

2017 Annual Meeting

FEDERATION OF TAX ADMINISTRATORS

June 13, 2017

THE WESTIN SEATTLE



Federal Partnership Audit Legislation – State Impacts



Panelists

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Discussion

- New IRS Partnership Audit Rules – Issues Raised for States Generally
- Comparison of New IRS Rules with Pennsylvania Entity Level Assessments
- Interested Parties Draft Model
- Predictions
- Questions



New IRS Partnership Audit Rules

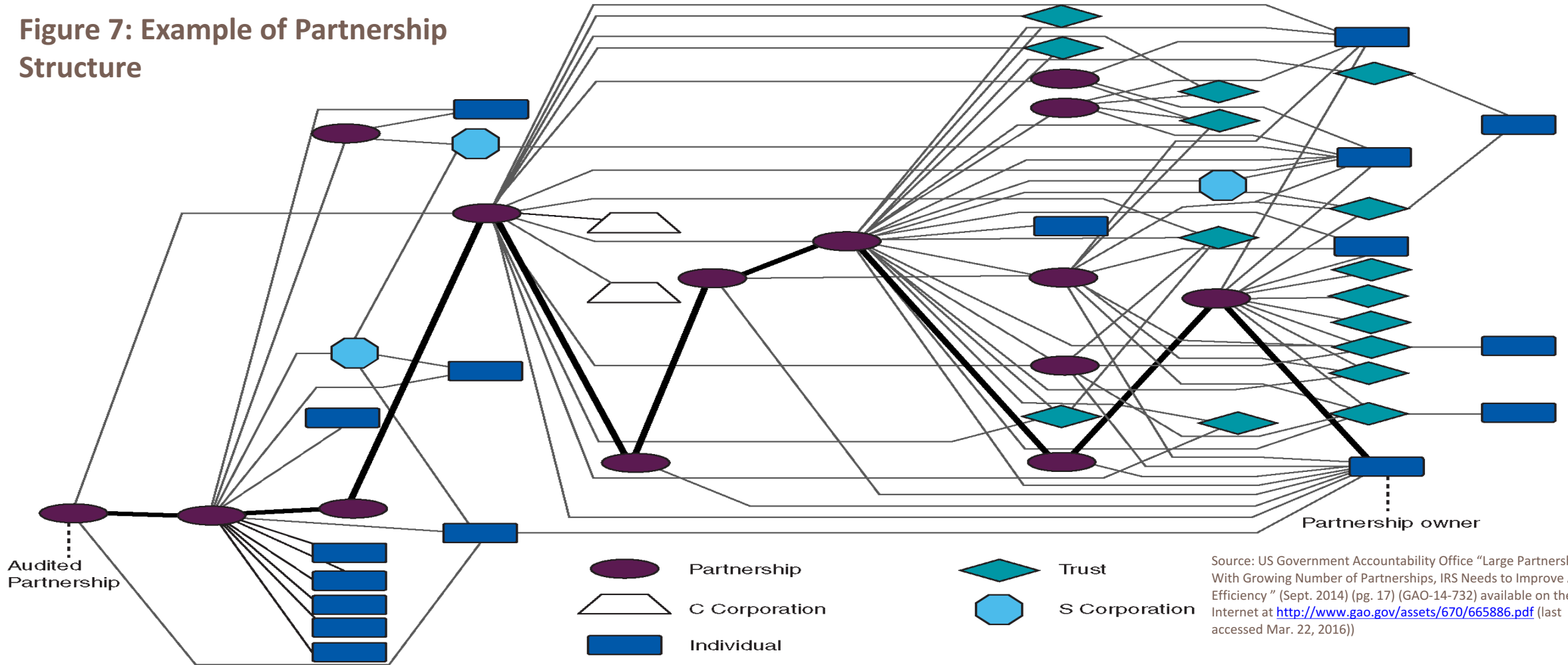
The Bipartisan Budget Act of 2015 (BBA) was signed November 2, 2015 and established new audit rules for partnerships.

Why?



