zones

New Businesses created in Opportunity Zones

Expansion of Businesses already in Opportunity Zones

Businesses expanding into Opportunity Zones

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What is QOZ Property?

- There are three categories of QOZ Property permitted under IRC Section 1400Z-2(d)(2)(A):
  - Qualified opportunity zone stock (“QOZ Stock”);
  - Qualified opportunity zone partnership interest (“QOZ Interest”); or
  - Qualified opportunity zone business property (“QOZ Business Property”).
- QOZ Property cannot include an interest in another QO Fund.

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QOZ Stock

- Any stock in a domestic corporation if:
  a. the QO Fund acquired the stock after December 31, 2017 at its **original issue** for cash;
  b. at the time of issue, the corporation was a qualified opportunity zone business (“QOZ Business”) or was organized to be a QOZ Business; and
  c. during **substantially all** of the time the QO Fund held the QOZ Stock, the corporation qualified as a QOZ Business.
- At this time, there is no guidance as to what period of time a corporation must qualify as a QOZ Business to satisfy the “substantially all” requirement for QOZ Stock.

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QOZ Interest

- Consists of any capital or profits interest in a domestic partnership (including an LLC treated as a partnership for federal tax purposes) if:
  a. the QO Fund acquired the interest after December 31, 2017 in exchange for cash;
  b. at the time the QO Fund acquired the interest in the partnership, the partnership was a QOZ Business or was organized to be a QOZ Business; and
  c. during **substantially all** of the time the QO Fund held the interest, the partnership qualified as a QOZ Business.
- At this time, there is no guidance as to what period of time a partnership must qualify as a QOZ Business to satisfy the "substantially all" requirement for a QOZ Interest.

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QOZ Business Property

- Tangible property that a QO Fund or QOZ Business purchased after December 31, 2017 and that is used by the QO Fund/QOZ Business in a trade or business operating in a QO Zone for **substantially all** of the time that the QO Fund/QOZ Business owns the property.
- The **original use** of the property in the QO Zone must begin with the QO Fund or QOZ Business, **or** the QO Fund/QOZ Business must **substantially improve** the property.
  - "Original use" – not defined in the statute. Regulations/caselaw address use of the term in other statutory contexts – "First use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer."

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QOZ Business Property

- Property will be treated as "substantially improved" if the basis of the QO Fund or QOZ Business in the property increases over a 30-month period beginning at acquisition by an amount that exceeds its initial basis (i.e., the purchase price) in the property.
  - The improvement expenditures of the QO Fund or QOZ Business in the property over the 30-month period must <u>exceed</u> the original acquisition price.
  - Permits parties to purchase and develop property without having to meet the "original use" requirement. Does not permit parties to purchase developed property with little or no additional improvement.
  - Revenue Ruling 2018-29 – substantial improvement measured by addition to adjusted basis of the building, not the underlying land.
- The statute does not define what period of time or what amount of use would satisfy the "substantially all" requirement for QOZ Business Property.

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QOZ Business Property – Related Party Restriction

- To qualify as QOZ Business Property, the QO Fund or QOZ Business can only acquire the property from an <u>unrelated party</u>.
- Property that a QO Fund or QOZ Business purchases in a transaction involving certain prohibited relationships such as individuals from the same family, entities related through common ownership or control, or entities from the same controlled group, may <u>NOT</u> be considered QOZ Business Property.

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What is a QOZ Business?

REQUIREMENTS:

1. The activity must be a trade or business in which substantially all of the tangible property owned or leased by the taxpayer is QOZ Business Property.
   - Proposed regulations define "substantially all" in this limited context to mean at least 70%.
2. At least 50% of the total gross income of the taxpayer must be from the active conduct of such trade or business activity WITHIN THE ZONE, and the taxpayer must use a substantial portion of its intangible property in the active conduct of such trade or business.
3. Less than 5% of the average aggregate unadjusted bases of the property of the entity may be attributable to nonqualified financial property (e.g., debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, or annuities).
4. "Sin Business" Restriction The trade or business activity must not constitute a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

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Basic Model for Real Estate Development Project

Real Estate Development
- New construction
- Substantial improvement of adjusted basis excluding land

