The New Federal (and State?) Partnership Audit Rules

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Subchapter K

- One level of tax
  - Imposed on the owners
  - For their share of current income items
- So
  - 1065 – Partnership determines tax treatment
  - Schedule K – Partnership determines tax items
  - Schedule K-1 Partnership allocates items (distributive share) to partners
  - 1040/1120 – Partners report items

Subchapter K

- Non-recognition –
  - Contributions to partnership
  - Distributions to partners
- So – partner’s basis in partnership has to be tracked.

Subchapter K

- Allocations not in accordance with interest in partnership (special allocations)
  - Affects all partners (some get more, some get less than their interest)
  - May be respected if they have substantial economic effect and don't violate specific rules
- Requires tracking of partner's capital accounts

Subchapter K

- Two basic types of audit issues:
  1. Issues that affect the 1065/Schedule K – how items of income, gain, loss, expense and credit are recognized and valued
  2. Issues that affect the Schedule K-1s – how tax items are allocated among the partners
- To know if type 2 issues will make any difference – have to know the tax profiles of all the affected partners

Example

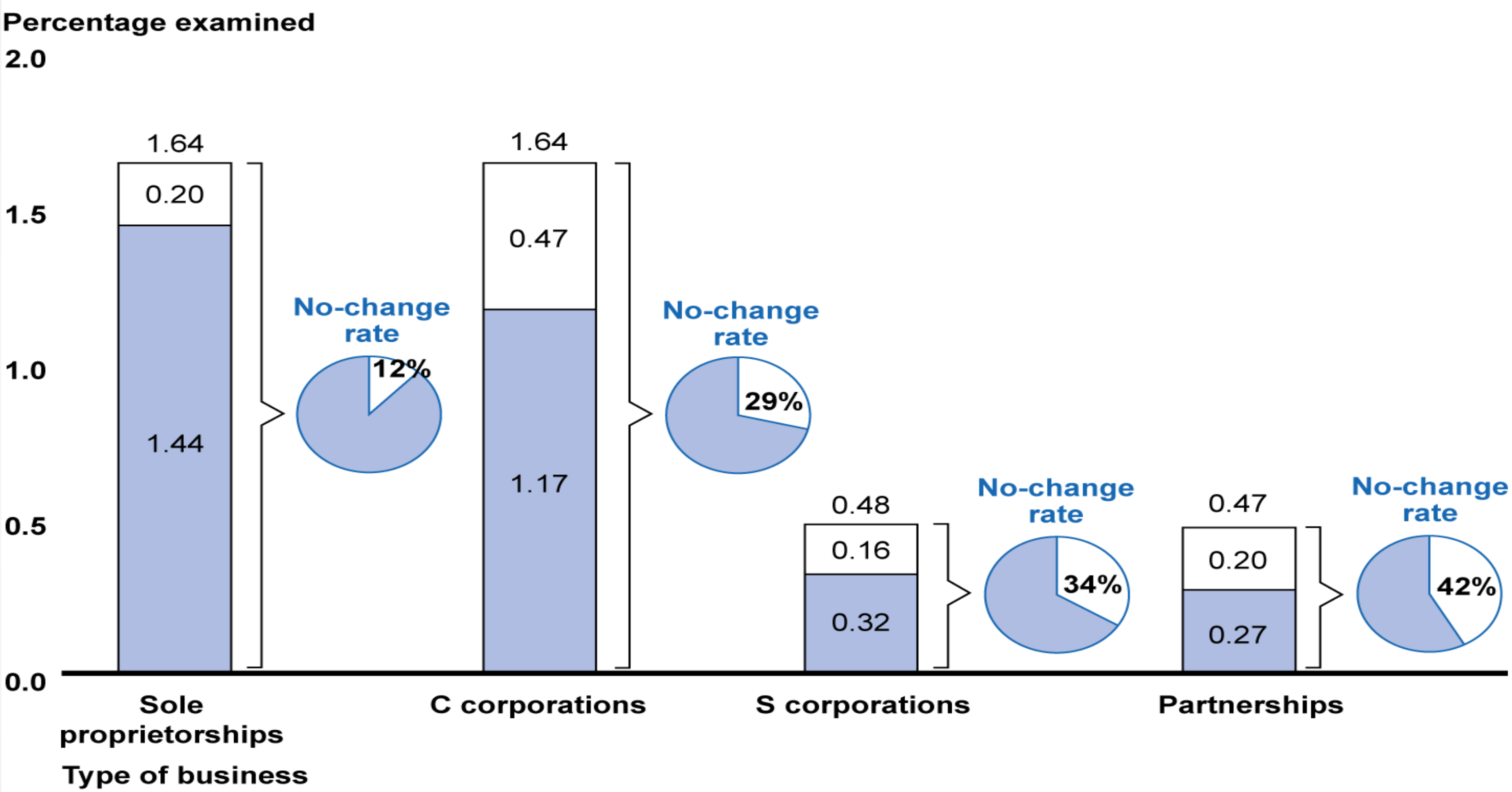
- Partners X and Y have equal interests in partnership P but have agreed to share certain items of gain on an 80/20 basis. If X and Y have the same profile (identical income/loss/expense/ etc. from nonpartnership sources, identical tax rates, etc.), then reallocating the gain on a 50/50 basis may not affect current tax (but might affect future).

