
MSATA 2018

Understanding the New IRS Partnership Audit Rules

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Presented by:

Nikki Dobay, Sr. Tax Counsel, Council On State Taxation

Helen Hecht, General Counsel, Multistate Tax Commission

Fred Nicely, Sr. Tax Counsel, Council On State Taxation

Overview

- ▶ Introduction: The Bipartisan Budget Act of 2015 and the New Federal Centralized Partnership Audit Regime
- ▶ Background: State Reporting For Federal Audit Adjustments
- ▶ State Issues Presented Under Federal Centralized Audit Regime
- ▶ Proposed Model Legislation and Recent Developments
- ▶ Questions

- ▶ Changes to Partnership Audit Rules:
The Centralized Partnership
Audit Regime

Partnership Audit Rules Background

- ▶ The Bipartisan Budget Act of 2015 Adopted New IRS Audit Procedures for Partnerships and Multi-Member LLCs
 - ▶ HR 1314 (P.L. 114-74) enacted in 2015
 - ▶ Projected \$9.3 Billion revenue-raiser (federal alone)
- ▶ Consolidated Appropriations Act of 2018, HR 1625 (P.L. 115-141), enacted in March 2018, made several useful technical corrections and added a unique new “pull-in procedure” described later in these slides
- ▶ The New Audit Rules For Taxable Years Beginning After December 31, 2017
 - ▶ Option to elect into the new rules for earlier years (few did so)
- ▶ Expected to raise additional tax revenue by enabling the IRS to more efficiently audit “large” partnerships and LLCs
 - ▶ According to Government Accountability Office (GAO), less than one percent of large partnerships were audited during 2012, compared to a 27 percent audit rate of corporations with assets exceeding \$100 million

Centralized Partnership Audit Regime Overview

- ▶ **Centralized Partnership Audit Regime (CPAR) Applies to All Subchapter K Entities**
 - ▶ All Partnership and Operating Agreements for entities taxed as a partnership (including most JV's) should be reviewed and amended.
- ▶ **By Default, Audit Adjustments Assessed and Collected at the Entity Level**
 - ▶ The partnership pays the tax, interest, and penalties on any “imputed underpayments” in the adjustment year (partner allocation adjustments also flow-through in adjustment year).
 - ▶ The tax due is calculated at the highest corporate or individual rate (37% in 2018).
 - ▶ Liability Mismatch: current partner group still retains liability for former partner group underpayment
- ▶ **Replaces Tax Matters Partner With “Partnership Representative”**
 - ▶ The Partnership Representative has the sole, exclusive authority to make decisions on behalf of the p'ship in IRS audit proceedings.
 - ▶ Important decisions: opt-out and audit rules elections, reporting decisions, appeal rights and decisions settlement authority, statute of limitations waivers, etc.
 - ▶ The Tax Matters Partner concept eliminated beginning with 2018 taxable year.

Centralized Partnership Audit Regime Overview

- ▶ Important Elections: There are at least three ways that partnerships may opt-out or otherwise adjust their liability under the new audit rules:
 - ▶ The True Opt-Out Election: Section 6221 Election
 - ▶ Applies only to “small” partnerships (more later)
 - ▶ Voluntary Reporting During 270-Day Period: Section 6225 Reporting
 - ▶ Partners affected by a reallocation must agree to file individual amended returns; OR
 - ▶ Partnership demonstrates that a portion of the imputed underpayment is allocable to a tax-exempt entity or a C corporation or individual with LTCG or qualified dividends, i.e., with a lower max. tax rate than the highest marginal rate (37% in 2018); or
 - ▶ Partnership makes new “pull-in” election and enlists the help of its accounting firm.
 - ▶ The Push-Out Election: Section 6226 Election
 - ▶ The Partnership Representative elects on behalf of the Partnership to push-out the audit adjustment to the former partner group from the year under review.

Opting Out of Centralized Partnership Audit Regime

- ▶ “Small” Partnerships May Opt-Out of Centralized Partnership Audit Regime (Section 6221)
 - ▶ P’ships and their partners that opt-out are subject to pre-TEFRA rules for p’ship audits
- ▶ **Criteria**
 - ▶ 100 or Fewer K-1s: P’ship must have fewer than 100 partners all of whom must be “eligible”;
 - ▶ Eligible Partners: Partners must be individuals, C or S corporations, and/or estates of deceased partners; and
 - ▶ Disclose Partners: The names and taxpayer identification numbers (TINs) of each partner must be provided to the IRS (particularly applicable with S corporation partners)
- ▶ **Annual Election**
 - ▶ Partnership Must Make Annual Election: the partnership must make a “Section 6221 election” on its timely-filed federal tax return for the opt-out year
 - ▶ Notice to All Partners: P’ship must timely notify all partners of the election to opt-out

Centralized Partnership Audit Regime Timeline

If Partnership fails to timely opt-out, is ineligible, or chooses not to opt-out, then any IRS audit proceeds as follows:

1. IRS sends Notice of Administrative Proceeding to Partnership Representative and the Partnership itself.
2. After conducting audit, IRS will send a Notice of Proposed Partnership Adjustments (NOPPA)
3. Within 270 days of receiving the NOPPA, the partnership can request to modify the imputed underpayment under certain circumstances (see the earlier slide discussing voluntary reporting under Section 6225)

Centralized Partnership Audit Regime Timeline (cont.)

