# *January 1, 2018, Proposed Effective Date for Implementation of New Partnership Audit Rules Is Fast Approaching*

The January 1, 2018, effective date for new partnership audit rules is approaching, and although the regulations are currently on hold, it is still possible that the January 1st effective date will stick. Enacted as part of the Bipartisan Budget Act of 2015 (the "Act"), the new partnership audit rules repeal the "TEFRA" partnership regime and replace it with a new set of rules that significantly change the manner in which partners and former partners are treated for tax purposes when there are audit adjustments. If these rules go into effect, partners of partnerships will need to address the new rules and modify their partnership agreements to comply. Further, partners will have to consider whether to opt out of the new regime where this option is available. Also, advisors in partnership acquisitions and dispositions will need to consider the new rules, which generally shift responsibility for tax adjustments from former partners to the partners in place at the time of a tax adjustment.

Note, for purposes of this discussion, our reference to "partners" and "partnerships" applies to members of limited liability companies ("LLC's") that are treated as partnerships for federal tax purposes.

**Important Changes**. The most important changes are as follows:

1. **Tax Underpayments to be Collected at Partnership Level**. Under the prior TEFRA law, tax liabilities, including related interest and penalties, could only be collected at the individual partner level. Under the new partnership audit regime, those liabilities will be collected at the partnership level, unless the partnership is eligible to make an election to opt out of the regime and does in fact make that election.

The imputed underpayment paid by the partnership results in the current partners (the "adjustment year" partners) being effectively responsible for paying the tax for the partners who were partners during the tax year for which the adjustment was made (the "reviewed year" partners). This applies regardless of whether the current partners are the same as the partners in the reviewed year. If partners want to ensure that the ultimate responsibility falls on the partners for the reviewed year, then indemnification provisions in the Partnership agreement may address this. An alternative procedure permitting the partnership to elect to furnish to each partner in the reviewed year a statement of the partner's share of the adjustment may be permitted, as discussed below.

2. **New Tax Terms and Concepts**. The new rules create new legal terms and concepts that did not exist under TEFRA, such as "partnership representative," "imputed underpayment," "reviewed year," and "adjustment year."

The "partnership representative" replaces the "tax matters partner," and has sole authority to act on behalf of the partnership. Interestingly, the partnership representative does not need to be a partner in the partnership.

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The "imputed underpayment" will be calculated using the highest tax rate for the reviewed year.

These terms and concepts should be included in partnership agreements going forward to incorporate the new requirements of the Internal Revenue Code and to provide clarification of the rights and obligations of the partnership and the partners.

3. **Limited Partner Ability to Participate in an IRS Audit**. The new partnership audit rules significantly curtail the ability of partners to participate in an audit or litigation with the IRS. Where partners wish to preserve these rights, partnership agreements may need to be revised to provide contractual rights to partners that previously existed under TEFRA. These rights are generally vested in the partnership representative.

4. **Ways to Avoid or Modify Tax at Partnership Level**. The new partnership audit procedures provide for three ways to modify or avoid tax collection at the partnership level.

First, certain partnerships with no more than 100 partners can make an annual "opt-out" election on a timely filed tax return. The opt-out rules are generally limited to partnerships where each partner is an individual, C corporation, S corporation, or estate of a deceased partner. If any of the partners is another partnership or a trust, the partnership cannot elect out of the new regime. In addition, S corporation shareholders are counted individually for purposes of the 100-partner test.

Second, if a partnership becomes subject to an audit and is issued a final partnership adjustment ("FPA"), it may elect out of the "imputed underpayment" process. The partnership must provide the IRS with a statement of each partner's share of any adjustment to income, gain, loss, deduction, or credit, and must make this election within 45 days of receiving the FPA. In this case, the partners need not amend their prior year tax returns to reflect the adjustment, but must pay their share of the deficiency with the return for the tax year in which the FPA is issued.

Third, a partnership can reduce the amount of the "imputed underpayment" if one or more of the "reviewed year" partners files an amended return and pays the tax attributable to the adjustment allocable to that partner. To implement this, the partnership must submit information to the IRS sufficient to modify the "imputed underpayment" within 270 days of the FPA. Partnerships should consider whether to establish a method that allows for the implementation of this alternative, and whether it should be addressed in the partnership agreement going forward.

