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On June 13, 2019, DeEtte L. Loeffler, a partner at Miller Monson, will be speaking at the *Estate Administration Boot Camp* presented by NBI (National Business Institute). Her topics will include final and fiduciary income tax returns, portability of tax exemptions, and estate, gift and GST tax planning. The event runs June 12 and 13 at the Hampton Inn, Downtown San Diego. For more details, please visit <https://nbi-sems.com>.



On April 25, the Tom Homann LGBT Law Association (THLA) celebrated its annual dinner with California Supreme Court Associate Justice Leondra Kruger. At the celebration, Judy Bae received THLA's *Friend of the Community Award*. In March, Judy was also recognized by California State Assembly member Dr. Shirley Weber for her community activism at Dr. Weber's *Salute to Women Leaders in the 79th Assembly District*.



MMPPH welcomes Paralegal Mary Tigue-Velardi to the staff. Mary graduated from the University of San Diego with her Paralegal Certificate and has decades of experience in estate planning and administration. She originally hails from Minnesota but has lived in San Diego for many years and raised her family here. She is a baker and gardener in her spare time. Mary and her husband love spending time with their daughter's family who finally saw the light and moved back to San Diego.

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REAL ESTATE INVESTING: TO FORM AN LLC OR NOT? *By Katie Lepore, CPA, J.D., LL.M., Taxation*

Real estate investors often ask whether they need a Limited Liability Company (LLC) to protect themselves from liability. And if they do need one, at what point do they need one? After one rental property? After five rental properties? After \$1 million of real estate

value? After \$5 million of real estate value? Unfortunately, there is not a hard and fast rule or any single right answer to these questions. The analysis will be different for each investor as each person has a different piece of property, risk tolerance, return on investment, etc. Below are some factors that should be weighed in the decision process for investors when considering an LLC. This analysis is largely directed towards investors residing in California.

Liability Protection

An LLC generally offers the owners asset protection, if formed and operated correctly. For example, in the event a tenant slips and falls and sues the owner, the LLC would be liable. Any awards from a successful lawsuit would be limited to the assets of the LLC, but the owner's personal assets, such as his or her primary residence and bank accounts, should be protected from liability related to the LLC. Of course, this means an owner's investment in the LLC can be lost. Because of this, some investors prefer a separate LLC for each rental property or after a certain dollar amount of value to further protect themselves from liability. By placing all their properties in one LLC, the entirety of their portfolio could be at risk for a lawsuit related to only one property.

However, this analysis would be applicable only to lawsuits related to the LLC. For instance, if an owner is sued personally for something unrelated to the real estate business, such as a bad car accident or sexual harassment, the owner's personal assets are still at risk.

In contrast, other investors prefer an umbrella insurance policy to protect themselves from risk. While it may not provide as comprehensive liability coverage as holding the assets in an LLC, buying insurance generally has less administrative burdens and may come at a reduced cost when compared to an LLC. See further discussion of these items, below.

Risk Tolerance

Whether or not to form an LLC is a very personalized decision. Some people are risk averse and desire the utmost protection no matter the cost. Other people are more concerned about their bottom line and are willing to take more risks to possibly reap more rewards. The risk analysis will be different for each property. For instance, having a property that is in another state where the owner does not see the condition of the property or cannot personally vet plumbers or contractors may increase the risk that a tenant will trip over a raised tree root that is overlooked. Working with

a property manager may help mitigate these risks, but unless the property manager is competent, it may not make much of a difference. The condition of the property also affects the risk of liability as does the type of tenants and the location of the property. Instituting a good process to evaluate potential tenants is essential to mitigating risk.

Additionally, the non-real estate assets of the owner may play a role in the analysis of whether an LLC would be a good idea, as well as the value of the real estate itself. An investor with one single family residence versus one with an apartment complex may approach the value of their investment differently. Similarly, an investor who has \$5 million non-real estate assets may approach the analysis differently than one who has \$500,000. While no one desires to lose any investment, the analysis will be different in each situation depending on how each of the investors approaches the value of his or her assets.