Federal Partnership Audit Reform

- Bipartisan Budget Act of 2015
  - o Includes federal partnership audit reform
  - o Generally applies to tax years beginning after 12/31/17
    - But certain elections can make it applicable RIGHT NOW
  - o Meant to simplify auditing partnerships and assessing liabilities – expected to raise $9.3 billion (over 10 years)

IRS audit/adjustment rates by entity type

Figure 5: Fiscal Year 2012 Examination and Adjustment Rates for Different Types of Tax Returns



Not adjusted

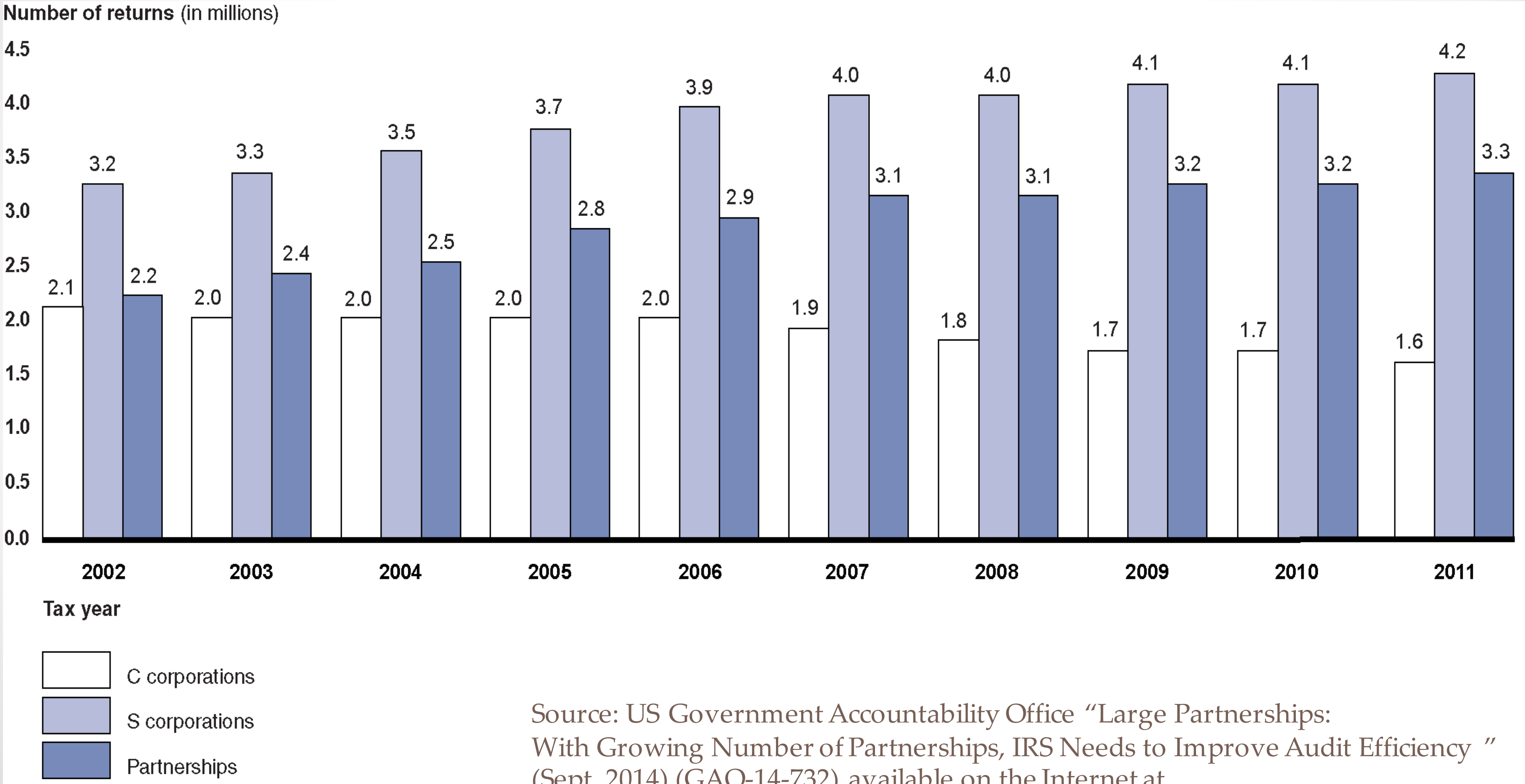
Adjusted

Source: IRS.

Source: US Government Accountability Office " Partnerships and S corporations: IRS Needs to Improve Information to Address Tax Noncompliance" (May 2014) (available on the Internet at http://www.gao.gov/assets/670/663185.pdf (last accessed Mar. 22, 2016))

IRS returns by entity type

Figure 4: Number of Returns by Form of Business, Tax Years 2002 to 2011



Source: GAO analysis of IRS data. I GAO-14-732

Source: US Government Accountability Office "Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency " (Sept. 2014) (GAO-14-732) available on the Internet at http://www.gao.gov/assets/670/665886.pdf (last accessed Mar. 22, 2016))