Multi-tiered Partnership Structure

Figure 7: Example of Partnership Structure



Source: GAO analysis of IRS documentation. | GAO-14-732

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))

From 2002 to 2011

- The number of large partnerships (those with assets in excess of \$100 million and 100+ direct or indirect partners) more than tripled
- Only 0.8% of such entities were audited by the IRS, compared with 27.1% of comparable large corporations
- IRS did something unusual – it estimated that procedural rules would generate revenue - \$10 Billion over 10 years



Key Points of BBA

- Partnership-level audit
- New “partnership representative”
- “Partnership pays” - partnership-level “imputed underpayment” assessment
- “Pay up” – partners may file amended returns and pay tax
- “Push out” – partnership may report adjustments to the partners
- Small partnerships may elect out



Key Points of BBA

- Offsetting 1065 item adjustments may be netted but reallocation amounts are not
- Assessment is made in year audit is finalized
- All partners bound by final resolution of partnership proceeding
- Partners do not have right to be notified of or participate in proceedings (audit, appeal, judicial review)



Potential Issues - Common

New audit rules raise common questions for both IRS and states:

- How to treat tiered partnerships
- How to adjust outside basis, especially when reviewed year partners and adjustment year partners are different
- Logistics of adjusting when a partnership no longer exists



Potential Issues - Common

- On January 18, 2017 U.S. Treasury issued long-awaited temporary regulations on the IRS centralized partnership audits
- On January 20, 2017 the White House issued an order to withdraw all regs that had been provided to Federal Register but had not yet been published
- How to proceed while in limbo



Potential Issues - State

Federal rules also raise issues for states:

- Nexus over out-of-state partnerships (where there is a resident partner)
- Resident vs non-resident treatment
- Residents entitled to credit for taxes paid to other states
- Non-residents entitled to apportionment
- Partners may change residency between reviewed and adjustment years



Potential Issues - State

- States have adopted partnership withholding and “composite” returns to address compliance issues
- Will state require adjustment to be taken into account in adjustment year like IRS, or will state require adjustment to be made in reviewed year
- Will state allow separate state-level adjustments to imputed underpayment amounts



Potential Issues - State

Effect on partnerships ultimately owned by corporations

- Assuming that the partnership is ultimately owned or controlled more than 50% by a corporation and is part of a unitary business – if it elects the “partnership pays” option, should the adjustment at the state level be computed on a combined basis with corporate owners



1. Conformity to Federal Elections

- a. Federal Elections – follow or diverge?
- b. States should conform to federal rules
- c. Especially with partnership that “opt out” or partnerships that “opt in early”
 - i. Allow Partnerships to “opt out” so that the partnership remains liable for the state tax deficiency
 - ii. Allow the “Pay up” procedure under I.R.C. Sec. 6225



2. Imputed Underpayments

- a. States may have to change statutes to permit partnerships to be assessed

3. Ability to Reduce State tax Income Liability

- a. States should provide a way for a partnership to reduce its liability by proving that a partner is a tax exempt entity or subject to lower rates (for any applicable reason) ; or not subject other income tax regime (think financial institution)
- b. Partners that have sold their interest – all or a portion

4. Credit for Taxes Paid

5. Composite Returns

6. Nonresident partners withholding with Federal Adjustments



7. Qualified Investments Partnerships

- a. Should remain exempt unless qualification is lost due to federal audit adjustment (think excess non-passive income)

8. Apportionment Rules

- a. Reviewed year versus adjustment year



9. Information Included on Federal Adjustment Notice

- a. Come on – give us the info so the states can make some sense of the thing!
- b. AICPA is joining on this as well as other comments

10. RAR Statutes

- a. Most state RAR statutes should be amended
- b. MTC a model RAR
- c. Some adjustments needed
 - i. Amendments should specify that the states “opening” should be limited to the federal issues – no fishing trips!



11. “The Moving Partner”

- a. Sounds like Bekins will have more work – but how to handle a partner that was a resident and has moved to another state.
- b. Due Process issues abound!

12. “The Moving Partnership”

- a. Now the partnership is here – now it is not –



13. Dealing with Tiered Structures

- a. NO word from IRS
- b. Partnership should be able to “opt out” of federal election and remain liable for the state taxes, or file refund claim in its own right.



14. Designation of Partnership Representative

- a. Federal designation of PR should flow through to states –
UNLESS partnership determines otherwise



15. Constitutional Limitations

- a. “Interstate Commerce” restrictions do not exist on federal level.
- b. Due Process needs to be considered

16. Regulatory Authority

- a. States must use their APA process to gain input from taxpayers, practitioners, and others. – No fiat!



