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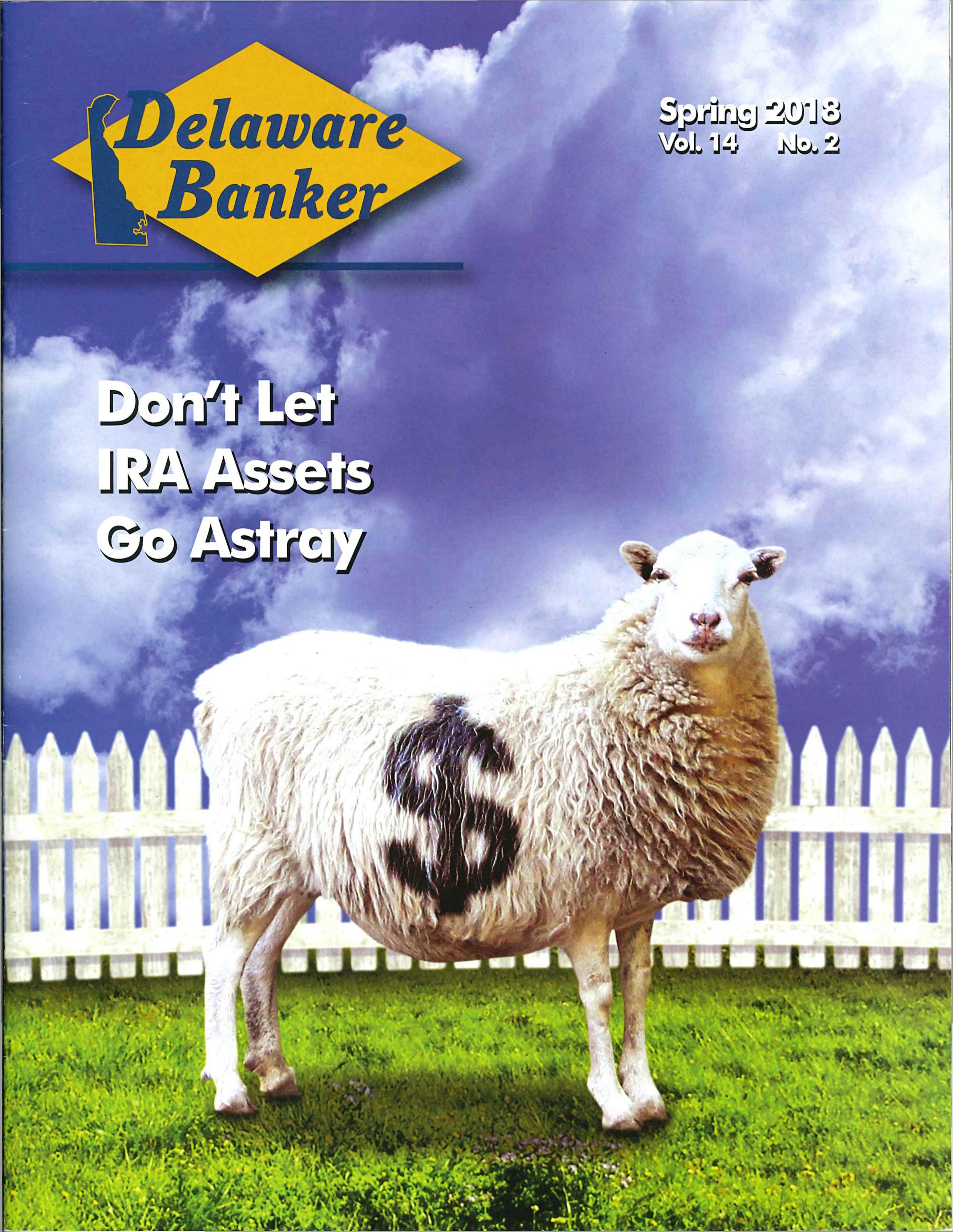

Don't Let IRA Assets Go Astray

Trust-Owned Businesses and the Potential Impact of the New Partnership Audit Rules on Trustees

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Everyone is well aware of the recently enacted Tax Cuts and Jobs Act of 2017—a law that provides for sweeping changes to many areas of the United States tax regime and generally goes into effect for taxable years beginning on or after January 1, 2018. At risk of being lost in the shuffle, however, are the new partnership audit rules (the "New Partnership Audit Rules") that originally were approved by Congress under the Bipartisan Budget Act of 2015[1] but are currently in effect for the same taxable years.