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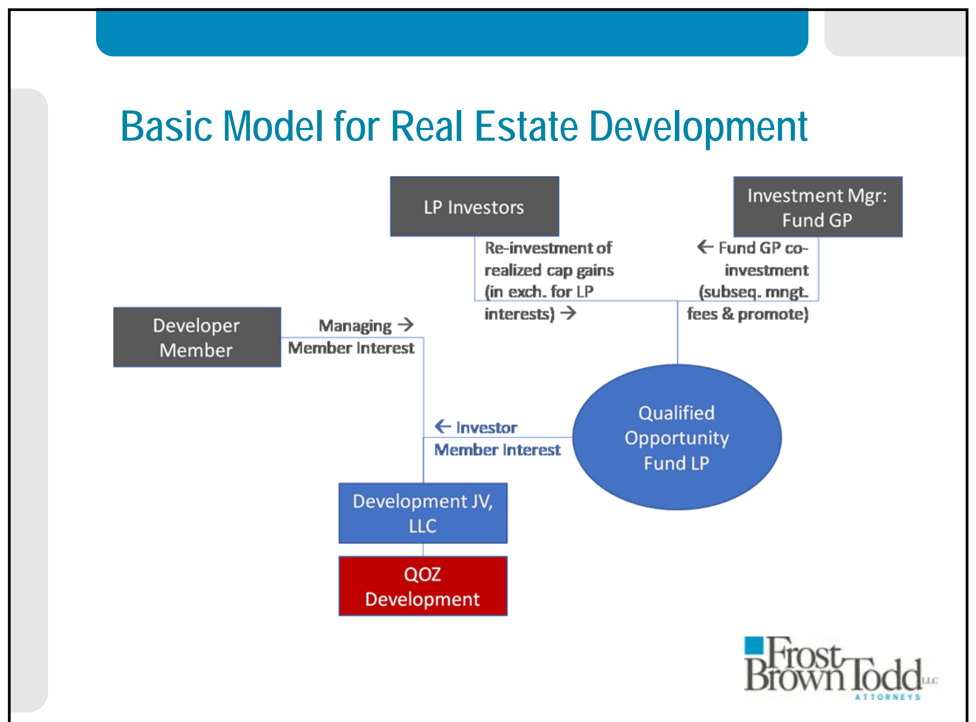

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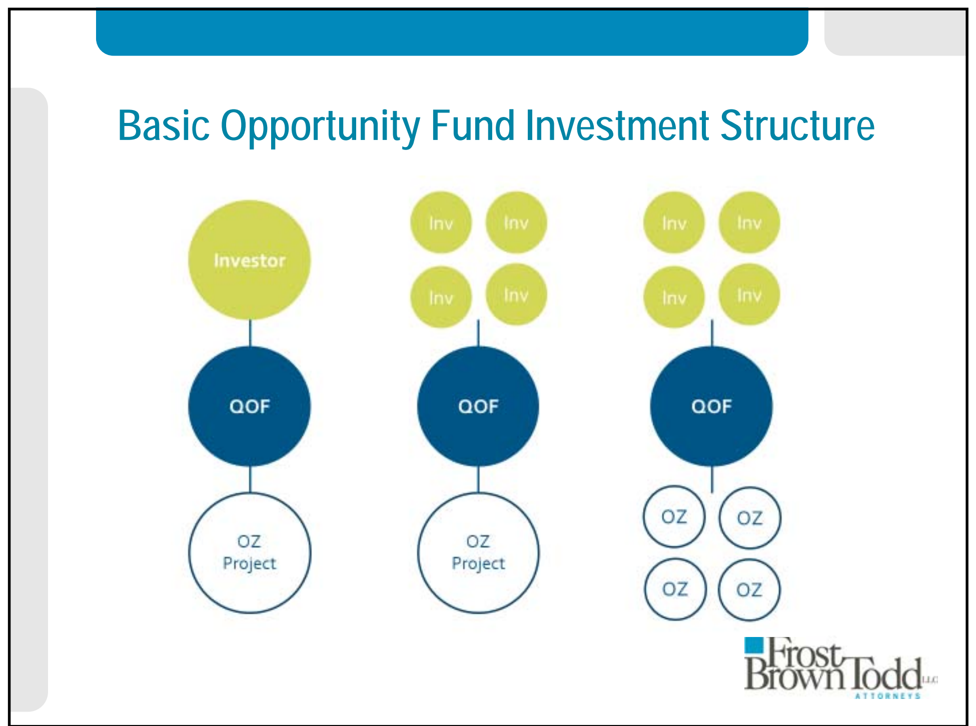

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Mixed Fund Investment

- A taxpayer is permitted to invest funds in a QO Fund of which only a portion of the investment consists of gain for which the taxpayer made a deferral and exclusion election under IRC Section 1400Z-2.
- However, taxpayer will only be entitled to Opportunity Zone tax incentives on the portion of the investment for which the taxpayer made the election (i.e., the reinvested capital gain).
- If the taxpayer makes a "mixed fund" investment, the taxpayer is treated as having made two separate investments in the QO Fund – one investment to which the deferral election was made, and the other investment consisting of the remaining amount. The tax incentives only apply to the former investment and not the latter.

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Civil Penalties for Noncompliance

- If a QO Fund fails to meet the requirement that it must hold at least 90 percent of its assets in QOZ Property, the QO Fund must pay a penalty for each month that the fund is in non-compliance.
- No penalty will be imposed where there is reasonable cause for the QO Fund's failure to meet the threshold. At this time there is no guidance as to what might constitute "reasonable cause".

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Questions?

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TAB
D

Bill Tucker, CPA

Education and Professional Designations

- B.S. in Accounting from the Franklin College
- Certified Public Accountant (CPA)

Previous Experience

- Tax Director at The Walnut Group
- Tax- PwC

Bill joined Truepoint in January of 2017 as a Tax Specialist. Bill enjoys volunteering with People Working Cooperatively and at the local schools in Hebron, KY where he lives with his wife and two children. In his free time, he loves to run and play golf. Bill gets the most satisfaction from his job when he's solving complex, and often times stressful, tax issues for his clients. A fun fact about Bill is that for his first job out of college he taught English in Japan.

