Tax Impact

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Partnerships: If you're audited, will you be ready?

The Bipartisan Budget Act of 2015 established a new "centralized audit" regime for partnerships, including LLCs taxed as partnerships. Although the new audit rules apply to partnership tax returns for tax years beginning after 2017, the IRS didn't finalize regulations on these rules until December 2018.

A quick refresher

Here's a brief review of the new audit rules. Most significantly, the rules are designed to shift many of the burdens associated with auditing partnership returns from the IRS to the partnership itself, and its partners. They do this by allowing the IRS to determine tax adjustments — and assess any additional taxes, penalties and interest (at the highest marginal individual or corporate tax rate) — at the *partnership* level.

The IRS now has the authority to assess and collect taxes from the partnership on these "imputed underpayments" without having to consider partners' circumstances or tax attributes that might reduce their individual tax liabilities. That burden is now imposed on the partnership, which may 1) seek a modification of an imputed underpayment by demonstrating that it should be taxed at a lower rate or by having partners file amended returns and paying the resulting tax, or 2) elect to "push out" partnership adjustments to the relevant partners.

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One risk associated with the new audit regime is that, unless partners from the tax year being audited are held responsible for imputed underpayments, new partners may end up paying tax liabilities that were the responsibility of former partners.

Final regulations narrow scope of new rules

One significant provision of the final regs narrows the scope of items subject to adjustment under the centralized audit regime. Although proposed regs would have allowed the IRS to adjust a broad range of items connected to a partnership, the final regs limit an audit's scope to items that 1) appear (or are required to appear) on the partnership's tax return, or 2) are *required* to be maintained in the partnership's books and records.

So, for example, an individual partner's outside basis in a partnership interest wouldn't fall within the scope of a partnership audit, even if the partnership chooses to maintain that information in its books and records.

The final regs also set forth complex procedural rules, including rules for requesting

The partnership representative: Choose carefully

One significant change under the new audit regime is replacement of the "tax matters partner" with a "partnership representative," which must be designated each year on the partnership's tax return. Previously, partners had the right to participate in a partnership audit. But under the new rules and final regulations, the partnership representative has the "sole authority to act on behalf of the partnership" and to bind the partnership and its partners in connection with an IRS audit.

Given this broad authority, it's important to choose a representative carefully. Unlike the tax matters partner, a partnership representative need not be a partner in the partnership. It can be any individual with a substantial presence in the United States or even an entity (including the partnership itself), provided it designates an individual with a substantial U.S. presence through whom it will act.

It's also important to ensure that your partnership agreement includes procedures for selecting and removing a representative and a requirement that the representative notify the partners of certain events. And, even though the representative has sole authority to act on the partnership's behalf *from the IRS's perspective*, there's no reason the partnership agreement can't place limits on the representative's authority. For example, it might prohibit the representative from taking certain actions without the approval of a specified percentage of the partners.

modifications of imputed underpayments and making a pushout election.

Steps partnerships should take

There are many steps partnerships can take to minimize the impact of the new audit rules. First, a partnership should determine whether it's eligible for the "small partnership election." This allows it to opt out of the centralized audit regime and follow the old audit rules, under which the IRS generally assesses and collects taxes at the individual partner level.

Your partnership is eligible to opt out if it has 100 or fewer partners, all of which are qualifying partners. Qualifying partners are individuals, C corporations (including foreign entities that would be treated as C corporations if they were domestic), S corporations or estates of deceased partners. If your partnership has just one nonqualifying partner (such as a partnership or trust) it can't opt out, regardless of its size.

It's also a good idea to amend your partnership agreement to facilitate actions that can reduce the impact of the new audit rules. For example, you might amend the agreement to:

1. Require current or former partners to furnish tax information or file amended returns in the event of an audit,
2. Require the partnership to make a pushout election in the event of an audit, or
3. Indemnify partners against tax liabilities that were the responsibility of former partners.

You should also update the agreement to establish procedures for selecting a partnership representative and set forth the representative's duties and responsibilities to the partnership. (See "The partnership representative: Choose carefully" above.)