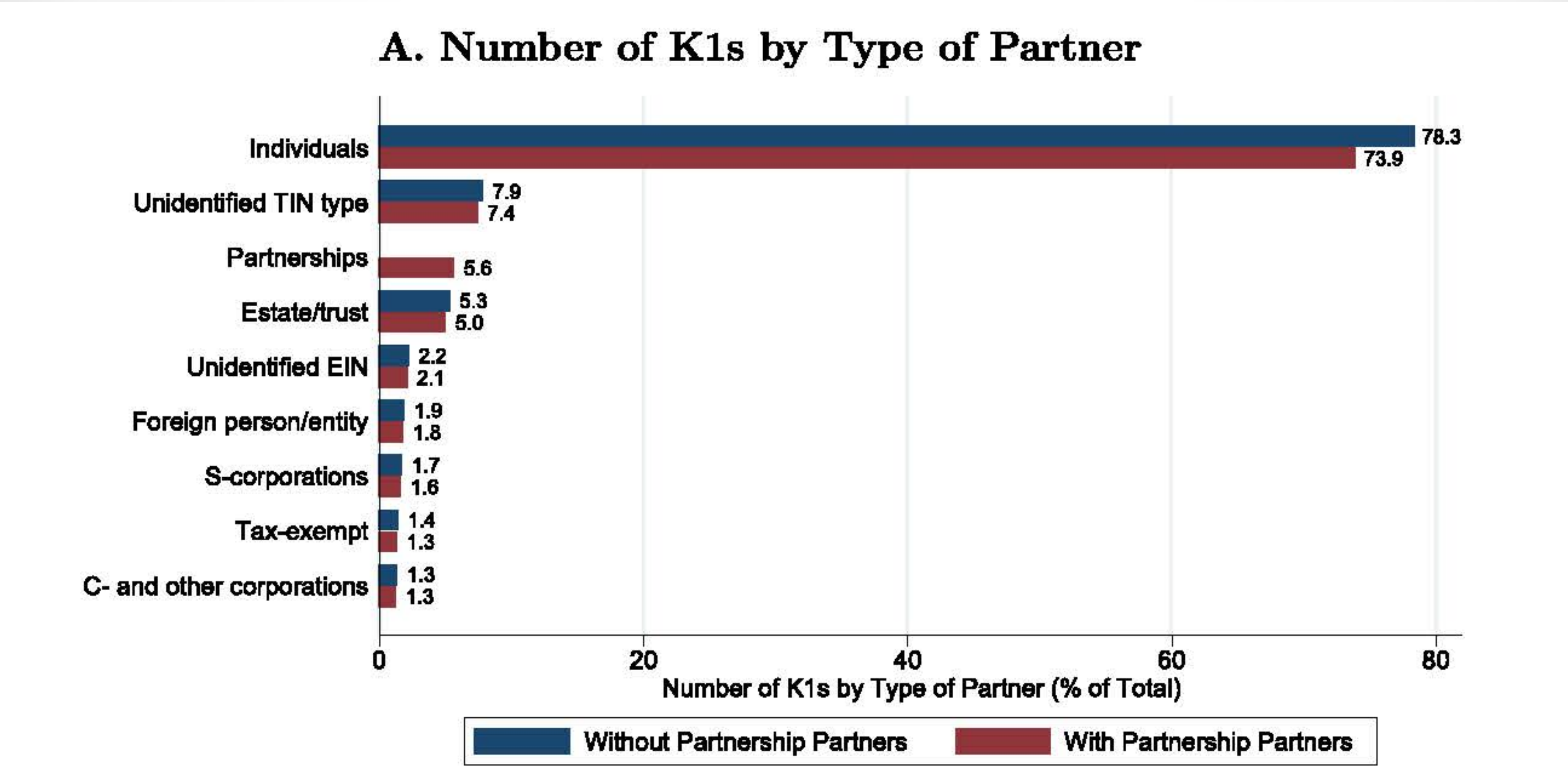
Growth of large partnerships

Table 16: Number of Large Partnerships by Industry Group, Tax Years 2002 to 2011

	Tax Year									
Industry Group	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Mining	18	32	35	44	76	99	131	129	127	170
Manufacturing Transportation and Warehousing	23	25	27	39	56	85	105	108	116	142
Transportation and Warehousing	43	43	51	40	56	61	92	87	96	114
Finance and insurance	**1,799**	**2,195**	**2,715**	**3,190**	**4,731**	**5,707**	**5,530**	**6,124**	**5,955**	**7,333**
Real Estate, Rental and Leasing	695	685	782	870	1,081	1,275	1,486	1,401	1,287	1,507
Professional, Scientific, and Technical Services	55	57	69	74	85	86	108	109	98	129
Holding companies	56	53	72	89	113	157	186	200	193	233
Other	143	152	198	256	320	403	446	442	387	471

Source: GAO analysis of IRS data from the Enhanced Large Partnership Indicator (ELPI) File and Business Returns Transaction File, Compliance Data Warehouse. I GAO-14-732

Other Statistics



Richard Prisinzano, U.S. Treasury Department; **Danny Yagan,** University of California, at Berkeley Economics Department, Draft Paper for NYU Spring Colloquium on Tax Policy and Public Finance – 2016, "Business in the United States – Who Owns It and How Much Tax Do They Pay?"

