A. Real Estate Activities.

1. Scarn Will Defer The Most Gain Under The Installment Method; It Is Recommended Scarn Change His Method of Accounting To Claim Prior Missed Depreciation.

Following the installment sale of Property 3, where at least one payment from the sale is to be received after the end of the tax year in which the sale occurred, the installment method of reporting gain must be used. I.R.C. §§ 453(a), (b)(1). Under the installment method a taxpayer is permitted to defer the recognition of gain, as Scarn desires. Cf. I.R.C. § 1001(c). Gain is prorated and recognized over the period of years in which installment payments are received. I.R.C. § 453(c). The amount of taxable gain recognized on an installment sale in a given year is calculated by multiplying the total installment payments received in that year by the gross profit ratio for the sale. *Id.* The gross profit ratio is equal to the gross profit on the installment sale divided by the total contract price. Treas. Reg. § 15A.453-1(b)(2)(i).

\[
\text{Gross Profit} = 1,400,000 \text{ ($2,000,000 selling price – $600,000 adjusted basis). See id. at (b)(2)(v). The selling price is $2,000,000, which does not include the 6% annual interest Scarn is set to receive with each payment. Id. at (b)(2)(ii). The contract price is also $2,000,000. See id. at (b)(2)(iii). Under the installment method, Scarn’s adjusted basis includes his adjusted basis for tax purposes plus any selling expenses (unknown if any at this time) related to the sale of the property. Id. at (b)(2)(v). Initially, Scarn had a “stepped-up basis” of $300,000, the fair market value at the date of Scarn’s grandfather’s death, in the land, which included Property 3. I.R.C. § 1014(a). Scarn then partitioned the land in three equal parts, giving Scarn a basis in Property 3’s land of, at all times, $100,000. The $560,000 Scarn spent on building the home on Property 3 was a capital} \]
expenditure. I.R.C. § 263(a). Scarn was not permitted to deduct this capital expenditure in full at that time; instead the expenditure was included in his basis. I.R.C. § 1016(a)(1). At the time Property 3 was placed in service, Scarn had an adjusted basis of $660,000.

To recover capital expenditures, taxpayers may deduct a reasonable allowance for the exhaustion, wear and tear of property used in the business, or property held for the production of income. I.R.C. § 167(a). Scarn was entitled to claim depreciation of $10,000 annually for six full years, beginning when Property 3 was held for rent on January 1, 2013. See Treas. Reg. § 1.167(a)-11(e)(1). Scarn neglected to take such depreciation deductions. Regardless, the basis of the property must nevertheless be reduced by the amount that Scarn was entitled to deduct. I.R.C. § 1016(a)(2). Scarn’s adjusted basis, reflecting the $60,000 of allowable depreciation deductions is $600,000. To mitigate the effect of this rule, Scarn may make a change in his method of accounting from the “impermissible” method used, under which Scarn did not take any annual depreciation, to a permissible method, allowing him to claim the prior missed depreciation. Rev. Proc. 2007-16, § 3; Rev. Proc. 2018-31, § 6.01(3)(a). Upon such change, Scarn will make a net negative section 481(a) adjustment of $60,000, taken in full in taxable year 2019, allowing Scarn to claim the $60,000 as a deduction against his ordinary income. Id. at § 6.07(3)(a).

**Gross Profit Ratio** = 0.70 ($1,400,000 gross profit / $2,000,000 contract price).

**Gain Recognized and Characterization of Gain.** Each payment received will consist of: (i) gain on the sale, (ii) return of Scarn’s adjusted basis in the property, and (iii) interest. Scarn will recognize gain on the sale as follows:

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<thead>
<tr>
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<th>2020</th>
<th>2021</th>
<th>Total</th>
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<tbody>
<tr>
<td>Installment Payments</td>
<td>$1,250,000</td>
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<td>$250,000</td>
<td>$2,000,000</td>
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Property 3 is excluded from capital asset status, as it is real property used in Scarn’s business. I.R.C. § 1221(a)(2). However, Property 3 is section 1231 property and gain from the sale will nevertheless be characterized as long-term capital gain, taxed at a favorable rate. I.R.C. §§ 1231(a)(3), (b)(1). Property 3 is also section 1250 property, a depreciation recapture section. I.R.C. § 1250(c). Since Property 3 was placed in service after 1986 and is subject to MACRS, the straight-line method must be used, therefore there is no depreciation recaptured as ordinary income following the sale. See I.R.C. § 1250(a)(1). Instead, the gain is “unrecaptured section 1250 gain,” to the extent of the amount of long-term capital gain which would be treated as ordinary income if section 1250(b)(1) included all depreciation. I.R.C. § 1(h)(6)(A). Since Scarn did not claim depreciation, and if he can prove such, he is permitted to take into account the amount of depreciation allowed –zero– in calculating his unrecaptured gain. See I.R.C. § 1250(b)(3). Thus, all $1,400,000 gain recognized would be section 1231 long-term gain. However, if Scarn makes the section 481(a) adjustment claiming $60,000 of depreciation in 2019, which is recommended, Scarn will have $60,000 of unrecaptured section 1250 gain taxed at a rate of 25%, I.R.C. § 1(h)(1)(D); the remaining $1,340,000 is taxed as section 1231 long-term capital gain. Additionally, the 6% interest payments Scarn is set to receive with each payment are taxed as ordinary income.

2. Scarn’s Activities Rise To The Level Of A Business Under Section 162, Entitling Scarn To Take A Section 199A Deduction, Subject To Limitations.

A taxpayer is entitled to a deduction of up to 20 percent of qualified business income (“QBI”) earned in a qualified trade or business (“QTB”). I.R.C. § 199A. Therefore, Scarn’s rental activities must rise to the level of a QTB to be entitled to take the deduction. A QTB is a section 162 trade or business other than the trade or business of performing services as an employee.” Treas. Reg. § 1.199A-1(b)(14). A safe harbor is available under which a rental real estate enterprise (“RREE”) will be treated as a QTB for purposes of section 199A. See Rev. Proc. 2019-38. While
it is currently unknown whether Scarn qualifies for the safe harbor, failure to satisfy the requirements will not prevent Scarn from otherwise establishing a business under section 162, which he can do.

(a) Safe Harbor. Scarn’s rental activities will be treated as a QTB upon satisfying the following requirements: (1) separate books and records are maintained to reflect income and expenses for the RREE; and (2) 250 or more hours of rental services were performed per year in any three of the five consecutive taxable years ending with the taxable year. *Id.* at § 3.03. As discussed below, Scarn likely performs 250 hours of rental services per year. *See id.* at § 3.04 (defining “rental services”). Problematic however, Scarn has failed to keep track of payments received from his tenants in arrears; it is unlikely Scarn will be able to satisfy the first requirement of providing separate books and records. It must be determined whether this failure to keep records is an ongoing issue, and if so, must be addressed and corrected as it has wide-ranging implications.

(b) Scarn’s Real Estate Activities are a QTB Under Section 162. Whether an activity is a business depends on the facts and circumstances, but three factors have to be present: (1) Scarn must intend to make a profit; (2) Scarn must be regularly and actively involved in the activity; and (3) the activity must have begun. *See Comm’r v. Groetzinger*, 480 U.S. 23, 35-36 (1987). An activity is presumed to be engaged in for profit if the activity produces gross income in excess of deductions attributable to such activity for any three of the five consecutive years ending with the taxable year. I.R.C. § 183(d). Scarn’s nominal profit earned in most years did not reflect the depreciation deductions of $10,000 ($30,000 accounting for all three properties) attributable to his rental activities, therefore gross income will likely not exceed the attributable deductions. *See id.*

The test for determining whether a taxpayer conducted an activity for profit is whether the taxpayer entered into, or continued, the activity “with the actual and honest objective of making a profit.” *Dreicer v. Comm’r*, 78 T.C. 642, 645 (1982), aff’d without published opinion, 702 F.2d
Determining whether a taxpayer operates an activity with an actual and honest profit motive typically involves applying the nine factors contained in Treas. Reg. § 1.183-2(b). Not all factors are applicable in every case, no one factor is controlling, and a numerical majority does not decide the issue. Id. Balancing the factors, Scarn has the requisite profit intent.

