REVENUE RECOGNITION

In May of 2014, the Financial Accounting Standards Board ("FASB") issued its final standard on Revenue from Contracts with Customers known as Accounting Standards Codification ("ASC") 606. Since the new standard was first introduced, the FASB has issued several Accounting Standard Updates to either amend or clarify the new guidance. The revenue standard has far-reaching implications for all industries as it eliminates industry-specific revenue recognition guidance under its predecessor standard, ASC 605.

The underlying principle of the new standard is that an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In order to recognize revenue ASC 606 introduces a 5 step model;

1. Identify the contract(s) with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations in the contract
5. Recognize revenue when (or as) the entity satisfies a performance obligation

For private companies, the new standard is effective January 1, 2019, and the impact of adoption, as well as the new disclosures required, will need to be reflected in an entity's financial statements for reporting periods **after** January 1, 2019.

In order to understand and quantify the implications of adopting the new standard an entity should consider the following questions;

1. How do we get paid? Is it at A Point in Time, for example, once a project is fully complete and transferred to the end customer, or do we get paid Over a Period of Time?
2. Who controls the asset that is ultimately being delivered as it is being constructed?
3. Is there a gap between when a bill for services, an asset, or a product is delivered to the customer and when the customer is required to pay for what was rendered?
4. What is your process for recognizing revenue on change orders, discounts, rebates, etc…?
5. Do you have a process for tracking and quantifying wasted materials or wasted labor?
6. Do you offer complimentary services for projects, such as design or engineering services which have traditionally been billed separately?

The answer to each of these questions will impact how revenue is recognized under the new standard. The above questions should be among the questions considered by companies as they begin to take an inventory of the various types of contracts they enter into as a part of their regular operations. Even if it is determined that the adoption of the new standard will not materially impact an entity's financial statements, the entity is not absolved from the enhanced disclosures required by the new standard.
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ARE YOU IN COMPLIANCE WITH THE NEW PARTNERSHIP AUDIT RULES?

Many real estate–related businesses are formed as partnerships, making them subject to the regulations for partnership audits under the Bipartisan Budget Act of 2015 (BBA). The proposed regulations — which significantly change the previous rules regarding partnership audits and liability for any resulting adjustments — take effect for taxable years beginning after December 31, 2017.

Liability for adjustments

The proposed regulations provide a default audit regime, under which the IRS will assess tax on an adjustment that increases a partnership's income against the partnership itself, instead of against the individual partners from that tax year. That means the economic burden will be borne by the partners in place when the audit adjustment is completed, *not* those in place during the tax year that income was underreported.

Alternatively, a partnership can elect to "push out" the adjusted items to the partners from the relevant tax year. The partners would then take their shares of the adjustments into account on their individual tax returns. (Separate proposed regulations provide rules addressing how partners that are pass-through entities, such as partnerships or limited liability companies, take into account pushed-out adjustments.)

Partnerships must make the push-out election no later than 45 days after the date of the IRS notice of final partnership adjustment. The partnership must provide a statement to the IRS and every partner from the relevant tax year, reporting each partner's share of the adjustment.

Certain partnerships with 100 or fewer partners generally can elect to opt out of the BBA rules entirely, so long as each partner is an individual, C corporation, foreign entity treated as a C corporation, S corporation or the estate of a deceased partner. If a partner is a partnership or limited liability company, though, the overall partnership can't elect out of the rules.

Partnerships must elect out of the rules annually, and must disclose certain demographic information about each partner during the taxable year. If the IRS approves the election, it will audit the partnership under the rules that apply to individual taxpayers.

The new partnership representative

The BBA replaces the previous "tax matters partner" with a "partnership representative" who has the sole authority to act on the partnership's behalf in IRS proceedings. Partnership representatives have broad authority to bind their partnerships and partners, including the ability to extend the statute of limitations, proceed to court, enter settlements and make push-out elections.

The partnership representative must have a "substantial presence" in the United States, but need not be a partner. Moreover, the BBA doesn't require the representative to communicate with the partners during an audit.

In addition, the partnership must designate a partnership representative every year on its tax return, and the appointment is valid only for that year. If the partnership fails to designate a representative for a taxable year, the IRS has the power to do so.

