MANAGEMENT & *TAX CONCEPTS*

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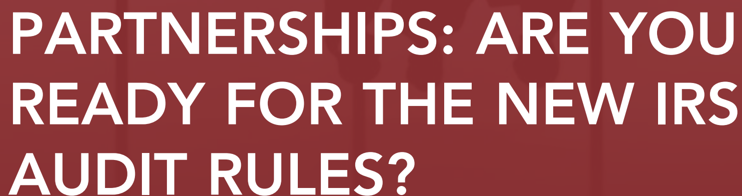

PARTNERSHIPS: ARE YOU READY FOR THE NEW IRS AUDIT RULES?

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Partnerships: Are you ready for the new IRS audit rules?

If your business is a partnership, including a limited liability company taxed as a partnership, it's critical to consider the potential impact of "centralized audit" rules that are now in force. There are steps you can take before an IRS audit to minimize the burden, including opting out of the new rules (if eligible), amending your partnership agreement and appointing an appropriate "partnership representative."

GETTING THE GIST

The new rules are complex, but it's important for partnerships to understand their gist so they can be prepared in the event of an audit. The biggest change allows the IRS to determine tax adjustments — and assess additional taxes, penalties and interest — at the *partnership* level. This is a significant departure from the tax agency's previous approach: generally assessing and collecting taxes at the individual partner level.

The new rules have consequences. First, they give the IRS authority to assess and collect taxes from a partnership on "imputed underpayments" in the tax year being audited (the "reviewed year") at the highest marginal tax rate. That can be done without considering partner-level circumstances or tax attributes that might reduce partners' tax liabilities.

Second, because a partnership takes imputed underpayments into account in the *adjustment year* — that is, the year in which the audit is completed — the new rules can lead to inequitable results for the partnership's current partners. These partners are potentially liable for tax underpayments that benefited reviewed-year partners who've since left the partnership.

How to opt out

If your partnership is eligible to opt out of the centralized audit rules (see main article), here's the procedure for making that election:

- Check the designated box on a timely filed (including extensions) Form 1065 Schedule B.
- Complete and attach to your return Form 1065 Schedule B-2, which includes, among other things, each partner's name, tax identification number and federal tax classification, along with an affirmative statement that all partners are eligible.
- Notify all partners of the election within 30 days after it's made.

If the IRS deems the election invalid, it'll notify you in writing and the centralized audit rules will apply to your partnership. Once a valid election is made, it can't be revoked without IRS consent.

To avoid these results, a partnership may obtain a modification of an imputed underpayment by showing that a lower tax rate is appropriate. Or it can ask the responsible partners to file amended returns and pay the additional tax. Alternatively, partnerships can file an election to "push out" adjustments to the reviewed-year partners.

CHOOSING A REPRESENTATIVE

The new rules discard the "tax matters partner" in favor of a powerful "partnership representative" who must be designated on the partnership's tax return each year. The representative has "sole authority to act on behalf of the partnership" in its dealings with the IRS.

Gone are the days when individual partners had the right to participate in an audit. Considering the partnership representative's vast authority, it's critical to choose yours carefully. Keep in mind that the representative needn't be a partner. Any individual with a substantial U.S. presence can serve, as well as an entity (even the partnership itself) that designates an individual to act on its behalf.

MINIMIZING THE IMPACT

There are several steps you can take before an audit to minimize the impact of the new rules:

Opt out, if eligible. Partnerships can opt out of the new audit rules if they file 100 or fewer Schedule K-1s (including K-1s filed by any S corporation partners) and *all* their partners are either individuals, S corporations, C corporations (including foreign entities that would be treated as C corporations if they were organized in the U.S.) and estates of deceased partners. (See "How to opt out" on page 2.)

Amend your partnership agreement. If you can't opt out, consider amending your partnership agreement to streamline the centralized audit process. Useful provisions include 1) requiring current and former partners to provide tax information or file amended returns if necessary, 2) requiring the partnership to make a pushout election, and

3) indemnifying current partners against tax liabilities attributable to former partners.

Establish procedures for selecting and removing partnership representatives. It's also a good idea to outline the representative's duties and responsibilities and to place appropriate limits on his or her (or its) authority. For example, you might prohibit the representative from taking certain actions without the approval of a majority of the partners.

About this last step, you may recall that, as far as the IRS is concerned, the partnership representative has sole authority to act on the partnership's behalf. But that doesn't mean you can't set forth contractual rules governing the relationship between the representative and the partnership.

WEIGHING THE COSTS

Partnerships should familiarize themselves with the new audit rules and assess the rules' potential tax impact on the partnership and its partners. Those eligible to opt out should consider doing so. Others should ponder strategies for managing the audit process, such as amending their partnership agreements and appointing the right partnership representative. •

Sailing the seas of business on a healthy cash flow

Pulling in revenue that will ultimately boost the bottom line is every business's goal. However, keeping your company in prime shape to seize profitable opportunities and overcome financial challenges is related to another objective: having a healthy cash flow.