Nichole Williams, CPA

Education and Professional Designations

- B.S. in Accounting and a B.B.A. in Finance from the University of Kentucky, summa cum laude
- Certified Public Accountant in both Ohio and Kentucky

Previous Experience

- Tax Manager at PwC

Nichole joined Truepoint in September of 2014 as a Tax Specialist. Outside of work, she has volunteered with many local youth organizations, including the Boy Scouts, Cincinnati Youth Collaborative, and the Adopt A Class Foundation. Nichole enjoys following University of Kentucky sports and decorating and design. One of Nichole's favorite things about working at Truepoint is that she really gets to know the clients that she's serving. Something that her clients may not know about her, is that she loves attending Taylor Swift, Kesha, and Dixie Chicks concerts.

John Wolfenden, JD

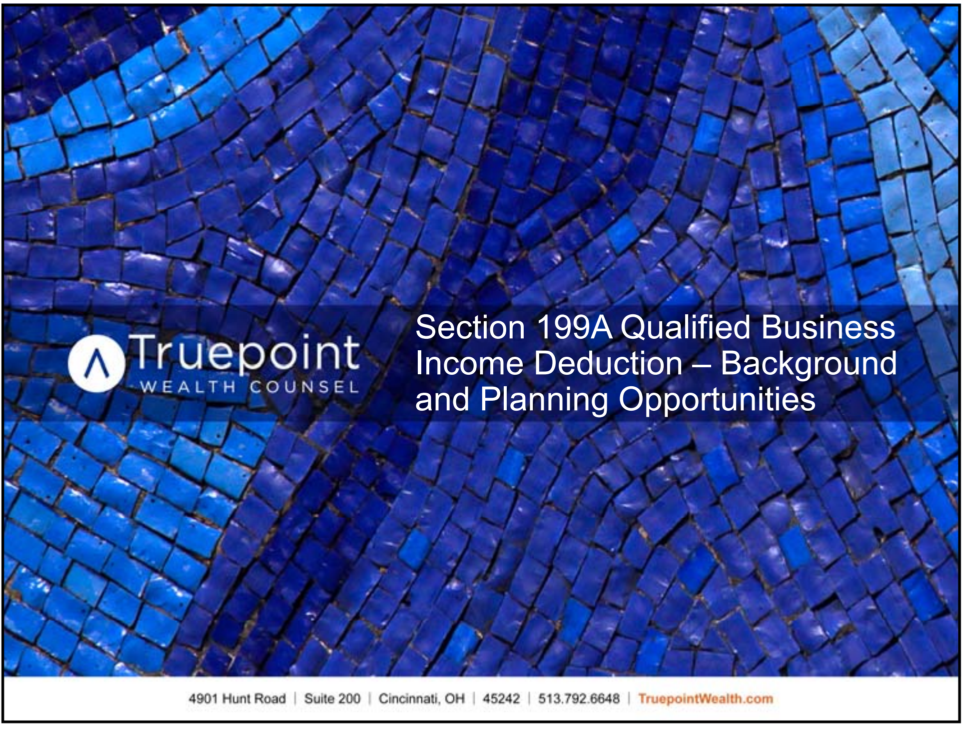
Education and Professional Designations

- Bachelor of Arts degree from Denison University
- Juris Doctor degree from The University of Cincinnati College of Law, magna cum laude

Previous Experience

- Attorney at Kohnen and Patton
- Law Clerk at The Robison Law Firm

John joined Truepoint in August of 2015 as a Tax Specialist. One of John's favorite things about Truepoint is the coordinating efforts between the various teams. John's extensive community involvement includes being a member of the American, Ohio and Cincinnati Bar Associations, participating in the Cincy Next program through the Cincinnati USA Regional Chamber of Commerce and serving on the Tax Institute Planning Committee for the Cincinnati Bar Association. John is a new parent to twin boys. Between caring for his sons and his various community commitments, John admits that he no longer has much free time, but the small amount that he does have is spent golfing and reading.



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Agenda

- Basics … "Basics"
- Examples
  - Service business
  - Non-service business
  - Other limitations
- Planning
  - Maximize deduction by lowering taxable income
  - 199A benefit from estate planning

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The Deduction

Applies to taxable years after December 31, 2017 and before January 1, 2026.

