# Maximizing the IRC §199A Deduction

Prepared by:
Scott W. Dolson
Frost Brown Todd

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# Maximizing the IRC § 199A Deduction


**PROFESSIONALS**

**Scott W. Dolson**
sdolson@fbtlaw.com
502.568.0203


**PRACTICES**

Tax Law

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*Legal Update*

Taxpayers who qualify for the IRC § 199A deduction (the "Deduction") will be one of the big winners under the Tax Cuts and Jobs Act (the "2017 Tax Act"). IRC § 199A provides for a deduction equal to 20% of a taxpayer's qualified business income (subject to the adjustments and limitations discussed below). But for many taxpayers, maximizing the Deduction will require careful planning.

Attorneys at Frost Brown Todd have developed substantial experience assisting closely-held business clients with their entity tax planning and governance issues, and in particular founders organizing LLCs and S corporations. Contact Scott Dolson or any other member of the Tax Law Practice Group if you need assistance or would like additional information.

## Who can take advantage of IRC § 199A?

The benefits of IRC § 199A are potentially available to any taxpayer other than a C corporation. Eligible taxpayers include those operating as sole proprietorships (including single member LLCs), LLC members and S corporation shareholders, and trusts and estates. The Deduction is being referred to as a "pass-through entity" deduction, but the scope of eligible taxpayers isn't limited to pass-through entities.

Many taxpayers will not be eligible for the Deduction. Wage earners won't qualify for the Deduction unless they have other business income. Capital gains, dividends, interest income and certain other categories of income won't support a Deduction. The Deduction doesn't help if a business is generating only losses. For example, the Deduction can be missed entirely if a start-up has losses in the early years and then is sold in a transaction qualifying for capital gains treatment. If a taxpayer's taxable income level exceeds certain limits, the availability and amount of the Deduction will be limited as discussed below. If the taxpayer is engaged in certain service and professional activities, the Deduction will phase out entirely at certain income levels. For the most part, the Deduction will be available to a taxpayer who earns business income directly or through a pass-through entity, and either has taxable income below phase-out and cut-off limits or engages in a non-professional/service business that either pays wages or invests in depreciable property used in the business.

The preceding paragraph identifies only some of the key factors that go into determining eligibility for taking the Deduction. The balance of this article works through the rules in some detail, but shouldn't be considered a substitute for individualized tax planning or advice. Taxpayers who have multiple sources of business income should certainly work closely with their advisors to ensure that they configure their business ownership arrangements in a way that maximizes their Deduction.

## The mechanics of the Deduction

For purposes of avoiding additional complication, the application of the Deduction to agriculture and horticulture cooperative income, qualified cooperative dividends, qualified real estate investment trust (REIT) dividend income and qualified publicly traded partnership income has been excluded from this article. Each of these categories of income may qualify for the Deduction.

The Deduction will be determined on an annual basis. The Deduction will appear as a line item on an individual's Form 1040. In order to calculate the Deduction, an individual will generally need to know for each source of business income whether that income is service-based income (as it is specifically defined for purposes of the Deduction) or non-service-based income, how the taxpayer's aggregate qualified business income compares to the excess of taxable income over net capital gains, whether taxable income exceeds the thresholds discussed below, and if so, the aggregate W-2 wages and investment in depreciable property associated with each source of business income. The annual calculation of the Deduction may require substantial coordination and cooperation between taxpayers and the sources of their business income. As previously mentioned, wage earners who don't have any additional business income won't be eligible for the Deduction, but some of them will be eligible for the Deduction because they own or invest in businesses.

**The Deduction is based on a taxpayer's "qualified business income."** The Deduction is based on a taxpayer's qualified business income. Qualified business income generally means a taxpayer's net (after deductions, including W-2 wages and other expenses of the business) trade or business (i.e., ordinary) income effectively connected to the United States or Puerto Rico. Excluded from a taxpayer's qualified business income are wages, partnership guaranteed payments for services, capital gains, annuities, dividends, interest income not allocable to a trade or business, and any deduction related to these items. Rent and other ordinary income from real estate activities qualify for the Deduction. Fees paid to developers, real estate managers, construction managers and others within the real estate industry may qualify for the Deduction depending on whether the activity falls inside or outside of the "specified service trade or business" category. A partner's share ordinary income under IRC § 751(a) resulting from the sale of the partnership's assets (e.g., depreciation recapture) should be treated as qualified business income for purposes of the Deduction.