Turn to your advisor

All partnerships should familiarize themselves with the final regulations and take steps to protect themselves in the event of an audit, including opting out of the new rules if they're eligible. Contact your tax advisor for additional information. ■

Income tax withholding

Examine your withholding allowances today

If you receive paychecks from one or more employers, it's a good idea to do an annual checkup to make sure the right amount of income tax is being withheld. Even if you claimed an appropriate number of withholding allowances on Form W-4, there's no guarantee that your total withholdings will match your tax liability for the year. Many people learned this lesson the hard way during the 2018 tax filing season, receiving smaller refunds than expected or even owing the IRS more taxes.

The problem with withholding tables

An employer determines the amount of tax to withhold from your paycheck by consulting the IRS's withholding tables. These tables estimate withholdings based on the amount and frequency of your wages, the number of withholding allowances you claim, and your marital status.

To avoid unpleasant surprises on your 2019 return, review your withholdings now and adjust them if necessary for the rest of the year.

But while these estimates are reasonably on target for many people, for some they result in over- or underwithholding. If you overwithhold, you're essentially making an interest-free loan to the government. If you underwithhold, you'll have to make a payment with your tax return, plus penalties and interest in some cases.

After the Tax Cuts and Jobs Act (TCJA) reduced individual income tax rates, the IRS adjusted the withholding tables to reflect taxpayers' lower tax bills. But for many people, the tables overcompensated for the new tax law, reducing their refunds or even requiring them to make payments with their 2018 returns.

Avoiding surprises

To avoid unpleasant surprises on your 2019 return, review your withholdings now and adjust them if necessary for the rest of the year. A review is particularly important if you:

- Had a large refund or tax bill in 2018,
- Have multiple jobs or are part of a dual-income family,
- Work only part of the year,
- Claim the child tax credit,
- Have dependents age 17 or older, or
- Typically itemize deductions.

You should also double-check your withholdings if your income is very high or your tax return is complex.

Begin the review by filling out the IRS's withholding calculator at the IRS's website. You'll be asked for information about your filing status; income; dependents; various deductions, credits and adjustments; and current withholding arrangements. The calculator estimates your tax liability for the year and tells you whether you need to increase or decrease your withholdings (and by how much) to avoid an underpayment or overpayment.

For additional peace of mind, or if your tax situation is particularly complex, ask your tax advisor to review the results. Your situation may be considered "complex," for example, if you're subject to alternative minimum tax, pay self-employment taxes, owe taxes on a child's investment income (the "kiddie" tax), have long-term capital gains or qualified dividends, or collect taxable Social Security benefits.

To adjust your withholding amount, submit a new Form W-4 to your employer. You can reduce your withholdings by increasing the number of withholding allowances or increase them by specifying an additional dollar amount you want withheld from each paycheck. Be aware that the IRS is planning to release a new, more complex Form W-4 designed to produce more accurate withholding amounts.

Have regular checkups

It's good practice to review your withholdings at the beginning of each tax year. That way, any adjustments you make can be spread over the entire year with minimal impact on the size of your paychecks. And consider revisiting your withholding calculations during the year if any major life changes, such as marriage, divorce, birth or adoption of a child, or death of a spouse, have an impact on your tax liability. Contact your tax advisor for further guidance. ■

The GST tax and your estate plan: What you need to know

The Tax Cuts and Jobs Act doubled the generation-skipping transfer (GST) tax exemption to $10 million beginning last year. The exemption is adjusted annually for inflation. (For 2019, the exemption amount is $11.4 million.) However, even though most families won't be affected by the GST tax, it's important to note that, beginning in 2026, the GST tax exemption is scheduled to return to a pre-TCJA level of $5 million.

What is the GST tax?

The GST tax is a flat, 40% tax on transfers to "skip persons," including grandchildren, family members more than a generation below you, nonfamily members more than 37½ years younger than you, and certain trusts (if all of their beneficiaries are skip persons). If your child has predeceased his or her children on the date of the gift, however, those grandchildren are no longer considered skip persons.