**Favoring a profit intent.** First, the time and effort expended by Scarn in carrying on the activity. *Id.* at (b)(3). Scarn has taken care of all the minor repairs, has undertaken advertising the properties himself, handles all tenant interactions, and presumably has forgone seeking employment opportunities elsewhere. Additionally, Scarn’s involvement does not have the substantial personal or recreational aspects that may disfavor a profit objective. Scarn does take pleasure in working with his hands and takes pride in running the most meticulously maintained rentals in the city, as he should; success in a business is largely obtained by pleasurable interest therein. For this reason, factor nine (elements of personal pleasure) is neutral. *Id.* at (b)(9). To this point, Scarn can show extensive business activity over a substantial period of time – satisfying the requirement that he must be regularly and actively involved in the activity to qualify as a business under section 162. See *Groetzinger*, 480 U.S. at 35.

Second, expectation that assets used in activity may appreciate in value. Treas. Reg. § 1.183-2(b)(4). Regardless of whether an activity derives profit from current operations, an expectation that assets will appreciate in value suggests a profit motive. Of note, Scarn’s rental activity and the holding of the properties’ land are a single activity. See *id.* It is fairly common for a taxpayer to show that the land, and associated property, is intended to appreciate in value, especially as Scarn began his real estate activities during a booming residential real estate market. Objectively, the $2,000,000 sale price of Property 3 is misleading in illustrating expected appreciation as that value was likely derived after favorable zoning changes. Nevertheless, the properties’ appreciation is sufficient to recoup accumulated losses of prior years since Scarn’s
expenses were low and he was able to turn a nominal profit most years. *See Carmody v. Comm’r*, T.C.M. 225 (2016).

Further, Scarn’s financial status. Treas. Reg. § 1.183-2(b)(8). While Scarn’s wife earns a comfortable salary, Scarn has recently experienced an increase in household debt. It is unlikely that Scarn is seeking to offset his wife’s income, illustrating he does not have the financial wherewithal to sustain a history of financial losses for the activity. However, this may change year to year, as the overall financial status of the Scarns is unknown, but generally substantial capital would in turn disfavor a profit objective. As well, Scarn was not conducting the activity to offset taxable income from other sources. *See id.*

**Disfavoring a profit intent.** First, the manner in which Scarn carries on the activity. Treas. Reg. § 1.183-2(b)(1). A taxpayer operates in a businesslike manner when, among other things, he has a business plan, keeps complete records, and responds to losses by changing what he does. *See Engdahl v. Commissioner*, 72 T.C. 659, 666-67 (1979). To our knowledge, Scarn has no formal business plan, nor operational structure, illustrated by failing to run credit checks on prospective tenants as well as failing to keep records of payments received from his tenants. Second, the expertise of Scarn or his advisor. *Id.* at (b)(2). Regardless of Mr. Wilson’s expertise as a rental real estate advisor, after receiving advice, Scarn is expected to undertake a basic investigation of the factors that would affect profit, which he did not do before investing his sizable inheritance in the venture. *See Westbrook v. Comm’r*, T.C.M. 634 (1993). Additionally, Scarn’s history of income or losses, and the amount of occasional profits. Treas. Reg. §§ 1.183-2(b)(6), (b)(7). These factors may disfavor a profit intent, as Scarn invested $1,680,000 and has only turned a nominal profit most years. However, factor four (expectation assets may appreciate in value) mitigates these factors, as discussed above. As well, a series of losses during the initial stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. *Id.* at (b)(6).
Scarn is entitled to a section 199A deduction as his activities rise to the level of a QTB. The totality of the facts and circumstances indicates Scarn engaged in his rental activities with the objective of making a profit and was regularly and actively involved in the activity since it began.