- Provides owners of pass-through businesses a deduction up to 20% of the owner's "qualified business income" (QBI):
  - QBI means "…amount of qualified items of income, gain, deduction, and loss with respect to <u>any trade or business</u> [within the U.S.]…" Prop. Reg. §1.199A-1(b)(4)[1]
- Allowed to individuals, trusts and estates that are owners of:
  - Sole proprietorships
  - S-corporation stock
  - Partnership/LLC interests
  - Rental real estate trade or business **(more on this later)**
  - <u>NOT</u> available to income earned through a C corp or wage income
- Also applies to qualified REIT and PTP income. We will not be covering these.
- The deduction is <u>not</u> used to compute AGI and is not an itemized deduction.
- Overall it appears that this deduction is intended to benefit business owners that are not traditional service providers (i.e. lawyers, doctors) and who use wage labor and have large capital investment. However, if taxpayer's taxable income is below a certain threshold level, they can still fully benefit from this deduction even if a service provider. The limitations support this intention:
  - Limitations begin applying to owners with taxable income exceeding a certain threshold and:
    - If the business is a service business as defined under the law
    - If wages paid by the business or wages plus basis of its property are not high enough to avoid phase-in of these limitations

1 – all section references are to the Internal Revenue Code of 1986, as amended.

Qualified Business Income

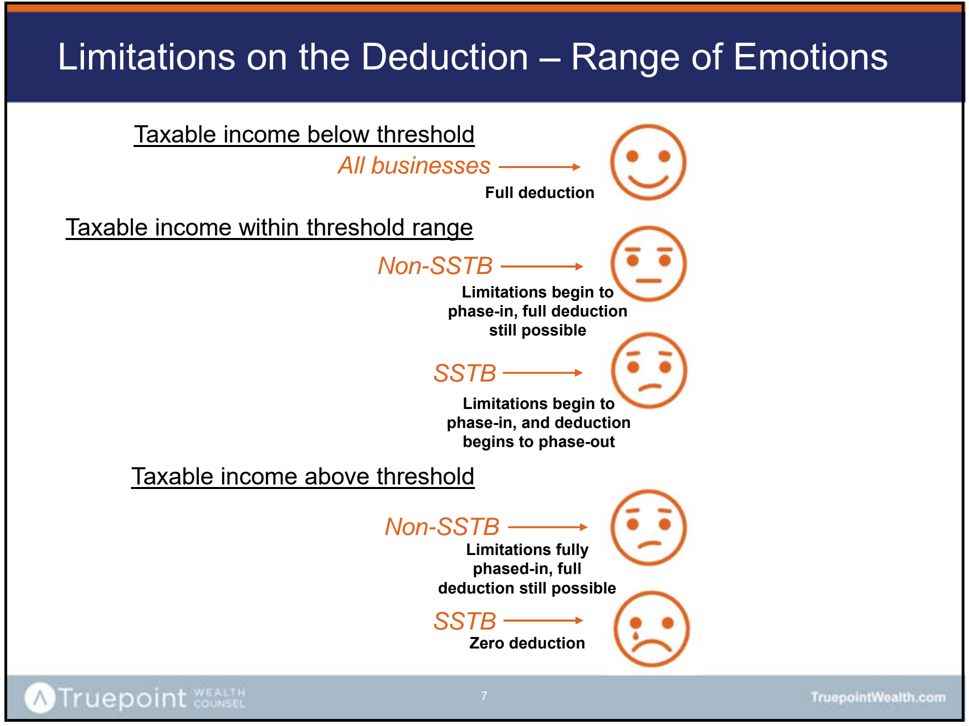
- "Trade or business" – as defined under § 162**.** Remember there is A LOT of guidance on "trade or business." Some factors include being involved in an activity with regularity and continuity with the intention of making a profit.
  - Fact intensive
  - EXCLUDES certain types of investment-related items such as capital gains/losses, dividends and non-business interest income. Employee compensation and guaranteed partner payments are also excluded.
- Taxpayer owner of multiple businesses
  - <u>Generally</u>, the QBI must be determined for EACH business separately. Subject to aggregation, common control and other rules under the proposed regulations.
    - Negative QBI from a business is netted against positive QBI from any other business. Prop. Reg. §1.99A-1(d)(2)(iii)(A).
    - If the net QBI for all business in a year is negative, the negative result is treated as QBI from a separate business and carried over. Prop. Reg. §1.99A-1(d)(2)(iii)(B).
- Rental property? **Unclear**.
  - However, proposed regulations did clarify that if property is rented to a commonly controlled trade or business, that rental or licensing activity will be treated as a trade or business for QBI purposes even if that activity does not rise to the level of a trade or business. Prop. Reg. §1.99A-1(b)(13).
    - Applies to business owners who own rental property separately from operating business.
    - Watch-out for blended business rules for service businesses.

Service v. Non-Service Business

- A “Specified Service Trade or Business” (SSTB) is any trade or business that involves the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business if the principal asset of that trade or business is the reputation or skill of one or more of its employees or owners. §199A(d)(2)(A).
  - Also includes any trade or business involving the performance of investing and investment management services as well as trading or dealing in securities, partnership interests or commodities. §199A(d)(2)(B).
- The proposed regulations broadened the inclusiveness of some of these service categories.
  - For example: “…the performance of services in the field of health means the provision of medical services by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists and other similar healthcare professionals performing services in their capacity as such who provide medical services directly to a patient…” Prop. Reg. §1.199A-1(b)(2)(ii).
- The proposed regulations address splitting/combining certain business lines in order to control classification as a SSTB. 50%/80% tests.