4. After 270 days, the IRS sends its Notice of Final Proposed Adjustments (FPA)
5. Within 45 days of receiving the FPA, the partnership may elect to push out the imputed underpayment to reviewed year partners OR pay at entity level
 - ▶ Operating Agreement should address P'ship Rep authority to make Push-Out Election
 - ▶ Push-Out Election brings with it increased interest rate (by 2 percent) on imputed underpayment
 - ▶ Election must be timely made even if tax petitioned
6. OR, within 90 days of receiving the FPA, the partnership may file a petition for readjustment with the U.S. Tax Court, appropriate U.S. district court, or the Court of Federal Claims

Statute of Limitations

- ▶ The statute of limitations structure for auditing partnership also significantly changed in light of the new centralized audit regime.
- ▶ Code Section 6235 provides a single partnership statute of limitations of 3 years after the later of:
 - ▶ (i) the date of filing the partnership return (IRS Form 1065);
 - ▶ (ii) the due date of the partnership return; or
 - ▶ (iii) the date the partnership files an “administrative adjustment request” (e.g., an amended return)

- ▶ **Background: State Reporting of Federal Audit Adjustments**

Reporting Federal Audit Adjustments: Background

- ▶ States typically use federal taxable income, and other federally determined amounts, for computing state taxable income—so if a taxpayer underreports federal taxable income, the taxpayer will likely also owe additional state tax
- ▶ This allows states to benefit from federal audit efforts, including information exchange w/IRS
- ▶ IRS audits can take years – audits generally extend beyond normal federal and state statute of limitations
- ▶ IRS audit issues are often resolved at different times, with some issues creating refunds and others creating liabilities (however, the IRS plans to finalize all BBA partnership audits at one time)
- ▶ Some IRS audit adjustments have no impact at the state level (e.g., some federal tax credit adjustments)

Reporting Federal Audit Adjustments: Background

- ▶ Multistate Tax Commission currently has a Model Statute for states on how to report federal audit adjustments
- ▶ Model Statute Details
 - ▶ Model Statute adopted in 2003 when all states already had some type of reporting requirement in place
 - ▶ No state has fully adopted the Model Statute
 - ▶ Model Statute needs updating to:
 - ▶ Address changes in IRC and IRS audit procedures (including partnership audits)
 - ▶ Add provisions that create efficiency for taxpayers and tax administrators

Reporting Federal Audit Adjustments: Background

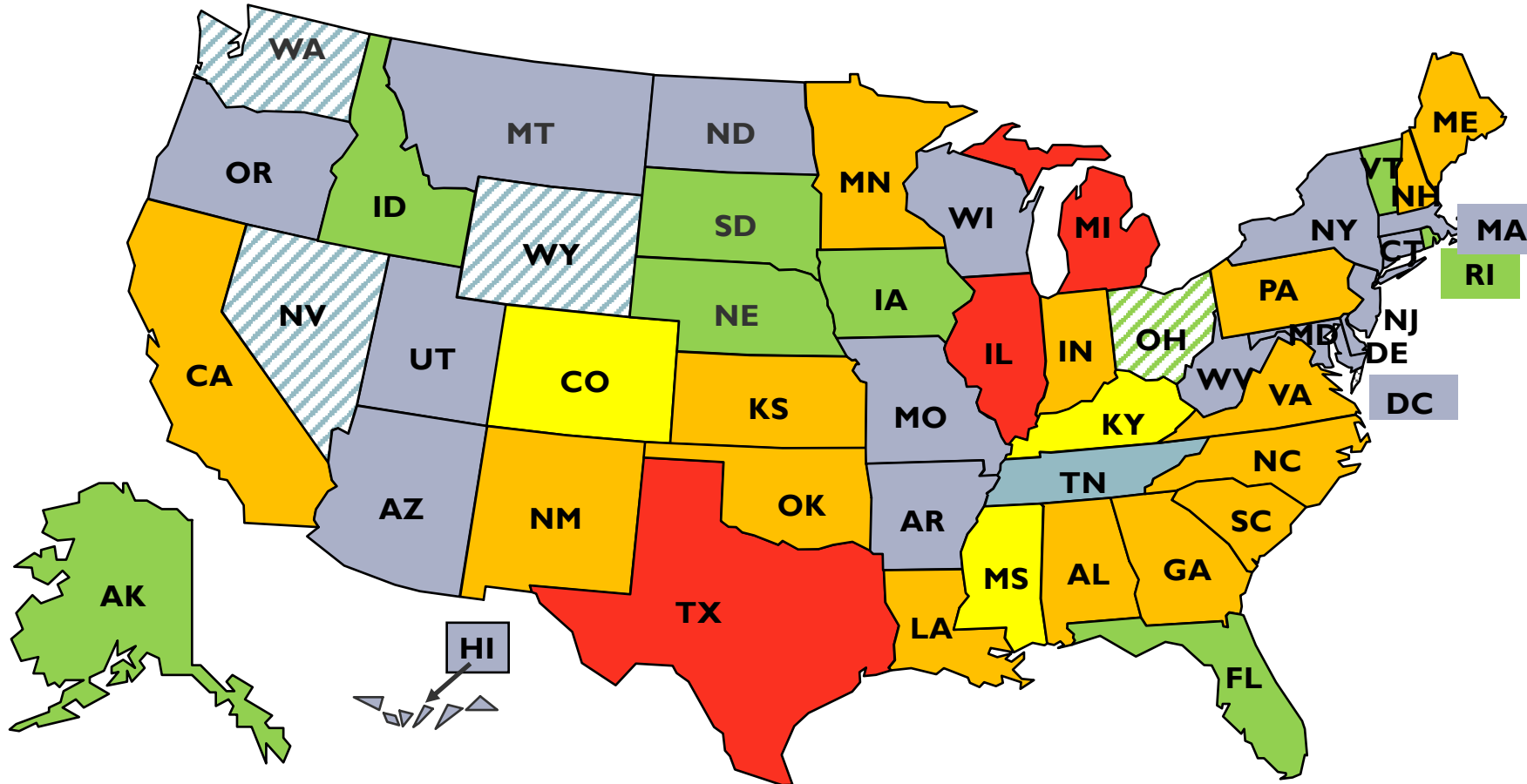
- ▶ Taxpayer groups (a/k/a “Interested Parties”) working to inform state legislators of the need for uniformity
- ▶ The method to report federal audit adjustments varies widely
 - ▶ Full amended return
 - ▶ Other state-specific notice requirements (e.g., simplified amended return or other written notification)
 - ▶ State-specific spreadsheet or template