**Conclusion**. The new partnership audit procedures are a significant development in the arena of partnership taxation. Considering the level of authority granted to the designated representative with respect to settling disputes with the IRS, and the potential for future partners to carry the tax burden of changes arising in years in which they were not partners, partnerships and their partners should evaluate the current provisions of their partnership and LLC agreements and make changes to reflect the new laws.

**Observations**. The IRS recently released proposed regulations to implement the new partnership audit rules, providing comprehensive guidance on how to opt out of the new regime, how to implement it and what elections to make thereunder. The IRS did reserve and asked for comments on some issues. In general, the proposed regulations reflect the IRS's strong desire to discourage partnerships from opting out of the new rules and to have partnerships, rather than partners, pay tax on imputed underpayments. On January 20, 2017, the White House put a freeze on the proposed regulations, subjecting them to immediate withdrawal for review and approval by the Trump administration. There is no deadline to complete the required review, although there was recent indication that some additional guidance may be forthcoming this summer.

## *Generation-Skipping Tax Basics You Should Know*

The federal gift and estate taxes are popular topics in the media, and most clients understand the basic concept of these taxes: when a person makes a gift either during life or at death, that gift is subject to gift or estate tax (factoring in certain exemptions). A tax that receives much less press and which many clients do not understand, or may not even know exists, is a third transfer tax known as the generation-skipping transfer ("GST") tax. To understand how the GST tax works, it helps first to understand the history of that tax.

Imagine a very wealthy individual who wants to leave his considerable property for his children, grandchildren and succeeding generations. He could leave his property to his children, who could in turn leave the property to their children, and so on down the generational line. But at each generation, upon the death of the current asset owner, there could be an estate tax that reduces the family wealth.

Instead of opting to pass wealth generation-by-generation down the family line, that wealthy individual instead could leave his property in trust at his death. There would be an estate tax to be paid at that time. But after that one-time tax, the family wealth would pass into trusts for the benefit of his children, grandchildren and so on, with no further estate taxation.

The IRS perceived the availability of this technique as a significant loophole in the federal wealth transfer laws, so, in 1976, the first GST tax was enacted. However, that tax was practically unworkable, so it was repealed and re-enacted in a new form in 1986. That 1986 version of the GST tax – with changes put into effect over the years – is still with us.

The GST tax imposes a flat tax at the highest current federal estate tax rate (40% in 2017) on certain transfers of wealth that “skip” an intervening generational level at which estate or gift tax might have been levied.

The following are answers to some frequently asked questions about the GST tax that may help explain how the tax applies and how it can be avoided:

**I know I can give a certain amount of property away without owing gift or estate tax. Is the same true for GST tax?**

Yes. As with estate and gift tax, there is a certain amount each individual can give to “skip persons” (generally, individuals more than one generation below the donor) either during life or at death, without triggering GST tax. The GST tax exemption amount is currently the same as the estate and gift tax exemption amount[1], or $5,490,000. There is also a GST “annual exclusion” amount, which is the same as the gift tax annual exclusion amount, or $14,000 per year, per recipient in 2017. This means you can transfer up to $14,000 per year (or $28,000 if you are married and you and your spouse elect to split gifts on your gift tax returns) to any skip person without using any of your GST exemption or paying GST tax. Note that to qualify for this GST annual exclusion, the gift must generally be directly to a skip person, or to a “grandchildren’s trust” that must meet certain specific requirements.

**If I have a $5,490,000 estate and gift tax exemption and a $5,490,000 GST exemption, does that mean I can protect $10,980,000 from transfer tax?**

No. You can protect $5,490,000 from estate/gift tax, and $5,490,000 from GST tax, but in order for a transfer to a skip person to be protected from both taxes, both exemptions must be applied to the same transfer. For instance, a $100,000 outright gift to a grandchild would qualify for both the $14,000 gift tax annual exclusion and the $14,000 GST tax annual exclusion. However, that leaves $86,000 subject to federal gift tax (against which the donor’s gift tax exemption could apply to negate that tax) and $86,000 separately subject to the GST tax (against which the donor’s GST exemption could apply to negate that tax). If the donor had exhausted his $5,490,000 estate and gift tax exemption and his $5,490,000 GST tax exemption, then the donor would owe federal gift tax on the $86,000 subject to tax (a tax of $34,400 at the applicable 40% gift tax rate) and a separate GST tax at the maximum 40% rate, or an additional $34,400. In fact, there is an additional gift tax on the amount of the GST tax paid by the donor, costing another 40% of the GST tax paid of $34,400, or about $13,760. In other words, the donor would have to spend $82,560 in taxes to pass $100,000 to a grandchild – a total cost of $182,560.