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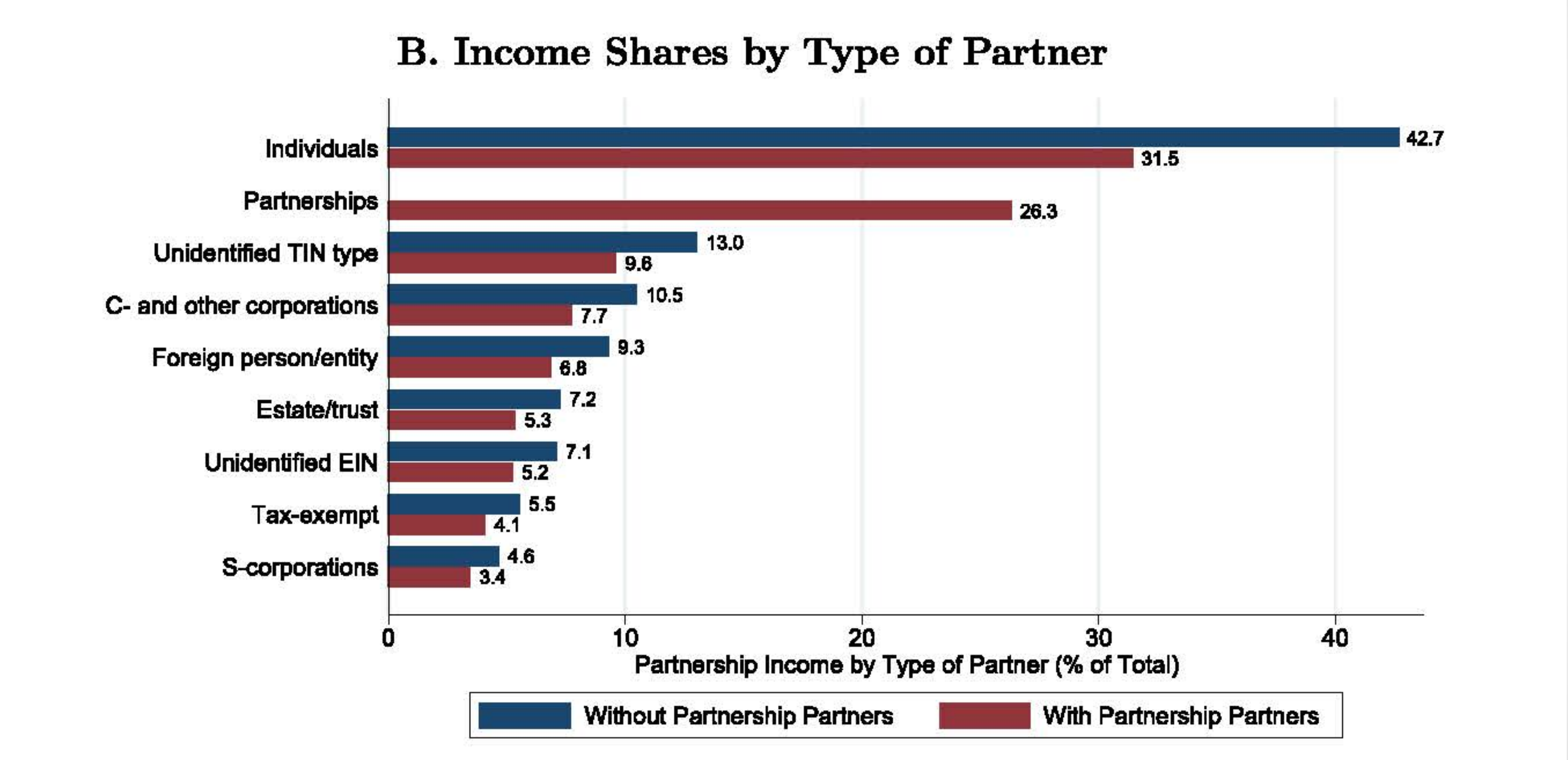