Reporting Federal Audit Adjustments: Opportunities for Enhancements

- ▶ Uniformity alone would aid taxpayers and improve compliance
 - ▶ 180 days allows for more accurate reporting
 - ▶ Clear final determination date that requires reporting federal tax changes once is more efficient for tax agencies and taxpayers
 - ▶ Streamlined reporting would enable taxpayers to report adjustments more quickly and accurately
- ▶ Other recommendations to improve efficiency
 - ▶ Many federal audit adjustments are *de minimis*; however, most states still require full reporting
 - ▶ Difficult for taxpayers to make “estimated payments” during IRS audit
 - ▶ States unnecessarily wait for tax payments from taxpayers
 - ▶ Taxpayers are subject to interest on under-remitted amounts

When Do Taxpayers Have to File

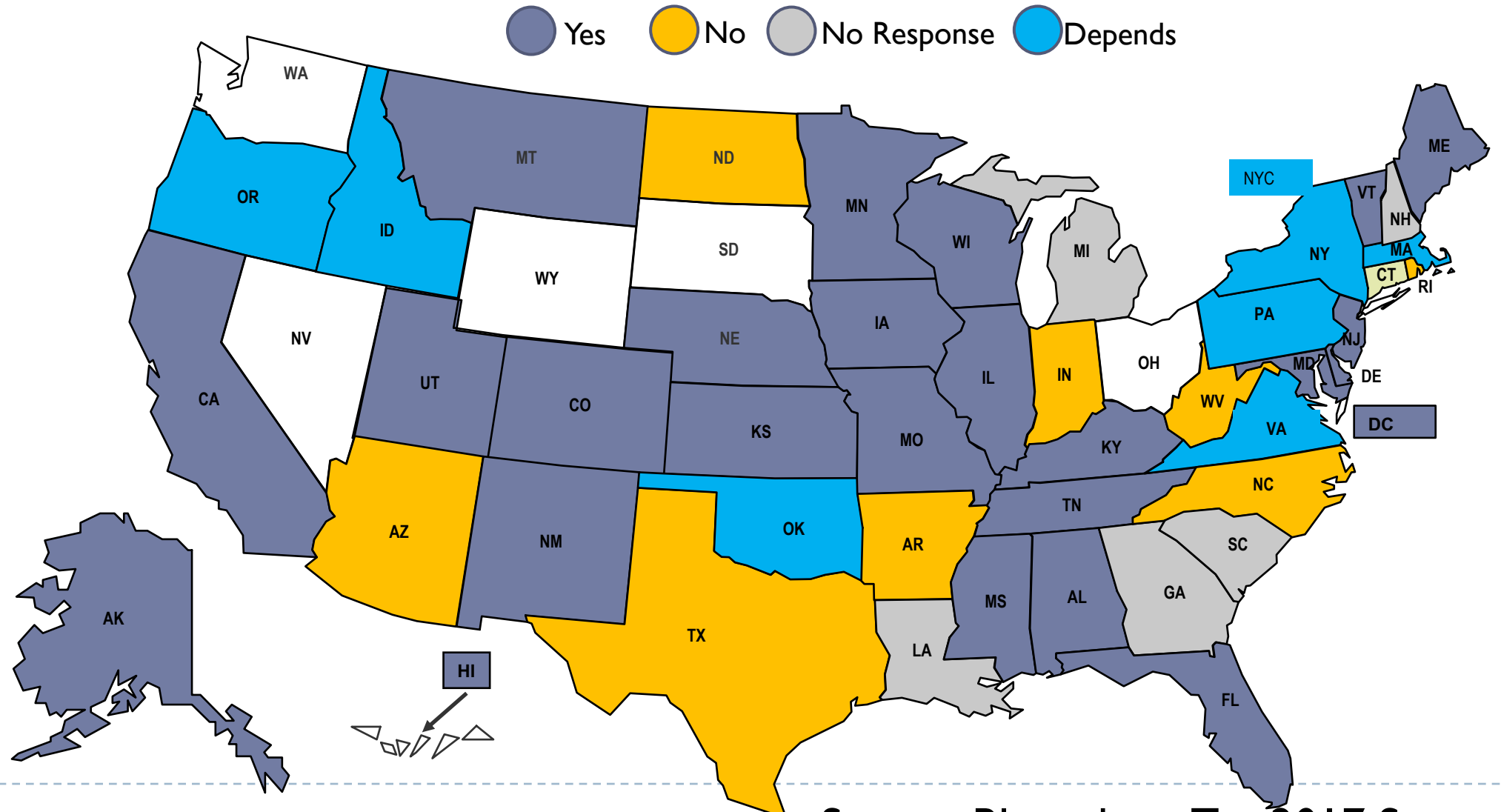
- Report Changes within 30 days
- Report Changes within 60 days
- Report Changes within 90 days
- Report Changes within 120 days
- Report Changes within 180 days or longer
- No statutory time limit to report federal changes
- No Corporate Income Tax



Notes

CA: Within 6 months
 IA: 60 days for payment, 180 days for refund
 NH: Within 6 months
 NY: 120 days for combined reports
 OH: No state CIT; post-TY 2015, 60 days for amended municipal income tax returns
 OK: Within one year
 OR: 60 days if Portland/Multnomah County
 PA: Within 6 months (Tax Years pre-2013, 30 days)
 VA: Within one year.