GST tax applies to gifts or bequests directly to a skip person (a "direct skip") and to certain transfers by trusts to skip persons. Gifts that fall within the annual gift tax exclusion (currently, $15,000 per recipient; $30,000 for gifts split by married couples), either outright or to qualifying "direct skip trusts," are also shielded from GST tax.

What are potential allocation traps?

To take advantage of the GST exemption, you (or your estate's representative) must allocate it to specific gifts and bequests (on a timely filed gift or estate tax return). Allocating the exemption wisely can provide substantial tax benefits. To avoid costly mistakes, the tax code and regulations provide for automatic allocation under certain circumstances. Your exemption is automatically allocated to direct skips as well as to contributions to "GST trusts." These are trusts that *could* produce a generation-skipping transfer, subject to several exceptions.

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Often, the automatic allocation rules work well, ensuring that your exemption is allocated in the most tax-advantageous manner. But in some cases, they can lead to undesirable results. Suppose you establish a trust for your children, with the remainder passing to your grandchildren. You assume the automatic allocation rules will shield the trust from GST tax. But the trust gives one of your children a general power of appointment over 50% of the trust assets, disqualifying it from GST trust status. Unless you affirmatively allocate your exemption to the trust, distributions or other transfers to your grandchildren will be subject to GST taxes.

Here's another example: You establish a trust for your children, but there's a remote possibility that the trust will make a generation-skipping transfer, so it's a GST trust for automatic allocation purposes. Because the trust is unlikely to result in GST taxes, your exemption is wasted. That's not a problem if your estate is well within the exemption amount, but what if you need to allocate your exemption elsewhere? If so, you're better off opting out of automatic allocation and allocating your exemption to direct skips or to trusts that are more likely to trigger GST taxes.

Turn to your advisor

The rules regarding allocation of the GST tax exemption are complex, and mistakes can be costly. If you're planning to make gifts to your grandchildren or other loved ones more than one generation below you or nonrelatives more than 37½ years younger than you, huddle with your estate planning advisor to understand the ins and outs of the GST tax. ■

TAX TIPS

Helping employees pay down student loan debt

In a 2018 private letter ruling, the IRS gave its blessing to an employer's innovative student loan repayment (SLR) program. Essentially, the ruling allowed the employer to link matching contributions to employees' 401(k) plan accounts to *either* 1) the amount of elective contributions an employee makes to the plan *or* 2) the amount of student loan repayments an employee makes outside the plan. Although the ruling applies only to the specific employer that requested it, it may create an opportunity for other employers to offer tax-advantaged student loan assistance to their employees, provided they design these programs carefully and follow the ruling's guidance. ■

Upstream estate planning offers significant income tax benefits

Much of estate planning revolves around "downstream" strategies — that is, shifting wealth to your children or others in the younger generation. But "upstream" strategies involving gifts to your parents can also be effective, especially if you and your parents' estates are well within the gift and estate tax exemption amount. Here's one example:

Say you own rental residential real estate with a fair market value of $1 million and, as a result of depreciation deductions over the 15 years you've owned it, an adjusted basis of only $100,000. If you were to sell the real estate now, you would trigger a $900,000 gain. Suppose, instead, that you gift the property to your mother. Three years later she dies, and the property passes back to you as part of her estate. You receive a stepped-up basis in the property equal to its fair market value at that time, which has grown to $1.2 million, and can sell the property income-tax-free. Be aware that, under the tax code, this strategy won't work if you or your spouse inherits the property within one year after gifting it. ■

Overlooked charitable deductions

Most people know that they can claim cash or property donated to charity as itemized deductions. But some overlook deductions for properly substantiated out-of-pocket expenses associated with their charitable activities. For example, if you prepare baked goods for a charity fundraiser or cook food for a soup kitchen, you can deduct the cost of the ingredients. And if you use your car for charitable work, you can deduct 14 cents per mile. The U.S. Tax Court has even ruled that the cost of a babysitter who watches your kids while you do volunteer work for a qualified charity is deductible. ■