Far-reaching implications

The effects of the new rules could reach beyond partnerships' federal income tax liabilities, as the rules also have implications for state and local taxes, financial reporting and the formation of new partnerships. Your CPA can help ensure your real estate business is in the best position to protect itself under the regulations.PDF Version of Article
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YOUR FINANCIAL STATEMENT; SEEK AND YOU SHALL FIND THE TRUTH

Do you truly understand your company's financial statement? If you have a good handle on its three components — the balance sheet, income statement and statement of cash flows — you should be equipped to make wise business decisions.

Behold the balance sheet

On this report, you tally your company's assets, liabilities and net worth to create a snapshot of its financial health.

Net worth or owners' equity is the extent to which assets exceed liabilities. Because the balance sheet must balance, assets must equal liabilities plus net worth. If the value of your liabilities exceeds the value of the assets, your net worth will be negative. There are a number of balance sheet ratios worth monitoring, including:

Growth in accounts receivable compared to the growth in sales. If receivables are growing faster than the rate at which sales are increasing, customers may be taking longer to pay. They may be running into financial trouble, or finding quality issues with the products or services.

Growth in inventory vs. the growth in sales. When inventory levels increase at a faster rate than sales, the company is producing products faster than they're being sold. This can tie up your cash. Moreover, the longer inventory remains unsold, the greater the likelihood it will become obsolete.

Growing companies often must invest in inventory and accounts receivable, so increases in these accounts don't always signal problems. Typically, jumps in inventory or receivables should correlate to rising sales.

The ratio of current assets to current liabilities. If this ratio falls below 1, the company may struggle to pay bills coming due. Some business experts believe a current ratio of less than 2:1 is problematic.

Enter the income statement

The income statement shows sales, expenses, and the income or profits earned after expenses over a given period. A commonly used term when discussing income statements is "gross profit," or the income earned after subtracting the cost of goods sold from revenue. Cost of goods sold includes the cost of labor and materials required to make a product. Another important term is "net income," which is the income remaining after all expenses (including taxes) have been paid.

Like the balance sheet, the income statement can reveal potential problems. It may show a decline in gross profits, which means production expenses are rising more quickly than sales.

Next: The statement of cash flows

This statement shows all the cash flowing into and out of your company. For example, your company may have cash inflows from selling products or services, borrowing money and selling stock. Outflows may result from paying expenses, investing in capital equipment and repaying debt.

Although this report may seem similar to an income statement, its focus is solely on cash. For instance, a product sale might appear on the income statement, even though the customer won't pay for it for another month. But the money from the sale won't appear as a cash inflow until it's collected. To remain in business, companies must continually generate cash needed to pay creditors, vendors and employees. So you should watch your statement of cash flows closely.

Revealing information

Each of the reports described above can reveal much about your business's financial position and performance. Moreover, by carefully analyzing your financial statement, you may be able to uncover potential money-management problems.PDF Version of Article
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HEAVY EQUIPMENT TRAINING IMPROVES WITH SIMULATORS

At a recent trade show, the head of a general contracting company was intrigued by a demonstration of simulators for training crane operators. He'd seen a similar demo back in the mid-1990s and remembers considering the technology crude at best. But the latest equipment and software seemed far more promising.

The graphics were extremely realistic. Even more impressive, the simulators accurately captured the behavior of the rigging and hoisting cables. Virtual loads moved just as they would in the real world. Suddenly, the contractor found himself seriously considering whether he should invest in a simulator.

Potential benefits

The manufacturer's rep explained that professional-grade simulation technology, used for decades in training pilots, has now been adapted for cranes and other heavy construction equipment. The contractor listened carefully to the potential benefits:

***Better managed risk*.** Trainees can gain experience with a range of situations and conditions they might encounter on the job. They can make beginners' mistakes without catastrophic consequences. Simulators let you measure progress objectively, so you can ensure operators are ready before sending them into the field.

***Faster training*.** With simulators, a single instructor can work with several trainees at once. And the units can run 24/7, regardless of weather conditions, so trainees get concentrated instruction without interruptions or delays.

***Reduced costs*.** Simulators reduce costs of damage to actual heavy equipment, the expense of transporting authentic assets between training and jobsites, and costs of citations and legal payments from disgruntled building owners whose sites may have been damaged.