Pennsylvania's New Rules

Before the BBA, Pennsylvania's legislature instituted entity-level assessments with Act 52 of 2013, which was signed by the Governor on July 9, 2013



Pennsylvania's New Rules

72 P.S. §7306.2 – Tax imposed at partnership level

- Applies to underreporting of income by more than \$1 million
- Applies to partnerships with 11 or more individual partners or partnerships that have at least one partner that is a corporation, LLC, partnership or trust



Pennsylvania's New Rules

72 P.S. §7306.2 – Tax imposed at partnership level

- Does not apply to publicly traded partnerships
- Only the partnership may appeal the adjustment
- Final adjustment is binding on all partners
- Assessment is made for the tax year being adjusted



Comparison of IRS and PA Rules

IRS

- Any partnership is subject to the rules
- Small partnerships can elect out
- Entity level review
- Partnership representative

PA

- Only certain partnerships qualify
- Non-qualifying partnerships can elect in
- Same
- No designation



Comparison of IRS and PA Rules

IRS

- Partners have no right to be informed or participate
- Partnership must file appeals; partners may not
- Push-out election available

PA

- Silent
- Same
- No-push out election



Comparison of IRS and PA Rules

IRS

- Small partnerships can elect out
- Tax imposed in year audit is finalized

PA

- No election out provisions, but partnerships with less than 11 individual partners are not subject to rules
- Tax imposed in tax year under review



Comparison of IRS and PA Rules

IRS

- Partnership can submit evidence of tax exempt partners to lower IU
- Partnership can submit evidence of other tax rates to lower IU (corporate partner, capital gain)

PA

- Tax exempt partners are taken into account when calculating tax amount due
- Pennsylvania personal income tax only has one rate



Comparison of IRS and PA Rules

IRS

- Partners in the year audit finalized may not be the same partners as in year under audit – potential liability for someone who wasn't a partner in year under audit

PA

- N/A – Adjustment made to tax year under review so no issues with differing partners



Comparison of IRS and PA Rules

IRS

- Individuals may lose out on ability to use NOLs, passive losses, other credits, etc. to offset adjustment

PA

- Individual partner may file petition for refund and demonstrate adjustment would not have resulted in additional tax due (other losses, credits, etc.)



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Interested Parties Draft Model Uniform Statute and Regulation for Reporting Adjustments to Federal Taxable Income and Federal Partnership Audit



- **Interested Parties:**

- ABA Section of Taxation SALT Committee Task Force
- American Institute of CPAs (AICPA)
- Council on State Taxation (COST)
- Institute for Professionals in Taxation (IPT)
- Tax Executives Institute (TEI)

- **Note:** This draft has not yet been formally endorsed by the Interested Parties and is meant to be a draft for discussion purposes only.



Overview of Draft

- Section A—Definitions
- Section B—Reporting Adjustments to Federal Taxable Income – General Rule
- Section C—Reporting Adjustments to Federal Taxable Income – Partnership Level Audits
- Section D—Assessments of Additional [State] Tax, Interest, and Penalties Arising from Adjustments to Federal Taxable Income
- Section E—Estimated [State] Tax Payments During the Course of a Federal Audit
- Section F—Claims for Refund or Credits of [State] Tax Arising from Federal Adjustments Made by the IRS
- Section G—Scope of Adjustments and Extensions of Time
- Section H—Effective Date



Section A—Highlights

- **Partnership Definitions:**

- **“Federal Partnership Representative”** shall mean the person the Partnership designates, for the taxable year, as the Partnership’s representative pursuant to IRC Section 6223(a).
- **“Imputed Underpayment”** shall mean the amount determined by applying the applicable [State] income tax rate, as determined under subsection C(4)(a), to all partnership adjustments made by a Partnership Level Audit properly apportioned to [State].
- **“Partnership Adjustment Tracking Report”** shall mean a form prescribed by [State Agency] that conforms with the form promulgated by the IRS modified by [State Agency] as necessary to allow [State] to identify all a Partnership’s partners and their allocable share of any federal audit adjustments.