Costs

In California, LLCs are subject to a minimum franchise tax of \$800 per year, plus an additional fee when gross receipts exceed \$250,000. Filing *Articles* with the Secretary of State costs a one-time \$70 fee, and owners will need to pay \$20 every other year to file a *Statement of Information* with the Secretary of State. There is also a cost to form the LLC initially, since an attorney should prepare an operating agreement.

The California Franchise Tax Board takes a broad interpretation of what constitutes "doing business" in California. Therefore, managing the LLC or performing activities on behalf of the LLC constitutes doing business in California and subjects the LLC to tax in California. As a result, even if the owner forms the LLC in another state or hires an out-of-state property manager, if he or she is managing the business and/or making business decisions from California, the LLC will be subject to California tax (the analysis is the same even if the rental property is located outside California).

Furthermore, unlike other states, California does not allow for “series LLCs” to be formed in California, wherein one entity is the owner of several other entities and just the one “parent” or “master” entity is subject to tax and registration. For other states, this can be an effective way to reduce owners’ risk by having a separate LLC for each piece of property while still keeping costs low. In California, however, each of those LLCs will incur the \$800 minimum tax, not just the parent LLC.

In contrast, an umbrella insurance policy could cost around \$150-400 per year depending on the property. While an umbrella policy could be more beneficial for the investor’s bottom line, most umbrella policies offer coverage up to only \$1 million or \$2 million, though larger policies are available. The umbrella policy generally kicks in only after primary insurance coverage is exhausted, which could cause insurance premiums to increase in future years after a payout or claim. Furthermore, investors should be clear on what the insurance policy covers, including a routine slip and fall, injury due to mold or earthquake, or any claims relating to the tenant rental contract. In this regard, an LLC will provide more exhaustive overall coverage since it will automatically protect all activities relating to the LLC and not just those enumerated in the insurance policy. Owners choosing to buy insurance should review their policies carefully and ask questions about any exclusions and exceptions included in the policy. Policies that are less expensive may provide less coverage.

Mortgages

In the event the investor is looking to purchase the property with a mortgage or has an existing mortgage on the property, this may complicate the analysis when it comes to an LLC. Most mortgages contain a due on sale/due on transfer clause which allows the lender to call the loan due upon a sale or transfer of the property. This may include transferring the property from the investor’s name individually to his or her wholly-owned LLC. It is not a certainty that the loan would be called but definitely is a

risk. Some lenders may approve the transfer to the LLC or approve it so long as the owner provides a personal guaranty.

It can also sometimes be difficult to find a lender willing to loan directly to an LLC (aside from a hard money lender). A smaller regional bank may be more willing to do so, or it may be likely that a larger institution would be more willing to refinance an existing loan. Once an LLC has a larger portfolio, lenders may feel more secure lending directly to the LLC but for an entity that is just starting, it can sometimes be difficult to obtain a loan. It is common for lenders to require personal guaranties from owners even if the loan to value ratio is low.

Ongoing Administration

Running an LLC has ongoing requirements in order for the liability protection to remain intact. An LLC only provides liability protection if a creditor cannot “pierce the corporate veil.” While there are several factors that are analyzed before a creditor can pierce the corporate veil, one of them is whether the owners treat the LLC as an extension of themselves. Therefore, investors need to treat their LLC as a legitimate business, including keeping adequate separate books and records for the company. Major management and business decisions should be documented with valid supporting business reasons for the decision and discussion among owners and/or managers. Contracts should be signed only by those with proper authority to sign them. Additionally, records with the Secretary of State should be kept up-to-date.

Holding rental properties in the investor’s name individually, or his or her family trust, still requires good recordkeeping but does not require all the formalities that come with holding property in an LLC.