**Section 199A Limitations.** Scarn is only entitled to a deduction on the QBI earned in his rental business. QBI means the net amount of qualified items of income, gain, deduction, and loss with respect to any QTB of the taxpayer. I.R.C. § 199A(c)(1). QBI however does not include any item of short- or long-term capital gain or loss, or reasonable compensation paid by any QTB. I.R.C. §§ 199A(c)(3), (c)(4)(A); Treas. Reg. § 1.199A-3(b)(2). Consequently, the gain recognized from the sale of Property 3 is not included in Scarn’s QBI. The section 199A deduction for a tax year is equal to the lesser of: (1) the combined QBI amount of the taxpayer, or (2) an amount equal to 20% of the excess (if any) of the taxpayer’s taxable income over the taxpayer’s net capital gain under section 1(h) for the taxable year. I.R.C. § 199A(a). Scarn’s “combined QBI amount” is determined, and potentially limited, based on whether his taxable income—adjusted gross income minus standard or itemized deductions—exceeds the threshold amount. See I.R.C. § 199A(b). For joint filers the threshold amount is $315,000 in 2018 and $321,400 in 2019. I.R.C. § 199A(e)(2); Rev. Proc. 2018-57, § 3.27. After determining Scarn’s taxable income, his combined QBI amount will be calculated, and potentially limited, in one of the following ways.

**Below Taxable Income Threshold.** If Scarn’s taxable income is at or below the threshold amount, Scarn’s “combined QBI amount” is equal to 20% of Scarn’s QBI. I.R.C. § 199A(b)(2).

**Above Taxable Income Threshold.** If Scarn’s taxable income exceeds the threshold amount, his “combined QBI amount” is equal to the lesser of: (A) 20% of Scarn’s QBI; or (B) the “Qualified Property Limitation,” which is, relevant to Scarn as a sole proprietor, 2.5% of the UBIA of qualified property with respect to his QTB. Treas. Reg. § 1.199A-1(d)(2)(iv)(A). The properties Scarn holds—all three in 2018, and Properties 1 and 2 in 2019—are qualified property. I.R.C. §
199A(b)(6). The UBIA of each property is $660,000, the basis at the time the properties were placed in service, without regard to any adjustments described in section 1016(a)(2). Treas. Reg. § 1.199A-2(c)(3). Therefore, Scarn’s Qualified Property Limitation in 2018 was $49,500 (2.5% X 1,980,000) and in 2019 was $33,000 (2.5% X 1,320,000), if such limitation applies. The Qualified Property Limitation is phased in if Scarn’s taxable income exceeds the threshold by less than $100,000 ($315,000-$415,000 in 2018 and $321,400-$421,400 in 2019). I.R.C. § 199A(b)(3)(B). If the taxable income exceeds this phase-in range, the Limitation applies in full. The Qualified Property Limitation is phased-in in an amount equal to (1) 20% of QBI minus the Qualified Property Limitation, multiplied by (2) the ratio of (i) taxable income in excess of the threshold amount, to (ii) $100,000. Treas. Reg. § 1.199A-1(d)(2)(iv)(B). Thus, calculating the amount of Scarn’s deduction can only be done upon determining his taxable income and QBI.

3. **Scarn May Deduct Mortgage Interest To Extent Proceeds Allocated To Business Use.**