Section A—Highlights

- **Partnership Definitions:**

- “**Partnership Level Audit**” shall mean an examination by the IRS that results in adjustments to Partnership-related items at the Partnership level for the tax year pursuant to Subchapter C of Title 26, Subtitle F, Chapter 63 of the IRC for which the Partnership has not made a qualifying election out pursuant to IRC Section 6221(b).
- “**Resident Partner**” shall mean an individual, estate of a deceased individual, or trust that was a partner of the Partnership and considered a resident of [State] for income tax purposes for the Partnership’s taxable year that is subject to a Partnership Level Audit.
- “**State Partnership Representative**” shall mean the Federal Partnership Representative or the person the Federal Partnership Representative designates for the taxable year to be the Partnership’s representative for [State] tax purposes pursuant to subsection C(1).



Section B—Highlights

Reporting Adjustments to Federal Taxable Income – General Rule

- **Except in the case of a Partnership subject to a Partnership Level Audit**, and all direct and indirect partners thereof, a Taxpayer shall notify the [State Agency] of adjustments to its federal taxable income made by the IRS or reported by the Taxpayer on a timely filed amended federal income tax return as follows: * * *
- Section B provides the general rule for taxpayer's required to notify a state of a federal change (on audit or otherwise); however, it will not apply in the case of a partnership level audit under new partnership audit provisions.
- Section B continues to include an optional de minimus provision. Note this provision will not apply in the case of a partnership level audit under the new BBA provisions nor shall it apply to the partners of a partnership that was audited under the new partnership audit provisions.



Section C—Reporting Adjustments to Federal Taxable Income – Partnership Level Audits

- **Subsection (1):** The Federal Partnership Representative for the federal taxable year at issue in a Partnership Level Audit shall have authority to act on behalf of the Partnership with [State Agency] as the State Partnership Representative unless the Federal Partnership Representative has validly delegated such authority to another person. Such delegation shall be made by notifying the [State Agency] in writing and shall be deemed accepted by the [State Agency] unless the [State Agency] disapproves of the designation, for reasonable cause, in writing within fifteen (15) days following the Federal Partnership Representative's mailing of such notice to the [State Agency]. The Partnership and its direct and indirect partners shall be bound by any actions taken under this Section C by the State Partnership Representative.

Section C—Reporting Adjustments to Federal Taxable Income – Partnership Level Audits

- **Subsection (2):** In the event the adjustments made by the IRS to the federal taxable income of a Partnership subject to a Partnership Level Audit do not result in an Imputed Underpayment to [State], the State Partnership Representative shall file Amended Schedule K-1 Reports using the procedure in subsection C(4)(b). In addition, a Partnership that has been dissolved or becomes insolvent before or during the prescribed reporting periods provided in subsection C(3) shall be required to use the procedure in subsection C(4)(b).

Section C—Reporting Adjustments to Federal Taxable Income – Partnership Level Audits

- **Subsection (3):**

(a) In the event the adjustments made by the IRS to the federal taxable income of a Partnership subject to a Partnership Level Audit result in an Imputed Underpayment to [State], the State Partnership Representative shall file a Federal Adjustments Report with the [State Agency] within sixty (60) days of the Final Determination Date. The Federal Adjustments Report shall indicate the Partnership's taxable income apportioned to [State].

(b) At the time the Federal Adjustments Report is filed, the State Partnership Representative must elect to:

(i) pay the Imputed Underpayment of [State] tax on behalf of all partners pursuant to subsection C(4)(a);

(ii) mail Amended Schedule K-1 Reports to each partner reflecting the partner's increase in taxable income apportioned to the State; or

(iii) pay the Imputed Underpayment of [State] tax on behalf of all partners that are not Resident Partners and mail an Amended Schedule K-1 Report to each Resident Partner reflecting the partner's increase in taxable income apportioned to the State.

(c) The election made under subsection C(3)(b) is irrevocable unless the [State Agency], in its discretion, otherwise allows.