Anonymity and Deterrence

Investors often wish to remain anonymous, or to keep their identity private, to help deter potential tenants or creditors from knowing their primary address or net worth. In California, this is

difficult to achieve in its entirety because the public Secretary of State records require LLC member names to be disclosed. It is possible to hire a service or company to act as agent for service of process, and to provide a business address and an address for the members, although the owner names will likely still be disclosed. Even if the LLC is formed in another state, it will need to register as a “foreign” LLC in California.

Holding property individually, or in the name of the investor’s family trust, does not provide anonymity either because the name of the trustee must be included when taking title on the publicly recorded deed.

Other investors think that putting their property into an LLC will help deter potential creditors or tenants from suing. The belief is that potential creditors would see that the LLC provides liability protection, making a lawsuit harder to win and limiting potential damages to the assets of the LLC and not the owner’s personal assets. This is a clear advantage over holding assets outright or in a family trust.

Co-Ownership

In the event investors purchase property as partners or in a group, having a formal entity or operating agreement can be extremely helpful to address potential issues that could arise among the owners. While it is unlikely that partners would have disagreements or conflicts at the time of purchasing the property, issues may arise at a later point. Having a proper agreement in place to address these issues ahead of time can save thousands of dollars later. For instance, take the example of an LLC with two equal members without a formal operating agreement. In the event the members have a falling out or disagreement, they may look to dissolve the LLC. Since dissolution was not addressed in a formal operating agreement, the dissolution would fall to state law in California Corporations Code Section 17707.01. If the members cannot agree upon terms of dissolution or one member is not communicating with the other, the members may be

forced to go through a very expensive court proceeding to dissolve.

A formal operating agreement can address the rights and responsibilities of each member and also address such items as funding repairs for the property, transferring ownership, establishing a right of first refusal if one partner is looking to sell, encumbering the property, and other issues. In this regard, an LLC generally provides more benefits when compared to holding title with a partner as tenants-in-common or joint tenants.

Estate Planning

An LLC also may provide a useful tool for estate planning and transferring wealth to younger generations. An LLC can be structured in such a way as to give voting membership to some family members and non-voting membership to other family members. This could allow parents or grandparents to begin to transfer equity or wealth to younger generations while still retaining managerial control. An LLC can provide for a seamless transition between generations and a great way to teach younger family members the proper way to run and manage the properties at a slower, more gradual rate.

In California, property taxes can be a large expense for real properties. Proposition 13 provides owners a way to keep the assessed value of the property fairly low if the property has been held in the family for a long period of time. Frequently parents pass this low assessed value to their children by using the parent-child exclusion from reassessment. However, property held within an LLC is not eligible for the parent-child exclusion from reassessment. Therefore, those owning low-basis real property should discuss with their attorney the best way to hold the property to maximize the use of the parent-child exclusion.

Real property investors should have a proper estate plan in place including a living/family trust. While the family trust does not provide asset or liability protection, it does help to avoid

probate at the investor's eventual death. Probate in California can be a very costly and long process that can usually be avoided with a family trust. A family trust should likely be created whether the investor creates an LLC or not.

Income Taxes and Pass Through Deduction

An LLC is considered to be a "pass through" entity in that it pays no tax of its own, besides the California \$800 minimum franchise tax and possible gross receipts fee mentioned above. All items of income and expense will eventually be passed through the entity to be reported on the member(s)' income tax return(s). LLCs that have more than one member have the default tax classification of a "partnership"; LLCs with only one member, or with a married couple owning it as community property in California, may elect to be treated as a "disregarded entity." A disregarded entity means the LLC is disregarded for federal income tax purposes and would not need to file its own federal income tax return.