   Generally, a deduction is allowed for all ordinary and necessary expenses attributable to carrying on any trade or business. I.R.C. § 162(a). Complementing section 162, section 163 allows a deduction for “all interest paid or accrued within the taxable year on indebtedness,” including “interest expense allocated to a trade or business expenditure.” I.R.C. §§ 163(a), (h)(2)(A). In general, interest expense on a debt is allocated in the same manner as the debt to which such interest expense relates is allocated. Temp. Treas. Reg. § 1.163-8T(a)(3). As such, it is inconsequential that the mortgaged collateral is used in Scarn’s rental business; whether the mortgage interest is deductible interest allocated to a business expenditure or nondeductible personal interest, is determined by tracing the debt proceeds to Scarn’s specific expenditures. Id. Of Scarn’s expenditures, only the electric car has a possibility of being used in Scarn’s business. Therefore, we need to determine to what extent, if any, Scarn uses the car for business, keeping in mind that as a general rule traveling between one’s home and one’s place of business constitutes
nondeductible commuting expenses. *See Comm’r v. Flowers*, 326 U.S. 465 (1946). As there are exceptions to this rule, such as the home office exception, further information is needed as to how Scarn operates his business. *See Bogue v. Comm’r*, T.C.M. 164 (2011).

**B. Tax Court Matters.**

1. **The Notice Is Valid Because Scarn Was Not Prejudiced Upon Actually Receiving It.**

   Upon determining that there is a deficiency in respect to a taxpayer’s taxes as reported, the Commissioner is authorized to send notice of such deficiency to the taxpayer by certified or registered mail. I.R.C. § 6212(a). Although the Commissioner is permitted to mail a notice to a taxpayer's last known address, it is not a mandatory provision. I.R.C. 6212(b)(1); *Mulvania v. Comm’r*, 81 T.C. 65, 67-68 (1983). “The important thing is that the taxpayer have actual notice and not that he have it any particular way.” *Clodfelter v. Comm’r*, 527 F.2d 754, 757 (9th Cir. 1975), affg. 57 T.C. 102 (1971). Thus, irrespective of the improperly addressed notice, a notice is valid if the taxpayer actually receives the notice in sufficient time to file a timely petition without prejudicial delay. *See id.; Mulvania*, 81 T.C. at 68 (1983). Generally, the Tax Court has held that when a notice is actually received by the taxpayer with at least 30 days remaining in the filing period, the taxpayer had sufficient time to petition the Court for review. *See, e.g., Bulakites v. Comm’r*, T.C. 1998-256 (45 days remaining); *Loftin v. Comm’r*, T.C. 1986-322 (30 days remaining). Here, the Commissioner mailed the Notice to Scarn on April 16, 2019, and it appears Scarn actually received the Notice on May 14, 2019, allowing Scarn more than 60 days to file a timely petition without prejudicial delay. The Notice is valid.

2. **The Period Of Limitations Did Not Expire Before The Notice Was Mailed.**

   The IRS is generally required to assess all income taxes within three years after the original tax return was filed. I.R.C. § 6501(a). Generally, a tax return is deemed filed on the last day prescribed to file, regardless of whether the return was filed before such date. *See I.R.C. § 6501(b).*
In 2016, taxpayers could file a timely 2015 tax return up through April 18, 2016 (the last day prescribed to file), as April 15 fell on a legal holiday. See I.R.C. § 6702(a); I.R.C. § 7503. Therefore, when the Commissioner mailed the Notice on April 16, 2019 by certified mail the period of limitations was timely suspended. I.R.C. § 6503(a)(1). See also Frieling v. Comm’r, 81 T.C. 42, 54 (1983) (the date the notice is mailed, not the date on which it was received by the taxpayer, determines whether the notice is timely and sufficient to toll the period of limitations). Additionally, the IRS will likely successfully argue, because Scarn did not file his Form 8886, the section 6501(c)(10) period of limitations did not start to run, therefore the Notice was timely. See May v. United States, 691 F. App’x. 334 (2017).

3. Scarn’s Petition To The Tax Court Was Untimely And His Case Will Be Dismissed.

A taxpayer has 90 days after the mailing of a notice of deficiency to petition the Tax Court for redetermination of the deficiency. I.R.C. § 6213(a). The Notice was mailed on April 16, 2019, which required Scarn to file his petition with the Tax Court on or about July 15 – 90 days after the mailing. Ultimately, Scarn did not file the petition on time when doing so on August 1, 2019.