SSTB and Blended Businesses

- Blended businesses and multiple services/related entities
  - Even if a business is providing multiple services, look at the business as a WHOLE to determine if a SSTB.
  - De minimus rule – If only a minor portion of the gross receipts of a trade or business are attributable to one of the SSTB fields, a de minimis rule may permit the avoidance of SSTB classification.
    - A trade or business is not a SSTB if the trade or business has $25 million or less in gross receipts and less than 10% of gross receipts are attributable to the performance of services in the specified fields; if more than $25 million, the test is less than 5% of gross receipts. *See* Prop. Reg. §1.199A-5(c)(1).



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Thresholds

Taxpayer/Tax Filing Status	Threshold Limitations
Single Threshold range - $157,500 - $207,500 Married filing jointly (MFJ) Threshold range - $315,000 - $415,000 Estate/non-grantor trust Threshold range - $157,500 – 207,500	SSTB Taxable income before QBI deduction less than threshold **– 20% deduction** Taxable income before QBI deduction within threshold range **– reduce deduction – phase-out of QBI, W-2 wages and basis of qualified property by applicable percentage, and phase-in wage and capital limitation** Taxable income before QBI deduction greater than threshold range **– no deduction**
	Non-SSTB Taxable income before QBI deduction less than threshold **– 20% deduction** Taxable income before QBI deduction within threshold range **– reduce deduction – phase-in wage and basis limitation** Taxable income before QBI deduction greater than threshold **– wage and basis limitation**
ALL TAXPAYERS	The deduction cannot exceed 20% x taxable income less net capital gain (in other words, the deduction cannot exceed 20% of ordinary income)

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Wage and Capital Limitation

- Wage and basis limitations begin to be phased-in as taxpayer's income exceeds previously mentioned thresholds.
  - Also, for SSTBs, the amount of QBI, W-2 wages and share of basis of qualifying property are reduced which may further phase-out the deduction for SSTB income.

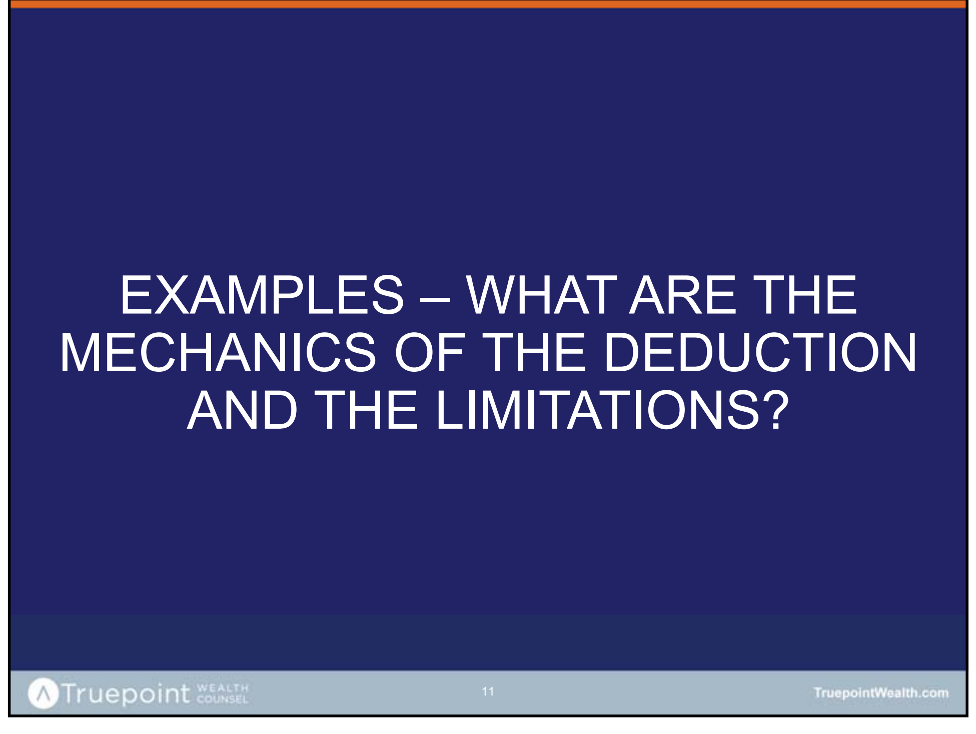
- ***Essentially, the higher a taxpayer's share of W-2 wages and/or unadjusted basis of qualified property of a business, the less the QBI deduction will be impacted by the phase-in of these limitations taxable income exceeds the thresholds.***

- Wages. The taxpayer's share of total W-2 wages can be calculated using three different methods per IRS Notice 2018-64. Wages subject to withholding, elective deferrals, and deferred compensation are included per §199A(b)(4).