As real estate often appreciates over time, investors may be subject to paying capital gains tax on significant appreciation in value upon sale of real property. The gain is equal to the investor's sale price less his or her basis in the property. An owner's basis in a piece of real property is generally his or her original purchase price, less depreciation, plus the costs of major improvements. Upon the death of an individual, any assets owned by that individual enjoy a basis "step up" wherein the basis is increased (or decreased) to the asset's fair market value as of the date of death. However, barring possible elections to be made within a partnership, this basis step up is not available for properties owned within an LLC since the decedent did not own the real properties at his or her death; instead, the decedent owned an interest in an LLC (which owned the real properties). Therefore, the decedent's basis in the LLC is stepped up to fair market value as of the date of death, but the basis of the actual real properties will be governed by what tax benefits

may be available to the LLC due to a member's death.

Investors should also be cognizant of the tax benefits available for income from pass-through sources under Internal Revenue Code Section 199A. While the deduction should be available to rental property owners whether the property is held inside or outside of an LLC, to qualify for the deduction, investors should be aware of the recordkeeping and other requirements. The safe harbor related to rental real estate was detailed in MMPH's March 2019 newsletter, available on our website at:

<https://www.mmpgh.com/wp-content/uploads/2019/03/March-2019-Newsletter.pdf>.

Taxation as an S-Corporation

An LLC offers investors the ability to have the entity taxed as an S-corporation, which may provide additional tax benefits. While an S-corporation may be advisable for some investors, it can have detrimental tax effects for others. Investors should only make the decision to be taxed as an S-corporation after discussing their situation with competent counsel. An S-corporation has restrictions on the types of entities that can be shareholders, including only certain kinds of trusts. S-corporations may provide tax savings by way of self-employment taxes for certain investors, but it may also cause larger gains upon dissolution or distribution of the properties from the entity. For example, transferring real properties out of an S-corporation triggers capital gains tax, so such entities are generally not recommended for holding real property.

Conclusion

While there is no one right answer for investors when it comes to the question of forming an LLC, an LLC would likely provide greater and more comprehensive liability coverage for investors than an insurance policy. It also can simplify future ownership disputes and deter possible litigation. There are drawbacks and costs to creating and running an LLC and

several personal qualities of the investor and the property will factor into the analysis. The investor's risk tolerance and net worth may greatly affect his or her decision to form an LLC, as would the condition of the property and its value. In any regard, the question of whether to form an LLC should not be taken lightly and investors should consult with trusted counsel for help with the analysis. If you have questions, please contact our office for assistance.



FEDERAL TAX UPDATE

By Katie Lepore, CPA, J.D.,
LL.M., Taxation

State and Local Tax Refunds Inclusion in Income. Due to the recent change in itemized deductions for 2018 capping taxpayers' state and local tax deduction at \$10,000, a question was raised as to how much of a taxpayer's state tax refund would need to be included in income in the next tax year. Since taxpayers in most high-tax states will not be able to deduct the full amount of their state and local taxes due to the \$10,000 cap, the IRS issued Revenue Ruling 2019-11 stating that if a taxpayer received a benefit from deducting state and local taxes in prior years and then recovers a portion of those taxes in the current year (refund), the taxpayer must include in gross income the lesser of: a) the total itemized deductions in the prior year less the amount of itemized deductions the taxpayer would have claimed if the taxpayer paid the proper amount of state and local tax, or b) the itemized deductions in the prior year less the standard deduction.

Revised EIN Application Process. The IRS has changed the rules regarding who may apply for an Employer Identification Number on their website. Beginning May 13, 2019, only individuals with tax identification numbers may request an EIN as the "responsible party" on the application. Entities will no longer be able to use their own EIN to obtain additional EINs.

Withholding Changes. The IRS announced that it plans to issue a new Form W-4 for tax year 2020 which better incorporates the changes made by the Tax Cuts and Jobs Act. Last summer the IRS issued a draft version of the Form W-4 and asked for comments. A revised draft is expected to be released in May 2019. The form is intensive and lengthy as opposed to the current Form W-4 which is only a quarter of a page. The new form asks for additional non-wage income such as interest and dividends along with deductions in an attempt to calculate the exact amount of tax owed.