States That Require Filing/Payment Based on Partial Settlement



- ▶ State Issues Presented Under Federal Centralized Audit Regime

State Effects - Generally

- ▶ Issues the states need to address:
 - ▶ State procedural rules need to be amended to match the new federal partnership audit and adjustment process
 - ▶ Whether to allow different treatment at the state level
 - ▶ How to treat amended federal returns taxpayers may file during the modification period
 - ▶ How are partnerships that pay the tax subject to state reporting requirements
 - ▶ Can partnerships simply file amended returns (entity returns along with any composite or withholding returns) and K-1s for partners and have partners file amended returns for the reviewed year?
 - ▶ Proper allocation and apportionment of federal adjustments
 - ▶ How to collect tax owed when the liability will have occurred years earlier and the partnership may be defunct or partners may have moved from the state

State Effects – Apportionment

- ▶ At the federal level, the IRS can impose tax on 100 percent of any adjustment. For state purposes, that adjustment often needs to be apportioned and/or allocated if the partnership is operating or doing business in multiple states.
 - ▶ Many states use different apportionment rules for partnerships that are part of a unitary business
- ▶ If the partnership pays, the payment is being made on behalf of its partners.
 - ▶ Can the partnership's apportionment factor be used as a general rule?
 - ▶ How do resident individual partners calculate their credits for taxes paid to other states?
 - ▶ Will other states provide credit to partners for tax paid by the partnership in another state?
 - ▶ Can a partnership seeking to pay the tax on behalf of its direct and indirect partners be forced to know (and certify ?) the residency status of its indirect partners?

State Effects – Nexus Considerations

- ▶ At the federal level, the IRS has jurisdiction to collect tax from all partnerships and partners. States, however, may only impose and collect tax on taxpayers with the requisite contacts and substantial nexus (pesky Constitution!).
 - ▶ Should/can the new audit rules expand the state's ability to impose and collect tax from out-of-state partners?
 - ▶ Nexus can vary year by year – partnership activity in state can change along with partners' residency status in a state
- ▶ Example: Nevada partnership with five partners—four are California individual residents and one is a Nevada individual.
 - ▶ Original Return Filing: The partnership does not file a California return because it does not do business in the State. California partners report 100 percent of their partnership income on their California individual returns.

New Federal Partnership Audit Rules: State Implications

- ▶ MTC “Partnership Project” work group referred model to Uniformity Committee -
 - ▶ Website: <http://www.mtc.gov/Uniformity/Project-Teams/Partnership-Informational-Project>
- ▶ MTC Uniformity Committee referred model to MTC Executive Committee
- ▶ May be a public hearing on the model later this year

New Federal Partnership Audit Rules: State Implications

- ▶ State Legislative Activity to Date
 - ▶ 2016—only Arizona passed a bill
 - ▶ Arizona bill does not comprehensively address federal changes (e.g., fails to address tiered partnerships)
 - ▶ 2017—five states proposed legislation but all died/failed
 - ▶ 2018—Georgia and Hawaii enacted conformity legislation; California has a bill pending; Minnesota introduced legislation but bill died
 - ▶ Hawaii's legislation has problems similar to AZ

- ▶ 2019 will be the time to act!

▶ Draft Model Legislation

How It's Accomplished: Interested Parties

- ▶ The Interested Parties that prepared the Draft Model Statute are:
 - ▶ ABA Section of Taxation SALT Committee Task Force (ABA)
 - ▶ American Institute of CPAs (AICPA)
 - ▶ Council On State Taxation (COST)
 - ▶ Institute for Professionals in Taxation (IPT)
 - ▶ Master Limited Partnership Association (MLPA)
 - ▶ Tax Executives Institute (TEI)
- ▶ The Interested Parties have been working with the Multistate Tax Commission (MTC), this presentation is based on revisions to the Draft Model as of July 24, 2018
- ▶ Note: Interested Parties are in the process of obtaining formally endorsement of the Draft Model (dated July 24, 2018)

How It's Accomplished: Draft Model Statute – Overview of MTC's May 2018 Version

Section A—Definitions

Section B—Reporting Adjustments to Federal Taxable Income – General Rule

Section C—Reporting Adjustments to Federal Taxable Income – Partnership Level Audit and Administrative Adjustment Request

Section D—*De Minimis* Exception

Section E—Assessments of Additional [State] Tax, Interest, and Penalties Arising from Adjustments to Federal Taxable Income – Statute of Limitations

Section F—Estimated [State] Tax Payments During the Course of a Federal Audit

Section G—Claims for Refund or Credits of [State] Tax Arising from Federal Adjustments Made by the IRS

Section H—Scope of Adjustments and Extensions of Time

Section I—Effective Date

Optional Regulations

How It's Accomplished: Key General Definitions

▶ **Federal Adjustments**

- ▶ Change to item or amount used by the taxpayer to compute state tax owed, whether resulting from an IRS audit, amended federal return, or administrative adjustment request by the taxpayer

▶ **Federal Adjustments Report (FAR)**

- ▶ Method or form required to report Federal Adjustments to state
- ▶ Includes an amended state tax return or uniform multistate report

▶ **Final Determination Date**

- ▶ For IRS audits, date on which no Federal Adjustments arising from an audit remain to be finally determined
- ▶ For combined/consolidated returns, applies to entire group
- ▶ For amended federal returns, refund claims, and administrative adjustment requests,