- Basis. Basis of "qualified property" – "the term qualified property means, with respect to any trade or business…for a taxable year, tangible property of a character subject to the allowance for depreciation under section 167(a) – (A) which is held by, and available for use in, the trade or business at the close of the taxable year, (B) which is used at any point during the taxable year in the trade or business's production of QBI, and (C) the depreciable period for which has not ended before the close of the…taxable year." Prop. Reg. §1.199A-2(c)(1)(i). "Depreciable period" starts when "the property was first placed in service" and ends on the later of (a) 10 years later, or (b) the end of the last full year of the applicable recovery period. Prop. Reg. §1.199A-2(c)(2).
  - "In the case of any addition to, or improvement of, qualified property that has already been placed in service…such addition or improvement is treated as separate qualified property first placed in service on the date such addition or improvement is placed in service." Prop. Reg. §1.199A-2(c)(1)(ii).

Aggregation

- Aggregation
  - Combine QBI, wage and capital aspects for separate businesses if certain tests are met as provided in Prop. Reg. § 1.199A-4(b)(1):
    - the trades or businesses are commonly controlled for the majority of the tax year (i.e. same group owns at least 50%) for a majority of the tax year
    - all of the items attributable to the trades or businesses are taken into account in the same tax year (excepting short years);
    - none of the trades or businesses are SSTBs;
    - and the trades or businesses satisfy two of three factors – providing products and services that are the same or customarily offered together, sharing facilities or significant centralized business elements (i.e. accounting, IT, etc.), and operating in coordination with (or reliance on) one or more of the businesses in the aggregated group (i.e. "supply chain interdependence").
  - Aggregation is at the OPTION of the TAXPAYER, and all of the owners of a business do NOT have to make the same aggregation decision.



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Income Below Threshold, Subject to Overall Limit

Example 1

Nichole, married and a 50% partner in Williams & Tucker LLC accounting firm, has $350,000 of ordinary business income in 2018. Her husband has $50,000 of pension income for the year and $10,000 of long-term capital gain . Their charitable donations total $115,000 for the year. Assume no other itemized deductions and MFJ.

Item	Amount	Notes
Potential 199A deduction based on QBI	$70,000	20% x $350,000
Taxable income before QBI	$295,000	AGI $410,000 -Deductions ($115,000) Taxable income $295,000
Potential 199A deduction based on taxable income	$57,000	Taxable income $295,000 -Capital gains ($10,000) Ordinary income $285,000 * 20% Overall limitation $57,000
199A deduction	$57,000	Subject to overall limitation.

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Income Above Threshold, SSTB

Example 2

Same facts as above, except Nichole has $500,000 of ordinary business income in 2018.

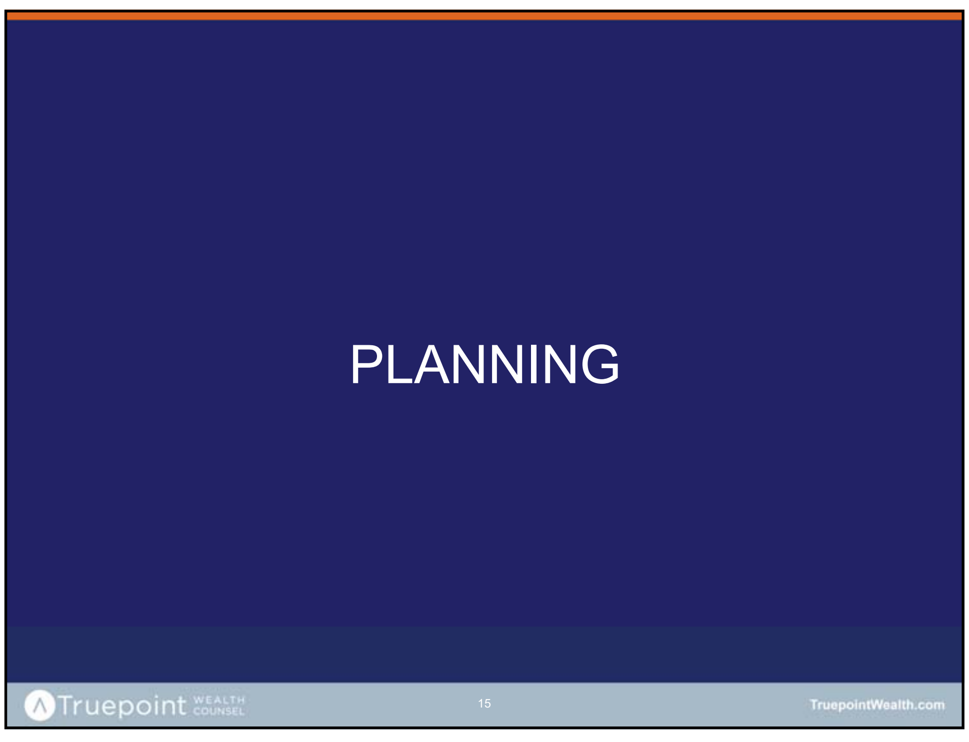
Item	Amount	Notes
Potential 199A deduction based on QBI	$100,000	20% x $500,000
Taxable income before QBI	$445,000	AGI $560,000 -Deductions ($115,000) Taxable income $445,000
199A deduction	$0	MFJ upper threshold exceeded (+415,000). Since SSTB, zero deduction.