Section 199A Updates. The IRS issued draft Form 8995-A, Qualified Business Income Deduction, on April 15. The form would be used to calculate the qualified business income deduction under Section 199A for tax year 2019. The deduction is available to some taxpayers with income from pass-through sources. Also, the IRS recently issued corrections to the Regulations governing Section 199A in T.D. 8947.

Opportunity Zones Guidance Released. The IRS issued additional guidance on April 17, 2019 regarding Opportunity Zones created under the Tax Cuts and Jobs Act. The guidance provides a more flexible timeline for investing and allows Opportunity Zone Funds up to 6 months to invest in a qualified investment after receiving funds. The guidance also further defines which businesses may qualify for the tax benefits and extends the benefits to vacant buildings and raw land.

Supreme Court to Address Trust Nexus. On April 16, 2019, the U.S. Supreme Court heard oral arguments in *N.C. Dep't of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust*. In the case, North Carolina courts denied the right of the state to tax a trust's income solely because a beneficiary of the trust lived in North Carolina. In *Kaestner*, the trust's books and records are housed in New York, the trustee is a resident of Connecticut, and assets are managed and held in Boston, with trust

beneficiaries living in multiple states. With each state having different rules regarding the ability of the state to tax a trust and when that right arises, the Court's ruling should provide needed guidance. A decision is expected in late June 2019. California law currently imposes tax on out-of-state trusts which have a California beneficiary, so this decision could impact California's ability to impose this tax.

Legislation Governing IRS. On April 9, the House of Representatives approved H.R. 1957, the *Taxpayer First Act of 2019*. Among other things, the bill would restrict the IRS's use of private debt collectors, establish a separate office of appeals, improve the whistleblower program, and provide for better security surrounding the IRS's technology to help protect against identity theft. Senate Finance Committee Chairman Senator Chuck Grassley (R-IA) and Ranking Member Senator Ron Wyden (D-OR) introduced a similar bill in the Senate.

Legislation Regarding Retirement Plans. The House Ways and Means Committee passed two bills regarding retirement plans, namely, H.R. 1759, *Building on Reemployment Improvements to Deliver Good Employment for Workers (BRIDGE for Workers) Act*, and H.R. 1994, *Setting Every Community Up for Retirement Enhancement (SECURE) Act*. The *BRIDGE for Workers Act* amends the Social Security Act to broaden the definition of those eligible for unemployment insurance. The *SECURE Act*, among other things, makes it easier for taxpayers to move from one retirement plan to another and even offers a tax credit to small businesses who automatically enroll their employees in retirement plans. It also provides tax benefits to various groups such as first responders and health care workers. In the Senate, the *Retirement Enhancement and Savings Act of 2019 (RESA)*, S. 972, was introduced with similar provisions.

Senator Wyden Proposes Mark-to-Market Gains. Senator Ron Wyden (D-OR), Ranking Member of the Senate Finance Committee,

announced on April 2 that he plans to introduce a tax plan which marks to market capital assets each year to ensure wealthy taxpayers with appreciated assets pay tax on the appreciation each year, at ordinary rates.¹ Senator Wyden stated that this plan would close loopholes that allow the richest in society to defer and possibly avoid taxes on their wealth and appreciation.

Several experts are skeptical of his plan and look forward to seeing how it will address several issues such as when there is a decline in value, how it affects the basis of inherited assets, and paying the tax on the appreciation when the asset has not been liquidated.

Proposed Regulations Regarding Life Insurance. The IRS has issued Proposed Regulations, REG-103083-18, with regard to new reporting rules under Section 6050Y of the Internal Revenue Code for reportable sales of life insurance contracts to third parties and payments of reportable life insurance death benefits.