**Is Section 1231 gain qualified business income?** A significant unresolved issue is whether "Section 1321 gain", which is generally gain recognized on a taxpayer's sale of depreciable property used in a trade or business (e.g., rental property; equipment) that is held for more than one year, will be treated as qualified business income for purposes of IRC § 199A. IRC § 199A(c)(3)(B) provides that no Deduction is allowed for any item of capital gains. The references to short-term/long-term capital gains in IRC § 199A(c)(3)(B)(i) appears to be taken directly out of the wording of IRC § 1222, which deals with only with gain and loss on "capital assets." IRC § 1221(a)(2) specifically provides that an item of Section 1231 property is not a capital asset. But IRC § 1231(a)(1) provides that net Section 1231 gain "shall be treated as long-term capital gains." So, when IRC § 199A(c)(3)(B)(i) refers to "items of long-term capital gain", does this include net Section 1231 gains or only net gains on the sale of a capital asset? Assuming Section 1231 property can qualify for the Deduction, if Section 1231 property is held by a partnership, it would be necessary to sell the Section 1231 property rather than the partnership interest (or LLC interest) to claim the Deduction. Under IRC § 741, the sale of the partnership interest is generally treated as the sale of a capital asset. Section 1231 gain property that qualifies for capital gains treatment is not a "hot asset" under IRC § 751. But the sale of Section 1231 property held for less than one year would be subject to ordinary income treatment and should qualify for the Deduction.

**What's excluded from qualified business income?** IRC § 199A excludes wages, guaranteed payments to a partner for services and "reasonable compensation paid to the taxpayer by any qualified trade or business for services rendered with respect to the trade or business" from a taxpayer's qualified business income. The Committee Report for the 2017 Tax Act refers to reasonable compensation as any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer. But IRC § 199A itself does not provide any guidance regarding the specific meaning of reasonable compensation or limit the application of the concept to compensation paid by S corporations. The IRS could attempt to rely on this language to expand the scope of business income not eligible for the Deduction beyond S corporations not paying "reasonable compensation." But did Congress mean to include sole proprietorships or partnerships within the scope of this provision? If a sole proprietor designs and sells dresses, can the IRS successfully argue that reasonable compensation for services should be netted out of the owner's qualified business income? What if the sole proprietor practices law? Would the IRS successfully take the position that all of the income is a result of the attorney's services, and that a reduction for "reasonable compensation" would mean 100% of the income, thereby reducing qualified business income to zero?

**Calculation of the Deduction.** IRC § 199A provides that taxpayer's Deduction is generally equal to **the lesser of** the taxpayer's (i) combined qualified business income (20% of aggregate qualified business income) or (ii) 20% of the excess of taxable income over net capital gains. This limitation on the amount of the Deduction is critical because it means that the Deduction will never exceed 20% of the excess of the taxpayer's taxable income over net capital gains. The helpful way to understand the relationship between qualified business income and taxable income is walk through Form 1040 (the U.S. Individual Income Tax Return). A taxpayer's business income, along with net capital gains, W-2 wages and other income will be entered on the Form 1040's income lines to determine total income, and in the case of the taxpayer's business income, the amounts entered will be net of any associated business deductions (e.g, W-2 wages paid by the business). After total income is determined, income is reduced by amounts paid or contributed with respect to health saving accounts, health insurance premiums, self-employment taxes, retirement accounts, IRAs and the like to determine "adjusted gross income." Adjusted gross income is then reduced by the taxpayer's itemized or standard deductions to determine taxable income, the amount which ties back into qualified business income for purposes of determining the availability and amount of the Deduction. If a taxpayer's income is limited to business income, the excess of the taxpayer's taxable income over net capital gains will always be less than aggregate business income for purposes of calculating the Deduction. Every taxpayer qualifies for at least the standard deduction, and most business owners and self-employed taxpayers deduct self-employment taxes, health insurance expenses and contributions to retirement accounts. If there are wages, dividends and interest income on the Form 1040 along with business income, the taxable income amount may not serve as a ceiling on the Deduction.