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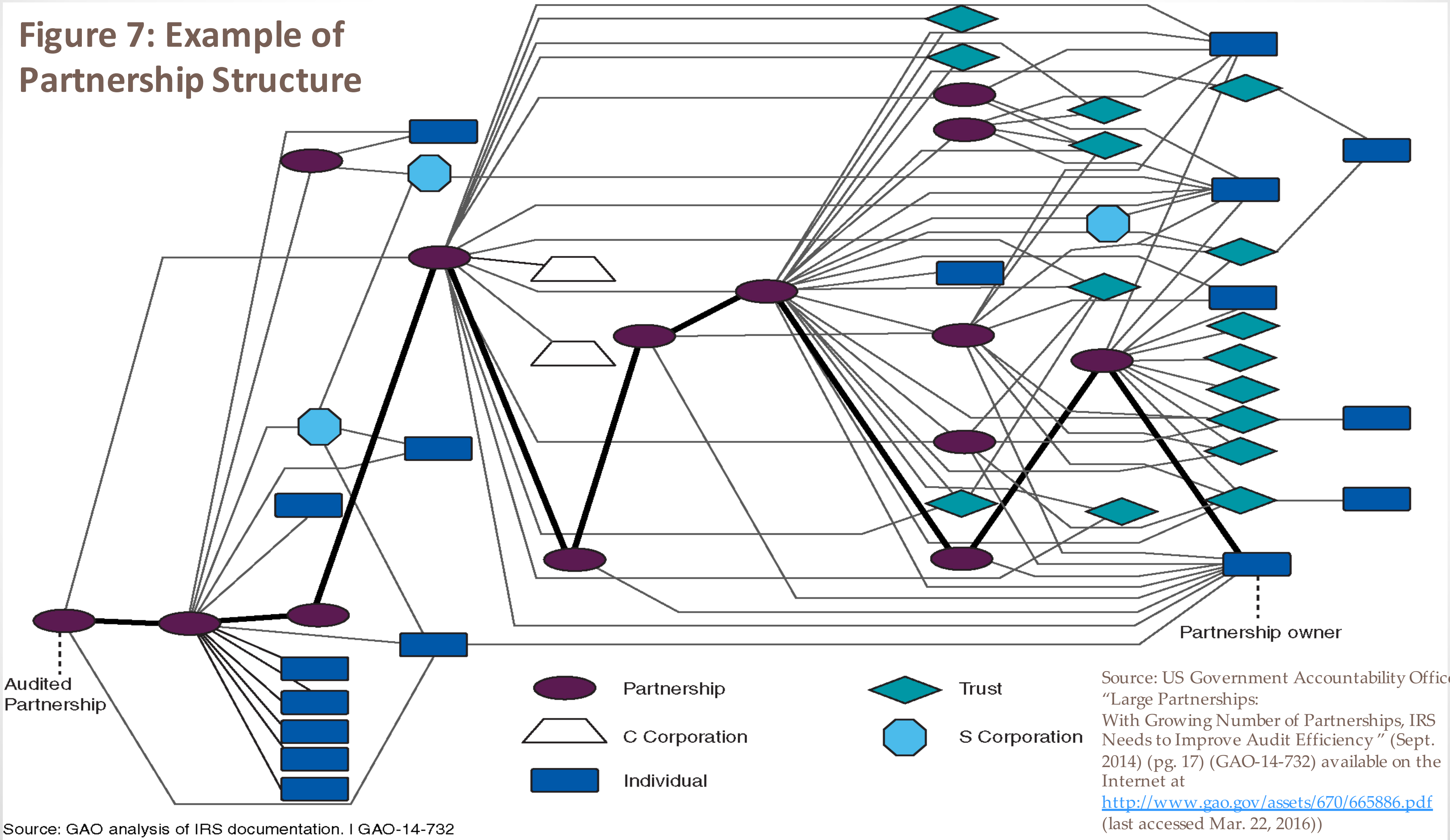
Other Statistics

