Tax Impact

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MorisonCogen LLP
Certified Public Accountants • Business Consultants

Partnerships: Get ready for new audit rules

For partnerships, including limited liability companies taxed as partnerships, new audit rules are a game changer. The rules apply to returns for partnership tax years that begin after December 31, 2017, including amended returns. The changes aren't merely procedural; they substantially alter the taxation of partnerships, effectively imposing *entity-level* taxes on partnerships.

There's plenty of time to prepare for the new rules, but you should begin thinking about how they'll affect you. If you're contemplating a new business venture that will be taxed as a partnership, it's a good idea to address the new rules in your partnership or operating agreement.

Tax on all partnerships

The new audit rules, added by the Bipartisan Budget Act of 2015, will affect all partnerships, regardless of size. However, certain partnerships with 100 or fewer partners will be able to opt out of the new rules (see "Can you opt out?" on page 3), but the opt-out process itself involves additional reporting and disclosure requirements.

Under the new rules, the IRS will assess and collect taxes at the partnership level. This is a significant departure from current rules, under which the IRS generally assesses and collects taxes at the individual partner level. By easing the administrative burden associated with collecting tax from individual partners, the new rules will likely produce a dramatic rise in the number of partnership audits.

Tax assessed at highest rate

The new rules don't just streamline the audit process; in some cases, they'll actually increase the aggregate tax liability of the partnership and its partners. In an audit under the new rules, the IRS will determine any adjustments to the partnership's income, gains, losses, deductions or credits — as well as to partners' distributive shares of these items — and assess any additional taxes, penalties and interest against the partnership. Additional taxes will be determined by multiplying the net adjustment by the highest marginal individual or corporate tax rate for the audited year. The result is an "imputed underpayment," which the partnership takes into account in the *adjustment year*.

This approach will create several problems for partnerships and their partners. For example, because the new rules assess the tax at the highest marginal rate, partners lose the benefit of partner-level tax attributes that ordinarily would reduce their tax liability. To ease this burden, partnerships will be allowed to reduce their imputed underpayment by proving that a portion of it is attributable to tax-exempt partners, partners taxed at

Can you opt out?

Partnerships with 100 or fewer partners may opt out of the new audit rules by filing an annual "small partnership election." But before you jump to any conclusions about your partnership's status, be aware that you can opt out only if your partners are individuals, C corporations (including foreign entities that, were they domestic, would be treated as C corporations), S corporations or estates of deceased partners.

A partnership with just one nonqualifying partner (another partnership or a trust, for example) doesn't qualify, regardless of its size. This means that tiered partnerships or limited liability companies generally won't be able to opt out. Also, for any S corporation partners, each shareholder counts as a partner for purposes of the 100-partner threshold.

If you opt out, in addition to filing annual elections, you'll need to inform your partners of the choice to opt out and provide certain information to the IRS about each partner (including shareholders of S corporation partners).

lower rates, or income taxed at lower rates (such as capital gains). But compiling this information from all your partners may be time consuming.

Tax mistakes of others

Another significant issue: Because the new rules take additional taxes into account in the adjustment year, current partners may be liable for tax mistakes that benefited former partners. Two exceptions will allow a partnership to shift the liability back to its former partners. Partnerships can reduce or avoid entity-level taxation by:

1. Having some or all of the partners from the year under review file amended returns reporting their distributive shares of partnership adjustments and pay the tax within 270 days, or

2. Making an election, within 45 days after the audit, to provide partners from the year under review with adjusted information returns. Those partners would then take the adjustments into account on their individual returns for the adjustment year.

These exceptions allow you to avoid inequitable results, but meeting them will be a challenge.

No more "tax matters partner"

By the time the new rules take effect, you'll need to replace your "tax matters partner" with a "partnership representative." This person can be a partner or nonpartner and must have a substantial U.S. presence.

Choose your representative carefully. He or she will have broad authority to bind the partnership and its partners in dealing with the IRS, and partners will no longer have the right to participate in a partnership audit. Now is the time to begin the process of selecting a partnership representative.

What's next?