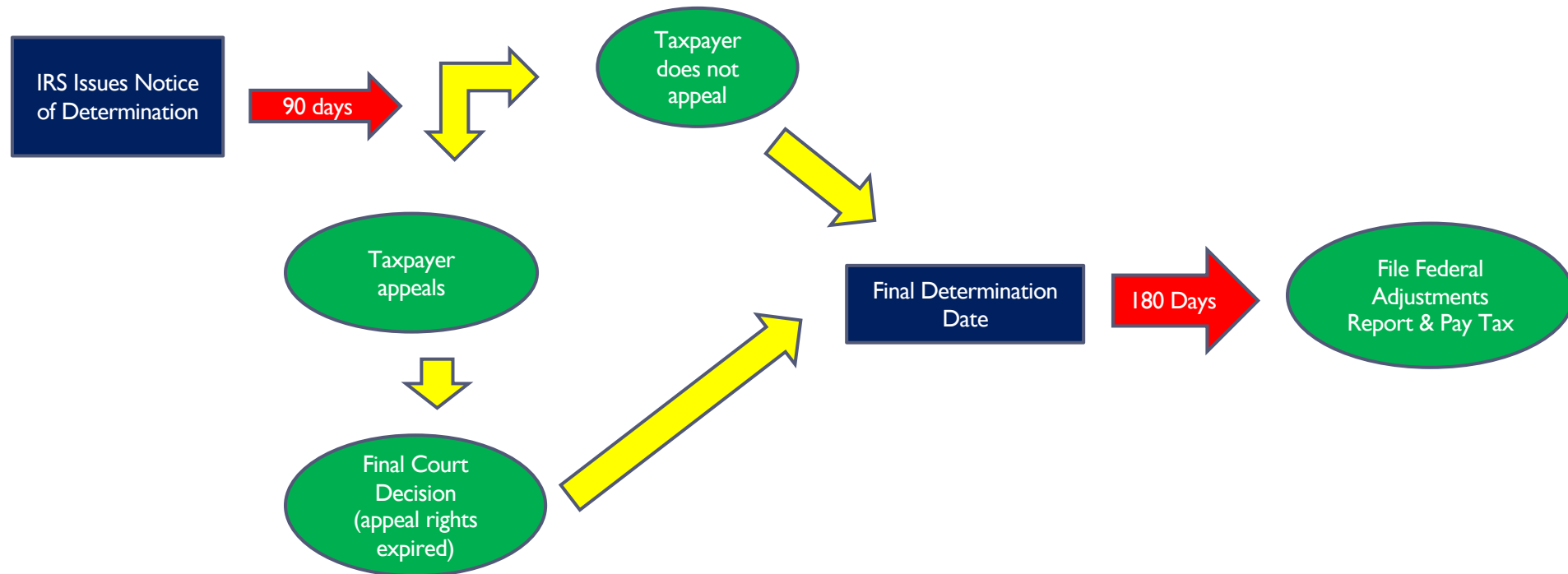
▶ 30 the date on which the requests were filed

How It's Accomplished: General Reporting Process

- ▶ **Reporting Adjustments to Federal Taxable Income – General Rule**
 - ▶ Taxpayers shall file a Federal Adjustments Report within **180 days** after the Final Determination Date for Reviewed Year and Subsequently Affected Years
- ▶ This provision does **not** apply to a partnership or their partners (unless the partner filed an amended return during the modification period) subject to a partnership level audit

Flow Chart Following Reporting Federal Audit Adjustment

(This is not for Partnerships subject to Partnership Level Audit)



How It's Accomplished: Key Partnership Definitions

- ▶ **Direct Partner**

- ▶ Partner holding an interest directly in Partnership or Pass-Through Entity

- ▶ **Indirect Partner**

- ▶ Partner in a Partnership or Pass-Through Entity that also holds an interest in another Partnership or Pass-Through Entity

- ▶ **Resident Partner**

- ▶ Individual, trust or estate Partner domiciled in the state

- ▶ **Tiered Partner**

- ▶ Partner that itself is a Partnership or Pass-Through Entity

How It's Accomplished: Key Partnership Definitions

- ▶ **Audited Partnership**

- ▶ Partnership directly subject to Partnership Level Audit

- ▶ **Partnership Level Audit**

- ▶ BBA audit (IRC Section 6221(b))

- ▶ **Reallocation Adjustment**

- ▶ Federal Adjustment that changes the distributive shares of partnership income, gain, loss, expense, or credit allocated to partners
 - ▶ Positive reallocation adjustment increases income owed by Partner
 - ▶ Negative reallocation adjustment decreased income owed by Partner

How It's Accomplished: Reporting Federal Adjustments for Partnership Level Audits – Default Rule

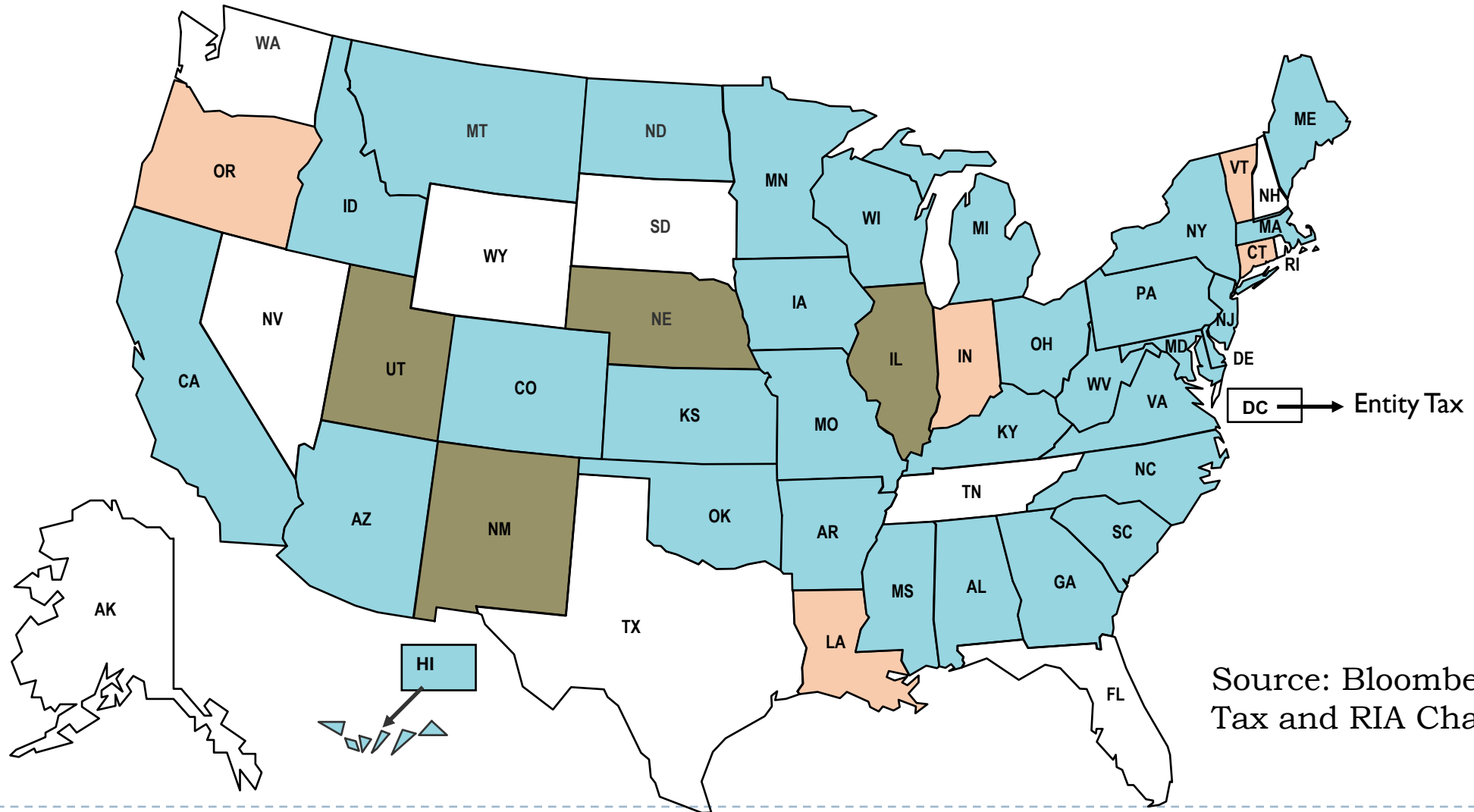
- ▶ For Reviewed Years, Audited Partnership shall:
 - ▶ Within 90 days of the Final Determination Date
 - ▶ File a Federal Adjustments Report;
 - ▶ Notify Direct Partners of their distributive share adjustments; and
 - ▶ File amended composite/withholding returns and pay the related tax liability on behalf of such partners
 - ▶ Within 180 days of the Final Determination Date, excluding Tiered Partners, each Direct Partner
 - ▶ File an Federal Adjustment Report to the state; and
 - ▶ Pay the additional tax, including penalty and interest, to the state (less any applicable credits)