**What if one of my children predeceases me, and I make a gift to his or her children? Is that subject to GST tax?**

No. This is known as the “predeceased child” exception to the GST tax. All grandchildren who are the children of a predeceased child of yours are treated as your children for transfer tax purposes, and gifts to them made after the death of their parent are not subject to GST tax.

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[1] The estate and gift tax exemption is one unified exemption that can be used during life and/or at death. It is sometimes referred to in this article as the “estate tax exemption” and sometimes as the “gift tax exemption,” depending on whether it is applied to a gift made at death or during life.

**What if I make gifts to nieces and nephews, other family members or friends? Are those subject to GST tax?**

It depends on the recipient of the gift and how old she is. One rule applies to lineal relations. A generational level is assigned to each person who is a lineal descendant of a grandparent of either you or your spouse by comparing (i) the number of generations between the grandparent and such person, with (ii) the number of generations between the grandparent and you or your spouse. For example, let's say you make a gift to your niece. There are three generations between your niece and your grandparents, and two generations between you and your grandparents, which means there is one generation between you and your niece. Accordingly, your niece will not be treated as a skip person with respect to you.

A person who is not a lineal descendant of a grandparent of you or your spouse is subject to a different rule: that unrelated person is treated as a skip person with respect to you if he or she is more than 37 ½ years younger than you, so gifts to such person are subject to GST tax. This age rule does not apply to the lineal descendants of your grandparents. Therefore, in the example above, even if your niece is 40 years younger than you, she will not be treated as a skip person with respect to you.

**Is it possible to have different amounts of estate tax exemption and GST exemption remaining at my death?**

Yes. Although the estate and gift tax exemption and the GST exemption amounts are the same, donors often use different amounts of their exemptions at different times. For example, a $1,000,000 lifetime gift to a child is subject to gift tax, but not GST tax, because the child is not a skip person. Accordingly, the gift would use a portion of the donor's gift tax exemption, but the donor would not need to allocate GST exemption to the gift, leaving the donor with more GST tax exemption than gift tax exemption remaining.

Gift and GST tax exemption amounts may become imbalanced when clients make gifts to life insurance trusts to pay premiums on the policies owned by the trust. Those gifts typically are eligible for the gift tax annual exclusion but not the GST tax annual exclusion. That means that although gifts to the trust may not use any gift tax exemption, GST tax exemption may be allocated to those gifts, leaving the donors with more estate tax exemption than GST exemption remaining at death. Depending on the terms of the trust, the donor may opt not to allocate GST exemption to the trust, as discussed below.

**How does the GST tax apply to gifts I make to a trust?**

Although gifts made to certain trusts are treated as "direct skips," (i.e., where all beneficiaries are skip persons, similar to an outright cash gift to a grandchild), most gifts to trusts are treated as "indirect skips" because most trusts have both skip-person and non-skip-person beneficiaries (for example, both children and grandchildren). In such cases, the application of the GST tax is somewhat complicated.

If an individual makes an indirect skip gift to a trust, he must first decide whether he wants the trust to be exempt from GST tax or not. If so, he will need to allocate an amount of his GST exemption equal to the amount of the gift on a timely filed gift tax return. Allocating GST exemption to the entire gift, as well as all subsequent gifts made to the trust, means that no GST tax will be due upon the gift to the trust, any distribution from the trust or the termination of the trust (assuming nothing is done to "taint" the GST-exempt status of the trust, a subject beyond the scope of this article). This is true even if the trust investments perform very well and the trust eventually grows to be much larger than the amount of GST exemption allocated to it.