Section C—Reporting Adjustments to Federal Taxable Income – Partnership Level Audits

- **Subsection (4):**

(a) For Partnerships making an election pursuant to subsection C(3)(b)(i) or that fail to timely make an election pursuant to subsection C(3)(b), the State Partnership Representative shall, within one hundred twenty (120) days of the Final Determination Date, file with the [State Agency] a schedule indicating each partner's apportioned share of under-reported [State] taxable income and calculate and pay the additional [State] tax owed by the Partnership as follows:

(i) the under-reported [State] taxable income [(other than that portion attributable to Unrelated Business Taxable Income)] of all [tax-exempt or nontaxable] partners multiplied by zero (0) percent; plus

(ii) the under-reported [State] taxable income of all individual partners, S corporations, trusts, estates of deceased partners, disregarded entities that are not owned by a C corporation, or entities treated as Partnerships for [State] tax purposes multiplied by the highest [State] individual income tax rate; plus

(iii) the under-reported [State] taxable income of all C corporation partners and disregarded entities owned by a C corporation, including other entities taxed as such, [as well as the portion of under-reported [State] taxable income attributable to Unrelated Business Taxable Income of all [tax-exempt or nontaxable] partners] multiplied by the highest [State] corporate income tax rate.

Section C—Reporting Adjustments to Federal Taxable Income – Partnership Level Audits

- **Subsection (4) (cont.):**

(b) For Partnerships subject to C(2) or that make an election pursuant to subsection C(3)(b)(ii), the State Partnership Representative shall, within ninety (90) days of the Final Determination Date, (i) mail Amended Schedule K-1 Reports to each partner reporting each partner's share of under or over-reported [State] taxable income, and (ii) file with the [State Agency] a schedule indicating each partner's share of under-or over-reported [State] taxable income. Each partner furnished an Amended Schedule K-1 Report under this subsection shall file a Federal Adjustments Report and pay any additional tax due within one hundred eighty (180) days of the Final Determination Date.

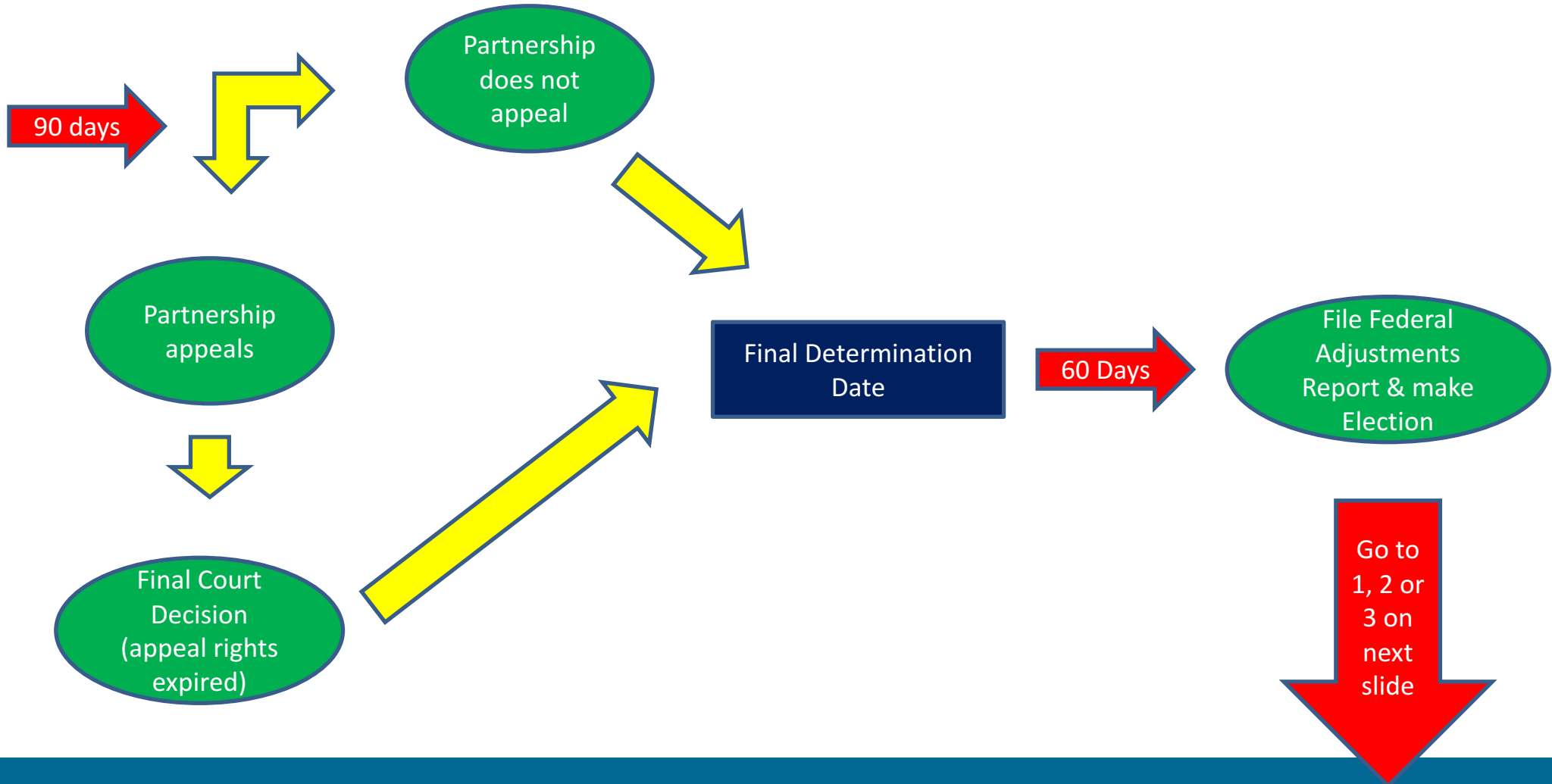
Section C—Reporting Adjustments to Federal Taxable Income – Partnership Level Audits