Instructors' time can be spent on developing higher-level training tasks, too, while trainees work their way through more basic simulation exercises individually. Ultimately, better-trained operators mean more productivity, greater efficiency and fewer accidents.

Cost considerations

The contractor was nearly convinced. But he wanted to make sure that a simulator would be a wise investment, not just a shiny new toy. Daunted by the range of prices, from about $30,000 to more than $1 million, he sought guidance from his CPA.

His accountant said that, together, they could estimate what value a simulator might add to his company. When shopping for one, they'd need to identify not only the right model, but also a vendor who would work within his budget and provide value-added services such as support and training. They might also explore the possibility of renting or leasing.

Mission accomplished

After much research, this particular contractor decided to invest in a crane simulator. Although there was a learning curve, his company took to the technology quite readily. Over time, his operators demonstrated the greater efficiency and fewer mistakes he was looking for. And there was an added benefit: Word got around that his company provided cutting-edge training, which attracted some strong job candidates.PDF Version of Article
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BIG TAX SAVINGS AHEAD FOR BUSINESS

The new federal tax legislation signed into law in late December 2017 triggers a massive overhaul of the U.S. tax regime. The Tax Cuts and Jobs Act (TCJA) has been widely heralded as business-friendly, and that description is no joke. If you own a business, you're likely to enjoy substantial tax cuts, even if you don't benefit from the new 21% corporate tax. Here are some of the most significant changes.

Reduced taxes for pass-throughs

Owners of businesses operating as partnerships, limited liability companies, S corporations and sole proprietorships report net income on their individual tax returns. Until now, they've paid taxes on that income at ordinary income tax rates as high as 39.6%. Beginning in 2018, the TCJA cuts the highest individual tax rate to 37%. And it raises the threshold for that rate to $500,000 in taxable income for single filers and $600,000 for joint filers.

More important, the law establishes a generous new deduction that will slash taxable income from pass-through entities. Beginning in 2018, the qualified business income (QBI) deduction generally allows taxpayers to deduct 20% of QBI (not salary) from a pass-through entity. Combined with the lower top tax rate on ordinary income, the deduction translates to a 29.6% top rate on pass-through income.

Once taxable income exceeds $157,500 for single filers or $315,000 for joint filers, a "wage limit" begins phasing in. The wage limit phases in completely at $207,500 for single filers and $415,000 for joint filers. At that point, taxpayers generally will deduct the lesser of:

- 20% of QBI, or
- The greater of 1) 50% of the W-2 wages paid by the business or 2) 25% of the wages paid plus 2½% of the unadjusted basis (meaning the purchase price) of tangible depreciable property (for example, real estate).

Notably, the QBI deduction is reduced and eventually eliminated for "specified service businesses" (such as law or accounting firms, consultants, or any business whose principal asset is the reputation or skill of one or more employees) above a threshold amount of taxable income. Specifically, the deduction begins to be reduced when an owner's taxable income exceeds $157,500 for single filers and $315,000 for joint filers. And it's eliminated when taxable income exceeds $207,500 and $415,000, respectively.

Be aware that the reduced tax rates and QBI deduction will expire after 2025 without congressional action.

Accelerated depreciation deductions

The TCJA extends and modifies bonus depreciation for qualifying property (for example, office furniture, software and qualified improvement property). For qualified property placed in service between September 28, 2017, and December 31, 2022 (or by December 31, 2023, for certain property with longer production periods), businesses generally can expense 100% of the cost of such property (both new and used) in the year the property is placed in service. Beginning in 2023, the amount of the allowable deduction will drop, shrinking 20 percentage points each year for four years and disappearing in 2027, absent congressional action.

The TCJA also expands the immediate expensing of equipment under Section 179 — permanently. For 2018, it increases the maximum deduction for qualifying property to $1 million (from $510,000) and raises the phaseout threshold to $2½ million (from $ million). The definition of qualified real property now includes several improvements to nonresidential real property (for example, roofs; heating, ventilation and air conditioning; and

alarm and security systems).

Limited interest expense deduction

The TCJA isn't all good news, though. Many businesses will be disappointed to learn that it might increase their cost of borrowing by limiting the amount of interest expense they can deduct beginning in 2018.

The law generally restricts the deduction to 30% of adjusted taxable income, although it allows an indefinite carryforward for unused interest expense (with special rules for partnerships). Companies whose average annual gross receipts don't exceed $25 million are exempt. Real estate businesses can elect out of the limit, but with some negative consequences in regard to their depreciation deductions. There are also exceptions for certain other types of businesses.