4. Scan Can Challenge His Tax Liability In Another Court.

As the petition must be dismissed for lack of jurisdiction in the Tax Court, the IRS will assess Scarn’s 2015 taxes. Scarn is required to pay the assessment in full and then file a claim for refund with the IRS. I.R.C. § 7422. However, Scarn will not be permitted to challenge his tax liability with the IRS. See I.R.C. § 6330(c)(2)(b). Therefore, Scarn is required to wait six months after filing the refund claim, or until he receives a notice of disallowance from the IRS, before he may file a suit for refund and challenge the merits of the deficiency in District Court or the U.S. Court of Federal Claims. Flora v. United States, 362 U.S. 145 (1960); 28 U.S.C. § 1346(a)(1).
Dear Mr. Scarn,

After careful review of the information you have provided, we have prepared our conclusions and recommendations regarding your Tax Court case, concerning your 2015 tax returns. As well, we address your tax obligations and our recommendations related to your real estate activities. If any information has changed or is incorrect as addressed, please advise us as it may affect the accuracy of our analysis.

**Tax Court Matters**

Due to the important nature and time constraints associated with your Tax Court case, we address this issue first. The IRS has determined there is a deficiency in respect to your 2015 tax return because they are disallowing a large deduction you had claimed in that year. The deficiency process begins when the IRS mails a valid notice of deficiency, within the period of limitations for assessment and collection.

The IRS mailed you a notice of deficiency (the “Notice”) on April 16, 2019. The concern is whether the Notice is valid considering the incorrect address, and the fact that you received it a month later. We believe that the Notice is valid. Although the Notice was incorrectly addressed, this in and of itself does not invalidate the Notice. Since you actually received the Notice on May 14, 2019 and still had more than 60 days to file your petition, the Tax Court will conclude that the Notice is valid.
Additionally, a deficiency must be assessed within the required period of limitations. The date the Notice is mailed suspends the running of the period of limitations on assessment. If the IRS failed to mail within such period, the IRS is prevented from being able to assess your taxes. The IRS generally has three years after the last day you were allowed to file your tax returns to assess a deficiency. Therefore, although you filed your 2015 tax return early, in February of 2016, your return will be deemed filed on the last day available to you to file, April 18, 2016. The IRS mailed the letter two days prior on April 16, suspending the period of limitations. As well, we understand that you completed a Form 8886 with Mr. Wilson. We ask that you provide us with a copy of the Form 8886, if available, as well as furnish any information you have regarding the transaction. In addition to filling out the Form, you were likely required to file the form with your tax returns. As such, the IRS will argue, that your period of limitations had not even began to run because you did not file such form. Either way, the Notice was timely sent.

After the IRS mailed the Notice on April 16, 2019, you had 90 days to file a petition with the Tax Court for a redetermination of the deficiency. The Tax Court will find that you untimely filed your petition when doing so on August 1, 2019, beyond the 90 limit, and the Court will dismiss your case. The IRS will then have the ability to assess your taxes, requiring you to pay the amount assessed in full. After payment, you can still challenge your underlying tax liability. That is why it is important we get ahead of this issue, as we must quickly file a claim for refund with the IRS. You must then wait, generally six months following the claim for refund before we can file a suit for refund and challenge the merits of the deficiency in a District Court or the U.S. Court of Federal Claims.

Given the timeframe, we recommend we meet as soon as possible. We ask that you provide, in addition to the documents discussed above, any documents you have received regarding this matter, as well as your recent tax transcripts dating back through 2015.
Real Estate Activities

1. Sale of Property 3. Following the sale of Property 3, you have a gain of $1,400,000. Your gain from the installment sale is calculated under the installment method of reporting gain because you are scheduled to receive payments over the next two years. Your gain is prorated and recognized over the three years in which you are set to receive payments, allowing you to defer gain of $525,000, as you desired. Each payment received consists of three components: (i) gain on the sale, (ii) return of your basis in the property, and (iii) interest, which is additional gain from the sale, taxed as ordinary income. You will recognize gain as follows:

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The $1,400,000 gain reflects the $2,000,000 sale price minus your basis in the property of $600,000. Your basis includes $100,000 for the land plus the $560,000 you spent to construct the home. Unfortunately, your basis also reflects a deduction of $60,000 for depreciation that you were allowed to take but your accountant neglected to do so. The IRS assumes you took the deductions, and therefore you must account for them. Fortunately, there is a procedure in which you can make an adjustment and claim the $60,000 of depreciation deductions in full in the 2019 tax year. Upon making the adjustment, $60,000 of your $1,400,000 gain will be taxed at a rate of 25% (lower than your taxable income rate), whereas the remaining $1,340,000 will be considered long-term capital gain, taxed at an even lower, more favorable rate. If you forgo claiming the deduction, all $1,400,000 gain recognized would be taxed at the favorable long-term gain rate. Making the adjustment will likely provide the greatest tax savings and is therefore recommended. Although you may pay more in capital gains tax, your savings by deducting $60,000 against your taxable
income in 2019 will likely be more beneficial. We can provide a more detailed analysis upon determining your taxable income in 2019, based on the additional deductions you are likely entitled to, as discussed below, and prepare the forms required to make such adjustment.

2. **Section 199A Deduction in 2018 and 2019.** When you have income from your rental activities, you are entitled to a deduction equal to the lesser of the combined qualified business income ("QBI") amount (generally 20% subject to certain limitations) or 20% of your taxable income. This deduction will reduce your taxable income. We believe your activities rise to the level of a qualified trade or business ("QTB"), entitling you to take a deduction.

We believe the IRS will recognize your rental activity as a business because you carry on the activity with an actual and honest objective of making a profit, and you are regularly and actively involved in the activity. Favoring your profit intent is: (1) the time and effort you spend in carrying on your rental activity, which also establishes you are regularly and actively involved in the activity; (2) the expectation that assets used in your activity will appreciate in value; and (3) the fact that you are not conducting the activity to offset taxable income from other sources.

Objectively, the following factors disfavor a profit intent: (1) the manner in which you carry on the activity, (2) beginning your rental activity without conducting an investigation of the factors that would affect earning profit; and possibly (3) the amount of occasional profits and your history of losses. Specifically, we believe the IRS will find that the manner in which you carry on your rental activity disfavor’s a profit intent, because it has been expressed that you did not track partial payments received from your tenants in arrears.

The IRS also provides a safe harbor in which a rental enterprise is treated as a QTB. However, because you must maintain separate books and records reflecting your income and expenses, we find you do not satisfy all the requirements. It is important that you document all activity conducted related to your rental activity, and keep such documentation separate from
personal matters. This activity includes the time spent on maintaining the property, collecting rent, and general management of the activities. Keeping such records will also work to mitigate the factors which disfavor your profit intent, as discussed above.

As your rental activities are a QTB, you are entitled to a take a deduction on the QBI earned in your rental business. Calculating your deduction is a fact intensive inquiry. Before we can determine the amount of your deduction, we must first determine your taxable income in both 2018 and 2019. Depending on such amounts your deduction may be limited. We recognize the complexity of calculating your deduction, as well as the implications it may have in regard to other beneficial tax planning and wish to discuss and illustrate such calculations in more detail at your convenience.

3. Mortgage Interest Deductibility As A Business Expense. Although your mortgaged property is used in your business, this alone does not entitle you to a business deduction on the mortgage interest. Instead, you are permitted to deduct the mortgage interest to the extent the mortgage proceeds were used in your business, determined by tracing the proceeds to your specific expenditures. To determine, whether your mortgage interest is a deductible business expense, we need to know how the car is used, as you will not be able to claim a deduction regarding the other use of the mortgage proceeds. We can then determine that amount, if any, of your business deduction.

We hope this is helpful and that we can meet soon to discuss these matters further. Please feel free to call our office at (123) 555-1124 and we can address any questions or concerns. We look forward to working with you in the future.

Sincerely,

J.D. TEAM NUMBER_________