**How a taxpayer's taxable income affects the Deduction.** There are two critical taxable income levels for determining the availability of the Deduction that are labelled for illustration purposes in this article as the "Phase Out Threshold" and the "Cutoff Threshold." Taxpayers with taxable income (the line item on their Form 1040) of less than $315,000 for a joint return and $157,500 for a single filer (the "Phase Out Threshold"), will qualify for a 20% deduction equal to the **lesser of** (i) their combined qualified business income (20% of aggregate qualified business income), or (ii) 20% of the excess of taxable income over net capital gains. When the Phase Out Threshold is reached, the availability of the Deduction will require making a calculation for each source business income that takes into account aggregate W-2 wages and original investment in depreciable property. When taxable income reaches the "Cutoff Threshold" at $415,000 (for joint filers) and $207,500 for single filers, qualified business income for non-specified service trades or businesses will be based entirely on the aggregate wage/capital investment formula and the Deduction won't apply to business income generated by a specified service trade or business. The threshold amounts are adjusted for inflation for years after 2018.

For purposes of 2.5% of unadjusted basis calculation with respect to depreciable property, depreciable property must be used for the production of qualified business income and must have been placed in service prior to **the later of** either 10 years or the applicable depreciation recovery period under IRC § 168, and is determined without regard to whether the property was actually expensed under IRC § 179. Additionally, depreciation anti-abuse rules similar to IRC § 179(d)(2) apply in determining the unadjusted basis calculation.

**Limitations on the Deduction for a "specified service trade or business."** As mentioned in the preceding paragraph, the availability of the Deduction is more restricted for taxpayers engaging in "specified service trades or businesses". This category of businesses includes doctors, attorneys, CPAs, actuaries, consultants, performing artists, professional athletes, persons engaging in financial or brokerage services and taxpayers engaged in "any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees." Congress expressly excluded engineers and architects from the scope of a specified service trade or business. Specified service firms operating ancillary businesses that generate income outside of the scope of the specified business may explore spinning those businesses out to owners if there is sufficient W-2 wages or original investment in depreciable assets to support the Deduction. Otherwise, it may prove difficult for large service firms to separate the income, wages and equipment used in the ancillary business from the firm's tainted services. Professional firms may explore whether they can separate out administrative back-office functions into a separate business and charge their professional practice an administrative services fee qualifying for the Deduction, but this will work only if the management firm has net business income after payment of the wages. Firms could convert lower paid professionals to partner status, making them eligible for the Deduction. Obviously, converting employees into partners for purposes of qualifying for the Deduction triggers numerous business and tax consequences for both the firm and the professional that would need to be considered.

Taxpayers may have both qualifying and non-qualifying business income. For example, a successful neurosurgeon may qualify for the Deduction if the doctor invests in a restaurant that pays substantial W-2 wages. Taxpayers who have business income that qualifies for the Deduction may also have capital gains, dividends, interest income and perhaps wages that won't qualify for the Deduction.

**The Deduction won't affect a taxpayer's amount of self-employment income or state income taxes.** A taxpayer's self-employment income will be calculated based on an individual's business income before the Deduction. As the Deduction is applied below the taxable income line, most state and local taxes will be calculated without regard to the Deduction.

**Carryover of qualified business income losses.** A taxpayer's qualified business income losses in one year will carry over into subsequent years and offset the taxpayer's qualified business income for purposes of computing the Deduction. This offset of qualified business losses would appear to apply to any net business losses carried over into 2018 from prior years. IRC § 172(d)(8) has been amended to provide that a taxpayer's net operating loss does not include the Deduction.

**The effect of the Deduction on the tax basis of a partner or S corporation shareholder.** If a taxpayer takes the Deduction based on an allocation of business income from an S corporation or partnership (LLC), the taxpayer should be entitled to a basis increase in his or her pass-through entity without reduction for the Deduction. For example, if a taxpayer is allocated $100 of business income and takes a $20 Deduction, the taxpayer's basis in the LLC interest should increase by $100 (not by $80). Otherwise, assuming that the basis prior to the income allocation was zero, if the tax basis in the LLC interest was only $80 and the LLC distributed $100, the taxpayer would be taxed on $20 of the distribution (the amount in excess of $80), offsetting at least in part the economic benefit of the Deduction. IRC § 199A doesn't appear to have any direct guidance on this issue.