Every organization, if it's around long enough, will experience strong economies and repressed ones. As captain of your proverbial ship, your job is to ensure your business sails the seas on a healthy cash flow in good times and bad.

SUCCESS COMES IN CYCLES

The cash flow success of virtually any company depends on two cycles. From an operational point of view, the first is the *sales* cycle — that is, how long it takes your business to 1) design, develop and produce or provide a product or service; 2) market that product or service; and 3) eventually close a sale and collect the accounts receivable.

The importance of collections cannot be overstated. From clear, accurate invoicing to using bank lockboxes for faster access to money, collections certainly is a major aspect of cash flow management.

Many companies either underestimate the difficulty of the sales cycle or lose sight of its tendency to gradually expand in length. The former problem often affects start-ups: Entrepreneurs may believe they can get their wares to market, close deals and collect on them more quickly than reality allows.

The latter quandary, losing sight of the elongation of the sales cycle, can affect even well-established companies. Regular customers may start taking longer to pay. Or a major buyer might jump ship and be harder to replace than expected.

ALONG COMES DISBURSEMENTS

The second cycle is *disbursements*. This is the process of managing the regular, outgoing payments to employees, vendors, creditors (including short- and long-term financing) and other parties. As payments go out, your cash flow is affected.

The sales and disbursements cycles aren't separate functions; they overlap. If they don't do so evenly, your delayed cash flow can create a crisis. That's why it's critical for business owners to understand the interaction between the money being spent to generate revenue and the revenue actually being generated.

That is, just as you work to match revenue to expenses, you also should ensure that your sales cycle (cash inflows, including outside financing) at least matches your disbursements cycle (cash outflows). Ideally, you're converting sales to cash more quickly than you're paying expenditures — thereby strengthening cash flow.

FULL-PICTURE ACCOUNTING

As your sales and disbursement cycles roll along, your company generates data. Failing to process

this information completely and accurately could lead to cash flow confusion — or worse.

That's why, if you're not leveraging the power of today's financial software, you're leaving yourself vulnerable to the whims of fortune. At minimum, your accounting system should allow you to enter common transactions such as logging cash receipts onto deposit slips, cash disbursements onto checks, and purchase and sales transactions onto orders and invoices. Consider, also, how you may be able to automate some of the processes, saving both time and money.

From there, review your use of ledgers. Every basic accounting system has a general ledger. But you may need a system with multiple subsidiary ledgers and special journals that simultaneously post when documents are saved.

Report generators are also critical for managing cash flow accurately. Your system should allow you to readily generate accounting reports — daily, weekly, monthly and annually. This means being able to easily record and access recurring transactions as well as accounts payable aging and payment scheduling.

Today's accounting systems also can provide you with a "dashboard" of real-time information, so you're less likely to be caught off guard by cash flow disruptors. In addition, budgeting tools can help you set and monitor budgets, perform "What if?" analyses, and compare actual results to goals.

A MANAGEABLE VOYAGE

Effective cash flow management is feasible with determination and adept planning. If you keep your eyes on the horizon and monitor the right metrics carefully, you should experience, if not smooth sailing, at least a manageable voyage toward profitability. •

Keep these trustee traits front and center

A critical but often overlooked aspect of estate planning is deciding who will serve as the trustee for your estate. This person will be responsible for managing all related financial, tax and administrative affairs, so you should devote careful thought and planning to the decision.

Your trustee will handle a wide range of estate-related duties, some of which can be complex and time-consuming. These typically include making sure assets are distributed as directed in your last will and testament, managing assets held in trust on behalf of beneficiaries, and paying any outstanding taxes and bills.

INDIVIDUAL VS. CORPORATE

Your first decision in choosing a trustee is whether you'll designate an individual or a corporate trustee. Many people reflexively choose an individual — such as a close friend, spouse or other family member — because they think someone who's close to them will be best equipped for the responsibility. However, this isn't always the case, especially with large, complicated estates.

Also, the trustee is responsible for ensuring that all estate planning documents, including your last will and testament, are executed objectively and without bias. The personal feelings of close friends and family members can sometimes make it hard for them to accomplish this.

If there isn't a close friend or family member who you believe is capable of handling trustee duties faithfully and objectively, you could designate a corporate trustee instead. You'll benefit from professional investment management and estate settlement experience while also minimizing the potential impact that family dynamics and emotions could play in the fulfillment of your wishes.

The personal feelings of close friends and family members can sometimes make it hard for them to accomplish tasks objectively.

Your corporate trustee will be subject to strict fiduciary regulations that ensure decisions are made in the best interests of your estate, not any particular individual or beneficiary. By designating a corporate trustee, you can be assured that your estate plan will be executed objectively and unemotionally.

SERVICES AND FEES

Many bank trust departments and trust companies provide corporate trustee services. In addition to handling estate settlement, they may offer other professional services such as investment, financial and tax advice. In addition, they can usually tap into a network of other professionals that can be helpful in the estate settlement process, such as CPAs, attorneys and insurance agents.