And much, much more

The provisions discussed above only skim the surface. The TCJA also makes changes related to, among other things, foreign income, net operating losses, like-kind exchanges, the domestic production activities deduction, research and experimentation expensing, excessive compensation and the deductibility of entertainment expenses and employee fringe benefits. Your CPA can help you wade through it all to minimize your tax liability.PDF Version of Article
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TIME TO GET "REAL"

Qualifying for the real estate professional exception to the PAL rules

Most property owners know that the passive activity loss (PAL) rules can prevent a taxpayer from claiming passive losses from real estate if the taxpayer's only other income is nonpassive (such as salary from a job). Exceptions exist, though, including the real estate professional exception. A recent case, *Hickam v. Commissioner*, addresses whether a mortgage broker/lender could take advantage of the exception. It provides a useful refresher on what it takes to qualify as a real estate pro.

Who qualifies?

Rental real estate activities are generally considered *passive*, so rental losses can usually offset only *passive* income. The Internal Revenue Code, however, grants an exception for certain taxpayers who materially participate in the activity and are real estate professionals. To qualify as a real estate professional, you must perform:

1. More than 50% of your "personal services" in real property trades or businesses, and
2. More than 750 hours of services in real property trades or businesses.

If you meet these requirements, you can deduct your rental losses even if you don't have passive income.

Why were the taxpayer's deductions rejected?

In *Hickam*, the taxpayer was an independent contractor who brokered real estate mortgages and other loans in 2011. In 2012, he also worked for an employer, originating loans secured by real estate. As a side job, the taxpayer managed and maintained three rental real estate properties.

The taxpayer claimed combined rental losses of $47,730 for 2011 and $48,945 for 2012. After an audit, the IRS

rejected these deductions.

The Tax Court ruled in favor of the IRS. It found that the taxpayer had failed to prove the amount of time he'd spent on mortgage brokerage and loan origination services, as required for the first test. He also couldn't show that he'd performed more than 750 hours in real property trades or businesses in which he'd materially participated for 2011 or 2012.

Notably, the court held that the taxpayer's mortgage and loan services didn't constitute a "real estate trade or business," because they related to residential and commercial loans — not to the operation and brokerage of real property. So, the court faulted the taxpayer because it wanted substantiation for the amount of time he'd spent on non-real estate trades or businesses in order to determine if the percentage of time he'd spent on rental real estate personal services was greater than 50% of his *total* personal services. In other words, the court was concerned about the first test to qualify, not the second one.

The taxpayer here didn't begin to reconstruct his hours of service on the mortgage/lending activities and rental property activities until after the audit. His re-created documentation for 2011 and 2012 allegedly was based on leases, bank statements, checkbooks, bills and receipts. But he didn't present any of this corroborating evidence at trial. Not surprisingly, the court found the "vague, nondescriptive entries and ballpark estimates of time" unreliable and disallowed the rental real estate loss deductions.

Be prepared

If your rental losses are challenged, you'll need to be able to establish your hours of participation. Contemporaneous records aren't required, but you should at least have appointment books, calendars or narrative summaries that identify the services performed and the approximate amount of hours for each.PDF Version of Article
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5 MAJOR CONSTRUCTION RISK FACTORS IDENTIFIED IN RECENT STUDY

It's impossible to run any business without incurring risks, but the construction industry is riskier than most. Smart contractors do all they can to understand and mitigate the business threats they face so their businesses remain viable in times good, bad and uncertain.

One helpful resource is the *Construction Risk Index 2017*, released just last year by insurance analysts and consultancy Willis Towers Watson. The firm surveyed 350 high-level industry executives from around the world to identify megatrends affecting the global construction market and the risks posed by each.