**The alternative minimum tax won't reduce amount of the Deduction and the Deduction applies when calculating the AMT**. Under the 2017 Tax Act, the alternative minimum tax (AMT) for C corporations was repealed. Unfortunately, the AMT for individual taxpayers remains in place (the 2017 Tax Act did increase income levels necessary before AMT kicks in). The good news is that IRC § 199A(f)(2) states that, for purposes of determining AMT under IRC § 55, qualified business income is determined without regard to any adjustments required for the AMT computation. The calculation of the IRC § 199A deduction, therefore, is no different for taxpayers who are subject to AMT. The AMT is computed by making adjustments to taxable income specifically listed in IRC §§ 56 and 58 and adding back items to taxable income specifically listed in IRC § 57. As the Deduction is subtracted from adjusted gross income to calculate taxable income (the Deduction is removed from taxable income for purposes of calculating the Deduction) and the AMT computation begins with taxable income, the AMT computation must specifically adjust or addback the Deduction to remove it to not apply for AMT purposes. The 2017 Tax Act, however, provides for no addback or adjustment of the Deduction for purposes of calculating the AMT. Taxpayers who are subject to AMT, therefore, may take the Deduction against their income for AMT purposes as well.

## IRC § 199A planning pointers

**The Deduction sunsets.** The Deduction doesn't apply to taxable years beginning after December 31, 2025. This outside date will make long-term choice of entity planning more difficult. Perhaps some businesses will begin life as LLCs taxed as a partnership and take advantage of the Deduction. When the Deduction sunsets, the owners may consider converting the LLC into a C corporation to take advantage of the 21% corporate rate, assuming Congress hasn't acted to extend the Deduction or change corporate rates.

**How the calculation of the Deduction on a business-by-business basis can affect planning.** A critical planning point is that the determination of the Deduction is made on a business by business basis with respect to the application of the W-2 wages/capital investment formula. Once the taxable income thresholds are hit, the Deduction will be limited or not available if a taxpayer has a business generating substantial qualified business income that doesn't pay any wages (or invest in depreciable property) or a business that pays out all most of its income in wages. If a taxpayer has reached the income thresholds and has service income in addition to other qualified business income, or engages in several separate business activities, the positioning of income producing assets, employees and depreciation assets among the taxpayer's entities will need to be carefully considered. For example, a law firm partnership operating a non-professional services ancillary business may conclude that the only way for its owners to claim the Deduction with respect to the income of the ancillary business is to put that business in a separate LLC and spin that business, along with its employees and equipment, out to the owners.

**Wage compensation planning issues.** With respect to W-2 wages, not only the taxpayer's wages count, but also all W-2 wages paid by a business. The use of independent contractors will reduce the W-2 wages of a business. It may make sense for a business to convert independent contractors to W-2 employees in order to increase its aggregate W-2 wages. On the flip side, employees will be motivated to find a way to become an independent contractor in order to have a shot at qualifying for the Deduction. Some former employees will undoubtedly want to set themselves up as independent contractors working through S corporations in an attempt to qualify for the Deduction, but some taxpayers could face difficulties if faced with a challenge by the IRS that the business pays too little in W-2 wages.

**Deduction planning for professional/service businesses.** Taxpayers will want to avoid having their business categorized as a specified service trade or business due to the harsh limitations on the scope of the Deduction for income generated by these service businesses. In addition to segregating in separate entities professional and other business income, taxpayers will undoubtedly be aggressive in characterizing activities as the sale of a product rather than the providing of services. Similarly, with respect to a field such as healthcare, taxpayers will be sure to distinguish between activities involving the providing of professional services by licensed physicians and nurses and activities such as operating gyms, which are related to a person's health, but don't involve the providing of services by licensed professionals. A closer question might be the services provided by a well-known professional trainer.

The S corporation may be an attractive choice for maximizing the Deduction. In some cases, it may make sense to operate a business as an S corporation rather than as a sole proprietorship or through a partnership. This is because a sole proprietorship or partner cannot be paid W-2 wages, but an S corporation owner can also be an employee of the business. For example, if an individual makes $1,000,000 annually selling games through a sole proprietorship that has no employees and owns no depreciable property, and the taxpayer has no other sources of income, then the owner would not be entitled to a Deduction because the owner's taxable income would exceed the Cutoff Threshold and there would be no W-2 wages or depreciable property associated with the business to support the Deduction. Plus, 100% of the owner's income would be subject to employment taxes. Restructuring as an S corporation creates an opportunity to undertake both IRC § 199A and self-employment tax planning, provided that "reasonable compensation" is paid to the owner/employee.