While they may not have received the same press as the Tax Cuts and Jobs Act, the New Partnership Audit Rules also effect a fundamental change, in this case to the default rules governing how the IRS will audit partnerships and multi-member limited liability companies taxed as partnerships (each such entity, a "partnership") and their partners and members (each such party, a "partner").[2]

Generally, under the New Partnership Audit Rules, audits will be conducted, and "imputed underpayments" of tax, interest, and penalties will be collected, at the partnership level, rather than at the partner level.[3] These rules were enacted to streamline the IRS's audits of large partnerships, and many commentators believe that the New Partnership Audit Rules will increase the number of partnership audits.

An understanding of, and appropriate planning regarding, the New Partnership Audit Rules are extremely important for a partnership and its partners. This is especially true, as discussed in greater detail below, with regard to trustees of any trust that is a partner in a partnership—improper planning for the New Partnership Audit Rules may leave a trustee vulnerable to claims for breach of trust.

Partnerships Subject to the New Partnership Audit Rules

Before discussing some of the key aspects of the New Partnership Audit Rules, it is important to understand which partnerships the rules will affect. The simple (but incomplete) answer is all of them. The New Partnership Audit Rules are intended to set up the default partnership audit regime and automatically are applicable to all partnerships and their partners that are subject to U.S. income taxation.[4]

The good news—for those partners who do not wish their partnerships to be subject to these rules—is that certain partnerships may opt out of the New Partnership Audit Rules.[5] The potential bad news for the same partners is that a partnership having one or more "ineligible partners" cannot opt out.

Specifically, a partnership can affirmatively elect out of the New Partnership Audit Rules if the partnership is required to issue 100 or fewer Schedule K-1s and such Schedule K-1s are required to be issued only to "eligible partners."[6] To be an eligible partner, a partner must be: (i) an individual, (ii) a C corporation, (iii) an S Corporation, (iv) the estate of a deceased partner, or (v) a foreign entity that would be a C corporation under U.S. tax regulations.[7] If it is an option for a partnership, the election to be excluded from the New Partnership Audit Rules must be made on each and every timely filed partnership tax return (Form 1065) for each tax year.[8]

Unfortunately, a partnership may not elect out of the New Partnership Audit Rules if more than 100 Schedule K-1s (including Schedule K-1s required to be issued to the shareholders of a partner S corporation) are required to be issued to eligible partners or if any partner of such partnership is an ineligible partner. An ineligible partner is any partner that is one of the following: (i) another partnership, (ii) a trust, including a revocable trust or grantor trust, (iii) a foreign entity that wouldn't be taxed as a C corporation under U.S. tax regulations, (iv) an entity

(continued on p. 20)

(continued from p. 21)

Vince Thomas practices in the firm's tax and business planning sections. His business practice primarily involves counseling companies in complex business transactions, including, mergers, acquisitions, corporate restructurings, and financing transactions. He also has substantial experience counseling distressed companies with tax issues, Delaware corporate governance advice, and transactional matters. Vince also has a substantial trust practice. He primarily represents institutional trustees with all aspects of the administration of Delaware statutory and common law trusts, including, transfer of trust situs, trust reviews, tax planning, decanting, merger, and petitions in the Delaware Court of Chancery. Vince has extensive experience with DING Trusts, Delaware asset protection trusts, Delaware dynasty trusts, Delaware statutory trusts, liquidating trusts, settlement trusts and other sophisticated tax planning structures. He routinely combines his tax, trust and transactional experience to advise distressed companies with liquidation structures.