- **Subsection (4) (cont.):**

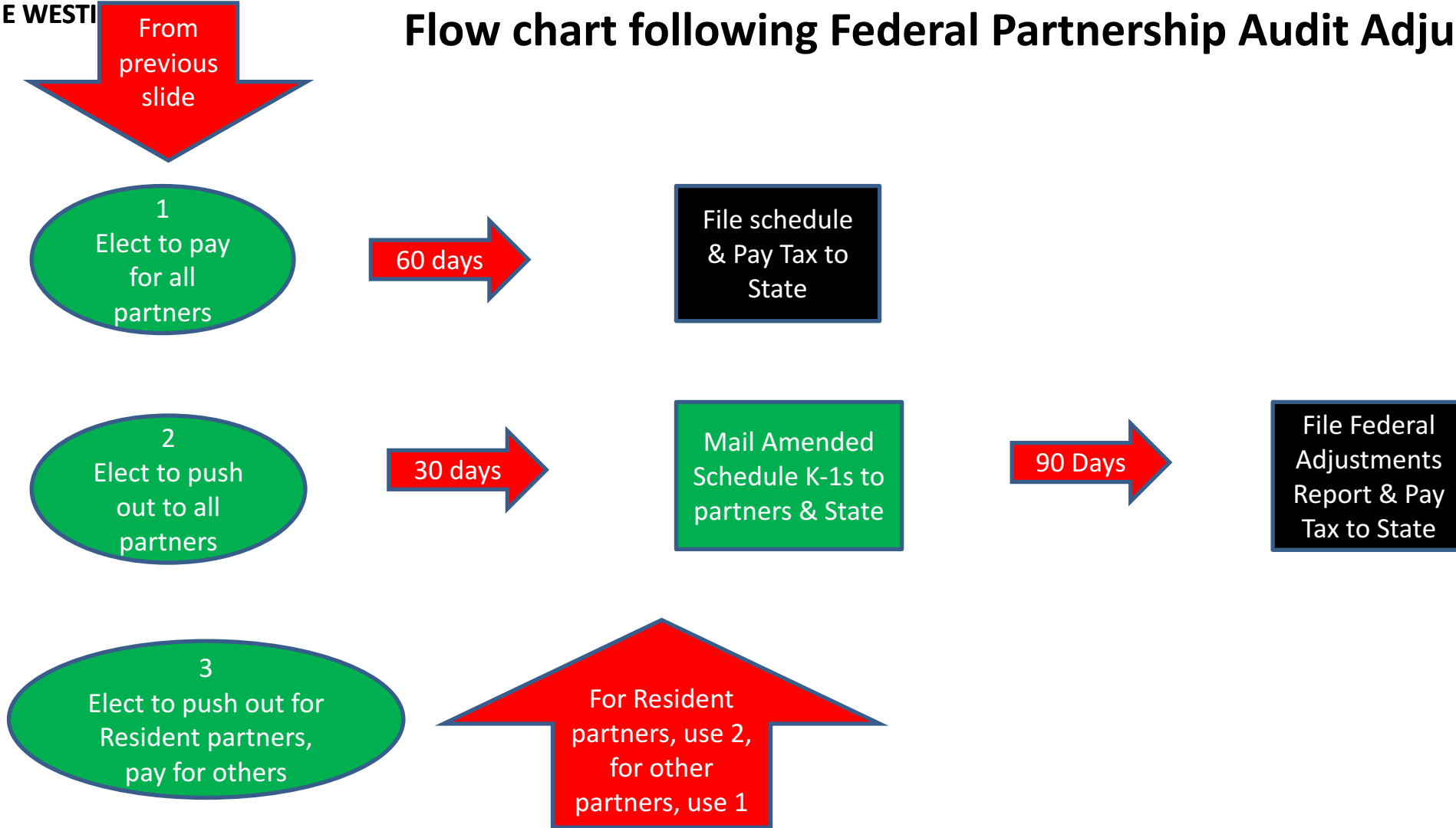
(c) For Partnerships making an election pursuant to subsection C(3)(b)(iii), the State Partnership Representative shall (i) within one hundred twenty (120) days of the Final Determination Date, file with [State Agency] a schedule indicating each partner's share of under-reported [State] taxable income and calculate and pay the additional [State] tax owed by the partners that are not Resident Partners pursuant to the rules of C(4)(a), and (ii) within ninety (90) days of the Final Determination Date, mail Amended Schedule K-1 Reports to each Resident Partner reporting each partner's share of under-reported [State] taxable income. Each Resident Partner furnished an Amended Schedule K-1 Report under this subsection shall file a Federal Adjustments Report and pay any additional tax due within one hundred eighty (180) days of the Final Determination Date.