If the decision is made to convert a sole proprietorship or partnership into an S corporation as part of a taxpayer's IRC § 199A planning for purposes of generating W-2 wages, the taxpayer should carefully decide what business operations, assets and employees are moved into the S corporation. Obviously, any professional services related business, assets or employees should be kept outside of the S corporation.

**Deduction planning with partnership guaranteed payments.** If a taxpayer makes a loan to an LLC, the interest on the indebtedness is excluded from the scope of qualified business income. But a guaranteed payment made to a holder of preferred LLC units for the use of the member's capital should be eligible for treatment as qualified business income.

**The Deduction marriage penalty.** There may be a "marriage penalty" associated with the calculation of the Deduction. For example, if a highly compensated doctor marries a lawyer whose income falls below the single person's Phase-Out Amount, the lawyer will lose the ability to take the Deduction.

**Dealing with the taxable income thresholds.** The effective tax rate on the income between the Phase Out Threshold and the Cutoff Threshold is effectively 83% for taxpayers with taxable income exceeding the cliff established by the Cutoff Threshold, with no W-2 wages or investment in depreciable property associated with the business generating the business income, because of the total loss of the Deduction would otherwise be available in full if income was under the Phase Out Threshold. This is true as well for service providers with income above the cliff at the Cutoff Threshold, where the service provider loses the Deduction with respect to his service income even if he has sufficient W-2 wages and/or investment in depreciable property to support the Deduction. Perhaps joint filers with income slightly exceeding the Cutoff Threshold will decide to reduce their taxable income by giving $100,000 to charity and receiving a full $63,000 Deduction (assuming that they have sufficient taxable income to support the Deduction) rather than forking $83,000 over to Uncle Sam.

**Dealing with Section 1231 property**. As discussed above, if a taxpayer desires to take the position that gain on Section 1231 property qualifies for the Deduction, it will be necessary for a partnership to distribute the property out to partners for sale, prior to the sale or redemption of a partnership interest. Gain triggered by the sale of a partnership interest would be excluded capital gains for IRC § 199A purposes (IRC § 741 provides that the sale of a partnership interest is considered the sale of a capital assets, subject to the "hot assets" treatment in IRC § 751), regardless of the partnership's holdings of Section 1231 property held for more than one year.

## IRC § 199A examples

- Debbie has $100,000 in wages, $100,000 of net capital gains and $100,000 of interest income. None of Debbie's income is qualified business income. Debbie does not qualify for the Deduction.
- Joan earns $100,000 of business income as an independent contractor, and has $100,000 of net capital gains and $100,000 of interest income. Joan's Form 1040 shows taxable income of $240,000 after netting out contributions to retirement plans, payment of health insurance premiums and the taking of itemized deductions. Joan determines that 20% of the excess of taxable income over net capital gains ($32,000) is greater than 20% of aggregate qualified business income ($20,000). Joan's Deduction will be $20,000. In spite of the fact that IRC § 199A reduces Joan's net income by $20,000, all of her business income will be subject to self-employment taxes and her state's income tax.
- Mary earns $150,000 of business income from her physician practice and has $50,000 of net capital gains. Mary's Form 1040 shows taxable income of $150,000. Mary determines that 20% of the excess of taxable income over net capital gains ($20,000) is less than 20% of aggregate qualified business income ($30,000). Mary's Deduction will be limited to $20,000.
- Ken earns $600,000 of business income from his law practice and has $50,000 of net capital gains. Ken's Form 1040 shows taxable income of $570,000. Because Ken's taxable income on his joint return exceeds $415,000 and his business income is from a specified service trade or business (his law practice), Ken and his spouse Doree will not qualify for the Deduction.
- Ken earns $500,000 practicing law and has no other income. Ken's Form 1040 joint return shows $400,000 of taxable income. Ken determines that 20% of his excess of taxable income over net capital gains ($80,000) is less than 20% of his aggregate business income ($100,000). Ken's Deduction would be capped at $80,000. But since Ken's income also exceeds the $315,000 Phase Out Threshold, a calculation applying IRC § 199A's complicated phase out rules applicable for taxable income falling between $315,000 and $415,000 would need to be made to determine the amount of his Deduction, taking into account his law practice's aggregate wage compensation and investment in depreciable property. Ken's actual Deduction will be substantially less than $80,000 due to the phase out of qualified business income for specified service businesses. If Ken is practicing as a sole proprietor with no employees, the Deduction will be further reduced. If Ken's wife Doree works and earns a $200,000 salary, then their joint taxable income would exceed the $415,000 Cutoff Threshold and they would not be entitled to the Deduction.