Their report ranks these trends and forecasts their likely impacts over the next 10 years. Here are five of the pertinent risk factors to watch out for:

1. ***Geopolitical instability and regulatory change.*** This trend ranked in the top three among respondents from every region except North America in terms of both its potential industry impact and the difficulty of managing the risk. This concern highlights the important role public funding plays in maintaining a healthy construction economy, and it recognizes how negative changes in governmental policies, priorities and regulations could have severe consequences. The difficulty of predicting such changes increases the threat they can pose.
2. ***Workforce management and talent optimization.*** Although hardly a new problem, the continuing and growing need to attract and retain talented young people is another megatrend that poses risks for the

worldwide construction industry. In too many markets, the industry is perceived as one with limited employee growth potential and limited opportunities for women. This puts it at a disadvantage in recruiting needed skilled workers. Industrywide efforts are needed to promote construction as a rewarding career path.

3. ***Business model and strategy challenges*.** The third trend identified in the study covers risks associated with evolving business models in the global construction market. Examples include threats from new and emerging competitors, changes in the supply chain, increased merger and acquisition activity and an increasing need for businesses to diversify. These risks were ranked highest by the North American executives surveyed.
4. ***Risks from digitization and new technologies*.** Digital technologies such as 3D printing, drones and building information modeling (BIM) are already transforming many construction industry practices. Further advances will likely lead to even more changes over the next 10 years. Among the risks associated with these changes are potential failures of critical IT systems, liabilities arising from more widespread use of BIM, overreliance on technology leading to increased human error, and security threats from cyberattack and data security breaches.
5. ***Complex operating models in a global business landscape*.** Infrastructure projects in developing countries represent a likely source of growth for construction companies. But expanding operations across new emerging markets comes with some inherent complications. Managing workers from various cultures in countries with different regulatory systems will present challenges along with opportunities.

Studies such as the *Construction Risk Index 2017* can help both contractors and risk management specialists prepare for new and evolving industry conditions. These findings should stimulate the development of new strategies and instruments to mitigate business threats that construction companies will face over the next 10 to 20 years. By keeping abreast of these developments, you'll put yourself in a better position to protect your bottom line.PDF Version of Article
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SUBCONTRACTORS, WHAT SHOULD YOU DO WHEN A BID GOES BAD?

From childhood on, we're all told that "everyone makes mistakes." Unfortunately, sometimes this particular aspect of the human condition can afflict subcontractors as they submit bids.

Make the right mistake

Most bidding errors are simple slips of the pencil or mouse — such as miscalculating a dollar amount or transposing figures on a spreadsheet. In a lawsuit, courts may consider these errors mechanical or clerical in nature as long as the error in question was an honest mistake and other parties were not significantly injured. A favorable outcome is "judicial relief" to the subcontractor in question, which will prevent you from being unduly punished and would usually restore you to the same financial position you held before the bid.

But it's less likely for courts to excuse you if they define your bidding error as gross negligence. Bidding errors that courts may deem gross negligence include such mishaps as failing to seal the bid and forgetting to acquire the proper signatures. Omitting a bid bond and improperly notarizing a signature are also serious mistakes.

Act quickly

If you discover a bidding error, immediately notify the customer — even if the mistake is only a possibility. If you use the telephone to do so, follow up with a certified letter detailing the nature of the error and include a request

to withdraw the bid if the error is found out to be substantial. Then offer to meet with the customer to explain how the error occurred. At this time, you can request the return of any bid deposit you may have made. Do nothing that the owner or general contractor might construe as contract acceptance.

Also, consider disqualifying yourself from further bidding on that project to avoid another party's claim that the error was an attempt to get a second look at the bid. This may prevent a court from judging the erroneous bid valid, and may save you from having to forfeit your bid bond. If the error occurs before the bid's acceptance, or if the bid is accepted before the contract's performance, there is more of a likelihood that you can obtain judicial relief. The key is keeping all involved parties on a level playing field without significantly injuring anyone.

Explain yourself

If full or partial performance occurs, you may have a much harder time obtaining judicial relief. Why? Because, at that point, an irrevocable change of position has taken place among the parties involved. Legally, when two innocent parties are at fault, many courts penalize the more negligent party. In other words, the errant bidder may bear the guilt if he or she starts work on a project before rectifying the matter.

As mentioned, giving prompt notice before accepting the bid is a better tactic. Merely advising other parties of an error won't suffice. You must explain the error's nature with substantial, competently expressed evidence. This proof often consists of worksheets, take-off notes, estimator's notes and employee testimony. Failing to provide such evidence may make judicial relief unobtainable.