How It's Accomplished: Reporting Federal Adjustments for Partnership Level Audits – Default Rule

- ▶ For Tiered Partners
 - ▶ Within 90 days after the date of federal deadline for Tiered Partners the Tiered Partners shall:
 - ▶ Complete all the above reporting requirements; and
 - ▶ Make all payments
 - ▶ Upon request, Audited Partnership or Tiered Partner with over 10,000 Direct Partners can request an additional 60-day extension

Composite Returns for Individuals

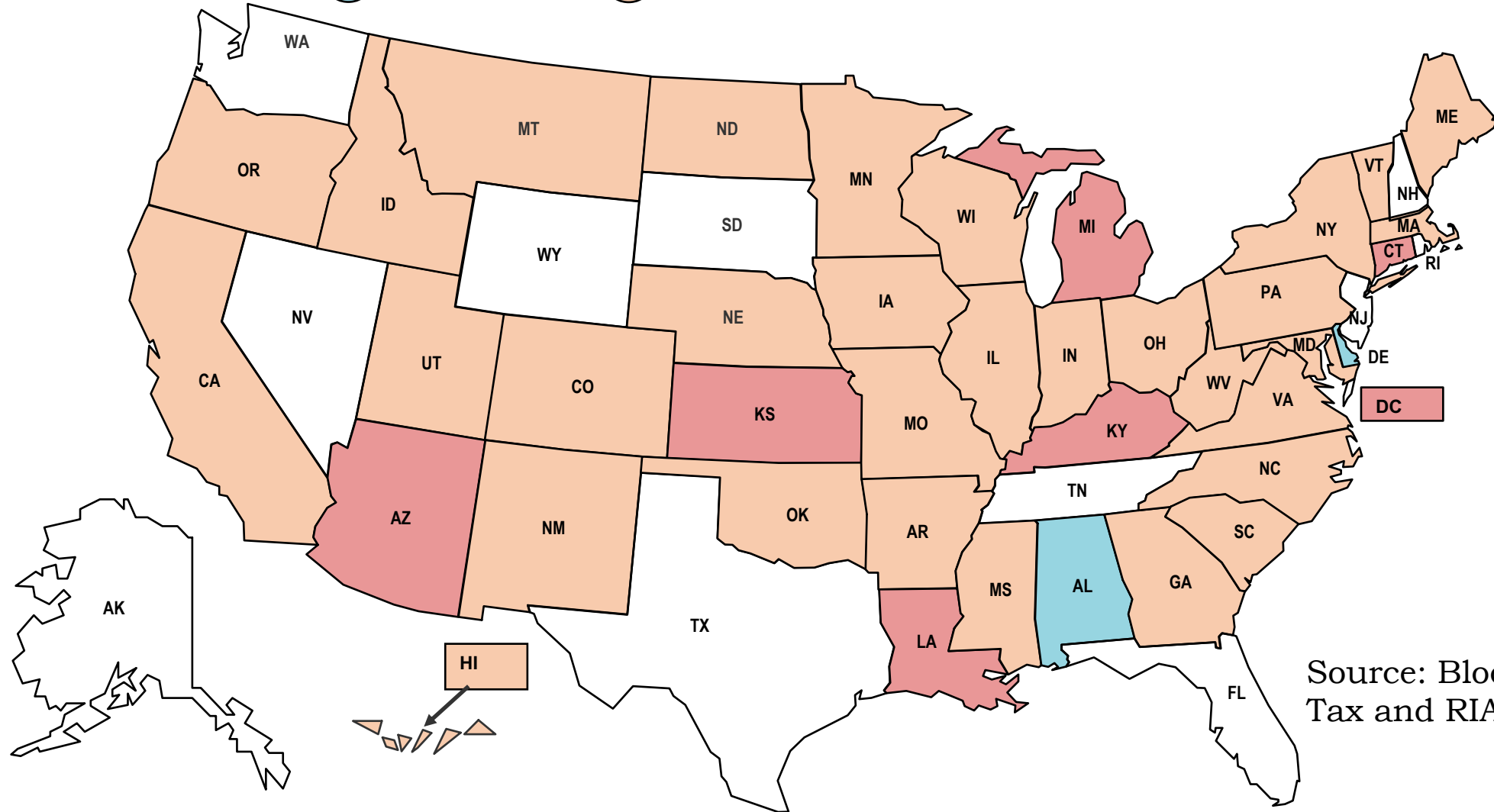
Optional Required Under Certain Circumstances Not Permitted