Justin Duda concentrates his practice in the area of business transactions, including mergers and acquisitions, corporate restructurings, and financing matters. Justin acts as outside counsel to a number of regional clients, whom he regularly advises in contractual and corporate governance matters. He also has extensive experience advising clients regarding in- and out-of-court restructurings. Justin currently represents a number of institutional trustees and high net worth individuals looking to take advantage of Delaware's comprehensive trust laws and highly regarded court system, including with regards to transfers of trust situs, decantings, and trust modifications.

Notes:

1- The Bipartisan Budget Act of 2015 (BBA), Pub. L. No. 114-74 § 1101(g)(1).

2- The New Partnership Audit Rules replace the prior partnership audit regime, which included audits: (i) under the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"); (ii) under the Electing Large Partnership rules pursuant to the Taxpayer Relief Act of 1997; and (iii) of small partnerships outside of the rules set forth by TEFRA.

3- *See* 26 U.S.C. §§ 6221(a), 6225(a).

4- *See* 26 U.S.C. § 6221(a).

5- In the event that a partnership properly opts out of the New Partnership Audit Rules, an IRS audit will be conducted, and any underpayment of tax, interest, and penalties will be paid, at the partner level.

6- For purposes of determining whether a partnership is at or under this 100 Schedule K-1 threshold for opt out purposes, Schedule K-1s required to be issued by an S corporation that is a direct partner of the partnership to its shareholders shall be counted. See 26 U.S.C. § 6221(b)(1)(B); Reg. § 301.6221(b)-1(b)(2)(ii).

7- *See* 26 U.S.C. § 6221(b)(1)(C); Reg. § 301.6221(b)-1(b)(3)(i).

8- *See* 26 U.S.C. § 6221(b)(1)(A); Reg. § 301.6221(b)-1(c).

9- *See* Reg. § 301.6221(b)-1(b)(3)(ii).

10- *See* Reg. § 301.6221(b)-1(b)(3)(i).

11- *See* 26 U.S.C. § 6221(a); Prop. Reg. § 301.6241-1(a)(1).

12- *See* 26 U.S.C. § 6226; Prop. Reg. § 301.6626-1.

13- *See* id.

14- *See* id.

15- On March 23, 2018, the President signed into law the Consolidated Appropriations Act, 2018, which, among other things, provided for certain technical amendments to the New Partnership Audit Rules. These technical amendments include rules—already reflected in Proposed Regulations published by the IRS—allowing for the tax payments owed by a partnership, but for a valid push-out election, to be further pushed out upon a valid push-out election to the partners and shareholders of pass-through entities that are partners of the relevant partnership. See Consolidated Appropriations Act, 2018, Pub. L. No. 115-141, at § 204.

16- *See* 26 U.S.C. § 6225(c); Prop. Reg. § 301.6225-2(d)(2). The newly passed Consolidated Appropriations Act, 2018 also provides for so-called "pull-in" procedures, whereby the partners from the tax year under audit, rather than filing amended returns, may pay the tax that would be due under such amended returns, make changes to the relevant tax attributes for subsequent years, and provide the relevant information to the IRS in order to review the changes to such tax attributes. *See* Pub. L. No. 115-141, at § 203.

17- *See* 26 U.S.C. § 6225(c); Prop. Reg. § 301.6225-1(c)(1).

18- *See* 26 U.S.C. § 6623(a).

19- *See Id*; Prop. Reg. § 301.6223-2(c).

20- *See* Prop. Reg.§ 301.6223-2(a).

21- *See* 26 U.S.C. § 6223(a).

22- It should be noted that Proposed Regulation § 301.6223-2(c)(1) promulgated with regard to the New Partnership Audit Rules provides, in part, that "[n]o state law, partnership agreement, or other document or agreement may limit the authority of the partnership representative or the designated individual [in the case where the partnership representative is an entity] as described in section 6223 and this section." However, this Proposed Regulation has yet to be finalized, and it is unclear to what extent a court will fail to uphold a partnership or operating agreement that subjects a partnership representative to the will of the partners. Therefore, it is important that all such agreements be updated to protect the current partners of each partnership, especially where such partnership cannot seek to opt out of the New Partnership Audit Rules.