STATE TAX NEWS

By Katie Lepore, CPA, J.D.,
LL.M., Taxation

FTB Admits Unverified Withholding Errors. The FTB announced that a system error caused it to issue refunds to approximately 23,500 taxpayers during the period of March 8 to March 11, 2019 without verifying the claimed wage withholding. According to the FTB, this may have resulted in the taxpayer's withholding being increased or decreased incorrectly and erroneous Notice of Tax Return Change letters being mailed. It will be reviewing each affected return in the coming weeks and began contacting affected taxpayers on April 22, 2019.

¹ <https://www.finance.senate.gov/ranking-members-news/wyden-to-unveil-plan-to-ensure-wealthy-pay-their-fair-share->

Sales Tax Collection Law Amended. On April 25, 2019, Governor Newsom signed AB 147 which amended California's sales and use tax to align it with the 2018 US Supreme Court decision in *South Dakota v. Wayfair*. The bill increases the value of sales an out of state retailer must have before it is required to collect California use tax from purchasers located in California from \$100,000 (or more than 200 separate transactions) to \$500,000. It also increases to \$1,000,000 the value of personal property sold before sales tax must be collected by the out of state retailer. See Revenue and Tax Code Sections 6203 and 7262. The law is not retroactive, so out of state retailers who made sales in excess of \$100,000 in California between April 1 and April 25, 2019 must still collect sales and use taxes for that interim period.

Santee to Avoid Enforcement of Short-Term Rental Restrictions. The Santee City Council agreed that Santee should not actively monitor and look to punish homeowners who advertise or rent on a short-term basis, even through mediums such as Airbnb. However, while the City Council agreed to not actively deter such short-term rentals, it warns that if it receives excessive noise complaints, safety concerns, or other issues related to short-term rentals, it will enforce the code which disallows short-term rentals. The City of San Diego is looking at instituting regulations regarding short-term rentals. These are currently regulated in Carlsbad, Del Mar, Encinitas, Imperial Beach, Oceanside, and Solana Beach. Short-term rentals are prohibited in El Cajon, Coronado, National City, and Poway.²

FTB Offers Payment Voucher for Multiple Taxpayers. The FTB announced that it will be releasing new forms in 2019 for business tax payments and for payments related to both Court-Ordered Debt and for Vehicle Registration Debt that allow taxpayers to submit one check for multiple tax accounts. In 2018, the FTB

developed forms to assist employers, payroll companies, and tax preparers to submit a single check for multiple personal and fiduciary income taxpayers. The FTB cites streamlined efficiencies and recordkeeping as the reason for the new forms. For individuals, Form FTB 5007 can be used when submitting one voucher for multiple individuals, and for trusts and estates, taxpayers may use Form FTB 5008.

Los Angeles Acts Prevent Rejection of Section 8 Tenants. The Los Angeles City Council's Housing Committee issued a proposal that would stop landlords from rejecting potential tenants who use Section 8 to pay for their housing. Section 8 is a federal program that provides housing assistance to low-income renters. Tenants are reporting that it is hard to find a landlord willing to rent to them so the proposal would prohibit landlords from discriminating against potential tenants based on "source of income." Landlords report that the federal program subjects them to much more bureaucratic red tape before receiving rental income and there are plenty of tenants looking to rent who do not have a Section 8 voucher. Several cities in California, including San Diego, already have ordinances in place that protect Section 8 tenants.

Rent Control Bill Dies. AB 36, which would have lifted the statewide restrictions on rent control, failed to make it out of committee on April 24, 2019. Its sponsor, Richard Bloom (D-Santa Monica), announced he will withdraw the bill. AB 1482, which would cap rents and limit increases to no more than 5% per year plus the cost of living, is still in committee.

Composting Human Remains? Washington State is set to be the first state to allow the composting of human remains, beginning in May of 2020. The process will be costly – estimated at \$5,000, which is more than the current cost of cremation, and could take 30 days. See:

<https://www.nytimes.com/2019/01/26/us/death-human-compost.html>.

No similar bill has been introduced in California.

² <https://www.sandiegouniontribune.com/story/2019-04-15/santee-says-its-not-interested-in-regulating-short-term-rentals>

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