Income Above Threshold, Non-SSTB

Example 3

Bill is a 50% shareholder in the S-corp Tucker Enterprises, Inc., a manufacturing business. He files a joint return with his wife reporting $750,000 of taxable income, of which $500,000 is ordinary income from Bill's S-corp interest. Bill's allocable share of W-2 wages is $100,000 and share of business unadjusted basis is $500,000.

Item	Amount	Notes
Potential 199A deduction based on QBI	$100,000	20% x $500,000
Taxable income before QBI	$750,000	Exceeds upper income threshold for MFJ – apply wage and basis limitation
Wage and basis limitation	$50,000	Greater of: (1) 50% of W-2 wages, $50,000, or (2) the sum of 25% of W-2 wages, $25,000, plus 2.5% of the unadjusted basis of the qualified property immediately after its acquisition: $12,500, for a sum of $37,500.
Potential 199A deduction based on taxable income	$150,000	20% x $750,000
199A deduction	$50,000	Compare to previous example - $50K deduction for same business income and higher taxable income.



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Income Above Threshold – Reduce Taxable Income?

Example 4

John is a single self-employed lawyer. His taxable income in 2018 would be $225,000 including $200,000 of QBI from his legal practice. Without planning, his QBI is completely phased-out. However, with a defined benefit plan contribution of $75,000, he is able to benefit from 199A.

Item	Amount	Notes
Potential 199A deduction based on QBI	$40,000	20% x $200,000
Taxable income before QBI with defined benefit contribution	$150,000	Below income threshold
Potential 199A deduction based on taxable income	$30,000	20% x $150,000
199A deduction	$30,000	$40K deduction for same business income but with defined benefit contribution.

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199A Benefits as Part of Estate Planning

Example 5

Kathleen and her husband are 50/50 owners of Commercial Cleaners, LLC. This LLC provides cleaning and other related services to commercial properties. The couple's taxable income in 2018 would be $850,000 including $600,000 of QBI from the LLC. The original basis of the qualified property owned by the LLC is $500,000 and $50,000 of wages are paid.

Item	Amount	Notes
Potential 199A deduction based on QBI	$120,000	20% x $600,000
Taxable income before QBI	$850,000	Above income threshold
Wage and basis limitation	$25,000	Greater of: (1) 50% of W-2 wages, $25,000, or (2) the sum of 25% of W-2 wages, $12,500, plus 2.5% of the unadjusted basis of the qualified property immediately after its acquisition: $12,500, for a sum of $25,000.
Potential 199A deduction based on taxable income	$170,000	20% x $850,000
199A deduction	$25,000	Limited by wage and basis

199A Benefits as Part of Estate Planning

Example 5 continued

Instead in 2018, for estate planning purposes, Kathleen gifts 25% of her interest to irrevocable trust A for the benefit of son Tom. Her husband gifts 25% of his interest to irrevocable trust B for the benefit of daughter Claire. These are the only assets owned by each trust.

Item	Amount	Notes
Potential 199A deduction based on QBI for each trust	$30,000	20% x $150,000
Taxable income before QBI for each trust	$150,000	25% of $600,000
Wage and basis limitation	N/A	Income for each trust is below limitation threshold
Overall limitation	$30,000	20% x $150,000
199A deduction for each trust TOTAL:	$30,000 $60,000	$60,000 now deductible following gifts.

NOTE: be careful with trusts. The proposed regulations contain anti-abuse provisions for trusts: "Trusts formed for funded with a significant purpose of receiving a deduction under section 199A will not be respected for purposes of section 199A." Prop. Reg. §1.199A-6(d)(3)(v).

Other Planning Ideas

- Reduce taxable income using other techniques – charitable gifts, etc.
- Increase taxable income to further benefit from 199A deduction – rather than use self-employed retirement plan, consider Roth IRA contributions to still benefit from tax favored retirement investment but not reduce taxable income.
- Increase capital investment, increase wages paid.
- Refinance/planning with debt.
- Entity Selection

Parting Thoughts

- There is still a lot of gray area in the law.
  - As mentioned – rental properties, SSTBs
  - What about the sale of business assets? If capital gain, no QBI; however, what if the gain is ordinary?
- Still waiting on guidance from the IRS/final 199A regulations.

Disclosures

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TAB
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Richard J. Hassebrock

Richard Hassebrock graduated magna cum laude from the Salmon P. Chase College of Law at Northern Kentucky University in 1998 and started with the Office of Chief Counsel in September 1998 in the Cincinnati, Ohio office, where he continues to work today in the Small Business/Self-Employed group. He was promoted to Senior Counsel in 2010 and has tried more than 50 cases in the United States Tax Court.

Interacting with the Office of Chief Counsel: Tips and Suggestions

12/4/2018

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Interacting with the Office of Chief Counsel: Tips and Suggestions

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Today's Talking Points

- Interacting with Chief Counsel During the Examination Phase
- Interacting with Chief Counsel During the Collection Phase
- Interacting with Chief Counsel During Appeals Consideration
- Interacting with Chief Counsel After Filing a Petition with the United States Tax Court

What Does the Office of Chief Counsel Do?