Careful on the phone

A special note about phone bids: Some subcontractors still use this approach, with the customer confirming the bid with a return call. Letting your fingers do the walking in such a manner is risky, because courts are more likely to hold a subcontractor to a phone bid if the customer can show "reliance" — that is, the customer's good-faith belief in the subcontractor's promise.

When making a phone bid, try to specify that the bid is only an estimate and not a firm price. Then verify the bid with a written memo stating the date, time, place, party contacted, nature of the conversation and any variances with bid documents. Finally, confirm the memo with a certified letter to the general contractor.

Be prepared

Bidding should not have to be tumultuous, though it is obviously a competitive process. Be prepared for mishaps with a plan to recover and you'll stand a better chance of minimizing the financial impact of any error.PDF
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UNDERSTANDING THE INS AND OUTS OF DEFEASANCE

Prices for commercial real estate are trending up in many parts of the country, and interest rates may soon follow, although at a slower pace. In such an environment, some property owners are starting to think about exiting their loans early through defeasance. That's a big decision, though, that requires a solid understanding of what's involved.

In a nutshell

Defeasance allows you to avoid traditional prepayment loan penalties, such as those associated with yield

maintenance, by substituting collateral. Typically, you'll replace the real property that's been securing the loan with a portfolio of U.S. Treasury securities, which have maturities that align with the debt service schedule. Generally, a special purpose entity — the successor borrower — assumes the borrower's role and makes the remaining payments from the cash flow the securities generate.

Once the successor borrower is in place, you can refinance or sell the real property. The lender benefits from receiving the same payments from a more reliable piece of collateral. For lenders that issue mortgage-backed securities, defeasance also increases the value of the mortgage-backed securities by improving the odds that investors will receive all of their principal and interest payments.

Timing issues

Defeasance may be appealing in a low interest rate climate, because it lets borrowers lock in low-rate loans by refinancing. Any cost-benefit analysis should always include the income tax impact of the defeasance transaction. This can be significant and will depend on the structure (legal or in-substance), the economics (defeasance premium or discount), and whether it's done in conjunction with a refinancing, a sale or a like-kind exchange of the property.

Defeasance is generally worth considering if:

- You have enough equity in a property to cover the substitute collateral's cost, and
- The related fees (such as fees for attorneys, accountants, the successor borrower and a defeasance consultant) don't exceed the applicable prepayment penalty you'd otherwise have to pay to exit.

Obviously, you'll be better off if you can refinance before interest rates begin to climb, as they're expected to do in the next few years.

Some borrowers forgo defeasance, opting to wait for a loan's 30- to 180-day open prepayment window. But those who wait may find that interest rates have increased, driving up their borrowing costs.

For many borrowers, the optimal time to pursue defeasance is 12 to 18 months before loan maturity, which gives them time to monitor rates, capital market conditions and costs so they don't end up with a higher interest rate. It's important to choose securities that maximize cash flows and not just satisfy the payment requirements.

Negotiate upfront

Defeasance isn't always practical based on existing loan documents. To give yourself more options, negotiate future loans to include defeasance-friendly provisions, such as the rights to select the successor borrower and choose non-Treasury securities for the substitute portfolio.PDF Version of Article
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THEY'RE BACK: AUDIT RULES TARGETING PARTNERSHIPS CAN NOW BE APPLIED

The IRS has reissued proposed partnership audit regulations, withdrawn earlier this year as part of the Trump administration's regulatory freeze. The proposed Centralized Partnership Audit Regime regulations (Reg-136118-15) — reportedly identical to the withdrawn regulations — apply to partnership tax years starting after December 31, 2017. But partnerships can elect to apply them for partnership tax years starting after November 2, 2015.

Who'll be affected?

The new audit rules, prompted by the Bipartisan Budget Act of 2015, will affect all partnerships, regardless of size. Certain partnerships with 100 or fewer partners will be able to opt out of the new rules. However, 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 major 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.

How will the new rules work?

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

How will the rules affect tax liability?

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 a partner to avoid inequitable results, but meeting them will be a challenge.

Who's your "partnership representative"?

For partners only: 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.

What about opting out?

Partnerships with 100 or fewer partners may opt out of the new audit rules. But 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 instance) doesn't qualify, regardless of its size.

Big changes

The new audit rules alter many significant aspects of partnership audits. Consult with your tax advisor to learn, in detail, how your partnership will be affected.PDF Version of Article
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