- If Ken's business income was not generated through a "specified service trade or business", then the application of the wages/capital investment formula in the preceding example would still phase in once Ken and Doree reach the Phase Out Threshold and would apply fully once they reach the Cutoff Threshold. But unlike the preceding example, Ken and Doree would still be entitled to the Deduction based on a formula taking into account the aggregate wages and original investment in depreciable property and the amount of business income, calculated on a business-by-business basis. If all of the business income comes from one investment and all of the wages are paid in another business, Ken and Doree would not qualify for the Deduction.
- Ken practices law and invests in a medical device development and sale business. Ken earns $600,000 from his law practice and is allocated $500,000 of qualified business income from the medical device partnership. Ken and Doree also have $200,000 of dividends and $50,000 of net capital gains. Ken's Form 1040 joint return shows $970,000 in taxable income. Ken's share of W-2 wages from the medical device partnership is $100,000. The medical device company leases all of its equipment. Ken determines that 20% of the excess of his taxable income over net capital gains ($250,000) exceeds 20% of aggregate business income ($220,000), so the taxable income limitation won't apply to reduce Ken's and Doree's Deduction. But because Ken's taxable income exceeds the $415,000 Cutoff Threshold, he would not be entitled to any Deduction with respect to his attorney income. With respect his allocation of medical device company business income, Ken's Deduction would be limited to $20,000 - the lesser of $20,000 (20% of $100,000) or $50,000 (50% of Ken's share of W-2 wages paid by the medical device company).
- Mary earns $1,000,000 as a sole proprietor that is not a specified service trade or business and has $250,000 of net capital gains, $100,000 of dividends and $200,000 of interest income. Mary's Form 1040 single return shows $1,400,000 of taxable income. Mary's taxable income exceeds the $207,500 Cutoff Threshold applicable to single filers. Mary's business doesn't pay any W-2 wages or have any investment in depreciable property. Mary is not entitled to take the Deduction. All of Mary's income as a sole proprietor is subject to self-employment taxes.
- Mary doesn't like the result in the preceding example and restructures by incorporating her business as an S corporation. Mary's S corporation passes through to her $500,000 of net business income, after paying her (and deducting from business income), $500,000 of W-2 compensation. Mary also has $250,000 of net capital gains, $100,000 of dividends and $200,000 of interest income. Mary determines that 20% of the excess of her taxable income over net capital gains ($180,000) is greater than 20% of aggregate business income ($100,000). Assuming that Mary is paid reasonable compensation, she would be entitled to a $100,000 Deduction - the lesser of (20% of $500,000) or $250,000 (50% of $500,000). By restructuring as an S corporation, only the $500,000 of Mary's W-2 wages would be subject to employment taxes - the $500,000 passed through to her as an S corporation shareholder would not be subject to employment taxes.
- Patricia's start-up business incurred $150,000 of qualified business losses in year one. In year two, her business generates $250,000 in qualified business income, but her Deduction will be limited to a 20% deduction on $100,000 of qualified business income, as her $150,000 in year-one losses must be offset against her year-two gains.



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- Patricia's S corporation sells dresses designed by Patricia and has $1,000,000 in business income, after payment to Patricia of $100,000 in W-2 wages. The IRS challenges Patricia's Deduction arguing that under IRC § 199A(c)(4), reasonable compensation for her services were not deducted from business income in the calculation of the Deduction. Query whether the IRS would make the same argument if Patricia earned $1,000,000 in business income through a sole proprietorship?

For more information, please contact Scott Dolson or any other attorney in Frost Brown Todd's Tax Law Practice Group.