The IRS is working on regulations that will clarify, or even modify, the new rules. In the meantime, familiarize yourself with the new rules and determine whether you'll be eligible to opt out. If not, consider strategies for mitigating the impact, such as amending agreements to require partners to provide tax information or file amended returns in the event of an audit, or indemnifying partners against unexpected tax liabilities. ■

When an inheritance is too good to be true

How income in respect of a decedent works

Most people are genuinely appreciative of inheritances, and who wouldn't enjoy some unexpected money? But in some cases, it may be too good to be true. While most inherited property is tax-free to the recipient, this isn't always the case with property that's considered income in respect of a decedent (IRD). If you have large balances in an IRA or other retirement account — or inherit such assets — IRD can be a significant estate planning issue.

IRD explained

IRD is income that the deceased was entitled to, but hadn't yet received, at the time of his or her death. It's included in the deceased's estate for estate tax purposes, but not reported on his or her final income tax return, which includes only income received before death.

> ***If you inherit IRD property, you may be able to minimize the tax impact by taking advantage of the IRD income tax deduction.***

To ensure that this income doesn't escape taxation, the tax code provides for it to be taxed when it's distributed to the deceased's beneficiaries. Also, IRD retains the character it would have had in the deceased's hands. For example, if the income would have been long-term capital gain to the deceased, such as uncollected payments on an installment note, it's taxed as such to the beneficiary.

IRD can come from various sources, including unpaid salary, fees, commissions or bonuses, and distributions from traditional IRAs and employer-provided retirement plans. In addition, IRD results from deferred compensation benefits and accrued but unpaid interest, dividends and rent.

The lethal combination of estate and income taxes (and, in some cases, generation-skipping transfer tax) can quickly shrink an inheritance down to a fraction of its original value.

What recipients can do

If you inherit IRD property, you may be able to minimize the tax impact by taking advantage of the IRD income tax deduction. This frequently overlooked write-off allows you to offset a portion of your IRD with any estate taxes paid by the deceased's estate and attributable to IRD assets. You can deduct this amount on Schedule A of your federal income tax return as a miscellaneous itemized deduction. But unlike other deductions in that category, the IRD deduction isn't subject to the 2%-of-adjusted-gross-income floor.

Keep in mind that the IRD deduction reduces, but doesn't eliminate, IRD. And if the value of the deceased's estate isn't subject to estate tax — because it falls within the estate tax exemption amount ($5.45 million for 2016), for example — there's no deduction at all.

Calculating the deduction can be complex, especially when there are multiple IRD assets and beneficiaries. Basically, the estate tax attributable to a particular asset is determined by calculating the difference between the tax actually paid by the deceased's estate and the tax it would have paid had that asset's net value been excluded.

If you receive IRD over a period of years — IRA distributions, for example — the deduction must be spread over the same period. Also, the amount includible in your income is *net* IRD, which means you should subtract any deductions in respect of a decedent (DRD). DRD includes IRD-related expenses you incur — such as interest, investment advisory fees or broker commissions — that the deceased could have deducted had he or she paid them. Thus, to minimize IRD, it's important to keep thorough records of any related expenses.

Be prepared

As you can see, IRD assets can result in an unpleasant tax surprise. Because these assets are treated differently from other assets for estate planning purposes, contact your estate planning advisor. Together you can identify IRD assets and determine their tax implications. ■

IRS hobby loss rules

Is it a business or hobby?

Are you launching a "side business"? Perhaps you hope to turn your love of writing or photography into a paying gig. Or maybe you'd like to sell some of that beer you're brewing in the garage. If, like many start-up business owners, you're operating at a loss, it's critical to understand the IRS's "hobby loss" rules.

Business losses are fully deductible, but hobby losses aren't. Deductions for hobby expenses generally can't exceed your gross receipts (if any) from the activity. Also, you must claim hobby losses as itemized deductions, which may further reduce their tax benefits.

What's a hobby?

"Hobby" is a bit of a misnomer. You'll find the rules in Internal Revenue Code Section 183, entitled "Activities not engaged in for profit." The key to distinguishing between deductible and nondeductible losses is whether you engage in an activity with a profit motive. The IRS can't read your mind, of course, so it analyzes objective factors, including the following, to decide whether an activity is engaged in for profit:

- Whether you treat it like a business, keep accurate records and use those records to improve its performance,
- Your expertise and that of your advisors,

- The time and effort you (or your employees) expend in carrying on the activity,
- Whether you expect to profit from the appreciation of assets used in the activity,
- Your success in carrying on other similar or dissimilar activities,
- Your history of income or loss with respect to the activity and whether its performance is improving at a reasonable rate, and
- The amount of occasional profits, if any.