- 15-20% of income cannot be traced to partners (or back to partnerships) – because of the nature of the partners or circular partnership holdings
- Almost 70% of partnership income accrues to the top 1% income earners

Multi-tiered Partnership Structure



Source: US Government Accountability Office "Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency" (Sept. 2014) (pg. 17) (GAO-14-732) available on the Internet at http://www.gao.gov/assets/670/665886.pdf (last accessed Mar. 22, 2016))

Implications for the States

- Large financial market and production states (and venture capital markets) are likely to see the greatest impact
- Smaller and more rural states – partnerships are likely to be simpler, more closely held, investment partnerships (with real estate predominating) and less likely to have multistate implications

New Regime - Basic Rules

- IRS may assess and collect from partnerships at the entity level for 1065 and Schedule K-1 issues
  - Collection ***from partnership*** (not partners) in "year of adjustment" rather than "year of review"
- Option to elect out for partnerships with 100 or fewer partners
  - Partners cannot be other partnerships, LLCs (including SMLLCs), trusts, or tax exempt organizations
  - Audit, assessment and collection ***at partner level*** – "Back to the Future" – Pre-TEFRA
  - Election is the PARTNERSHIP's (not the partners' individually)
    - Who's going to decide?

New Regime - Basic Rules

- Partnership representative (f/k/a "Tax Matters Partner") makes binding decisions for the partners and the partnership
  - o Doesn't even have to be a partner
    - If one has not been appointed, the IRS will appoint one for you
  - o How will partnership representative be:
    - Controlled?
    - Compensated and indemnified?
  - o Does this mean that EVERY PARTNERSHIP/LLC AGREEMENT in America has to be revised to cover this point?

New Regime - Basic Rules

- After assessment, partnerships (that can't elect out) can:
  - Modify the proposed entity level assessment by presenting information specific to partners' taxes—including amended returns
  - "Push out" the entity level tax liability by providing Schedule K type reports to partners for their share of the tax imposed at the partnership level – current year
    - Cost: 2% higher interest rate

State Issues

- Will state law conform to the new federal changes?
  - Not automatically
    - New federal rules are primarily in IRC secs. 6221 to 6241 (administrative procedures)
    - States use the IRC only to compute taxable income and do not incorporate IRC administrative procedures
      - States usually have their own procedures
    - Practitioners need guidance for dealing with partnership and operating agreements

State Issues

- Without automatic adoption, where does that leave states?
  - For partnerships assessed by the IRS at the entity level, how will states impose related state tax?
  - How are states to deal with the liability being assessed in "year of adjustment" rather than "year of review"?
  - Most states never conformed to TEFRA

Existing State Enforcement Mechanisms

- Many states already use two types of enforcement mechanisms for nonresident partners:
  - Impose withholding requirement on partnership for income passed through to nonresident partners (or nonresident partner consents to state taxation)
  - Impose a composite filing requirement
- Could states modify/expand these to require entity level audit liability remittance?