- **Providing Legal Advice to IRS Revenue Agents Conducting Examinations**
- **Providing Legal Advice to IRS Revenue Officer Attempting to Collect Delinquent Tax Liabilities**
- **Coordinating Litigation Between the IRS and the Department of Justice/US Attorney's Office in the United States District Courts**
- **Tax Court Litigation**

Chief Counsel Interaction During the Examination Phase

- When Does Counsel Get Involved with an Examination?
  - For the most part, Counsel does not get involved with taxpayer examinations and generally, you will not have to deal with Counsel during that process
  - Novel or complex legal issues arising during the examination – Counsel may provide advice informally or formally to the IRS, but generally, this is subject to attorney-client privilege and you may or may not actually get to communicate with the Chief Counsel attorney
  - Taxpayer/Witness Interviews – Counsel may be present and even do the questioning
  - IRS Examiner/Manager Requests Counsel Intervention

Chief Counsel Interaction During the Collection Phase

- Again, the most part, Counsel does not get involved in the average Collection case either
- Chief Counsel gets pulled in when issues arise in clouded ownership issues (nominees, alter-egos, sham trusts, etc.)

Chief Counsel Interaction During the Appeals Consideration Phase

- Again, very rare to have an appearance by Chief Counsel Attorney while you are involved in the Appeals Phase of a Case
- Appeals Pre-conferences
- Fast Track Mediation Conferences

Tax Court

- Petition
- Answer
- Discovery, Informal and Formal
- Settlement Negotiations
- Trial Preparation and Trial
- Briefing
- Appeal

Tax Court: The Petition and the Answer

- What happens when Chief Counsel get served with the petition?
- What happens after Chief Counsel attorney files the answer?
- If Chief Counsel attorney makes affirmative allegations, you should file a reply because if you do not, we will likely file a Rule 37(c) Motion – See Tax Court Rule 37(c)

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Tax Court: Discovery

- Branerton Conference
- Informal Discovery
- Formal Discovery

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Tax Court: Settlement Negotiations

- Better deal than Appeals?
- New Documents?
- Hazards of Litigation?

Tax Court: Trial Preparation and Trial

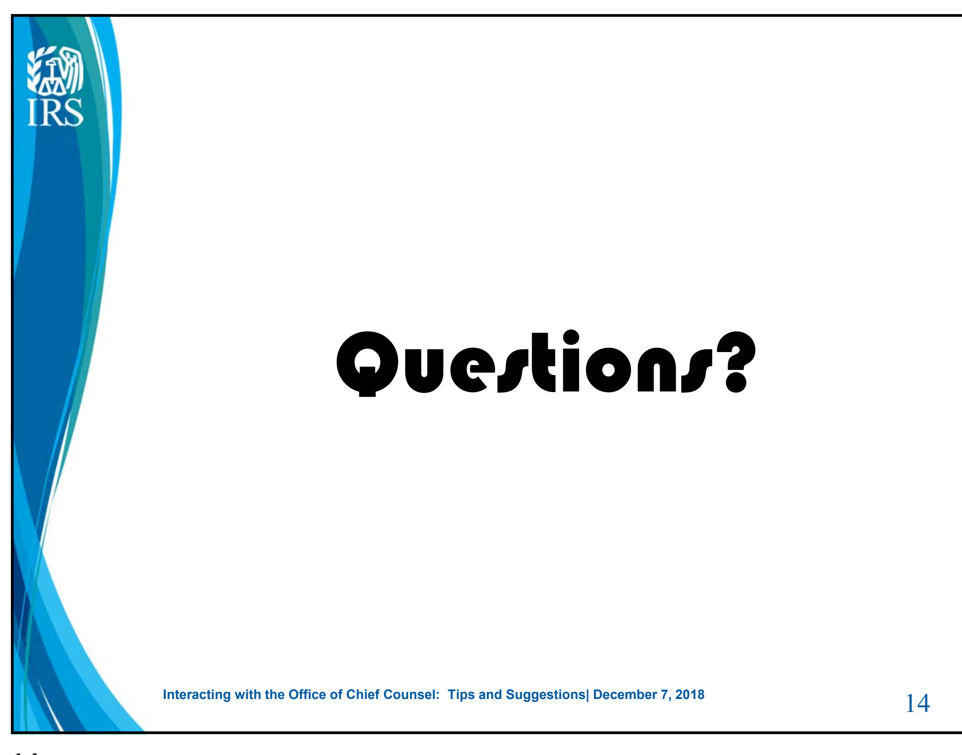
- Stipulation of Facts and Tax Court Rule 91
- Witnesses
- Time and Date Certain
- Conference Calls with the Judge
- Calendar Call
- Trial

Briefing

- Simultaneous or Seriatim?
- Time Frame?
- Be sure to plan in advance
- Extension of Time?

Decisions and Appeals of Tax Court Decisions

- Drafting and Signing Decisions
- Tax Court Rule 155 Decisions
- Appealing a Negative Decision?



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