The IRS also considers whether you have other substantial sources of income from which you're deducting losses (thus making it more likely the activity isn't engaged in for profit) and elements of personal pleasure or recreation (the less enjoyable the activity, the more likely you have a profit motive).

An activity is presumed to be for profit if it's been profitable in at least three of the last five tax years.

No single factor determines the outcome. An activity is *presumed* to be for profit if it's been profitable in at least three of the last five tax years (although the IRS can attempt to prove that it hasn't been).

What if you incorporate?

There's a common misconception that the hobby loss rules apply only to individuals. While the rules don't apply to C corporations, operating an activity through a flow-through entity such as an S corporation, limited liability company or partnership won't shield you from the hobby loss rules. In fact, doing so can lead to unexpected — and unwelcome — tax consequences.

Consider the recent case of *Estate of Stuller v. U.S.* The Stullers operated a horse-breeding farm through an S corporation. They owned the land used by the farm and received rental income from the S corporation. In a decision that was upheld on appeal, a federal district court ruled that the Stullers didn't have a profit motive and, therefore, couldn't deduct the S corporation's substantial losses against their income from other sources. Even though the ruling meant that the Stullers received no tax benefit from the S corporation's rental expenses, they were still required to report the rental income on their individual tax returns.

Treat it like a business

The best way to increase the chances that the IRS will treat an activity as a business is to conduct it in a businesslike manner. Create a business plan and budget, consult advisors and keep good records. ■

Shift capital gains to your children

Giving appreciated stock or other investments to your children can minimize the impact of capital gains taxes. For this strategy to work best, however, your child must not be subject to the "kiddie tax." That tax applies *your* marginal rate to unearned income received by a dependent child under the age of 19 (24 for full-time students) in excess of a specified threshold ($2,100 in 2016).

Here's how it works: Say Bill, who's in the top tax bracket, wants to help his daughter, Mollie, buy a new car. Mollie is 22 years old, just out of college, and currently looking for a job — and, for purposes of the example, won't be considered a dependent for 2016. Even if she finds a job soon, she'll likely be in the 10% or 15% tax bracket this year. To finance the car, Bill plans to sell $20,000 of stock that he originally purchased for $2,000. If he sells the stock, he'll have to pay $3,600 in capital gains tax (20% of $18,000), plus the 3.8% Medicare surtax, leaving $15,716 for Mollie. But if Bill gives the stock to Mollie, she can sell it tax-free and use the entire $20,000 to buy a car. (The capital gains rate for the two lowest tax brackets is 0%.) ■

The right way to deduct bad debt

If your business plans to take a partial bad debt deduction, consult your accountant to be sure you record it properly. Recent IRS guidance illustrates the right — and wrong — ways to do so. In an example provided in the guidance, a taxpayer wasn't entitled to partial bad debt deductions because the taxpayer hadn't *charged off* the amounts in question during the relevant tax years. Simply setting up or adding to a reserve account isn't enough. The purpose of the charge-off requirement is to "perpetuate evidence of a taxpayer's election to abandon part of the debt as an asset." ■

Court victory for "net, net gift" strategy

It's well established that a net gift — where the recipient agrees to pay the resulting gift tax — allows you to reduce the gift's value for gift tax purposes by the amount of tax the recipient pays. The U.S. Tax Court has now also given its stamp of approval to the "net, *net* gift" strategy.

That's where the recipient also assumes the estate's potential *estate* tax liability under Internal Revenue Code Section 2035(b). This section requires that, if you die within three years after making a gift, any gift tax paid on the gift be included in your estate, which could create an estate tax liability. The court's decision allows you to reduce the value of net, net gifts by the actuarially determined value of the recipient's contingent liability for this potential additional tax on your estate. ■

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- Representation before taxing authorities
- Multi-jurisdiction tax filing
- Examination of tax returns
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Morison Cogen LLP • 484 Norristown Road • Suite 100 • Blue Bell, PA 19422
Phone 267.440.3000 • Fax 267.440.3001 • www.morisoncogen.com