Source: Bloomberg Tax and RIA Charts

Withholding for Individuals

Optional Required* Not Required



Source: Bloomberg Tax and RIA Charts

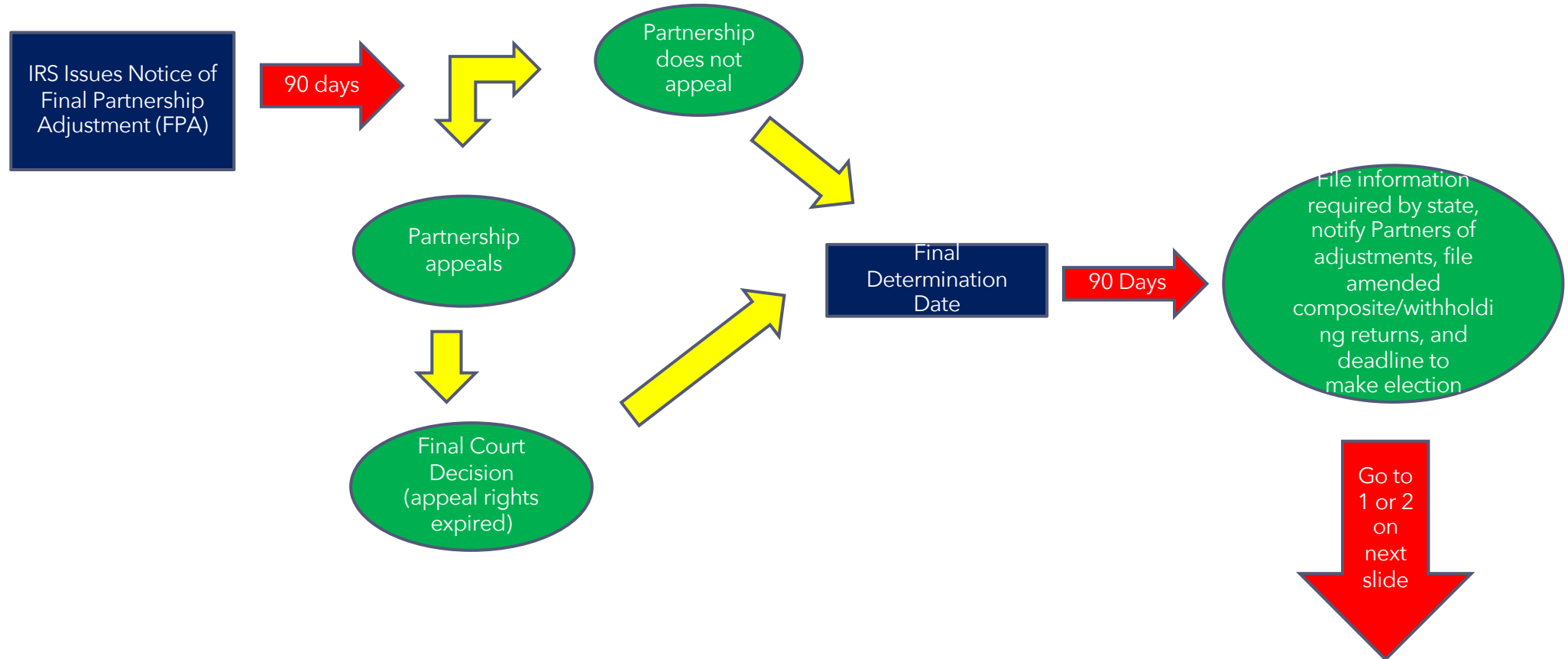
How It's Accomplished: Reporting Federal Adjustments for Partnership Level Audits – Election

- ▶ Alternatively, Audited Partnership can make an election to pay the tax for Reviewed Years
- ▶ Within 90 days of Final Determination Date the Audited Partnership shall:
 - ▶ File a Federal Adjustments Report; and
 - ▶ Notify the state of the election
- ▶ Within 180 days of Final Determination Date, the Audited Partnership shall:
 - ▶ Pay tax on behalf of partners based on calculation prescribed
 - ▶ Tax calculated at the highest tax rate for each partner type
- ▶ Tiered Partners – Also eligible to make the election but are not subject to the interim time restrictions – must finalize all elections, reporting, and payment of the tax within 90 days after the date of federal deadline for Tiered Partners
 - ▶ Federal deadline is extended due date of the Audited Partnership's return for the adjustment year