If GST exemption is not allocated to indirect skip gifts made to a trust, the trust will not be exempt from GST tax. In that case, GST tax will be owed (i) when any distribution is made from the trust to a skip person, and (ii) upon the termination of the trust, to the extent the trust property is paid to a skip person. GST tax is not owed at the time of the gift to the trust. Accordingly, even if a trust theoretically could be subject to GST tax because no GST exemption was allocated to it, if no distributions are ever made from the trust to a skip person, and no skip person receives any trust property when the trust terminates, no GST tax will ever be owed with respect to the trust. In circumstances where a trust is primarily intended to benefit the donor's children (and may distribute entirely to them during their lifetimes), the donor will often opt not to apply GST exemption to the trust, even if the trust property could potentially be paid to a skip person.

But donors also have to be mindful of the rules governing automatic allocation of GST exemption. Depending on the type of trust, GST exemption may be automatically allocated to the gift – even if the trust is not intended to skip generations. It is extremely important to be mindful of these automatic allocation rules and to accurately reflect the intended GST tax treatment of the trust on gift tax returns – especially on the return reporting the first gift to the trust. We recommend express allocation GST exemption, if desired, rather than relying on automatic allocation (which makes keeping track of exemption used over the years easier) or expressly “opting out” of automatic allocation when not desired. It is very difficult, and sometimes impossible, to reverse an inadvertent allocation of GST exemption, and such a mistake may waste some of this valuable tax benefit.

## *The Nonprofit Forum*

*This is another in a series of articles on nonprofit organizations and issues that we feature in our regular Updates. We have found this area to be one of ever-increasing interest to our clients and colleagues, and we hope you will find these articles helpful and insightful.*

**CAUTION: The Dangers of Non-Board Members on Board Committees**

Many public charities and private foundations have found it very helpful to staff their board committees with individuals they might ultimately consider for board membership. These committees can be valuable both to the organization and to the participating members in determining the extent of their mutual interest in each other and their future relationship in furthering the organization's objectives.

That being said, the organization should be mindful of the fact that committees of the board that are authorized to undertake functions and make decisions that otherwise are responsibilities of the board cannot include voting participants who are not board members. For example, it would not be appropriate for an organization's executive committee to include non-board members. Among the other sorts of committees that likely fall into this category are investment, nominating, audit and finance.

Of course, non-board members may participate in these committees in a non-voting advisory capacity. We have particularly seen this with investment committees. But the corporate record-keeping with respect to the meetings of these committees should be careful to note the non-participation of these individuals when votes are taken.

Organizations with board committees are encouraged to examine their committee rosters to confirm that they are complying with these rules. And while eager and helpful non-board members can certainly participate in the deliberations of these committees, they cannot ultimately vote on any committee issues.

## As Sherman Wells continues to expand, we would like to warmly welcome two new members to the Tax and Trusts & Estates Group:

**Bozena M. (“Bonnie”) Diaz, Associate**

Bonnie began her career at a large New York law firm, where she specialized in M&A and capital market transactions for Fortune 500 companies. She currently specializes in tax planning for middle-market corporations, limited liability companies, partnerships, not-for-profit institutions, and individuals. She counsels clients on issues related to acquisitions, tax-free reorganizations, restructurings of their operations, and business and real estate joint ventures. Bonnie's experience also includes tax controversy matters, and representation of clients before the IRS. She also regularly counsels clients on issues of employee benefits and plan qualification, executive compensation, and employment and severance agreements. Bonnie received her J.D. from the Georgetown University Law Center, and her LL.M. in Tax from New York University School of Law. In addition to being an exceptional tax attorney, Bonnie is also the mother of two daughters.

**Katrina A. Gieniec, Paralegal**

Katrina has more than 12 years of experience, having begun her career at Holland & Knight LLP, and later working with Day Pitney LLP and Lindabury, McCormick, Estabrook & Cooper, P.C. Her primary focus is estate and trust administration, including probate, marshalling and valuing assets, preparing federal and state estate and inheritance tax returns and accountings, and assisting with federal and state estate tax audits. Katrina received an M.A. in business and finance from the Academy of Economics in Krakow, Poland. She is a welcome addition to our existing group of seven trust and estates paralegals and fiduciary accountants.

Welcome to the Sherman Wells team, Bonnie and Katrina!

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