Procedural Issues for States

- Statutes of limitation and notices to partners
- Start date of audit (as relates to each partner)
- Adjustments that affect one partner
- Adjustments that affect multiple partners
- Adjustments that affect past years or future years
- Adjustments resulting in refunds
- Who represents the partnership with respect to appealing or settling issues?
- Penalties and interest
- Collection of liabilities

Procedural Issues for States (cont.)

- Assessment in "year of adjustment" rather than reviewed tax year
  - Partners in adjustment year could be different than partners in "reviewed year"
  - Partners move – change state of residence
    - Paying for other people's taxes
- Will states conform to federal elections?
  - Allow separate state elections?
- Post-federal audit information sharing
  - Is state's receipt of partnership-level tax liability enough information to assess partners?
  - How will states obtain information they need for state purposes (e.g., apportionment data? Business/nonbusiness income? Unitary determinations?)

Arizona – The First Adopter

- Faced a "minor" problem: No statutory authority to even audit a partnership
- Largely adopts federal procedures, with some revisions
  - New law amended RAR statute and added new statute. Ariz. Laws 2016, ch. 155 (S.B. 1288) (signed May 11, 2016)
- If partnership is assessed by IRS :
  - For increases to AZ taxable income, **partnership** must file AZ return and pay tax within 90 days after final IRS determination
  - For decreases to AZ taxable income, or if partnership makes federal "push out" election:
    - Partnership must provide "reviewed year" partners (and DOR) an adjusted K-1 within 90 days after final IRS determination
      - Partnership must pay tax if it fails to timely issue adjusted K-1s
      - Partnership must pay tax on any RAR adjustments that it does not properly include on the adjusted K-1s
    - **Partners** receiving adjusted K-1 must file an amended AZ return and pay tax within 150 days after final IRS determination reporting the changes

Nexus of Partners & Partnerships

- Type matters
  - Individuals or corporations
  - General or limited
  - Active or passive
  - Operational or investment
- Nexus over the partnership may be essential for a state that needs information from that entity to audit a resident partner
  - Loss of revenue if state adopts entity level partnership assessment and resident partner has interest in out-of-state audited partnership?

State Cases are Mixed

- Alabama –
  - In *Lanzi*, state appeals court ruled that an individual's interest in an LLC was not sufficient to create nexus over that individual
- Pennsylvania –
  - In *Marshall Jr. v. Commonwealth*, the state Commonwealth Court held that a Texas resident's holding of a limited partnership interest was sufficient to subject him to income tax in PA because the partnership had substantial commercial assets in the state, which the limited partner was well aware of. (Affirmed in *Wirth v. Commonwealth*)

State Cases are Mixed

- In Kentucky –
  - An out-of-state corporate limited partner was held to have nexus in the state. *Asworth Corp. v. Revenue Cabinet*

- In New Jersey –
  - The state appellate court ruled that a corporate limited partner which had no control of the business in NJ and had no unitary relationship with the limited partnership did not have nexus in the state. *BIS LP, Inc. v. Director, Division of Taxation*

Apportionment - Individuals

- Resident individuals – taxed on 100% with credit for taxes paid on partnership income to other states on a source basis
- Nonresident individuals – taxed on a source basis (partnership items allocated or apportioned at partnership level)

Apportionment - Corporations

- Three general possibilities:
  - Include partnership tax items but no apportionment factors or other source information (use corporate factors only)
  - Include proportional share of factors with corporate factors
  - Allocate or apportion partnership items at the partnership level and flow through source information to corporate partner

Apportionment - Generally

- For unitary partnerships distributing business income – include proportional share of partnership factors
- For non-unitary partnerships distributing operational items – apportion using corporation’s factors
- For non-unitary partnerships distributing investment items – allocate at the partnership level and flow-through the sourcing information