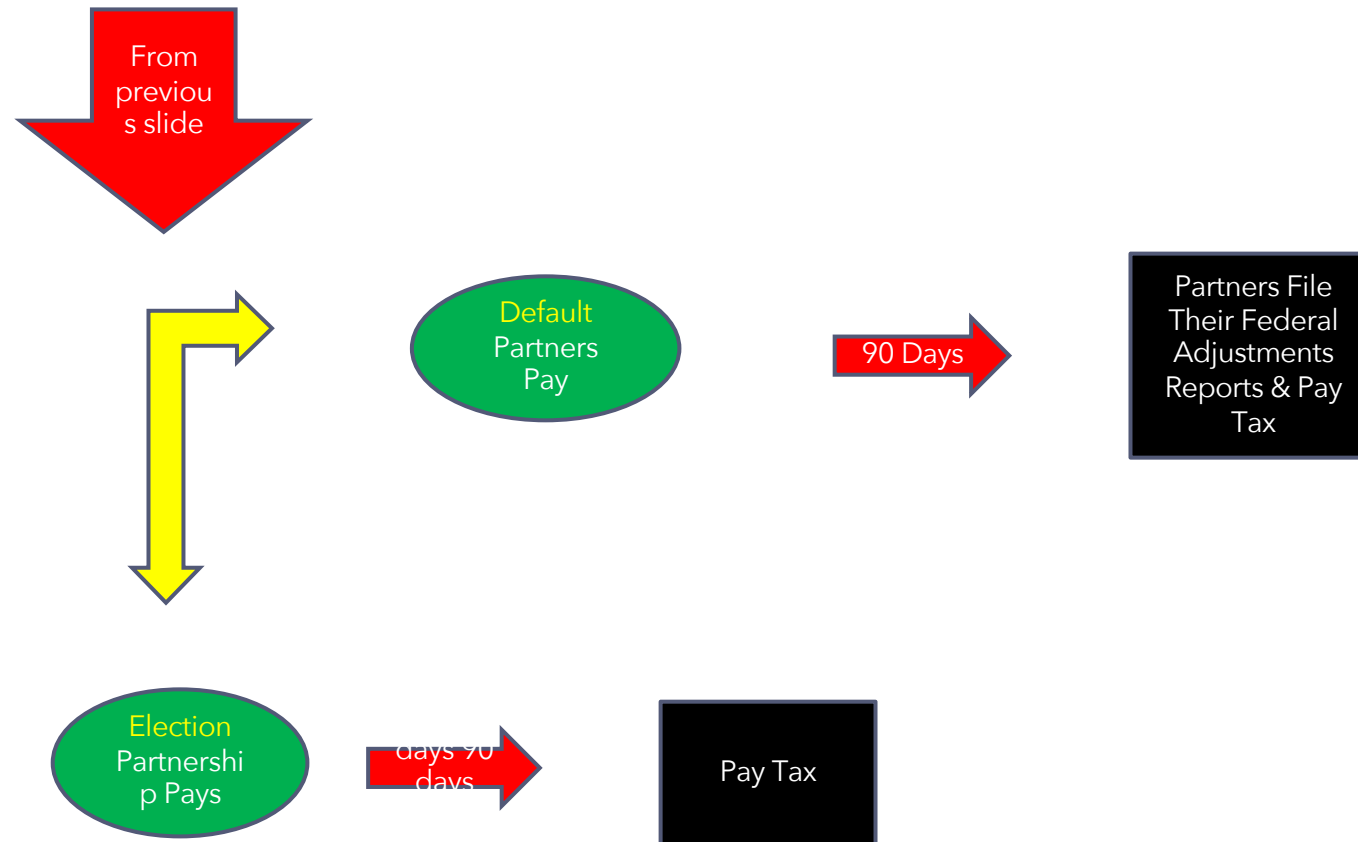
How It's Accomplished: Reporting Federal Adjustments for Partnership Level Audits – Election

- ▶ Exceptions to the Partnership Pays Election
 - ▶ Distributive share for unitary Direct Corporate Partners excluded – adjustment must be reported by those corporate partners
 - ▶ Distributive share for tax exempt partners excluded
 - ▶ Presumption that Indirect Partners are treated as residents unless partnership proves otherwise – which allows for specific sourcing of certain types of income that are generally subject to special state sourcing rules (e.g., investment income)
- ▶ Optional provisions to either allow or disallow partnership pays election where partnership did not have an initial filing obligation with a state in the reviewed year

Flow Chart following Federal Partnership Audit Adjustment — Slide 1



Flow Chart following Federal Partnership Audit Adjustment – Slide 2



* For Composite Return Partners, Option 1 is used

Alternative Election by Mutual Agreement

- ▶ To address unique situations, the Model allows the Audited Partnership or Tiered Partners to enter into a mutual agreement with the [State Agency]
 - ▶ Can agree to use:
 - ▶ A different reporting method
 - ▶ A different payment method
 - ▶ Audited Partnership & Tiered Partners required to demonstrate requested method is reasonable

Other Items of Note

▶ Partnership Representative

- ▶ Federal Partnership Representative is the default, but taxpayer can request a separate State Partnership Representative be appointed
- ▶ State may establish “reasonable qualifications” by rule

▶ Pay-up/Pull-in

- ▶ At the federal level, partners are able to file amended federal returns for the reviewed year or simply pay their share of the tax during the 270 day modification period.
- ▶ These partners are excluded from the partnership reporting requirements of Section C of the Draft Model Statute and required to report under the general reporting provisions of Section B (*i.e.*, file separate amended state returns)

Comparison of Federal Process to Draft State Model

Federal Audit Reporting Process	Draft MTC State Model Process
Default – Partnership pays the tax using highest individual/corporate income tax rates	Default – Partnership notifies partners and partners pay the tax (composite/withholding filers still subject to partnership paying the tax)
Has option for partners to file amended returns (or simply pay (“pull-in”)) to remit tax	Such partners required to report under the general reporting requirements at the state level (<i>i.e.</i> , file separate amended state return). Those partners are <u>not</u> be included in any partnership pays tax calculation.
Has option for partnership to “push-out” tax to review year partners to remit the tax when they file their tax return for the year IRS completes the audit (adjustment year)	“Push-out” option requires reporting and payment on an amended return for original (“reviewed”) year. Ability to report/pay tax on current year tax return unavailable (likely an administrative systems issue w/most states)
Tiered Partners – must complete all filings by the extended due date of the Audited Partnership's return for the adjustment year	Subject to extension, Tiered Partners must complete all reporting and payments 90 days after the extended due date of the Audited Partnership's return for the adjustment year

► Questions?

Nikki Dobay: ndobay@cost.org

Helen Hecht: hhecht@mtc.gov

Fred Nicely: fnicely@cost.org