Of course, corporate trustees charge a fee for their services that typically ranges between 1% and 2.5% of the value of the estate's assets annually, depending on the size of the estate. So, cost should be a main factor in deciding whether to designate an individual or a corporate trustee.

If yours is a small and relatively simple estate, and you have a close friend or family member who's both equipped and willing to serve as trustee, this could be your best option. However, if your estate is large and complex, or you don't have any good options for designating an individual trustee, you could be better off designating a corporate trustee.

There is a third "hybrid" option: You could designate both a corporate trustee and an individual who'd share estate settlement responsibilities and serve as co-trustees together. While there's potential for this to lead to conflict, if you carefully allocate responsibilities it could be a way to ensure that you have the best of both worlds. For example, the corporate trustee could handle the more complicated administrative and investment duties while the individual trustee takes care of simpler routine tasks such as paying outstanding bills and taxes.

PROS AND CONS

Carefully weigh the pros and cons of designating an individual vs. a corporate trustee for your estate. Doing so will help ensure that your wishes are fulfilled while easing the burden on your loved ones during a difficult time. •

Congress enhances taxpayer rights with the Taxpayer First Act

The Taxpayer First Act (TFA), signed into law in July 2019, expands and strengthens taxpayers' rights and protections in their dealings with the IRS. Here are some of the highlights:

Independent appeals process. The TFA establishes the IRS Independent Office of Appeals to review disputes between taxpayers and the IRS. It also implements safeguards to help ensure that the office is independent and not merely a "rubber stamp" for IRS decisions. Among other things, the act provides that IRS appeals personnel shouldn't consult with attorneys previously involved in a case.

In addition, the TFA gives taxpayers access to nonprivileged case files and requires the appeals office to notify taxpayers in writing if their appeals are denied (including the reasons for the denial). The process includes a way to protest such denials.

Third-party contacts. The TFA limits the IRS's ability to contact third parties — such as lenders, customers or vendors — for information about a taxpayer. Under the act, the IRS must notify the taxpayer at least 45 days in advance (and not more than a year in advance) that it intends to contact such third parties.

Innocent spouse relief. The tax code provides "innocent spouses" with relief from joint liability for their spouses' improprieties on a joint return under certain circumstances. The TFA provides that, when the IRS denies such relief and the taxpayer seeks review by the Tax Court, the court should review the determination *de novo* — that is, anew, without deference to the IRS's decision.

Cybersecurity and identity theft protection. To help the IRS strengthen cybersecurity and prevent identity theft and refund fraud, the TFA facilitates information-sharing with state tax agencies and the private sector. The act also requires the IRS to establish a single point of contact for victims of tax-related identity theft, and it increases penalties for disclosure of taxpayer information by return preparers. (Several other reforms are included as well.)

Technological improvements. The TFA instructs the IRS to develop Internet-based platforms for Form 1099 filings and for disclosing taxpayer information for third-party income verification. It also charges the IRS with expanding electronic filing of tax returns; publishing guidance on the use of electronic signatures; appointing a chief information officer; and developing, implementing and updating a multiyear strategic plan to address the tax agency's IT needs.

Other changes include plans to improve customer service, enhanced whistleblower protections and procedures, reduced user fees for low-income taxpayers, and a more prominent role for the IRS National Taxpayer Advocate. •

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TAX PLANNING AND PREPARATION

Taxes are a part of life, and at Martin Hood we can help you find ways to minimize the impact that taxes have on you and your family. We work with our clients year-round to develop and implement effective tax planning strategies to reduce year-end tax bills. Our state and international tax team performs extensive research in areas that reach beyond our local community. In addition to income tax preparation, we can prepare gift and estate tax returns, sales and payroll tax returns, and informational tax returns for not-for-profit organizations. We also assist clients with IRS audits and notices from tax authorities.

BUSINESS ADVISORY SERVICES

We provide accounting assistance and a comprehensive approach to helping with whatever keeps you up at night. We can help set up an accounting system to help you cover your accounting needs on your own in a more efficient manner, fill a temporary need for accounting staff, or fill a more permanent role in basic accounting or acting as an outsourced controller — all while keeping the bigger picture in mind and pulling in our tax, assurance, and planning expertise to serve as a well-rounded business advisor in nearly all tax, accounting, and financial matters.

ESTATE AND RETIREMENT PLANNING

The Estate and Retirement Planning team at Martin Hood helps our clients recognize the importance of proper planning for business succession, education, retirement, and wealth accumulation. This process is presented in an open and candid manner, placing family and retirement needs at the forefront of every plan. Our team strives to help you build a plan that minimizes the estate tax burden and helps you achieve your financial goals.

Tax Specialty Areas

- State and Local Taxation
- International Tax Issues
- Trusts and Estates
- Partnerships
- C corporations
- S corporations
- Individual tax compliance
- Tax planning
- Construction and Manufacturing
- Non-profits