Flow chart following Federal Partnership Audit Adjustment – Slide 1

IRS Issues Notice of Final Partnership Adjustment (FPA)



Flow chart following Federal Partnership Audit Adjustment – Slide 2



Section C—Reporting Adjustments to Federal Taxable Income – Partnership Level Audits

- **Subsection (4) (cont.):**

(d) Each partner's share of under-reported [State] taxable income shall be determined as specified in the Partnership agreement in effect for the federal taxable year subject to adjustment. A partner may not file an amended [State] return or take any similar action to obtain a refund of the tax paid by the Partnership on the partner's behalf under this subsection, and any such action shall be invalid.

(e) The [State Agency] shall promulgate reasonable regulations as it deems necessary to address special allocations among or between the partners that are affected by the Partnership Level Audit.

Section C—Reporting Adjustments to Federal Taxable Income – Partnership Level Audits

- **Subsection (5):**

(a) If a partner that is part of a “tiered partnership structure,” as defined in IRC Section 6226(b)(4), receives an Amended Schedule K-1 Report pursuant to subsection C(3)(b)(ii), subsection C(3)(b)(iii) or subsection C(5)(b)(ii), and is a Partnership, S corporation, or other pass-through entity, such partner shall, with respect to that partner’s share of the adjustment, file a Partnership Adjustment Tracking Report with the [State Agency] that includes such information as the [State Agency] may reasonably require.

(b) Such partner shall also either (i) calculate the Imputed Underpayment of [State] tax pursuant to the rules of subsection C(4)(a) or (ii) furnish Amended Schedule K-1 Reports pursuant to subsection C(4)(b).

(c) For purposes of subsection C(5)(a), with respect to a partner’s share of the adjustment, the Partnership Adjustment Tracking Report shall be filed, and the Imputed Underpayment shall be paid or Amended Schedule K-1 Reports mailed, within sixty (60) days of receipt of the Amended Schedule K-1 Report issued pursuant to subsection C(4)(b) or C(4)(c), but not later than the extended federal due date, regardless if the Partnership seeks an extension, for the federal tax return for the taxable year of the Partnership that includes the Final Determination Date.

Section C—Reporting Adjustments to Federal Taxable Income – Partnership Level Audits

- **Subsection (6):** For all purposes of this section C, apportionment of [State] taxable income shall be based on the apportionment factors applicable to the federal taxable year that was subject to adjustment, modified as necessary for any adjustments resulting from a Partnership Level Audit.

Predictions

- Will MTC/ABA/AICPA efforts lead to a uniform approach at the state level?
- Will there be substantial technical corrections at the federal level?
- Will federal tax reform include a partnership-level tax election?
- Will states “experiment” with partnership-level taxation?



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Questions?

